BYU Law Review

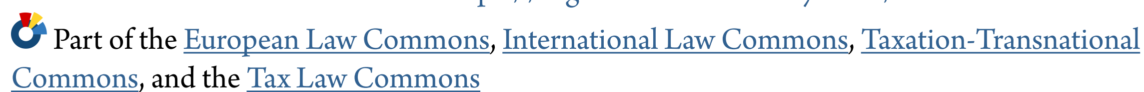
Volume 1990 | Issue 4 Article 2

11-1-1990

Direct Taxation-Whither in the Single Market of 1992?

Philip Bentley

Follow this and additional works at: https://digitalcommons.law.byu.edu/lawreview


Part of the European Law Commons, International Law Commons, Taxation-Transnational Commons, and the Tax Law Commons

Recommended Citation

Philip Bentley, *Direct Taxation-Whither in the Single Market of 1992?*, 1990 BYU L. Rev. 1339 (1990).
Available at: https://digitalcommons.law.byu.edu/lawreview/vol1990/iss4/2

This Article is brought to you for free and open access by the Brigham Young University Law Review at BYU Law Digital Commons. It has been accepted for inclusion in BYU Law Review by an authorized editor of BYU Law Digital Commons. For more information, please contact hunterlawlibrary@byu.edu.

Direct Taxation—Whither in the Single Market of 1992?

*Philip Bentley**

I. Introduction

The Treaty establishing the European Economic Community[1] (EEC) was signed in Rome on 25 March 1957. Its objective was to create a common market among the original six signatories—Belgium, France, Germany (F.R.), Italy, Luxembourg and the Netherlands—by 31 December 1969.[2] In at least two areas the original deadline was respected; internal customs tariffs and equivalent charges on trade between member states were abolished, and a common external tariff was established.

Also by that time, considerable progress had been made in ensuring the freedom of movement for workers,[3] and some progress had been made in removing restrictions on the freedom of establishment by self-employed persons and companies.[4] Modest

---

* Barrister and partner, Stanbrook and Hooper, Brussels, Belgium.

1. Treaty Establishing the European Economic Community, March 25, 1957, art. 8, 298 U.N.T.S. 3 (effective Jan. 1, 1958) [hereinafter Treaty of Rome]. An English translation is located at 1 Comm. Mkt. Rep. (CCH) ¶ 151 (1971).

The European Economic Community is usually referred to as the EEC. There is, however, a growing tendency to use the symbol EC. Strictly speaking, EC symbolizes European Communities, namely the Economic Community, the Coal and Steel Community and the Euratom Community. Since the Council, Commission, and Court of Justice are institutions of all three communities, they are sometimes referred to as the EC Council, the EC Commission, etc. This article uses EEC to describe things belonging to only the European Economic Community, and EC to describe things belonging to all three communities.

2. *Id.*

3. 11 J.O. Comm. Eur. (No. L 257) 2 (1968); 11 J.O. Comm. Eur. (No. L 257) 13 (1968). Translated in *Regulation (EEC) No. 1612/68 Of The Council of 15 October 1968 on freedom of movement for workers within the Community*, O.J. Eur. Comm. Special Edition 1968(II) 475 (1972); *Council Directive of 15 October 1968 on the abolition of restrictions on movement and residence within the Community for workers of Member States and their families*, O.J. Eur. Comm. Special Edition 1968(II) 485 (1972).

4. *E.g.*, 7 J.O. Comm. Eur. 850 (1964) (Translated in *Council Directive of 25 February 1964 on the co-ordination of special measures concerning the movement and residence of foreign nationals which are justified on grounds of public policy, public security or public health*, O.J. Eur. Comm. Special Edition 1963-1964 117 (1972)). *Cf. Council Directive of 21 May 1973 on the abolition of restrictions on movement and residence*

steps had been taken in abolishing restrictions on the free movement of capital.[5] By 1977 a harmonized and sophisticated system of value added tax[6] was in place in all nine member states (Denmark, Ireland, and the United Kingdom having joined in 1973),[7] and by 1981 the EC Court of Justice in Luxembourg could pride itself on an impressive list of innovative judgments which filled some of the blanks left by the EC Council.[8]

Despite this progress, little had been achieved in the area of direct taxation. In 1977, the member states did adopt a directive on mutual assistance between the tax authorities in matters of direct taxation,[9] which was amended in 1979 to bring value added taxes within its scope.[10] The member states had little difficulty in adopting this directive since it did not involve any surrender of sovereignty. On the contrary, it tended to protect the budgetary revenue of each member state.

