

Tax Policy of Estonia in the framework of the EU Integration

Tax Policy of Estonia in the framework of the EU Integration

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Introduction

Tax policy is formulated through a political process. The institutional framework is important for the formulation of tax policy. The domestic situation as well as the international aspects influences the design of tax policy. Estonian tax policy choices are very closely connected to the process of EU integration. Estonia faces the challenge to harmonize its tax policy with EU rules and prepare for membership of the Economic and Monetary Union. This implies constraints to the policy choices of government.

Some historical facts about Estonian accession to the EU

Since regaining its independence in 1991¹ Estonia has been establishing relations with the European Union. Diplomatic relations between the EU and Estonia were established on 27 August 1991. The Trade and Economic Co-operation Agreement was signed in May 1992 and entered into force in March 1993. The Free Trade Agreement was signed in July 1994 and entered into force on 1 January 1995. European Association Agreement (hereafter the Europe Agreement) was signed in June 1995. On 28 November 1995 Estonia submitted its application for EU membership, based upon the unanimous decision of the Parliament approving the Europe Agreement between Estonia and the EU. The Europe Agreements entered into force in February 1998. At the 1995 Madrid summit the EU member states gave the Commission the task to compile reports on the candidate countries. The reports, completed in 1997, analysed the candidate countries' readiness for accession on the basis of the Copenhagen criteria.² At the 1997 Luxembourg summit it was decided on the basis of the Commission's report to start accession negotiations with five Central and Eastern European countries - Estonia, Poland, Slovenia, the Czech Republic and Hungary - as well as Cyprus and Malta. On 31 March 1998 Estonia started the accession negotiations with the European Union. The negotiations were based on Estonia's readiness to adopt the EU's principles and *acquis communautaire* and to implement it as of the moment of accession. The negotiations were concluded at the Copenhagen European Council on 13 December 2002. In March 2003, the European Parliament adopted a report giving the green light to the accession of Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, and Slovenia in 2004. The Accession Treaty was signed on 16 April 2003 at the Athens European Council. On 14 September 2003, Estonian citizens voted in favour of joining the European Union.³ The accession of Estonia took place on 1 May 2004.⁴

¹ Estonia re-established its independence on 20 August 1991, when the Supreme Soviet of the Republic of Estonia passed the decision on Estonian independence. On 7 October 1992, the 7th Riigikogu (Parliament), elected on 20 September 1992, passed a declaration restoring the constitutional state power, which brought an end to the transition period. This decision declared the continuation of the Republic of Estonia declared on 24 February 1918, which fell victim to Soviet aggression and was unlawfully incorporated into the Soviet Union in 1940 (<http://www.estica.org/>).

² In December 1993 the European Union adopted the so-called Copenhagen criteria for the accession of candidate countries: (1) stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities; (2) the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union; (3) the ability to take on the obligations of membership by adopting the common rules, standards and policies that make up the body of EU law.

³ There were 867,714 eligible voters in Estonia, of which 555,835 (64.1 per cent) took part in the referendum. 369,657 citizens (66.8 per cent of voters) voted in favour of joining the European Union: 183,454 citizens (33.2 per cent) were against.

Objectives of the research

I will analyse the institutional framework influencing tax policy of Estonia, particularly the constraints imposed by EU tax rules. Estonia has to harmonize all its relevant legislation with the obligatory body of the EU legislation.⁵ Therefore, the *acquis communautaire* has to be carefully considered when the Estonian tax policy is analysed. It is important to understand to which extent national tax policy is subject to EU regulation and which constraints are imposed on national tax policy making of EU Member States.

I will examine tax rates, tax burdens and revenue structures in Estonia and in the EU to see what are the main differences between tax policies of Estonia and of the EU countries. This comparison is particularly relevant in view of Estonia's accession to the EU and because tax policy is co-ordinated and partly harmonised in the EU. Although currently tax policy decisions require unanimity in the EU Council, there have been several initiatives to establish qualified majority voting for tax policy decisions. In the formulation of tax policy, Estonia has to take into account the developments in tax policy in the EU, and possible reactions of the other Member States as well as EU institutions. The objective is to find out what are possible consequences of the accession in the field of taxation.

For this purpose I will examine tax harmonization in the EU. I will focus on developments in the field of the value added tax and income taxes. I will consider the relevant secondary legislation as well as the case law of the European Court of Justice. In addition, trends of taxation in the EU are analysed. The last part of the work compares tax policy of Estonia with that of the EU to see what are the major differences and what has still to be done before accession to harmonize Estonian tax legislation with the *acquis communautaire*.

Outline of the research

The first chapter examines tax policy of Estonia. The first section of Chapter 1 gives an overview of the most important tax policy developments since the beginning of the 1990s. Section 1.2 analyses the total tax burden as well as tax revenue ratios and tax structure of Estonia. Section 1.3 gives a short overview of the value added tax (hereafter VAT) in Estonia. Section 1.4 examines policy in the field of income taxation.

Currently, important tax policy trends in the EU are tax competition, tax co-ordination, and tax harmonization. Tax harmonization may lead to convergence of tax systems (of tax legislations, tax rates, tax structures etc.). Tax competition can also lead to spontaneous harmonization or convergence of the tax systems.

Chapters 2 - 4 give an overview of tax co-ordination and harmonization in the EU. Chapter 2 examines why tax co-ordination is necessary and summarises the most important developments in the fields of VAT and income tax. In addition, the implications of the launch of the euro are analysed. Chapter 3 looks more closely at the harmonization of various important

⁴ However, the research was finalized before EU accession. The copy of the PhD Dissertation was closed on December 31, 2003. Therefore, all the developments after the end of 2003 are not included in the text of the dissertation. The chapters related to the Estonian tax policy were closed on April 30, 2004. It follows that all the developments in the Estonian tax policy up to EU accession are included in the text of the dissertation. Therefore, the changes of the Estonian tax legislation which became effective upon EU accession or after May 1, 2004 are not included in the dissertation.

⁵ Estonia also succeeded to negotiate some transitional periods and derogations from the application of the EU tax legislation. See Chapter 7 and Annex A.

parts of the VAT, namely, tax system, tax base, and tax rates. The rules of the Sixth Directive, which is the most important legislative act in this field, are thoroughly examined. Chapter 4 gives an overview of the developments in the field of income taxes. In the field of business taxation three directives have been adopted by Member States: the Merger Directive, the Parent-Subsidiary Directive, and the Interest-Royalty Directive.⁶ Furthermore, Member States have agreed on the text of the Code of Conduct. This political agreement establishes potentially harmful measures, which have to be abolished by Member States. In addition, some other important policy documents (like the Commission's proposals) as well as the ECJ's most important rulings on income tax are examined.

Chapter 5 analyses economic effects of tax competition as well as the impact of taxation on economic growth. In addition, potential positive and negative effects of tax harmonization are considered. Chapter 6 gives an overview of developments of tax systems in Member States as well as developments in tax level and tax structure. It also examines convergence of tax structures, tax rates (statutory as well as effective tax rates), and tax burdens in the EU.

Chapter 7 compares tax policies in Estonia and the EU. The first section of Chapter 7 compares the tax performance (tax structure, tax rates, tax burdens, tax mix) of Estonia with that of the EU Member States. Section 7.2 contains a comparative analysis of the Estonian tax legislation. The Estonian VAT legislation is compared with EU Sixth Directive to see to which extent it is in accordance with EU rules. The section also analyses the remaining steps to be taken to harmonize the VAT legislation with EU rules. In addition, the income tax legislation is analysed from the point of view of the EU integration. EU Member States must respect the fundamental Treaty principles on non-discrimination and the free movement of persons, goods, services and capital. It is important to examine whether the Estonian tax system is in accordance with EU rules, most importantly the economic freedoms of the EC Treaty. It is also analysed to which extent the current legislation is in line with the secondary EU legislation in the field of corporate taxation.

Chapter 8 gives an overview of the main findings of the research and draws the conclusions.

⁶ In addition, Member States have adopted the Mutual Assistance Directive and the Capital Duty Directive.

1 Tax policy of Estonia

1.1 Overview of Estonian tax policy since 1990

1.1.1 Introduction of tax system after regaining independence

From the early 1990s Estonia started to reform its economic system. Among other reforms a completely new tax system was introduced. A comprehensive package of tax laws was worked out in 1990. The following taxes were introduced: personal income tax, corporate income tax, VAT, activity license tax, land tax, excise tax, natural resources tax, pollution tax, and local taxes.

1.1.2 Introduction of flat rate income tax

Several changes to the tax system were implemented in 1993-1994. Important principles of taxation were introduced to bring the system in line with tax laws of the developed countries, especially with those of the EU.⁷ On December 8, 1993, the Estonian Parliament adopted the Income Tax Act⁸, which included all taxes on income, paid by both natural and legal persons.⁹ A flat rate (26%) was introduced for both corporate and personal income,¹⁰ while the tax base was broadened by the abolition of several tax exemptions. The main objectives of the changes were to stimulate the economy through lowering the income tax rate and raising indirect tax rates. In addition, the Law on Local Taxes¹¹ was adopted, which gives municipalities the right to establish several local taxes.¹²

1.1.3 Abolition of corporate tax on reinvested profits

The third important tax reform was implemented in 2000. On December 15, 1999, the Estonian Parliament adopted a new Income Tax Act, which became effective on 1 January 2000. Important changes were introduced in the field of corporate taxation. Before 2000 profits of legal persons were taxed. From 2000 profits of resident companies are free of tax but any distribution, as dividends, benefits in kind as well as transactions, which can be considered as hidden distribution of profits are taxed at a rate of 26/74, i.e. 26% on the grossed up amount.¹³ Thus, Estonia did not abolish the tax on corporate profits; rather the taxation was

⁷ In 1993, several new important tax laws were adopted, namely, the Value Added Tax Act (Law Nr. 203, State Gazette I 1993, 60, 847; passed by Parliament on August 25 and became effective on January 1, 1994) and the Fuel Excise Duty Act (Law Nr. 182, State Gazette I 1993, 38, 563; passed on June 17 and became effective on July 1, 1993).

⁸ Law Nr. 263, State Gazette I 1993, 79, 1184; became effective on January 1, 1994.

⁹ 'Basic World Tax Code' was used as an example when drafting the new Income Tax Act. This project was worked out by tax experts Ward M. Hussey and Donald C. Lubick and sponsored by the Harvard University International Tax Program.

¹⁰ The basic exemption deductible from the income of a resident natural person is EEK 12 000 for a year 2003. See section 1.4.5.

¹¹ Law Nr. 418, State Gazette I 1994, 68, 1169, passed on September 21, 1994, became effective on October 24, 1994.

¹² Local Councils are allowed to establish the following taxes: local income tax, sales tax, poll tax, boat tax, commercial and advertisement tax, tax for closing roads and streets, motor vehicle tax, tax for keeping animals, and entertainment tax. Local Councils within predetermined limits set tax rates.

¹³ The Income Tax Act did not change the main principles of taxation of income of natural persons. They continue to pay income tax on income earned (including income from entrepreneurship). The

postponed until profits are distributed. The tax reform aimed at a reduction of the tax burden on an expanding company which is re-investing its profits. In the long run it is expected to have a positive effect on economic growth and the standard of living.¹⁴ In addition, the tax reform aimed to achieve greater tax neutrality, to minimise tax-induced distortions, to improve the fiscal environment for investment, and to avoid outflow of capital.

1.1.4 New laws on VAT and excises to harmonise them with EU rules

The new VAT act entered into force on April 1, 2003. Its main objective is to bring the Estonian VAT system more closely into line with the requirements of the EU's Sixth Directive¹⁵. Although the new VAT act is not in complete alignment with EU rules, it largely follows the Sixth Directive.

On July 14, 2000 the Estonian Parliament adopted the new Alcohol Excise Duty Act.¹⁶ Its main objective is to bring the Estonian alcohol excise duty system more closely into line with the requirements of the EU legislation. The current system is to a large extent in conformity with EU *acquis communautaire*.

On June 19, 2000 the Estonian Parliament adopted the Act Amending Mineral Oils Excise Duty.¹⁷ On April 18, 2001 the Estonian Parliament adopted the Act Amending the Tobacco Excise Duty Act¹⁸ introducing two-component excise duty rate on cigarettes. The excise duty on cigarettes consists of a specific levy and a proportional (ad valorem) tax depending on the retail price of the cigarettes. The Estonian government aims to harmonise its legislation in the field of excises with EU rules upon accession with some exceptions. Estonia has negotiated a transitional period for cigarettes and smoking tobacco. It may postpone the application of the overall minimum excise duty on the retail selling price (inclusive of all taxes) for cigarettes of the price category most in demand until 31 December 2009, provided that it gradually adjusts its excise duty rates towards the overall minimum provided for in the Directive. Moreover, Estonia may postpone the application of the overall minimum excise duty levied on smoking tobacco until 31 December 2009.¹⁹

1.2 Tax level and tax structure developments

1.2.1 Total tax burden

Tax revenues amounted to around 34% of GDP in 2000 and 2001 (see table 1 and figure 1). If non-tax revenue is taken into account then total revenue ratio amounts to around 36 percent of GDP.

Income Tax Act describes in more detail different types of income of natural persons and non-residents and introduces the principles of computing income. Self-employment income is taxed on a cash basis. Other income is, with certain important exemptions, charged on broadly conventional income tax principles. The tax period is the calendar year. In most cases, income tax is collected by withholding. The tax rate, above the personal tax threshold (a basic exemption), is a flat rate of 26 percent.

¹⁴ Explanatory Letter to Income Tax Act, p.1.

¹⁵ Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, OJ, 145 13.06.1977, p.1.

¹⁶ The Alcohol Excise Duty Act came into effect on January 1, 2001.

¹⁷ The Act Amending Mineral Oils Excise Duty became effective on September 1, 2000.

¹⁸ The Act Amending the Tobacco Excise Duty Act became effective on July 1, 2001.

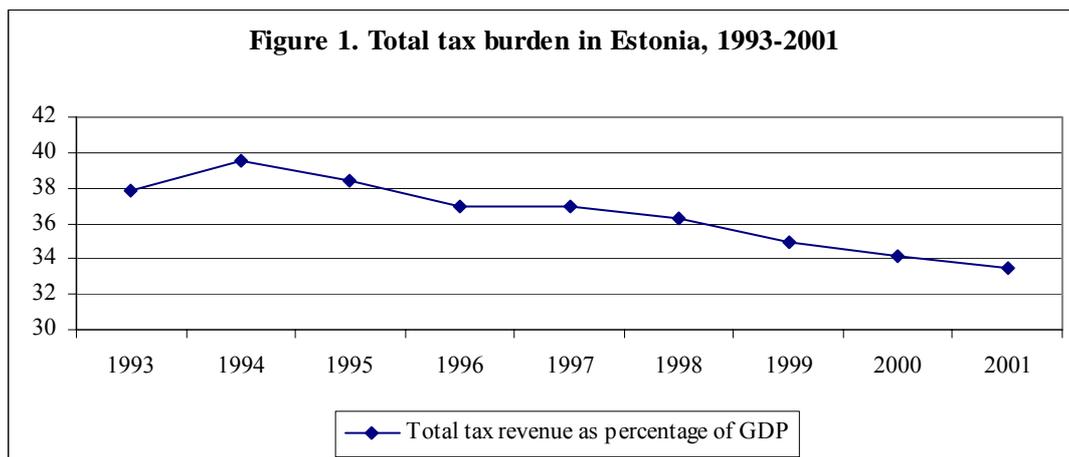
¹⁹ See also Annex A presenting the results of accession negotiations in the taxation chapter.

Table 1. Estonia: Tax Structure in 1993-2001 (as percentage of GDP)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
Total tax revenue	37.8	39.6	38.4	37.0	37.0	36.3	34.9	33.6	33.5
Direct taxes	25.4	25.0	24.2	22.6	22.6	23.6	22.8	20.9	20.6
Personal income tax	8.5	8.1	8.8	8.3	8.2	8.5	8.6	7.6	7.5
Corporate income tax	4.8	3.5	2.6	1.7	1.9	2.6	2.1	1.0	0.8
Social tax	12.0	13.0	12.4	12.2	12.1	12.1	11.7	11.9	11.9
Land tax				0.4	0.4	0.4	0.4	0.4	0.4
Indirect taxes	12.4	14.5	14.2	14.4	14.3	12.7	12.1	12.7	12.8
VAT	9.2	11.2	10.1	10.0	10.4	8.7	8.4	9.4	9.1
Excises	1.9	2.1	2.8	3.3	3.7	3.8	3.5	3.2	3.6
Other taxes	1.3	1.3	1.3	1.0	0.2	0.2	0.2	0.1	0.2

Source: IMF and Ministry of Finance of Estonia

Figure 1 shows that the total tax burden has decreased since 1994. Direct taxes as percentage of GDP decreased since 1999, whereas the share of indirect taxes in GDP slightly increased since 2000. The share of corporate taxes declined from 1999 and that of personal income taxes since 2000.



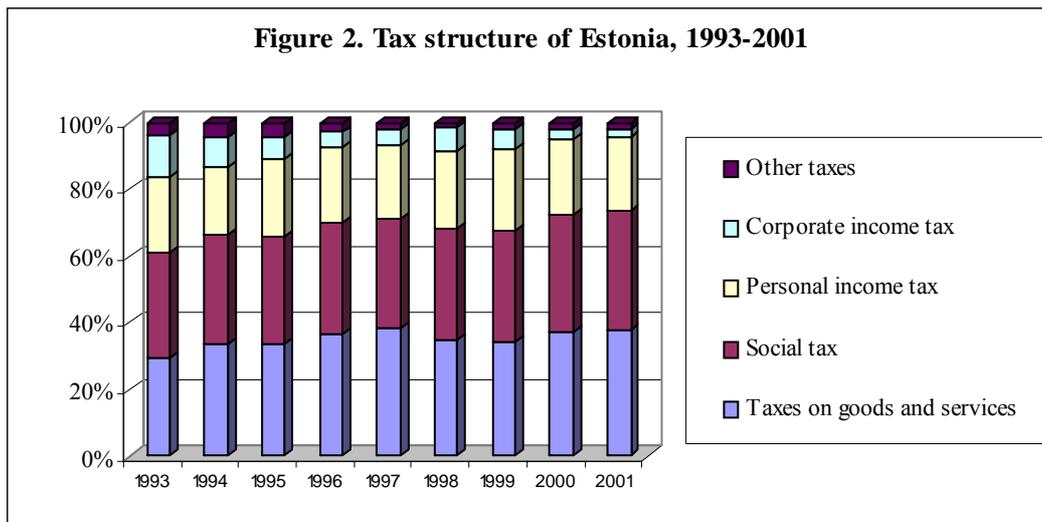
Source: IMF and Ministry of Finance of Estonia

1.2.2 Tax structure

1.2.2.1 Overall tax mix

Table 1 shows that the social tax (which includes social security contributions and the medical insurance tax) is the most important single tax (11.9 percent of GDP in 2001), followed by the VAT (9.1 percent), personal income tax (7.5 percent), excises (3.6 percent), corporate income tax (0.8 percent), land tax (0.4 percent), and a number of smaller taxes (local taxes, gambling tax, customs duties - together 0.2 percent).

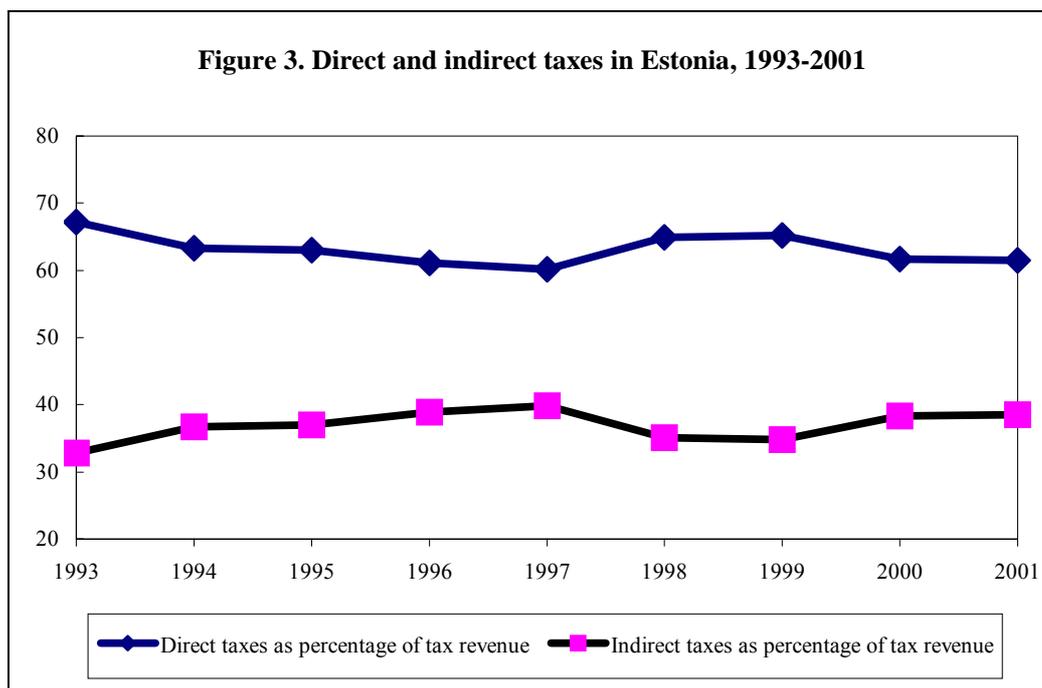
Figure 2 displays that the share of taxes on goods and services in the total tax burden increased (from 29.3 percent in 1993 to 37.9 percent in 2001). The share of the social tax also increased: from 31.9 percent in 1993 to 35.4 percent in 2001. The share of the personal income tax was the same in 2001 as in 1993. However, the share of the corporate income tax in total tax revenue decreased from 12.6 percent in 1993 to 2.3 percent in 2001. It follows that the taxes on capital have been decreasing while the taxes on consumption and employment income have been increasing.



Source: IMF and Ministry of Finance of Estonia

1.2.2.2 Mix of direct and indirect taxes

The reduction in the burden of corporate taxation accounts for the bulk of the fall in the share of direct taxes from 67.2 percent of total tax revenues in 1993 to 61.5 percent in 2001. Excise taxes account for most of the corresponding increase in the share of indirect taxes.



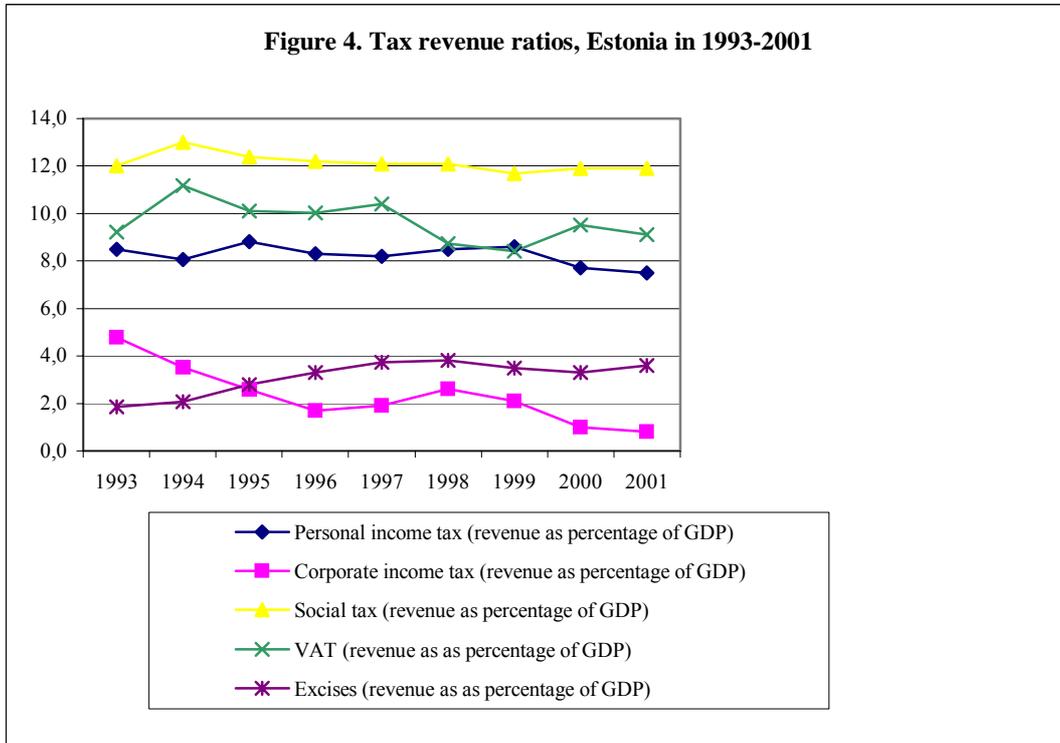
Source: IMF and Ministry of Finance of Estonia

1.2.3 Tax revenue ratios

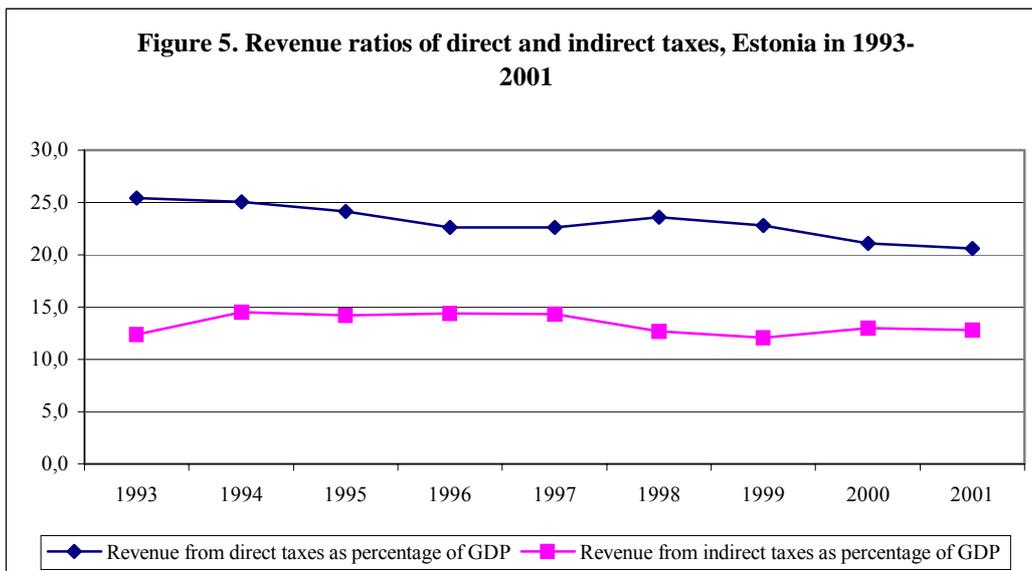
Figure 4 shows that the shares of the social tax and the personal income tax in GDP remained most stable since 1993 with ratios around 12 percent and around 8 percent of GDP correspondingly. In case of corporate taxes the clear downward trend can be distinguished. The share of the corporate income tax decreased from 4.8 percent in 1993 to 0.8 percent in

2001. The share of excise taxes increased from 1.9 percent of GDP in 1993 to 3.6 percent of GDP in 2001.

Figure 5 shows that the share of direct taxes decreased from 25.4 percent of GDP in 1993 to 20.6 percent in 2001. This is mainly due to the fall in corporate tax revenues since 1998. The share of indirect taxes remained more or less the same in the period 1993 – 1997, but slightly decreased afterwards.



Source: IMF and Ministry of Finance of Estonia



Source: IMF and Ministry of Finance of Estonia

1.3 Value Added Tax

The Estonian VAT act entered into force on January 1, 2002 and it is to a great extent in line with EU Sixth Directive²⁰. The Estonian VAT act has been amended several times. The Estonian Parliament adopted last amendments on January 29, 2003. The amendments became effective on April 1, 2003.

1.3.1 *The main features of the VAT system*

The current system of VAT is largely identical to the common VAT system used in the European Community. The VAT is applied up to and including the retail trade stage. The final consumer of goods and services is intended to bear the tax burden. This principle is followed by allowing the VAT-liable traders a credit for the VAT levied on their inputs (including capital goods). The total tax due by registered suppliers is equal to the difference between the amount of VAT shown on sale invoices and the amount of VAT shown on purchase invoices. In cases of exempt domestic supplies, no credit is given for the tax on inputs. In cases of exemption on importation, the tax paid on inputs (purchases) is credited against the tax paid on sales (outputs). Domestically supplied goods and services are taxed equally with imported goods and services. A zero rate of tax is applied on export.

1.3.2 *Definition of the tax base*

1.3.2.1 *Scope and territorial application*

1.3.2.1.1 *Scope of VAT*

The object of the VAT is defined in §4 of the Estonian VAT act. The VAT is applied to taxable supply, which includes: supply of goods and services effected in Estonia, the import of goods and services into Estonia, provision of services outside Estonia which are considered export of services²¹. In addition, certain exempt supply of goods or services can be considered a taxable supply if a taxpayer opts to be taxed on these supplies.²²

1.3.2.1.2 *Territorial application of VAT*

Estonian VAT system is based on territoriality principle. VAT is applied to the supply of goods or services effected within the Republic of Estonia by taxable persons.

1.3.2.2 *Taxable persons*

A taxable person is defined in §2(1) of the Estonian VAT act as a person, including a legal person in public law and a state, rural municipality and city agency (hereafter a person), who effects taxable supplies as a result of the business thereof, including a non-resident within the meaning of the Income Tax Act engaged in business in Estonia and a person importing goods into Estonia.

Article 2(4) of the VAT act specifies business as the independent economic activity of a person, as a result of which goods are transferred or services are provided for consideration or without consideration. A notary's and a bailiff's professional activities are also deemed to be

²⁰ Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, OJ, 145 13.06.1977, p.1.

²¹ See section 1.3.2.3 for the definition of export of services.

²² See section 1.3.2.7.

business.²³ The services conducted between a foreign company and its permanent establishment located in Estonia are not deemed to be business.²⁴ Public bodies are considered taxable persons in respect of their taxable supplies, if these can also be effected by non-public taxable persons.²⁵ A foreign legal person with a permanent establishment in Estonia is a taxable person in respect of taxable supply, which the person effects through such a permanent establishment. Intra-group supplies of goods and services between associated companies registered as one taxable person are not taxed.²⁶

1.3.2.3 Taxable transactions

The Estonian VAT act distinguishes between supplies (§3(1) of the VAT act), non-supplies (§3(2) of the VAT act)²⁷ and taxable supplies (§4 of the VAT act). The supply of goods and services effected in Estonia, import of goods and services, and export of services²⁸ are included in the concept of ‘taxable supplies’.

²³ See § 2(4) of the VAT act.

²⁴ See § 2(4) of the VAT act.

²⁵ See § 2(2) of the VAT act.

²⁶ §3(2)7) of the VAT act excludes from VAT the transactions between persons registered as a single taxable person provided that the person who acquired goods or services as a result of the transaction uses the goods or services entirely for the purposes of the person’s taxable supply. Registration of taxable persons as single taxable person is stipulated in § 12 of the Estonian VAT act (see section 1.3.2.11).

²⁷ §3(2) of the VAT act stipulates that the following are not deemed to be supply:

1. non-monetary contributions to the share capital of a company;
2. transfer of foreign goods placed in a free zone or free warehouse (within the meaning of the Customs Code) if the goods have not been placed under any customs procedure or consumed or used under conditions other than those prescribed in the customs rules;
3. transfer of foreign goods, including foreign goods placed in a free zone or free warehouse, which are placed under a customs procedure other than release for free circulation, on the condition that the goods have not been unlawfully removed from under customs supervision or consumed or used under conditions other than those prescribed in the customs rules;
4. carriage of goods out of Estonia by the owner of the goods without an attached or subsequent transfer transaction;
5. granting use of state assets without charge, privatisation of rural municipality or city assets, or handing over of plantations of perennial crops which are not entered in the land register to entitled subjects in the course of land reform;
6. handing over of the assets of a company to another company upon the merger, division or transformation of the company pursuant to the Commercial Code;
7. transactions between persons registered as a single taxable person, where the person who acquired goods or services as a result of the transaction uses the goods or services entirely for the purposes of the person’s taxable supply;
8. handing over of goods the value of which does not exceed EEK 50 in business interests and for advertising purposes, or handing over of goods free of charge as product samples not for sale;
9. handing over of money or transfer of securities;
10. sale of accounts receivable.

²⁸ §5 (2), §7 (2) and § 17 (3) 1) provide that the following services are considered export of services and a zero rate is applied on those supplies if they are effected by Estonian taxable persons:

1. construction, valuation or maintenance of an immovable property located abroad, or services relating to the transfer of such immovable property or preparation or co-ordination of related construction work;
2. cultural, artistic, sporting, educational, scientific or entertainment services provided abroad, including organisation of related events;
3. valuation or repair of movable property located abroad;

1.3.2.3.1 Supply

§3(1) of the Estonian VAT act defines supply as the transfer of goods and provision of services in the course of business activities. Provision of goods or services by an employer to an employee as well as non-business use of goods and services are considered supplies if the taxable person has deducted the VAT on such goods and services.²⁹

1.3.2.3.2 Supply of goods

§3(3) of the Estonian VAT act defines concept of ‘goods’ as tangible goods, livestock, electric power and heat.

Handing over goods free of charge as product samples is not deemed to be a supply. Furthermore, handing over goods free of charge for advertising purposes is not deemed to be a supply, if the value of the object concerned does not exceed EEK 50.

An operational lease is treated as provision of services and a financial lease is treated as transfer of goods. If a lease contract provides for the transfer of ownership to another person upon payment of the final installment, the transaction is treated as a financial lease. In other cases, the transaction is treated as an operational lease.³⁰

1.3.2.3.3 Supply of services

‘Services’ are defined residually in §3(4) as the provision of benefits or transfer of rights in the course of business activities not included in the category of goods.

-
4. the provision of services relating to the international carriage of goods or passengers, as specified in the list established by a regulation of the Government of the Republic or, on the authorisation thereof, the Minister of Finance;
 5. the intermediation of transactions between sellers and purchasers of goods or services if the goods are used in a foreign country or if the object of intermediation is the export of services;
 6. the maintenance, chartering or leasing of or establishment of a usufruct on a sea-going vessel used for navigation on the high seas or an aircraft used on international routes, or the leasing, repairing or maintenance of or establishment of a usufruct on equipment used on such sea-going vessel or aircraft;
 7. the sale of tourism services provided in Estonia, including package tours, to foreign tour operators or travel agencies for intermediation to non-resident natural persons travelling to Estonia and on the basis of which such persons are serviced in Estonia;
 8. the sale of package tours to tourists travelling from Estonia to foreign states, on the basis of which the tourists are serviced outside the Estonian customs territory.

In addition, the following services provided to a non-resident, except those provided to a non-resident’s permanent establishment in Estonia are considered to be export of services:

1. transfer of intellectual property rights;
2. advertising services;
3. consulting, accounting, legal, auditing, engineering, data processing or information services or services for the electronic transmission of information;
4. financial and insurance services, including reinsurance;
5. supply of staff;
6. hiring or leasing of or establishment of a usufruct on movable property;
7. telecommunications services, including assignment of rights to use transmission lines;
8. services of agents procuring one of the services specified in clauses 1)–7) for their principal.

²⁹ See §3(1) of the VAT act. This provision also applies for provision of goods or services by an employer to a servant or a member of the management or control body of the employer.

³⁰ See § 3(5) of the VAT act.

1.3.2.3.4 Importation of goods and services

Import of goods is defined in §6(1) as importation of goods into Estonia for free circulation (within the meaning of the Customs Code³¹). It also includes the release for free circulation of products obtained from outward processing of Estonian goods, and other cases which result in a customs debt.³² Temporary import of goods for the purpose of an operational lease is not deemed to be import.

The definition of ‘import of services’ is provided in § 6(3) of the Estonian VAT act which stipulates that it is the provision of the following services to an Estonian taxable person by a non-resident, except for services provided through the non-resident’s permanent establishment in Estonia:

1. transfer of intellectual property rights;
2. advertising services;
3. consulting, accounting, legal, auditing, engineering, data processing or information services or services for the electronic transmission of information;
4. financial and insurance services, including reinsurance;
5. supply of staff;
6. hiring or leasing of or establishment of a usufruct on movable property;
7. telecommunications services, including assignment of rights to use transmission lines;
8. services of agents procuring one of the services specified in above-mentioned clauses 1)–7) for their principal.

§6(4) provides that after Estonia’s accession to the European Union, hiring, leasing or, establishing a usufruct on, a means of transport supplied by a non-resident shall not be deemed to be import of services.

1.3.2.4 Place of taxation

1.3.2.4.1 Goods

In the case of goods the place of supply is deemed to be Estonia if the goods are delivered or made available to a recipient in Estonia, including on the border of Estonia, or if the goods are exported from Estonia.³³

1.3.2.4.2 Services

§ 7 (1) 5) stipulates that the place of supply of services is considered Estonia if the seat of the provider or the permanent establishment through which the services are provided is located in Estonia, except in the case provided for in § 7 (2) of the Estonian VAT act (see below).

In addition, the place of supply is considered Estonia if:

1. an immovable property located in Estonia is constructed, valued or maintained or services relating to the transfer of an immovable property located in Estonia or to preparation or co-ordination of the related construction work are provided³⁴;
2. cultural, artistic, sporting, educational, scientific or entertainment services, including the organisation of related events, are provided in Estonia³⁵;

³¹ The concept of importation is based on the Estonian Customs Code, which gives a definition of this customs procedure.

³² These procedures are also defined in the Customs Code.

³³ §7(1)1) of the Estonian VAT act.

³⁴ §7 (1) 2) of the Estonian VAT act.

³⁵ §7 (1) 3) of the Estonian VAT act.

3. a movable property located in Estonia is valued or repaired³⁶.

§7 (2) provides that the place of supply is not Estonia if an Estonian taxable person provides the following services:

1. construction, valuation or maintenance of an immovable property located abroad, or services relating to the transfer of such an immovable property or preparation or co-ordination of related construction work;
2. cultural, artistic, sporting, educational, scientific or entertainment services provided abroad, including organisation of related events;
3. valuation or repair of a movable property located abroad.

Furthermore, the place of supply is not Estonia if an Estonian taxable person provides the following services to a non-resident:

- a. transfer of intellectual property rights;
- b. advertising services;
- c. consulting, accounting, legal, auditing, engineering, data processing or information services or services for the electronic transmission of information;
- d. financial and insurance services, including reinsurance;
- e. supply of staff;
- f. hiring or leasing of or establishment of a usufruct on a movable property;
- g. telecommunications services, including assignment of rights to use transmission lines;
- h. services of agents procuring one of the services specified in above-mentioned clauses a)–g) for their principal.

§ 7 (3) of the Estonian VAT act provides that as of Estonia's accession to the European Union, the place of supply in the case of the hiring or leasing of or establishment of a usufruct on a means of transport supplied by an Estonian taxable person to a non-resident is deemed to be Estonia.

1.3.2.5 Chargeable event and chargeability of tax

The chargeable event³⁷ takes place at the date on which the first of one of the following acts is performed:

1. the dispatch of a good or the making of a good available to a purchaser, or the provision of a service;
2. the issue of an invoice for the good or service;
3. full or partial payment for the good or service;
4. in the case of self-supply or non-business use³⁸, the chargeable event is deemed to occur when these transactions take place.

If the provision of services continues for longer than a tax period, the services are deemed to have been provided during the tax period when the provision of services terminates. In the case of regular transfers of goods or provision of services to the same purchaser or in the case of the financial lease of goods, the chargeable event is deemed to take place at the taxation period overlapping with the end of the period of time for which an invoice is submitted or during which payment for goods or services received is to be made as agreed.

³⁶ §7 (1) 4) of the Estonian VAT act.

³⁷ That is the event by occurrence of which the tax authority becomes entitled to claim the tax from the person liable to pay.

³⁸ These cases are specified in clause 3 (1) of the Estonian VAT Act. See also section 1.3.2.3.

In the case of import of goods, the chargeable event occurs and the tax is due either when the goods are released within the meaning of the Customs Code or when customs debt is incurred.³⁹ In the case of export of goods, the chargeable event takes place at the date on which the first of one of the following acts is performed:

1. the dispatch of a good or the making of a good available to a purchaser, or the provision of a service;
2. full or partial payment for the good or service.⁴⁰

1.3.2.6 Taxable amount

VAT is charged as a percentage of the taxable amount (the consideration). The taxable amount is comprised of the selling price of the goods or services and other amounts which the purchaser of the goods or services or a third party is to pay to the seller of the goods or the provider of the services for the corresponding goods or services.⁴¹

Grants allocated to a taxable person from the state budget for the transfer of goods or services for a price lower than their usual value are included in the taxable value.⁴²

In the event of the hire purchase of goods, interest is not included in the taxable amount.⁴³ In the event of the financial lease of goods, interest is included in the taxable amount.⁴⁴ In the case of the financial lease or hire purchase of an immovable property, the land tax costs payable by the purchaser to the seller are not included in the taxable amount.⁴⁵ The taxable value of a factoring service is the contract fee and a fee for handling the accounts.⁴⁶

In the case of an operational lease, the taxable amount is the amount due during a tax period pursuant to the contract. In the case of a financial lease or hire purchase, the taxable amount is the selling price, excluding interest, of the goods sold on hire purchase or on the basis of the financial lease contract.⁴⁷

The taxable amount does not include any discounts provided to the purchaser if such discounts are applied to all purchasers and under the same conditions.⁴⁸

In the case of internal use or non-business use of goods and services, the market price⁴⁹ of the goods or services is deemed to be the taxable amount.⁵⁰ In the case of transfer of goods free of charge or for a price lower than their usual value, including financial lease or hire purchase, or the provision of services, including services concerning an operational lease of goods or factoring services, for a price lower than their usual value, the taxable amount is the market price at the time of the transfer of the goods or provision of the services.⁵¹

In the case of imported goods the taxable amount is the customs value of the goods determined in accordance with the Customs Code.⁵² The taxable amount also includes all import duties and other expenses such as commission, packing, transport and insurance costs, in-

³⁹ See §8(5) of the Estonian VAT act.

⁴⁰ See §8(4) of the Estonian VAT act.

⁴¹ §14(1) of the Estonian VAT act.

⁴² §14(2) of the Estonian VAT act.

⁴³ §14(3) of the Estonian VAT act.

⁴⁴ §14(3) of the Estonian VAT act.

⁴⁵ §14(3) of the Estonian VAT act.

⁴⁶ §14(4) of the Estonian VAT act.

⁴⁷ §14(3) of the Estonian VAT act.

⁴⁸ §14(7) of the Estonian VAT act.

⁴⁹ §14(4) of the Estonian VAT act specifies that the market price is the average local price excluding the VAT.

⁵⁰ §14(5) of the Estonian VAT act.

⁵¹ If the Tax Board finds that the reported taxable amount of goods or services is lower than the market price, the Tax Board may establish the market price as the taxable amount (§14(6) of the Estonian VAT act).

⁵² §15(1) of the Estonian VAT act.

curred up to the first place of destination within the customs territory of Estonia, if those expenses are not included in the customs value.⁵³ ‘First place of destination within the customs territory of Estonia’ means the place mentioned on the consignment note or any other document by means of which the goods are imported. In the absence of such an indication, the first place of destination is considered to be the place of the first transfer of cargo in the customs territory of Estonia.

The taxable amount of goods imported by a traveller in excess of the limit that is allowed to import free of customs duties is comprised of the purchase price of the goods and all import duties. A traveller must prove the purchase price on the basis of the payment documents. If such documents are missing or if the declared value of the imported goods is not acceptable to the customs authorities, the goods must be taxed on the basis of the market price of the valued goods or of identical or of similar goods.⁵⁴

In the case of release for free circulation of products obtained in the outward processing of Estonian goods, the taxable value is comprised of the value added during such processing and the loading, packing, transportation and insurance costs added to the price of the goods outside the Estonian customs territory, including all import duties.⁵⁵

In the case of imported services the taxable amount is comprised of the selling price of the services and other amounts which the purchaser of the services or a third party is to pay to the provider of the services for the corresponding services.⁵⁶

Special rules (hereafter referred to as the ‘margin scheme’) apply to resale of second-hand goods, original works of art, collectors’ items or antiques if registered taxable person bought those goods from a person who is not a taxable person or a taxable person who is not registered.⁵⁷ The taxable amount can then be considered the difference between the selling price and purchase price of the goods. The ‘margin scheme’ can also be applied to importation of original works of art, collectors’ items or antiques,⁵⁸ and acquisition of original works of art sold to the taxable person by the author or the holder of the copyright.⁵⁹ However, taxable persons may also opt for application of the general procedure for calculation of taxable amount.⁶⁰

Derogation from this ‘margin scheme’ is introduced by §35, for sales by public auction. In the cases of such sales, the taxable amount is the amount paid by the purchaser on the basis of an invoice or other sales document issued by the organiser of the sale, less the difference between the initial selling price of the goods sold by public auction and the amount of the commission obtained or to be obtained by the organiser from the principal of the organiser pursuant to the contract. The total amount payable by the purchaser of the goods includes the auction price of the goods and other amounts, which the purchaser is required to pay to the

⁵³ §15(5) of the Estonian VAT act stipulates that the tax established by the Estonian VAT Act is not included in the taxable amount of imported goods.

⁵⁴ §15(3) of the Estonian VAT act.

⁵⁵ §15(4) of the Estonian VAT act.

⁵⁶ §14(1) of the Estonian VAT act.

⁵⁷ Special rules also apply if those goods were supplied by a registered taxable person who resells second-hand goods, original works of art, collectors’ items or antiques under the same ‘margin scheme’.

⁵⁸ The purchase price in the case of importation of original works of art, collectors’ items or antiques is deemed to be the taxable amount plus the value added tax.

⁵⁹ §34(3) provides that ‘margin scheme’ can be applied for those goods only if the person has notified the Tax Board.

⁶⁰ §34(7) of the Estonian VAT act.

organiser in connection with the acquisition of the goods. The total amount must be exclusive of VAT.⁶¹

1.3.2.7 Exemptions

A distinction is made between domestic exemptions and exemptions on importation and exportation. In the case of domestic exemptions no right of deduction arises. By contrast, the exemptions on exportation are accompanied with a right of deduction, therefore, these transactions are, in effect, zero-rated.

1.3.2.7.1 Domestic exemptions

§18 distinguishes between two categories of exemptions: §18(1) deals with the goods and services of a social nature, and §18(2) with other goods and services. The former list of activities includes postal services⁶²; medical services⁶³; certain non-profit activities⁶⁴; various social services; training services⁶⁵; transportation of sick, injured or disabled persons⁶⁶; and services relating to shelters for the protection of children and young persons. The other exempted goods and services include insurance and re-insurance services⁶⁷; the leasing or letting of immovable property⁶⁸; provision of dwelling maintenance services to owners of dwellings; supply of immovable property; goods the input VAT for which is not subject to deduction⁶⁹; goods subject to resale;⁷⁰ money and securities; services provided by credit or financial institutions; valid postal payment means of the Republic of Estonia;⁷¹ organising of lotteries or gambling, and lottery tickets; and investment gold.

⁶¹ This procedure for calculation of taxable amount is applied if the organiser of a sale by public auction acts on the basis of a contract according to which a commission is payable on the sale of goods by public auction.

⁶² Including postal payments of state pensions and other benefits paid from state budget. See §18 (1) 1) of the Estonian VAT act.

⁶³ The health services specified in the list of health services established by a regulation of the Government of the Republic on the basis of the Health Insurance Act, and the supply of human organs, human tissue, breast milk, human blood and blood products made from human blood as specified in the list established by a regulation of the Government of the Republic or the Minister of Social Affairs. See §18 (1) 2) of the Estonian VAT act.

⁶⁴ Services provided free of charge by a non-profit association to its members, and services provided by a non-profit association to natural persons relating to the use of sports facilities or sports equipment. See §18 (1) 3) of the Estonian VAT act.

⁶⁵ Including private tuition relating to basic, secondary or higher education. See §18 (1) 6) of the Estonian VAT act.

⁶⁶ If those persons are transported in vehicles which are specially designed for such purpose and which correspond to the requirements established on the basis of the Traffic Act. See §18 (1) 7) of the Estonian VAT act.

⁶⁷ Including insurance services provided by insurance brokers and insurance agents.

⁶⁸ In addition, exemption is applied on establishment of a usufruct on immovable property and the costs relating to land tax and building insurance demanded by the lessor of a dwelling or the provider of maintenance services from the recipient of the service. Exemption is not applied on the provision of accommodation services, the leasing or letting of or establishment of a usufruct on multi-storey car parks and premises for parking vehicles, and the hiring or leasing of or establishment of a usufruct on permanently installed equipment or machinery or safes. See §18 (2) 2) of the Estonian VAT act.

⁶⁹ This exemption does not apply to goods the input value added tax for which has been partially deducted. See §18 (2) 4) of the Estonian VAT act.

⁷⁰ On the condition that the taxable person was not entitled to deduct the input value added tax neither in full nor in part upon acquisition of the goods.

⁷¹ On the condition that they were sold at their nominal value.

1.3.2.7.2 Option for taxation

§18 (3) provides that taxable persons may opt for taxation in the cases of leasing or letting of immovable property; supply of immovable property; services provided by credit or financial institutions; and investment gold⁷².

1.3.2.7.3 Exemption on importation

§19 provides that the same exemptions, which apply for domestic goods and services are also applied for importation. In addition, the exemption is applied for gold, banknotes, coins and securities imported by the Bank of Estonia; revenue stamps; and goods concerning which, pursuant to the customs rules, a declaration of goods need not be submitted when they are carried across the customs frontier. In addition, §19 (2¹) provides that VAT is not imposed on the import of the following goods:

1. temporarily exported goods which are returned to Estonia if such goods are returned in the same condition within the meaning of the Customs Code, goods returned to Estonia on the basis of guarantees prescribed by a contract if such goods have previously been exported, goods which after being imported have been carried out of Estonia on the basis of guarantees prescribed by a contract for the purposes of performing work under guarantee and are returned to Estonia, and spare parts imported into Estonia for the purposes of performing work under guarantee on goods the import of which is certified. Full or partial replacement of goods or substitution of like goods for the original goods during the warranty period is also deemed to be work performed under guarantee;
2. books, periodicals or other data media sent from foreign states to libraries, research and development institutions or educational institutions as donations or in exchange;
3. confiscated counterfeit clothes and footwear which shall be transferred to state or local government health care or social welfare institutions pursuant to the procedure prescribed by law;
4. the catch of an undertaking engaged in commercial fishing at sea which is unprocessed or has undergone preservation procedures for marketing purposes and which is imported to a port prior to sale.

1.3.2.7.4 Exemption on exportation

§17 (3) of the Estonian VAT act provides that exported goods or services are zero-rated (exempt from VAT with a right to deduct input VAT).

1.3.2.8 Deductions

The registered taxable person has the right to deduct the input VAT from the VAT he is liable to pay. Input VAT is defined in §20(3) as: (1) VAT to be paid on goods or services which a registered taxable person acquires or receives from another registered taxable person and uses for the purposes of business; (2) VAT calculated by the taxable person on the taxable value of services imported for the purposes of business or paid on goods imported for the purposes of business.

⁷² On the condition that investment gold has been transferred to a registered taxable person by a registered taxable person who in the business thereof normally supplies gold for industrial purposes or by a registered taxable person who produces investment gold or transforms any gold into investment gold, and services relating to such supply, provided by an agent acting in the name and for the account of another person.

§ 22 (1) of the Estonian VAT act stipulates that upon the receipt of goods or services from another registered taxable person, input VAT must be deducted on the basis of an original invoice meeting the requirements of the Estonian VAT act. Upon the import of services, input VAT must be deducted on the basis of an invoice received from the non-resident, and upon the import of goods, input VAT can be deducted on the basis of the customs declaration of release for free circulation and the document certifying payment of VAT. In the case of import of goods, input VAT must be deducted in the tax period during which the goods are received and the VAT is paid. In other cases, input VAT must be deducted in the tax period during which the goods or services and the invoice from the seller of the goods or services are received.⁷³

If a registered taxable person uses goods or services both for the purposes of taxable supply and supply exempt from tax, input VAT is partially deducted from the calculated VAT. Partial deduction is based on the proportion of the taxable supply, excluding imports of goods and services, of a taxable person to the amount of the total supply effected by the person in Estonia and the supply of services provided outside Estonia and considered under export of services.⁷⁴

1.3.2.9 Persons liable for payment of the tax

A taxable person must pay VAT after the person has been registered as a taxable person.^{75 76} In addition, a person not registered as a taxable person is liable to pay the tax on goods or services for which the person has issued an invoice or other sales document in which the amount of VAT is indicated.⁷⁷

Liability on importation

A person who is a debtor in respect of VAT within the meaning of the Customs Code is liable to pay the VAT due on importation.

1.3.2.10 Special schemes

§ 32 establishes the special rules applied for transfer of right to cut standing crop and for timber and related services. If a registered taxable person transfers the right to cut standing crop or transfers timber or processed timber to another registered taxable person or if a registered taxable person provides logging, extraction, on-road transportation, loading, unloading, reloading, sorting, stacking or transport services for timber or processed timber to another registered taxable person, the purchaser of the goods or services must consider the amount of VAT indicated on the invoice concerning the transaction to be the VAT payable by the purchaser and must pay only the sales price, exclusive of VAT, of the goods or services to the seller. The purchaser deducts the input VAT from the calculated VAT during the same tax period in which the purchaser considered the amount of VAT as payable by the purchaser.

The so-called 'margin scheme' is applied for second-hand goods, works of art, collectors' items and antiques purchased for resale by registered taxable persons from non-taxable persons, non-registered persons, and registered taxable persons reselling these items under the same 'margin scheme'. This margin scheme was dealt with in the section 1.3.2.6. Under this

⁷³ §22(5) of the Estonian VAT act.

⁷⁴ §23(1) of the Estonian VAT act.

⁷⁵ §2(3) of the Estonian VAT act.

⁷⁶ The obligation of registration arises when taxable supply, excluding import of goods, of a taxable person exceeds EEK 250 000 (EUR 16 025) as calculated from the beginning of a calendar year (§9(1) of the Estonian VAT act). See section 1.3.2.11.1.

⁷⁷ §2(3)2) of the Estonian VAT act.

scheme VAT is applied on the difference between the selling and buying price, so avoiding double taxation on goods that have previously been taxed.

From the beginning of 2004, the margin scheme will also be applicable to the travel agents in cases where a travel agent enters into an agreement with a customer in the name of the travel agent and uses goods or services acquired from other taxable persons for the purposes of servicing travellers. In other cases, travel agents shall be subject to the general procedure for calculation of taxable amount. In order to calculate the taxable amount of a service provided by a travel agent, the total cost, inclusive of VAT, of the goods and services acquired by the travel agent from other taxable persons for the purposes of servicing travellers shall be deducted from the total price, exclusive of VAT, of the package paid by the travellers to the travel agent. If services ordered by a travel agent are provided by another person outside Estonia, the intermediation services provided by the travel agent must be treated as an export of services. A travel agent does not have the right to deduct the VAT paid by the travel agent to other taxable persons upon acquisition of goods or services for the purposes of servicing travellers from the calculated VAT of the travel agent.

The special scheme applicable to investment gold was dealt under section 1.3.2.7.2.

1.3.2.11 Administrative obligations

1.3.2.11.1 Compulsory registration

Estonia applies EUR 16 025 (EEK 250 000) turnover limit for compulsory registration of VAT taxable persons. Below that threshold the registration is voluntary.

1.3.2.11.2 Possibility for group registration

§ 12 of the Estonian VAT act provides a possibility to register two or more taxable persons as one taxable person. The Tax Board of Estonia must register a parent undertaking and its subsidiaries as a single taxable person on the basis of a joint application by such taxable persons. Taxable persons to whom at least one of the following circumstances applies must also be registered as a single taxable person on the basis of a joint application:

at least 50 per cent of the shares of each public limited company to be registered as a single taxable person or of the holdings in each private limited company or a general or limited partnership to be registered as a single taxable person are owned by one and the same person;

at least 50 per cent of the votes determined by the shares of each public limited company or private limited company to be registered as a single taxable person or by the contributions into each general or limited partnership to be registered as a single taxable person are owned by one and the same person.

1.3.2.11.3 Submitting a return

The tax period is one calendar month. VAT returns must be submitted to the Tax Board by the twentieth day of the month following the tax period. The Tax Board may establish a tax period longer than one calendar month for the taxable person, provided that it begins on the first day of the calendar month and ends on the last day of one of the following calendar months. In this case, VAT returns must still be submitted to the Tax Board by the twentieth day of the month following the tax period.

The following persons are required to submit VAT returns:

- a. registered taxable persons;

- b. persons not registered as taxable persons, on transactions concerning which they have issued an invoice or other sales document in which the amount of VAT is indicated.

1.3.3 Tax rates

Estonia applies a standard rate of 18 percent on most goods and services and a reduced rate of 5 percent. In addition, zero rating is applied for selected goods and services.

The reduced rate of 5 percent is applied on the following goods and services:

1. books;⁷⁸
2. medicines, medical equipment or medical devices;
3. chemical pest control agents (biocides) if the purchaser is a social welfare institution or health care provider;
4. handling of hazardous waste;
5. funeral items and services;
6. the organisation of performances or concerts by a state, municipal or private performing arts institution or the national opera;⁷⁹
7. heat sold to individuals, housing associations, apartment associations, churches, congregations or bodies or organisations financed from the state, rural municipality or city budget, and peat, fuel briquettes, coal or firewood sold to individuals;
8. accommodation provided by hotels and similar establishments.

Zero rates are applied on the following goods and services:

1. exported goods or services;
2. sea-going vessels used for navigation on high seas, and equipment transferred together with the vessel;
3. aircraft operating on international routes, and equipment transferred together with the aircraft;
4. electricity generated by wind, and hydro-electricity;
5. periodicals sold under a subscription;
6. textbooks and workbooks for primary schools and gymnasiums.

1.4 Taxation of income

1.4.1 The main features of income taxation

In 2000, Estonia introduced a new system of corporate taxation. The most important difference with the previous system and the conventional corporate income tax system is that the object of taxation has been changed. Resident legal persons do not pay tax on earned profits but on distributed profits. Retained profits are exempt from tax. Branch offices and permanent establishments are subject to tax on transfer of income earned in Estonia.

The distribution of profits by the Estonian corporations is taxed at a rate of 26/74. Income tax on fringe benefits is payable by the employer at a rate of 26/74.⁸⁰ The same rate (26/74)

⁷⁸ Excluding textbooks and work books for primary school and gymnasiums that are subject to a zero rate.

⁷⁹ On the condition that the organiser of the performance or concert has not incurred tax arrears during the same calendar year and the funds received by the organiser from the state, rural municipality or city budget or the Cultural Endowment of Estonia amount to at least 10 per cent of its income during the calendar year.

⁸⁰ In addition, the fringe benefits are subject to social contributions at a rate of 33%. The taxation of fringe benefits is stipulated below.

applies to gifts and donations, expenses not related to business activities and other distributions of this kind.

Social benefits and pension scheme in Estonia

Wages and salaries are taxed with the social security tax (which includes social security contributions and the medical insurance tax) at the rate of 33%. In addition, the employer withholds unemployment security contribution of 1 percent (withheld from the gross salary) and additionally pays 0,5% percent (calculated on the gross salary). Contributions to a mandatory funded pension are 2 percent (withheld from the gross salary). This is only the case if the employee has joined a mandatory funded pension system.

The income tax, unemployment security contributions, pension insurance contributions as well as social security contributions have to be paid by the employers to the State budget. The employee has no additional tax liability.

Social security tax (which includes social security contributions and the medical insurance tax) is payable on wages and other remuneration paid to employees in money. Tax is payable on the monthly basis. Social tax is applied at a rate of 33% on the value of the benefit including the calculated income tax. For example, if the net income received by the employee is EUR 100 then the company will pay EUR 35,14 income tax and EUR 44,59 social security contributions. Unemployment insurance payments are shared between employer and employee. Employers pay tax at rate of 0,5% on gross payroll payments and additional 1% is withheld from payments made to employees. Contributions to a mandatory funded pension are 2 percent (withheld from the gross salary). This is only the case if the employee has joined a mandatory funded pension system.

Compensations for illness and old age pensions are financed by the social security authorities from the state budget and companies do not have major direct obligations in addition to paying the 33% social security tax.

Capital taxes

There is no net wealth/capital tax in Estonia. Capital gains are generally included in the taxable income of individuals and taxed at a general rate.

Inheritance and gift tax

There are no inheritance and gift taxes in Estonia, but if the person sells inherited property and according to the law the gain from such property is subject to income tax, the full sales price will be subject to income tax.

1.4.1.1 Jurisdictional criteria

An individual is a resident if he or she has a permanent place of residence in Estonia or stays in Estonia for 183 days or longer during a tax period. Estonian state public servants who are in foreign service are also residents. The 'incorporation method' is used to determine residence of an entity: a legal person is a resident if it is established pursuant to Estonian law.⁸¹ Residents are subject to unlimited tax liability, i.e. tax is applied on their worldwide income,⁸² while non-residents are subject to limited tax liability, i.e. tax is applied on their income derived from sources within Estonia.

⁸¹ If the residency prescribed on the basis of an international agreement differs from the residency prescribed pursuant to law or if the agreement prescribes more favourable conditions for taxation of the income of non-residents than those provided by law, the provisions of the international agreement apply.

⁸² In order to avoid double taxation of the income earned abroad, a resident taxpayer who has derived income from abroad can deduct income tax paid or withheld on such income abroad from the income tax to be paid.

Dual residence

The Estonian tax treaties contain rules which provide how the residence should be determined where an individual or a company is considered a resident of both Contracting States under the tax treaty. The criteria used in case of individuals are, for example, habitual abode and permanent home, personal and economic relations, centre of vital interests, length of stay and nationality. If a person other than an individual has a dual residence, the question is settled by mutual agreement procedure.

1.4.1.2 Corporate taxation

Under the Estonian tax system, the distribution of profits (as well as transactions that can be treated as hidden distributions of profits) are subject to income tax. Income taxation has shifted from earning profits to the distribution of profits. The term “distribution” is treated wider than just direct dividend payments. It also includes hidden profit distributions and certain expenses, which can be considered profit allocation, e.g. fringe benefits, gifts, donations, and expenses and payments unrelated to business. In case of the fringe benefits the social contributions at a rate of 33% are also applied in addition to the income tax. It means that altogether the tax is applied at a rate of 79.73%. For example, if the taxable value is EUR 100 then the company will pay EUR 35.14 corporate income tax and EUR 44.59 social security contributions. The employee gets a benefit in a value of EUR 100, with no additional tax liability.

All kind of resident legal persons, including public bodies, as well as non-profit associations and foundations are taxed on the same principles as corporations.⁸³ Although public bodies, non-profit associations and foundations do not distribute profits, they pay tax on their costs, i.e. on gifts and charitable contributions as well as on fringe benefits. A state agency or agency of a local government unit pays tax only on fringe benefits. In the case of fringe benefits an employer who is an individual can also be the payer of tax.

The above taxable benefits (i.e., fringe benefits, gifts and charitable contributions) are not subject to income tax at shareholder level – they are exempt in the hands of the recipient.

Taxation of dividends

Income tax is payable by a company distributing dividends. The income tax is also imposed on the payments to the legal persons established in territories with low tax rates⁸⁴, irrespective of whether the person operates in Estonia or not. In addition, the Income Tax Act comprises CFC rules under which the profits of companies located on the low-tax territories are deemed to constitute taxable income of the residents. The act also consists a so-called transfer pricing provision (see section 2.4.2.8).

Inter-Company Dividends

The dividends paid to non-resident companies owning less than 25% of the share or stock capital or votes of the commercial undertaking distributing the dividends are subject to income tax twice: in addition to the income tax at a rate of 26/74, the withholding tax at a rate of 26% is applied on dividend payments (bringing the total tax burden to approximately 45.24%).

In case of dividends paid to resident companies, credit system is implemented to ensure that tax liability arises only at the first instance of dividend distribution. In case of any further

⁸³ The same principles that apply to corporations apply to commercial undertakings, non-profit associations, legal persons under public law and churches, congregations and associations of congregations, as well as legal persons established under prior legal acts that have not been re-registered and are under compulsory dissolution.

⁸⁴ See section 1.4.4 for a definition of low tax territories.

instances of distribution of the same dividend, no actual tax liability arises. The tax credit is received only if the direct holding of the dividend recipient in the profit-distributing company is at least 20%.

It follows that the current Estonian system of dividend taxation differentiates Estonian and foreign parent companies in a sense that it provides different minimum shareholding rate for exclusion of double taxation of dividends. When dividends are paid to the Estonian parent company holding 20% of shares the double taxation is eliminated, while the same applies to foreign legal persons starting from shareholding rate of 25%.

In case of the domestic dividends, the double taxation occurs when the dividends are redistributed by the receiver. In case of the foreign dividends, the double taxation occurs immediately at the moment of the distribution. So the discrimination of the foreign corporate shareholder is twofold: (1) the threshold for exemption is 25% instead of 20% and (2) the tax is payable immediately, without waiting for the redistribution. The issue is discussed in greater detail in section 1.4.6 as well as in section 7.2.2.2.4.

If dividends are received from foreign companies, the credit method is applied to avoid double taxation.

Example of tax calculation

If a company earns taxable profits of 100, it can distribute 74 to a shareholder, paying a tax of 26. If the shareholder is an individual, there is no further tax at shareholder level. If the shareholder is a resident company (or a permanent establishment of a foreign company) holding 20% of the shares, that company/permanent establishment can redistribute the received dividend free of tax. In that case, if the shareholding is less than 20%, there is again 26/74 tax on redistribution, etc. If the shareholder is a non-resident company holding 25% or more, no further tax. If the shareholding is less than 25%, 26% tax must be withheld by the company distributing the dividend, bringing the total tax burden to 45,24%.

Reserves and Provisions

Companies can establish reserves without tax consequences.

Tax Losses

Possibility to carry forward losses is not provided in the Estonian legislation. It is not relevant in the Estonian situation because profits are not taxed before they are distributed, and therefore, losses have no effect on corporate taxation. Profit distributions are subject to income tax even if a company has an accounting loss.

Capital Gains

Resident companies and permanent establishments of non-resident companies registered with the Estonian authorities are not subject to tax on their capital gains until the gains are distributed. Capital gains are not taxed separately, but are included into profits subject to corporate income tax upon distribution. Thus, the capital gains received by the company are not taxable as an income, but becomes subject to taxation upon distribution.

Non-resident companies without a permanent establishment in Estonia are subject to tax at a rate of 26% on their capital gains derived from Estonian sources.⁸⁵

⁸⁵ The sale of shares by a non-resident is subject to income tax only if the transferred holding is a holding of at least 10 per cent in a company of whose property, according to the balance sheet as of the last day of the preceding financial year, more than 75 per cent is made up of immovables or structures as movables, which are located in Estonia.

Groups of Companies

Companies forming a corporate group are treated as individual companies for tax purposes. Thus, there is no fiscal unity or similar concept in the Estonian tax legislation.

Thin Capitalisation

There are currently no thin capitalisation regulations in Estonia.

Transfer Pricing

If the value of a transaction conducted between associated resident and non-resident persons differs from the value of similar transactions conducted between independent persons, the tax administrator may, upon making an assessment of income tax, apply the value of transactions used by independent persons under similar conditions. See also section 1.4.2.8.

Tax collection

A legal person has the obligation to file income tax return for the period of taxation (calendar month) by the 10th day of the month following the taxation period, regardless of whether any events resulting in tax obligations have occurred. Income tax is to be transferred to the tax authorities by the same date.

Companies have to file annual accounts by the tax administrator no later than six months after the end of the financial period.

1.4.1.3 Tax rates

A flat rate (26%) is applied for all kinds of personal income. Income tax is not charged on certain types of gains from transfer of property (see section 1.4.5.3). Interest payments are generally tax exempted. However, if the interest rate is substantially higher than the usual rate on similar debt claims on the same market conditions, 26% withholding income tax is levied on the difference (the lower rate can be applied if the interest is paid to non-resident and double taxation treaty is in force).

Income tax is not charged on state pensions and the mandatory funded pensions on a total amount which does not exceed three times the basic exemption deductible from the income⁸⁶; state scholarships and grants; international and state cultural, scientific and sports awards and lottery prizes.⁸⁷ Pension benefits paid by voluntary pension funds are subject to tax at reduced rate (10%) or exempted from tax if certain conditions are met.⁸⁸ Certain insurance benefits are subject to tax at reduced rate (10%) or exempted from tax.⁸⁹

The tax rate for profits earned and retained in the company is 0 %. A resident company pays income tax on profit distributed as dividends or other profit distributions.⁹⁰ The tax rate on gross dividends is 26%, although the income tax is calculated on net amount of the dividends by applying the tax rate of 26/74.⁹¹ Thus company not distributing profit is not obliged to

⁸⁶ § 23 of the Income Tax Act specifies that the basic exemption deductible from the income of a resident individual is EEK 12 000 for a year 2003.

⁸⁷ See also section 1.4.5.

⁸⁸ See section 1.4.5. where the taxation of pensions is discussed in greater detail.

⁸⁹ § 20 and § 21 of the Income Tax Act list the benefits which are subject to tax at regular or reduced rate. The other insurance benefits are exempted from the income tax.

⁹⁰ The tax period for the profit distribution is a calendar month. Income tax is reported on one return together with the income tax withheld from individuals and social contributions paid.

⁹¹ It is important to note that the tax rate in the case of all instances of the profit distributions is not 26% but 26/74. The rate of 26/74 means that the amount of dividends, fringe benefits, etc. is a tax-inclusive amount. Withholding 26% on the gross amount has simply been replaced with 26/74 of the net amount. The goal is to guarantee equal treatment with all kind of payments subject to withholding at the rate of 26%.

pay income tax. Income tax on fringe benefits is payable by the employer at a rate of 26/74.⁹² The same rate (26/74) applies to gifts and donations, expenses not related to business activities and other distributions of this kind. In addition, a withholding tax of 26 percent is charged on profit distributions to non-residents with less than a 25 percent shareholding. As a result, there is a double taxation: a corporate income tax of 26/74 and a withholding tax of 26 percent. No withholding tax or other personal income tax is applied on dividend income received by residents from Estonian companies.

Withholding taxes

Domestic income tax rates for payments to non-residents (both entities and individuals) are as follows:

- Payments from services provided in Estonia – 15 %;
- Royalties – 15%;
- Interest – 0%;
- Rental payments – 26%;
- Dividends - 0 or 26 %. The 0 % rate is applied if the recipient is a company holding 20 % or more of the share capital or individual.

The withheld tax rates mentioned above may be reduced or waived under tax treaties.

Taxation of non-residents

The taxable income of the non-residents consists only of income gained from Estonian sources. Business profits are taxed in Estonia if the business of the non-residents was carried out in Estonia. For legal persons established in low-tax territories⁹³, income tax is imposed on all service fees paid by Estonian residents notwithstanding the place where the service was provided.

The branches of foreign commercial undertakings⁹⁴ and other registered permanent establishments⁹⁵ are exceptions – they are taxed analogously to resident legal persons, although the Income Tax Act contains some provisions that only apply to income of permanent establishments. The rules for deductions are the same for all kind of businesses, including permanent establishments. If the property belonging to a non-resident and used by its Estonian permanent establishment is taken out of a permanent establishment, the transfer is considered a distribution of profit and taxed as dividends. Obviously, the rule only applies if the property is taken out without sufficient explanation showing its purpose. The dividend treatment also applies to payments made to the head office, other units of the company or to third persons, if no goods or services are delivered to the permanent establishment in return for the money. Payments by the permanent establishment to the head office or third persons that can be considered fringe benefits, expenses not related to business, gifts, and donations are always taxed at the rate of 26/74 of the net amount on a monthly basis.

Income of non-residents is generally taxed by withholding at a rate of 26%, except for royalties, and remuneration for the performance of artists or sportsmen in which cases a rate of 15

⁹² In addition, the fringe benefits are subject to social contributions at a rate of 33%. It means that altogether the tax is applied at a rate of 79.73%.

⁹³ See section 1.4.4 for a definition of low tax territories.

⁹⁴ A foreign commercial undertaking has to be registered in the Estonian Commercial Register.

⁹⁵ Permanent establishment of a non-resident legal person is defined in § 7 of the Income Tax Act. Permanent establishment is any place through which the permanent economic activities of a non-resident are wholly or partly carried out in Estonia. If an agent of a non-resident is operating in Estonia, who is authorised to carry out transactions in the name of the non-resident and repeatedly carries out transactions in the name of the non-resident, the non-resident is deemed to have a permanent establishment in Estonia.

per cent applies. In the cases where more favourable rates are agreed under the Convention for the Avoidance of Double Taxation, these rates apply for taxation of income of non-residents. An income tax of 15% is also withheld on the remuneration paid for services provided to the non-resident in Estonia⁹⁶, except if the non-resident has a branch entered in the Estonian Commercial Register or a permanent establishment registered at a local tax authority.⁹⁷ An income tax is also withheld from the remuneration paid for the services provided by legal persons established in low-tax territories⁹⁸ to Estonian residents.⁹⁹ The rate of income tax to be withheld is 15%.

Non-profit associations and foundations benefiting from income tax incentives

§ 11 of the Income Tax Act regulates the composition of a list of non-profit associations and foundations benefiting from income tax incentives. According to the Explanatory Letter to Income Tax Act, in order to grant tax incentives it should be checked and ensured that the activities of the recipient of charitable contributions are aimed for the public benefit and that the charitable contributions received are used for the designated purpose. In order to benefit from income tax incentives a non-profit association must meet the requirements specified in the Income Tax Act. The main criterion is that the entity must pursue its activities for the public benefit. In addition, such associations must not distribute their assets or income to their members, and their administration expenses and remuneration must not be too high in comparison with commercial entities.¹⁰⁰ The Income Tax Act also sets out an all-inclusive list of circumstances, under which an applicant is not included in the list and under which a person is to be excluded from the list.¹⁰¹ The Government of Estonia approves a list of non-profit associations and foundations whose activities are aimed at supporting science, culture, education, sports, law enforcement, health care, social welfare, the preservation of nature, cultural autonomy of a national minority, or the support of churches, congregations or religious societies in the public interest. Before being included in the list, the documents and activities of the organization are carefully checked. If the organization fails to conform to the requirements, it will be deleted from the

⁹⁶ § 29 of the Income Tax Act.

⁹⁷ § 41 of the Income Tax Act.

⁹⁸ See section 1.4.4 for a definition of low tax territories.

⁹⁹ § 41 of the Income Tax Act.

¹⁰⁰ § 11(3) of the Income Tax Act lists the following requirements that a non-profit association or foundation applying for inclusion in the list has to meet:

1. the association or foundation does not distribute its assets or income, grant material assistance or monetarily appraisable benefits to its founders, members, members of the management or controlling body, nor to a spouse, direct blood relative, sister, brother, descendant relative of a sister or brother, direct relative of a spouse, or sister or brother of a spouse of any of the above mentioned persons;
2. upon the dissolution of the association or foundation, the assets remaining after satisfying the claims of creditors are transferred to a non-profit association or foundation pursuing similar goals or to a legal person in public law, the state or a local government;
3. the administrative expenses of the association or foundation do not exceed the rate justified by the nature of its activities and the objectives specified in its articles of association;
4. the association or foundation does not pay higher remuneration to its employees or members of the management or controlling body than is paid for similar work in business.

¹⁰¹ According to § 11(5) of the Income Tax Act non-profit association or foundation is not included in the list if:

1. it is engaged in business as its principal activity or uses business income for purposes other than those specified in its articles of association;
2. it has tax arrears for which no payment schedule has been arranged;
3. it is undergoing dissolution or bankruptcy proceedings;
4. the documents submitted by the non-profit association or foundation for inclusion in the list do not meet the requirements established by legislation.

list.¹⁰² Legal persons registered on the basis of the Churches and Congregations Act¹⁰³ are granted the income tax incentives automatically, without being included in the list and without having to meet the requirements listed in the Income Tax Act. Other religious associations that have been registered in accordance with the Non-profit Associations Act must apply for inclusion in the list pursuant to the established procedure. An automatic income tax incentive is also granted to Estonian political parties.

1.4.2 Taxation of corporate income

Resident legal persons have to pay income tax on the following items: dividends, hidden profit distributions, fringe benefits, gifts and charitable donations, reception expenses, and non-business expenses.

1.4.2.1 Taxation of dividends and other profit distributions

Dividends are defined in § 18(2), which provides that a dividend is a payment which is made from the net profit or the retained profits from previous years pursuant to a resolution of a competent body of a legal person, and the basis for which is the recipient's holding in the legal person (ownership of shares, partnership in a general or limited partnership or membership in a commercial association, or other forms of holding pursuant to the legislation of the home country of the company). A payment is considered a dividend if the following five conditions are met:

1. a payer of a dividend is an Estonian company;
2. a payment is made from the net profit of a company;
3. a payment is made in monetary or non-monetary form;
4. a basis for a payment is a decision of a competent body of a company;
5. a recipient of a payment has a legal right to participate in the profit distribution of a company.

These conditions are cumulative. If the payment does not meet any of the above conditions then it is not considered a dividend but other profit distribution which is equally taxable.¹⁰⁴ Income tax must also be paid on hidden profit distributions, such as the transfer of property at a price that is lower than the market value, or vice versa, the purchase of property at a price that is higher than the market value. Income tax must also be paid in cases where the law prohibits the payment of dividends or if a loan is granted to the shareholders that is prohibited under the law. Income tax is not levied (again) on dividends received by resident individuals.¹⁰⁵ Consequently, double taxation of dividends is avoided in these cases. Double

¹⁰² According to § 11(6) of the Income Tax Act the Government of the Republic has the right to delete a non-profit association or foundation from the list if it becomes evident that it does not meet the requirements or if facts specified in previous footnote appear, or

1. if the non-profit association or foundation has failed to file reports and tax returns with the tax administrator during the terms and pursuant to the procedure prescribed by legislation, or
2. if the non-profit association or foundation has failed to report changes made in its articles of association to the local Tax Board office of its seat within thirty days after an entry concerning the change is made in the non-profit associations and foundations register, or
3. if the non-profit association or foundation derives income from activities not specified in its articles of association.

¹⁰³ State Gazette, I 1993, 30, 510; 44, 637; 1994, 28, 425.

¹⁰⁴ §50(1) of the Income Tax Act stipulates that income tax has to be paid on profit distributed as dividends or other profit distributions upon payment thereof in monetary or non-monetary form. Income tax is not charged on profit distributed by way of a bonus issue.

¹⁰⁵ §18(1) provides that income tax is charged only on dividends and profit distributions received by a resident individual from a foreign legal person in monetary or non-monetary form.

taxation of dividends is also avoided if dividends are distributed to legal persons who hold a qualifying interest (at least 20%). The resident companies whose holding is less than 20% have to pay the income tax again when they redistribute the dividends. Double taxation is also not avoided in the case of non-residents who have to pay income tax on dividends received from resident companies. Income tax is withheld on those dividends at the rate of 26 per cent immediately at the moment of distribution of dividends by the Estonian company.¹⁰⁶ However, double taxation is avoided in the case of foreign direct investment if a non-resident legal person owns at least 25 per cent of the share capital or votes of the resident company distributing the dividends. Dividends distributed to such legal person, except a legal person located in a low tax rate territory, are not subject to income tax at a shareholder level. Since the company tax is levied upon distribution, it is important to understand how the tax is calculated at that moment. For example, a company receives a dividend of 100 in year 1. It does not make a distribution in year 1. The tax payable is 0. In year two it earns fully taxable profits of 250, and does not make a distribution. The tax payable is 0. In year 3 it earns fully taxable profits of 150, and in September, (before the profit has been determined) distributes a dividend of 50. The income tax of 17.57 has to be reported and paid.¹⁰⁷ If the company would distribute dividend of 300 in October, the income tax of 105.41 has to be reported and paid.¹⁰⁸

1.4.2.2 *Taxation of other transactions*

Taxation of repayments of capital

Repayments of capital are not subject to income tax at a paying company level. If the receiver of the repayment of capital (i.e. in the case of a reduction in the share capital and in the case of redemption or return of shares or contributions) is a resident individual or a non-resident (an individual or a legal person), the income tax at a rate of 26% has to be paid. The income tax is charged on the amount in which the payments made to a person exceed the acquisition cost of the holding or the contribution made by the person upon acquisition of the holding (shares, contributions).

Taxation of repayment of loans

The repayment of loan is not subject to income tax. In addition, the interest payments are also, as a general rule, tax exempt (the exception is the interest that exceeds the market rate as well as interest payments to a legal person located in a low tax rate territory).

Taxation of liquidation proceeds

Payments made upon liquidation are not subject to income tax at a selling company level. Payments made upon liquidation are subject to income tax (26%) at the level of the receiver of the payments if the liquidation proceeds are paid to an individual or a non-resident (an individual or a legal person). However, if the non-resident selling the assets is from the country with which Estonia has a tax treaty in force, the payments made upon liquidation are not subject to income tax. Any payments made before the liquidation may be considered profit distributions and taxed as dividends at a rate of 26/74 (26% on the grossed up amount).

¹⁰⁶ However, in cases where the recipient of the dividend is a non-resident subject to the provisions of the Convention for the Avoidance of Double Taxation, rates according to the Convention apply.

¹⁰⁷ A company has to report the dividend on its monthly tax return of September (the month when the dividend payment was made). The tax payment is due on October 20th.

¹⁰⁸ If a company paid the dividends out in October then it has to be reported on its tax return of October. The tax payment is due on November 20th.

Sale of assets

The sale of assets will not have any additional Estonian income tax consequences neither for the selling company or buying company. The income from the sale of assets is not taxed until an actual distribution of profits takes place or the company is liquidated.

Sale of stock (shares)

The sale of shares is subject to income tax (26%) only if shares are sold by a natural person or a non-resident. The sale of shares by a non-resident is subject to income tax only if the transferred holding is a holding of at least 10 per cent in a company of whose property, according to the balance sheet as of the last day of the preceding financial year, more than 75 per cent is made up of immovables or structures as movables, which are located in Estonia. It follows that the sale of assets triggers tax consequences only if the assets sold by a non-resident company include the considerable amount of the immovable property (i.e. real estate).

1.4.2.3 Taxation of fringe benefits

Employers¹⁰⁹ have to pay income tax on fringe benefits granted to employees¹¹⁰. In addition to income tax, social contributions have to be paid on fringe benefits.¹¹¹ The employee is not taxed on such fringe benefits, since the employer has paid all taxes on them.

Fringe benefits are defined as any goods, services, remuneration in kind or monetarily appraisable benefits or gifts which are given to employees in connection with an employment or service relationship, membership in the management or controlling body of a legal person, or a long-term contractual relationship. Benefits that an employer grants to the person related to the employee (the spouse, parent or child of an employee) are also deemed to be fringe benefits.

The Income Tax Act contains an exhaustive list of fringe benefits, which includes the following items:

1. full or partial covering of housing expenses;
2. the use of a vehicle or other property of the employer free of charge or at a preferential price for activities not related to employment or service duties or to the employer's business;
3. payment of insurance premiums, unless such obligation is prescribed by law;
4. compensation for official travel expenses and payment of daily allowances, in so far as they exceed the limits established by the Government of Estonia;
5. compensation for the use of an automobile in personal ownership or leased on the basis of a finance lease contract, in so far as it exceeds the limits established by the Government of the Republic;¹¹²

¹⁰⁹ The list of employers who have to pay income tax on fringe benefits is provided in § 48(2) and it includes resident natural and legal persons, state or local government agencies as well as non-residents who have a permanent establishment in Estonia or whose employees work in Estonia.

¹¹⁰ For the purpose of taxation of fringe benefits, an employee is defined in § 48(3) as a person employed under an employment contract, a public servant, a member of the management or controlling body, or an individual who sells goods to an employer during a period longer than six months. An individual who works or provides services on the basis of a contract for services, authorisation agreement or any other contract under the law of obligations is also deemed to be an employee for the purpose of taxation of fringe benefits.

¹¹¹ Subsection 8 of §2(1) of the Law on Social Tax. The fringe benefits are subjected to social contributions to ensure that all kind of payments received by employee are treated equally.

¹¹² For example, the limit for compensation for the use of an automobile in personal ownership is EEK 2000 a month.

6. loans given with lower interest than the minimum rate established by the Minister of Finance;
7. transfer free of charge or sale or exchange at a price lower than the market price, of a thing, security, proprietary right or service;
8. purchase of a thing, security, proprietary right or service at a price higher than the market value;
9. giving up a monetary claim, unless the estimated reasonable costs of collecting the monetary claim exceed the claimed amount;
10. coverage of expenses relating to formal or informal education acquired in the adult education system.

1.4.2.4 Taxation of gifts, donations and reception expenses

The taxation of gifts and charitable donations depends on the status of the recipient of the gifts and donations. A resident legal person must pay income tax on all gifts and donations made to other legal persons, individuals or non-residents.¹¹³ In addition, a resident legal person must pay income tax on gifts and donations made to non-profit associations or foundations not benefiting from income tax incentives according to the list approved by the Government of Estonia.¹¹⁴ Tax is only partially imposed on charitable donations made to non-profit associations and foundations benefiting from income tax incentives according to the above-mentioned list. If recipient of the charitable donation is included in the above-mentioned list, the payer of the donations is subject to income tax only in the amount of donations exceeding 2 per cent of the total remuneration paid by it to its employees during the previous calendar month on which the social contribution was imposed. Income tax is not imposed on donations made to state or local government authorities. In all other cases the donations made are fully subject to income tax.

If a taxpayer does not make charitable donations subject to taxation every month, the taxpayer may calculate the income tax of the calendar year in total. In the case of a calculation in total, income tax is charged on the total amount of the donations, which exceeds 2 per cent of the total amount of the remuneration payments on which the social contribution was imposed during the same calendar year. If the total amount of the donations is less than 2 per cent of the total amount of the payments on which social contribution was imposed, income tax shall be charged on the total amount of the gifts and donations which exceeds 5 per cent of the total amount of the payments subject to individually registered social tax made by the taxpayer during the same calendar year.

¹¹³ § 49(1) of the Income Tax Act. § 49(2) of the Income Tax Act provides that income tax is not charged on the following gifts and donations made to non-profit associations or foundations included in the list of non-profit associations and foundations benefiting from income tax incentives approved by the Government of Estonia; to legal persons founded on the basis of the Churches and Congregations Act and entered in the register of Estonian churches, congregations and associations of congregations; to a person who owns a hospital; to a state or local government scientific, cultural, educational, sports, law enforcement or social welfare institution; or a manager of a protected area in a total amount not exceeding one of the following limit values:

1. 3 per cent of the amount of the payments subject to social tax (individually registered social tax) made by the taxpayer during the same calendar year;
2. 10 per cent of the profits for the last financial year of a taxpayer dissolved as of 1 January of a calendar year, calculated pursuant to the legislation regulating accounting.

Income tax is also not charged on expenses incurred by a trade union entered in the register of trade unions in connection with organising children's camps or projects of recreational holidays and leisure activities.

¹¹⁴ § 49(2) of the Income Tax Act.

1.4.2.5 Taxation of expenses not related to business

A resident legal person has to pay income tax on expenses not related to business. The list of these expenses is stipulated in § 51(4). According to § 51, all resident legal persons must pay income tax on the total amount of the loans and advance payments given to associated individuals in a calendar month, which exceeds 50 per cent of the total amount of the payments made by the legal entity during the preceding calendar month on which the social contribution was imposed pursuant to the Social Tax Act.¹¹⁵

In addition, all resident companies must pay income tax on the expenses not related to business provided in § 51(2). A resident non-profit association, foundation, church, congregation or association of congregations must pay income tax on the expenses stipulated in § 51(3). All expenses not related to business, and other payments, made through or on account of the income of a permanent establishment are also subject to income tax.

§ 51(2) provides the exhaustive list of expenses on which a resident company as well as a non-resident making expenses through a permanent establishment must pay income tax. It includes the following expenses not related to business:

1. fines;
2. interest paid on the basis of § 28 of the Taxation Act;
3. the cost of property seized from the taxpayer;
4. payments for special use of water without the relevant permit for special use of water or in amounts exceeding the permitted amount;
5. the pollution charge paid;
6. compensation for environmental damage;
7. entrance and membership fees paid to non-profit associations, unless participation in such associations is directly related to the business of the taxpayer;
8. undocumented payments¹¹⁶;
9. expenses incurred or payments made in order to purchase services not related to the business of the taxpayer;
10. expenses incurred or payments made in order to fulfil obligations not related to the business of the taxpayer.

A resident non-profit organizations must pay income tax on expenses not related to the goals of their activities specified in the person's articles of association as well as on following expenses and payments:

1. fines;
2. interest paid on the basis of § 28 of the Taxation Act;
3. the cost of property seized from the taxpayer;
4. payments for special use of water without the relevant permit for special use of water or in amounts exceeding the permitted amount;
5. the pollution charge paid;
6. compensation for environmental damage;
7. undocumented payments.

¹¹⁵ Loans and advance payments refunded during the same calendar month by natural persons associated with the resident legal person, the cost of goods and services purchased out of the aforementioned advance payments during the same calendar month, and the size of salaries or service fees paid out of such advance payments shall be deducted from the total amount of the loans and advance payments.

¹¹⁶ §51(2) specifies that this item includes expenses concerning which the taxpayer does not have a source document in compliance with the requirements prescribed in legislation regulating accounting.

1.4.2.6 *Taxation of other payments not related to business*

Resident companies must pay income tax on some other payments not related to business. § 52(2) provides the exhaustive list of this kind of payments and includes the following payments:

1. acquisition of property unnecessary for carrying on the business;
2. granting a loan or making of an advance payment to a legal person located in a low tax rate territory or acquisition of a right of claim against a legal person located in a low tax rate territory in any other manner.
3. acquisition of securities issued by a legal person located in a low tax rate territory¹¹⁷;
4. acquisition of a holding in a legal person located in a low tax rate territory;
5. payment of a fine for delay or a contractual penalty, or extra-judicial compensation for damage, to a legal person located in a low tax rate territory.

1.4.2.7 *Taxation of interest income*

Interest payments are generally tax exempted. However, if the interest rate is higher than the usual rate on similar debt claims on the same market conditions, a 26% withholding income tax is levied on the difference.

1.4.2.8 *Transfer pricing*

The concept of transfer pricing is introduced in the Estonian Income Tax Act. According to the law, if the value of a transaction conducted between associated resident and non-resident persons differs from the value of similar transactions conducted between independent persons, the tax administrator may, upon making an assessment of income tax, apply the value of transactions used by independent persons under similar conditions. Income tax is levied on transfer pricing adjustments, i.e. the amount of the income the taxpayer would have received or the loss the taxpayer would not have sustained had the value of the transaction conducted between the related parties at arm's length. The chargeable income tax rate is 26/74 of the net amount or 26% from the gross amount.

1.4.3 *Taxation of non-residents' income*

Companies

Non-resident companies are taxable on business income derived from Estonian sources. Apart from income derived through a permanent establishment in Estonia, taxable business income of a non-resident company includes income from a trade or business carried out in Estonia. For the calculation of income attributable to a permanent establishment in Estonia, the separate entity approach is applied.

A non-resident company that is registered in a low-tax territory is subject to income tax (by withholding) on all income derived from the provision of services to an Estonian resident, irrespective of where the services were provided or used.

Estonian-source capital gains derived by non-residents from the disposal of immovable and movable property are subject to income tax by way of assessment. Gains from movable property are considered to be derived from an Estonian source if:

- the property was registered in Estonia prior to the disposal; or
- the property was located in Estonia prior to the disposal and is sold or exchanged to a resident of Estonia.

¹¹⁷ Unless such securities meet the requirements specified in clauses 102 (1) 1)-3) of the Investment Funds Act.

In addition, income tax is levied on gains derived by a non-resident if:

- the transferred asset is a right in immovable property or a building regarded as movable property located in Estonia; or
- at least a 10% participation in a company is transferred and at least 75% of the assets of the company is made up of Estonian-situs immovable property or buildings regarded as movable property.

Income of non-resident companies, other than income subject to withholding tax (see section 1.4.1.3), is taxed by assessment in the same manner and at the same rate (26%) as income of sole proprietors, unless the non-resident has a permanent establishment in Estonia.

Individuals

Non-resident individuals are taxable on their income from Estonian sources. Most types of income are taxed by way of withholding. All withholding taxes are levied on gross payments and no deductions or personal allowances are granted. The withholding taxes are final taxes, and the non-resident recipient has no obligation to file an income tax return for income so taxed.

Income of non-residents other than income subject to withholding tax is taxed by assessment in the same manner and at the same rate (26%) as income of residents. However, no personal deductions or allowances are granted to non-residents.

Income from a business carried on in Estonia is taxable whether earned through a permanent establishment or not.

1.4.3.1 Taxation of permanent establishment of a non-resident

Permanent establishment of a non-resident legal person is defined in § 7 of the Income Tax Act. Permanent establishment is any place through which the permanent economic activities of a non-resident are wholly or partly carried out in Estonia.¹¹⁸ If a representative of a non-resident is operating in Estonia, who is authorised to carry out and repeatedly carries out transactions in the name of the non-resident, such a non-resident is deemed to have a permanent establishment in Estonia.¹¹⁹ When a non-resident carries on business in Estonia through a permanent establishment, the income which the permanent establishment might be expected to derive if it were a distinct and a separate taxpayer engaged in the same or similar activities under the same or similar conditions and dealing wholly independently of the non-resident of which it is a permanent establishment are attributed to the permanent establishment.¹²⁰

As a general rule, a non-resident legal person with a registered permanent establishment¹²¹ pays income tax on the same basis as a resident legal person.¹²² The income tax is imposed

¹¹⁸ Permanent establishment can be:

- a branch;
- a centre of management, or an office, factory or workshop;
- a building site, a place of construction, or an installation or assembly project;
- a place where the examination or extraction of natural resources is carried out, as well as any supervisory activities related thereto;
- a place for the provision of services (including management and consultation services).

¹¹⁹ § 7(2).

¹²⁰ § 7(3).

¹²¹ If an international agreement for avoidance of double taxation (hereafter a tax treaty) is in force between Estonia and some other country, the residents of treaty partners do not have to be registered to enjoy the equal treatment with Estonian residents. Tax treaties concluded by Estonia do not contain the requirement of registration for permanent establishments. If domestic law is different from the conditions of international agreement, provisions of the international agreement apply. In addition, §

on the permanent establishment analogously to a resident company: only the profit that is taken out of a permanent establishment is taxed.

Separate accounts must be maintained for the permanent establishment under the requirements of Estonian legislation. Accounting entries serve as the basis for profit distribution. Generally, the rules for taxation of income of the permanent establishments are the same as for all other types of businesses. The rules for deductions are the same for all companies. However, § 53 of the Income Tax Act provides some differences in taxation applicable for permanent establishments. The provisions of § 53 specify the rules of taxation of economic transactions between permanent establishment and its head office.

Income tax is imposed on the cost of property which is taken out of a permanent establishment, in the amount which exceeds the total amount of the cost of property of the permanent establishment located in Estonia before the year 2000 and the cost of property brought into Estonia for the purposes of the permanent establishment after the year 2000, unless other property or a service is provided in return for such property. If the property is taken out without sufficient explanation showing its purpose, this kind of transfer is considered a distribution of profit and taxed as a dividend. This principle is also applied to transfers of profit earned and transferred to the head office or other structural units of the non-resident. In addition, payments made to third parties pursuant to the orders of a non-resident through or on account of its permanent establishment, if no goods or services are received in return for such payments are taxed as dividends. The only difference compared to the taxation of Estonian companies is that from the profit distribution the initial investment expense (whether in the form of money or tangible assets) and further investments can be deducted.

All fringe benefits granted by a non-resident to its employees or members of the management or controlling body through or on account of its permanent establishment are subject to income tax, irrespective of whether the recipient of fringe benefits is a resident or non-resident. Gifts and donations made and costs of entertaining guests incurred by a non-resident through or on account of its permanent establishment are also subject to income tax, irrespective of whether the recipient of the gifts or donations, or the guest or business partner is a resident or non-resident.¹²³ In addition, expenses not related to business, and other payments, made through or on account of the income of a permanent establishment are always taxed analogously to the profit distributions.

1.4.4 Taxation of income of legal persons located in low tax rate territories

As a general rule, the retained profits are not taxed according to the Estonian system of corporate taxation. However, §22 provides an exception to this rule by subjecting all income (including retained profits) of a legal person located in a low tax rate territory to income tax, irrespective of whether the legal person has distributed any profits or not.

In addition, an income tax of 26% is withheld from the payments to a legal person located in a low tax rate territory for services provided to an Estonian resident. Income tax is also applied on acquisition of securities issued by a legal person located in a low tax rate territory¹²⁴; acquisition of a holding in a legal person located in a low tax rate territory; payment of a fine for delay or a contractual penalty, or extra-judicial compensation for damage, to a legal person located in a low tax rate territory; grant of a loan or making of an advance pay-

6(5) of the Income Tax Act provides that if an international agreement ratified by the Parliament of Estonia prescribes more favourable conditions for charging or withholding income tax than those provided by domestic law, the provisions of the international agreement apply.

¹²² The basis for taxation of business income is provided in §§ 48-52 of the Income Tax Act.

¹²³ § 53(3) of the Income Tax Act provides that representatives of the non-resident's head office or other structural unit located outside Estonia are also deemed to be guests or business partners.

¹²⁴ Income tax is not applied if such securities meet certain requirements specified in the Investment Funds Act.

ment to a legal person located in a low tax rate territory or acquisition of a right of claim against a legal person located in a low tax rate territory in any other manner.

Definition of a low tax rate territory

A low tax rate territory is defined in § 10(1) as a foreign state or a territory with an independent tax jurisdiction in a foreign state, which does not impose a tax on the profits earned or distributed by a legal person or where such tax is less than two-thirds of the income tax which an individual who is an Estonian resident would, pursuant to the Income Tax Act, have to pay on a similar amount of business income, without taking into account the deductions allowed under the Act. If taxes imposed on the income earned or distributed by different types of legal persons differ, a territory is deemed to be a low tax rate territory only with regard to legal persons in the case of whom the tax meets the conditions for low tax rate territories specified in the Income Tax Act.

In addition to the condition that a legal person has to be located in a low tax rate territory, two other conditions have to be fulfilled in order to consider the income of a foreign legal person to be the taxable income of a resident. At first, legal person has to be controlled by Estonian residents. A legal person is deemed to be controlled by Estonian residents if one or several legal or individuals who are Estonian residents own at least 50 per cent of the shares, votes or rights to the profits of the legal person directly or together with associated persons. In addition, the resident has to own at least 10 per cent of the shares, votes or rights to the profits of the legal person directly or together with associated persons, in order to qualify for this special provision.

A legal person is not deemed to be located in a low tax rate territory if more than 50 per cent of its annual income is derived from: (1) manufacturing of goods, trade in goods, and provision of transport, communications, accommodation and tourism services in the home country of the legal person, or provision of insurance services by a legal person holding an insurance activities license; (2) chartering of freighting vessels.

The Government of the Republic has established a list of territories, which are not regarded as low tax rate territories.¹²⁵ This list includes the following states:

- The United States of America, excluding the Virgin Islands and the Marshall Islands
- The Republic of Austria
- The Kingdom of Belgium
- The People's Republic of China, excluding Hong Kong and Macau
- The Kingdom of Spain
- The Kingdom of the Netherlands, excluding Aruba and the Netherlands Antilles
- Ireland
- The Republic of Island
- The Republic of Italy
- Japan
- Canada
- The Republic of Greece
- The Republic of Lithuania
- The Republic of Latvia
- The Republic of Moldova
- The Kingdom of Norway
- The Republic of Poland
- The Republic of Portugal, excluding Madeira

¹²⁵ Regulation of the Government of the Republic No. 11 of January 11, 2000, amended by Regulation of the Government of the Republic No. 7 of January 10, 2001.

- The Republic of France
- The Kingdom of Sweden
- The Federal Republic of Germany
- The Republic of Finland
- The United Kingdom of Great Britain and Northern Ireland, excluding Bermuda, the British Virgin Islands, the Cayman Islands, Gibraltar, the Channel Islands, Isle of Man, Montserrat, the Turks and the Caicos Islands
- The Kingdom of Denmark
- The Czech Republic
- Ukraine
- The Republic of Kazakhstan
- The Republic of Belarus

In addition to this list, the Tax Board of Estonia has established so-called ‘black list’, which includes the territories, which might be regarded low tax territories. This unofficial list includes the following territories:

- Andorra
- Anguilla
- Antigua & Barbuda
- Aruba
- The Bahamas (including Abaco and Eleuthera)
- Bahrain
- Barbados
- Belize
- Bermuda
- Brunei
- The Cayman Islands (including Cayman Brac and Grand Cayman)
- The Channel Islands (including Alderney, Guernsey, Jersey, Sark)
- Chile
- The Cook Islands
- Costa Rica
- Cyprus
- Djibouti
- Dominican Republic
- French Polynesia (including Bora Bora and Tahiti)
- Gibraltar
- Grenada
- Guam
- Guatemala
- Hong Kong
- Isle of Man
- Jamaica
- Kenya
- Kuwait
- Labuan
- Lebanon
- Liberia
- Liechtenstein
- Luxembourg
- Macau

Tax policy of Estonia

- Macedonia
- Madeira
- Maldives
- Malta
- The Marshall Islands (including Kwajalein)
- Mauritius
- Monaco
- Montserrat
- Nauru
- The Netherlands Antilles
- New Caledonia
- Niue
- Oman
- Palau
- Panama
- Puerto Rico
- Qatar
- Saint Christopher and Nevis / Saint Kitts and Nevis
- Saint Helena
- Saint Vincent and The Grenadines
- San Marino
- The Sheyshells
- Singapore
- Switzerland
- Trinidad and Tobago
- Turks and the Caicos Islands
- The United Arab Emirates (including Dubai)
- Uruguay
- Vanuatu
- Venezuela
- Vietnam
- The Virgin Islands UK (including Tortola)
- The Virgin Islands US (including Saint Croix)
- Western Samoa

1.4.5 Taxation of income of individuals

Individuals are subject to general income tax applied on income derived in the calendar year from:

- employment (monetary payments)
- business (self-employed income);
- property / investment (rental income, interest on deposits and loans, royalties, capital gains on disposal of business, movable and immovable property);
- other sources (alimony and certain pensions, scholarships, grants, awards, lottery prizes, insurance indemnities and payments from pension funds).

Tax rate

Personal income tax is levied with a 26 % flat rate.

Foreign tax credit

A credit method is applied in order to avoid double taxation. Credit may be granted for foreign taxes paid limited to the amount of Estonian tax payable on that income (ordinary credit) on a source-by-source basis. Taxpayer is required to submit a document certifying the payment of income tax. In certain circumstances exemption method is applied: when the taxpayer has received remuneration for working abroad and he/she has stayed in the foreign country for 183 days or more in any consecutive 12 months period and the remuneration has been taxed in this foreign country.

Tax collection

Period of taxation is a calendar year. The income tax return is filed with the tax authorities no later than by 31 March of the following year. Declarations are prepared on a self-assessment basis and may be audited up to three years. Married resident couples may file tax returns jointly. Additional amount of tax due is paid to Tax and Customs Board not later than by 1 July. Additional tax on business income or gains from transfer of property is payable by 1 October.

1.4.5.1 Taxation of dividends

Dividends and other profit distributions paid by Estonian legal person or permanent establishment of a non-resident legal person are not taxed at shareholder level. Income tax is charged on all dividends and other profit distributions received by a resident individual from a foreign legal person in monetary or non-monetary form.^{126 127}

1.4.5.2 Taxation of pensions

In addition to the state pensions funded pensions exist in Estonia.¹²⁸ Income tax is not charged on state pensions and the mandatory funded pensions on a total amount which does not exceed three times the basic exemption deductible from the taxable income.^{129 130}

Mandatory funded pension

If a beneficiary pursuant to an insurance contract for a mandatory funded pension attains the age which, pursuant to the State Pension Insurance Act, entitles the person to an old-age pension, income tax is charged on payments which the person receives pursuant to law and the Funded Pensions Act, with the exception of a voluntary funded pension, to an extent of that part which exceeds three times the rate of basic exemption. Income tax is charged on payments made from a mandatory pension fund to the successor of a unit-holder and on payments made to a beneficiary pursuant to an insurance contract for a mandatory funded pension.

¹²⁶ § 18 (1) of the Income Tax Act.

¹²⁷ Estonia is using ordinary credit method for the prevention of double taxation of income derived from abroad. See section 1.4.6.

¹²⁸ Funded Pensions Act became effective on October 1, 2001. The Act provides the conditions and procedure for the making of contributions to and payments from funded pensions and the bases for the establishment and operation of pension funds. § 3 (1) of the Funded Pensions Act provides for the following types of funded pension: 1) mandatory funded pension; 2) voluntary funded pension.

¹²⁹ § 19 (3) (1) of the Income Tax Act.

¹³⁰ In addition, the basic exemption can be deducted from the taxable part of the total of the pensions. Thus, if the receiver of the pensions has no other income, the exempted amount is EEK 48 000 for a year 2003.

Voluntary funded pension

Payments from voluntary pension funds may be subject to tax at regular or reduced rate (10%) or exempted from taxation. Income tax is not charged on a pension paid to a policyholder pursuant to an insurance contract for a voluntary funded pension which meets the conditions of § 152 of the Funded Pensions Act¹³¹ after the policyholder has attained 55 years of age or after his or her total and permanent incapacity for work has been verified, on the condition that the insurance contract prescribes that corresponding payments shall be made in equal or increasing amounts at least once every three months until the death of the policyholder. In addition, income tax is not charged on insurance benefits paid in the event of death. The reduced rate (10%) is applicable to the following payments made to a policyholder pursuant to an insurance contract for a voluntary funded pension or to a unit-holder of a voluntary pension fund: (1) payments made by the insurer to the policyholder after the policyholder has reached 55 years of age but not before five years have passed since the contract was entered into; (2) payments made by the insurer in the event of the total and permanent incapacity for work of the policyholder; (3) payments made in the case of the liquidation of the insurer.¹³² All other payments made to a policyholder pursuant to an insurance contract for a voluntary funded pension or to a unit-holder of a voluntary pension fund are subject to tax at regular rate (26%).

1.4.5.3 Tax exemptions

Income Tax Act lists other items of income which are exempted from tax. Income tax is not charged on certain kind of income from employment like compensation for official travel, accommodation and other expenses and daily allowances; compensation for service or employment related use of an automobile in the personal ownership; compensation paid in connection with an accident at work or an occupational disease and childbirth allowances paid by an employer to an employee or public servant.¹³³ Income tax is not charged on certain

¹³¹ § 152 of the Funded Pensions Act specifies the following conditions of insurance contract for voluntary funded pension:

1. The policyholder and the insured shall be natural persons.
2. A policyholder is required, pursuant to the contract, to pay insurance premiums pursuant to the procedure prescribed by law and in the contract. The insurer is required to pay a pension pursuant to the procedure provided for in the contract from the due date provided for in the contract.
3. The payment of a pension may commence at the time provided for in the contract (hereafter pensionable age), but not before the policyholder has attained 55 years of age, or, in the event of the total and permanent incapacity for work of the policyholder, as of the verification of such incapacity.
4. A pension shall be paid periodically at least once every three months until the death of the policyholder, unless otherwise prescribed in the contract.
5. A policyholder has the right to terminate a contract at any time until he or she attains pensionable age.
6. An insurer has the right to terminate a contract on the basis provided for in the Insurance Act and on other bases provided by law.
7. The proprietary rights arising from a contract shall not be security for a loan or encumbered in any other way.
8. Upon entry into a contract, the parties thereto may only agree on terms which do not contradict the provisions of the Funded Pensions Act.

¹³² See § 21 (2) and (3) of the Income Tax Act.

¹³³ § 13 (3) lists all items of employment income that are exempted from tax. Income tax is not charged on:

1. compensation for official travel, accommodation and other expenses and daily allowances paid to a public servant, an employee or a member of the management or controlling body of a legal person under the conditions and within the limits established by the Government of

types of gains from transfer of property (i.e. income tax is not charged on property returned in the course of ownership reform and income from the transfer of property in personal use).¹³⁴ Income tax is not charged on sums insured and insurance indemnities not specified in

-
- the Republic, and compensation for expenses arising from appointment to a position located in another area;
 2. compensation for service or employment related use of an automobile in the personal ownership of the taxpayer or leased by the taxpayer on the basis of a finance lease contract, paid to a public servant, employee, or member of the management board or a body substituting for the management board of a legal person, in accordance with the conditions and within the limits established by the Government of the Republic;
 3. payments made to a member of the Parliament;
 4. payments made to the President of the Republic;
 5. payments made to the Prime Minister and ministers;
 6. compensation paid in connection with an accident at work or an occupational disease, in an amount not exceeding one national pension rate per calendar month per person;
 7. the cost of meals given free of charge to members of the crews of ships during voyages and to members of the crews of civil aircraft during flights, which does not exceed EEK 90 per day per person;
 8. childbirth allowances paid by an employer to an employee or public servant, in an amount not exceeding 5/12 of the basic exemption granted to a resident natural person during a tax period;
 9. technical aids which are granted by an employer to an employed person receiving benefits and the value of which does not exceed 50 per cent of the total size of payments subject to social tax made to the employee or public servant during one calendar month;
 10. in-service training and re-training of employees paid for by the employer upon termination of the employment or service relationship due to redundancy;
 11. expenses incurred by an employer for the treatment of damage caused to the health of an employee or public servant as a result of an accident at work or an occupational disease;
 12. certain payments made to diplomats and compensation for the cost of a uniform of the Defence Forces.

¹³⁴ § 15 (4) and (5) list the gains from transfer of property which are not subject to income tax. According to § 15 (4) income tax is not charged on:

1. accepted succession;
2. property returned in the course of ownership reform;
3. expropriation payments and compensation paid upon expropriation;
4. income from the transfer of movable property in personal use;
5. income from the transfer of land returned in the course of ownership reform;
6. income derived by a person holding a public capital bond from the sale of privatisation vouchers issued to him or her on the basis of the public capital bond;
7. income derived by an entitled subject of the agricultural reform from the sale of the employment share issued in his or her name;
8. income derived by a person who is an entitled subject of the ownership reform from the sale of privatisation vouchers issued to him or her on the basis of an unlawfully expropriated property compensation order;
9. income from the exchange of a holding (shares, contributions) in the course of a merger, division or transformation of companies or non-profit co-operatives.
10. § 15 (5) stipulates that gains from the transfer of immovable property, a structure or apartment as a movable property or contributions to a housing association are not subject to income tax if:
11. an essential part of the immovable property or the object of apartment ownership or a right of superficies is a dwelling which was used by the taxpayer as his or her permanent or primary place of residence until transfer, or
12. an essential part of the immovable property or the object of apartment ownership or a right of superficies is a dwelling, and the immovable property has been transferred to the taxpayer's ownership through restitution of unlawfully expropriated property, or

the Income Tax Act as taxable items, the surrender value payable upon termination of a life insurance contract, or insurance indemnities paid in the event of death.

1.4.5.4 Deductions

Basic exemption and increased basic exemption in case of three or more children

The basic exemption specified in the Income Tax Act for a tax period is deductible from the income of a resident individual. The increased basic exemption is deductible from the income of a resident individual in case of three or more children.¹³⁵

Maintenance support

A resident individual has the right to deduct support paid by him or her to a resident individual during a tax period from the income which he or she receives during the tax period if such support is subject to taxation.¹³⁶

Housing loan interest

A resident individual has the right to deduct, from the income which he or she receives during the tax period, interest payments made during a tax period to a resident credit or financial institution or a branch of a non-resident credit institution entered in the Estonian commercial register for a loan or finance lease taken in order to acquire a house or apartment for himself or herself or for his or her spouse, parents or children.¹³⁷

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13. an essential part of the immovable property or the object of apartment ownership or a right of superficies is a dwelling and such dwelling and the land adjacent thereto has been transferred to the taxpayer's ownership through privatisation with the right of pre-emption
 14. and the size of the registered immovable property does not exceed 2 hectares, or
 15. an essential part of the immovable property is a summer cottage or garden house and the size of the registered immovable property does not exceed 0.25 hectares and the immovable property has been in the taxpayer's ownership for more than two years, or the summer cottage or garden house has been in the taxpayer's ownership as a movable property for more than two years prior to registration, or
 16. the structure or apartment as a movable property was used by the taxpayer as his or her permanent or primary place of residence until transfer, or if the structure or apartment as a movable property has been transferred to the taxpayer's ownership through restitution of unlawfully expropriated property or through privatisation with the right of pre-emption, or
 17. the summer cottage or garden house is a structure regarded as a movable property and has been in the taxpayer's ownership for more than two years, or
 18. an apartment in a building belonging to the housing association was used by the taxpayer as his or her permanent or primary place of residence while he or she was a member of the housing association.

¹³⁵ § 23¹ of the Income Tax Act stipulates that (1) one resident parent or guardian of a child or other person maintaining a child, who maintains three or more minor children may deduct increased basic exemption from his or her income in the tax period for each child of up to 17 years of age, starting with the third child; (2) the increased basic exemption is applicable for the third and each subsequent child in so far as the taxable income of the child is lower than the basic exemption for the tax period; (3) the increased basic exemption is applicable as of the year in which the child is born, a guardian is appointed for him or her or the maintenance obligation arises until the year in which the child specified in subsection (1) attains 17 years of age (inclusive).

¹³⁶ § 24 of the Income Tax Act

¹³⁷ § 25 of the Income Tax Act. The same paragraph stipulates that only the loan or finance lease interest payments made upon the acquisition of one house or apartment may be deducted from taxable income at any one time.

Training expenses

A resident individual has the right to deduct expenses which he or she incurs for the training of himself or herself or a dependent of less than 26 years of age, and which are paid on the basis of a written agreement with the resident's educational institution, from the income which the resident individual receives during the tax period.¹³⁸

Gifts, donations and trade union entrance and membership fees

A resident individual has the right to deduct gifts and donations, except services provided as gifts or donations, of which there is documented proof and which are made during a tax period to persons included in the list of non-profit associations and foundations benefiting from income tax incentives, to legal persons founded on the basis of the Churches and Congregations Act or to a state or local government scientific, cultural, sports, educational or social welfare institution, a manager of a protected area, or a university in public law from the income. Furthermore, a resident individual has the right to deduct entrance and membership fees of which there is documented proof and which are paid during a tax period to a trade union entered in the non-profit associations and foundations register from the income which he or she receives during the tax period, in an amount not exceeding 2 per cent of the taxpayer's income of the same tax period, after the deductions mentioned above have been made. The deduction of gifts and donations and admission and membership fees is limited to 5 per cent of the taxpayer's income of the same tax period, after the above-mentioned deductions have been made. Gifts and donations may be made in monetary or non-monetary form. The cost of a non-monetary gift or donation is the market price of the property, and in the case of sale of the property at a preferential price, the cost of the gift or donation is the difference between the market price and selling price of the property.

Contributions to mandatory funded pension

A resident individual has the right to deduct the contributions to a mandatory funded pension from the income.

Contributions to voluntary funded pension

A resident individual has the right to deduct the following from the income:¹³⁹

- a. that part of the insurance premiums paid under an insurance contract for a voluntary funded pension, the purpose of which is to ensure payment of the insured sum as a pension¹⁴⁰;
- b. amounts paid to acquire units of a voluntary pension fund¹⁴¹.

Insurance premiums

A resident individual has the right to deduct from the income the unemployment insurance premiums paid pursuant to the Unemployment Insurance Act.

Restriction on deductions from taxable income

The deductions of housing loan interest, training expenses, gifts, donations and trade union entrance and membership fees are altogether limited to EEK 100 000 per taxpayer during a tax period, and to not more than 50 per cent of the taxpayer's income of the same tax period, after the deductions relating to enterprise have been made.

¹³⁸ § 26 of the Income Tax Act

¹³⁹ Those deductions (mentioned in paragraphs 1) and 2)) are limited to 15 per cent of the taxpayer's income, after the deductions have been made.

¹⁴⁰ § 28 (1) 1) of the Income Tax Act

¹⁴¹ § 28 (1) 2) of the Income Tax Act.

1.4.6 Issues of double taxation

Important issue in corporate taxation is the avoidance of economic double taxation of dividends. The income tax is levied at the moment when dividends are paid.¹⁴² At the shareholder level, the dividends are then subject to income or corporation tax. In order to avoid that the distributed profits are taxed twice, at company level and at shareholder level, most countries provide some form of dividend relief at either corporate or at shareholder level. Different company tax systems provide relief for double taxation in different extent. At one extreme, the corporation is taxed entirely separately from its shareholders (classical system). Under this system all kinds of profits are taxed fully in the hands of the company and its shareholders. At the other extreme dividends are fully exempt from income tax at shareholder level or the shareholders are subject to full credit for the corporate tax paid.

Another form of double taxation occurs in case of group companies. In the cases of groups of companies the profit distributions can be taxed twice: at the level of company distributing the dividends as well as at the level of company receiving the dividends. Double taxation can occur if the profit earned by a company is distributed by its subsidiaries. Taxing the parent company's profits would result in double taxation.

Capital Gains

Capital gains are not taxed separately in Estonia¹⁴³, but are included into profits subject to corporate income tax upon distribution. Thus, the capital gains received by the company are not taxable as an income, but becomes subject to taxation upon distribution.

1.4.6.1 Elimination of domestic double taxation of dividends

1.4.6.1.1 Dividends received by individuals from Estonian companies

Estonia applies exemption method of alleviating the economic double taxation of corporate dividends at shareholder level by exempting dividend payments at shareholder level. Exemption is not extended to non-resident individuals.

Estonian system for elimination of double taxation of distributed profits at shareholder level is similar to that employed in Greece.¹⁴⁴ However, Estonia unlike any EU Member State exempts retained profits from income tax.

1.4.6.1.2 Dividends received by resident individuals from non-resident companies

Dividends received from non-resident companies are not exempted from personal income tax. Income tax is charged on all dividends and other profit distributions received by a resident individual from a foreign legal person in monetary or non-monetary form. § 45 of the Income Tax Act provides for ordinary credit method for the prevention of double taxation of income derived from abroad. The credit is allowed not only for the withholding tax levied

¹⁴² The dividends are paid out of profits which have usually already been liable for corporation tax. In Estonia, however, the income tax is charged only at the moment when profits are distributed.

¹⁴³ The exception is the sale of shares by a non-resident, which is subject to income tax only if the transferred holding is a holding of at least 10 per cent in a company of whose property, according to the balance sheet as of the last day of the preceding financial year, more than 75 per cent is made up of immovables or structures as movables, which are located in Estonia

¹⁴⁴ The system that exempts dividend income from individual income taxation is applied in Greece since 1992. Greece is the only EU Member State that provides full relief at shareholder level in order to eliminate the economic double taxation of company profits. The annual profit is taxed, whether retained or distributed at a rate of 35%. No withholding tax is levied upon distribution. Distributed profits are exempt from income tax in the hands of the individual or corporate shareholder.

abroad but also for the underlying corporation tax (any income tax paid or withheld on income derived from abroad). Double taxation of dividends received by Estonian residents (both natural and legal persons) from non-residents is avoided if the dividends had been subject to taxation in a foreign country that levies tax rate which is lower or equal to that levied in Estonia.

1.4.6.1.3 Dividends received by resident legal persons from Estonian companies

If a resident company or a non-resident's permanent establishment which is registered in Estonia has received dividends from a resident company and the recipient of the dividends owns, at the time of payment of the dividends, at least 20 per cent of the shares or votes of the payer of the dividends, the recipient of the dividends may deduct an amount which equals to 26/74 of the dividends received from the resident company from the income tax payable. The time of the distribution is the moment when the dividend payment is made and the 26/74 credit can also be claimed at that time.

1.4.6.1.4 Dividends received by non-residents

Income tax is charged on dividends and on other profit distributions received by a non-resident individual from an Estonian company. Income tax is also charged on dividends and on other profit distributions received by a non-resident legal person from an Estonian company. However, if, at the moment dividends are announced or paid, a non-resident legal person¹⁴⁵ owns at least 25 per cent of the share capital or votes of the resident company distributing the dividends, such dividends are not subject to income tax. Thus, in case of non-resident companies, double taxation is avoided if a non-resident owns at least 25 per cent of the share capital or votes of the resident company distributing the dividends. Dividends distributed to such legal person, except a legal person located in a low tax rate territory, are not subject to income tax at shareholder level.

1.4.6.1.5 Dividends received by resident legal persons from non-resident companies

If a resident company has received dividends from a non-resident company, the recipient of dividends may deduct the income tax withheld from such dividends abroad from the income tax on distributed profits. If the resident company who has received dividends owns, at the time of payment of the dividends, at least 20 per cent of the shares or votes of the non-resident company which paid the dividends, the recipient of the dividends may deduct also the income tax paid on the share of profit abroad which was the basis for the dividends in addition to the income tax withheld from the dividends from the income tax on distributed profits. The amount of deduction may not exceed 26/74 of the amount of dividends paid by the non-resident.¹⁴⁶

1.4.7 *Neutrality issues*

On efficiency grounds the decisions regarding investment, its financing or its location should in principle not be driven by tax considerations. If tax system favours one type of investment over another or one producer over another it may imply economic inefficiency and, consequently, a lower level of productivity of capital. Therefore, tax systems should ideally be 'neutral' in terms of economic choices and the production cost structure not tax differences should determine the choice among marginal sources of finance (debt, retained earnings or

¹⁴⁵ Except a legal person located in a low tax rate territory (see § 29(8)).

¹⁴⁶ See § 54(5) of the Income Tax Act. The same paragraph adds that the income tax of a foreign state may be deducted only in the amount which it is mandatory to pay pursuant to the law of the state or an international agreement.

new equity capital). If tax burdens on interest, distributed and retained profits differ, taxation affects the way in which investment is financed. For example, interest deductibility favours investments financed by debt over investments financed by equity. Different tax treatment of distributed and retained earnings causes economic distortions.

Classical system of corporate taxation does not distinguish between retained and distributed profits. Distributed profits are taxed twice: at the company level and at the shareholder level. The double taxation of distributed profits (as in case of classical system) raises the required pre-tax rate of return of investment and, thus, discourages distribution of dividends and discriminates in favour of retained profits. Moreover, a classical system discriminates against equity financing in favour of loan financing.

Although Estonia uses also some form of exemption system, the corporate tax system used in Estonia distinguishes between retained and distributed profits by exempting the former from income tax. Furthermore, capital gains are not taxed in Estonia: the capital gains received by the Estonian company are not taxable as an income, but are included into profits which become subject to taxation upon distribution. Thus, Estonian tax system is biased in favour of retained profits. Although the intention of the Income Tax Act is to promote investments, it discriminates against distributed profits, thus causing a bias towards retaining profits. What is more, profits distributed to non-resident individuals or non-resident portfolio investors are taxed at a higher rate than profits distributed to residents (both natural and legal persons), to non-resident legal persons' permanent establishments registered in Estonia or to non-resident legal person whose holding is at least 25 per cent, which distorts allocation of resources and thus implies loss of efficiency.

According to Cnossen (1995)¹⁴⁷, higher burden on distributed profits favours mature companies, which are able to rely on profit retention to finance investments and do not need new equity. Investments by old firms financed through retained earnings tend to yield a lower (before-tax) return than can be obtained elsewhere. If profit distributions are taxed more heavily it discriminates against new companies, which have to rely on issuing new shares. In other words resources are misallocated. In addition, the tax bias in favour of old firms inhibits the entry of new firms.¹⁴⁸

In Estonia, which is emerging economy, it is especially important to encourage the creation of new businesses. Although the first argument about the development of capital markets might be less important in case of a small open economy like Estonia who relies heavily on foreign capital, the other arguments are very relevant in the case of Estonia. The more favourable treatment of retained earnings can cause the retention of profits rather than payout of dividends and, thus, investments are not made into the businesses where the (pre-tax) return is highest.

Additional distortions are caused by the fact that dividends distributed to non-resident individuals and non-resident portfolio investors are subject to double taxation.¹⁴⁹ The profits distributed to them are subject to a corporate income tax of 26/74 and an income withholding tax of 26 percent. Double taxation of profit distributions to non-resident individuals and non-resident portfolio investors raises the required pre-tax rate of return and discourages foreign investment. Furthermore, dividends distributed to resident corporate shareholders holding less than 20% are also subject to double taxation.

¹⁴⁷ See p.11.

¹⁴⁸ Cnossen (1995).

¹⁴⁹ The major reason behind this policy is to stimulate investments into domestic economy and to avoid the possibility that profits will be left untaxed altogether. It has also been argued that this income would be taxed anyway at the investor's home country applying credit method and taxing its residents on the basis of their worldwide income.

Furthermore, the Estonian tax system favours the financing of a company through loan capital rather than equity capital, since interest payments as well as the repayment of loan are, as a general rule, exempt from tax.

In conclusion, comparison of tax rates on dividends and retained profits reveals the under-taxation of retained profits relative to distributed profits. Comparison of tax rates on profits distributed to residents and non-residents reveals the overtaxation of profits distributed to non-resident individuals and non-resident portfolio investors relative to profits distributed to residents, non-resident¹⁵⁰ permanent establishments and non-resident direct investors.¹⁵⁰ In addition, interest is undertaxed because interest payments are in many cases exempt from income taxes or deductible from the corporate income tax base. Furthermore, current income tax system implies different treatment of the corporate sector (legal persons) and non-corporate sector (e.g. self-employed). This implies distortionary effects on the economic choices and, consequently, welfare loss.

1.4.8 *International aspects of corporate taxation*

1.4.8.1 *Avoidance of international double taxation*

In case of cross-border investment the income is taxed either on the basis of the source principle or on the residence principle. Under the source principle, income is taxed in the country where the income arises, irrespective of where the earner of income resides. Under the residence principle, income is taxed in the country where the earner of income resides. In practice, governments use both source-based taxes and residence-based taxes on capital income¹⁵¹, which may give rise to international double taxation.

Profits that result from international investment might be taxed at three different levels.¹⁵² Firstly, taxation will take place at the level of subsidiary which carries out the investment. Secondly, profits may be taxed at the level of the parent company when they are repatriated from the subsidiary.¹⁵³ Thirdly, the personal taxes of the shareholders are levied in the event of profit repatriation from the parent company. In addition, the tax burden at each level depends on how the investment is financed.

Estonia is using a credit method to prevent double taxation of income received from abroad. According to this method all foreign source income is taxed in the country of residence¹⁵⁴, however, a taxpayer may deduct the tax paid on foreign source income from the domestic tax liability.^{155 156} As a result, the country of residence levies the difference between tax levels of

¹⁵⁰ Most EU countries overtax retained profits, both relative to interest and dividend. See Gorter and de Mooij (2001), pp. 21-22

¹⁵¹ For example, Estonia uses the residence principle for taxing Estonian residents and the source principle for taxing non-residents.

¹⁵² See Baker & McKenzie (2001).

¹⁵³ In general, the issues of double taxation of those profits are dealt in bilateral tax treaties between the countries.

¹⁵⁴ § 45(1) of the Income Tax Act.

¹⁵⁵ § 45(1) stipulates that if a resident taxpayer has derived income from abroad during a tax period, income tax paid or withheld on such income abroad is deducted from the income tax to be paid. Income tax is calculated separately for income derived in Estonia and for income derived in each foreign country.

¹⁵⁶ § 45 (6) provides that if more income tax is paid or withheld in a foreign country than prescribed by the law of the country or an international agreement, only the mandatorily payable part of the income tax of the foreign country may be deducted from income tax payable in Estonia.

a residence country and a source country.¹⁵⁷ The credit method is applied asymmetrically: no refund is provided if tax level is higher in a foreign country than in Estonia.¹⁵⁸ This method of avoidance of international double taxation is called an indirect credit method.¹⁵⁹

1.4.8.2 *International neutrality issues*

One important issue of tax policy is the problem of designing a suitably tax-neutral jurisdiction in which to base the company who is operating in international scale. Similar investments should not face markedly different effective levels of taxation purely because of their country location. Differences in the tax levels may imply welfare losses because economic activity may not take place in the lowest (pre-tax) cost location by the lowest cost producers. If tax policy favours investment into one location over another, then economic activity may take place at a higher pre-tax cost, which implies welfare losses. Investing in a low tax jurisdiction may yield higher after-tax returns on capital than a similar investment in a high tax jurisdiction despite a lower productivity of the inputs used. The result of locational inefficiency is thus a lower level of productivity of capital, and reduced international competitiveness and growth.

If a company decides to invest in one country rather than another because of lower tax burden it implies absence of capital export neutrality (hereafter CEN). CEN occurs when the tax system is neutral towards the export of capital since the investors face the same effective tax burden on income from similar investments, whether they invest in the domestic economy or abroad. In such situations the tax systems provide no incentives to invest at home rather than abroad, and vice versa (principle of neutrality on the home market).

The countries adhering to the principle of capital export neutrality use the credit method. According to credit method source tax will be credited against the residence-based tax. A State of the resident country determines the effective tax rate by taxing foreign source income of its residents such that all their income is taxed at the same rate. CEN is attained if each company faces the same effective tax rate irrespective of the location of its investment: all companies have to pay the same rate regardless of the place of activities and the level of tax applied to foreign source income. Consequently, they are neither encouraged nor discouraged to invest abroad.¹⁶⁰ CEN is achieved when investors are taxed on world-wide income and receive full credit against domestic tax liabilities for all taxes paid abroad. If CEN is achieved the production cost structure not tax differences will determine the place of economic activity. In Estonia, who uses ordinary credit method, CEN is achieved partially because domestic company faces higher effective tax rate if it is investing into countries with higher tax level than that in force in Estonia.

Capital import neutrality (hereafter CIN) is achieved when there is no competitive advantage between two different companies, regardless of their different residence location or type of investments. The countries adhering to the principle of capital import neutrality use the exemption method. According to the exemption method, a home country provides tax exemption for foreign source income of its residents. Capital import neutrality aims to ensure that all taxpayers within the same jurisdiction are taxed equally, thus, that residents investing abroad bear the same tax burden as their foreign competitors (principle of neutrality on the

¹⁵⁷ §45(2) provides that a taxpayer is required to pay the difference between the foreign income tax and Estonian income tax if the domestic income tax on foreign income calculated in accordance with the Income Tax Act exceeds the amount of income tax paid in the foreign country.

¹⁵⁸ §45(3) of the Income Tax Act.

¹⁵⁹ If a full credit method were applied, home country should also refund the overpaid amount of income tax paid in the foreign country to their residents. At present, however, there is no country that applies full credit method.

¹⁶⁰ Terra and Wattel (1997), p. 102.

foreign market). In effect, there is no competitive advantage between two different companies, regardless of their residence location: economic activity is determined by the costs of the company because in the place of activity each competitor faces equal tax level.

In the context of Estonia's integration to the EU, Member States can raise the questions of neutrality. If Estonian tax system and effective tax level differs from those applied in the EU, the current Member States can put pressure to Estonia to change their policy. One example is Ireland, who has considerably lower statutory level of corporate taxation than other Member States and this issue has been raised often at the EU level.

Not only the differences in effective and statutory tax rates can hamper cross-border economic activities but also the differences in corporate tax systems. The Commission's recent study on company taxation¹⁶¹ has identified loss-compensation in general and the difficulties encountered by businesses with loss offset as a key element in the analysis of tax obstacles to cross-border economic activity in the Internal Market. Furthermore, current corporation tax systems require separate accounting of taxable profits per Member State on arm's length basis. The difficulties in the application of the arm's length principle, for instance, may involve double taxation if the tax authorities in one Member State do not accept the transfer prices used in another Member State.¹⁶²

The Commission concludes in its study¹⁶³ that the potential distortions resulting from the 15 different tax systems within the EU are high. In addition, according to the findings by the Commission's study, the existence within the Internal Market of 15 separate tax jurisdictions is the main cause of remaining tax obstacles to cross-border economic activity. Since, the Commission together with the ECJ is one of the major actors influencing EU tax policy, the corporate tax system of Estonia, which is very different from the systems applied in the other Member States, may become under close scrutiny by EU institutions.

To remove the tax obstacles to cross-border economic activity that have been identified by the Commission's study, it proposes a solution under which companies can operate one consolidated tax base for their EU wide activities.¹⁶⁴ Consolidated profits would be shared by participating Member States on the basis of the weighted share in various economic activities of the corporation (formula apportionment). The Commission proposes that the company tax rates continue to be set by Member States. If this solution would be adopted, Estonia may be able to continue applying its current system of corporate taxation under which retained profits are taxed at a zero rate.

¹⁶¹ Commission (2001c).

¹⁶² Cnossen (2003), p. 225.

¹⁶³ Commission (2001c).

¹⁶⁴ The main general suggestions by the Commission are Common Base Taxation and Home State Taxation. Under Common Base Taxation, two or more Member States would harmonize their rules for computing taxable profits in respect of firms with cross-border operations. Under Home State Taxation, participating Member States would maintain their own profit determination rules, but businesses with cross-border operations would be taxed in the Member State in which their headquarters are located (the principle of mutual recognition). See section 2.4.5 where the Commission's study is discussed in greater detail.

2 Tax co-ordination and harmonization in the EU

2.1 Introduction

The EU does not have a common policy for taxation as it has common policy for trade, competition, and agriculture. Its policy is one of co-ordination and harmonization (or approximation) of national tax policies as much as necessary for the functioning of the internal market. Tax harmonization can be defined as a process of adjusting tax systems of different jurisdictions in order to achieve a common policy objective. Narrowly defined, tax harmonization implies convergence towards a more uniform effective tax burden across EU Member States.¹⁶⁵ It can occur as a result of action at EU level by Member States, the Commission or other EU institutions (as the European Court of Justice, hereafter referred to as the ECJ or as the Court). Harmonization does not mean unification: differences in national laws may persist, if they do not violate EU law. Tax co-ordination is a wider term, which includes any policy action or measures undertaken to achieve an objective shared by a group of countries.¹⁶⁶ The aim of tax co-ordination is to influence the tax practices of the Member States.¹⁶⁷ Tax co-ordination might take the form of tax treaties between Member States, international agreements or legislative acts of the EU.

If identical tax bases, tax rates, and tax systems are achieved among Member States it is called 'full harmonization'.¹⁶⁸ By contrast, 'partial harmonization' describes the situation where something less than identical bases, rates, systems, etc. (such as approximation of the base, minimum or maximum statutory tax rates) are achieved.¹⁶⁹

2.1.1 *Why is tax co-ordination (and tax harmonization) necessary?*

The countries co-ordinate tax policies to achieve higher level of neutrality for investment decisions, which in turn contributes to more efficient allocation of resources. Although the harmonization of tax burdens can also take place as a result of the interplay of market forces, it is often argued that government action in the form of tax policy co-ordination is necessary. By co-ordinating their tax policies states intend to achieve that the resources would be allocated according to their comparative economic advantage not according to the tax differentials. Harmonization of the definition of tax base, which contributes to transparency for economic decision-making, can improve efficiency in resource allocation.¹⁷⁰ Furthermore, it is argued that with a centrally coordinated tax harmonization, rather than one enforced by the competition of tax systems, Europe would not have to give up its social welfare achievements and current levels of redistribution.¹⁷¹

The gradual reduction of market barriers has considerably increased mobility of factors, particularly mobility of capital. Portfolios have become more international, the number of cross border mergers as well as foreign direct investment has increased. As a result of liberalisation, globalisation and integration of the markets, the international spillover effects of national tax policies have increased. Because capital can move more easily from one jurisdiction to another, the differences in tax policies can have important impact on investment

¹⁶⁵ Kopits (1992), p. 3.

¹⁶⁶ Tanzi (1989).

¹⁶⁷ Commission (1992a), p. 19.

¹⁶⁸ Ibid.

¹⁶⁹ Ibid.

¹⁷⁰ Kopits (1992), p. 3.

¹⁷¹ See Sinn (1990), pp. 489-504. See also Chapter 5 for more discussion about tax competition and tax harmonization.

flows. Integration of financial markets intensifies tax competition among tax jurisdictions for internationally mobile capital. Furthermore, the cross-border shopping can result in erosion of tax base of high tax countries and in dead-weight loss caused by travel to another country (e.g. higher transportation costs and loss of time).¹⁷² In the field of corporate taxation, differences in tax laws can cause double taxation or non-taxation of the cross-border income flows. Double taxation occurs when the country of residence imposes a tax on foreign source income which has already been taxed in the country of source. Non-taxation of the cross-border income occurs when the foreign source income is taxed neither in the country of residence nor in the country of source. Tax co-ordination can contribute to the elimination of double taxation or non-taxation. One important form of bilateral tax co-ordination is double taxation agreement between the states. It is argued that co-ordination of the methods of providing relief for double taxation of the income from cross-border investments decreases the tax barriers for cross-border investments and thus contributes to efficient allocation of resources and economic growth.

According to the report by the Commission (1992a),¹⁷³ any narrowing of the differences in tax base and statutory tax rates between Member States would reduce the potential for tax arbitrage activities.¹⁷⁴ H.W. Sinn argues that in order to limit cross border purchases it is necessary to harmonise the tax rates¹⁷⁵ in a sufficiently narrow band, which will make gains from tax arbitrage lower than transportation and transaction costs of cross border shopping.¹⁷⁶

In addition to efficiency considerations, Member States co-ordinate tax policies to tackle tax avoidance and fraud. In order to efficiently tax cross-border income, the co-operation between tax administrations of the Member States is necessary, namely an exchange of information as well as mutual assistance in tax collection. The development of new technological possibilities – and in particular the growth of the Internet as a medium for international commerce – is rapidly changing business environment. The use of e-commerce makes it increasingly difficult to identify the economic operators and the taxable transactions. This erodes the tax base of countries and makes cooperation between governments more necessary.

Furthermore, Member States are concerned of the diminution of their tax base through competition from other tax jurisdictions. According to the OECD report of 9 April 1998¹⁷⁷, tax competition has the potential to cause harm by distorting financial and real investment flows, thereby undermining the integrity and fairness of tax structures, discouraging compliance by all taxpayers, reshaping the desired level and mix of taxes and public spending, causing undesired shifts of tax burden to less mobile tax bases, and increasing administrative costs and compliance burdens on tax authorities and taxpayers.¹⁷⁸

¹⁷² Although, according to Cnossen (2001) cross-border shopping of goods is not significant phenomenon in terms of overall impact on manufacturing location decisions and revenue, the cross-border shopping of services and 'virtual goods' (i.e. software, music and TV) through the Internet may become a more important problem (see also section 2.3.5.2 where the problems concerning the taxation of e-commerce business are discussed in greater detail).

¹⁷³ Hereafter this report is referred to as Ruding Report.

¹⁷⁴ Commission (1992a), p. 40.

¹⁷⁵ This applies not only to consumption taxes but also to income taxes because the latter taxes are also included in the prices of goods and services in the hidden form.

¹⁷⁶ Sinn (1990), pp. 489-504.

¹⁷⁷ See OECD (1998).

¹⁷⁸ See OECD (1998), paragraph 30.

2.1.2 Tax harmonization in the EU

Although Member States are in principle free to determine their own national tax systems, this freedom is subject to the overriding goals of the Treaty establishing the European Community (hereafter the EC Treaty).¹⁷⁹ The founding treaties of the European Union lay out the objective to create a single internal market. For that purpose Member States aim step by step to abolish the barriers to free movement of goods, persons, services and capital. Discriminatory taxes can create obstacles to the establishment of a single market and the EC Treaty stipulates that discriminatory taxes should be abolished.¹⁸⁰

Not only discriminatory tax provisions can impose restrictions on free movement in the Internal Market, but also non-discriminatory provisions, if they lead to disadvantageous treatment of people, goods or investments from other Member States.¹⁸¹ Sometimes restrictions on free movement can arise from differences in national tax systems or from the absence of harmonization of tax laws of the Member States.¹⁸² Therefore, some harmonization of tax rules is necessary. Tax harmonization can be achieved either spontaneously (through market forces), through positive action at the EU level (implementation of common policies, coordination of policies, approximation of legislation, etc.) or through negative action by the ECJ, namely, through prohibitions of certain types of conduct of the Member States that are in breach of the EU rules.

The problem is that national tax systems of the Member States have not been designed in the first place to comply with the principle of non-discrimination of non-residents. When most

¹⁷⁹ Vanistendael (2001).

¹⁸⁰ Article 90 of the Treaty states that no Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products. The same article also states that no Member State shall impose on the products of other Member States any internal taxation of such a nature as to afford indirect protection to other products.

¹⁸¹ For example, tax provisions can impose restrictions on the free movement, not because they discriminate against foreigners entering the country to establish themselves or work in this country, but because they discourage nationals from establishing themselves or working in other EU countries. The ECJ has stipulated in its case law that EC Treaty prohibits not only direct discrimination but also indirect discrimination as well as non-discriminatory restrictive measures that are disproportionate. The ECJ has interpreted the four economic freedoms of the EC Treaty as forbidding the enactment of national legislative provisions that impede or render unattractive the exercise of any such freedoms, even if such rules apply without regard to nationality. Not only is (unjustified) unequal treatment of products, capital and economic agents operating under the same conditions (discrimination) prohibited, but also (unjustified) distinction based on criteria other than nationality of persons or origin of goods as well as restrictive measure without distinction (restriction). In Case C-152/73 (*Sotgiu*), the ECJ held that any national measure that is capable of restricting free movement, regardless of whether or not applied in a discriminatory way, is prohibited by the Treaty, unless it serves an overriding public interest objective. This reasoning was developed by the ECJ in cases like Case C-8/74 (*Dassonville*) and Case C-120/78 (*Cassis de Dijon*). It follows from the case law by the ECJ in tax issues that EU concept of discrimination goes beyond the international tax law concept of discrimination. International tax law prohibits only direct discrimination, whereas European tax law concept also prohibits indirect discrimination as well as non-discriminatory restrictive measures that are disproportionate. See also section 4.1.2 for more elaborate discussion of this issue.

¹⁸² For example, in the case of cross-border investments income is often taxed both in the country of subsidiary as well as in the country of the parent company. Resulting double taxation may pose barriers to free movement in the Internal Market. In addition, separate accounting of taxable profits on arm's length basis may involve double taxation if the transfer prices used in one state are not accepted by another state. Another impediment to free movement is the restricted possibility of the taking into account of incurred cross-border losses of a foreign branch or a subsidiary or a permanent establishment.

of the national tax systems were put into place, the principles applied to taxation by the ECJ were not established yet.¹⁸³ The case law of the ECJ has direct impact on the tax systems of the Member States by prohibiting certain national tax rules. It also has indirect impact on the tax systems because EU countries that have similar tax rules as those prohibited by ECJ decisions have to change these rules. ECJ rulings also have certain anticipatory effects because Member States have to make necessary adjustments to their tax policies to accommodate expected trends in the case law of the ECJ. Member States realise that it is better to include EU law aspects in tax legislation from the beginning instead of the necessary corrections having to be made later.¹⁸⁴

Two types of taxes can be distinguished: direct and indirect taxes. Indirect taxes are imposed on goods or services, e.g. consumption taxes like VAT and excise duties. Direct taxes, such as personal income tax, corporate income tax, wealth tax, profit tax, and capital gains tax are imposed on individuals or corporations.

The Treaty of Rome mentions the need to harmonise the legislation concerning turnover taxes, excise duties and other forms of indirect taxation. However, the EC Treaty does not provide any specific requirement for direct taxes to be harmonised in the same way as indirect taxes. Policies of direct taxation have to be approximated only so far as they directly affect the establishment or functioning of the common market. The necessity for harmonization and co-ordination of direct tax measures lies in the idea that the differences in national tax systems can create barriers to the free movement of persons, goods, capital and services and, consequently, cause distortions in the functioning of the internal market.

Most important taxes in the context of EU integration are the customs duties, the VAT, excise taxes, capital duties, and corporate taxes. Fiscal harmonization began in the field of indirect taxes. Discriminatory customs duties and other taxes imposed on goods and services are considered the most important impediments to the free movement of goods and services in the Single market. To date, the major steps toward harmonization have been achieved in the field of indirect taxation, most importantly, the abolition of customs duties, the introduction of the Community Customs Code and common VAT system as well as the harmonization of the most important excise duties. The harmonization of indirect taxes has been far more advanced than the harmonization of direct taxes so that the room for further harmonization in the former area is much smaller than in the field of direct taxation.

EC Treaty provides that the European Community is based upon a customs union.¹⁸⁵ The provisions of the Customs Union apply to products originating in Member States and to products coming from third countries which are in free circulation in Member States.¹⁸⁶ The Customs Union entails the total prohibition of customs duties on imports and exports and charges having equivalent effect between Member States¹⁸⁷ as well as the adoption of the Common Customs Tariff at the outside borders of the Community.¹⁸⁸

¹⁸³ See Vanistendael (1998a), p. 332. This also applies for new Member States because their national tax systems have also not been designed to comply with EU law.

¹⁸⁴ See Hendricks (2000), p. 413.

¹⁸⁵ Article 23 of the EC Treaty stipulates that the Community ‘... shall be based upon a customs union which shall cover all trade in goods and which shall involve the prohibition between Member States of customs duties on imports and exports and of all charges having equivalent effect, and the adoption of a common customs tariff in their relations with third countries.’

¹⁸⁶ See Article 23 of the EC Treaty.

¹⁸⁷ Article 25 of the EC Treaty. The same article stipulates that this prohibition shall also apply to customs duties of a fiscal nature.

¹⁸⁸ See Articles 26-27 of the EC Treaty.

Member States introduced a common system of VAT as a replacement of national turnover tax systems in 1967.¹⁸⁹ In 1972, a draft framework directive on excise duties and indirect taxes other than VAT levied directly or indirectly on the consumption of products¹⁹⁰ envisaged the progressive harmonization of excise duties and taxes on goods. With effect from the beginning of 1974 Member States were to apply a harmonized system of excise duties to mineral oils, manufactured tobacco, alcohol, beer, and wine. All other duties and taxes on goods other than turnover tax were to be discontinued, with the exception of those which did not require border controls or tax adjustments. Any proposed changes in the rates of existing duties were to be subject to a consultation procedure. Following the Commission's White Paper on the Internal Market¹⁹¹, which focuses on the measures that are directly necessary to achieve a single market by 1992,¹⁹² the Commission put forward a proposal for a framework directive on excise duties and proposals on structure of duty on the main dutiable products in 1990. The proposal was adopted and eight directives implemented in the field of excises: so-called 'horizontal directive'¹⁹³, three directives on the harmonization of the structures of excise duties, namely on mineral oils¹⁹⁴, alcohol and alcoholic beverages¹⁹⁵, and manufactured tobacco¹⁹⁶ and four directives on the approximation of rates of duties applicable to the excises on mineral oils¹⁹⁷, alcohol and alcoholic beverages¹⁹⁸, cigarettes¹⁹⁹, and manufactured tobacco other than cigarettes²⁰⁰.

¹⁸⁹ See section 2.3 and Chapter 3 for more elaborate discussion on the harmonization in the field of the VAT.

¹⁹⁰ OJ 1972, C43/23; Bull. Supp. 3-72, 6.

¹⁹¹ Commission (1985).

¹⁹² The Commission noted in its White Paper with regard to the removal of tax barriers that the harmonisation of indirect taxes is an essential part of achieving a true single market. The White Paper demonstrated that in order to abolish fiscal frontiers there must be a considerable measure of approximation of indirect taxes. The Commission expressed the view that it must be considered whether it would be practically possible, in the absence of border controls, for Member States to charge significantly different levels of indirect taxation.

¹⁹³ Council Directive 92/12/EEC of 25 February 1992 on the general arrangements for products subject to excise duty and on the holding, movement and monitoring of such products, OJ L 76, 23.3.1992, p. 1. The horizontal directive prescribes that products subject to excise duty moving under duty-suspension arrangements between the territories of the Member States must be accompanied by a document drawn up by the consignor.

¹⁹⁴ Council Directive 92/81/EEC of 19 October 1992 on the harmonization of the structures of excise duties on mineral oils, OJ L 316, 31.10.1992, p. 12. This directive provides for a common definition of (thirty types of) mineral oil.

¹⁹⁵ Council Directive 92/83/EEC of 19 October 1992 on the harmonization of the structures of excise duties on alcohol and alcoholic beverages, OJ L 316, 31/10/1992, pp. 21 – 27. The directive is built on the distinctions made between beer, wine, fermented beverages other than wine and beer, intermediate products and ethyl alcohol.

¹⁹⁶ Council Directive 72/464/EEC (OJ L 303 of 31 December 1972, p. 3, as amended) laid down general provisions concerning excise duties on manufactured tobacco, and special provisions concerning the structure of excise duties applicable to cigarettes. Council Directive 79/32/EEC (OJ L 10 of 16 January 1979, as amended) laid down the definitions of the various groups of manufactured tobacco. Council Directive 92/78/EEC amended these directives (Council Directive 92/78/EEC of 19 October 1992 amending Directives 72/464/EEC and 79/32/EEC on taxes other than turnover taxes which are levied on the consumption of manufactured tobacco, OJ L 316, 31/10/1992, pp. 5 – 7). The directive was replaced in 1995 by Directive 95/59/EC, which codifies the various directives (Council Directive 95/59/EC of 27 November 1995 on taxes other than turnover taxes which affect the consumption of manufactured tobacco, OJ L 291, 6.12.1995, p. 40).

¹⁹⁷ Council Directive 92/82/EEC of 19 October 1992 on the approximation of the rates of excise duties on mineral oils, OJ L 316, 31/10/1992, pp. 19 – 20.

¹⁹⁸ Council Directive 92/84/EEC of 19 October 1992 on the approximation of the rates of excise duty on alcohol and alcoholic beverages, OJ L 316, 31/10/1992, pp. 29 – 31.

In 1969, Council Directive 69/335/EEC²⁰¹ concerning indirect taxes on the raising of capital was adopted.²⁰² The preamble of the directive provides that the indirect taxes on the raising of capital, in force in Member States in 1969, namely the duty chargeable on contribution of capital to companies and firms and the stamp duty on securities, gave rise to discrimination, double taxation and disparities which interfered with the free movement of capital. Therefore, the Council decided that in order to create a common market whose characteristics were similar to those of a domestic market, it was necessary that duty on the raising of capital within the common market by a company or firm should be charged only once and at a uniform rate. The Directive 69/335/EEC sets out to harmonize structures and rate of duty. As regards the stamp duty on securities, the Directive provides that they should be abolished altogether, regardless of the origin of such securities, and regardless of whether they represented a company's own capital or its loan capital. Furthermore, the Directive states that other indirect taxes with the same characteristics as the capital duty or the stamp duty on securities should be abolished.²⁰³ Article 4 of the Directive provides that certain transactions must be and others may be subject to capital duty.²⁰⁴ Moreover, according to the Directive

¹⁹⁹ Council Directive 92/79/EEC of 19 October 1992 on the approximation of taxes on cigarettes, OJ L 316, 31.10.1992, p. 8.

²⁰⁰ Council Directive 92/80/EEC of 19 October 1992 on the approximation of taxes on manufactured tobacco other than cigarettes, OJ L 316, 31.10.1992, p. 10.

²⁰¹ Council Directive 69/335/EEC of 17 July 1969 concerning indirect taxes on the raising of capital (OJ L 249, 3.10.1969, p. 25)

²⁰² Although the Directive 69/335/EEC is classified as legislation on indirect taxation, the Directive is, by virtue of its aims, more closely related to the harmonization of direct taxes. See Farmer, P. (1999), 'An outline of the case law of the European Court of Justice on the capital duty legislation', *EC Tax Review*, Vol. 1, p. 198.

²⁰³ Farmer (1999) points out that the Directive 69/335/EEC retains considerable importance mainly because of this abolition in so far as it precludes the imposition of other taxes within its harmonized domain. Farmer, P. (1999), 'An outline of the case law of the European Court of Justice on the capital duty legislation', *EC Tax Review*, Vol. 1, p. 199.

²⁰⁴ Transactions compulsorily subject to capital duty under Article 4(1) include the following:

- a. the formation of a capital company;
- b. the conversion into a capital company of a company, firm, association or legal person which is not a capital company;
- c. an increase in the capital of a capital company by contribution of assets of any kind;
- d. an increase in the assets of a capital company by contribution of assets of any kind, in consideration, not of shares in the capital or assets of the company, but of rights of the same kind as those of members, such as voting rights, a share in the profits or a share in the surplus upon liquidation;
- e. the transfer from a third country to a Member State of the effective centre of management of a company, firm, association or legal person, whose registered office is in a third country and which is considered in that Member State, for the purposes of charging capital duty, as a capital company;
- f. the transfer from a third country to a Member State of the registered office of a company, firm, association or legal person, whose effective centre of management is in a third country and which is considered in that Member State, for the purposes of charging capital duty, as a capital company;
- g. the transfer from a Member State to another Member State of the effective centre of management of a company, firm, association or legal person which is considered in the latter Member State, for the purposes of charging capital duty, as a capital company, but is not so considered in the other Member State;
- h. the transfer from a Member State to another Member State of the registered office of a company, firm, association or legal person, whose effective centre of management is in a third country and which is considered in the latter Member State, for the purposes of charging capital duty, as a capital company, but is not so considered in the other Member State.

85/303/EEC²⁰⁵ Member States are free to exempt the contributions of capital altogether since 1 January 1985. The view expressed in preamble of this directive is that capital duty has a negative impact on the regrouping and development of undertakings and that the best solution would be to abolish capital duty. However, since it was conceived that the loss of revenue which would result from such a measure were unacceptable for certain Member States, Article 7(2) provides that Member States may either exempt from capital duty all transactions other than those referred to in Article 7(1) or charge duty on them at a single rate not exceeding 1 %. Pursuant to Article 7(1) Member States must exempt from capital duty transactions that were, as of 1 July 1984, exempted or taxed at a rate of 0,50 % or less.²⁰⁶

Harmonization in the field of direct taxes has not been considerable. The influence of the EC law to the direct tax legislation of the Member States comes mainly through the negative constraints imposed by the ECJ, namely through the prohibitions of tax restrictions against residents and income from other Member States.

Personal income taxes are practically not harmonised at EU level. The Commission has adopted two recommendations: one on the taxation of certain items of income received by non-residents in a Member State other than that in which they are resident²⁰⁷ and the other concerning the taxation of small and medium-sized enterprises²⁰⁸. In the area of social security contributions, a regulation concerning the application of social security systems to migrant workers was adopted in 1971.²⁰⁹ In 2003, the Council adopted the Savings Directive.²¹⁰ Moreover, some provisions of the EC Treaty, most importantly these, which concern the free movement of persons and services, impose constraints on the policies of personal income taxation of the Member States.

The decisions of the ECJ have provided the most important basis for integration of the income tax systems of the Member States. ECJ judgements in several cases have been aimed at making the four freedoms of the Internal Market (the free movement of persons, goods and capital, and the freedom to provide services) prevail over obstacles raised by national income tax systems.²¹¹ In its case law the ECJ has challenged the application of some well-established rules of international taxation. The challenges have taken place mainly on the

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- i. Under Article 4(2) Member States have the option of subjecting the following transactions, to the extent that they were taxed at the rate of 1 % as at 1 July 1984, to capital duty:
 - j. an increase in the capital of a capital company by capitalisation of profits or of permanent or temporary reserves;
 - k. an increase in the assets of a capital company through the provision of services by a member which do not entail an increase in the company's capital, but which do result in variation in the rights in the company or which may increase the value of the company's shares;
 - l. a loan taken up by a capital company, if the creditor is entitled to a share in the profits of the company;
 - m. a loan taken up by a capital company with a member or a member's spouse or child, or a loan taken up with a third party, if it is guaranteed by a member, on condition that such loans have the same function as an increase in the company's capital.

²⁰⁵ Council Directive 85/303/EEC of 10 June 1985 amending Directive 69/335/EEC concerning indirect taxes on the raising of capital, OJ L 156, 15/06/198, pp. 23 – 24.

²⁰⁶ The exemption is subject to the conditions which were applicable, on that date, for the grant of the exemption or, as the case may be, for imposition at a rate of 0,50 % or less.

²⁰⁷ Commission Recommendation 94/79/EC of 21 December 1993 on the taxation of certain items of income received by non-residents in a Member State other than that in which they are resident, OJ L 039 10.02.1994 p. 22.

²⁰⁸ Commission Recommendation 94/390/EC of 25 May 1994 concerning the taxation of small and medium-sized enterprises, OJ L 177 of 9 July 1994, p. 1.

²⁰⁹ Council Regulation No. 1408/1971; OJ L 149 of 5 July 1971, p. 6.

²¹⁰ Council Directive on taxation of savings income in the form of interest payments, OJ L 157 26.6.2003, p. 38.

²¹¹ See section 4.1.

question in which way a national tax system is allowed to treat differently resident and non-resident taxpayers inside the EU.²¹² EC Treaty stipulates the principle that tax provisions are not allowed to constitute a real barrier to the free movement in the Internal Market. Although distinguishing between resident and non-resident taxpayers is not allowed, the ECJ has accepted some justifications for differential treatment of residents.²¹³

Fiscal sovereignty versus co-ordination

Tax policy has been an area what Member States want to set to a large extent by themselves to preserve their national sovereignty. Sovereignty in fiscal matters is related to the principle of subsidiarity introduced by the Treaty of Maastricht, which implies that the legislation at EU level should be implemented only if such legislation cannot be enforced satisfactorily at Member State level. The EU Treaty suggests that policies should be implemented at EU level only if it is strictly necessary.²¹⁴ A purely national approach is not always the best solution to handle cross-border problems such as environmental pollution or international spill-over effects of national tax policies. In addition, co-ordination is necessary in the fields of an exchange of information and mutual assistance in the collection of taxes in order to tackle tax avoidance and tax fraud. Furthermore, Vanistendael points out that the fiscal sovereignty of the Member States in tax matters, allowing Member States to determine freely the rules of their national tax system without having regard to what happens in the other Member States or in the Internal Market as a whole is incompatible with the Economic and Monetary Union and the Internal Market.²¹⁵ Some authors have pointed at the contradictory goals implied by EC Treaty to accomplish the Internal Market without borders and Member States' will to maximise their tax position.²¹⁶ Member States have been often blocking the tax harmonization measures proposed by the Commission because they found them running against their national interests. The ECJ, on the other hand, has played a significant role in the area of the four freedoms in the EC Treaty by its important tax decisions ruling against the national measures of the Member States, which restrict the free movement within the Internal Market. At the moment, two trends can be distinguished in the area of EU tax policy. On the one hand, Member States want to hold on to their sovereignty to set their own tax policy. On the other hand, there is a growing tendency towards co-operation in the field of taxation. Member States recognise that after the completion of the EMU, it becomes increasingly important to remove remaining barriers between the various states to safeguard the maximum effect of the Internal Market.²¹⁷ Several Member States have expressed the view that the Internal Market can only be used to its greatest advantage by bringing the tax systems of the Member States in line with each other and more tax co-ordination is necessary in the field of taxation.²¹⁸ The EMU can be important impulse for further co-ordination of policies (see section 2.5.). Stable tax revenues are a prerequisite for the EMU, therefore, Member States are especially concerned about their national tax positions and are interested to ensure stability of

²¹² See Vanistendael (1998).

²¹³ See section 4.1.3.

²¹⁴ Article 5 of the EC Treaty stipulates that 'The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein. In areas which do not fall within its exclusive competence, the Community shall take action, in accordance with the principle of subsidiarity, only if and insofar as the objectives of the proposed action cannot be sufficiently achieved by Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community. Any action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty.'

²¹⁵ Vanistendael (2001).

²¹⁶ For example, see Vermeend (1998), pp. 151 - 159.

²¹⁷ Ibid, p. 152.

²¹⁸ See Monti (1998), p. 152.

their tax revenues.²¹⁹ In this context, the discussion about harmful tax competition has intensified lately and political agreement (the Code of Conduct) has been adopted by Member States (see section 2.4.3.).

2.2 Legal basis of tax harmonization

The founding treaties are the most important basis for any harmonization at EU level. Any action at EU level has to have legal basis in the treaties. Any secondary legislation has to be based upon some particular Treaty Article.²²⁰ The fundamental tax rules are to be found in Articles 90-92. Fiscal measures may be harmonised either under Article 93 (indirect taxes) or under Article 94 (indirect and direct taxes).

The EC Treaty transfers the far-reaching powers regarding legislation and the administration of justice to EC institutions. The structure of an independent legal order has been created by the important decisions of the ECJ such as *Van Gend en Loos*²²¹ and *Costa-Enel*.²²² In addition to the doctrines of supremacy of Community law over national law established by the ECJ, the other important principles, most importantly concerning the four freedoms of the Internal Market, have been worked out by the ECJ in its judgements.

The founding treaties of the EU impose important constraints upon the autonomy of the Member States to design and implement their tax laws and policies. Member States' freedom is restricted by the tax provisions, and also by other EC rules, especially the four freedoms (free movement of goods, services, persons and capital as expressed in Articles 23-25, 39, 43, 48, 49, 50 and 57 of the EC Treaty) as well as the rules on competition (Articles 81-89 of the EC Treaty) and state monopolies (Article 31 of the EC Treaty). Especially the free movement of workers (Articles 39-42 of the EC Treaty) and the right of establishment (Articles 43-48 of the EC Treaty) have had an important negative integrative effect on national direct tax systems.²²³ Member States have to eliminate or change their tax provisions, which are protectionist or discriminatory. The ECJ has ruled that not only the discriminatory national tax provisions are prohibited, but also non-discriminatory provisions, which restrict the free movement in the Single Market.

*State aid provisions*²²⁴

The tax provisions have also to be in compliance with competition provisions of the EC Treaty, namely Articles 87-89. The EC Treaty prohibits State aid to undertakings (Articles 87-88), including fiscal support measures unless they qualify for one of the derogations from the general principle of incompatibility laid down in Article 87(1). Specific national tax measures possibly constituting state aid have to be notified to the Commission prior their implementation. If the Commission prohibits the fiscal support measure but the Member State does not abide or if it has implemented a measure without prior notification, the Commission may take that State to the ECJ.

The ECJ has developed case law concerning the application of Articles 87-89 on tax matters. The ECJ has focused on the question of whether a tax measure is restricting free movement within the internal market and whether it might be justified with reference to one of the grounds included in Article 87(2) and (3).²²⁵

²¹⁹ See section 2.5 where EMU issues are discussed in greater detail.

²²⁰ Craig and de Bu'rcia (1998).

²²¹ Case 26/62.

²²² Case 6/64.

²²³ Terra and Wattel (1997), p.19.

²²⁴ See also section 2.4.4.2 where issues of fiscal state aid are discussed in greater detail.

²²⁵ If a tax measure constitutes aid that is caught by Article 87(1), it can nevertheless qualify for one of the derogations from the principle of incompatibility with the common market provided for in Arti-

In its Notice on State aid²²⁶ the Commission stated that the main criterion in applying Article 87(1) to a tax measure is that the measure provides in favour of certain undertakings in the Member State an exception to the application of the tax system. The common system applicable should thus first be determined. It must then be examined whether the exception to the system or differentiations within that system are justified by the general scheme of the tax system, that is to say, whether they derive directly from the basic or guiding principles of the tax system in the Member State concerned. If this is not the case, then State aid is involved. The Commission's Notice on State aid and its implementation are discussed in further detail in section 2.4.4.3.

In principle, all special regimes providing specific tax preferences not available under the normal tax system are prohibited because they distort competition. In a judgement delivered in 1974²²⁷, the ECJ held that any measure intended partially or wholly to exempt firms in a particular sector from the charges arising from the normal application of the general tax system without there being any justification for this exemption on the basis of the nature or general scheme of this system constitutes State aid. The judgement also points out that the fact that the fiscal measure brings charges in the relevant sector more into line with those of its competitors in other Member States does not alter the fact that it is aid.

State aid is afoot if the tax measure concerns only certain situations or taxpayers who are subject to this specific tax.²²⁸ An advantageous tax provision is considered State aid if it is limited to certain geographical regions, or to certain sectors of economic activity. Even very broadly defined sectors may be caught by the State aid prohibition: the Commission decided that a 10 per cent tax rate (at variance with the general tax rate of 32 per cent) for the whole of the Irish manufacturing sector constitutes State aid because it excludes traders and services and favours export-oriented undertakings.²²⁹

Pursuant to Article 88(3), specific measures that are regionally and temporarily limited have to be notified to the Commission prior their implementation. Member States may not put their proposed aid measures into effect until the Commission has approved them. The Commission examines the compatibility of aid not in terms of the form which it may take, but in terms of its effect. The judgement by the ECJ delivered in 1974²³⁰ states that Article 87 does not distinguish between the measures of State intervention concerned by reference to their causes or aims but defines them in relation to their effects.

The Commission may decide that the Member State must amend or abolish aid which the Commission finds to be incompatible with the common market. Where aid has already been implemented in breach of these rules, the Member State must in principle recover, from the

cle 87(2) and (3). The EC Treaty qualifies as aid measures which are intended to promote the economic development of a region. Article 87(3)(a) and (c) explicitly provides, in the case of this type of aid, for possible derogations from the general principle of incompatibility. Furthermore, where the recipient, whether a private or public undertaking, has been entrusted by the State with the operation of services of general economic interest, the aid may also qualify for application of the provisions of Article 85 of the Treaty.

²²⁶ Commission notice on the application of the State aid rules to measures relating to direct business taxation, 11 November 1998, OJ C384 of 10.12.1998, p.5.

²²⁷ Case C-173/73 (*Italy v Commission*).

²²⁸ See Schön, (1999), 'Taxation and State Aid Law in the European Union', *Common Market Law Review*, p. 925.

²²⁹ See Case E-2/98, 'Proposal for appropriate measures under Article 93(1) (i.e. now Article 88(1)) of the EC Treaty concerning Irish Corporation Tax (ICT)', in OJ C395 of 18 December 1998, p. 19.

²³⁰ Case C-173/73 (*Italy v Commission*).

recipient(s), the aid illegally granted (with interest), irrespective of national time limits or other national legal impediments to recovery.²³¹

Other provisions

However, even if no State Aids are involved, domestic tax provisions can cause a distortion to the functioning of the Single Market. Articles 95 and 96 of the EC Treaty may apply for eliminating such market distortions.

2.3 Developments in the field of value added tax

VAT is a most important revenue earner in the EU. It raises one-fifth of all tax revenues of the Member States, and nearly half of 'own resources' in the common EU budget. Harmonization of indirect taxes is considered necessary to ensure free movement of goods and services. Articles 90-91 of the EC are the most important bases for indirect taxes. They prohibit tax discrimination and protective taxation in relation to movements of goods between Member States. The EC prohibitions contained in articles 90-91 form the legal basis of negative integration by ECJ rulings.

Article 90 deals with discriminatory taxation on foreign products. It forbids a Member State to treat domestic products more favourably than those from the other Member States and only allows taxation that is part of internal tax levied indiscriminately on both domestic and foreign products. Policies applying differential tax rates are allowed so long as they are directed at objectives that are compatible with the Treaty, even if they may place some imported products at a disadvantage.²³² Article 90 aims to promote neutrality of competition between domestic products and products from other Member States within a national market. Article 90 requires no implementation by means of harmonising Directives. Article 90 has been directly effective since 1 January 1962. It has been invoked many times in the ECJ to abolish national measures favouring local products.²³³

Article 93 provides juridical basis for the harmonization of turnover taxes (and other indirect taxes) in the EU. The Treaty specifically provides for such harmonization, because indirect taxes may create an immediate obstacle to the free movement of goods and the free supply of services within an Internal Market. Article 93 gives the Council the power to adopt provisions for the harmonization of legislation concerning turnover taxes, excise duties, and other form of indirect taxation to the extent that such harmonization is necessary to ensure the establishment and the functioning of the internal market. The Council, on the basis of Commission proposals, adopts the harmonization provisions unanimously.

The secondary legislation harmonising the area of indirect taxes consists mostly of directives. The wording of Article 93 includes also the adoption of regulations which are directly applicable in all Member States and effectively legal instruments allowing adoption of a more unified common system. One such regulation (218/92)²³⁴ relates to administrative cooperation in the field of indirect taxation (VAT). However, the European Parliament does not like the choice of regulation as harmonising measure in the field of taxation, because it does

²³¹ The only justifications that the ECJ accepts for not recovering illegally granted aid, are (1) absolute impossibility to recover the aid; (2) if from Community action the recipient may reasonably infer that everything is in order (justified expectations). See also Terra and Wattel (2001), pp. 197-198.

²³² Farmer and Lyal (1994), p. 43.

²³³ For example, Case 112/84 (*Michel Humblot*), Case C-47/88 (*Commission v. Denmark*), Case C-375/95 (*Commission v. Hellenic Republic*), Case 299/86 (*Drexel*), and Case C-276/91 (*Commission v. France*).

²³⁴ Council Regulation (EEC) No 218/92 of 27 January 1992 on administrative cooperation in the field of indirect taxation (VAT), OJ L 024, 01/02/1992, pp. 1 – 5.

not leave much room for national legislators to change its content.²³⁵ However, the directives harmonising the field of indirect taxes are usually so detailed that although implemented by national legislators, they leave only limited possibility to change their scope or add provisions to them.²³⁶ However, the European Commission finds in its report analysing the current VAT system²³⁷ that the directives still leave too much flexibility for Member States, which results in a large degree of divergence in common VAT system (see section 3.5).

Member States are free to apply their own tax laws, which have to be in accordance with the Community directives. The directives harmonising the area of indirect taxation must be consistent with the fundamental principles set out in Articles 90 and 91. In addition, national measures implementing the common European VAT system remain subject to scrutiny under Article 90 of the EC Treaty.²³⁸

These legal bases in the EC tax law (the Treaty provisions and legislative acts harmonising the tax policies of the Member States) impose constraints upon the tax policies of the Member States. Following section will mostly consider the aspects of positive integration through the regulatory measures at EC level.

2.3.1 The VAT Harmonization Policy since 1960s

According to the EC Treaty Member States are required to harmonise their taxes on consumption (Article 93). The VAT is the only important tax, which has been harmonised to a considerable degree. The following section analyses the extent of VAT harmonization starting with the historical overview of the harmonization steps.

Before the introduction of the common VAT system, most of the Member States used different types of the cumulative multistage tax systems.²³⁹ The Report of 1963 by the Fiscal and Financial Committee, chaired by Professor Fritz Neumark from Germany (generally referred to as Neumark Report²⁴⁰) summarised the defects of the cascade turnover tax. It distorts the international trade because it does not allow an exact calculation of the amounts of tax to be refunded and of the amount of the corresponding countervailing duties or refunds when the principle of country of destination is applied. Moreover, tax paid depends on the unknown number of stages in the chain from producer to consumer. The Neumark Report recommended to adopt the VAT which then existed in only one of the Member States, namely in France.

Step-by-step implementation of a VAT system

From the 1960s the EU has step-by-step implemented a common system of VAT. The first step, adoption of the common system of VAT, made it possible to calculate accurately the countervailing taxes to be imposed on imports from other Member States, and the amounts by which taxes should be remitted on exportation. Member States introduced a common system of VAT as a replacement of the national turnover tax systems, with the adoption of First and Second Council Directives 67/227 and 228 of 11 April 1967 on the harmonization of the laws of the Member States relating to turnover taxes.²⁴¹ The First and Second Directives

²³⁵ Hinnekens (1997), p. 31.

²³⁶ Ibid.

²³⁷ See Commission (1996b), p.18.

²³⁸ Farmer and Lyal (1994), p. 37.

²³⁹ France was the first European country to introduce a VAT system in 1954.

²⁴⁰ International Bureau of Fiscal Documentation (1963).

²⁴¹ First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of the Member States concerning turnover taxes, OJ 071, 14/04/1967, pp. 1301 – 1303 and Second Council Directive 67/228/EEC of 11 April 1967 on the harmonisation of legislation of Member States con-

formulated the basic principles by which common systems should abide. The common system of VAT is based on the principle that a consumption tax, which is exactly proportional to the price, is applied to goods and services, whatever the number of transactions in the production and distribution process before the stage at which tax is charged.²⁴²

According to the First and Second Directives, Member States were free to decide on the standard rate of tax and to subject certain goods and services to increased or reduced rates. In addition, subject to consultation, Member States were free to determine their own exemptions. The First and Second Directives permitted Member States such discretion that in practice nine different and separate national systems existed rather than one common system.²⁴³ Major areas treated differently in the various Member States were: agriculture, the retail sector, special types of business (notably building construction, the letting of land or premises, and financial operations), rules on exemptions, deductibility of the tax, and the treatment of services across frontiers.²⁴⁴

The second major step towards harmonised VAT system was made by the adoption of the Sixth VAT Directive 77/388 of 17 May 1977.²⁴⁵ The Sixth Directive was adopted to achieve more harmonised European System of VAT. It defined more precisely what constitutes the territorial application, taxable transactions, place of taxable transactions, taxable persons, chargeable events, taxable amounts, rates and exemptions, deductions and liability for payment of tax, and other important VAT concepts. Greater degree of harmonization of the national tax bases was achieved by this change. One reason for measures to introduce more tax base uniformity was the adoption of the VAT as an 'own resource' in the Community budget.²⁴⁶ It was necessary to achieve a greater degree of harmonization of the tax base in order to ensure that the coverage of the tax was reasonably equivalent in each Member State, since the Community rate of VAT has to be applied to a uniform tax base throughout the EU. In order to achieve common basis of assessment it was deemed to be necessary to harmonise the exemptions within the national systems. The common definition of the place of supply is necessary to determine which country is entitled to impose tax to avoid double taxation or non-taxation.

However, the Sixth Directive only achieved partial harmonization because it leaves the range of options open for Member States.²⁴⁷ In particular, important decisions about application of zero-rates, reduced rates as well as supplementary high rates were left to Member States' discretion.

2.3.2 *The White Paper*

On 29 June 1985, the Commission published a White Paper on the Internal Market²⁴⁸, which focuses on the measures that are directly necessary to achieve a single market by 1992 thereby creating a more favourable environment for stimulating enterprise, competition and

cerning turnover taxes - Structure and procedures for application of the common system of value added tax, OJ P 071, 14/04/1967, pp. 1303 - 1312.

²⁴² International Bureau of Fiscal Documentation (1991).

²⁴³ Terra and Wattel (1997), p.72.

²⁴⁴ International Bureau of Fiscal Documentation (1991), p. 39 and Easson (1993), p. 101.

²⁴⁵ Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonisation of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment, OJ 145 13.06.1977, p.1.

²⁴⁶ The Decision of 21 April 1970 on the replacement of financial contributions from Member States by the Communities' own resources (OJ L 94 28. 4. 1970, p. 19) provides that the budget of the Communities is financed from the Communities' own resources. These resources include those accruing from value added tax and obtained by applying a common rate of tax on a basis of assessment determined in a uniform manner according to Community rules.

²⁴⁷ European Tax Systems (1995), p. I/20.

²⁴⁸ Commission (1985).

trade. The Commission noted that in order to ensure the free movement within the internal market, it is essential that frontier controls are abolished and put forward proposals²⁴⁹ for their abolition in 1987.

With regard to the removal of tax barriers the Commission stipulated that the harmonization of indirect taxes is an essential part of achieving a true single market. The White Paper demonstrated that in order to abolish fiscal frontiers there must be a considerable measure of approximation of indirect taxes. The Commission expressed the view that it must be considered whether it would be practically possible, in the absence of border controls, for Member States to charge significantly different levels of indirect taxation. The Commission saw problems in the widely divergent rates and coverage of VAT, which imposes the system to heavy and systematic fraud and evasion.

The Commission proposed a switch to a system under which goods and services would be taxed in their country of origin. The Commission intended to abolish the current destination-based VAT system and replace it by the definitive system, according to which taxation takes place in the country of origin. It means that all intra-EU sales would be treated as domestic sales at present, however, the tax would be cleared between Member States in order to preserve the country of destination principle. The Commission put forward proposals for such a system in 1987 under the work programme to establish the internal market by January 1993. The key elements of these proposals, which were designed to achieve a genuine internal market by means of taxation in the country of origin, were:

- a harmonised tax structure with two rates of VAT;
- harmonization, within a defined band, of the rates applied by Member States;
- a clearing mechanism for the redistribution of VAT receipts.

The proposal for a new common VAT system was made with the objective of achieving a true Single Market in which intra-Community sales and purchases of goods would be treated in the same way as those taking place within Member States. However, the ECOFIN Council recognised in 1989 that it would be impossible by the time of the abolition of border controls on 1 January 1993, to achieve the harmonization necessary to move onto a new common VAT system and therefore decided to adopt a transitional system which would enable controls at the Community's internal borders to be abolished whilst allowing tax to continue to be collected in the Member State of destination under certain well defined circumstances (transactions between taxable persons and large-scale distance selling to private individuals). At the same time, however, the Council reaffirmed both legally and politically the commitment it had made in April 1967 to introduce a definitive system of taxation where goods and services would be taxed in the Member State of origin by the new target date of 31 December 1996.

The Commission presented the White Paper to the meeting of the European Council in Milan, at which Member States began the negotiations that led to the conclusion of the Single European Act, which among other things expanded the possibility of majority voting on the issues related to the single market. This change did not have any effect on decision-making in tax matters, however. Tax harmonization laws are expressly excluded from the qualified majority procedure.

²⁴⁹ COM (87) 322 final, OJ 1987 C252/2.

2.3.3 *The System after the Abolition of Fiscal Border Controls*

In 1991, important harmonization measures were introduced by Directive 91/680²⁵⁰. These changes were necessitated by the elimination of internal borders and border tax adjustments maintained only at company's level on 1 January 1993. In order to abolish customs' checking at borders within the EU, it was necessary to adjust its VAT system. Member States agreed to tax cross-border trade between registered businesses within the EU on a deferred payment or postponed accounting basis. The VAT on transactions between registered businesses is collected on a reverse charge basis, which is a form of self assessment for a business acquiring services: purchasers of out-of-state goods declare the intra-Community acquisitions, apply VAT and get credit for an equal amount. The control at the borders has been replaced by a VAT information exchange system (VIES), which requires taxable persons to file quarterly reports of out-of-state supplies and acquisitions. Customs' documentation for trade between Member States was no longer required. Tax authorities have to monitor the proper rebate of VAT credits for exports to EU Member States by checking the books of taxable persons. From the beginning of 1993 the terms 'importation' and 'exportation' refer only to trade with non-Member States. For trade within the Internal Market, the terms 'intra-Community acquisition' and 'intra-Community supply' were introduced. The taxable event (intra-EU acquisition) must be reported on the internal VAT return not at the border as before abolition of frontiers. In case of intra-EU acquisitions the customer is entitled to deduct VAT in the same manner as on domestic supplies.

The system currently in force involves taxation in the country of consumption, at the rates and under the conditions applicable in that country. This transitional system has a number of defects, notably because it is complicated, susceptible to fraud and out of date.²⁵¹ The problem of so called 'carousel fraud' is becoming of increasing concern. Tax revenue is lost because the goods that are tax exempt in the Member States are delivered to the territories without VAT control. Moreover, the Commission believes that the complexity of current system encourages operators, disheartened by the cumbersome nature of their obligations and the scale of their costs, not to declare their activities or declare them in the country in which their costs would be lowest.²⁵² For these reasons, the Commission seeks to replace the transitional VAT system by a definitive one, under which the goods would be taxed in the country of origin.

2.3.4 *The Monti Paper*

In 1996, the Commission put forward new proposals. Before doing so, the Commission carried out an evaluation of the operation of the transitional arrangements²⁵³ and polled Member States on their views, concluding that a different approach to that proposed in 1987 under the work programme to establish the Internal Market would have to be taken. The Commission published a policy document²⁵⁴, which proposed a new common system of VAT that is suited to the single market and in which domestic and intra-Community transactions are treated equally. The programme put forward in 1996 differed in two main respects from the 1987 proposals.²⁵⁵ Firstly, the substance of the 1987 proposals was based on the principle that taxation should take place at the place of supply (place where the goods are located

²⁵⁰ Council Directive 91/680/EEC of 16 December 1991 supplementing the common system of value added tax and amending Directive 77/388/EEC with a view to the abolition of fiscal frontiers, OJ L 376, 31/12/1991, pp. 1 – 19.

²⁵¹ See Commission (2001a), p. 11.

²⁵² See Commission (1996b), p. 13.

²⁵³ Commission (1994).

²⁵⁴ Commission (1996b).

²⁵⁵ See Commission (2000a), pp. 3-4.

when they are sold, place of supply of immovable property, etc.) and the clearing mechanism would operate on the basis of declarations by taxable persons. The 1996 programme put forward the idea that taxation should be based on a trader's 'tax domicile' so that there would be one single place of registration with a reallocation mechanism based on official national statistics to ensure that VAT receipts accrue to the Member State where consumption takes place. Secondly, the 1987 proposals were based on the 'big bang' approach, i.e. an immediate switchover to the definitive system, whereas the 1996 programme envisaged a gradual changeover to the definitive system.

The policy document published by the Commission analysed thoroughly the limitations of current system. The Commission expresses the view that the defence of national sovereignty in a system of taxation which ensures a direct allocation of VAT revenues between Member States gradually leads to a real loss of national sovereignty over tax matters; this is because fragmentation of the activities of taxable persons between various Member States prevents administrations from being able to monitor the overall activity of a firm and to ensure that any deductions made are justified. The Commission points out that the transitional system gives Member States the illusion of having retained full national sovereignty in determining their revenues and the overall operation of the VAT system: in reality the system's complexity and subjectivity, the fact that it is ill-suited to new economic challenges and the divergences that exist with regard to its application have a detrimental effect on the competitiveness of businesses without guaranteeing Member States the certainty of being able to receive the revenues to which they are entitled.

The Commission states that the transitional system has succeeded to a degree by removing physical tax frontiers, however, intangible frontiers remain insofar as goods still have to be tracked when they cross internal borders. These remaining barriers are the result of:

- extreme complexity;
- general provisions of the Sixth Directive which are out of date or not adapted to current commercial practices;
- differences in the application of VAT rules among Member States.

The Commission stipulates that the new VAT system will have to satisfy the following criteria:

- it must abandon the segmentation of the single market into 15 tax areas;
- it must be simple and modern so as to rise to the challenges of the 21st century;
- it must guarantee equal treatment of all transactions carried out in the Community;
- it must ensure effective taxation and guarantee proper monitoring, thereby maintaining the level of VAT revenues.

2.3.4.1 Proposed common system of VAT

The Commission proposed a new system which involves a complete overhaul of the existing system of VAT, with major consequences for the Community as a whole and for each Member State individually. The Commission in its Paper sketches the broad outline of the new common system, describing (1) essential characteristics, (2) the key features, and (3) the consequences.

Essential characteristics

(a) Elimination of any distinction between domestic and intra-Community transactions to ensure equality of treatment and neutrality in the single market:

- to ensure that no activity is more difficult to exercise in one Member State than in another;
- any purchase can be made on the same terms throughout the EC;
- transaction involving several Member States should not be allowed to result in more obligations than one carried out within a single Member State.

(b) Taxation of all transactions carried out within the EC:

- the mechanism of fractioned payments should be strengthened to ensure that the tax system is self-checking;
- the clear sharing of responsibilities between the supplier (correct invoicing of the tax due) and the buyer (correct proof of the taxes he deducts);
- consequently, the remission/taxation mechanisms for trade between Member States must be abolished.

The Commission believes that taxation should be based on commercial transactions rather than on physical monitoring of the goods, which cannot always be proven.

Key features

(a) Single place for operators:

- a taxable person is registered in one place only;
- all the transactions of a given operator will have to be taxed at one place for the entire Community, whereby a distinction will no longer be made according to the Member State in which they are carried out;
- the right to deduct must be also exercised strictly and exclusively at the place of taxation.

(b) End of direct allocation of VAT revenues by the tax system:

- the proposed system abandons the direct allocation of VAT revenues by the actual tax system, replacing it with a new reallocation mechanism;
- the reallocation of revenues between Member States cannot be based on data provided in the tax returns of taxable persons because this would reintroduce the monitoring of the physical movement of goods;
- in order to determine the revenues of each Member State in terms of taxed consumption which occurs on its territory, the Commission proposes to quantify consumption by means of statistics on the basis of consumption side of National Accounts, appropriate input-output tables and other information (statistical surveys, annual reports etc.)

Consequences

As a consequence of the proposed common system, very intensive harmonization of tax mechanisms is inevitable, the system needs to be completely modernised and a new approach towards collection, administration and control is necessary.

(a) Harmonization measures

- *Harmonization of rates.* In the system of VAT based on taxation in the country of origin and enabling a taxable person to effect supplies to any destination in the EU, the different VAT rates create distortions of competition. Furthermore, maintaining the possibility of applying too many different rates from one Member State to another would endanger neutrality vis-à-vis the conditions of competition with the risk that business locations would be influenced by the differences in VAT rates. The Commission proposes to address the matter of rates as follows. As far as the *standard rate* is concerned, the Commission services consider that the introduction of a single rate would provide a perfect solution avoiding any tax-related distortion of competition and ensuring that the tax is applied simply and uniformly throughout the EU. Nevertheless, an approximation within a rather narrow band (e.g. 2 – 3 percentage points) might be sufficient. As regards the *reduced rate(s)*, harmonization of their number and scope is necessary from a purely technical standpoint. The Commission remains convinced that only a small number of rates is compatible with the objective of simplifying the tax. On 20 December 1995, the Commission put for-

ward a proposal providing for a minimum standard rate of 15 per cent²⁵⁶ and a maximum rate of 25 per cent²⁵⁷, as the very first step towards the approximation of standard rates.

- *Other harmonization measures.* The Commission believes that harmonization of many other aspects is absolutely necessary. Aspects such as the extent of and conditions for exercising the right to deduct, exemptions, the tax treatment of small firms or other special schemes are mentioned in the Monti Paper. The entire range of options, authorisations and derogations allowed by the existing system also needs to be reviewed.

(b) *Uniform application.* The Commission states that the harmonization of rates and other aspects of the common system will be a definite step forward. It is nevertheless indispensable to ensure that a more unified approach is taken regarding interpretation of the legislation. To that end, the Commission intends shortly to propose that the VAT Committee be turned into a regulatory committee, with the Commission being given powers to take measures implementing acts adopted by the Council. The Commission believes that thought will also have to be given to the strategy to be taken, in terms of the type of legal instrument (a directive or a regulation?) and the decision-making process (unanimity or qualified majority?), for arriving at a common VAT system that is genuinely common and uniformly applied.²⁵⁸

(c) *Modernisation of the existing system.* The Commission believes that a re-examination of the approach taken in the 1970s in a number of fields, e.g. areas excluded from the scope of the tax (activities carried on by public authorities, holding companies, etc.), or transactions exempted because they relate to certain activities carried on in the general interest (public postal services, activities of public broadcasting organisations, etc.) or because of the technical difficulties involved in applying the tax (telecommunications, real estate, financial and insurance services, etc.) (see also section 2.3.5.1). Attempts will also have to be made to achieve a better match between the tax territory and the customs territory of the Community.

(d) *Administration, control and collection in the new system.* The Commission observes that the considerable simplification of the proposed system offers the additional benefit of simplifying administration of the tax since the existing opportunities for evasion will be reduced (the abolition of the VAT-free circulation of goods in intra-Community trade will eliminate the key condition for the fraud within the internal market) and a single VAT supervisory relationship will provide a more complete understanding of each business to the benefit of effective control.

The Commission suggests a 'tax statute' for the taxpayers. The compliant taxpayer should have, at least, the right to expect clarity of his obligations, fair and correct administration of the tax and an avoidance of unnecessary disruption of his economic life. Fulfilling these ba-

²⁵⁶ This proposal for a minimum standard rate was implemented as a directive. Council Directive 2001/4/EC of 19 January 2001 stipulates that the minimum standard rate of VAT, for the period 1 January to 31 December 2005, may not be less than 15 %. See Council Directive 2001/4/EC of 19 January 2001 amending the Sixth Directive (77/355/EEC) on the Common system of value added tax, with regard to the length of time during which the minimum standard rate is to be applied, OJ L 22 of 24 January 2001, p. 17.

²⁵⁷ This proposal for a maximum standard rate was never implemented as a directive (failed three times because of the lack of agreement in the Council).

²⁵⁸ Some commentators have expressed the view that a regulation should be preferred as the type of legal instrument. If the VAT is to be applied within the single market as if transactions were performed within a single Member State, only one directly applicable VAT Code should apply. See Terra and Wattel (1997), p. 94.

sic obligations encourages voluntary compliance, which frees resources to be concentrated on non-compliant traders.

The proposed common system also has two major implications for the administration of the tax: collective responsibility and a greater emphasis on co-operation. Under the current system, each Member State is responsible for the administration, control and collection of the tax. Under the new system this individual responsibility will be replaced by a *collective responsibility*. All Member States will be responsible collectively for the global tax receipts which are due to each of them according to their consumption.

Member States need to be made confident in each other in three ways: powers, tasks and performance. Each Member State needs to be reassured that each other Member State has a sufficient minimum level of national control and collection powers. Each Member State also must be reassured that a sufficient minimum of common control and collection tasks will be carried out. Finally each Member State must be reassured that the quality of performance of these tasks will meet acceptable standards.

Greater emphasis is necessary on administrative co-operation since it will become more central in the operation of the new system. The Commission believes that the new collective responsibility will give a great incentive to this co-operation. Further, the monitoring and evaluation of each Member State's performance must include their performance in co-operation. Nevertheless three further initiatives are needed. Firstly, the existing legal framework for mutual assistance and administrative co-operation requires extensive reform. Secondly, effective control and collection under the new system will require agreed common control methodologies. Thirdly, new tools and methodologies for co-operation will be needed. In developing these tools, the infrastructure and experience of transitional regime, notably the VAT Information Exchange System (VIES) will be important. Finally, a new spirit of co-operation between individuals in national tax administrations, based on a much deeper mutual understanding and confidence, needs to be established. A programme to achieve this, building on past experience, needs to be put in place before the entry into force of the new system.

The Commission proposed a work programme involving a stage-by-stage movement to the definitive system and has made a number of proposals in that context. However, it has become evident in the last few years that, because of the importance of VAT for tax revenues, most Member States are reluctant to agree with proposals designed to lead towards the definitive system. For this system the further harmonization of the tax system and reduction in special arrangements and derogations would be necessary because if a Community trader's entire economic activity is taxed in one single Member State, taxation systems have to be closely harmonised to ensure the uniform application. There also has to be some approximation of tax rates to ensure that the tax has a neutral impact on business competition. In addition, in order to move to the definitive system the re-distribution of tax receipts is necessary. In fact, the introduction of the proposed system requires Member States to embark on a legislative harmonization which is more extensive than has ever before been contemplated in the field of indirect taxation. However, Member States have not reached unanimous agreement on such fundamental changes in VAT system. In particular, unanimity could not be achieved for VAT rate bands and VAT revenue distribution through cross-national VAT crediting and a subsequent clearing mechanism. Consequently, very little progress has been made in the Council on the Commission's proposed 1996 programme. On the other hand, it is accepted that the current transitional arrangements have a number of shortcomings, because they are complicated, susceptible to fraud and out of date. According to the Sixth Directive (Article 281) the transitional arrangements are extended automatically until the Council has decided on the definitive system.

2.3.5 *The Latest Developments in VAT*

2.3.5.1 *The New VAT Strategy*

In June 2000 the Commission established a new VAT legislative strategy²⁵⁹ for the following five years, which concentrated on bringing about an overall improvement in the operation of the common VAT system that would directly benefit EU taxpayers. The Commission stressed that an origin based definitive system remains a long term Community goal. The new strategy proposed by the Commission focuses on simplification, modernisation and a more uniform application of present arrangements, and a closer administrative co-operation. So long as the present system of VAT-based Community own resources is in existence, closer administrative co-operation and the other measures aimed at preventing fraud are expected to help to maximise the VAT base and thereby ensure that this tax plays the full part in providing income that Community budgetary rules intended.

The objective of such measures is to create fresh impetus within the Council to achieve the improvements to the present system as quickly as possible. This is of course only possible if all Member States are prepared to consider changes to their national VAT systems (and, if necessary, to agree to a reduction in the large number of special schemes or options, derogations, etc. which exist at present) which can help bring about an overall improvement in the way the common VAT system operates. If the present transitional arrangements are retained Member States will also have to accept the need for greater emphasis on tighter controls and closer administrative co-operation in order to deal with the problem of fraud highlighted in the Commission's report on administrative co-operation and VAT control.²⁶⁰ The fact that under the transitional VAT system goods can circulate between Member States without VAT being paid inevitably creates risks, particularly of 'carousel fraud', and thus stringent counter-measures are required. Intra-Community trade is valued at EUR 930 billion annually. VAT accounts for 15 to 25% depending on the Member State, i.e. EUR 162.75 billion. According to the Commission's estimates fraud accounts for 5% of this amount, in other words a loss of EUR 8 billion in tax revenue.

The Council has adopted several proposals after the new strategy was announced: concerning the abolition of fiscal representatives²⁶¹ and the minimum level for the VAT standard rate²⁶² and in a political agreement by the Council on the proposal concerning the improvement of mutual assistance on the recovery of claims²⁶³. Existing proposals have been reviewed in line with this new strategy and new proposals have been made. Of particular importance is the first proposal made after the new strategy was announced – the proposal to

²⁵⁹ Commission (2000a).

²⁶⁰ Report from the Commission to the Council and the European Parliament - Third Article 14 report on the application of Council Regulation (EEC) No 218/92 of 27 January 1992 on administrative cooperation in the field of indirect taxation (VAT) and Fourth report under Article 12 of Regulation (EEC, Euratom) No 1553/89 on VAT collection and control procedures (COM(2000) 28 final of 28 January 2000) http://europa.eu.int/comm/taxation_customs/publications/official_doc/com/com.html

²⁶¹ Council Directive 2000/65/EC of 17 October 2000 amending Directive 77/388/EEC as regards the determination of the person liable for payment of value added tax.

²⁶² Council Directive 2001/41/EC of 19 January 2001 amending Directive 77/388/EEC as regards the length of time during which the minimum standard rate is to be applied.

²⁶³ Proposal for a European Parliament and Council Directive amending Council Directive 76/308/EEC on mutual assistance for the recovery of claims resulting from operations forming part of the system of financing the European Agricultural Guidance and Guarantee Fund, and of agricultural levies and customs duties and in respect of value added tax and certain excise duties presented by the Commission on 26 June 1998 (COM(98) 364 final) (OJ C 269 of 28 August 1998, p. 16) and (COM (1999) 183 final) (OJ C 179 of 24 June 1999, p. 6).

modify the rules applying VAT to certain services supplied by electronic means²⁶⁴. This proposal had the principal objective of protecting EU competitiveness by eliminating a major disadvantage for EU service providers relative to their non-EU competitors. Linked to this was the proposal presented by the Commission on invoicing²⁶⁵, which is designed to make it possible for European traders to use electronic invoicing and storage so as to improve competitiveness and promote electronic commerce. In addition, the proposal concerning the right to deduction and abolition of the procedure provided for under the Eighth Directive²⁶⁶ is crucial to the simplification of existing procedures. It covers areas where refunds of VAT are difficult to obtain from other Member States. The Commission intends to carry on with the work on existing proposals as well as to present new proposals, focusing on the recasting of the Sixth Directive, the place of supply of goods, and on travel agents²⁶⁷. Some of this work is already under way. Further work is also being undertaken in respect of financial services and in the field of subsidies/activities of public authorities/services as well as co-ordination of customs and taxation policies.

As for VAT rates, the Commission finds it necessary to review and rationalise the rules and derogations applying to the definition of reduced VAT rates in the medium term. This will be after the evaluation of the pilot project introduced by the Directive 1999/85/EC on labour intensive services²⁶⁸. Particular attention will be paid to the rates applying to virtual products compared with traditional products and the use of reduced VAT rates in Community policies (e.g. to help protect the environment and promote employment).

2.3.5.2 VAT on electronic commerce

2.3.5.2.1 Background

Electronic commerce (hereafter e-commerce) provides fundamentally new ways of conducting business. Traditional intermediaries are replaced by new ones, new products and markets

²⁶⁴ Proposal for a regulation of the European Parliament and of the Council amending Regulation (EEC) No 218/92 on administrative cooperation in the field of indirect taxation (VAT) and Proposal for a Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic means presented by the Commission on 7 June 2000 (COM(2000)349 final). This proposal was adopted as a directive in May 2002 (Council Directive 2002/38/EC of 7 May 2002 amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, published in the OJ L 128/41 of 15 May 2002). See section 2.3.5.2 for more details about this directive.

²⁶⁵ Proposal for a Council Directive amending Directive 77/388/EEC with a view to simplifying, modernising and harmonising the conditions laid down for invoicing in respect of value added tax presented by the Commission on 17 November 2000 (COM(2000) 650 final). This proposal was adopted as a directive in December 2001 (Council Directive 2001/115/EC of 20 December 2001 amending Directive 77/388/EEC with a view to simplifying, modernising and harmonising the conditions laid down for invoicing in respect of value added tax). See section 3.2.12 about this directive.

²⁶⁶ Proposal for a Council Directive amending Directive 77/388/EEC as regards the rules governing the right to deduct value added tax and proposal for a Council Regulation (EC) on verification measures, measures relating to the refund system and administrative cooperation measures necessary for the application of Directive 98/xxx/EC presented by the Commission on 17 June 1998 (COM(1998) 377 final) (OJ C 219 of 15 July 1998, p. 16 and 20).

²⁶⁷ The Commission has presented a proposal concerning the special scheme for travel agents (Amended proposal for a Council Directive amending Directive 77/388/EEC as regards the special scheme for travel agents (COM/2003/0078 final)).

²⁶⁸ Council Directive 1999/85/EC of 22 October 1999 amending Directive 77/388/EEC as regards the possibility of applying on an experiment basis a reduced VAT rate on labour-intensive services. See also section 3.3.

are created and new kinds of relationships are forged between consumers and businesses and between the different parts of global enterprises.²⁶⁹ OECD highlights in its discussion draft for Ottawa Ministerial conference of 1998 that e-commerce has the potential to be one of the greatest developments of the 21st century and that governments must provide a fiscal climate within which e-commerce can flourish in order to realise its potential to spur growth and employment. OECD emphasises that new challenges arise in taxation as governments continue to seek to raise revenue without distorting economic and technological choices.

2.3.5.2.2 Definition of e-commerce

E-commerce can be defined as ‘... the use of computer networks to facilitate transactions involving the production, distribution, and sale and delivery of goods and services in the marketplace.’²⁷⁰ OECD has defined electronic commerce as ‘... business occurring over networks which use non-proprietary protocols that are established through an open standard setting process such as the Internet.’²⁷¹

2.3.5.2.3 Growth of e-commerce

E-commerce is growing fast. A number of goods which in the past could be supplied physically only, can now be transferred in digitised form. Mail-order companies approach their customers more and more through the Internet. Payment systems through Internet are developing. The volume of inter-company and intra-group supplies through Internet is growing.²⁷²

The number of devices connected to the Internet grew 10 times between 1995 and 2000.²⁷³ The number of Internet domains (com names registered) has grown 20 times during the same period. For the end of 2000 there were close to 20 million domain names registered in the .com registry alone. Most (75%) domain names have been registered, and related to, small businesses.²⁷⁴

2.3.5.2.4 Classification of e-commerce transactions

In many cases the e-commerce transactions concluded do not involve the supply of goods. Often, the transaction will consist of a supply of various services, such as reservations, lodging or transport, the supply of information, amusement or software licenses. With respect to these transactions, usually there is only electronic contact between the supplier and the customer, and transaction does not result in cross-border movement of goods, in contrast with traditional selling methods.²⁷⁵

It has become customary to distinguish between following e-commerce transactions:²⁷⁶

- Digital business-to-business delivery;
- Non-digital business-to-business delivery;
- Digital business-to-consumer delivery;
- Non-digital business-to-consumer delivery.

In the case of non-digital deliveries orders for goods and the contracts of sale are concluded over the Internet while the goods and services are actually supplied physically (off-line). In

²⁶⁹ See OECD (2001b).

²⁷⁰ See Abrams and Doernberg (1997) as referred to in McLure (2001), p. 1.

²⁷¹ OECD (1999).

²⁷² Kogels (1999), p. 117.

²⁷³ See OECD (2001b), p. 68.

²⁷⁴ See OECD (2001b), p. 67.

²⁷⁵ See Kortenaar and Spanjersberg (1999), p. 180.

²⁷⁶ See Hinnekens (2001), p. 118.

the case of digital deliveries (digitised) goods and services are ultimately supplied by electronic means (on-line).

2.3.5.2.5 Interim Report on e-commerce

In 1997, recognising that the emerging e-commerce raises a number of issues for the future of the EU common VAT system, the services of the European Commission began examining the tax implications. The Interim Report on the implications of electronic commerce for VAT and Customs²⁷⁷ made a fundamental recommendation that existing taxes can, and would, be made to work, and consequently the Internet should not lead to new or special taxes for e-commerce.²⁷⁸ The Interim Report found that in several instances, the existing mechanisms and legal base would be sufficient to ensure that taxes are collected. This in particular applies when tangible goods are purchased over electronic networks but are then delivered by traditional means. In the case of tangible products, goods purchased from third countries are taxed at import, exported goods are zero-rated and intra-Community sales of goods are taxed, under a special regime for distance sales, either in the Member State of the seller or the buyer (dependent largely on the volume of such trade carried out by the seller²⁷⁹). Under the common VAT system tangible goods imported into the EU via commercial channels by either registered traders or unregistered traders or consumers can be taxed at the border or at the post office. For VAT purposes, the tangible goods purchased by private consumers are treated in the same way as any other form of distance sales. For example, in the case of mail order delivery tax is collected from the delivery agent (and by him from the customers), when the goods pass the frontier on importation, the only exemption being postal deliveries under a threshold (which varies from nil to EUR 22 in Member States²⁸⁰). If registered traders buy tangible goods moving between Member States, the system of reverse charging applies. Registered traders could also employ reverse charging for purchases of intangible products and services. The most difficult problem is how to collect a tax on sales of intangible products to consumers and unregistered traders. The Commission stresses that online services ordered by EU private consumers from suppliers outside the EU present the greatest challenge in terms of collection of VAT. McLure argues that reverse charging is not a realistic option in this case, especially as it would amount to a tax on honesty.²⁸¹ This implies that a vendor would need to be able to identify the state of destination of sales and to differentiate between sales to registered traders and sales to others.

In its Interim Report the Commission did not propose any change to the rules concerning tangible goods purchased by private consumers over electronic networks. However, the sphere of e-commerce in which the Commission considered the changes necessary was the

²⁷⁷ Document XXI/98/0359 of 3 April 1998 which is available on http://europa.eu.int/comm/dgs/taxation_customs/

²⁷⁸ One example of the proposed special tax for e-commerce is a 'bit tax' to be levied on the number of bits transferred over the Internet.

²⁷⁹ In case of the purchases by distance sales (e.g. by mail, from catalogues or by phone) the place of taxable transaction is the country of consumption (destination principle applies). This rule applies to firms who make a taxable supply over certain threshold. The destination principle is not applied when the total value of supplies does not exceed EUR 100 000 in current or previous year (see Article 28b (B) of the Sixth Directive). Member States may limit the threshold to EUR 35 000 (see Article 28b (B)(2) of the Sixth Directive). However, Article 28b (B) (3) of the Sixth Directive provides that vendors may opt for taxation in a Member State of destination notwithstanding the threshold. In the cases when intra-EU acquisitions below a threshold of EUR 10.000 per year are made by companies or individuals whose own supplies are VAT exempt and who do not have right for deduction, the same rules as for ordinary private consumers apply to them (i.e. the VAT is applied in the country of purchase). See also section 3.2.4.1.

²⁸⁰ See Jenkins and Wilkie (2001), p. 13.

²⁸¹ See McLure (2001), p. 4.

delivery of goods and services on-line by digital means. The Commission highlighted that the reverse charging currently used did not apply to the full range of such deliveries, so it was necessary to widen existing scope for reverse charging. Although the reverse charge mechanism ensures the correct taxation of most business-to-business transactions, the new provisions were necessary to comprehensively take account of the full range of services and intangibles which can be delivered by digital means today. Furthermore, the new rules were considered necessary to ensure that electronically delivered services can, in all cases, be exported free of charge.

2.3.5.2.6 Communication by the Commission

The general principles of taxation of electronic deliveries were first set out in a Communication from the Commission in June 1998.²⁸² It was stated in this Communication that the EU common VAT system should '... provide the legal certainty, simplicity and neutrality required for the full development of electronic commerce'. The aim of neutrality was further clarified as following: the consequences of taxation should be the same for transactions in goods and services, whether they are purchased from within or from outside the EU, whether delivery is effected on-line or off-line or regardless of the mode of commerce used.

The most significant of the principles set out in Commission Communication of 1998 were that, for VAT purposes, electronic transactions should be taxed as services and taxation should take place in the jurisdiction where consumption takes place. The Commission's communication was considered by the ECOFIN Council at its meeting on 6 July 1998 where Member States, on the basis of the guidelines advocated by the Commission, agreed on the principles that formed the basis of a Community input to the OECD Ministerial Conference in Ottawa in October of the same year.

The Council endorsed three main principles:

- no new or additional taxes need to be considered for e-commerce but existing taxes – and specifically VAT – should be adapted so that they can be applied to e-commerce;
- for consumption taxes, electronic deliveries should not be considered as goods but as supplies of services;
- supplies of such services consumed in Europe should be taxed in Europe, irrespective whether they are performed from countries inside or outside the EU, and services performed from an EU country to a third country shall not be taxed in the EU.

2.3.5.2.7 OECD on e-commerce

In 1998, the OECD Conference in Ottawa discussed international tax rules for e-commerce and also endorsed the approach that taxation should take place in the jurisdiction where consumption takes place. In addition, the Ottawa Conference set out the principle that self-assessment (the so-called reverse charge mechanism) should be used as a means of collecting tax on cross-border taxation of services and intangible property between businesses.

2.3.5.2.8 Commission proposal on e-commerce

The Commission proposed the directive to amend the provisions of the Sixth VAT Directive to tackle with problems identified in its Interim Report. The European Commission adopted on 7 June 2000 a proposal for a directive to modify the rules for applying VAT to e-

²⁸² COM (1998) 374 final. Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee-Electronic commerce and indirect taxation. <http://europa.eu.int/comm/taxation-customs/publications/official-doc/com/com.htm>

commerce as well as certain broadcasting services.²⁸³ The Commission stressed in its Explanatory Memorandum to the Proposal that the legal basis made it difficult to correctly apply the principles of consumption-based taxation to transactions involving the supply of services and products in digital form over electronic networks (which includes broadcasting services). The main problem identified by the Commission was widening the scope of the reverse charging to cover the whole potential range of goods and services which could be provided via the Internet.

According to the Commission, the additional problem concerns the question of identification of business customers. For the reverse charge procedures, suppliers need to be able to distinguish between business customers (taxable persons) and final consumers (non-taxable persons) – in effect to make a taxing decision they need to know if their customer is registered for VAT. For this purpose, in order to ensure that in the case of digital goods and services the supplier is able to distinguish between business and non-business customers at the point of a transaction, the Commission intends to put in place an on-line 24-hour verification system to check the existence and validity of VAT registration number, the assurance being that if the supplier makes the necessary check before completing an on-line transaction, his liability will be at an end and tax will be collected by self-assessment from the business customer.²⁸⁴

The Commission's proposal also contains a number of facilitation and simplification measures aimed at ensuring that the administration and collection of VAT takes full advantage of the potential benefits afforded by electronic technology. The necessary legal measures to decrease the tax compliance burden for non-EU operators and remove the barriers in the existing tax system to the growth of e-commerce were included in the proposal. The Commission services have already started work on the tools and technical measures needed. It is already possible to complete electronically procedures relating to tax returns and registration.

2.3.5.2.9 Directive on e-commerce

The Council approved the Directive 2002/38/EC dealing with e-commerce transactions on 7 May 2002.²⁸⁵ The directive on the taxation of certain services supplied by electronic means was a first step in implementing a new strategy to modernise the existing VAT rules and to ensure that common VAT system is in conformity with the principles set out by July 1998 ECOFIN Council meeting and the OECD Ministerial Conference of the same year. The directive modifies the Sixth Directive on taxing electronic deliveries in accordance with these principles. The tax rules of the Directive 2002/38/EC are similar to those proposed by the Commission for the telecommunications services.²⁸⁶ In 1997, responding to negative cross-border effects on EU VAT revenue collection and on competition in telecommunication sec-

²⁸³ Proposal for a regulation of the European Parliament and of the Council amending Regulation (EEC) No 218/92 on administrative cooperation in the field of indirect taxation (VAT) and Proposal for a Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic means presented by the Commission on 7 June 2000 (COM(2000)349 final).

²⁸⁴ One criticism with this approach is that by removing the need for compliance in the case of Business-to-Business supplies of digital products the EU is placing a psychological barrier in the way of compliance for supplies of digital products to final consumers, particularly if they are in the minority. See Jenkins and Wilkie (2001), p. 14.

²⁸⁵ Council Directive 2002/38/EC of 7 May 2002 amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, published in the OJ L 128/41 of 15 May 2002. However, the European Parliament indicated that it may initiate an action against the Council which did not follow its earlier opinion on the correct legal basis for the Directive. See Hinnekens (2002), p. 65

²⁸⁶ See Kogels (1999), pp. 121–122 and Raponi (2000), p. 189.

tor from non-EU countries, the European Commission submitted a proposed amendment to the Sixth Directive with a view to making all telecommunications services consumed within the EU subject to VAT. The Commission intended that the telecommunications services of entrepreneurs outside the EU should be taxed in that country where the customer has his place of business, permanent establishment or place of residence. Conversely, telecommunications services rendered to customers outside the EU would no longer bear European VAT. Telecommunications services provided to private consumers and non-registered persons should be taxed where they are effectively utilized or exploited. In such cases, a provider of those telecommunications services established outside the EU must be registered for VAT in those Member States where his customers are located and is thereby deemed to be established in such a Member State. He must charge and remit the VAT of that Member State. In 1999 the EU modified the Sixth Directive. The amendment entails introducing a new definition under Article 9(2)(e) of the Sixth Directive.²⁸⁷ In the case of telecommunications services defined under Article 9(2)(e) of the Sixth Directive supplied by a taxable person established outside the Community to non-taxable persons established inside the Community, the place of supply of services is deemed to be within the territory of the country where the effective use and enjoyment of the services take place within the territory of the country.²⁸⁸ This modification of the Sixth Directive concerning the telecommunications services did, however, not cover the services that are supplied via the Internet, but only the services pertaining to the transfer of the signals over the communication network, or the right of use of facilities employed for transfer of those signals. The Directive 2002/38/EC modified the Sixth Directive on taxing electronic commerce to eliminate the distortions of competition in this area.²⁸⁹

In order to determine the place of supply the Directive 2002/38/EC provides for the definition of the services supplied 'by the electronic means'. Furthermore, the directive amends Article 9 of the Sixth VAT Directive on the place of supply of services so that electronically delivered services supplied for consumption within the EU are subject to EU VAT and those supplied for consumption outside the EU are exempt from VAT. To this end, electronically supplied services provided from third countries to persons established in the Community or from the Community to recipients established in third countries should be taxed at the place of the recipient of the services.²⁹⁰

The general rule according to Article 9(1) of the Sixth VAT Directive with regard to the place of services is that it is deemed to be the place where the supplier has established his business or has a fixed establishment from which the service is supplied. For supplies to non-taxable persons no change is introduced and therefore businesses will continue to charge

²⁸⁷ Article 9(2)(e) of the Sixth Directive stipulates that telecommunications services are deemed to be '... services relating to the transmission, emission or reception of signals, writing, images and sounds or information of any nature by wire, radio, optical or other electromagnetic systems, including the related transfer or assignment of the right to use capacity for such transmission, emission or reception. Telecommunications services within the meaning of this provision shall also include provision of access to global information networks.'

²⁸⁸ See Article 9 (3) and (4) of the Sixth VAT Directive.

²⁸⁹ See preamble to the Directive 2002/38/EC. The directive also addresses the tax treatment of radio and television broadcasting services supplied on subscription or pay-per-view basis. This is an increasingly significant commercial activity, largely directed at consumers, where the previously existing tax provisions discriminated against European business and gave a significant tax-induced price advantage to the non-EU operator. In the preamble to the Directive 2002/38/EC it is stipulated that the rules previously applicable to VAT on radio and television broadcasting services and on electronically supplied services, under Article 9 of the Sixth Directive were inadequate for taxing such services consumed within the Community and that in the interests of the proper functioning of the internal market, such distortions should be eliminated and new harmonised rules introduced for this type of activity.

²⁹⁰ See preamble to the Directive

VAT, in the Member State where the supplier is established, as provided for in Article 9(1) of the Sixth Directive. For supplies to non-EU customers, however, the directive contains a legal base for making such electronic supplies exempt from VAT.

Article 9(2) establishes several exceptions to the general rule of Article 9(1). Certain services listed in Article 9(2)(e) are linked to the customer's country within the EC provided that he/she is an entrepreneur. The services listed in Article 9(2)(f) of the Sixth Directive have been added to Article 9(2)(e) when delivered electronically. The place of supply will be covered by the usual Article 9(2)(e) rules except, where supplies are made by non-established taxable persons to final consumers in the EU or by EU suppliers to any consumer outside the EU, the place of supply will be the place of consumption. Non-EU suppliers selling to customers in the Community will now be required to apply taxes on the same basis as an EU operator when transacting business in the Community. This means that they must charge and account for VAT on sales to final consumers in the EU. The off-shore on-line suppliers will be compelled to register and account for VAT on his sales to EU final customers, even if he has no 'substantial nexus' with the EU (in the sense of the presence of people and equipment) but only a website accessible to those consumers.²⁹¹ For businesses outside the EU, it will only be in the case of sales to final consumers that they will be required to register for VAT purposes and charge VAT. The non-EU operators who supply services to non-taxable persons established in the Community have the possibility to be identified for VAT in a single Member State.²⁹² This would normally be the Member State where the first taxable supply in the EU is made. The registering would not require a fixed establishment in this Member State. A single place of registration would enable the operator to discharge all obligations for EU VAT with a single administration.

2.3.5.2.10 Criticism on the directive

The new directive (and earlier Commission proposal) met criticisms as being inconsistent with economic neutrality and other principles of international taxation. The Commission has been criticised for moving unilaterally on the problem of taxation of e-commerce transactions, without waiting for the achievement of an international consensus on these issues.²⁹³ Several commentators, analysing Commission's approach, argue that the non-EU suppliers will have an incentive to register in the Member State with the lowest VAT rate, i.e. Luxembourg with 15 per cent. Thus, businesses from outside the EU who register in a low-tax jurisdiction would have competitive advantage over EU businesses and non-EU businesses registering in jurisdictions with higher tax level. McLure argues that VAT level will depend on whether the product is delivered in tangible or intangible form.²⁹⁴ Some products that are exempt when delivered in tangible form might be taxed when delivered on-line. Furthermore, it has been argued that under the directive taxation of non-EU entrepreneurs would solely depend on their voluntary compliance and the tax authorities do not have the means effectively to enforce the taxation of e-commerce services in the country of consumption.²⁹⁵ With respect to foreign suppliers the authorities cannot identify the e-commerce transaction or the payment. In addition, an on-line supplier often does not even know his customer's lo-

²⁹¹ See Jenkins and Wilkie (2001), p. 14.

²⁹² The Directive 2002/38/EC establishes for the operators providing electronically supplied services, who are neither established nor required to be identified for tax purposes within the Community, a special scheme by adding Article 26c to the Sixth Directive. In applying this scheme any operator supplying such services by electronic means to non-taxable persons within the Community, may, if he is not otherwise identified for tax purposes within the Community, opt for identification in a single Member State. See section 3.2.11 for more detailed discussion of this scheme.

²⁹³ See McLure (2001), p. 7.

²⁹⁴ Ibid.

²⁹⁵ See Kortenaar and Spanjersberg (1999), p. 183.

cation because usually the customer's actual name and address cannot be determined from the Internet address. This would make it impossible to identify the country of consumption in which a return should be filed.²⁹⁶

Kortenaar and Spanjersberg argue that with respect to intangible services provided by foreign suppliers to private persons the destination principle could only be implemented by major interventions in the liberties of the citizens and entrepreneurs involved in the transactions, while such interventions would not guarantee the effectiveness of the scheme.²⁹⁷ For this reason they suggest a VAT zero-rate for all transactions that show a significant distortion of competition because certain sales by foreign companies cannot be taxed effectively. In order to ensure tax neutrality between digital and conventional trade, this zero-rate should apply to both e-commerce transactions and to supplies of tangible products that are essentially identical to these services.²⁹⁸ In contrast, Hinnekens argues that exemption from VAT for certain services related to e-commerce is objectionable because of loss of tax revenue and of lack of neutrality of taxation. He argues that the proper policy is not to drop these taxes but to make them better collectible.²⁹⁹

McLure³⁰⁰ argues that e-commerce would be less problematic under the definitive system than under the transitional system. Under the so-called clearing-house system proposed by the Commission it would not be necessary to identify the location of purchasers of digital content in the case of intra-Community transactions.

2.3.5.3 *The Commission's latest Communication*

In May 2001, the European Commission presented a Communication 'Tax Policy in the European Union'³⁰¹. It identifies both general objectives and a number of specific priorities in direct and indirect taxation. The Commission expresses the view that a high degree of harmonization is essential in the indirect tax field. The indirect taxes may create distortions of competition as well as obstacles to the free movement of goods and the free supply of services within an Internal Market. The Commission reassures that origin-based system remains the long-term goal of the Community. So long as the present system of VAT-based Community own resources is in existence, closer administrative co-operation and the other measures aimed at preventing fraud are taken to maximise the VAT base and thereby ensure that this tax plays the full part in providing income that Community budgetary rules intended.

2.4 **Developments in the field of income tax**

Progress in harmonization of direct taxes has been much less substantial than in the field of indirect taxation. One of the reasons for this is the requirement of a unanimous decision by the Council. Another obstacle to the harmonization of direct taxes is the fact that the EC Treaty foresees much less harmonization in the field of direct taxation than in the field of indirect taxation. Direct tax policy has been an area where Member States want to decide mostly by themselves. However, national sovereignty to determine their income tax systems is undermined by the increasing economic integration. Member States' freedom in the field of taxation is restricted by the growing mobility of international capital and by tax policies of the other countries.

²⁹⁶ Ibid, pp. 180 - 183.

²⁹⁷ Ibid, p. 184.

²⁹⁸ Ibid, p. 187.

²⁹⁹ See Hinnekens (2001), p. 119.

³⁰⁰ See McLure (2001), p. 8.

³⁰¹ Commission (2001a).

The next sections review the most important policy documents of the EU income taxation: the Neumark and Van den Tempel Reports, the Ruding Report, the Monti Report, a package of measures to tackle harmful tax competition (hereafter the tax package or package)³⁰², the Commission's Communication on fiscal state aid³⁰³, and the latest Commission's Study on Company Taxation³⁰⁴.

2.4.1 *The Neumark and Van den Tempel Reports*

Since the early years of the Community various committees have put forward proposals for harmonising the corporate tax systems of the Member States. The first official report on tax harmonization was the report of 1963 by the Fiscal and Financial Committee, chaired by Professor Fritz Neumark from Germany (known as the Neumark Report³⁰⁵). It recommended universal adoption of a German type imputation system with a split rate for retained and distributed profits by Member States of the EU. In 1967, the Commission presented a 'Programme for the tax harmonization of direct taxes'³⁰⁶. It recognised that a certain harmonization of direct taxation is necessary to realise the free movement of persons and capital and to avoid a distortion of competition. 'Programme for the tax harmonization of direct taxes' contained a number of policy issues, such as the integration of corporate and individual income taxation, an introduction of single comprehensive individual income tax, the taxation of investment income of financial intermediaries, the double taxation, the combating of international tax avoidance and evasion, removing tax impediments to cross-border mergers and parent-subsidiary relations, and abolition of withholding taxes on dividends and interest. In 1968, the Commission presented a pre-draft for a 'European Double Taxation Convention'³⁰⁷. This draft was discussed several times among Member States but no agreement was achieved. In 1969, two other policy issues contained in the Commissions Programme of 1967 were translated into proposals for a Parent-Subsidiary Directive³⁰⁸ and a Merger Directive³⁰⁹.

When Professor van den Tempel from the Netherlands in 1970 published his study on Corporation Tax and Individual Income Tax in the European Communities (hereafter Van den Tempel Report), a majority of (then) six Member States applied the so-called classical tax system (the Netherlands, Luxembourg) or had announced to switch to this system (Italy).³¹⁰ Professor van den Tempel recommended his country's classical system of taxation of distributed company profits to be adopted within the EU. A classical system was found to be the best solution by Van den Tempel Report, since it avoids the main disadvantage of imputation systems when foreign shareholders are concerned.³¹¹ The imputation system treats differently resident and non-resident shareholders, because the tax credits are not granted to non-resident shareholders. The same disadvantage affects domestic shareholders receiving dividends from abroad. Thus, in case of classical system the problem of different treatment of

³⁰² Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy – Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation - Taxation of saving, OJ C 002, 06/01/1998, p. 1 - 6.

³⁰³ Commission (1998). See section 2.4.4.3.3 about the Commission's Communication.

³⁰⁴ Commission (2001c). See section 2.4.5 about the Commission's Study.

³⁰⁵ International Bureau of Fiscal Documentation (1963).

³⁰⁶ Memorandum of the Commission to the Council of 26 June 1967, *Bulletin of the European Communities*, supplement 8 (1967).

³⁰⁷ Document 11.414/XIV/68 of 1 July 1968.

³⁰⁸ COM (69) 5 final of 15 January 1969, OJ. C 39 of 22 March, p. 7.

³⁰⁹ *Ibid*, p. 1.

³¹⁰ See Thömmes (1990b), p. 469.

³¹¹ *Ibid*.

resident and non-resident shareholders as in case of imputation system cannot arise. However, the classical system has one serious disadvantage.³¹² Namely, it tends to reduce the management's willingness to distribute the profits. In result, especially the small investors are discouraged from buying productive capital in the form of shares. At the same time, it is one of the advantages of the imputation system that it constitutes an incentive for profit distribution and proper declaration of dividend income.³¹³

In 1975, the Commission presented an 'Action Programme for Taxation'³¹⁴. This programme was much less ambitious than the Commission Programme of 1967.³¹⁵ In the introduction the Commission expressed its intention for the near future to restrict Community measures to those which are absolutely indispensable. Absolute priority was given to the two 1969 proposals on cross border co-operation, namely, proposals for a Parent-Subsidiary Directive and a Merger Directive.

Both Neumark and Tempel reports identified the unharmonised tax treatment of cross-border dividend payments as a major problem within an internal market. The different treatment of resident and non-resident shareholders by Member States and resulting distortions in resource allocation in the Single Market led the Commission to propose a directive aiming at the approximation of these factors. The Commission submitted to the Council a proposal for a directive to harmonise the systems of company taxation and of withholding taxes on dividends³¹⁶. Whereas the Neumark Report recommended a split rate system and the van den Tempel Report a classical system, the Commission did not follow the Neumark nor the Van den Tempel conclusions, but recommended a partial imputation system with mainstream rates between 45 per cent and 55 per cent. According to the proposal, the tax credit was also to be given to shareholders residing in another Member State. The major aim of the Directive was to counterbalance the negative effects of the imputation systems for foreign shareholders by providing for a Community wide corporation tax credit to all shareholders resident wherever within the EC. The Commission proposal followed the system of the majority of the Member States, since for 1975 most Member States had switched to an imputation system or to a split-rate system. Therefore, the classical system would have had small chance of being adopted by a unanimous decision. The Council never discussed the proposal, because the European Parliament, which has to be consulted under the rules of the EC Treaty, did not deliver its opinion. In 1979, the European Parliament refused to give a final opinion on the proposal, producing only an interim report saying that it would be mistake to attempt to harmonise corporation tax rates without at the same time harmonising the basis of assessment.³¹⁷ The Parliament criticised the Commission for not having tackled harmonization of tax burden and asked the Commission to pursue a comprehensive approach covering the whole set of regulations for determining taxable profits as well as tax rates and tax systems.³¹⁸ The Commission's proposal was withdrawn in 1990. One of the reasons for the failure of the proposal was that the essential part of it was to grant tax credit to residents of another Member State. This, however, causes budgetary problems: the State granting the credit, i.e. the final shareholder's State of residence, and the State which has the corresponding corporation tax income are not the same.³¹⁹ The solution of this problem required a budgetary

³¹² See Thömmes (1990a), p. 213.

³¹³ Ibid.

³¹⁴ Commission (1975).

³¹⁵ See Thömmes (1990b), p. 469.

³¹⁶ Proposal for a directive of the Council concerning the harmonization of systems of company taxation and of withholding taxes on dividends, COM (75) 392 final of 23 July 1975, OJ C 253 of 5 November 1975, p. 2.

³¹⁷ Interim Report of the 'Nyborg Committee', Doc. 104/79 of 8 May 1979, OJ C 140 of 5 June 1979, p. 19.

³¹⁸ Ibid.

³¹⁹ See Thömmes (1990b), p. 473.

compensation mechanism which could only work on the basis of further approximated tax rates and tax base. However, Member States' governments feared for their fiscal sovereignty once harmonization of tax rates and tax base had been achieved.³²⁰

In 1983, in its resolution the European Parliament expressed a view that it is necessary to harmonise taxation in the EC. In addition, the Parliament stressed once more that there was no point in harmonising rates until the Commission produced proposals to harmonise the tax base. As a response to the Parliament's criticism, the Commission in 1988 drafted a proposal on the harmonization of the tax base for enterprises, which dealt with depreciation rules, taxation of capital gains and losses, rules relating to provisions for liabilities and charges, valuation of inventory, valuation of other assets, and deductibility of charges and expenditure. According to the Explanatory Memorandum, the purpose of the proposed Directive was to harmonise taxable base, i.e. the rules for determining the taxable profits of undertakings. It was considered that the objective of optimal allocation of resources, important for the establishment of the internal market, would not be reached unless there was at least some approximation of the rules to determine the taxable profits of enterprises. Furthermore, the draft proposal aimed according to the Commission, to harmonise the provisions concerning the carry-over of losses, which would improve the situation of Community firms and to enhance their ability to compete with non-European Union countries. Another important objective of the Directive was to bring more transparency into enterprise's taxation by forbidding Member States to grant tax incentives by means of the rules on the determination of taxable profits. If that proposal had been adopted, Member States would not have any longer been allowed to introduce incentives which affect the taxable base.³²¹ The most Member States were reluctant to support such a proposal, because they felt that it would undermine their fiscal sovereignty too much and thus it was never even officially submitted to the Council.

In 1980 the Commission adopted a 'Report on the scope for convergence of tax systems in the Community'.³²² It provides detailed description of national tax systems. The report declares that tax sovereignty is one of the fundamental components of national sovereignty and therefore, alignment of national tax systems is not an easy matter. However, it also states that '... such a move towards alignment is equally important in the context of increasingly close co-ordination of national policies and the framing of genuine common policies in the key economic sectors'.

The Commission's White Paper of 1985³²³ contained little on direct taxation. Only few questions of direct taxation were addressed³²⁴, the most prominent being the measures designed to encourage cross-border co-operation, namely the Merger, the Parent Subsidiary and the Arbitration Directives.

In 1990, in its guidelines on company taxation³²⁵ the Commission once again underlined the urgency of an adoption of the package of three Directives. In its guidelines the Commission defined its new approach which was based on three ideas: direct tax measures should be geared to the completion of the Internal Market; they should be consistent with the principle of subsidiarity; and all initiatives should be defined through a consultative process with Member States. A major change was brought about by the announcement that the 1975 pro-

³²⁰ Ibid.

³²¹ See Kuiper (1988), pp. 319-329.

³²² The report is published as Supplement 1/1980 to the Bulletin of the European Communities.

³²³ Commission (1985).

³²⁴ Commission (1985), page 38, point 151; page 31, point VI 3, Period 1985-1986.

³²⁵ Commission (1990).

posals for a directive to harmonise the systems of company taxation and of withholding taxes on dividends³²⁶ had been withdrawn.

On the basis of Commission guidelines, and following Commission proposals, three measures (so-called tax package of 1990) - two directives and one convention - were adopted on 11 June 1990, when a political compromise was found at the meeting of ECOFIN Council in Luxembourg. The Merger Directive³²⁷ is designed to defer taxation of capital gains resulting from certain categories of business re-organisations, in order to create within the Community conditions similar to those of a domestic market. The Parent-Subsidiary Directive³²⁸ deals principally with the elimination of double taxation on distributed profits between a subsidiary and a parent company of another Member State. Both directives apply since 1 January 1992. The principal objective of the Arbitration convention³²⁹ is to establish a procedure to resolve transfer-pricing disputes giving rise to double taxation. The convention entered into force on 1 January 1995 but its application is currently suspended as its prolongation beyond 2000 still awaits ratification in several Member States. These three measures (tax package of 1990) are examined in greater detail below (see section 4.2).

Two further proposals aiming to tackle afore-mentioned tax obstacles to cross-border investment, were made in January 1991. The first proposal aimed to abolish withholding taxes levied on cross-border interest and royalty payments between companies of different Member States. After almost four years of negotiations in the Council, the Commission decided to withdraw it in November 1994 so as to be able to carry out a comprehensive review of the proposal. The Commission, at the request of the ECOFIN Council, resubmitted the draft directive on 6 March 1998.³³⁰ The proposal was adopted as the Interest and Royalties Directive³³¹ in June 2003 and is due to take effect from 1 January 2004. The Directive is considered in detail below (see section 4.2.4.).

The other proposal on imputation of foreign losses³³² is designed to allow an enterprise to offset against its results the losses incurred by its foreign subsidiaries and permanent establishments.³³³ The proposal was discussed in the Council in 1992, but not since then. Proposal is considered in detail below (see section 4.3).

³²⁶ Proposal for a directive of the Council concerning the harmonization of systems of company taxation and of withholding taxes on dividends, COM (75) 392 final of 23 July 1975, OJ C 253 of 5 November 1975, p. 2.

³²⁷ Council Directive 90/434/EEC of 23 July 1990.

³²⁸ Council Directive 90/435/EEC of 23 July 1990.

³²⁹ Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises [COM (90/436/EEC)].

³³⁰ Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, COM (1998) 67 final, OJ C 123, 22 March 1998.

³³¹ Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, 26.6.2003, p. 49.

³³² Proposal for a Council Directive concerning arrangements for the taking into account by companies the losses of their permanent establishments and subsidiaries situated in other Member States [COM (94) 595] of 24 January 1991.

³³³ The situation where company incurs losses in another Member State often leads to higher tax burden because loss-compensation is generally available domestically but not always in cross-border situations and even when cross-border loss compensation is available, the general conditions (timing, availability of profits etc.) are more generous in the domestic context. Therefore, cross-border situations are often taxed more heavily because the foreign losses are not taken into account which causes economic double taxation.

2.4.2 *The Ruding Report*

In 1990, following the above-mentioned Commission's guidelines on company taxation, the Commissioner Scrivener gave the Committee of Independent Experts on Company Taxation under the Chair of the former Netherlands Government Minister of Finance Onno Ruding a mandate for the analysis of company tax issues. The Committee were asked to evaluate the importance of taxation for business decisions with respect to the location of investment and the international allocation of profits between enterprises, in order to determine whether existing differences in corporate taxation and the burden of business taxes among Member States led to major distortions affecting the functioning of the Internal Market. The mandate was based upon three main questions:

Do differences in taxation cause distortions in the functioning of the Internal Market?

If such distortions arise, can they be eliminated through the interplay of market forces and tax competition or is Community action required?

In the event that Community action is deemed to be necessary, what specific measures should be taken?

In March 1992 the Ruding Committee presented its report (known as the Ruding Report).³³⁴

At the time the Ruding Report was published, the large-scale plans for harmonization of income tax in general and corporate tax in particular had been abandoned.³³⁵ Based on the subsidiarity principle and the importance of tax policy for sovereignty of the country, the report argues in favour of limiting Community action to the minimum necessary to ensure that the internal market functions smoothly. However, the Report draws attention to the necessity of far-reaching harmonization and co-ordination in the area of company taxation (in particular corporate taxation).

According to the Ruding Report the need for tax co-ordination arises because tax policies of one state may have spillover effects for economic welfare of other countries.³³⁶ Lack of tax co-ordination may enable governments to impose negative economic spillover effects on each other, for example, by offering particular tax advantages.³³⁷ The taxation of income of non-residents can cause double taxation, export part of the tax burden to foreign countries, and thereby impose a welfare loss on them. Also, the imposition of domestic taxes can cause an export of capital from the domestic economy. Thus, there will be positive spill over effect for the welfare of foreign country. A higher source-based capital income tax will tend to reduce the level of domestic investments and will thereby reduce capital imports. Another example of a spill over effect concerns the shifting of profits to the countries with relatively low tax rate without the shifting of real economic activity. As a consequence, the countries with relatively high tax rates may experience a revenue loss. In addition, tax policy of the large country can have spill over effects for the international level of interest rates.³³⁸

Simple theoretical models predict that under tax competition business and capital income tax rates will tend to converge towards zero.³³⁹ Ruding Report concludes that governments acting in the best interest of their own (small) country would therefore tend to drive their marginal effective business and capital income tax rates towards zero and to rely instead on taxes on more immobile factors of production such as labour and land. Furthermore, any attempts to harmonise business and capital taxes at a positive level through international agreements would reduce the welfare of the group as a whole by causing a capital flight to the rest of the

³³⁴ Commission (1992a).

³³⁵ Vanistendael (2000).

³³⁶ Commission (1992a), p. 144

³³⁷ Ibid, p. 143.

³³⁸ Ibid, p. 145

³³⁹ Ibid, pp. 143-151.

world. The only gain from international co-ordination in these models is the international exchange of information to make residence-based taxes enforceable.³⁴⁰

Ruding Report stresses that a distinction should be made between international portfolio investments in debt instruments, international portfolio investments in shares, and international direct investment by multinational corporations. In principle, prediction of theoretical models that the tax competition will result in the diminution of source-based taxes on business and capital applies to all forms of portfolio investments. In the field of international portfolio investments, withholding taxes on interest payments to non-residents are already very low or even zero. However, the withholding taxes in case of international investments on shares tend to be higher than those on interest payments.³⁴¹ Ruding Report also states that governments are likely to remain corporation tax on the profits underlying the distributed dividends. This applies particularly to direct non-financial investments, which are less mobile internationally, because of adjustment costs that accompany the relocations of this kind of investments. Due to the higher mobility of financial investments, governments tend to impose a lower tax on these investments.

Of special interest, Ruding Report³⁴² concludes that effects of corporate income tax harmonization will result in a gain in economic efficiency for the EU as a whole.³⁴³ The reasoning of the report can be summarised as follows. In the world of high capital mobility, the rates of return after corporation tax tend to be equalised. Consequently, the pre-tax rates of return will tend to be low in the countries where effective corporate tax rates are low, and vice versa. Tax harmonization would result in an efficiency gain, because capital would be reallocated towards countries where it can be invested more productively. However, the income of low-tax countries would be reduced and the income of high tax countries increased. However, as most of the EC gain from corporate tax harmonization would come at the expense of the rest of the world, the magnitude and even the existence of the gains from harmonization depend on the level around which effective corporate tax rates are harmonised.³⁴⁴ If tax rates are harmonised at a low level, capital will be attracted to Europe and the EU as a whole could then gain at the expense of the rest of the world. If tax rates are harmonised at a high level, capital will be driven out of Europe and the EU as a whole could then suffer a loss.

The Ruding Committee commissioned survey of European companies, to find out whether differences in business taxation among Member States cause distortions in the functioning of the Internal Market, particularly with respect to investment decisions and competition. The research was based on questionnaire to which 965 replies were received from companies based in 16 countries, representing an average response of over eleven per cent. The most important conclusions arising from the survey can be summarised as following.

- a. Taxation does appear to have a significant impact on the location of real activities of multinationals. Forty-seven per cent of respondents claimed that tax was always or usually a major factor in determining the location of a production plant.
- b. Taxation has a still greater impact on the financial and legal structure of companies. Seventy-eight per cent of respondents claimed that tax was always or usually a major factor in the decision as to where to locate a financial centre. Around seventy per cent of respondents claimed that tax was always or usually a major factor in the financial arrangements.

³⁴⁰ Ibid, p. 147.

³⁴¹ Ibid, pp. 148-149.

³⁴² Ibid, pp. 98-99.

³⁴³ Ruding Report uses results of a simplified simulation model (Fuente and Gardner (1990)) consisting of the EC, the United States and Japan.

³⁴⁴ See Commission (1992a), pp. 93-109.

- c. Taxation is an important factor in determining the form in which profit is repatriated to a parent company.
- d. There is strong support for co-ordinated action by the Community institutions to move towards convergence of corporate taxes within the EU.

The Ruding Report concluded that action at the Community level should concentrate on the following priorities:³⁴⁵

- a. removing those discriminatory and distortionary features of countries' tax arrangements that impede cross-border business investment and shareholding;
- b. setting a minimum level for statutory corporation tax rates and also common rules for a minimum tax base, so as to limit excessive tax competition between Member States intended to attract mobile investment or taxable profits of multinational firms, either of which tend to erode the tax base in the Community as a whole; and
- c. encouraging maximum transparency of any tax incentives granted by Member States to promote investment.

Interestingly, the Committee did not include the recommendation to harmonise tax systems among its priorities. However, the Report recommends establishment of a minimum statutory corporation tax rate of 30% for both retained and distributed profits of all companies of the Member States. It also recommends the adoption of a maximum statutory corporation tax rate of 40%. In addition, Report prescribes that there should be only one kind of corporate tax in the EU.³⁴⁶ It also recommends that there should be a set of minimum standards for the tax base to cover.³⁴⁷

The response to the Ruding Report

In 1992, the Commission indicated in its response to the report³⁴⁸ that priority should be given to the elimination of double taxation on cross-border income flows. The Commission expressed the view that although the Ruding Report provided an excellent basis for wide-ranging discussion and consultation with Member States with a view to formulating legislation proposals, the recommendation on corporate tax systems, bases and rates frequently went beyond what is strictly necessary at EC level. It dismissed the idea of an EC-wide maximum corporation tax rate, which the Commission felt should be left to market forces. As regards a minimum rate, the Commission considered the idea worth examining, but thought 30 per cent too high in view of the Member States' attempts to alleviate the tax burden and of possible tax competition from third states. Furthermore, the Commission suggested that the proposed measures could have the effect of reducing the tax base, which might in turn involve an increase in tax rates.

Partly as a result of the fear of loss of sovereignty by Member States with regard to taxes, the Ruding Report did not lead to far-reaching proposals of Community legislation, but merely to 'Guidelines to Taxation of Undertakings in the Context of the Improvement of the Internal Market'³⁴⁹. The Council conclusions introduced a number of criteria that should be taken into account in deciding whether action was appropriate at Community level. The need to

³⁴⁵ Ibid, p.13.

³⁴⁶ If this could not be achieved, local income taxes should be taken into account when fixing the statutory corporation tax rate so that combined rate of tax falls within the range of 30-40% prescribed by the Committee.

³⁴⁷ See Commission (1992a), pp.15-16.

³⁴⁸ Commission (1992b).

³⁴⁹ See 'Guidelines on Company Taxation linked to the Further Development of the Internal Market – Council Conclusions', press release (10088/92–Presse 216) after the ECOFIN Council meeting of 23 November 1992.

eliminate double taxation was recognised. Furthermore, the need to ensure effective single taxation was stressed.

The Economic and Social Committee had ‘much esteem for the quality’ of the Ruding Report, but expressed the view that it ‘will remain a reference document for researchers’³⁵⁰.

The Commission realises in its latest Communication on company taxation³⁵¹ that the detailed and valuable findings and recommendations of the Ruding Report met with limited support and failed to achieve much progress. The Commission concludes that in essence the basic analysis of the Ruding report still remains valid today. Because of deeper integration, as well as of new developments in tax competition with more emphasis on specific tax regimes and the equitable distribution of tax revenue among Member States, the pressing need for tax co-ordination has become much clearer. However since the Ruding report very little has been achieved in the field of specific regulation, and in that respect its impact has been disappointing.

2.4.3 *The Monti Report*

On 20 March 1996, Commissioner Monti proposed a new view of taxation policy in a Discussion Paper to the Informal Meeting of ECOFIN Ministers to be held in Verona on 13 April 1996.³⁵² Three main, interlinked and mutually reinforcing challenges for the EU were identified:

1. the stabilisation of the Member States’ tax revenues;
2. the smooth functioning of the Internal Market; and
3. promoting employment.

The Commission realised that the single market does not appear to be functioning properly, especially as regards cross-border interest payments, taxation of permanent establishments, the lack of fully developed tax-treaty network, and taxation of non-residents.

The ECOFIN Council appointed personal representatives to the High Level Group, which met four times in 1996. The summary of main conclusions of the meetings of the Group is given in Monti Report³⁵³, published on 22 October 1996. The Commission also gives its own assessment of the tax policy issues and its views concerning the way forward.

At first, the need to reverse the tendency of taxation systems to be detrimental to employment was highlighted in the Monti Report.³⁵⁴ There was a broad consensus in the High Level Group that tax on labour needs to be reduced. The options for financing reductions are public expenditure reductions and increased taxation elsewhere. The alternative tax bases could be consumption, or factors of production other than labour.³⁵⁵ For example, revenue from increased use of environmental and energy taxes could be used to finance reductions in taxes on labour.

The High Level Group did not support the idea of minimum corporation tax rates. However, representatives stressed the need for defining acceptable and unacceptable conduct in a Com-

³⁵⁰ See ESC Opinion on the Ruding Report and the Commission’s Reaction to it, *European Taxation*, April, pp. 146-150 as referred to in Terra and Wattel (2001), p. 189.

³⁵¹ Commission (2001b), p. 4.

³⁵² Commission (1996a).

³⁵³ Commission (1996c).

³⁵⁴ According to the Monti Report, between 1980 and 1994, the European average of the implicit tax rate on employed labour increased steadily from 34.7 % to 40.5%. The same rate for other factors of production (capital, self-employed labour, energy, natural resources) decreased from 44.1% to 35.2%. The rate for consumption was broadly stable, rising slightly from 13.1% to 13.8%.

³⁵⁵ See Commission (1996c), p. 9.

munity context, and at sharing information more closely on other Member States' taxation policies and measures.

Many personal representatives drew particular attention to the problem of capital income taxation, both within the Union and worldwide. Capital income, particularly interest income from savings, forms the most mobile base of all, and differences in taxation can cause serious distortions to capital allocation and flows. The introduction of the Euro as a common currency may increase this sensitivity to tax differences. In response to this problem, many representatives called for a minimum level of taxation on interest income from savings to be ensured throughout the Union in order to prevent economic disruptions and revenue losses. Some favoured a minimum withholding tax; while others supported more exchange of information between administrations on the interest income of non-residents.³⁵⁶

The representatives recommended the following initiatives³⁵⁷:

- a. securing broad agreement on what types of measure are harmful in a community context;
- b. defining common standards across a range of areas (a 'code of good conduct');
- c. introducing greater co-ordination of measures that are taken by the taxation authorities of the Member States and designed to prevent tax competition from harming the common interest; and
- d. reinforcing co-operation between tax authorities in the mutual fight against tax fraud and evasion.

Thus, the main conclusion of the Monti Report is that more co-ordination is needed in the area of corporate taxes, in order to tackle harmful tax competition and create better environment for employment. The text is a compromise between representatives of different Member States, who all had to agree with the conclusions of the Group summarised in the Report. Probably this is a reason why the Report is very general in its content, mainly wording the over-all political objectives, but not offering concrete policy measures. More concrete policy action was designed in the next documents by the EU institutions.

There have been some important steps towards greater tax co-ordination since the Monti Report was published, notably in the direct tax field. In particular, the comprehensive agreement by the Council on a package of three measures to tackle harmful tax competition proposed by the Commission (see next section) were steps forward towards greater tax co-ordination.

2.4.4 EU policy to tackle harmful tax competition

2.4.4.1 Background

Globalisation and increasing openness of the markets have created new challenges for national tax policies. The markets are much more integrated due to new technological possibilities and the reduction of market access barriers. Some production factors, such as capital, and also, highly skilled labour have attained high international mobility. Therefore, some economic activities such as investments and savings, financial services etc. can easily move to the country with a lowest effective tax level. The effects of these developments are particularly strong in the Single Market where the liberalization process is relatively advanced (e.g. telecommunications, energy, public procurement, financial services). The integration of the markets has considerably increased competition between the jurisdictions for mobile tax bases. Because the mobile factors are very sensitive to the differences in tax rates, the gov-

³⁵⁶ Ibid, p. 8.

³⁵⁷ Ibid, p. 12.

ernments have to decrease the tax burden on these mobile factors in order to avoid these factors to move out from the countries. The resulting tax competition is an increasingly important issue in the EU.

Tax competition can be defined as improving the relative competitiveness of a country by means of policy and legislation in order to attract mobile economic activities and the corresponding tax base.³⁵⁸ Member States offer various tax advantages and reduce overall tax burden to improve their competitive position and to attract investments. There are several ways to define harmful tax competition. No single definition exists. It has been held that tax competition can become harmful when it provides taxpayers with the means to considerably lower their tax contribution or even to avoid all taxation while at the same time continuing to benefit from public services in their country of residence.³⁵⁹ Tax competition has the potential to be harmful by distorting investment flows, thereby undermining the integrity and fairness of the tax structure, shifting the tax burdens and increasing administrative costs.³⁶⁰

The Commission concludes in its latest study about company taxation³⁶¹ that welfare implications of tax competition in general are manifold, as tax competition affects the tax structure, the tax burden and, ultimately, the financing and the provision of public goods. Tax competition may affect to different extents the various existing tax bases, thereby inducing differentiation or approximation of effective tax rates, and the corresponding increase or diminution of a number of tax distortions. At the same time, it may induce a change in the overall tax burden, in the form, for instance, of a downward pressure on the overall tax level. Its effect on welfare will then depend on a number of factors, such as the State expenditures and revenues structures, the overall public finance position of the State, etc. In order to stabilize their tax revenues Member States of the EU found that some collective action is necessary, which led to the agreement on harmful tax competition.

The Commission considers in its working document that tax competition in itself is generally to be welcomed.³⁶² However, unrestrained competition for mobile factors can both bias tax systems against employment and make a reduction in the overall tax burden more difficult. Furthermore, tax competition can hamper efforts to reduce budget deficits, which is needed in order to comply with the Stability and Growth Pact. Therefore, the Commission concludes that more tax co-ordination is needed in the area of tax competition, because otherwise harmful tax competition will become an increasing source of conflict among Member States. This kind of argumentation brought the Commission to the Verona Memorandum of 1996.³⁶³

During the informal meeting of Ministers for Economic Affairs and Finance in Verona in April 1996, the Commission initiated a discussion of ways to counter harmful tax competition in the European Union.³⁶⁴ This discussion was held at the informal meeting of finance ministers in Mondorf-les-Bains in September 1997. Discussion concerned the need for co-ordinated action at European level to tackle harmful tax competition in order to help to achieve certain objectives such as reducing the continuing distortions in the single market, preventing significant losses of tax revenue and getting tax structures to develop in a more employment-friendly way. Three areas were particularly highlighted: business taxation, taxation of savings income and the issue of withholding taxes on cross-border interest and royalty payments between companies.

³⁵⁸ Buur (2000), p.9.

³⁵⁹ See Parly (2000), p. 406.

³⁶⁰ OECD (1998).

³⁶¹ Commission (2001c).

³⁶² See Commission (1997a), p. 2.

³⁶³ See Commission (1996c).

³⁶⁴ See Commission (1997a) and Commission (1996a).

ECOFIN Council on 1 December 1997 agreed on a package of three measures to tackle harmful tax competition proposed by the Commission.³⁶⁵ The package seeks to develop a coordinated approach to harmful tax competition. The three measures included the Resolution on a code of conduct for business taxation (hereafter the Code of Conduct or Code)³⁶⁶, as well as the texts on the proposals of two Directives: one concerning the taxation of savings and the other withholding taxes on the interest and royalty payments between related companies³⁶⁷. The tax package is a political non-enforceable commitment of the Member States. The fact that three measures are included into a package means that in principle the effectuation of each measure in the package is conditional on the others becoming effective as well. Although on the Interest and Royalties Directive Member States reached an agreement, it could not be adopted, because of disagreement in respect of Savings Directive. However, at the meeting of Council of Economics and Finance Ministers of 21 January 2003 political agreement was reached on the tax package including a proposed Savings Directive.³⁶⁸ The Council adopted a package of three measures to tackle harmful tax competition in June 2003. The Directive on savings taxation is due to take effect from 1 January 2005 and that on interest and royalties from 1 January 2004.³⁶⁹ The Code of Conduct is already operating, although extensions for limited periods of time have been allowed for certain business tax measures viewed as having harmful features. Member States with dependent and associated territories have agreed to ensure the adoption there of the same measures adopted in the Community concerning savings taxation and to ensure the standstill and rollback of harmful business taxation measures in accordance with the Code of Conduct.³⁷⁰

³⁶⁵ Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy – Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation - Taxation of savings, OJ C 002, 06/01/1998, pp. 1 - 6.

³⁶⁶ Ibid, Annex 1.

³⁶⁷ Ibid, Annex 2.

³⁶⁸ The Council agreed that the Savings Directive should be implemented into Member States' national laws from 1 January 2004 and be applied from 1 January 2005. The Savings Directive stipulates that Member States should either pay taxes on income from savings in the fixed amount of 20 per cent withholding tax or to provide information on income to the authorities of the individual's country of residence at least once a year. According to the Savings Directive all Member States, with the exception of Austria, Belgium and Luxembourg will automatically exchange information about cross-border EU interest payments, originating in their territories, which are paid after the Directive comes into effect. Instead of exchanging information Austria, Belgium and Luxembourg will apply a transitional withholding tax, whereof 75 per cent of the collected revenue will be paid to the relevant residence Member State. During this transitional period the three countries will apply a staged withholding tax (15 per cent in the first three years, 20 per cent after 1 January 2007 and 35 per cent starting January 2010). The agreement does not commit all three countries to implement the information system after 2010; the system switch depends on whether the other Member States will reach unanimous arrangements (as defined in the OECD Agreement on Exchange of Information on Tax Matters) with the US, Switzerland, Liechtenstein, San Marino, Monaco and Andorra. The Council also approved a draft agreement with Switzerland concerning the taxation of savings income including the extension of benefits of the parent/subsidiary and interest/royalty Directives with a derogation for Spain to allow it to negotiate separately with Switzerland on these two Directives. The Council agreed that the four elements of this agreement with Switzerland should also constitute the basis for agreements between the EU and Liechtenstein, Andorra, Monaco and San Marino. The Council reaffirmed that the exchange of information on as wide a basis as possible is to be the ultimate objective of the European Union in line with international developments.

³⁶⁹ See section 4.2.4 about Interest and Royalty Directive.

³⁷⁰ Member States in question are the United Kingdom and the Netherlands and the relevant dependent and associated territories are the Channel Islands, the Isle of Man and the dependent and associated territories of the UK and the Netherlands in the Caribbean.

2.4.4.2 *The Code of Conduct*

2.4.4.2.1 Scope of the Code

The Code of Conduct concerns business taxation, namely those measures, which affect, or may affect, in a significant way the location of business activity in the Community. The tax measures covered by the Code include both laws and regulations and administrative practices. The Code is a political agreement, an instrument of international soft law. It is stated in the Code that it does not affect rights, obligations and powers of the Member States or the Community. The Code is not legally binding document nor can it be invoked before the ECJ. Above all, it represents the outcome of a political process.³⁷¹

According to the Code of Conduct, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by this Code. Such a level of taxation may operate by virtue of the nominal tax rate, the tax base or any other relevant factor. The aim of this criterion is only to target tax niches developed to attract the internationally most mobile investments.

2.4.4.2.2 Criteria for assessment of harmful measures

The Code of Conduct specifies the following five criteria to be taken in account when assessing whether such measures are harmful:

- a. tax advantages are accorded only to non-residents or in respect of transactions carried out with non-residents;
- b. tax advantages are ring-fenced from the domestic market, so they do not affect the national tax base;
- c. advantages are granted even without any real economic activity and substantial economic presence within the Member State offering such tax advantages;
- d. the rules for profit determination in respect of activities within a multinational group of companies departs from internationally accepted principles, notably the rules agreed upon within the OECD;
- e. the tax measures lack transparency, including where legal provisions are relaxed at administrative level in a non-transparent way, thereby allowing the tax authorities room for discretion.

The Code of Conduct also contains two more criteria, which have to be taken into account when an assessment is made whether the tax measure in question is harmful. First, the effects of the tax measure on other Member States, inter alia in the light of how the activities concerned are effectively taxed throughout the Community. Second, insofar as the tax measure is used to support the economic development of particular regions, an assessment should be made of whether the measure is in proportion to, and targeted at, the aims sought. In assessing this, particular attention should be paid to special features and constraints in the case of the outermost regions and small islands, without undermining the integrity and coherence of the Community legal order, including the internal market and common policies.

Some countries (i.e. France) have insisted that the Code of Conduct should be included in the *acquis communautaire* of the Community to ensure that new Member States agree to comply with its principles.³⁷² In addition, it has been argued that the Code of Conduct Group should be consulted during the enlargement negotiations in order to make sure that the preferential

³⁷¹ See Santos (2000), p. 419.

³⁷² See Parly (2000), p. 407.

tax regimes of the new Member States are not harmful within the meaning of the Code of Conduct.³⁷³

2.4.4.2.3 Procedure for assessment of harmful measures

Member States commit themselves not to introduce new harmful tax measures (standstill principle), and to amend laws and practices with a view to eliminate any existing harmful measures as soon as possible while taking into account the Council's discussions following the review process (rollback principle). Member States will inform each other of existing and proposed tax measures which may fall within the scope of the Code. The European Council in Feira on 19 and 20 June 2000 stressed that 1 January 2003 is the final deadline for the rollback of harmful tax regimes.

A group consisting a high-level representative from each Member State and the Commission (so-called Primarolo group³⁷⁴ or the Code of Conduct Group) was set up to select and review the harmful tax measures in accordance with paragraphs E and G of the Code of Conduct. The group reported regularly on the measures assessed. These reports are forwarded to the Council for deliberation and, if the Council so decides, published. The Commission assists the group in carrying out the necessary preparatory work for its meetings as well as facilitates the provision of information and the review process. The Council and Member States review the provisions of the Code two years after its adoption.

According to Mr. Antonio Carlos Santos, former State Secretary for Tax Affairs of Portugal and member of the Code of Conduct Group, points out that any kind of decision-making based on voting procedures was systematically avoided within the Code of Conduct group because the Council did not clarify the decision-making process.³⁷⁵ The Group favoured decisions taken on the basis of a broad consensus. However, Mr. Antonio Carlos Santos stresses that when the 66 harmful measures named in the final list are analysed, it appears that only rarely did real consensus exist about the decision to include a specific measure or not.³⁷⁶

2.4.4.2.4 Report by Code of Conduct Group

The Group set up to monitor follow-up of the Code of Conduct submitted the Report to the Council on November 23, 1999.³⁷⁷ The Report is based on lists, summaries and generic background papers provided by the Commission in cooperation with Member States (some of whom provided their own lists).³⁷⁸ The Report contains descriptions of over 200 preferential tax regimes in Member States, 66 of which are considered to be potentially harmful. The list of harmful measures includes 26 measures of associated territories and remaining 40 measures are those of the Member States. The list includes tax measures which provide for a significantly lower effective tax level, including zero taxation, than those which generally apply in a Member State concerned. The Netherlands has the greatest number of harmful measures in this list (namely, ten measures), followed by Belgium, Ireland and Luxembourg with five measures each. Sweden and the United Kingdom – if one does not take into account Guernsey, Jersey, Isle of Man and Gibraltar – do not have any measure included in the list.³⁷⁹

³⁷³ Ibid, p. 409.

³⁷⁴ Mrs. Dawn Primarolo, the UK Paymaster General, chaired the group of representatives.

³⁷⁵ See Santos (2000), p. 419.

³⁷⁶ Ibid.

³⁷⁷ Code of Conduct Group, European Council, *Report of Code of Conduct (Business Taxation)*, SN 4901/99, November 23, 1999. The text of this report is available on the following website http://europa.eu.int/comm/taxation_customs/taxation/law/primarolo.htm

³⁷⁸ Ellis (2000), p. 414.

³⁷⁹ Hamaekers (2000).

Mr. Frits Bolkestein, the current European Commissioner responsible for tax matters, has highlighted that the Code of Conduct Group's conclusions that certain tax measures are harmful does not mean that they must all be abolished in their entirety.³⁸⁰ Many of them may simply need some refinement to ensure that the rules are open and transparent or that they comply with internationally accepted principles.³⁸¹ The Code of Conduct Group was of the opinion that certain holding company regimes in the EU are harmful. However, not all holding company regimes are harmful, they may not result in income avoiding tax altogether – income that has benefited from a harmful tax regime in another country should not also benefit from the holding company regime.³⁸² The Code of Conduct Group agreed that certain issues such as general zero rates or no business taxation, related guarantees and tax credits that are calculated on the basis of employment-related liabilities, will be considered further during a review procedure of the Code of Conduct by a Taxation Policy Group, to be appointed by the Council.^{383 384}

Member States and their dependent and associated territories have now introduced revised or replacement measures in substitution for the 66 measures which were considered potentially harmful by Primarolo Group. For beneficiaries of those regimes on or before 31.12.2000, a "grand-fathering" clause has been provided under which benefits have to lapse no later than 31.12.2005, independently of whether or not they were granted for a fixed period. Some extensions of benefits for defined periods of time beyond 2005 have been agreed for measures in Member States and their dependent and associated territories.³⁸⁵ The Council asked the Code of Conduct Group to monitor standstill and the implementation of rollback and report to the Council by the end of 2003.

The harmful tax measures may also be challenged under the state aid rules (see section 2.4.4.3). In addition, Article 96 provides for directives proposed by the Commission if some of the Member State is distorting competition in the common market, adopted by a qualified majority.

2.4.4.2.5 Reactions to EU policy to tackle harmful tax competition

EU policy to tackle harmful tax competition has been criticized for several grounds. Some reactions by Member States and business Community are presented below.

Criticisms of the Code of Conduct

Several commentators have argued that the Code of Conduct is following more the interests of larger than smaller Member States.³⁸⁶ According to Ellis (2000)³⁸⁷ the fundamental problem of the Code of Conduct is that it tries to level of playing field that is by definition not even. The large countries have significant advantages over small ones because companies operating in a large country are facing lower tax costs than they face in a small country. The most important tax areas where large countries have advantages over small ones are transfer pricing, withholding taxes on interest and royalty payments, the international double tax-

³⁸⁰ Bolkestein (2000), p. 405.

³⁸¹ Ibid.

³⁸² Ibid.

³⁸³ Hamaekers (2000).

³⁸⁴ Some Member States criticized those new criteria, because they were not based on the Code of Conduct.

³⁸⁵ The Commission has decided to bring an action before the ECJ seeking the annulment of the Council decision which authorized Belgium to renew the application of a preferential tax scheme to certain coordination centers whose approval was to expire before the end of 2005.

³⁸⁶ See Klaver and Timmermans (1999), pp. 187-188 and Ellis (2000), p. 415.

³⁸⁷ See p. 415.

tion, loss compensation and depreciation relief.³⁸⁸ Because big countries have these advantages over small ones, they can impose higher taxes and still remain competitive. Ellis argues that by taking away the small countries' opportunity to cultivate niche markets, the natural advantage of the large countries is strengthened.³⁸⁹ In addition, it is argued that less-developed regions and dependent territories need to use preferential tax schemes in order to attract investment and promote competitiveness because these preferential tax regimes can promote the free flow of capital and help to mitigate the competitive disadvantages (geographical location, lack of resources, etc.) of a given country or region, in particular of those which merely have a formal independence.³⁹⁰

In addition, it has been argued that decision-making process under the Code of Conduct is non-transparent and can favour larger Member States. Mr. Antonio Carlos Santos, former State Secretary for Tax Affairs of Portugal and member of the Code of Conduct Group, discussing political character of the Code of Conduct in contrast to the legal character of the state aid provisions of the EC Treaty, states that the non-binding character of the Code offers little guarantee of impartiality. He also criticizes the political decision-making process within the Code of Conduct Group and fears that political sanctions may be used more easily against the small countries.³⁹¹

Reactions to Primarolo Report by Member States

The final report was not received enthusiastically by some of the Member States.³⁹² The most critical comments were made by the Netherlands which stated that the Primarolo Group had gone beyond its mandate and the criteria that had been used to identify harmful tax measures were not based on the Code of Conduct. Furthermore, the Netherlands held that the report neither contained a broad cross-state review nor an in-depth evaluation of the effects that the tax measures could have on the choice of business location. In addition, some Member States criticized the list of the potentially harmful measures by the Code of Conduct Group and made reservations about the evaluation of some of their regimes. For example, the Netherlands and Luxembourg argued that it was not in line with the criteria of the Code of Conduct under which all the measures that affect choice of a business location had to be included. The Ireland stated that it was not indicated in respect of which measures to what extent the effective level of taxation was lower than the level generally applied in the Member State. Several Member States argued that the list is inconsistent.³⁹³ It was also argued that the Primarolo Report does not clarify what the elements were that caused certain measures to be classified as harmful.³⁹⁴

Some Member States were much more positive towards Code of Conduct. For example, France stated that the scope of Code is well-defined and the working methods advocated by it are appropriate and based on transparency, openness, dialogue and critical analysis. France held that even if it does not share the opinion of the group on its regimes, France did not object to their inclusion in the list of the Code of Conduct Group, since discussions concerning this subject will continue.

Comments by the business community

The tax package has said to be following more Member States' interest of maintaining their tax revenues rather than removing the tax obstacles to the Internal Market and increasing the

³⁸⁸ Klaver and Timmermans (1999), p. 188.

³⁸⁹ Ellis (2000), p. 415.

³⁹⁰ Santos (2000), p. 417.

³⁹¹ Ibid, p. 420.

³⁹² Hamaekers (2000), pp. 398-399.

³⁹³ Ibid, p. 398.

³⁹⁴ See Ellis (2000), p. 416.

EU's global competitiveness. The Council's approach has not attached enough priority to the elimination of obstacles to cross-border business activities and investment, and diminution of tax costs and administrative burden that the companies entail operating in the Single Market.³⁹⁵ According to Business and Advisory Committee to OECD (BIAC) tax burden is only one of the factors which is taken into account in determining the place of establishment of a business and that, therefore, tax differences are not harmful.³⁹⁶

Some arguments behind the policy to tackle harmful tax competition have also been criticized, for example, the reasoning that the erosion of the tax base resulting from harmful tax competition has led Member States to tax less mobile bases, particularly labour, more heavily. Such reasoning assumes that the amount of lost revenue, if any, resulting from tax competition would allow alleviation of the tax burden on labour. According to UNICE³⁹⁷, it seems to be an exaggeration of the budgetary effects of the sort of tax competition covered by the Code of Conduct. Furthermore, this reasoning takes for granted that the business activities that benefit from 'harmful' tax regimes within the EU would have stayed within the EU if taxed under a 'normal' system.

UNICE believes that an implementation of the Code of Conduct would lead to an overall increase in the tax burden on business where a reduction is urgently needed.³⁹⁸ Certain Member States have already attempted to expand the scope of the Code to include general low-tax systems prevailing in other Member States. In UNICE's view tax competition is the only counterweight against the upward pressure on government revenues in the EU and that this type of competition must be allowed to continue, as acknowledged by the Commission's approval (July 1998) of the general Irish corporation tax rate of 12.5 per cent applicable to all companies.

Some Member States make an effort to tackle foreign low-tax regimes by unilaterally subjecting low-taxed foreign-source income to domestic taxation, even though the foreign operations have economic substance and, based on these Member States' general tax systems, such income would normally not be subject to domestic taxation (e.g. Germany and France)³⁹⁹. UNICE believes that given that generally applicable low-tax regimes are not, and should not be, in conflict with the Code of Conduct, these Member States should not be allowed to continue their taxation of foreign-source income insofar as it is derived from such regimes.⁴⁰⁰

2.4.4.3 *Fiscal state aid and harmful tax competition*

2.4.4.3.1 Background

The Commission has highlighted that the state aid provisions of the Treaty also contribute through their own mechanism to the objective of tackling harmful tax competition. State aid is one important impediment to free competition. About 30% of state aid is allocated by means of tax measures.⁴⁰¹ The Commission and the ECJ have scrutinised fiscal state aid measures under Article 87 of the EC Treaty since 1960s. Over the last years the issue of state aid has gained importance with the increasing opening of the markets and liberalisation in the Single Market. The more integrated economy leaves less policy instruments to Member States to protect their domestic economy (i.e. with the introduction of the third stage of the

³⁹⁵ See UNICE (1999).

³⁹⁶ The Business and Industry Advisory Committee to the OECD (BIAC) (2000).

³⁹⁷ See UNICE (1999), p. 76.

³⁹⁸ Ibid.

³⁹⁹ Ibid, pp. 77-78.

⁴⁰⁰ Ibid, p. 78.

⁴⁰¹ Commission (1997b), p. 13.

EMU the participating States have lost the ability to use monetary policy to protect their economy in the case of asymmetric shocks). Thus, Member States may increasingly use fiscal aid measures to protect their domestic economy. However, such protectionist measures can affect free competition and, consequently, it becomes more important to tackle distortionary fiscal state aid measures in the Single Market. In 1997, the Commission changed its policy towards Member States' fiscal measures by applying more strictly the state aid provisions of the EC Treaty and laid down more rigorous criteria for fiscal aid measures. This is a consequence of the commitment of both the Council as well as the Commission to tackle harmful tax competition within the EU.⁴⁰² In 1998, the Commission published a notice on the application of State aid rules to measures relating to direct business taxation.⁴⁰³

2.4.4.3.2 State aid provisions in the EC Treaty

The fundamental rules concerning the state aid are contained in Articles 87 and 88 of the EC Treaty. The former stipulates the substantive legal principles while the latter contains procedural provisions. Article 87(1) states that 'any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market'. Since Article 87 refers to aid measures 'in any form whatsoever', fiscal state aid measures are also included. Articles 87(2) and (3) provide exemptions to Article 87(1) by specifying the forms of state aid which are allowed under the Treaty. The importance of Article 87 in the context of harmful tax competition relies in the fact that while the Code of Conduct has no binding force and cannot be judicially executed among Member States, the Treaty's articles on State aid confer on the Commission the power to forbid certain measures if they are not covered by the exemptions provided by Articles 87(2) and (3).⁴⁰⁴

Article 87(1) stipulates four conditions which need to be met for a measure to be considered 'state aid':

- advantage conferred to a firm;
- granted by a Member State or through State resources;
- specificity or selectivity;
- distortion of competition and impact on trade between Member States.

Article 87 distinguishes between general and specific tax measures. Selective fiscal aid is prohibited under Article 87(1). Tax measure is considered to be selective or specific if 'certain undertakings or the production of certain goods' are favoured by it. Aid is selective if it is not available to all economic agents. On the other hand, it is not necessary that all economic agents benefit equally from the 'general measure'.⁴⁰⁵ For example, the depreciation rules may constitute derogation from the general tax rules if they set special tax rates or tax bases with respect to certain sectors or taxpayers but they do not necessarily constitute state aid. In 1974 the ECJ introduced a justification for a selective tax measure in the 'nature or general scheme of the tax system' by accepting that general tax measures arising from national tax system do not constitute state aid under Article 87(1).⁴⁰⁶ Furthermore, Article 87(1) does not prohibit Member States from reducing or abolishing a tax or changing its general tax scheme in order to further its economic aims.⁴⁰⁷ Tax measures pursuing general

⁴⁰² See Pinto (1999), p. 295.

⁴⁰³ Commission (1998). See section 2.4.4.3.3 about this notice.

⁴⁰⁴ Schön (1999), p. 912.

⁴⁰⁵ Ibid, p. 932.

⁴⁰⁶ See Case C-173/73, (*Italy v Commission*).

⁴⁰⁷ Quigley (1988) as referred to in Schön (1999), p. 924

economic policy objectives (provided they apply to all taxpayers without distinction) are not considered state aid.

In addition to the 'selectivity' criterion tax incentive has to 'affect trade between Member States' to qualify as a tax measure prohibited under Article 87(1) of the EC Treaty. Non-discriminatory measures are also included because they may distort competition with respect to competing products.

This is the picture of fiscal state aid up to and including 1998 when the Commission issued its first guidelines on fiscal state aid.

2.4.4.3.3 The Commission's guidelines on fiscal state aid

On 1 December 1997, following the adoption of the package to tackle harmful tax competition, the Commission undertook to draw up guidelines on the application of Articles 87 and 88 of the Treaty to measures relating to direct business taxation. These guidelines were adopted in the framework of the Code of Conduct and followed the Council's decision contained in the package to tackle harmful tax competition that the Commission undertakes to publish guidelines on the application of the state aid rules. In 1998 the Commission presented 'Notice on the application of State-aid rules to measures relating to direct business taxation'⁴⁰⁸ (hereafter the Communication or the Notice) which intended to clarify whether a corporate tax measure can be qualified as state aid under Article 87(1) of the Treaty. In addition to providing a tool in the countering of harmful tax competition the Notice also aims at setting uniform principles and standards applicable to fiscal state aid provisions in order to ensure objectivity and equality of treatment between Member States as well as to guarantee transparency and predictability of the Commission's decisions.⁴⁰⁹

In its Communication the Commission explained the application to the fiscal state aid of the principles contained in Article 87 as developed by the case law of the ECJ and by the Commission. The Notice explains in detail the criteria the Commission uses in corporate tax matters. The Notice interpreted Article 87 as meaning that it sets the following four conditions to identify state aid contained in tax measures:

- a. the national measure confers upon addressees an advantage which relieves them of charges that are normally borne from their budgets. The advantage may be provided through a reduction in the firm's tax burden in various ways, for example, reduction in the tax base (such as special deductions, special or accelerated depreciation arrangements, special tax-free reserves, etc), a total or partial reduction in the amount of tax (such as exemption or a tax credit), or special lenience in the recovery of the tax claim (deferment, cancellation or even rescheduling of tax debts);
- b. the advantage is granted by the State or through State resources. A loss of tax revenue is equivalent to consumption of State resources in the form of fiscal expenditure. This criterion also applies to aid granted by regional or local bodies in Member States. Furthermore, this includes foregoing tax revenue, which would normally have been collected. State support may be provided just as much through tax provisions of a legislative, regulatory or administrative nature as through the practices of the tax authorities.
- c. the measure must be selective or specific (non-general or non-horizontal), and favouring certain undertakings or the production of certain goods.⁴¹⁰ The selective advantage involved here may derive from an exception to the tax provisions of a legis-

⁴⁰⁸ Commission (1998), p. 3.

⁴⁰⁹ Ibid.

⁴¹⁰ However, a selective measure may still be justified by the nature or general scheme of the national tax system. If so, the measure is not considered to be aid within the meaning of Article 87(1) of the Treaty.

lative, regulatory or administrative nature or from a discretionary practice on the part of the tax authorities.

- d. the measure must affect competition and trade between Member States. This criterion presupposes that the beneficiary of the measure exercises an economic activity, regardless of the beneficiary's legal status or means of financing. The criterion of trade being affected is met if the recipient firm carries on an economic activity involving trade between Member States. The mere fact that the aid strengthens the firm's position compared with that of other firms which are competitors in intra-Community trade is enough to allow the conclusion to be drawn that intra-Community trade is affected. Neither the fact that aid is relatively small in amount⁴¹¹, nor the fact that the recipient is moderate in size or its share of the Community market very small⁴¹², nor indeed the fact that the recipient does not carry out exports⁴¹³ or exports virtually all its production outside the Community⁴¹⁴ do anything to alter this conclusion.

The third (selectivity) requirement is fulfilled if the application of preferential tax provision is left to the discretion of the tax authorities. Individual rulings by the tax authorities do not constitute state aid if they are merely interpretations and applications of general tax rules in specific cases, but may constitute state aid if they depart from the general tax rules through administrative discretion on the basis of other than objective and public criteria. The ECJ has ruled that treating economic agents on a discretionary basis may mean that the individual application of a general measure takes on the features of a selective measure, in particular where exercise of the discretionary power goes beyond the simple management of tax revenue by reference to objective criteria.⁴¹⁵ The decisive criterion for the state aid nature of administrative practices is non-transparent, discretionary and differentiated treatment on a case-by-case basis by a Member State's tax authority.⁴¹⁶ Thus, an administrative ruling which granted a single Spanish company the carry-forward of losses was deemed to be a selective aid.⁴¹⁷

2.4.4.3.4 Distinction between state aid and general measures

In its Notice the Commission highlights that it is important to distinguish between state aid and tax measures which are open to all economic agents operating within a Member State (so-called general measures). General measures must be effectively open to all firms on an equal access basis, and they may not *de facto* be reduced in scope through, for example, the discretionary power of the State to grant them or through other factors that restrict their practical effect. However, this condition does not restrict the power of the Member States to decide on the economic policy which they consider most appropriate and, in particular, to spread the tax burden as they see fit across the different factors of production.