One reason for the limited EEC legislation in direct taxation matters could be the lack of dispositions in the Treaty of Rome on this subject. There are no express references in the

---

within the Community for nationals of Member States with regard to establishment and the provision of services, 7 O.J. EUR. COMM. (No. L 172) 14 (1973) (where real progress came on the abolition of restrictions on movement and residence within the Community for nationals of member states with regard to establishment and the provision of services).

5. *First Directive of 11 May 1960 for the implementation of Article 67 of the Treaty*, 3 J.O. COMM. EUR. 921 (1960) (amended by *Second Council Directive of 18 December 1962*, 6 J.O. COMM. EUR. (No. 9) 62 (1963)) (superseded by *Council Directive of 24 June 1988 for the implementation of Article 67 of the Treaty*, 31 O.J. EUR. COMM. (No. L 178) 5 (1988) [hereinafter *Council Directive of 24 June 1988*]).

6. *Sixth Council Directive of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes—Common system of value added tax: uniform basis of assessment*, 20 O.J. EUR. COMM. (No. L 145) 1 (1977).

7. *Common Market in Profile*, 1 Common Mkt. Rep. (CCH) ¶ 101 (June 18, 1987) (Greece joined subsequently on 1 January 1981 and Spain and Portugal on 1 January 1986).

8. *E.g.*, A.G. v. Bundesmonopolverwaltung für Branntwein, 1979 E. Comm. Ct. J. Rep. 649, 3 Comm. Mkt. L.R. 494. For a recent discussion of cases on the free movement of goods, see Gormely, *Some Reflections on the internal Market and Free Movement of Goods*, 1989 LEGAL ISSUES EUR. INTEGRATION 9. *See also* Van Rijn, *A Review of the Case law of the Court of Justice On Articles 30 to 36 EEC In 1986 and 1987*, 25 COMMON MKT. L. REV. 593 (1988). For a discussion on the freedom of establishment and freedom to provide services *see infra* notes 29-31 and accompanying text.

9. *Council Directive of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation*, 20 O.J. EUR. COMM. (No. L 336) 15 (1977).

10. *Council Directive of 6 December 1979 amending Directive 77/799/EEC concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation*, 22 O.J. EUR. COMM. (L 331) 8 (1979).

Treaty of Rome to *direct* taxation in the sense of taxes levied directly on an individual or a company, as opposed to taxes on products, which are usually referred to as *indirect* taxation.

The references to taxation in articles 95 to 99 of the Treaty of Rome concern the taxation of products,[11] and so, more often than not, are invoked in cases about indirect taxation.[12] Article 220 of the Treaty of Rome says that "Member States shall, so far as necessary, enter into negotiation with each other with a view to securing for the benefit of their nationals . . . the abolition of double taxation within the Community." This provision has not yet been used but it clearly envisages direct, rather than indirect, taxation.[13]

The EC Commission has been aware for a long time that differences in direct taxation in the member states could obstruct the creation of a truly common market. Article 100 of the Treaty of Rome provides a mechanism for dealing with such problems. Article 100 states: "The Council shall, acting unanimously on a proposal from the Commission, issue directives for the approximation of such provisions laid down by law, regulation or administrative action in Member States as directly affect the establishment or functioning of the Common Market." Pursuant to this provision, the EC Commission made the following proposals for directives in the area of direct taxation.