Provided they apply without distinction to all undertakings and to the production of all goods, the following national tax measures do not constitute state aid:

- 1) Measures having a 'technical nature', such as:
 - depreciation rules (e.g. the general availability of relatively short depreciation periods);

⁴¹¹ With the exception, however, of aid meeting the tests of the *de minimis* rule. See the Commission notice published in OJ C 68, 6.3.1996, p. 9.

⁴¹² Joined Cases C-278/92, C-279/92 and C-280/92 (Spain v Commission), [1994] ECR I-4103.

⁴¹³ Case C-102/87 (*France v Commission*).

⁴¹⁴ Case C-142/87 (*Belgium v Commission*).

⁴¹⁵ Case C-241/94 (*France v Commission*).

⁴¹⁶ See Pinto (1999), p. 345.

⁴¹⁷ Commission, OJ 1996, C 72/2, 4 as referred to in Schön (1999), p. 932.

- relatively long loss carry-over periods;
 - low rate of taxation⁴¹⁸;
 - generous unilateral rules for the prevention of international double taxation.
- 2) Measures pursuing general economic policy objectives⁴¹⁹ through a reduction of the tax burden related to certain production costs, such as:
- research and development (R&D) expenses;
 - the environment-friendly investments;
 - training and employment activities.

The Commission highlights that the above-mentioned fiscal measures will be considered not to constitute state aid only as long as they do not have the effect of favouring certain taxpayers and/or sectors of the economy. The Notice also clarifies that the fact that some firms or some sectors benefit more than others from tax measures does not necessarily mean that they are caught by Article 87(1). According to the Commission, a shift of the tax burden between the firms or factors of production does not necessarily constitute state aid, even if the preferential tax treatment benefits certain branches. For example, tax incentives for environmental, R&D or training investment favour only the firms which undertake such investment, without necessarily constituting state aid. Similarly, the measures designed to reduce the taxation of labour for all firms have a relatively greater effect on labour intensive industries than on capital-intensive industries, but again do not necessarily constitute state aid.

It is essential to distinguish between selective tax incentives and measures in accordance with the 'general scheme' which deal with the fiscal aspects of a tax and do not constitute state aid at all or which apply not only to certain undertakings or goods but also to the whole economy.⁴²⁰ The selective tax rules which affect certain enterprises or groups of enterprises may not be considered to be state aid according to the Commission. The Member State have possibility to provide justification for the measures whose economic rationale makes them necessary to the functioning and effectiveness of the tax system.

2.4.4.3.5 Compatibility with the common market of fiscal state aid

The EC Treaty defines state aid as measures which are intended to promote the economic development of a region. Article 87(3)(a) and (c) explicitly provides, in the case of state aid intended to promote the economic development of particular areas, for possible derogations from the general principle of incompatibility laid down in Article 87(1). The Commission considers this type of aid to be compatible with the common market if it is 'in proportion to, and targeted at, the aims sought'. For the examination of regional aid the criteria allow account to be taken of other possible effects, in particular of certain effects brought to light by the code of conduct. Where a derogation is granted on the basis of regional criteria, the relevant measures must:

- contribute to regional development and relate to activities having a local impact. The establishment of off-shore activities does not, to the extent that their externalities on the local economy are low, normally provide satisfactory support for the local economy,
- relate to real regional handicaps,

⁴¹⁸ Ireland, for instance, got rid of its special and regional schemes and instead lowered its normal corporate tax rate to 12.5 per cent for all profit-pursuing activities anywhere. See Walsh (1998).

⁴¹⁹ In its Notice the Commission clarifies that concerning this category of fiscal measures there must be a justification for the measure consisting of an appreciable goal of domestic economic policy or another desirable social or economic goal.

⁴²⁰ Schön (1999), pp. 916-917.

- be examined in a Community context. Any negative effects which such measures may have on other Member States have to be taken into account.

2.4.4.3.6 The procedure for Commission's investigation

According to the Commission the main criterion in applying Article 87(1) to a tax measure is that the measure provides in favour of certain undertakings in the Member State an exception to the application of the tax system. According to the Notice it should be determined whether the four conditions to identify state aid are met and, in particular, whether a fiscal measure constitutes an exception to the general tax system. The notice requires a determination of the general tax system of the Member State concerned and then to find out whether the fiscal measure concerned is to be labelled as a specific measure, i.e. the exception to the system or differentiation within that system. If this is the case, then it must be examined whether this exception or differentiation is justified 'by the nature or general scheme' of the tax system, that is to say, whether it derives directly from the basic or guiding principles of the tax system in the Member State concerned. This investigation will lead to the decision by the Commission on the compatibility of the fiscal measure with the EC rules on state aid.

In its Notice the Commission highlighted as did the ECOFIN Council when adopting the Code of Conduct, that Member States should remove the general or specific anti-abuse measures vis-à-vis groups of companies headquartered within their jurisdiction which avail themselves, through subsidiary companies without much economic substance, of the benefits of a low tax regime applied by another Member State, after that regime has been approved by the Commission under the EC State Aid Rules.⁴²¹ According to the Notice the Commission should examine or re-examine case by case, as noted by the Council in the package to tackle harmful tax competition, the tax arrangements in force as well as proposed new legislation in Member States.

2.4.4.3.7 Change in Commission's policy

The Commission has changed its policy towards Member States' fiscal measures over the last years. The Notice on State Aid foresees a stricter application of State Aid rules of the EC Treaty. Using these new rules, the result can be that tax regimes that did not constitute state aid in the past will now be caught by Article 87(1). One example is the Irish corporation tax case⁴²² where the Commission changed its position lately. In 1980 Ireland introduced a preferential tax rate of 10% for companies deriving income from manufacturing activities within the country. The Commission considered it compatible with state aid provisions because this 10% rate was regarded part of the general Irish tax system and therefore outside the scope of Article 87. In 1998, however, the Commission changed its view with respect to the preferential 10% rate for manufacturing activities in the Recommendation concerning this Irish corporation tax issue.⁴²³ The background to the Recommendation is a substantial reform of the Irish corporate tax system and the introduction of two different tax rates from 2003 depending on the nature of taxable income: the new 12.5% tax rate will apply on income from trading activities whereas the remaining income from non-trading activities will be subject to 25% tax rate.⁴²⁴ The Recommendation stresses with respect to the 10 per cent tax rate for the

⁴²¹ See Terra and Wattel (2001), p. 200.

⁴²² For a detailed explanation of the Irish corporate tax regime and its recent changes, see McNally (1999) and Pinto (1999).

⁴²³ See Commission Decision of 22 July 1998 in the Irish corporation tax case, SG(98)D/7209 and Case E-2/98, 'Proposal for appropriate measures under Article 93(1) (i.e. now Article 88(1)) of the EC Treaty concerning Irish Corporation Tax (ICT)', in OJ C395 of 18 December 1998, p. 19. The Commission Recommendations can be found in Press Release IP 98/691 of 22 July 1998.

⁴²⁴ See Pinto (1999), p. 350 and McNally (1999) for a description of the new Irish corporate tax regime.

manufacturing sector that while the ‘selectivity’ condition was not regarded as met in 1980, it now appears to be fulfilled. The Commission stipulates that the measure imposed a lower rate of tax on manufacturing sector than on other sectors without any justification for this on the basis of the nature or general scheme of the tax system. The Commission found that the reason for setting lower rate for the Irish manufacturing sector (at variance with the general tax rate of 32 per cent) was rather the attraction of mobile investment in the manufacturing sector to Ireland through the reduction of the sector’s cost of production. The Commission decided that this lower rate constituted state aid because it excluded traders and services and favoured export-oriented undertakings. The Commission’s decision is remarkable because in it the Commission admitted its fault for not considering the lower rate for the Irish manufacturing sector as state aid for a period of almost twenty years. It is also interesting to note that the Commission found a justification for considering favourable treatment of manufacturing and service companies as state aid, lying in the ‘growing awareness of the effects of harmful tax competition ... following the Code of Conduct’.⁴²⁵

The Commission highlights in its Recommendation⁴²⁶ that it is not taking the view on what level of corporate taxation should be in Ireland. It follows that the new 12.5% rate applicable on trading income from 2003 will not be considered state aid prohibited under Article 87(1) of the EC Treaty. Thus, setting the low rate of taxation by other Member States will also be considered compatible with the Treaty. ‘In itself, this seems a corollary of the unrestricted sovereignty of the Member States in the area of direct taxation, which is not to be affected by EU law, meaning *inter alia* that Member States are free to set their general corporate tax rate at any level they feel appropriate, even a very low one.’⁴²⁷ Furthermore, by accepting differential 12.5% tax rate for only trading activities, ‘the Commission is in fact acknowledging that Member States have full sovereignty not only in setting a single general corporate tax rate, but also in differentiating rates depending on the underlying category of income derived by (both resident and non-resident) corporate taxpayers.’⁴²⁸

The analysis of the Notice and the Commission’s latest decisions shows that the Commission has substantially changed its policy as to the assessment of the compatibility of tax incentives with EC Treaty state aid rules. As a result of the Recommendation, a tax incentive resulting in a reduction of costs and limited to the selected sectors will from now on be considered state aid even where it is available for both residents and non-residents.⁴²⁹

2.4.4.3.8 Connection between fiscal state aid and harmful tax measures

The Notice on fiscal state aid is part of the package to tackle harmful tax competition within the EU. The Code of Conduct is broader in scope than the Notice, because it also covers general tax measures implemented by Member States and having harmful effects. By contrast, the Notice applies exclusively to fiscal state aid measures, which must be selective or specific to fall under its scope.⁴³⁰ Furthermore, the state aid provisions only have an effect on a particular case, i.e. on specific points, and thus, it is possible that similar incompatible tax measures will remain even after the implementation of the judgement or decision. In addition, a state aid decision looks ‘ex post’ at the challenged measure, instead of acting as a guide for future developments. Moreover, application of state aid provisions may lead to inconsistent decisions. In contrast, the implementation of the Code of Conduct offers opportunity for more comprehensive and consistent solutions. According to one view, for example,

⁴²⁵ See Pinto (1999), p. 350.

⁴²⁶ See Commission Press Release IP 98/691 of 22 July 1998.

⁴²⁷ Pinto (1999), p. 351.

⁴²⁸ Ibid.

⁴²⁹ Ibid, pp. 349-354.

⁴³⁰ Ibid, p. 346.

if some type of tax regime is considered harmful, this type of regimes in all Member States could be examined and adjusted at the same time.⁴³¹

The main difference between guidelines on fiscal state aid and harmful tax measures lies in the fact that the Notice is based on state aid rules which have been laid down in the EC Treaty and are legally binding whereas the Code of Conduct is lacking legally binding force. The procedural rules governing the carrying out and completion of state aid investigations are stricter than those which apply to investigations carried out in the Code of Conduct Group.⁴³² An interesting difference between the application of state aid rules to fiscal measures and EU policies to tackle harmful tax competition is that, traditionally, state aid favours domestic companies to protect them from international competition, whereas harmful tax measures give preferential treatment to certain activities of foreign undertakings, like internationally mobile functions of multinational enterprises.⁴³³

The regulatory content of the Code of Conduct does not affect state aid provisions.⁴³⁴ Furthermore, in its 1998 Communication the Commission stated, that, the qualification of a tax measure as harmful under the Code of Conduct does not affect its possible qualification as a state aid.⁴³⁵ However, in its Notice the Commission declared its intention to make an assessment of the compatibility of fiscal aid with the common market, taking into account, *inter alia*, the effects of aid that are brought to light in the application of the Code of Conduct. On 25 February 2000 the European Commissioner for Competition, Mr. Mario Monti, announced that all of the measures listed in the final report of the Code of Conduct Group will be examined for their compatibility with the State Aid rules in Articles 87-89 of the EC Treaty on the basis of the Commission's Communication.

2.4.4.3.9 Implementation of the Notice

The Commission examined the compatibility with EU state aid rules of both the tax arrangements in force (analogous to the Code of Conduct's roll-back provision) and proposed new legislation in Member States (analogous to the Code of Conduct's standstill provision) according to the principles contained in the Notice. The Commission's work was similar to the one already undertaken by the Primarolo group (see section 2.4.4.1). The Commission studied all national measures already discussed within the Code of Conduct Group. On July 11, 2001 the Commission decided to launch formal investigation procedures under Article 88(2) of the EC Treaty for eleven national corporate tax schemes in eight Member States⁴³⁶

⁴³¹ See Hendricks (2000), pp. 413-414.

⁴³² Bolkestein (2000), p. 405.

⁴³³ According to the Code of Conduct, the tax measure is considered to be harmful if tax advantages are accorded only to non-residents or in respect of transactions carried out with non-residents. See also Schön (1999), pp. 934-935 and Terra and Wattel (2001), p. 198.

⁴³⁴ See preamble of the Code of Conduct (Annex 1 to the Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy – Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation - Taxation of saving, OJ C 002, 06/01/1998 p. 1).

⁴³⁵ Commission (1998), p.7.

⁴³⁶ Tax provisions for which the Commission decided to open the formal state aid investigation procedure were the following: the German Special Fiscal Regime for Control and Co-ordination Centres of Foreign Companies; the Spanish Special Fiscal Regime for Biscaye Co-ordination Centres; the French Headquarters and Logistics Centres Regime; the French special tax regime for international treasury pools; the Irish Tax Exemption on Foreign Income; the Luxembourg Coordination Centres Regime; the Luxembourg Finance Companies Regime; the Netherlands Special Fiscal Regime for International Financing Activities; the Finnish Captive Insurance Regime in the Åland islands; the United Kingdom Gibraltar Qualifying Offshore Companies Rules; and the Gibraltar Exempt Offshore Companies Rules.

and required Member States to suspend application of the measures under scrutiny.⁴³⁷ In addition, the Commission required four Member States to amend existing national laws so as to comply with EC state aid rules.^{438 439} The above-mentioned tax measures (altogether 15 tax provisions in 12 Member States) were mainly preferential tax arrangements granted to multinational companies active in the insurance and financial sector.

The first final decision adopted by the Commission in relation to the 11 investigation procedures it initiated on July 11, 2001 concerned preferential tax scheme for captive insurance companies in the Åland islands (Finland). On July 10, 2002 the Commission closed the formal investigation procedure and concluded that the 10% reduction in corporation tax granted to captive insurance companies in the Åland islands constituted state aid. The Commission found that the scheme did not qualify under any of the exceptions provided in the EC Treaty. The Commission holds in its Press Release⁴⁴⁰ that the scheme cannot be considered a general tax measure, since, although it is not restricted to specific sectors of the economy, in practice it benefits only those groups of companies that are large enough to be able to set up a captive insurance company.

On August 26, 2002 the Commission declared illegal the special tax regime available to so-called coordination centres⁴⁴¹ located in the province of Biscaye (Spain).⁴⁴² The Biscaye special tax provision provided for an alternative method (the cost-plus method) to calculate the income tax applicable to the coordination centres based in the province. The Commission states in its Press Release⁴⁴³ that although this method does not constitute state aid per se, its practical application can give rise to state aid. The Commission concluded that the Biscaye regime excluded financial costs from the calculation to determine the tax base. This reduced the tax burden on companies approved under the scheme and was not compatible with EU state aid rules. The Biscaye coordination centres scheme was abolished on 30 April 2002.⁴⁴⁴

On October 16, 2002 the Commission declared illegal the special Luxembourg tax regimes available to so-called coordination centres and finance companies. Although they were abolished by Luxembourg in 1996, a number of companies continued to benefit under the scheme until the end of 2001. The special tax provision provided for the cost-plus method to calculate the income tax applicable to the coordination centres and finance companies⁴⁴⁵. The Commission concluded that practical application of the cost-plus method by the Luxem-

⁴³⁷ The Commission stated that has doubts whether the preferential tax arrangements granted exclusively to multinational companies, or to companies active in the financial services sector, comply with state aid rules, because they only seem to relieve beneficiaries of a part of their normal tax burden. See the Commission's Press Release of July 11, 2001, IP/01/982.

⁴³⁸ Tax provisions for which the Commission proposed Member States appropriate measures in order to put an end to their incompatibility with state aid rules were the following: the Belgian Fiscal Regime of Coordination Centres; the Greek Fiscal Regime for offices of Foreign Companies; the Italian Tax incentives linked to the Trieste Financial Services and Insurance Centre; and the Swedish Foreign Insurance Companies Taxation Regime.

⁴³⁹ In regard to these four measures, the Commission stated that Member States concerned have to put the tax provisions in conformity with EC rules. If they refuse, the Commission will then open, also for these four measures, the formal investigation procedures. See the Commission's Press Release of July 11, 2001, IP/01/982.

⁴⁴⁰ See the Commission's Press Release of July 10, 2002, IP/02/1029.

⁴⁴¹ A coordination centre provides banking, marketing, insurance, logistics and other services to the companies of the international group to which it belongs.

⁴⁴² In the beginning of 2002, after the Commission started formal proceedings against the scheme, the Spanish government abolished it. However, under EU rules, the Commission must take a decision once it has started formal proceedings. See the Commission's Press Release of August 26, 2002, IP/02/1236.

⁴⁴³ The Commission's Press Release of August 26, 2002, IP/02/1236.

⁴⁴⁴ Ibid.

⁴⁴⁵ A finance company grants loans to the companies of the international group to which it belongs.

bourg authorities was liable to reduce the tax burden on companies approved under the scheme and was not compatible with EU state aid rules.⁴⁴⁶

On December 11, 2002 the Commission declared illegal the French special tax regime for international treasury pools. The French treasury pool regime concerns the tax deduction of interest expenses borne by a French subsidiary in connection with loans provided by its parent company. It only applies to parent companies and their French subsidiaries operating within a multinational group of companies established in at least two foreign countries other than France, provided that such subsidiaries have agreed with the tax authorities that they intend to operate under a special treasury pool arrangement. The French regime was introduced to mitigate the interest-deduction limitation in the French Tax Code and to increase the international competitiveness of multinational groups. However, the Commission's investigation revealed that the tax advantage granted under the regime constitutes a selective advantage benefiting only the French subsidiaries operating under the above-mentioned treasury pool arrangement. The Commission found that especially in case of risky international financing the distortion of competition created by the tax advantage is very substantial.⁴⁴⁷

On December 11, 2002 the Commission declared illegal the Italian tax incentives linked to the Trieste Financial Services and Insurance Centre.⁴⁴⁸

On February 17, 2003 the Commission decided that the special tax breaks in Belgium, Ireland and the Netherlands constituted State aid.⁴⁴⁹ The fiscal measures concerned included the Co-ordination Centres scheme in Belgium, the International Financing Activities scheme in the Netherlands and the Foreign Income scheme in Ireland. In each case, the Commission found that the scheme granted tax breaks that cannot be reconciled with the EU's rules on State aid.⁴⁵⁰ The three decisions constituted a vital building block in repealing certain tax schemes deemed harmful by the Code of Conduct. This approach is coherent with the one already followed in the nine previous business taxation cases for which the Commission had closed its State aid investigations⁴⁵¹ without ordering the beneficiaries to pay back the tax advantages already granted because beneficiaries had legitimate reasons to believe that they were lawful.

⁴⁴⁶ The Commission's Press Release of October 16, 2002, IP/02/1481.

⁴⁴⁷ See the Commission's Press Release of December 11, 2002, IP/02/1847.

⁴⁴⁸ These incentives grant banking and insurance undertakings operating in Central and Eastern European Countries several tax reductions. See the Commission's Press Release of December 11, 2002, IP/02/1851.

⁴⁴⁹ See the Commission's Press Release of February 18, 2003, IP/03/242.

⁴⁵⁰ Belgium contested the Commission's decision and applied to the Council for authorisation to renew the application of a preferential tax scheme to certain coordination centres whose approval was to expire before the end of 2005.⁴⁵⁰ At its meeting on 16 July the Council granted Belgium's request. The Commission has decided to bring an action before the Court of Justice seeking the annulment of the Council decision. The Commission considers that the Council's decision is unlawful, because it came after a final decision taken by the Commission on 17 February. In general only the Commission has power to rule on the compatibility of state aid with the Treaty. In matters of state aid the Council's role under the Treaty is restricted. The Commission argues in its Press Release of 16/07/2003 (IP/03/1032) that the Council may act before the Commission investigates a case, or while the Commission inquiries are in progress, but not after the investigation is complete and a decision has been taken.

⁴⁵¹ These are, in addition to those 7 schemes already mentioned (namely, the Spanish Special Fiscal Regime for Biscaye Co-ordination Centres; the Luxembourg Coordination Centres Regime and the Finance Companies Regime; the Finnish Åland Islands Captive Insurance Regime; the French special tax regime for international treasury pools; the Greek Fiscal Regime for offices of Foreign Companies; and the Italian Trieste Financial Services and Insurance Centres Regime), the following 2 schemes: the German Coordination Centres Regime and the Swedish Foreign Insurance Companies Taxation Regime.

On May 16, 2003 the Commission decided that the special tax regime for international headquarters and logistics centres breaches state aid rules. The French regime offers fiscal benefits to Headquarters and Logistics Centres or to the multinational groups to which they belong, by reducing their normal tax burden. The Commission found that the French regime reduces the taxable earnings of the French Headquarters and Logistics Centres and also confers a treasury advantage by exonerating them from the advance payment of the tax by derogation from the French tax code. The Commission concluded that the French regime results in selective lower effective taxation, which is not allowed by state aid rules.⁴⁵²

On June 24, 2003 the Commission decided that the Belgian tax regime for US Foreign Sales Corporations is not in line with EU state aid rules. The Commission stated that the Belgian scheme reduces the normal tax burden that Foreign Sales Corporations or the multinational groups to which they belong would face.⁴⁵³

2.4.5 The Commission's Study on Company Taxation

2.4.5.1 Background and objectives of the study

The ECOFIN Council in December 1998 asked the Commission to carry out an analytical and comprehensive study on company taxation in the EU. As requested by the Council on 22 July 1999, the study: 'will be undertaken in the general context of the Vienna European Council conclusions emphasising the need to combat harmful tax competition whilst taking into account that co-operation in the tax policy area is not aiming at uniform tax rates and is not inconsistent with fair tax competition, but is called for to reduce the continuing distortions in the Single Market also in view of stimulating economic growth and enhancing the international competitiveness of the Community, to prevent excessive losses of tax revenue or to get tax structures to develop in a more employment-friendly way'. This study⁴⁵⁴ was also undertaken on the basis of the ECOFIN Council conclusions asking to find out existing differences in the effective level of corporate taxation in the Community and the policy issues that such differences may give rise to. The study also intends to examine whether the current application of company taxation in the Internal Market creates inefficiencies and prevents operators from exploiting its full benefits as well as to highlight remaining tax obstacles to cross-border economic activity in the Internal Market. The study aims to identify the main tax provisions that may hamper cross-border economic activity in the Single Market. On this basis assessment is made of the effects on the location of economic activity and investments. The study analyses differences in effective levels of corporate tax in Member States, taking into account, inter alia, the results of the Ruding Report⁴⁵⁵. In this context it is noted that little progress has been achieved as a result of findings and recommendations of this earlier study. The mandate given to the Commission for this study on company taxation, however, is broader as it explicitly requests the analysis of tax obstacles in the Internal Market.

The study also considers the influence of corporate tax bases on effective levels of taxation. The Commission highlights the tax policy issues involved in reducing tax-induced distortions and examines possible remedial measures, taking account of the respective spheres of competence of the Member States and the Community.

The Commission believes that company taxation systems in the EU have failed to keep up with developments such as globalisation, economic integration in the Internal Market and the Economic and Monetary Union and acknowledges that a new approach is needed. The re-

⁴⁵² See the Commission's Press Release of May 16, 2003, IP/03/698.

⁴⁵³ See the Commission's Press Release of June 24, 2003, IP/03/887.

⁴⁵⁴ See Commission (2001c).

⁴⁵⁵ Commission (1992a).

removal of the tax obstacles will reduce compliance costs and incidences of double taxation, thus generating efficiency gains in the Internal Market and stimulating economically beneficial cross-border operations. This would be a substantial contribution towards improving the competitiveness of EU business.

2.4.5.2 Findings with respect to effective tax rates

The study on company taxation in the EU aimed to analyse effective tax rates in the EU in view of their effects on the location of economic activity and investments⁴⁵⁶. The mandate given to the Commission by the Council demands a quantitative assessment of how the general criteria of efficiency of company tax system is satisfied at the EU level, taking into account the existence of fifteen different tax systems.

In the framework of company taxation, statutory corporate tax rates give some information, however, they do not evaluate the real tax burdens, the diversity of the elements composing the tax base or, the interrelations of different tax systems. The effective tax rates take into account deductions and exemptions and they are the result of the statutory tax rate applied to the tax base. Effective tax rates allow measuring real tax burden and the impact of taxes on the economic activity.

Differences in effective tax burdens amongst national jurisdictions within the EU may give rise to two different behaviours of firms.⁴⁵⁷ On the one hand, effective tax rates differentials may create incentives to locate new production or to relocate existing ones in countries with lower effective tax burden thus influencing allocation of resources and economic activity. On the other hand, tax differentials may induce tax optimisation process by location of the taxable base with a subsequent loss of tax revenues for some tax jurisdictions, without any influence on the actual allocation of production and economic activity. The Commission's study concentrates on the effects of corporate tax differentials on resource allocation.

The study on effective tax rates shows that there are considerable differences among the effective tax rates of the various EU countries.⁴⁵⁸ According to the paper there are large variations – up to 30% – in effective company tax rates across the EU. In addition to the differences in effective tax burdens faced by the investors resident in the different Members States, there are large variations in the way each country treats investments in or from other countries.

The Commission concludes that in accordance with the results of economic modelling, there are wide differences among the effective tax rates of the various countries and this regards both domestic and international investments. The range of differences in domestic effective corporate taxation rates is around 37 percentage points in the case of a marginal investment (between –4.1% and 33.2%) and around 30 percentage points in the case of a more profitable investment (between 10.5% and 39.7%); for transnational investment the difference between the effective tax burden of subsidiaries located abroad can rise above 30 points. The analysis suggests that there is considerable variation in the effective tax burden depending on the type of investment and its financing. In each Member States, tax system tends to favour investment in intangibles and machinery and debt is the most tax-efficient source of finance.

The conclusion of the Commission is that the effective tax burden in the European Union is primarily determined by the nominal rate of taxation and that this domination of nominal tax rates increases as the profitability of the enterprise increases. Usually, the narrower is the definition of the tax base, the wider is the discrepancy between the effective marginal tax rate and the statutory rate, and the higher is the latter, the more rapid is the increase of the effective average tax rate towards the statutory rate when profits grow.

⁴⁵⁶ See Commission (2001c).

⁴⁵⁷ Giannini. and Maggiuli (2001).

⁴⁵⁸ See Commission (2001c), pp. 199-202.

However, although in most countries the effective marginal tax rate is lower than the statutory rate and effective tax rate increases towards it with profitability, for some Member States (Ireland, France, Denmark, Finland, and the UK) the effective tax rate for an equity financed investment is slightly greater than the statutory rate and decreases with the increase in profitability. The reason is the presence of relatively high real property taxes, like real estate taxes in Ireland and the UK, which more than compensate, at the margin, the benefits of the deductions from the tax base.

Moreover, the study concludes that the differences in effective tax rates are attributable mainly to the differences in national statutory tax rates rather than to the differences in the size of the tax base. A general result of the study is that the most important tax driver influencing the effective tax burdens and their differences across countries is the overall statutory tax rate (the corporate tax rate including surcharges and local rates). Regardless the amount of tax benefits and deductions, tax rate differentials more than compensate for differences in tax base and the relative weight of rates in determining the effective tax burden of companies rises along with the growth in the rate of profitability. This finding is in contradiction with earlier belief that higher nominal tax rates were compensated by lower tax bases and more exemptions and deductions.

Simulating the impact of hypothetical harmonization of particular features of taxation system in isolation suggests the importance of the statutory rate in determining the observed differences in effective tax rates across countries. Tax rate harmonization would be very powerful in reducing dispersions of effective tax rates, whereas harmonization of the tax bases would not provide comparable gains in efficiency. The economic modelling shows that introducing a common statutory tax rate in the EU would significantly decrease the dispersion of marginal and average effective tax rates across Member States. No other policy scenario has such a significant impact on the dispersion of effective tax rates. Scenarios implying a common tax base or a system consisting in applying the definition of the home country tax base to the EU-wide profits of a multinational tend to increase the dispersion in effective tax rates if overall nominal tax rates are kept constant.

Another interesting finding concerns specific tax regimes, which the Code of Conduct Group considered to be potentially harmful. The Commission finds that the differences in effective tax rates with respect to these preferential tax regimes and comparable 'regular' tax regimes for financing business operations are much smaller than the differentials in effective tax rates between Member States for common industrial investments. Thus, when harmful preferential tax regimes are eliminated within the EU, differences in the nominal rates will offer alternative possibilities of arbitrages. The Commission expresses the opinion that in the context of the imminent enlargement this trend could be compounded.

However, the Commission services study has not analysed the size of possible welfare losses associated with the existing differences in effective tax rates and the effects of tax competition. Therefore, the Commission finds that there is no convincing evidence to recommend specific actions on the approximation of the national corporate tax rates or the fixing of a minimum corporate tax rate.

The conclusion of the Commission on the study of effective tax burden has been that the introduction of a Common European tax base would not affect very much the fiscal autonomy of the Member States. The Commission continues to believe that company tax rates are a matter for Member States to decide. They would be able to exercise full sovereignty of the tax rates.

2.4.5.3 *Tax obstacles*

The Commission has identified a number of tax obstacles to cross-border economic activity in the Internal Market.⁴⁵⁹ Transfer pricing and the shortcomings of double taxation conventions are identified in the study as the source of significant obstacles. Transactions within groups of companies have significantly increased in recent years and extended into the field of intangible assets which are proving extremely difficult for both companies and taxation authorities to value for taxation purposes. Such complexity necessarily brings with it costs. Costs, which one could argue, have no productive purpose – certainly for companies. Furthermore for those small and medium-sized enterprises that venture cross border in the EU these costs represent a significant additional burden.

The study by the Commission identifies particular difficulties in relation to cross-border loss-compensation which, from a business perspective, constitute one of the most important obstacles to cross-border economic activity. Groups of companies still face the prospect of being taxed on profits in one Member State whilst incurring losses in another for which no relief is granted. The current rules in Member States generally allow only for the offsetting of losses of foreign permanent establishments but not for those of subsidiaries belonging to the same group but located in different EU countries. If available, the loss compensation often takes place only at the level of the parent company or is deferred in comparison to domestic losses (which creates significant interest cost). The differences which exist in Member States' domestic loss compensation arrangements have also impact on business decisions. The current loss compensation arrangements entail a risk of economic double taxation where losses cannot be absorbed locally. This situation provides an incentive in favour of domestic investment and of investment in larger Member States.

The study also identifies the area of double taxation conventions as a potential source of obstacles and distortions for cross-border economic activities within the EU. Although the intra-EU network of double taxation treaties is largely complete, there nevertheless remain some gaps. Most treaties within the EU follow the OECD Model but there are significant differences in the terms of the various treaties and their interpretation. There are also instances of divergent application of treaties by the treaty partners, leading to double taxation or non-taxation. Additional problem is the increasing complexity of treaty provisions, which creates high compliance costs and uncertainty. Moreover, the study shows that tax treaty provisions based on the OECD Model, in particular non-discrimination articles, are not adequate to ensure compliance with the EU law principle of equal treatment. Moreover, the lack of co-ordination in the treaty practice of the Member States in relation to third countries, for example regarding limitation of treaty benefits, is liable to give rise to distortions and partitioning of the Internal Market. The Commission services have reviewed possible solutions and these are all documented in the study. The filling of the few remaining gaps in the existing network of double taxation treaties within the EU would be helpful. Moreover, the current tax treaties of the Member States could be improved in order to comply with the principles of the Internal Market, in particular in relation to access to treaty benefits. Better co-ordination of treaty policy in relation to third countries would also help. In addition, the study identifies a possible need for binding arbitration where conflicts arise between treaty partners in the interpretation and application of a treaty, leading to possible double taxation or non-taxation. The most complete solution to such problems would be the conclusion under Article 293 of the Treaty of a multilateral tax treaty between Member States, conferring interpretative jurisdiction on the Court. Another possibility, leaving intact the existing bilat-

⁴⁵⁹ See Commission (2001c), pp. 36-37 about consequences of 15 separate tax jurisdictions within the Internal Market.

eral system, would be to elaborate an EU version of the OECD model convention and commentary (or of certain articles) which met the specific requirements of EU membership.⁴⁶⁰ The Commission believes that the main cause of tax obstacles to cross-border economic activity in the Internal Market is the existence of fifteen different tax systems. This is a fundamental issue and the study has examined a number of possible solutions in the form of ‘comprehensive approaches’ which would in the longer term provide companies with a consolidated corporate tax base for their EU-wide activities. (See next section.) After identifying the major obstacles to free movement in the Internal Market, the Commission proposes a two-track strategy to remove them. The Commission plans a number of targeted measures on such issues as the extension of the Directives on dividends and mergers, cross border loss relief, transfer pricing, and double taxation conventions.

2.4.5.4 *Consolidated tax base for companies*

The Commission believes that companies must in the longer term be allowed a consolidated corporate tax base for their EU wide activities to avoid the current costly inefficiencies of fifteen separate sets of tax rules. The Commission in its study has identified a number of ways of achieving a consolidated base and it plans to launch and lead a wide-ranging and detailed debate on the subject. The Commission expresses the view that only providing multinational companies with a consolidated corporate tax base for their EU-wide activities will systematically tackle the tax obstacles to cross-border economic activity in the Single Market. The Commission believes that it is necessary to develop an appropriate apportionment mechanism. Member States will have freedom to determine their national tax rate to their specific share of the overall tax base as computed according to a commonly agreed allocation mechanism.

The Commission believes that the most important advantages of providing EU businesses with a single consolidated tax base for their EU-wide activities are first, that the compliance cost resulting from the need to deal with 15 tax systems within the Internal Market would be significantly reduced; secondly, that transfer pricing problems within the group of companies would disappear within the EU; thirdly, profits and losses could be consolidated on an EU basis; and fourthly, many international restructuring operations would be simpler and less costly.

The Commission’s study⁴⁶¹ also examines a number of comprehensive approaches to address the various tax obstacles by providing multinational companies with a common consolidated tax base for their EU-wide activities:

- ‘Home State Taxation’ approach under which the tax base for the group as a whole would be computed in accordance with the tax code of the group’s home state (i.e. where the group’s head office is located). Once the relevant group profit has been computed on this basis, the next step is to use a formula to divide the group profit among the relevant Member States This approach is conceived as an optional scheme for companies in Member States with a sufficiently similar tax base.
- ‘Common (Consolidated) Base Taxation’ - completely new harmonised EU rules for the determination of a single tax base on European level. This again would be an optional scheme for companies existing as a parallel system alongside present national rules.
- ‘European Corporate Income Tax’ approach under which the tax could be levied at the European level and a part or all of the revenue could go directly to the EU. The Commission believes that this model, although originally conceived as a compulsory

⁴⁶⁰ For a discussion on the issue of the EU model convention see Pistone (2002).

⁴⁶¹ See Commission (2001c), pp. 44-45.

scheme for large multinationals, could also be an optional scheme operating alongside national rules.

- ‘Traditional’ approach - harmonised national rules on company taxation by devising a single EU company tax base and system as a replacement for existing national systems.

2.4.5.5 *Response to the Commission’s Study on Company Taxation*

Cnossen (2003) argues that although a consolidated tax base for companies (Home State Taxation or Common Base Taxation proposed by the Commission) would probably contribute to a reduction of cross-border obstacles, it would also increase tax rate competition because the tax base cannot be used anymore to attract investment.⁴⁶² Commentators point out that Home State Taxation could potentially increase tax competition for headquarters location, because favourable rules on the tax base could become a key factor in company decisions on where to locate their head offices.⁴⁶³ As a result, new externalities would arise. Furthermore, according to the commentators, the co-existence of two different systems (national and community-wide) could form a source of tax arbitrage processes between national and community-wide rules.⁴⁶⁴ Additional problem under the proposed consolidated tax base for companies concerns formula apportionment.⁴⁶⁵ If tax base sharing is based on payroll, sales, and property, then the corporate tax becomes a tax on these factors. Cnossen (2003)⁴⁶⁶ argues that this creates new distortions in the allocation of resources within the EU.

2.5 EMU and tax harmonization

Since the beginning of 1990s little harmonization has taken place in the field of direct taxes. That may change in future since the importance of convergence and stability of economic policies in the European Union are highlighted as a result of the introduction of the common currency. With the third stage of the EMU, the Stability and Growth Pact has increasingly focused the debate on budgetary developments. The Broad Economic Policy Guidelines have established new challenges for Member States’ fiscal policies. A budget that is close-to-balance or in surplus remains a prerequisite for macroeconomic stability.⁴⁶⁷

The tax harmonization and co-ordination issues have reappeared on the political agenda because of several reasons. After the introduction of euro in 1999, exchange risks and the costs of international payments have been reduced, and prices have become more comparable. As a result, the tax barriers become more visible. Furthermore, the introduction of the single currency has increased mobility of businesses, capital and people by abolishing the financial borders in the EMU. After capital markets have been liberalised, Member States that fail to adapt their tax system to competitive situation are losing their financial institutions that are moving across the border. The transparency brought about by the euro increases the role of taxation as a factor in investment and location decisions. These developments are likely to strengthen tax competition for mobile tax bases. In addition, taxation is almost the only policy tool left to improve a Member States’ competitive position, which may also intensify tax competition among Member States. Such competition is considered harmful by some Mem-

⁴⁶² See Cnossen (2003), pp. 230 – 232.

⁴⁶³ See Stevens (2002) and Cnossen (2003).

⁴⁶⁴ Ibid.

⁴⁶⁵ Under the Commission’s proposal consolidated profits would be shared by the participating Member States on the basis of the weighted share in various economic activities of the corporation (formula apportionment).

⁴⁶⁶ See p. 231.

⁴⁶⁷ Commission (2001a), p. 5.

ber States because it erodes their tax revenues. One mean to fight against such tax competition would be further harmonization and co-ordination of tax policies.

It has been argued that, more tax co-ordination is needed between Member States after the introduction of the euro. The main arguments, why more tax harmonization is necessary after the single currency has been adopted, are the following.

It has been argued that an extremely high degree of economic integration as a result of the EMU requires a reduction of national sovereignty over tax policies as well.⁴⁶⁸ After the launch of euro, tax policy is the main remaining area where the objectives of the Internal Market have not been achieved. The Commission has expressed the view that it is contradictory to do nothing to remove tax distortions while trying to remove all other kind of distortions related to capital movements.⁴⁶⁹ Tax differences are considered to be the main remaining obstacles to the free movement in the Internal Market.

Furthermore, the EMU is expected to increase the mobility of capital, which can make the capital, especially internationally mobile capital, even more difficult to tax. This can lead to a rising tax burden on labour, which can intensify the already severe problems of structural unemployment in the EU.

In addition, it has been argued that the successful EMU requires a high degree of policy co-ordination, including in the field of taxation in order to ensure that the fiscal policies of the Member States are in harmony with the monetary policy. In euro area monetary policy is exercised at the supra-national level: the EU institution – the ECB – has taken over the responsibility for exchange rate and interest rate policy. As a result, Member States participating in the third stage of the EMU have been left only one important macroeconomic policy tool, which is tax policy. Vanistendael (1998)⁴⁷⁰ argues that in order for the ECB to be coherent in its monetary policy it is essential that Member States do not contradict the policies of the ECB. Because of this possibility of contradictory policies in monetary and fiscal fields, more co-ordination of national tax policies is needed.⁴⁷¹

Furthermore, it has been argued that stable taxes are prerequisite for the EMU and that strict fiscal criteria of the Stability and Growth Pact⁴⁷² make it almost mandatory for participating states to avoid a loss in national tax revenues caused by tax competition from other Member States. According to the Stability and Growth Pact fiscal position has to be close to balance or in surplus in normal times so that automatic stabilisers can operate. The provisions of the pact provide for Excessive Deficit Procedure when the 3% reference value for budget deficits is exceeded.⁴⁷³ These rules limit considerably the fiscal flexibility of the governments in the euro zone.

⁴⁶⁸ See Ruding (1998), pp. 72-73.

⁴⁶⁹ The Commission (1996a), p. 9.

⁴⁷⁰ See pp. 77-78.

⁴⁷¹ See Vanistendael (1998).

⁴⁷² The pact consists of a Resolution and two Council regulations, one on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies and another on speeding up and clarifying the implementation of the so-called Excessive Deficit Procedure.

⁴⁷³ The pact clarifies the conditions under which the participants in the EMU will be allowed to exceed the 3% reference value for deficit without being determined to have an excessive deficit. In case of exceptional and temporary circumstances the 3% deficit ceiling can be exceeded without considering the deficit excessive. The pact considers an excessive deficit of the country to be exceptional if its GDP has declined at least 2% and the excess deficit is temporary and small. The countries in which GDP declines between 0.75 and 2% need the agreement of the Council to qualify a deficit in excess of 3% to be exceptional. Sanctions in case of excessive deficits take the form of deposits, which start at 0.2% of GDP and rise up to a maximum of 0.5% of GDP. Additional deposits are required each year

Developments in 2002 and 2003 have shown that several EU countries have difficulties meeting the budgetary requirement of the Stability and Growth Pact. In 2003, the fiscal deficit for the euro area continued to increase for a third consecutive year, mainly reflecting lower growth than expected. The nominal deficit rose from 2.3% of GDP in 2002 to 2.7% of GDP in 2003 and is projected to be roughly unchanged in 2004 and 2005. In 2003, only five euro-area countries had achieved budget positions (both in nominal and cyclically adjusted terms) that met the 'close to balance or in surplus' requirement of the Stability and Growth Pact. In four euro-area countries actual deficits were equal to or above 3% of GDP in 2003, whereas two biggest euro area countries (Germany and France) had deficits above the 3% of GDP reference value. Portugal succeeded in reducing the nominal deficit from 4.1% of GDP in 2001 to 2.8% in 2002 and 2003, however, this improvement was due to one-off measures and on the basis of the current policies, Portugal is projected to breach the threshold again in 2004. Large deficits also remain in Italy (over 2% of GDP in 2002 and 2003) in spite of sizeable one-off measures. The deficit is projected to breach the reference value (3% of GDP) by 2004 and to approach 4% of GDP in 2005. In the Netherlands, the nominal deficit in 2003 amounted to 3.2% of GDP. The Netherlands is projected to breach the threshold again in 2004 and 2005.⁴⁷⁴ A deficit of 3.6% of GDP in 2002 in Germany⁴⁷⁵ and a deficit of 3.1% of GDP in 2002 in France⁴⁷⁶ have resulted in the excessive deficit procedure being activated in those countries.

In this context tax competition – that occurs mostly in the field of corporation tax – is getting more attention as it is considered to destabilise tax revenues of the countries and further harmonization measures are asked for in the European Union. In its latest Communication on company taxation⁴⁷⁷, the Commission argues that the pattern of international investments is likely to be increasingly sensitive to cross-border differences in corporate tax rules. Moreover, the Commission points out that while considerable progress has been made in the removal of the wide range of barriers to the establishment of the Internal Market, the tax impediments to cross-border activities within the Internal Market are becoming increasingly important. The Internal Market and the EMU strongly impact the way EU companies carry out business in the Community and set the incentive to create effective pan-European business structures. This is because EU companies increasingly no longer define one Member State but rather the whole EU as their "home market". The resulting structural changes lead to the EU-wide re-organisation and centralisation of business functions within a group of companies, many of which were traditionally present in many or even all Member States. These tendencies, in turn, have impact on the taxation of these companies.⁴⁷⁸

On the other hand, several arguments have been formulated against further tax harmonization. Under the third stage of the EMU, Member States have lost their ability to use monetary policy in the cases of shocks affecting one country rather than another. Fiscal policy is one of the few means that countries have been left after giving up monetary policy tools. Thus, if tax policies would be harmonised, Member States would lose this last tool to deal with asymmetric shocks.

until the excessive deficit is corrected. If the excessive deficit is not corrected within two years, the deposit is converted into fine; otherwise it is returned.

⁴⁷⁴ See the Communication from the Commission to the Council and the European Parliament 'Public finances in EMU – 2003', adopted by the Commission on 21 May 2003, COM (2003) 283 final.

⁴⁷⁵ In Germany, the general government deficit increased from 3.5% in 2002 to 3.9% of GDP in 2003.

⁴⁷⁶ In France, the actual deficit reached 4.1% of GDP in 2003.

⁴⁷⁷ Commission (2001b), p. 29.

⁴⁷⁸ See Commission (2001b).

2.6 The latest Commission's initiatives

2.6.1 Background

In the context of the Internal Market and the EMU several harmonization initiatives have been put forward in the European Union. Vanistendael makes a point that Member States have no interest in a European tax policy.⁴⁷⁹ Individual Member States have been blocking harmonization measures because they found them being against their national interests. Major argument for necessity of further harmonization is made on the grounds of four economic freedoms and fair competition in an Internal Market without borders. The four freedoms in the EC Treaty set the limits to the tax policy making of the Member States when a tax provision constitutes a real barrier to trade.

In order to meet the aims of the founding treaties (the four freedoms and fair competition within the Internal Market) the abolition of tax barriers to free movement is necessary. The European institutions like the ECJ and the Commission have been implementing these policy goals identified in the EC Treaty. The Commission has been pushing for approximation of tax laws mainly to facilitate cross-border flows of income and to abolish barriers to cross-border trade and investment.⁴⁸⁰

2.6.2 Policy Document on Taxation

In May 2001, the European Commission presented a Communication 'Tax Policy in the European Union'⁴⁸¹. It identifies both general objectives and a number of specific priorities in direct and indirect taxation.

2.6.2.1 Background

In 2000 at the Lisbon European Council, the EU set itself an ambitious strategic goal – to become 'the most competitive and dynamic knowledge-based economy in the world'. Then, in December 2000 at Nice, it agreed reforms to the EU's institutions that will pave the way for an enlarged Union. And, with the third stage of the EMU, there is an increased focus on budgetary developments.

With the development of the Internal Market, Member States are required to eliminate tax obstacles facing private individuals and businesses that wish to work and operate freely in this market. According to the Commission, this is even more crucial with the advent of the EMU, where differences in the national tax systems are becoming increasingly evident and are therefore likely to have a growing influence on economic decisions by individuals and enterprises. Furthermore, the increasing globalisation of economies has among the other things caused greater competition for investment. Improvements in communication and transport, and above all the rise of the Internet, are creating new opportunities but also posing complex challenges for taxation systems. It is becoming easier to evade tax by moving mobile capital to low tax jurisdictions or tax havens.

In the beginning of the paper, the Commission recognises that although progress towards greater tax co-ordination has been slow since 1996 when the Monti Report was published, there have been some important achievements, notably in the direct tax field. In particular, the comprehensive agreement on key elements of the tax package reached at the Council meeting on 26-27 November 2000 were steps forward towards greater tax co-ordination. The Commission believes that the efforts to curb harmful tax competition through the Code of

⁴⁷⁹ See Vanistendael (2001).

⁴⁸⁰ See Vanistendael (1998a), p. 333.

⁴⁸¹ Commission (2001a).

Conduct for business taxation and the proposals on the taxation of income from savings will allow Member States to consolidate their tax revenue raising capacities, thus offering scope for reducing the high average tax burden on labour. Moreover, the EU has moved towards closer co-operation between Member States, for example in the agreement on principles for exchange of information on savings income and on mutual assistance in recovery of tax claims. However, the Commission believes that there is much more to be done in the area of tax co-ordination.

The Commission acknowledges that the Communication of 21 December 2000 on the Contribution of Public Finances to Growth and Employment⁴⁸² showed that all in all, the tax reforms implemented over the past three years represent a move in the right direction. Some Member States have made progress in rendering their tax systems more employment-friendly by lowering the fiscal burden on labour, even if overall taxation on labour still remains very high by international standards in many Member States. While the reforms vary in coverage and depth, most Member States are cutting direct taxation on personal and corporate income and in some cases employers' and employees' social security contributions.

2.6.2.2 Reduction of tax burden and removing obstacles to the free movement

The Commission points out that it is essential to reduce the overall tax burden and at the same time to get the balance right between cutting taxes, investing in public services and sustaining fiscal consolidation. In addition, in accordance with the Commission, EU tax policy should support Member States' efforts to reform their taxation systems and, as a priority, serve the interests of citizens and business wishing to avail themselves of the four freedoms of the Internal Market. It must, therefore, focus on the removal of tax obstacles to the exercise of those four freedoms.

2.6.2.3 Harmful tax competition

The Commission recognises that, considerable progress has been made in identifying harmful tax practices and agreeing timetables for their elimination. The Commission also makes a point that company taxation policy in the Internal Market should not hinder the possibility of general tax competition while tackling all harmful or economically undesirable forms of tax competition. According to the Commission, some degree of tax competition within the EU may be inevitable and may contribute to pressure for lower taxes.

2.6.2.4 How much harmonization?

The Commission expresses the view that there is no need for an across the board harmonization of the Member States' tax systems. Provided that they respect Community rules, Member States are free to choose the tax systems that they consider most appropriate. The level of public expenditure is equally a matter for national preferences as long as this is adequately met by revenues in such a way that budget positions remain close to balance or in surplus.

Moreover, the Commission underlines that in many tax fields harmonization is neither necessary nor desirable in view of the widely differing characteristics of the Member States' tax systems and different national preferences. However, the Commission stresses that Member States' choices do not take place in isolation and international aspects need to be taken into account.

The Commission expresses the view that a high degree of harmonization is certainly necessary in the field of indirect taxes, as such taxes can create an immediate obstacle to the free movement of goods and the free supply of services within the Internal Market. Indeed, a significant degree of harmonization of indirect taxes has already taken place. On the other hand,

⁴⁸² See Commission (2000c).

direct tax systems require only limited harmonization. There is, for example, no compelling need to harmonise personal income taxes unless they entail discrimination or double taxation. Such taxes can generally be left to Member States even when the EU achieves a higher level of integration than at present. Nevertheless, Member States must respect the fundamental Treaty principles on non-discrimination and the free movement of workers within the EU. Furthermore, even in this area it may be necessary to co-ordinate national tax systems in order to prevent discrimination in cross-border situations or to remove obstacles to the exercise of the four freedoms. The Commission finds that there is an intermediate zone of direct taxation of mobile tax bases, in particular the taxation of companies and the taxation of capital, where the situation is less clear-cut and which may have direct effects on the Internal Market. In this area, Member States have become more favourable to the idea of increased co-ordination. The Commission is examining whether more can be done to tackle direct tax obstacles to the Internal Market, notably in the field of company taxation, while respecting the sovereignty of the Member States. The Commission expresses the view, that the level of taxation in this area is however a matter for Member States to decide, in accordance with the principle of subsidiarity.

The Commission expresses the view that although a move to qualified majority voting at least for certain tax issues is indispensable, and in particular when there are serious distortions of the Internal Market, the legal basis will, for the present, remain unanimity. Since the legal basis will remain unanimity it will, after enlargement, be much more difficult to have any new Community legislation agreed. Therefore, the Commission wants to find other methods to achieve progress in removing tax obstacles and distortions to the Internal Market in the fields where legislation is not absolutely essential (notably in the direct taxation). So, the Commission intends to pursue all available mechanisms to achieve its policy objectives, in particular:

- step up its efforts of monitoring the implementation of EU tax law by Member States and work together with Member States towards common guidance notes as well as more active use of infringement proceedings in the tax field (see next section); and
- an increased use of non-legislative approach and the mechanism of enhanced co-operation – the solutions that do not imply binding legislation. The use of non-legislative or soft law solutions could be particularly effective in cases where they have a firm legal foundation, based on the Treaty and the case law of the ECJ. In such cases, instruments such as Communications, recommendations, guidelines, statements of best practice, model agreements and interpretative notices can provide guidance to Member States on the application of the Treaty principles and promote the rapid removal of obstacles to the Internal Market. Furthermore, the Commission proposes to develop guidance on important ECJ rulings and to co-ordinate, via appropriate Communications from the Commission, the implementation of jurisprudence by the ECJ.

2.6.2.5 Use of infringement proceedings

The Commission expresses the view that a different means of removing tax obstacles to the smooth functioning of the Internal Market is to make more pro-active, well-focused and even-handed use of infringement proceedings. There are a number of areas (the taxation of companies and collective investment vehicles, for example) where Member States' tax rules may contravene either the Treaty or existing Community legislation. While the Commission regularly submits its observations to the ECJ in tax cases brought by individual taxpayers, it has itself brought only a limited number of infringement proceedings against Member States in the area of direct taxation. However, the rapid development of EU case law in the direct tax field over the last few years through cases brought by individual litigants has highlighted the need for more Commission action. The different levels to which case law has developed in the indirect and direct tax fields can be largely explained by the different degrees of

Community competence in these areas. However, it is also true that Court actions involve high costs for both taxpayers and administrations. Moreover, in many instances the general application of a specific case in an individual Member State is not entirely clear. The current legal approach also tends to be asymmetrical in its effects in that, even where a ruling forces a number of the Member States to introduce new tax rules they often do so in vastly differing ways. The Commission has a role here in proposing a common response to such rulings, including where necessary through Community legislation. The Commission also plays an important role in ensuring that ECJ rulings are respected and properly implemented by Member States.

The Commission draws attention that Article 96 of the Treaty provides a legal basis for the Commission to take action to deal with distortions of the conditions of competition in the Internal Market, including proposing directives, which may be adopted by qualified majority.⁴⁸³ This provision has never yet been used. Mr. Frits Bolkestein, the current European Commissioner responsible for tax matters, has expressed the view that in this highly sensitive area it would be preferable if the distortions in question could be eliminated on the basis of Code of Conduct and as part of a package measures which balances the interests of the Member States.⁴⁸⁴

Since both direct and indirect tax measures may fall under the state aid provisions of the EC Treaty, the Commission pays close attention to them and will continue to take steps to ensure that the Treaty is respected. As regards direct taxes, and following its Notice on the application of state aid rules to measures relating to direct business taxation⁴⁸⁵, the Commission intends to adopt a more pro-active strategy generally in the field of tax infringements and be more ready to initiate action where it believes that Community law is being broken.⁴⁸⁶ It will also ensure the correct application of judgements of the ECJ. The Commission expresses the view that the current approach in the direct tax field of leaving the development of case law to chance by simply reacting to cases taken by taxpayers to the ECJ is not a proper basis for progress towards agreed Community objectives.

⁴⁸³ Article 96 empowers the Commission to act where legal or administrative rules of a Member State distort conditions of competition in the common market, and this distortion needs to be eliminated. In such a case, the Council may adopt a Directive proposed by the Commission on the basis of qualified majority.

⁴⁸⁴ Bolkestein (2000), p. 405.

⁴⁸⁵ Commission (1998).

⁴⁸⁶ See section 2.4.4.3.9 about implementation of the Notice by the Commission.

3 Harmonization in the field of VAT

Following sections will look more closely at the harmonization of various important parts of the VAT, namely, tax system, tax base, and tax rates.

3.1 Common VAT system

Article 1 of the Sixth Directive provides that EU Member States must replace their national turnover taxes by the common VAT system. Any other form of turnover tax is excluded.

3.1.1 Advantages of the VAT

One of the main reason why the VAT was chosen as a common European consumption tax is its advantage in implementing the destination country principle. The VAT system permits to treat trade among EU countries as well as trade with third countries according to the destination principle and thereby makes possible to achieve territorial neutrality in intra-EU trade. Under destination principle exports leave a country free of tax and imports are taxed at the same rate as that applied to the domestic goods. As a result, all goods and services sold to final consumers in a Member State are taxed equally, whether they have been produced domestically or abroad. The VAT system enables to determine the exact amount of tax at every stage of production and to refund that amount upon exportation. In order to achieve this kind of territorial neutrality necessary for proper functioning of the Single Market, it is essential to ensure that the destination principle is fulfilled.⁴⁸⁷

In addition to the aim of achieving neutrality in the treatment of goods and services entering international trade, a VAT aims to achieve neutrality with respect to domestic production and distribution. The principle of internal neutrality means that the VAT paid on consumer expenditures is directly proportional to the expenditure of each consumer, irrespective of the number of stages through which the goods or services have passed in the production or distribution chain.⁴⁸⁸ According to the case law of the ECJ⁴⁸⁹ the deduction system is meant to relieve the trader entirely of the burden of VAT payable or paid in the course of all his eco-

⁴⁸⁷ Vanistendael (1999) highlights that until 1993, the territorial impact of VAT within the European Union was neutral in the sense that any product would be subject to the same tax burden, which would be determined by the country of consumption. Since the changes were introduced to the VAT system when the border controls were abolished on 1 January 1993, the tax burden on private consumption of goods has no longer been determined exclusively by the place of consumption, but also by the place from which the goods are supplied. Cross-border consumer purchases are no longer subject to border tax adjustment but carry the VAT burden levied in the country of purchase. Direct imports of households are taxable according to the origin principle. There are exemptions from this general rule, as the destination principle is still applied under the special schemes (distance sales (e.g. by phone, post or from catalogues), household purchases of new motor vehicles and intra-Community acquisitions of intermediate inputs by VAT-exempt firms). In the case of services, the destination principle is applied to a more limited extent than in the case of goods. The general rule by Article 9(1) of the Sixth Directive for the place of supply of services deems the place of taxation to be where the supplier has established his business or has a fixed establishment from which the service is supplied. However, Article 9(2) establishes several exceptions to this general rule. Certain services are linked to the customer's country within the EC provided that he/she is an entrepreneur. Article 9(2)(e) lists certain services that are taxable in the country where the customer has established his business. As a result, the services are not always taxed in the country of consumption. Vanistendael argues that after the abolition of border controls, territorial neutrality of VAT is no longer guaranteed since the end-user of goods or services can now choose to buy goods or services in different Member States at different rates.

⁴⁸⁸ Kogels (1999), p. 118.

⁴⁸⁹ See, for example, Case 50/87 (*Commission v France*), paragraph 15.

economic activities. The common system of VAT consequently ensures that all economic activities, whatever their purpose or results, provided they are themselves subject to VAT, are taxed in a wholly neutral way.^{490 491} The possibility to deduct the VAT on inputs from the VAT on outputs ensures that final consumers bear the intended VAT burden, irrespective of the VAT rates applied at intermediate stages in the chain of production and distribution. A multistage and comprehensive VAT (that taxes the broad range of goods and services at a uniform rate and is applied through all stages of production and distribution process) allows to minimise the tax distortions to domestic production and distribution and permits to leave the optimal allocation of resources to the free play of market forces.⁴⁹² The VAT is neutral regarding the technology used as well as the form and methods of conducting business. The credit/invoice system permits to avoid cumulation of tax during the production-distribution process and avoids the discrimination against specialised firms in favour of vertically integrated firms, which is characteristic of gross turnover taxes.⁴⁹³ In addition, under the VAT, it makes no difference in which stage value is added in the production-distribution process.⁴⁹⁴ In order to achieve a neutral impact of VAT on production and consumption, the scope of VAT should be as wide as possible. Another advantage of VAT is that it raises more revenue with lower administrative and economic costs than other broadly based consumption taxes and allows the government to raise tax revenue of roughly 0.4 per cent of GDP for every percentage point of VAT rate.^{495 496}

3.1.2 *The basic principles of the European VAT system*

The basic principles of the common VAT system were stipulated by the First and Second Directives and further specified by further directives, most importantly by the Sixth Directive. The Sixth Directive (77/388) formulated more clearly several important VAT concepts. The adoption of directive 92/77⁴⁹⁷ supplementing the common system of VAT and amending directive 77/388 was another essential step towards harmonization of VAT systems of the Member States. It laid down rules for VAT rates and created conditions necessary for removal of internal borders. This Directive also introduced the concepts of intra-Community acquisition of goods and the exemption for intra-Community supplies.

A turnover tax is a general tax on consumption levied to all private expenditures. It is directly proportional to the price to which it is applied, whatever the number of transactions in the production and distribution process before the stage at which tax is charged. The VAT is

⁴⁹⁰ See Case C-333/91 (*Sofitam*), paragraph 10.

⁴⁹¹ The provisions of the Sixth Directive do not always ensure that the principle of neutrality is followed. For example, different methods of financing a company's activities lead to different VAT treatment. In Case C-4/94 (*BLP*), the ECJ explicitly stated that if, instead of raising extra capital by selling shares which was exempt transaction, BLP had taken out a bank loan, the VAT charged on services of a financial adviser would have been fully deductible. See also section 3.4 where the problems which arise from the current VAT system are discussed.

⁴⁹² See Cnossen (1993), p. 74. Cnossen also points out other advantages of a VAT, i.e. that it is a stable and flexible source of government revenue; and it enables to limit tax avoidance more easily than some other taxes.

⁴⁹³ See Genser (2001), p. 1.

⁴⁹⁴ Cnossen (1998a), p. 1.

⁴⁹⁵ See Cnossen (1998b), p. 1 and Genser (2001), p. 1.

⁴⁹⁶ Cnossen (1998b, p 18) draws attention to some disadvantages of the VAT. Over-use of VAT may contribute to the maintenance of an oversized, inefficient public sector. In addition, the poorly administered VAT may degenerate into a highly distortionary, multistage cumulative turnover tax that hampers specialization and hence economic growth.

⁴⁹⁷ Council Directive 92/77/EEC of 19 October 1992 supplementing the common system of value added tax and amending Directive 77/388/EEC (approximation of VAT rates), OJ L 316, 31/10/1992, pp. 1 – 4.

applied up to and including the retail stage. The amount of tax is expressed as a percentage on the retail price. VAT is applied to all goods as well as services except those that are explicitly exempted. The tax is due as soon as consumer has made the expenditure to attain consumption. The person who has made the expenditure pays the tax. Traders who add the VAT to the selling price collect it. Community VAT system is built around the obligation to issue correct invoices: an invoice contains information as to which VAT regime is applicable; it enables the tax authorities to carry out controls and customers to prove their right to deduction.

One important principle of the European VAT system is the right of deduction of the input VAT by traders (the suppliers of the taxable transaction). Traders deduct from the VAT, which they collect from customers, the VAT that they themselves have been charged by their suppliers. The European VAT system permits a full credit of the VAT on inputs from the VAT on outputs. A taxable person⁴⁹⁸ charges VAT on the invoice to his customer and remits that VAT minus any prepaid VAT on his monthly or quarterly VAT return. The right of a trader (purchaser) to a tax credit arises at the same time than the supplier becomes liable to pay the tax (see also section 3.2.5). A person making taxable supplies and therefore receiving VAT from customers ('a taxable person') must account to the authorities for the remittance or claim. It is only the final consumer⁴⁹⁹ who bears the tax burden, because he/she has no right to levy it or make any claims to the authorities. Consequently, VAT only generates government revenue when the customer cannot deduct the VAT charged by taxable person. In other words: as long as goods and services are exchanged between taxable persons, the tax burden is zero.⁵⁰⁰

As a general rule, the country of consumption is entitled to levy tax. Domestic goods and services are taxed equally with imported goods and services. The tax is calculated on the basis of the consideration or price for the supply of goods or provision of services. In the case of importation the tax is calculated on the customs value of the goods. VAT is also applied on intra-EU acquisitions (supplies of goods for consideration by a taxable person from another Member State). As a general rule, supplies of goods by taxable persons to taxable persons in other Member States as well as exports are exempt from VAT with a right to deduct input VAT (also referred to as zero rate supplies).

However, some exceptions to the destination-based taxation were introduced by the Directive 91/680/EEC⁵⁰¹, which adopted the rule that purchases by private individuals will generally be taxed in the country of purchase. This rule applies with two exceptions: special conditions apply, firstly, for the distance sales, and, secondly, for the purchases of some other items such as new cars and other new means of transport (see section 3.2.4).

The adoption of Directive 91/680/EEC created a framework for a VAT system without fiscal frontiers. Special Directives were adopted for passenger transport⁵⁰², for second-hand goods, works of art, collectors' items and antiques⁵⁰³, travel agents, as well as for investment

⁴⁹⁸ As defined in Article 4 of the Sixth Directive, see section 3.2.2.

⁴⁹⁹ Including government bodies and taxable persons performing domestic services who are exempted, see section 3.2.7.

⁵⁰⁰ Kogels (1999).

⁵⁰¹ Council Directive 91/680/EEC of 16 December 1991 supplementing the common system of value added tax and amending Directive 77/388/EEC with a view to the abolition of fiscal frontiers, OJ L 376, 31/12/1991, pp. 1 – 19.

⁵⁰² Council Directive 94/4/EC of 14 February 1994 amending Directives 69/169/EEC and 77/388/EEC and increasing the level of allowances for travellers from third countries and the limits on tax-free purchases in intra-Community travel, OJ L 060, 03/03/1994, pp. 14 – 15.

⁵⁰³ Council Directive 94/5/EC of 14 February 1994 supplementing the common system of value added tax and amending Directive 77/388/EEC - Special arrangements applicable to second-hand goods, works of art, collectors' items and antiques, OJ L 060, 03/03/1994, pp. 16 – 24.

gold⁵⁰⁴. In addition, special simplification measures were implemented.⁵⁰⁵ In 1995, the Council adopted the so-called Second Simplification Directive.⁵⁰⁶ Member States retain their special schemes for small undertakings, they also remain the freedom to apply a special scheme involving flat rate rebates of input VAT to farmers not covered by normal schemes. The Sixth Directive establishes the basic principles of this scheme for farmers and also adopts a common method for calculating the value added of these farmers for the purposes of collecting own resources (see section 3.2.10). Member States also retain, within certain limits and subject to certain conditions, special measures derogating from this Directive in order to simplify the levying of tax or to avoid fraud or tax avoidance (see section 3.2.13).

3.2 Common definition of tax base

3.2.1 Scope and territorial application

Definition of VAT

Article 2 of the First VAT Directive⁵⁰⁷ defined turnover tax to be levied in the European Union as a general tax on consumption. Nowhere is it stated what ‘consumption’ is actually supposed to mean in a VAT context. Simons has defined VAT as an indirect consumption tax levied on the supplier of transactions, but deemed to or intended to be borne by the consumer.⁵⁰⁸ Simons (1996) states that taxable transactions should be restricted to transactions ‘in het maatschappelijk verkeer’, which means all transactions performed within the economic sphere. This test was proposed in replacement of the definition by the Sixth Directive which provides that taxable transactions are deemed to be all supplies of goods or services effected for consideration.⁵⁰⁹ The reason for proposing this replacement was the way how the notion of ‘consideration’ was translated in many civil law countries. Williams, therefore, proposes the term ‘against payment’ in his IMF contribution and Vanistendael prefers term ‘for compensation’.⁵¹⁰

Some commentators regard VAT as a tax which essentially aims to tax actual private consumption, some, however, take the view that its primary purpose is to tax spending.⁵¹¹ As Simons concludes from a judgement by the ECJ in the *Mohr* case⁵¹², the ECJ seems to have decided that VAT is primarily a tax on consumption.⁵¹³ In the *Mohr* case the ECJ ruled that grant received by Jürgen Mohr as compensation for discontinuing milk production was not taxable since no consumption could be distinguished. In its judgement in *Mohr* the ECJ gave guidelines for interpretation of the VAT rules and more specifically defined the concept of consumption in case of supply of services. The Advocate General stipulated in its opinion

⁵⁰⁴ Council Directive 98/80/EC of 12 October 1998 supplementing the common system of value added tax and amending Directive 77/388/EEC - Special scheme for investment gold, OJ L 281, 17/10/1998, pp. 31 - 34

⁵⁰⁵ Council Directive 92/111/EEC of 14 December 1992 amending Directive 77/388/EEC and introducing simplification measures with regard to value added tax, OJ L 384, 30/12/1992, pp. 47 - 57.

⁵⁰⁶ Council Directive 95/7/EC of 10 April 1995 amending Directive 77/388/EEC and introducing new simplification measures with regard to value added tax - scope of certain exemptions and practical arrangements for implementing them, OJ L 102, 05/05/1995, pp. 18 - 24.

⁵⁰⁷ First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of the Member States concerning turnover taxes, OJ 071, 14/04/1967, pp. 1301 - 1303.

⁵⁰⁸ Simons (1994) as referred to in Vanistendael (1999), p. 14.

⁵⁰⁹ See Vanistendael (1999), p. 14.

⁵¹⁰ Ibid, p. 14.

⁵¹¹ See Van Hilten (1999), p. 3.

⁵¹² Case C-215/94 .

⁵¹³ See Simons (1996).

delivered on 23 November 1995 that the scope of VAT is ‘... limited by its character as tax on consumption. A trader must supply goods or services for consumption by identifiable customers in return for a price paid by the customer or by a third party.’ He found that this requirement was not met in the *Mohr* case and the Community by compensating farmers did not acquire goods or services for its own use but acted in the common interest. The Advocate General therefore held that, in this case, the public authorities, whether Community or national, could not be regarded as consumers of a service within the meaning of Article 2(1) of the Sixth Directive.⁵¹⁴ According to Simons the ECJ has by ruling in the *Mohr* case given a basic and principled decision about the scope of VAT and one simple guideline for interpretation of VAT rules. Furthermore, Simons (1996)⁵¹⁵ argues that in cases *Coöperatieve Aardappelenbewaarplaats*⁵¹⁶ and *Apple and Pear Development Council*⁵¹⁷ the ECJ would have been more understandable if it had grounded the judgement on the absence of any kind of consumption by the receiver. The ECJ ruled in its judgement in *Apple and Pear Development Council* that for the provision of services to be taxable within the meaning of the Second VAT Directive, there must be a direct link between the service provided and the consideration received. The ECJ’s decision was based on *Coöperatieve Aardappelenbewaarplaats* judgement in which the ECJ ruled that the concept of ‘the supply of ... services effected for consideration’ presupposes the existence of a direct link between the service provided and the consideration received. In contrast to Simons, van Hilten (1999) argues that in the *Apple and Pear Development Council* case consumption does in fact take place for VAT purposes.^{518 519}

Scope of VAT

The scope of VAT is stipulated in Article 2 of the Sixth Directive which states that the following are subject to VAT:

- a. the supply of goods or services effected for consideration within the territory of the country by a taxable person acting as such;
- b. the importation of goods.

⁵¹⁴ See also sections 3.2.3 and 3.2.6 for more detailed description of the *Mohr* case.

⁵¹⁵ P. 90.

⁵¹⁶ Case C-154/80.

⁵¹⁷ Case C-102/86.

⁵¹⁸ P. 6.

⁵¹⁹ In *Apple and Pear Development Council* national tax authorities refused to allow deduction for the purposes of VAT input tax on services provided to Apple and Pear Development Council in connection with those activities funded by the mandatory charges imposed upon commercial growers of apples and pears in England and Wales. Development Council’s functions relate essentially to advertising and the promotion and improvement of the quality of apples and pears grown in England and Wales. The Development Council imposes on growers a mandatory annual charge at a rate not exceeding a specified amount in respect of each hectare of land planted with apple and pear trees or specified amount in respect of every 50 apple or pear trees planted on a grower’s land. The charges are levied to enable the Development Council to meet the expenses incurred in the exercise of its functions. The ECJ stated in its judgment that no relationship exists between the benefits which individual growers obtain from the services provided by the Development Council and the amount of the mandatory charges which they are obliged to pay. The ECJ argued that the charges, which are imposed by virtue not of a contractual but of a statutory obligation, are always recoverable from each individual grower as a debt due to the Development Council, whether or not a given service of the Development Council confers a benefit upon him. The ECJ stated that it follows that mandatory charges of the kind imposed on the growers do not constitute consideration having a direct link with the benefits accruing to individual growers as a result of the exercise of the Development Council’s functions. The ECJ held that the exercise of the Development Council’s functions does not therefore constitute a supply of services effected for consideration within the meaning of Article 2(1) of the Sixth Directive.

Moreover, transitional provisions (Article 28a) provide that the following are subject to VAT:

- a. intra-Community acquisitions of goods for consideration within the territory of the country by a taxable person or by a non-taxable legal person;
- b. intra-Community acquisitions of new means of transport effected for consideration within the country by taxable persons or nontaxable legal persons;
- c. the intra-Community acquisition of goods which are subject to excise duties effected for consideration within the territory of the country by a taxable person or a non-taxable legal person.

Territorial application of VAT

The common VAT system is based on the territoriality principle. The VAT is applied to the supply of goods or services effected within the territory of the country by a taxable person acting as such and to the importation of goods (Article 2 of the Sixth Directive). According to Article 3 of the Directive the concept of 'territory of the country' is defined in Article 299 of the EC Treaty in respect of each Member State. Article 3 also lists the territories, which are excluded from the territory of the country.

3.2.2 Taxable persons

Concept of 'taxable person' is defined in Article 4 of the Sixth Directive. It states that 'taxable person' means any person who independently carries out in any place any economic activity⁵²⁰ (specified in paragraph 2 of the same Article), whatever the purpose or results of that activity. Article 28a extends the concept of a taxable person to cover persons performing an intra-Community supply of new means of transport.⁵²¹ Article 4(4) specifies that use of the word 'independently' in the definition of a taxable person intends to exclude employees from an obligation to charge VAT on services provided to their employers. The same provision allows Member State to treat as single taxable person persons who are closely bound to one another by financial, economic and organisational links, although they are legally independent. Thus, the Sixth Directive leaves to Member States discretion not to tax intra-group supplies within the associated company.⁵²²

The economic activities are specified to comprise all activities of producers, traders and persons supplying services including mining and agricultural activities and activities of the professions. The exploitation of tangible or intangible property for the purpose of obtaining income therefrom on a continuing basis is also considered an economic activity.

Article 4(1) refers that the concept of 'taxable person' includes any economic activity 'whatever the purpose or results'. According to the case law of the ECJ, Article 4 of the Sixth Directive confers a very wide scope on VAT; the term "exploitation", within the meaning of Article 4(2), refers, in accordance with the requirements of the principle that the system of VAT should be neutral, to all transactions, whatever their legal form, by which it is sought to obtain income from the goods in question on a continuing basis.⁵²³ However, according to

⁵²⁰ Thus, any person may be taxable person and therefore be entitled to recovery of input VAT. Whether a person is subject to European VAT depends on the performance of economic activities within the territory as defined in Article 3 of the Sixth Directive. See Terra and Wattel (2001), p. 238.

⁵²¹ Article 28a(4) of the Sixth Directive provides that any person who from time to time supplies a new means of transport under the conditions laid down in Article 28c (A) must also be regarded as a taxable person.

⁵²² This group registration is generally restricted to persons established within the territory of a Member State. Not all Member States apply this possibility for group registration. See Terra and Wattel (2001), p. 240.

⁵²³ See Court's judgment in Case C-186/89 (Van Tiem v Staatssecretaris van Financiën).

the case law of the ECJ certain activities fall outside the scope of the VAT. For example, a person who makes supplies, which are in all cases free of charge, cannot be regarded as a taxable person.⁵²⁴ Another example is an illegal transaction, such as the importation and supply of drugs⁵²⁵, and the importation of counterfeit currency notes.⁵²⁶

Some other judgments by the ECJ have had the effect of reducing the scope of the concept of economic activity and consequently the scope of VAT. The ECJ has held that a holding company whose sole purpose is to acquire holdings in other undertakings, without involving itself directly or indirectly in the management of those undertakings, without prejudice to its rights as a shareholder, cannot be regarded as a taxable person.⁵²⁷ That conclusion of the ECJ is based in particular on the finding that the mere acquisition and holding of shares in a company is not to be regarded as an economic activity within the meaning of the Sixth Directive, conferring on the holder the status of a taxable person.⁵²⁸ The ECJ has, furthermore, held that the mere acquisition of financial holdings in other undertakings does not amount to the exploitation of property for the purpose of obtaining income therefrom on a continuing basis because any dividend yielded by that holding is merely the result of ownership of the property.⁵²⁹ However, the Court has held that it is otherwise where the holding is accompanied by direct or indirect involvement in the management of the companies in which the holding has been acquired, without prejudice to the rights held by the holding company as shareholder.⁵³⁰ The Court held in its *Floridienne* judgment⁵³¹ that involvement of that kind in the management of subsidiaries must be regarded as an economic activity within the meaning of Article 4(2) of the Sixth Directive, in so far as it entails carrying out transactions which are subject to VAT by virtue of Article 2 of that directive. Thus, the mere involvement of a holding company in the management of its subsidiaries without carrying out transactions subject to VAT under Article 2 of the Sixth Directive cannot be regarded as an economic activity within the meaning of Article 4(2) of the Sixth Directive.⁵³² The ECJ argued that in the *Floridienne* case the amount of the dividend depended partly on unknown factors and that entitlement to dividends was merely a function of a shareholding, the direct link between the dividend and a supply of services (even where the services were supplied by a shareholder who was paid dividends), which is necessary if the dividends are to constitute consideration for the services, did not exist.⁵³³ In its judgment in *Floridienne*, the ECJ stated that interest

⁵²⁴ Case 89/81 (*Hong-Kong*). The case concerns the question whether the Hong-Kong Trade Development Council, which provides free of charge for traders information and advice, can be considered a taxable person. The ECJ held in its judgment that a person who habitually provides services for traders, free of charge in all cases, cannot be regarded as a taxable person.

⁵²⁵ See Case C-289/86 (*Happy Family*).

⁵²⁶ See Case C-343/89 (*Witzemann*) and Terra and Wattel (1997), p.157.

⁵²⁷ See Case C-60/90 (*Polysar*), paragraph 17 and Case C-142/99 (*Floridienne*), paragraph 17.

⁵²⁸ See Case C-60/90 (*Polysar*), paragraph 17.

⁵²⁹ See, for example, Cases C-60/90 (*Polysar*), paragraph 17; C-333/91 (*Sofitam*), paragraph 12; and C-80/95 (*Harnas & Helm CV v Staatssecretaris van Financiën*), paragraph 15.

⁵³⁰ Case C-60/90 (*Polysar*), paragraph 14; and Case C-142/99 (*Floridienne*), paragraph 18.

⁵³¹ See Case C-142/99, paragraph 19.

⁵³² See Case C-102/00 (*Welthgrove*), paragraph 17.

⁵³³ *Floridienne*, a holding company at the head of a group of companies operating in the chemicals, plastics and agri-foodstuffs sectors, and Berginvest, an intermediary holding company at the head of the plastics division, claimed that they were directly or indirectly involved in the management of their subsidiaries, in particular by supplying them with administrative, accounting and information technology services and with loan finance. Furthermore, *Floridienne* and *Berginvest* received dividends from their subsidiaries on their shares and interest on the loans. When they provide services to their subsidiaries, *Floridienne* and *Berginvest* carry out taxable transactions, in respect of which tax which has been imposed on goods and services supplied to them is deductible. Their practice of deducting the entirety of their input tax was called into question by the Belgian tax authorities, in particular on the

paid by the subsidiaries to the holding company on loans it has made to them must not fall within the scope of VAT, where the loan transactions do not constitute, for the purposes of Article 4(2) of the Sixth Directive, an economic activity of the holding company.⁵³⁴

In *EDM*, the ECJ has held that activities, which consist in the simple sale of shares and other securities, such as holdings in investment funds, do not constitute economic activities within the meaning of the Sixth Directive.⁵³⁵

In *BLP*⁵³⁶, the ECJ held that Article 2 and Article 17 of the Sixth Directive are to be interpreted as meaning that, except in the cases expressly provided for by those articles, where a taxable person supplies services to another taxable person who uses them for an exempt transaction, the latter person is not entitled to deduct the input VAT paid, even if the ultimate purpose of the transaction is the carrying out of a taxable transaction.⁵³⁷

In several other cases the ECJ has ruled on the issue on the scope of VAT. In the *Régie Dauphinoise* case, the ECJ held that interest received by a property management company on investments, made for its own account, of sums paid by co-owners or lessees cannot be excluded from the scope of VAT, since the interest does not arise simply from ownership of the asset but is the consideration for placing capital at the disposition of a third party.⁵³⁸ The ECJ stated in *Régie Dauphinoise* that loan transactions are subject to VAT only if they constitute either an economic activity of the operator within the meaning of Article 4(2) of the Sixth Directive or the direct, permanent and necessary extension of a taxable activity, without, however, being incidental to that activity within the meaning of Article 19(2) of the directive.⁵³⁹ According to the case law of the ECJ⁵⁴⁰, where a holding company makes capital available to its subsidiaries, that activity may of itself be considered an economic activity, consisting in exploiting that capital with a view to obtaining income by way of interest therefrom on a continuing basis, provided that it is not carried out merely on an occasional basis and is not confined to managing an investment portfolio in the same way as a private investor and provided that it is carried out with a business or commercial purpose characterised by, in particular, a concern to maximise returns on capital investment.

In its judgments in *Rompelman*⁵⁴¹ and *Gabalfrisa*⁵⁴², the ECJ held with regard to the question of when a person becomes a taxable person, that initial investment expenditure incurred for

ground that some of the goods and services received were used in the collection of dividends and interest, an activity which the authorities consider to be exempt from VAT. Taking the view that the interest on the loans made by Floridienne and Berginvest to their subsidiaries relates nevertheless to a specific professional activity of a financial nature, the authorities reinstated it in the denominator of the fraction used to calculate the general deductible proportion. By contrast, as regards the dividends, only those paid by the subsidiaries which had actually received management assistance were included in the income reinstated in the denominator of that fraction. See paragraphs 6-7 of the judgment of the ECJ in *Floridienne*.

⁵³⁴ See paragraphs 21 and 32 of the judgment.

⁵³⁵ See Case C-77/01 (*EDM*).

⁵³⁶ Case C-4/94.

⁵³⁷ Paragraph 28 of the judgment.

⁵³⁸ Case C-306/94 (*Régie Dauphinoise*), paragraph 17.

⁵³⁹ See paragraph 18 of the judgment.

⁵⁴⁰ See Case C-155/94 (*Wellcome Trust*), paragraph 36; Case C-230/94 (*Enkler v Finanzamt Homburg*), paragraph 20; and Case C-142/99 (*Floridienne*), paragraph 28.

⁵⁴¹ Case 268/83. The ECJ stated that the acquisition of a right to the future transfer of property rights in part of a building yet to be constructed with a view to letting such premises in due course may be regarded an economic activity within the meaning of Article 4 (1) of the Sixth Directive.

⁵⁴² Case 147/98. The ECJ stated in its ruling that Article 17 of the Sixth Directive precludes national legislation which makes the exercise of the right to deduct value added tax paid by a taxable person, liable thereto before he starts regularly carrying out taxable transactions, conditional upon the fulfilment of certain non-proportionate requirements. The requirements in question include that of requiring the submission of an express request for such a right to deduct before the tax concerned becomes

the needs of, and with the view to carrying on, an enterprise is considered an economic activity.⁵⁴³ However, the ECJ added that this does not preclude the tax administration from requiring the declared intention to be supported by objective evidence.⁵⁴⁴

In accordance with Article 4(5) of the Sixth Directive public bodies are considered non-taxable persons in respect of the activities or transactions if two conditions are met: (1) these bodies are governed by public law, and (2) such activities are carried out under public authority. If VAT is not applied for activities performed by public bodies, the problem arises that market conditions can be distorted if competing activities that are performed by private bodies bear a higher tax burden. Therefore, Article 4(5) provides that public bodies are considered taxable persons if they engage in activities or transactions, where treatment of them as non-taxable persons would lead to 'significant distortions of competition'⁵⁴⁵ *vis-à-vis* the private sector.⁵⁴⁶

In certain conditions the possibility of private competition is ruled out because of a monopoly position of a government body. Therefore, a number of activities are always taxable, regardless of the legal form of the undertakings or the presence of distortions of competition in relation to the private sector. The Sixth Directive contains the list of activities in relation to which the public bodies are 'in any case'⁵⁴⁷ considered taxable persons. The list of these activities (in relation to which undertakings are considered taxable persons) is included in Annex D. This list includes, for example, telecommunications; the transportation of goods and passengers; port and airport services; the running of trade fairs and exhibitions; warehousing; the activities of travel agencies; the supply of water, gas, electricity and steam; the running of staff shops, co-operatives, industrial canteens and similar institutions. As a minimum, Member States should tax all the activities listed in Annex D. However, the use of the words 'in any case' in Article 4(5)⁵⁴⁸ indicates that Annex D does not contain an exhaustive list of the activities in respect of which public bodies may be taxable.⁵⁴⁹ The ECJ has held that the distinction between public and private activities has to be derived pursuant to the legal system applicable to public authorities under national law.⁵⁵⁰

due and compliance with a time-limit of one year between that submission and the actual commencement of taxable transactions.

⁵⁴³ See Terra and Wattel (2001), p. 239.

⁵⁴⁴ See Case 268/83 (*Rompelman*), in which the ECJ stated that '... this provision does not preclude the tax administration from requiring the declared intention to be supported by objective evidence such as proof that the premises which it is proposed to construct are specifically suited to commercial exploitation.'

⁵⁴⁵ Article 4(5) of the Sixth Directive. The ECJ stated in its judgment in Case 231/87 (*Carpaneto Piacentino*) that the second subparagraph of Article 4(5) of the Sixth Directive must be interpreted as meaning that Member States are required to ensure that bodies subject to public law are treated as taxable persons in respect of activities in which they engage as public authorities where those activities may also be engaged in, in competition with them, by private individuals, in cases in which the treatment of those bodies as non-taxable persons could lead to significant distortions of competition.

⁵⁴⁶ See cases on access to roads on payment of a toll (Case C-276/97 (*Commission v French Republic*), Case C-358/97 (*Commission v Ireland*), Case C-359/97 (*Commission v UK*), Case C-408/97 (*Commission v The Netherlands*), and Case C-260/98 (*Commission v Greece*)).

⁵⁴⁷ Article 4(5) of the Sixth Directive.

⁵⁴⁸ The third indent of Article 4(5) of the Sixth Directive provides that 'In any case, these bodies shall be considered taxable persons in relation to the activities listed in Annex D, provided they are not carried out on such a small scale as to be negligible.'

⁵⁴⁹ Farmer and Lyal (1994), p. 117.

⁵⁵⁰ In its judgment in Case 231/87 (*Carpaneto Piacentino*), the ECJ stated the following: 'An analysis of the first subparagraph of Article 4(5) in the light of the scheme of the directive shows that it is the way in which the activities are carried out that determines the scope of the treatment of public bodies as non-taxable persons. In so far as that provision makes such treatment of bodies governed by public law conditional upon their acting "as public authorities", it excludes therefrom activities en-

The ECJ has interpreted the ‘distortion-of-competition’ criterion widely. If a public body has a monopoly on the supply of certain services, it does not compete with private sector in a formal sense. However, it can compete with the other types of businesses providing the competing goods or services. For example, the post office may not compete with other letter carriers, but it does compete with other forms of transportation and communications, such as delivery services and newspapers. Hence, the services of the post office should be taxed.⁵⁵¹

3.2.3 Taxable transactions

The concept of ‘taxable transactions’ includes supply of goods (Article 5 of the Sixth Directive), supply of services (Article 6), imports (Article 7), intra-Community acquisition of goods, and means of transport (Article 28a).

3.2.3.1 Supply of goods

Article 5(1) defines ‘supply of goods’ as the transfer of the right to dispose of tangible property as an owner. The ECJ has held that ‘supply of goods’ in Article 5(1) of the Sixth Directive must be interpreted as meaning the transfer of the right to dispose of tangible property as owner, even if there is no transfer of legal ownership of the property.⁵⁵² In accordance with the ECJ ruling in *SAFE*⁵⁵³, it is for the national court to determine in each individual case, on the basis of the facts of the case, whether there is a transfer of the right to dispose of the property as owner within the meaning of Article 5(1) of the Sixth Directive.

According to Article 5(2) tangible property includes electric current, gas, heat, refrigeration and the like. Member States may also consider certain rights *in rem* and interests in immovable property as well as shares or interests equivalent to shares to be tangible property (Article 5(3)).⁵⁵⁴

Compulsory transfers for compensation, by order made by public authority or in pursuance of the law, are also considered supplies of goods according to Article 5(4)(a). The term also

gaged in by them not as bodies governed by public law but as persons subject to private law. Consequently, the only criterion making it possible to distinguish with certainty between those two categories of activity is the legal regime applicable under national law.’ The ECJ added that ‘... the bodies governed by public law referred to in the first subparagraph of Article 4(5) of the Sixth Directive engage in activities "as public authorities" within the meaning of that provision when they do so under the special legal regime applicable to them. On the other hand, when they act under the same legal conditions as those that apply to private traders, they cannot be regarded as acting "as public authorities". It is for the national court to classify the activity at issue in the light of that criterion.’ See paragraph 15 and 16 of the judgment.

⁵⁵¹ Cnossen (1993), p. 97.

⁵⁵² Case C-320/88 (*SAFE*). The ECJ argued in its judgment that ‘... it is clear from the wording of this provision that "supply of goods" does not refer to the transfer of ownership in accordance with the procedures prescribed by the applicable national law but covers any transfer of tangible property by one party which empowers the other party actually to dispose of it as if he were the owner of the property. This view is in accordance with the purpose of the directive, which is designed inter alia to base the common system of VAT on a uniform definition of taxable transactions. This objective might be jeopardized if the preconditions for a supply of goods - which is one of the three taxable transactions - varied from one Member State to another, as do the conditions governing the transfer of ownership under civil law. Consequently, the answer to the first question must be that "supply of goods" in Article 5(1) of the Sixth Directive must be interpreted as meaning the transfer of the right to dispose of tangible property as owner, even if there is no transfer of legal ownership of the property.’ See paragraphs 7-9 of the judgment.

⁵⁵³ Case C-320/88.

⁵⁵⁴ If Member States choose not to consider the transfer of certain rights *in rem* and interests in immovable property as well as shares or interests equivalent to shares as taxable supplies of goods, these transfers are supplies of services. See Terra and Wattel (2001), p. 241.

includes transfers by way of conditional sale or hire purchase arrangements, if ownership must pass at the latest upon payment of the final instalment (Article 5(4)(b)). In addition, the transfer of goods pursuant to a contract under which commission is payable on purchase or sale, is considered to be supply of goods (Article 5(4)(c)). According to Article 5(6), the private use of goods or their application for non-business purposes is also treated as supplies made for consideration, if the VAT on the goods in question or the component parts thereof was wholly or partly deductible.⁵⁵⁵ The ECJ ruled in its judgment in *De Jong*⁵⁵⁶ that Article 5(6) of the Sixth Directive must be interpreted as meaning that, when a taxable person (a building contractor) acquires land solely for his private use but erects on that land in the pursuit of his business a dwelling for his own use, only the house, and not the land, is to be regarded for the purposes of that provision as having been applied for his private use. The taxable amount will then be the value of the building alone and not that of the land.⁵⁵⁷

⁵⁵⁵ However, applications for the giving of samples or the making of gifts of small value for the purposes of the taxable person's business shall not be so treated (Article 5(6)).

⁵⁵⁶ Case C-20/91.

⁵⁵⁷ The facts of the case are the following. Mr de Jong, a building contractor, made an exempt purchase of a plot of land with a building on it. He then demolished the existing building and constructed two dwellings, one for the purchaser on the part of the land that had sold to a third party, and the other for himself on the other part of the plot. Mr de Jong deducted, by way of input tax, the VAT that had been invoiced to him on the goods and services supplied for construction of the houses. When he put one of these dwellings to private use, he recorded on his VAT return by way of liability to tax ("output tax") an amount equal to the tax deducted ("input tax") on the goods and services used for the construction of the dwelling put to private use. However, the Netherlands tax administration considered that, the taxable amount should include not only the value of the house but also the value of the land on which it had been built, since the house and the surrounding land should be regarded as a single supply of goods. Mr de Jong argued that the taxable amount was incorrectly determined and that the land had always formed part of his private assets and had not become part of his business assets when the house was built. The Netherlands Government contended that the construction of a dwelling on land made available to the undertaking for that purpose gave rise, for the purposes of turnover tax, to a new immovable property comprising the building and surrounding land. Consequently, it was that unit resulting, in that form, from the pursuit of the taxable person's business activity that the latter had applied to his private use. On the other hand, the German Government and the Commission argued, on the premise that the taxable person acquired the land for his private purposes and did not use it for business purposes, that the land never formed part of the assets of the undertaking and cannot therefore have been applied to private use. They stated that the fact that a person engaged in business builds, in his capacity as a taxable person, a dwelling for private use on land belonging to him personally does not have the effect of converting the land into a business asset. The ECJ ruled in its judgment that the taxation of land in those circumstances is not in conformity with the objective of equal treatment pursued by Article 5(6) of the Sixth Directive, since it would cause the tax burden to vary according to whether the building contractor built the house in pursuit of his business in the capacity of a taxable person or acted in the capacity of an ordinary consumer by arranging for a third party to build a house on his land. In the latter case, VAT would be payable under the Sixth Directive only on the price paid for the house, but not on the price paid for the land. It follows that, regardless of whether the land and the building are inseparable under national legislation, it is necessary to distinguish, for the purposes of Article 5(6) of the Sixth Directive, between the taxation of land which a taxable person owns in his private capacity and the taxation of a building which the taxable person has erected on that land in pursuit of his business. The ECJ held that the basis of assessment would be the value of the building alone and not that of the land. The ECJ concluded that Article 5(6) of the Sixth Directive is to be interpreted as meaning that, when a taxable person (a building contractor) acquires land solely for his private use but erects on that land in the pursuit of his business a dwelling for his own use, only the house, and not the land, is to be regarded for the purposes of that provision as having been applied for his private use. See paragraphs 3-21 of the judgment.

Member States may also consider as supplies of goods the handing over of certain works of construction (Article 5(5)). Article 5(7) contains some more options for taxable supplies (e.g. the application of self-constructed goods for the purposes of business, the retention of goods by a taxable person or his successors when he ceases to carry out a taxable economic activity where the VAT on such goods became wholly or partly deductible upon their acquisition).

Article 5(8) provides that Member States may consider that a transfer of all or part of the assets of a company does not constitute a supply of goods, and in that event the recipient must be treated as the successor to the transferor.⁵⁵⁸ Where appropriate, Member States may take the necessary measures to prevent distortion of competition in cases where the recipient is not wholly liable to tax (Article 5(8)).

3.2.3.2 *Supply of services*

Supply of services is a residual category and is defined as any transaction, which does not constitute a supply of goods. Such transactions may include assignments of intangible property; obligations to refrain from an act or to tolerate an act or situation; the performances of services in pursuance of an order made by or in the name of a public authority or in pursuance of the law (Article 6(1)).

Sixth Directive provides for a broad application of the tax to all forms of consumption, as, for example, a service may exist merely in 'obligations to refrain from an act or to tolerate an act or situation'⁵⁵⁹. However, in the cases *Apple and Pear Development Council*⁵⁶⁰ and *Mohr*⁵⁶¹ the ECJ considered that the imposition in the fruit-growing industry of a mandatory charge to finance those activities and compensation received for the discontinuation of milk production did not constitute supply of service. In its case law the ECJ has added some conditions to those laid down in the Sixth Directive for supplies to be considered taxable. In cases *Coöperatieve Aardappelenbewaarplaats*⁵⁶² and *Apple and Pear Development Council*⁵⁶³ the ECJ stated that for the provision of services to be taxable there must be a direct link between the service provided and the consideration received (see also section 3.2.1). In the *Mohr* case the Advocate General stated that for the provision of services to be taxable a trader must supply goods or services for consumption by identifiable customers in return for a price paid by the customer or by a third party.

In the *Mohr* case, the ECJ ruled on the question whether an undertaking to discontinue milk production given by a farmer under a Community regulation fixing compensation for the definitive discontinuation of such production constitutes a supply of services for the purposes of the Sixth Directive. Jürgen Mohr, the German farmer, received a grant as compensation for discontinuing milk production. The German national court referred the following two questions to the ECJ for a preliminary ruling: (1) Does a farmer who is a taxable person and definitively discontinues milk production thereby make a supply of services within the meaning of Article 6(1) of Council Directive? (2) Is the compensation a taxable payment in the sense of the Sixth Directive? The German tax administration (Finanzamt) submitted that a milk producer who undertakes definitively to discontinue his production supplies a service for consideration within the meaning of Articles 2 and 6(1) of the Directive. Thus, Finanzamt regarded this compensation as consideration received for a taxable supply and assessed

⁵⁵⁸ This provision prevents large amounts of VAT from becoming due that would be deductible anyway, but the VAT which is payable is not always collected by the Revenue, for example, in cases of bankruptcy. See Terra and Wattel (2001), p. 242.

⁵⁵⁹ Article 6(1).

⁵⁶⁰ Case C-102/86.

⁵⁶¹ Case C-215/94.

⁵⁶² Case C-154/80.

⁵⁶³ Case C-102/86.

it as being subject to VAT. German authorities stated in this regard that payment of compensation and an undertaking to discontinue milk production are mutually dependent, thus establishing the direct link between the service provided and consideration for it, as required by the case law of the Court⁵⁶⁴. However, the ECJ found that interpretation of the Directive unacceptable. It recalled that, according to Article 2(1) of the First Council Directive VAT is a general tax on the consumption of goods and services. However, in a *Mohr* case, there is no consumption as envisaged in the Community VAT system. As the Advocate General Jacobs notes at point 27 of his Opinion, by compensating farmers through the medium of the competent national authorities for the loss of income resulting from discontinuation of milk production,⁵⁶⁵ the Community did not acquire goods or services for its own use but acted in the common interest of promoting the proper functioning of the Community milk market. In those circumstances, the undertaking given by a farmer that he will discontinue his milk production does not entail either for the Community or for the competent national authorities any benefit which would enable them to be considered consumers of a service. The undertaking in question does not therefore constitute a supply of services within the meaning of Article 6(1) of the Directive.

Advocate General also stressed that *Mohr* case is distinguishable from cases which, it has been argued, are analogous, for example, the case where the vendor of a business gives an undertaking to the purchaser not to set up business in competition; there the purchaser receives a service of personal benefit to him. It is also distinguishable from cases in which a public authority is the direct recipient of a supply of goods or services which it uses for its public activities, for example, where it obtains land by compulsory purchase for a road-building scheme. In such case the public authority is a consumer as in a private transaction. The German Government challenged the interpretation of the ECJ given in the judgment in *Mohr*. In the *Landboden-Agrardienste* case⁵⁶⁶ the German Government argued that the subsidy to farmers for the extensification of potato production paid under a national scheme was a payment for services. In their view, a farmer's act of limiting production or refraining from marketing certain products is a service in its own right, separate from the supply of products to consumers and entailing separate consideration. Furthermore, the German Government argued that by requiring, in *Mohr*, that the public authority must acquire goods or services for its own use, the Court added a condition not laid down in the Sixth Directive.⁵⁶⁷

⁵⁶⁴ Case C-154/80 (Coöperatieve Aardappelenbewaarploaats) and Case C-16/93 (Tolsma).

⁵⁶⁵ In accordance with Council Regulation (EEC) no. 1336/86 of 6 May 1986 fixing compensation for the definitive discontinuation of milk production (OJ L 119/21, 8 May 1986).

⁵⁶⁶ Case C-384/95. The case concerned the question whether compensation for the extensification of potato production paid under a national scheme is subject to turnover tax. The compensation was granted to German undertaking (Landboden-Agrardienste) in return for a 20% reduction in its annual potato production. The German tax authorities considered that the compensation should be included in taxable amount. The taxpayer contended that compensation could not be regarded as payment for supply of services. It pointed out in particular that it was impossible to identify a specific recipient of the service provided in return for the compensation payments.

⁵⁶⁷ See paragraph 16 of the judgment in *Landboden-Agrardienste*. The German Government also states that '... the fact that VAT is a general tax on consumption cannot be used as a basis for determining whether there is a supply of services. For that purpose recourse should be had solely to the wording of Article 6 of the Sixth Directive, from which it is apparent that any transaction which does not constitute a supply of goods must be regarded as a supply of services when it is economic in nature and does not fall exclusively within the private sphere. The question of who benefits from a supply of services or of its economic impact is therefore entirely irrelevant to the meaning of that term.' (Paragraph 17 of the judgment in *Landboden-Agrardienste*). According to the German Government, this case is concerned with an exchange transaction, because the farmer is paid for a specific service. The German Government argues that 'The link between the service supplied and the compensation is so close that the attachment between the payment and the service cannot be regarded as purely technical. Since the public authority pays compensation only if production is reduced, the related obligation

The ECJ was not convinced and argued that only the nature of the undertaking given is to be taken into consideration when determining whether a payment made by a public authority constitutes consideration for a supply of services for the purposes of the Sixth Directive: for such an undertaking to be covered by the common system of VAT it must imply consumption.⁵⁶⁸ The ECJ held that a transaction such as that at issue in *Landboden-Agrardienste*, namely the undertaking given by a farmer to reduce production, did not give rise to any consumption. The ECJ, furthermore, argued that the farmer does not provide services to an identifiable consumer or any benefit capable of being regarded as a cost component of the activity of another person in the commercial chain. The ECJ concluded that since the undertaking given by a farmer to reduce production does not entail either for the competent national authorities or for other identifiable persons any benefit which would enable them to be considered to be consumers of a service, it cannot be classified as a supply of services within the meaning of Article 6(1) of the Sixth Directive.

Article 6(2)(a) and (b) of the Sixth Directive stipulates that use of goods or services carried out free of charge for non-business purposes must be treated as supplies of services for consideration.⁵⁶⁹ Member States may derogate from these provisions provided that such derogation does not lead to distortion of competition. The ECJ has held that 6(2)(a) of the Sixth Directive is designed to prevent the non-taxation of business goods used for private purposes and therefore that provision requires the taxation of the private use of such goods only where the tax paid on their acquisition was deductible.⁵⁷⁰ According to the judgment of the ECJ in *Kühne*⁵⁷¹, Article 6(2)(a) must be interpreted as precluding taxation of the depreciation of business goods in respect of their private use where the VAT on such goods was not deductible because they were purchased from a non-taxable person. Taxation of the depreciation of the goods is also prohibited where, although the taxable person was not able to deduct the VAT in respect of the supply of the goods to him, he was none the less able to deduct the VAT on the supplies of goods and services which he sought and obtained from other taxable persons for the maintenance or use of the goods. In such a case, it is allowed to tax the expenses incurred for the maintenance and use of the goods, since such a solution avoids not only the double taxation of the goods themselves but also the non-taxation of final use.⁵⁷² In

constitutes a supply of services for consideration. Nor does it really matter whether the recipient of the service is the public at large or the authority as representative of the public at large, since that is not one of the factors laid down by Articles 2, 6 and 11 of the Sixth Directive.’ (Paragraph 18 of the judgment in *Landboden-Agrardienste*).

⁵⁶⁸ Paragraph 20 of the judgment.

⁵⁶⁹ Article 6(2)(a) and (b) reads as following: ‘The following shall be treated as supplies of services for consideration:

- (a) the use of goods forming part of the assets of a business for the private use of the taxable person or of his staff or more generally for purposes other than those of his business where the value added tax on such goods is wholly or partly deductible;
- (b) supplies of services carried out free of charge by the taxable person for his own private use or that of his staff or more generally for purposes other than those of his business.’

⁵⁷⁰ See Case 50/88 (*Kühne*), paragraph 8.

⁵⁷¹ Case 50/88.

⁵⁷² See judgment of the ECJ in Case 50/88 (*Kühne*). Dr Kühne, who as a lawyer is a taxable person for VAT purposes, bought from a private person, who was therefore a non-taxable person, a second-hand business car which was also used for his private purposes. The German tax authorities charged VAT on the car in respect of its depreciation in proportion to the private use made of it by Dr Kühne. Dr Kühne challenged the tax assessment and claimed that since he had been unable to deduct the VAT on the car, if tax were charged on the depreciation of the car by reason of his private use turnover tax would be levied twice, which would be contrary to the VAT system. The ECJ was referred for a preliminary ruling to find out whether Article 6(2)(a) of the Sixth Directive precludes taxation of the depreciation of business goods in respect of their private use where the VAT on such goods was not deductible because they were purchased from a non-taxable person. The ECJ was also asked whether

addition, the ECJ has held in its judgment in *Mohsche*⁵⁷³ that the taxation of private use is not allowed where the use includes services on which the VAT was not deductible.⁵⁷⁴ Moreover, self-supply of service may be treated as supply of service for consideration if the VAT on such a service, had it been supplied by another taxable person, would not be wholly deductible (Article 6(3)).⁵⁷⁵

If a taxable person acting in his own name but on behalf of another takes part in a supply of services, he shall be considered to have received and supplied those services himself (Article 6(4)).

Article 5(8) allows Member States to choose whether or not to tax the transfer of all or part of the assets of a company. In most of the Member States such a transfer of a business is treated as a non-taxable event.

3.2.3.3 Imports

‘Importation’ of goods is defined in Article 7 as the entry into the EU of goods that are not of the EU origin. The chargeable event is constituted by the entry of the goods into the territory of a Member State, or rather the release for free circulation of the goods by the customs authorities. The place of importation is normally the Member State in which the goods first enter the EU. However, in cases when goods enter the EU under arrangements for temporary

VAT on goods is considered partly deductible within the meaning of Article 6(2)(a) where, although the taxable person was not able to deduct the VAT in respect of the supply of the goods to him, he was none the less able to deduct the VAT on the various goods and services supplied by other taxable persons for the use and maintenance of the goods. The ECJ held that since a taxable person is not permitted to deduct the residual tax on business goods purchased second-hand from a non-taxable person, the VAT on such goods must be considered not to be deductible for the purposes of Article 6(2)(a) and no tax may therefore be levied under that provision on the depreciation of the goods in respect of their private use. Such taxation of business goods on which the residual tax was not deductible would lead to double taxation contrary to the principle of fiscal neutrality which is inherent in the common system of value-added tax, of which the Sixth Directive forms part. In respect to the second question, the ECJ stated that Article 6(2)(a) provides that the private use of business goods may be taxed only if the VAT on the goods themselves, and not the expenses incurred for their use and maintenance, was deductible. Thus, taxation of the private use is prohibited even if taxable person was able to deduct the value-added tax on the goods or services which he sought and obtained from other taxable persons for the maintenance or use of the goods on which the VAT was not deductible. See judgment of the ECJ in *Kühne*, paragraph 7-15.

⁵⁷³ Case C-193/91.

⁵⁷⁴ Mr Mohsche, a tool manufacturer, used for private purposes a motorcar belonging to his business. In assessing the value added tax payable, the tax authorities included in the taxable amount a sum corresponding to the provision for depreciation of the vehicle and a percentage of certain expenses incurred for the use and maintenance of the vehicle. The ECJ was referred for a preliminary ruling and asked whether Article 6(2) of the Sixth Directive prohibits taxation of the private use of goods forming part of the assets of a business upon whose acquisition the taxable person was able to deduct the VAT, in so far as such use also includes services which the taxable person received without deduction of input VAT from third parties for the maintenance or use of the goods. The ECJ held that Article 6(2)(a) must be interpreted as precluding taxation of the private use of goods forming part of the assets of a business upon whose acquisition the taxable person was able to deduct the value added tax in so far as such use also includes services which the taxable person received without deduction of input tax from third parties for the maintenance or use of the goods. See Case C-193/91 (*Mohsche*), paragraph 15.

⁵⁷⁵ Article 6(3) reads as following: ‘In order to prevent distortion of competition and subject to the consultations provided for in Article 29, Member States may treat as a supply of services for consideration the supply by a taxable person of a service for the purposes of his undertaking where the value added tax on such a service, had it been supplied by another taxable person, would not be wholly deductible.’

importation with total exemption from import duty or under transit arrangements, the place of import is the Member State within the territory of which these goods cease to be covered by those arrangements (e.g. the transit procedure is completed).

3.2.3.4 *Intra-Community acquisitions of goods*

‘Intra-Community acquisition of goods’ means acquisition of the right to dispose as owner of movable tangible property dispatched or transported to the person acquiring the goods by or on behalf of the vendor or the person acquiring the goods to a Member State other than that from which the goods are dispatched or transported (Article 28a(3)).

As a general rule, supplies of goods by taxable persons in one Member State to taxable persons in another Member State are exempted from VAT (Article 28c) and corresponding intra-Community acquisitions of goods by taxable persons and non-taxable legal persons are taxable in the country of destination (Article 28a). The right of deduction is granted to the intra-Community acquisitions if the goods are used for activities for which a right to deduction exists.

3.2.3.5 *Means of transport*

Generally, all supplies of goods to another Member State are exempted from VAT provided that the acquirer has a certain status. In case of new means of transport, supplies are exempt regardless of the status of the acquirer or the vendor.⁵⁷⁶

3.2.4 *Place of taxable transactions*

Title VI of the Directive deals with the common definition of the place of supply and lays down the common rules for determination of a country that is entitled to impose the VAT. Article 8 specifies the rules for supply of goods and Article 9 for the supply of services.

3.2.4.1 *Goods*

Generally, the place of supply of goods in the case of goods not dispatched or transported is deemed to be the place where the goods are when the supply takes place (Article 8(1)(b)). In the case of goods dispatched or transported, the place of supply of goods is deemed to be the place where the goods are at the time when dispatch or transport begins (Article 8(1)(a)). If the goods are installed or assembled by or on behalf of the supplier, the place of supply is deemed to be the place where the goods are installed or assembled (Article 8(1)(a))⁵⁷⁷. In the case of goods supplied on board of ships, aircraft or trains during the part of a transport of passengers effected in the Community: at the point of the departure of the transport of passengers (Article 8(1)(c)).

⁵⁷⁶ Article 28a(2)(a) of the Sixth Directive stipulates that the following is considered to be a ‘means of transport’: vessels exceeding 7,5 metres in length, aircraft the take-off weight of which exceeds 1550 kilograms and motorized land vehicles the capacity of which exceeds 48 cubic centimetres or the power of which exceeds 7,2 kilowatts, intended for the transport of persons or goods. In order not to be considered as ‘new’ means of transport, both of the following conditions must be simultaneously fulfilled: (1) they must be supplied more than three months after the date of first entry into service. However, this period shall be increased to six months for the motorized land vehicles; (2) they must have travelled more than 6 000 kilometres in the case of land vehicles, sailed for more than 100 hours in the case of vessels, or flown for more than 40 hours in the case of aircraft.

⁵⁷⁷ Article 8(1)(a) stipulates that in cases where the installation or assembly is carried out in a Member State other than, that of the supplier, the Member State within the territory of which the installation or assembly is carried out shall take any necessary steps to avoid double taxation in that State.

In the cases of purchases by private individuals the place of taxable transaction is generally the country of purchase. However, several exceptions apply to this general rule. In case of the purchases by distance sales⁵⁷⁸ the place of taxable transaction is the country of consumption (destination principle applies). This rule applies to firms who make a taxable supply over certain threshold.⁵⁷⁹ In the cases where intra-EU acquisitions below a threshold of EUR 10.000 per year are made by companies or individuals whose own supplies are VAT exempt and who do not have right for deduction, the same rules as for ordinary private consumers apply to them. As an effect, the purchases below a threshold of EUR 10.000 by taxable persons not entitled to deduct VAT, flat-rate scheme farmers, and non-taxable legal persons are taxed in the country of purchase, unless the purchase is based on a distance sale. Purchases by final consumers of new means of transport are subject to VAT in the country of registration.

3.2.4.2 Services

The general rule with regard to the place of services is provided in Article 9(1), which stipulates that it is deemed to be the place where the supplier has established his business or has a fixed establishment from which the service is supplied or, in the absence of such a place of business or fixed establishment, the place where he has his permanent address or usually resides. The place of the supply of services connected with immovable property, such as the services of estate agents and of architects, is deemed to be the place where the property is situated. The place where transport services are supplied is deemed to be the place where transport takes place, having regard to the distances covered. With regard to valuations of movable tangible property or work on movable tangible property, which includes contract work that is treated as services based on the Second Simplification Directive, the same Directive provides that these services are deemed to take place where the VAT identification number of the customer of the services has been issued, provided the goods in question are dispatched or transported out of the Member State where the services were physically carried out. When the place of supply is shifted to the place where the customer's VAT number has been issued, the VAT liability is also shifted to the customer.⁵⁸⁰ The place of supply of certain services rendered to customers established outside the Community or for taxable persons established in the Community, but not in the same country as the supplier, is where the customer has his business or resides (Article 9(2)(e)). When the services are rendered from outside the EC to a taxable person within a Member State the place of supply is within that Member State. The list of the so-called Article 9(2)(e) services to which this provision applies includes for example legal services, advertising, engineering, consulting, accounting, data processing, banking, insurance, and other financial services as well as the hiring out of movable tangible property other than means of transport, the services of agents who act in the name and for the account of another, procuring the above-mentioned services, telecommunication services, radio and television broadcasting services, and electronically supplied services. Article 9(2)(f) provides that in case of the radio and television broadcasting services, and electronically supplied services the place of supply when those services are performed for non-taxable persons who are established, have their permanent address or usually reside in a Member State, by a taxable person who has established his business or has a fixed

⁵⁷⁸ Sales by mail order, teleshopping, and any other sale when the goods are transported to the customer in another Member State

⁵⁷⁹ The destination principle is not applied when the total value of supplies does not exceed EUR 100 000 in current or previous year (see Article 28b (B) of the Sixth Directive). Member States may limit the threshold to EUR 35 000 (see Article 28b (B)(2) of the Sixth Directive). Article 28b (B) (3) of the Sixth Directive provides that vendors may opt for taxation in a Member State of destination notwithstanding the threshold.

⁵⁸⁰ Terra and Wattel (2001), p. 247.

establishment from which the service is supplied outside the Community or, in the absence of such a place of business or fixed establishment, has his permanent address or usually resides outside the Community, shall be the place where the non-taxable person is established, has his permanent address or usually resides.⁵⁸¹ According to Article 9(3) Member States may, in order to avoid double taxation, non-taxation or the distortion of competition, derogate from Article 9(2)(e) with regard to the hiring out of forms of transport and also with regard to the supply of services referred to in Article 9(2)(e), except for the radio and television broadcasting services, and electronically supplied services when supplied to non-taxable persons.⁵⁸² Article 9(4) provides that in the case of telecommunications services and radio and television broadcasting services when performed for non-taxable persons who are established, have their permanent address or usually reside in a Member State, by a taxable person who has established his business or has a fixed establishment from which the service is supplied outside the Community, or in the absence of such a place of business or fixed establishment, has his permanent address or usually resides outside the Community, Member States must consider the place of supply of services as being within the territory of the country where the effective use and enjoyment of the services take place within the territory of the country. When the place of supply of the so-called Article 9(2)(e) services is deemed to be in a Member State other than the one where the supplier of the service is established, or when the supplier is established outside the Community, the recipient of the service becomes liable for the VAT.

3.2.5 *Chargeable event and chargeability of tax*

The chargeable event, that is the event by occurrence of which the tax authority becomes entitled to claim the tax from the person liable to pay, takes place at a moment when the goods are delivered or the services are performed (Articles 10(1) and 10(2)). However, if a payment is due before the goods are delivered or the services are performed, the tax becomes chargeable on receipt of the payment and on the amount received (Article 10(2)).⁵⁸³

In case of imported goods, the chargeable event occurs and the tax becomes chargeable when the goods enter the territory of the EU. However, if goods are placed under warehousing or transit arrangements, the chargeable event occurs and the tax becomes chargeable when these procedures are completed.

In case of intra-Community acquisitions, the chargeable event occurs when the acquisition of goods is effected. The tax becomes chargeable on issuance of the invoice or, at the latest, on the fifteenth day of the next month after the acquisition has been effected (Article 28d).

⁵⁸¹ See section 2.3.5.2 and 3.2.11 for more detailed discussion concerning VAT on e-commerce transactions.

⁵⁸² More specifically, Member States may according to Article 9(3) consider:
the place of supply of services, which under this Article would be situated within the territory of the country, as being situated outside the Community where the effective use and enjoyment of the services take place outside the Community;
the place of supply of services, which under this Article would be situated outside the Community, as being within the territory of the country where the effective use and enjoyment of the services take place within the territory of the country.

⁵⁸³ By way of derogation from the above provisions, Member States may provide that the tax becomes chargeable, for certain transactions or for certain categories of taxable person either:

- no later than the issue of the invoice or of the document serving as invoice; or
- no later than receipt of the price; or
- where an invoice or document serving as invoice is not issued, or is issued late, within a specified period from the date of the chargeable event.

3.2.6 Taxable amount

The general rule is that VAT should be charged as a percentage of the taxable amount. Article 11 distinguishes between domestic supplies and imported goods. For domestic supplies taxable amount is defined in Article 11(A)(1)(a) as everything, which constitutes the consideration, which has been or is to be obtained by the supplier from the purchaser, the customer or a third party for such supplies.⁵⁸⁴ Article 11(A)(1)(a) also stipulates that taxable amount includes subsidies directly linked to the price. From this provision it follows that subsidies must be included in the taxable amount.

However, in the *Mohr* case the ECJ ruled that the compensation received for the discontinuation of milk production is not taxable under Article 11(A)(1)(a) of the Sixth Directive since no consumption could be distinguished. The ECJ argued that no consumption occurred because by compensating farmers for the loss of income as a result of ceasing milk production the public authorities did not acquire goods or services for their own use, but instead acted in the common interest. According to Simons, the ECJ judgement in the *Mohr* case overruled Article 11(a)(1) of the Sixth Directive which includes subsidies in the taxable amount.⁵⁸⁵

Simons argues that subsidies do not belong to the scope of VAT because an indirect general consumption tax is levied at the supplier but is deemed to be borne by the consumer. In cases of public services such as public transport, subsidised culture, social housing, etc., the consumption tax has to be paid over by the consumers; therefore, government grants to achieve artificial market level should remain outside the scope of a VAT.⁵⁸⁶

Van Hilten does not, however, presume to conclude from the *Mohr* case that all subsidies are non-taxable.⁵⁸⁷ He argues that such a conclusion would not accord with the legal character of VAT as a general tax: all consumption should be taxed, irrespective who pays, and the tax should be based on the total level of consumption. Van Hilten supposes that the ECJ intended to contrast the individual's 'own' interest with the collective 'general' interest. Consumption and, therefore, taxation do not occur in the latter cases because the activity for which the subsidy has been granted does not result in consumption by an identifiable individual(s).⁵⁸⁸

In the case of internal use or non-business use of goods and services, the purchase price or the cost price is applied as a taxable amount.⁵⁸⁹ In the case of self-supplies, the open market value is applicable.⁵⁹⁰

The taxable amount includes taxes, duties, levies and charges, and incidental expenses such as commission, packing, transport and insurance costs charged by the supplier. The taxable amount does not include price reductions by way of discount for early payment, price discounts and rebates, also certain kind of repayments entered in a suspense account.

⁵⁸⁴ However, in the *Tolsma* case the voluntary payments of by-passers to a organ-grinder were not treated as consideration for a (contractually) rendered service because of direct link between supply and expenditure (consideration for supply of services) was deemed to be lacking.

⁵⁸⁵ See Simons (1996), pp. 89-90.

⁵⁸⁶ Ibid, pp. 89-90.

⁵⁸⁷ See Van Hilten (1999), p. 5.

⁵⁸⁸ Ibid, pp. 5-6.

⁵⁸⁹ Article 11(A)(1)(b) of the Sixth Directive provides that in respect of private use of goods or their application for non-business purposes, the purchase price of the goods or of similar goods or, in the absence of a purchase price, the cost price, determined as the time of supply is applied as a taxable amount. Article 11 (A) (1) (c) of the Sixth Directive provides that in respect of use of services for non-business purposes the full cost to the taxable person of providing the services is applied as a taxable amount.

⁵⁹⁰ See Article 11(A)(1)(d) of the Sixth Directive.

Directive 94/5/EC⁵⁹¹ inserted a new Article 26a, which contains special rules applicable to second-hand goods, works of art, collectors' items and antiques effected by taxable dealers if those goods were supplied to the dealer otherwise than by way of taxable supply. Purchases for resale by traders from private individuals, businesses that have no possibility to deduct VAT on their purchases and non-taxable persons will be subject to so-called 'margin scheme'. The taxable amount of the supplies of goods by a taxable dealer is the profit margin made by the taxable dealer, less the amount of VAT relating to the profit margin. That profit margin must be equal to the difference between the selling price charged by the taxable dealer for the goods and the purchase price. The margin scheme results in payment of VAT when the difference between the selling price and purchase price is positive. When this difference is negative, no VAT is due and no VAT is refunded on the negative margin.⁵⁹²

Derogation for this 'margin scheme' is introduced by Article 26a(C), namely, for sales by public auction. Member States may use the special taxable amount of supplies of second-hand goods, works of art, collectors' items or antiques effected by an organiser of sales by public auction, acting in his own name, pursuant to a contract under which commission is payable on the sale of those goods by public auction.

In the case of travel agents, the taxable amount is travel agent's margin, namely, the difference between the total amount to be paid by the traveller, exclusive of VAT, and the actual cost to the travel agent of supplies and services provided by other taxable persons where these transactions are for the direct benefit of the traveller.

In respect of second hand cars, the Sixth Directive allows Member States to continue various different national systems of taxation. Directive also harmonises the definition of second-hand cars.

Article 28e stipulates that in the case of intra-Community acquisitions the taxable amount is determined according to Article 11(A), it means that the same conditions apply to these acquisitions as for supplies of goods and services within the territory of the country. In the case of fictitious acquisitions the taxable amount is determined in accordance with the provisions of self-supplies, i.e. the taxable amount is the purchase price of the goods or of similar goods or, in the absence thereof, the cost price determined at the time of the supply.⁵⁹³

In the case of imported goods, the taxable amount is the value of the goods for customs purposes, determined in accordance with the Community provisions in force. According to the EC Treaty, Member States should impose the tax on imports in the same way as it is imposed on similar domestic products. Taxes, duties, levies and other charges due outside the importing state and those due by reason of importation as well as incidental expenses incurred up to the first place of destination within the territory of the importing state are included in the taxable amount.

3.2.7 Exemptions

A distinction should be made between domestic exemptions, exemptions on importation, those on exportation, and exemptions relating to international goods traffic. In the case of exemptions within the territory of the country no right of deduction arises. By contrast, in the case of three other types of transactions the exemption is accompanied with a right of deduction, therefore, these transactions are, in effect, zero-rated. It follows that the exemption from taxation is not always an advantage because if persons making exempt transactions have no possibility to deduct input tax, they bear the tax burden.

⁵⁹¹ Council Directive 94/5/EC of 14 February 1994 supplementing the common system of value added tax and amending Directive 77/388/EEC - Special arrangements applicable to second-hand goods, works of art, collectors' items and antiques, OJ L 060, 03/03/1994, pp. 16 – 24.

⁵⁹² See Terra and Wattel (2001), p. 256.

⁵⁹³ See Terra and Wattel (2001), p. 258.

3.2.7.1 *Exemptions within the Territory of the Country*

The treatment of exemption without the right to deduction was applied to many types of supply when the Sixth Directive was adopted in 1978 either because, as in the case of services of the types provided by the public sector or which are classified as being provided for the general good of society (public postal services, activities of public broadcasting organisations, etc.), taxation was not considered appropriate or, as in the case of real estate, some financial and insurance services, and telecommunications no satisfactory technique for taxing them could be found.⁵⁹⁴ Article 13 distinguishes between two categories of exemptions: Article 13(A) deals with certain activities exempted in the public interest, and Article 13(B) with other exemptions. The former list of activities includes the postal and telecommunication services,⁵⁹⁵ medical and dental services, various social, cultural, and educational services, the supply of services and of goods related to the protection of children and young persons, certain charitable, religious and other non-profit activities, as well as non-commercial radio and television activities. The other exemptions include insurance and reinsurance transactions, the leasing or letting of immovable property, financial and banking transactions⁵⁹⁶, the supply at face value of postage stamps, betting, lotteries and other forms of gambling, and the transactions related to buildings or land. The sale and rental of immovable property is, as a general rule, exempted, however, new residential construction as well as alteration and maintenance of existing buildings, are taxable.

Taxable persons are not allowed a right of option for taxation except in cases of letting and leasing of immovable property, the supply of buildings and certain financial and banking transactions.

During the transitional period Member States may under certain conditions continue to subject to tax the transactions exempt under the Directive (these transactions are listed in Annex E to the Directive), to continue to exempt the activities set out in Annex F which should be taxed, or to grant to taxable persons the option for taxation of exempt transactions under the conditions set out in Annex G.

The same exemptions as for domestic supplies also apply for intra-Community acquisitions.

3.2.7.2 *Exemptions on importation*

Article 14 provides that Member States must exempt (with the right to deduction) final importation of goods of which the supply by a taxable person is in all circumstances exempted within the country. It means that the same exemptions, which apply for domestic goods and services, should also be applied for importation.

If goods qualify for exemption from customs duties other than as provided for in the Common Customs Tariff, Member States should also grant the same exemption for final importation of those goods. This provision intends to ensure that the same exemptions are applied for VAT and customs purposes. However, Member States may not to grant the exemption where this would be liable to have a serious effect on conditions of competition. In addition, Articles 14(1)(b) until (j) of the Sixth Directive list various other exemptions. The supply of

⁵⁹⁴ See Commission (1996b).

⁵⁹⁵ In many EC countries the exemption for telecommunication is abolished and the exemption for postal services in discussion (because of the introduction of competition within Member States).

⁵⁹⁶ The Sixth Directive distinguishes between 'core' services and 'secondary' (or 'complementary') services. The 'core' services are exempt from VAT and they include transactions in money, stocks and other securities, the operation of current or deposit accounts, lending money or advancing credit, and the management of special investment funds. Taxable secondary services include financial advice, debt collection and the keeping of securities. If the complementary services would be also exempted, financial institutions would be induced to provide these services 'in-house' rather than purchasing them from specialized traders. See Cnossen (1998a), p. 9.

services, in connection with the importation of goods, is exempted, but the value of such services is included in the taxable amount (Article 14(1)(i)).

3.2.7.3 *Exemptions related to exports, international transport and international goods traffic*

According to Article 15 both exports as well as international transport are exempted from VAT. 'Exports' means the supply of goods dispatched or transported to a destination outside the Community by or on behalf of the vendor. 'International transport' means transport to a third country and not intra-Community transport. Moreover, the exemption is applied in the case of supplies made at the retail stage of goods to be carried in the personal luggage of travellers. That exemption is subject to the condition that the traveller is not established within the Community, that the goods are transported to a destination outside the Community before the end of the third month following that in which the supply was made, and that the total value of the supply, including VAT, is more than EUR 175. Furthermore, the exemption is granted when intra-Community supplies are followed by an intra-Community acquisition i.e. if the supplies are made to taxable persons (Article 28(c)).

Article 16 introduces additional exemptions related to international goods traffic. These exemptions are linked to different kind of customs formalities, like transit, placements of goods in temporary storage, a free zone or in a free warehouse, customs warehousing or inward processing arrangements.

3.2.8 *Deductions*

The right for input tax credit arises at the time when the deductible tax becomes chargeable⁵⁹⁷, i.e. at the same time as the VAT on the purchase of the input becomes due (when the input tax is invoiced by another entrepreneur or when the goods are delivered or the services are performed, or when the payment is received).

Article 17(2) provides that the right to deduction or refund of the VAT is restricted to goods and services used for the purposes of taxable transactions. The taxable person is entitled to deduct from the tax, which he is liable to pay in respect of his supplies the tax invoiced to him by another taxable person (Article 17(2)(a)). The taxable person may also deduct the tax invoiced to him on acquired goods or imported goods (Article 17(2)(b)). In addition, taxable person has a right to deduct the tax due in cases of internal use and self-supply (Article 17(2)(c)). Taxable person also has the right to a deduction or refund in so far as the goods and services are used for the purposes of economic activities carried out in another country (including Member States), which would be eligible for deduction of tax if they had occurred in the territory of the home country (Article 17(3)). The same article also offers a right of deductibility when goods and services are used in connection with certain VAT exempt activities that are performed for non-EU customers, or for export transactions.⁵⁹⁸ For other VAT exempt activities within the territory, the input VAT is not deductible.

If the expenditure is not strictly business expenditure, taxable person is not entitled to deduct it. In addition, the expenditures, which were non-deductible according to the national laws of the Member States when the Directive came into force, may not be deducted.

The ECJ has ruled on several occasions on the subject of deductibility of certain financial transactions. In *Polysar*⁵⁹⁹, the ECJ held that a holding company whose sole purpose is to acquire holdings in other undertakings, without involving itself directly or indirectly in the management of those undertakings, without prejudice to its rights as shareholder, does not

⁵⁹⁷ See also section 3.2.5 about chargeable event and chargeability of tax.

⁵⁹⁸ As a general rule, no deduction is permitted for goods and services supplied based on Article 13 (exempt transactions), or those used for non-business purposes.

⁵⁹⁹ Case C-60/90.

have the status of a taxable person for the purposes of VAT and therefore has no right to deduct tax under Article 17 of the Sixth Directive. The ECJ stated that ‘... the mere acquisition of financial holdings in other undertakings does not amount to the exploitation of property for the purpose of obtaining income therefrom on a continuing basis because any dividend yielded by that holding is merely the result of ownership of the property. It is otherwise where the holding is accompanied by direct or indirect involvement in the management of the companies in which the holding has been acquired, without prejudice to the rights held by the holding company as a shareholder.’⁶⁰⁰

In *BLP*⁶⁰¹, the ECJ held that Article 2 and Article 17 of the Sixth Directive are to be interpreted as meaning that, except in the cases expressly provided for by those directives, where a taxable person supplies services to another taxable person who uses them for an exempt transaction, the latter person is not entitled to deduct the input VAT paid, even if the ultimate purpose of the transaction is the carrying out of a taxable transaction.⁶⁰² The ECJ argued that the wording of those provisions shows that to give rise to the right to deduct, the goods or services in question must have a direct and immediate link with the taxable transactions, and that the ultimate aim pursued by the taxable person is irrelevant in this respect.

Determination of deductible proportion

In the cases where a taxable person uses goods and services both for deductible and non-deductible⁶⁰³ transactions, only the proportion of input tax that is attributable to the former is deductible (Article 17(5)). The deductible proportion is determined on an annual basis. When in a given tax period, the amount of deductions exceed the amount of tax due, Member States may either pay a rebate or carry the excess forward to the following period.

Article 19 provides for calculation method (the so-called ‘*pro-rata* method’) to determine the deductible proportion. By virtue of Article 19(1), the proportion deductible is made up of a fraction having as numerator, the total amount, exclusive of VAT, of turnover per year attributable to transactions in respect of which VAT is deductible and, as denominator, the total amount, exclusive of VAT, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which VAT is not deductible.

The ECJ has specified in various judgments the rules governing the determination of the deductible proportion.

In *Sofitam*⁶⁰⁴, the ECJ held that Article 19(1) of the Sixth Directive must be interpreted as meaning that share dividends received by an undertaking which is not subject to VAT in respect of the whole of its transactions are to be excluded from the denominator. The ECJ argued that since the receipt of dividends is not the consideration for any economic activity within the meaning of the Sixth Directive, it does not fall within the scope of VAT, so that dividends resulting from holdings fall outside the deduction entitlement.⁶⁰⁵

⁶⁰⁰ Paragraphs 13-14 of the judgment.

⁶⁰¹ Case C-4/94.

⁶⁰² Paragraph 28 of the judgment.

⁶⁰³ Exempt or non-business transactions.

⁶⁰⁴ Case C-333/91.

⁶⁰⁵ *Satam*, a holding company, deducted, from the VAT which it was liable to pay, the whole of the VAT charged on the goods and services which it had acquired during the same tax period. Having established that the revenue received by *Satam* included, on the one hand, various proceeds subject to VAT and, on the other hand, dividends not subject to VAT, the French tax authority took the view that *Satam* should have deducted VAT on goods and services acquired by it only up to the percentage resulting from the ratio between the amount of its taxable receipts and the annual amount of its total receipts, including the dividends which it had received. The tax authority therefore claimed from *Satam* additional VAT resulting from the reduction in its deduction entitlement. *Satam* objected to that claim and maintained that the dividends were not to be included in the deductible proportion. *Satam* argued that the total annual amount to be included in the denominator in accordance with Article 19

In *Cibo*⁶⁰⁶, the ECJ held referring to the *Floridiene* case that the involvement of a holding company in the management of companies in which it has acquired a shareholding constitutes an economic activity within the meaning of Article 4(2) of the Sixth Directive where it entails carrying out transactions which are subject to VAT by virtue of Article 2 of that directive, such as the supply by a holding company to its subsidiaries of administrative, financial, commercial and technical services. The ECJ thus stated that expenditure incurred by a holding company in respect of the various services which it purchased in connection with the acquisition of a shareholding in a subsidiary forms part of its general costs and therefore has, in principle, a direct and immediate link with its business as a whole. Thus, if the holding company carries out both transactions in respect of which VAT is deductible and transactions in respect of which it is not, it follows from the first paragraph of Article 17(5) of the Sixth Directive that it may deduct only that proportion of the VAT which is attributable to the former. In its judgment in *Floridiene*⁶⁰⁷, the ECJ stated that interest paid by the subsidiaries to the holding company on loans it has made to them must be excluded from the denominator of the fraction used to calculate the deductible proportion, where the loan transactions do not constitute, for the purposes of Article 4(2) of the Sixth Directive, an economic activity of the holding company.⁶⁰⁸

Based on Article 17(4)⁶⁰⁹, the Eighth Directive⁶¹⁰ and the Thirteenth Directive⁶¹¹ were adopted, which provide the arrangements for refund of VAT to taxable persons not established in the territory of the country. The Eighth Directive lays down detailed arrangements for the refund of VAT paid in a Member State by taxable persons established in another Member State and the Thirteenth Directive provides the arrangements for the refund if taxable persons are established outside the Community.

The Court has clarified the link existing between the right to deduction in the Member State of establishment and the right to a refund in another Member State where the expenditure is incurred. The ECJ held in *Debouche*⁶¹² that taxable person who performs in the Member State of establishment exclusively exempt transactions is not entitled to a refund of the VAT charged on services supplied to him in a Member State in which he is not established and in

included only sums received by the taxable person in respect of the performance of transactions subject to VAT or expressly exempt from VAT, to the exclusion of income such as dividends, which did not relate to any activity giving rise to turnover and did not fall within the scope of VAT. (See paragraph 3-6 of the judgment.) The ECJ held in its judgment in *Sofitam* that since the receipt of dividends is not the consideration for any economic activity within the meaning of the Sixth Directive, it does not fall within the scope of VAT. Consequently, dividends resulting from holdings fall outside the deduction entitlement. Consequently, dividends must be excluded from the calculation of the deductible proportion referred to in Articles 17 and 19 of the Sixth Directive, if the objective of wholly neutral taxation ensured by the common system of VAT is not to be jeopardized. See paragraph 13-14 of the judgment.

⁶⁰⁶ Case C-16/00.

⁶⁰⁷ Case C-142/99.

⁶⁰⁸ See paragraphs 21 and 32 of the judgment.

⁶⁰⁹ Article 17(4) provides that the Council shall adopt before 31 December 1977, on a proposal from the Commission and acting unanimously, Community rules laying down the arrangements under which refunds are to be made in accordance with paragraph 3 to taxable persons not established in the territory of the country.

⁶¹⁰ Eighth Council Directive 79/1072/EEC of 6 December 1979 on the harmonization of the laws of the Member States relating to turnover taxes-Arrangements for the refund of value added tax to taxable persons not established in the territory of the country, OJ L 331, 27.12.1979, p. 11.

⁶¹¹ Thirteenth Council Directive 86/560/EEC of 17 November 1986 on the harmonization of the laws of the Member States relating to turnover taxes - Arrangements for the refund of value added tax to taxable persons not established in Community territory, OJ L 326, 21/11/1986, pp. 40-41.

⁶¹² Case C-302/93.

which those services are not exempted. Thus, a taxable person who benefits from exemption and is consequently not entitled to deduct input tax is not, in accordance with the objective pursued by the VAT directives, entitled to a refund of VAT paid in another Member State either.⁶¹³

With regard to partial exemption in the Member State of establishment, the ECJ has held that the provisions of the Eighth Directive must be interpreted as meaning that:⁶¹⁴

- a. they grant taxable persons established in a Member State where only part of their transactions are taxed a right to partial refund of the VAT which has been charged in a Member State where they are not established on goods or services used for the purposes of their transactions in the Member State of establishment;
- b. the amount of VAT refundable is calculated, first, by determining which transactions give rise to a right to deduction in the Member State of establishment and, second, by taking account solely of the transactions which would also give rise to a right of deduction in the Member State of refund if they were carried out there and of the expenses giving rise to a right to deduction in the latter State.⁶¹⁵

The ECJ held in its judgment in *Paschi Di Siena*⁶¹⁶ referring to Article 17 of the Sixth Directive that the right to deduct VAT may be exercised to the extent to which the goods and services which gave rise to the payment of VAT are used for the purposes of the taxable person's transactions. The ECJ stipulated in its judgment: 'Provided that the taxable person carries out both taxed transactions and exempt transactions in the Member State of establishment, he therefore enjoys a right to partial deduction in that State. It must be inferred from the foregoing that, if that taxable person incurs expenditure in a Member State other than the Member State of establishment for the purposes both of his taxed transactions and his exempt transactions in the latter State, he has a right of partial refund in the first State. In order to determine the amount of any refund in circumstances such as those in point in the main proceedings it is appropriate, pursuant to Article 2 of the Eighth Directive, to apply the provisions of Article 17(3)(a) of the Sixth Directive and verify whether the transactions in question would give rise to a right to deduction in the Member State of refund. Thus, in the case of a taxable person carrying out taxed transactions and exempt transactions in the Member State where he is established, it is appropriate to consider whether the former transactions would also give rise to a right to deduction in the Member State of refund in the event of

⁶¹³ Mr Debouche, a lawyer established in Belgium, hired a car from a leasing company established in the Netherlands which he used exclusively for his professional activity in Belgium. In Belgium, the services supplied by lawyers are exempted from VAT. By contrast, the same services are subject in the Netherlands to turnover tax. (See paragraph 3-4 of the judgment in *Debouche*.) In accordance with Article 3(b) of the Eighth Directive the taxpayer must, if he is to qualify for a refund, prove by means of a certificate issued by the authorities of the State in which he is established that he is a taxable person for the purposes of VAT in that State. The ECJ held in its judgment in *Debouche* that a taxable person who benefits from exemption and is consequently not entitled to deduct input tax is not, in accordance with the objective pursued by the VAT directives, entitled to a refund of VAT paid in another Member State either.

⁶¹⁴ See Case C-136/99 (*Paschi Di Siena*), paragraph 32.

⁶¹⁵ Monte dei Paschi di Siena is a banking and financial establishment whose business headquarters is in Italy and which has a representative office in France. It applied for refund of the VAT charged on the expenditure incurred by it in France in connection with the setting up of that office in France. The tax authorities refused to grant that application. The national court referred to the ECJ on the question whether the Eighth Directive must be interpreted as granting taxable persons established in a Member State where only some of their transactions are taxed the right to partial refund of the VAT charged, in a Member State where they are not established, on goods or services which are used for the purposes of their transactions in the Member State of establishment and, if so, how the amount of the VAT to be refunded must be calculated. See paragraph 18 of the judgment.

⁶¹⁶ Case C-136/99.

their being carried out there. If that is not the case, the said taxed transactions cannot be taken into account in calculating the amount of the refund. The apportionment carried out in accordance with Article 19 of the Sixth Directive must therefore, if necessary, be adjusted by reference to the transactions which would give rise to a right to deduction if they were carried out in the Member State of refund. After the appropriate apportionment is carried out, it is necessary to determine what expenditure may be taken into account in calculating the refund. In that connection, reference must be made to Article 5 of the Eighth Directive, which provides that the right to refund is to be determined in accordance with Article 17 of the Sixth Directive, as applicable in the Member State of refund. That article must be construed as meaning that the expenditure to be taken into account is that which gives rise to a right to deduction in that State. The amount of the refund is determined by applying the apportionment to the VAT paid in respect of such expenditure.⁶¹⁷

3.2.9 *Persons liable for payment of the tax*

Taxable persons who carry out taxable transactions and any person who mentions the value-added tax on an invoice are liable to pay the tax. In the case of the supply of certain intangible services (so-called Article 9(2)(e) services) supplied by a non-resident, these services are subject to reverse charge, i.e. the recipient of services is liable to pay the tax if he is a taxable person established within the EC.⁶¹⁸ In some cases, a representative of the taxable person may be made liable.

Liability for intra-Community acquisitions

Any person who makes a taxable intra-Community acquisition of goods is liable for the payment of the VAT due. In the case of intra-Community acquisitions in VAT warehouses, the person liable for the payment of the VAT due is the person who causes the goods to cease to be covered by the VAT warehousing arrangement. In the case of intra-Community acquisition effected by a person established abroad, the Member State may designate another person to be liable for the payment of the VAT, e.g. a tax representative.

Liability for importation

According to Article 21(2) Member States may determine who is designated or accepted as being liable for the payment of the VAT due on importation.

3.2.10 *Special schemes*

Title XIV of the Sixth Directive provides for five special schemes: for small undertakings (Article 24), for farmers (Article 25), for second-hand goods, works of art, collectors' items and antiques (Article 26a), for travel agents (Article 26), and for investment gold (Article 26b)).

The Directive allows Member States to introduce special measures for small undertakings, namely, simplified procedures⁶¹⁹ and exemption from tax. Member States may apply simplified procedures for small undertakings such as flat-rate schemes for charging and collecting the tax to reduce the administrative burden on small enterprises. Article 24(1) contains the condition that this kind of procedures may not lead to a reduction of tax. As another measure

⁶¹⁷ Paragraphs 25-29 of ECJ judgment in Case C-136/99 (*Paschi Di Siena*).

⁶¹⁸ The recipient of the services becomes liable for the VAT, which he has to report in his periodic VAT return in so far as he is not entitled to deduction of the amount due at the same time.

⁶¹⁹ Article 22 requires that taxable persons maintain records of their sales, purchases and of the tax charged on its transactions. To keep such records may be beyond the capabilities of small undertakings. See Terra and Wattel (2001), p. 279.

for small undertakings, Member States may exempt taxable persons whose annual turnover is below EUR 5.000.

Member States may also apply common flat-rate scheme for agricultural sector⁶²⁰. Under this scheme supplies by a farmer under the special scheme are exempt, and the farmer also gets a flat-rate compensation to offset the VAT paid by him on inputs. The amount of refund may not exceed the VAT paid on inputs. Every flat-rate farmer may opt, subject to the rules and conditions laid down by each Member State, for application of the normal VAT regime or the simplified scheme for small undertakings.

Another special scheme is allowed for second-hand goods, works of art, collectors' items and antiques purchased for resale by traders from private individuals, businesses that have no possibility to deduct VAT on their purchases and non-taxable persons. This so-called margin scheme was dealt with in the section 3.2.6. ('Taxable amount'). Under this scheme VAT is applied on the difference between the selling and buying price. However, businesses ('taxable dealers') buying and selling such goods from each other may opt for application of the normal VAT regime.

Article 26 provides the special scheme applicable to travel agents. All transactions performed by the travel agent in respect of a journey are treated as a single service supplied by the travel agent to the traveller. It must be taxable in the Member State in which the travel agent has established his business or has a fixed establishment from which the travel agent has provided the services. The VAT is applied to journeys and related services within the Community; travel outside the Community is zero-rated (exempted with a right to deduction). Where these transactions are performed both inside and outside the Community, only that part of the travel agent's service relating to transactions outside the Community is exempted. Tax charged to the travel agent by other taxable persons on the transactions performed by the travel agent in respect of a journey which are for the direct benefit of the traveller, are not eligible for deduction or refund in any Member State. The taxable amount is the travel agent's margin, that is, the difference between the total amount to be paid by the traveller, exclusive of VAT, and the actual cost to the travel agent of supplies and services provided by other taxable persons where these transactions are for the direct benefit of the traveller.

Article 26b provides special scheme for investment gold.⁶²¹ Member States must exempt from VAT investment gold as well as services of so-called disclosed agents when they intervene in the supply of investment gold for their principal. The exemption on investment gold transactions is accompanied with the right to limited deduction. Certain operators may opt for normal taxation with full deduction. Moreover, reverse charge is applicable to investment gold transactions.

3.2.11 Rules applicable to e-commerce and broadcasting services

The Council approved the Directive 2002/38/EC dealing with e-commerce transactions as well as radio and television broadcasting services on 7 May 2002.⁶²² The Directive stipulates that such services were effected for consideration and consumed by customers established

⁶²⁰ Farmers are considered to be another group that may be burdened by the keeping of detailed records necessary for a VAT return. See Terra and Wattel (2001), p. 279.

⁶²¹ The special scheme for investment gold was introduced by the Council Directive 98/80/EC of 12 October 1998 supplementing the common system of value added tax and amending Directive 77/388/EEC - Special scheme for investment gold, OJ L 281, 17/10/1998, pp. 31 - 34

⁶²² Council Directive 2002/38/EC of 7 May 2002 amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, published in the OJ L 128/41 of 15 May 2002.

in the Community are taxed in the Community and are not taxed if consumed outside the Community. To this end, radio and television broadcasting services and electronically supplied services provided from third countries to persons established in the Community or from the Community to recipients established in third countries must be taxed at the place of the recipient of the services. Article 9(2) (f) of the Sixth Directive provides that in case of the radio and television broadcasting services, and electronically supplied services the place of supply when those services are performed for non-taxable persons who are established, have their permanent address or usually reside in a Member State, by a taxable person who has established his business or has a fixed establishment from which the service is supplied outside the Community or, in the absence of such a place of business or fixed establishment, has his permanent address or usually resides outside the Community, shall be the place where the non-taxable person is established, has his permanent address or usually resides.⁶²³ To define electronically supplied services, examples of such services are included in an Annex L to the Sixth Directive.^{624 625}

Preamble of the Directive 2002/38/EC stipulates that in order to facilitate compliance with fiscal obligations by operators providing electronically supplied services, who are neither established nor required to be identified for tax purposes within the Community, a special scheme is established. In applying this scheme any operator supplying such services by electronic means to non-taxable persons within the Community, may, if he is not otherwise identified for tax purposes within the Community, opt for identification in a single Member State. The non-established operator wishing to benefit from the special scheme should comply with the requirements laid down therein, and with any relevant existing provision in the Member State where the services are consumed. The Member State of identification must under certain conditions be able to exclude a non-established operator from the special scheme. Where the non-established operator opts for the special scheme, any input VAT that he has paid with respect to goods and services used by him for the purpose of his taxed activities falling under the special scheme, should be refunded by the Member State where the input V

AT was paid, in accordance with the arrangements of the thirteenth Council Directive 86/560/EEC⁶²⁶. The optional restrictions for refund in Article 2(2) and (3) and Article 4(2) of the same Directive are not applied. Subject to conditions which they lay down, Member States should allow certain statements and returns to be made by electronic means, and may also require that electronic means are used. Those provisions pertaining to the introduction of electronic tax returns and statements should be adopted on a permanent basis. It is desirable to adopt all other provisions for a temporary period of three years which may be extended for practical reasons but should, in any event, based on experience, be reviewed within three years from 1 July 2003.

⁶²³ See also section 3.2.4.

⁶²⁴ ANNEX L to the Sixth Directive contains the following illustrative list of electronically supplied services:

- Website supply, web-hosting, distance maintenance of programmes and equipment.
- Supply of software and updating thereof.
- Supply of images, text and information, and making databases available.
- Supply of music, films and games, including games of chance and gambling games, and of political, cultural, artistic, sporting, scientific and entertainment broadcasts and events.
- Supply of distance teaching.

⁶²⁵ Annex L specifies that where the supplier of a service and his customer communicates via electronic mail, this shall not of itself mean that the service performed is an electronic service within the meaning of the Sixth Directive.

⁶²⁶ Directive 86/560/EEC of 17 November 1986 on the harmonisation of the laws of the Member States relating to turnover taxes - arrangements for the refund of value added tax to taxable persons not established in Community territory

Special scheme for e-commerce

Special scheme for non-established taxable persons supplying electronic services to non-taxable persons was introduced by the Directive 2002/38/EC.⁶²⁷ Article 26c was added to the Sixth Directive which provides that Member States must permit a non-established taxable person supplying electronic services to a non-taxable person who is established or has his permanent address or usually resides in a Member State to use a special scheme in accordance with the following provisions.⁶²⁸ The non-established taxable person must state to the Member State of identification⁶²⁹ when his activity as a taxable person commences, ceases or changes to the extent that he no longer qualifies for the special scheme.⁶³⁰ Such a statement must be made electronically.⁶³¹ The Member State of identification must identify the non-established taxable person by means of an individual number.⁶³² Based on the information used for this identification, Member States of consumption may keep their own identification systems.⁶³³ The Member State of identification must notify the non-established taxable person by electronic means of the identification number allocated to him.⁶³⁴ The Member State of identification must exclude the non-established taxable person from the identification register if: (a) he notifies that he no longer supplies electronic services, or (b) it otherwise can be assumed that his taxable activities have ended, or (c) he no longer fulfils the requirements necessary to be allowed to use the special scheme, or (d) he persistently fails to comply with the rules concerning the special scheme.⁶³⁵ The non-established taxable person must submit by electronic means to the Member State of identification a VAT return for each calendar quarter whether or not electronic services have been supplied.⁶³⁶ The return must be submitted within 20 days following the end of the reporting period to which the return refers.⁶³⁷ The VAT return must set out the identification number and, for each Member State of consumption where tax has become due, the total value, less VAT, of supplies of electronic services for the reporting period and total amount of the corresponding tax. The applicable tax rates and the total tax due must also be indicated.⁶³⁸ The non-established taxable person must pay the VAT when submitting the return.⁶³⁹ Notwithstanding Article 1(1) of the Directive

⁶²⁷ See Article 3 of the Council Directive 2002/38/EC of 7 May 2002 amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, published in the OJ L 128/41 of 15 May 2002.

⁶²⁸ Article 26c (B) (1). Article 26c (B) (1) also stipulates that the special scheme shall apply to all those supplies within the Community.

⁶²⁹ Article 26c (A) (c) provides that 'Member State of identification' means the Member State which the non-established taxable person chooses to contact to state when his activity as a taxable person within the territory of the Community commences.

⁶³⁰ Article 26c (B) (2).

⁶³¹ Article 26c (B) (2).

⁶³² Article 26c (B) (3).

⁶³³ Article 26c (B) (3).

⁶³⁴ Article 26c (B) (3).

⁶³⁵ Article 26c (B) (4).

⁶³⁶ Article 26c (B) (5).

⁶³⁷ Article 26c (B) (5).

⁶³⁸ Article 26c (B) (5). The value added tax return must be made in euro. Member States which have not adopted the euro may require the tax return to be made in their national currencies. If the supplies have been made in other currencies, the exchange rate valid for the last date of the reporting period shall be used when completing the value added tax return. The exchange must be done following the exchange rates published by the European Central Bank for that day, or, if there is no publication on that day, on the next day of publication. See Article 26c (B) (6).

⁶³⁹ Article 26c (B) (7). Article 26c (B) (7) also stipulates that payment shall be made to a bank account denominated in euro, designated by the Member State of identification. Member States which

86/560/EEC, the non-established taxable person making use of this special scheme must, instead of making deductions under Article 17(2) of the Sixth Directive, be granted a refund according to the Directive 86/560/EEC. Articles 2(2)⁶⁴⁰, 2(3)⁶⁴¹ and 4(2)⁶⁴² of the Directive 86/560/EEC must not apply to the refund related to electronic supplies covered by this special scheme.⁶⁴³ The non-established taxable person must keep records of the transactions covered by this special scheme in sufficient detail to enable the tax administration of the Member State of consumption to determine that the VAT return is correct.⁶⁴⁴

3.2.12 Administrative obligations

Administrative obligations for persons liable for payment of VAT are stipulated in Article 22 of the Sixth Directive as amended by Article 28h of Directive 91/680/EEC.

Registration

Every taxable person must state when his activity as a taxable person commences, changes or ceases. Member States must, subject to conditions which they lay down, allow the taxable person to make such statements by electronic means, and may also require that electronic means are used.

Identification numbers

Member States have to identify by means of an individual number every taxable person who within the territory of the country effects supplies of goods or services giving him the right of deduction, with the exception of cases of occasional transactions or occasional supplies of new means of transport. This obligation extends to cover certain non-taxable persons or exempt persons making intra-Community acquisitions.

Keeping accounts

Every taxable person must keep accounts in sufficient detail for VAT to be applied and inspected by the tax authority.

Keeping a register

Every taxable person must keep a register of the goods he has dispatched or transported or which have been dispatched or transported on his behalf to another Member State.

have not adopted the euro may require the payment to be made to a bank account denominated in their own currency.

⁶⁴⁰ Article 2(2) of Directive 86/560/EEC provides that Member States may make the refunds conditional upon the granting by third States of comparable advantages regarding turnover taxes.

⁶⁴¹ Article 2(3) of Directive 86/560/EEC provides that Member States may require the appointment of a tax representative.

⁶⁴² Article 4(2) of Directive 86/560/EEC provides that Member States may, however, provide for the exclusion of certain expenditure or make refunds subject to additional conditions.

⁶⁴³ Article 26c (B) (8).

⁶⁴⁴ Article 26c (B) (9). The same article provides that these records should be made available electronically on request to the Member State of identification and to the Member State of consumption. These records shall be maintained for a period of 10 years from the end of the year when the transaction was carried out.

Invoicing

In 2001, the Council adopted the directive providing new rules on invoicing.⁶⁴⁵ Along the other objectives the directive aims to make it possible for European traders to use electronic invoicing and storage.

Every taxable person must issue an invoice in respect of goods or services which he has supplied or rendered to another taxable person or to a non-taxable legal person (i.e. a public body). This obligation is extended to all distance sales that are taxed in the Member State of arrival⁶⁴⁶ and to intra-Community supplies of goods, without limiting the obligation to transactions with taxable persons or to non-taxable legal persons.

The following details are required for VAT purposes on invoices:

- a. the date of issue;
- b. a sequential number, based on one or more series, which uniquely identifies the invoice;
- c. the VAT identification number under which the taxable person supplied the goods or services⁶⁴⁷;
- d. where the customer is liable to pay tax on goods supplied or services rendered or has been supplied with exempt goods, the VAT identification number under which the goods were supplied or the services rendered to him;
- e. the full name and address of the taxable person and of his customer;
- f. the quantity and nature of the goods supplied or the extent and nature of the services rendered;
- g. the date on which the supply of goods or of services was made or completed or the date on which the payment on account was made, insofar as that a date can be determined and differs from the date of issue of the invoice;
- h. the taxable amount per rate or exemption, the unit price exclusive of tax and any discounts or rebates if they are not included in the unit price;
- i. the VAT rate applied;
- j. the VAT amount payable, except where a specific arrangement is applied for which the Sixth Directive excludes such a detail;
- k. where an exemption is involved or where the customer is liable to pay the tax, reference to the appropriate provision of the Sixth Directive, to the corresponding national provision, or to any indication that the supply is exempt or subject to the reverse charge procedure;
- l. where the intra-Community supply of a new means of transport is involved, the particulars specified in Article 28a(2) of the Sixth Directive;
- m. where the margin scheme is applied, reference to Article 26 or 26a of the Sixth Directive, to the corresponding national provisions, or to any other indication that the margin scheme has been applied;
- n. where the person liable to pay the tax is a tax representative, the VAT identification number together with his full name and address.

⁶⁴⁵ Council Directive 2001/115/EC of 20 December 2001 amending Directive 77/388/EEC with a view to simplifying, modernising and harmonising the conditions laid down for invoicing in respect of value added tax.

⁶⁴⁶ This rule applies to firms who make a taxable supply over certain threshold. See section 3.2.4.

⁶⁴⁷ Member States may require taxable persons established on their territory and supplying goods or services on their territory to indicate the VAT identification number of their customer. In cases of intra-Community transaction, the invoice must indicate the VAT identification number of both the supplier of the goods and the persons acquiring the goods.

Member States may provide that invoices in respect of goods supplied or services rendered in their territory do not have to fulfil some of these conditions in the following cases:

- a. when the amount of the invoice is minor, or
- b. when commercial or administrative practice in the business sector concerned or the technical conditions under which the invoices are issued make it difficult to comply with all these conditions.

In any case, these invoices must contain the following:

- a. the date of issue,
- b. identification of the taxable person,
- c. identification of the type of goods supplied or services rendered,
- d. the tax due or the information needed to calculate it.

Invoices issued may be sent either on paper or, subject to an acceptance by the customer, by electronic means. Invoices sent by electronic means must be accepted by Member States provided that the authenticity of the origin and integrity of the contents are guaranteed:

- a. by means of an advanced electronic signature⁶⁴⁸; Member States may however ask for the advanced electronic signature to be based on a qualified certificate and created by a secure-signature-creation device⁶⁴⁹; or
- b. by means of electronic data interchange⁶⁵⁰ when the agreement relating to the exchange provides for the use of procedures guaranteeing the authenticity of the origin and integrity of the data; however, Member States may, subject to conditions which they lay down, require that an additional summary document on paper is necessary.

Invoices may, however, be sent by other electronic means subject to acceptance by the Member State(s) concerned. The Commission will present, at the latest on 31 December 2008, a report, together with a proposal, if appropriate, amending the conditions on electronic invoicing in order to take account of possible future technological developments in this field. Member States may not impose on taxable persons supplying goods or services in their territory any other obligations or formalities relating to the transmission of invoices by electronic means. However, they may provide, until 31 December 2005, that the use of such a system is to be subject to prior notification.

Submitting a return

Every taxable person must submit a return by a deadline to be determined by Member States. That deadline may not be more than two months later than the end of each tax period. The tax period must be fixed by each Member State at one month, two months or a quarter. Member States may, however, set different periods provided that they do not exceed one year. Member States must, subject to conditions which they lay down, allow the taxable person to make such returns by electronic means, and may also require that electronic means are used.

⁶⁴⁸ Within the meaning of Article 2(2) of Directive 1999/93/EC of the European Parliament and of the Council of 13 December 1999 on a Community framework for electronic signatures, OJ L 13, 19.1.2000, p.12.

⁶⁴⁹ Within the meaning of Article 2(6) and (10) of Directive 1999/93/EC of the European Parliament and of the Council of 13 December 1999 on a Community framework for electronic signatures, OJ L 13, 19.1.2000, p.12.

⁶⁵⁰ As defined in Article 2 of Commission Recommendation 1994/820/EC of 19 October 1994 relating to the legal aspects of electronic data interchange, OJ L 338, 28.12.1994, p.98.

The return must set out all the information needed to calculate the tax that has become chargeable and the deductions to be made including, where appropriate, and in so far as it seems necessary for the establishment of the basis of assessment, the total value of the transactions relative to such tax and deductions and the value of any exempt transactions. In addition, the return must also set out:

- 1) - the total value, less VAT, of (exempt) intra-Community supplies of goods on which tax has become chargeable during the period,
- the total value, less VAT, of the supplies of goods installed or assembled and of distance sales effected within the territory of another Member State for which tax has become chargeable during the return period where the place of departure of the dispatch or transport of the goods is situated in the territory of the country; or
- 2) the total amount, less VAT, of the intra-Community acquisitions of goods effected within the territory of the country on which tax has become chargeable. The following must also be added: the total value, less VAT, of the supplies of goods installed or assembled and of distance sales effected in the territory of the country on which tax has become chargeable during the return period, where the place of departure of the dispatch or transport of the goods is situated within the territory of another Member State.

Every taxable person must pay the net amount of the VAT when submitting the regular return. Member States may, however, set a different date for the payment of that amount or may demand an interim payment.

Submitting a statement

Member States may require a taxable person to submit a statement, including all the particulars that have been mentioned on the returns, concerning all transactions carried out in the preceding year. That statement must provide all the information necessary for any adjustments. Member States must, subject to conditions which they lay down, allow the taxable person to make such statements by electronic means, and may also require that electronic means are used.

Submitting a recapitulative statement

Every taxable person identified for VAT purposes must also submit a recapitulative statement of the persons acquiring goods identified for VAT purposes to whom he has performed the intra-Community supplies of goods, the so-called 'EC sales list'.

The recapitulative statement must be drawn up for each calendar quarter within a period and in accordance with procedures to be determined by Member States, which must take the measures necessary to ensure that the provisions concerning administrative cooperation in the field of indirect taxation are in any event complied with. Member States must, subject to conditions which they lay down, allow the taxable person to make such statements by electronic means, and may also require that electronic means are used.

The recapitulative statement must set out:

- a. the number by which the taxable person is identified for purposes of VAT in the territory of the country and under which he effected the intra-Community supplies of goods;
- b. the number by which each person acquiring goods is identified for purposes of VAT in another Member State and under which the goods were supplied to him;
- c. for each person acquiring goods, the total value of the supplies of goods effected by the taxable person. Those amounts must be declared for the calendar quarter during which the tax became chargeable.

The recapitulative statement must also set out:

- a. for the (exempt) fictitious supplies of goods in cases of transfers of goods within the undertaking, the number by means of which the taxable person is identified for purposes of VAT in the territory of the country as well as the number by which he is identified in the Member State of arrival of the dispatch or transport and total amount of exempt supplies of goods;
- b. the amounts of adjustments made pursuant to Article 11 (C) (1) of the Sixth Directive (in the case of cancellation, refusal or total or partial non-payment, or where the price is reduced after the supply takes place). Those amounts must be declared for the calendar quarter during which the person acquiring the goods is notified of the adjustment.

By way of derogation from the above mentioned rules, Member States may require recapitulative statements to be filed on a monthly basis, and may also require that recapitulative statements give additional particulars.

3.2.13 Simplification measures

According to Article 27 the Council, acting unanimously on a proposal from the Commission may allow Member States to introduce special measures in order to simplify the procedure for charging the tax or to prevent certain types of tax evasion or avoidance.

3.3 Harmonization of VAT rates

Although VAT rates have not been harmonised in the EU and Member States are free to establish their own rates, some common rules have been adopted. In June 1991 Member States agreed to the Directive 92/77⁶⁵¹ on the approximation of VAT rates. Article 12 of the Sixth Directive introduces rules for VAT rates. The standard rate of VAT is fixed by each Member State as a percentage of the taxable amount and must be the same for the supply of goods and for the supply of services as well as to the importation of goods. Member States are allowed to apply increased or reduced rates to certain categories of supplies, provided that each reduced rate is fixed at such a level that deduction of the total input tax is permitted in the normal way⁶⁵². Article 12 also introduces limitations of the number of different rates and minimum rates for VAT. The minimum standard rate of VAT, for the period 1 January to 31 December 2005, may not be less than 15 %.^{653 654} Member States may also apply up to two reduced rates on specified categories of goods and services⁶⁵⁵, neither of which may be lower

⁶⁵¹ Council Directive 92/77/EEC of 19 October 1992 supplementing the common system of value added tax and amending Directive 77/388/EEC (approximation of VAT rates), OJ L 316, 31/10/1992, pp. 1- 4.

⁶⁵² Article 12(4) stipulates: 'Each reduced rate shall be so fixed that the amount of value added tax resulting from the application thereof shall be such as in the normal way to permit the deduction therefrom of the whole of the value added tax deductible under the provisions of Article 17.'

⁶⁵³ Council Directive 2001/4/EC of 19 January 2001 amending the sixth Directive (77/355/EEC) on the Common system of value added tax, with regard to the length of time during which the minimum standard rate is to be applied, OJ L 22 of 24 January 2001, p. 17.

⁶⁵⁴ Council Directive 2002/38/EC of 7 May 2002 introduced the provision that the reduced rate should not be applied to radio and television broadcasting services and certain electronically supplied services. See Article 1(2) of the Council Directive 2002/38/EC of 7 May 2002 amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, published in the OJ L 128/41 of 15 May 2002.

⁶⁵⁵ The goods and services to which reduced rates of VAT can be applied are listed in Annex H to the Sixth Directive.

than 5%.⁶⁵⁶ However, the transitional provisions of Article 28(2) introduce a series of derogations to this rule. As a transitional measure, the countries applying zero rates or rates less than 5% were able to maintain them provided that they are applied for clearly defined social reasons and operate for the benefit of the final consumer. Those countries that did not already apply a reduced rate before beginning of 1993 may not do so after this date. Member States may apply a reduced rate to supplies of natural gas and electricity provided that no risk of distortion of competition exists. A Member State intending to apply such a rate must, before doing so, inform the Commission. The Commission shall give a decision on the existence of a risk of distortion of competition. If the Commission has not taken that decision within three months of the receipt of the information a risk of distortion of competition is deemed not to exist.

Article 12(3)(c) provides that Member States may provide that the reduced rate, or one of the reduced rates, which they apply in accordance with the third paragraph of Article 12(3)(a)⁶⁵⁷ must also apply to imports of works of art, collectors' items and antiques. The result of the application of the reduced rate upon importation is that, the VAT burden on imported and domestic goods based on the margin scheme is equalized and a taxable dealer who imports goods at a reduced rate may apply the margin scheme.⁶⁵⁸

Article 12(3)(c) also provides that Member States may apply the reduced rate to domestic supplies of works of art made by their creator or his successors in title, and this reduced rate is not restricted to supplies to taxable dealers. The same article provides that Member States may also apply the reduced rate to supplies of works of art, effected on an occasional basis by a taxable person other than a taxable dealer, where these works of art have been imported by the taxable person himself or where they have been supplied to him by their creator or his successors in title or where they have entitled him to full deduction of value-added tax.

Labour-intensive services

In 1999, the Council adopted Directive 1999/85/EC⁶⁵⁹, which amends the Sixth Directive as regards the possibility of applying on an experimental basis a reduced VAT rate on labour-intensive services. According to Article 28(6) of the Sixth Directive the Council, acting unanimously on a proposal from the Commission, may authorise any Member State to apply for a maximum period of three years between 1 January 2000 and 31 December 2002 the reduced rates provided for in Article 12(3)(a)⁶⁶⁰ to services listed in as maximum of two of the categories set out in Annex K⁶⁶¹. In exceptional cases a Member State may be authorised to apply the reduced rate to services in three of the categories set out in Annex K.

⁶⁵⁶ Article 12(3)(a).

⁶⁵⁷ Article 12(3)(a) stipulates that Member States may also apply either one or two reduced rates. These rates shall be fixed as a percentage of the taxable amount, which may not be less than 5 %, and shall apply only to supplies of the categories of goods and services specified in Annex H.

⁶⁵⁸ See Terra and Wattel (2001), p. 264.

⁶⁵⁹ Council Directive 1999/85/EC of 22 October 1999 amending Directive 77/388/EEC as regards the possibility of applying on an experiment basis a reduced VAT rate on labour-intensive services, OJ L 277, 28/10/1999, pp. 34–36.

⁶⁶⁰ Article 12(3)(a) stipulates that Member States may also apply either one or two reduced rates. These rates shall be fixed as a percentage of the taxable amount, which may not be less than 5 %, and shall apply only to supplies of the categories of goods and services specified in Annex H.

⁶⁶¹ ANNEX K provides the following list of supplies of services:

1. Small services of repairing:
 - bicycles,
 - shoes and leather goods,
 - clothing and household linen (including mending and alteration).
2. Renovation and repairing of private dwellings, excluding materials which form a significant part of the value of the supply.

The services concerned must satisfy the following requirements:

- (a) they must be labour-intensive;
- (b) they must be largely provided direct to final consumers;
- (c) they must be mainly local and not likely to create distortions of competition;
- (d) there must be a close link between the lower prices resulting from the rate reduction and the foreseeable increase in demand and employment.

Article 28(6) states that the application of a reduced rate must not prejudice the smooth functioning of the internal market.

3.4 The Problems of the Common VAT System

The common European VAT system has several shortcomings. The Commission analysed the limitations of current VAT system in a policy document⁶⁶², which was published in 1996. The first important shortcoming of the present system is its complexity. In order to determine the place of supply of taxable transactions, complex rules are applied. The place of supply of goods is generally deemed to be the place where the goods are when the supply takes place – the country of destination is collecting the tax. This means that taxable persons who have taxable supplies in different Member States have to divide their turnover up between various states and this fragments the Single Market.⁶⁶³ According to the Commission, the Sixth Directive contains 25 different rules and exceptions for determining the place of supply.⁶⁶⁴ These rules often result in traders having to satisfy identification, declaration and payment obligations in Member States in which they operate but are not established. Traders therefore have to make a distinction, between those of their sales that are deemed to be located within their own Member State and those which are deemed to be located on the territory of another Member State or outside the Community altogether. Depending on the nature of the transaction the place of supply of goods and services is determined by combinations of a number of different factors, some of which cannot always be decided with certainty, such as:⁶⁶⁵

- the place at which the seller and buyer are established,
- the tax status of the person to whom goods or services are supplied;
- the VAT identification number of the person supplied;
- the location of the goods at the time of supply;
- the person who organises transport and the place of departure or arrival;
- the place of departure or arrival of goods;
- the nature of services or goods supplied;
- the turnover achieved by the seller in the Member State in which the goods are supplied.

Companies face problems in obtaining the deduction or refund of VAT paid in Member States in which they are not established. By definition, under the principle of taxation at the place of destination for supplies to taxable persons, the transitional arrangements remove any possibility of tax deduction in a Member State other than that of taxation. However, if a tax-

3. Window cleaning and cleaning in private households.

4. Domestic care services (e.g. home help and care of the young, elderly, sick or disabled).

5. Hairdressing.

⁶⁶² See Commission (1996b).

⁶⁶³ Ibid.

⁶⁶⁴ This figure can easily be challenged as being too low according to Terra and Wattel (1997, p. 89).

⁶⁶⁵ See Commission (1996b), p. 9. This problem is relevant mostly in the case of services.

able person incurs VAT costs in a country where he is neither established nor making taxable supplies it can only be recovered by making a claim for repayment under the provisions of the Eighth Directive⁶⁶⁶ - a slow, cumbersome and costly procedure. The interaction of the rules governing taxation/deduction with the rules determining the taxable person further complicates the tax system leading to great uncertainty among traders. The result is considerable risk and high costs for businesses. Furthermore, the complexity of the system makes it extremely difficult to control and provide scope for tax avoidance schemes and encourages fraudulent activity both of which reduce tax yield.

Secondly, the present system has become obsolete, which gives rise to tax evasion and distortions of competition. Most of the basic rules laid down in the Sixth Directive date back to 1970s, and often reflect conditions as they were in the late 1960s. Current VAT system is based on the monitoring of physical movement of goods and is not adapted to modern business practice which relies on accounting and inventory control methods to keep track of transactions. Moreover, the common system is poorly suited to activities which were previously the exclusive domain of public services but are currently being taken on by private firms or are open to competition between public and private sectors. One example is the sector of postal services, which is increasingly open to competition by private companies and has already been completely privatised in some Member States. Another example is provision of air traffic control and navigation services.

In accordance with Article 4(5) of the Sixth Directive public bodies are not considered taxable persons for certain of their activities or transactions. This leads to distortion of competition, as the same transaction will be taxed or not depending on whether the transaction is carried out by a private or a public body. A comparable distortion of competition applies with a number of VAT exemptions in the social or cultural area between providers in the public and private sectors. These departures from the general concept of VAT for the public sector (exemption or non-taxable status) are having an increasingly distortive effect on trade in these sectors.

Furthermore, the Sixth Directive contains provisions which do not conform to the principle of tax neutrality. The most obvious example is to be found in the mechanism of exemption (without the right to deduction), which is currently applicable to many types of supply. The main problems which arise from the current exemption mechanism are:

- distortions originating from various exemptions under current VAT system (i.e. healthcare and education, cultural services, immovable property, finance, insurance, and public sector activities);
- distortion due to the cascade effect because suppliers of these types of services are unable to recover VAT on their purchases;
- distortions due to the existence of a number of options either to exempt or to tax;
- the need for taxable persons, who are involved in both taxable and exempt transactions, to carry out often complicated apportionment calculations to determine their entitlement to deduction of VAT;
- the problems for tax authorities of assessing the merits or quantum of claims for repayment of VAT under the Eighth Directive from businesses which may be exempt or partially exempt in their own Member States.

The fourth important problem of the current system which creates barriers in the Single market is that the Sixth Directive leaves Member States with a lot of powers and options. The result is a large degree of divergence in national implementation. The Commission points out a number of reasons why the common VAT system lacks uniformity. The legal instruments

⁶⁶⁶ 79/1072/EEC.

used are directives, which unlike directly applicable regulations, are transposed, by adaptation, into the existing legal systems of the Member States. The form and method of implementing the prescribed purpose of a Directive are matters for each Member State and as a result differences of interpretation occur. Furthermore, the formulation of the Sixth Directive provides for considerable discretion. Comparison of the Commission's proposal for a Sixth VAT Directive with the final text adopted by the Council, reveals that the imperative 'must' has been replaced by the optional 'may' in various Articles.

Divergence in the application of common VAT system has a variety of other origins: special arrangements, options and powers granted by the directive (66), temporary or transitional derogations which have not been repealed, other derogations authorised by the Council (some 130), shortcomings in transposition or differences in the interpretation of common provisions arising either from ambiguity and from inconsistency between different linguistic versions or fundamental lack of clarity or ambiguity in the terminology of the Directive itself.

One example is the legislation governing invoicing which varies widely from one Member State to another. There is no fixed practice dictating what or how much information must be included in an invoice. Nor has the Community adopted a common legal framework for electronic invoicing and self-billing. Consequently, Member States' rules are very diverse, ranging from a total ban to extreme flexibility.

The complexity of the rules that the firms face when operating in the Single market creates economic obstacles to free movement and causes tax avoidance. Moreover, complex rules and divergence in application cause legal uncertainty because sellers have to take into account a lot of factors when determining whether and where their sales are to be taxed, consequently they are exposed to the financial risk that the tax administration might come up with a different interpretation. In effect, the costs for application of current common VAT system are much higher if transactions are carried out in a Member State other than the one in which business is established.⁶⁶⁷

The Commission (1996b)⁶⁶⁸ concludes that the present system has become a significant burden to the competitiveness of the EU. The Commission sums up the consequences for operators (the need to become familiar with the specific legislation applied in the different Member States; discrimination between purely domestic and intra-Community transactions; legal uncertainty due to the various factors which sellers must take into account in determining whether and where their sales are to be taxed; and major costs, especially in terms of economies of scale) and evaluates that the application of the current transitional system generates costs which some businesses put at 20% of their total tax costs. In addition it sums up the consequences for consumers (they do not benefit from all the advantages which the single market should offer and their freedom to obtain supplies on the market conditions of other Member States is restricted) and for administrations (loss of sovereignty over monitoring; the circulation within the EU of goods which are totally exempt from tax may encourage the development of 'black markets' and thus create opportunity to commit tax evasion or avoidance; wrong application of tax rules or their circumvention by means of clever tax accounting may lead to a reduction VAT revenues or even displacement of activity to third countries where no Community VAT is payable).

In its Explanatory Memorandum to Proposal for a Council Directive amending the Sixth Directive⁶⁶⁹ the Commission identifies several problems in the area of VAT on services.⁶⁷⁰

⁶⁶⁷ See Commission (1996b), pp. 10-13.

⁶⁶⁸ See p. 13.

⁶⁶⁹ Commission (2003).

⁶⁷⁰ See also section 3.5 where the proposal is discussed in greater detail.

According to the Commission, a general problem arises when a taxable person receives a service which is subject to a VAT in another country (i.e., in the country where the supplier of the service is established). In order to recover the VAT costs, a person has to ask for a refund under the Eighth or Thirteenth Directives. The refund procedure can be complicated and very time-consuming. In order to avoid this procedure, there is often a tendency to inappropriately use the reverse charge mechanism.

Furthermore, in many instances, a service provider may supply services in respect of movable tangible property in a Member State other than where they are established. The VAT is due in the Member State where the work was performed. At present this means that the service provider may be required to register with the tax administration in that Member State and pay VAT. For many businesses this can prove administratively onerous, especially where they carry out activities in a number of Member States. The control of such businesses can also prove burdensome for tax administrations.

In addition, an existing Article 9(2)(e), which lists services for which a customer that is a taxable person can account for VAT under the reverse charge mechanism, has caused several problems of interpretation, namely it is often difficult to determine, which services are covered by Article 9(2)(e) rule and which are not. The reality is that all new and all previously unknown services that do not fall within the scope of one of the exceptions are taxable where the supplier is established. This equally applies to services that are conducive to being supplied at a distance or at differing stages in the production chain. It can lead to cases of double taxation, unintentional non-taxation and often complicated and time consuming refund procedures under the Eighth or Thirteenth Directives.

And finally, the present rules do not adequately address composite or bundled services. Such services may consist of a number of different aspects, some which may be covered under existing Article 9(2)(e) and some that may not. Invariably an issue on how to characterise such a supply arises, as parties involved in such a transaction would seek to benefit from the reverse charge mechanism, rather than have the place of supply fall under the general rule.

3.5 The Commission's proposal on the place of supply of services

The proposal⁶⁷¹ provides a new general rule for the place of supply of services under which the place of taxation is the place of consumption.

The new general rule with respect to the place of supply of services to taxable persons would thus be determined on the basis of where the taxable person receiving the service is established, rather than the jurisdiction in which the supplier of the services is established. The taxable person receiving the supply would therefore rely on the reverse charge mechanism for supplies made by persons established in different countries.

This is proposed as the general rule while simultaneously maintaining a number of exceptions, largely based on existing criteria.

The first exception from the general rule relates to supplies of services related to immovable property. This would be essentially the same as existing Article 9(2)(a) of the Sixth VAT Directive.

The second exception relates to passenger transportation services. Services of transporting goods for taxable persons are covered by the general rules, whereas for all transport services for non-taxable persons the place of supply shall be the place of departure.

The third exception from the general rule applies to cultural, artistic, sporting, entertainment and similar activities. This applies equally to both taxable and non-taxable customers. The text remains virtually unchanged from the existing Article 9(2)(c), first indent, but no longer

⁶⁷¹ Commission (2003).

includes a reference to scientific and educational services with respect to taxable persons. This would result in the taxable person being required to use the reverse charge mechanism rather than pay VAT and request a refund under the Eighth or Thirteenth Directive. The provision of scientific and educational services supplied to non-taxable persons would continue to be taxable at the place where the services are physically carried out.

A final exception from the general rule applies to the place of supply of what can be described as tangible services when supplied to a taxable person. The effect of this exception is to ensure that services that are supplied for immediate consumption at a readily identifiable location (e.g., restaurant meals and haircuts) are treated as being supplied at the place of origin. The exception has three components. The first component requires that the service be rendered in the Member State where the supplier is established or has a fixed establishment. The second component requires the physical presence of both the service provider and the customer. The third component is that the services must be provided directly to an individual for immediate consumption, reflecting the nature of these services.

The long-term hiring or leasing of movable tangible property (e.g., the long term leasing of automobiles) and work on movable property (e.g., the repair of an automobile) are expressly excluded and such supplies would fall under the general rule.⁶⁷²

⁶⁷² 'Long-term hiring or leasing' is defined to mean an agreement that provides continuous possession or use of movable tangible property for a period of more than 30 days. For example, where a taxable person hires an automobile at an airport for business use for a period of five days, the place of supply would be where the supplier is established, not where the business customer is established. This rule better reflects where the movable tangible property is going to be consumed and provides administrative ease for suppliers.

4 Harmonization in the field of income taxes

4.1 How much harmonization has been achieved in the field of income taxation?

Although Member States generally remain exclusive right to legislate in the area of direct taxation, they are bound in the exercise of their legislative powers by the limits imposed by EU law. Member States' autonomy to set their own tax policy is limited by the Community objective to achieve the Internal Market without borders and related principles of economic freedoms (goods, services, capital⁶⁷³, persons and the freedom of establishment) in the founding Treaties as well as by the legislative acts of the EU. The ECJ through its judgments has been restricting the freedom of the Member States to legislate in income tax matters. The ECJ has stated that although direct taxation falls within the competence of the Member States, the latter must exercise that competence consistently with Community law and therefore avoid any overt or covert discrimination by reason of nationality.⁶⁷⁴ The case law by the ECJ has shown that there is an increasing conflict between the fundamental freedoms of the Single Market with free and fair competition and a level playing field in income and corporate taxation on the one hand, and the imperatives of a coherent and efficient national income tax system on the other.⁶⁷⁵

The main principles of EU law in the area of free movement have first been developed in the ECJ's case law on the free movement of goods. There is a convergence of case law principles applicable in the other areas of free movement.⁶⁷⁶ Apart from this convergence of the contents of EU law on free movement, there is a tendency to apply the converged principles in a similar way to all areas of national law. In *SAIL*⁶⁷⁷, the ECJ stated explicitly that the effectiveness of Community law cannot vary according to the various spheres of national law that it may affect.⁶⁷⁸ In *Hubbard*⁶⁷⁹, the ECJ confirmed this statement by stipulating that

⁶⁷³ The EC Treaty introduces the exception to the principle of the free movement of capital and the total prohibition of discrimination on the basis of residence or source. Article 58 of the EC Treaty gives Member States the discretion to apply their national tax provisions which distinguish between resident and non-resident investors and between domestic and foreign-source capital income. However, such provisions may not amount to arbitrary discrimination or disguised restriction of free movement of capital and payments (Article 58(3)).

⁶⁷⁴ The ECJ has stated in several income tax cases that "... although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers retained by Member States must nevertheless be exercised consistently with Community law". See, for example, Case C-279/93 (*Schumacker*) (paragraph 21), Case C-118/96 (*SAFIR*), and Case C-294/97 (*Eurowings*). The ECJ has in other cases used slightly different wording by stipulating that "... although direct taxation falls within the competence of the Member States, the latter must none the less exercise that competence consistently with Community law and therefore avoid any overt or covert discrimination by reason of nationality." See for example, Case C-80/94, (*Wielockx*) (paragraph 16), Case C-107/94 (*Asscher*) (paragraph 36), Case C-250/95 (*Futura*) (paragraph 19), Case C-264/96 (*ICI*) (paragraph 19), Case C-307/97 (*St Gobain*) (paragraphs 56 and 57), Case C-311/97 (*Royal Bank of Scotland*) (paragraph 19), and Case C-35/98 (*Verkooijen*) (paragraph 32).

⁶⁷⁵ See Vanistendael (1998), p. 77.

⁶⁷⁶ Behrens (1992), Classen (1995) as referred to in Van Thiel (2001b), p. 47.

⁶⁷⁷ Case 82/71.

⁶⁷⁸ See paragraph 5 of the judgment.

⁶⁷⁹ Case C-20/92.

Community law affects the various branches of national law.⁶⁸⁰ The essence of the Hubbard rule is that the contents of Community law cannot vary according to the area of national law that is affected by it.⁶⁸¹ According to Hubbard rule the free movement provisions are in principle capable of affecting any national measures irrespective of the subject matter they concern⁶⁸², thus, also including income tax measures.

Harmonization in the form of secondary EC legislation has not been substantial in the field of income and corporate taxation. Until now, the Community has adopted tax-related legislation only in limited areas. Article 7 of Regulation 1612/68 provides that migrant workers are entitled to the same social and tax advantages as the workers of the host state, thus reiterating a constitutional limit to the exercise of national legislative powers by incorporating the principle of non-discrimination. Several non-binding EU instruments have been adopted by the institutions which, however, do not have force of law.⁶⁸³ In addition, the multinational convention, designed to eliminate the double taxation in connection with the transfer pricing of associated enterprises (the Arbitration Convention) was adopted in 1990.⁶⁸⁴ The Arbitration Convention is not a legal act in the framework of the Community institutions but exists directly among Member States and is essentially a multilateral agreement under international law. The Arbitration Convention is discussed in section 4.3.3. Only three legislative acts (directives) have been adopted in income tax field. As the first concrete step in the field of direct taxation, the Council of Ministers adopted in 1977 the Directive on mutual assistance by tax administrations of the Member States.⁶⁸⁵ This directive as well as two directives adopted in 1990 is based on Article 94 of the EC Treaty. One of the directives adopted in 1990 aims at elimination of double taxation of dividends in the case of parent companies and subsidiaries of different Member States, and is hereafter referred to as the Parent-Subsidiary Directive.⁶⁸⁶ The Directive is discussed in section 4.3.1. The other directive, provides for any capital gains arising from a merger, or a similar operation, to be taxed only upon realisation, and

⁶⁸⁰ The ECJ stated in paragraph 19 of its judgment that ‘... it should be observed that, as the Court held in Case 82/71 (*SAIL*) (paragraph 5), the effectiveness of Community law cannot vary according to the various branches of national law which it may affect.’ The ECJ stipulated in paragraph 20 of its judgment that specific circumstances (the fact that the substantive proceedings come under the law of succession in the case at issue) do not justify excluding the application of the right to freedom to provide services enshrined in Community law.

⁶⁸¹ See Van Thiel (2001b), pp. 46-47.

⁶⁸² See Van Thiel (2001a), p. 28.

⁶⁸³ The Commission adopted a non-binding recommendation on the taxation of frontier workers (Commission Recommendation 94/79/EC of 21 December 1993 on the taxation of certain items of income received by non-residents in a Member State other than that in which they are resident, OJ L 039 10.02.1994 p. 22) as well as recommendations on the taxation of small and medium-sized enterprises (Commission Recommendation 94/390/EC of 25 May 1994 concerning the taxation of small and medium-sized enterprises, OJ L 177 of 9 July 1994, p. 1.). In addition, the Council has adopted code of conduct on harmful tax competition (Conclusions of the ECOFIN Council Meeting on 1 December 1997 concerning taxation policy – Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation – Taxation of saving, OJ C 002, 06/01/1998, pp. 1 – 6).

⁶⁸⁴ Convention 90/436 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, OJ L 225, 20/08/1990, p. 10 – 24. The convention entered into force on 1 January 1995 but its application is currently suspended as its prolongation beyond 2000 still awaits ratification in several Member States.

⁶⁸⁵ Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, OJ L 336, 27/12/1977, pp. 15 – 20.

⁶⁸⁶ Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225, 20/08/1990, p.6.

is hereafter referred to as the Merger Directive.⁶⁸⁷ The Directive is discussed in section 4.3.2. Van Thiel (2001a) observes that the extent of harmonization by secondary Community legislation is limited to certain specific aspects, such as withholding taxes on certain dividend flows and mutual assistance. Member States retain their taxing and regulatory powers in the field of cross-border mergers as Merger Directive merely provides temporary deferral of taxation of merger-related capital gains.⁶⁸⁸

4.2 Developments in the case law of the ECJ

The most important progress in the harmonization of income tax systems of the Member States has been achieved by the decisions of the ECJ. Such case law has important impact on the design of the Member States' tax rules. The basis of the case law of the ECJ has not been any provision in the EC Treaty on income taxation, as there are not such provisions, but the provisions on non-discrimination and on four fundamental economic freedoms in the founding Treaties. The four freedoms encompass two principles: a right of cross-border circulation (market access and exit) and a prohibition of discrimination on grounds of nationality of persons or origin of goods (market equality).⁶⁸⁹

In implementing the policy goal to achieve free movement of goods, persons, services and capital within the Internal Market, the ECJ has interpreted the free movement provisions broadly as prohibiting not only distinctions based on nationality or origin (open, direct or overt discrimination), but also distinctions on the basis of other criteria – the application of which leads to the result mainly disadvantaging foreign products or factors (indirect or covert discrimination). For example, different treatment on the basis of residency can cause covert discrimination if the application of such criteria results in a different tax treatment of a category of persons that mainly comprises foreign nationals. The ECJ has also interpreted the four freedoms as forbidding the enactment of national legislative provisions that impede or render unattractive the exercise of any such freedoms, even if such rules apply without regard to nationality. Thus, Member States are prohibited to introduce measures, including tax provisions, which are discriminatory or which could somehow impede or restrict the resident of another Member State in making use of the four freedoms (e.g. freedom to work or provide services or freedom of establishment). However, even if foreign products or factors are treated disadvantageously, which leads to restriction to free movement, there may be a justification for it either because an exception is foreseen by the Treaty or because the measure may be necessary in the overriding public interest⁶⁹⁰ and is proportional⁶⁹¹.

The ECJ has relied in income tax cases on two different approaches that have been developed by the Court in non-tax cases: non-discrimination approach and non-restriction approach.⁶⁹² The non-discrimination principle in the area of income taxation means that it is

⁶⁸⁷ Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, OJ L 225, 20/08/1990, p.1.

⁶⁸⁸ See Van Thiel (2001a), pp. 22-23.

⁶⁸⁹ See Terra and Wattel (2001), p. 30.

⁶⁹⁰ See Case 8/74 (*Dassonville*).

⁶⁹¹ The ECJ applies a proportionality test to check whether the restriction on the EC freedom is proportionate to the overriding public interest justifying this restriction. A national measure fails the proportionality test if the overriding public interest can also be achieved by measures which are less restrictive on intra-Community trade (for example, Case 120/78 (*Cassis de Dijon*) and Case C-238/89 (*Pall Corp*) (paragraphs 11 and 12)) or if the measure in question is not in proportion to the goal pursued (Case C-51/93 (*Meyhui*) (paragraph 10) and Case C-315/92 (*Estée Lauder*) (paragraph 13)). See Van Thiel (2001a), pp. 73 and 111.

⁶⁹² See Terra and Wattel (1997), pp. 27–28 and Vanistendael (2001).

forbidden to treat non-residents from other Member States less favourably for income tax purposes than the residents. On the other hand, the non-restriction principle forbids the national rules which lead to disadvantageous treatment of people, goods or investments from other Member States. Not only is (unjustified) unequal treatment of products, capital and economic agents operating under the same conditions (discrimination) prohibited, but also (unjustified) distinction based on criteria other than nationality of persons or origin of goods as well as a restrictive measure without distinction (restriction). According to the first approach, when residents and non-residents are treated the same way, but as a result, non-residents face an obstacle when operating in another Member State, there is no violation of the EC Treaty. This approach is typical for the case law with respect to indirect taxation on the basis of Article 90 of the Treaty. The second approach is more radical and it is based on EC Treaty provisions with respect to the free movement of goods. Non-restriction approach has also been applied in the cases concerning mobility restrictions.⁶⁹³ In addition, the ECJ has increasingly defended non-restriction approach in the other areas (free movement of workers and freedom of establishment), furthermore, several Advocate Generals have opined in favour of such an approach.⁶⁹⁴ In its case law the ECJ has not taken a definitive position on which of the two approaches is the valid one in the field of taxation. The recent case law of the ECJ points to a gradual shift towards non-restriction approach. Van Thiel (2001a) predicts that the ECJ will align its reading of the Treaty provisions on persons with those on goods (including the income tax area).⁶⁹⁵

4.2.1 *The scope of application of Community law*

As a general rule, Community law only benefits European nationals (citizens and companies⁶⁹⁶) who engage in economic activity⁶⁹⁷ which is not purely domestic, but crosses Member States' borders.⁶⁹⁸ An individual or a company can claim protection under the EC Treaty if encountering a discriminatory or restrictive measure when making use of one of the four freedoms enshrined in the Treaty.⁶⁹⁹ Individuals who move to another Member State to work there, exercise their right of freedom of movement under Article 39 of the EC Treaty and enjoy Community law benefits as 'migrant workers'. The freedom of establishment laid

⁶⁹³ For example, Case 321/87 (*Commission v Belgium*). The case concerns free movement of persons, namely, whether Community law prevents a Member State from checking, within its territory, compliance with the obligation imposed on persons enjoying a right of residence under Community law to carry their residence or establishment permit at all times, where an identical obligation is imposed on its own nationals as regards their identity card. The ECJ found that the carrying out of such controls upon entry into the territory of a Member State may, depending on the circumstances, constitute a barrier to the free movement of persons within the Community, a fundamental principle of the (then) EEC Treaty. That would be the case in particular if it were found that the controls in question were carried out in a systematic, arbitrary or unnecessarily restrictive manner. See paragraph 15 of the judgment.

⁶⁹⁴ See, for example, Advocate General in his Opinion on *Wielockx*.

⁶⁹⁵ See Van Thiel (2001a), pp. 90-92.

⁶⁹⁶ With regard to companies, it should be noted in this context that it is their corporate seat that serves as the connecting factor with the legal system of a particular State, like nationality in the case of natural persons (Case C-270/83 (*Avoir fiscal*), paragraph 18, and Case C-330/91 (*Commerzbank*), paragraph 13).

⁶⁹⁷ However, it has been argued that an economic nexus no longer seems to be necessary for individuals and undertakings to be able to rely on the EC Treaty as against incompatible national laws because with the entry into force of the Treaty on European Union, the word 'economic' was eliminated from the title of the (then) EEC Treaty (which therefore became an EC Treaty), and thus the Treaty no longer addresses economic issues alone. See Terra and Wattel (2001) p. 24.

⁶⁹⁸ See Van Thiel (2001a), p. 41.

⁶⁹⁹ De Broe (2002), p. 71.

down in the EC Treaty requires the actual performance of a cross-border activity by means of a permanent establishment in another Member State.⁷⁰⁰ A self-employed person may also rely on the right of establishment provision of the EC Treaty provided that some foreign element justifies the application of EU law.⁷⁰¹

Werner

According to the ECJ in *Werner*⁷⁰², the scope of Community law is limited to intra-Community cross-border situations and EU law does not apply to purely internal situations or to situations that have insufficient connection with the EU because they involve third-country nationals or are otherwise located outside the EU. Thus, in cases of purely domestic situations where no cross-border element is involved, Community law does not apply. This means that workers who have never exercised the right of freedom of movement within the Community (i.e. workers who are active only in the state of which they are nationals) cannot claim EC Treaty benefits.⁷⁰³

In *Werner*, the ECJ considered the situation of a German dentist, who had obtained his diploma in Germany and worked there, to be internal even though the dentist was a resident of the Netherlands. The main question at issue was whether Werner as a national of Germany residing in another Member State, might rely on Community law against his own Member State.

Mr. Werner worked as an employee for another dentist in Germany but lived in the Netherlands. After finishing his employment contract, Mr. Werner opened a dental practice as a self-employed dentist in Germany but continued to live in the Netherlands. Several tax advantages available for residents of Germany were not available to him as a non-resident. Non-residents were subject to a higher rate and tariff for the tax and, in addition, they could not benefit from the preferential tariff for married couples. Furthermore, year-end adjustment of monthly deductions was not available to them. Finally, certain deduction or reliefs which were available to residents were not available to non-residents. In brief, Mr. Werner was subject to a significantly higher tax burden than residents.

In the earlier *Biehl* case⁷⁰⁴ the ECJ considered the situation of a taxpayer within the scope of EU law. Mr Biehl was a German national subject to Luxembourg tax legislation, which linked the possibility of a refund of an overpayment of tax to the requirement of permanent residence in the territory of Luxembourg and therefore had a particularly adverse effect on taxpayers who were nationals of other Member States. The main difference between *Biehl* and *Werner* was that Mr Biehl was a German national subject to Luxembourg tax legislation, whereas Mr Werner was a German national who remained subject to the legislation of the State of which he was a national. Mr Biehl moved to another State in order to take employment there while Mr Werner lived in a State other than the one in which he had an economic activity (a private practice).

⁷⁰⁰ In *Daily Mail*, the right of a company for a tax-free emigration under freedom of establishment provision of the EC Treaty was at issue. *Daily Mail* claimed that it was exercising the right of establishment when transferring its central management and control to another Member State and that the EC Treaty gave it the right to cease to be resident in the United Kingdom without paying emigration tax. In its decision, the ECJ held that EC Treaty conferred no right on a company incorporated under the legislation of a Member State and having its registered office there to transfer its central management and control to another Member State. Thus, the ECJ decided that in the 'present state of Community law', the Treaty did not provide companies with the right to transfer residence and control and a tax-free emigration of the company should not be allowed on the basis of EC law. See judgment of the Court in Case 81/87 (*Daily Mail*). The case is discussed in greater detail below.

⁷⁰¹ For example, Case 115/78 (*Knoors*).

⁷⁰² Case C-112/91.

⁷⁰³ See Van Thiel (2001a), pp. 61-63.

⁷⁰⁴ Case C-175/88. See section 4.2.2 for more elaborate discussion of the case.

The referring court in the *Werner* case wanted to know whether the right of establishment under EC Treaty (Article 52 of the EEC Treaty (now Article 43 of the EC Treaty)) went beyond national treatment and if so, whether the higher tax burden on non-resident nationals was a prohibited restriction on free movement. In addition, the referring court asked whether the contested German tax measure constituted an infringement of the prohibition of indirect discrimination laid down in general non-discrimination clause of (then) Article 7 of the EEC Treaty (now Article 12 of the EC Treaty).⁷⁰⁵

The ECJ has held on several occasions that a self-employed person who is a national of the host Member State, provided that some foreign element justified the application of the Community law, may rely on the right of establishment provision of the EC Treaty. In *Knoors*⁷⁰⁶, the ECJ held that the fact that Mr Knoors had acquired a trade qualification in another Member State was enough to consider him a person to whom Community law applies. Mr Knoors was a Netherlands national who wished to establish himself in the Netherlands in reliance on the professional qualifications that he had acquired in another Member State (Belgium). However, the ECJ argued in *Werner* that, unlike Mr Knoors, Mr Werner was a German national setting up a practice in his State of origin on the basis of a professional qualification and professional experience acquired in that State. The ECJ stated that in *Werner* case there was no foreign element involved and that, therefore, it was purely internal situation, which was not covered by EU law. Thus, the ECJ held that persons who possess and always possessed solely the nationality of the host Member State cannot rely on EU law. Advocate General Darmon in his Opinion on *Werner* stated that the freedom of movement within the EC granted to Community nationals was deemed to involve movement for the purposes of an economic activity. The Court has also held, in its judgment in *Singh*⁷⁰⁷ that nationals of the Member States have in particular the right, which they derive directly from Treaty provisions on free movement of workers (Article 39) and freedom of establishment (Article 43), to enter and reside in the territory of other Member States in order to pursue an economic activity there as envisaged by those provisions.

The Advocate General argued that Mr Werner had never availed himself of the freedom of movement provided for in the Treaty with a view of to working or with a view to establishing himself in a Member State other than that of which he was a national. In that case he had not pursued any professional activity in the Member State where he resided either as an employee or as a self-employed person. The residence of Mr. Werner was not connected with any activity as a provider of services. Thus, Mr. Werner had exercised his freedom of movement only in order to reside in the Netherlands, without any connection with any economic activity.

The ECJ confirmed the Opinion of the Advocate General and held that the only factor which took the *Werner* case out of a purely national context was the fact that Mr Werner lived in a Member State other than that in which he practised his profession. Accordingly, freedoms of movement of the EC Treaty were not applicable to his situation. Thus, the ECJ ruled that cross-border residence unrelated to economic activity was insufficient to bring a case within the scope of application of directly applicable Community law.

Van Thiel comments that the situation of Werner obviously had cross-border elements with economic relevance.⁷⁰⁸ The higher tax burden was the result of a non-resident becoming es-

⁷⁰⁵ According to ECJ judgment in Case C-152/73 (*Sotgiu*) Article 7 prohibits, within the field of application of the Treaty, any discrimination, whether overt or covert, on grounds of nationality. See also section 4.1.2. for ECJ judgment in *Sotgiu*.

⁷⁰⁶ Case 115/78.

⁷⁰⁷ Case C-370/90.

⁷⁰⁸ See Van Thiel (2001a), p. 271.

established in Germany. In its later decisions⁷⁰⁹, the ECJ has held that when for a specific tax purpose residents and non-residents are in an objectively comparable situation, then Member States are under obligation to grant non-residents national treatment. Primary Community law is indeed based on nationality, though most differences in the field of direct taxes are derived by the status of non-resident.⁷¹⁰ Van Raad (1986) has called for a different extension of the concept of non-discrimination in the field of direct taxes, so as to make it directly connected to residence.

Both the referring court and the Commission considered Werner's situation within the scope of application of EU law.⁷¹¹ The referring court thought so because Mr Werner was economically active in a Member State other than his state of residence (cross-border establishment). The Commission argued that Mr Werner was a beneficiary of services in the Netherlands where he was a resident and, as a frontier worker enjoyed indirect tax advantages provided by EU law. It has been suggested that the ECJ would have done better to conclude that Community law applied, but that this was case of reverse discrimination⁷¹² which was not prohibited in the present state of EU law.^{713 714} Furthermore, Van Thiel criticizes the judgment on the ground that allowing Member States to discriminate against their own nationals or in the cases of purely domestic situation is at odds with the very concept of internal market.⁷¹⁵

It has been argued that the *Werner* judgment lost most of its value since the entry into force of the general residence directives (90/364/EEC⁷¹⁶, 90/365/EEC⁷¹⁷ and 90/366/EEC⁷¹⁸).⁷¹⁹ Van Thiel (2001a) expresses opinion that since the entry into force of residence directives, Member States are no longer allowed to undermine cross-border residence by domestic measures that restrict the exit of nationals for personal reasons unrelated to economic activity.⁷²⁰ In addition, it has been argued that after the introduction of the notion of the EU citizenship by Article 17 of the EC Treaty, the individual is protected by EC Treaty even if it is not clear whether he transfers his residence in connection with the exercise of one the eco-

⁷⁰⁹ For example, Case C-279/93 (*Schumacker*). The case is discussed in greater detail in section 4.2.2.

⁷¹⁰ See Pistone (2002), p. 130.

⁷¹¹ See Van Thiel (2001a), p. 438.

⁷¹² Reverse discrimination appears when Member States discriminate against their own economic activities.

⁷¹³ In joined cases C-64/96 and C-65/96 (*Uecker and Jacquet*) the national court asked whether the fundamental principles of a Community moving towards the EU still permit a national rule which is incompatible with Community law to continue to be applied by a Member State against its own nationals and their spouses from non-member countries. The ECJ stated any discrimination which nationals of a Member State may suffer under the law of that State fall within the scope of that law and must therefore be dealt with within the framework of the internal legal system.

⁷¹⁴ Van Thiel (2001b), pp. 48-49 observes that the constitutionally guaranteed minimum of economic integration is incomplete if the concept of equal treatment is still interpreted as a prohibition of discrimination of cross-border as compared to domestic economic activities, rather than as a right to pure equal treatment. With a pure equal treatment reading, the ECJ would place emphasis on national measures (or bilateral treaties) that distort competition in the internal market, rather than merely considering measures that restrict cross-border activities.

⁷¹⁵ See Van Thiel (2001a), p. 278.

⁷¹⁶ Council Directive 90/364/EEC of 28 June 1990 on the right of residence, OJ L 180, 13/07/1990 pp. 26 – 27.

⁷¹⁷ Council Directive 90/365/EEC of 28 June 1990 on the right of residence for employees and self-employed persons who have ceased their occupational activity, OJ L 180, 13/07/1990, pp. 28 – 29.

⁷¹⁸ Council Directive 90/366/EEC of 28 June 1990 on the right of residence for students, OJ L 180, 13/07/1990, pp. 30 – 31.

⁷¹⁹ See Van Thiel (2001a), pp. 275 and 439.

⁷²⁰ *Ibid*, p. 275.

conomic freedoms. Citizens of the EU enjoy the rights conferred by the Treaty, such as the right to move and reside freely within the territory of the Member States.⁷²¹ It is suggested that one can expect that the ECJ will accord Treaty protection to a citizen of the Union transferring his/her residency from one Member State to another without making use of the four economic freedoms.⁷²² Terra and Wattel (2001)⁷²³ observe that it is possible that Mr Werner, were his situation to be referred to the ECJ once more, would now be given access to the Treaty under Article 18 (the right of residence) and/or Article 12⁷²⁴ (general discrimination provision). In *Uecker and Jacquet*⁷²⁵ the ECJ noted that citizenship of the Union, established by Article 8 (now Article 18) of the Treaty is not intended to extend the scope *ratione materiae* of the Treaty also to internal situations which have no link with Community law.⁷²⁶ The ECJ held in its *Uecker and Jacquet* judgment⁷²⁷ that Community legislation regarding freedom of movement for workers cannot be applied to the situation of workers who have never exercised the right to freedom of movement within the Community. It is unclear whether the residence directives or EC Treaty articles on the notion of citizenship (Article 17) and the right of residence (Article 18) are relevant in the area of free movement.

The ECJ has dealt with the question of the scope of application of Community law in other cases. In *Halliburton*⁷²⁸, the ECJ considered the Dutch transfer tax on a Dutch buyer of an immovable property located in the Netherlands within the scope of EU law, because of possible adverse effects of a differential transfer tax treatment on the German seller.⁷²⁹ In *Asscher*⁷³⁰, the ECJ allowed a Dutch national to invoke EU law against his Member State of origin, because he was also economically active in Belgium.⁷³¹ In *Gilly*⁷³², the ECJ considered

⁷²¹ Article 18 (ex Article 8a) of the Treaty stipulates that ‘... [e]very citizen of the Union shall have the right to move and reside freely within the territory of the Member States, subject to the limitations and conditions laid down in this Treaty and by the measures adopted to give it effect.’

⁷²² De Broe (2002), p. 72.

⁷²³ See p. 28.

⁷²⁴ Article 12 (ex Article 6) of the Treaty stipulates that ‘... [w]ithin the scope of application of this Treaty, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited.’

⁷²⁵ Joined cases C-64/96 and C-65/96, paragraph 23.

⁷²⁶ The ECJ, furthermore, stated that Article M of the Treaty provides that nothing in that Treaty is to affect the EC Treaty, subject to the provisions expressly amending those treaties. See paragraph 23 of the judgment.

⁷²⁷ Joined cases C-64/96 and C-65/96, paragraph 17.

⁷²⁸ Case C-1/93.

⁷²⁹ *Halliburton* concerned Dutch transfer tax on the alienation of immovable property. The Netherlands legislation provides for exemption from taxation if both the transferring company and the acquiring company are incorporated in the Netherlands. The German subsidiary of US group of companies (*Halliburton*) transferred and sold to the Netherlands subsidiary of the group its permanent establishment in the Netherlands, which included immovable property. *Halliburton* was denied exemption. The Netherlands argued that the situation was purely internal and, therefore, Community law did not apply. However, the ECJ held that that payment of a tax on the sale of immovable property constituted a burden which renders the conditions of sale of the property more onerous and thus had repercussions on the position of the transferor. As a result, the vendor was in a distinctly less favourable position than if it had chosen the form of a public or private limited company instead of that of a permanent establishment for its business in the Netherlands. In addition, the ECJ noted that although the difference in treatment had only an indirect effect on the position of companies constituted under the law of other Member States, the non-resident German company was discriminated against. See paragraphs 19 and 20 of the judgment.

⁷³⁰ Case C-107/94.

⁷³¹ Mr Asscher was a Dutch national who worked and lived in the Netherlands, but was also a director of a Belgian company. He moved his residence from the Netherlands to Belgium in 1986. As a result of change in tax legislation in 1990, Mr Asscher as a non-resident was subject to higher tax rate in the Netherlands than residents. The ECJ ruled that Mr Asscher had to be equated with a Belgian

cross-border residence for private reasons and dual nationality to be sufficient to bring the case within the scope of EU law.⁷³³ In *ICI*⁷³⁴, the ECJ assumed that EU law applied to a relationship between two resident companies that had exercised their right to free movement through another resident holding company (see below for further discussion of the case). In *X and Y*⁷³⁵ the ECJ stated that in the case of sale of shares that are subject to capital gains treatment, the fact that the transferee company is established in another Member State or that a company established in another Member State has a holding in the transferee company, is sufficient to bring the case within the scope of EU law.⁷³⁶ In the *Uecker and Jacquet* case⁷³⁷ the ECJ held that a national of a non-EU country married to a worker having the nationality of a Member State cannot rely on Community legislation when that worker has never exercised the right to freedom of movement within the Community because that case has no factor linking it with any of the situations governed by Community law and all elements of it are purely internal to a single Member State.

Schumacker

The factual and legal aspects of the *Schumacker* case⁷³⁸ are very similar to those in the *Werner* case⁷³⁹. *Schumacker* also dealt with the problem that German Income Tax Law applied different tax regimes to employed persons according to their residence. The main difference between Mr. Werner and Mr. Schumacker was that the former was a German national who resided in the Netherlands while Mr. Schumacker was a Belgian national who lived with his wife in Belgium, but was employed in Germany.

Advocate General Léger states in its Opinion in *Schumacker* that by contrast with *Werner*, *Schumacker* certainly comes within the scope of Community law. A German national working in Germany where he acquired his professional qualifications, Mr Werner never exercised the freedoms conferred by the Treaty, particularly that of establishing himself in another Member State. The only foreign element was the fact that he resided in the Netherlands. In the *Schumacker* case, a Belgian national who acquired his qualifications and professional experience elsewhere than in Germany, exercised the right of freedom of move-

national who had some economic activity in the Netherlands and, thus, Mr Asscher had to be allowed access to Article 43 of the Treaty.

⁷³² Case C-336/96.

⁷³³ The only thing which distinguished Mrs Gilly from Mr Werner was her dual nationality. Mrs Gilly was originally a German national and acquired French nationality by marriage. She was educated in Germany and employed as a teacher in Germany. She resided in France with his husband but all her economic activities remained in Germany. The ECJ held that Mrs Gilly must be considered in France as a worker exercising her right to freedom of movement, as guaranteed by the Treaty, in order to work in a Member State other than that in which she resided. The ECJ added that the circumstance that she had retained the nationality of the State in which she was employed in no way affected the fact that, for the French authorities, she was a French national working in another Member State.

⁷³⁴ Case C-264/96.

⁷³⁵ Case C-436/00.

⁷³⁶ The Swedish Government considered that the fundamental freedoms conferred by the Treaty had no bearing in *X and Y* since it concerned a situation internal to a Member State. The Advocate General and the ECJ did not consider it a purely domestic situation because of the existence of a foreign element, namely of the fact that the parent company or shareholders of the transferee company are established in another Member State. See paragraphs 33-34 of the judgment and paragraphs 21-22 of the opinion. See also section 4.1.2 where the case is dealt in greater detail.

⁷³⁷ Joined cases C-64/96 and C-65/96, paragraph 16 and an operative part of the judgment.

⁷³⁸ Case C-279/93 (*Schumacker*). The case is discussed in greater detail in section 4.1.2.

⁷³⁹ Case C-112/91.

ment for workers laid down in Article 39 of the Treaty in order to go to Germany and take up employment there. The situation is therefore not purely internal to one Member State.⁷⁴⁰

Van Thiel observes that workers of a Member State, who stay at home and work abroad, enjoy EU law benefits in the State of work if certain conditions are fulfilled (*Schumacker*).⁷⁴¹ Workers who work at home, but move residence abroad, may qualify for EU law benefits as 'frontier workers' depending on their nationality. If they only have the nationality of the work state, they do not enjoy EU law benefits (*Werner*). If they (also) have the nationality of the state of residence, they do (*Gilly*)⁷⁴². Thus, according to ECJ case law, the persons who possess and always possessed solely the nationality of the host Member State cannot rely on EU law.

Daily Mail

Unlike *Biehl*, *Werner* and *Schumacker* which concerned individual workers, *Daily Mail* concerned a company. Daily Mail transferred its central management and control to the Netherlands prior to the sale in order to avoid capital gains tax in the UK. The UK law required Treasury consent prior to such transfer. The consent was not given if Daily Mail was not going to pay an exit tax before transferring its corporate residence abroad. Daily Mail considered this requirement of prior approval an obstacle to its right of establishment under Article 58 (now Article 48) of the Treaty. In its *Daily Mail* decision, the ECJ held that although the Treaty prohibited the Member State of origin from hindering companies from establishing in another Member State (right of exit)⁷⁴³, the Treaty conferred no right on a company incorporated under the legislation of a Member State and having its registered office there to transfer its central management and control to another Member State.⁷⁴⁴ Thus, the ECJ decided that in the 'present state of Community law', the Treaty did not provide companies with the right to transfer residence and control.

Furthermore, the ECJ noted that Article 293 of the Treaty provided for the conclusion, so far as is necessary, of agreements between Member States with a view to securing inter alia the retention of legal personality in the event of transfer of the registered office of companies from one country to another. No convention in this area has yet come into force.⁷⁴⁵ Thus, the ECJ interpreted Article 293 of the Treaty as an explicit Treaty derogation from directly applicable Community law on the free movement, until such time as a multilateral Convention on corporate connecting factors and the loss of legal personality in case of their relocation, had come into force.⁷⁴⁶ Daily Mail was therefore refused the right of tax free exit, because of the absence of secondary Community law in the area of international private law, not in the area of income tax law.⁷⁴⁷ The ECJ, thus, defined the question at issue as a problem of international company law rather than as a problem of tax law.⁷⁴⁸

ICI

The case⁷⁴⁹ concerned the compatibility with Article 43 of the EC Treaty of domestic legislation which made a particular form of tax relief available to companies belonging to a consor-

⁷⁴⁰ Opinion of Mr Advocate General Léger delivered on 22 November 1994, Case C-279/93 (*Schumacker*), paragraph 33.

⁷⁴¹ See Van Thiel (2001a), p. 284.

⁷⁴² Case C-336/96.

⁷⁴³ Case 81/87 (*Daily Mail*), paragraph 16.

⁷⁴⁴ Ibid, paragraph 25.

⁷⁴⁵ Ibid, paragraph 21.

⁷⁴⁶ See Van Thiel (2001a), pp. 427-428.

⁷⁴⁷ See Van Thiel (2001b), p.114.

⁷⁴⁸ See Terra and Wattel (2001), p. 69.

⁷⁴⁹ Case C-264/96 (*ICI*).

tium subject to the condition that, where the consortium controlled a holding company, most of the subsidiaries thereof were resident in the national territory.

Although the companies involved had never exercised their right of establishment in the sense of Articles 52 and 58 (now Articles 43 and 48) of the Treaty, the ECJ nevertheless did not consider the situation purely domestic for lack of cross-border economic activity. The mere fact that the consortium to which both resident companies belonged consisted also of subsidiaries in other Member States was a sufficient cross-border element, in the opinion of the ECJ, to take the case outside its purely domestic context.⁷⁵⁰

However, the ECJ ruled that although the legislation at issue was incompatible with Community law in not granting tax relief where the holding company owned by the consortium controlled mainly subsidiaries having their seat in the Community, the situation at issue lied outside the scope of Community law because the holding company controlled mainly subsidiaries having their seat in non-member countries. Accordingly, when deciding an issue concerning a situation which lied outside the scope of Community law, the national court was not required, under Community law, either to interpret its legislation in a way conforming with Community law or to disapply that legislation.⁷⁵¹

4.2.2 *Case law prohibiting discrimination of non-residents and restrictions to free movement*

The ECJ has generated a large body of case law since 1986 on the compatibility of national income tax laws with the EC Treaty.⁷⁵² This case law also includes several important decisions in the area of corporate taxation.⁷⁵³

In its case law⁷⁵⁴ relating to the differential taxation of residents and non-residents, the ECJ has ruled that non-residents must also be allowed to enjoy tax benefits where, apart from the residence criterion, they are in an identical situation for tax purposes. It follows from the tax decisions of the ECJ that permanent establishments of persons from other Member States have to be taxed according to the same rules as apply to residents and tax rules that disadvantage permanent establishments are potentially in breach of Community law.⁷⁵⁵ Several judgements by the ECJ have prohibited the measures distinguishing between residents and non-residents or companies having their seat in the Member State and permanent establish-

⁷⁵⁰ See Van Thiel (2001b), p.123.

⁷⁵¹ Case C-264/96 (*ICI*), paragraphs 31-35.

⁷⁵² Case C-270/83 (*Avoir fiscal*), Case 81/87 (*Daily Mail*), Case C-175/88 (*Biehl*), Case C-204/90 (*Bachmann*), Case C-300/90 (*Commission v Kingdom of Belgium*), Case C-112/91 (*Werner*), Case C-330/91 (*Commerzbank*), Case C-1/93 (*Halliburton*), Case C-279/93 (*Schumacker*), Case C-80/94 (*Wielockx*), Case C-484/93 (*Svensson*), Case C-415/93 (*Bosman*), Case C-107/94 (*Asscher*), Case C-151/94 (*Biehl II*), Joined Cases C-283/94, C-291/94, and C-292/94 (*Denkavit, Vitic and Vormeer*), Case C-28/95 (*Leur Bloem*), Case C-250/95 (*Futura*), Case C-118/96 (*SAFIR*), Case C-336/96 (*Gilly*), Case C-264/96 (*ICI*), Case C-307/97 (*Saint-Gobain*), Case C-311/97 (*Royal Bank of Scotland*), Case C-391/97 (*Gschwind*), Case C-439/97 (*Sandoz*), C-229/98 (*Vander Zwalmen*), Case C-294/97 (*Eurowings*), Case C-55/98 (*Vestergaard*), Case C-200/98 (*X AB & Y AB*), Case C-251/98 (*Baars*), Case C-87/99 (*Zurstrassen*), Case C-35/98 (*Verkooijen*), Case C-375/98 (*Epson*), Case C-141/99 (*AMID*), Joined cases C-397/98 and C-410/98 (*Metallgesellschaft*), Case C-136/00 (*Danner*), Case C-324/00 (*Lankhorst-Hohorst*), Case C-385/00 (*Groot*), Case C-436/00 (*X and Y*), Case C-422/01 (*Skandia*).

⁷⁵³ Case C-270/83 (*Avoir fiscal*), Case 81/87 (*Daily Mail*), Case C-330/91 (*Commerzbank*), Joined Cases C-283/94, C-291/94, and C-292/94 (*Denkavit, Vitic and Vormeer*), Case C-28/95 (*Leur Bloem*), Case C-250/95 (*Futura*), Case C-264/96 (*ICI*), Case C-307/97 (*Saint-Gobain*), Case C-311/97 (*Royal Bank of Scotland*), Case C-294/97 (*Eurowings*), Case C-200/98 (*X AB & Y AB*), Case C-375/98 (*Epson*), Case C-141/99 (*AMID*), Joined cases C-397/98 and C-410/98 (*Metallgesellschaft*), Case C-294/99 (*Athinaiki Zithopiia*), C-324/00 (*Lankhorst-Hohorst*), Case C-168/01 (*Bosal*).

⁷⁵⁴ *Schumacker*, paragraphs 36-38.

⁷⁵⁵ See Van Thiel (2001a), pp. 309-310

ments of another Member State, for example, the imposition of higher levies on insurance contracts concluded with foreign companies⁷⁵⁶ or the exclusion of a permanent establishment of another Member State from enjoyment of tax concessions applied to companies having their seat in the Member State in question⁷⁵⁷. Another example is the case law of the ECJ on the national tax systems which favour domestic investment over foreign investment.⁷⁵⁸

The ECJ has decided that the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination. In *Sotgiu*⁷⁵⁹ the ECJ first interpreted the Treaty as prohibiting also covert discrimination. In *Sotgiu* the question arose whether the fact that a separation allowance was granted only for German residents constituted discrimination. The ECJ ruled that the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result.⁷⁶⁰ In *Sotgiu*, the ECJ first developed a ‘freedom-oriented’ or ‘restriction-based’ rather than an ‘equality-oriented’ or ‘discrimination-based’ reading of the Treaty.⁷⁶¹ Under that approach, any national measure that is capable of restricting free movement, regardless of whether or not applied in a discriminatory way, is prohibited by the Treaty, unless it serves an overriding public interest objective and is proportional.⁷⁶²

It follows that with respect to intra-Community tax treaties, the case law by the ECJ in tax issues confirms that Community concept of discrimination goes beyond the international tax law concept of discrimination. International tax law prohibits only direct discrimination, whereas European tax law concept also prohibits indirect discrimination as well as non-discriminatory restrictive measures that are disproportionate. Under the OECD model tax convention it is assumed that a non-resident is in a different position and can be subject to different treatment unless specifically forbidden by a non-discrimination rule of Article 24.⁷⁶³ Under EC Treaty non-residents of other Member States shall not be treated differently from residents.

⁷⁵⁶ Case C-118/96 (*SAFIR*).

⁷⁵⁷ Case C-307/97 (*Saint-Gobain*). The case is discussed below.

⁷⁵⁸ For example, Case C-35/98 (*Verkooijen*). The case is discussed below.

⁷⁵⁹ See Case C-152/73.

⁷⁶⁰ The ECJ stated in its judgment in *Sotgiu* that the taking into consideration, as a criterion for the grant of a separation allowance, of the fact that a worker had his residence in another Member State might constitute a forbidden discrimination. However, the ECJ added that this was not the case if the scheme relating to such an allowance took account of objective differences in the situations of workers according to whether their residence at the time when they take up their employment was within the territory of the state concerned or abroad.

⁷⁶¹ See Van Thiel (2001a), p. 7.

⁷⁶² This reasoning was developed by the ECJ in cases like Case C-8/74 (*Dassonville*) and Case C-120/78 (*Cassis de Dijon*). See Van Thiel (2001a), pp. 7-8.

⁷⁶³ Article 24 of the OECD model tax convention reads: ‘(1) Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. [...] (3) The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents. [...] (5) Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation

Biehl

The case⁷⁶⁴ concerned a tax measure which was claimed to constitute an indirect exit restriction. Mr Biehl was a German national who pursued an activity as an employed person in Luxembourg and was thus subject to Luxembourg tax provision under which the repayment of any overpaid income tax is refused if the taxpayer is not resident in the territory of the Luxembourg during the entire year. This tax provision had a particularly adverse effect on taxpayers who were nationals of other Member States. Mr Biehl challenged the decision of the tax authorities of Luxembourg who refused to repay the sums corresponding to tax deducted in excess of the total amount of his tax liability. He claimed that this tax provision of Luxembourg introduced a covert discrimination between taxpayers, prohibited by Community law, because the provision mainly applied to taxpayers who were not Luxembourg nationals.

The ECJ recalls in its judgment in *Biehl* that according to the case law of the ECJ, laid down for the first time in its judgment in *Sotgiu*, the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination. Different treatment on the basis of other criteria of differentiation than nationality (e.g. residency) causes covert discrimination if the application of such criteria results in a different tax treatment of a category of persons that mainly comprises foreign nationals. Advocate General Darmon argues in its Opinion⁷⁶⁵ that it must be determined first of all whether the rule at issue before the national court, although applicable without distinction, leads in fact to different treatment for Luxembourg nationals and for nationals of the other Member States. Advocate General stresses that it is important to bear in mind that an actual comparison of situations may show that a situation which is treated differently does not constitute unlawful discrimination if, in the final analysis, the national in question is not in a less favourable position than nationals of the host State. The ECJ holds in its *Biehl* judgment⁷⁶⁶ that even though the criterion of permanent residence in the national territory refers to in connection with obtaining any repayment of an overdeduction of tax applied irrespective of the nationality of the taxpayer concerned, there is a risk that it will work in particular against taxpayers who are nationals of other Member States. Often such persons leave in the course of the year the country. In addition, the ECJ holds that a national provision such as the one at issue is liable to infringe the principle of equal treatment in various situations. That is so in particular where no income arises during the year of assessment to the temporarily resident taxpayer in the country he has left or in which he has taken up residence. In such a situation, that taxpayer is treated less favourably than a resident taxpayer because he will lose the right to repayment of the overdeduction of tax which a resident taxpayer always enjoys.⁷⁶⁷ The ECJ rules in its judgment that the withholding of fiscal advantages is a restriction of the right of establishment conferred by Article 52 (now Article 43) of the Treaty.

Biehl II

Luxembourg amended its legislation to bring it in line with the *Biehl* judgment by deleting from its tax law the condition that an employee must have been resident for the entire taxable year in order to be eligible for annual adjustment of wages tax. However, the Commission found that by June 1994 the Grand Duchy was still not complying with its obligations under EC Treaty. The Luxembourg tax legislation continued to provide that in order to obtain a

and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.’

⁷⁶⁴ Case C-175/88 (*Biehl*).

⁷⁶⁵ Case C-175/88 (*Biehl*).

⁷⁶⁶ *Ibid*, paragraph 14.

⁷⁶⁷ *Ibid*, paragraph 16.

refund of overpaid income tax, or regularisation by means of annual adjustments, the taxpayer had to have been resident throughout the entire tax period or alternatively to have been employed in Luxembourg for at least nine months. If the taxpayer did not meet these requirements, he had to make an application for review to obtain a refund of the overpaid tax on equitable grounds. The Luxembourg Government argued that the purpose of its legislation was to ensure application of the principle of progressive taxation by preventing the procedure normally followed by the tax office from leading to the grant to temporary residents of repayments of arbitrary amounts owing to the lack of information concerning their annual income. Furthermore, in order to be able to calculate tax repayments to temporary residents, the tax authority had to be informed of income earned abroad by the taxpayer before he took up residence in the Grand Duchy or after he left it, so that it could determine the appropriate rate of tax to be applied to his Luxembourg income. The ECJ held in its judgment in *Biehl II*⁷⁶⁸ that, although the legislation in question, which required an unbroken period of residence or work in Luxembourg for a certain period of time before the taxpayer could benefit from certain tax advantages accorded to resident taxpayers, applied irrespective of the nationality of the taxpayer concerned, there was a risk that it would work in particular against nationals of other Member States, since those persons often leave in the course of a year the country. Those persons also often cease working in Luxembourg on the expiry of a short-term employment contract.

Bachmann

An indirect exit restriction was also an issue in *Bachmann*. Mr Bachmann, a German national who temporarily moved to Belgium in connection with employment there, was refused a deduction from taxable income of the contributions paid in Germany pursuant to contracts with German insurance companies concluded before he came to Belgium. The refusal was based on the Belgian tax provisions which provided that only contributions paid to a mutual insurance company recognized by Belgium and pension and life insurance contributions paid in Belgium may be deducted from taxable income. In addition, Belgian tax law provided for later taxation of the benefits if the contributions were deducted, whereas if the contributions had not been deducted, the benefits were exempted from tax.

The Advocate General noted in his Opinion that the legislation in question applied to all persons liable to income tax in Belgium. There was thus no discrimination based directly on nationality.⁷⁶⁹ However, in accordance with case law of the Court, laid down for the first time in its judgment in *Sotgiu*, "[...] the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other criteria of differentiation, lead to the same result". Mr Bachmann and the Commission considered that the criterion at issue in *Bachmann*, namely that of the payment of insurance contributions in Belgium, applying as it did to all workers regardless of their nationality, led to indirect discrimination based on nationality. According to them, as with the criterion at issue in the *Biehl* case, "[...] there is a risk that it will work in particular against taxpayers who are nationals of other Member States"⁷⁷⁰. Although the Belgian Government argued that Belgian workers are just as much affected as workers from other Member States, the Advocate General maintained that "[...] it would be primarily nationals of other Member States who would be disadvantaged by the condition complained of".⁷⁷¹ The Advocate General concluded that the Belgian tax provision, which made it com-

⁷⁶⁸ Case C-151/94.

⁷⁶⁹ See Jointed Opinion of Mr Advocate General Mischo in Cases C-204/90 (*Bachmann*) and C-300/90 (*Commission v Kingdom of Belgium*), paragraph 4.

⁷⁷⁰ Paragraph 14 of the judgment, Case C-175/88 (*Biehl*).

⁷⁷¹ Jointed Opinion of Mr Advocate General Mischo in Cases C-204/90 (*Bachmann*) and C-300/90 (*Commission v Kingdom of Belgium*), paragraph 4.

pletely impossible to deduct contributions paid to insurance companies having no establishment in Belgium, went beyond what was objectively necessary to achieve its intended aim and was thus incompatible with Article 49 of the Treaty. The Advocate General added that since it had not been objectively justified, it also constituted a restriction on freedom of movement for workers and was incompatible with Article 39.⁷⁷² The ECJ, however, did not fully agree with the Opinion of the Advocate General. It held that although that tax provision constituted a restriction to the free movement it was still justified by the need to ensure the cohesion of the tax system. The ECJ, having applied a test of proportionality, concluded that it was not possible to ensure the cohesion of such a tax system by means of measures with less restrictive effect on Treaty freedoms.⁷⁷³ The ECJ stated that the cohesion of the Belgian tax system presupposed that, in the event of a State being obliged to allow the deduction of life assurance contributions paid in another Member State, it should be able to tax sums payable by insurers.⁷⁷⁴ Thus, the ECJ allowed denying non-residents the right of deduction if it cannot tax the benefits that they receive abroad.⁷⁷⁵ The ECJ found the Belgian recapturing rule acceptable although the national measure at issue in *Bachmann* was restricting the freedoms of the Treaty. In effect, the ECJ in principle allowed tax provisions that restrict the exercise of the Treaty freedoms provided that they are justified in order to preserve fiscal coherence and proportionate. See section 4.2.3. about further discussion of the case.

Werner

The case⁷⁷⁶ considered also indirect exit restriction. Mr Werner was refused tax benefits because he did not live in the State of which he was a national and where he had taxable income as a self-employed person.⁷⁷⁷

The referring court wanted to know whether Article 52 of the EEC Treaty (now Article 43 of the EC Treaty) went beyond national treatment and if so, whether the higher tax burden on non-resident nationals was a prohibited restriction on free movement. In addition, the referring court asked whether the contested German tax measure constituted an infringement of the prohibition of indirect discrimination laid down in the general non-discrimination clause of Article 7 of the EEC Treaty (now Article 12 of the EC Treaty).⁷⁷⁸ The ECJ stated that in the *Werner* case there was no foreign element involved and that, therefore, it was a purely internal situation which was not covered by EU law.⁷⁷⁹ According to ECJ ruling, Mr Werner never exercised the freedoms conferred by the Treaty, particularly that of establishing himself in another Member State: he was a German national working in Germany where he acquired his professional qualifications.

⁷⁷² Ibid, paragraphs 28 and 29.

⁷⁷³ Paragraphs 24-27 of the judgment.

⁷⁷⁴ Paragraph 23 of the judgment.

⁷⁷⁵ See also section 4.2.3 for more elaborate discussion of coherence defence.

⁷⁷⁶ Case C-112/91. See also section 4.2.1 about the *Werner* case.

⁷⁷⁷ Mr. Werner worked as an employee for another dentist in Germany but lived in the Netherlands. After finishing his employment contract, Mr. Werner opened a dental practice as a self-employed dentist in Germany but continued to live in the Netherlands. Several tax advantages available for residents of Germany were not available to him as a non-resident. Non-residents were subject to a higher rate and tariff for the tax and, in addition, they could not benefit from the preferential tariff for married couples. Furthermore, year-end adjustment of monthly deductions was not available to them. Finally, certain deduction or reliefs which were available to residents were not available to non-residents. In brief, Mr. Werner was subject to a significantly higher tax burden than residents.

⁷⁷⁸ According to ECJ judgment in Case C-152/73 (*Sotgiu*) Article 7 prohibits, within the field of application of the Treaty, any discrimination, whether overt or covert, on grounds of nationality.

⁷⁷⁹ See section 4.2.1.

Schumacker

The case⁷⁸⁰ dealt with the problem that German Income Tax Law applied different tax regimes to employed persons according to their residence. Mr. Schumacker was a Belgian national who was employed in Germany. Advocate General Léger states in its Opinion in *Schumacker* that Mr Schumacker, a Belgian national who acquired his qualifications and professional experience elsewhere than in Germany, exercised the right of freedom of movement for workers laid down in Article 39 of the Treaty in order to go to Germany and take up employment there. A national of a Member State who exercises his right of freedom of movement under Article 39 to work in another Member State (where he receives all his income) whilst continuing to reside in his State of origin, had to pay tax on the income received in his State of employment without his personal circumstances and his family responsibilities being taken into consideration. This led to clear discrimination at the expense of the non-resident, who was subject to a different tax regime from that applicable to residents.⁷⁸¹ Tax rules which apply to residents and non-residents different conditions regarding income tax may fall within the scope of Article 39 of the EC Treaty. Article 39(2) of the Treaty requires the abolition of any discrimination based on nationality between workers of the Member States as regards, inter alia, remuneration. In principle, that article does not preclude a non-resident employed person from being taxed by the State of employment more heavily than a resident in the same employment where they are not in comparable situations from the tax point of view.^{782 783}

The ECJ recalls in its judgment that it has consistently held that the rules regarding equal treatment forbid not only discrimination on the basis of nationality but also discrimination on the basis of other factors (e.g. residence) which lead to a similar result. The Court states that although it is true that the rules at issue in *Schumacker* apply irrespective of the nationality of the taxpayer concerned, national rules of that kind, under which a distinction is drawn on the basis of residence in that non-residents are denied certain benefits which are, conversely, granted to persons residing within national territory, however, are liable to operate mainly to the detriment of nationals of other Member States. Furthermore, the ECJ recalls that it is settled law that discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations. The ECJ acknowledges that in relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable. The situation of a resident is different in so far as the major part of his income is normally concentrated in the State of residence. Moreover, that State generally has available all the information needed to assess the taxpayer's overall ability to pay, taking account of his personal and family circumstances. Consequently, the fact that a Member State does not grant to a non-resident certain tax benefits which it grants to a resident is not, as a rule, discriminatory since those two categories of taxpayers are not in a comparable situation.⁷⁸⁴

The ECJ holds in its judgment in *Schumacker* that the position is different, however, in a case where the non-resident receives no significant income in the State of his residence and obtains the major part of his taxable income from an activity performed in the State of employment, with the result that the State of his residence is not in a position to grant him the

⁷⁸⁰ Case C-279/93 (*Schumacker*).

⁷⁸¹ Opinion of Mr Advocate General Léger, Case C-279/93 (*Schumacker*), paragraphs 70 and 71.

⁷⁸² Ibid, paragraph 111.

⁷⁸³ In fact, most countries tax residents and non-residents differently. Residents are normally taxed on their worldwide income and enjoy full personal deductions and other tax benefits, while non-residents are usually subject to limited tax liability (i.e. tax on income derived from sources within the state) and any personal allowances are usually limited or denied to them.

⁷⁸⁴ Paragraphs 26 – 35 of the judgment.

benefits resulting from the taking into account of his personal and family circumstances.⁷⁸⁵ In the case of a non-resident who receives the major part of his income and almost all his family income in a Member State other than that of his residence, discrimination arises from the fact that his personal and family circumstances are taken into account neither in the State of residence nor in the State of employment.⁷⁸⁶ The ECJ rules that Article 39 of the Treaty must be interpreted as precluding the application of rules of a Member State under which a worker who is a national of, and resides in, another Member State and is employed in the first State is taxed more heavily than a worker who resides in the first State and performs the same work there when, as in the main action, the national of the second State obtains his income entirely or almost exclusively from the work performed in the first State and does not receive in the second State sufficient income to be subject to taxation there in a manner enabling his personal and family circumstances to be taken into account.⁷⁸⁷ The ECJ did not specify in *Schumacker* the exact proportion of income that non-resident should earn in another Member State in order to be entitled to the same tax treatment there as a resident. The ECJ has also avoided giving quantitative guidelines in the subsequent case law. In *Wielockx* (see below), the ECJ did not quantify the proportion of income that non-resident should earn in the state of source, to qualify for equal treatment. Several bilateral treaties refer to 90% of worldwide income. The Commission recommendation stipulates that treatment identical to that of residents should be granted to non-residents if they earn 75% or more of their income in source state.⁷⁸⁸ In its judgment in *Gschwind*⁷⁸⁹, the ECJ accepted the requirement that a non-resident should earn 90% of family income in the state of source to qualify for equal treatment.⁷⁹⁰

Wielockx

The case⁷⁹¹ concerned different treatment of residents and non-residents by refusing to deduct from the latter's taxable income contributions to a pension reserve. Since residents were granted such a deduction, they had an advantage which was denied to non-residents. Mr Wielockx, a Belgian national living in Belgium was a partner in a physiotherapy practice in the Netherlands. He received his entire income and was liable to pay tax there. He claimed that EC Treaty precludes a Member State from refusing to deduct from his taxable income

⁷⁸⁵ Paragraph 36.

⁷⁸⁶ Paragraph 38.

⁷⁸⁷ Paragraph 47.

⁷⁸⁸ Commission Recommendation 94/79/EC of 21 December 1993 on the taxation of certain items of income received by non-residents in a Member State other than that in which they are resident, OJ L 039, 10/02/1994, pp. 22 – 28. Recommendation 94/79/EC stipulates that the persons and income may not be subjected in the Member State imposing tax to any more burdensome taxation than if the taxpayer were resident in that Member State provided that the income derived by the individuals in question from the country of activity constitutes at least 75 % of their total taxable income. If this condition is met, the individuals in question should benefit, in the country of activity, from the same special deductions for determining taxable income and from the other general deductions or tax reliefs granted to residents. It is explained in the explanatory memorandum of the recommendation that the Commission considers equal treatment justified only where non-residents are in a situation comparable to that of residents. Such a situation is deemed to exist where a non-resident derives the preponderant part of his income (i.e. at least 75 % of his total taxable income) in the country of activity. In that case, the amount of income taxable in the country of residence is unlikely to be sufficient for the deductions and other reliefs provided for in that country's legislation to apply.

⁷⁸⁹ Case C-391/97.

⁷⁹⁰ The ECJ accepted in *Gschwind* that German tax legislation under which resident married couples are granted favourable tax treatment whilst the same treatment of non-resident married couples is made subject to the condition that at least 90% of their total income must be subject to tax in Germany. See below about the *Gschwind* case.

⁷⁹¹ Case C-80/94. The *Wielockx* case is also discussed in section 4.2.3.

his contribution to the pension reserve if residents are in fact granted such a deduction. The ECJ held that Article 43 of the Treaty precludes a Member State from allowing residents to deduct from their taxable income business profits which they allocate to form a pension reserve while denying that benefit to non-resident taxpayers from another Member State who receive all or almost all of their income in the first State. From *Wielockx* it can be concluded that the principles developed by the ECJ in *Schumacker* apply not only to employees under the free movement of workers provision of the Treaty but also to self-employed individuals under the freedom of establishment provision.

In *Wielockx*, the ECJ ruled that since fiscal cohesion was secured by a tax treaty concluded with another Member State, the cohesion defence could not be invoked to justify the refusal of a deduction from taxable income of the premiums paid to a non-resident company. It follows from *Wielockx*⁷⁹² that where, as a result of double-taxation conventions like those which follow the model of the OECD, fiscal cohesion is no longer established in relation to one and the same person but is shifted to another level, that of the reciprocity of the rules applicable in the Contracting States, the principle of fiscal cohesion may not be invoked to justify such a deduction. The giving away of a right to tax future income under a tax treaty cannot be used as an argument for the refusal of a deduction connected with that future income.⁷⁹³

*Asscher*⁷⁹⁴

Mr Asscher was a Dutch national who worked and lived in the Netherlands, but was also a director of a Belgian company. He moved his residence from the Netherlands to Belgium in 1986. As a result of change in tax legislation in 1990, Mr Asscher as a non-resident was subject to a higher tax rate in the Netherlands than residents. The ECJ considered Mr Asscher a self-employed person who made use of his freedom of establishment. The ECJ ruled that Mr Asscher had to be equated with a Belgian national who had some economic activity in the Netherlands and Mr Asscher had to be allowed access to Article 43 of the Treaty. The ECJ held that there was an unjustified discrimination of a Dutch national who moved from the Netherlands to Belgium.

Gilly

The case⁷⁹⁵ concerns Mr Gilly, a French national who worked in France, and his wife, who had dual German and French nationality and worked in a German state school. The income received by Mrs Gilly in Germany was taxed in that State under tax bracket I, which meant that her personal and family circumstances were not taken into account when calculating her tax liability. However, since these circumstances were taken into account in France for the purpose of calculating the couple's joint tax liability and of granting various tax rebates and deductions, the ECJ held that the German tax authorities were not obliged to take account of her personal and family circumstances. The ECJ took the view that the unfavourable consequences which the tax credit mechanism in question might entail for Mrs Gilly were the result primarily of the differences between the tax scales of the Member States concerned, and that, in the absence of any Community legislation in this field, the determination of these scales was a matter for Member States.⁷⁹⁶

⁷⁹² Paragraphs 24, 25 and 41 of the judgment.

⁷⁹³ See Betten, R. (1998), *Income Tax Aspects of Emigration and Immigration of Individuals*, IBFD Publications, pp. 181-182.

⁷⁹⁴ Case C-107/94.

⁷⁹⁵ Case C-336/96 (*Gilly*).

⁷⁹⁶ See paragraph 47 of the judgment.

Gschwind

The case⁷⁹⁷ dealt with a taxpayer (Mr Gschwind) who worked in Germany and resided with his family in the Netherlands where his wife worked and obtained 42% of the family's income. The income from Mr Gschwind's work, which represented 58% of the family's income, was taxed in Germany while that of his wife was taxed in the Netherlands. Germany amended its legislation in 1996 in order to bring the German income tax law in line with the *Schumacker* and *Wielockx* judgments. As a result of those amendments, a worker from another Member State is allowed the same deductions relating to his personal and family circumstances as those to which a resident is entitled. Married taxable persons from other Member States may be taxed using the 'splitting' method and tariff provided that at least 90% of their worldwide income must be taxable in Germany or, otherwise, that income from foreign sources, which is tax-exempt in Germany, must not exceed DEM 24 000. Mr Gschwind objected the refusal of tax authorities to grant him the right to choose joint assessment of his income with that of his wife. Mr Gschwind argued that the refusal to apply splitting benefit to married Community citizens working in Germany and residing in another Member State on the ground that, as 42% of the couple's worldwide income is received in the State of residence was contrary to Article 48 of the Treaty and to the judgments of the Court of Justice in *Schumacker* and *Asscher*. The ECJ, however, found that Mr Gschwind's situation was clearly different from that of Mr Schumacker, whose German salary represented almost all the family's income; neither Mr Schumacker nor his wife had any significant income in their State of residence that would enable their personal and family circumstances to be taken into account. The ECJ did not require extending the German splitting benefit to Mr Gschwind because 42% of the family income was earned in the Netherlands. The ECJ held that Article 39 (2) of the Treaty is to be interpreted as not precluding the application of a Member State's legislation under which resident married couples are granted favourable tax treatment such as that under the splitting procedure whilst the same treatment of non-resident married couples is made subject to the condition that at least 90% of their total income must be subject to tax in that Member State or, if that percentage is not reached, that their income from foreign sources not subject to tax in that State must not be above a certain ceiling, thus maintaining the possibility for account to be taken of their personal and family circumstances in the State of residence.⁷⁹⁸

Zurstrassen

The case⁷⁹⁹ concerned the issue whether a worker who is a national of a Member State can be obliged by another Member State, in which he resides and obtains almost all the income of his household, to pay income tax as a single person because his spouse, from whom he is not separated, and his children do not reside in the same State. Luxembourg denied the splitting benefit to Mr Zurstrassen, who was a Belgian national but resident and employed in Luxembourg where he earned 98% of the family income because that tax benefit for married couples was subject to the requirement that both taxpayers should be residents in Luxembourg (Mr Zurstrassen's wife was not living in Luxembourg but across the border in Belgium). The ECJ held that if one of the taxpayers is a resident, the requirement that the other spouse must also reside in Luxembourg for the benefit of joint taxation to be obtained constituted covert discrimination on grounds of nationality and does not ensure the equal treatment required by Article 39 (2) of the Treaty.⁸⁰⁰ The ECJ stated that Luxembourg is the only State which can take account of Mr Zurstrassen's personal and family circumstances since he is not only resident in that State but, additionally, is paid almost the entire earned income of the

⁷⁹⁷ Case C-391/97 (*Gschwind*).

⁷⁹⁸ Paragraph 32 of the judgment in *Gschwind*.

⁷⁹⁹ Case C-87/99 (*Zurstrassen*).

⁸⁰⁰ See paragraph 20 of the judgment.

household there.⁸⁰¹ The Court concluded that Community law precludes the application of national rules under which, as regards income tax, the joint assessment to tax of spouses who are not separated either de facto or by virtue of a judicial decision is conditional on their both being resident on national territory and that tax advantage is denied to a worker who is resident in that State, where he/she receives almost the entire income of the household, and whose spouse is resident in another Member State.

De Groot

This case⁸⁰² concerned a taxpayer who was a resident of the Netherlands and was employed in the Netherlands and in three other Member States. As a result of the application of the proportionality factor by the Dutch tax authorities, Mr de Groot benefited from the allowances relating to his personal and family circumstances only in proportion to the income which he had received in the Netherlands. Since his personal liabilities and personal and family circumstances were not taken into account, even in part, in the levying of foreign tax, he received less tax relief on account of personal liabilities borne by him, and was able to take less advantage of the tax-free allowance, than would have been the case if he had derived his total earned income from one or more employments exercised only in the Netherlands. Mr de Groot claimed that the use of the proportionality factor method constituted an obstacle to the free movement of workers.⁸⁰³ The Netherlands Government argued that it is legitimate for the State of residence to take into account the personal and family circumstances of a resident taxpayer only in proportion to the income derived in its territory. The Netherlands Government stated that the sole means of remedying a disadvantage such as that suffered by a taxpayer in Mr de Groot's situation is for the State or States of employment to grant the allowances relating to the taxpayer's personal and family circumstances in proportion to the income derived in those States.⁸⁰⁴ The ECJ, however was not convinced and argued referring to its judgments in *Schumacker* and *Gschwind* that the Member State of employment is required to take into account personal and family circumstances only where the taxpayer derives almost all or all of his taxable income from employment in that State and where he has no significant income in his State of residence, so that the latter is not in a position to grant him the advantages resulting from taking account of his personal and family circumstances.⁸⁰⁵ The ECJ stressed that the Court has also ruled⁸⁰⁶ that it is a matter for the State of residence, in principle, to grant the taxpayer all the tax allowances relating to his personal and family circumstances because that State is best placed to assess the taxpayer's personal ability to pay tax, since that is where his personal and financial interests are centred.⁸⁰⁷ The ECJ concluded that Article 48 of the Treaty precludes rules whereby a taxpayer forfeits, in the calculation of the income tax payable by him in his State of residence, part of the tax-free amount of that income and of his personal tax advantages because, during the year in question, he also received income in another Member State which was taxed in that State without his personal and family circumstances being taken into account. The ECJ, furthermore, held that Community law contains no specific requirement with regard to the way in which the State of residence must take into account the personal and family circumstances of a worker who, during a particular tax year, received income in that State and in another Member State, except that the conditions governing the way in which the

⁸⁰¹ See paragraph 23 of the judgment.

⁸⁰² Case C-385/00 (*Groot*).

⁸⁰³ See paragraph 33 and 50 of the judgment in *De Groot*.

⁸⁰⁴ The Netherlands Government referred to ECJ judgment in *Schumacker*. See paragraph 59 of the judgment in *De Groot*.

⁸⁰⁵ See paragraph 89 of the judgment in *De Groot*.

⁸⁰⁶ The ECJ referred to paragraph 32 of the *Schumacker* judgment.

⁸⁰⁷ See paragraph 90 of the judgment in *De Groot*.

State of residence takes those circumstances into account must not constitute discrimination, either direct or indirect, on grounds of nationality, or an obstacle to the exercise of a fundamental freedom guaranteed by the Treaty.

Verkooijen

The case⁸⁰⁸ concerned a legislative provision of the Netherlands which made the grant of an exemption from the income tax payable on dividends paid to natural persons subject to the condition that those dividends were paid by a company whose seat was in the Netherlands. Mr Verkooijen, a Netherlands national, was refused an exemption from income tax on share dividends received from a Belgian parent company of his Netherlands employer. The Dutch Supreme Court referred the issue to the ECJ for a preliminary ruling asking whether the fact that the income tax exemption for dividends did not apply to dividends received on foreign shares was in accordance with the free movement of capital in the EC.

The ECJ held that the Dutch dividend exemption that was not extended to dividends received on foreign shares was in violation of the freedom of capital movements. The ECJ noted that such a legislative provision had the effect of dissuading nationals of a Member State residing in the Netherlands from investing their capital in companies which had their seat in another Member State. The ECJ observed that it was clear from the legislative history of that Dutch tax provision that the exemption of dividends, accompanied by the limitation of that exemption to dividends on shares in companies which had their seat in the Netherlands, was intended specifically to promote investments by individuals in companies so established in the Netherlands in order to increase their equity capital. The ECJ noted that such a provision also had a restrictive effect as regards companies established in other Member States since the dividends which such companies paid to Netherlands residents received less favourable tax treatment than dividends distributed by a company established in the Netherlands, so that their shares were less attractive to investors residing in the Netherlands than shares in companies which had their seat in other Member States. The ECJ concluded that such a tax provision constituted a restriction on capital movements prohibited by Community legislation.⁸⁰⁹

SAFIR

The case⁸¹⁰ dealt with a Swedish tax on premiums paid on capital insurance policies taken out with foreign institutions. The Swedish tax legislation established different tax regimes for capital life insurance policies, depending on whether they are taken out with companies established in Sweden or with companies established elsewhere. The ECJ considered the tax legislation to be incompatible with the freedom to provide and purchase services. The ECJ stated that such legislation ‘... contains a number of elements liable to dissuade individuals from taking out capital life assurance with companies not established in Sweden and liable to dissuade insurance companies from offering their services on the Swedish market.’⁸¹¹

X and Y

The case⁸¹² dealt with the tax consequences when individuals sell shares that are subject to capital gains treatment. Swedish tax law provided that the sale of shares to a foreign company or to a Swedish company held through a foreign company had to be made at market value, or else the sale would be deemed to have taken place at market value.⁸¹³ The taxpayers

⁸⁰⁸ Case C-35/98.

⁸⁰⁹ Paragraphs 34-36.

⁸¹⁰ Case C-118/96 (*SAFIR*).

⁸¹¹ *Ibid.*

⁸¹² Case C-436/00 (*X and Y*).

⁸¹³ See Wiman (2003), pp. 191-201 about the *X and Y* case.

argued that a seller of shares to a Swedish company was treated less favourably when the seller holds an interest in the acquiring through a foreign company, compared with the situation where the interest was held through a Swedish company.⁸¹⁴ The ECJ held that the Swedish tax provision was contrary to EC Treaty (Articles 43 and 48).

Danner

The case⁸¹⁵ dealt with a Finnish tax provision that precluded or restricted the deductibility for income tax purposes of voluntary pension insurance contributions paid to foreign pension insurance institutions.

The case is in some respects similar to the earlier *Bachmann* case which was discussed above. Mr Danner was a doctor of German and Finnish nationality who had emigrated from Germany to Finland but continued to pay pension contributions into his German pension fund. Mr Danner claimed, for Finnish tax purposes that the contributions should be deductible to the same extent as contributions paid to voluntary insurance schemes taken out with Finnish institutions. The tax authorities allowed him only partial deduction.

Under Finnish Income Tax Law pension insurance contributions to certain compulsory or statutory schemes were fully deductible from taxable income. However, that rule did not apply to contributions to analogous foreign schemes: the contributions for voluntary pension insurance taken out with a foreign insurance institution were not deductible under the Finnish Income Tax Law.^{816 817} According to the Opinion of Advocate General Jacobs in *Danner*, this signifies a violation of the free movement of services⁸¹⁸ and discrimination on ground of nationality⁸¹⁹. The ECJ in its judgment⁸²⁰ followed the Opinion of the Advocate General. It held that the tax provision at issue restricted the freedom to provide services.⁸²¹ The ECJ stated, referring to the *SAFIR* case⁸²², that in view of the important role played by

⁸¹⁴ See paragraph 20 of the judgment.

⁸¹⁵ Case C-136/00 (*Danner*).

⁸¹⁶ The deduction, however, was still granted in two cases: (1) where the pension was granted by a permanent establishment in Finland of a foreign insurance institution, and (2) where the person concerned had moved to Finland from abroad and had not been liable to taxation in Finland during the five years preceding that move. In such a case, however, contributions were only deductible in the year of the move and the three following years.

⁸¹⁷ The tax provision, which excluded the deduction of contributions for voluntary pension insurance taken out with a foreign insurance institution, was inserted into the legislation within 12 months of Finland's accession to the European Union and entered into force on 1 January 1996. In the course of the legislative process leading to the adoption of this provision, the Finnish Government took the view that the tax regime applicable to voluntary pension insurance formed a coherent system in which the deductibility of contributions was based on the premiss that the pension benefits paid to the pensioner would be subject to tax at a later stage. The new rule was thus justified by the fact that it was impossible to ensure the taxation in Finland of pensions paid by foreign institutions or to verify whether the conditions for deductibility were satisfied. The insertion of the tax provision was considered necessary in order to avoid that such pensions would escape taxation in Finland, either because the recipient had moved abroad or because of insufficient information about pension payments.

⁸¹⁸ Advocate General Jacobs noted that those rules were liable to dissuade individuals from taking out voluntary pension insurance with foreign institutions and to dissuade foreign institutions from offering their services on the Finnish market because availability of fiscal advantages is an important factor in an individual's choice of a pension insurance institution. See Opinion of Advocate General Jacobs, Case C-136/00 (*Danner*), paragraph 30.

⁸¹⁹ The Advocate General noted that since Finnish tax legislation distinguished expressly between foreign and Finnish insurance institutions it was overt discrimination on grounds of nationality. See Opinion of Advocate General Jacobs, Case C-136/00 (*Danner*), paragraph 31.

⁸²⁰ Case C-136/00 (*Danner*).

⁸²¹ Paragraph 30.

⁸²² Case C-118/96, paragraph 30.

the possibility of obtaining tax deduction, such tax legislation was liable to dissuade individuals from taking out voluntary pension insurance with institutions established in a Member State other than Finland and to dissuade those institutions from offering their services on the Finnish market.⁸²³ Although the ECJ still referred to the *Bachmann* defence as possible justification for discriminatory measure, it stipulated that Finnish tax rules could not be justified on the same grounds as in *Bachmann* since there was no direct connection between the deductibility of insurance contributions and the taxation of sums payable by insurers.⁸²⁴ Furthermore, the ECJ stated referring to the *Wielockx* case that the principle of fiscal cohesion might not be invoked to justify the refusal of a deduction since fiscal coherence was secured by a bilateral convention concluded with another Member State (Germany).

Skandia

The case⁸²⁵ concerned the deductibility of pension premiums paid to an insurance company by an employer and the subsequent taxation of the payments to an employee. Swedish tax law distinguishes between pension insurance and endowment insurance. Under the tax regime applying to pension insurance, premiums paid by the employer under the policy are immediately deductible in calculating his taxable income. Retirement benefits paid out subsequently are subject to tax in their entirety in the hands of the insured beneficiary, namely the retired employee, as earned income. The different regime is applicable to endowment insurance: premiums paid by an employer are not deductible and deduction in the hands of the employer is permitted only once the pension is paid to the employee. A pension insurance policy taken out with an insurance company established in another Member State, as a rule, does not qualify as a pension insurance and is termed endowment insurance instead. As a result, the right to deduction arises at a later date than where the same insurance is taken out with an insurance company established in Sweden. It follows that the tax regime applying to occupational pension insurance differs according to whether the insurance company is established in Sweden or in another Member State. The Supreme Administrative Court referred the following question to the ECJ for a preliminary ruling: Do the provisions of EC law preclude application of national tax rules under which an insurance policy issued by an insurance company in the UK, Germany or Denmark which meets the conditions laid down in Sweden for occupational pension insurance – apart from the condition that the policy must be issued by an insurance company operating in Sweden – is treated as an endowment insurance policy with income tax effects which may be less favourable than the tax effects of a pension insurance policy?

The Advocate General stated in its Opinion that the Swedish tax provision provides for the application of different tax rules to the same situation, namely the taking out of occupational pension insurance, depending on whether it is taken out with an insurance company which is, or is not, established in Sweden.⁸²⁶ He concluded that Swedish tax law provides for less favourable tax regime if pension insurance is taken out with a company established in a Member State other than Sweden compared to a regime which applies when the company is established in Sweden and thus includes indirect form of discrimination, contrary to the freedom to provide services.⁸²⁷ The ECJ followed the conclusions of the Advocate General and held that Article 49 of the EC Treaty precludes an insurance policy issued by a company established in another Member State which meets the conditions laid down in national law for pension insurance, apart from the condition that the policy must be issued by a company operating in the national territory, from being treated differently in terms of taxation, with in-

⁸²³ Paragraph 31.

⁸²⁴ Paragraph 37.

⁸²⁵ Case C-422/01 (*Skandia*).

⁸²⁶ See Case C-422/01 (*Skandia*), paragraph 27.

⁸²⁷ See Case C-422/01 (*Skandia*), paragraphs 31-32.

come tax effects which, depending on the circumstances in the individual case, may be less favourable.⁸²⁸

Latest developments in pensions taxation

At present, EU investors often find their choice restricted by national governments imposing higher taxes on non-domestic funds.⁸²⁹ In its Communication of April 2001⁸³⁰, the Commission pointed out that not allowing mobile workers tax deduction for pension contributions paid to their original scheme restricts their right of free movement. Furthermore, the tax discrimination prevents pension funds from making use of their freedom to provide services. Finally, tax discrimination prohibits companies with establishments in different Member States from centralising their occupational pension arrangements into one single scheme for all their employees throughout the Union.⁸³¹

In the end of 2002, the European Commission decided to begin legal proceedings against six EU Member States for discriminatory pension tax regimes. In February 2003 the Commission sent a formal request to Denmark to amend its legislation regarding pension contributions and opened infringement proceedings against five other Member States (see below).⁸³²

In Denmark, the pension contributions paid by the employer are exempt from income tax in the hands of the employee. The employee is able to deduct from income tax the contributions paid by him-/herself if the contributions are paid to pension institutions established in Denmark. However, if the contributions are paid to pension institutions not established in Denmark, employees cannot deduct the contributions they pay themselves and are subject to income tax on their employers' contributions. Denmark did not amend its legislation despite a formal request from the Commission to do so in February 2003. In July 2003 the Commission decided to refer Denmark to the ECJ because pension contributions paid to non-Danish funds are not tax deductible while contributions paid to domestic funds are. The Commission considers that Danish law contravenes EU principles of freedom to provide services (Article 49 of the EC Treaty) and the free movement of workers and capital (Articles 39 and 56 of the EC Treaty).

In addition, the Commission also sent official requests for information to Belgium, Spain, France, Italy, and Portugal. These countries appear to have similar discriminatory tax rules to contributions to foreign pension funds.⁸³⁴ The Commission has also expressed its serious concerns as to the compatibility with EU law of the tax legislation of the United Kingdom and Ireland regarding pension contributions.⁸³⁵ The Commission decided to issue formal requests (so-called 'letters of formal notice') to the UK and Ireland for information concerning their legislation and practice.⁸³⁶

In the end of 2003, the European Commission has formally requested Belgium, France, Spain, and Portugal to change their tax legislation and give pension contributions paid to

⁸²⁸ See operative part of the judgment, Case C-422/01 (*Skandia*).

⁸²⁹ See Commission (2001c).

⁸³⁰ See the Commission's Press Release IP/01/575.

⁸³¹ See the Commission's Communication of July 9, 2003.

⁸³² See the Commission's Press Release IP/03/179.

⁸³³ The latest information on infringement procedures concerning all Member States can be found at the following site: http://europa.eu.int/comm/secretariat_general/sgb/droit_com/index_en.htm

⁸³⁴ See the Commission's Press Release IP/03/179.

⁸³⁵ See the Commission's Communication of July 9, 2003.

⁸³⁶ In both the UK and Ireland, the exemption from income tax of contributions paid by the employer in the hands of the employee and the deductibility of the employee's own contributions depends on the form of the pension arrangement (a trust) and the presence of a representative in the respective Member State to fulfil the administrative duties. See the Commission's Communication of July 9, 2003.

pension funds located in other Member States the same tax treatment.⁸³⁷ According to the Commission's December 17, 2003 press release, the requests have been sent in the form of so-called "reasoned opinions", the second stage of the infringement procedure provided for in Article 226 of the EC Treaty. The Commission claims that under existing Belgian, French, Spanish, and Portuguese legislation, pension contributions paid to foreign funds are not tax deductible while contributions paid to domestic funds are. The Commission considers that Danish law contravenes EU principles of freedom to provide services (Article 49 of the EC Treaty) and the free movement of workers and capital (Articles 39 and 56 of the EC Treaty).

4.2.2.1 Case law in the field of corporate taxation

*Avoir fiscal*⁸³⁸

The Commission complained that the French Republic failed to grant to branches and agencies set up in France by insurance companies of other Member States the benefit of the shareholders' tax credit known as 'avoir fiscal', from which corresponding French undertakings benefited.⁸³⁹ The Commission argued that the arrangements for granting the 'avoir fiscal' infringed Article 52 (now Article 43) of the Treaty because they constituted discrimination against foreign companies and an indirect restriction on the freedom to set up secondary establishments. Furthermore, there was different treatment of similar situations, because foreign and domestic companies engaged in similar activities (namely, insurance business) and the determination of taxable income was not different in case of residents and non-residents, yet, they were treated differently as to the amount of tax to be paid. Moreover, by using the residence criterion to grant the imputation credit, France applied different treatment on grounds of residence; and, the French registered-office test of corporate residence⁸⁴⁰ was a criterion equivalent to nationality in regard to natural persons because the registered office served to connect the company to a given legal system. Finally, the different treatment placed branches and agencies of companies of other Member States in a less favourable situation than domestic enterprises. The Commission submitted that French income tax law constituted an indirect restriction on the setting up of secondary establishments contrary to Article 52(1) (now Article 43(1)) because foreign companies were forced to set up a subsidiary instead of a branch or an agency.⁸⁴¹

The ECJ ruled in its *Avoir fiscal* judgement that French law constituted different treatment of similar situations because the imputation credit was granted to companies whose registered office was in France but denied to companies whose registered office was in another Member State. The ECJ held that a distinction based on the Member State in which a company had its seat might, under certain conditions, be justified in an area such as tax law. However, where the legislation of a Member State places companies whose registered office is in its national territory and branches and agencies situated in its territory of companies whose seat is abroad on the same footing for tax purposes, it cannot, for the purposes of the same tax, treat them differently in regard to the grant of an advantage related to that tax.⁸⁴² By treating

⁸³⁷ See the Commission's Press Release IP/03/1756.

⁸³⁸ Case C-270/83. *Avoir fiscal* was the first case concerning direct taxation and was brought for the preliminary ruling of the ECJ by the Commission against the French Republic in 1983.

⁸³⁹ France applies an imputation system for avoidance of economic double taxation of distributed company profits: a shareholder receiving a dividend also receives the right to credit the corporation tax levied on the profits out of which the dividend was paid. However, France grants this credit only to resident shareholders, and, under bilateral tax treaties also to certain foreign shareholders.

⁸⁴⁰ According to the French tax legislation 'avoir fiscal' is available only to companies whose registered office is in France, including subsidiaries established by foreign companies, that credit is not granted to agencies and branches which foreign companies have opened on French territory.

⁸⁴¹ See Van Thiel (2001a), pp. 141-144.

⁸⁴² Case C-270/83, (*Avoir fiscal*), paragraphs 19 and 20.

the two forms of establishment in the same way for the purposes of taxing their profits, the legislature of that Member State has admitted that there is no objective difference between their positions in regard to the detailed rules and conditions relating to that taxation which could justify different treatment. The ECJ held that by failing to extend to branches and agencies set up in France by companies whose registered office was in other Member States the benefit of the shareholders' tax credit enjoyed by French insurance companies, the French Republic had infringed the principle of non-discrimination laid down in the Rome Treaty. In addition, the ECJ held that the fact that insurance companies whose registered office was situated in another Member State were at liberty to establish themselves by setting up a subsidiary in order to have the benefit of the imputation credit could not justify different treatment. The ECJ stated that Article 52 of the EEC Treaty (now Article 43 of the EC Treaty) left traders free to choose the appropriate legal form in which to pursue their activities in another Member State and that freedom could not be limited by discriminatory tax provision.⁸⁴³ The fact that setting up a subsidiary would allow them to avoid discrimination against branches could not justify such discrimination. That discrimination constituted a restriction on the right of establishment of insurance companies whose registered office was in another Member State, which was contrary to the freedom of establishment provisions of the EC Treaty (Article 43). Lastly, the Court held that the rights conferred by Article 43 of the Treaty were unconditional and that a Member State could not make respect for them subject to the contents of a tax treaty concluded with another Member State.

Commerzbank

The case⁸⁴⁴ questioned a tax measure which laid down arrangements for the repayment of overpaid tax which provided that, in the event of repayment being made, a company was entitled to compensation calculated as a percentage of the sums repaid, on condition that it was resident for tax purposes. Commerzbank claimed that the refusal to grant repayment supplement to non-residents constituted a restriction of the right of establishment and indirect discrimination on grounds of nationality, since the companies affected were for the most part foreign.

According to the UK Government, the double taxation treaty removed any possibility of discrimination against non-resident companies since the latter are exempt from tax which only resident companies must pay. Advocate General Darmon, however, recalls that the ECJ held in its judgment in *Avoir fiscal* that '... the rights conferred by Article 52 of the Treaty are unconditional and a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State.'⁸⁴⁵ The Advocate General concludes that the observance of Community law cannot depend on the application of a tax treaty concluded with a third country.

In addition, the Advocate General submits that, in investigating the discriminatory character of the terms of granting the repayment supplement, the situation of an exempt non-resident company may not be compared with that of a resident company who is not exempt and who cannot claim repayment supplement. Consequently, the fact that a company would not have been exempt from tax if it had been resident in the taxing Member State is immaterial for the purpose of answering the question at issue.

Furthermore, the Advocate General recalls the judgment of the ECJ in *Avoir fiscal*, where the Court had based its decision on the inconsistency that two categories of taxpayers were placed on the same footing for tax purposes, but not for purposes of receiving the advantages related to taxation.

⁸⁴³ Ibid, paragraph 22.

⁸⁴⁴ Case C-330/91 (*Commerzbank*).

⁸⁴⁵ Paragraph 26.

The Advocate General considers the tax measure to be in breach with the free movement provisions of the Treaty (Articles 52 and 58 (now 43 and 48)), which prevent the legislation of a Member State from granting repayment supplement on overpaid tax to companies which are resident for tax purposes in that State whilst refusing the supplement to companies resident for tax purposes in another Member State.

The ECJ confirms the Opinion of the Advocate General. The Court states that the use of the criterion of fiscal residence within national territory for the purpose of granting repayment supplement on overpaid tax is liable to work more particularly to the disadvantage of companies having their seat in other Member States, which, indeed, are often the non-resident companies.⁸⁴⁶ The ECJ holds that the fact that the exemption from tax which gives rise to the refund is available only to non-resident companies cannot justify a rule of a general nature withholding the benefit. The ECJ, therefore, considers that rule discriminatory.

Futura

The case⁸⁴⁷ concerns the refusal by the Luxembourg tax authorities to offset against the profits for 1986 the losses incurred by the Luxembourg branch of French company since 1981. The Luxembourg Law allows non-resident taxpayers to deduct from the total of their net income previous losses carried forward from previous years, '... provided that they are economically related to income received locally and that accounts are kept within the country'. In order to meet this condition, the accounts relating to the taxpayer's activities in Luxembourg must comply with the relevant Luxembourg rules (hereafter referred to as 'proper accounts'). Futura claims that the refusal to allow losses to be carried forward where no proper accounts have been kept in Luxembourg discriminates against non-resident taxpayers in relation to resident taxpayers.⁸⁴⁸

The Advocate General notes that Luxembourg Law imposes additional conditions on non-resident companies to carry forward losses, namely the requirements for there to be a relationship between losses and income received locally and for separate accounts to be kept and held in Luxembourg. A branch of a foreign company must keep a second set of accounts, separate from those kept at the undertaking's seat, even though the branch has no legal personality of its own. The requirement for separate accounts results in additional administrative costs for the branch and consequently for the non-resident taxpayer. That means that a foreign company will be able to carry forward losses for its branch in Luxembourg only if it accepts additional costs and draws up separate accounts in Luxembourg. However, a Luxembourg company is under no obligation to produce separate accounts for its Luxembourg branch.⁸⁴⁹ Freedom to set up a branch in another Member State is therefore restricted as the branch has to incur additional costs.⁸⁵⁰ The Commission and Futura argued that different tax rules would restrict freedom to choose between the various possible forms of establishment, which is not allowed under the case law of the Court.⁸⁵¹ The Advocate General concludes that the requirement for separate and proper accounts to be kept in Luxembourg is incompatible with Community law.⁸⁵²

The ECJ confirms the conclusion of the Advocate General by ruling that Article 52 (now Article 43) of the Treaty precludes the carrying forward of losses from being made subject to the condition that, in the year in which the losses were incurred, the taxpayer must have kept and held in that State proper accounts relating to his activities carried on there. The ECJ

⁸⁴⁶ Paragraph 15.

⁸⁴⁷ Case C-250/95 (*Futura*).

⁸⁴⁸ Opinion of Mr Advocate General Lenz, Case C-250/95 (*Futura*), paragraph 11.

⁸⁴⁹ *Ibid*, paragraph 34.

⁸⁵⁰ *Ibid*, paragraph 36.

⁸⁵¹ Case 270/83 (*Avoir fiscal*), paragraph 22.

⁸⁵² Opinion of Mr Advocate General Lenz, Case C-250/95 (*Futura*), paragraph 35-40.

added that the Member State concerned may, however, require the non-resident taxpayer to demonstrate clearly and precisely that the amount of the losses which he claims to have incurred corresponds, under its domestic rules governing the calculation of income and losses which were applicable in the financial year concerned, to the amount of the losses actually incurred in that State by the taxpayer.

ICI

The case⁸⁵³ concerned the refusal by the UK Inland Revenue to allow one resident company belonging to a group (Coopers) to compensate its losses with the profits of another resident company of the same group (ICI), on the ground that, although all the companies involved were resident in the United Kingdom, the subsidiaries controlled by the holding company interposed between them (Holdings) were resident abroad.

The Advocate General holds in his opinion that domestic legislation which makes consortium relief available to companies only if the business of the holding company controlled by the company seeking relief consists, wholly or mainly, in holding shares of subsidiaries resident in the UK constitutes a restriction on freedom of establishment.

The ECJ confirms the opinion of the Advocate General and states that the requirement that most of the companies controlled by Holdings had to be resident in the United Kingdom is a restriction on freedom of establishment, prohibited by the Treaty. Relief is thereby precluded in all cases where the holding company's business consists, wholly or mainly, in the holding of shares of companies resident outside the United Kingdom, and even where such companies are established in other Member States. The Advocate General noted in his Opinion that it is the latter aspect which is of significance for Community law, since in those circumstances the legislation at issue limits, or at least discourages, the exercise by British companies of the right to create corporate structures in other Member States.

Royal Bank of Scotland

The case⁸⁵⁴ concerns the compatibility with Community law of a Greek tax provision under which foreign companies are always subjected to a tax rate of 40% whereas domestic public limited companies are taxed not at 35% if they issue registered shares or their bearer shares are quoted on the Athens Stock Exchange. Royal Bank of Scotland who operates a branch in Greece, claimed that this provision provided for unequal treatment between domestic and foreign companies which is prohibited under the Treaty. Whereas domestic public limited companies are able to enjoy the more favourable tax rate at certain conditions, all foreign companies are subjected to the higher tax rate, irrespective of the legal form which they have chosen and the type of the shares which they issue. Foreign companies are always subject to a tax rate of 40% whereas domestic companies are taxed at 35% where they satisfy a particular criterion. Moreover, the higher tax rate never applies to domestic banks - since domestic public limited companies in the banking sector are required to issue registered shares - whereas foreign banks are always subject to it.

Advocate General Alber recalls in his Opinion on *Royal Bank of Scotland* that as the ECJ has consistently held, discrimination is characterised by the application of different provisions to objectively comparable situations or the application of the same provision to different situations. In its case law⁸⁵⁵ relating to the differential taxation of residents and non-residents, the ECJ has ruled that non-residents must also be allowed to enjoy tax benefits where, apart from the residence criterion, they are in an identical situation for tax purposes. The Commission draws attention to the fact that Greek tax law for the purpose of taxing profits, treats Greek and foreign companies equally with regard to the determination of taxable income but

⁸⁵³ Case C-264/96 (*ICI*).

⁸⁵⁴ Case C-311/97 (*Royal Bank of Scotland*).

⁸⁵⁵ *Schumacker*, paragraphs 36-38.

does not grant to the latter companies the more favourable tax rate of 35% - even under the same conditions as those which apply to companies with their seat in Greece. The Advocate General concludes in his opinion that Greek tax provision at issue by applying a higher tax rate to the income of foreign companies than on that of domestic companies, imposes a heavier tax burden on the former companies and infringes right of establishment provision of the Treaty. The ECJ confirms the opinion of the Advocate General and rules that EC Treaty precludes legislation of a Member State, such as the tax legislation in question in *Royal Bank of Scotland*, which, in the case of companies having their seat in another Member State and carrying on business in the first Member State through a permanent establishment situated there, excludes the possibility, accorded only to companies having their seat in the first Member State, of benefiting from a lower rate of tax on profits, when there is no objective difference in the situation between those two categories of companies which could justify such a difference in treatment.

Saint-Gobain

The case⁸⁵⁶ raised the question of whether a branch establishment in Germany of a company having its seat in France was eligible for tax benefits such as a participation exemption and tax credit for underlying tax for dividends paid to that branch on shares held in companies in other Member States (Italy and Austria) and in third States (Switzerland and the US). Under German law and double-taxation treaties the tax concessions in question could only be granted to German residents.

The ECJ held in its judgment that, the refusal to grant the tax benefits to the permanent establishments in Germany of non-resident companies made it less attractive for those companies to have intercorporate holdings through German branches, since the tax benefits in question could only be granted to German residents, which restricted the freedom to choose the most appropriate legal form for the pursuit of activities in another Member State.⁸⁵⁷ The ECJ regarded the difference in treatment to which branches of non-resident companies were subject in comparison with resident companies as well as the restriction of the freedom to choose the form of secondary establishment constituting a single composite infringement of the right of establishment provisions of the Treaty.⁸⁵⁸

The German Government argued that content and application of bilateral treaties with third States was not a Community competence but a competence of the Member States. Furthermore, the Swedish Government observed that double-taxation treaties were based on the principle of reciprocity and that the balance inherent in such treaties would be disturbed if the benefit of their provisions was extended to companies established in Member States which were not parties to them. The ECJ observed, referring to the *Gilly* case⁸⁵⁹, that Member States remained competent to determine the criteria for taxation of income and wealth and that they were at liberty, in the framework of bilateral agreements concluded in order to prevent double taxation, to determine the connecting factors for the purposes of allocating powers of taxation as between themselves.⁸⁶⁰ However, the ECJ stated that as far as the exercise of the power of taxation so allocated is concerned, Member States nevertheless might not disregard Community rules. In the case of a tax treaty concluded between a Member State and a third State, the national treatment principle requires the Member State which is party to the treaty to grant to the permanent establishments of non-resident companies the advantages provided for by that treaty on the same conditions as those which apply to resident companies. Moreover, the ECJ stated, that the obligations which Community law im-

⁸⁵⁶ Case C-307/97 (*Saint-Gobain*).

⁸⁵⁷ Paragraph 42.

⁸⁵⁸ Paragraph 43.

⁸⁵⁹ Case C-336/96.

⁸⁶⁰ Paragraph 56.

posed on Germany did not affect in any way those resulting from its agreements with the United States of America and the Swiss Confederation. The ECJ added that EU law did not affect the rights of the non-member countries which were parties to the treaties and would not impose any new obligation on them.⁸⁶¹

Eurowings

The case⁸⁶² concerned certain German trade tax rules which treated traders leasing assets from non-resident lessors less favourably than those leasing from residents. A relief for the German trade tax ('Gewerbesteuer') was available if business assets had been leased from another business, unless they were leased from a business not subject to 'Gewerbesteuer'. As a result, the German companies leasing assets from a foreign lessor were not available for those tax advantages. Eurowings, an aviation company incorporated under German law, leased an aircraft from an Irish limited company. The national court observed that the fiscal treatment of a lessee who leased an asset from a lessor established in another Member State was less favourable than where the lessee leased such an asset from a lessor established in Germany, which might constitute covert discrimination contrary to Article 59 (now 49) of the Treaty. Furthermore, the national court stated that this system represented a competitive disadvantage for a provider of services established in another Member State. The Advocate General concluded in his Opinion that such a system established a restriction on the freedom to provide services because the recipient of a cross-border service was always taxed, whereas it was by no means certain that the recipient of a domestic service was required, in one form or another, to bear a comparable burden or even any burden whatsoever. The ECJ confirmed the Opinion of the Advocate General by stating that Article 59 (now 49) of the Treaty precluded such a national tax measure.

AMID

The case⁸⁶³ concerned the deduction of losses by Belgian corporations with permanent establishments in countries with which Belgium had concluded a tax treaty. According to the Belgian tax legislation, losses realised in Belgium must first be offset against profits realised in Belgium, second against profits realised in countries with which Belgium did not conclude a tax treaty and, finally, against losses realised through a permanent establishment in a tax treaty country.⁸⁶⁴ As a result, the taxable basis of a corporation with losses in Belgium was increased with the amount of the profits of a permanent establishment in a tax treaty country. A Belgian company AMID was not allowed, for tax purposes, to deduct losses incurred by its Belgian establishment in the previous accounting year from the profits made by that establishment in the subsequent accounting year, on the ground that those losses should have been set off against the profits made by its Luxembourg establishment in the previous accounting year.⁸⁶⁵ AMID argued that since the Belgian tax provisions placed companies with branches abroad at a disadvantage compared with companies having branches only in Belgium, these provisions are in breach of the EC Treaty.⁸⁶⁶ The Belgian tax rules limit the amount of the carried forward losses of Belgian corporations with a permanent establishment in another Member State compared to the amount of carry-forward losses of Belgian corporations with a permanent establishment in Belgium. The national court requested a preliminary ruling from the ECJ on the following question: does Article 43 of the EC Treaty preclude the application of national legislation under which a business loss incurred in that

⁸⁶¹ Paragraph 57-59.

⁸⁶² Case C-294/97.

⁸⁶³ Case C-141/99 (*AMID*).

⁸⁶⁴ See De Broe (2003), p.11.

⁸⁶⁵ See ECJ judgment in Case C-141/99 (*AMID*), paragraph 2.

⁸⁶⁶ *Ibid*, paragraph 14.

Member State during an earlier taxable period by a company established in that state can be offset against the profits made by that company during a later taxable period only to the extent to which that loss cannot be attributed to the profit made by a permanent establishment of that company in another Member State during that earlier period with the result that the loss thus attributed cannot be offset, in either of the Member States concerned, against the taxable income of that company, whereas, if the permanent establishment were located in the same Member State as the company, the business losses in question could be set off against the taxable income of that company.⁸⁶⁷ The ECJ held that for Belgian companies which have used their right of free establishment in order to create branches in other Member States, the Belgian tax provisions limit the possibility of carrying forward losses incurred in that Member State during a previous tax period where, during that same tax period, those companies made profits in another Member State through the intermediary of a permanent establishment, whereas it would be possible to set off those losses if the permanent establishments of those companies were situated exclusively in the Member State of origin.⁸⁶⁸ The ECJ concluded that Belgian tax provision is in breach of the EC Treaty (Article 43).⁸⁶⁹

Metallgesellschaft

The cases⁸⁷⁰ concerned the payment of advance corporation tax (hereafter ACT). Under UK tax system certain 'qualifying distributions', most typically the payment of dividends, entailed the obligation to pay ACT. However, the exemption from liability to pay ACT was available if a group income election was made by a subsidiary and its parent company. Such an election was open only to companies one of which owned at least 51% of the other and both of which were resident in the United Kingdom. Two German companies (Metallgesellschaft Ltd and Others and Hoechst AG) claimed that their United Kingdom subsidiaries had suffered a cash-flow disadvantage in comparison with the subsidiaries of parent companies resident in the United Kingdom, since, unlike the latter, which were permitted to benefit from a group income election, no such option was available to them. Metallgesellschaft and Hoechst sought to obtain restitution of or interest damages for this loss. According to the German companies, the national legislation in question tended to discourage companies resident in another Member State from establishing subsidiaries in the United Kingdom and therefore constituted an unjustified restriction on freedom of establishment. Their subsidiary submission was that that legislation was likewise incompatible with the Treaty provisions on the free movement of capital.⁸⁷¹ The ECJ held in its judgment that since legislation such as that in question run counter to the Treaty provisions on freedom of establishment, it was unnecessary to consider whether it also run counter to the Treaty provisions on the free movement of capital.⁸⁷² It stated that it was contrary to the provisions on freedom of establishment of the EC Treaty for the tax legislation of a Member State to afford companies resident in that Member State the possibility of benefiting from a taxation regime allowing them to pay dividends to their parent company without having to pay advance corporation tax where their parent company was also resident in that Member State but to deny them that possibility where their parent company had its seat in another Member State.⁸⁷³

⁸⁶⁷ Ibid, paragraph 16.

⁸⁶⁸ Ibid, paragraph 22.

⁸⁶⁹ See an operative part of the ECJ's judgment in Case C-141/99 (*AMID*).

⁸⁷⁰ Joined cases C-397/98 and C-410/98.

⁸⁷¹ Paragraph 36 of the judgment.

⁸⁷² Paragraph 75.

⁸⁷³ Paragraph 76.

Lankhorst-Hohorst

The case⁸⁷⁴ concerned the German thin capitalization provision which provided that repayment of interest by a subsidiary established in Germany to its parent company whose corporate seat is in the Netherlands was reclassified as a covert distribution of profits. That thin capitalization provision applied only to repayments in respect of loan capital which a company limited by shares subject to unlimited taxation had obtained from a shareholder not entitled to corporation tax credit. The ECJ argued that such a provision introduced a difference in treatment between resident subsidiary companies according to whether or not their parent company had its seat in Germany.⁸⁷⁵ The ECJ stated that in the large majority of cases, resident parent companies receive a tax credit, whereas, as a general rule, non-resident parent companies do not.⁸⁷⁶ The result of the German provision was therefore that a subsidiary which had obtained loan capital from a non-resident parent company was subject to taxation in respect of the interest in question, whereas a subsidiary which had obtained loan capital from a resident parent company was not. The ECJ held that such a difference in treatment between resident subsidiary companies made it less attractive to corporations having their seats in other Member States to exercise the freedom of establishment by way of formation, acquisition or maintenance of a German subsidiary and constituted an obstacle to which is prohibited by Article 43 of the EC Treaty.⁸⁷⁷ The ECJ stipulated that the tax measure in question makes it less attractive for companies established in other Member States to exercise freedom of establishment and they may, in consequence, refrain from acquiring, creating or maintaining a subsidiary in the State which adopts that measure.⁸⁷⁸

Bosal

The case⁸⁷⁹ concerns the Netherlands corporate tax law, which provides that the costs incurred by a parent company in connection with its holding in subsidiaries may be deducted only to the extent to which those costs are indirectly instrumental in making profit which is taxable in the Netherlands. As a result of this provision of the Netherlands tax law, Bosal Holding BV (hereafter Bosal) was refused the deduction of financing costs made in connection with its subsidiaries in other Member States. Consequently, the financing expenses of Bosal were not deductible anywhere because the relevant Member State did not take account of the abovementioned costs in levying tax on the subsidiary.⁸⁸⁰ Bosal argued that, by allowing costs to be deducted only if they are instrumental in taxable profits being made in the Netherlands, the Dutch law inhibits the exercise of the freedom of establishment, as it penalises the creation of subsidiaries in another Member State.⁸⁸¹

The Advocate General concluded in its opinion delivered on 24 September 2002⁸⁸² that Article 43 of the EC Treaty, in conjunction with Article 48 of the EC Treaty, precludes national rules which provide that a Member State may grant a parent company subject to tax in that Member State a deduction on costs relating to a holding owned by it provided that the relevant subsidiary makes profits which are subject to tax in the Member State in which the parent company is established.

The ECJ, on the other hand, relied in its judgment also on the provisions of the Parent-Subsidiary Directive (90/435/EEC). The ECJ held that although Article 4(2) of the Parent-

⁸⁷⁴ Case C-324/00 (*Lankhorst-Hohorst*).

⁸⁷⁵ Paragraph 27 of the judgment.

⁸⁷⁶ Paragraph 28-29 of the judgment.

⁸⁷⁷ Paragraph 32 of the judgment.

⁸⁷⁸ See paragraph 38 of the opinion.

⁸⁷⁹ Case C-168/01 (*Bosal*).

⁸⁸⁰ See Wattel (2003), p. 157 and ECJ judgment, Case C-168/01 (*Bosal*), paragraph 11.

⁸⁸¹ See ECJ judgment, Case C-168/01 (*Bosal*), paragraph 16.

⁸⁸² Case C-168/01 (*Bosal*), paragraph 85.

Subsidiary Directive offers a possibility to refuse the deduction of costs incurred by parent companies in connection with holdings in the capital of their subsidiaries, that possibility may be exercised only in compliance with the fundamental provisions of the Treaty.⁸⁸³ The ECJ held in its judgment that the Dutch provision at issue constitutes a hindrance to the establishment of subsidiaries in other Member States.⁸⁸⁴ Moreover, it goes against objective set forth by the Directive, spelt out in the third recital of its preamble, according to which it is necessary to introduce a common system and to eliminate the disadvantage due to the application of tax provisions governing relations between parent companies and subsidiaries of different Member States which are less favourable than those applicable to relations between parent and subsidiary companies of the same Member State.⁸⁸⁵ The ECJ concluded that, interpreted in the light of Article 43 of the Treaty, the directive precludes a national provision which, when determining the tax on the profits of a parent company established in one Member State, makes the deductibility of costs in connection with that company's holding in the capital of a subsidiary established in another Member State subject to the condition that such costs be indirectly instrumental in making profits which are subject to tax in the Member State in which the parent company is established.⁸⁸⁶

4.2.2.2 *Exit taxes*

When individuals or companies transfer their residence from one country to another (or individuals renounce their citizenship), the resulting change of tax jurisdiction gives rise to issues of allocation of taxing powers between the countries. The countries suffer revenue loss because they are not able to tax emigrants that previously had enjoyed deductions or tax deferrals, their unrealized capital gains or future income derived from sources in and/or outside the country of emigration. Although most countries have not introduced any specific measures to tackle the negative tax revenue effects caused by emigration, several EU countries impose exit taxes aimed at counteracting the loss of latent revenue. In some countries accrued income is deemed to be realized for tax purposes and accrued but not yet realized capital gains on property are to be valued and included in the taxable basis upon emigration. Some Member States have introduced the rules that provide for an extended tax liability for a certain period after emigration. In addition, several EU countries recapture previously granted deductions or tax deferrals. Recapture is applied in cases where a taxpayer has previously enjoyed a tax deferral of a realized capital gain or a tax advantage relating to some kind of deferred income scheme (e.g. a tax deduction for premiums paid under a private pension plan or life insurance).

The following five types of exit taxes can be distinguished⁸⁸⁷:

- a. General exit taxes are levied on all accrued but not yet realized taxable gains and are typically applied by countries that levy a comprehensive capital gains tax. Currently none of the EU States levies such taxes;
- b. Limited exit taxes are levied on accrued but not yet realized capital gains on certain kinds of property and are applied by countries that levy a capital gains tax only on selective items of property, often substantial shareholdings. From EU countries Germany, Austria, the Netherlands, Denmark and France apply such a tax upon emigration⁸⁸⁸;

⁸⁸³ Case C-168/01 (*Bosal*), paragraphs 25-26.

⁸⁸⁴ Case C-168/01 (*Bosal*), paragraph 27.

⁸⁸⁵ Case C-168/01 (*Bosal*), paragraph 28.

⁸⁸⁶ See Case C-168/01 (*Bosal*), an operative part of the judgment.

⁸⁸⁷ See Betten (1998), pp. 11 – 34.

⁸⁸⁸ See International Fiscal Association (2002), p.29.

- c. Unlimited extended income tax liability - the emigrated taxpayer continues to be treated as a resident taxpayer by his/her former country of residence despite the fact that he/she no longer has the residence of that country. Unlimited extended income tax liability appears in the current tax systems of Sweden, Finland, Ireland, Spain and Italy, albeit that there are significant differences between the various jurisdictions, basically with respect to the persons captured by the tax and the events triggering the tax⁸⁸⁹;
- d. A limited extended income tax liability is restricted to income and capital gains from sources within the emigration country. It appears in Germany, Sweden and the United Kingdom⁸⁹⁰;
- e. Recaptures of previously granted tax deductions or deferrals - the emigrating taxpayer, who in the past has taken advantage of a tax deduction or deferral, is subject to income tax upon emigration to make up for prior deduction or deferral. The tax systems of Finland, Germany, France, Sweden, Denmark, the Netherlands, Belgium and the United Kingdom provide for some sort of recapture mechanism.⁸⁹¹

In addition to those exit taxes, the countries introduce other specific measures to safeguard their taxing rights in the case of emigration.⁸⁹² Those include, for example, rules of residence⁸⁹³ and acceleration of payment of taxes other than emigration taxes⁸⁹⁴.

There is no principle in international tax law which country has the right to tax the income or gain which accrued before the taxpayer emigrated. There are two main approaches to the taxation of gains accrued but not yet realized during the period a taxpayer is resident in a country⁸⁹⁵:

1. an emigration country has the right to tax unrealized gains that accrued during the period of residency of the taxpayer;
2. the country where a taxpayer is resident at the moment of realization is exclusively entitled to levy tax on the entire gain.

Lack of agreement in the issue who is entitled to tax accrued but not yet realized gains and the differences in approach of emigration and immigration country lead to double taxation.⁸⁹⁶

⁸⁸⁹ Ibid, p.30.

⁸⁹⁰ Ibid.

⁸⁹¹ Ibid.

⁸⁹² See International Fiscal Association (2002), pp.30-32 for more detailed overview of these measures.

⁸⁹³ For example, the Scandinavian countries have enacted legislation in order to deny non-residence status to temporary non-residents in the framework of their unlimited extended tax liabilities.

⁸⁹⁴ France has introduced specific rules if an individual transfers his residence out of the country: the taxpayer should provisionally report all income accrued until emigration – even if it is not yet at his disposal – at the latest 30 days before emigration. On 14 December 2001, the *Conseil d'Etat* referred to the ECJ for a preliminary ruling on the compatibility of the French exit tax on substantial shareholdings with the freedom of establishment (Article 43 of the EC Treaty). This request (Case C-9/02 (*Lasteyrie*)) is considered below. Another French exit tax provides for the recapture, when residence is transferred to another country, of the tax deferrals previously granted to the taxpayer on capital gains realised on shares, but this provision was not challenged in the case referred to the ECJ by *Conseil d'Etat* in 2001. See Martin (2003).

⁸⁹⁵ See Betten (1998), p. 101.

⁸⁹⁶ In certain circumstances the migrating individual may be subject to full or partial non-taxation as a result of transferring his residence from a country not levying exit tax. For example, international non-taxation can occur if neither the emigration nor the immigration country taxes capital gains. Double non-taxation can also occur if a taxpayer moves from a country which taxes capital gains upon realization but not upon emigration to a country which does not impose any income tax on capital gains.

International double taxation occurs if the country of immigration taxes the entire gain at the moment of realization and the emigration country had also levied exit tax on part of that gain which accrued during the residence in that country. Very few EU countries⁸⁹⁷ permit immigrants to value their property at the economic value at the moment of immigration, in effect, double taxation occurs as long as both emigration as well as immigration country levy tax on the amount by which the value increased during the period of residence in the emigration country.

In the case of extended tax liabilities the international double taxation occurs if taxpayer is taxed in the country of residence as well as in the country in which the taxpayer was formerly resident (and may still be national). For example, an emigrant is exposed to international double taxation if he maintains sources of income that are subject to non-resident income tax liability in emigration country for which that country has not given up taxing rights to the immigration country under a tax treaty. Another example is double taxation resulting from the recapture of previously granted tax deductions or deferrals if the immigration country considers the entire pertinent income to be taxable. International double taxation as well as non-taxation can occur as a result of the differences that exist between the systems applied by Member States with respect the tax deferred items of income, such as pensions, and to deductions from taxable income related to income from life insurance contracts.

Consequently, unilateral taxation of accrued but not yet realized capital gains, extension of tax liability as well as recaptures of tax deductions without regard to the taxation of the income in the immigration country may cause double taxation. To avoid such double taxation some countries take measures to give the relief which is provided either unilaterally under the domestic law or under a tax treaty between the emigration and immigration countries.

Betten (1998) identifies several other problems that exit taxes create. An exit tax on unrealized capital gain may create an ability to pay problem for taxpayers and the risk that income tax is paid on income that is never realized (if the value of the underlying property decreases). The payment of taxes by emigrants is accelerated in comparison with resident taxpayers who do not emigrate. The income tax burden of resident taxpayers has therefore a lower cash value than the income tax burden imposed on emigrants.

The assessment of exit taxes raises the question of whether such taxes are in accordance with the fundamental freedoms guaranteed by EC Treaty. Exit taxes can hamper the freedom of movement within the internal market by making the cross-border economic activities more costly than similar domestic activities or even totally inhibit the movement to another State by taxing the accrued but not yet realized capital gains or levying the tax to make up for the prior deduction or deferral. Where payment of the exit tax (i.e. those in force in Austria and Germany) cannot be deferred, their existence may effectively prohibit emigration. This effect is in conflict with the free movement provisions of the EC Treaty.⁸⁹⁸ The other taxes as well as safeguarding measures imposed upon transfer of residence can create restrictions to the free movement within the Internal Market and violate EU law. For example, some Member States (Belgium, Denmark and the Netherlands) apply recapture of tax deductions to prevent taxpayers from taking advantage of legislation in order to avoid taxation of pension payments. However, the measures taken can create restrictions to movement within the Internal Market. In addition to the recapture measures in the field of pensions, the other recapture measures (e.g. in the field of group insurance schemes or of stock options) can also restrict the individual in the exercise of his/her freedom to work either as an employed or a self-employed person.⁸⁹⁹ The huge differences in the taxation systems of pensions and life insur-

⁸⁹⁷ Denmark, and for substantial shareholdings Austria and sometimes also the Netherlands. See Betten (1998), p. 140.

⁸⁹⁸ See Betten (1998), p. 177.

⁸⁹⁹ De Broe (2002), pp. 70-71.

ance between the various Member States as well as the impact of recapture measures restrict the mobility of employees and freedom of establishment within the Internal Market. Whether emigration taxes restrict the freedoms enshrined in the EC Treaty cannot be answered in general.⁹⁰⁰ Every case has to be analysed separately. The ECJ has to determine in each individual case whether there is forbidden discrimination or restriction to Treaty freedoms and if it is so, whether a justification for it exists and whether the measure is in proportion to the general interests of the Member State. So far, there are only few rulings by the ECJ of whether (indirect) exit taxes are in accordance with the fundamental freedoms guaranteed by EC Treaty. *Daily Mail* has been the only case in which the ECJ ruled on the compatibility of an emigration tax (requirement of Treasury to pay a substantial amount of tax upon exit in order to get a consent to emigrate from UK tax jurisdiction) with EU law. The ECJ held in its *Daily Mail* judgment that Treaty freedoms prohibit the Member State of origin from hindering companies from establishing in another Member State (right of exit). In *ICI*, the Advocate General pointed out that tax disincentives undoubtedly made the creation of cross-border corporate structures a less attractive prospect for companies. The Advocate General noted that tax provisions imposed by a Member State that restrict the exit of taxpayers from that State are prohibited under EC Treaty.⁹⁰¹ In *Bosman*, the ECJ stated that the same applies in the field of free movement of workers, with regard to rules that impede the freedom of movement of nationals of one Member State wishing to engage in employment in another Member State.⁹⁰² In its *Bosman* ruling, the Court, referring to its previous decisions, pointed out that ‘...the provisions of the Treaty relating to freedom of movement for persons are intended to facilitate the pursuit by Community citizens of occupational activities of all kinds throughout the Community, and preclude measures which might place Community citizens at a disadvantage when they wish to pursue an economic activity in the territory of another Member State.’⁹⁰³ The ECJ held that “[p]rovisions which preclude or deter a national of a Member State from leaving his country of origin in order to exercise his right to freedom of movement therefore constitute an obstacle to that freedom even if they apply without regard to the nationality of the workers concerned [...]”.⁹⁰⁴ Some other cases (i.e. *Biehl*, *Werner*, *Asscher*, *Bachmann*, *Wielockx*, *Danner*, and *X and Y*) concerned indirect exit restrictions. In 2001, the ECJ was asked to issue a preliminary ruling on the compatibility of an emigration tax, i.e. the French limited exit tax on substantial shareholdings, with EU law.⁹⁰⁵

Daily Mail

The case⁹⁰⁶ concerned a tax measure which was claimed to constitute an indirect exit restriction. *Daily Mail* and *General Trust plc* sought to avoid capital gains tax by transferring its central management and control (and therefore its residence for tax purposes) to the Netherlands prior to sale of its holdings.⁹⁰⁷ If these holdings were to be sold immediately after arrival in the Netherlands, then no capital gain tax in the Netherlands would ensue. British law required Treasury consent prior to such transfer abroad of a corporate residence. The Treasury, however, required *Daily Mail* to pay a substantial exit tax before emigration. *Daily Mail* claimed that it was exercising the right of establishment when transferring its central management and control and that Articles 43 and 48 of the EC Treaty gave it the right to cease to

⁹⁰⁰ Ibid, p. 70.

⁹⁰¹ Opinion of Mr Advocate General Tesauro, Case C-264/96 (*ICI*), paragraphs 15-18.

⁹⁰² Case C-415/93 (*Bosman*), paragraph 97.

⁹⁰³ Ibid, paragraph 94.

⁹⁰⁴ Ibid, paragraph 96.

⁹⁰⁵ Case C-9/02 (*Lasteyrie*).

⁹⁰⁶ Case 81/87.

⁹⁰⁷ See Terra and Wattel (2001), pp. 68-69.

be resident in the United Kingdom for the purpose of establishing its residence in the Netherlands without prior consent or the right to obtain such consent unconditionally.

The Advocate General argued in his Opinion that EU law cannot be relied on if "objective factors" show that a particular activity was carried out "in order to circumvent" national legislation⁹⁰⁸. The Advocate General added that the fact that the essential activities of a company took place on the territory of a Member State other than that to which it intended to transfer its central management might not be ignored and that such circumstances might, in certain cases, constitute an indication that what is involved is not a genuine establishment, in particular when the effect of the transfer of the central management was to cause the company to cease to be subject to legislation which would otherwise apply to it.⁹⁰⁹ Moreover, the Advocate General stated in his Opinion that '... Member States are not prevented from requiring a company to settle its fiscal position upon any transfer of its central management [...].'⁹¹⁰

According to the Advocate General, a tax-free emigration of the company should not be allowed on the basis of EU law. The ECJ reached at a similar conclusion by reasoning that Articles 43 and 48 of the Treaty could not be interpreted as conferring on companies incorporated under the law of a Member State a right to transfer their central management and control and their central administration to another Member State while retaining their status as companies incorporated under the legislation of the first Member State.⁹¹¹ The ECJ stated, that '... in the present state of Community law Articles 43 and 48 of the Treaty, properly construed, confer no right on a company incorporated under the legislation of a Member State and having its registered office there to transfer its central management and control to another Member State.'⁹¹² The ECJ also held that Council Directive 73/148⁹¹³, conferred no right on a company to transfer its central management and control to another Member State as its title and provisions referred solely to the movement and residence of natural persons, and the directive could not, by their nature, be applied by analogy to legal persons.⁹¹⁴

In respect of possible tax avoidance motivation of Daily Mail, the ECJ reasoned that '[...] the principal reason for the proposed transfer of central management and control was to enable the applicant, after establishing its residence for tax purposes in the Netherlands, to sell a significant part of its non-permanent assets and to use the proceeds of that sale to buy its own shares, without having to pay the tax to which such transactions would make it liable under United Kingdom tax law, in regard in particular to the substantial capital gains on the assets which the applicant proposed to sell. After establishing its central management and control in the Netherlands the applicant would be subject to Netherlands corporation tax, but the transactions envisaged would be taxed only on the basis of any capital gains which accrued after the transfer of its residence for tax purposes.'⁹¹⁵

X and Y

The case⁹¹⁶ dealt with the tax consequences when individuals sell shares that are subject to capital gains treatment. Swedish tax law provided that, as a general rule, an individual can sell a capital asset at cost basis without further tax consequences. However, if the buyer is a

⁹⁰⁸ The Advocate General referred to Case 229/83 (*SARL*).

⁹⁰⁹ Paragraph 9 of the Opinion.

⁹¹⁰ Paragraph 13 of the Opinion.

⁹¹¹ Paragraph 24 of the Judgment.

⁹¹² Paragraph 25 of the Judgment.

⁹¹³ Council Directive 73/148 of 21 May 1973 on the abolition of restrictions on movement and residence within the Community for nationals of the Member States with regard to establishment and the provision of services.

⁹¹⁴ Paragraphs 27 and 28.

⁹¹⁵ Paragraph 7.

⁹¹⁶ Case C-436/00 (*X and Y*).

foreign company, the same rule is not applicable.⁹¹⁷ Effective January 1, 1999, the principle that the sale of shares to a foreign company had to be made at market value, or else the sale would be deemed to have taken place at market value, was introduced.⁹¹⁸ Effective January 1, 2000, also sales to Swedish companies held through a foreign company came under the market value rule.⁹¹⁹ The reason, why the different rules were introduced for sales of assets to foreign companies, was that otherwise the taxpayers could avoid taxation. Namely, the concern has been that a taxpayer would first sell the shares at cost basis to a foreign company under his control. This sale would later be followed by the individual emigrating, presumably to a country with no or low capital gains tax so that a subsequent sale of the shares is not taxed. As a consequence, the taxpayer may escape tax altogether.⁹²⁰

The taxpayers X and Y raised the question whether the difference in the tax implications depending on whether the shares were transferred to a Swedish company without foreign owners or to a Swedish company with foreign owners is compatible with the provisions of the EC Treaty. X and Y argued that the less advantageous tax treatment of Swedish companies in which the transferor had a direct or indirect holding through a foreign legal person constituted an obstacle to the free movement of capital (Article 56 of the EC Treaty) and to the freedom of establishment (Article 43 of the EC Treaty). The Advocate General argued that the Swedish tax provision is an infringement of Article 43 of the EC Treaty and it cannot be justified on the ground of general interest. Although he acknowledged in principle that the combat of tax evasion and effective fiscal supervision are requirements which could justify restrictions on freedom of establishment,⁹²¹ he could not find the provisions proportionate as all transactions with a foreign connection are set at a disadvantage regardless of whether there is a tax avoidance motive present.⁹²² The Advocate General argued that as the purpose of the tax provision was to prevent that an individual could emigrate and then realise the capital gain tax free, such a problem would only arise if the transferor leaves Sweden. He concluded that to be consistent with the principle of proportionality a measure should apply only to individuals who actually leave the national territory.⁹²³ The ECJ held in its judgment⁹²⁴ the following:

‘1. Articles 43 EC and 48 EC preclude a national provision such as that at issue in the main proceedings, which excludes the transferor at undervalue of shares in companies from the benefit of deferral of tax due on capital gains made on those shares where the transfer is to a foreign legal person in which the transferor directly or indirectly has a holding - provided that that holding gives him definite influence over the decisions of that foreign legal person and allows him to determine its activities - or to a Swedish limited company which is a branch of such a foreign legal person.

2. Articles 56 EC and 58 EC preclude a national provision such as that at issue in the main proceedings, which excludes the transferor at undervalue of shares in companies from the benefit of deferral of tax due on capital gains made on those shares where the transfer is to a foreign legal person in which the transferor directly or indirectly has a holding which is not such as to give him definite

⁹¹⁷ See Wiman (2003), pp. 193-194.

⁹¹⁸ See Wiman (2003), p. 195.

⁹¹⁹ Ibid.

⁹²⁰ See Wiman (2003), p. 194.

⁹²¹ See paragraph 48.

⁹²² See paragraphs 54-56.

⁹²³ See paragraph 59.

⁹²⁴ See an operative part of the judgment.

influence over the decisions of that foreign legal person or allow him to determine its activities.'

Lasteyrie

The case⁹²⁵ concerns the French exit tax on substantial shareholdings. The national provisions at issue are the following.⁹²⁶ The exit tax is triggered by the transfer of residence by taxpayers who have been French residents for at least six years in the last ten years. The taxpayer must have held for the last five years, together with his family group, at least 25% of the capital of a French company liable to corporate income tax. The taxpayer who meets those conditions must within the 30 days preceding departure report the capital gain calculated as the difference between the market value of the shares at the date of departure and their acquisition cost. The exit tax is waived if the taxpayer keeps the shares for five years after departure or if he becomes a French resident again within five years while still holding the shares. The deferred payment is provided for the taxpayer if he posts sufficient guarantees.⁹²⁷ Although the French system is designed so that normally the tax should take the form of a preserving assessment with deferred payment, the posting of required guarantees can entail a cost which can, in some cases, discourage a taxpayer from transferring residence.⁹²⁸ Mr de Lasteyrie du Saillant filed an action asking for the nullification of the French exit tax on substantial shareholdings described above. On 14 December 2001, the *Conseil d'Etat* referred the case to the ECJ for a preliminary ruling. The following question was referred: does Article 43 of the EC Treaty preclude the creation by a Member State, in order to prevent tax avoidance, of a mechanism such as the French exit tax? On March 13, 2003, the Advocate General Mischo gave his opinion. He argued that there is no need for reporting requirements and a guarantee to ensure the efficiency of taxation within the EU as the Mutual Assistance Directive ensures that each country can enforce its taxation rights within the EU. The French exit tax cannot be justified by overriding requirements in the general interest. The moving of a taxpayer to another country does not constitute tax avoidance or tax abuse as such, therefore the French rules extend too far and are disproportionate to the objective. The rules cannot be justified under the principle of fiscal coherence, because the fact that a taxpayer moves to another country does not mean that France is not in a position to apply a coherent tax system. The Advocate General Mischo argues that the French system is not coherent in itself as France does not intend to levy the tax in all cases, e.g. an exception applies if the taxpayer remains abroad at least five years, or returns to France within five years. The Advocate General stressed that the principle that countries are free to define the criteria for allocation of taxation rights is acknowledged, but the rules for allocation established by the countries concerned have to be in line with the EC Treaty. The ECJ followed the conclusion of the Advocate General Mischo and held in its judgment that the French exit tax is in conflict with Article 43 of the EC Treaty.

4.2.3 *Justifications for national tax measures that violate Community law*

The national laws must yield to Community law and discriminatory tax measures as well as national provisions that restrict free movement within the Internal Market are prohibited. The ECJ has held that a discriminatory measure is compatible with Community law only if it is justified by acceptable reasons. A measure restricting free movement may be justified on the basis of two different categories of grounds, firstly, if it falls within the scope of one of the

⁹²⁵ Case C-9/02.

⁹²⁶ The description is based on Martin (2003), pp. 121-123.

⁹²⁷ See Martin (2003), p. 122 for the description of those guarantees.

⁹²⁸ See Martin (2003), p. 129.

derogations expressly provided by the Treaty⁹²⁹, or secondly, if it can be justified on other grounds which are not provided for by the EC Treaty but which have been recognised by the ECJ and accepted by it as overriding requirements in the general interest. A restriction on the fundamental freedoms can only be justified if (1) it pursues a legitimate aim compatible with EC Treaty; (2) is justified by pressing reasons of public interest; (3) is of such a nature as to ensure achievement of the aim in question; and (4) is proportional.^{930 931} The ECJ applies a proportionality test to check whether the restriction on Treaty freedom is proportionate to the overriding reason justifying this restriction.⁹³² This test is very strict, since the ECJ carefully

⁹²⁹ See Case 352/85 (*Bond van Adverteerders*), paragraph 32, in which the Court stated that discriminatory national rules '... are compatible with Community law only if they can be brought within the scope of an express derogation'. The Treaty allows impediments to the four fundamental economic freedoms through discriminatory provisions on the basis of nationality if they are justified on grounds of public policy, public security or public health. For example, Article 39(3) of the EC Treaty stipulates that freedom of movement of workers is subject to limitations justified on grounds of public policy, public security or public health. In addition, if a taxpayer faces the discriminatory measure in connection with the right of establishment or free movement of services, Articles 45 and 46 EC, which are applicable pursuant to Article 55 EC, provide possibility for derogation. Article 46 mentions public policy, public security and public health as reasons that can justify limitations to the freedom of establishment. These justifications are not most relevant in tax cases and are not usually brought up in direct tax cases. (See Martin (2003), pp. 129-130). Moreover, if a taxpayer faces the discriminatory measure in connection with the exercise of the free movement of capital, Article 58(1)(a) provides that free movement of capital does not preclude a Member State from treating taxpayers differently on the basis of their residence or the place where they invest their capital. However, the ECJ has stressed in *Verkooijen* that as provided in Article 58(3) of the Treaty such different treatment cannot constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments and that any justification for such a different treatment should be proportionate to the goal to be achieved. In addition, Article 58(1)(a) provides that the free movement of capital does not limit the right of the Member States to take all necessary measures to avoid tax fraud. This provision is also subject to the condition that such measures may not lead to arbitrary discrimination or a disguised restriction on the free movement of capital and payments.

⁹³⁰ See Case C-250/95 (*Futura*), paragraph 26; Case C-35/98 (*Verkooijen*), paragraph 43; Case C-324/00 (*Lankhorst-Hohorst*), paragraph 33.

⁹³¹ In Case C-19/92 (*Kraus*), paragraph 32, the ECJ stated that those justifications on the grounds of general interest have to meet the following conditions: they must be applied in a non-discriminatory manner; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it. However, as Advocate General Jacobs draws attention in its Opinion in Case C-136/00 (*Danner*), although the ECJ has never formally abandoned the principle that national rules which discriminate as regards the origin of the service in question are compatible with Community law only if they can be brought within the scope of an express exemption, and continues to refer to it in leading judgments (e.g. Case C-124/97 (*Läärä and Oy Transatlantic Software*), paragraph 31 of the judgment) and from time to time applies it (e.g. in Case C-311/97 (*Royal Bank of Scotland*), paragraph 32 of the judgment), in most of the recent cases, however, involving national rules which might have been regarded as (directly) discriminatory, the Court has avoided assessing whether the rules in issue were discriminatory, and has examined grounds of justification not expressly mentioned in the Treaty. For that purpose the Court has either classified the rule in issue merely as an obstacle to freedom to provide services (e.g. Case C-118/96 (*SAFIR*), paragraphs 25 to 30 of the judgment) or referred to a 'difference in treatment' which might be justified on grounds not mentioned in the Treaty (e.g. Case C-294/97 (*Eurowings*), paragraph 36). The Advocate General argues that in view of the fundamental importance of the question whether (overtly) discriminatory measures such as those at issue in the main proceedings can be justified on grounds not expressly mentioned in the Treaty, the Court should clarify its position in order to provide the necessary legal certainty. See paragraph 35 – 37 of the Opinion. The ECJ in its judgment, however, did not address the issue.

⁹³² Martin (2003), p. 131.

examines whether less restrictive measure could have been devised to achieve the legitimate public aims admitted as justification.⁹³³

4.2.3.1 *Necessity to preserve the coherence of the tax system*

In the cases *Commission v Belgium*⁹³⁴ and *Bachmann v Belgium*⁹³⁵, the ECJ ruled that if a tax is necessary for protecting the integrity of a Member State's national tax system, it may be maintained, in spite of its effects. Both cases concerned the compatibility with Community law of the Belgian tax law provisions pursuant to which the deductibility for income tax purposes of certain insurance contributions is conditional on those contributions being paid in Belgium, either to a Belgian undertaking or to the Belgian establishment of a foreign undertaking. As a general rule, differential tax treatment of service providers of other Member States in comparable situations as residents is not allowed. The ECJ recognised that the Belgian tax provisions in question are running against the rules of the EC Treaty (Articles 39 (free movement of workers) and Article 49 (freedom to provide services)). However, the ECJ ruled in judgments of *Bachmann* and *Commission v Belgium* that the discriminatory tax measures were justified by the need to preserve the coherence of the Belgian tax system, a justification not expressly mentioned in the EC Treaty. This ruling is a potential escape route for some national tax rules which otherwise are in breach of EU rules.

The ECJ agrees in *Bachmann* that the Belgian measure constituted a restriction to the free movement, but states that a requirement that premiums are deductible only if paid to companies established in Belgium is compatible with Article 59 (now Article 49) if indispensable to achieve a public-interest objective such as coherence of the tax system. The ECJ recognises that under Belgian tax law, there is a direct connection between the deductibility of premiums and the taxation of subsequent income: if premiums are not deducted then future income is not taxed. In such a tax system the loss of revenue resulting from the deduction of life assurance contributions from total taxable income - which includes pensions and insurance payable in the event of death - is offset by the taxation of pensions, annuities or capital sums payable by the insurers. Where such contributions have not been deducted, those sums are exempt from tax. Therefore, coherence of Belgian tax system presupposes that, if insurance premiums are deductible, Belgium should be able to tax the income paid out by the insurance undertakings.⁹³⁶ With respect to proportionality of such a tax measure, the ECJ concludes that coherence of the tax system cannot be ensured by means of measures that are less restrictive; and that any other measure to guarantee the recovery of tax on subsequent income would have the same consequences as those resulting from the non-deductibility of the premiums.⁹³⁷

The ECJ has been criticized of accepting the cohesion defence in *Bachmann* for several grounds.⁹³⁸ It has been argued that the decision by the ECJ in *Bachmann* potentially undermines a well-established understanding of what national measures are prohibited by the Treaty and what possible justifications the ECJ might accept. Furthermore, it has been argued that the tax measure at issue is disproportionate in relation to the aim of safeguarding fiscal coherence between deduction and later taxation; and that there are probably less restrictive means by which the taxation of such payments could be secured, such as by imposing obligations on insurers who wish to have their policies qualify for deduction. Terra and Wattel (2001) predict that if a *Bachmann*-like case were to be referred to the ECJ again, de-

⁹³³ Ibid.

⁹³⁴ Case C-300/90.

⁹³⁵ Case C-204/90.

⁹³⁶ See judgment of the ECJ in Case C-204/90 (*Bachmann*), paragraphs 21-23.

⁹³⁷ Ibid, paragraph 27.

⁹³⁸ See Knobbe-Keuk (1994), Farmer (1995/1996), Wattel (1996), Vanistendael (1996), and Van Thiel (2001a), pp. 240 and 246-254.

nial of deduction would no longer be accepted, as the aim of safeguarding coherence can also be achieved by less restrictive but just as effective measures.⁹³⁹ However, in its judgment in *Danner*⁹⁴⁰ the ECJ referred to the coherence defence of the *Bachmann* case as possibly acceptable justification for restrictive measures if a direct connection exists between the deductibility of contributions and later taxation.⁹⁴¹

The ECJ's decision in *Bachmann* was also criticized for not taking account of the effect on cohesion of double tax treaties. Under such treaties, income may not be taxable in Belgium, even though premiums were deductible, because according to the OECD Model Tax Convention, tax jurisdiction is allocated exclusively to the Member State of domicile, irrespective of where the premiums had been deducted. The Member State concerned had itself given up the need to maintain coherence at the individual level by agreeing to an overall (or macro-level) coherence at tax treaty level.⁹⁴² The ECJ corrected its position in *Wielockx* (see below).

The scope of coherence justification was limited by the ECJ in later cases (*Wielockx*⁹⁴³, *Svensson*⁹⁴⁴, *ICI*⁹⁴⁵, *Eurowings*⁹⁴⁶, *Verkooijen*⁹⁴⁷, *Baars*⁹⁴⁸, *Metallgesellschaft*⁹⁴⁹, *Danner*⁹⁵⁰ and *Lankhorst-Hohorst*⁹⁵¹). In its case law the ECJ has stressed that Member States may rely on the need to preserve fiscal coherence only if there is a direct link between any fiscal advantage and a corresponding disadvantage. In addition, the ECJ has stipulated that cohesion argument must be viewed in the light of European regulations, bilateral tax treaties and the possibilities of mutual assistance in tax matters.

According to the *Wielockx*⁹⁵² judgement, Member States cannot rely on the 'cohesion' argument of *Bachmann* case if the cross-border tax aspect is covered by a tax treaty in a manner which implies that the Member State involved has waived its national cohesion in relation to its treaty partner in order to reach bilateral cohesion. *Wielockx* was a case in some aspects similar to *Bachmann*. In the Netherlands only resident taxpayers could deduct payments to a pension reserve. Payments made on the liquidation of the reserve, or made periodically from it, were treated as income and subject to tax. The Netherlands relied on the Netherlands-Belgium tax treaty, under which such income was taxable only in the State of residence, to claim that the fiscal cohesion of its system would be jeopardised if non-residents could deduct payments into the reserve from their Netherlands tax liability. The ECJ stated in its judgment in the *Wielockx* case that the fiscal cohesion discussed in *Bachmann* required 'a correlation between the sums which are deducted from the taxable income and the sums

⁹³⁹ See Terra and Wattel (2001), p. 68.

⁹⁴⁰ Case C-136/00.

⁹⁴¹ See paragraph 36 of judgment, where the ECJ stressed that under the Belgian tax system, the loss of revenue resulting from the deduction of insurance contributions was offset by the taxation of pensions, annuities or capital sums payable by insurers. By contrast, where such contributions had not been deducted, those sums were exempted from tax. This was not the case in *Danner* because pensions payable by foreign institutions to Finnish residents were taxable even if the contributions were not deducted. See previous section and below for more elaborate discussion of the *Danner* case.

⁹⁴² See Van Thiel (2001a), pp. 250-251.

⁹⁴³ Case C-80/94.

⁹⁴⁴ Case C-484/93.

⁹⁴⁵ Case C-264/96.

⁹⁴⁶ Case C-294/97.

⁹⁴⁷ Case C-35/98.

⁹⁴⁸ Case C-251/98.

⁹⁴⁹ Joined cases C-397/98 and C-410/98.

⁹⁵⁰ Case C-136/00.

⁹⁵¹ Case C-324/00.

⁹⁵² Case C-80/94.

which are subject to tax'.⁹⁵³ In addition, the ECJ stated that the effect of tax treaties following the OECD model was that the State taxed all pensions received by residents in its territory, but, conversely, waived the right to tax pensions received abroad even if they derived from contributions paid in its territory which it treated as deductible. Fiscal cohesion had not therefore been established in relation to one and the same person by a strict correlation between the deductibility of contributions and the taxation of pensions but is shifted to another level, that of the reciprocity of the rules applicable in the Contracting States.⁹⁵⁴ The ECJ held that since fiscal cohesion was secured by a bilateral convention concluded with another Member State, the cohesion defence might not be invoked to justify the refusal of a deduction such as that in issue in *Wielockx*.⁹⁵⁵

In *Svensson*⁹⁵⁶, the ECJ showed that a macro-economic link between tax expenditure and tax revenue was insufficient to justify discriminatory tax measure. Luxembourg granted subsidy to its residents for mortgage interest payments, provided that mortgaged loan was taken out with a Luxemburg bank. Luxembourg justified the denial of subsidy to non-residents with the fact that the subsidy was paid out of Luxemburg tax revenue. The ECJ dismissed this argument as there was no direct link between the subsidy and its financing.⁹⁵⁷

In *ICI*, the ECJ rejected the United Kingdom's submission that fiscal cohesion required that a consortium relief, whereby the members of a consortium could transfer losses incurred by subsidiaries established in England of a holding company owned by them for relief against their own profits, be limited to cases where the majority of the subsidiaries in question were United Kingdom residents. The ECJ argued that in *ICI*, there was no direct link between the consortium relief granted for losses incurred by a resident subsidiary and the taxation of profits made by non-resident subsidiaries.⁹⁵⁸

In *Eurowings*, the ECJ held that the different treatment of residents and non-residents could not be justified on grounds linked to the need for coherency of taxation. German Government explained that German trade tax rules were designed to avoid only double payment of German tax, i.e. not the duplication of German tax and that of another Member State. The Court held there was merely an 'indirect link' between a fiscal advantage accorded to a German lessee of a German-established lessor and the unfavourable tax treatment of such lessors in the form of their liability to pay tax on their rental income.⁹⁵⁹

From *Verkooijen* and *Baars* it can be concluded that the link between tax deferral and later taxation must be present within the same tax and with the same taxpayer, or within the same contract. According to the ECJ, the connection between corporation tax on a company's profits and individual income tax on dividends paid out of those profits does not justify differential treatment of foreign dividends as it concerns two different taxes, levied from two different persons.⁹⁶⁰

Verkooijen concerned a partial exemption from personal income tax, conferred in respect of share dividends, provided that the companies paying the dividends were established in the Netherlands. The Dutch government pointed at the coherence between corporate tax on the profits of a company and the exemption from individual income tax on dividends paid out from those profits. The exemption of dividends served to mitigate the effects of double taxation - in economic terms - resulting from the levying on the company of corporation tax in respect of its profits and the taxation of the same profits distributed in the form of dividends

⁹⁵³ Case C-80/94, paragraph 23.

⁹⁵⁴ Ibid, paragraph 24.

⁹⁵⁵ Ibid, paragraph 25.

⁹⁵⁶ Case C-484/93.

⁹⁵⁷ See Terra and Wattel (2001), p. 71.

⁹⁵⁸ Case C-264/96, paragraph 29.

⁹⁵⁹ Case C-294/97, paragraph 42.

⁹⁶⁰ See Terra and Wattel (2001), pp. 71-76

borne by natural persons who are shareholders, by way of income tax. Fiscal coherence could not be achieved if the Netherlands were required to prevent economic double taxation through exemption of dividends paid out of company profits which had not been taxed in the Netherlands but elsewhere.⁹⁶¹ However, the ECJ was not convinced. It noted that in *Bachmann* and *Commission v Belgium*, a direct link existed, in the case of one and the same taxpayer, between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy, both of which related to the same tax. In those cases, there was a link between the deductibility of contributions and the taxation of sums payable by insurers under old-age insurance and life assurance policies, which it was necessary to safeguard the cohesion of the tax system at issue. The ECJ stated that no such direct link existed in *Verkooijen* between the grant to shareholders residing in the Netherlands of income tax exemption in respect of dividends received and taxation of the profits of companies with their seat in another Member State and that they were two separate taxes levied on different taxpayers.⁹⁶²

Baars also concerned a Dutch tax measure, in this case wealth tax. Dutch tax law made the exemption from Dutch wealth tax subject to the condition that the holding be held in a company established in the Netherlands, denying it to the holders of shares in companies established in other Member States. The Netherlands Government argued that the restriction of the undertaking exemption to shares held in companies having their seat in the Netherlands was justified by the need to maintain cohesion in the Netherlands tax system.⁹⁶³ However, the ECJ was not convinced. It argued that *Baars* concerned two separate taxes (a net wealth tax and a corporation tax on profits) levied on different taxpayers (an individual shareholder receiving the dividends and a company paying the dividends) and there was no required 'direct link' between tax advantage (an exemption from net wealth tax on an individual shareholder) and the taxation of the income (corporate tax on company profits). The Court, held that it was therefore irrelevant that companies established in the Netherlands are subject to corporation tax in the Netherlands and that companies established in another Member State are not.

⁹⁶¹ Weber (1999) observes that Member States who justified the discriminatory provision by arguing that the dividend exemption counters double taxation have based their argumentation on a wrong interpretation of the (then) applicable Dutch rules. Double taxation arises in the case of classical system under which corporate income tax is levied on the profits of a company and subsequently income tax is levied with respect to the distributed dividends. However, when a Dutch company distributed dividend the Netherlands was not in effect levying any tax under the application of the dividend exemption. On the one hand the dividends were exempt from Dutch income tax, while on the other hand the levied dividend withholding tax could be credited against the income tax due (or else the dividend withholding tax would have been refunded). Thus, the Dutch dividend exemption resulted in a complete exemption of dividends: no dividend withholding tax (creditable or refundable) and no Dutch income tax was levied. Weber (1999) notes that it is exactly the same where the dividend exemption would be applicable to dividends on foreign shares, as neither Dutch dividend withholding tax nor income tax with respect to foreign dividends would be levied. Thus, discriminatory tax treatment could not be justified on the grounds that the cohesion of the Dutch tax system would have been at risk when the scope of the dividend exemption was extended to dividends received on foreign shares.

⁹⁶² See paragraphs 49-58.

⁹⁶³ The Netherlands Government contended that the exemption was designed to mitigate the effects of economic double taxation arising from a company's profits being charged to corporation tax and the assets invested by the shareholder in that company being charged to wealth tax. It explained that only assets invested in shares in a company established in the Netherlands were wholly or partially exempt from wealth tax, since only profits which such a company had made in the Netherlands were subject to corporation tax there. Assets invested in shares in a company having its seat in another Member State ought not to benefit from the exemption from wealth tax because profits made by that company were not subject to corporation tax in the Netherlands, so that there was no double taxation to offset. See paragraphs 33-35 of the judgment in *Baars*.

Terra and Wattel (2001)⁹⁶⁴ observe that from *Verkooijen* and *Baars* it can be concluded that Member States cannot argue that fiscal cohesion justifies them refusing imputation credit for foreign dividends on the grounds that foreign dividends are paid out of profits which have not borne domestic corporation tax. Member States must recognize foreign corporation tax as just as creditable as domestic corporation tax on the profits out of which the dividends were paid and must recognize foreign dividends as equivalent to domestic dividends.

Advocate General Fennelly notes in its opinion in *Metallgesellschaft* that for the coherence defence to succeed ‘... there must be a direct and, from the point of view of the application of the particular tax in question, fundamental organic link between the application of that tax and the exemption or relief therefrom, which, though made available to the resident taxpayer, is denied to his non-resident counterpart.’⁹⁶⁵ He argued that such a strict correlation was lacking in the *Metallgesellschaft* case. The case concerned the UK group income election scheme. The United Kingdom Government argued that the refusal to grant resident subsidiaries of non-resident parent companies the right to make a group income election was justified by the need to preserve the cohesion of the United Kingdom's tax system. The Government contended that the principle on which the United Kingdom's tax system was based was that companies should be liable to tax in respect of their profits and that their members should at the same time be liable to tax in respect of their share of those profits which the companies, in certain cases, pay out in the form of dividends. In order to mitigate that double taxation in economic terms, corporate shareholders resident in the United Kingdom were exempt from corporation tax on the dividends which they receive from their resident subsidiaries, as that exemption was offset by the advance corporate tax charge on the payment of dividends by subsidiaries to their parent companies.⁹⁶⁶ The ECJ, however, was not convinced and ruled that there is no direct link in the *Metallgesellschaft* case between, on the one hand, the refusal to exempt subsidiaries in the United Kingdom of non-resident parent companies from payment of the advance corporate tax under a group income election and, on the other, the fact that parent companies having their seat in another Member State and receiving dividends from their subsidiaries in the United Kingdom are not liable to corporation tax in the United Kingdom.⁹⁶⁷

Advocate General Fennelly notes in its opinion in *Metallgesellschaft* that it is clear that a mere diminution in the tax revenues of the host Member State cannot justify a refusal to extend a particular benefit to non-resident companies. He adds that Member State must take account of the liability of such non-residents to pay comparable taxes in their Member State of residence. He argues, ‘... it would seem that the true scope for fiscal cohesion as a justification for the differential treatment of non-residents would concern only situations in which there is a real and substantial risk that extending equal treatment in respect of a particular benefit would potentially facilitate tax evasion in both the host Member State and the Member State of residence of the claimant non-resident taxpayer.’⁹⁶⁸

In the *Danner* case⁹⁶⁹, the Finnish and Danish Governments submitted that the Finnish tax rules which preclude or restrict the deductibility of voluntary pension insurance contributions paid to foreign pension insurance institutions could be justified by the need to preserve the coherence of the Finnish tax system.^{970 971} The Advocate General argued that the Finnish tax

⁹⁶⁴ Paragraph 73.

⁹⁶⁵ Paragraph 33.

⁹⁶⁶ Paragraphs 61-63.

⁹⁶⁷ Paragraph 69.

⁹⁶⁸ Paragraph 32.

⁹⁶⁹ Case C-136/00.

⁹⁷⁰ See Opinion of Advocate General Jacobs, Case C-136/00 (*Danner*), paragraphs 43 – 44.

rules in the *Danner* case could not be justified on the same grounds as in the *Bachmann* case since there was no direct link between deductibility of contributions and the taxation of pensions, and that the rules in issue in any event infringed the principle of proportionality. The Advocate General noted that under the Finnish tax system the pensions payable by foreign insurance undertakings to residents in Finland would be taxed, independently of whether the contributions paid to those undertakings were deductible. If Mr Danner stays in Finland, the pensions which he will receive from the two German schemes will be subject to Finnish income tax despite the fact that he is not allowed to deduct the contributions paid to those schemes. The Advocate General also noted, referring to the *Wielockx* case, that fiscal coherence was secured by a bilateral convention concluded with Germany.⁹⁷²

The ECJ followed the Opinion of the Advocate General and stipulated that Finnish tax rules could not be justified on the same grounds as in the *Bachmann* case since there is no direct connection between the deductibility of insurance contributions and the taxation of sums payable by insurers.⁹⁷³ The ECJ noted that under the Finnish tax system, pensions payable by foreign institutions to Finnish residents were taxed, irrespective of whether the insurance contributions paid to build up such pensions were or were not deducted from the taxable income of their recipients. The ECJ stressed that if Mr Danner continued to live in Finland, the pensions which he would receive from the German insurers would be subject to income tax in Finland, despite the fact that he has not been entitled to deduct the contributions paid to those schemes.⁹⁷⁴

The justification based on the need to preserve the cohesion of a Member State's tax system has been argued before the ECJ on a number of occasions but accepted only in *Commission v Belgium*⁹⁷⁵ and *Bachmann v Belgium*⁹⁷⁶. In its subsequent case law the ECJ has not allowed Member States to rely on the fiscal coherence defence.⁹⁷⁷

4.2.3.2 Lack of harmonization of income tax legislation

In *Avoir Fiscal*, the ECJ held that the absence of harmonization does not release Member States from their obligation to apply their national tax legislation in a non-discriminatory way. The French Government argued that since the legislation at issue has not been harmonized, different treatment of residents of various Member States is necessary in order to take account of the differences between the tax systems and tax treaties. The ECJ responded that the fact that the laws of the Member States on corporation tax have not been harmonized cannot justify the difference of treatment. The ECJ added that although it is true that in the

⁹⁷¹ Mr Danner, a doctor of German and Finnish nationality, worked in Germany until 1977 when he moved to Finland. He was refused a full deduction for pension insurance contributions paid by him to pension insurance schemes operated by German insurance institutions. Referring Court asked whether Finnish tax provisions that restricted or precluded the deductibility for income tax purposes of voluntary pension contributions paid to pension providers in other Member States, whilst allowing the deductibility of contributions to equivalent voluntary pension schemes operated by pension providers in Finland, were contrary to EC Treaty. The case is also discussed in the previous section.

⁹⁷² The Advocate General stresses that in view of the fundamental importance of the question whether (overtly) discriminatory measures such as those at issue in the *Danner* case can be justified on grounds not expressly mentioned in the Treaty, such as necessity to preserve fiscal coherence, the Court should clarify its position in order to provide the necessary legal certainty. According to the opinion of the Advocate General, analysis whether a restrictive tax measure can be justified should be based on whether the restriction can be justified under the principle of proportionality. See Opinion of Advocate General Jacobs, Case C-136/00 (*Danner*), paragraphs 37 - 40.

⁹⁷³ Paragraph 37.

⁹⁷⁴ Paragraph 38.

⁹⁷⁵ Case C-300/90.

⁹⁷⁶ Case C-204/90.

⁹⁷⁷ See Eicker (2002), pp. 332-333.

absence of such harmonization, a company's tax position depends on the national law applied to it, Article 52 (now Article 43) of the Treaty prohibits Member States from laying down in their laws conditions for the pursuit of activities by persons exercising their right of establishment which differ from those laid down for its own nationals.

In its *Daily Mail* decision, the ECJ in its decision⁹⁷⁸ also was based on a lack of harmonization. The ECJ noted that Article 293 of the Treaty provided for the conclusion, so far as is necessary, of agreements between Member States with a view to securing inter alia the retention of legal personality in the event of transfer of the registered office of companies from one country to another. No convention in this area has yet come into force.⁹⁷⁹ Thus, the ECJ allowed derogation from directly applicable Community law on the free movement, on the basis of a lack of harmonization.

4.2.3.3 *Necessity to prevent a reduction of tax revenue*

In *Saint Gobain*⁹⁸⁰, the German Government argued that the refusal to allow non-resident companies having a permanent establishment in Germany certain tax concessions granted to resident companies was justified by the need to prevent a reduction in tax revenue given the impossibility for the German tax authorities to compensate for the reduction in revenue brought about by the grant of the tax concessions in question by taxing dividends distributed by non-resident companies. The ECJ, however, stated in response to that argument that a reduction of revenue was not one of the grounds listed in Article 56 of the EC Treaty (now Article 46 EC) and could not be regarded as a matter of overriding general interest which might be relied upon in order to justify unequal treatment that is in principle incompatible with Article 52 (now 43) of the Treaty.⁹⁸¹

In *ICI*,⁹⁸² the Government of the United Kingdom argued that the pre-condition for tax relief - that most of the subsidiaries controlled by the holding company must be resident in the UK - was justified by the objective to prevent a reduction in revenue, since the Inland Revenue could not tax profits made by subsidiaries located outside the United Kingdom in order to offset the revenue lost through the granting of relief on losses incurred by resident subsidiaries.⁹⁸³ The ECJ did not accept this justification.⁹⁸⁴

In *Verkooijen*,⁹⁸⁵ the Netherlands Government argued that the tax levied on company profits by the tax authorities of a State other than the Netherlands cannot be offset by granting an exemption in respect of dividends to persons residing in the Netherlands who are shareholders of such companies since that would automatically entail a loss of revenue for the Netherlands tax authorities in that they would not receive any tax on the profits of the companies distributing dividends.⁹⁸⁶ However, the ECJ held that reduction in such tax revenue cannot be regarded as an overriding reason in the public interest which may be relied on to justify a measure which is in principle contrary to a fundamental freedom.⁹⁸⁷

In *Metallgesellschaft*,⁹⁸⁸ the Court held again that as regards the loss of revenue for the United Kingdom tax authorities which would have resulted from affording resident subsidiaries of non-resident parent companies the possibility of making a group income election and

⁹⁷⁸ Case 81/87 (*Daily Mail*).

⁹⁷⁹ Ibid, paragraph 21.

⁹⁸⁰ Case C-307/97.

⁹⁸¹ See Case C-307/97 (*Saint Gobain*), paragraphs 49 and 50.

⁹⁸² Case C-264/96.

⁹⁸³ See paragraph 25.

⁹⁸⁴ See paragraph 28.

⁹⁸⁵ Case C-35/98.

⁹⁸⁶ Paragraph 52.

⁹⁸⁷ Paragraph 59.

⁹⁸⁸ Joined cases C-397/98 and C-410/98 (*Metallgesellschaft*).

to be exempted from paying advance corporation tax, diminution of tax revenue could not be regarded as a matter of overriding general interest which may be relied upon in order to justify a measure which is contrary to a fundamental freedom.⁹⁸⁹

4.2.3.4 Result in abuse of the situation, tax evasion and tax avoidance

Although prevention of abuse has been accepted as a justification for national legislation that violates Community law in several non-tax cases⁹⁹⁰ and has also been recognized *in abstracto* in tax cases, it has not actually been able to save restrictive national tax measures brought before the ECJ.⁹⁹¹

In *Daily Mail*, the Advocate General argued in his Opinion, that EU law cannot be relied on if "objective factors" show that a particular activity was carried out "in order to circumvent" national legislation⁹⁹². Although the ECJ did not base its refusal of a tax-free emigration on the argument that it was necessary to tackle tax avoidance but on the argument that the Treaty did not confer the company of a Member State a right to transfer its central management and control and their central administration to another Member State⁹⁹³, tax avoidance was mentioned in the ruling as a principal reason of the emigration⁹⁹⁴.

In *ICI*⁹⁹⁵, the United Kingdom argued that the restrictive tax provision was designed to reduce the risk of tax avoidance and abuse.⁹⁹⁶ The ECJ, however, did not accept this reasoning and held that the tax legislation at issue did not have the only purpose of preventing wholly artificial arrangements, but applied generally to all situations in which the group companies were established outside the United Kingdom. The ECJ, furthermore, stated that the fact that a company is having its seat in another Member State does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the other Member State.⁹⁹⁷

It may be inferred from the *ICI* decision that the ECJ may in principle accept restrictive anti-abuse measures but only if the tax measure at issue has the specific purpose of preventing wholly artificial arrangements.⁹⁹⁸

In *Metallgesellschaft*,⁹⁹⁹ the Court held as it did in *ICI*, that the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment.¹⁰⁰⁰

In *Lankhorst-Hohorst*¹⁰⁰¹, the ECJ confirmed its judicature in the *ICI* decision,¹⁰⁰² according to which a provision that does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent a Member State's tax legislation but applies generally to

⁹⁸⁹ Paragraph 59.

⁹⁹⁰ See Case C-110/99 (*Emsland-Stärke*). The ECJ held that a finding of an abuse requires a combination of objective circumstances in which, despite formal observance of the conditions laid down by the Community rules, the purpose of those rules has not been achieved. The ECJ, furthermore, stated that a finding that there is an abuse presupposes a subjective element consisting in the intention to benefit from an advantage as a result of the application of the Community rules by artificially creating the conditions for obtaining it. (Paragraphs 52-53 of the judgment).

⁹⁹¹ See Terra and Wattel (2001), pp. 77-84.

⁹⁹² The Advocate General referred to the ECJ's judgment in Case 229/83 (*SARL*).

⁹⁹³ See paragraph 24 of the Judgment.

⁹⁹⁴ See paragraph 7 of the Judgment.

⁹⁹⁵ Case C-264/96.

⁹⁹⁶ See paragraph 25.

⁹⁹⁷ See paragraph 26.

⁹⁹⁸ See Terra and Wattel (2001), p. 83.

⁹⁹⁹ Joined cases C-397/98 and C-410/98 (*Metallgesellschaft*).

¹⁰⁰⁰ Paragraph 57.

¹⁰⁰¹ Case C-324/00 (*Lankhorst-Hohorst*).

¹⁰⁰² Case C-264/96 (*ICI*), paragraph 26.

certain situations cannot be justified as a rule preventing tax avoidance. German thin capitalization provision at issue in *Lankhorst-Hohorst* did not have the only purpose of preventing purely artificial constructions which aimed at escaping German corporation tax but rather applied in general to any situation in which the parent was having its seat abroad. The ECJ argued that such a situation does not, of itself, entail a risk of tax evasion, since such a company will in any event be subject to the tax legislation of the State in which it is established.¹⁰⁰³ The ECJ concluded in *Lankhorst-Hohorst* that the risk of tax evasion offers no excuse for a tax measure which would, therefore, also apply to a situation which, of itself, does not entail a risk of tax evasion.¹⁰⁰⁴ The provision's scope was too wide to justify the restriction on freedom of establishment.¹⁰⁰⁵

In *X and Y*¹⁰⁰⁶, the ECJ, referring to the *Centros* case¹⁰⁰⁷, stated that the national courts may, case by case, take account – on the basis of objective evidence – of abuse or fraudulent conduct in order to deny them the benefit of the provisions of Community law, but they must nevertheless assess such conduct in the light of the objectives pursued by those provisions.¹⁰⁰⁸ The ECJ, however, held that the Swedish provision at issue, insofar as it excludes categorically and generally any share transfer from the tax benefit, does not allow the national courts to make such a case-by-case analysis.¹⁰⁰⁹ Furthermore, the ECJ, referring to the *Centros* case¹⁰¹⁰, stated that the criterion on the basis of which the Swedish provision excluded certain types of share transfers from the tax advantage – namely the fact that the transfer is to a company established in another Member State or a branch set up in Sweden by such a company – relates to the exercise of the freedom of establishment guaranteed by the Treaty and cannot, therefore, in itself, constitute an abuse of the right of establishment.¹⁰¹¹ Furthermore, in *X and Y*¹⁰¹² the ECJ held that the Swedish tax provision was not specifically designed to exclude from a tax advantage purely artificial schemes designed to circumvent tax law, but concerned, generally, any situation in which, for whatever reason, the transfer at undervalue was to a company established in another Member State. The ECJ concluded that tax evasion or fraud cannot be inferred generally from the fact that the transferee company or its parent is established in another Member State and cannot justify a fiscal measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty.¹⁰¹³

4.2.3.5 *Offsetting advantages*

In *Avoir fiscal*¹⁰¹⁴, the ECJ expressly excluded that a differential treatment could be compensated by advantages. The ECJ held that the difference in treatment could not be justified by any advantages which, according to the French Government, balanced out the disadvantages resulting from the failure to grant the benefit of imputation credits.

In *Commerzbank*, the United Kingdom Government justified the national provision at issue (the denial of repayment supplement) by offsetting advantages. The UK argued that far from

¹⁰⁰³ See Case C-324/00 (*Lankhorst-Hohorst*), paragraph 37 of the judgment.

¹⁰⁰⁴ Ibid.

¹⁰⁰⁵ See Körner (2003).

¹⁰⁰⁶ Case C-436/00.

¹⁰⁰⁷ Case C-212/97, paragraph 25.

¹⁰⁰⁸ Case C-436/00 (*X and Y*) paragraph 42.

¹⁰⁰⁹ Case C-436/00 (*X and Y*) paragraph 43.

¹⁰¹⁰ Case C-212/97, paragraph 27.

¹⁰¹¹ Case C-436/00 (*X and Y*), paragraph 43.

¹⁰¹² Case C-436/00.

¹⁰¹³ Case C-436/00 (*X and Y*), paragraphs 61-62.

¹⁰¹⁴ See paragraph 21.

suffering discrimination under the United Kingdom tax rules, non-resident companies which were in Commerzbank's situation enjoyed privileged treatment, enjoying exemptions from tax normally payable by resident companies.¹⁰¹⁵ The ECJ was not convinced. It stated that the fact that the exemption from tax which gave rise to the refund was available only to non-resident companies could not justify a rule of a general nature withholding the benefit.¹⁰¹⁶ The fact that non-resident enjoyed an advantage in one respect could not justify disadvantageous treatment in other respects such as repayment supplement entitlement.¹⁰¹⁷ In *Asscher*¹⁰¹⁸, the ECJ noted with regard to the tax rate for foreign taxpayers that a higher rate for foreigners could not be argued by an appeal to the absence of a social security contribution and the – potential – progressive advantage as a result of the method of prevention used in the Netherlands. A less favourable rate of taxation for non-residents could not be justified by pointing to the fact that social security contributions were not levied in the Netherlands, which was not necessarily the case in other Member States. The Court held that there was no direct link between the application of a higher rate to the income of certain non-residents who receive less than 90% of their worldwide income in the Netherlands and the fact that no social security contributions were levied on the income of such non-residents from sources in the Netherlands.¹⁰¹⁹

In *Saint Gobain*¹⁰²⁰, the ECJ held that the difference in tax treatment between resident companies and branches could not be justified by other advantages which branches enjoyed in comparison with resident companies and which would compensate for the disadvantages of not being allowed the tax advantages in question. The ECJ stated that even if such advantages existed, they could not justify breach of the obligation laid down in Article 52 (now 43) of the Treaty to accord the same domestic treatment concerning the tax advantages in question.

In *Verkooijen*, the Netherlands Government argued that to apply the dividend exemption to taxpayers who were shareholders in companies with their seat in other Member States would enable such taxpayers to secure a twofold advantage since they could enjoy tax reliefs both in the Member State in which the dividend was paid and in the Member State where it was received, namely the Netherlands.¹⁰²¹ The ECJ, however, held that it was clear from settled case-law that unfavourable tax treatment contrary to a fundamental freedom could not be justified by the existence of other tax advantages, even supposing that such advantages exist.¹⁰²²

In *Eurowings*, the national court wondered whether it was necessary to take into consideration the fact that the Irish lessor paid no tax comparable to the German trade tax and enjoyed low corporation tax at 10%. German tax authorities argued that that difference of treatment could be justified by the fact that the lessor established in another Member State was there subject to lower taxation. The ECJ, however, held that any tax advantage resulting for providers of services from the low taxation to which they were subject in the Member State in which they were established could not be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State.

However, in *Bachmann*, the ECJ implicitly accepted the compensation defence in the form of cohesion. In *Bachmann*, the Belgian Government submitted that, with respect to the insur-

¹⁰¹⁵ See paragraph 16.

¹⁰¹⁶ See paragraphs 17-19.

¹⁰¹⁷ See also Terra and Wattel (2001), pp. 85-86.

¹⁰¹⁸ See Case C-107/94 (*Asscher*).

¹⁰¹⁹ See paragraph 59.

¹⁰²⁰ See paragraph 53.

¹⁰²¹ Paragraph 54.

¹⁰²² Paragraph 61.

ance contracts, the non-deductibility of the premiums is compensated by the non-taxation of the subsequent income, so that the financial effect is not less favourable for non-nationals. The Commission noted, however, that only taxpayers who have retained their fiscal domicile in Belgium would be able to benefit from this. Advocate General Mischo observed that the disadvantages of non-deductibility of premiums could not be compensated by the advantages of non-taxation in Belgium of subsequent payments in all cases. The Advocate General argued that the likelihood was that it would be primarily Belgian nationals who fell into that category, rather than nationals of other Member States. Furthermore, the Advocate General observed that whereas a taxpayer paying his contributions in Belgium might choose between the deduction of the contributions and the exemption from tax of the capital created, the same choice was not available to a taxpayer who paid his contributions to an insurance company established outside Belgium, because he did not enjoy the benefit of deductibility. The Court did not explicitly reject the Belgian argument that the non-deductibility of premiums was compensated by the non-taxation of subsequent income; but, it implicitly accepted that argument in the form of coherence of the tax system i.e. the coherence between the non-deductibility of the premiums and the non-taxation of the subsequent income received by Mr. Bachmann from the insurance company. The ECJ observed that a connection existed between the deductibility of premiums and the taxation of subsequent income, because in Belgium the income was not taxed if the premiums were not deducted. In such a system the revenue loss resulting from the deductibility of premiums was compensated by the taxation of subsequent income. The ECJ reintroduced the concept of compensation; not from the perspective of a worker, who as a beneficiary of the directly applicable right of free movement was refused the right to deduct, but from the perspective of the Member State's revenue position.¹⁰²³

4.2.3.6 *Effectiveness of fiscal supervision and difficulty to obtain the necessary information*

In *Futura*, the ECJ recalled that the Court has repeatedly held that the effectiveness of fiscal supervision constitutes an overriding requirement of general interest capable of justifying a restriction on the exercise of fundamental freedoms guaranteed by the Treaty¹⁰²⁴. The ECJ considered justified the Luxembourg requirement of separate accounting to safeguard that a loss to be offset against domestic profits was economically connected to its territory.¹⁰²⁵ However, the ECJ did not accept the rule that such loss could only be carried over if it was demonstrated on the basis of separate accounting.¹⁰²⁶

The ECJ has in several cases denied accepting the justification that discriminatory tax measure is necessary for effective fiscal supervision. In *Bachmann*, the ECJ stated that refusing deduction is a disproportionate measure to safeguard the effectiveness of fiscal supervision. In *Vestergaard*, the ECJ held that the need for effective fiscal supervision could not justify the Member State making the tax deduction subject to different conditions according to whether the courses took place in that State or in another Member State.¹⁰²⁷

The ECJ has also ruled that certain legal measures can no longer be justified ever since the possibility for tax authorities to exchange information was introduced by the Mutual Assistance Directive (77/799/EEC of 19 December 1977).

¹⁰²³ See Van Thiel (2001a), pp. 231-248.

¹⁰²⁴ The ECJ referred to the judgment in Case 120/78 (*Cassis de Dijon*), paragraph 8. See paragraph 31 of the ECJ judgment in *Futura*.

¹⁰²⁵ The ECJ stated in paragraph 31 of its judgment: 'A Member State may therefore apply measures which enable the amount of both the income taxable in that State and of the losses which can be carried forward there to be ascertained clearly and precisely.'

¹⁰²⁶ See Terra and Wattel (2001), pp. 76-77.

¹⁰²⁷ See paragraph 25 of the judgment.

In *Halliburton*, the Netherlands Government contended that the tax authorities were unable to check whether the legal forms of entities constituted in other Member States were equivalent to those of public and private limited companies within the meaning of the relevant national legislation. The Court ruled that information pertaining to the characteristics of the forms in which companies might be constituted in other Member States could be obtained under the arrangements provided for in Mutual Assistance Directive.

In *Schumacker*, the ECJ ruled that there was no administrative obstacle to account being taken of a non-resident's personal and family circumstances in his State of employment because under the Mutual Assistance Directive there were ways of obtaining the necessary information comparable to those existing between tax authorities at national level.

In *Bachmann*, the Belgian, Netherlands and Danish governments contended that tax measures were necessary, given the difficulty of checking certificates relating to the payment of contributions in other Member States. The ECJ, with reference to the Mutual Assistance Directive, rejected that justification. The Belgian Government pointed out that certain Member States had no legal basis for requiring insurers to provide the information needed to monitor payments made within their territory. The ECJ noted in that regard that although Article 8(1) of the Mutual Assistance Directive imposed no obligation on the tax authorities of the Member States to collaborate where their laws or administrative practices prevent the competent authorities from carrying out enquiries or from collecting or using information for those States' own purposes, the inability to request such collaboration could not justify the non-deductibility of insurance contributions. There was nothing to prevent the tax authorities concerned from demanding from the person involved such proof as they consider necessary and, where appropriate, from refusing to allow deduction where such proof was not forthcoming.¹⁰²⁸

In *Danner*, the Finnish and Danish Governments submitted that the non-deductibility of contributions paid to pension schemes operated by foreign insurance institutions was justified by the need to ensure the effectiveness of fiscal controls and to prevent tax evasion.¹⁰²⁹ The ECJ upheld that justification. It recalled that the Mutual Assistance Directive might be relied on by a Member State in order to obtain from the competent authorities of another Member State all the information enabling it to ascertain the correct amount of income tax¹⁰³⁰ or all the information it considers necessary to ascertain the correct amount of income tax payable by a taxpayer according to the legislation which it applies¹⁰³¹. In addition, the ECJ noted as regards the effectiveness of the supervision of the taxation of pensions paid to Finnish residents, it might be ensured by measures which restrict freedom to provide services to a lesser degree than a national measure such as that at issue in *Danner*. Furthermore, the ECJ pointed out that, before receiving a pension from a foreign institution, the taxpayer would normally have applied for deduction of the contributions relating thereto, and the application for deduction and the documentary evidence provided by taxpayers at the time such applications were made would constitute a valuable source of information about the pensions which would be paid to taxpayers at a later stage.¹⁰³²

In *Lankhorst-Hohorst*¹⁰³³, the ECJ refused to accept the justification based on the concern to ensure the effectiveness of fiscal supervision, on the ground '... that no argument has been put to the Court to show how the classification rules contained in Paragraph 8a(1), Head 2,

¹⁰²⁸ See paragraphs 17-20 of the judgment.

¹⁰²⁹ See paragraph 44 of the judgment.

¹⁰³⁰ The ECJ referred to Case C-55/98 (*Vestergaard*), paragraph 26.

¹⁰³¹ The ECJ referred to Case C-80/94, (*Wielockx*), paragraph 26.

¹⁰³² See paragraphs 44-52.

¹⁰³³ Case C-324/00.

of the KStG are of such a nature as to enable the German tax authorities to supervise the amount of taxable income.¹⁰³⁴

4.2.3.7 *The disadvantageous effect of contested tax measure is easily avoidable*

In *Bachmann*, the Belgian Government contended that the tax measures at issue were easily avoidable as a Community national wishing to accept a job in Belgium could easily bring his contract to an end and conclude a new contract with a mutual insurance company recognized by Belgium, with a view to gaining the benefit of deductibility. The ECJ rejected this justification on the ground that the termination of the contract in the home state and the conclusion of new contracts in the host state would constitute, by reason of the arrangements and expense involved, a restriction on freedom of movement.¹⁰³⁵

4.2.3.8 *Consumer protection*

In *Bachmann*, it was argued that discriminatory provision was necessary in order to protect consumers because Belgium was unable to check the reliability of foreign companies with no branch in Belgium. The Court did not accept that argument.¹⁰³⁶

4.2.3.9 *Justifications accepted by the ECJ*

From the settled case law of the ECJ it can be concluded that the need to safeguard the cohesion of a tax system,¹⁰³⁷ the effectiveness of fiscal supervision¹⁰³⁸, and the prevention of tax avoidance¹⁰³⁹ constitute overriding requirements of general interest capable of justifying a restriction on the fundamental freedoms guaranteed by the Treaty. The justification that a tax measure is necessary for protecting the cohesion of a Member State's national tax system was accepted by the ECJ only in the cases *Commission v Belgium*¹⁰⁴⁰ and *Bachmann v Belgium*¹⁰⁴¹. The effectiveness of fiscal supervision only constituted a justification accepted by the ECJ in the *Futura* case¹⁰⁴². Prevention of abuse has not actually been able to save restrictive national tax measures brought before the ECJ but has been recognized *in abstracto* in *ICI*¹⁰⁴³ and *Lankorst-Hohorst*¹⁰⁴⁴. It may be inferred from those judgments by the ECJ that the Court may in principle accept anti-abuse measures that infringe EU law but only if the legislation at issue has the specific purpose of preventing wholly artificial arrangements designed to circumvent domestic tax rules.¹⁰⁴⁵

4.3 Legislative acts in the field of corporate taxation

Legal basis of secondary Community tax legislation

No explicit reference to the harmonization of direct taxes is provided in the founding Treaties. The main legal bases for the harmonization of direct taxes are the general harmonization

¹⁰³⁴ Ibid, paragraph 44.

¹⁰³⁵ See paragraphs 12 and 13 of the judgment.

¹⁰³⁶ See Terra and Wattel (2001), p. 64.

¹⁰³⁷ Case C-204/90 (*Bachmann*), paragraphs 21-28, Case C-300/90 (*Commission v Kingdom of Belgium*) and Case C-136/00 (*Danner*), paragraph 36.

¹⁰³⁸ Case C-250/95 (*Futura*) (paragraph 31) and Case C-254/97 (*Baxter and Others*), paragraph 18.

¹⁰³⁹ Case C-264/96 (*ICI*), paragraph 26, Case C-324/00 (*Lankhorst-Hohorst*), paragraph 37, C-410/98 (*Metallgesellschaft*), paragraph 57, and Case C-436/00 (*X and Y*), paragraphs 42-43 and 61-62.

¹⁰⁴⁰ Case C-300/90.

¹⁰⁴¹ Case C-204/90.

¹⁰⁴² Case C-250/95, paragraph 31.

¹⁰⁴³ Case C-264/96.

¹⁰⁴⁴ Case C-324/00.

¹⁰⁴⁵ See *ICI*, paragraph 26 and *Lankorst-Hohorst*, paragraph 37.

provisions (Articles 94 and 95) and the complementary provision of Article 308, which allows appropriate measures to be adopted ‘... if action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community and the Treaty has not provided the necessary powers’¹⁰⁴⁶. Article 94 of the EC Treaty provides for the ‘approximation’ of those laws and regulations that ‘directly affect the establishment or functioning of the common market’.¹⁰⁴⁷ Article 94 provides the main legal basis for harmonization of direct taxes by adoption of directives which are the most important legal instruments dealing with corporate taxes. However, to date only four Directives have been adopted. The Regulation is a quite exceptional instrument for harmonising direct tax laws of the Member States to one another. Some provisions dealing with direct tax issues are included in regulations, however, they constitute only accessory provisions among the non-tax rules.¹⁰⁴⁸

Direct taxation is referred to in only few other provisions. Second indent of Article 293 of the EC Treaty recommends that Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals the abolition of double taxation within the Community.¹⁰⁴⁹ In *Gilly*¹⁰⁵⁰, the national court raised the question of the direct applicability of this provision. The Advocate General argued that the wording of this provision is not sufficiently clear and unconditional for direct effect to be attributed to it and that it cannot give rise to rights in favour of individuals which the national courts must safeguard. The ECJ held in its judgment that the second indent of Article 293 does not have direct effect.¹⁰⁵¹

The legal obligation Article 293 imposes on Member States to reach the requested result is rather weak.¹⁰⁵² It is only stated that Member States shall ‘... enter into negotiations’. No right of initiative is provided either for the Commission or for any of the other EU institutions. The Advocate General argued in *Gilly*¹⁰⁵³ that the second indent of Article 293 imposes on Member States an obligation to act, namely to enter into negotiations so far as is necessary, but not an obligation to achieve a specific result.¹⁰⁵⁴ The Advocate General, furthermore, argued that the provision, as worded, does not lay down an absolute obligation but leaves Member States a wide discretion to decide whether to enter into negotiations with each other.¹⁰⁵⁵

¹⁰⁴⁶ Article 308 is the legal basis of the EC Regulation on the European Economic Interest Grouping, which contains tax provisions.

¹⁰⁴⁷ Article 94 of the EC Treaty states that the Council shall issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market provided that the Council takes decisions by unanimity voting on a proposal from the Commission.

¹⁰⁴⁸ Article 40 of Regulation No. 2137/85 of 25 July 1985 establishing the fiscal transparency of EEIGs. Regulation No. 257 of 15 October 1968 establishes that an employee who is a citizen of one Member State must enjoy the same social and fiscal advantages in the state where he or she is employed as the employee who is a citizen of that state. See Hinnekens (1997), p. 31.

¹⁰⁴⁹ From a purely international law perspective, based on a strict interpretation of Article 293, one could argue that it is for Member States to enter into negotiations with each other with a view to securing the elimination of double taxation within the EU. However, according to the case law of the ECJ (see Case C-336/96 (*Gilly*) and Case C-307/97 (*Saint-Gobain*)), it is clear that such reservation of powers is not exclusive and may not prevent the ECJ from ascertaining the compatibility of the legislation of the Member States with EU law. See Pistone (2002), p. 131.

¹⁰⁵⁰ Case C-336/96.

¹⁰⁵¹ See Case C-336/96 (*Gilly*), paragraphs 14-17.

¹⁰⁵² See Thömmes (1990b), p. 465.

¹⁰⁵³ Case C-336/96.

¹⁰⁵⁴ See Case C-336/96 (*Gilly*), paragraph 34.

¹⁰⁵⁵ See Case C-336/96 (*Gilly*), paragraph 35.

The Arbitration Convention has been adopted in 1990 on the basis of Article 293 (see section 4.3.3.).

Article 163(2) mentions the need for the removal of legal and fiscal obstacles to co-operation between undertakings in the field of research and technological development to enable them to exploit the internal market potential to the full. Article 175(2) mentions ‘provisions primarily of a fiscal nature’ in the context of environmental policy. Article 58 allows to apply the tax provisions 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, introducing the derogation to Article 56 (the free movement of capital)¹⁰⁵⁶.

Article 95 was introduced by Single European Act amending the EC Treaty. Article 95 seeks to ensure the adoption of all kinds of measures aimed at achieving the establishment of the internal market¹⁰⁵⁷ by derogation from Article 94. This derogation allows adoption of these measures by a qualified majority, whereas Article 94 requires unanimous votes at the Council. Moreover, Article 95 refers to ‘measures’, including all kind of EC action provided by EC Treaty whereas Article 94 allows only the issuing of directives. However, Article 95(2) contains an important restriction by stipulating that qualified majority decisions shall not apply to fiscal provisions.

Another provision that can potentially serve as a basis for EU tax measure is Article 96 of the EC Treaty. Article 96 of the Treaty provides a legal basis for the Commission to take action to deal with distortions of the conditions of competition in the Internal Market, including proposing directives, which may be adopted by qualified majority. Article 96 empowers the Commission to act where legal or administrative rules of a Member State distort conditions of competition in the common market, and this distortion needs to be eliminated.¹⁰⁵⁸ This provision has never yet been used.

Legislative acts adopted and proposed in the field of corporate taxation

As the first concrete step in the field of direct taxation, the Council of Ministers adopted in 1977 the Directive on mutual assistance by tax administrations of the Member States.¹⁰⁵⁹ This directive as well as two directives adopted in 1990 and one adopted in 2003 are based on Article 94 of the EC Treaty. One of the directives adopted in 1990 aims at elimination of double taxation of dividends in the case of parent companies and subsidiaries of different Member States, and is hereafter referred to as the Parent-Subsidiary Directive.¹⁰⁶⁰ The other directive, provides for any capital gains arising from a merger, or a similar operation, to be

¹⁰⁵⁶ However, Article 58(3) specifies that these tax provisions shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56.

¹⁰⁵⁷ The objective to establish the internal market is set out in Article 14, which states that the Community shall adopt measures with the aim of progressively establishing the internal market in which the free movement of goods, persons, services and capital is ensured.

¹⁰⁵⁸ Article 96 stipulates that where the Commission finds that a difference between the provisions laid down by law, regulation or administrative action in Member States is distorting the conditions of competition in the common market and that the resultant distortion needs to be eliminated, it shall consult Member States concerned. If such consultation does not result in an agreement eliminating the distortion in question, the Council shall, on a proposal from the Commission, acting by a qualified majority, issue the necessary directives. The Commission and the Council may also take any other appropriate measures provided for in the EC Treaty.

¹⁰⁵⁹ Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, OJ L 336, 27/12/1977, pp. 15 – 20.

¹⁰⁶⁰ Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225, 20/08/1990, p.6.

taxed only upon realisation, and is hereafter referred to as the Merger Directive.¹⁰⁶¹ In addition, the multinational convention, designed to eliminate the double taxation in connection with the transfer pricing of associated enterprises was adopted in 1990, hereafter referred to as the Arbitration Convention.¹⁰⁶²

Furthermore, after the adoption of three legislative acts in 1990 (hereafter referred to as 'tax package of 1990'), the Commission has proposed several corporate tax directives. One proposal was adopted in June 2003 and is due to take effect from 1 January 2004. This directive provides for on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, and is hereafter referred to as the Interest and Royalties Directive.¹⁰⁶³ One important proposal on the cross-border off-setting of losses¹⁰⁶⁴ is still pending.

4.3.1 *The Parent-Subsidiary Directive*

The first proposal for Parent-Subsidiary Directive dates back as far as the year 1969. The proposal was finally adopted in 1990.

4.3.1.1 *Background*

In the cases of cross-border investments international groups of companies often face the problem that profit distributions are often taxed twice: in the country of the subsidiary as well as in the country of the parent company. Importance of withholding taxes on profit distribution by multinational companies was underlined in the Ruding Report. According to the research done by the Ruding Committee, economic double taxation arising from withholding taxes levied by source countries on cross-border dividend payments between related companies was one of the major causes for bias against inward or outward investment. Therefore, the removal of such taxes was considered necessary.

Additional problems for the companies are the differences in the tax provisions that govern the relations between parent companies and subsidiaries of different Member States. In addition, these provisions are generally less advantageous than those applicable to parent companies and subsidiaries of the same Member State. These problems can pose barriers to investments and grouping together of companies. Therefore, the introduction of a common system has a major impact to the transfrontier co-operation.

4.3.1.2 *Purpose of the Directive*

According to the preamble of the Directive its aim is to eliminate the disadvantage caused by the differences in tax provisions which pose the impediments to the co-operation between companies of different Member States and to facilitate the cross-border grouping together of companies within the EU in order to create within the Community conditions analogous to

¹⁰⁶¹ Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, OJ L 225, 20/08/1990, p. 1.

¹⁰⁶² Convention 90/436 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises, OJ L 225, 20/08/1990, p. 10 – 24. The convention entered into force on 1 January 1995 but its application is currently suspended as its prolongation beyond 2000 still awaits ratification in several Member States.

¹⁰⁶³ Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, 26.6.2003, p. 49.

¹⁰⁶⁴ Proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States, COM (90) 595 final of 6 December 1990, OJ C 53 of 28 February 1991, p. 30.

those of an internal market and in order to ensure the establishment and effective functioning of the common market. The Directive aims to make the taxation of cross-border situations as advantageous as in domestic relations: to eliminate double taxation with respect to cross-border dividend payments within European groups of companies to the same extent as is the case with respect to similar domestic payments. In accordance with the recitals to the Directive, the overall objective of the Directive is to introduce with respect to grouping together of companies of different Member States, tax rules which are neutral from the point of view of competition, in order to allow enterprises to adapt to the requirements of the internal market. More specifically, the main objective of the Directive is to abolish both juridical and economic double taxation with respect to profit distributions from a subsidiary in one Member State to its parent in another Member State. The Directive permits tax-free distribution of profits if all the requirements of the Directive are met. The Directive aims to increase neutrality within the single market by eliminating double taxation of intra-group dividends.

4.3.1.3 *Scope*

The Directive exclusively refers to distributions of profits paid by subsidiaries of one Member State to parent companies of other Member State (Article 1(1)). Hence, it applies to the cross-border situations. The domestic distributions of profit fall outside of the scope of the Directive.

4.3.1.4 *Main features*

The Directive stipulates that intra-group cross-border profit distributions must be free of withholding tax at source as well as of double corporate tax in the Member State of the parent company. The Member State of the subsidiary has to abolish any withholding tax and the Member State of the parent company has to exempt the distributed profits or impute the tax already paid in the Member State where the subsidiary has its seat.

Article 4 requires Member States to refrain from taxing distributed profits received by a parent company from its subsidiary (exemption method), or to tax such profits while authorising the parent company to deduct from the amount of tax due that fraction of the corporation tax paid by the subsidiary which relates to those profits, and if appropriate, the amount of withholding tax levied by the Member State in which the subsidiary is resident, up to the limit of the corresponding domestic tax (ordinary credit method). Member States applying the ordinary credit method are obliged also to give relief for the underlying corporate income tax paid by the subsidiary on profits out of which the distribution is made. However, the Directive does not explicitly address the situations in which dividends are redistributed through groups of companies which have multiple tiers. Current interpretation is that Member States using the credit method are required to take into account only the tax paid by first-tier subsidiaries, they are not required to give relief for tax paid by the lower tier EC subsidiaries.¹⁰⁶⁵
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Article 5 of the Directive provides for relief from withholding tax at source with respect to profit distributions. It requires that profits which a subsidiary distributes to its parent company shall, at least where the latter holds a minimum of 25% of the capital of the subsidiary, be exempt from withholding tax in the state of residence of the subsidiary. The wording 'shall be [...] exempt' indicates that exemption at source is mandatory: Member States are not allowed to levy a dividend withholding tax at the time of distribution and refund it to the parent company only after it applies for a refund and proves that it is a qualifying company.

¹⁰⁶⁵ See Farmer and Lyal (1994), p. 269.

¹⁰⁶⁶ However, according to the amended directive the taxes paid by any lower tier subsidiaries are covered. See section 4.3.1.12.

Member States are permitted to levy tax only during the minimum holding period of two years and refund it after that condition has been met.¹⁰⁶⁷

4.3.1.5 *Qualifying companies*

Articles 2-5 of the Directive stipulate the requirements that the companies have to fulfil in order to qualify for the tax-free distribution of their profits. The Directive applies to payments made between companies, which take one of the forms listed in the Annex to the Directive. In line with the general principle of EU law, directives only ever express minimum standard. Member States are free to extend the tax-free treatment of profit distributions to the entities other than those included in the list. In fact, some frequently used types of companies are excluded from the list. The EC Commission Communication to the Council and the European Parliament¹⁰⁶⁸ recommends that the scope of the Directive should be extended to all enterprises subject to corporation tax whatever their legal form, and successively to all entities subject to income tax.

In addition, the distributing and recipient companies have to be considered residents in different Member States for tax purposes.¹⁰⁶⁹ This provision excludes the domestic parent-subsidiary relations from the scope of the Directive. The Directive also stipulates the condition that the company may not, under the terms of a tax treaty concluded with a non-EU country, to be considered resident for tax purposes outside the Community. This provision aims to ensure that only EU resident corporations benefit from the Directive. Article 2 also specifies that the companies must be subject to one of the national corporation taxes listed in Article 2, without the possibility of any option or of being exempt. Exempted companies do not qualify because there is no reason to avoid double taxation if there is no double taxation due to the exemption. The exclusion of the companies that have an option refers to the possibility offered by some European national tax systems for a company to opt for corporate income tax liability or fiscal transparency. A taxpayer has different choices for tax liability: taxation of the company or of the partners.^{1070 1071} However, this provision does not exclude companies which are subject to tax in principle but which benefit from a relief related to certain categories of income.¹⁰⁷²

Article 3(1) stipulates the additional requirement that in order to qualify as a parent, a company of a Member State has to have a minimum holding of 25 % in the capital of a company of another Member State (the subsidiary). In accordance to the first indent of Article 3(2), Member States have the option to bilaterally agree to replace the criterion of a holding in the capital by that of a holding of voting rights. In respect of the minimum participation requirement, it is important to bear in mind that Directive only specifies minimum standard,

¹⁰⁶⁷ According to the ECJ's ruling in joined cases C-283/94, C-291/94, and C-292/94 (*Denkavit, Vitic and Vormeer*) it is not necessary that a period of time during which the parent company must have a holding in the subsidiary should have come to an end at the time when the Directive benefits are granted. Although Member States have the option of not applying the Directive if the minimum holding has been maintained for less than two years on the date of payment of the dividends, they must apply it retroactively if the holding is still maintained when the two-year period expires (the ECJ in its *Denkavit-VITIC-Voormeer* judgement (joined cases C-328/94, C-291/94, and C-292/94)). See also section *Minimum holding period* for more elaborate examination of the *Denkavit-VITIC-Voormeer* case.

¹⁰⁶⁸ Commission Communication to the Council and to Parliament (92) 1118 final subsequent to the conclusions of the Ruding Committee indicating guidelines on company taxation linked to the further development of the internal market, Brussels, 26 June 1992.

¹⁰⁶⁹ Article 2(b) of the Parent-Subsidiary Directive.

¹⁰⁷⁰ Companies that have an option are excluded probably because they pose too many implementation problems and tax planning opportunities. See Terra and Wattel (1997), p. 235.

¹⁰⁷¹ See for joined cases C-283/94, C-291/94, and C-292/94 (*Denkavit, Vitic and Vormeer*).

¹⁰⁷² Raby (1992), p. 222.

Member States may also give the benefits of the Directive if the holding is less than 25%.¹⁰⁷³ The profit distribution must be made by virtue of the companies' association with each other, for reasons other than a liquidation of the subsidiary.¹⁰⁷⁴

4.3.1.6 Anti-abuse provisions

Minimum holding period

Article 3(2) provides derogation to a minimum participation requirement of Article 3(1). Namely, it contains an anti-abuse provision, which states that in order to qualify as a parent, company must hold the shares for an uninterrupted period of at least two years.¹⁰⁷⁵ Article 3(2) gives Member States the option of withholding the application of the Directive in cases where the parent companies do not maintain for the minimum period the required percentage of the subsidiary's capital. Thus, in situations where a company purchases and then, shortly after a distribution, alienates shares, which constitute the required participation, Directive benefits may be denied.¹⁰⁷⁶ The purpose of this anti-abuse provision is to prevent what might be referred to as 'directive shopping'.¹⁰⁷⁷

Most of the Member States have taken advantage of this provision that allows them to deny tax-free distribution of profits if companies are using artificial arrangements with no other purpose than to enjoy benefits of the Directive that the company would not enjoy in the absence of such arrangements. In respect of the minimum holding period, some Member States (i.e. Denmark, France and Spain) have opted for the two-year holding period. The others (like Belgium, Germany, Italy and the Netherlands) have opted for a holding period of at least one year. The shorter holding period is not specifically provided for in the Directive, but it has been justified on the basis that EC Directives only ever specify minimum standards.¹⁰⁷⁸

It is unclear from the wording of Article 3(2) whether the minimum holding period must be completed before the companies concerned are entitled to the benefits of the Directive. Majority of the Member States took the view that since Article 3(2) of the Directive is silent on the matter, Member States retain a discretion. This opinion was shared, on the whole, by the Governments of Germany, Belgium, Greece, Italy and the Netherlands. According to those Governments, the minimum holding period should be completed before dividend distribution and withdrew the Directive benefits in the case of distributions within the minimum holding period although in retrospect the company held the shares longer than holding period required. This interpretation was argued to be the only one which allows authorities to counter abuse. Subsequent checks as to whether the holding period has in fact been complied with was argued to give rise to many practical and technical difficulties, particularly in the case of cross-border payment of dividends.¹⁰⁷⁹ However, the ECJ argued in its *Denkavit-VITIC-*

¹⁰⁷³ Ruding Report recommends a reduction in the 25 per cent participation threshold. See Commission (1992a).

¹⁰⁷⁴ Article 4 of the Parent-Subsidiary Directive.

¹⁰⁷⁵ Article 3(1)(a) of the Directive provides that the status of a parent company is to be attributed to any company of a Member State which fulfils certain conditions set out in Article 2 of the Directive and has a minimum holding of 25% in the capital of a company of another Member State. The second indent of Article 3(2) of the Directive provides each Member State with the option, by way of derogation from paragraph 1, of "not applying this Directive to companies of that Member State which do not maintain for an uninterrupted period of at least two years holdings qualifying them as parent companies or to those of their companies in which a company of another Member State does not maintain such a holding for an uninterrupted period of at least two years".

¹⁰⁷⁶ Helminen (2000), p. 163.

¹⁰⁷⁷ See Weber (2000), pp. 21-24.

¹⁰⁷⁸ See Eamonn McGregor (1992), p. 340.

¹⁰⁷⁹ See Judgment of 17 October 1996 in joined cases C-283/94, C-291/94, and C-292/94 (*Denkavit, Vitic and Vormeer*), paragraph 21.

Voormeer judgement¹⁰⁸⁰ that it follows from the wording of Article 3(2), and in particular from the use of the present tense ('maintain') in all language versions except the Danish, that, in order to receive the tax advantage, the parent company must have a holding in the subsidiary during a certain period of time, without it being necessary that this period should have come to an end at the time when the tax advantage is granted. The ECJ stated that according to the preamble of the Directive it seeks, by the introduction of a common tax system, to eliminate any disadvantage to cooperation between companies of different Member States as compared with cooperation between companies of the same Member State and thereby to facilitate cross-border cooperation. Thus, with a view to avoiding double taxation, Article 5(1) of the Directive provides for exemption in the State of the subsidiary from withholding tax upon distribution of profits. The ECJ highlighted that it follows from the purpose of the Directive that Member States cannot unilaterally introduce restrictive requirement that a holding period must already have been completed when the profits in respect of which the Directive benefits apply are distributed.

The main issue in *Denkavit-VITIC-Voormeer* joined cases was whether the Directive permits a Member State to apply a rule under which withholding tax must be deducted by a subsidiary company from distributions which it makes to its parent company within the minimum holding period, so that the parent company is denied the exemption from withholding tax for the minimum holding period even where it ultimately maintains its holding beyond that period.

The ECJ ruled in its *Denkavit-VITIC-Voormeer* judgement¹⁰⁸¹ that it is not necessary that a period of time during which the parent company must have a holding in the subsidiary should have come to an end at the time when the Directive benefits are granted. The ECJ also stipulated that Member States are free to draw up rules for ensuring compliance with the minimum period. The ECJ stated that the Directive does not require a Member State to grant the exemption from the beginning of this period without being certain of being able to obtain payment of the tax later, in the event that the parent company fails to observe the minimum holding period which the Member State has laid down. Likewise, it does not follow from the Directive that a Member State is obliged to grant the tax exemption immediately if the parent company undertakes unilaterally to observe the minimum holding period. Thus, Member States are not obliged to grant the advantage immediately and may provisionally apply withholding tax on dividends which should be refunded after the minimum withholding period is completed.

4.3.1.7 General anti-abuse provision

In Article 1(2) of the Directive a general anti-abuse provision is set out, which permits Member States to include domestic or agreement-based provisions required for the prevention of fraud or abuse in their national legislation.¹⁰⁸² It provides Member States possibility to withhold the benefit which is provided by the Directive when it is considered a matter of abuse under domestic or bilateral anti-abuse provisions. The directive does not define precisely what encompasses transactions constituting 'fraud or abuse'.¹⁰⁸³ The reference to the agreement-based provisions means that existing treaty-based prohibitions will continue to apply. The question has been raised whether anti-abuse concepts based on case law are included in this definition. According to the literal reading of the text it is not so.¹⁰⁸⁴

¹⁰⁸⁰ See joined cases C-283/94, C-291/94, and C-292/94 (*Denkavit, Vitic and Vormeer*).

¹⁰⁸¹ Ibid.

¹⁰⁸² Article 1(2) stipulates that '... directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse.'

¹⁰⁸³ See De Hosson (1990), p.414.

¹⁰⁸⁴ See Raby (1992), p. 220.

Thus, Member States have left discretionary power to deny the benefits of the Directive in cases of abuse. Most Member States have relied on anti-abuse provision of Article 1(2) to ensure that solely *bona fide* business structures benefit from the Directive.¹⁰⁸⁵ Belgium requires, for its participation exemption to apply, that the foreign subsidiary may not be located in a low tax jurisdiction and may not benefit from a special (favourable) tax regime in its country of residence (anti-tax haven regulation).¹⁰⁸⁶ Some Member States (i.e. France and Spain) introduced specific legislation with anti-abuse measures after the Directive became effective.¹⁰⁸⁷ Spanish law denies the benefits of the directive where the parent company or the subsidiary is resident in a specified list of tax havens.¹⁰⁸⁸ This list includes locations such as Luxembourg (specifically companies covered by the holding company regime), Gibraltar, Liechtenstein, the Channel Islands and most of the Caribbean tax havens.

From the judgement by the ECJ in the *Denkavit-VITIC-Voormeer* case¹⁰⁸⁹ it may be inferred that a general anti-abuse provision may not be relied on by Member States to widen the scope of the specific anti-abuse provision if the abuse in question is already regulated by a specific anti-abuse provision. In addition, from the judgements of the ECJ in the *Leur Bloem*¹⁰⁹⁰ case it follows that the ECJ does not allow disproportionate measures in national anti-abuse provisions.¹⁰⁹¹ The ECJ ruled in its *Leur Bloem* judgment that Member States have to apply anti-abuse provisions in accordance with the proportionality principle: the national anti-abuse measures should serve their purpose but have no effects beyond that purpose¹⁰⁹². This can be concluded from the text of the Directive (the national anti-abuse provisions are allowed when they 'are required for the prevention of fraud and abuse') and from the case law of the ECJ¹⁰⁹³.

4.3.1.8 *The concept of profit distribution*

It is not stated explicitly in the Directive what is meant by the profit distribution (under the Directive). The Directive does not mention that the domestic law or tax treaty provisions should be referred to for the definition of the distribution of profits. It is argued that, probably, the drafters of the Directive did not want the meaning of the term of the profit distributions to be dependent too much on national tax law and therefore, it must be given an autonomous meaning independent of domestic law definitions or tax treaty definitions.¹⁰⁹⁴ Terra and Wattel (1997) argue that the concept of profit distributions is a Community concept, to be interpreted autonomously by the ECJ and national courts.¹⁰⁹⁵

The Directive uses the term 'distribution of profits' not the term 'dividends'. The concept of profit distribution is generally understood to be somewhat wider than that of dividend. According to Helminen (2000)¹⁰⁹⁶ one reason why the concept of profit distribution should be given broad meaning with respect to the Directive is that the term 'dividend' could have been used if it had been intended for the meaning to be narrow. A broad meaning is also in line with the aims of the Directive.

¹⁰⁸⁵ See Terra and Wattel (1997), p. 249.

¹⁰⁸⁶ Ibid.

¹⁰⁸⁷ See Raby (1992), p. 220.

¹⁰⁸⁸ Morris (1992) as referred to in Raby (1992), p. 220.

¹⁰⁸⁹ Joined cases C-283/94, C-291/94, and C-292/94 (*Denkavit, Vitic and Vormeer*).

¹⁰⁹⁰ Case C-28/95 (*Leur Bloem*).

¹⁰⁹¹ The *Leur Bloem* judgement actually concerned the anti-abuse provision in the Merger Directive and the proportionality requirement of the ECJ is further elaborated under section 4.2.2.

¹⁰⁹² See Weber (2000), p. 28.

¹⁰⁹³ See paragraph 43 of the *Leur Bloem* judgment (Case C-28/95).

¹⁰⁹⁴ See Helminen (2000), p. 162 and Terra and Wattel (1997), p. 243.

¹⁰⁹⁵ Terra and Wattel (1997), p. 243.

¹⁰⁹⁶ Helminen (2000), p. 162.

Because the Directive does not define the concept of profit distribution, it is not totally clear what income items are included in the concept.¹⁰⁹⁷ The concept of profit distribution covers any payment by the subsidiary to the parent company, on grounds of the shareholder relationship between the companies. According to Articles 3 and 4 of the Directive, this concept covers profit distributions made by virtue of association between the companies based on a holding in the equity capital of a subsidiary. Article 4 does not clarify what ‘association’ exactly means. In general, the distribution of profits to shareholders includes such transactions between a company and its shareholders, by which the assets of the company are decreased and the assets of the shareholder increased. The distribution of profits includes, in addition to dividend, other gratuitous transfers to shareholders based on a shareholder relationship.¹⁰⁹⁸ Constructive dividends¹⁰⁹⁹ also must be covered by the Directive even though the text of the Directive does not expressly state so. There is no reason why income from debt should not qualify under the Directive.¹¹⁰⁰

Article 4(1) excludes profit distributions in situations where the subsidiary is liquidated. Thus, distributions upon liquidation of the subsidiary are expressly not covered at the parent level and the Directive does not hinder the State of the parent company to tax liquidation distributions received from a subsidiary when the subsidiary is liquidated. Because Article 4(1) uses the wording ‘except when the subsidiary is liquidated ...’, it is not clear whether this exception also covers situations of the partial liquidation of the subsidiary.¹¹⁰¹ Helminen (2000) argues that the objective of the Directive, as expressed in the preamble of the Directive, is to make the taxation of cross-border situations as advantageous as in domestic relations, not to make it more advantageous, and therefore, the benefits of Article 4(1) should also not be required to be granted with respect to liquidation distributions in connection with partial liquidations, if the state of residence of the parent company would not eliminate double taxation with respect to similar distributions in purely domestic relations. Article 5 does not contain any reference to liquidation distributions, therefore, there is no reason why liquidation distributions should be treated differently from other profit distributions.¹¹⁰² Thus, it seems that the Directive grants an exemption of withholding tax at the subsidiary level for liquidation distributions because they are expressly excluded under Article 4 but not under Article 5. It is argued that this asymmetry in tax treatment of liquidation distributions between the parent level and the subsidiary level is not justified.¹¹⁰³

In practice, there is no consensus on the issue whether liquidation distributions are covered by the Directive and if it is so, which kinds of liquidation distributions were intended to be covered by the Directive.

4.3.1.9 *The concept of withholding tax*

The concept of withholding tax has not been explicitly provided in the Directive.¹¹⁰⁴ The ECJ has held that the nature of a tax, duty or charge must be determined by the ECJ, under Community law, according to the objective characteristics by which it is levied, irrespective

¹⁰⁹⁷ For elaborate analysis on the concept of profit distributions see Helminen (2000), pp. 161-171.

¹⁰⁹⁸ Helminen (2000), p. 162.

¹⁰⁹⁹ For example, payments labelled ‘interest’ by the subsidiary on a loan extended by the parent company which, however, the tax authorities do not recognize as a loan and which is recharacterised as equity capital for tax purposes. See Terra and Wattel (1997), p. 243.

¹¹⁰⁰ See Helminen (2000), pp. 166-167.

¹¹⁰¹ Ibid, p. 170.

¹¹⁰² See Terra and Wattel (1997), pp. 243-244 and Helminen (2000), p. 170.

¹¹⁰³ Ibid.

¹¹⁰⁴ Article 7 of the Directive specifies the scope of the concept of withholding tax by stipulating that the term ‘withholding tax’ does not apply to an advance payment or prepayment of corporate taxes.

of its classification under national law.¹¹⁰⁵ In Opinion of Advocate General in *Epson*¹¹⁰⁶ it was also stated that it is for the ECJ to determine, irrespective of classifications under national law, to what extent a withholding tax established by a Member State constitutes a tax within the meaning of the Directive and is therefore prohibited under Article 5(1) of the Directive. In other words, Advocate General considered that Community law concepts such as 'withholding tax on profits distributed' should not be interpreted using semantic distinctions or theories of national law. Moreover, Advocate General argued that that is what the principle of the primacy of Community law over national law requires. If that were not so, it would be possible to determine the scope of Community rules on the basis of distinctions, and therefore provisions, of national law, contrary to the intention of the Community legislature.¹¹⁰⁷

The ECJ has specified the concept of withholding taxes in its judgments in *Epson*¹¹⁰⁸ and *Athinaiki Zithopiia*¹¹⁰⁹. *Epson* concerned Portuguese tax and in *Athinaiki Zithopiia* Greek tax was at issue.

In *Epson* a succession and donation tax in respect of transfers of shares in companies (imposto sobre as sucessões e doações, hereafter 'ISD') was at issue. ISD was provided for by the Portuguese Corporation Tax Code and it was levied, whenever profits are distributed, on the dividends paid by companies which have their seat in Portugal. *Epson Europe BV* (hereafter *Epson*) argued that that ISD falls within the scope of the Directive, while the Portuguese Government and the Portuguese tax authority took the opposite view. Specifically, *Epson* argued that the Directive, and Article 5(4) in particular, cover all taxation, however described, which acts as a withholding tax on dividends distributed by a subsidiary to its parent company in another Member State. The Portuguese Government and the Portuguese tax authority contended that the derogation under Article 5(4) of the Directive does not apply to ISD, since that tax is levied not on income but on the value of securities, reflecting the extent to which the dividends are capitalised. Thus, the Portuguese Government and the Portuguese tax authority argued that the tax at issue establishes a tax on transfers of assets and is therefore not subject to the prohibition under Article 5(4) of the Directive.

In Advocate General's Opinion in *Epson* it was argued that from the wording alone of the exemption introduced by Article 5(4) of the Directive it can be noted that the Community legislature refers to 'profits' and 'withholding tax', not income tax, tax on profits or corporation tax, nor does it use any other similar expression which would lead to a strict interpretation of that provision. In Advocate General's view, this means that all withholding taxes are subject to the prohibition laid down in the Directive, whatever the name or nature of the tax levied on distributed profits. In other words, 'withholding tax' cannot be interpreted as being confined to the taxes listed by name in Article 2, since it applies to all taxes levied in the Member State of the subsidiary on distributed profits (dividends). Advocate General took the view that the objectives of the Directive would be undermined if the Portuguese Republic had the freedom to retain taxes which, although in practice constituting a withholding tax, were given a different name in order to bypass the prohibitions under the Directive or had borne a different name under a provision of national law predating the Directive, which leads essentially to the same result.

In its judgment in *Epson*¹¹¹⁰, the ECJ agreed with the Advocate General's Opinion and held that it is clear that ISD is a withholding tax for which the chargeable event is the payment of dividends or of any other income from shares, that the taxable amount is the income from the

¹¹⁰⁵ Joined Cases C-197/94 and C-252/94 (*Bautiaa and Société française maritime*), paragraph 39

¹¹⁰⁶ Case C-375/98 (*Epson*).

¹¹⁰⁷ Opinion of Mr Advocate General Cosmas in Case C-375/98 (*Epson*), paragraph 45.

¹¹⁰⁸ Case C-375/98 (*Epson*).

¹¹⁰⁹ Case C-294/99 (*Athinaiki Zithopiia*).

¹¹¹⁰ Case C-375/98.

shares and that the taxable person is the holder of the shares. ISD thus has the same effect as a tax on income. It is immaterial in that respect that it is called succession and donation tax and that it is levied in parallel with corporation tax. In those circumstances, the objective of the Directive to ensure that cooperation between companies of different Member States is not penalised as compared with cooperation between companies in the same Member State and thereby to facilitate the grouping together of companies at Community level, would be undermined if Member States were permitted deliberately to deprive companies in other Member States of the benefit of the Directive by subjecting them to taxes having the same effect as a tax on income, even if the name given to the latter places them in the category of tax on assets. Thus, the ECJ held that the term withholding tax contained in it is not limited to certain specific types of national taxation and it cannot be inferred from Article 2(c) of the Directive that other taxes having the same effect as mentioned in this provision are authorised, particularly since the final part of Article 2 refers expressly to any other tax which may be substituted for any of the above taxes.

Another important case in which the ECJ specified the concept of the withholding tax in the context of the Parent Subsidiary Directive is *Athinaiki Zithopiia*¹¹¹¹. The facts of the case are the following. The Dutch company Amstel International holds 92.17 per cent of the share capital of Athinaiki Zithopiia AE, a Greek public limited company. The Greek legislation provides that where a Greek public limited company, whose gross income includes nontaxable income or income subject to reduced taxation, distributes profits, those profits are deemed to arise ratably from that income. As a consequence, in order to determine the basic taxable income, nontaxable income and income subject to reduced taxation are first converted into gross amounts and then added back into the taxable basis *pro tanto*.¹¹¹² Dividends distributed by Athinaiki Zithopiia AE bear the tax on the distributed profits including income which has been subject to reduced taxation entailing extinction of tax liability and also nontaxable income. The Greek Administrative Court of First Instance referred to the ECJ for a preliminary ruling a question whether the taxation at issue qualifies as a withholding tax within the meaning of Article 5(1) of the Parent Subsidiary Directive.

Article 5(1) of the Directive stipulates that profits which a subsidiary distributes to its parent company shall, at least where the latter holds a minimum of 25 per cent of the capital of the subsidiary, be exempt from withholding tax. Article 7(1) specifies the scope of the term 'withholding tax' as follows: 'The term "withholding tax" as used in this Directive shall not cover an advance payment or prepayment (*précompte*) of corporation tax to the Member State of the subsidiary which is made in connection with a distribution of profits to its parent company.' Advocate General Alber argues in its Opinion¹¹¹³ delivered on 10 May 2001 that the exception in Article 7(1) of the Directive is not applicable in the case of Greek tax in question, since it is not an advance payment or prepayment but definitive taxation that is at issue.

Advocate General Alber argues that from the ECJ's judgment in *Epson*¹¹¹⁴ it follows that the application of Article 5(1) of the Directive depends not on how the domestic tax provision is described or on the tax regime it forms part of, but exclusively on its effect. The Directive is

¹¹¹¹ Case C-294/99 (*Athinaiki Zithopiia*).

¹¹¹² The Greek Income Tax Code states that if the net profits arising from the balance sheet of Greek public limited companies also include non-taxable income, in order to determine the taxable profits of the legal person there shall be added thereto the fraction of non-taxable income corresponding to distributed profits in any form, after transformation of that amount into a gross amount by the addition of the corresponding tax. The provisions of the Greek legislation also apply by analogy to the distribution of profits by Greek public limited companies whose profits also include profits subject to special determination or taxation in their own name.

¹¹¹³ Opinion of Advocate General Alber, Case C-294/99 (*Athinaiki Zithopiia*).

¹¹¹⁴ Case C-375/98.

supposed to create fiscal neutrality, in order to reduce the tax burden on cross-border cooperation and thereby to promote the freedom of establishment and the free movement of capital. Advocate General Alber argues that under the broad interpretation required by the Court, the concept of withholding tax includes every tax provision that has the effect of taxing distributions of profits by a resident subsidiary company to a non-resident parent company. The specific designation or the structure of the tax is immaterial. Advocate General argues that the Greek national tax provisions leads to special taxation where profits are distributed. Moreover, it is because of the distributions that tax is levied. Thus, although the taxation falls within the framework of income tax payable by the undertaking making the distribution, it involves a withholding tax.

On the other hand, Advocate General stresses that taxation of the activity of the resident subsidiary company must be distinguished from withholding tax. In principle, the former is not affected by the Directive. However, a Member State is unable in that context to enact provisions which are in practice equivalent to a withholding tax. Thus, within the field of application of the Directive, tax legislation that links particular fiscal charges to a distribution of profits is prohibited if in the absence of the distribution those fiscal charges would not arise. In practice, the distribution of profits is thereby equated to their retention.¹¹¹⁵

Advocate General concludes that in the *Athinaiki Zithopiia* case the tax burden increases only because the applicant distributes its profits and the provisions which lead to the increase in tax burden are to be equated to a withholding tax and are incompatible with Article 5 of the Directive.

The ECJ in its judgment¹¹¹⁶ agreed with the Advocate General's Opinion and held that there is a withholding tax, within the meaning of Article 5(1) of the Directive, where national legislation provides that, in the event of profit distribution by a subsidiary to its parent company, in order to determine the taxable profits of the subsidiary, its total net profits, must be reincorporated into the basic taxable amount, when income falling within those two categories would not be taxable on the basis of the national legislation if they remained with the subsidiary and were not distributed to the parent company.

Although Article 10(2) of the tax treaty between the Hellenic Republic and the Kingdom of the Netherlands permits Greece to tax dividends paid by a company established in Greece to a shareholder resident in the Netherlands at a rate of 35 per cent at a maximum, the ECJ held that the rights conferred on economic operators by Article 5(1) of the Directive are unconditional and a Member State cannot make their observance subject to an agreement concluded with another Member State.

4.3.1.10 Problems

The Parent-Subsidiary Directive does not cover all types of profit distributions. The Directive covers profit distributions paid between associated companies where the parent company has a holding of 25% in the subsidiary located in another Member State.¹¹¹⁷ The Directive does not specifically state whether the holding of 25% must be held directly in order to qualify or whether indirect holdings through an intermediary holding company controlled by the ultimate shareholder company also qualify. In the absence of any express provision, the Commission takes the view that the Directive only has binding effects in cases of direct ownership. This requirement creates cross-border problems, particularly in the case of restructuring, because indirect holdings are not taken into account to calculate the Directive's threshold, which can have undesirable implications for the internal organisation of groups of

¹¹¹⁵ See Opinion of Advocate General Alber, Case C-294/99 (*Athinaiki Zithopiia*), paragraph 27.

¹¹¹⁶ Case C-294/99 (*Athinaiki Zithopiia*).

¹¹¹⁷ Some Member States do apply thresholds of 5% or 10%, which are lower than the Directive's 25%.

companies and hamper restructuring operations.¹¹¹⁸ According to the amended directive indirect holdings in any lower tier subsidiaries are also covered. In addition, the threshold requirement will be gradually lowered from 25% to 10% by a year 2009.

Additional problems may arise when a company possesses a permanent establishment through which it holds shares in other companies. It may happen that holdings in the capital of the other companies and profits derived therefrom will be attributed for tax purposes to the permanent establishment of a company. This is likely to happen in particular when the permanent establishment and the company whose shares are held are situated in the same State, although it may also happen when they are situated in different States. If the State or States concerned are Member States of the EC, the question arises as to whether a parent/subsidiary relationship as defined by the Directive can be constituted by means of a shareholding held through a permanent establishment. The situations where a parent company and its subsidiary are in the different Member States are covered in the Directive 2003/123/EC of 22 December 2003, which states that the payment of profit distributions to, and their receipt by, a permanent establishment of a parent company should give rise to the same treatment as that applying between a subsidiary and its parent. It is stated in the preamble of the Directive that the situations where a parent company and its subsidiary are in the same Member State should be dealt with on the basis of national legislation by the Member State concerned.

The Directive currently applies only to operations between companies liable to corporation tax who do not enjoy the right to opt to be so liable and who take one of the legal forms set out in the list attached to the Directive. Consequently the Directive does not cover some dividend distributions even where the companies concerned are wholly liable to corporation tax and pay or receive dividends. Partnerships which in some Member States are liable to or may opt to be liable to corporation tax are excluded from the scope of the Directive even where national legislation and bilateral double taxation treaties treat profits distributed by such companies to their associate companies as dividends. To overcome this problem the Commission presented a proposal for a directive to extend it to all companies subject to corporation tax irrespective of their legal form. The proposed provision was included in the amended text of the Directive.¹¹¹⁹

The problems above have been dealt with in the directive 2003/123/EC of 22 December 2003. However, several problems are still not dealt with by the directive 2003/123/EC.

For example, the Directive only sets out the basic rules for the abolition of double taxation. Member States are left to choose by themselves the method of the avoidance of double taxation. The interpretations adopted by each of the Member States' implementation laws differ significantly from each other. This is particularly true as far as the credit method under the Directive is concerned.¹¹²⁰ The Directive does not provide detailed rules on the computation and operation for tax credit. The Directive also lacks precision of defining important concepts of the Directive. Member States are free to draw up their own detailed provisions in the light of their domestic law and existing bilateral tax treaties. However, resulting differences in national interpretations set limits to the effective elimination of double taxation on cross-border intra-group profit distributions that is the purpose of the Directive.

Some other terms have not been defined precisely by the Directive.¹¹²¹ For example, Article 3(1) contains the requirement that qualifying company (the parent) has to have a minimum holding of 25 % in the capital of a company of another Member State (the subsidiary). This wording has been criticised for its vagueness. It is not clarified in the Directive what is meant by 'holding'. In addition, it is not clear what is meant by 'capital'. The definition of capital

¹¹¹⁸ See section 4.3.1.12.

¹¹¹⁹ See section 4.3.1.12.

¹¹²⁰ See Thömmes (1992), pp. 254-255.

¹¹²¹ See Weber (2000), pp. 21-22.

may include equity capital, share capital carrying a right to fixed dividends, loan capital and other borrowings.¹¹²² The voting right requirement has also raised questions: whether it refers to the number of voting rights in general or the number of voting shares. Some more issues are unclear with respect to the voting right criterion, for example, whether the person holding the voting rights should also be a shareholder.¹¹²³

The general anti-abuse provision of Article 1(2) has been criticised for not providing workable definition of transactions constituting ‘abuse’. The Directive does not give any guidance as to what precisely is intended to be included within the concept of ‘the prevention of fraud or abuse’. Member States have left discretion to introduce their own anti-abuse provisions when implementing the Directive into national law. There is enormous scope for differences of approach in implementing the directive which contradicts one of the principles in the jurisdiction of the ECJ, that Community law must be applied uniformly among Member States.¹¹²⁴ It has been argued that lack of precise definitions for general anti-abuse provision undermines the harmonization attempts of the Directive.¹¹²⁵

The vague wording of Article 1(2) has raised some doubts whether Directive is precise enough to have direct effect. However, the terms of Article 5 dealing with the removal of withholding taxes on profit distributions are precise enough to meet the criterion of clarity.¹¹²⁶

Furthermore, the subject-to-tax requirement of the Directive has been criticised for its ambiguous wording. It is not clear whether the income of the company has to be subject to tax in order to qualify for the benefits of the Directive or is it enough if the receiving company is subject to tax.¹¹²⁷

4.3.1.11 *Obstacles relating to the imputation systems*

The Directive does not deal with the distortionary effects of discriminatory imputation systems of the Member States. According to Article 7 of the Directive, the term ‘withholding tax’ does not apply to an advance payment or prepayment of corporate taxes and thus the Directive does not affect imputation systems such as those in force in France, Italy, Spain, Portugal, Finland, and the UK.

Under these imputation systems the domestic recipient of a dividend may credit the tax paid by the company on the distributed profits against his own tax liability. The tax credit for the corporation tax available to domestic shareholders is not available to non-resident shareholders. Under some tax treaties a partial repayment of this credit is made to non-resident investors, usually subject to a withholding tax.¹¹²⁸ However, in the absence of the treaty provision this will not be done. In result, domestic investors are in more favourable position than investors from Member States to which this system of credits is not extended; moreover, investors from different Member States obtain different returns from an investment in the same Member State. This distortion may affect post-tax returns and cause switches of investment all over Europe. These imputation systems contain a considerable bias towards domestic investment.

Under the shareholder relief system dividends are included in the taxable profits and no tax credit is granted. There are, however, ways of mitigating double taxation such as taxing dividends at a lower rate than that normally applying or granting other forms of tax relief on dividend payments – so called ‘shareholder relief’. However, such preferential tax arrange-

¹¹²² Oliver (1999), pp. 204 - 205.

¹¹²³ See Weber (2000), p. 22.

¹¹²⁴ See Knobbe-Keuk (1992) and Weber, D. (1996), p. 64.

¹¹²⁵ See Raby (1992), pp. 216-223 and Weber (1996), pp. 63-69.

¹¹²⁶ See Raby (1992), pp. 216- 223.

¹¹²⁷ See Weber (2000), p. 21.

¹¹²⁸ Raby (1992), p. 219.

ments sometimes apply only to domestic shareholdings and not to dividends from foreign shares. Where this is the case, such discrimination usually concerns individuals but may also apply to company dividend payments. As confirmed by the European Court of Justice in its judgement in Case C-35/98 (*Verkooijen*) these arrangements are not compatible with the free movement of capital.¹¹²⁹

Thus, it follows from Article 7 of the Directive that Member States may continue application of imputation systems as well as shareholder relief systems. Several commentators have expressed the opinion that the objectives of the Directive cannot be achieved without dealing with the matter of imputation credits and shareholder reliefs.¹¹³⁰

4.3.1.12 *The amendments to the Directive*

The Commission presented a proposal for amendment of the Parent-Subsidiary Directive suggesting that its scope should be broadened. The Commission proposed that the Directive should cover both direct and indirect shareholdings. In addition, a lower minimum holding threshold was proposed. Furthermore, the Commission proposed to extend the Directive to all companies subject to corporation tax irrespective of their legal form.

The proposal was adopted as a directive 2003/123/EC on 22 December 2003 and the Member States must harmonize their legislation with its requirements by 1 January 2005 at the latest.¹¹³¹

According to the amended directive, a minimum holding threshold will be gradually lowered from 25% to 10%. As from 1 January 2005, the required holding will be decreased to 20%. The threshold is decreased to 15% as from 1 January 2007 and to 10% as from 1 January 2009.

Furthermore, the amended directive provides that the payments made by any lower tier subsidiaries are covered by the directive. It follows that the new directive also covers indirect holdings which meet the minimum threshold requirement.

The current Directive contains a list of companies to which the Directive applies. The amended Directive extends the scope of its benefits to other entities which carry out cross-border activities in the EC and which meet all the conditions laid down in the Directive.

The scope of the amended Directive also includes the companies which are run under the European Company Statute, including the European Company (SE) and the European Cooperative Society (SCE).

4.3.2 *The Merger Directive*

4.3.2.1 *Background*

The first proposal for the Merger Directive was made already in 1969. Council Directive 90/434/EEC on the common system of taxation applicable to mergers, divisions, transfers of

¹¹²⁹ Dutch legislation exempted income tax on the first NLG 1 000 of dividends paid by Dutch companies (NLG 2 000 for married couples). This relief did not apply to dividends paid by companies from other Member States. The ECJ ruled that such a provision was a restriction on the free movement of capital. See section 4.1 for more elaborate examination of the *Verkooijen* case.

¹¹³⁰ See Raby (1992), pp. 219-220, Terra and Wattel (1997), pp. 231-253 and Commission (2001c).

¹¹³¹ The Council Directive of December 22, 2003 (2003/123/EC) amending Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, published in L 7/41.

assets and exchanges of shares concerning companies of different Member States¹¹³² was finally adopted in 1990. The aim of the Directive is to decrease the tax costs in cross-frontier mergers.

The discrimination against cross-border mergers in comparison to domestic ones creates barriers to the free movement within the Internal Market. The underlying objective of the Merger Directive is to eliminate the barriers that exist in setting up transnational companies and groups. The Directive aims to remove the tax obstacles to the mergers concerning companies of different Member States. According to the preamble to the Merger Directive differences between the systems of Member States tend to produce distortions, and, therefore, it is necessary to introduce common rules.

4.3.2.2 *Scope*

The Directive applies to mergers, divisions, transfers of assets and exchanges of shares in which companies from two or more Member States are involved (Article 1). The scope of the Directive is quite limited and its impact upon national tax revenues rather modest.¹¹³³ Directive merely provides temporary deferral of taxation of the capital gains related to cross-border mergers.

4.3.2.3 *Qualifying companies*

In order to qualify for the benefits of the Merger Directive companies from different Member States must be involved in the restructuring operations. The companies qualify for the benefits if the following conditions are met:

- they are subject to corporation tax;
- according to the tax laws of a Member State are considered to be resident in that State for tax purposes and, under the terms of a tax treaty concluded with a third State, are not considered to be resident for tax purposes outside the Community;
- take one of the forms listed in the Annex to the Directive.

4.3.2.4 *Restructuring operations covered*

Restructuring operations concerned are defined in Article 2(a) – (d). The Directive covers the following operations:

- a) mergers of companies, which is defined as an operation whereby
 - one or more companies, on being dissolved without going into liquidation, transfer all their assets and liabilities to another existing company in exchange for the issue to their shareholders of securities representing the capital of that other company, and, if applicable, a cash payment not exceeding 10 per cent of the nominal value, or, in the absence of a nominal value, of the accounting par value of those securities,
 - two or more companies, on being dissolved without going into liquidation, transfer all their assets and liabilities to a company that they form, in exchange for the issue to their shareholders of securities representing the capital of that new company, and, if applicable, a cash payment not exceeding 10 per cent of the nominal value, or in the absence of a nominal value, of the accounting par value of those securities,
 - a company, on being dissolved without going into liquidation, transfers all its assets and liabilities to the company holding all the securities representing its capital;

¹¹³² Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, OJ L 225, 20/08/1990, p.1.

¹¹³³ Easson (1993), p. 195.

- b) divisions of companies, which is defined as an operation whereby a company, on being dissolved without going into liquidation, transfers all its assets and liabilities to two or more existing or new companies, in exchange for the pro rata issue to its shareholders of securities representing the capital of the companies receiving the assets and liabilities, and, if applicable, a cash payment not exceeding 10 % of the nominal value or, in the absence of a nominal value, of the accounting par value of those securities;
- c) transfers of assets whereby a company transfers one or more branches of its activity to another company in exchange for the transfer of securities representing the capital of the company receiving the transfer;
- d) exchange of shares whereby a company acquires a majority of the voting rights in a company in exchange for the issue to the shareholders of the company acquired of securities representing the capital of that company in exchange for their securities.

In the case of mergers and divisions assets and liabilities must remain connected with the permanent establishment of the receiving company in the Member State of the transferring company.

4.3.2.5 *Main features*

The Directive provides the system of deferral of the taxation of the capital gains relating to the assets transferred until their actual disposal, permits exemption from taxation of the corresponding capital gains, while at the same time ensuring their ultimate taxation by the State of the transferring company at the date of their disposal.

4.3.2.6 *Tax rules under the Directive*

Article 4 provides that a merger or division shall not give rise to any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes. This is achieved by connecting the transferred assets and liabilities with a permanent establishment of the receiving company in the Member State of the transferring company. Technically the values for tax purposes at which the transferring company carried the assets in its accounts should be maintained in the accounts of the permanent establishment resulting from the merger. Tax will be imposed later on the difference between the disposal price and the old tax value when the receiving company disposes of the assets transferred.

The receiving company must compute depreciation and capital gains according to the rules that would have applied to the transferring company if the merger, division or transfer of assets had not taken place. Special rules apply to triangular operations (mergers, divisions or transfer of assets by a company with a permanent establishment in another Member State).

Tax-exempt provisions or reserves are not taxed at the time a merger, division or transfer of assets takes place. However, the receiving company must assume the rights and obligations of the transferring company as regards the restatement of these provisions or reserves in its taxable profit.

Member States must ensure that cross-border operations covered by the Directive are subject to the same national rules relating to the transfer of losses from the transferring company to the receiving company that they apply to domestic mergers, divisions or transfers of assets.

No tax is charged at the time shares are exchanged but Member States may tax the profit generated by the subsequent disposal of shares received in exchange in the same way as they would tax the profit from the disposal of the shares exchanged.

4.3.2.7 *Anti-abuse provisions*

Member States have the option of not applying the Directive or excluding profit if the merger, division, transfer of assets or exchange of shares has as its principal or one of its principal objectives tax evasion or tax avoidance, or if the operation is intended to prevent employees from being represented on the company's management bodies. The anti-abuse clause contained in Article 11(1)(a) of the Merger Directive further clarifies that the fact that one of the operations referred to in Article 1 is not carried out for valid commercial reasons such as the restructuring or rationalisation of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives.

According to the ECJ the anti-abuse clause has to be applied individually and proportionally. The principle of proportionality requires that national provisions should not go further than is necessary to eliminate the unjustified entitlement of the Directive benefits. The benefits of the Directive should not be withheld in cases of genuine cross-border co-operation.¹¹³⁴ The ECJ ruled in its *Leur Bloem*¹¹³⁵ judgement that the legal principles of proportionality and effective judicial review have to be followed when applying the anti-abuse provision.¹¹³⁶ In *Leur Bloem*, the ECJ considered that in order to determine whether the principal or one of its principal objectives of a merger operation was tax evasion or tax avoidance '... the competent national authorities cannot confine themselves to apply predetermined general criteria but must subject each particular case to a general examination. According to established case law, such an examination must be open to judicial review.'¹¹³⁷ The ECJ explicitly provided that the proportionality principle has to be observed by Member States when applying the anti-abuse clause of the Directive.¹¹³⁸ The ECJ considered that '... the laying down of general rule automatically excluding certain categories of operations from the tax advantage' on the basis of predetermined criteria '... whether or not there is actually tax evasion or tax avoidance, would go further than is necessary for preventing such tax evasion or tax avoidance and would undermine the aim pursued by the Directive. This would also be the case if a rule of this kind were to be made subject to the mere possibility of the grant of a derogation, at the discretion of the administrative authority.'¹¹³⁹

4.3.2.8 *Independent business as interpreted by the ECJ*

The ECJ has in its decisions formulated some principles related to tax-neutral transfers of assets under the Merger Directive. In the *Anderesen & Jensen ApS* case¹¹⁴⁰ the ECJ gave the judgment on two basic questions in relation to the interpretation of the Directive.

Firstly, the ECJ was asked whether there is a conflict with the requirement of independence if a transferring company (the parent company) provides a security or a guarantee for a receiving company (the subsidiary) to which a branch of activity is transferred? The ECJ stipulated that it is for the national court to determine whether a transfer of assets involves an independent business, but the security or guarantee is not automatically in conflict with the requirement of independence.

Secondly, the ECJ was asked whether there is a conflict with the concept of "company" or "branch" if the proceeds of a loan are separated from the debt liability and the proceeds are

¹¹³⁴ See Farmer and Lyal (1994), p. 292.

¹¹³⁵ Case C-28/95.

¹¹³⁶ See Albregtse and Kogels (1999), pp. 27-29. See also Hoenjet (1997) and Thömmes (1997) about *Leur Bloem* case.

¹¹³⁷ Case C-28/95 (*Leur Bloem*), paragraph 41.

¹¹³⁸ Ibid, paragraph 43.

¹¹³⁹ Ibid, paragraph 44.

¹¹⁴⁰ Case C-43/00.

permitted to remain in the transferring company? The ECJ replied that in the case above, there is a conflict with the concept of “company” or “branch” and that such separation of the loan proceeds and the obligations arising from the loan are excluded by the Directive’s definition of an independent branch of activity.

4.3.2.9 Problems

The Directive only addresses the short-term problems of the realisation of capital gains in the course of a merger. However, it does not concern with long-term tax obstacles to cross-border mergers coming from the differences between Member States’ systems of taxation of distributed company profits, and the differences in tax treatment between a foreign subsidiary and a foreign branch. Harmonising national tax systems is politically unattainable for the time being.¹¹⁴¹ Furthermore, the effectiveness of the Merger Directive and the Parent-Subsidiary Directive is reduced by the fact that they do not cover all companies subject to corporation tax and apply solely to direct holdings of 25% or more.

4.3.2.10 The latest study by the Commission about the Merger Directive

The Commission in its latest study¹¹⁴² realises that although the Merger Directive has improved the situation, it is not wholly satisfactory and does not enable companies to undertake cross-border restructuring operations in the way they would wish. Despite the Directive, cross-border restructuring operations can still involve significant tax costs. Although tax arrangements applying to cross-border restructuring operations covered by the Directive have existed since 1990, the Directive on company law which is intended to permit and regulate cross-border company mergers has still not been adopted¹¹⁴³, due to difficulties concerning the issue of worker involvement. Consequently cross-frontier mergers and divisions are still hampered by the fact that some national legislation does not allow companies to be absorbed or divided by foreign companies. If cross-border mergers or divisions of companies are not legally possible, extra costs for companies who are unable to improve their organisation are created. Currently only cross-border transfers of assets or exchange of shares can be undertaken in all Member States.

The Commission believes that effectiveness of the Merger Directive is reduced by the fact that it does not cover all types of operation which may be involved in restructuring. At present the Merger Directive does not cover certain company restructuring operations even though the companies in question may be wholly subject to corporation tax. The Commission presented a proposal for a Directive¹¹⁴⁴ to remedy this situation. It would amend the 1990 Merger Directive to extend it to all businesses subject to corporation tax irrespective of their legal form.

The Directive does not cover partnerships if they are not subject to corporation tax but their profits are taxed at partner level. Cross-border restructuring of such businesses could involve an extremely large tax burden for their associates. Moreover, transfers of assets by natural persons who own a business which is not operated as a company and who wish to transfer it to a company in consideration for shares of that company are not covered by the Directive.

There are doubts about whether the ‘subsidiarisation’ of companies’ branches is covered by the Merger Directive. This involves the transfer by means of a transfer of assets within the

¹¹⁴¹ See Terra and Wattel (1997), pp. 255-273.

¹¹⁴² Commission (2001c).

¹¹⁴³ Tenth proposal for a Council directive on cross-border mergers on public limited companies (COM (84) 727 final of 8 January 1985).

¹¹⁴⁴ Proposal for a Council Directive amending Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, COM (1993) 293 final.

meaning of the Directive of a permanent establishment located in a Member State to a new company established in the same Member State. Article 4 of the Directive makes the deferral of capital gains tax conditional on the assets continuing to be effectively connected with a permanent establishment situated in the Member State of the transferring company. The Commission takes the view that, given the Directive's purpose, Article 4, which was designed to cover mergers and divisions of companies, cannot be intended to exclude the conversion of permanent establishments into subsidiaries from the Directive's scope. The conversion of a branch into a subsidiary does not affect the taxation right of the State where the former permanent establishment was located and cannot be interpreted as excluding it from the Directive's tax neutrality principle.

Generally, the objective of the Merger Directive is to guarantee the tax neutrality of restructuring operations covered by the Directive and, at the same time, safeguard Member States' financial interests. Consequently - for mergers, divisions or transfers of assets - the assets transferred by the receiving, divided or transferring company must remain effectively connected with a permanent establishment of the receiving company located in the Member State of the acquired, divided or transferring company. The Directive does not apply when there is no permanent establishment.

The mergers and divisions of holding companies which do not result in the creation of a permanent establishment in the Member State of the company concerned are equally not covered by the Directive. Similarly, the transfer of cash between companies of a same group but situated in different Member States often cannot benefit from the exemption of capital gains taxation whereas it is common that in the framework of group taxation schemes within Member States such transfers do not give rise to capital gains taxation.

The Commission intends to examine to which extent specific transfer taxes arising on cross-border restructuring operations (notably on immovable property) could be taken into account. In this context, the Commission proposes that specific transfer taxes arising on cross-border restructuring operations should be included in the Capital Duty Directive.¹¹⁴⁵

Furthermore, the Commission recognises that there are important divergences of national measures transposing the Merger Directive. In some cases national legislation seems to have adopted transposition measures which raise doubts concerning their compatibility with the Directive. In others, divergent legislation has been adopted because of the Directive's lack of clarity on some - particularly important - points. The lack of uniformity in national legislation undermines the practical usefulness of the directive. Some national legislation makes the application of the Merger Directive subject to conditions which are not laid down in the Directive. According to Member States concerned these are based on Article 11(1)(a) of the Directive which allows them not to apply the Directive or to deny its benefit where the merger, division, transfer of assets or exchange of shares has as its principal objective or as one of its principal objectives tax evasion or tax avoidance ('anti-abuse-clause'). The case most often cited is where a number of the Member States require that shares received under a transfer of assets or an exchange of shares be kept for a certain period which varies from three to seven years. The rapid disposal of shares received as a result of a transfer of assets or exchange of shares could be an abuse within the meaning of Article 11 of the Directive. However, in its judgement in *Leur Bloem* case, the European Court of Justice ruled that such abuse had to be assessed on a case-by-case basis. A blanket refusal to apply the Directive where shares received are disposed of before a particular deadline without giving taxpayers an opportunity to prove that such disposals are not of an abusive nature is therefore unlikely to be consistent with the Directive. Moreover, minimum holding periods that are particularly long - up to five or seven years after the initial operation - appear to be difficult to justify on the grounds of preventing abuse.

¹¹⁴⁵ 69/335/EEC and 85/303/EEC.

Article 8(1) of the Merger Directive provides that the exchange of shares within the meaning of the Directive may not give rise to taxation of the associate company relinquishing its shares for exchange. However, Article 8(2) states that Member States may subsequently tax the gain arising out of the subsequent disposal of shares received in the same way as the gain arising out of the transfer of shares existing before the acquisition. In some Member States shareholders exchanging shares in the acquired company for shares in the acquiring company are taxed before disposing of the shares received in the acquiring company, especially if shares in the acquired company are transferred by the acquiring company before shareholders dispose of shares in the acquiring company. The Commission argues that such an approach does not seem to be fully in line with Article 8 of the Merger Directive which does not provide for any form of taxation before a shareholder sells shares in the acquiring company received in exchange for shares in the acquired company.

The Commission realises that the Merger Directive could be clarified to make it clear that instances of economic double taxation should be avoided. One example for this could be to prescribe that capital gains arising on the sale of shares received in exchange for shares or assets are calculated on the basis of the market value at the time of the exchange, thus resolving previously accumulated 'hidden reserves' without immediate tax consequences. A more radical change to the Directive would be to extend its scope so as to defer the triggering of tax charges where assets are moved to another Member State while preserving Member States' tax claims.

4.3.2.11 The Commission's proposal concerning the Directive

In 1993, the Commission presented proposal for amendment of the Merger Directive suggesting that its scope be extended to cover other entities subject to company taxation. On 20 October 2003, the Commission made amendments to the existing proposals for the Merger Directive with a view to broadening the scope and the coverage of both individual taxes and types of transactions.¹¹⁴⁶ The modified directive would apply to a larger range of entities, including the European Company (SE) and the European Cooperative Society (SCE). The proposal intends to ensure a tax neutral transfer of registered office of a SE or a SCE between Member States. Furthermore, the proposed directive would apply to new type of business reorganisation, including the partial division or split-off. The modified directive would make the deferral regime – as provided for in the Merger Directive – applicable to the conversions of branches into subsidiaries. The Member States would have to implement the new Directive into their national law by 1 January 2005 at the latest.

4.3.3 The Arbitration Convention

The Arbitration Convention is based upon Article 293 of the EC Treaty. The Convention is not a legal act in the framework of the Community institutions but exists directly among Member States and is essentially a multilateral agreement under international law. Therefore, the principles of case law developed by the ECJ (like direct effect, supremacy of Community law) are not applicable for the Convention. EU institutions have no similar rights in respect to the Convention as they have in respect of the EU legal acts and the national courts not EU institutions have the right for enforcement jurisdiction concerning the Convention. The ECJ has no jurisdiction to give preliminary rulings concerning the validity and interpretation of the Convention as it has in the case of the Community acts. The Commission has no right to initiate the infringement procedure if it considers that a Member State has failed to fulfil its obligations, as it has in the case of Community acts.

¹¹⁴⁶ COM(2003)613final.

4.3.3.1 *Background*

If during the fiscal audit of a multinational enterprise, a disagreement regarding the inter-company prices should ensue between the respective national tax administrations there may be a risk that the tax administration of one Member State will not or not fully recognise the price paid by the subsidiary in that Member State to its parent company situated in another Member State. Consequently the tax administration of that State may then increase the amount of the subsidiary's profit without this being matched up by a corresponding adjustment of the parent's profit by the tax administration in another Member State.¹¹⁴⁷ Most of the bilateral treaties for the avoidance of double taxation, based on OECD Model Convention, contain the provision concerning transfer pricing. The convention provides that the competent authorities of the states concerned have to resolve the complaints of the enterprises affected by profit adjustment by mutual agreement procedure, but there is no guarantee that double taxation will be eliminated if no agreement is reached. Procedure under bilateral tax treaties is also very time-consuming and it can take years before the agreement is reached.

4.3.3.2 *Aims of the Convention*

The Arbitration Convention aims to eliminate double taxation in connection with the adjustment of transfers of profits between associated enterprises by providing for a new Community-wide arbitration procedure. The Convention requires the tax administrations of the Member States within a certain period to come to a binding solution concerning a given matter with a view *inter alia* to securing the abolition of double taxation for the benefit of their nationals. The adoption of the Arbitration Convention was expected to be particularly beneficial to small and medium sized enterprises wishing to operate in the Single Market, for whom the cost and time-consuming transfer pricing procedure was most discouraging.

4.3.3.3 *Main features*

The main features of the Arbitration Convention can be summarised as following¹¹⁴⁸:

- the contractual obligation for Member States to settle the dispute definitely;
- the establishing of a neutral authority equipped with powers to finally determine the required decision as to how to avoid double taxation;
- in the long term, the development of common substantive standards on transfer pricing questions.

The Arbitration Convention contains two main principles: the arm's length principle and the obligation to eliminate double taxation.

4.3.3.4 *The scope*

The Convention concerns only with double taxation resulting from adjustment of profits of associated enterprises, and not with the elimination of double taxation generally. Article 1 provides that the Convention applies where, for the purposes of taxation, profits which are included in the profits of an enterprise of a Contracting State are also included or are also likely to be included in the profits of an enterprise of another Contracting State as a result of an adjustment made by the competent authorities of one of those states.

4.3.3.5 *Rules and procedures of the Convention*

The Arbitration Convention provides that if the competent authorities do not reach agreement within two years of the date on which the case was first submitted to one of the compe-

¹¹⁴⁷ See Thömmes (1990a), p. 212.

¹¹⁴⁸ See Thömmes (1990b), p. 464.

tent authorities, the complaint will be submitted to an advisory commission. The advisory commission consists Chairman, equal number of representatives from each competent authority concerned and an even number of independent persons. The commission makes its decisions by a simple majority vote. The advisory commission shall deliver its opinion not more than six months from the date on which the matter was referred to it. The competent authorities acting by common consent have to take a decision that will eliminate the double taxation within six months of the date on which the advisory commission delivered its opinion. The competent authorities may take a decision that deviates from the advisory commission's opinion. If they fail to reach agreement, they shall be obliged to act in accordance with that opinion. For the purposes of this Convention, the double taxation of profits shall be regarded as eliminated if either the profits are included in the computation of taxable profits in one State only or the tax chargeable on those profits in one State is reduced by an amount equal to the tax chargeable on them in the other.

4.3.3.6 *Problems*

The Arbitration Convention entered into force on 1 January 1995. However, the application of the convention is currently suspended as its prolongation beyond 2000 still awaits ratification in three Member States.¹¹⁴⁹ The self-imposed limitation on a duration of the Arbitration Convention contains its weakness: Article 20 of the EC Arbitration Convention states that the convention will be in force for a period of five years. In order to extend its duration a decision favouring an extension must be made by all EC Member States. This decision must be unanimously taken. Any one Member State's refusal to extend the application of the Convention will therefore terminate its application, after its initial period of five years have come to an end.

It has been pointed out that some Member States intend to interpret the Convention in a way which either lengthens the procedure considerably or will even exclude the taxpayer from using it after it has first gone through the national appeal procedures. This is contrary to the intent of the Convention.¹¹⁵⁰

4.3.3.7 *The latest Commission's initiatives*

The Communication by the Commission¹¹⁵¹ finds that the Arbitration Convention, which seeks to provide a binding dispute resolution procedure in transfer pricing, is rarely used and that certain of its provisions may act as a deterrent for taxpayers to make use of it. The Commission recognises the improvement of the Arbitration Convention as a priority issue. The Commission expresses the view that the shortcomings of the convention must be removed and its provisions should be made subject to interpretation by the ECJ, preferably by turning it into an instrument of Community law. Moreover, subject to safeguards to prevent aggressive tax planning, a framework should be established for prior agreement between the tax administrations involved or at least consultation before tax administrations enforce transfer-pricing adjustments. The Commission intends to examine necessary improvements to the Arbitration Convention with a view to presenting a formal proposal for a Directive.

¹¹⁴⁹ It is expected that all the countries will agree with the extension of the convention beyond the next five-year period, so that it can enter into force on 1 January 2005.

¹¹⁵⁰ See UNICE (1999), p. 79.

¹¹⁵¹ Commission (2001b).

4.3.4 *Interest and Royalties Directive*

Not only the differences in taxation of cross-border dividend payments¹¹⁵², but also the differences in cross-border interest and royalty payments within group of companies can pose impediments to the investment flows between Member States and the grouping together of companies. In most Member States domestic interest and royalty payments are exempt from withholding tax. Cross-border payments, however, often suffer double taxation through the levying of withholding tax in the state of payment and an income tax in the state of reception, even though double tax treaties mitigate such double taxation.

On 6 December 1990, the Commission submitted a Proposal for a Directive on the abolition of withholding taxes on cross-border payments of interest and royalties within group of companies.¹¹⁵³ The Council was not able to reach an agreement upon the Directive and it was withdrawn in 1994. However, it was reintroduced by the Commission during Verona meeting of the ECOFIN Ministers in 1996. ECOFIN Council on 1 December 1997 agreed on the tax package of three measures to tackle harmful tax competition proposed by the Commission.¹¹⁵⁴ The package included a Proposal for the Interest and Royalties Directive. On 6 March 1998 the European Commission, at the request of the ECOFIN Council, resubmitted the draft directive.¹¹⁵⁵ The Council adopted the tax package including the Interest and Royalties Directive¹¹⁵⁶ (hereafter: the Directive) in June 2003.¹¹⁵⁷ In comparison with the Proposal, the scope of the Directive was narrowed: the Proposal applied to direct or indirect holdings of 25 per cent or more, the Council decided to limit the scope of the directive to direct holdings.¹¹⁵⁸ In addition, the Directive only applies to companies that take one of the forms listed in the Annex to the Directive.¹¹⁵⁹ Furthermore, the Council narrowed the scope of definitions of interest and royalty.¹¹⁶⁰

¹¹⁵² Taxation of cross-border dividend payments within groups of companies is regulated by the Parent-Subsidiary Directive (see section 4.2.1).

¹¹⁵³ OJ C 53, 28 February 1991, p. 26. Amended by the Directive of 10 June 1993, OJ C 178, 1993.

¹¹⁵⁴ See section 2.4.4.

¹¹⁵⁵ Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, COM (1998) 67 final, OJ C 123, 22 March 1998.

¹¹⁵⁶ Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157, 26.6.2003, p. 49. The Directive is due to take effect from 1 January 2004.

¹¹⁵⁷ See also section 2.4.4.

¹¹⁵⁸ See Article 3(b) of the Directive.

¹¹⁵⁹ The draft Directive contained a requirement that the qualifying company needed to have economic links with the economy of the Member State where it was formed. This requirement is stipulated neither in the Parent-Subsidiary Directive nor in the Merger Directive. Thus, the draft Directive introduced a specific criterion companies had to meet in order to qualify for the benefits of the Directive. The adopted Directive does not provide for that requirement but lists the qualifying companies in a separate Annex like the Parent-Subsidiary Directive and the Merger Directive.

¹¹⁶⁰ Article 2(2) of the draft directive provided that if the income and payments are considered to be interest or royalties according to the tax treaty in force between Member States in question then the definitions provided in that treaty are applied. The draft directive, furthermore, stipulated that in the absence of a tax treaty, the definitions in the tax legislation of the Member State where the interest or royalties arise, if wider, are followed for the purposes of the Directive. The aim of this provision was to ensure that all types of payments between parent companies and subsidiaries regarded as interest or royalties by Member States were treated equally. Thus, a Member State adopting a broad domestic law definition could not escape the operation of the directive. (Terra and Wattel (2001), p. 301.) However, the Council decided to delete this provision from the final text of the Directive.

4.3.4.1 *Background*

Withholding taxes on royalty and interest income are usually eliminated or significantly reduced under bilateral tax treaties. However, even when tax treaties apply for the cross-border interest and royalty payments, the tax credit for the withholding tax paid in the State of the debtor company is limited to that part of domestic tax which is attributable to the foreign source income in question.¹¹⁶¹ Therefore, in cases where the domestic tax is lower than the foreign tax, the latter will constitute a higher tax burden. Furthermore, bilateral agreements vary considerably in their manner by which they abolish double taxation of royalty and interest income and they do not always ensure that double taxation is completely eliminated. In addition, the application of tax treaties entails burdensome administrative formalities and the refunding of the overpaid tax often takes time. The crediting of the foreign withholding tax also is a time-consuming matter. This gives rise to the cash-flow problems and opportunity cost for the companies concerned. This cumbersome application procedure under the bilateral treaties is especially discouraging for small and medium-sized companies. In addition, the differences in national tax provisions of the Member States applicable to interest and royalty payments, pose the barrier to the free movement of capital.

4.3.4.2 *Purpose of the Directive*

As formulated in the preamble of the Directive, its objective is to eliminate the above-mentioned distortions of the Common Market. The Directive aims to put an end to the disadvantageous tax treatment of cross-border interest and royalty payments in comparison with taxation of these payments between companies of the same Member State and to ensure that interest and royalty payments are subject to tax only once in a Member State.

4.3.4.3 *Scope*

The Directive applies exclusively to payments between associated companies. Payments made by a company or a permanent establishment in a Member State to a company or a permanent establishment in another Member State fall into the scope of the Directive (Article 1(1) of the Directive). Thus, it only applies to the cross-border situations and the domestic transactions fall outside of the scope of the Directive. The application of the Directive is restricted to the arm's length amount.

4.3.4.4 *Main features*

The Directive addresses the area of interest and royalties paid between associated companies within the EU. In the source state, the Directive provides for exemption from tax on such payments. Member State must exempt interest and royalty payments made between parent companies and subsidiaries in different member states from liability to any taxes levied on such income in that Member State.¹¹⁶² Thus, the Directive deviates from an important rule of international taxation allowing source countries to subject within certain limits interest and royalties paid to non-residents to withholding taxes. In principle, all cross-border payments of interests and royalties between associated companies are fully exempt from any taxation in the source state and are taxable exclusively in the recipient state.

¹¹⁶¹ Thömmes (1990b), p. 476.

¹¹⁶² Article 1(1) of the Directive provides that interest and royalty payments arising in a Member State must be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State.

4.3.4.5 Definitions

The definitions of interest and royalty stipulated in Article 2 of the Directive largely follow those of the OECD Model Double Taxation Convention.¹¹⁶³

Interest is defined as income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payments are not regarded as interest.¹¹⁶⁴

Royalties means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films and software, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; payments for the use of, or the right to use, industrial, commercial or scientific equipment.¹¹⁶⁵ The major difference as compared to the OECD model definition of royalties is that the definition of the Directive includes payments for the use of software.

4.3.4.6 Qualifying companies

Article 3 of the Directive stipulates the criteria that the companies have to meet in order to qualify for the benefits of the Directive. The Directive applies to companies, which take one of the forms listed in the Annex to the Directive.¹¹⁶⁶ The company has to be considered resident in a Member State according to the tax laws of that Member State and may not, within the meaning of a tax treaty concluded with a third country, to be considered resident for tax purposes outside the Community. This tax residence requirement is intended to avoid abuse of the Directive through use of dual residence.¹¹⁶⁷ In addition, the company or the permanent establishment to which the payment is made has to be the beneficial owner of the income from the payment. Article 3(a)(iii) of the Directive specifies that the companies must be subject to one of the national corporation taxes listed in the same Article, without being exempt.¹¹⁶⁸

Article 3(b) stipulates the additional requirement that in order to qualify for the benefits of the Directive, a company of a Member State has to have a direct minimum holding of 25 % in the capital of a company of another Member State. However, Member States have the option of replacing the criterion of a minimum holding in the capital with that of a minimum holding of voting rights.¹¹⁶⁹

¹¹⁶³ Article 4(1) contains the derogation to the definition of interest and royalty under Article 2 of the Directive. It provides that the Member State where interest arises may exclude the application of the Directive in certain situations. See section 4.2.4.8.

¹¹⁶⁴ Article 2(a) of the Directive.

¹¹⁶⁵ Article 2(b) of the Directive.

¹¹⁶⁶ In line with the general principle of EC law, directives only ever express minimum standard. Thus, the Member States are free to extend the benefits of the Directive to the entities other than those included in the list.

¹¹⁶⁷ See Weber (2000), p. 20.

¹¹⁶⁸ Both the Parent-Subsidiary Directive and Merger Directive contain the subject-to-tax requirement. However, the Interest and Royalties Directive does not contain the requirement that the qualifying company must be subject to tax without the possibility of an option contained in the Parent-Subsidiary Directive and Merger Directive.

¹¹⁶⁹ The Parent-Subsidiary Directive and the Merger Directive also contain the option of replacing the criterion of a minimum holding in the capital with that of a minimum holding of voting rights. However, the Interest and Royalties Directive does not contain the requirement that Member States can only replace the criterion of a minimum holding in the capital with that of a minimum holding of voting rights if a bilateral agreement is achieved.

Article 1(10) provides a derogation to a minimum participation requirement of Article 3(b). Namely, it contains an anti-abuse provision, which states that Member States have the option of not applying the Directive in circumstances where the conditions set out in Article 3(b) have not been maintained for an uninterrupted period of at least two years.

4.3.4.7 *Permanent establishments*

Unlike the Merger Directive, the Directive also applies to payments to and from permanent establishments. In accordance with Article 3(c) permanent establishment means ‘a fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on’. This definition is almost identical to the OECD Model definition (stipulated in Article 5 of the OECD Model Treaty).

4.3.4.8 *Exclusion of payments as interest or royalties*

Article 4(1) contains the derogation to the definition of interest and royalties under Article 2 of the Directive. It provides that source State is not obliged to ensure the benefits of the Directive in the following cases:

- payments which are treated as a distribution of profits or as a repayment of capital under the law of the source State;
- payments from debt-claims which carry a right to participate in the debtor's profits;
- payments from debt-claims which entitle the creditor to exchange his right to interest for a right to participate in the debtor's profits;
- payments from debt-claims which contain no provision for repayment of the principal amount or where the repayment is due more than 50 years after the date of issue.

4.3.4.9 *Anti-abuse provisions*

In addition to specific anti-abuse provisions already mentioned, the Directive also contains other anti-abuse provisions.

Article 4(2) contains a special relationship provision: the Directive will only be applicable to the amount of interest and royalty payments between the various parties that are effectuated at arm's length. Article 4(2) stipulates that where by reason of a special relationship between the payer and the beneficial owner, the amount of payments exceeds the amount which would have been agreed in the absence of such a relationship, the Directive applies only to the latter amount.

Article 5 contains general anti-abuse provisions. Article 5(1) allows a Member State to apply domestic or agreement based provisions required for the prevention of fraud or abuse. Article 5(2) also provides that a Member State may withdraw the benefit of or refuse to apply the Directive in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse.

4.3.4.10 *Problems*

The Directive only applies to transactions between associated companies. This can cause adverse effects on competition between associated and independent companies. In addition, small companies can be disadvantaged by the Directive, given that they are less likely to enter into intra-group financing arrangements than large companies and, hence more likely to attract external capital and purchase technology from third parties.¹¹⁷⁰

¹¹⁷⁰ Weber (2000).

Like the Parent-Subsidiary Directive and the Merger Directive, the Directive has been criticised for not defining the important concepts clearly enough. Some of these concepts are identical to those used in the Parent-Subsidiary Directive and the Merger Directive and are dealt under sections 4.3.1. and 4.3.2. For example, the concepts such as ‘a holding’, ‘capital’, as well as the voting right requirement.

Furthermore, the usefulness of the Directive will be undermined by its relatively narrow scope: the Directive, as adopted, will not apply either in case of indirect shareholdings or in case of non-EU companies holding 25% or more in the capital or voting rights of the paying or receiving company.

4.4 Draft directive on the cross-border offsetting of losses

The Commission has put forward several proposals for directives. In 1975, following the Neumark Report of 1962 and the Tempel Report of 1970 several initiatives aimed to achieve a limited degree of harmonization of the corporate tax system, tax base and rates. In 1984 and 1985, the directives on loss-compensation were proposed. These were later withdrawn. A draft proposal of 1988 for the harmonization of the tax base was never tabled, due to the lack of agreement in Member States. There are currently five Commission proposals for Directives in the direct taxation area on the Council’s table, one of them is in the corporate taxation domain. This proposal is dealt with in this section: a draft directive on cross-border offsetting of losses.

4.4.1 Background

Another impediment to cross-border investments and the grouping together of companies is the restricted possibility of the taking into account of incurred cross-border losses of a foreign branch or subsidiary or permanent establishment. Whereas losses incurred by a branch of activity on the domestic level do not raise any problems since loss-compensation is generally available domestically, the situation is less favourable if the losses are incurred abroad. Even when cross-border loss compensation is available, the general conditions (timing, availability of profits etc.) are more generous in the domestic context. Furthermore, the range of different domestic provisions on loss compensation (concerning both losses resulting from domestic activities and foreign investment) is considered detrimental to the good functioning of the Internal Market and may work as an obstacle to cross-border economic activity.

For Member States using credit method for avoidance of double taxation the problem of double taxation of profits realised abroad is in many cases already solved. States who apply this method, in general, take also into account losses from abroad. However, this is not always the case. Sometimes the compensation of the losses with the profits of the other branches situating abroad is subject to certain restrictive criteria. Moreover, in those Member States using exemption method on foreign profits from other permanent establishments, the loss compensation is even more restricted. The countries using exemption method, except for some more or less restricted unilateral agreements, do not take into consideration a domestic enterprise’s foreign losses.¹¹⁷¹

Since European cross-border investment is often based on the foundation of a subsidiary the risk of incurring losses in this subsidiary, which are not going to be taken into account for taxation on the parent company’s level, discourages investors. In the absence of cross-border relief, investments in a location with an existing tax base, mostly in bigger Member States, will tend to be favoured. Moreover, the present arrangements put foreign investment at a disadvantageous position compared to domestic investment.

¹¹⁷¹ See Thömmes (1990), p. 474 and Thömmes(1990a), p. 214.

In December 1990, the Commission submitted a proposal for a directive on the cross-border offsetting of losses between headquarters and their branches.

4.4.2 *The tax rules*

In respect of losses of permanent establishments situated in another Member State, the home State of the enterprise must choose one of the two methods, the credit method defined in Article 6, or the method of deducting losses and reincorporating subsequent profits, as defined in Article 7. The credit method involves taxation of world-wide income of the enterprise, including foreign losses and the crediting of foreign tax paid. The method of deducting losses and reincorporating subsequent profits involves the deduction from the enterprise's taxable profits for a given tax period of the loss incurred in the same tax period by the enterprise's permanent establishments situated in other Member States, followed by the incorporation of subsequent profits of such permanent establishments into the enterprise's taxable income to the extent of the loss subsequently deducted.

4.4.3 *The latest findings by the Commission's study on company taxation*

The study¹¹⁷² has identified loss-compensation in general and the difficulties encountered by businesses with loss offset as a key element in the analysis of tax obstacles to cross-border economic activity in the Internal Market. The study has identified the absence of cross-border loss-relief or full consolidation at EU level as one of the major obstacles that requires action as a matter of priority.

According to information provided by various members of the panel assisting the Commission with the study, EU-based multinationals could have made considerable savings if they had been allowed to offset losses incurred by subsidiaries in other EU Member States with the profits of the parent company (or even within the group as a whole). The savings resulting from such an arrangement would be primarily in terms of financing cost, as a consequence of advancing loss-compensation compared to the current situation. There is clear evidence of numerous EU-based groups paying substantial amounts of corporate taxes in specific Member States while the overall EU group result was negative.

The study examined two different targeted measures which would lead to the following results:

- An amended version of the existing proposal. This would allow parent companies to take into account the losses incurred by both permanent establishments and subsidiaries situated in another Member State.
- A more complete scheme for the consolidation of group income along the lines of the Danish system of 'joint taxation' under which a group of companies with a Danish parent company is taxed as if it were organised as a branch structure so that Denmark taxes the consolidated result of the group. The Danish system enables parent companies and their branches and foreign subsidiaries to be taxed jointly in home country, thereby enabling the parent to take into account losses incurred by foreign subsidiaries (and branches). The Commission believes that the advantage of this system over the existing proposal lies in the greater symmetry between the taxation of profits and the offset of losses.

The Commission withdrew its old proposal for a directive on the cross-border offsetting of losses and consults Member States on these issues to find comprehensive solutions.

¹¹⁷² See Commission (2001b), p. 13.

5 Tax competition and harmonization - analysis of economic effects

This chapter analyses the economic effects of tax competition as well as the impact of taxation on economic growth. In addition, the potential positive and negative effects of tax harmonization will be considered.

5.1 Why is tax competition harmful?

It has been argued that tax competition between the states to attract investments and capital might lead to inefficient allocation of resources. Tax competition may force governments to decrease taxes and consequently public services to the sub-optimal level, namely to the level, which is lower than is preferred by electorate. It is argued that tax competition leads to the situation that tax revenues are only enough to cover the costs for necessary infrastructure and state services but not for the redistribution of income. Wolfgang Schön suggests that the funding of those public goods that are less significant for economically powerful taxpayers would be endangered by tax competition.¹¹⁷³ H.W. Sinn points out that the losers of tax competition will be those who cannot escape high taxation (e.g. immobile part of labour force and landowners) and those who benefit from a large government sector. Also, the poor will lose because government will no longer be able to maintain their current scales of redistribution.¹¹⁷⁴ He argues that tax competition may erode the welfare states of the European Union. Sinn (1990) argues that the tax competition will not bring the required level of tax harmonization via a process of iterative adjustment and therefore centrally planned European level tax harmonization is needed to avoid distortions. In his opinion, the most practicable option is simply to harmonize tax rates via collective agreements between the European governments or, more or less equivalently, to allocate all redistributive activities to a central European government. On the other hand, Klaver and Timmermans question the argument that tax competition will damage the European welfare states. They point out that those who oppose structural adjustments of European welfare states sometimes use this argumentation.¹¹⁷⁵

Several writers have questioned the assumption that voters can fully express their preferences about size and composition of public sector. Modern public finance theory, above all the 'public choice' school doubts that the political structures within a closed governmental system are able to achieve efficient allocation of resources and optimal supply of public services. Tax competition that leads to the lowering of tax level can even bring a gain in the total welfare if a substantial share of public spending is wasteful or unproductive and the lowering of tax rates reduces that expenditure.¹¹⁷⁶ Tanzi and Schuknecht have expressed the view that total expenditure could be reduced to less than 30% of GDP without sacrificing much in terms of social or economic objectives.¹¹⁷⁷

According to the Tiebout's idea of voting with feet: people and companies can choose the location, which provides the most preferred mix of taxes and public services. The countries with higher taxes are usually able to provide better public service. Countries with lower taxes are generally able to provide less public service. Of course, there also exists the problem of 'free riding', namely it is possible to consume public services in one country and pay taxes in another jurisdiction. Furthermore, there is usually no direct connection between taxes paid and public benefits received.

¹¹⁷³ Schön (2000), p.94.

¹¹⁷⁴ Sinn (1990), pp. 489-504.

¹¹⁷⁵ Klaver and Timmermans (1999), p. 187.

¹¹⁷⁶ Tanzi and Zee (1998a), p.31.

¹¹⁷⁷ Tanzi and Schuknecht (1996) as referred to in OECD (1997), p.10.

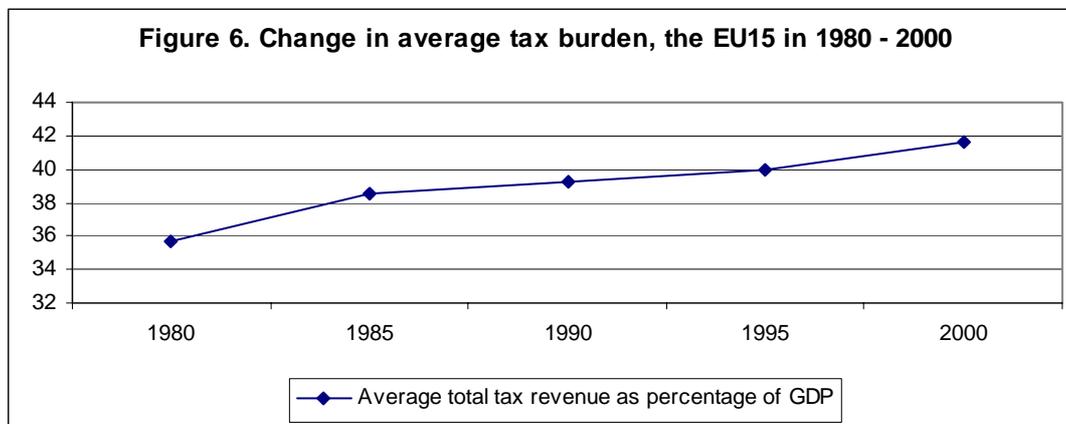
Erosion of tax bases

If capital moves from the countries with higher taxes to those with lower taxes, it might decrease the total tax revenue available for public spending. Lowering of the tax level might be in the domestic interests of one country who gains tax revenue by attracting investment and mobile capital, however, it might be inefficient from an international point of view, because the total amount of tax revenue could drop. In addition, it is argued that it might be unfair from the point of international equity, because one country gains in the expense of the others who lose part of their tax base if capital moves out from these countries. Fairness becomes a problem if some distributions of tax revenue resulting from the greater mobility of factors and tax bases are politically unacceptable to certain EU Member States.¹¹⁷⁸

Undesired change in tax structure

It has also been argued that tax competition forces the countries to have different tax structure that they would otherwise prefer to have. If countries compete for mobile tax base it may lead to 'tax race to the bottom', which could result even in total disappearance of tax on capital.¹¹⁷⁹ On the other hand tax burden might fall to the less mobile sources of income, which are easier to tax. In this way tax competition can lead inequality in tax treatment between mobile and less mobile factors. Also, the fairness and acceptability of the tax laws of the Member States could be jeopardised because the capacity of the Member States to tax income from capital on the basis of recipients' ability to pay is undermined.¹¹⁸⁰

In overall, tax competition has not led to smaller tax burden (see also Chapter 6 about trends in taxation). In fact, tax burden has increased 50% since 1965 (total tax revenue as percentage of GDP as increased from 27.8 in 1965 to 41.6 in 1999). From figure 6 is apparent that the share of taxes in GDP within the EU increased considerably between 1980 and 2000 (by 5.9 percentage points).



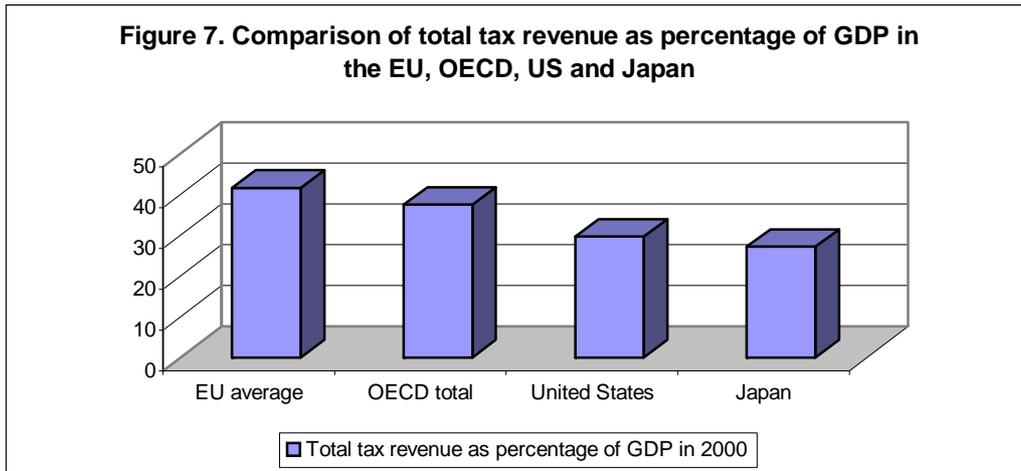
Source: OECD (2002).

Tax level is much higher in the EU than in the US, Japan, and also in the other OECD countries (see figure 7). Tax burden as a percentage of GDP was 29.6 per cent in the US and 27.1 per cent in Japan in 2000 while the EU average for 2000 was 41.6 per cent.

¹¹⁷⁸ Devereux and Pearson (1989), p.37.

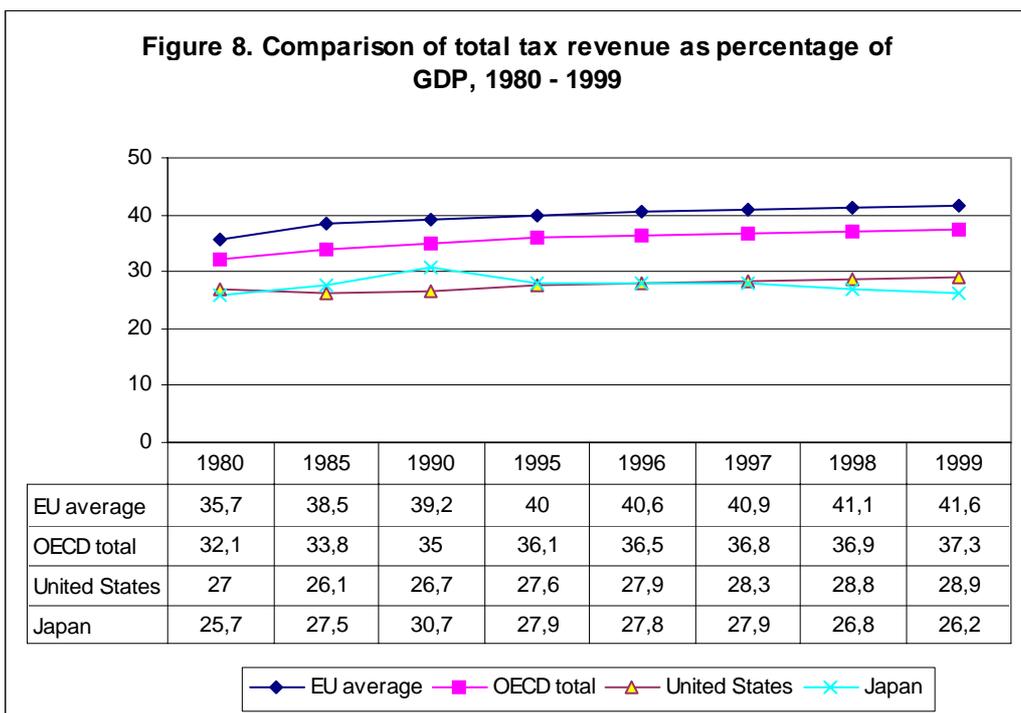
¹¹⁷⁹ Buur (2000), p.12.

¹¹⁸⁰ Commission (1992a), p.38.



Source: OECD (2002).

Tax burden has been rising more quickly in the EU than in the US and Japan (see figure 8). Total tax revenue as percentage of GDP increased 5.9% within the EU between 1980 and 1999 while the increase was only 1.9% in the US and 0.5% in Japan during the same period. Since 1990 total tax burden has increased 2.4% within the EU and 2.2% within the US. In Japan, however, total tax burden has even decreased by 4.5% during the same period.



Source: OECD (2001a).

However, the Commission draws the attention to the fact that if we look at the comparative changes of tax burdens on different factors, we can see that average effective tax rate on capital has fallen from 45% to less than 35% in the last fifteen years, and implicit tax rate on labour has risen from 35% to 42% in the same period. The capital movements have been liberalised in Europe and, consequently, capital (especially financial capital) is very mobile. In contrast, labour is far less mobile in Europe (because of language and cultural barriers, and also, differences in benefit systems as well as taxation with regard to pensions and annui-

ties¹¹⁸¹, labour regulations, etc). Because some factors of production are much more mobile than the others, tax burden of these factors decreases in the expense of the less mobile factors and the tax burden falls more to the less mobile factors, that is to labour, consumption, land, and real estate. It is argued that rising effective tax rates on labour income indicate that governments have in fact tried to shift the tax burden towards the more immobile factor of production. Furthermore, it has been argued that high taxes on labour have negative impact on employment and heavy tax burden on labour is one of the causes of high unemployment. According to the study by the Commission taxation has an enormous bearing on employment.¹¹⁸² The Commission draws conclusions on some economic research, which shows that about four out of ten and a half percentage points of unemployment in Europe are due to the overburdening of labour in terms of taxation.¹¹⁸³

At the same time, the Commission realises that the shift in the tax burden towards relatively immobile factors within the EU is not wholly attributable to tax competition, but is partly the result of the ageing of the EU population, the evolution of tax rates and the fact that employment income is a relatively stable and easily taxable base.¹¹⁸⁴ Some commentators question the reasoning by the Commission that tax competition shifts the tax burden from mobile factors to less mobile factors. One example of declining tax burden on labour is the Netherlands, where it has declined since 1985 while the burden on capital has stayed more or less the same.¹¹⁸⁵ Klaver and Timmermans argue that the fact that the tax burden on labour has increased in other countries has more to do with their failure to make structural adjustments in the public sector and their traditionally low tax burden on capital than with an excessive tax competition.¹¹⁸⁶ Tax competition tends to keep tax burdens lower, and lower tax burdens encourage wage cost moderation and foster a more attractive business climate.¹¹⁸⁷ In addition, if low mobility of labour is one reason of over-taxation of labour and high level of unemployment, one solution might be the implementation of policies that will increase labour mobility.

Simple theoretical models predict that tax competition between governments will result in diminution of source-based corporation tax towards zero.¹¹⁸⁸ Gordon (1986) and Razin and Sadka (1991) projected that capital income taxes will vanish altogether in small open economies faced with perfect capital mobility, given that residence countries cannot enforce taxes on foreign source capital income.¹¹⁸⁹ Frenkel, Razin and Sadka (1991) show that zero taxation of capital is optimal, given the set of available tax instruments, when two small countries can co-ordinate their tax policies but capital can flow without costs to tax havens in the rest of the world and escape residence taxation. Economic models show that it is actually better not to tax capital at all since it simply leads to capital flight. It is especially relevant in case of taxation of highly mobile capital. According to the Ramsey rule, it is recommended to tax immobile factors more heavily, and mobile factors less heavily because taxes imposed on the most mobile factors are the most distortionary.

¹¹⁸¹ The systems of the Member States are similar in some respects, however, very different in others. There are barriers to transferring provisions for old age from one Member State to the other. Although taxation of pensions and annuities is regulated by bilateral treaties between Member States, there still exist many cases of double taxation or the double non-taxation of benefits. This results in problems for free movement of workers.

¹¹⁸² Commission (1996c).

¹¹⁸³ Tabellini and Daveri (1997) as referred to in Sommerhalder (1999), p.247.

¹¹⁸⁴ Commission (1996c), p.4.

¹¹⁸⁵ Klaver and Timmermans (1999), p. 186.

¹¹⁸⁶ Ibid, pp. 186-187.

¹¹⁸⁷ Ibid, p. 190.

¹¹⁸⁸ Commission (1992a), pp. 143-151.

¹¹⁸⁹ See Sørensen (2000).

With integrated international financial markets lower capital income taxes should not lead to an increase in domestic investment, although domestic savings may increase, because if the prospective returns are higher internationally, domestic savings may be invested abroad. On the other hand, reductions in effective tax rates on investment could raise domestic investment and might attract foreign savings, depending on returns at world market.¹¹⁹⁰

Distortion in the allocation of resources

In case of neutral tax systems the consumption decisions would be taken on the basis of pre-tax prices; likewise investments decisions would be taken on the basis of pre-tax rates of return. Impact of the tax systems to the economic decisions implies an inefficient allocation of resources because the resources are not allocated in the most profitable way in the absence of taxes. If economic decisions are determined mostly by tax differences, then the economic activity is not performed at a lowest possible pre-tax cost, which leads to welfare loss and sub-optimal allocation of resources.

Tax competition can lead to the situations, in which the resources are allocated according to the principle of tax minimisation rather than comparative economic advantage. If firms choose their location mostly based on tax rate differences rather than considerations of real economic factors, it will lead to welfare loss. It is argued that tax differences may cause distortions of resource allocation in the capital market because capital moves to the country with a lowest effective tax rate instead of the most efficient use. In addition, differing tax rates may lead to trade diversion and consequent welfare loss.

Differences in consumption tax rates¹¹⁹¹ may cause the cross border purchase by residents of high tax countries in neighbouring states, which have lower consumption taxes. As a result, investment decisions are affected in favour of the low tax countries. Cross-border shopping might contribute to inefficient allocation of resources, and also erode the tax base of countries with high consumption taxes. Cross border shopping can also create welfare loss caused by the transaction costs related to the shopping from another state (e.g. transportation costs and loss of time). Purchases across frontiers will become more widespread with a development of phone and mail order purchases, and also, of new technologies and electronic commerce. It is argued that VAT rate harmonization is necessary because otherwise tax competition can cause inefficiently low tax rates.

However, Bracewell-Milnes criticises the opinion that tax difference can cause inefficiencies if they affect the location of economic activities. He draws the analogy with a supermarket who competes with its rivals on price or otherwise, and tries to attract geographically mobile customers and to affect the location of their activities. The promotion activities of this store might also be accompanied by the dead-weight loss, which is considered to be normal part of its business.¹¹⁹²

With the introduction of the EMU, which removes some more impediments from the free movement of capital (like exchange risks and transaction costs), taxes will become even more important factor in determining the allocation of resources. If Member States have no independent monetary policy they have fewer options for domestic policy measures to pursue aims of growth, stabilisation, structural adjustment, or regional development and they might have incentives to use taxes to achieve competitive advantages for their producers.¹¹⁹³

¹¹⁹⁰ OECD (1997, p.11).

¹¹⁹¹ And also income tax rates because these taxes are also included in the prices of goods and services in the hidden form.

¹¹⁹² Bracewell-Milnes (1999), p.87.

¹¹⁹³ On the other hand, the autonomy in tax policy making can be necessary for EU Member States to pursue these aims if states have lost ability to use independent monetary policy and important constraints are imposed to fiscal policy by Stability and Growth Pact.

It has been argued that it can intensify tax competition, create additional economic distortions and cause the erosion of tax revenues. According to the Commission, the launch of the euro has changed the position of several Member States who see the necessity for more tax co-ordination in the field of direct taxes.¹¹⁹⁴

5.2 Why is tax competition beneficial?

The proponents of tax competition say that it is a good disciplinary mechanism to avoid that government sector will expand to the size, which is bigger than desired by the electorate. Competition from other tax jurisdictions puts pressure to governments to reduce tax level and raise the efficiency of public sector. The tax competition forces the governments to provide better public service for less tax revenue and to decrease the share of inefficient public sector. The governments must improve their tax systems by adapting them to changing competitive situation.

However, it is argued that tax competition will not lead to lower taxes but governments just shift the tax burden from mobile factors to less mobile factors (labour, consumption, real estate) which are more easy to tax. However, shifting of tax burden has some social and political limits because from certain level it can be considered unacceptable for electorate. Increasing tax burden on labour can increase unemployment and increasing consumption taxes may raise prices.

5.3 The impact of taxation to the economic growth

Many economists agree that the link exists between taxation and economic growth. One way that taxation may influence economic growth is by lowering savings and investment. Taxation may affect these aggregates mainly through its impact on the net rates of return to these activities.¹¹⁹⁵

The overall effect from lower tax level can be positive and tax revenue may even rise if economy is situating in the point of Dupuit (Laffer) curve where lower taxes would be accompanied with higher revenue. Lower taxes may contribute to economic growth through stimulating effects what lower taxes may have to economy (e.g. through increased work effort, saving and investment, which can increase growth potential). At the same time, too high taxes may decrease saving and investment and, consequently, reduce economic growth. Too high taxes that significantly distort economic choices create an excess burden resulting in economic inefficiency.

Several studies have attempted to assess the impact of taxation on economic performance at the macro level. Some empirical evidence shows a significant negative relationship between the level of the tax/GDP ratio and the rate of economic growth. According to Keith Marsden: 'Analysis of data for two groups of countries, covering a twenty-year period, shows that incomes rose more rapidly in countries that chose to compete by extracting less tax revenue from their enterprises and citizens. Lower taxes were associated with higher rates of growth of investment, productivity and private consumption. Countries that chose big government, and more public services financed by higher taxes, experienced slower economic growth.'¹¹⁹⁶ Many economists have related the lower rates of economic growth and higher levels of unemployment in OECD countries since 1970s to the general increase in the tax burden and to specific characters of the tax systems, particularly the extent to which they

¹¹⁹⁴ Monti (1998).

¹¹⁹⁵ OECD (1997), p.7.

¹¹⁹⁶ Marsden (1998), p. 51 as referred to in Bracewell-Milnes (1999), p.87.

interfere with incentives to save, invest and work.¹¹⁹⁷ The cross-country study by OECD suggests that the increase in the average (weighted) tax rate of about 10 percentage points over the past 35 years may have reduced OECD annual growth rates by about ½ percentage points.¹¹⁹⁸

The other authors find that there is no clear evidence that lower taxes stimulate an economic growth. If lower taxes cause rise of government deficit, it may cause the worsening of macroeconomic environment, the decline in saving and investment and, slow down of growth. In addition, tax expenditure also has beneficial effects, even if the taxes distort the economic activity. Consequently, higher tax burden can enhance the economic growth if the combined effect of distortionary taxes and beneficial government expenditures yields a net improvement for the economic performance.¹¹⁹⁹ Taxation may be beneficial for the economy if it provides the financial basis for the provision of public goods that improve living standard and social welfare. More and better public goods and services may also increase the productivity of private fixed and human capital and hence increase economic growth.¹²⁰⁰ The overall effect of particular tax measure depends on the type of spending financed by it. The problem is that taxes are not always spent for the purposes, which stimulate economic growth, either because of political ‘inefficiencies’ or because of redistributive policies that may yield benefits for society but will not be immediately reflected in economic growth.¹²⁰¹

5.4 Corporate tax harmonization and economic efficiency

Currently companies are confronted with a single market in which 15 different company tax systems apply. There are clearly several tax obstacles to cross-border business activities: imputation systems as applied by some Member States, lack of cross-border loss compensation, and double taxation of cross-border income payments. Under the imputations systems the tax credits available to domestic shareholders may not be available to non-resident shareholders. In addition, whereas loss-compensation is generally available domestically, the situation is less favourable if the losses are incurred abroad. Furthermore, withholding charges may be charged on cross-border dividend and interest payments. This causes losses of economic efficiency, generates specific compliance costs, and contributes to a lack of transparency.¹²⁰²

Neutrality issues

Impact of the tax systems to the investment decisions may imply absence of neutrality and can constitute a waste of resources.¹²⁰³ A purely tax-induced decision to invest in one country rather than another implies inefficient allocation of resources because the resources are not invested into the most profitable uses in the absence of taxes. If tax system favours one type of investment over another, or one producer over another, then goods may be produced at a higher pre-tax cost. Thus, the economic activity is not performed at a lowest possible pre-tax cost, which implies welfare loss.

Under capital export neutrality (CEN) a tax system does not affect the decision by any specific company as to in which country to invest. The domestic/foreign composition of the investment income does not influence the world-wide tax thereon. CEN could be achieved if income were taxed only in the investors’ country of residence and if there were no discrimi-

¹¹⁹⁷ OECD (1997), p.7

¹¹⁹⁸ Ibid, p.10.

¹¹⁹⁹ See, for example, Barro (1991) as referred to in Engen and Skinner (1996), p.629.

¹²⁰⁰ OECD (1997), p.15.

¹²⁰¹ Atkinson (1995), 171-98 as referred to in Engen and Skinner (1996), p.629.

¹²⁰² Commission (2001b), p. 29.

¹²⁰³ See Devereux and Pearson (1989).

nation between domestic and foreign-source income in the capital-exporting country. This could be achieved if all countries applied the "world-wide" or "residence" principle, that is, levied taxes on the income accruing to their residents regardless of the source of that income. A pure credit system with no limitation on the foreign tax credit and no deferral of domestic taxes on profits retained abroad would ensure capital export neutrality. Under such a regime, the free mobility of capital would tend to equate the effective tax burden across borders, because each investor would then also obtain the same after-tax rate of return on domestic and foreign investments. A cross-country equalisation of the rates of return before tax implies that no output gain can be made by reallocating capital from one country to another.¹²⁰⁴

A tax system achieves capital import neutrality (hereafter CIN) when all investors, both domestic and from foreign countries, investing in any one national economy face the same after-tax rate of return on similar investments. This implies that the cost of capital and the tax rate for any inbound investment must not depend on the home country, that is the country of residence of the investor. In fact, the application of the residence principle can lead to cases where a domestic company investing in a given country is placed at a competitive disadvantage compared to a similar foreign company investing in the same country – because the tax rates applied in their home countries are different. Therefore, in order to avoid distortions of competition and to achieve capital import neutrality, income should be taxed according to the source principle. According to this principle, a government should tax all income originating within its jurisdiction at the same rate, regardless of the origin of the beneficiary of the income.

Several authors argue that achieving CEN is more important than achieving CIN in the context of the single market, because the advantages of investing in one location rather than another are greater than the differences in efficiency between competing firms.¹²⁰⁵ Thus a harmonised tax system should be in favour of a residence-based structure.¹²⁰⁶

In the context of the EU integration, if similar investments face markedly different effective levels of corporate taxation in different Member States, it provides an incentive for companies to choose the most tax-favoured locations for their investment, which may not be the most favourable location in the absence of taxes. This may imply welfare costs because economic activity may not take place in the lowest (pre-tax) cost location by the lowest cost producers. The Commission's latest study on effective tax rates shows that there are considerable differences among the effective tax rates of the various EU countries (see section 2.6.1. Policy Document on Taxation). These differences may imply an inefficient allocation of resources and, thus, welfare costs. According to the Commission's study on company taxation¹²⁰⁷ the range of variations of the effective tax burdens of subsidiaries located in different host countries can reach more than 30 percentage points regardless of the method of financing of the subsidiary. Similarly, the level of the effective tax burdens that subsidiaries operating in a given country face depends heavily on where their parent company is located. Similarly, the range of variations of the effective tax burdens can rise above 30 points. Thus, the principles of both CEN and CIN are violated. These differences in effective tax rates can be an incentive for companies to alter their behaviour to minimise their global tax burden, which implies the potential distortions in the allocation of resources of transnational investments.

Moreover, if companies are free to choose the most tax-favoured form of finance, then the international tax system works such that foreign multinationals operating in a host country

¹²⁰⁴ See Commission (2001c).

¹²⁰⁵ See Devereux and Pearson (1989), Sørensen, (1990), Tanzi and Bovenberg (1990), and Keen (1993).

¹²⁰⁶ See Devereux and Pearson (1989).

¹²⁰⁷ Commission (2001c).

are likely to face a lower effective tax burden than domestic companies. This implies the violation of neutrality principle on the home market.

The Commission concludes that current situation is not optimal with regard to the proper functioning of the Internal Market. Indeed, the absence of capital export neutrality may lead to distortions in the international allocation of investment as investments may take place not in the lowest cost locations but in the lowest tax locations. This in turn potentially limits growth in productivity and employment in the EU.

It is argued that further harmonization of tax systems and tax rates is necessary in order to neutralise the effects of tax differentials on efficient functioning of the single market. The proponents of further tax harmonization argue that it would contribute to economic welfare by decreasing tax-induced distortions and reducing the complexity of corporate taxes for companies operating within the Internal Market.

The results of economic modelling of corporate tax harmonization

In case of tax harmonization the harmonization of tax base (co-ordination of tax systems) and harmonization of tax rates should be distinguished.¹²⁰⁸ Tax co-ordination includes the reforms in the tax systems in order to make them more neutral for investment decisions. The effects of the co-ordination of tax systems are very difficult to quantify, however, some research has been conducted by the Commission. Some other authors have conducted research about corporate tax rate harmonization, the results of which are summarised below.

Results of the Commission's study

The Commission examined how the measures of effective tax rates would be different in the event of various hypothetical tax policy scenarios. Fifteen hypothetical policy scenarios were considered. After considering a range of different investments the Commission provided following conclusions on the effect of hypothetical scenarios.

Economic modelling by the Commission's study shows that introducing a common statutory tax rate in the EU would have a major impact by decreasing the dispersion of effective tax rates. Introducing a common statutory tax rate in the EU would have a significant impact by decreasing the dispersion of effective tax rates across Member States. There is a significant fall in the average dispersion of both the cost of capital and the effective average tax rates facing parent companies between alternative Member States. There is also a fall in the dispersion between subsidiaries located in a given Member State which are owned by parents located in other Member States. To the extent that taxation matters, such scenario would be likely to go some way in reducing locational inefficiencies within the EU.

No other policy scenario has such a significant impact on the dispersion of effective tax rates. Scenarios implying a common tax base or a system consisting in applying the definition of the home country tax base to the EU-wide profits of a multinational tend to increase the dispersion in effective tax rates if overall nominal tax rates are kept constant. Furthermore, since withholding taxes on dividends between subsidiaries and their parents have been abolished within the EU, the international features of corporation taxes do not play a significant role in increasing distortions. Introducing a common means of taxing foreign source income, for example, has little impact on the dispersion of effective tax rates. Similarly, introducing a common form of integration of corporate and personal taxes in each Member State does not tend to reduce the dispersion of effective tax rates between Member States.

Results of other studies

Fuente and Gardner (1990), and Sørensen (2000) run computer simulations with applied general equilibrium models that capture the interdependence of the main variables featuring

¹²⁰⁸ See Sørensen (1990).

in the discussion on tax competition and tax coordination.¹²⁰⁹ Fuente and Gardner conclude that complete harmonization of EU tax rates increases GDP by 2.1%. The main reason behind this result is that Fuente and Gardner assume that the EU will harmonise the tax rate at a relatively low level. This would lead to a net inflow of capital from the rest of the world. Accordingly, the welfare gain experienced by the EU comes at the expense of welfare losses in the US and Japan. Fuente and Gardner emphasise that the level around which the effective corporate tax rates are harmonized is crucial for the magnitude and even the sign of the gains from tax harmonization. They also conclude that the gains from tax coordination accrue particularly to the large countries in the EU. Indeed, the five largest EU countries (France, Germany, Italy, UK and Spain) experience a welfare gain of 2.2%, on average. Some smaller countries, such as Luxembourg and Ireland, even lose under a regime of tax coordination, relative to tax competition. On average, the welfare gain for the seven smaller EU countries (Belgium, Denmark, Greece, Ireland, Luxembourg, the Netherlands and Portugal) is a modest 0.4%.

Sørensen (2000) has conducted a systematic quantitative study of the impact of a potential harmonization of capital income taxes.¹²¹⁰ He presented an applied general equilibrium model (TAXCOM) describing the allocation and distribution effects of tax competition and tax co-ordination within a unified framework. The model intends to offer a rough estimate of the likely magnitude and distribution of the gains from tax co-ordination. The analysis focused on the effects of EU tax coordination that takes the form of an international agreement on a binding minimum tax on capital income, levied at source and chosen so as to maximize the population-weighted average of national welfare levels for the co-ordinating countries, accounting for the fact that national governments will set the remaining fiscal instruments to maximize their own welfare. The welfare gain from co-ordination is estimated to be roughly 0.2% of GDP for the average EU country.

The welfare gain for the EU is much smaller in the analysis conducted by Sørensen than that conducted by Fuente and Gardner. One important reason is that, whereas the effective tax rate in Fuente and Gardner declines under a regime of tax harmonization, the tax rate rises in the TAXCOM model.¹²¹¹ Accordingly, tax harmonization in TAXCOM causes an outflow of capital from Europe to the rest of the world. Despite of this outflow of capital, Sørensen reports a welfare gain. This is due to the positive welfare implications of a more equitable income distribution.

There is slight fall in economic activity in the TAXCOM model since co-ordination leads to a substantial increase in the level of capital taxation in the EU. Despite the slightly lower labour income tax rate and the rise in infrastructure spending, the higher capital tax rate suffices to finance an increase in redistributive transfers in the EU. In particular, the increase in the corporate income tax rate in all EU countries by around 5 percentage points on average, allows for higher transfers to the poor and thus a more equitable income distribution. More specifically, the gains from tax harmonization accrue to residents who are relatively worse off: the poorest quintile of the residents of the representative country will profit as much as 7.6% whereas the richest quintile loses 1.9%.

The welfare gain is limited by the fact that countries use infrastructure spending and labour taxes more aggressively to attract mobile capital when capital tax competition is neutralized through co-ordination. The gain for the EU is further limited by the fact that higher capital taxes drive capital out of the EU, thus benefiting the rest of the world. A sensitivity analysis reveals that the welfare gain from regional tax co-ordination within the EU could be larger than 0.2% of GDP, especially if the interest elasticity of capital supply is very low, as is of-

¹²⁰⁹ See Gorter and de Mooij (2001).

¹²¹⁰ See Sørensen (2000).

¹²¹¹ See Gorter and de Mooij (2001).

ten assumed. However, even under assumptions most favourable to tax co-ordination, the gains from regional co-ordination are likely to remain below 1% of GDP, according to TAXCOM model. The model also suggests that the gains from tax co-ordination would be unevenly distributed across Member States, due to asymmetries in economic structures and preferences. For example, the analysis indicated that the Nordic countries would gain disproportionately more from tax co-ordination, assuming that the high level of taxation in the Nordic countries reflects a relatively strong social preference for redistribution. Furthermore, the model indicates that even if the median's voter's gain from regional tax co-ordination may be modest, the poorer sections of society deriving a large part of their incomes from public transfers are likely to gain significantly. TAXCOM model indicates that tax harmonization allows for a large increase in transfers of the order of 11-15%.

If tax co-ordination involves the US as well, the TAXCOM model suggests that the welfare gain for the EU increases to more than 0.3% of GDP, since the rise in the US capital tax will limit the outflow of capital from the EU. However, the analysis suggests that the US would not be motivated to engage in tax co-ordination, since the harmonized level of capital income taxation would be too high from the American perspective, given that US has a lower social preference for redistribution than Europe.

In sum, simulations with applied general equilibrium models suggest that the gain of EU tax coordination is between virtually zero and 2% of GDP. These welfare gains are, however, unequally distributed. First, large and high-tax countries typically gain more than small and low-tax countries. Second, the gains from tax coordination are likely to be unequally distributed over poor and rich residents within countries. For instance, in the TAXCOM model, the poor gain while the rich are worse off.

Thus, the results of analysis show that the gains from the harmonization are rather small. According to Sørensen (2000) the implication of tax harmonization is increase in tax level, a decline in output and the private capital stock as well as substantial increase in redistribution. Because tax harmonization causes a drop in the GDP in the EU, the desirability of harmonization depends from social preference for redistribution. Furthermore, analysis assumes that all additional government revenue is spent unwastefully. However, the government could also spend the additional revenue in a wasteful way. This threat of wasteful government spending is especially relevant in the context of enlargement. According to the different estimates the corruption is much higher in the accession countries than in the current Member States. In the East-European countries the efficient control systems for revenue spending are not in place yet. If tax co-ordination leads to higher tax level and government spending, it can cause increased welfare loss.

5.5 Why is tax harmonization harmful?

Political efficiency versus economic efficiency

There is trade-off between economic efficiency and political efficiency. Tax competition may reduce political distortions, however, to create economic inefficiencies, and tax harmonization can reduce economic distortions, however to create some political inefficiencies.¹²¹²

The major problems that arise with tax harmonization are, first, that in the absence of tax competition governments are more likely to act against best interests of their electorates, because tax competition from other jurisdictions puts pressure to governments to respond to the wishes of the constituency.¹²¹³ Second, usually harmonization leads to higher than the initial tax burden, and third, it might be impossible to reach uniform tax level (and tax structure), which will be in the best interest of all countries.

¹²¹² See Cnossen (2001), p. 9.

¹²¹³ For more elaborate discussion see McLure (1986).

According to the Leviathan approach formulated by Geoffrey Brennan and James Buchanan the bureaucrats and politicians are interested to see a public sector larger than desired by their constituents, and to redistribute income towards themselves.¹²¹⁴ They criticise the assumption made by standard normative public finance approach that politicians holding power will exercise that power in the public interest (however exactly defined).¹²¹⁵ Also, that standard normative approach does not take into account political feasibility of proposed policies. According to Leviathan theory the government who possesses monopoly power to tax acts analogically to the rational monopolist and implements the tax policy, which maximises its revenues.¹²¹⁶ Leviathan model also proposes that if to make it easier for government to raise revenue, government will tend to raise more.¹²¹⁷ Thus expanding the power to tax expands the reach of the government's fiscal monopoly and is likely to expand the total tax take.¹²¹⁸ Beyond some point, the value to citizens of any expansion of taxation will be less than the cost to them in the extra taxes for which they are liable.¹²¹⁹ Taken into account that total tax level is already comparatively high in the EU, the further expansion of taxation may not be desirable. As the size and composition of public sector depends on the preferences of the electorate of the Member State concerned, there are no grounds for far-reaching harmonization of the tax policy throughout the EU.¹²²⁰

Frey and Eichenberger stress that tax harmonization may cause significant political distortions because it weakens the incentives for politicians and bureaucrats to take into account of their constituents' preferences.¹²²¹ One important mechanism to ensure that politicians respect electorates' preferences is so-called exit possibility, namely the option to vote with one's feet and leave the country, which does not provide an efficient combination of taxes and public services. Harmonization narrows these exit options because taxes are equalised.¹²²² Frey and Eichenberger conclude that harmonization is an effective means to raise the tax level and therefore to cement the importance and power of the politicians' cartel.

Keen and Edwards have shown that the problem whether tax competition is harmful boils down to the ideological issue that depends very much on whether one believes that the government is a benevolent maximiser of its citizens' welfare (if so, then tax co-ordination is beneficial). If one believes that the government is untrustworthy revenue maximiser, then tax competition is beneficial.¹²²³ In second model competition is constructive and implies a transparent and efficient tax policy, where the tax burden is the price to be paid for public goods and services. In this model, inefficient public sectors are unable to compete.

In case of harmonization of corporate tax rates, the minimum rates should not be fixed at the level of the Member States having the high tax levels. The practice of tax harmonization in the EU demonstrates that tax rates are rather corrected upwards than downwards (examples are the establishment of minimum VAT rates, minimum excise rates for tobacco products, alcohol beverages and mineral oils, also several proposals to establish minimum rates for corporate taxes by Commission (e.g. Ruding Report)). No maximum levels of taxation have been established in the European Union so far. Although the Commission states in its work program (1996) that common VAT rate should be lower than the present EU average rate, it might be politically difficult to attain such an agreement. One reason is that it is always diffi-

¹²¹⁴ Brennan and Buchanan (1980).

¹²¹⁵ Brennan (1997).

¹²¹⁶ Brennan and Buchanan (1980).

¹²¹⁷ Brennan (1997), p.100.

¹²¹⁸ Ibid.

¹²¹⁹ Ibid, p.101.

¹²²⁰ Klaver and Timmermans (1999), p. 190.

¹²²¹ Frey and Eichenberger (1996), pp. 335-349.

¹²²² If taxes are harmonised in the EU, there remain the possibilities to leave the EU and choose a country outside the EU, which offers more favourable combination of taxes and public services.

¹²²³ Sommerhalder, (1999), p. 247.

cult to decrease public expenditures from existing level to lower level. In addition, a Stability and Growth Pact sets strict limits for budget deficit and consequently restricts the government's fiscal policy choices. Therefore, harmonization at lower tax level might be politically not feasible. At the same time, tax harmonization at too high levels could result in the flight of mobile factors and the tax base to countries outside the EU.¹²²⁴

Diversity between the states

An additional aspect of tax harmonization is the difficulty to co-ordinate while maintaining the adequate level of diversity between the states. Diversity follows not only because national preferences toward redistribution vary, but it also reflects differences in factor productivities, in population size and composition, in capital composition, and in mobility of various types of capital.¹²²⁵ Diversity between Member States will further increase after enlargement of the EU.

Small versus large states

Theoretically, small countries should be less motivated to co-ordinate capital taxes than larger countries if it leads to higher tax level, because small countries face a higher elasticity of capital supply from the world capital market. Results of research show that small countries set relatively low effective tax rates, compared to large countries.¹²²⁶ More specifically, the five largest EU members, Germany, France, Italy, UK and Spain, have an effective tax rate that is, on average over the sample period, 11.2% higher than in the smaller member states. The mean effective tax rate, calculated over the years between 1990 and 1999, of small countries is 24.6%, while the mean effective tax rate of large countries is no less than 35.8%. The difference between small and large countries has declined, however, over the last ten years from 10.8% in 1990 to 8.5% in 1999.¹²²⁷

Model simulations suggest that the welfare effects from tax harmonization will be unequally distributed, both over countries and over interest groups within countries. For example, large countries tend to benefit more from tax coordination than small countries, if the latter gain at all. In addition, it is argued that it is optimal for smaller countries to have lower taxes and for bigger countries to have higher taxes because the large countries have fiscal advantage over the small ones, namely the size of their domestic markets.¹²²⁸ Larger countries inevitably have some fiscal economies of scale.¹²²⁹ Therefore, companies acting in a larger country have less necessity to go cross-border when expanding their activities than companies in a small country.¹²³⁰ Companies operating in a small country are facing higher tax costs than they face in a big country. For instance, as long as profits and losses cannot be consolidated across borders within the EU, companies operating in a small country have less opportunity for loss compensation and depreciation relief than companies operating in a larger country. Companies based in a small country but operating on a pan-European scale will tend to be

¹²²⁴ Commission (1992a), pp. 45-46.

¹²²⁵ See comment by Bruno Jullien in Sørensen (2000).

¹²²⁶ This conclusion is founded on analysis of effective tax on the basis of micro data. See Gorter and de Mooij (2001).

¹²²⁷ The difference between statutory tax rates of small and large countries is modest (see Gorter and de Mooij (2001)). In particular, for the big five EU member states (France, Germany, UK, Italy and Spain), the statutory tax rate on retained profit is, on average, 3% higher than for the small member states (Austria, Belgium, Denmark, Finland, Greece, Ireland, Luxembourg, Netherlands, Portugal, Sweden). For distributed profits, the difference is even smaller due to the lower tax rate on distributed profits in the German split rate system.

¹²²⁸ Ellis (1999), p. 79.

¹²²⁹ Klaver and Timmermans (1999), p. 187.

¹²³⁰ Sommerhalder (1999), p.249.

confronted with higher tax costs in connection with mergers, transfer-pricing, withholding taxes on interest and royalty payments, the international double taxation, etc.¹²³¹ Because big countries have these advantages over small ones, they can impose higher taxes and still remain competitive. Also, different taxes might be optimal for the countries with a different economic structure or development level.

It is questionable why should countries with low tax level agree to tax harmonization if they will lose from it. Thus, it seems to be impossible for Member States to agree about tax level that would be in the best interests of all of the countries. If a unanimous agreement is required for tax harmonization than the harmonization can be achieved only if compensation is provided for the countries that lose from the harmonization. However, harmonization can lead to less efficient allocation of resources and welfare loss, if the harmonization is accomplished at too high level, so that the efficiency gain of winning countries is smaller than the costs of countries who lose from harmonization.

Jullien¹²³² argues that given that compensatory transfers are difficult to implement, one would rather see a global negotiation allowing for the adjustment of taxes to local conditions than the imposition of some minimal standard. Taking into account national specificities will be extremely difficult for capital taxes, much more than for VAT. Moreover, monitoring the behaviour of states with complex tax schemes will require costly centralization and will limit the ability to use differential taxation as a national policy instrument.¹²³³

In sum, major problem with harmonization in the EU is that it might lead to higher tax level and consequently to the loss of growth potential. Also, it might lead to the strengthened position of inefficient governments and public sectors, which can find tax harmonization as a good way to protect their high-tax regimes from tax competition from the other EU jurisdictions. This may lead to the loss of competitiveness vis-à-vis the other countries (e.g. US, Japan, other OECD countries).

The increased mobility of capital throughout the world means that if taxes in the Community were harmonised at relatively high levels, it could result in the flight of capital and tax base to the countries outside the Community. Hence tax harmonization should not lead to too high tax level compared to the EU's main trading partners. Furthermore, any harmonization achieved at the Community level should be sufficiently flexible to enable the EC to take appropriate action in response to major tax changes in non-member countries.¹²³⁴

¹²³¹ Klaver and Timmermans (1999), p. 188.

¹²³² See comment by Bruno Jullien in Sørensen, P. B. (2000).

¹²³³ Ibid.

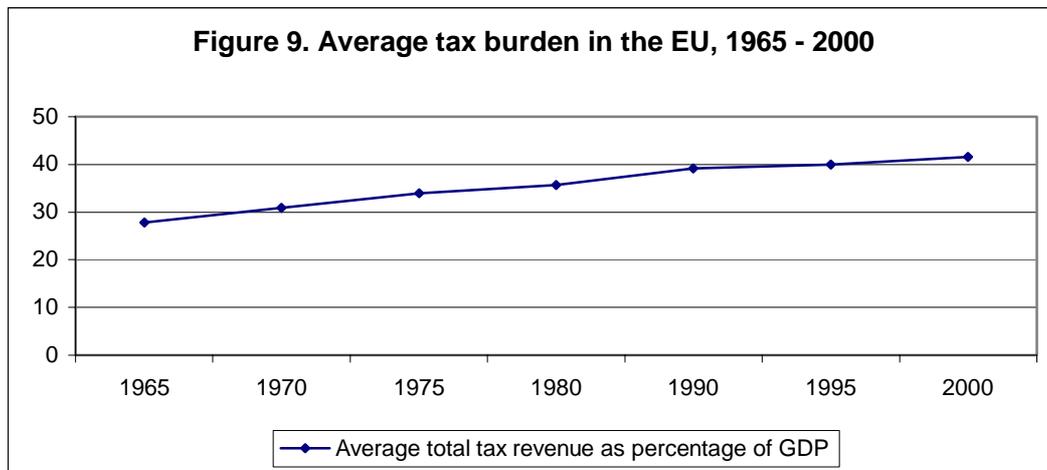
¹²³⁴ Commission (1992a), pp.45-46.

6 Trends of taxation in the EU

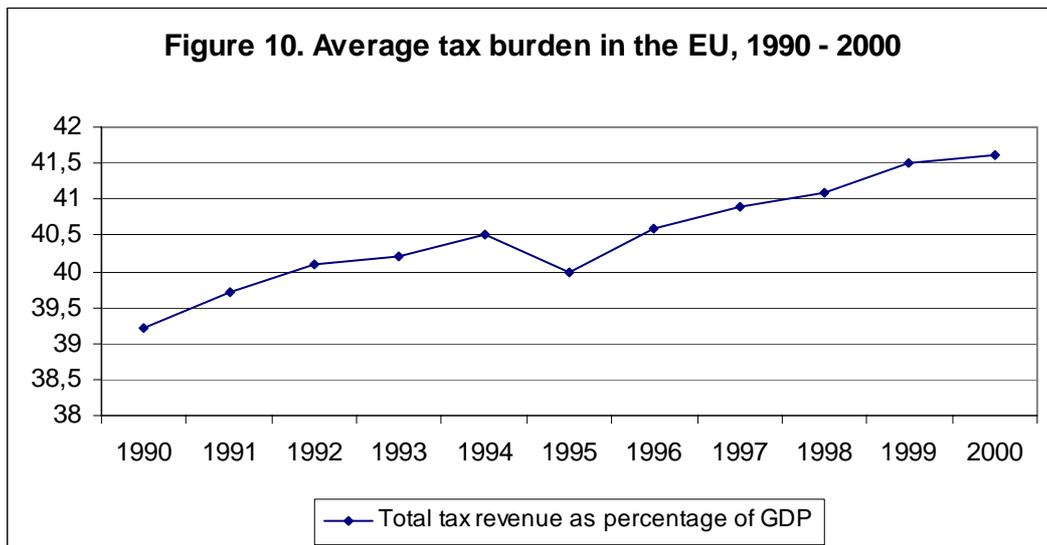
6.1 Tax burden and tax structure developments

6.1.1 Total tax burden

One method of calculating tax burden is based upon comparison of tax revenues to GDP. The OECD tax revenue statistics and national accounts allow calculation of these ratios up to 2000. From figures 9 and 10 is apparent that total tax burden has increased by approximately 14 percentage points since 1965, by 5.9 percentage points since 1980 and by 2.1 percentage points since 1990.



Source: OECD (2002).

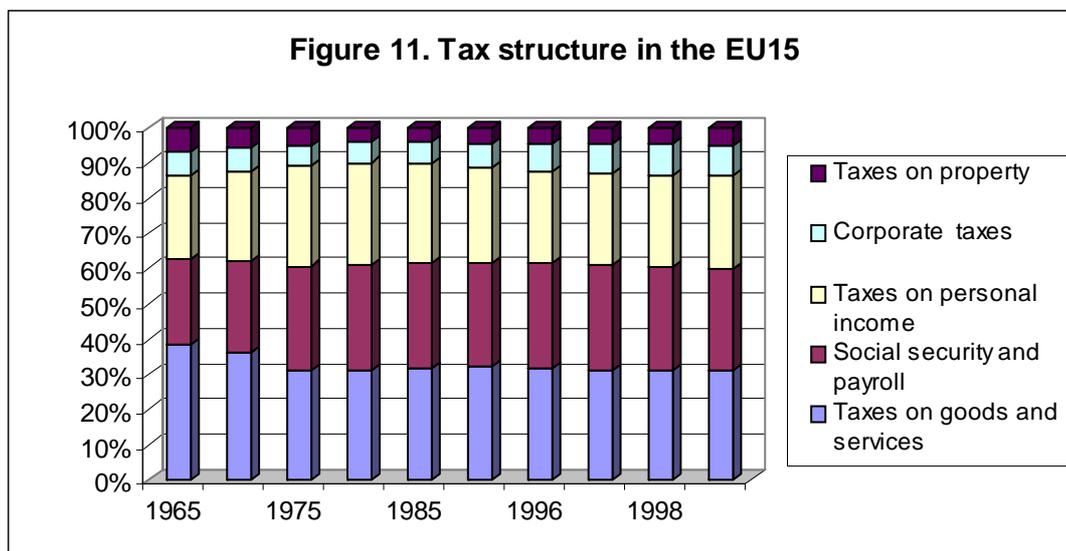


Source: OECD (2002).

6.1.2 Developments in tax structure

From figure 11 one can see developments in tax structure. It can be observed that tax structure has remained quite stable. Comparing the tax structures of 1965 and 1999, it can be concluded that share of taxes on goods and services has decreased (by 7.8 percentage points)

and share of taxes on social security contributions as well as corporate income has increased (by 4.5 percentage points and by 2 percentage points respectively). Since 1980 no major changes have taken place in average tax structure of the Member States. The biggest change has taken place in relative share of taxes on personal income which has decreased by 3.4 percentage points (from 29% in 1980 to 25.6% in 1999) and in share of taxes on corporate income which has increased by 2.9 percentage points (from 5.8% in 1980 to 8.7% in 1999).



Source: OECD (2001a).

Thus, statistical data about developments in tax structure do not provide evidence of tax competition for mobile tax basis which should lead to a decrease in relative share of corporate taxes and an increase in share of taxes on personal income and of taxes on goods and services in order to preserve overall tax revenues. In fact, opposite developments have occurred: share of taxes on personal income and on goods and services has decreased and of taxes on corporate income has increased.

6.2 VAT

6.2.1 Developments in tax system

The extent of harmonization in the field of VAT

The adoption of the European VAT system diminishes tax autonomy of the Member States. Harmonization of turnover tax in the EU intends to achieve uniformity by the adoption of Directives, most notably the Sixth VAT Directive. The VAT Directives constrain the room for design of national policies in the field of general consumption tax. A common structure for turnover tax is established by the introduction of VAT, which is the only tax system that Member States are allowed to use. Not only have been the rules determining the tax base harmonised to a large extent, but also the procedures for collection and administration (VAT Information Exchange System (VIES), VAT identification numbers, multiple registration of companies for VAT purposes, VAT representatives). However, Member States are still free to determine their VAT rates. This freedom is restricted by the Sixth Directive which has established the statutory minimum rates (15 percent) and some more restrictions for rate setting by Member States. The maximum rates have not been established, however, Member States' freedom to set maximum rates is restricted by competition from other tax jurisdic-

tions. Tax rates still vary, although the band of divergence has been narrowing (see section 6.4.2. on convergence of VAT rates).

Although much progress has been achieved in the tax base harmonization, there are still major differences in the tax base from one Member State to another. Differences in tax base come from various derogations and exemptions to the application of the Sixth Directive, applied by Member States. Certain supplies of goods or services may be exempt in one country but taxable in another; the threshold below which small businesses are exempt from tax, or enjoy special privileges, varies from country to country, as does the treatment of farmers; and some countries, most notably the UK, make substantial use of zero-rating.¹²³⁵ Divergence of tax base also comes from the fact that VAT is collected by national tax administrations, which have different practices and compliance ratios.

The implementation of the definitive system

Current VAT system applied in the EU is called transitional system. It is accepted that the current transitional arrangements have a number of shortcomings, because they are complicated, susceptible to fraud and out of date. The Commission proposed a work programme involving a stage-by-stage movement to the definitive clearing-house system. However, the implementation of the proposed definitive system to replace the transitional system is not likely to take place in the near future. Mr. Frits Bolkestein, member of the EU Commission responsible for the Internal Market and Taxation, realises that it has become very clear over the past few years that Member States are currently unwilling to accept the changes that would be needed for a definitive system to be implemented.¹²³⁶ The governments of fifteen Member States have to reach an agreement on approximation of VAT rates and legislation as well as on a compensation mechanism to ensure that revenues continue to accrue to the countries in which consumption takes place. However, the move to the definitive system is inconsistent with subsidiarity principle in the EU: the right of the Member States to choose their level of taxation and public spending – as it requires virtually identical VAT rates.¹²³⁷ Member States are not able to reach a unanimous agreement upon unified system of taxation and this means that it is unlikely that any significant progress towards definitive system will be made in the immediate future.

6.2.2 *Developments in tax level*

6.2.2.1 *Statutory tax rates*

Table 2 contains the overview of statutory VAT rates in 1990 and 2004. It can be seen that means of reduced rates and standard rates have increased by 2.66 percentage points (from 7.54 in 1999 to 10.2 in 2004) and by 1.5 percentage points (from 18.1 in 1999 to 19.6 in 2004) respectively.

Table 2. Domestic VAT rates in the EU, 1990 and 2004

	1990						2004			
Austria				10	20	32	10	16	20	
Belgium	0	1	6	17	19	25	33	6	12	21
Denmark				0	22					25
Finland								8	17	22
France		2.1	5.5	13	18.6	22		2.1	5.5	19.6
Germany				7	14			7	16	

¹²³⁵ Easson (1993), p. 8.

¹²³⁶ Bolkestein (2000), p. 403.

¹²³⁷ See McLure (2001), p. 8.

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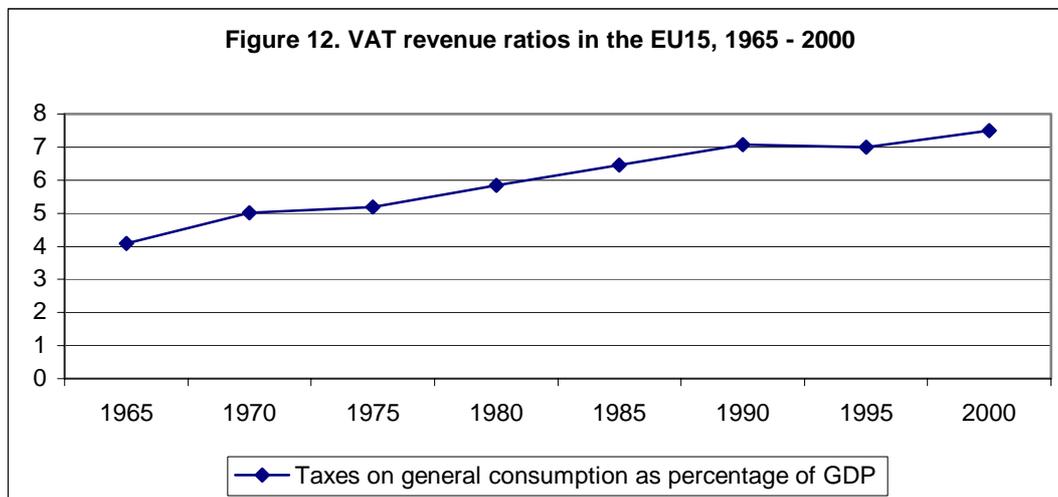
Greece		4	8	18	36		4	8	18	
Ireland	0	2.3	10	12.5	21		4.4	13.5	21	
Italy		4	9	12	19	38	4	10	20	
Luxembourg			3	6	12		3	6	12	15
Netherlands				6	18.5			6	19	
Portugal		0	8	17	30		5	12	19	
Spain				6	12	33	4	7	16	
Sweden			0	25			6	12	25	
United Kingdom			0	17.5			5	17.5		
EU average				7.54	18.1			10.2	19.6	
Standard Deviation ¹²³⁸				5.18	3.61			4.34	3.08	
Range ¹²³⁹				17	13			17	10	

Source: European Tax Handbook, KPMG, European Tax Center.

6.2.2.2 VAT revenue ratios

Statutory tax rate that can be derived from the tax laws do not measure the real tax burden. In order to analyse developments in real tax level, the effective tax rates should be compared. They are the result of the statutory tax rate applied to the taxable amount. Effective tax rates differ considerably from legal or statutory tax rates. Effective tax rate is usually considerably lower because of different kind of derogations and exemptions that erode the taxable amount.

One method of calculating effective tax burden is based upon comparison of tax revenues to GDP. We can see from figure 12 that average effective VAT burden has also increased in the EU, however, the growth of VAT revenue ratios has slowed down after 1990: VAT revenue as percentage of GDP has only increased by 0.3 percentage points between 1990 and 2000 (from 7.1 % to 7.5%).



Source: OECD (2002).

¹²³⁸ The standard deviation measures the variation of the country results from the EU average.

¹²³⁹ The range measures the difference between the maximum and minimum tax rates.

6.3 Corporate taxation

6.3.1 Developments in tax system

The systems of corporation taxation have been harmonized much less than VAT systems. There exist major differences in the company tax systems of the Member States. One possibility to distinguish between the company tax systems is according to the way and extent they provide relief for double taxation. It is possible to classify company tax systems according to the extent of the integration of the corporation income tax into the corporate personal income tax of the shareholder. According to this classification three different kind of company tax systems can be distinguished: the double taxation system (the classical system), the double taxation reducing systems, and the double taxation avoiding systems.¹²⁴⁰

Under *double taxation system or classical system* all kinds of profits are taxed fully in the hands of the company and its shareholders. Under classical system, the corporation is taxed entirely separately from its shareholders. Classical system does not eliminate double taxation as shareholders receiving the dividends are neither exempt from income tax at the company or shareholder level nor are they granted a tax credit or some other relief to offset the corporation tax already levied on the profits of which the dividends form a part.

Double taxation reducing systems only reduce the double taxation of dividends but do not avoid it completely. Several systems of company taxation provide some form of relief for double taxation by applying a lower rate of tax to the dividends, by taxing only a proportion of the value of the dividends or by granting a specified imputation tax credit in the amount of a percentage of the dividend received - so called 'shareholder relief'. Dividend-deduction system provides dividend relief at corporate level by allowing deduction for dividends from taxable profits. Dual rate system also provides relief against economic double taxation at corporate level by taxing distributed profits at lower rate than retained profits.¹²⁴¹ Schedular treatment system provides dividend relief at the shareholder level by taxing distributed profits at a schedular, usually flat, personal income tax rate separate from the tax on other personal income. Under partial imputation systems the shareholder includes the dividends she/he receives in the tax base for income or corporation tax but is granted a tax credit equivalent to part of the corporation tax paid by the company distributing the dividend on the profits from which the dividends derive. Under this system dividends are incorporated together with a tax credit that corresponds to the corporation tax underlying the dividends in the individual income tax base and then progressively taxed together with the other sources of income. However, since the tax credit is generally smaller than the underlying corporate tax, the double taxation on dividends is only partially abolished.

Double taxation avoiding systems provide full relief for double taxation. In the case of full tax imputation system, double taxation is completely avoided by crediting full amount of the corporation tax paid on the personal income tax of the shareholder. Under this system, divi-

¹²⁴⁰ See Baker & McKenzie (2001).

¹²⁴¹ Within the EU, Austria and Italy apply dual rate system or dual income tax, which favours equity capital against debt financing. Under this system, a share of profits that can be attributed to the increase in the equity capital of a company is deducted from the ordinary taxable income and taxed at lower rates compared to the rest of the profits. In Austria the reduced tax rate of 25 percent instead of the standard rate of 34 percent is levied on deemed profits that are attributed to the increase of equity capital of an Austrian company. In Italy the reduced rate of 19 percent instead of 37 percent is applied. This dual rate system is different from the dual income tax applied in Scandinavian countries. This dual income tax system is known as the Nordic Model and it generally provides for a progressive tax rate for employment income and taxes capital income separately, at a lower proportional rate.

dends are incorporated together with a tax credit in the individual income tax base.¹²⁴² If the individual income tax exceeds the corporation tax credit, the difference has to be paid by the shareholder. If the corporation tax credit exceeds the personal income tax, the excess corporation tax credit is refunded to the shareholder. As a result distributed profits are subject only to the personal income tax of the shareholder. An avoidance of double taxation can also be achieved through a dividend exemption system, which exempts dividends from personal income tax at the shareholder level. The full imputation system and the dividend exemption system result generally in a complete avoidance of double taxation at shareholder level.

The various systems exist side by side in the EU. The following corporation tax systems can be distinguished within the Community:¹²⁴³

- 1) The double taxation system or classical system is only used in Ireland, what taxes dividends fully at both corporate and shareholder level.
- 2) The double taxation reducing systems are used in ten Member States:
 - Six Member States (Austria, Belgium, Denmark, Germany, Luxembourg, Sweden) tax dividends on a schedular basis.
 - Four countries use partial imputation system: France, Portugal, Spain and the UK provide partial relief at shareholder level.
- 3) The double taxation avoiding systems can be classified into two subgroups: full tax imputation or dividend exemption system at the shareholder level.
 - Two Member States (Greece and The Netherlands) use dividend exemption system at the shareholder level. Greece is the only EU Member State that provides full relief at shareholder level in order to eliminate the economic double taxation of company profits.¹²⁴⁴ The Netherlands exempts dividend income at shareholder level, however it levies a net wealth tax on shares and other assets.
 - Two Member States (Finland¹²⁴⁵ and Italy) use the full tax imputation system at the shareholder level.

Irrespective of the particular system used by a Member State dividends paid to shareholders are often taxed differently depending on whether they are domestic or cross border, i.e. foreign dividends. Relief for corporation tax is in general only granted to domestic dividends. Two examples illustrate this: first a shareholder in two companies, one domestic, one foreign, receiving dividends may receive on the domestic dividend a tax credit (imputation system) or some form of shareholder relief (modified classical system), but on the foreign dividend an unusable or only partially repayable tax credit (imputation system) or no or a reduced form of shareholder relief (modified classical system). Second, two shareholders resident in two different states who own shares in the same company may be taxed differently, one making use of the tax credit, the other unable to and/or receiving a partial repayment (imputation system) or one receiving shareholder relief, the other not or only a reduced form of relief (modified classical system). In principle, these differences are considered discriminatory, and hence an obstacle to the Internal Market.¹²⁴⁶

¹²⁴² The grossed-up amount of the individual income tax is, as a general rule, taxed progressively in EU Member States applying imputation systems. See Baker & McKenzie (2001).

¹²⁴³ This classification follows Cnossen (2001), pp. 52 – 56 and Baker & McKenzie (2001).

¹²⁴⁴ The system that exempts dividend income from individual income taxation is applied in Greece since 1992. The annual profit is taxed, whether retained or distributed at a rate of 35%. No withholding tax is levied upon distribution. Distributed profits are exempt from income tax in the hands of the individual or corporate shareholder.

¹²⁴⁵ The full imputation system used in Finland is equivalent to the dividend exemption systems in Greece and The Netherlands. See Cnossen (2001), p. 55.

¹²⁴⁶ See Commission (2001c).

The denial of tax credit for foreign source dividends results in a double taxation of foreign source dividends with foreign corporation tax and domestic personal income tax. This double taxation evidently hampers cross-border activities. Furthermore, as far as outbound investments in other EU Member States are concerned, there is presumably a conflict with fundamental economic freedoms embodied in the EC Treaty, particularly with the freedom of establishment and the free movement of capital.¹²⁴⁷ Under imputation system, the conflict with EU law could be solved by extending the corporation tax credit to foreign source dividends. However, it is very complicated to implement cross-border foreign corporation tax credits into domestic imputation systems. Moreover, crediting foreign corporation taxes on a unilateral basis is very costly for country's budget.¹²⁴⁸

Recent trends in the EU

The current trend in the EU seems to be towards a partial or total switchover from the imputation system to the modified classical system or shareholder relief system. Denmark and Belgium changed from their partial imputation systems to schedular treatment systems in 1991 and 1992 respectively. Sweden changed from a dividend exemption scheme to a shareholder relief system in 1995. Luxembourg gave up the classical system in favour of a reduced taxation of dividends at the shareholder level in 1994. The recent changes include the abolition of full imputation system and introduction of a shareholder relief system (schedular treatment of corporate profits) in Germany, the abolition of partial imputation systems in favour of a classical system (in Ireland) or a shareholder relief system (in the United Kingdom)¹²⁴⁹. The UK greatly reduced the tax credit granted to recipient of a dividend and limited dividend tax credits only to domestic residents. The Netherlands employs the exemption system since 2001.

These developments of switchover from imputation systems to the classical system and shareholder relief systems can be explained by the requirements of the EU law and the complexity of imputation systems in comparison with the classical system and shareholder relief systems. The classical system and shareholder relief systems do not come into conflict with the fundamental freedoms of the EC Treaty, since – from the perspective of a domestic investor – domestic and foreign source dividends are treated exactly the same way: dividends are subject to taxation at the company level as well as the shareholder level.¹²⁵⁰ Although the classical system and shareholder relief systems do not discriminate cross-border activities against domestic investment, they are not neutral towards economic decisions of investors. For example, equity financing of outbound investments is generally discriminated against debt financing, since dividend income is taxed twice and interest is taxed only once.¹²⁵¹

Among other reforms to be implemented between 2000 - 2005¹²⁵², Germany also changed the method of elimination of double taxation of corporate profits. The imputation method of dividend tax relief was abolished and replaced by schedular treatment system by which only 50 per cent of shareholder's dividend income and taxable gains on shares¹²⁵³ are included in the shareholder's taxable personal income.

¹²⁴⁷ See Baker & McKenzie (2001), p. 21.

¹²⁴⁸ See Baker & McKenzie (2001).

¹²⁴⁹ However, in the UK, the relief is so small that the system approximates the classical system, see Cnossen (2001), p. 54.

¹²⁵⁰ See Baker & McKenzie (2001).

¹²⁵¹ Ibid.

¹²⁵² German tax reform also abandons dual rate system under which distributed profits are taxed at lower rate than retained profits. The statutory corporate tax rates on retained and distributed corporate income are aligned by reducing rate on retained profits from 51.8% to 38.6% and rate on distributed profits from 43.0% to 38.6%.

¹²⁵³ Only capital gains on shares representing a substantial interest (shareholding at least 1 per cent) are included in taxable income.

One of the reasons behind tax reforms has been seen the ongoing process of international tax competition. The trend in Member States to abolish imputation systems characterises a tax policy that strengthens the international competitiveness of the tax systems by cutting back advantages for the resident tax payers.¹²⁵⁴ For example, in Germany, the abolition of the full imputation system and the introduction of a shareholder relief system in 2001 were accompanied by a reduction of corporation tax from 40% (on retained earnings) and 30% (on distributed profits) to 25%. One of the major goals of the changes in the German tax system was to stimulate investment and employment in Germany and to make Germany a more attractive location for international investment. The German tax reform also intended to make its tax system more neutral towards international capital flows.¹²⁵⁵

Altogether, we can conclude that although there exist some trends concerning switchover from the imputation system to the modified classical system or shareholder relief system, the tax systems of the Member States are far from being harmonised or co-ordinated.

6.3.2 *Developments in tax level*

6.3.2.1 *Statutory tax rates*

*Most important tax reforms since 1998*¹²⁵⁶

The dominant trend in the recent tax reforms has been a lowering of the statutory tax rates on profits. This has been seen in eight of the fifteen Member States. Austria reduced corporation tax rate from 34% to 25% on deemed profits that can be attributed to the increase of equity capital ('dual income tax'). Denmark reduced corporation tax rate from 34% to 32% and to 30%. In addition it reduced declining-balance depreciation on machinery from 30% to 25%. France reduced corporation tax rate from 41.67% to 40%, 37.77% and to 36.43%. In addition, the coefficient of declining-balance depreciation was reduced by 0.25%. Germany reduced corporation tax rate from 45% to 40% and to 25%. In addition, reduced corporation tax rate on distributed profits was abolished. Furthermore, Germany reduced declining-balance depreciation on machinery from 30% to 20% and straight-line depreciation on buildings from 4% to 3%. Greece reduced corporation tax rate from 40% to 37.5% and final tax rate on interest receipts of a corporation from 20% to 15%. Ireland reduced corporation tax rate from 32% to 28%, 24% and to 12.5%. Portugal reduced corporation tax rate from 34% to 32%. United Kingdom reduced corporation tax rate from 31% to 30%. In addition, first year allowance for investment in machinery was reduced.

Only one state increased the statutory tax rate. Finland increased corporation tax rate from 28% to 29% and also increased real estate tax. At the same time Finland reduced declining-balance depreciation on machinery from 30% to 25%.

Aggregate statutory tax rates

Table 3 provides aggregate statutory tax rates¹²⁵⁷ on profits in 1998 and 2001. From table 3 is apparent that dominant trend has been lowering of the statutory tax rates on profits. This has been seen in six Member States: Ireland, Denmark, the United Kingdom, Portugal, France, and Germany have reduced the aggregate statutory tax rate on profits. The biggest decrease has taken place in Ireland followed by the two biggest countries: Germany and France. However, no changes in aggregate statutory tax rates during the period from 1998 to 2001 have taken place in seven countries: Sweden, Austria, the Netherlands, Spain, Luxem-

¹²⁵⁴ See Baker & McKenzie (2001).

¹²⁵⁵ Sørensen (2001).

¹²⁵⁶ Summary is based on Baker & McKenzie (2001).

¹²⁵⁷ Aggregate statutory tax rates on profits include the corporation tax plus local profit taxes and surcharges (a surcharge is a tax on corporate tax that is often imposed as a temporary measure).

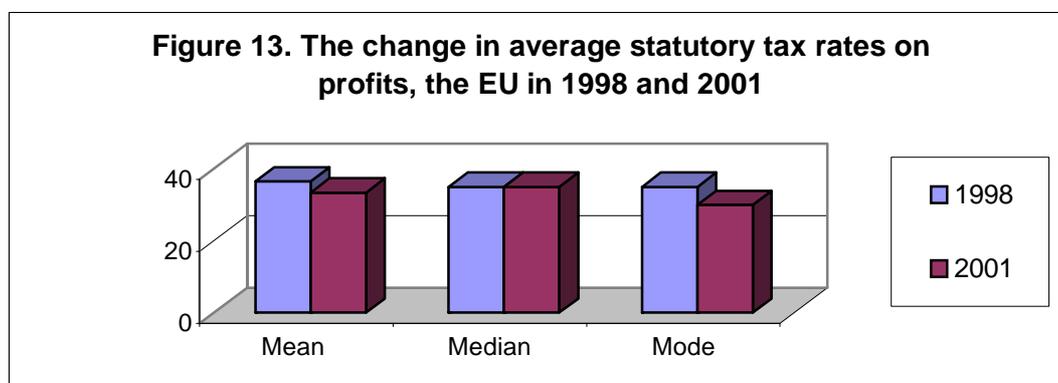
bourg, Belgium, and Italy. Two countries have indeed increased the aggregate statutory tax rates on profits: Finland and Greece.

Table 3. Aggregate statutory tax rates on profits, the EU in 1998 and 2001

Country	1998	2001
Ireland	32.00	12.50 ¹²⁵⁸
Sweden	28.00	28.00
Finland	28.00	29.00
Denmark	34.00	30.00
United Kingdom	31.00	30.00
Austria	34.00	34.00
Netherlands	35.00	35.00
Spain	35.00	35.00
Portugal	37.40	35.20
France	41.67	36.43
Luxembourg	37.45	37.45
Greece	35.00	37.50
Germany	56.66	39.35
Belgium	40.17	40.17
Italy	41.25	41.25

Source: Baker & McKenzie (2001).

Form figure 13 is apparent that EU average aggregate statutory tax rates have decreased in 2001 compared to 1998. EU mean aggregate statutory tax rate has declined by almost 10 percent from 36.4 in 1998 to 33.4 in 2001.



Source: Baker & McKenzie (2001).

Table 4 provides capital income (dividend, retained profit, and interest) tax rates of all EU countries for 1990 and 2000. Table 4 reports the top marginal rate on corporate profits. The graduated tax structures and the special corporate tax rates to different types of businesses are not taken into account. In addition, the figures exclude local taxes and surcharges.

Table 4. Total tax rate on interest, dividend, and retained profit, EU 1990/2000

¹²⁵⁸ Although the corporation tax rate of 12.5 percent will become effective from 2003 it was already considered for the year 2001 in Baker & McKenzie (2001), since companies making investment decisions will most probably focus on this rate when establishing their business plans rather than on the current ordinary rate in Ireland.

Trends of taxation in the EU

Country	Interest		Dividend		Retained profits	
	1990	2000	1990	2000	1990	2000
Austria	50	25	48	51	65	34
Belgium	25	55	56	73	41	39
Denmark	40	15	55	59	64	32
Finland	30	29	29	29	57	50
France	57	54	59	54	73	69
Germany	53	51	53	51	77	71
Great Britain	40	40	48	48	61	58
Greece	50	15	46	40	73	67
Ireland	56	24	46	59	77	39
Italy	50	27	58	46	68	65
Luxemburg	56	46	71	46	71	62
Netherlands	60	60	74	74	35	35
Portugal	40	40	58	48	43	39
Spain	56	40	74	45	74	61
Sweden	25	30	55	50	55	50

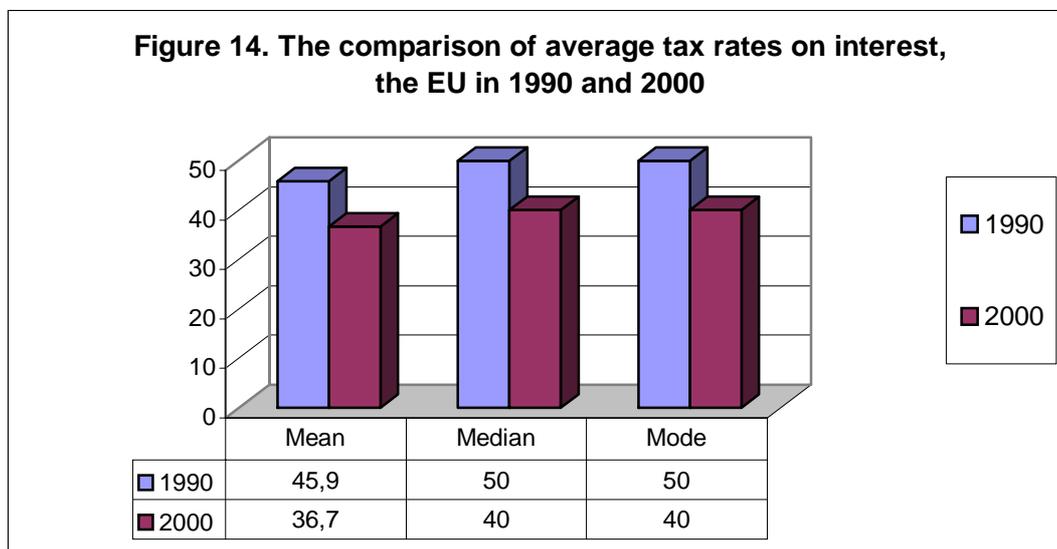
Source: IBFD (2000) and Gorter and de Mooij (2001).

Have tax rates declined?

Figures 14 - 16 compare average tax rates on interest, dividend and retained profits in the EU in 1990 and 2000.

Interest

From figure 14 is apparent that tax rates on interest have decreased between 1990 and 2000: the mean, median and mode tax rates have declined.¹²⁵⁹

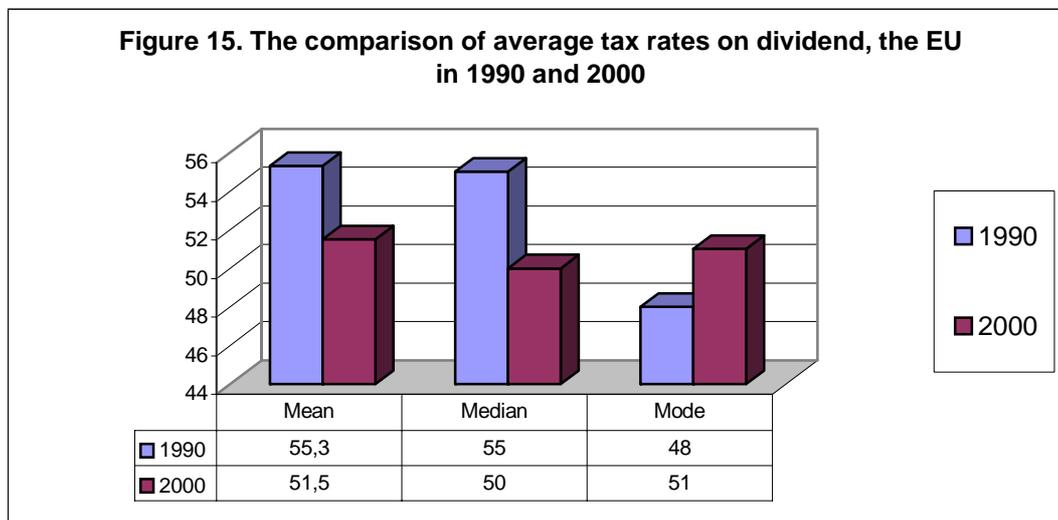


Source: IBFD (2000) and Gorter and de Mooij (2001).

¹²⁵⁹ Testing the comparison of two paired populations of means: the value of test statistic is equal to 2.07. Consequently, the decrease in mean tax rate of interest is statistically significant (at level 0.1).

Dividend

From figure 15 is apparent that tax rates on dividend have decreased in the EU between 1990 and 2000: the mean and median have declined.¹²⁶⁰ The mode tax rate has increased, however, from 48 in 1990 to 51 in 2000.



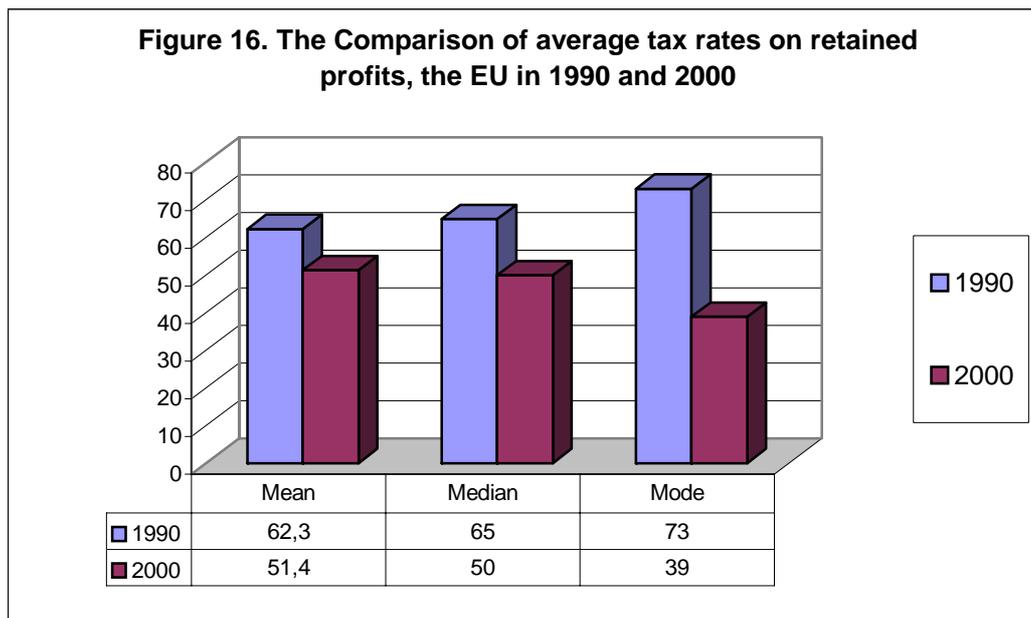
Source: IBFD (2000) and Gorter and de Mooij (2001).

Retained profits

From figure 16 is apparent that tax rates on retained profits have decreased between 1990 and 2000: the mean, median and mode tax rates have declined.¹²⁶¹

¹²⁶⁰ However, testing the comparison of two paired populations of means gives the value for t-statistic 1.29 for dividend. Since p-value is equal to 0.22, the decrease is statistically insignificant.

¹²⁶¹ Testing the comparison of two paired populations of means: the value of test statistic is equal to 3.11 and p-value is equal to 0.008. Thus, the decrease in mean tax rate of retained profit is statistically significant.



Source: IBFD (2000) and Gorter and de Mooij (2001).

6.3.2.2 *Effective tax rates*

Effective tax rates take into account not only the statutory corporate tax rates but also other aspects of the tax systems which determine the amount of tax effectively paid. In addition to statutory rate the effective tax rate on business profits depends also on the rules defining the tax base. The effective tax rate takes into account the tax base and the manner in which corporate and personal tax systems are integrated. Effective tax rates, usually - but not always - refer to tax payment divided by a measure of taxable income.¹²⁶² The taxable income is the profit expressed in accordance with tax legislation – accounting profit is often subject to series of adjustment to arrive at the taxable income. Therefore, effective corporate tax rate is usually considerably lower because of different kind of tax provisions that erode the taxable income. In particular, depreciation allowances for machinery and buildings, valuation of inventories, general investment reliefs, the treatment of reserves and provisions, and the tax treatment of capital gains at the company level cause differences between the statutory and effective tax rates.

Different methods to compute effective tax rates

In computing effective tax rates different methods can be distinguished.¹²⁶³ The existing approaches to measure the effective tax burden are based on two types of analysis implying either backward-looking concepts or, alternatively, forward-looking concepts. *Backward looking method* is based on the observation of ex-post data. This method measures effective tax rates on the basis of current data arising from aggregate macroeconomic accounts or from accounts of companies. *Forward looking methods* involve computing the effective tax burden for a hypothetical prospective investment project over the assumed life of the project or the effective tax burden for hypothetical future model firm behaviour. In practice, it consists in defining a hypothetical investment identical in all countries and then applying to this identical hypothetical investment the different national tax codes. The advantage of forward-looking effective tax rates is that they measure the impact of taxes on *new* investment projects. Instead, backward looking methods refer to *existing* capital. Furthermore, forward

¹²⁶² Gorter and de Mooij (2001), p. 23.

¹²⁶³ See OECD (2000a), Gorter and de Mooij (2001), and Giannini and Maggioli (2001).

looking methods permit international comparisons and are able to provide an indication of the general pattern of incentives to investment that are attributable to different national tax laws as well as to the working of the international tax regime.¹²⁶⁴ Compared to the forward looking methods, the backward looking methods have the advantage that they take account of tax planning activities, complex tax provisions and discretionary administrative practices of tax authorities.

The effective tax rates based on backward looking methods can be classified into two sub-groups:

- *Macro approach.* Measures for the tax burden using aggregate economic data from national accounts are computed as a percentage of domestic corporate taxes (in general only corporate income tax) relative to various income measures, such as aggregated domestic corporate profits or the corporate operating surplus. Ratio of capital income tax and operating surplus is computed on the basis of macro data: the sum of the corporate income tax and personal capital income tax is divided by the total operating surplus of the economy. This approach measures the overall tax burden on capital income that is levied on the corporate and the personal level.
- *Micro approach.* This method of calculating effective tax rates is based upon micro data from the financial accounts of individual firms or consolidated returns. Approaches based on micro data generally express the effective tax burden as a percentage of the tax liability relative to the profits from companies' annual accounts. This method measures tax burden on corporation by computing a ratio of corporate tax liabilities and pre-tax corporate income by dividing the corporate income tax paid by the firm by its pre tax corporate income. The median ratio in a country is then the effective tax rate.

Two additional methods of computing effective tax rates can be distinguished¹²⁶⁵:

- *Marginal effective tax rates* measure the wedge between the pre- and post tax return on a marginal investment project that does not yield an economic rent. Hence, it measures the incentive effects of taxes on marginal investment and/or savings decisions. Effective tax rates based on this forward-looking method are calculated on the basis of the tax code, not on the basis of tax data. The model developed by King and Fullerton (1984)¹²⁶⁶ derives the marginal effective tax rate by computing the percentage wedge between the rate of return on investment of a series of hypothetical investments and a given rate of return on savings. The King-Fullerton effective tax rates refer to the overall tax wedge between the before-tax and post-tax rate of return on a marginal investment and measure the overall tax burden on capital income that is levied on the corporate and the personal level. The King-Fullerton approach explicitly takes into account the fiscal details such as depreciation allowance, inventory valuation, investment incentives, and preferential savings provisions.
- *Average effective tax rates* (usually referred to as 'project-based' analysis of effective tax rates) measure the overall tax burden on a typical investment. It is forward looking method that measures tax burden on corporations. Devereux and Griffith (1998) adjusted the King-Fullerton approach in order to calculate the *average effective tax rate*, i.e. the average percentage wedge on a range of *inframarginal* investment projects on which firms earn an economic rent. Present value of corporate income tax liabilities on profits of a hypothetical investment is divided by the present value amount of net profits.

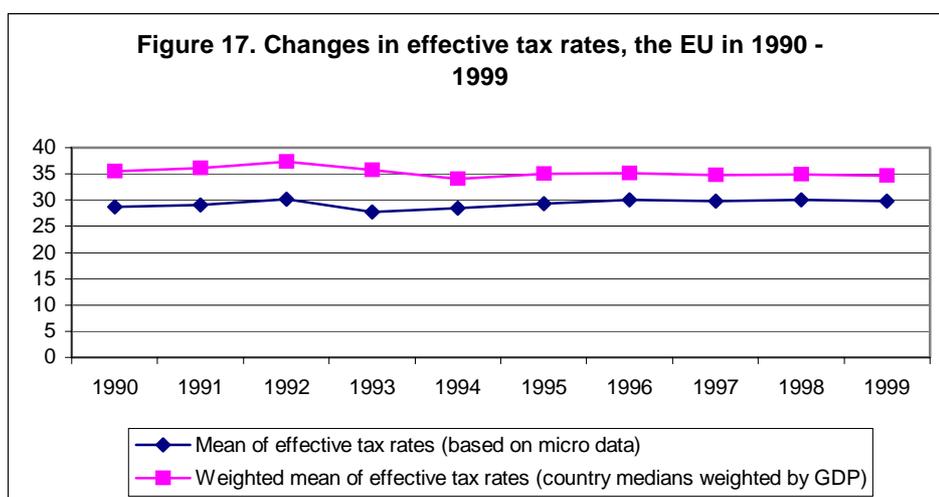
¹²⁶⁴ Commission (2001b), p. 6.

¹²⁶⁵ See Gorter and de Mooij (2001).

¹²⁶⁶ King and Fullerton (1984).

*Trends in effective tax rates**Effective tax rates based on micro approach*

In analysing trends in effective tax rates Gorter and de Mooij (2001)¹²⁶⁷ find that, unlike the statutory tax rates, effective capital income tax rates have not declined in Europe during the last decade. Indeed, effective tax rates computed on the basis of micro data have remained constant during the last decade (see figure 17). This is explained by the fact that the decrease in statutory rates has been accompanied by a broadening of the capital income tax base. The simultaneous reduction in statutory tax rates and broadening of tax base appears to be the recent trend in capital income taxation, and indeed of income taxation in general.¹²⁶⁸ Many tax reforms in the past, have shown that countries – in addition to the broadening of the tax base – tend to reduce the relief for corporation tax in order to compensate for the revenue loss in the event of a lowering of the tax rates.¹²⁶⁹



Source: Calculations by Gorter and de Mooij (2001)¹²⁷⁰ on the basis of the Worldscope database

Effective marginal tax rates

The study by Baker & McKenzie of March 2001 presents estimates of the effective levels of company taxation in the 15 Member States of the European Union for the years 1998-2001. The main aim of the study was to determine effective marginal tax rates (EMTR) on domestic investment. The computation of the EMTR and the quantitative analysis was based on the King and Fullerton approach, which was also used in earlier international tax burden comparisons by the OECD (1991) and the European Commission (the Ruding Report of 1992). The results of the study by Baker & McKenzie are summarised in table 5. Within the EU, seven Member States have reduced the EMTR for corporations: Austria, Denmark, France, Germany, Greece, Ireland and Portugal. No relevant changes during the period 1998-2001 are reported for five Member States (Belgium, Italy, Luxembourg, Spain and Sweden). Three Member States (Finland, the Netherlands and the United Kingdom) have even increased the EMTR.

We can see from figure 18 that the greatest reduction has taken place in Ireland that has gradually reduced the corporation tax rate by more than 60 percent (from 32 percent in 1998 to 12.5 percent in 2001). Greece who has the lowest EMTR has reduced the corporation tax

¹²⁶⁷ See Gorter and de Mooij (2001).

¹²⁶⁸ See Gorter and de Mooij (2001), Commission (2000b), and OECD (2000b).

¹²⁶⁹ See Baker & McKenzie (2001).

¹²⁷⁰ See Gorter and de Mooij (2001).

rate by 28% (from 9.37 in 1998 to 6.76 in 2001). The countries with the highest EMTRs in 1998 – France, Germany and Austria - have also reduced the corporation tax rate. As a consequence of the tax reform in Austria in 2000, its EMTR has declined by 24% (from 24.09 to 18.25). As a result of German tax reform which became effective on January 1, 2001, the overall EMTR of German corporation decreased by 13% (from 28.81% in 1998 to 25.2% in 2001). The reduction of the EMTR in France amounts to 8%. As a result of the developments in Member States, EU average EMTR has fallen by 9% (from 19.9 in 1998 to 18.1 in 2001).

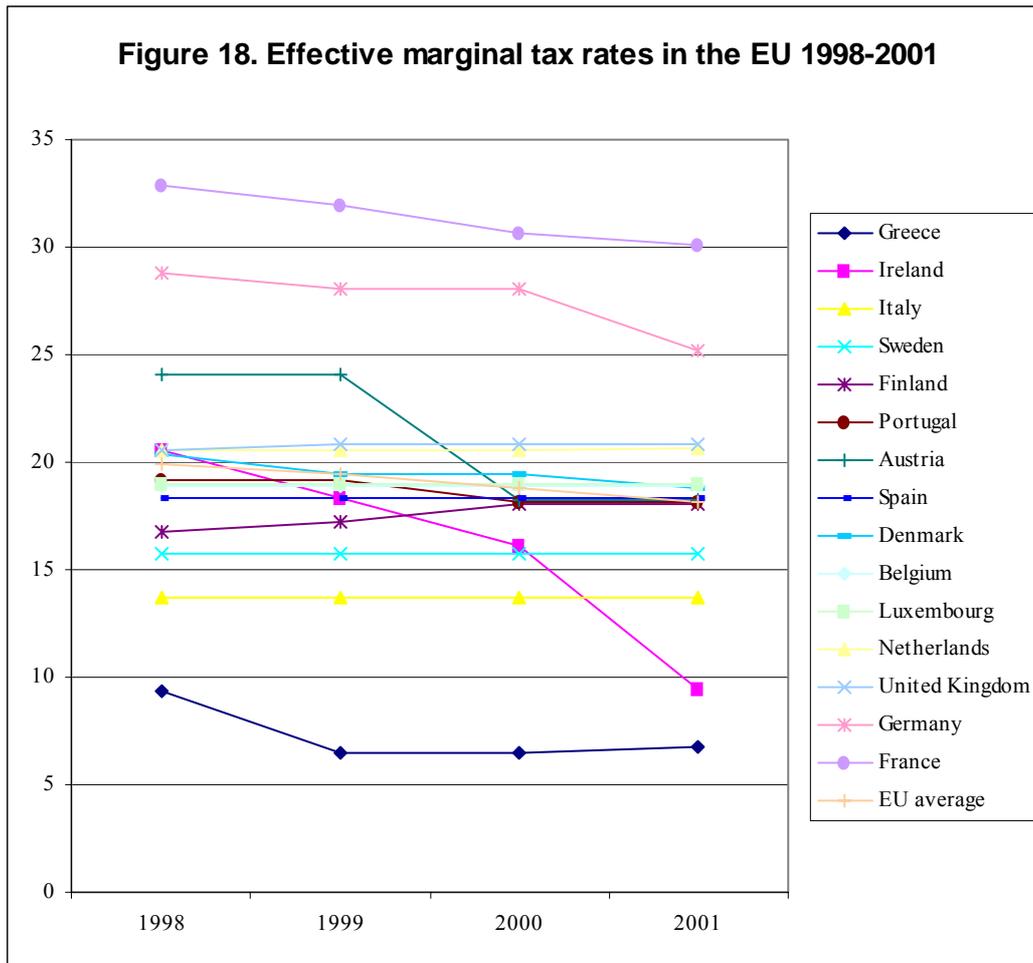
The effects of the tax reductions on the country positions from the highest to the lowest EMTR are only minor. The countries at the top positions in the country ranking (Greece, Italy, Sweden, Finland) as well as at the bottom positions (France and Germany) remained the same. Apart from Ireland, Austria and Portugal, no country could improve its position. From figure 18 is apparent that most of the countries have the EMTRs close to EU average rate of 18.13%. Seven Member States have an EMTR between 18% and 19%. Apart from Ireland and Greece, the countries with relatively low EMTRs such as Italy and Sweden did not further reduce their tax burdens. Thus, there is no evidence that a ‘race to the bottom’ is taking place in the EU.¹²⁷¹

Table 5. Effective marginal tax rates 1998-2001

Country	1998	1999	2000	2001
Greece	9.37	6.46	6.46	6.76
Ireland	20.59	18.35	16.08	9.43
Italy	13.74	13.74	13.74	13.74
Sweden	15.73	15.73	15.73	15.73
Finland	16.72	17.24	18.09	18.09
Portugal	19.15	19.15	18.15	18.15
Austria	24.09	24.09	18.25	18.25
Spain	18.30	18.30	18.30	18.30
Denmark	20.33	19.40	19.40	18.81
Belgium	18.89	18.89	18.89	18.89
Luxembourg	18.98	18.98	18.98	18.98
Netherlands	20.60	20.60	20.60	20.67
United Kingdom	20.56	20.83	20.83	20.83
Germany	28.81	28.03	28.03	25.20
France	32.83	31.90	30.65	30.11
EU average	19.91	19.45	18.81	18.13
Standard deviation	5.46	5.83	5.54	5.60
Range	23.46	25.44	24.19	23.35

Source: Baker & McKenzie (2001).

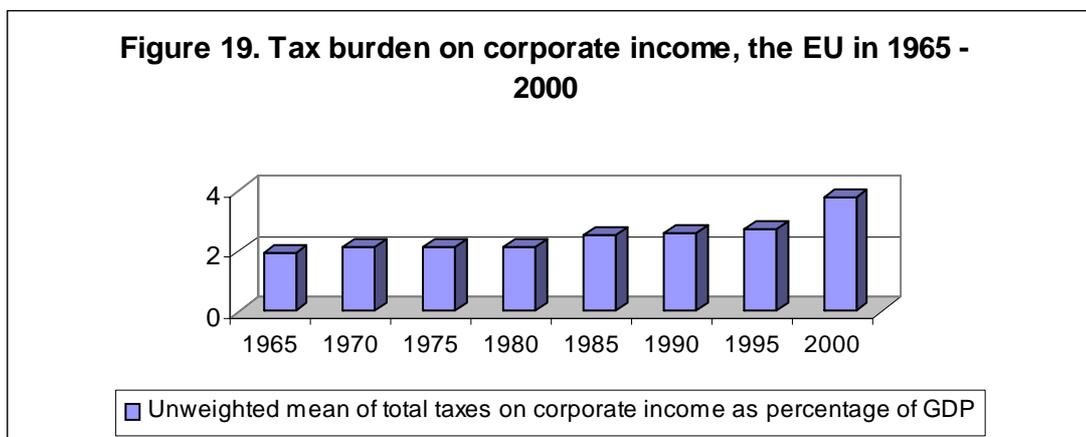
¹²⁷¹ See Baker & McKenzie (2001).



Source: Baker & McKenzie (2001).

Tax revenue ratios

An alternative method of calculating effective tax burden is based upon comparison of tax revenues to GDP. From figure 19 we can see that tax burden on corporate income has been increasing since 1965. Between 1990 and 2000 tax revenue as percentage of GDP increased from 2.6 to 3.8.



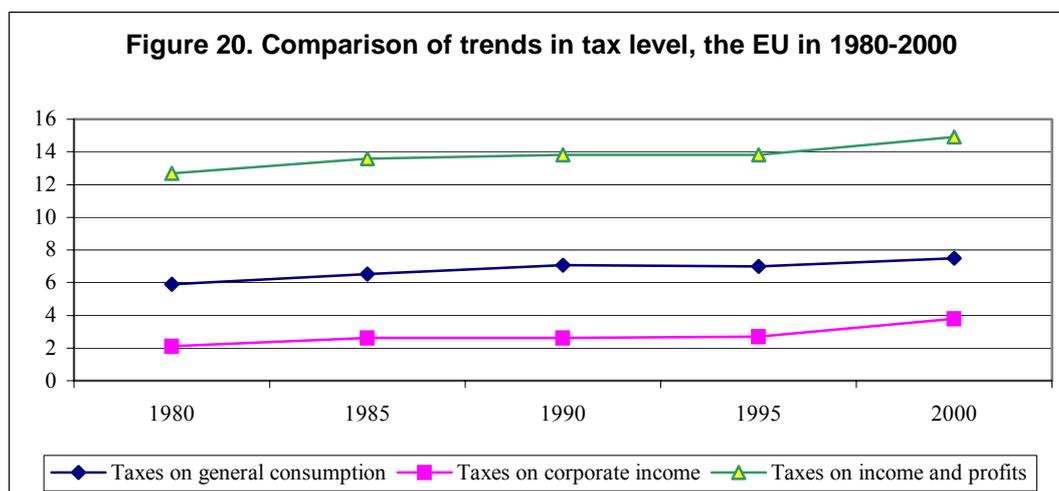
Source: OECD (2002).

Conclusions about developments in tax level

Statistical analysis does not support the idea that tax competition has led to a decrease in statutory and effective rates of corporate tax and an increase in taxes on labour and consumption. Although the statutory tax rates have declined in Europe during the last decade, there is no statistical evidence that the effective capital income tax rates have declined. In fact, different methods of calculating effective tax burden provide slightly different results. Gorter and de Mooij (2001)¹²⁷² find that the effective capital income tax rates have not declined but remained constant during the last decade. Results of the study by Baker & McKenzie of March 2001 show that EU average effective marginal tax rate on domestic investment have declined by 9 percent between 1998 and 2001 (from 19.9 to 18.1). However, corporate tax revenue ratios have increased during last decade. Most of the studies on effective tax rates conclude that on average the effective tax rates on capital have remained constant for Member States. This is explained by the fact that the recent tax reforms have combined cuts in statutory rates with measures to broaden the capital income tax base as well as reductions in the relief for corporation tax in order to compensate for the revenue loss accompanying the decrease in tax rates.

The trends in taxation of income and profits as well as consumption during the last two decades are compared in figure 20. We can see that taxes on corporate income have increased as well as taxes on all income and profits and taxes on general consumption. No major differences in these trends can be distinguished.

Altogether we can conclude about tax level in the field of corporate taxation that the dominant trend has been a lowering of the statutory tax rates on profits. However, this was combined with a broadening of the tax bases, in particular with a cut back of the depreciation rules. Furthermore, the dominant trend away from the use of imputation systems towards shareholder relief systems also has an overall impact of broadening of the tax base by reduction of the relief for corporation tax to domestic shareholders. Since the changes in the corporation tax systems only burden resident taxpayers, this trend clearly indicates that Member States are trying to strengthen the international competitiveness of their tax systems.¹²⁷³



Source: OECD (2002).

¹²⁷² See Gorter and de Mooij (2001).

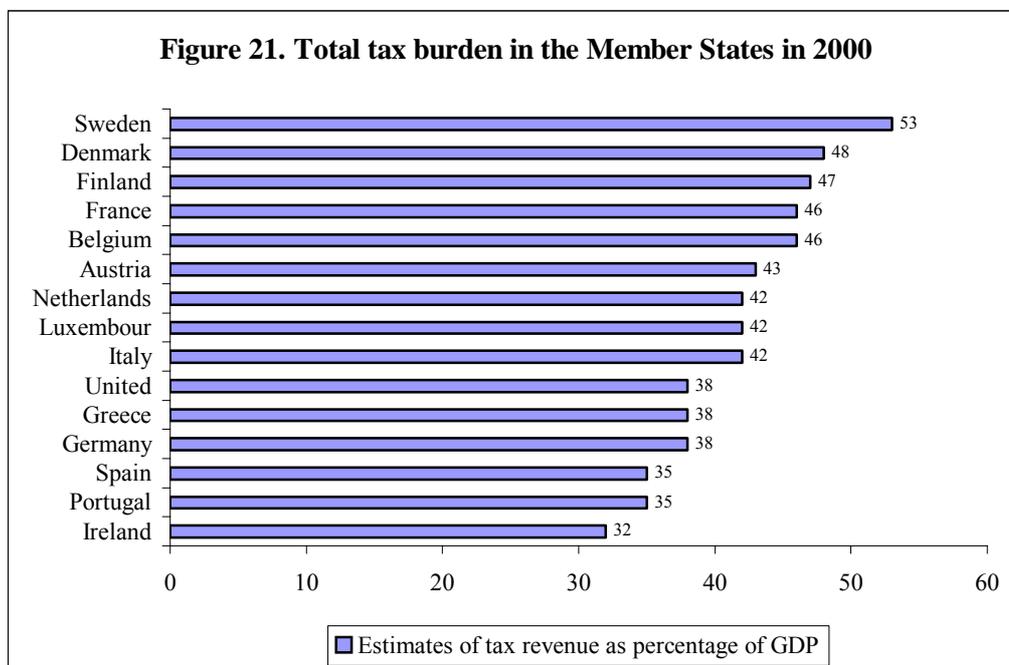
¹²⁷³ See Baker & McKenzie (2001).

6.4 Tax convergence

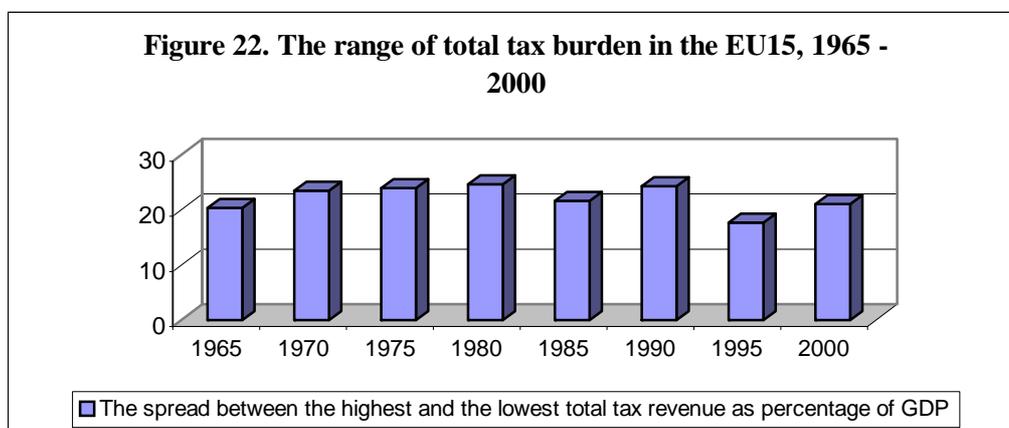
We can use measures of variation like the range and the standard deviation for analysing the convergence of tax rates. The range measures the difference between the maximum and minimum tax rates. The standard deviation measures how much the country rates deviate from the EU average.

6.4.1 Total tax burden

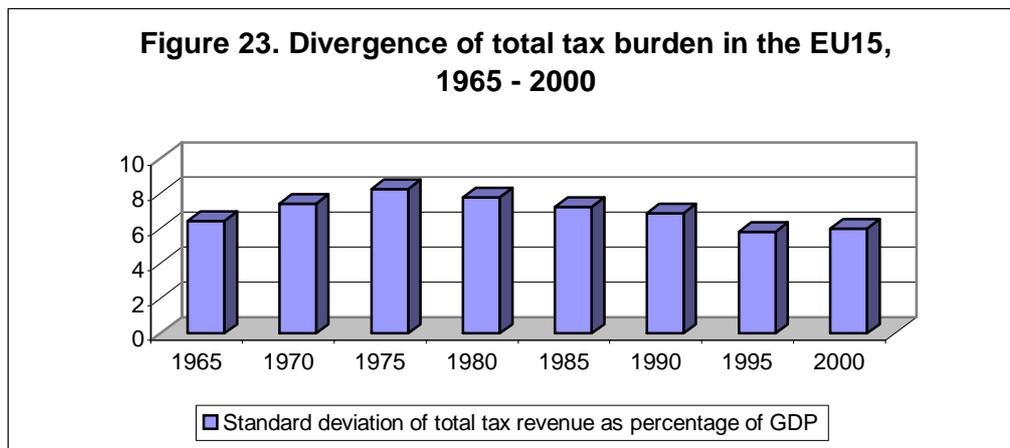
We can see the developments in range of total tax burden in figure 22. No clear trend can be distinguished. However, from figure 23 is apparent that some decrease in standard deviation of total tax revenue has taken place since 1975. Average total tax burden in the EU has increased by approximately 14 percentage points since 1965, thus, total tax burdens in Member States have converged towards higher level. Despite of some convergence, the spread between the highest and the lowest total tax burden was still 21 percentage points in 2000, varying from 32% in Ireland to 53% in Sweden (see figure 21).



Source: OECD (2001a).

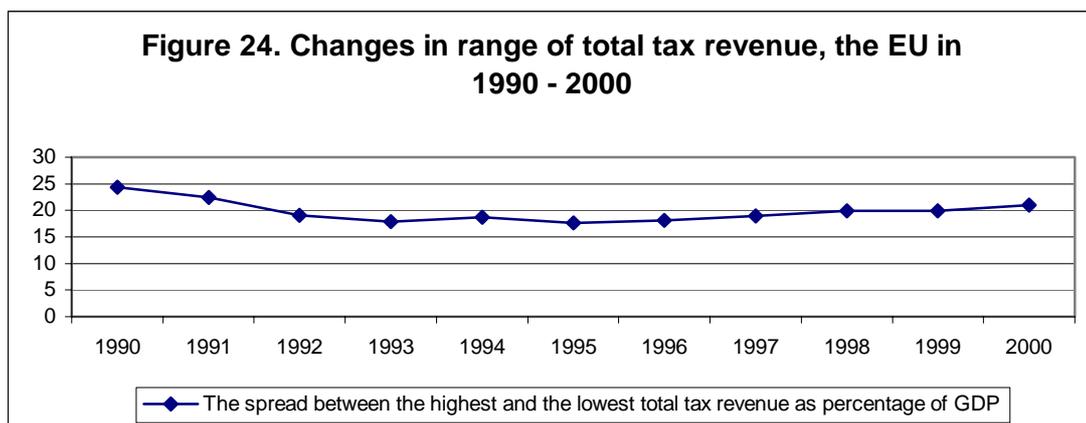


Source: OECD (2001a).



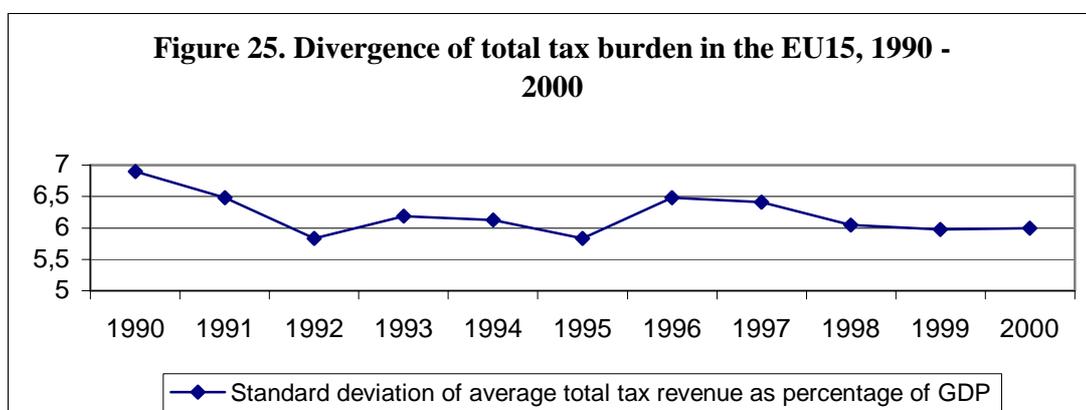
Source: OECD (2001a).

Some decrease in the spread between the highest and the lowest tax burden is noticeable between 1990 and 2000 (see figure 24).



Source: OECD (2001a).

Standard deviation of total tax burden has also decreased between 1990–2000 (see figure 25).



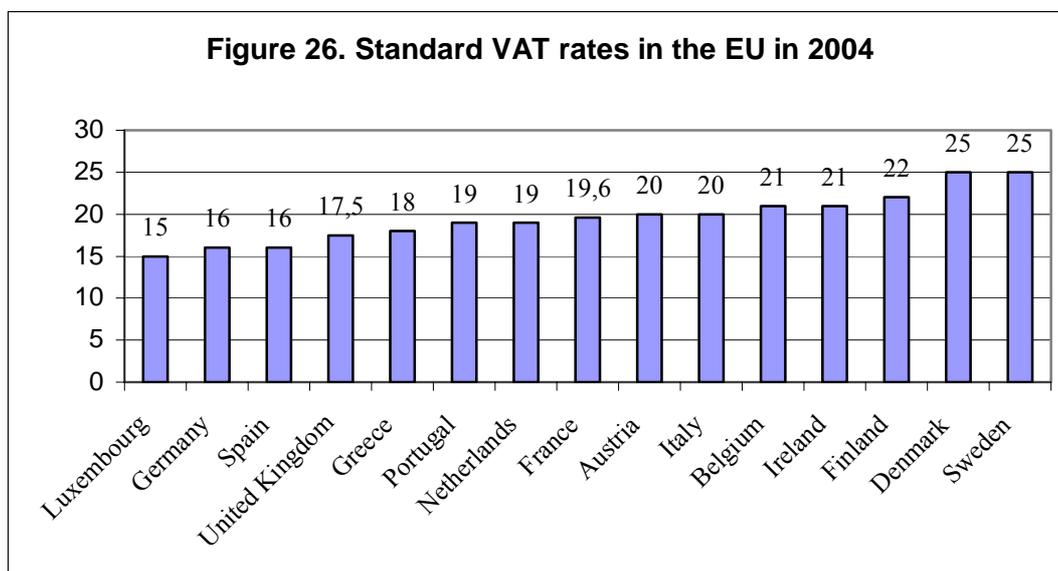
Source: OECD (2001a).

Altogether, we can conclude that some convergence of total tax burden has occurred since 1975, including last decade.

6.4.2 VAT

6.4.2.1 Statutory tax rates

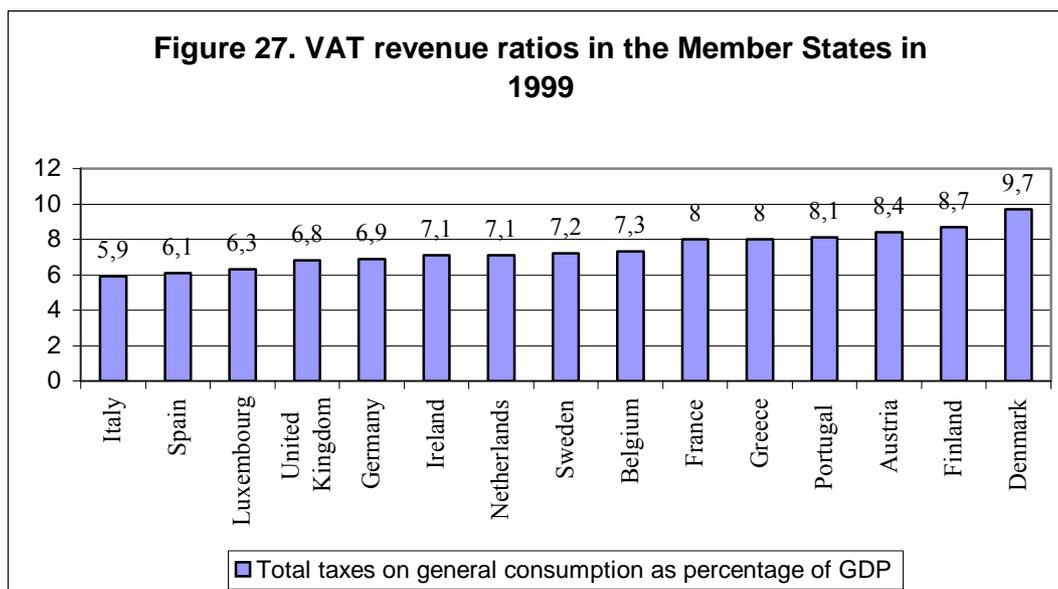
From table 2 (see section 6.2.2.1.) is apparent that some convergence of statutory VAT rates has taken place in the EU between 1990 and 2000. The number of different rates applicable in Member States has decreased, furthermore, the spread between the highest and the lowest standard rates has slightly decreased (from 13 in 1990 to 10 in 2000¹²⁷⁴) and standard deviation of standard as well as reduced rates has decreased. However, standard VAT rates still vary from 15% in Luxembourg to 25% in Denmark and Sweden (see figure 26).



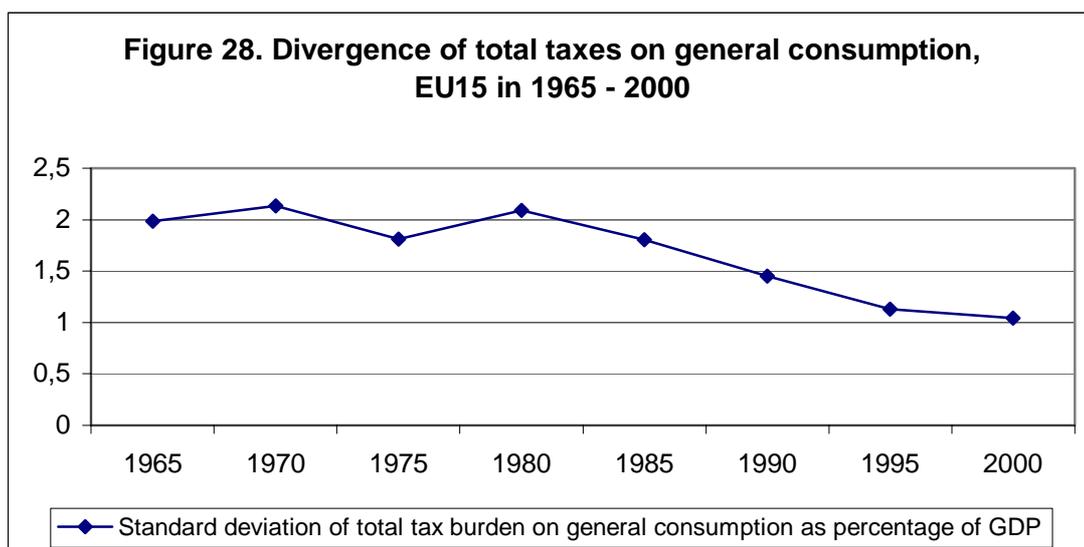
6.4.2.2 VAT revenue ratios

Although the divergence of VAT revenue ratios has decreased considerably since 1980 (see figure 28), the spread between the highest and the lowest VAT revenue ratio is 3.8 in 1999, varying from 5.9 in Italy to 9.7 in Denmark (see figure 27). Thus, in spite of VAT rate convergence, there are still considerable differences in the statutory as well as effective tax rates among Member States.

¹²⁷⁴ One reason why the range of standard VAT rates has decreased is that Luxembourg had to increase its standard rate to the EU minimum level (15%).



Source: OECD (2001a).

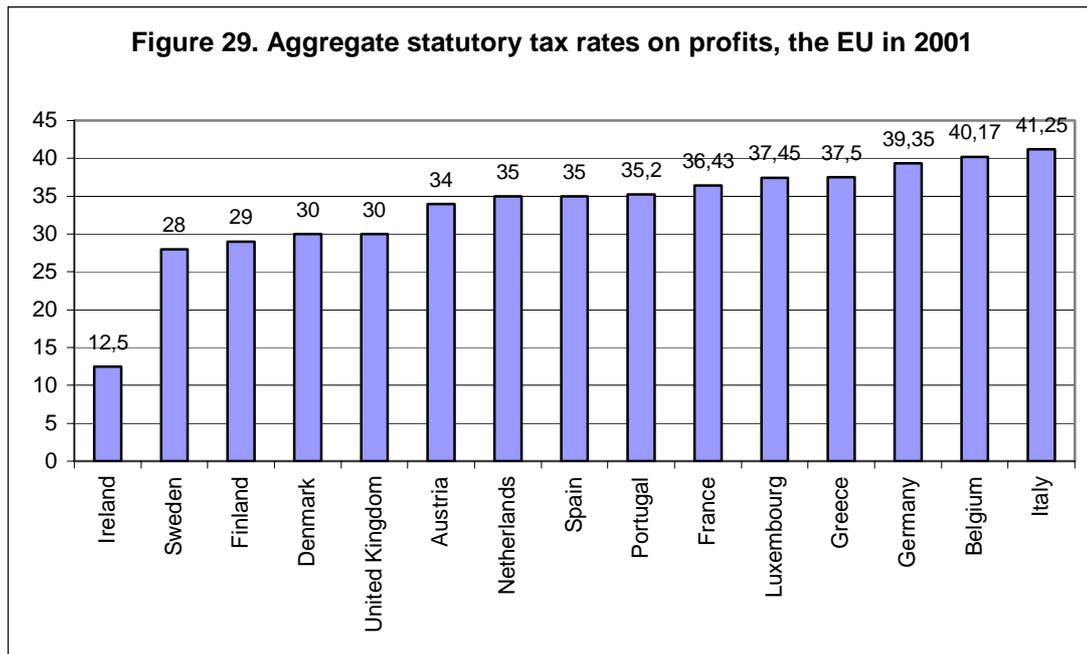


Source: OECD (2002).

6.4.3 Corporate taxation

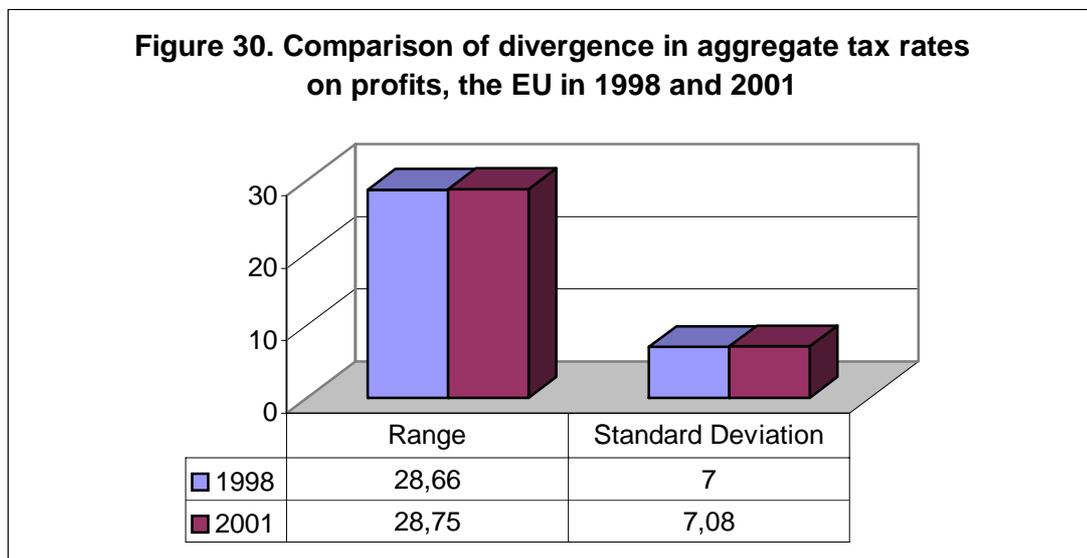
6.4.3.1 Statutory tax rates

From figure 29 is apparent that aggregate statutory tax rates as from January 1, 2001, including surcharges, vary between 12.5% in Ireland and 40.17% in Belgium. The range of statutory rates is substantial, the spread between the highest and the lowest tax rate amounts to 27.67 percentage points. Ireland's rate of 12.5% is the lowest followed by a group of the Member States with rates around 30% (Sweden 28%, Finland 29%, Denmark 30%, United Kingdom 30%). At the upper end there is a group with rates around 40% (Germany 39.35%, Belgium 40.17%, Italy 41.25%).



Source: Baker & McKenzie (2001).

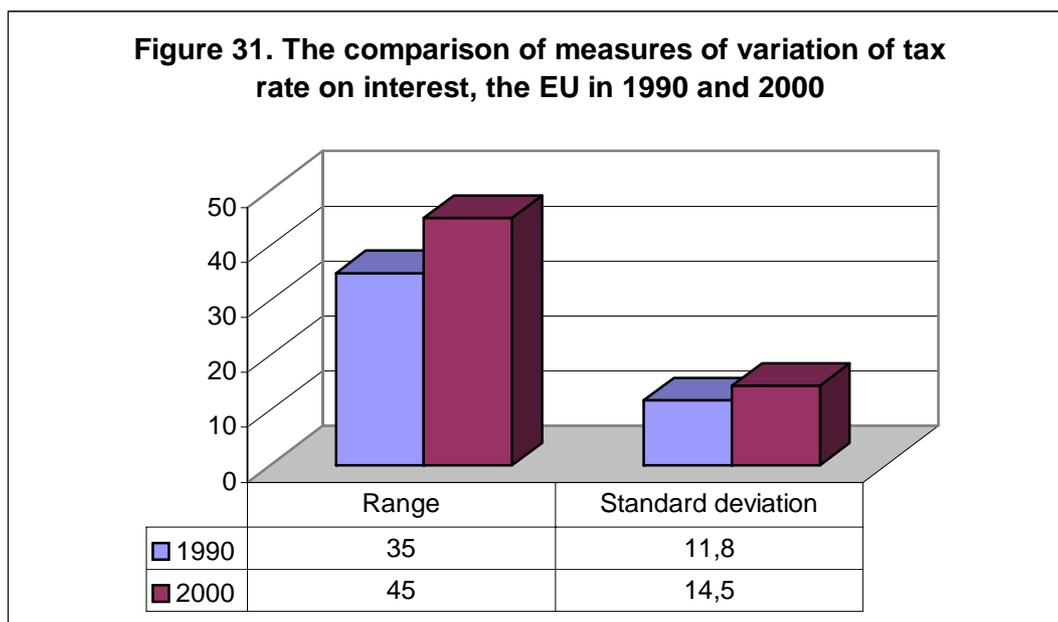
Figure 30 compares the range and standard deviation of aggregate statutory profit tax rates in the EU in 1998 and 2001. We can see that the range and standard deviation have not changed considerably, the decrease in range and standard deviation is not significant.



Source: Baker & McKenzie (2001).

Interest

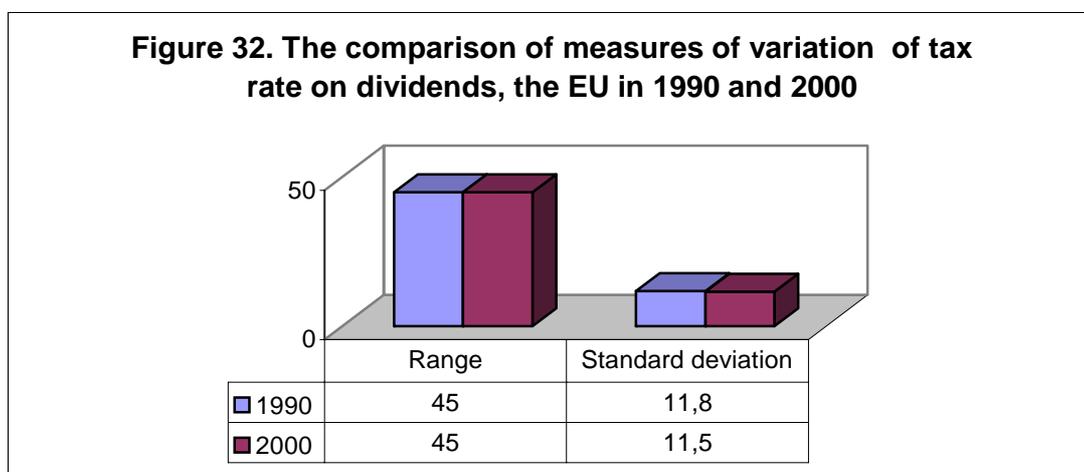
From figure 31 is apparent that the variation of statutory tax rates on interest has increased: the range of tax rates has increased from 35 to 45 and standard deviation from 11.8 to 14.5.



Source: IBFD (2000) and Gorter and de Mooij (2001).

Dividend

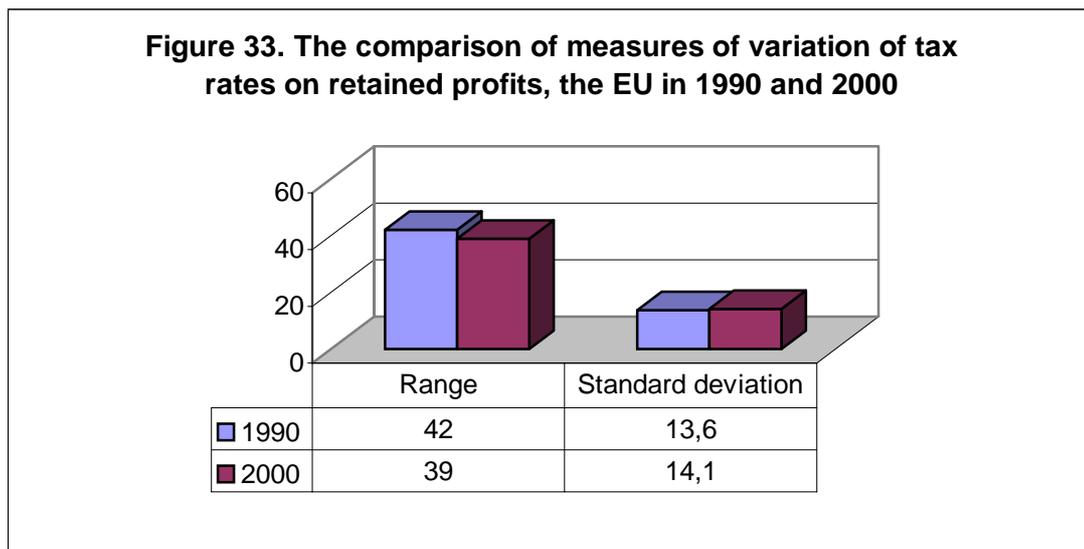
From figure 32 is apparent that the variation of statutory tax rates on dividend has remained approximately the same: the range of tax rates is 45 in 1990 as well as in 2000. Standard deviation has slightly decreased from 11.8 to 11.5.



Source: IBFD (2000) and Gorter and de Mooij (2001).

Retained profits

From figure 33 is apparent that the variation of statutory tax rates on retained profits has not changed considerably: the range of tax rates has decreased from 42 to 39 and standard deviation has increased from 13.6 to 14.1.



Source: IBFD (2000) and Gorter and de Mooij (2001).

Gorter and de Mooij (2001) have used more complicated analysis to find out whether capital tax systems in Member States have converged. In order to verify whether EU integration in the last decade has induced convergence, they represented systems of capital taxation by points in the three dimensional space spanned by the tax rates on dividend, retained profits, and interest. The set of EU systems is then a scatter of fifteen points. The mean distance from the centre of gravity measures the degree to which capital tax systems are similar in their mix of taxation of interest, dividend, and retained profit. If it decreases, capital tax systems converge; if it increases, capital tax systems diverge. The value of mean distance from the centre of gravity is 18.9 in 1990 and 20.8 in 2000. Thus, capital income tax systems have become more dissimilar in their mix of taxation of interest, dividend, and retained profit.

6.4.3.2 *Effective tax rates*

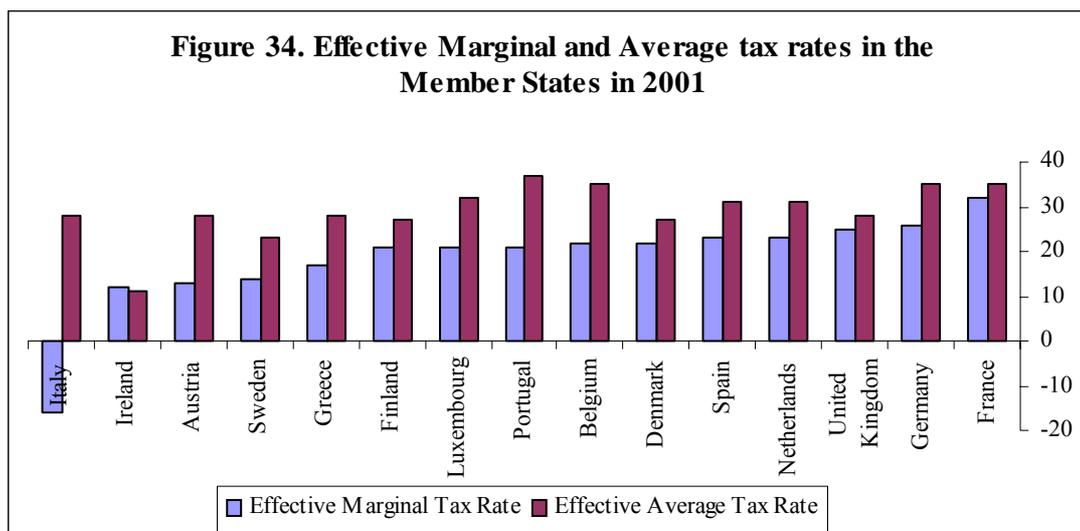
The Commission's latest study about effective tax rates

The Commission services study on company taxation¹²⁷⁵ presents estimates of effective corporate tax rates (marginal and average) on domestic and transnational investments in Member States taking into account different forms of investments in the manufacturing sector as well as different sources of finance. The computation of effective tax rates relies on a revised and extended methodology of the so-called King & Fullerton approach, set out by Devereux and Griffith. This computation is supplemented by data arising from the computation of the 'European Tax Analyser' model which utilises the model-firm approach set out by the University of Mannheim. Effective tax rates have been calculated for a so-called 'marginal' investment (where the post-tax return just equals the alternative market interest rate) or for an 'inframarginal' or 'average' investment project (i.e. one that earns extra-profits). The calculations consider primarily corporation taxes in each country, but also include the effect of personal income taxation of dividends, interest and capital gains.

According to the Commission's study, there is large variation in the effective tax burden faced by investors resident in the different EU Member Countries, as well as in the way each country treats investments in or from other countries. The range of differences in domestic effective corporate taxation rates is around 37 percentage points in the case of a marginal investment (between -4.1% and 33.2%) and around 30 percentage points in the case of a

¹²⁷⁵ Commission (2001b).

more profitable investment (between 10.5% and 37%)¹²⁷⁶ (see figure 34). The Commission notes that across the range of domestic and cross-border indicators presenting the effective tax burden at the corporate level, there is a remarkable consistency as far as the relative position of the Member States, notably at the upper and the lower ranges of the ranking, is concerned (see figure 34). In general, Germany, and France tend to show the highest tax burdens while Ireland, Sweden and Finland tend to be at the lower range of the ranking. Only Italy's ranking changes materially when the profitability of the investment changes. Due to the working of the dual income system, marginal investments are, in fact, subsidised, whereas more profitable investments suffer an effective tax burden which is in the middle range of the ranking.



Source: Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee 'Towards an Internal Market without tax obstacles. A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities', COM (2001) 582 final, Brussels, 23.10.2001

A study by Baker and McKenzie (2001) conducted under different hypotheses concerning the economic context and the applied tax codes, shows that in the most similar economic situation to that considered in this study (pre-tax rate of return of 6% as against a post-tax rate of return of 5% considered in the Commission study), the range of variation is 32 points in the case of a marginal investment (from 4.9% to 36.8%). When the pre-tax rate of return is fixed at 10% (base case in the Baker and McKenzie computation), the range of variation is 23 points (from 6.8 to 30.1).

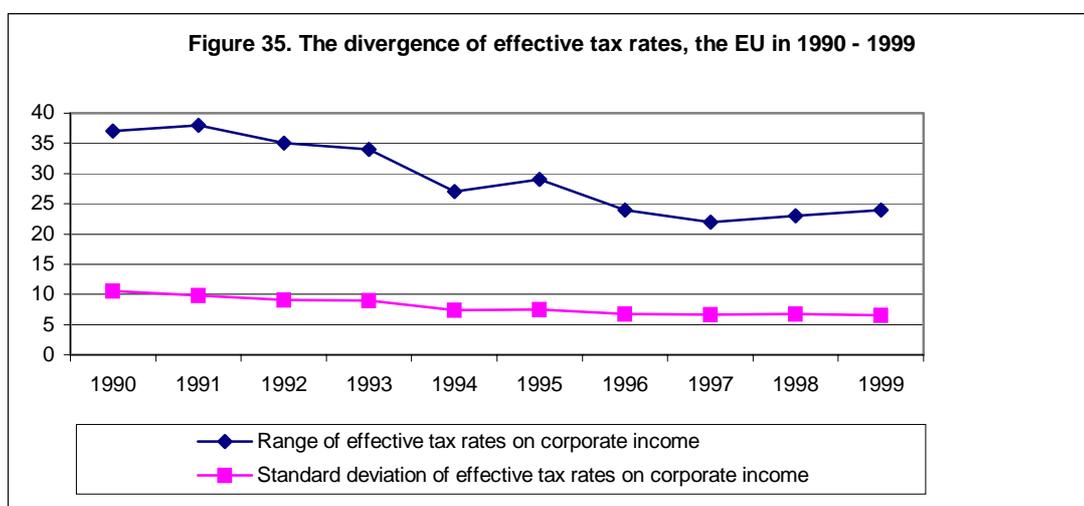
The Commission concludes that the EU wide spread observed between the effective rates of taxation in the international analysis are the results of complex interactions between different tax regimes and cannot be explained by just one feature of taxation. However, the analysis of general regimes tends to show that - leaving aside preferential tax regimes - the different national nominal tax rates on profits (statutory tax rates, surcharges and local taxes) can explain many of the differences in effective corporate tax rates between countries. Although tax regimes are designed as more or less integrated systems (in general high tax rates on profits seem to correlate with a narrower taxable base and vice versa), tax rate differentials tend to outweigh the differences in the tax bases. The quantitative analysis also shows that the relative weight of rates in determining the effective tax burden of companies rises when the profitability of the investment rises and that, consequently, any compensatory effects of a lower tax base on effective tax rates tend to disappear when the profitability rises. The study con-

¹²⁷⁶ The introduction of personal taxation substantially increases the effective tax burdens and the observed differences.

ducted by Baker and McKenzie concluded that, in general, the composition of the tax base does not have a great impact on the effective tax burden and that the level of the tax rate is the truly important factor for the difference in the tax burden.

Effective tax rates based on micro approach

Comparison of EU effective tax rates, which are calculated on the basis of micro data from the financial accounts of individual firms reveals that the effective tax rates have converged across countries over the past decade.¹²⁷⁷ From figure 35 is apparent that the range and variation of effective tax rates have decreased: the range of tax rates has decreased from 37 in 1990 to 25 in 1999 and standard deviation from 10.6 in 1990 to 6.5 in 1999. Thus, effective tax rates have converged in contrast with statutory tax rates which have diverged. This can be explained by the fact that the effective tax rates take account of differences in the tax base.¹²⁷⁸



Source: IBFD (2000) and Gorter and de Mooij (2001).

Comparison of convergence of statutory and effective tax rates

From table 6 is apparent that divergence is smaller in the case of marginal tax rates: both the range and the standard deviation are smaller. This again, is explained by the fact that the effective tax rates take into account the differences in tax base.

Country	Aggregate statutory tax rate	Effective marginal tax rate
Ireland	12.5	9.43
Sweden	28	15.73
Finland	29	18.09
Denmark	30	18.81
United Kingdom	30	20.83
Austria	34	18.25
Netherlands	35	20.67
Spain	35	18.3

¹²⁷⁷ Data about effective tax rates is based on calculations of Gorter and de Mooij (2001) on the basis of the Worldscope database.

¹²⁷⁸ Another reason is that the effective tax rates based on micro data refer to *corporate* taxes not to *capital* income taxes like the statutory tax rates.

Portugal	35.2	18.15
France	36.43	30.11
Luxembourg	37.45	18.98
Greece	37.5	6.76
Germany	39.35	25.2
Belgium	40.17	18.89
Italy	41.25	13.74
Mean	33.39	18.13
Range	28.75	23.35
Standard Deviation	7.08	5.41

Source: Baker & McKenzie (2001).

Conclusions about convergence of corporate tax rates

The divergence in the tax rates is very big: for example, the difference between the highest and the lowest corporation tax rates amounts to 27.67 percentage points. Furthermore, there are considerable differences between the national corporation tax bases. However, some convergence of effective corporate tax rates has taken place during last decade. Divergence of statutory as well as effective tax rates has decreased. The study by Baker & McKenzie (2001) finds that the developments over the past four years show that the effective marginal tax rates within the EU converge on a lower average, which seems to settle at a level just below 20%, between 18% and 19%.

7 Comparison of tax policy of Estonia with that of the EU

The first section of this chapter compares the tax level and tax structure of Estonia with those of the EU. The Estonian tax burdens, tax rates and tax mix are compared with those of the current EU Member States (EU-15). In 2004, the ten new Member States (NMS-10) will join the EU, therefore, the most important indicators are analysed in the context of the enlarged Union (EU-25).

The second section of this chapter compares the Estonian tax legislation with the *acquis communautaire* in the fields of VAT and income tax.

7.1 Comparison of tax level and tax structure (tax burdens, tax rates, tax mix)

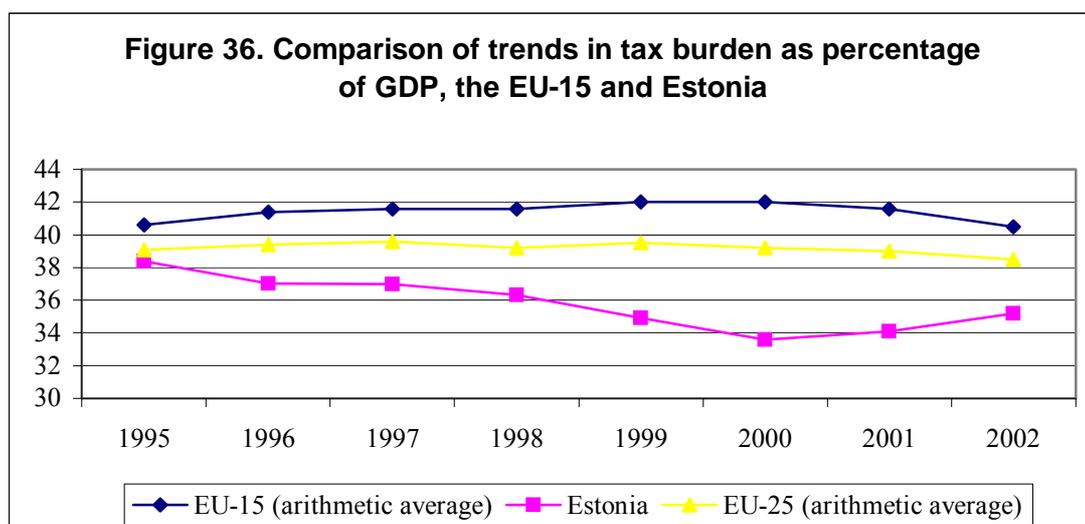
7.1.1 Total tax level

This section compares the overall tax burden (measured as the total amount of taxes and compulsory actual social contributions as a percentage of GDP) in Estonia and in the EU.

7.1.1.1 Trends in tax level

Comparing the trends in tax level reveals that the total tax burden has increased in the EU-15 between 1995 and 1999 while the trend has been decreasing in Estonia (see Figure 36). The Estonian tax-to-GDP ratio has been rising during recent years (2000-2002). However, the majority of EU Member States have substantially reduced their tax levels as a percentage of GDP between 2000 and 2002. These reductions in the majority of Member States have been partly due to reforms in tax systems, particularly through cuts in personal income tax rates and in social contributions.

In 2002, the overall tax burden (arithmetic average of the total amount of taxes and social security contributions) in the EU-25 stood at 38.5% of GDP. The tax-to-GDP ratio increased from 39.1% in 1995 to 39.5% in 1999, then declined steadily from 1999 to 2002. In 2002, as compared with 1999, the EU-25 tax-to-GDP ratio decreased by 1 percentage point.



Source: Eurostat and Ministry of Finance of Estonia.

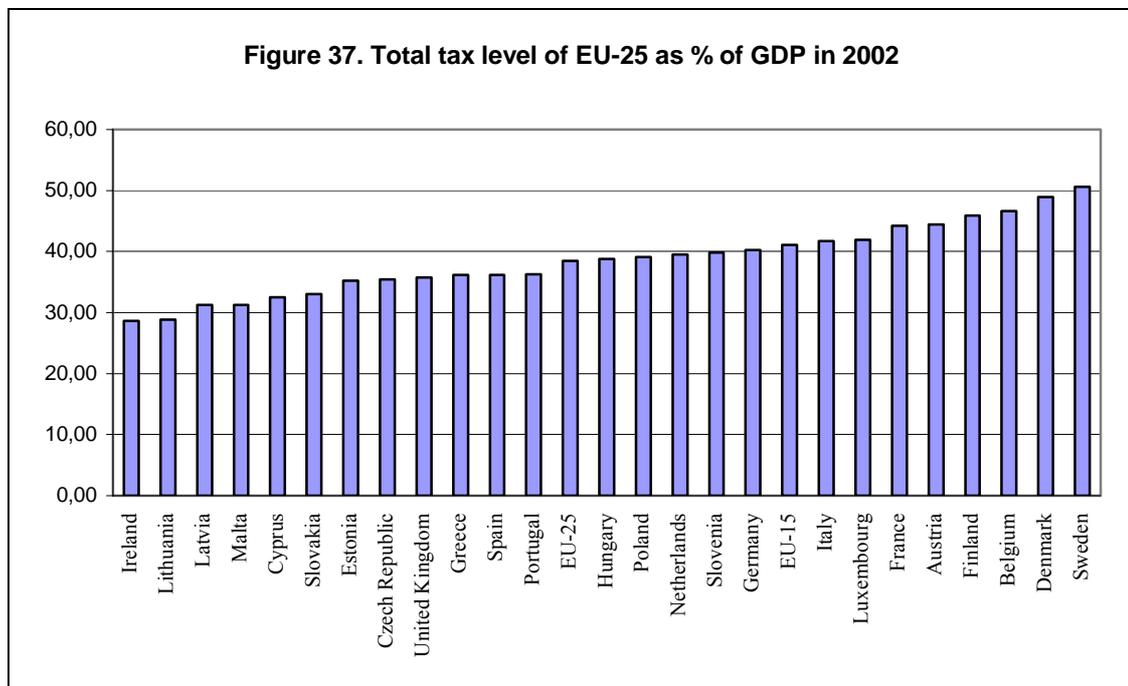
7.1.1.2 Tax levels in Estonia and in the EU

In 2004, ten new Member States will join the EU. Therefore, it is necessary to include the data about new Member States when comparing the tax levels in the EU. The new Member States have generally a lower tax-to-GDP ratio than the old Member States. In 2002, taking the arithmetic averages, the total tax burden in relation to GDP of new Member States is 6.6 percentage points lower than the average level of the EU-15 countries.¹²⁷⁹ However, by referring to the GDP-weighted averages the difference is much smaller. In 2002 the GDP-weighted EU-15 average was 40.5% and the new Member States average was 37.3 – the difference is only around three percentage points.¹²⁸⁰

In all ten new Member States (NMS), the tax-to-GDP ratio was lower in 2002 than the EU15 average (40.5%), ranging from 28.8% in Lithuania to 39.8% in Slovenia. The total tax burden in relation to GDP is close to EU-15 average ratio in three countries: Slovenia, Poland and Hungary (see Figure 37). The tax-to-GDP ratio is substantially lower in the remaining new Member States: Czech Republic, Estonia, Slovakia, Cyprus, Malta, Latvia, Lithuania. Among EU-15 only Ireland has a ratio lower than the ratios of those seven new Member States (see Figure 37).

Among the Member States there are substantial differences regarding the total tax burden. Sweden recorded the highest tax-to-GDP ratio (50.6% in 2002), followed by Denmark (48.9%), Belgium (46.6%) and Finland (45.9%). The lowest ratios are in Ireland (28.6%), Lithuania (28.8%), Latvia and Malta (31.3% each) and Cyprus (32.5%).

The total tax level in relation to GDP is lower in Estonia (35,2%) than the arithmetic average of the EU-15 countries (41,1%) or the arithmetic average of the EU-25 countries (38,5%). However, tax-to-GDP ratio is higher in Estonia than the arithmetic average of new Member States (35.2 percent in Estonia as compared to 34.5 percent in new Member States).



Source: Eurostat

¹²⁷⁹ Tax-to-GDP ratio (arithmetic average) is 34.5 per cent in new Member States and 41.1 per cent in EU-15

¹²⁸⁰ Eurostat (2004).

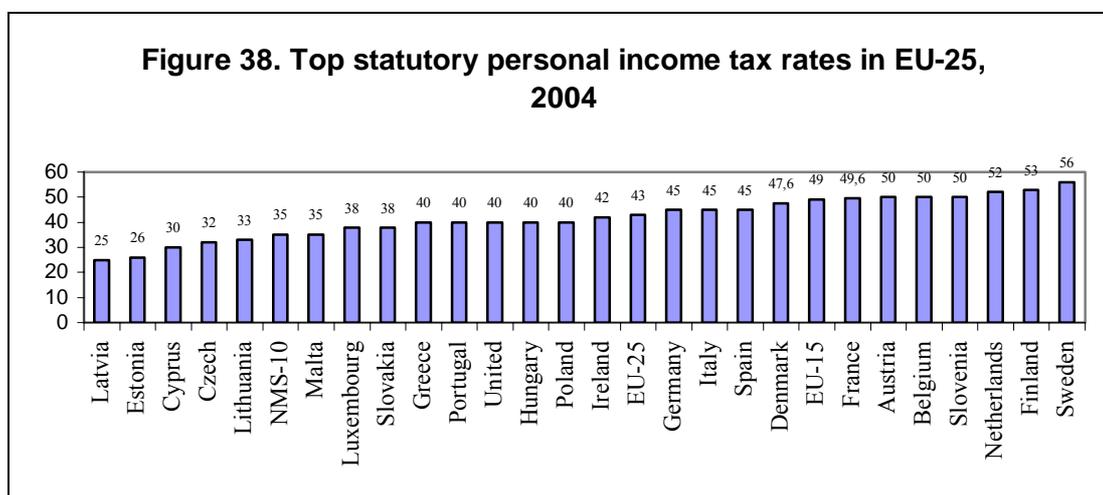
7.1.2 Tax rates

This section compares the tax rates (corporate and personal income tax rates as well as VAT rates) of Estonia with those of the EU-25 countries.

7.1.2.1 Personal income tax rates

The biggest difference between Estonia and the EU is in the area of personal income tax. In contrast to the flat rate of personal income tax (26%) used by Estonia, all EU-15 Member States apply progressive tax rate. However, several new Member States also apply the flat rate of personal income tax. The flat rate of personal income tax is applied in Latvia, Lithuania and Slovak Republic.

Figure 38 presents the personal income tax rates of Estonia and those of the EU-25 Member States.¹²⁸¹ The Estonian tax rates are below the unweighted average rate of the EU-15 as well as of the EU-25. The top statutory rate of personal income tax applied in Estonia (26%) is much lower than unweighted average of EU-15 (49%) or of the EU-25 (43%). In fact, among EU-25 only Latvia has a top statutory personal income tax rate lower than Estonia.



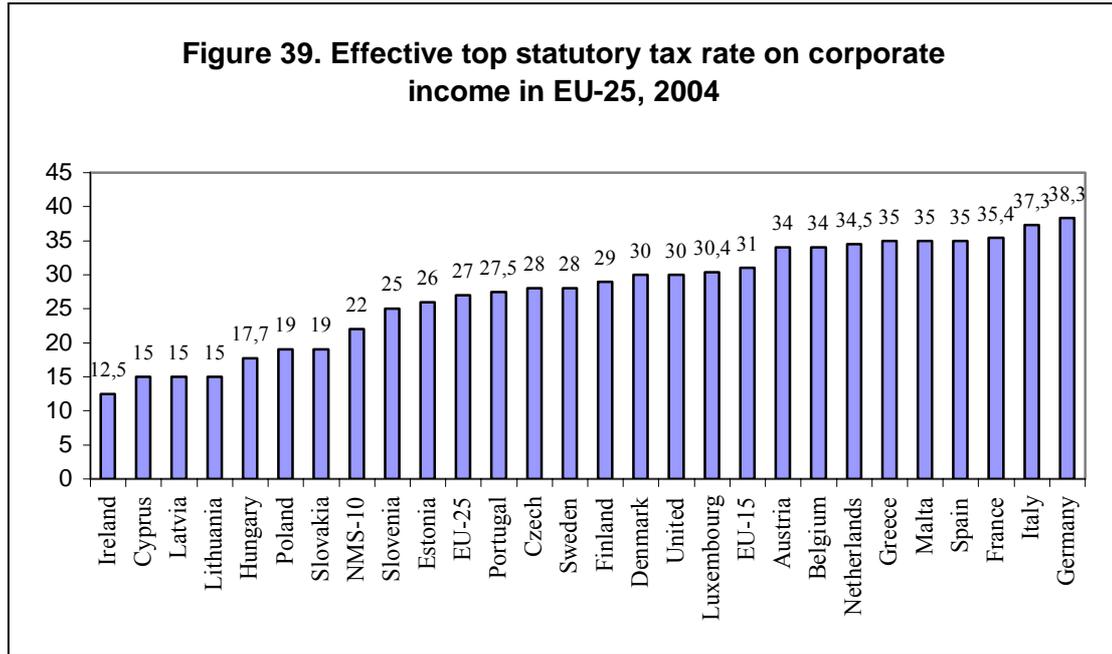
Source: Eurostat

7.1.2.2 Corporate income tax rates

Figure 38 presents the corporate income tax rates of Estonia and those of the EU-25 Member States.¹²⁸² The statutory rate of Estonian corporate income tax (26%) is by 5 percentage points lower than (unweighted) EU-15 average and by one percentage point lower than (unweighted) EU-25 average. Furthermore, the statutory rate of Estonian corporate income tax is by 4 percentage points lower than (unweighted) average in new Member States (22%). However, the Estonian corporate income tax rate is not directly comparable because the rate for Estonia refers only to distributed profits; as from 2000 the tax rate on retained earnings is zero. It means that a rate of 26% only applies in case of distributed profits and the overall corporate tax rate of Estonia is much lower than 26%.

¹²⁸¹ Individual income tax rate for EU-25 countries is top statutory rate on residents without surcharges.

¹²⁸² EU-25 corporate income tax rates include the corporation tax plus local profit taxes and surcharges. The rate for Italy includes 'IRAP' (rate 4.25%) a local tax levied on a tax base broader than corporate income.

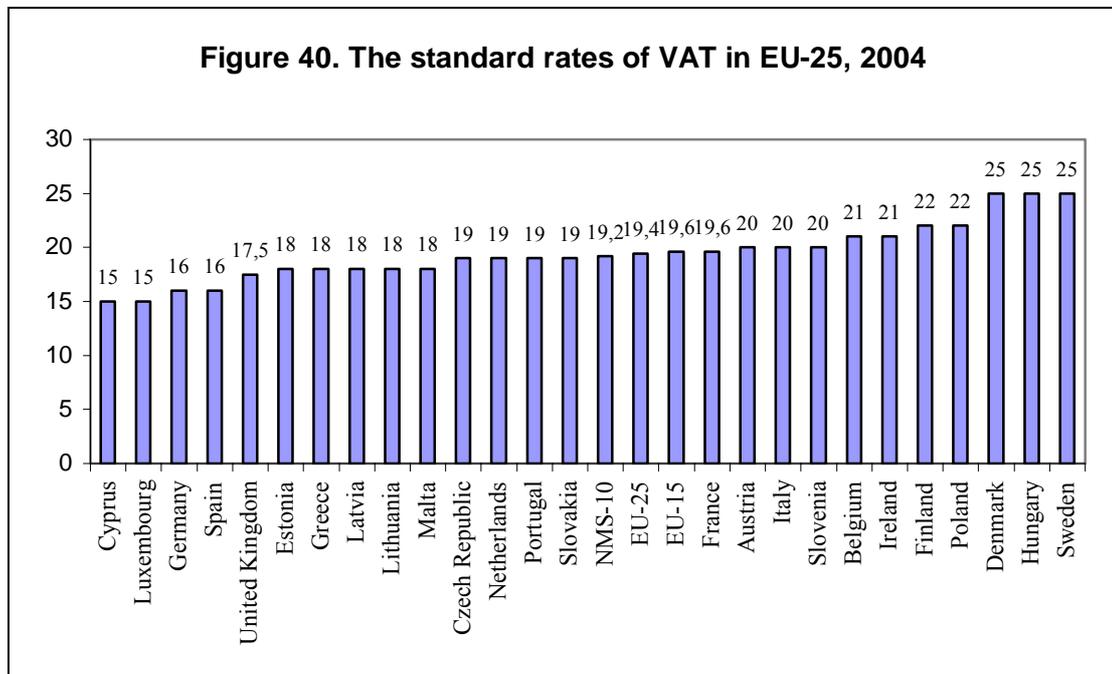


Source: Eurostat

7.1.2.3 VAT rates

The standard rate of VAT in Estonia is very close to EU average. The Estonian VAT rate is 1.6 percentage points below the EU-15 average level and 1.4 percentage points below the EU-25 average level (see figure 40).

The standard VAT rates are very close in the EU-15 and in the new Member States, which is mostly caused by the fact that the VAT rates and structures are by a large extent harmonized in the EU-25.



Source: IBFD

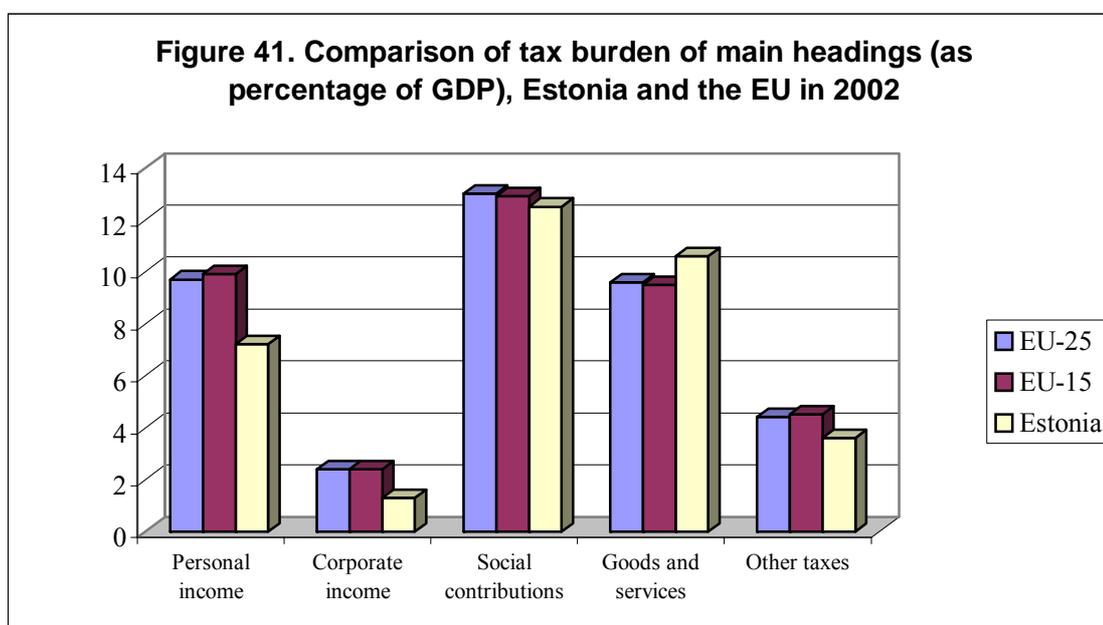
Conclusions

The tax rates of Estonia are reasonably close to those in the EU. However, in some key aspects there are wide differences. The most significant differences are in the field of income taxation. The EU-25 (arithmetic) average top statutory personal income tax rate in 2004 is 43%, while the personal income tax rate of Estonia is 26%, which is 17 percentage points lower. The difference compared to the EU-15 average is even larger - 23 percentage points (26 percent in Estonia as compared to 49 percent in the EU-15). The top statutory corporate tax rate is very close to the EU average: the statutory corporate tax rate of Estonia (26%) is only one percentage point lower than the EU-25 (arithmetic) average of corporate tax rate in 2004. The EU-15 (arithmetic) average of corporate tax rate in 2004 is five percentage point higher than in Estonia (31 percent in EU-15 as compared to 26 percent in Estonia). However, the tax rates in the field of corporate taxation are not directly comparable because Estonia does not apply the corporate tax on reinvested income. It means that a rate of 26% only applies in case of distributed profits, the tax rate on retained earnings is zero. It can be concluded that the smallest difference is in the VAT rate, which is slightly below the EU average level in Estonia (1.6 percentage points below the EU-15 average level and 1.4 percentage points below the EU-25 average level).

7.1.3 Tax revenue ratios

Main revenue items

Figure 41 compares tax ratios (as a percentage of GDP) of main revenue items. We can see that tax burdens are very similar in Estonia and in the EU. Major difference is in tax burdens on corporate and personal income. Personal income tax revenue as percentage of GDP is 2.5 percentage points higher in the EU-25 than in Estonia. Corporate income tax revenue as percentage of GDP is 1.1 percentage points higher in the EU-25 than in Estonia. Tax revenue of taxes on goods and services as percentage of GDP is 1 percentage point higher in Estonia than in the EU-25 in 2002.

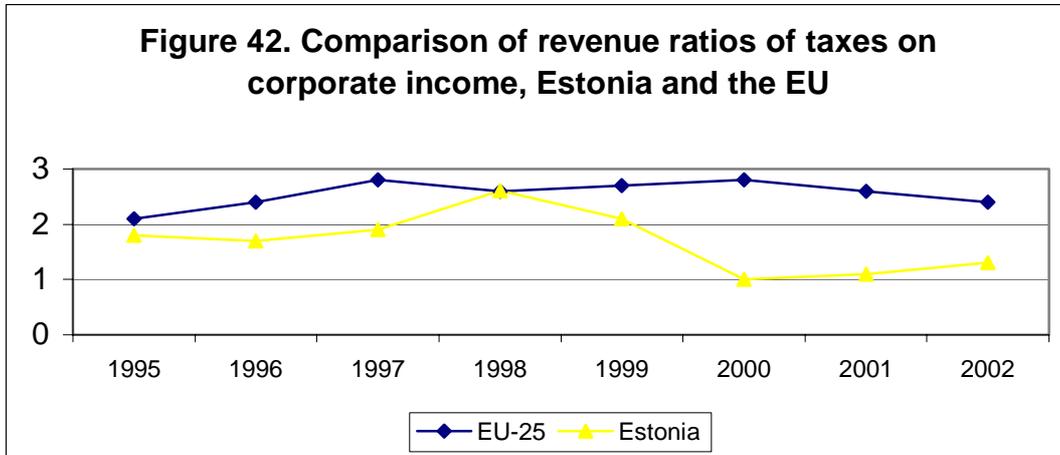


Source: Eurostat and Ministry of Finance of Estonia.

Taxes on corporate income

Figure 42 compares the revenue ratios of corporate taxes in Estonia and the EU (the revenue ratios are practically identical in the EU-25 and EU-15, therefore, only data of EU-25 is in-

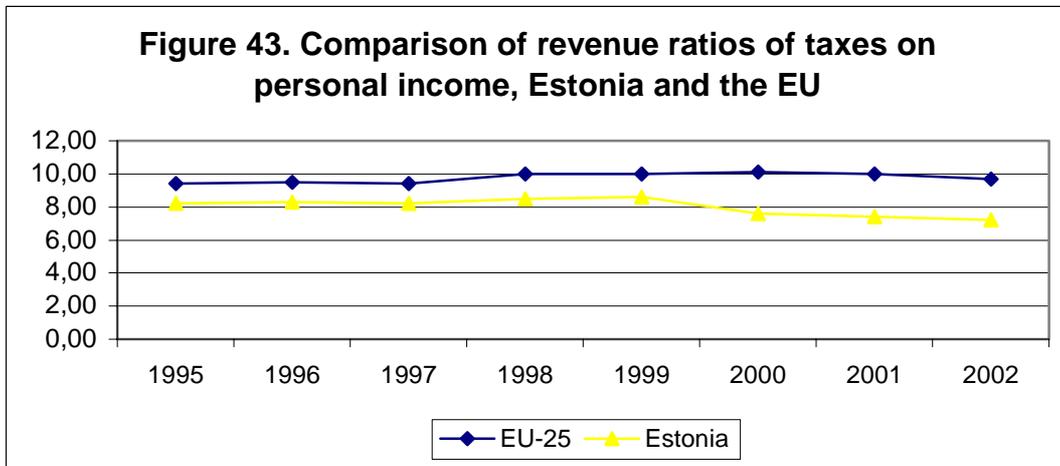
cluded). Tax revenue as percentage of GDP is 0.3 percentage points higher in the EU-25 in 1995 and 1.1 percentage points higher in the EU-25 in 2002. It can be concluded that tax burden on corporate income is considerably lower in Estonia than in the EU.



Source: Eurostat and Ministry of Finance of Estonia.

Taxes on personal income

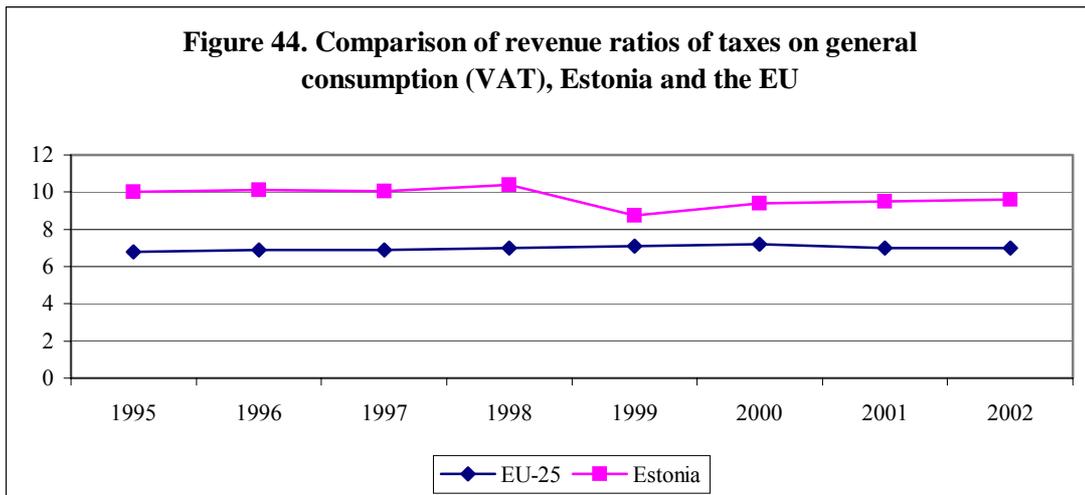
From figure 43 it is apparent that tax revenue as percentage of GDP is also higher in the EU in the case of personal taxes (the revenue ratios are practically identical in the EU-25 and EU-15, therefore, only data of EU-25 is included). Difference is 1.2 percentage points in 1995 and 2.5 percentage points in 2002.



Source: Eurostat and Ministry of Finance of Estonia.

Taxes on general consumption (VAT)

Figure 44 compares VAT ratios in Estonia and in the EU (the revenue ratios are practically identical in the EU-25 and EU-15, therefore, only data of EU-25 is included). Revenue ratio of VAT as percentage of GDP is higher in Estonia, although the difference is decreasing: VAT ratio is 3.2 percentage points higher in 1995 (10 percent in Estonia as compared to 6.8 percent in the EU-25), however, in 2002 the difference is 2,6 percentage points (9.6 percent in Estonia as compared to 7 percent in the EU-25).

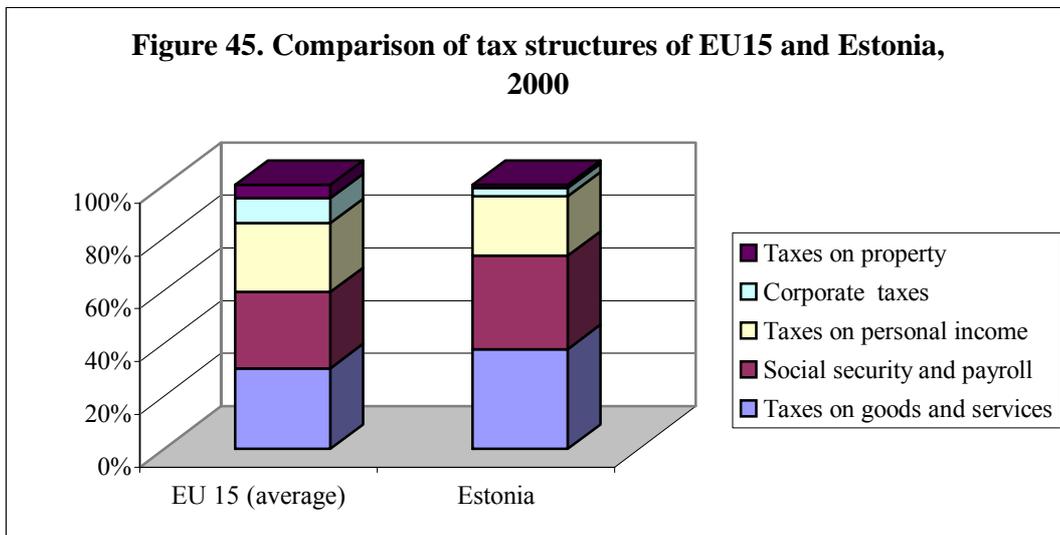


Source: Eurostat and Ministry of Finance of Estonia.

7.1.4 Tax structure

Overall tax mix

Regarding the tax structure of the tax revenues by major types of taxes, it can be concluded that the structure of tax revenues in Estonia is similar to that in EU countries. We can see from Figure 45 that revenue structure (as percentage of total tax revenue) of Estonia in 2002 is similar to the EU unweighted average of the same year.

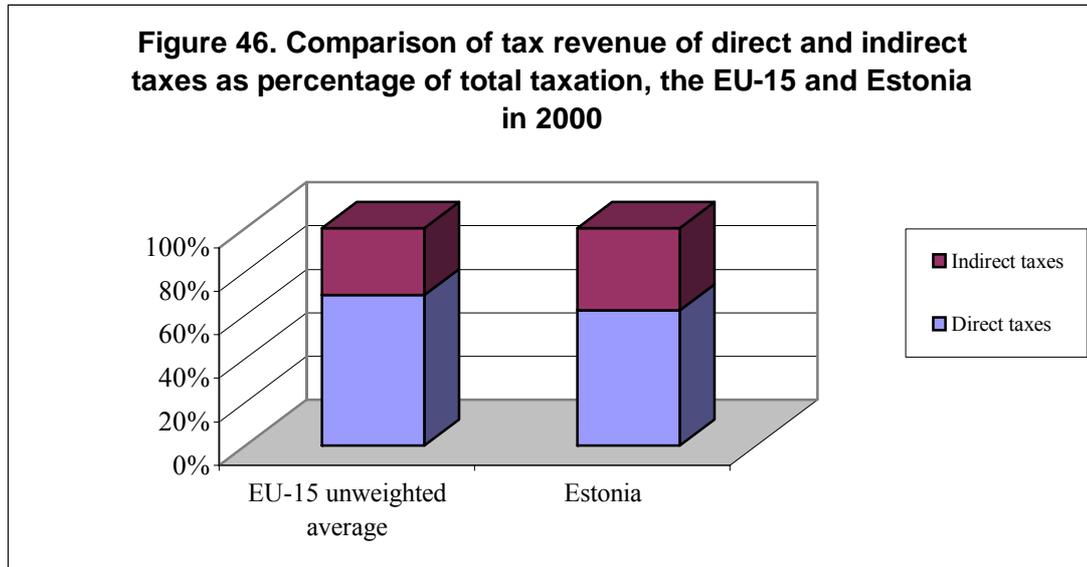


Source: OECD (2002) and Ministry of Finance of Estonia.

The combined level of social security, payroll and personal income taxes is relatively high in Estonia (57.9 percent of total tax burden as compared to 54.0 percent in the EU). The share of taxes on goods and services is also relatively higher (37.7 percent of total tax burden compared to EU average of 30.0 percent). The corporate income tax is the only tax the share of which is considerably at variance with the one in the EU15. After abolition of tax on reinvested profits in the beginning of 2000, the share of corporate taxes has fallen to 3 percent of total tax burden (EU average was 9.2 percent in 2000).

Mix of direct and indirect taxes

Regarding the tax structure of the tax revenues by major types of taxes, it can be concluded that Estonia has a lower share of direct taxes in relation to total tax revenues than the EU-15 (see figure 46). In 2000 the difference between the EU-15 and Estonia was about six percentage points. One of the reasons of this difference can be found in the generally lower tax rates applied in Estonia regarding corporate tax and personal income tax (see section 7.1.2). The share of indirect taxes is higher in Estonia than in the EU.



Source: OECD (2002) and Ministry of Finance of Estonia.

Conclusions

Comparison of tax levels and tax structures in Estonia and the EU demonstrates that the tax structures as well as tax levels are very similar. Statutory tax rates on income and profits are lower in Estonia, however, the effective tax rate is very much the same as an EU average. Revenue ratio of VAT as percentage of GDP is higher in Estonia. The biggest difference lies in the effective tax rate on profits (measured as a revenue ratio of taxes on corporate income) which is considerably lower in Estonia. However, the share of this tax in total tax burden is very small (3 per cent in Estonia and 9 per cent in the EU in 2002).

7.2 Comparison of Estonian tax legislation with the *acquis communautaire*

7.2.1 VAT

7.2.1.1 The main features of the VAT system

The main principles of the Estonian VAT system¹²⁸³ are in line with the system used in the EU. Special schemes are applied for small undertakings, for second-hand goods, works of art, collectors' items and antiques, for travel agents and for investment gold. Title XIV of the Sixth Directive provides for five special schemes: for small undertakings (Article 24), for

¹²⁸³ See section 1.3.1.

farmers (Article 25), for second-hand goods, works of art, collectors' items and antiques (Article 26a), for travel agents (Article 26), and for investment gold (Article (26b)). In Estonia the special scheme for farmers is not applied because it was considered too complicated to apply such a scheme for farmers. However, it is not in breach of the EU law as Article 25 of the Sixth Directive provides only for the possibility for Member States to apply such a scheme for farmers.¹²⁸⁴

7.2.1.2 *Definition of the tax base*

7.2.1.2.1 *Scope and territorial application*

Definition and scope of VAT

§ 1 of the Estonian VAT act provides that VAT is applied as tax on added value.¹²⁸⁵ The definition provided in the Estonian VAT act is not in breach of the EU law. However, in interpretation of the scope of VAT the Estonian tax authorities have to take into consideration the provisions of the Sixth Directive and the rulings of the ECJ.¹²⁸⁶ The ECJ has specified the definition and scope of the VAT in its case law. The Court has stressed that in order to determine whether a transaction is caught by the Sixth Directive, it is necessary to examine the transaction in the light of the objectives and nature of the common system of VAT. According to Article 2 of the First Council Directive, VAT is a general tax on the consumption of goods and services and the ECJ has held that a transaction falls within the scope of VAT if it gives rise to any consumption.¹²⁸⁷ In addition, the ECJ has held that the concept of 'the supply of ... services effected for consideration' presupposes the existence of a direct link between the service provided and the consideration received.¹²⁸⁸

The scope of the Estonian VAT is stipulated in Article 4 of the VAT act, which provides that the VAT is applied to the taxable supply, which includes:

- the supply of goods and services effected in Estonia;
- the importation of goods and services into Estonia; and
- the provision of services the place of supply of which is not Estonia and which are considered an export of services¹²⁸⁹.

The scope of European VAT is stipulated in Article 2 of the Sixth Directive which states that the supply of goods or services effected for consideration within the territory of the country is subject to VAT. However, in the Estonian VAT act it is not mentioned that the supply should be effected for consideration. It follows that the Estonian VAT act should be changed accordingly.

Territorial application of VAT

VAT is applied within the Republic of Estonia. It can be concluded that the Estonian VAT system is based on the territoriality principle, as also is EC common VAT system¹²⁹⁰.

¹²⁸⁴ Article 25 of the Sixth Directive provides: '... Member States may apply to farmers a flat-rate scheme tending to offset the value added tax charged on purchases of goods and services made by the flat-rate farmers'.

¹²⁸⁵ § 1 of the Estonian VAT act stipulates: 'Value added tax is applied as tax on added value, with the exception of special cases arising from this Act.'

¹²⁸⁶ The ECJ has held that the interpretation of the scope of the VAT may not be left to the discretion of each Member State. See Case C-154/80 (*Coöperatieve Aardappelenbewaarplaats*), paragraph 9.

¹²⁸⁷ See, for example, Case C-384/95 (*Landboden-Agrardienste*), paragraph 22, Case C-215/94 (*Mohr*), paragraph 19, and section 3.2.1 where these cases are discussed in greater detail.

¹²⁸⁸ See Case C-154/80 (*Coöperatieve Aardappelenbewaarplaats*), Case C-102/86 (*Apple and Pear Development Council*), and section 3.2.1 where these cases are discussed in greater detail.

¹²⁸⁹ See section 1.3.2.3 for the definition of export of services.

7.2.1.2.2 Taxable persons

Taxable person is defined in §2(1) of the Estonian VAT Act as a person, including a legal person in public law and a state, rural municipality and city agency (hereinafter: a person), who effects taxable supply as a result of the business thereof, including a non-resident within the meaning of the Income Tax Act engaged in business in Estonia and a person importing goods into Estonia. § 2 (4) of the Estonian VAT act stipulates that business is the independent economic activity of a person, as a result of which goods are transferred or services provided for a consideration or without a consideration.

Article 4 of the Sixth Directive defines Community concept of 'taxable person'. It states that 'taxable person' means any person who independently carries out in any place any economic activity (specified in paragraph 2 of the same Article), whatever the purpose or results of that activity. Article 28a extends the concept of a taxable person to cover persons performing an intra-Community supply of new means of transport. Estonia has to extend the concept of a taxable person to cover persons performing an intra-Community supply of new means of transport upon accession.

Article 4(4) of the Sixth Directive specifies that the use of the word 'independently' in the definition of a taxable person intends to exclude employees from an obligation to charge VAT on services provided to their employers. In the Estonian VAT act it is also stated that in order to be considered a taxable person, he has to be involved in the independent economic activity.

Economic activity is not defined in the Estonian VAT Act. The Estonian VAT act has to be changed taking into account the definition provided by Article 4 of the Sixth Directive.¹²⁹¹

§ 2 of the Estonian VAT act¹²⁹² is in breach of the Sixth Directive. Firstly, according to the Estonian VAT act the taxable person is a person who effects taxable supply. The Sixth Directive, on the other hand, does not contain such a condition. The Sixth Directive includes everyone who performs economic activities in the definition of a taxable person. The Estonian provision does not correspond to the Sixth Directive because not only persons who effect taxable supply can be taxable persons but also persons who do not effect taxable supply (for example if they do not effect taxable supplies themselves but they acquire the intra-Community goods or intra-Community new means of transport). Secondly, it follows from the wording of the Estonian VAT act that a taxable person is also a person who performs economic activities free of charge. However, according to the case law of the ECJ activities which are in all cases free of charge fall outside the scope of the VAT. The ECJ has held that a person who makes supplies, which are in all cases free of charge, cannot be regarded as a taxable person.¹²⁹³ The ECJ, furthermore, stated that services provided free of charge are different in character from the taxable transactions which presuppose the stipulation of a price or consideration.¹²⁹⁴ The ECJ referred to Article 2 of the Sixth Directive¹²⁹⁵ which pro-

¹²⁹⁰ Article 2 of the Sixth Directive stipulates that the value added tax is applied to the supply of goods or services effected *within the territory of the country* by a taxable person acting as such and to the importation of goods. Emphasis added by the author.

¹²⁹¹ Article 4(2) of the Sixth Directive stipulates that the economic activities shall comprise all activities of producers, traders and persons supplying services including mining and agricultural activities and activities of the professions. The exploitation of tangible or intangible property for the purpose of obtaining income therefrom on a continuing basis is also considered an economic activity.

¹²⁹² § 2 of the Estonian VAT act stipulates that a taxable person is a person who effects taxable supply as a result of the business thereof (§ 2(1) of the Estonian VAT act) and that business is the independent economic activity of a person, as a result of which goods are transferred or services provided for consideration or without consideration (§ 2(4) of the Estonian VAT act).

¹²⁹³ Case 89/81 (*Hong-Kong*).

¹²⁹⁴ See Case 89/81 (*Hong-Kong*), paragraph 10.

vides that only services provided by a taxable person against payment are to be subject to VAT.¹²⁹⁶ The ECJ, furthermore, stated that where a person's activity consists exclusively in providing services for no direct consideration, there is no basis of assessment and the free services in question are therefore not subject to VAT.¹²⁹⁷ Moreover, in cases *Coöperatieve Aardappelenbewaarplaats*¹²⁹⁸ and *Apple and Pear Development Council*¹²⁹⁹ the ECJ stated, referring to the earlier *Tolsma* case¹³⁰⁰, that for the provision of services to be taxable there must be a direct link between the service provided and the consideration received.

Some other judgments by the ECJ have reduced the scope of the concept of economic activity and consequently the scope of VAT.¹³⁰¹ For example, illegal transaction, such as the importation and supply of drugs¹³⁰², and the importation of counterfeit currency notes¹³⁰³, fall outside the scope of the VAT. The ECJ has held that activities, which consist in the simple sale of shares and other securities, such as holdings in investment funds, do not constitute economic activities within the meaning of the Sixth Directive.¹³⁰⁴ Moreover, the ECJ has held that a holding company, whose sole purpose is to acquire holdings in other undertakings, without involving itself directly or indirectly in the management of those undertakings, cannot be regarded as a taxable person.¹³⁰⁵ However, the Court has held that it is otherwise where the holding is accompanied by direct or indirect involvement in the management of the companies in which the holding has been acquired.¹³⁰⁶

Public bodies

§ 2(2) of the Estonian VAT act stipulates that public bodies are considered taxable persons in respect of their taxable supplies, which can also be effected by non-public taxable persons. Article 4(5) of the Sixth Directive provides that public bodies are considered taxable persons if they engage in activities or transactions, where treatment of them as non-taxable persons would lead to 'significant distortions of competition'¹³⁰⁷ *vis-à-vis* the private sector.¹³⁰⁸ The

¹²⁹⁵ Article 2 of the Sixth Directive provides as follows: 'The following shall be subject to value added tax: the supply of goods or services *effected for consideration* within the territory of the country by a taxable person acting as such; ...' (Emphasis added.)

¹²⁹⁶ See Case 89/81 (*Hong-Kong*), paragraphs 5 and 11.

¹²⁹⁷ See paragraph 10. The ECJ stated in paragraph 11 that economic activities which are carried out free of charge do not fall within the system of VAT, since they cannot constitute a basis of assessment.

¹²⁹⁸ Case C-154/80.

¹²⁹⁹ Case C-102/86.

¹³⁰⁰ In *Tolsma* (Case C-16/93) the voluntary payments of by-passers to an organ-grinder were not treated as consideration for a (contractually) rendered service because of direct link between supply and expenditure (consideration for supply of services) was deemed to be lacking.

¹³⁰¹ See section 3.2.2 for more elaborate discussion of the ECJ's rulings on the scope of the VAT.

¹³⁰² See Case C-289/86 (*Happy Family*).

¹³⁰³ See Case C-343/89 (*Witzemann*).

¹³⁰⁴ See Case C-77/01 (*EDM*).

¹³⁰⁵ See Case C-60/90 (*Polysar*), paragraph 17 and Case C-142/99 (*Floridienne*), paragraph 17.

¹³⁰⁶ Case C-60/90 (*Polysar*), paragraph 14 and Case C-142/99 (*Floridienne*), paragraph 18.

¹³⁰⁷ The ECJ stated in its judgment in Case 231/87 (*Carpaneto Piacentino*) that the second subparagraph of Article 4(5) of the Sixth Directive must be interpreted as meaning that Member States are required to ensure that bodies subject to public law are treated as taxable persons in respect of activities in which they engage as public authorities where those activities may also be engaged in, in competition with them, by private individuals, in cases in which the treatment of those bodies as non-taxable persons could lead to significant distortions of competition.

¹³⁰⁸ Article 4(5) of the Sixth Directive considers public bodies non-taxable persons in respect of the activities or transactions if the following conditions are met: (1) these bodies are governed by public law, and (2) such activities are carried out under public authority. In the Estonian VAT act it is not

ECJ has interpreted the ‘distortion-of-competition’ criterion widely. If a public body has a monopoly on the supply of certain services, it does not compete with private sector in a formal sense. However, it can compete with the other types of businesses providing the competing goods or services. Thus, in the light of the case law by the ECJ and the Sixth Directive, the public bodies should be considered taxable persons in respect of their services if they compete with the private sector providing competing goods or services where treatment of them as non-taxable persons would lead to significant distortions of competition.

The Sixth Directive contains the list of activities in relation to which the public bodies are ‘in any case’¹³⁰⁹ considered taxable persons. The list of these activities (in relation to which undertakings are considered taxable persons) is included in Annex D¹³¹⁰. As a minimum, Estonia should tax all the activities listed in Annex D of the Sixth Directive.

Intra-group supplies

The Sixth Directive leaves to Member States discretion not to tax intra-group supplies within the associated company.¹³¹¹ According to the Estonian VAT act intra-group supplies within the associated company are not taxed provided that the person who acquired goods or services as a result of the transaction uses the goods or services entirely for the purposes of the person’s taxable supply.¹³¹² The Estonian VAT act requires separate registration of the single taxable person.¹³¹³ The Estonian definition of the VAT Group differs from Article 4(4) of the Sixth Directive.¹³¹⁴ However, since Article 4(4) of the Sixth Directive is a “may” provision, it is questionable whether the wording of the Estonian Act contradicts EU law and should be changed.

7.2.1.2.3 Taxable transactions

The Estonian VAT act distinguishes between supplies (§3(1) of the VAT act), non-supplies (§3(2) of the VAT act) and taxable supplies (§4 of the VAT act).¹³¹⁵ In the Sixth Directive there is no such a distinction between supplies and taxable supplies. Title V of the Directive stipulates the common concept of the taxable transactions, which includes supply of goods (Article 5 of the Sixth Directive), supply of services (Article 6), imports (Article 7), intra-Community acquisition of goods, and means of transport (Article 28a).

The supply of goods and services effected in Estonia, importation of goods and services, and provision of services which are considered an export of services are included in the concept of ‘taxable transactions’ according to the Estonian VAT act.¹³¹⁶ It follows that the Estonian concept of ‘taxable supplies’ does not include intra-Community supplies and acquisitions of goods and intra-Community acquisitions of new means of transport, which have to be in-

stipulated in which conditions public bodies are considered non-taxable persons in respect of their activities or transactions.

¹³⁰⁹ Article 4(5) of the Sixth Directive.

¹³¹⁰ This list includes, for example, telecommunications; the transportation of goods and passengers; port and airport services; the running of trade fairs and exhibitions; warehousing; the activities of travel agencies; the supply of water, gas, electricity and steam; the running of staff shops, co-operatives, industrial canteens and similar institutions.

¹³¹¹ Article 4(4) of the Sixth Directive allows Member State to treat as single taxable person persons who are closely bound to one another by financial, economic and organisational links, although they are legally independent.

¹³¹² See section 1.3.2.2.

¹³¹³ See section 1.3.2.11.

¹³¹⁴ Article 4(4) allows Member State to treat as single taxable person persons who are closely bound to one another by financial, economic and organisational links, although they are legally independent.

¹³¹⁵ Such a distinction is probably necessary for the definition of taxable person as only a person who effects taxable supply is considered a taxable person.

¹³¹⁶ See § 4 of the VAT act.

cluded in the concept of taxable transactions upon accession. Moreover, the Estonian concept of taxable supply includes importation of services¹³¹⁷ and exportation of services¹³¹⁸. The latter transactions are not included in the Community concept of taxable transactions according to Title V of the Sixth Directive. The taxation of services is dealt in a separate provision (Article 9 of the Directive).

‘Export of services’ is exempt from Estonian VAT with a right to deduct input VAT. Those are services which are according to the Sixth Directive taxed in the country where the immovable property is situated, where those services are physically carried out, where the customer has established his business or where the effective use and enjoyment of the services takes place.¹³¹⁹

Supply

§3(1) of the Estonian VAT act defines supply as the transfer of goods and provision of services in the course of business activities. Provision of goods or services by an employer to an employee as well as non-business use of goods and services are considered supplies if the taxable person has deducted the VAT on such goods and services.¹³²⁰ This provision is in line with Article 5(6) of the Sixth Directive which provides that the private use of goods or their application for non-business purposes is also treated as supplies made for consideration, if the VAT on the goods in question or the component parts thereof was wholly or partly deductible.¹³²¹ The ECJ ruled in its judgment in *De Jong*¹³²² that Article 5(6) of the Sixth Directive must be interpreted as meaning that, when a taxable person (a building contractor) acquires land solely for his private use but erects on that land in the pursuit of his business a dwelling for his own use, only the house, and not the land, is to be regarded for the purposes of that provision as having been applied for his private use. The taxable amount will then be the value of the building alone and not that of the land.¹³²³

Supply of goods

According to §3(1) of the Estonian VAT act supplies include the transfer of goods in the course of business activities. Article 5(1) of the Sixth Directive defines ‘supply of goods’ as the transfer of the right to dispose of tangible property as an owner. The ECJ has held that ‘supply of goods’ in Article 5(1) of the Sixth Directive must be interpreted as meaning the transfer of the right to dispose of tangible property as an owner, even if there is no transfer of

¹³¹⁷ See section 1.3.2.3.3 for the definition of ‘import of services’.

¹³¹⁸ See section 1.3.2.3 for the list of services that are considered to be export of services.

¹³¹⁹ However, radio and television broadcasting services, and electronically supplied services are not included in the list of zero-rate supplies of the Estonian VAT act although they are included in the list of services of Article 9(2)(e) of the Sixth Directive. In addition, tourism services are not included in the list of exceptions in the Sixth Directive. See also sections 3.2.4. and 7.2.1.2.4. where the place of taxation in the case of services is discussed.

¹³²⁰ See §3(1) of the VAT act. This provision also applies for provision of goods or services by an employer to a servant or a member of the management or control body of the employer.

¹³²¹ However, applications for the giving of samples or the making of gifts of small value for the purposes of the taxable person’s business are not treated as taxable supplies (Article 5(6)). According to Article 3 (2) 8 of the Estonian VAT act handing over goods free of charge as product samples is not deemed to be supply. In addition, handing over goods free of charge in business interests for advertising purposes is not deemed to be supply, if the value of the object concerned does not exceed EEK 50. In contrast to the Estonian VAT act, the Sixth Directive does not provide the threshold value of gifts which are not treated as supplies made for consideration.

¹³²² Case C-20/91.

¹³²³ See section 3.2.3 for more elaborate discussion of this case.

legal ownership of the property.¹³²⁴ In other words, the mere transfer of economic ownership is enough to treat the transfer as supply of goods.¹³²⁵ In accordance with the ECJ's ruling in *SAFE*¹³²⁶, it is for the national court to determine in each individual case, on the basis of the facts of the case, whether there is a transfer of the right to dispose of the property as an owner within the meaning of Article 5(1) of the Sixth Directive.

§3(3) of the Estonian VAT act defines concept of 'goods' as tangible goods, livestock, electric power and heat. According to Article 5(2) of the Sixth Directive 'tangible property' used in the definition of supply of goods includes electric current, gas, heat, refrigeration and the like. An exhaustive list of the Estonian VAT act does not contain gas, refrigeration and the like, as does the list provided by the Sixth Directive. The Estonian definition is in breach of the Sixth Directive because it is questionable whether gas, refrigeration and the like can be included in the concept of 'tangible goods'. It is necessary to include those substances in the Estonian definition.

According to Article 5(3) of the Sixth Directive Member States may also consider certain rights *in rem* and interests in immovable property as well as shares or interests equivalent to shares to be tangible property. If a Member State (like Estonia) does not consider the transfer of certain rights *in rem* and interests in immovable property as well as shares or interests equivalent to shares as taxable supplies of goods, these transfers are supplies of services.

The Estonian VAT act stipulates that if a lease contract provides for the transfer of ownership to another person upon payment of the final instalment, the transaction is treated as transfer of goods.¹³²⁷ This provision is in line with Article 5(4)(b) of the Sixth Directive, which provides that the actual handing over of goods by way of conditional sale or hire purchase arrangements, if ownership shall pass at the latest upon payment of the final instalment is considered the supply of goods.

Compulsory transfer of the ownership of property for compensation, by order made by or in the name of a public authority or in pursuance of the law, is also considered supply of goods according to the Sixth Directive (Article 5(4)(a)). In addition, the transfer of goods pursuant to a contract under which commission is payable on purchase or sale, is considered to be supply of goods (Article 5(4)(c)). These provisions should be included in the Estonian VAT act upon accession.

Member States may also consider as supplies of goods the handing over of certain works of construction (Article 5(5)). Article 5(7) contains some more options for taxable supplies (e.g. the application of self-constructed goods for the purposes of business, the retention of goods by a taxable person or his successors when he ceases to carry out a taxable economic activity where the VAT on such goods became wholly or partly deductible upon their acquisition). Estonia may include these provisions into its VAT legislation.

¹³²⁴ Case C-320/88 (*SAFE*), paragraphs 7-9 of the judgment. See also section 3.2.3 where this case is discussed in greater detail.

¹³²⁵ The *SAFE* case concerned the Dutch tax authorities' VAT assessment on the supply by *SAFE* to another company of immovable property. 'Economic ownership' is a concept which has been developed by the Netherlands courts. The transfer of 'economic ownership' of immovable property takes place, when it is separate from the 'legal ownership', at the moment when the property is actually placed at the disposal of the other party. See opinion of the Advocate General in Case C-320/88 (*SAFE*), paragraphs 6-7. See also Terra and Wattel (2001), p. 241.

¹³²⁶ Case C-320/88 (*SAFE*) operative part of the judgment.

¹³²⁷ In other cases (if a lease contract does not provide for the transfer of ownership to another person upon payment of the final installment) the transaction is treated as supply of services. See § 3(5) of the VAT act.

Article 5(8) of the Sixth Directive allows Member States to choose whether or not to tax the transfer of all or part of the assets of a company.^{1328 1329} In Estonia such a transfer of a business is treated as a non-taxable event.¹³³⁰

Supply of services

The concept of ‘services’ is defined residually in §3(4) as the provision of benefits or transfer of rights not included in the category of goods in the course of business activities. This definition corresponds to Article 6(1) of the Sixth Directive which provides that supply of services is any transaction that does not constitute a supply of goods. Article 6(1) of the Sixth Directive adds that such transactions may include assignments of intangible property; obligations to refrain from an act or to tolerate an act or situation; the performances of services in pursuance of an order made by or in the name of a public authority or in pursuance of the law. Thus, the Sixth Directive provides for a broad application of the tax to all forms of consumption, as, for example, a service may exist merely in obligations to refrain from an act or to tolerate an act or situation.¹³³¹ In its case law the ECJ has added some conditions to those laid down in the Sixth Directive for supplies to be considered taxable. In the cases *Coöperatieve Aardappelenbewaarplaats*¹³³² and *Apple and Pear Development Council*¹³³³ the ECJ stated that for the service to be taxable there must be a direct link between the service provided and the consideration received. In the *Mohr*¹³³⁴ case the Advocate General stated that for the service to be taxable a trader must supply it for consumption by an identifiable customer in return for a price paid by the customer or by a third party.¹³³⁵

Article 6(2)(a) and (b) of the Sixth Directive stipulates that use of goods or services carried out free of charge for non-business purposes must be treated as supplies of services for consideration.¹³³⁶ According to §3(1) 2) of the Estonian VAT act provision of services for non-business use is considered supplies if the taxable person has deducted the VAT on such services.¹³³⁷ The ECJ has held that 6(2)(a) of the Sixth Directive is designed to prevent the non-taxation of business goods used for private purposes and therefore that provision requires the taxation of the private use of such goods only where the tax paid on their acquisition was

¹³²⁸ Article 5(8) provides that Member States may consider that a transfer of all or part of the assets of a company does not constitute a supply of goods, and in that event the recipient shall be treated as the successor to the transferor.

¹³²⁹ Most of the Member States do not impose VAT on the transfer of all or part of the assets of a company.

¹³³⁰ See §3(2) 6) of the VAT act.

¹³³¹ However, in the cases C-102/86 (*Apple and Pear Development Council*) and C-215/94 (*Mohr*) the ECJ considered that the imposition in the fruit-growing industry of a mandatory charge to finance those activities and compensation received for the discontinuation of milk production did not constitute supply of service. See section 3.2.3.

¹³³² Case C-154/80.

¹³³³ Case C-102/86.

¹³³⁴ Case C-215/94.

¹³³⁵ See also section 3.2.3 for more elaborate discussion of case law by the ECJ in this issue.

¹³³⁶ Article 6(2)(a) refers to the use of goods forming part of the assets of a business for the private use of the taxable person or of his staff (or more generally for non-business purposes). Article 6(2)(b) refers to supplies of services carried out free of charge by the taxable person for his own private use or that of his staff (or more generally for non-business purposes). See also section 3.2.3.

¹³³⁷ §3(1) 2) of the VAT act stipulates that ‘... provision of goods or services by a taxable person to an employee, servant or a member of the management or control body of the person, or application by a taxable person or an employee, servant or a member of the management or control body of the person of services or the goods forming part of the business assets of the person for purposes other than those of the business interests of the person, if the taxable person has deducted the input value added tax on such goods or services.’

deductible.¹³³⁸ According to the judgment of the ECJ in *Kühne*¹³³⁹, Article 6(2)(a) must be interpreted as precluding taxation of the depreciation of business goods in respect of their private use where the VAT on such goods was not deductible because they were purchased from a non-taxable person. Taxation of the depreciation of the goods is also prohibited where, although the taxable person was not able to deduct the VAT in respect of the supply of the goods to him, he was none the less able to deduct the VAT on the supplies of goods and services which he sought and obtained from other taxable persons for the maintenance or use of the goods. In such a case, it is consistent with the Community VAT system to tax the expenses incurred for the maintenance and use of the goods, since such a solution avoids not only the double taxation of the goods themselves but also the non-taxation of final use.¹³⁴⁰ In addition, the ECJ has held in its judgment in *Mohsche*¹³⁴¹ that the taxation of private use is not allowed where the use includes services on which the VAT was not deductible.¹³⁴²

Moreover, Article 6(3) of the Sixth Directive allows Member States to treat self-supply of service as supply of service for consideration if the VAT on such a service, had it been supplied by another taxable person, would not be wholly deductible.¹³⁴³ The Estonian VAT act does not provide such a possibility. Estonia has to include that provision concerning taxation of self-supply into its VAT legislation.

Importation of goods and services

Import of goods is defined in §6(1) of the Estonian VAT act as importation of goods into Estonia for free circulation (within the meaning of the Estonian Customs Code). The provisions of the Community Customs Code will replace the Estonian Customs Code upon accession. After accession the controls at the borders with Member States will be abolished and for trade within the Internal Market, the terms 'intra-Community acquisition' and 'intra-Community supply' will be used. The terms 'importation' and 'exportation' will be used only in the case of the trade with non-EU states.¹³⁴⁴

Intra-Community acquisitions of goods and means of transport

The provisions of the Sixth Directive dealing with the intra-Community acquisitions of goods and means of transport¹³⁴⁵ have to be included in the Estonian VAT act upon accession.¹³⁴⁶

¹³³⁸ See Case 50/88 (*Kühne*), paragraph 8.

¹³³⁹ Case 50/88.

¹³⁴⁰ See section 3.2.3 for more elaborate discussion of the *Kühne* case.

¹³⁴¹ Case C-193/91.

¹³⁴² See section 3.2.3 for more elaborate discussion of the *Mohsche* case.

¹³⁴³ Article 6(3) reads as following: 'In order to prevent distortion of competition and subject to the consultations provided for in Article 29, Member States may treat as a supply of services for consideration the supply by a taxable person of a service for the purposes of his undertaking where the value added tax on such a service, had it been supplied by another taxable person, would not be wholly deductible.'

¹³⁴⁴ 'Importation' of goods is defined in Article 7 of the Sixth Directive as the entry into the EU of goods that are not of the EU origin.

¹³⁴⁵ Generally, all supplies of goods to another Member State are exempted from VAT provided that the acquirer has a certain status. This rule is extended in cases of intra-Community supplies of new means of transport; such supplies are exempt regardless of the status of the acquirer or the vendor. The intra-Community acquisitions of new means of transport are always taxed in the country of arrival regardless of the status of the acquirer or the vendor. See Article 28a(1)(b) and Article 28c (A) of the Sixth Directive.

¹³⁴⁶ See also section 3.2.3.

7.2.1.2.4 Place of taxation

Supply of goods

In the case of goods the place of supply is deemed to be Estonia and Estonian VAT is applied if the goods are delivered or made available to the recipient in Estonia, including on the border of Estonia, or if the goods are exported from Estonia.¹³⁴⁷

The Sixth Directive provides more detailed rules for determination of the place of the taxable transaction. Generally, the place of supply of goods in the case of goods not dispatched or transported is deemed to be the place where the goods are when the supply takes place (Article 8(1)(b)). In the case of goods dispatched or transported, the place of supply of goods is deemed to be the place where the goods are at the time when dispatch or transport begins (Article 8(1)(a)). If the goods are installed or assembled by or on behalf of the supplier, the place of supply is deemed to be the place where the goods are installed or assembled (Article 8(1)(a)). In cases where the installation or assembly is carried out in a Member State other than that of the supplier, the Member State within the territory of which the installation or assembly is carried out must take any necessary steps to avoid double taxation in that State (Article 8(1)(a)). In the case of goods supplied on board of ships, aircrafts or trains during the part of a transport of passengers effected in the Community, the place of supply of goods is deemed to be at the point of the departure of the transport of passengers (Article 8(1)(c)). Those rules have to be included in the Estonian VAT act upon accession. In addition, the provisions of the Sixth Directive applicable in the case of purchases by distance sales¹³⁴⁸ have to be included in the Estonian VAT act upon accession. The distance sales over a threshold of EUR 100.000 per year effected by an Estonian company within the territory of another Member State must be taxed in the Member State of arrival. The place of taxable transaction must be Estonia in the case of distance sales effected within the territory of Estonia by firms of another Member State who make a taxable supply over a threshold of EUR 100.000 in a year (see Article 28b (B) of the Sixth Directive). Article 28b (B)(2) of the Sixth Directive provides that a Member State may limit the threshold to EUR 35 000 where that Member State fears that the threshold of EUR 100 000 referred to above would lead to serious distortions of the conditions of competition. Moreover, Article 28b (B)(3) of the Sixth Directive provides that vendors may opt for taxation in a Member State of arrival notwithstanding the threshold. Those provisions have to be included in the Estonian VAT legislation.

Supply of services

The general rule with regard to the place of taxation in the case of services provided in the Estonian VAT act¹³⁴⁹ is in line with the general rule of Article 9(1) of the Sixth Directive, which stipulates that the place of services in the EC is deemed to be the place where the supplier has established his business or has a fixed establishment from which the service is supplied or, in the absence of such a place of business or fixed establishment, the place where he has his permanent address or where he usually resides.

Article 9(2) of the Sixth Directive provides for several exceptions from this general rule. The place of the supply of services connected with immovable property, such as the services of

¹³⁴⁷ §7(1)1) of the Estonian VAT act.

¹³⁴⁸ Sales by mail order, teleshopping, and any other sale when the goods are transported to the customer in another Member State.

¹³⁴⁹ The general rule with regard to the place of taxation in case of services is stipulated in § 7 (1) 5) of the Estonian VAT act which provides that place of supply is considered Estonia if the seat of the provider of services or the permanent establishment through which the services are provided is located in Estonia.

estate agents and of architects, is deemed to be the place where the property is situated. This exception is also provided in the Estonian VAT act: §7 (1) 2) of the Estonian VAT act stipulates that the place of taxation is Estonia if an immovable property located in Estonia is constructed, valued or maintained or services relating to the transfer of an immovable property located in Estonia or to preparation or co-ordination of the related construction work are provided. The Estonian VAT act is in line with the rule of Article 9(2)(c) of the Sixth Directive which provides that cultural, artistic, sporting, scientific, educational, entertainment or similar activities, ancillary transport activities, valuations of movable tangible property or work on movable tangible property, are deemed to be performed where they are physically carried out.¹³⁵⁰ However, the Estonian VAT act does not provide for the rules that the place where transport services are supplied is deemed to be the place where transport takes place, having regard to the distances covered¹³⁵¹ and that the place of the supply of services relating to ancillary transport activities such as loading, unloading, handling and similar activities must be the place where those services are physically carried out¹³⁵². With regard to valuations of movable tangible property or work on movable tangible property, which includes contract work that is treated as services based on the Second Simplification Directive, the same Directive provides that these services are deemed to take place where the VAT identification number of the customer of the services has been issued, provided the goods in question are dispatched or transported out of the Member State where the services were physically carried out. When the place of supply is shifted to the place where the customer's VAT number has been issued, the VAT liability is also shifted to the customer (referred to as 'reverse charge'). Those provisions have to be included in the Estonian VAT act upon accession.

Article 9(2)(e) of the Sixth Directive provides that the place of supply of certain services¹³⁵³ rendered to customers established outside the Community or for taxable persons established in the Community, but not in the same country as the supplier, is where the customer has his business or resides. The Estonian VAT act¹³⁵⁴ provides that the provision of the following services to an Estonian taxable person by a non-resident, except for services provided through the non-resident's permanent establishment in Estonia is taxable in Estonia:

1. transfer of intellectual property rights;
2. advertising services;
3. consulting, accounting, legal, auditing, engineering, data processing or information services or services for the electronic transmission of information;
4. financial and insurance services, including reinsurance;
5. supply of staff;
6. hiring or leasing of or establishment of a usufruct on movable property;
7. telecommunications services, including assignment of rights to use transmission lines;
8. services of agents procuring one of the services specified in above-mentioned clauses 1)–7) for their principal.

¹³⁵⁰ See § 7 (1) 3) and § 7 (1) 4) of the Estonian VAT act that provide for that rule.

¹³⁵¹ This rule is stipulated in Article 9(2)(b) of the Sixth Directive.

¹³⁵² This rule is stipulated in Article 9(2)(c) of the Sixth Directive.

¹³⁵³ The list of the so-called Article 9(2)(e) services to which this provision applies includes for example legal services, advertising, engineering, consulting, accounting, data processing, banking, insurance, and other financial services as well as the hiring out of movable tangible property other than means of transport, the services of agents who act in the name and for the account of another, procuring the above-mentioned services, telecommunication services, radio and television broadcasting services, and electronically supplied services.

¹³⁵⁴ See § 4 and §6(3) of the Estonian VAT act.

This list includes most of the services provided in the list of so-called intangible services provided in Article 9(2)(e) of the Sixth Directive. However, radio and television broadcasting services, and electronically supplied services are not included in the Estonian list of services. In addition, obligations to refrain from pursuing or exercising, in whole or in part, a business activity or a right referred to in the so-called list of Article 9(2)(e) services should be taxable in Estonia if the customer of this service is established or resides in Estonia. The Estonian VAT act should also include the rule of Article 9(2) (f) which provides that in case of the electronically supplied services the place of supply must be in Estonia when those services are performed for non-taxable persons who are established, have their permanent address or usually reside in Estonia, by a taxable person who has established his business or has a fixed establishment from which the service is supplied outside the Community or, in the absence of such a place of business or fixed establishment, has his permanent address or usually resides outside the Community.¹³⁵⁵ Furthermore, the Estonian VAT act must also include the rule of Article 9(4) of the Sixth Directive on telecommunications services and radio and television broadcasting services.

7.2.1.2.5 Chargeable event and chargeability of tax

§ 8 (1) of the Estonian VAT act provides that the chargeable event takes place at the date on which the first of one of the following acts is performed:

- the dispatch of a good or the making of a good available to a purchaser, or the provision of a service;
- the issue of an invoice for the good or service;
- full or partial payment for the good or service;
- in the case of self-supply or non-business use, the chargeable event is deemed to occur when these transactions take place.

Articles 10(1) and 10(2) of the Sixth Directive provide that the chargeable event takes place at a moment when the goods are delivered or the services are performed. However, if a payment is due before the goods are delivered or the services are performed, the tax becomes chargeable on receipt of the payment and on the amount received (Article 10(2)). By way of derogation from those provisions, Member States may provide that the tax becomes chargeable, for certain transactions or for certain categories of taxable person either:

- no later than the issue of the invoice or of the document serving as invoice; or
- no later than receipt of the price; or
- where an invoice or document serving as invoice is not issued, or is issued late, within a specified period from the date of the chargeable event.

The Estonian VAT act is in line with the Sixth Directive in this respect.

§ 8 (5) of the Estonian VAT act provides that in the case of importation of goods, the chargeable event occurs and the tax becomes chargeable either when the goods are released within the meaning of the Customs Code or when customs debt is incurred.

Article 10(3) of the Sixth Directive provides that in case of imported goods the chargeable event occurs and the tax becomes chargeable when the goods enter the territory of the EU. However, if the goods are placed under warehousing or transit arrangements, the chargeable event occurs and the tax becomes chargeable when these procedures are completed.

Estonian VAT provision concerning chargeable event in case of imported goods also corresponds to the Sixth Directive. However, Estonia has to take into the consideration the provi-

¹³⁵⁵ See also section 3.2.4.

sions of the Sixth Directive dealing with the chargeable event in the case of imported goods which are subject to customs duties¹³⁵⁶ as well as the provisions of the Sixth Directive applicable in the case of intra-Community acquisitions¹³⁵⁷.

7.2.1.2.6 Taxable amount

The general rule of the Estonian VAT act, which stipulates that VAT is charged as a percentage of taxable amount, is in line with the Sixth Directive. The Estonian VAT act stipulates that the taxable amount is comprised of the selling price (excluding the VAT itself) of the goods or services and other amounts which the purchaser of the goods or services or a third party is to pay to the seller of the goods or the provider of the services for the corresponding goods or services.¹³⁵⁸ Article 11(A)(1)(a) of the Sixth Directive defines taxable amount as everything, which constitutes the consideration, which has been or is to be obtained by the supplier from the purchaser, the customer or a third party for such supplies. Article 11(A)(1)(a) also stipulates that taxable amount includes subsidies directly linked to the price. The Estonian VAT act stipulates that grants allocated to a taxable person from the state budget for the transfer of goods or services for a price lower than their usual value are included in the taxable value.¹³⁵⁹ However, the Estonian VAT act does not state explicitly, as does the Sixth Directive, that taxable amount includes subsidies directly linked to the price.¹³⁶⁰ There can be also other subsidies not only grants from the state budget which may qualify as subsidies that have to be included in the taxable amount under the Sixth Directive (for example, subsidies from EU central budget). It should be stated also in the Estonian VAT act that all subsidies directly linked to the price are included in the taxable amount.

§ 14 (5) of the Estonian VAT act provides that in the cases of provision of goods or services by an employer to an employee and non-business use of goods and services, the market price of the goods is applied as a taxable amount. The Sixth Directive stipulates that in the case of internal use or non-business use of goods and services, the purchase price or the cost price is applied as a taxable amount.¹³⁶¹ In the case of self-supplies, the open market value is applicable.¹³⁶² Those provisions must be included in the Estonian VAT act upon accession.

¹³⁵⁶ Second paragraph of Article 10 (3) of the Sixth Directive provides that where imported goods are subject to customs duties, to agricultural levies or to charges having equivalent effect established under a common Community policy, the chargeable event shall occur and the tax shall become chargeable when the chargeable event for those Community duties occurs and those duties become chargeable. Where imported goods are not subject to any of those Community duties, Member States must apply the provisions in force governing customs duties as regards the occurrence of the chargeable event and the moment when the tax becomes chargeable (third paragraph of Article 10 (3) of the Sixth Directive).

¹³⁵⁷ Article 28d (1) of the Sixth Directive provides that in case of intra-Community acquisitions, the chargeable event occurs when the acquisition of goods is effected. The intra-Community acquisition of goods is regarded as being effected when the supply of similar goods is regarded as being effected within the territory of the country (Article 28d (1)). The tax becomes chargeable on issuance of the invoice or, at the latest, on the fifteenth day of the next month after the acquisition has been effected (Article 28d (2)). By way of derogation from this general rule, tax becomes chargeable on the issue of the invoice where that invoice is issued to the person acquiring the goods before the fifteenth day of the month following that during which the taxable event occurs (Article 28d (3)).

¹³⁵⁸ §14(1) of the Estonian VAT act.

¹³⁵⁹ §14(2) of the Estonian VAT act.

¹³⁶⁰ See also section 3.2.6 about the case law of the ECJ concerning the inclusion of subsidies in the taxable amount.

¹³⁶¹ Article 11 (A) (1) (b) of the Sixth Directive provides that in respect of private use of goods or their application for non-business purposes, the purchase price of the goods or of similar goods or, in the absence of a purchase price, the cost price, determined as the time of supply is applied as a taxable

The Estonian VAT act does not state explicitly, as does the Sixth Directive¹³⁶³, that the taxable amount includes taxes, duties, levies and charges, and incidental expenses such as commission, packing, transport and insurance costs charged by the supplier. Moreover, the Estonian VAT act does not provide that certain kind of repayments entered in a suspense account should not be included in the taxable amount.¹³⁶⁴

Importation of goods

§15(1) of the Estonian VAT act which provides that in the case of imported goods the taxable amount is customs value of the goods determined in accordance with the Customs Code is in line with Article 11 (B) (1) of the Sixth Directive which stipulates that the taxable amount of imported goods is the value of the goods for customs purposes. §15(1) of the Estonian VAT act provides that the taxable amount also includes all import duties and other expenses such as commission, packing, transport and insurance costs¹³⁶⁵, incurred up to the first place of destination within the customs territory of Estonia¹³⁶⁶, if those expenses are not included in the customs value.¹³⁶⁷ This provision is exactly in line with Article 11 (B) (3) of the Sixth Directive.

Margin scheme

The Sixth Directive applies special rules (hereinafter referred to as the 'margin scheme') to second-hand goods, works of art, collectors' items and antiques effected by taxable dealers if those goods were supplied to the dealer otherwise than by way of taxable supply. The margin scheme is also applied in the case of travel agents. The Estonian VAT act also contains spe-

amount. Article 11 (A) (1) (c) of the Sixth Directive provides that in respect of use of services for non-business purposes the full cost to the taxable person of providing the services is applied as a taxable amount.

¹³⁶² See Article 11 (A) (1) (d) of the Sixth Directive.

¹³⁶³ See Article 11(2) of the Sixth Directive.

¹³⁶⁴ Article 11(3)(c) of the Sixth Directive stipulates that the taxable amount must not include '... the amounts received by a taxable person from his purchaser or customer as repayment for expenses paid out in the name and for the account of the latter and which are entered in his books in a suspense account. The taxable person must furnish proof of the actual amount of this expenditure and may not deduct any tax which may have been charged on these transactions.'

¹³⁶⁵ §15(1') of the Estonian VAT act stipulates that the other expenses referred to above must also be included in the taxable amount where they result from transport to another place of destination within the territory of Estonia if that place is known when the chargeable event occurs.

¹³⁶⁶ §15(1') of the Estonian VAT act stipulates that 'first place of destination within the customs territory of Estonia' means the place mentioned on the consignment note or any other document by means of which the goods are imported. In the absence of such an indication, the first place of destination is considered to be the place of the first transfer of cargo in the customs territory of Estonia.

¹³⁶⁷ §15(5) of the Estonian VAT act stipulates that the tax established by the Estonian VAT Act is not included in the taxable amount of imported goods.

cial rules applicable to second-hand goods, works of art, collectors' items and antiques¹³⁶⁸ as well as to services of travel agents¹³⁶⁹. See also section 7.3.2.10 about those margin schemes.

7.2.1.2.7 Exemptions

The Estonian VAT act makes a distinction between domestic exemptions and exemptions on importation. In the case of domestic exemptions no right of deduction arises. By contrast, the exemptions on importation and exportation are accompanied with a right of deduction, therefore, these transactions are, in effect, zero-rated.¹³⁷⁰ These principles correspond to the Sixth Directive.

Domestic exemptions

§18 of the Estonian VAT act distinguishes between two categories of exemptions: §18(1) deals with the goods and services of a social nature, and §18(2) with other goods and services. The former list¹³⁷¹ does not include several activities which must be exempted according to Article 13(A) of the Sixth Directive. For example, activities stipulated in Article 13(A) (1) (f)¹³⁷², Article 13(A) (1) (k)¹³⁷³, Article 13(A) (1) (n)¹³⁷⁴, and Article 13(A) (1) (o)^{1375 1376}.

¹³⁶⁸ In the case of resale of second-hand goods, original works of art, collectors' items or antiques the taxable amount can be considered the difference between the selling price and purchase price of the goods. The 'margin scheme' can also be applied to importation of original works of art, collectors' items or antiques; and acquisition of original works of art sold to the taxable person by the author or the holder of the copyright. However, taxable persons may also opt for application of the general procedure for calculation of taxable amount. Derogation from this 'margin scheme' is introduced by §35, namely, for sales by public auction (see section 1.3.2.6). This derogation is in line with Article 26a(C) of the Sixth Directive, which provides that Member States may use the special taxable amount of supplies of second-hand goods, works of art, collectors' items or antiques effected by an organiser of sales by public auction, acting in his own name, pursuant to a contract under which commission is payable on the sale of those goods by public auction.

¹³⁶⁹ §33 of the Estonian VAT act provides that in the case of travel agents the taxable amount is travel agent's margin, namely, the difference between the total amount to be paid by the traveller, exclusive of value added tax, and the actual cost to the travel agent of supplies and services provided by other taxable persons where these transactions are for the direct benefit of the traveller.

¹³⁷⁰ According to Estonian VAT act exportation of goods and services are considered taxable supplies that are taxed at zero-rate not exempt supplies. See Article 17 of the Estonian VAT act.

¹³⁷¹ See section 1.3.2.7 for that list.

¹³⁷² This subparagraph provides for exemption of services supplied by independent groups of persons whose activities are exempt from or are not subject to VAT, for the purpose of rendering their members the services directly necessary for the exercise of their activity, where these groups merely claim from their members exact reimbursement of their share of the joint expenses, provided that such exemption is not likely to produce distortion of competition.

¹³⁷³ This subparagraph provides for exemption of certain supplies of staff by religious or philosophical institutions.

¹³⁷⁴ This subparagraph provides for exemption of certain cultural services and goods closely linked thereto supplied by bodies governed by public law or by other cultural bodies recognized by the Member State concerned.

¹³⁷⁵ This subparagraph provides for exemption of the supply of services and goods by organizations whose activities are exempt in connection with fund-raising events organized exclusively for their own benefit provided that exemption is not likely to cause distortion of competition. Member States may introduce any necessary restrictions in particular as regards the number of events or the amount of receipts which give entitlement to exemption.

¹³⁷⁶ Article 13(A) (1) (q) also provides for exemption of activities of public radio and television bodies other than those of a commercial nature. However, according to Article 28 (3) (a) and Annex E of the Sixth Directive Member States may continue to subject those activities to VAT during the transitional period.

In the case of exemption of certain non-profit activities¹³⁷⁷ the Estonian VAT act does not contain the condition as does Article 13(A) (1) (I) of the Sixth Directive that such exemption should not cause distortion of competition.

§18 (2) 4) of the Estonian VAT act also provides for an exemption in the cases of goods the input VAT for which is not subject to deduction. The Sixth Directive does not provide for such an exemption but for an exemption on supplies of goods used wholly for an exempt activity when these goods have not given rise to the right to deduction, or of goods on the acquisition or production of which VAT did not become deductible.

In regard to the exemption on supply of immovable property it has to be pointed out that according to the Estonian VAT act the sale and rental of immovable property is exempted.¹³⁷⁸ Under the Sixth Directive the sale and rental of immovable property also is, as a general rule, exempted, however, new residential construction as well as alteration and maintenance of existing buildings, are taxable¹³⁷⁹. The Estonian rule, which does not provide for taxation in case of new residential construction as well as alteration and maintenance of existing buildings, is in breach of the Sixth Directive.

§18 (3) of the Estonian VAT act provides that taxable persons may opt for taxation in case of leasing or letting of immovable property; supply of immovable property; services provided by credit or financial institutions; and investment gold¹³⁸⁰. The Sixth Directive does not allow Member States to provide a right of option for taxation in the cases of the supply before first occupation of buildings or parts of buildings and the land on which they stand and the supply of building land.¹³⁸¹ The Estonian VAT act should exclude those supplies of immovable property from transactions in the cases of which taxpayers can opt for taxation.

Exemptions on importation

§19 of the Estonian VAT act, which provides that the same exemptions that apply for domestic goods and services are also applied for importation, is in line with the Sixth Directive.

Intra-Community acquisitions

Upon accession Estonia should also apply for intra-Community acquisitions the same exemptions as for domestic supplies.

7.2.1.2.8 Deduction of input-VAT

Article 17(1) of the Sixth Directive provides that the right for input tax deduction (or credit) arises at the time when the deductible tax becomes chargeable¹³⁸², i.e. at the same time as the

¹³⁷⁷ Services provided free of charge by a non-profit association to its members. See §18 (1) 3) of the Estonian VAT act.

¹³⁷⁸ With the possibility to opt for taxation. See §18 (3) 2) of the Estonian VAT act.

¹³⁷⁹ With a possibility for Member States to allow taxpayers a right of option for taxation. See Article 13 (C) of the Sixth Directive.

¹³⁸⁰ On the condition that investment gold has been transferred to a registered taxable person by a registered taxable person who in the business thereof normally supplies gold for industrial purposes or by a registered taxable person who produces investment gold or transforms any gold into investment gold, and services relating to such supply, provided by an agent acting in the name and for the account of another person.

¹³⁸¹ See Article 13 of the Sixth Directive.

¹³⁸² The chargeable event, that is the event by occurrence of which the tax authority becomes entitled to claim the tax from the person liable to pay, takes place at a moment when the goods are delivered or the services are performed (Articles 10(1) and 10(2) of the Sixth Directive). However, if a payment is due before the goods are delivered or the services are performed, the tax becomes chargeable on receipt of the payment and on the amount received (Article 10(2)). See also section 3.2.8.

VAT on the purchase of the input becomes due (when the input tax is invoiced by another entrepreneur or when the goods are delivered or the services are performed, or when the payment is received). The Estonian VAT act does not state explicitly when the right for input tax credit arises. However, from the Estonian VAT act it can be concluded that it arises at the time when the goods or services as well as invoice are received.¹³⁸³ The Estonian VAT act should state explicitly that the right for deduction arises at the moment when the deductible tax becomes chargeable or contain the provision that if a payment is due before the goods or services are received from another registered taxable person, the right for input tax credit arises when the input tax is invoiced by another entrepreneur or when the payment is received.

The main principles of the Estonian VAT act which have to be met in order to exercise the right to deduct input VAT are in line with the Sixth Directive: a taxable person is entitled to deduct from the tax, which he is liable to pay in respect of his supplies the tax invoiced to him by another taxable person. However, the Estonian VAT act stipulates that the right to deduct the input VAT is restricted to goods and services used for the purposes of business.¹³⁸⁴ This provision does not exactly correspond to Article 17(2) of the Sixth Directive which provides that the right to deduction or refund of the VAT is restricted to goods and services used for the purposes of taxable transactions because the latter transactions do not include exempt supplies but include non-business use and self-supply. Estonia also has to add the provision into the VAT act that provides for the right to deduct the tax invoiced to a taxable person on acquired goods. The Estonian VAT act should also include the rules of the Eighth and Thirteenth Directives, which provide the arrangements for refund of VAT to taxable persons not established in the territory of the country.¹³⁸⁵

The Estonian VAT act also provides for partial deduction in the cases where a registered taxable person uses goods or services both for the purposes of taxable supply and supply exempt from tax. §23(1) of the Estonian VAT act provides that if a registered taxable person uses goods or services both for the purposes of taxable supply and supply exempt from tax, input VAT is partially deducted from the calculated VAT. Partial deduction is based on the proportion of the taxable supply, excluding imports of goods and services, of a taxable person to the total amount of the total supply effected by the person in Estonia and the supply of services provided outside Estonia and considered under export of services. This provision is in line with EU law.

7.2.1.2.9 Persons liable for payment of the tax

The provisions of the Estonian VAT act correspond with provisions of the Sixth Directive (see also sections 1.3.2.9 and 3.2.9). However, Estonia has to include the provision in the VAT act that any person who makes a taxable intra-Community acquisition of goods is liable for the payment of the VAT due. In addition, the person who acquires new means of transport from another Member States must be made liable for the payment of the VAT upon

¹³⁸³ §22 (1) of the Estonian VAT act stipulates that upon the receipt of goods or services from another registered taxable person, input value added tax must be deducted on the basis of an original invoice meeting the requirements of the Estonian VAT act.

¹³⁸⁴ See § 20 (3) of the Estonian VAT act which provides the following: 'Input value added tax is:

- value added tax to be paid on goods or services which a registered taxable person acquires or receives from another registered taxable person and uses for the purposes of business;
- value added tax calculated by the taxable person on the taxable value of services imported for the purposes of business or paid on goods imported for the purposes of business.'

¹³⁸⁵ The Eighth Directive lays down detailed arrangements for the refund of VAT paid in a Member State by taxable persons established in another Member State and the Thirteenth Directive provides the arrangements for the refund if taxable persons are established outside the Community. See also section 3.2.8.

accession. In addition, Article 21 (1) (a) of the Sixth Directive provides that in the case of intra-Community acquisitions, the Member State may designate another person to be liable for the payment of the VAT, e.g. a tax representative. Furthermore, the same provision stipulates that the Member State may also provide that someone other than the taxable person is held jointly and severally liable for payment of the tax. Estonia may include those provisions in its VAT legislation.

Liability on importation

The Estonian VAT act provides that a person who is a debtor in respect of VAT within the meaning of the Customs Code of Estonia is liable to pay the VAT due on importation. However, the Community Customs Code will be applicable upon the accession.

7.2.1.2.10 Special schemes

Special scheme applied for transfer of right to cut standing crop and for timber and related services¹³⁸⁶ is not in line with the Sixth Directive and should be abolished upon accession. Other special schemes (those applied for second-hand goods, works of art, collectors' items and antiques, for travel agents, and for investment gold) are in line with the Sixth Directive. Estonia should also include the special scheme applicable to e-commerce and broadcasting services introduced by the Directive 2002/38/EC^{1387 1388}.

7.2.1.2.11 Administrative obligations

Compulsory registration

Estonia applies EUR 16 025 (EEK 250 000) turnover limit for compulsory registration of VAT taxable persons.¹³⁸⁹ Enterprises with a turnover below that threshold are considered outside the scope for the application of VAT, unless they voluntarily register. According to Article 24(2) of the Sixth Directive Member States may apply an exemption from tax to taxable persons whose annual turnover is equal to or higher than EUR 5 000. The agreement on EU accession granted Estonia a permanent derogation allowing small and medium sized enterprises whose annual turnover is less than EEK 250 000 not to be registered for VAT.¹³⁹⁰

¹³⁸⁶ See section 1.3.2.10.

¹³⁸⁷ Council Directive 2002/38/EC of 7 May 2002 amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services, published in the OJ L 128/41 of 15 May 2002.

¹³⁸⁸ See section 3.2.11 for the special rules applicable to e-commerce and broadcasting services.

¹³⁸⁹ See § 9 of the Estonian VAT act.

¹³⁹⁰ In its position paper to EU membership negotiations Estonia explained that '... the likely economic impact of harmonisation with *acquis* requirements would be that the lower registration threshold of VAT would endanger VAT revenue by increasing the number of potential VAT refund claims. VAT collected from undertakings whose annual turnover is between EUR 5000 and EUR 16 025 would be relatively small compared to input VAT and the collected VAT should often be returned to the taxable person. Due to lower threshold a great number of small and medium sized undertakings, private entrepreneur, non-profit organisations, foundations and state-owned undertakings would become taxable persons, while having little experience in accounting and therefore with the possibility of making mistakes in their declarations. The manual accounting commonly used by small and medium sized undertakings would give rise to calculation mistakes or even tax avoidance, which would be difficult to detect by the tax authorities. The control procedures would then increase the administrative expenditure. Lower threshold would also increase the workload of tax authorities remarkably, since there is a need to process additional number of declarations and instruct inexperienced new taxpayers in their VAT accounting. The result would be increased administrative expenditure, decreased tax revenue due to refunds of the excess amounts VAT paid and tax avoidance.'

Submitting a return

Upon accession the control at the borders within the EU will be replaced by a VAT information exchange system (VIES), which requires taxable persons to file quarterly reports of intra-Community supplies (EC sales lists). The Sixth Directive provides that Member States must, subject to conditions that they lay down, allow the taxable person to make such returns by electronic means, and may also require that electronic means are used. In Estonia it is already possible to submit tax returns by electronic means.

Other administrative obligations

Other administrative obligations provided in the Sixth Directive, including the possibility to register by electronic means, to use electronic invoicing and storage, to submit yearly statements as well as Intrastat reports by electronic means (see section 3.2.12), have to be included in the Estonian VAT legislation.

7.2.1.3 Tax rates

Estonia applies a standard VAT rate of 18 percent on most goods and services. This standard rate meets EU requirement that the standard rate of VAT may not be less than 15 per cent.

The reduced VAT rates currently effective in Estonia¹³⁹¹ are not exactly in line with the Sixth Directive. Article 12 of the Sixth Directive introduces limitations of the number of different VAT rates and minimum level of reduced rates for VAT. Member States may apply up to two reduced rates on specified categories of goods and services, neither of which may be lower than 5%.¹³⁹² The goods and services to which reduced rates of VAT can be applied are listed in Annex H to the Sixth Directive. A zero rate of VAT (exemption from VAT with a right to deduct input VAT) is allowed only in the cases of exportation, importation and intra-Community supplies and acquisitions. Thus, Estonia has to abolish zero rates currently applied on electricity generated by wind, and hydro-electricity; periodicals sold under a subscription; and textbooks and workbooks for basic schools and gymnasiums upon accession. The Estonian VAT act already contains the provision that as of Estonia's accession to the European Union, the rate of VAT on periodicals sold under a subscription, and textbooks and workbooks for basic schools and gymnasiums shall be 5 per cent.¹³⁹³

During EU accession negotiations Estonia requested a transitional period until 31 December 2006 in order to retain the zero-rate of VAT on electricity generated by wind and hydro-electricity, however, the transition period was not granted.¹³⁹⁴ Thus Estonia has to apply a standard rate of 18% on electricity generated by wind and hydro-electricity upon accession.

Furthermore, Estonia applies a reduced rate on heat sold to individuals, housing associations, apartment associations, churches, congregations or bodies or organisations financed from the state, rural municipality or city budget, and peat, fuel briquettes, coal or firewood sold to individuals, which is not in line with Article 12 (3) (a) and Annex H of the Directive. However, Estonia was granted a transitional period until 30 June 2007 to apply a reduced VAT rate (5%). After expiry of the transitional period the standard rate must be applied.

Conclusion

In important aspects the act follows the Sixth Directive, however, the VAT act is not in complete alignment with the rules of the EU VAT legislation.

¹³⁹¹ See section 1.3.3.

¹³⁹² Article 12(3)(a) of the Sixth Directive.

¹³⁹³ See § 17 (7) of the Estonian VAT act.

¹³⁹⁴ In its negotiating position CONF-EE 12/01 the EU reiterates that it cannot accept Estonian request since the common VAT system requires that a single rate is applied to the same product and electricity cannot be treated differently according to its method of generation.

7.2.2 *Income taxes*

Provisions of the Estonian Income Tax Act that violate EU law

In this section Estonian income tax legislation (Income Tax Act as well as some other relevant laws) are assessed from a perspective of whether the legislative provisions are in accordance with EU law.

7.2.2.1 *Taxation of individuals*

7.2.2.1.1 Taxation of dividends received by individuals

Estonian tax system differentiates between foreign and domestic dividends received by individuals. Dividends received by individuals from residents (including permanent establishments of non-residents) are exempted from tax while dividends received from non-residents are subject to income tax.¹³⁹⁵ Thus, resident individuals are granted an exemption from income tax on profit distributions received from resident companies but not from non-resident companies including those of the EU Member States which is restriction to free movement of capital and freedom of establishment forbidden under EC Treaty.

The *Verkooijen* case¹³⁹⁶ dealt with the issue whether or not the unfavourable effects of national tax systems, which only apply tax benefits for domestic shares, are in accordance with Community law. From ECJ judgement in *Verkooijen* it can be concluded that national tax systems, which provide a disincentive to cross-border activity or investment might be contrary to the EC Treaty provisions on the four basic freedoms.¹³⁹⁷

In the *Verkooijen* case, the Dutch national provision at issue (namely, the dividend exemption¹³⁹⁸) was similar to that in force in Estonia.¹³⁹⁹ *Verkooijen* concerned a legislative provision of the Netherlands which made the grant of an exemption from the income tax payable on dividends paid to individuals who were shareholders subject to the condition that those dividends were paid by a company whose seat was in the Netherlands. The ECJ held that the Dutch dividend exemption constituted a restriction on capital movements prohibited by Community legislation.

In the *Verkooijen* case, six grounds of justification were submitted to justify the discriminatory tax rule. Firstly, the Netherlands Government argued that the provision at issue falls within the scope of express derogation to the prohibition of any restriction of capital movements laid down in Article 56 of the EC Treaty. Derogation to free movement of capital is provided by Article 58(1) of the Treaty.^{1400 1401} The Netherlands Government argued that

¹³⁹⁵ Income Tax Act provides possibility for avoidance of double taxation of dividends received from non-residents. § 45(1) stipulates that if a resident taxpayer has derived income from abroad during a tax period, income tax paid or withheld on such income abroad is deducted from the income tax to be paid.

¹³⁹⁶ See section 4.2.2 where the *Verkooijen* case is discussed.

¹³⁹⁷ See paragraphs 34-36 of the *Verkooijen* judgement.

¹³⁹⁸ The shareholder subject to Netherlands income tax was exempt from tax if he received dividends of an amount which did not exceed NLG 1 000 (the sum of NLG 1 000 was increased to NLG 2 000 for any taxpayer to whom his spouse's income was attributed).

¹³⁹⁹ There is one important difference between the Estonian dividend exemption and the Dutch (former) dividend exemption that was under consideration in *Verkooijen*. The difference concerns the extent of exemption: in Holland the dividends were exempted at personal level if they did not exceed NLG 1000 or 2000. In Estonia no such limitation exists.

¹⁴⁰⁰ Article 58(1)(a) and (b) grants Member States the right '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' and 'to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation

that provision granted Member States the right to apply the tax provisions 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 invested¹⁴⁰² and, thus, that a legislative provision at issue in *Verkooijen* was not contrary to Community law.¹⁴⁰³

The ECJ, however, was not convinced. It noted that the case law of the ECJ already provided the possibility for Member States to establish certain distinctions based, in particular, on the residence of taxpayers¹⁴⁰⁴, provided that they applied to situations which were not objectively comparable (the ECJ referred to the *Schumacker* case) or could be justified by overriding reasons in the general interest, in particular in relation to the cohesion of the tax system (the *Bachmann* case and the *Commission v Belgium* case).¹⁴⁰⁵ The ECJ added that in any event Article 58(3) of the Treaty states specifically that the national provisions referred to by Article 58(1) should not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments. Thus, the ECJ did not accept that the restrictive tax provision could be justified by the derogation provided by Article 58(1) of the Treaty.

Terra and Wattel (2001, pp. 19-20) comment referring to the case law of the ECJ that Article 58 does not add to the possibilities which Member States already have to justify discriminatory measure because Member States have to meet the restriction set by Article 58(3).¹⁴⁰⁶

Although Article 58(1) legitimizes, to a certain extent, different tax treatment of resident and non-resident taxpayers, and of domestic and foreign-source investment income¹⁴⁰⁷, the rulings of the ECJ in cases such as *Verkooijen* show that this kind of different treatment of domestic and foreign dividends is forbidden under the EC Treaty if no acceptable justification is provided to the ECJ. So far none of the restrictive tax measures has been accepted by the ECJ on the ground of Article 58 and most probably the Estonian restrictive tax provision will not be accepted on that ground.

The other five grounds of justification submitted in *Verkooijen* had in common that they were not mentioned in the EC Treaty and could therefore be recognised as possible justifications, if at all, only if they were overriding requirements in the general interest.

Firstly, the restriction was justified by the need to preserve the cohesion of the Netherlands tax system.¹⁴⁰⁸ The ECJ did not accept the cohesion defence in *Verkooijen* by stating that no such direct link as in *Bachmann* existed between the grant to shareholders residing in the Netherlands of income tax exemption in respect of dividends received and taxation of the

and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.’ However, Article 58(3) adds that such different treatment ‘[...] shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56.

¹⁴⁰¹ Terra and Wattel (2001) comment that an introduction of Article 58 in the EC Treaty probably served to retain sovereignty as regards direct taxation and to minimize the scope of the ECJ judgments (i.e. those in *Avoir Fiscal* and *Biehl*), which required Member States to extend tax benefits for residents also to non-residents. Terra and Wattel (2001), p. 19.

¹⁴⁰² Paragraph 38 of the *Verkooijen* judgment.

¹⁴⁰³ Paragraph 41 of the *Verkooijen* judgment.

¹⁴⁰⁴ Although, in *Verkooijen* the residence of the company from whom taxpayers received the dividends was at issue.

¹⁴⁰⁵ Paragraph 43 of the judgment.

¹⁴⁰⁶ As was already noted, the ECJ also stated in *Verkooijen* that Member States have the possibility (recognized first in *Schumacker* and *Bachmann*) to distinguish between residents and non-residents and between internal and cross-border situations, provided there is a good justification for such distinction.

¹⁴⁰⁷ At least as far as income from capital is concerned. See Terra and Wattel (2001), pp. 18-19.

¹⁴⁰⁸ Paragraph 49 of the judgment.

profits of companies with their seat in another Member State.¹⁴⁰⁹ The ECJ argued that they were two separate taxes levied on different taxpayers.¹⁴¹⁰

Secondly, the United Kingdom Government submitted that a legislative provision such as the one at issue in *Verkooijen* might be objectively justified by the intention to promote the economy of the country by encouraging investment by individuals in companies with their seat in the Netherlands.¹⁴¹¹ However, the ECJ pointed out that, according to settled case-law¹⁴¹², aims of a purely economic nature cannot constitute an overriding reason in the general interest justifying a restriction of a fundamental freedom guaranteed by the Treaty.¹⁴¹³

Thirdly, the Netherlands Government argued that to apply the dividend exemption to taxpayers who are shareholders in companies with their seat in other Member States would enable such taxpayers to secure a twofold advantage since they could enjoy tax reliefs both in the Member State in which the dividend was paid and in the Member State where it was re-

¹⁴⁰⁹ In his first opinion Advocate General La Pergola argued that the Dutch tax provision at issue in *Verkooijen*, although constituting an obstacle to free movement of capital and freedom of establishment was justified by the necessity of preserving the cohesion of the Netherlands tax system. While the Advocate General recognised that there was in this case an obstacle to free movement of capital and freedom of establishment, he concluded in his first Opinion that restricting the exemption to individuals who received dividends from companies established in the Netherlands did not infringe Community law. In his opinion it was a solution justified by the necessity of preserving the cohesion of the Netherlands tax system. He argued that because the purpose of the dividend exemption was to mitigate domestic double taxation, the cohesion of the Dutch tax system would be at risk if the scope of the dividend exemption was extended to dividends received on foreign shares. However, the opinion of the Advocate General was based on misunderstanding of the Dutch legal system. The Advocate General noted in its first opinion that dividends tax already received could not be credited against income tax. This conclusion was incorrect because according to the Dutch Income Tax Act the dividends were exempt from Dutch income tax and the dividend withholding tax levied in the Netherlands could be credited against an individual's Dutch income tax liability or else the dividend withholding tax would be refunded). Thus, the Dutch dividend exemption resulted in a complete exemption of dividends: no dividend withholding tax (creditable or refundable) and no Dutch income tax was levied. (See Weber (1999), pp. 283-284). The Advocate General admitted his misunderstanding of the Dutch tax legislation in his second opinion in which he stated that he had given his first Opinion at the time on the premiss that at the point at which the income tax of individuals was assessed, there was in the Netherlands no provision for the deduction of the amount of the dividend tax levied at source on dividends paid by companies established in the Netherlands. (See paragraph 2 of the Opinion of Mr Advocate General La Pergola delivered on 14 December 1999). The Advocate General noted that on the basis of the additional information it appeared that the tax legislation of the Netherlands provided that, when income tax on the aggregate income of individuals was assessed, the amount deducted from dividends when the dividend tax was levied was taken into account. The Advocate General argues that the double taxation did not therefore exist other than in an economic sense, that is, resulting from a first levy of the tax on profits accruing to the companies distributing dividends and a second levy - when the income tax of individuals was assessed - on the same profits when they were distributed in the form of dividends to the shareholder. According to the view of the Advocate General those two involve two separate taxes - one on company profits, the other on the income of individuals, to which the exemption applies - concerning two separate persons, the company distributing dividends and the recipient shareholder. The Advocate General argued that in *Verkooijen* the direct link identified by the Court in *Bachmann* on the basis of strict criteria did not apply.

¹⁴¹⁰ Paragraph 56 – 58 of the judgment.

¹⁴¹¹ Paragraph 47 of the judgment.

¹⁴¹² Case C-120/95 (*Decker v Caisse de Maladie des Employés Privés*), paragraph 39, and Case C-158/96 (*Kohll v Union des Caisses de Maladie*), paragraph 41.

¹⁴¹³ Paragraph 48 of the judgment.

ceived.¹⁴¹⁴ The ECJ, however, stated that unfavourable tax treatment contrary to a fundamental freedom could not be justified by the existence of offsetting advantages.

Fourthly, the Netherlands Government submitted that extending dividend exemption to dividends received on foreign shares would automatically entail a loss of revenue for the Netherlands tax authorities in that they would not receive any tax on the profits of the companies distributing dividends. The ECJ held that the restriction on capital movements could not be justified by the necessity to prevent a reduction of tax revenue.¹⁴¹⁵

Finally, it was argued that if the Netherlands tax authorities were to grant an exemption for dividends on shares in a company established outside the Netherlands, such dividends would entirely escape taxation in the Netherlands.¹⁴¹⁶ However, the ECJ stated that such dividends did not systematically escape Netherlands taxation as a result of exemption of dividends; that was the case only if the shareholder subject to Netherlands income tax received from a company established in another Member State dividends of an amount which did not exceed the exempted NLG 1 000 or 2 000.¹⁴¹⁷

Thus the ECJ concluded that the restriction on capital movements might also not be justified on the grounds of general interest.

Can Estonian dividend exemption be justified by overriding requirements in the general interest?

Avoidance of double taxation

It can be argued that Estonia is avoiding double taxation of dividends by exempting the dividends at individual shareholder level. If the dividend exemption at individual shareholder level would not be applied, the dividends would be subject to double taxation: first at corporate level and then at individual shareholder level. Thus, it can be argued that Estonia is avoiding double taxation by exempting taxation of dividends at shareholder level because the tax is already levied at corporate level.

According to the current Income Tax Act¹⁴¹⁸, double taxation of dividends received by Estonian residents (both natural and legal persons) from non-residents is avoided if the dividends had been subject to taxation in a foreign country who levies tax rate which is lower or equal to that levied in Estonia.¹⁴¹⁹ Thus, there still exists discrimination of foreign dividends compared to domestic dividends, as the latter are exempted from taxation while the former are subject to ordinary credit. Moreover, in case of foreign dividends received by individuals, the tax paid on underlying profits is not taken into account.¹⁴²⁰

¹⁴¹⁴ Paragraph 54 of the judgment.

¹⁴¹⁵ See paragraph 52 and 59 of the judgment.

¹⁴¹⁶ Paragraph 53 of the judgment.

¹⁴¹⁷ Paragraph 60 of the judgment.

¹⁴¹⁸ § 45 of the Income Tax Act.

¹⁴¹⁹ Estonia is using credit method for the prevention of double taxation of income derived from abroad. According to this method all foreign source income is taxed in residence country, however, a taxpayer may deduct the tax paid on foreign source income from domestic tax liability. As a result, residence country levies the difference between tax levels of a residence country and a source country. The credit method is applied asymmetrically: no refund is provided if tax level is higher in a foreign country than in Estonia. Thus, international double taxation is avoided in case of foreign dividends if tax level in the foreign country is lower than that in Estonia or equal to that in Estonia.

¹⁴²⁰ If a resident company has received dividends from a non-resident company, the recipient of dividends may deduct the income tax withheld from such dividends abroad from the income tax on distributed profits. If the resident company who has received dividends owns, at the time of payment of the dividends, at least 20 per cent of the shares or votes of the non-resident company which paid the dividends, the recipient of the dividends may deduct also the income tax paid on the share of profit abroad which was the basis for the dividends in addition to the income tax withheld from the divi-

It follows that there is no excuse why exemption should not be extended to dividends received by shareholders resident in Estonia from companies established in other Member States because upon accession Estonia must recognize foreign corporation tax as just as creditable as domestic corporation tax on the profits out of which the dividends were paid and must recognize foreign dividends as equivalent to domestic dividends.¹⁴²¹ Although Estonia is in fact avoiding double taxation if dividends are received from domestic companies as such dividends have already been subject to withholding tax at corporate level, there is no justification for not allowing such an exemption in case of foreign dividends.

Coherence defence

Can the Estonian dividend exemption be justified by the coherence defence and meet the criteria of the ECJ identified in *Bachmann* and specified in later case law?

From *Verkooijen* and *Baars* it can be concluded that Member States cannot argue that fiscal cohesion justifies them refusing tax exemption for foreign dividends on the grounds that foreign dividends are paid out of profits which have not borne domestic corporation tax. A Member State must take account of the liability of such non-residents to pay comparable taxes in their Member State of residence.

In *Bachmann*, the Member State was allowed to base the cohesion of its tax system on a principle of correlation between the deductibility of contributions and taxation of later benefits. The Advocate General in his Opinion in *Verkooijen* describes criteria established for coherence justification as prescribing ‘... that the legislature concerned must establish a specific link between the exemption, the tax deduction, and the subjection to tax, offsetting one of these fiscal choices against the other so that the tax authorities can tax one and the same person at different times or in different ways, but always in respect of the same taxable assets or income and always in order to ensure that each taxpayer is treated in a consistent manner.’ From rulings of the ECJ in *Verkooijen* and *Baars* it can be concluded that the link between tax deferral and later taxation must be present within the same tax and with the same taxpayer, or within the same contract.

The ECJ did not accept the cohesion defence in *Verkooijen* by stating that no such direct link as in *Bachmann* existed between the grant to shareholders residing in the Netherlands of income tax exemption in respect of dividends received and taxation of the profits of companies with their seat in another Member State. The same applies in the case of the Estonian dividend taxation: foreign dividends are not exempted whether they are subject to income tax in the other country or not. In addition, analogically with the ECJ in *Verkooijen* it can be argued that Estonian dividend tax is levied at different taxpayers: the company distributing dividends and the recipient shareholder.¹⁴²² They involve two separate taxes - one on distributed company profits, the other on the income of individuals, to which the exemption applies. It can be argued that the Estonian dividend exemption if it were referred for preliminary ruling would probably not be accepted by the ECJ on ground of necessity to protect the coherence of the tax system.

A diminution of revenue

One argument of defence in the *Verkooijen* case, namely, that extending dividend exemption to dividends received on foreign shares would create the situation that such dividends would entirely escape domestic taxation, is relevant in case of Estonia and can possibly justify re-

divdends from the income tax on distributed profits. The amount of deduction may not exceed 26/74 of the amount of dividends paid by the non-resident. See § 54(5) of the Income Tax Act.

¹⁴²¹ See Terra and Wattel (2001), p. 73.

¹⁴²² Although, who bears the final tax burden (the question of tax incidence) is another issue. In a small, open economy any tax on companies is simply passed on to the immobile tax base, i.e. labour income and consumption.

striction to free movement in Estonia because exemption from tax on dividends received from a resident company is applied without any limitations and thus it cannot be argued as the ECJ did in *Verkooijen* that the dividends from non-resident companies would escape taxation in the Member State of receiver only if they did not exceed the exempted amount. In Estonia, no limitation to tax exemption exists. It follows that dividends received on foreign shares by Estonian individuals would entirely escape taxation in Estonia if foreign dividends were granted the same exemption which is currently applicable to dividends paid by resident entities. However, the ECJ has never accepted this argument (that the restrictive tax measure is necessary to avoid the situation that income would entirely escape domestic taxation) in its judgments. Advocate General Fennelly notes in its opinion in *Metallgesellschaft* that a mere diminution in the tax revenues of the host Member State cannot justify a refusal to extend a particular benefit to non-resident companies. In accordance with settled case law of the ECJ, the possibility of a reduction of domestic tax revenue cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify a treatment that is in principle incompatible with EU law. Therefore, the possibility of a reduction of revenue cannot justify the restriction on the freedom of establishment and capital caused by § 18(1) of the Income Tax Act of Estonia.

Tax avoidance justification

It is also doubtful whether the ECJ would accept the tax avoidance justification. Although prevention of abuse has been accepted as a justification for national legislation that violates Community law in non-tax cases¹⁴²³ and has also been recognized *in abstracto* in tax cases,¹⁴²⁴ it to date has not been accepted *in concreto* by the ECJ as a justification for restrictive national tax measures. In *ICI*,¹⁴²⁵ the United Kingdom argued that the restrictive tax provision was designed to reduce the risk of tax avoidance and abuse.¹⁴²⁶ The ECJ, however, did not accept this reasoning and held that the tax legislation at issue did not have the only purpose of preventing wholly artificial arrangements, but applied generally to certain situations.¹⁴²⁷ The ECJ, furthermore, stated in its *ICI* judgment that the fact that a company is having its seat in another Member State does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the other Member State.¹⁴²⁸ It may be inferred from the judgments by the ECJ such as those in *Emsland-Stärke*, *ICI*, *Leur-Bloem*, *Lankhorst-Hohorst* and the recent *Hughes de Lasteyrie* case that the Court may in principle accept restrictive anti-abuse measures but only if the tax measure at issue has the specific purpose of preventing wholly artificial arrangements.¹⁴²⁹

Effectiveness of fiscal supervision

The effectiveness of fiscal supervision only constituted a justification accepted by the ECJ in one single case,¹⁴³⁰ although it has been invoked by Member States again and again in several cases. Given that a justification also is subject to proportionality requirement, all the indications are that Estonian dividend exemption infringes EU law.

¹⁴²³ See Case C-110/99 (*Emsland-Stärke*), paragraphs 52 - 53 of the judgment.

¹⁴²⁴ Case C-264/96 (*ICI*), paragraph 26 of the judgment.

¹⁴²⁵ Case C-264/96.

¹⁴²⁶ See paragraph 25 of the judgment.

¹⁴²⁷ The ECJ, furthermore, stated that the establishment of a group's subsidiaries in other Member States does not, of itself, necessarily entail tax avoidance. See paragraph 25 and 26 of ECJ judgment in *ICI*.

¹⁴²⁸ See paragraph 26 of the judgment.

¹⁴²⁹ See also section 4.2.3 where the issue of abuse is discussed in greater detail.

¹⁴³⁰ Case C-250/95 (*Futura*) (paragraph 31 of the judgment).

7.2.2.1.2 Taxation of pensions

Contributions to the pension funds

A resident individual has the right to deduct from his/her income the contributions to a mandatory funded pension withheld on the basis of the Funded Pensions Act. In addition, a resident individual has the right to deduct the following from the income: (1) that part of the insurance premiums paid under an insurance contract for a supplementary funded pension which meets the conditions of § 152 of the Funded Pensions Act, the purpose of which is to ensure payment of the insured sum as a pension; (2) amounts paid to acquire units of a voluntary pension fund established in accordance with the procedure prescribed in the Funded Pensions Act.

Those tax provisions are incompatible with the EC Treaty because:

- only contributions made to resident companies are deductible¹⁴³¹;
- only contributions made by resident individuals are deductible.

Deductibility of contributions made to non-resident companies

The recent EU developments

At present, EU investors often find their choice restricted by national governments imposing higher taxes on foreign funds. Very few steps have been taken to bring about the single market for pension funds in the EU. There has been no positive harmonization (legislative acts by Community institutions) related to pensions. Some negative harmonization has been accomplished by the case law of the ECJ.¹⁴³²

According to ECJ rulings in *Commission v Belgium*¹⁴³³, *Bachmann*¹⁴³⁴, *Danner*¹⁴³⁵ and *Scandia*¹⁴³⁶ tax rules which provide tax benefits for pension and insurance premiums paid to resident institutions but refuse such benefits to pension and insurance premiums paid to non-resident institutions are running against the rules of the EC Treaty, unless they are necessary for protecting the integrity of the national tax system and proportional.¹⁴³⁷

In the cases *Commission v Belgium* and *Bachmann*, the ECJ ruled that if a tax is necessary for protecting the integrity of a Member State's national tax system, it may be maintained, in spite of its effects.¹⁴³⁸ Both cases concerned the compatibility with Community law of the Belgian tax law provisions pursuant to which the deductibility for income tax purposes of certain insurance contributions is conditional on those contributions being paid in Belgium, either to a Belgian undertaking or to the Belgian permanent establishment of a foreign undertaking. As a general rule, differential tax treatment of service providers of other Member States in comparable situations as residents is not allowed. The ECJ recognises in *Bachmann*

¹⁴³¹ Income Tax Act provides that only pension premiums paid to qualifying resident pension funds which are established according to the Funded Pensions Act are deductible. §27 of the Funded Pensions Act provides that the provisions of the Investment Funds Act apply to pension funds, pension management companies and depositaries of pension funds. §5 of the Investment Funds Act stipulates that the Act, except the provisions concerning Foreign Funds, applies to funds, management companies and depositaries which are founded or established in Estonia and the seats of which are in Estonia. §9 of the Investment Funds Act stipulates that a company that manages a fund shall be entered in the commercial register in Estonia and its seat shall be in Estonia.

¹⁴³² See section 4.2.2 where the ECJ's case law on pension taxation as well as the latest action by the Commission is discussed.

¹⁴³³ Case C-300/90.

¹⁴³⁴ Case C-204/90.

¹⁴³⁵ Case C-136/00.

¹⁴³⁶ Case C-422/01.

¹⁴³⁷ In *Futura*, the ECJ also accepted the justification that the tax measure is necessary to ensure the efficiency of fiscal supervision (see paragraph 31 of the judgment).

¹⁴³⁸ See section 4.2.2.

that the Belgian measure constitutes a restriction to the free movement, but stipulates that a requirement that premiums are deductible only if paid to companies established in Belgium is compatible with Article 49 if indispensable to achieve a public-interest objective such as coherence of the tax system. The ECJ recognizes that under Belgian tax law, there is a direct connection between the deductibility of premiums and the taxation of subsequent income: if premiums are not deducted then future income is not taxed. In such a tax system the loss of revenue resulting from the deduction of life assurance contributions from total taxable income - which includes pensions and insurance payable in the event of death - is offset by the taxation of pensions, annuities or capital sums payable by the insurers. Where such contributions have not been deducted, those sums are exempt from tax. Therefore, coherence of Belgian tax system presupposes that, if insurance premiums are deductible, Belgium should be able to tax the income paid out by the insurance undertakings.¹⁴³⁹

However, the scope of the coherence defence was limited by the ECJ in later cases (*Wielockx*¹⁴⁴⁰, *Svensson*¹⁴⁴¹, *ICI*¹⁴⁴², *Eurowings*¹⁴⁴³, *Verkooijen*¹⁴⁴⁴, *Baars*¹⁴⁴⁵, *Metallgesellschaft*¹⁴⁴⁶, *Danner*¹⁴⁴⁷, and *Lankhorst-Hohorst*¹⁴⁴⁸). In its case law the ECJ has stressed that Member States may rely on the need to preserve fiscal coherence only if there is a direct link between any fiscal advantage and a corresponding disadvantage. From rulings of the ECJ in *Verkooijen* and *Baars* it can be concluded that the link between tax deferral and later taxation must be present within the same tax and with the same taxpayer, or within the same contract. In addition, the ECJ has stipulated that cohesion argument must be viewed in the light of European regulations, bilateral tax treaties and the possibilities of mutual assistance in tax matters.

The *Danner* case¹⁴⁴⁹ also dealt with a tax provision that precluded or restricted the deductibility for income tax purposes of voluntary pension insurance contributions paid to foreign pension insurance institutions. The tax provision that was dealt in the *Danner* case is in many respects similar to the tax provision effective in Estonia. Under Finnish Income Tax Law pension insurance contributions to certain compulsory or statutory schemes were fully deductible from taxable income. However, that rule did not apply to contributions to analogous foreign schemes: the contributions for voluntary pension insurance taken out with a foreign insurance institution were not deductible but were later taxed in Finland.¹⁴⁵⁰ The ECJ in its judgment held that tax provision at issue restricted the freedom to provide services.¹⁴⁵¹ The ECJ stated, referring to the *SAFIR* case¹⁴⁵², that in view of the important role played by the possibility of obtaining tax deduction, such tax legislation was liable to dissuade individuals from taking out voluntary pension insurance with institutions established in a Member State other than Finland and to dissuade those institutions from offering their services on the Finnish market.¹⁴⁵³ The ECJ stipulated that Finnish tax rules could not be justified on the same grounds as in *Bachmann* since there was no direct connection between the deductibility

¹⁴³⁹ See judgment of the ECJ in Case C-204/90 (*Bachmann*), paragraphs 21-23.

¹⁴⁴⁰ Case C-80/94.

¹⁴⁴¹ Case C-484/93.

¹⁴⁴² Case C-264/96.

¹⁴⁴³ Case C-294/97.

¹⁴⁴⁴ Case C-35/98.

¹⁴⁴⁵ Case C-251/98.

¹⁴⁴⁶ Joined cases C-397/98 and C-410/98.

¹⁴⁴⁷ Case C-136/00.

¹⁴⁴⁸ Case C-324/00.

¹⁴⁴⁹ Case C-136/00.

¹⁴⁵⁰ See section 4.2 for more elaborate discussion of *Danner* case.

¹⁴⁵¹ Paragraph 30 of the judgment.

¹⁴⁵² Case C-118/96, paragraph 30 of the judgment.

¹⁴⁵³ Paragraph 31 of the judgment.

of insurance contributions and the taxation of sums payable by insurers.¹⁴⁵⁴ Furthermore, the ECJ stated referring to the *Wielockx* case that the principle of fiscal cohesion might not be invoked to justify the refusal of a deduction since fiscal coherence was secured by a bilateral convention concluded with another Member State. Consequent to the ECJ decision, it is clear that the Finnish tax authorities must now allow a deductions based on voluntary pension contributions paid to a pension fund established in an EU country.

In light of the ECJ case law, the Estonian pension taxation provisions contravene EU law because pension contributions paid to non-Estonian funds are not tax deductible while contributions paid to domestic funds are. More specifically, the Estonian pension tax provisions contravene EU principles of freedom to provide services (Article 49 of the EC Treaty) and the free movement of workers and capital (Articles 39 and 56 of the EC Treaty). Analogically with Finnish tax provisions Estonian tax rules cannot be justified by necessity to maintain coherence of the tax system since there is no direct connection between the deductibility of insurance contributions and the taxation of sums payable by insurers. Furthermore, fiscal coherence is secured by bilateral conventions with most EU Member States. It follows that Estonia has to change its tax legislation and give pension contributions paid to pension funds located in other Member States the same tax treatment (contributions paid to non-Estonian funds should be also tax deductible).

Deductibility of contributions made by non-residents

The deduction from taxable income of pension premiums is only allowed to resident taxpayers. Income Tax Act does not allow deduction from taxable income of contributions to the pension funds by non-resident taxpayers.

The ECJ held in its judgment in *Schumacker* that Article 39(2) of the Treaty precludes a non-resident employed person from being taxed by the State of employment more heavily than a resident in the same employment where the non-resident is in comparable situation as the resident, for example, receives the major part of his income and almost all his family income in other Member State¹⁴⁵⁵. From the judgment of the ECJ in *Schumacker* and *Biehl* it can be concluded that domestic tax legislation of the Member State should provide a non-resident with the same income-related benefits as a resident, if the non-resident is in a similar position as a resident from the tax point of view, i.e. receives the major part of his worldwide income in that Member State. Thus, where residents of Estonia are entitled to tax deductions then residents of other Member States working in Estonia should also get them to the extent that these deductions are attributable to income from Estonia. From *Wielockx* it can be concluded that the principles developed by the ECJ in *Schumacker* apply not only to employees under the free movement of workers provision of the Treaty but also to self-employed individuals under freedom of establishment provision.

¹⁴⁵⁴ Paragraph 37 of the judgment.

¹⁴⁵⁵ The ECJ did not specify in *Schumacker* the exact proportion of income that non-resident should earn in another Member State in order to be entitled to the same tax treatment there as a resident. The ECJ has also avoided giving quantitative guidelines in the subsequent case law. In *Wielockx*, the ECJ did not also quantify the proportion of income that non-resident should earn in the state of source, to qualify for equal treatment. In its judgment in *Gschwind*, the ECJ accepted the requirement that non-resident should earn 90% of family worldwide income in the state of source to qualify for equal treatment. Several bilateral treaties also refer to 90% of worldwide income. The Commission recommendation stipulates that treatment identical to that of residents should be granted to non-residents if they earn 75% or more of their income in source state. See also section 4.2.1.

Payments from the pension funds

Payments from resident voluntary pension funds may be subject to tax at regular or reduced rate (10%) or exempted from taxation.^{1456 1457} All pension benefits received from non-residents are subject to tax at regular rate (26%). This tax provision is incompatible with EC Treaty freedom to provide and purchase services because tax benefits only apply for the payments made by Estonian companies.

The ECJ has held in several judgments (i.e. *SAFIR*¹⁴⁵⁸, *Danner*¹⁴⁵⁹) that tax legislation of the Member State which provides for different tax regimes for insurance policies, depending on whether they are taken out with companies established in that Member State or with companies established elsewhere, where that legislation contains a number of elements liable to dissuade individuals from taking out insurance policies with companies established in other Member States and liable to dissuade those insurance companies from offering their services on the market in that Member State, is incompatible with EU law.¹⁴⁶⁰

Exit taxes

Exit taxes are one kind of emigration tax, whereby a country attempts to preserve their tax claim on existing latent or future income.¹⁴⁶¹ Estonia has no special exit taxes in case of emigration. If a person emigrates and wants to transfer the value of his/her pension to a pension fund in the immigration country, then, as a general rule, it is not possible to get the invested money from the fund before he/she is retired. In some exceptional cases it is possible, however, the Estonian income tax has to be paid. The same rules also apply in case of domestic transfers.

¹⁴⁵⁶ Income tax is not charged on a pension paid to a policyholder pursuant to an insurance contract for a voluntary funded pension which meets the conditions of § 152 of the Funded Pensions Act after the policyholder has attained 55 years of age or after his or her total and permanent incapacity for work has been verified, on the condition that the insurance contract prescribes that corresponding payments shall be made in equal or increasing amounts at least once every three months until the death of the policyholder. In addition, income tax is not charged on insurance benefits paid in the event of death. The reduced rate (10%) is applicable to the following payments made to a policyholder pursuant to an insurance contract for a voluntary funded pension or to a unit-holder of a voluntary pension fund: (1) payments made by the insurer to the policyholder after the policyholder has reached 55 years of age but not before five years have passed since the contract was entered into; (2) payments made by the insurer in the event of the total and permanent incapacity for work of the policyholder; (3) payments made in the case of the liquidation of the insurer. All other payments made to a policyholder pursuant to an insurance contract for a voluntary funded pension or to a unit-holder of a voluntary pension fund are subject to tax at regular rate (26%).

¹⁴⁵⁷ Income Tax Act (see § 20¹ and § 21) provides that only payments made by pension funds which are established according to the Funded Pensions Act can be subject to taxation at reduced rates or exempt from taxation. § 27 of the Funded Pensions Act provides that the provisions of the Investment Funds Act apply to pension funds, pension management companies and depositaries of pension funds. § 5 of the Investment Funds Act stipulates that the Act, except the provisions concerning Foreign Funds, applies to funds, management companies and depositaries which are founded or established in Estonia and the seats of which are in Estonia. § 9 of the Investment Funds Act stipulates that a company that manages a fund shall be entered in the commercial register in Estonia and its seat shall be in Estonia.

¹⁴⁵⁸ Case C-118/96.

¹⁴⁵⁹ Case C-136/00.

¹⁴⁶⁰ See, for example, Case C-118/96 (*SAFIR*), paragraph 30 and Case C-136/00 (*Danner*), paragraph 31.

¹⁴⁶¹ See section 4.2.2.2.

7.2.2.1.3 Exemptions

Income Tax Act lists other items of income which are exempted from tax.¹⁴⁶² Those exemptions are not applied in case of non-resident individuals. Exemptions applicable to non-resident individuals are listed in § 31 of the Income Tax Act. Not all exemptions applicable to resident individuals are applicable to non-resident individuals. Furthermore, Estonian resident spouses may opt to file a joint tax return,¹⁴⁶³ resulting in a lower tax burden, which is not available to non-resident taxpayers (see section 7.2.2.1.5 below where this provision is discussed in greater detail).

Tax rules which apply to residents and non-residents different conditions regarding income tax may fall within the scope of Article 39 or Article 43 of the EC Treaty. The ECJ has held in its judgment in *Schumacker* that Article 39 of the Treaty must be interpreted as precluding the application of rules of a Member State under which a worker who is a national of, and resides in, another Member State and is employed in the first State is taxed more heavily than a worker who resides in the first State and performs the same work there when, as in the main action, the national of the second State obtains his income entirely or almost exclusively from the work performed in the first State and does not receive in the second State sufficient income to be subject to taxation there in a manner enabling his personal and family circumstances to be taken into account.¹⁴⁶⁴ From *Wielockx*¹⁴⁶⁵ it can be concluded that the principles developed by the ECJ in *Schumacker* apply not only to employees under the free movement of workers provision of the Treaty but also to self-employed individuals under freedom of establishment provision (Article 43 of the EC Treaty).

Although the reasoning of the ECJ has not been particularly clear and has led to different interpretations¹⁴⁶⁶, it is necessary to allow income tax exemptions which are granted to residents also to non-residents who obtain their personal or family income entirely or almost exclusively (i.e. 75 – 95 per cent of their worldwide income) from the work performed in Estonia. In its judgment in *Gschwind*, the ECJ accepted the requirement that non-resident should earn at least 90% of family worldwide income in the state of source to qualify for equal treatment.¹⁴⁶⁷

From the judgment of the ECJ in *Groot* it can be concluded that a resident Member State should grant the tax exemptions relating to the taxpayer's personal and family circumstances not only in proportion to the income derived in that Member State but also in proportion to the income obtained in other Member States if that income was taxed in that other Member State without his personal and family circumstances being taken into account.¹⁴⁶⁸ The ECJ, furthermore, held that Community law contains no specific requirement with regard to the way in which the State of residence must take into account the personal and family circumstances of a worker who, during a particular tax year, received income in that State and in another Member State, except that the conditions governing the way in which the State of

¹⁴⁶² See section 1.4.5.

¹⁴⁶³ §44(2) of the Income Tax Act provides that resident spouses who have been married to each other during the whole tax period may submit a joint income tax return. The same paragraph stipulates that a joint income tax return may be submitted also if the marriage was contracted during the tax period or if one of the spouses died during the tax period.

¹⁴⁶⁴ Case C-279/93 (*Schumacker*), paragraph 47.

¹⁴⁶⁵ Case C-80/94.

¹⁴⁶⁶ See Wattel (1995) and Kemmeren (1998).

¹⁴⁶⁷ See also section 4.2.1.

¹⁴⁶⁸ The ECJ stressed in *Groot* by referring to its judgment in *Schumacker* that it is a matter for the State of residence, in principle, to grant the taxpayer all the tax allowances relating to his personal and family circumstances because that State is best placed to assess the taxpayer's personal ability to pay tax, since that is where his personal and financial interests are centred. See paragraph 90 of the judgment in *Groot*.

residence takes those circumstances into account must not constitute discrimination, either direct or indirect, on grounds of nationality, or an obstacle to the exercise of a fundamental freedom guaranteed by the Treaty.¹⁴⁶⁹ It follows that according to the case law of the ECJ Estonia should grant the tax exemptions relating to the taxpayer's personal and family circumstances not only in proportion to the income derived in Estonia but also in proportion to the income obtained in other Member States if that income was taxed in that other Member State without his/her personal and family circumstances being taken into account

7.2.2.1.4 Deductions

Paragraphs 23 to 28 of the Income Tax Act allow deductions only from the aggregate income of resident taxpayers. The basic exemption specified in the Income Tax Act for a tax period is deductible from the income of a resident individual.¹⁴⁷⁰ Increased basic exemption is deductible from the income of a resident individual in case of three or more children.¹⁴⁷¹ Thus, only residents are provided the right to deduct the basic exemption from their income.

A resident individual has the right to deduct support paid by him or her to a resident individual during a tax period from the income which he or she receives during the tax period if such support is subject to taxation.¹⁴⁷² In addition, a resident individual has the right to deduct housing loan interest¹⁴⁷³ as well as training expenses¹⁴⁷⁴ from the income. Moreover, a resident individual has the right to deduct certain gifts, donations and trade union entrance and membership fees¹⁴⁷⁵ from the income. Furthermore, a resident individual has the right to deduct certain insurance premiums and acquisition of pension fund units as well as contributions to a mandatory funded pension and unemployment insurance premiums from the taxable income.¹⁴⁷⁶ All these tax benefits are not applicable to non-residents.

Tax rules which apply to residents and non-residents different conditions regarding income tax may fall within the scope of the EC Treaty provisions which require the abolition of barriers to free movement within the Internal Market. From the reasoning of the ECJ in *Schumacker* and *Wielockx*, it can be concluded that it is necessary to allow deductions from taxable income which are granted to residents also to non-residents who obtain their income entirely or almost exclusively from the work performed in Estonia and do not receive in their resident State sufficient income to be subject to taxation there in a manner enabling their personal and family circumstances to be taken into account. It is also argued that in the light of case law of the ECJ, it is safe to assume that domestic tax legislation should provide a non-resident with the same personal deductions as a resident, if the non-resident is economically in a similar position as the resident for tax purposes.¹⁴⁷⁷ From the judgment of the ECJ in *Groot* it can be concluded that Estonia should grant the tax advantages relating to the resident taxpayer's personal and family circumstances not only in proportion to the income derived in Estonia but also in proportion to the income obtained in other Member States if that income was taxed in that other Member State without his personal and family circumstances being taken into account.¹⁴⁷⁸

¹⁴⁶⁹ See also section 4.2.2 where the *Groot* case is discussed in greater detail.

¹⁴⁷⁰ § 23 of the Income Tax Act specifies that the basic exemption deductible from the income of a resident individual is 12 000 kroons for a year 2003.

¹⁴⁷¹ § 23¹ of the Income Tax Act.

¹⁴⁷² § 24 of the Income Tax Act.

¹⁴⁷³ § 25 of the Income Tax Act.

¹⁴⁷⁴ § 26 of the Income Tax Act.

¹⁴⁷⁵ § 27 of the Income Tax Act.

¹⁴⁷⁶ § 28 of the Income Tax Act.

¹⁴⁷⁷ Michielse (2002).

¹⁴⁷⁸ See also section 4.2.2 where the *Groot* case is discussed in greater detail.

Training expenses

A resident individual has the right to deduct expenses which he or she incurs for the training of himself or herself or a dependent of less than 26 years of age, and which are paid on the basis of a written agreement with the resident's educational institution, from the income which the resident individual receives during the tax period.¹⁴⁷⁹ Thus only training expenses which are paid on the basis of a written agreement with the resident educational institution (as well as with a non-resident educational institution who has a permanent establishment in Estonia) are deductible. This is discrimination forbidden under EC Treaty. More specifically, the measure at issue is incompatible with the rules of Community law guaranteeing free provision of services. As a general rule, differential tax treatment of service providers of other Member States in comparable situations as residents is not allowed if such a treatment is not indispensable to achieve a public-interest objective such as coherence of the tax system.¹⁴⁸⁰

7.2.2.1.5 Joint assessment of spouses

The option to file a joint tax return of spouses is currently available only in the case of resident taxpayers.¹⁴⁸¹ From the judgments by the ECJ in *Schumacker* and *Wielockx*, it can be concluded that the joint assessment to tax of spouses has to be allowed also to non-residents who obtain their family income entirely or almost exclusively from the work performed in Estonia and do not receive in their resident State sufficient income to be subject to taxation there in a manner enabling their family circumstances to be taken into account. From the judgment by the ECJ in *Gschwind* it can be concluded that tax benefits available to residents do not have to be allowed to non-residents if significant part of their family income is earned in their resident country because in that case their family and personal circumstances can be taken into account in their resident country.¹⁴⁸²

From the ECJ's judgment in *Zurstrassen*¹⁴⁸³ it can be concluded that the joint assessment to tax of spouses who are not separated either *de facto* or by virtue of a judicial decision should not be subject to the requirement that both taxpayers are resident in Estonia. The ECJ held that tax advantage of joint assessment should also be allowed to a worker who is resident in the Member State, and whose spouse is resident in another Member State, where he/she receives almost the entire income of the household.

7.2.2.1.6 Exit taxes

There are no exit taxes in Estonia (neither for natural or legal persons), such as taxes on unrealized capital gains or on income derived from sources in and/or outside Estonia after emigration. Non-residents are taxed only on their income derived from sources within Estonia. Estonia does not apply the rules that provide for an extended tax liability for a certain period after emigration. In addition, Estonia does not recapture previously granted deductions or tax deferrals (e.g. a tax deduction for premiums paid under a private pension plan or life insurance). If the person emigrates, the capital gains that he/she derives from Estonia (i.e. from the sale of the real estate situated in Estonia or the shares of the Estonian companies) are taxed at the moment the income is received (i.e. when the non-resident sells the assets).

¹⁴⁷⁹ §26 of the Income Tax Act.

¹⁴⁸⁰ See for example ECJ rulings in *Bachmann*, *SAFIR* and *Danner*.

¹⁴⁸¹ §44(2) of the Income Tax Act provides that Estonian resident spouses who have been married to each other during the whole tax period may submit a joint income tax return.

¹⁴⁸² See also section 4.2.2 where the *Gschwind* case is discussed in greater detail.

¹⁴⁸³ Case C-87/99.

7.2.2.2 Taxation of legal persons

7.2.2.2.1 Transfer pricing rules

§ 50 (4) of the Income Tax Act of Estonia provides for transfer pricing rules. It stipulates that if the value of a transaction conducted between a resident legal person and a non-resident or a individual associated with the resident legal person differs from the value of similar transactions conducted between non-associated persons, the tax administrator may, upon determining the income tax, use the values of transactions applied by non-associated independent persons under similar conditions.

It follows that § 50 (4) of the Income Tax Act only applies in case of transactions conducted between a resident legal person and a non-resident (legal or natural person) or natural person. It does not apply in case of two resident legal persons who are associated, for example, in the case of a resident subsidiary whose parent company is also resident. Thus, such a transfer pricing provision introduces a difference in treatment between resident subsidiary companies according to whether or not their parent company has its seat in Estonia. It can be concluded from the ECJ's judgment in the *Lankhorst-Hohorst* case¹⁴⁸⁴ that transfer pricing provisions of EU Member State that provide different tax rules according to whether the parent company, that is to say, the shareholder in the subsidiary, is resident in that Member State or in another Member State infringe EU law.¹⁴⁸⁵

However, it can be concluded from the ECJ's decision in *Lankhorst-Hohorst* that the critical test in these circumstances is whether the same rules are also applied to domestic legal entities.¹⁴⁸⁶ In addition to a transfer pricing provision for international transactions, the Estonian tax law contains the arm's length principle for domestic transactions. Currently, the Estonian tax administration has the authority to make an upward adjustment to a company's taxable basis when it finds that certain transactions do not meet the arm's length principle. For example, if in a national situation an Estonian subsidiary does not apply market prices in transactions with its Estonian parent company, then, the tax administration can make corrections in profit calculation by applying market prices. Therefore, the Estonian transfer pricing rules do not infringe EU law because they do not provide different tax rules according to whether the parent company, is resident in Estonia or in another Member State.

7.2.2.2.2 Taxation of income of legal persons located in low tax territories

The Income Tax Act comprises the CFC rules under which the profits of companies located in the low-tax territories are deemed to constitute taxable income of the residents. The income tax is also imposed on certain payments to the legal persons established in territories with low tax rates, irrespective of whether the person operates in Estonia or not.¹⁴⁸⁷ Furthermore, double taxation of dividends is avoided in the case of foreign direct investment if a non-resident legal person owns at least 25 per cent of the share capital or votes of the resi-

¹⁴⁸⁴ Case C-324/00.

¹⁴⁸⁵ See also section 4.2.2.1 where the *Lankhorst-Hohorst* case is discussed in greater detail.

¹⁴⁸⁶ See Case C-324/00 (*Lankhorst-Hohorst*) where the ECJ based its conclusion on the fact that the German thin capitalization rules did not apply to domestic shareholders.

¹⁴⁸⁷ § 52(2) provides exhaustive list of payments which are subject to income tax and includes granting a loan or making of an advance payment to a legal person located in a low tax rate territory or acquisition of a right of claim against a legal person located in a low tax rate territory in any other manner; acquisition of securities issued by a legal person located in a low tax rate territory; acquisition of a holding in a legal person located in a low tax rate territory; and payment of a fine for delay or a contractual penalty, or extra-judicial compensation for damage, to a legal person located in a low tax rate territory.

dent company distributing the dividends. Dividends distributed to a legal person located in a low tax rate territory, are always subject to income tax at shareholder level.

These provisions may infringe EU law because they introduce different treatment for resident subsidiary companies according to whether or not their parent company has its seat in Estonia. For example, if Estonian company grants a loan to another company which is located in Luxembourg,¹⁴⁸⁸ this loan is subject to income tax while loan given to a resident company is not subject to income tax if it meets conditions established by the Minister of Finance. It can be concluded from the ECJ's judgment in the *Lankhorst-Hohorst* case¹⁴⁸⁹ that tax provisions of EU Member State that provide different tax rules according to whether the parent company, that is to say, the shareholder in the subsidiary, is resident in that Member State or in another Member State infringe EU law.

Furthermore, the ECJ has held, in general terms, that less favourable treatment in tax matters cannot be justified by low tax level in another Member State.¹⁴⁹⁰ The ECJ held in *Eurowings*¹⁴⁹¹ that any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State.

7.2.2.2.3 Thin capitalization

Thin capitalization legislation has drawn a lot of attention after the *Lankhorst-Hohorst* decision of the ECJ.¹⁴⁹² The case dealt with German's thin capitalization legislation, which was found to be incompatible with EC Treaty. The decision was based on the grounds that the debt-equity ratios imposed on German resident subsidiaries and the consequent disallowance of interest deductions applied only, in effect, where the parent company was resident abroad and not where it was resident in the ordinary course of affairs in Germany. The ECJ held that different treatment between resident subsidiary companies according to whether or not their parent company had its seat in Germany made it less attractive to corporations having their seats in other Member States to exercise the freedom of establishment.¹⁴⁹³

With respect to Estonia, the Income Tax Act imposes no ceiling on the amount of interest payments that a company may deduct in computing its taxable profits.

7.2.2.2.4 Dividends received from the Estonian companies

Avoidance of double taxation

The current Estonian system of dividend taxation differentiates Estonian and foreign parent companies in a sense that it provides different minimum shareholding rate for exclusion of double taxation of dividends. When dividends are paid to Estonian parent company holding 20% of shares, the double taxation is eliminated, while the same applies to foreign legal persons starting from shareholding rate of 25%. In addition, the Estonian parent company holding less than 20% of shares, has to pay the income tax at the moment of redistribution while in case of foreign persons, the income tax has to be paid immediately. So the discrimination of the foreign corporate shareholder is twofold: (1) the threshold for exemption is 25% instead of 20% and (2) the tax is payable immediately, without waiting for the redistribution.

¹⁴⁸⁸ Luxembourg is the only Member State which is included in the unofficial list of territories established by the Tax Board of Estonia, which might be regarded low tax territories. In addition, from new EU Member States Cyprus and Malta are included in this list. See section 1.4.4.

¹⁴⁸⁹ See section 4.2.2.1 where the *Lankhorst-Hohorst* case is discussed.

¹⁴⁹⁰ See Case C-294/97 (*Eurowings*), paragraphs 44-45 and Case C-422/01 (*Skandia*), paragraph 52.

¹⁴⁹¹ Case C-294/97.

¹⁴⁹² See section 4.2.2.1.

¹⁴⁹³ Paragraph 32 of the judgment.

This very significant disadvantage is also a violation of EC Treaty provisions which require equal treatment of resident and non-resident companies.

The change of the Income Tax Act has already passed the legislative procedure and will become effective on the date of Estonia's EU accession. According to this provision the double taxation will be eliminated if dividends are paid to non-resident parent company holding 20 per cent of the share capital or votes of the resident company distributing the dividends. However, the second timing disadvantage will not be eliminated.

Dividends distributed to parent companies in the other Member States

Income Tax Act provides that a resident company (including a general or limited partnership) must pay income tax on all dividends and other profit distributions.¹⁴⁹⁴ It follows that income tax must also be paid on profit distributions from Estonian subsidiaries to their parents in other Member States. From ECJ judgments in *Epson*¹⁴⁹⁵ and *Athinaiki Zithopiia*¹⁴⁹⁶ it can be concluded that this provision violates Article 5 of the Parent-Subsidiary Directive which provides for relief from withholding tax at source with respect to profit distributions from a subsidiary in one Member State to its parent in another Member State. Article 5(1) of the Directive stipulates that profits which a subsidiary distributes to its parent company shall, at least where the latter holds a minimum of 25 per cent of the capital of the subsidiary, be exempt from withholding tax in the state of residence of the subsidiary.

Does Estonian distribution tax on profits qualify under the Directive?

The concept of withholding tax has not been explicitly provided in the Directive.¹⁴⁹⁷ The ECJ has held that the nature of a tax, duty or charge must be determined by the ECJ, under Community law, according to the objective characteristics by which it is levied, irrespective of its classification under national law.¹⁴⁹⁸ The ECJ has held that the term withholding tax contained in the Parent-Subsidiary Directive is not limited to certain specific types of national taxation and it cannot be inferred from Article 2(c) of the Parent-Subsidiary Directive that other taxes having the same effect as mentioned in this provision are authorised, particularly since the final part of Article 2 refers expressly to any other tax which may be substituted for any of the taxes listed in the text of the Parent-Subsidiary Directive.¹⁴⁹⁹

The ECJ has specified the concept of withholding taxes in its judgments in *Epson* and *Athinaiki Zithopiia*.¹⁵⁰⁰ The ECJ developed in those judgments a definition of the qualifying tax based on the following criteria:¹⁵⁰¹

- Tax is paid directly to the tax authorities by the company making the distribution.¹⁵⁰²
- Tax burden increases only because the subsidiary distributes its profits.¹⁵⁰³

¹⁴⁹⁴ §50(1) of the Income Tax Act stipulates that income tax has to be paid on profit distributed as dividends or other profit distributions upon payment thereof in monetary or non-monetary form. Income tax is not charged on profit distributed by way of a bonus issue.

¹⁴⁹⁵ Case C-375/98.

¹⁴⁹⁶ Case C-294/99.

¹⁴⁹⁷ Article 7 of the Directive specifies the scope of the concept of withholding tax by stipulating that the term 'withholding tax' does not apply to an advance payment or prepayment of corporate taxes.

¹⁴⁹⁸ Joined Cases C-197/94 and C-252/94 (*Bautiaa and Société française maritime*), paragraph 39.

¹⁴⁹⁹ Article 2(c) of the Directive lists the taxes, which qualify for the benefits of the Directive. Final part of Article 2 stipulates that Directive also applies to '... any other tax which may be substituted for any of the above [listed] taxes.'

¹⁵⁰⁰ *Epson* concerned Portuguese tax and in *Athinaiki Zithopiia* Greek tax was at issue.

¹⁵⁰¹ See also Rolle (2003), p. 38.

¹⁵⁰² See Opinion of the Advocate General Alber delivered in Case C-294/99 (*Athinaiki Zithopiia*). In paragraph 32 of the opinion it is stated that '[...] The economic effect of taxation of the subsidiary is tantamount to taxation of the parent company, since the tax - as is typical for withholding taxes - is retained, and paid directly to the tax authorities, by the company making the distribution.'

- The chargeable event is the (formal or hidden) payment of dividends or of any other income from shares, the taxable amount is the income from the shares and the taxable person is the holder of the shares.¹⁵⁰⁴
- Tax levied is in direct relationship with the amount of profit distribution.

Estonian distribution tax on profits meets all those criteria. Thus, in light of the case law of the ECJ, the Estonian distribution tax on profits which an Estonian subsidiary distributes to its parent company in another Member State qualifies as a withholding tax within the meaning of Article 5(1) of the Parent Subsidiary Directive and should be abolished, at least where the parent company holds a minimum of 25 per cent of the capital of the subsidiary (this figure will be reduced to 10% as from 2009) and the shares have been held for at least two years.¹⁵⁰⁵ In course of the negotiations on Estonian Accession to the European Union, Estonia was granted a transitional period until 31 December 2008 to ensure full compliance with Article 5(1) of Parent-Subsidiary Directive. This means that Estonia can apply the distribution tax on outbound dividends at least until the beginning of 2009.

However, some commentators have questioned whether the conclusion reached by the ECJ is consistent with purpose of the Directive, expressed in the preamble.¹⁵⁰⁶ The presupposition of the directive is that first in the country of de subsidiary there is a corporation tax on the profits and the aim of the directive is not to abolish this corporation tax.

The Directive aims to make the taxation of cross-border situations as advantageous as in domestic relations: to eliminate double taxation with respect to cross-border dividend payments within European groups of companies to the same extent as is the case with respect to similar domestic payments. In accordance with the recitals to the Directive, the overall objective of the Directive is to introduce with respect to grouping together of companies of different Member States, tax rules which are neutral from the point of view of competition. However, in the *Athinaiki Zithopiia* case, the questioned Greek provision did not constitute a disadvantage for a company situated in another Member State since it was applicable to both resident and non-resident shareholders. Consequently, the provision in issue did not violate the principle of capital import neutrality.¹⁵⁰⁷ The effect of the *Athinaiki Zithopiia* judgment, therefore, is not the elimination of a (non-existent) distortion, but the creation of a preferential treatment.

The same applies in case of Estonian profit distribution tax. It appears particularly from the third recital of the preamble of the Parent Subsidiary Directive that the directive seeks to eliminate any disadvantage resulting from the fact that tax provisions governing relations between parent companies and subsidiaries of different Member States are less favourable than those applicable to relations between parent and subsidiary companies of the same

¹⁵⁰³ The ECJ held in its judgment in Case C-294/99 (*Athinaiki Zithopiia*) that there is a withholding tax, within the meaning of Article 5(1) of the Directive, where national legislation provides that, in the event of profit distribution by a subsidiary to its parent company, in order to determine the taxable profits of the subsidiary, its total net profits, must be reincorporated into the basic taxable amount, when income falling within those two categories would not be taxable on the basis of the national legislation if they remained within the subsidiary and were not distributed to the parent company.

¹⁵⁰⁴ In its judgment in *Epson*, the ECJ held that it is clear that Portuguese tax at issue is a withholding tax for which the chargeable event is the payment of dividends or of any other income from shares, that the taxable amount is the income from the shares and that the taxable person is the holder of the shares.

¹⁵⁰⁵ In course of the negotiations on Estonian Accession to the European Union, Estonia was granted a transitional period until 31 December 2008 to ensure full compliance with Article 5(1) of Parent-Subsidiary Directive.

¹⁵⁰⁶ See Rolle (2003), p. 40.

¹⁵⁰⁷ Ibid.

Member State, and thereby to facilitate the grouping together of companies at EU level.¹⁵⁰⁸ In fact, if profits distributed to companies in other Member States would be free from distribution tax, those companies would be treated more advantageously than Estonian companies if profits distributed to Estonian companies would continue to be subject to distribution tax. As Rolle (2003)¹⁵⁰⁹ concludes, the solution arising from the elimination of tax on profits distributed to companies in other Member States while domestic companies continue to be subject to tax, may generate a conflict with some of the principles laid down in the Code of Conduct as the resulting tax regime may then be regarded as potentially harmful because it seems to create advantages accorded only to non-residents which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question.¹⁵¹⁰

7.2.2.2.5 Discussion of possible developments after 2008

In light of the recent ECJ rulings, Estonian profit distribution tax qualifies as a withholding tax under the Parent-Subsidiary Directive and should be abolished in case of dividend distributions to parents in other Member States. In course of the negotiations on Estonian Accession to the European Union, Estonia was granted a transitional period until 31 December 2008 to ensure full compliance with Article 5(1) of the Parent-Subsidiary Directive. Thus, starting from 2009, Estonia probably has to introduce some changes into the income tax system if Estonian distribution tax is considered a withholding tax within the meaning of Article 5(1) of the Parent Subsidiary Directive and if Estonia does not manage to negotiate a longer transitional period or a permanent derogation. However, to negotiate a longer transitional period or a permanent derogation is probably not possible and therefore it is necessary to find another more realistic solution.

One possibility is to abolish the profit distribution tax on dividends paid to EU resident parent with 25 percent participation but continue to levy it in case of domestic profit distributions. In effect, the EU parent could repatriate profits from an Estonian subsidiary free of all Estonian tax. Foreign companies gain an advantage in Estonian market because they do not have to pay domestic dividend tax while profits distributed to Estonian resident companies are still subject to income tax. However, parent company still has to pay income tax on those profits in its resident Member State. However, if such a solution would be implemented then Estonia receives no tax income from profits gained in Estonia by the parent companies of the other Member States. Furthermore, if the country of the parent company has an exemption for participations, like the Netherlands, then those profits would escape taxation altogether. Another possibility is to abolish corporate income tax altogether and levy tax on corporate income (profits) only at the shareholder level in the form of individual income tax. There is no obvious logic in taxing companies. In a small open economy any tax on companies is simply passed on to the immobile economic factor, i.e. labour (Stevens (2002) pp. 106-107). In other words, from an economic point of view, a tax on companies only serves to distort the economy and to increase the administrative burden on businesses.¹⁵¹¹ It is possible to increase tax burden of the companies by applying some other taxes like environmental or energy taxes.

¹⁵⁰⁸ See Case C-294/99 (*Athinaiki Zithopiia*), paragraph 25 and Case C-168/01 (*Bosal*), paragraphs 22 and 28.

¹⁵⁰⁹ P.40.

¹⁵¹⁰ According to the Code of Conduct, tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the Member State in question are to be regarded as potentially harmful and therefore covered by the Code. See section 2.4.4.1.

¹⁵¹¹ However, it can also be argued that administratively it is less costly to tax companies than shareholders because the number of shareholders exceeds the number of companies.

In other hand, it can be argued that it is necessary to tax profits of companies, because countries also levy tax on the profits of an entrepreneur/individual. Another possibility is to have a profit tax notwithstanding of the legal situation of the enterprise.

The other possibility is to apply tax on the distributed profits at the moment when the profit are earned not when they are distributed. Then all the profits (both distributed and retained profits) would be taxed with the same tax rate. However, it would mean that Estonia would apply “the normal tax system” and give up its current tax system under which the tax is not applied until the profits are distributed. In the case of current company taxation system used in Estonia distributed profits are discriminated against¹⁵¹². Taxing both distributed and retained profits with the same tax rate would increase neutrality for economic decisions. The Estonian current tax system discourages distribution of dividends and discriminates in favour of retained profits against distributed profits. Different tax treatment of distributed and retained earnings can cause economic distortions because the choice of equity finance is influenced by the tax system. Discrimination of profit distribution causes bias towards re-investment of profits.

In my opinion, the last solution, namely, to apply tax on the distributed profits at the moment when the profit is earned, is the most preferable. Firstly, this solution would be the most preferred from the economic neutrality point of view. Secondly, such a solution would avoid the situation that the profits would leave Estonia untaxed and Estonia would receive no tax money from profits gained in Estonia.

7.2.2.2.6 Taxation of Inter-Company Dividends

The exemption method is applied if the resident company with the qualifying holding distributes the dividends received from another Estonian company. Tax credit system applies for dividends received from abroad. These provisions may infringe EU law constituting an obstacle to free movement of capital and freedom of establishment because they introduce different treatment for companies depending where the company paying the dividend is established.

7.2.2.2.7 Taxation of Capital Gains

Resident companies and permanent establishments of non-resident companies registered with the Estonian authorities are not subject to tax on their capital gains until the gains are distributed. Capital gains are not taxed separately, but are included into profits subject to corporate income tax upon distribution. Thus, the capital gains received by the company are not taxable as an income, but becomes subject to taxation upon distribution. Non-resident companies without a permanent establishment in Estonia are subject to tax at a rate of 26% on their capital gains derived from Estonian sources.¹⁵¹³ These provisions may infringe EU law because they introduce different treatment for resident companies and non-resident companies.

¹⁵¹² Especially if distributed to foreign shareholders who are individuals or foreign shareholders who are legal persons but whose holding is less than 25 per cent. The profits distributed to them are subject to double taxation: income tax at corporate level and at shareholder level. No personal income tax is applied on dividend income received by residents and non-resident permanent establishments.

¹⁵¹³ The sale of shares by a non-resident is subject to income tax only if the transferred holding is a holding of at least 10 per cent in a company of whose property, according to the balance sheet as of the last day of the preceding financial year, more than 75 per cent is made up of immovables or structures as movables, which are located in Estonia.

7.2.2.2.8 Taxation of mergers

The provisions of the Merger Directive have to be included in the Income Tax Act of Estonia upon accession. The Merger Directive obliges Member States to adapt their domestic legislation in such a way that the tax neutrality of restructuring operations covered by the Directive is guaranteed. The Merger Directive applies to mergers, divisions, transfers of assets and exchanges of shares in which companies from two or more Member States are involved. The Directive introduces a system of deferral of the tax on the capital gains that arise in connection with cross-border mergers.¹⁵¹⁴

In general, the Estonian Income Tax Act already is in line with the requirements of the Merger Directive. As a general rule merger, division or exchange of shares does not give rise to taxation of capital gains.

Resident companies and permanent establishments of non-resident companies registered with the Estonian authorities are not subject to tax on their capital gains until the gains are distributed. Non-resident companies without a permanent establishment in Estonia are subject to tax at a rate of 26% on their capital gains derived from Estonian sources. The tax only applies in case of realized capital gains, the latent gains are not taxed. For example, the sale of shares is subject to income tax (26%) if shares are sold by a individual or a non-resident¹⁵¹⁵. If a resident company sells the shares then the transaction is not subject to income tax.

Under the Estonian Income Tax Act, not disposal of the assets but payment of dividends is the event triggering taxation. Thus, there is no capital gains tax due as a result of the mergers, divisions, transfers of assets and exchanges of shares if these transactions do not involve any immediate profit distribution.

Under the Estonian Income Tax Act only the non-business costs of a company and the distribution of the profits (including hidden profit distributions) are subject to the Estonian income tax. If the property belonging to a non-resident and used by its Estonian permanent establishment is taken out of Estonia in the course of a cross-border merger, division, or transfer of assets, then the transfer is considered a distribution of profit and taxed as dividends.¹⁵¹⁶

The tax is also applied on outgoing payments if no goods or services are received in return as well as profit transfers. It follows that the transfer of assets in the course of a merger, division or exchange of shares does not trigger immediate tax consequences and does not contradict the principles of the Merger Directive. However, in order to guarantee that the Estonian Income Tax Act is in line with the principle of the Merger Directive that provides that taxation of the capital gain is deferred until actual disposal, it is recommendable to introduce the provision in the Estonian law which stipulates that the capital gain derived as a result of a merger, division or exchange of shares is not taxed until actual disposal of the assets.

However, at the moment it is not necessary to change the Estonian legislation because the Estonian corporate legislation does not provide for possibility of transactions prescribed in the Directive (namely, cross-border mergers, divisions, transfers of assets or exchanges of shares). The reorganization of companies is currently possible through the liquidation or the sale of assets.

¹⁵¹⁴ See Chapter 4 for more elaborate discussion of the Merger Directive.

¹⁵¹⁵ The sale of shares by a non-resident is subject to income tax only if the transferred holding is a holding of at least 10 per cent in a company of whose property, according to the balance sheet as of the last day of the preceding financial year, more than 75 per cent is made up of immovables or structures as movables, which are located in Estonia

¹⁵¹⁶ Obviously, the rule only applies if the property is taken out without sufficient explanation showing its purpose.

7.2.2.2.9 The Interest and Royalties Directive

The Interest and Royalties Directive (2003/49/EC) entered into force from 1 January 2004 and Estonia is required to implement it upon EU accession (from 1 May 2004). Estonia has to include the principles of the Directive into its domestic law. Under the current Income Tax Act, the interest and royalty payments made to associated companies in other EU Member States are subject to Estonian-source tax. However as from 1 May 2004, the provision has to be introduced in to the Estonian Income Tax Act under which interest and royalty payments to associated companies in other EU Member States would not be subject to the Estonian source tax provided the holding requirements are met (as discussed below). Attention needs to be paid to the various exclusions and qualifying conditions imposed. A careful review of the Estonian legislation implementing the Directive is required as, in a number of instances, provisions are to be applied at the discretion of an individual Member State.

The interest and royalty payments by the Estonian company to its parent company or a subsidiary resident in other EU Member State have to be tax exempt if the companies qualify for the benefits of the Directive. The Directive only applies in case of payments between associated companies. In order to be considered as an associated company, the paying company or a permanent establishment must have a direct minimum holding of 25 per cent in the capital or the voting rights in the receiving company, or vice versa, or a third company must have a direct minimum holding of 25 per cent in the capital or the voting rights of both the paying and the receiving company. In respect of the minimum participation requirement, it is important to bear in mind that Directive only specifies minimum standard, Estonia may also give the benefits of the Directive if the holding is less than 25%.

The holding requirement would be satisfied if either (1) the receiving or paying company has a minimum holding of 25% in the capital of the second company, or (2) if a third company has a minimum holding of 25% in the capital of both companies.

The Directive applies to companies, which take one of the forms listed in the Annex to the Directive. In this respect, a list of the companies covered for Estonia needs to be included in the Annex of the Directive. One may assume that the scope of the Directive will cover the same companies as those covered by the Parent-Subsidiary Directive and the Merger Directive, which are mentioned in the Annex II.9 of the Accession Treaty. In line with the general principle of EU law, directives only ever express minimum standard. Member States are free to extend the tax-free treatment of profit distributions to the entities other than those included in the list.

Another potential limitation to the application of the Directive is that a Member State is given the option of not applying the Directive where the associated companies condition has not been met for a period of two years prior to the interest/royalty payment. It follows that the tax-free treatment of the payments has to be provided if a minimum two-year holding period stipulated in the Directive has been satisfied. Estonia may also give the benefits of the Directive if the associated companies condition has been met for a shorter than a two-year holding period. The shorter holding period is not specifically provided for in the Directive, but it is justified on the basis that EC Directives only ever specify minimum standards.

The Directive specifies a number of other instances where Estonia is given the option of not applying the withholding exemption to the interest/royalty payments. These include cases where the payments are re-characterised as distributions and payments made on convertible debt.

There is also an exclusion in respect of the non-arm's length arrangements. It means that Estonia may refuse to apply the benefits of the Directive if the payments are not made at the arm's length amount. Where a payment exceeds that which would have been paid between independent parties, Estonia is not obliged to apply the nil withholding rate to the excess element of the payment.

Besides the special relationship provision referred to above, the Directive also includes specific fraud and abuse provisions enabling Estonia to withdraw the benefits of the Directive where the principal motive, or one of the principal motives, is tax evasion or tax avoidance. Estonia is not precluded from applying domestic legislation or agreement based provisions to prevent such abuse.

7.2.2.2.10 Arbitration Convention

Currently, the Arbitration Convention is not a part of the Estonian legal system. There seems to be no obstacles for Estonia of signing this Convention and Estonia probably is expected to sign this Convention after joining the EU.

7.2.2.2.11 Capital Duty Directive

The Capital Duty Directive¹⁵¹⁷ requires to harmonize structures and rates of capital duty. Article 4 of the Directive provides that certain transactions must and others may be subject to capital duty. Art. 4(1) reads "The following transactions shall be subject to capital duty: [...]"¹⁵¹⁸. Thus, the wording 'shall be [...]' seems to indicate that application of certain transactions to capital duty is mandatory and that Member States are obliged to levy capital duty on the transactions mentioned in this paragraph. However, according to the interpretation of several Member States¹⁵¹⁹, the Capital Duty Directive allows to apply lower level of taxation than 1 % stipulated by the Directive. Moreover, according to the Directive 85/303/EEC¹⁵²⁰ Member States are free to exempt the contributions of capital altogether since 1 January 1985.

¹⁵¹⁷ Council Directive 69/335/EEC of 17 July 1969 concerning indirect taxes on the raising of capital (OJ L 249, 3.10.1969, p. 25)

¹⁵¹⁸ Transactions compulsorily subject to capital duty under Article 4(1) include the following:

- a. the formation of a capital company;
- b. the conversion into a capital company of a company, firm, association or legal person which is not a capital company;
- c. an increase in the capital of a capital company by contribution of assets of any kind;
- d. an increase in the assets of a capital company by contribution of assets of any kind, in consideration, not of shares in the capital or assets of the company, but of rights of the same kind as those of members, such as voting rights, a share in the profits or a share in the surplus upon liquidation;
- e. the transfer from a third country to a Member State of the effective centre of management of a company, firm, association or legal person, whose registered office is in a third country and which is considered in that Member State, for the purposes of charging capital duty, as a capital company;
- f. the transfer from a third country to a Member State of the registered office of a company, firm, association or legal person, whose effective centre of management is in a third country and which is considered in that Member State, for the purposes of charging capital duty, as a capital company;
- g. the transfer from a Member State to another Member State of the effective centre of management of a company, firm, association or legal person which is considered in the latter Member State, for the purposes of charging capital duty, as a capital company, but is not so considered in the other Member State;
- h. the transfer from a Member State to another Member State of the registered office of a company, firm, association or legal person, whose effective centre of management is in a third country and which is considered in the latter Member State, for the purposes of charging capital duty, as a capital company, but is not so considered in the other Member State.

¹⁵¹⁹ For example, the Great Britain who does not levy taxes on raising capital and Germany who abolished its capital duty recently.

¹⁵²⁰ Council Directive 85/303/EEC of 10 June 1985 amending Directive 69/335/EEC concerning indirect taxes on the raising of capital, OJ L 156, 15/06/198, pp. 23 – 24.

7.2.2.2.12 Code of Conduct

The EU has adopted a Code of Conduct designed to inhibit “harmful” competition between national tax systems. Estonia’s company tax system appears fully consistent with the Code, which is summarized in section 2.4.4.1. Estonia’s company tax is transparent, with tax liabilities determined under law, and not by administrative discretion. It does not offer special incentives for non-residents, or transactions with non-residents. It has no special arrangements ring-fenced from the local market. It follows internationally accepted OECD principles.

7.2.2.2.13 Fiscal State Aid

Estonian income tax provisions are in line with EU fiscal state aid rules. Estonian tax provisions do not provide in favour of selected undertakings an exception to the application of the general tax system. Estonian Income Tax Act does not provide for any measure intended partially or wholly to exempt firms in a particular sector from the charges arising from the normal application of the general tax system without there being any justification for this exemption on the basis of the nature or general scheme of this system. Estonian tax measures are not limited to certain geographical regions, or to certain sectors of economic activity.

Conclusion

The tax legislation of Estonia is reasonably close to that in the EU. However, in some key aspects there are wide differences. The most significant differences are in the field of income taxation. In the field of VAT the Estonian legislation is in large extent harmonized with the obligatory body of the EU law (most importantly (the Sixth Directive).

8 Main findings of the research

8.1 Tax policy of Estonia (Chapter 1)

8.1.1 VAT

Estonia introduced the VAT in 1992. Chapter 1 examines the main provisions of the current VAT law, which is effective from April 1, 2003. The main features of the Estonian VAT system, the concepts used for definition of the tax base as well as tax rates are examined. The Estonian VAT act follows the Sixth Directive, however, it is not in complete alignment with EU rules. However, in important aspects the current system of VAT is identical to the common VAT system used in the European Community. The main principles of the Estonian system are exactly in line with the system used in the EU.

Estonia applies a standard rate of 18 percent on most goods and services. In addition, a reduced rate of 5 percent is applied on selected goods and services. Furthermore, a zero rate applies to certain goods and services.

8.1.2 Income Tax

In 2000, Estonia introduced a new system of corporate taxation. The most important difference with the previous system and the conventional system is that the object of taxation has been changed. Resident legal persons and non-residents with a permanent establishment in Estonia do not pay tax on earned profits but on distributed profits. Retained profits are exempt from tax. Income tax is levied on all profit distributions.

Issues of double taxation

Income tax is not levied (again) at shareholder level on dividends received by resident natural or legal persons. Consequently, double taxation of those dividends is avoided. Double taxation is not avoided in the case of dividends paid to non-resident individuals who have to pay income tax on dividends received from resident companies. Double taxation is also not avoided in the case of dividends paid to non-resident legal persons if they hold less than 25 per cent of the share capital or votes of the resident company distributing the dividends. However, double taxation is avoided in the case of dividends paid to non-resident legal persons if they hold at least 25 per cent of the share capital or votes. Dividends distributed to such legal person, except a legal person located in a low tax rate territory, are not subject to income tax at shareholder level.

On efficiency grounds decisions regarding an investment, its financing or its location should not be driven by tax considerations. If the tax burdens on interest, distributed and retained profits differ, taxation affects the way in which investment is financed. Different tax treatment of distributed and retained earnings causes economic distortions. Although the intention of the Income Tax Act is to promote investments, it discriminates against distributed profits, thus causing a bias towards retaining profits. Furthermore, profits distributed to non-resident individuals or non-resident portfolio investors are taxed at a higher rate than profits distributed to residents, to non-resident legal persons' permanent establishments registered in Estonia or to non-resident legal persons whose holding is at least 25 per cent, which distorts allocation of resources and thus implies loss of efficiency.

Additional distortions can be caused by the fact that interest is undertaxed under the Estonian corporate tax system because interest payments are in many cases exempt from income tax or deductible from the corporate income tax base. Furthermore, repayment of loan is not subject to income tax while the payment of dividends or repayment of capital is subject to income tax. This favours investments financed by debt over investments financed by equity.

Main findings of the research

Altogether, we can conclude that the Estonian tax system favours investments financed by retained earnings and debt over investments financed by new equity.

The Estonian income tax system discriminates against:

- Foreign shareholders who are individuals. The profits distributed to them are subject to an income withholding tax of 26 percent. Thus, there is a double taxation: a corporate income tax of 26/74 and a withholding tax of 26 percent.
- Foreign shareholders who are legal persons but whose holding is less than 25 per cent. They are subject to income tax twice: at corporate level and at shareholder level. No withholding tax or other income tax is applied on dividend income received by resident legal persons.
- Resident individuals. They have to pay income tax of 26 per cent on dividends received from non-residents while resident legal persons do not have to pay tax on such dividends.

Furthermore, the current Estonian system of dividend taxation differentiates Estonian and foreign parent companies in a sense that it provides different minimum shareholding rate for exclusion of double taxation of dividends. When dividends are paid to the Estonian parent company holding 20% of shares the double taxation is eliminated, while the same applies to foreign legal persons starting from shareholding rate of 25%. In case of the domestic dividends, the double taxation occurs when the dividends are redistributed by the receiver. In case of the foreign dividends, the double taxation occurs immediately at the moment of the distribution. It follows that the discrimination of the foreign corporate shareholder is two-fold: (1) the threshold for exemption is 25% instead of 20% and (2) the tax is payable immediately, without waiting for the distribution.

Avoidance of international double taxation

Estonia is using an ordinary credit method to prevent double taxation of income received from abroad. According to this method all foreign source income is taxed in residence country, but a taxpayer may deduct the tax paid on foreign source income from domestic tax liability. As a result, the residence country levies the difference between tax levels of a residence country and a source country. The credit method is applied asymmetrically: no refund is provided if tax level is higher in a foreign country than in Estonia.

International neutrality issues

One important issue of tax policy is the problem of designing a suitably tax-neutral jurisdiction for the company who is operating in international scale. Similar investments should not face markedly different effective levels of taxation purely because of their country location. Differences in the tax levels may imply welfare costs because economic activity does not take place in the lowest (pre-tax) cost location by the lowest cost producers. In the context of Estonia's integration to the EU, the questions of neutrality can be raised by Member States. If Estonian tax system and effective tax level differ from those applied in the EU, the current Member States can put pressure to Estonia to change its policy. One example is Ireland, who has considerably lower statutory level of corporate taxation than other Member States and this issue has been raised often at the EU level.

The Commission concludes in its recent study on company taxation¹⁵²¹ that the potential distortions resulting from 15 different tax systems within the EU are high. In addition, according to the findings by the Commission's study, the existence within the Internal Market of 15 separate tax jurisdictions is the main cause of remaining tax obstacles to cross-border economic activity. Since, the Commission together with the ECJ is one of the important actors

¹⁵²¹ Commission (2001c).

designing EU tax policy, the corporate tax system of Estonia may become under close scrutiny by the EU institutions.

To remove the tax obstacles to cross-border economic activity that have been identified by the Commission's study it proposes a solution under which companies can operate one consolidated tax base for their EU wide activities.¹⁵²² According to the Commission this would not affect very much the fiscal autonomy of the Member States since company tax rates continue to be set by Member States. If this solution would be adopted, Estonia may be able to continue applying its current system of corporate taxation under which reinvested profits are taxed at a zero rate.

8.2 Tax co-ordination and harmonization in the EU (Chapter 2)

The European Union does not have a common policy for taxation, its policy is one of co-ordination and harmonization of national tax policies as much as it is necessary for the functioning of the internal market. Although Member States are in principle free to determine their own national tax systems, this freedom is subject to the overriding goals of the founding treaties of the European Union, which lay out the objective to create a single internal market. For that purpose Member States aim step by step to abolish the barriers to free movement of people, goods, services and capital. Discriminatory taxes can create obstacles to the establishment of a single market and the Treaty establishing the European Community stipulates that discriminatory taxes should be abolished.¹⁵²³

Not only discriminatory tax provisions can impose restrictions on free movement in the Internal Market, but also non-discriminatory provisions, if they lead to disadvantageous treatment of people, goods or investments from other Member States. Sometimes restrictions on free movement can arise from differences in national tax systems or from the absence of harmonization of tax laws of the Member States.¹⁵²⁴ Therefore, some harmonization of tax rules is necessary. Tax harmonization can be achieved either spontaneously (through market forces), through positive action at EU level (implementation of common policies, co-ordination of policies, approximation of legislation, etc.) or through negative action by the ECJ, namely, through prohibitions of certain types of conduct of the Member States that are in breach of the EU rules. The case law of the ECJ has direct impact on the tax systems of the Member States by prohibiting certain national tax rules. It also has indirect impact on the tax systems because Member States that have similar tax rules as those prohibited by ECJ decisions have to change these rules. Rulings of the ECJ also have certain anticipatory effects because Member States have to make necessary adjustments to their tax policies to accommodate expected trends in the case law of the ECJ.

Major steps toward harmonization have been achieved in the field of indirect taxation. Harmonization in the field of direct taxes has remained limited. The influence of EU law on income tax legislation of the Member States comes mainly through the negative constraints

¹⁵²² See section 2.4.5 where the Commission's study is discussed in greater detail.

¹⁵²³ Article 90 of the Treaty states that no Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products. The same article also states that no Member State shall impose on the products of other Member States any internal taxation of such a nature as to afford indirect protection to other products.

¹⁵²⁴ For example, in the case of cross-border investments income is often taxed both in the country of subsidiary as well as in the country of the parent company. Resulting double taxation may pose barriers to free movement in the Internal Market. In addition, separate accounting of taxable profits on arm's length basis may involve double taxation if the transfer prices used in one state are not accepted by another state. Another impediment to free movement is the restricted possibility of the taking into account of incurred cross-border losses of a foreign branch or a subsidiary or a permanent establishment.

imposed by the ECJ, namely through the prohibitions of tax restrictions against residents of and income from other Member States. The ECJ and the European Commission have been the most important institutions pushing towards more coordinated rules of taxation in order to ensure that tax barriers do not restrict free movement in the Internal Market.

8.3 Harmonization in the field of VAT (Chapter 3)

The adoption of the European VAT system diminished the tax autonomy of the Member States. The VAT Directives constrain the room for national policies in the field of general consumption taxes. A common structure for a turnover tax has been established by the introduction of VAT, which is the only tax system that Member States are allowed to use. Not only the rules determining the tax base have been harmonised to a large extent, but also the procedures for collection and administration (i.e. VAT Information Exchange System (VIES), VAT identification numbers, and multiple registration of companies for VAT purposes). However, Member States are still free to set their own VAT rates. This freedom is restricted by the Sixth Directive which has established statutory minimum rates (the standard rate must not be less than 15 percent and the reduced rate must not be less than 5 percent) and some more restrictions for rate setting by Member States (see section 3.3). Maximum rates have not been established, however, Member States' freedom to set maximum rates is constrained by competition from other tax jurisdictions.

Although much progress has been achieved in tax base harmonization, there are still major differences in the tax base across Member States. Differences in tax bases result from various derogations and exemptions from the Sixth Directive. Certain supplies of goods or services may be exempt in one country but not in another and some countries make substantial use of zero-rating. Furthermore, the threshold below which small businesses are exempt from tax, or enjoy special privileges, varies from country to country, as does the treatment of farmers. Differences in tax bases also result from the fact that VAT is collected by national tax administrations with different practices and compliance ratios.

The implementation of the definitive VAT system

The current VAT system applied in the EU is a transitional system. It is widely recognized that current transitional arrangements have a number of shortcomings, because they are complicated, susceptible to fraud and out of date. The Commission proposed a work programme involving a stage-by-stage movement to the definitive clearing house system. However, the implementation of the proposed definitive system to replace the transitional system is not likely to take place in the near future. Member States are currently unwilling to accept the changes needed for a definitive system to be implemented.¹⁵²⁵ Fifteen Member States need to agree on approximation of VAT rates and legislation as well as on a compensation mechanism to ensure that revenues continue to accrue to the countries in which consumption takes place. However, the move to a definitive system requires a virtually unified system of VAT as well as more harmonised VAT rates. Member States are not able to reach a unanimous agreement upon such a unified system. It is unlikely that any significant progress towards a definitive system will be made in the near future. New Member States should therefore implement the present destination-based VAT system for intra-community trade.

¹⁵²⁵ Bolkestein (2000), p. 403.

8.4 Harmonization in the field of personal income and corporate taxes (Chapter 4)

The picture in the field of income taxation is very different from that in the area of value added taxation. Apart from few legislative acts, the income tax systems of the Member States have not been affected by the introduction of the Single Market. Although the harmonization has been rather limited, some steps have been taken to harmonise the corporate taxes. As the first concrete step in the field of direct taxation, the Council of Ministers adopted in 1977 the Directive on mutual assistance by tax administrations of the Member States. This directive as well as two directives adopted in 1990 is based on Article 94 of the EC Treaty. One of the directives adopted in 1990 aims at elimination of double taxation of dividends in the case of parent companies and subsidiaries of different Member States. The other directive provides for any capital gains arising from a merger, or a similar operation, to be taxed only upon realisation. In addition, the Arbitration Convention, designed to eliminate the double taxation in connection with the transfer pricing of associated enterprises was adopted in 1990. Furthermore, after the adoption of three legislative acts in 1990, the Commission has proposed several corporate tax directives. In June 2003, proposal on a common system of taxation applicable to cross-border flows of interest and royalty payments within groups of companies was adopted as the Directive¹⁵²⁶. The proposal on the cross-border off-setting of losses is still pending.

The most important progress in the harmonization of income tax systems of the Member States has been achieved by the decisions of the ECJ. Such case law has important impact on the design of the Member States' tax rules. The basis of the ECJ's case law has not been any provision in the EC Treaty on income taxation, as there are very few such provisions, but the provisions on non-discrimination and on the four fundamental economic freedoms in the founding Treaties. The four freedoms encompass two principles: a right of cross-border circulation (market access and exit) and a prohibition of discrimination on grounds of nationality of persons or origin of goods (market equality).

In implementing the policy goal to achieve free movement of goods, persons, services and capital within the Internal Market, the ECJ has interpreted the free movement provisions broadly as prohibiting not only distinctions based on nationality or origin (open, direct or overt discrimination), but also distinctions on the basis of other criteria resulting in disadvantages for foreign products or factors (indirect or covert discrimination). For example, different treatment on the basis of residency can cause covert discrimination if it results in different tax treatment of foreign nationals. The ECJ has also interpreted the four freedoms as forbidding the enactment of national legislative provisions that impede or render unattractive the exercise of any such freedoms, even if such rules apply without regard to nationality. Thus, Member States are not allowed to introduce measures, including tax provisions, which are discriminatory or which could somehow impede or restrict residents of another Member State in making use of the four freedoms. However, even if foreign products or factors are treated disadvantageously restricting their free movement, there may be a justification for it either because an exception is foreseen by the Treaty or because the measure may be necessary in the overriding public interest and is proportional.

The scope of application of Community law (section 4.2.1)

As a general rule, Community law only benefits European citizens and companies who engage in economic activity that crosses Member States' borders. An individual or a company

¹⁵²⁶ The Interest and Royalties Directive is due to enter into force on 1 January 2004.

Main findings of the research

can claim protection under the Treaty if encountering a discriminatory or restrictive measure when making use of one of the four freedoms.

Case law prohibiting discrimination of non-residents and restrictions to free movement (section 4.2.2)

The ECJ has generated a large body of case law since 1986 on the compatibility of national income tax laws with the EC Treaty. In its case law¹⁵²⁷ related to differential taxation of residents and non-residents, the ECJ has ruled that non-residents must be allowed to enjoy the same tax benefits as residents where, apart from the residence criterion, they are in an identical situation for tax purposes. It follows from the ECJ's tax decisions¹⁵²⁸ that permanent establishments of persons from other Member States have to be taxed according to the same rules as apply to residents. Tax rules that disadvantage foreign nationals are potentially in breach of Community law.

The ECJ has ruled that not only overt discrimination by reason of nationality but also all covert forms of discrimination are prohibited.¹⁵²⁹ International tax law prohibits only direct discrimination. Under the OECD model tax convention it is assumed that a non-resident is in a different position and can be subject to different treatment unless specifically forbidden by a non-discrimination rule of Article 24.

Justifications for national tax measures that violate Community law (section 4.2.3)

The national laws must yield to Community law and discriminatory tax measures as well as national provisions that restrict free movement within the Internal Market are prohibited. The ECJ has held that a discriminatory measure is compatible with Community law only if it is justified by acceptable reasons. A measure restricting free movement may be justified on the basis of two different categories of grounds, firstly, if it falls within the scope of one of the derogations expressly provided by the Treaty, or secondly, if it can be justified on other grounds which are not provided for by the EC Treaty but which have been recognised by the ECJ and accepted by it as overriding requirements in the general interest. A restriction on the fundamental freedoms can only be justified if (1) it pursues a legitimate aim compatible with EC Treaty; (2) is justified by pressing reasons of public interest; (3) is of such a nature as to ensure achievement of the aim in question; and (4) is proportional.¹⁵³⁰ The ECJ applies a proportionality test to check whether the restriction on Treaty freedom is proportionate to the overriding reason justifying this restriction.¹⁵³¹ The ECJ examines whether less restrictive measure could have been devised to achieve the legitimate public aims admitted as justification.

From the settled case law of the ECJ it can be concluded that the need to safeguard the cohesion of a tax system,¹⁵³² the effectiveness of fiscal supervision¹⁵³³, and the prevention of tax avoidance¹⁵³⁴ constitute overriding requirements of general interest capable of justifying a restriction on the fundamental freedoms guaranteed by the Treaty. The justification that a tax

¹⁵²⁷ Case C-279/93 (*Schumacker*) (paragraphs 36-38).

¹⁵²⁸ Case C-270/83 (*Avoir fiscal*), Case C-118/96 (*SAFIR*), and Case C-307/97 (*Saint-Gobain*).

¹⁵²⁹ In *Sotgiu*, the ECJ first interpreted the Treaty as prohibiting also covert discrimination. See Case C-152/73.

¹⁵³⁰ See Case C-250/95 (*Futura*), paragraph 26; Case C-35/98 (*Verkooijen*), paragraph 43; Case C-324/00 (*Lankhorst-Hohorst*), paragraph 33.

¹⁵³¹ Martin (2003), p. 131.

¹⁵³² Case C-204/90 (*Bachmann*), paragraphs 21-28, Case C-300/90 (*Commission v Kingdom of Belgium*) and Case C-136/00 (*Danner*), paragraph 36.

¹⁵³³ Case C-250/95 (*Futura*) (paragraph 31) and Case C-254/97 (*Baxter and Others*), paragraph 18.

¹⁵³⁴ Case C-264/96 (*ICI*), paragraph 26, Case C-324/00 (*Lankhorst-Hohorst*), paragraph 37, C-410/98 (*Metallgesellschaft*), paragraph 57, and Case C-436/00 (*X and Y*), paragraphs 42-43 and 61-62.

measure is necessary for protecting the cohesion of a Member State's national tax system was accepted by the ECJ only in the cases *Commission v Belgium* and *Bachmann v Belgium*. The effectiveness of fiscal supervision only constituted a justification accepted by the ECJ in the *Futura* case. Prevention of abuse has not actually been able to save restrictive national tax measures brought before the ECJ but has been recognized *in abstracto* in *ICI* and *Lankorst-Hohorst*. It may be inferred from those judgments by the ECJ that the Court may in principle accept anti-abuse measures that infringe EU law but only if the legislation at issue has the specific purpose of preventing wholly artificial arrangements designed to circumvent domestic tax rules.¹⁵³⁵

8.5 Economic effects of tax competition and harmonization (Chapter 5)

The following section outlines the economic effects of tax competition as well as the impact of taxation on economic growth. In addition, the economic effects of tax harmonization are summarized.

Negative effects of tax competition

Tax competition between states to attract investments and capital might lead to a sub-optimal level of public services, erosion of tax bases, undesired changes in tax structures and an inefficient allocation of resources.

Sub-optimal level of public services

It has been argued that tax competition can lead to the situation that tax revenues only cover the expenditures for necessary infrastructure and state services but not for the redistribution of income. Consequently, tax competition may erode the welfare states of the European Union. On the other hand, it has been pointed out that those who oppose structural adjustments of European welfare states sometimes use this argumentation.

Erosion of tax bases

If capital moves from countries with higher taxes to those with lower taxes, it might decrease the total tax revenue available for public spending. Lowering the tax level might be in the interest of one country because it may gain tax revenues by attracting investment and mobile capital. However, it might be inefficient from an international point of view, because the total amount of tax revenue could drop. Also, it is argued that it might be unfair from the point of international equity, because one country gains at the expense of other countries that lose part of their tax base if capital moves out.

Empirical data, however, suggests that tax competition has not led to smaller tax burdens (see Chapters 5 and 6 about trends in taxation). In fact, EU tax burden has increased by 5.9 percentage points between 1980 and 2000. Tax level is much higher in the EU than in the US, Japan, and also in the other OECD countries (see Chapter 5). Tax burden as a percentage of GDP was 29.6 per cent in the US and 27.1 per cent in Japan in 2000 while the EU average for 2000 was 41.6 per cent.

Undesired change in tax structure

It has also been argued that tax competition forces countries to have different tax structures that they would otherwise prefer to have. If countries compete for mobile tax bases it may lead to a 'tax race to the bottom', which could result even in total disappearance of tax on capital. On the other hand the tax burden might shift to less mobile sources of income, which

¹⁵³⁵ See *ICI*, paragraph 26 and *Lankorst-Hohorst*, paragraph 37.

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are easier to tax. In this way tax competition can lead to inequality in tax treatment between mobile and less mobile factors. The fairness and acceptability of the tax laws of the Member States could be jeopardised because the capacity of the Member States to tax income from capital on the basis of ability to pay is undermined.

Capital movements have been liberalised in Europe and, consequently, capital (especially financial capital) is very mobile. In contrast, labour is far less mobile in Europe (because of language and cultural barriers, and also, differences in benefit systems as well as taxation with regard to pensions and annuities, labour regulations, etc). Because some tax bases (i.e. capital) are much more mobile than others, tax burdens on them decrease at the expense of less mobile tax bases (labour, consumption, land, and real estate). It is argued that rising effective tax rates on labour income indicate that governments have tried to shift the tax burden towards more immobile factors of production. Furthermore, it has been argued that high taxes on labour have a negative impact on employment.

Simple theoretical models predict that tax competition between governments will result in diminution of source-based corporation taxes towards zero. Gordon (1986) and Razin and Sadka (1991) projected that capital income taxes will vanish altogether in small open economies faced with perfect capital mobility, given that residence countries cannot enforce taxes on foreign source capital income. Economic models show that it is actually better not to tax capital at all since it simply leads to capital flight. It is especially relevant in case of taxation of highly mobile capital. Frenkel, Razin and Sadka (1991) show that zero taxation of capital is optimal, given the set of available tax instruments, when two small countries can co-ordinate their tax policies but capital can flow without costs to tax havens in the rest of the world and escape residence taxation. According to the Ramsey rule, it is recommended to tax immobile factors more heavily, and mobile factors less heavily because taxes imposed on the most mobile factors are the most distortionary.

Distortion in the allocation of resources

Tax competition can lead to situations, in which resource allocation is driven by tax minimisation rather than comparative economic advantages. That will lead to welfare loss. It is argued that tax differences may cause distortions in the capital market because capital moves to the country with a lowest tax level instead of the most efficient use. In addition, different VAT rates may lead to trade diversion and, consequently, to welfare loss.

Differences in VAT rates may cause cross border purchases by residents of high tax countries. As a result, investment decisions are affected in favour of low tax countries. Cross-border shopping might contribute to inefficient allocation of resources, and also erode the tax base of countries with high consumption taxes. Cross border shopping can also create welfare loss caused by transaction costs (e.g. transportation costs and loss of time).

It is argued that VAT rate harmonization is necessary because otherwise tax competition can cause inefficiently low tax rates. Bracewell-Milnes (1999) criticises this opinion by drawing the analogy with a supermarket competing with its rivals and trying to attract geographically mobile customers. The promotional activities of this store might also be accompanied by a dead-weight loss, which is considered to be normal part of its business.

With the introduction of EMU, which has removed some more impediments to the free movement of capital (like exchange risks and transaction costs), taxation becomes an even more important factor in determining the allocation of resources. If Member States have no national monetary policy they might use taxation to achieve competitive advantages for their producers. It has been argued that it can intensify tax competition, create additional economic distortions and cause erosion of tax revenues. According to the Commission, the

launch of the euro has changed the position of several Member States who see a necessity for more tax co-ordination in the field of direct taxes.^{1536 1537}

Positive effects of tax competition

Proponents of tax competition consider it a good disciplinary mechanism to avoid expansion of the government sector to a size bigger than the electorate prefers. Tax competition puts pressure on governments to reduce their tax levels and to raise the efficiency of the public sector. It forces governments to provide better public services for less tax revenues.

Corporate tax rate harmonization and economic efficiency

Simulations with applied general equilibrium models suggest that the gain of EU tax rate harmonization is between virtually zero and 2% of GDP. This gain is, however, unequally distributed. First, large and high-tax countries typically gain more than small and low-tax countries. Second, the gains from tax rate harmonization are likely to be unequally distributed over poor and rich residents within countries. For instance, in the TAXCOM model, the poor gain while the rich lose.

According to Sørensen (2000) corporate tax rate harmonization implies an increase in tax level, a decline in output and private capital stock as well as a substantial increase in redistribution. Therefore, the desirability of tax rate harmonization depends on social preferences as it will not be accompanied by economic growth. Furthermore, the analysis assumes that all additional government revenue is spent efficiently. However, the government could also spend the additional revenue in a wasteful way. This threat of inefficient government spending is especially relevant in the context of enlargement, since corruption is higher in accession countries than in current Member States. If tax co-ordination leads to higher tax level and government spending, it can cause increased welfare losses.

Diversity between the states

Results of research show that small countries set relatively low effective tax rates, compared to large countries.¹⁵³⁸ Theoretically, small countries should be less motivated to co-ordinate capital taxes than larger countries if it leads to higher tax levels, because small countries face a higher elasticity of capital supply from the world capital market. In addition, it is argued that it is optimal for smaller countries to have lower taxes and for bigger countries to have higher taxes because the large countries have a fiscal advantage over the small ones, namely the size of their domestic markets.¹⁵³⁹ Therefore, they can impose higher taxes and still remain competitive. Also, different taxes might be optimal for countries with a different economic structure or development level or national preferences toward redistribution.

The practice of tax harmonization in the EU demonstrates that tax rates are corrected upwards rather than downwards (examples are the establishment of minimum VAT rates, minimum excise rates for tobacco products, alcohol beverages and mineral oils, also several proposals to establish minimum rates for corporate taxes by the Commission (e.g. Commission (1992))). No maximum levels of taxation have been established in the European Union so far. Although the Commission states in its work program¹⁵⁴⁰ that common VAT rate

¹⁵³⁶ See Monti (1998), pp. 2-3.

¹⁵³⁷ On the other hand, if EU Member States have lost ability to use independent monetary policy and important constraints are imposed to fiscal policy by Stability and Growth Pact, the sovereignty in tax policy making can be necessary for states to pursue aims of growth, stabilization, structural adjustment or regional development.

¹⁵³⁸ This conclusion is founded on an analysis of effective tax rates on the basis of a micro data set. See Gorter and de Mooij (2001).

¹⁵³⁹ Ellis (1999).

¹⁵⁴⁰ Commission (1996b).

should be lower than the present EU average rate, it might be politically difficult to attain such an agreement. One reason is that it is always difficult to decrease public expenditures from the existing level to a lower level. In addition, the Stability and Growth Pact sets strict limits for budget deficits and consequently restricts the government's fiscal policy choices. Therefore, harmonization at a lower tax level might not be politically feasible. At the same time, tax harmonization at too high levels could result in tax base erosion because mobile factors will move to countries outside the EU.¹⁵⁴¹

In sum, a major problem with tax rate harmonization in the EU is that it might lead to higher tax levels and, consequently, to a loss of growth potential. Also, it might strengthen the position of inefficient governments and public sectors considering tax harmonization a good way to protect their high-tax regimes from tax competition from other EU jurisdictions. The increased mobility of capital throughout the world means that if taxes in the EU were harmonised at relatively high levels, it could result in the flight of capital to countries outside the EU. This may lead to a loss of competitiveness vis-à-vis other countries (e.g. US, Japan, other OECD countries). Furthermore, it is difficult to co-ordinate while maintaining the adequate level of diversity between the states. Diversity between Member States will further increase after enlargement of the EU.

8.6 Trends in EU taxation (Chapter 6)

Developments in tax structures

Statistical data about developments in tax structures do not provide evidence of tax competition regarding mobile tax bases which should lead to a decrease in the relative share of corporate taxes and an increase in the share of taxes on personal income and on goods and services. In fact, the opposite has occurred: the share of taxes on personal income and on goods and services has decreased and that of taxes on corporate income has increased (see Chapter 6).

Developments in tax level

Although the statutory tax rates declined in the EU during the last decade,¹⁵⁴² there is no statistical evidence that effective capital income tax rates have declined.¹⁵⁴³ This is explained by the fact that the recent tax reforms in Member States have combined cuts in statutory rates with measures to broaden the capital income tax base as well as reductions in the relief for corporation tax in order to compensate for the revenue loss accompanying the decrease in tax rates.

Developments in corporate tax systems (section 6.3)

The current tendency in the EU is towards a partial or total switch from an imputation system to a modified classical system or a shareholder relief system. This development can be explained by the complexity of imputation systems in comparison with the classical system and shareholder relief systems. Furthermore, the classical system and shareholder relief systems do not violate the fundamental freedoms of the EC Treaty, since domestic and foreign source dividends are treated exactly the same way: dividends are subject to taxation at corporate level as well as shareholder level. Although the classical system and shareholder relief systems do not discriminate cross-border activities against domestic investment, they are not neutral towards investment decisions. For example, equity financing of outbound invest-

¹⁵⁴¹ Commission (1992a), pp. 45-46.

¹⁵⁴² See section 6.3.2.1.

¹⁵⁴³ In fact, different methods of calculation provide slightly different results. Gorter and de Mooij (2001) find that the effective capital income tax rates remained constant during the last decade. Corporate tax revenue ratios have increased during last decade. See section 6.3.2.1.

ments is generally discriminated against debt financing, since dividend income is taxed twice and interest is taxed once. Another reason behind the recent trend to abolish imputation systems is an attempt of the Member States to strengthen the international competitiveness of their tax systems by cutting back advantages for resident taxpayers.¹⁵⁴⁴ Altogether, it can be concluded that despite a tendency to switch from an imputation system to a modified classical system or a shareholder relief system, the tax systems of the Member States are far from being harmonised or co-ordinated.

Altogether we can conclude that an important trend in corporate taxation has been a reduction of statutory tax rates on profits. However, this was combined with a broadening of tax bases, in particular with a cut back in depreciation rules. Furthermore, the trend away from imputation systems towards the classical system and shareholder relief systems also has an overall impact of broadening the tax base by reducing the relief for domestic shareholders. As a result, average effective tax rates on capital have remained approximately constant in the EU during the last decade.

Tax convergence (section 6.4.)

Total tax burden

The average total tax burden in the EU increased by approximately 14 percentage points since 1965 while the standard deviation decreased somewhat. Thus, total tax burdens in Member States converged towards a higher level. Nonetheless, the spread between the highest and the lowest total tax burden was 21 percentage points in 2000, ranging from 32% in Ireland to 53% in Sweden.

VAT

Convergence of statutory as well as effective VAT rates has taken place in the EU. The number of different rates applicable in Member States has decreased, while the spread between the highest and the lowest standard rates has slightly decreased (from 13 in 1990 to 10 in 2000) and standard deviation of standard as well as reduced rates has decreased. However, standard VAT rates still vary from 15% in Luxembourg to 25% in Denmark and Sweden. Effective tax rates have also converged. The spread between the highest and the lowest VAT revenue ratio is 3.8, ranging from 5.9 in Italy to 9.7 in Denmark (see section 6.4.2.2) Thus, in spite of VAT rate convergence, there are still considerable differences in the statutory as well as effective tax rates among Member States.

Corporate tax

Divergence in corporate tax rates is large. The difference between the highest and the lowest corporation tax rates amounts to 27.67 percentage points. Furthermore, there are considerable differences between the national corporation tax bases. However, some convergence of statutory as well as effective corporate tax rates has taken place during the last decade.¹⁵⁴⁵

8.7 Comparison of tax policy of Estonia with that of the EU (Chapter 7)

Comparison of tax rates, tax level and tax structure (section 7.1)

The tax rates of Estonia are reasonably close to those of the EU. However, in some key aspects there are wide differences. The most significant differences are in the field of income taxation. The EU-25 (arithmetic) average top statutory personal income tax rate in 2004 is 43%, while the personal income tax rate of Estonia is 26%, which is 17 percentage points

¹⁵⁴⁴ See Baker & McKenzie (2001).

¹⁵⁴⁵ See section 6.4.3.

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lower. The difference compared to the EU-15 average is even larger - 23 percentage points (26 percent in Estonia as compared to 49 percent in the EU-15). The top statutory corporate tax rate is very close to the EU average: the statutory corporate tax rate of Estonia (26%) is only one percentage point lower than the EU-25 (arithmetic) average of corporate tax rate in 2004. The EU-15 (arithmetic) average of corporate tax rate in 2004 is five percentage point higher than in Estonia (31 percent in EU-15 as compared to 26 percent in Estonia). However, the tax rates in the field of corporate taxation are not directly comparable because Estonia does not apply the corporate tax on reinvested income. It means that a rate of 26% only applies in case of distributed profits, the tax rate on retained earnings is zero. The smallest difference is in the VAT rate, which is slightly below the EU average level in Estonia (1.6 percentage points below the EU-15 average level and 1.4 percentage points below the EU-25 average level).

Comparison of tax levels and tax structures in Estonia and the EU demonstrates that the tax structures as well as tax levels are very similar. Although statutory tax rates on income and profits are lower in Estonia than in the EU, the effective tax rates of Estonia are very close to EU average rates. Revenue ratio of VAT as percentage of GDP is even higher in Estonia than in the EU. The biggest difference between Estonia and the EU lies in the effective tax rate on profits (measured as a revenue ratio of taxes on corporate income) which is considerably lower in Estonia (1.1 percent of GDP in Estonia as compared to 2.2 percent in the EU-25 in 2002). However, the share of this tax in total tax burden is very small (3 per cent in Estonia and 9 per cent in the EU in 2002).

*Comparison of the Estonian VAT legislation with the *acquis communautaire* (section 7.2.1)*

Although the Estonian VAT act largely follows the Sixth Directive, it is not in complete alignment with EU rules. The most important provisions that are in breach of EU legislation are the following.

Taxable person

The definition provided in the Estonian VAT act is in breach of the Sixth Directive. Firstly, according to the Estonian VAT act the taxable person is a person who effects taxable supply. The Sixth Directive, on the other hand, does not contain such a condition. The Sixth Directive includes everyone who performs economic activities in the definition of a taxable person. Secondly, it follows from the wording of the Estonian VAT act that a taxable person is also a person who performs economic activities free of charge. However, according to the case law of the ECJ activities which are in all cases free of charge fall outside the scope of the VAT.¹⁵⁴⁶ Moreover, in the cases *Coöperatieve Aardappelenbewaarplaats* and *Apple and Pear Development Council* the ECJ stated, referring to the earlier *Tolsma* case, that for the provision of services to be taxable there must be a direct link between the service provided and the consideration received. Some other judgments by the ECJ have reduced the scope of the concept of economic activity and consequently the scope of VAT.¹⁵⁴⁷

Public bodies

The Estonian VAT act stipulates that public bodies are considered taxable persons in respect of their taxable supplies, which can also be effected by non-public taxable persons. This provision is in breach of EU law. In the light of the case law by the ECJ and the Sixth Directive, the public bodies should be considered taxable persons in respect of their services if they compete with the private sector providing competing goods or services where treatment of them as non-taxable persons would lead to significant distortions of competition.

¹⁵⁴⁶ Case 89/81 (*Hong-Kong*).

¹⁵⁴⁷ See section 3.2.2 for more elaborate discussion of the ECJ's rulings on the scope of the VAT.

The Sixth Directive contains the list of activities in relation to which the public bodies are 'in any case'¹⁵⁴⁸ considered taxable persons. The list of these activities (in relation to which undertakings are considered taxable persons) is included in Annex D¹⁵⁴⁹. As a minimum, Estonia should tax all the activities listed in Annex D of the Sixth Directive.

Taxable transactions

The supply of goods and services effected in Estonia, importation of goods and services, and provision of services which are considered an export of services are included in the concept of 'taxable supplies' according to the Estonian VAT act. Thus Estonian concept of 'taxable supplies' does not include intra-Community acquisition of goods and intra-Community acquisition of new means of transport, which have to be included in the concept of taxable transactions upon accession.

Supply of goods

According to the Estonian VAT act supplies include the transfer of goods in the course of business activities. Article 5(1) of the Sixth Directive defines 'supply of goods' as the transfer of the right to dispose of tangible property as an owner. The ECJ has held that 'supply of goods' in Article 5(1) of the Sixth Directive must be interpreted as meaning the transfer of the right to dispose of tangible property as an owner, even if there is no transfer of legal ownership of the property.¹⁵⁵⁰ In other words, the mere transfer of economic ownership is enough to treat the transfer as supply of goods. In accordance with the ECJ's ruling in *SAFE*, it is for the national court to determine in each individual case, on the basis of the facts of the case, whether there is a transfer of the right to dispose of the property as an owner within the meaning of Article 5(1) of the Sixth Directive.

The Estonian VAT act defines concept of 'goods' as tangible goods, livestock, electric power and heat. According to Article 5(2) of the Sixth Directive 'tangible property' used in the definition of supply of goods includes electric current, gas, heat, refrigeration and the like. An exhaustive list of the Estonian VAT act does not contain gas, refrigeration and the like, as does the list provided by the Sixth Directive. The Estonian definition is in breach of the Sixth Directive because it is questionable whether gas, refrigeration and the like can be included in the concept of 'tangible goods'. Therefore, it is necessary to include those substances in the Estonian definition of supply of goods.

Compulsory transfer of the ownership of property for compensation, by order made by or in the name of a public authority or in pursuance of the law, is also considered supply of goods according to the Sixth Directive (Article 5(4)(a)). In addition, the transfer of goods pursuant to a contract under which commission is payable on purchase or sale, is considered to be supply of goods (Article 5(4)(c)). These provisions should be included in the Estonian VAT act upon accession.

Supply of services

The Estonian concept of taxable supply includes imports and exports of services. Under the Sixth Directive, services cannot be imported or exported. Under the Estonian VAT act export of services is zero-rated, whereas under the Sixth Directive such services would not be taxed

¹⁵⁴⁸ Article 4(5) of the Sixth Directive.

¹⁵⁴⁹ This list includes, for example, telecommunications; the transportation of goods and passengers; port and airport services; the running of trade fairs and exhibitions; warehousing; the activities of travel agencies; the supply of water, gas, electricity and steam; the running of staff shops, co-operatives, industrial canteens and similar institutions.

¹⁵⁵⁰ Case C-320/88 (*SAFE*), paragraph 7-9 of the judgment. See also section 3.2.3 where this case is discussed in greater detail.

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because the services are not supplied in that Member State. The taxation of services is dealt in a separate provision of the Sixth Directive (Article 9 of the Directive).

Intra-Community acquisitions of goods and means of transport

The provisions of the Sixth Directive dealing with the intra-Community acquisitions of goods and means of transport have to be included in the Estonian VAT act upon accession.¹⁵⁵¹

Place of taxation

Supply of goods

In the case of goods the place of supply is deemed to be Estonia and thus Estonian VAT is applied if the goods are delivered or made available to the recipient in Estonia, including on the border of Estonia, or if the goods are exported from Estonia. The Sixth Directive provides more detailed rules for determination of the place of the taxable transaction. Generally, the place of supply of goods in the case of goods not dispatched or transported is deemed to be the place where the goods are when the supply takes place (Article 8(1)(b)). In the case of goods dispatched or transported, the place of supply of goods is deemed to be the place where the goods are at the time when dispatch or transport begins (Article 8(1)(a)). If the goods are installed or assembled by or on behalf of the supplier, the place of supply is deemed to be the place where the goods are installed or assembled (Article 8(1)(a)). In the case of goods supplied on board ships, aircraft or trains during the part of a transport of passengers effected in the Community, the place of supply of goods is deemed to be at the point of the departure of the transport of passengers (Article 8(1)(c)). Those rules have to be included in the Estonian VAT act upon accession. In addition, the provisions of the Sixth Directive applicable in the case of purchases by distance sales have to be included in the Estonian VAT act upon accession. The distance sales over a threshold of EUR 100.000 per year effected by an Estonian company within the territory of another Member State must be taxed in the Member State of arrival. The place of taxable transaction must be Estonia in the case of distance sales effected within the territory of Estonia by firms of another Member State who make a taxable supply over a threshold of EUR 100.000 (see Article 28b (B) of the Sixth Directive). Article 28b (B)(2) of the Sixth Directive provides that a Member State may limit the threshold to EUR 35 000. Moreover, Article 28b (B)(3) of the Sixth Directive provides that vendors may opt for taxation in a Member State of arrival notwithstanding the threshold.

Supply of services

The general rule with regard to the place of taxation in the case of services provided in the Estonian VAT act¹⁵⁵² is in line with the general rule of Article 9(1) of the Sixth Directive, which stipulates that the place of services in the EC is deemed to be the place where the supplier has established his business or has a fixed establishment from which the service is supplied or, in the absence of such a place of business or fixed establishment, the place where he has his permanent address or where he usually resides.

Article 9(2) of the Sixth Directive provides for several exceptions from this general rule. The place of the supply of services connected with immovable property, such as the services of estate agents and of architects, is deemed to be the place where the property is situated. This exception is also provided in the Estonian VAT act, which stipulates that place of supply is

¹⁵⁵¹ See also section 3.2.3.

¹⁵⁵² The general rule with regard to the place of services is stipulated in § 7 (1) 5) of the Estonian VAT act which provides that place of supply is considered Estonia if the seat of the provider of services or the permanent establishment through which the services are provided is located in Estonia.

considered Estonia if an immovable property located in Estonia is constructed, valued or maintained or services relating to the transfer of an immovable property located in Estonia or to preparation or co-ordination of the related construction work are provided. The Estonian VAT act also is in line with the rule of Article 9(2)(c) of the Sixth Directive which provides that cultural, artistic, sporting, scientific, educational, entertainment or similar activities, ancillary transport activities, valuations of movable tangible property or work on movable tangible property, are deemed to be performed where they are physically carried out. With regard to valuations of movable tangible property or work on movable tangible property, which includes contract work that is treated as services based on the Second Simplification Directive, the same Directive provides that these services are deemed to take place where the VAT identification number of the customer of the services has been issued, provided the goods in question are dispatched or transported out of the Member State where the services were physically carried out. When the place of supply is shifted to the place where the customer's VAT number has been issued, the VAT liability is also shifted to the customer (referred to as 'reverse charge'). Those provisions have to be included in the Estonian VAT act upon accession.

Article 9(2)(e) of the Sixth Directive provides that the place of supply of certain services¹⁵⁵³ rendered to the customers established outside the Community or for taxable persons established in the Community, but not in the same country as the supplier, is where the customer has his business or resides. The Estonian VAT act provides for a list of services provision of which to an Estonian taxable person by a non-resident is taxable in Estonia.¹⁵⁵⁴ This list includes most of the so-called Article 9(2)(e) services. However, radio and television broadcasting services, and electronically supplied services are not included in the Estonian list of services. In addition, obligations to refrain from pursuing or exercising, in whole or in part, a business activity or a right referred to in the so-called list of Article 9(2)(e) services should be taxable in Estonia if the customer of this service is established or resides in Estonia. The Estonian VAT act should also include the rule of Article 9(2)(f) which provides that in case of the electronically supplied services the place of supply must be in Estonia when those services are performed for non-taxable persons who are established, have their permanent address or usually reside in Estonia, by a taxable person who has established his business or has a fixed establishment from which the service is supplied outside the Community or, in the absence of such a place of business or fixed establishment, has his permanent address or usually resides outside the Community.¹⁵⁵⁵ Furthermore, The Estonian VAT act should also include the rule of Article 9(4) of the Sixth Directive which provides that in the case of telecommunications services and radio and television broadcasting services when performed for non-taxable persons who are established in Estonia, by a taxable person who has established his business from which the service is supplied outside the Community, the place of supply of services is considered to be in Estonia if the effective use and enjoyment of the services take place within the territory of Estonia.

Taxable amount

The Estonian VAT act does not state explicitly, as does the Sixth Directive, that taxable amount includes subsidies directly linked to the price.¹⁵⁵⁶ It should be stated also in the Esto-

¹⁵⁵³ The list of the so-called Article 9(2)(e) services to which this provision applies includes for example legal services, advertising, engineering, consulting, accounting, data processing, banking, insurance, and other financial services as well as the hiring out of movable tangible property other than means of transport, the services of agents who act in the name and for the account of another, procuring the above-mentioned services, telecommunication services, radio and television broadcasting services, and electronically supplied services.

¹⁵⁵⁴ See section 7.2.1.2.4.

¹⁵⁵⁵ See also section 3.2.4.

¹⁵⁵⁶ See also section 3.2.6 about the case law of the ECJ concerning the inclusion of subsidies in the taxable amount.

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nian VAT act that all subsidies directly linked to the price are included in the taxable amount.

§ 14 (5) of the Estonian VAT act provides that in the cases of provision of goods or services by an employer to an employee and non-business use of goods and services, the market price of the goods is applied as a taxable amount. The Sixth Directive stipulates that in the case of internal use or non-business use of goods and services, the purchase price or the cost price is applied as a taxable amount. In the case of self-supplies, the open market value is applicable. Those provisions must be included in the Estonian VAT act upon accession.

The Estonian VAT act does not state explicitly, as does the Sixth Directive, that the taxable amount includes taxes, duties, levies and charges, and incidental expenses such as commission, packing, transport and insurance costs charged by the supplier. Moreover, the Estonian VAT act does not provide that certain kind of repayments entered in a suspense account should not be included in the taxable amount. These provisions have to be included in the Estonian VAT legislation.

Exemptions

Domestic exemptions

The Estonian list of exemptions does not include several activities which must be exempted according to Article 13(A) of the Sixth Directive. For example, activities stipulated in Article 13(A) (1) (f)¹⁵⁵⁷, Article 13(A) (1) (k)¹⁵⁵⁸, Article 13(A) (1) (n)¹⁵⁵⁹, and Article 13(A) (1) (o)^{1560, 1561}. In the case of exemption of certain non-profit activities¹⁵⁶² The Estonian VAT act does not contain the condition, as does Article 13(A) (1) (l) of the Sixth Directive, that such exemption should not cause distortion of competition.

In regard to the exemption on supply of immovable property it has to be pointed out that Estonian rule which does not provide for taxation in case of new residential construction as well as alteration and maintenance of existing buildings is in breach of the Sixth Directive.

§18 (3) of the Estonian VAT act provides that taxable persons may opt for taxation in case of leasing or letting of immovable property; supply of immovable property; services provided by credit or financial institutions; and investment gold. The Sixth Directive does not allow

¹⁵⁵⁷ This subparagraph provides for exemption of services supplied by independent groups of persons whose activities are exempt from or are not subject to VAT, for the purpose of rendering their members the services directly necessary for the exercise of their activity, where these groups merely claim from their members exact reimbursement of their share of the joint expenses, provided that such exemption is not likely to produce distortion of competition.

¹⁵⁵⁸ This subparagraph provides for exemption of certain supplies of staff by religious or philosophical institutions.

¹⁵⁵⁹ This subparagraph provides for exemption of certain cultural services and goods closely linked thereto supplied by bodies governed by public law or by other cultural bodies recognized by the Member State concerned.

¹⁵⁶⁰ This subparagraph provides for exemption of the supply of services and goods by organizations whose activities are exempt in connection with fund-raising events organized exclusively for their own benefit provided that exemption is not likely to cause distortion of competition. Member States may introduce any necessary restrictions in particular as regards the number of events or the amount of receipts which give entitlement to exemption.

¹⁵⁶¹ Article 13(A) (1) (q) also provides for exemption of activities of public radio and television bodies other than those of a commercial nature. However, according to Article 28 (3) (a) and Annex E of the Sixth Directive Member States may continue to subject those activities to VAT during the transitional period.

¹⁵⁶² Services provided free of charge by a non-profit association to its members. See §18 (1) 3) of the Estonian VAT act.

Member States to provide a right of option for taxation in the cases of the supply before first occupation of buildings or parts of buildings and the land on which they stand and the supply of building land. The Estonian VAT act should exclude those supplies of immovable property from transactions in the cases of which taxpayers can opt for taxation.

Intra-Community acquisitions

Upon accession Estonia should also apply for intra-Community acquisitions the same exemptions as for domestic supplies.

Deduction of input-VAT

From the Estonian VAT act it follows that the right for input tax credit arises at the time when the goods or services as well as invoice are received. This provision is in breach with the Sixth Directive which provides that if a payment is due before the goods are delivered or the services are performed, the tax becomes chargeable on receipt of the payment and on the amount received. The Estonian VAT act should state explicitly that the right for deduction arises at the moment when the deductible tax becomes chargeable or contain the provision that if a payment is due before the goods or services are received from another registered taxable person, the right for input tax credit arises when the input tax is invoiced by another entrepreneur or when the payment is received.

The Estonian VAT act stipulates that the right to deduct the input VAT is restricted to goods and services used for the purposes of business.¹⁵⁶³ This provision does not exactly correspond to Article 17(2) of the Sixth Directive which provides that the right to deduction or refund of the VAT is restricted to goods and services used for the purposes of taxable transactions because the latter transactions include non-business use and self-supply. In addition, Article 17(2)(c) of the Sixth Directive provides that a taxable person has a right to deduct the tax due in cases of internal use and self-supply. This possibility is not provided in the Estonian VAT act. The Estonian VAT act should also include the rules of the Eighth and Thirteenth Directives, which provide the arrangements for refund of VAT to taxable persons not established in the territory of the country.

Persons liable for payment of the tax

Estonia has to include in its VAT legislation the provision that any person who makes a taxable intra-Community acquisition of goods is liable for the payment of the VAT due. In addition, the person who acquires new means of transport from another Member States must be made liable for the payment of the VAT upon accession. In addition, Article 21 (1) (a) of the Sixth Directive provides that in the case of intra-Community acquisitions, the Member State may designate another person to be liable for the payment of the VAT, e.g. a tax representative. Furthermore, the same provision stipulates that the Member State may also provide that someone other than the taxable person is held jointly and severally liable for payment of the tax.

Special schemes

Special scheme applied for transfer of right to cut standing crop and for timber and related services¹⁵⁶⁴ is not in line with the Sixth Directive and should be abolished upon accession. Furthermore, Estonia should include the special scheme applicable to e-commerce and broadcasting services introduced by the Directive 2002/38/EC.¹⁵⁶⁵

Administrative obligations

Compulsory registration

¹⁵⁶³ See § 20 (3) of the Estonian VAT act.

¹⁵⁶⁴ See section 1.3.2.10.

¹⁵⁶⁵ See section 3.2.11 for the special rules applicable to e-commerce and broadcasting services.

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Estonia applies EUR 16 025 (EEK 250 000) turnover limit for compulsory registration of VAT taxable persons. Enterprises with a turnover below that threshold are considered outside the scope for the application of VAT, unless they voluntarily register. According to Article 24(2) of the Sixth Directive Member States may apply an exemption from tax to taxable persons whose annual turnover is equal to or higher than EUR 5 000. The agreement on EU accession granted Estonia a derogation allowing small and medium sized enterprises whose annual turnover is less than EEK 250 000 not to be registered for VAT.

Other administrative obligations

Other administrative obligations provided in the Sixth Directive, including the possibility to register by electronic means, to use electronic invoicing and storage, to submit yearly statements and EC sales lists by electronic means (see section 3.2.12), have to be included in the Estonian VAT legislation.

Tax rates

The reduced VAT rates currently effective in Estonia¹⁵⁶⁶ are not exactly in line with the Sixth Directive. Estonia has to abolish zero rates currently applied on electricity generated by wind, and hydro-electricity; periodicals sold under a subscription; and textbooks and workbooks for basic schools and gymnasiums upon accession. The Estonian VAT act already contains the provision that as of Estonia's accession to the European Union, the rate of VAT on periodicals sold under a subscription, and textbooks and workbooks for basic schools and gymnasiums shall be 5 per cent. In addition, Estonia has to apply standard rate of 18% on electricity generated by wind and hydro-electricity upon accession.

Application of reduced rate on heat, peat, fuel briquettes, coal or firewood sold to individuals is not in line with Article 12 (3) (a) and Annex H of the Directive. However, Estonia was granted a transitional period until 30 June 2007 to apply a reduced VAT rate (5%) on heating sold to individuals as well as on the sale of peat, fuel briquettes, coal and firewood sold to individuals. After expiry of the transitional period the standard rate must be applied.

*Comparison of Estonian income tax legislation with the *acquis communautaire* (section 7.2.2)*

The most important provisions of the Estonian Income Tax Act that violate EU law are the following.

Dividend exemption

According to § 18(1) of the Income Tax Act dividends and other profit distributions that a resident individual receives from a non-resident company are taxed. Dividends received from a resident company are not taxed. This is discrimination forbidden under the EC Treaty. More specifically, the measure at issue is incompatible with the rules of EU law guaranteeing free movement of capital (Article 56 of the EC Treaty) and freedom of establishment (Article 43 of the EC Treaty).

Contributions to pension funds

Resident individuals have the right to deduct from the income the contributions to a mandatory funded pension withheld on the basis of the Funded Pensions Act. In addition, they have the right to deduct contributions to certain domestic voluntary funded pension funds. In light of the ECJ case law, the Estonian pension taxation provisions contravene EU law because pension contributions paid to non-Estonian funds are not tax deductible while contributions paid to domestic funds are. More specifically, the Estonian pension tax provisions contravene EU principles of freedom to provide services (Article 49 of the EC Treaty) and the free movement of workers and capital (Articles 39 and 56 of the EC Treaty). Estonian tax rules

¹⁵⁶⁶ See section 1.3.3.

cannot be justified by necessity to maintain coherence of the tax system since there is no direct connection between the deductibility of insurance contributions and the taxation of sums payable by insurers. Furthermore, fiscal coherence is secured by bilateral conventions with most EU Member States. It follows that Estonia has to change its tax legislation and give pension contributions paid to pension funds located in other Member States the same tax treatment (contributions paid to non-Estonian funds should be also tax deductible).

Deductibility of contributions made by non-residents

The deduction from taxable income of pension premiums is only allowed to resident taxpayers. Income Tax Act does not allow deduction from taxable income of contributions to the pension funds by non-resident taxpayers. From the judgments of the ECJ in *Schumacker* and *Biehl* it can be concluded that domestic tax legislation of the Member State should provide a non-resident with the same income-related benefits as a resident, if the non-resident is in a similar position as a resident from the tax point of view, i.e. receives the major part of his worldwide income in that Member State. Thus, where residents of Estonia are entitled to tax deductions then residents of other Member States working in Estonia should also get them to the extent that these deductions are attributable to income from Estonia. From *Wielockx* it can be concluded that the principles developed by the ECJ in *Schumacker* apply not only to employees under the free movement of workers provision of the Treaty but also to self-employed individuals under freedom of establishment provision.

Payments from the pension funds

Payments from resident voluntary pension funds may be subject to tax at regular or reduced rate (10%) or exempted from taxation. All pension benefits received from non-residents are subject to tax at regular rate (26%). This tax provision is incompatible with EC Treaty freedom to provide and purchase services because tax benefits only apply for the payments made by Estonian companies. The ECJ has held in several judgments (i.e. *SAFIR*, *Danner*) that tax legislation of the Member State which provides for different tax regimes for insurance policies, depending on whether they are taken out with companies established in that Member State or with companies established elsewhere, where that legislation contains a number of elements liable to dissuade individuals from taking out insurance policies with companies established in other Member States and liable to dissuade those insurance companies from offering their services on the market in that Member State, is incompatible with EU law.

Exemptions

The Estonian Income Tax Act lists items that are exempted from tax. Not all exemptions applicable to resident individuals are applicable to non-resident individuals. Tax rules that apply to residents and non-residents different conditions regarding income tax may fall within the scope of Article 39 or Article 43 of the EC Treaty. The ECJ has held in its judgment in *Schumacker* that Article 39 of the Treaty precludes the application of rules of a Member State under which a worker who is a national of, and resides in, another Member State and is employed in the first State is taxed more heavily than a worker who resides in the first State and performs the same work there when, as in the main action, the national of the second State obtains his income entirely or almost exclusively from the work performed in the first State and does not receive in the second State sufficient income to be subject to taxation there in a manner enabling his personal and family circumstances to be taken into account.¹⁵⁶⁷ From the judgment of the ECJ in *Groot* it can be concluded that the resident Member State should grant the tax exemptions relating to the taxpayer's personal and family cir-

¹⁵⁶⁷ In its judgment in Case C-391/97 (*Gschwind*), the ECJ accepted the requirement that non-resident should earn 90% of family worldwide income in the state of source to qualify for equal treatment.

Main findings of the research

cumstances not only in proportion to the income derived in that Member State but also in proportion to the income obtained in other Member States if that income was taxed in that other Member State without considering his personal and family circumstances.

Deductions

Paragraphs 23 to 28 of the Income Tax Act allow deductions only from the aggregate income of resident taxpayers. From *Schumacker* and *Wielockx* it can be concluded that tax rules which apply to residents and non-residents different conditions regarding the income tax may fall within the scope of the EC Treaty provisions which require the abolition of barriers to free movement within the Internal Market.

Training expenses

Resident individuals have the right to deduct from their taxable income expenses which they incur for the training, and which are paid on the basis of a written agreement with the resident's educational institution. This is discrimination forbidden under the EC Treaty since it is incompatible with the free movement of capital and freedom of establishment. As a general rule, differential tax treatment of service providers of other Member States in comparable situations as residents is not allowed if it is not indispensable to achieve a public-interest objective such as coherence of the tax system and proportional.¹⁵⁶⁸

Joint assessment of spouses

The option to file a joint tax return of spouses is currently only available to resident taxpayers. From *Schumacker* and *Wielockx* it can be concluded that this option has also to be allowed to non-residents obtaining their family income entirely or almost exclusively from work performed in Estonia and not receiving sufficient income in their resident State to be subject to taxation there in a manner enabling their family circumstances to be taken into account. From *Zurstrassen* it can be concluded that a joint tax return of spouses who are not separated either *de facto* or by virtue of a judicial decision should not be subject to the requirement that both taxpayers reside in Estonia. The option of joint assessment should also be available to workers resident in Estonia if they receive almost the entire income of their household in Estonia, even if their spouses are resident in another Member State.

Exit taxes

Exit taxes are one kind of emigration tax, whereby a country attempts to preserve their tax claim on existing latent or future income.¹⁵⁶⁹ There are no exit taxes in Estonia (neither for natural or legal persons), such as taxes on unrealized capital gains or on income derived from sources in and/or outside Estonia after emigration. Non-residents are taxed only on their income derived from sources within Estonia. Estonia does not apply the rules that provide for an extended tax liability for a certain period after emigration. In addition, Estonia does not recapture previously granted deductions or tax deferrals (e.g. a tax deduction for premiums paid under a private pension plan or life insurance). If the person emigrates, the capital gains that he/she derives from Estonia (i.e. from the sale of the real estate situated in Estonia or the shares of the Estonian companies) are taxed at the moment the income is received (i.e. when the non-resident sells the assets).

If a person emigrates and wants to transfer the value of his/her pension to a pension fund in the immigration country, then, as a general rule, it is not possible to get the invested money from the fund before he/she is retired. In some exceptional cases it is possible, however, the Estonian income tax has to be paid. The same rules also apply in case of domestic transfers.

¹⁵⁶⁸ See for example ECJ rulings in *Bachmann*, *SAFIR* and *Danner*.

¹⁵⁶⁹ See section 4.2.2.2.

Thin capitalization

Thin capitalization legislation has drawn a lot of attention after the *Lankhorst-Hohorst* decision of the ECJ.¹⁵⁷⁰ The case dealt with German's thin capitalization legislation, which was found to be incompatible with EC Treaty. The decision was based on the grounds that the debt-equity ratios imposed on German resident subsidiaries and the consequent disallowance of interest deductions applied only, in effect, where the parent company was resident abroad and not where it was resident in Germany. The ECJ held that different treatment between resident subsidiary companies according to whether or not their parent company had its seat in Germany made it less attractive to corporations having their seats in other Member States to exercise the freedom of establishment.

With respect to Estonia, the Income Tax Act imposes no ceiling on the amount of interest payments that a company may deduct in computing its taxable profits.

Transfer pricing rules

Estonian transfer pricing rules only apply in case of transactions conducted between a resident legal person and a non-resident (legal person or individual) or an individual. It does not apply in case of two resident legal persons that are associated, for example, in the case of a resident subsidiary whose parent company is also resident. Thus, the transfer pricing provision implies a difference in treatment between resident subsidiaries depending on whether or not their parent company has its seat in Estonia. It can be concluded from the ECJ's judgment in the *Lankhorst-Hohorst* case that transfer pricing provisions of EU Member State that provide different tax rules according to whether the parent company, that is to say, the shareholder in the subsidiary, is resident in that Member State or in another Member State infringe EU law.

However, it can be concluded from the ECJ's decision in *Lankhorst-Hohorst* that the critical test in these circumstances is whether the same rules are also applied to domestic legal entities.¹⁵⁷¹ In addition to a transfer pricing provision for international transactions, the Estonian tax law contains the arm's length principle for domestic transactions. Currently, the Estonian tax administration has the authority to make an upward adjustment to a company's taxable basis when it finds that certain transactions do not meet the arm's length principle. For example, if in a national situation an Estonian subsidiary does not apply market prices in transactions with its Estonian parent company, then, the tax administration can make corrections in profit calculation by applying market prices. Therefore, the Estonian transfer pricing rules do not infringe EU law because they do not provide different tax rules according to whether the parent company, is resident in Estonia or in another Member State.

CFC rules

The Income Tax Act comprises the CFC rules under which the profits of companies located in the low-tax territories are deemed to constitute taxable income of the residents. The income tax is also imposed on certain payments to the legal persons established in territories with low tax rates, irrespective of whether the person operates in Estonia or not. Furthermore, double taxation of dividends is avoided in the case of foreign direct investment if a non-resident legal person owns at least 25 per cent of the share capital or votes of the resident company distributing the dividends. Dividends distributed to a legal person located in a low tax rate territory, are always subject to income tax at shareholder level.

These provisions may infringe EU law because they introduce different treatment for resident subsidiary companies according to whether or not their parent company has its seat in

¹⁵⁷⁰ See section 4.2.2.1.

¹⁵⁷¹ In *Lankhorst-Hohorst* the ECJ based its conclusion on the fact that the German thin capitalization rules did not apply to domestic shareholders.

Estonia. For example, if Estonian company grants a loan to another company which is located in Luxembourg,¹⁵⁷² this loan is subject to income tax while loan given to a resident company is not subject to income tax if it meets conditions established by the Minister of Finance. It can be concluded from the ECJ's judgment in the *Lankhorst-Hohorst* case¹⁵⁷³ that tax provisions of EU Member State that provide different tax rules according to whether the parent company, is resident in that Member State or in another Member State infringe EU law.

Furthermore, the ECJ has held, in general terms, that less favourable treatment in tax matters cannot be justified by low tax level in another Member State.¹⁵⁷⁴ The ECJ held in *Eurowings* that any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State.

Income tax on profit distributions

A resident company must pay income tax on all dividends and other profit distributions. Under the Parent-Subsidiary Directive withholding taxes on cross-border intra-group profit distributions (as dividends) should be abolished. Article 5(1) of the Directive provides that, when the parent company holds at least 25 percent of the subsidiary's capital for a minimum period of two years, the profits distributed by the subsidiary to its parent company must be exempt from withholding tax. From ECJ judgments in *Epson*¹⁵⁷⁵ and *Athinaiki Zithopiia*¹⁵⁷⁶ it can be concluded that the Estonian tax on profits which an Estonian subsidiary distributes to its parent company in another Member State holding a minimum of 25 per cent of the capital of the subsidiary may qualify as a withholding tax within the meaning of Article 5(1) of the Parent Subsidiary Directive and should be abolished. However, it can be questioned whether Estonian tax on profits qualifies as a withholding tax under the Parent-Subsidiary Directive because it can be argued that it is in fact a corporate income tax not a withholding tax prohibited by Article 5(1) of the Directive. Moreover, it has been questioned whether the conclusion reached by the ECJ in *Epson* and *Athinaiki Zithopiia* is consistent with the purpose of the Directive, expressed in the preamble.¹⁵⁷⁷ The Directive aims at making taxation in cross-border situations as advantageous as in domestic relations by eliminating double taxation of cross-border dividend payments within European groups of companies. The overall objective of the Directive is to introduce tax rules that are neutral from the point of view of competition. However, in the *Athinaiki Zithopiia* case, the questioned Greek provision did not constitute a disadvantage for a company located in another Member State since it was applicable to both resident and non-resident shareholders. Consequently, it did not violate the principle of capital import neutrality.¹⁵⁷⁸ The effect of the *Athinaiki Zithopiia* judgment, therefore, was not the elimination of a (non-existent) distortion, but the creation of a preferential treatment. The same holds to the Estonian profit distribution tax. If profits distributed to companies in other Member States would be free from distribution tax, these companies would be treated more advantageously than domestic companies. As Rolle (2003) concludes, the solution arising from the judgment may generate a conflict with some of the

¹⁵⁷² Luxembourg is the only Member State which is included in the unofficial list of territories established by the Tax Board of Estonia, which might be regarded low tax territories. In addition, from future EU Member States Cyprus and Malta are included in this list. See section 1.4.4.

¹⁵⁷³ See section 4.2.2.1.

¹⁵⁷⁴ See Case C-294/97 (*Eurowings*), paragraphs 44-45 and Case C-422/01 (*Skandia*), paragraph 52.

¹⁵⁷⁵ Case C-375/98.

¹⁵⁷⁶ Case C-294/99.

¹⁵⁷⁷ See Rolle (2003), p. 40.

¹⁵⁷⁸ *Ibid.*

principles laid down in the Code of Conduct as the resulting tax regime may then be regarded as potentially harmful because it seems to create advantages for non-residents.

Taxation of Inter-Company Dividends

The exemption method is applied if the resident company with the qualifying holding distributes the dividends received from another Estonian company. Tax credit system applies for dividends received from abroad. These provisions may infringe EU law constituting an obstacle to free movement of capital and freedom of establishment because they introduce different treatment for companies depending where the company paying the dividend is established.

Avoidance of double taxation

The current Estonian system of dividend taxation differentiates Estonian and foreign parent companies in a sense that it provides different minimum shareholding rate for exclusion of double taxation of dividends. When dividends are paid to Estonian parent company holding 20% of shares, the double taxation is eliminated, while the same applies to foreign legal persons starting from shareholding rate of 25%. In addition, the Estonian parent company holding less than 20% of shares, has to pay the income tax at the moment of redistribution while in case of foreign persons, the income tax has to be paid immediately. So the discrimination of the foreign corporate shareholder is twofold: (1) the threshold for exemption is 25% instead of 20% and (2) the tax is payable immediately, without waiting for the redistribution. This very significant disadvantage is also a violation of EC Treaty provisions which require equal treatment of resident and non-resident companies.

The change of the Income Tax Act has already passed the legislative procedure and will become effective on the date of Estonia's EU accession. According to this provision the double taxation will be eliminated if dividends are paid to non-resident parent company holding 20 per cent of the share capital or votes of the resident company distributing the dividends. However, the second timing disadvantage will not be eliminated.

Taxation of Capital Gains

Resident companies and permanent establishments of non-resident companies registered with the Estonian authorities are not subject to tax on their capital gains until the gains are distributed. Capital gains are not taxed separately, but are included into profits subject to corporate income tax upon distribution. Thus, the capital gains received by the company are not taxable as an income, but becomes subject to taxation upon distribution. Non-resident companies without a permanent establishment in Estonia are subject to tax at a rate of 26% on their capital gains derived from Estonian sources.¹⁵⁷⁹ These provisions may infringe EU law because they introduce different treatment for resident companies and non-resident companies.

Taxation of mergers

In general, the Estonian Income Tax Act already is in line with the requirements of the Merger Directive. Under the Estonian law not disposal of the assets but the distribution of the dividends is the event triggering taxation. However, in order to guarantee that the Estonian Income Tax Act is in line with the principle of the Merger Directive that provides that taxation of the capital gain is deferred until actual disposal, it is recommendable to introduce

¹⁵⁷⁹ The sale of shares by a non-resident is subject to income tax only if the transferred holding is a holding of at least 10 per cent in a company of whose property, according to the balance sheet as of the last day of the preceding financial year, more than 75 per cent is made up of immovables or structures as movables, which are located in Estonia.

Main findings of the research

the provision in the Estonian law which stipulates that the capital gain derived as a result of a merger, division or exchange of shares is not taxed until actual disposal of the assets. However, at the moment it is not necessary to change the Estonian legislation because the Estonian corporate legislation does not provide for possibility of transactions prescribed in the Directive (namely, cross-border mergers, divisions, transfers of assets or exchanges of shares). The reorganization of companies is currently possible through the liquidation or the sale of assets.

The Interest and Royalties Directive

Estonia has to include the principles of the Interest and Royalties Directive into its domestic law. Under the current Income Tax Act, the interest and royalty payments made to associated companies in other EU Member States are subject to Estonian-source tax. However as from 1 May 2004, the provision has to be introduced into the Estonian Income Tax Act under which interest and royalty payments to associated companies in other EU Member States would not be subject to the Estonian source tax provided the holding requirements stipulated in the Interest and Royalties Directive are met. Attention needs to be paid to the various exclusions and qualifying conditions imposed.

The interest and royalty payments by the Estonian company to its parent company or a subsidiary resident in other EU Member State have to be tax exempt if the companies qualify for the benefits of the Directive. The Directive only applies in case of payments between associated companies. In order to be considered as an associated company, the paying company or a permanent establishment must have a direct minimum holding of 25 per cent in the capital or the voting rights in the receiving company, or vice versa, or a third company must have a direct minimum holding of 25 per cent in the capital or the voting rights of both the paying and the receiving company. In respect of the minimum participation requirement, it is important to bear in mind that Directive only specifies minimum standard, Estonia may also give the benefits of the Directive if the holding is less than 25%.

The Directive applies to companies, which take one of the forms listed in the Annex to the Directive. In this respect, a list of the companies covered for Estonia needs to be included in the Annex of the Directive. One may assume that the scope of the Directive will cover the same companies as those covered by the Parent-Subsidiary Directive and the Merger Directive, which are mentioned in the Annex II.9 of the Accession Treaty. In line with the general principle of EU law, directives only ever express minimum standard. Member States are free to extend the tax-free treatment of profit distributions to the entities other than those included in the list.

Another potential limitation to the application of the Directive is that a Member State is given the option of not applying the Directive where the associated companies' condition has not been met for a period of two years prior to the interest/royalty payment. It follows that the tax-free treatment of the payments has to be provided if a maximum two-year holding period stipulated in the Directive has been satisfied. Estonia may also give the benefits of the Directive if the associated companies condition has been met for a shorter than a two-year holding period. The shorter holding period is not specifically provided for in the Directive, but it is justified on the basis that EC Directives only ever specify minimum standards.

The Directive specifies a number of other instances where Estonia is given the option of not applying the withholding exemption to the interest/royalty payments. These include cases where the payments are re-characterised as distributions and payments made on convertible debt. There is also an exclusion in respect of the non-arm's length arrangements. Where a payment exceeds that which would have been paid between independent parties, Estonia is not obliged to apply the nil withholding rate to the excess element of the payment.

Besides the special relationship provision referred to above, the Directive also includes specific fraud and abuse provisions enabling Estonia to withdraw the benefits of the Directive where the principal motive, or one of the principal motives, is tax evasion or tax avoidance.

Estonia is not precluded from applying domestic legislation or agreement based provisions to prevent such abuse.

Arbitration Convention

Currently, the Arbitration Convention is not a part of the Estonian legal system. There seems to be no obstacles for Estonia of signing this Convention and Estonia probably is expected to sign this Convention after joining the EU.

Taxes on raising capital

The Capital Duty Directive (the Council Directive 69/335/EEC concerning indirect taxes on the raising of capital) requires to harmonize structures and rates of capital duty. Article 4 of the Directive provides that certain transactions must and others may be subject to capital duty. Art. 4(1) reads "The following transactions shall be subject to capital duty: [...]". Thus, the wording 'shall be [...]' seems to indicate that application of certain transactions to capital duty is mandatory and that Member States are obliged to levy capital duty on the transactions mentioned in this paragraph. However, according to the interpretation of several Member States¹⁵⁸⁰, the Capital Duty Directive allows to apply lower level of taxation than 1 % stipulated by the Directive. Moreover, according to the Directive 85/303/EEC Member States are free to exempt the contributions of capital altogether since 1 January 1985.

Code of Conduct

The EU has adopted a Code of Conduct designed to inhibit "harmful" competition between national tax systems. Estonia's company tax system appears fully consistent with the Code, which is summarized in section 2.4.4.1. Estonia's company tax is transparent, with tax liabilities determined under law, and not by administrative discretion. It does not offer special incentives for non-residents, or transactions with non-residents. It has no special arrangements ring-fenced from the local market. It follows internationally accepted OECD principles.

Fiscal State Aid

Estonian income tax provisions are in line with EU fiscal state aid rules. Estonian tax provisions do not provide in favour of selected undertakings an exception to the application of the general tax system. Estonian Income Tax Act does not provide for any measure intended partially or wholly to exempt firms in a particular sector from the charges arising from the normal application of the general tax system without there being any justification for this exemption on the basis of the nature or general scheme of this system. Estonian tax measures are not limited to certain geographical regions, or to certain sectors of economic activity.

Conclusion

The tax legislation of Estonia is reasonably close to that in the EU. However, in some key aspects there are wide differences. The most significant differences are in the field of income taxation. In the field of VAT the Estonian legislation is in large extent harmonized with the obligatory body of the EU law (most importantly (the Sixth Directive).

8.8 Accession negotiations (Annex A)

Transitional periods and derogations granted to Estonia

Estonia has been granted four transitional periods and one derogation from the *acquis* in the taxation chapter.

¹⁵⁸⁰ For example, the Great Britain who does not levy taxes on raising capital and Germany who abolished its capital duty recently.

Main findings of the research

VAT

By way of derogation, in implementing Article 24(2) to (6) of the Sixth Directive, Estonia may grant an exemption from VAT to taxable persons whose annual turnover is less than the equivalent in national currency of EUR 16,000 (EEK 250,000). In addition, Estonia may maintain a reduced rate on the supply of heating until 30 June 2007. Moreover, Estonia may maintain an exemption on international transport of passengers, referred to in point 17 of Annex F to the Sixth Directive, until the condition set out in Article 28(4) of the Sixth Directive is fulfilled or as long as the same exemption is applied by any of the present Member States, whichever is earlier.

Excises

Estonia may postpone the application of the overall minimum excise duty on the retail price (inclusive of all taxes) of cigarettes in the price category most in demand until 31 December 2009, provided that during this period Estonia gradually adjusts its rates towards the overall minimum excise duty. Estonia may postpone the application of the overall minimum excise duty on smoking tobacco until 31 December 2009.

Parent-subsidiary income taxation

By way of derogation from Article 5(1) of Directive 90/435/EEC (Parent-Subsidiary Directive), Estonia may, as long as it imposes income tax on distributed profits without taxing undistributed profits, and at the latest until 31 December 2008, continue to apply that tax to profits distributed by Estonian subsidiaries to their parent companies established in other Member States.

Annex A. Agreements reached at Estonia's accession negotiations with the EU in the taxation chapter

Agreement on accession to the EU grants Estonia:

- a transitional period until 30 June 2007 to apply a reduced VAT rate of not less than 5% on the supply of heating sold to individuals, housing associations, apartment associations, churches, congregations, and institutions or bodies financed from the state, rural municipality or city budget, as well as on the supply of peat, fuel briquettes, coal and firewood to individuals;
- the possibility to apply a VAT registration and exemption threshold for small and medium sized enterprises whose annual turnover is lower than EEK 250,000. Estonia shall take steps to ensure that any exemptions will have no adverse effects on the European Communities' own resources accruing from VAT.
- a transitional period until 31 December 2009 at the latest regarding the application of the overall minimum excise duty envisaged under 2002/10/EC as regards the structure and rate of excise duty on manufactured tobacco. Estonia will provide a calendar for gradual alignment with the Directive, starting in 2002. Moreover, Member States may, until full application of the *acquis*, maintain, with regard to private travellers entering their territories from Estonia, the same restrictions on the quantity of cigarettes as applied with regard to private travellers from third countries and carry out the necessary checks without affecting the proper functioning of the internal market. Member States making use of this possibility shall inform the Commission in advance thereof;
- a transitional period until 31 December 2008 to ensure full compliance with Article 5(1) of Directive 90/435/EEC (Parent-Subsidiary Directive). Estonia will provide the Union with information and a timetable as to how it intends to comply with Directive 90/435/EEC. Furthermore, Estonia will explain the measures envisaged and the timetable for the implementation in order to fully comply with the Treaty provisions on the free movement of capital at the latest by the date of accession.
- an exemption from VAT on international transport of passengers for the purposes of applying Article 28(3)(b) of Directive 77/388/EEC (Sixth Directive), until the condition set out in Article 28(4) of the Directive is fulfilled or for as long as the same exemption is applied by any of the present Member States, whichever is the earlier.

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¹⁵⁸¹ Names by which the cases are referred to are highlighted.

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