On 15 January 1969

Proposed Council Directive on the common tax system for parent companies and subsidiaries of different member states (Parent/Subsidiary Directive);[14]

Proposed Council Directive on the common tax system for mergers, split-ups and transfers of assets involving companies of different member states (Mergers Directive).[15]

---

11. *See* Treaty of Rome, *supra* note 1, arts. 95-99.

12. Barents, *Recent Case Law on the Prohibition of Fiscal Discrimination Under Article 95*, 23 COMMON MKT. L. REV. 641 (1986).

13. Article 220 of the Treaty of Rome was used as an alternative to the Arbitration Procedure Directive discussed *infra* notes 84-90 and accompanying text. Thus, the Arbitration Directive, as finally adopted, took the form of a multilateral convention between the member states made pursuant to Article 220 of the Treaty of Rome. *See Communication from the Commission to the Council*, 1985 EUR. COMM. DOC. (COM No.(85)360).

This article shall refer to the Arbitration Procedure Directive when referring to the original proposed directive. Reference to the convention as adopted shall be to the Arbitration Procedure Convention.

14. 12 J.O. COMM. EUR. (No. C 39) 7 (1969).

15. 12 J.O. COMM. EUR. (No. C 39) 1 (1969) [hereinafter Mergers Directive].

On 23 July 1975

Proposed Council Directive on the harmonization of systems of company taxation and of withholding taxes on dividends (Corporate Taxation Directive).[16]

On 29 November 1976

Proposed Council Directive on the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises (Arbitration Procedure Directive).[17]

On 24 July 1978

Proposed Council Directive on the application to collective investment institutions of the Council Directive harmonizing systems of company taxation and of withholding taxes on dividends (Collective Investment Directive).[18]

On 21 December 1979

Proposed Council Directive concerning the harmonization of income taxation provisions with respect to freedom of move-

16. *Proposal for a Council Directive concerning the harmonization of systems of company taxation and of withholding taxes on dividends*, 18 O.J. EUR. COMM. (No. C 253) 2 (1975) [hereinafter Corporate Taxation Directive].

Since this Article was written, the EC Commission adopted a communication of 18 April 1990 in which it proposed to cease all further work on this directive and to undertake a study on the disparity of corporate taxation in the Community and the extent to which competitive forces may lead to an alignment of Member States' corporate tax systems. Subject to this study, the EC Commission maintained its position that the EC Council should adopt, as quickly as possible, the package consisting of the Parent/Subsidiary Directive, the Mergers Directive, and the Arbitration Procedure Directive. This package should now be completed by including two other directives: one permitting all enterprises to deduct losses of their operating divisions in other Member States, whether they be permanent establishments or subsidiaries and another providing for the abolition of withholding tax on interest and royalty payments between companies of the same group.

The first step in the direction of allowing the set-off of losses of permanent establishments is found in article 133 of the proposed statute for a European Company. 32 O.J. EUR. COMM. (No. C 263) 41 (1989).

17. *Proposal for a Council Directive on the elimination of double taxation in connection with the adjustment of transfers of profits between associated enterprises (arbitration procedure)*, 19 O.J. EUR. COMM. (No. C 301) 4 (1976) [hereinafter Arbitration Procedure Directive].

18. *Proposal for a Council Directive on the application to collective investment institutions of the Council Directive concerning the harmonization of systems of company taxation and of withholding taxes on dividends*, 21 O.J. EUR. COMM. (No. C 184) 8 (1978) [hereinafter Collective Investment Directive].

ment of workers within the Community (Income Tax Directive).[19]

On 11 September 1984

Proposed Council Directive on the harmonization of the laws of the member states relating to tax arrangements for the carry-over of losses of undertakings (Loss Carryovers Directive),[20] subsequently amended on 25 June 1985.[21]

Although many barriers have arisen to the acceptance and implementation of these proposals by the member states, three of the proposed measures in this list recently have been adopted.[22] All three of the adopted measures had been included in the EC Commission's White Paper on Completion of the Single Market by 31 December 1992,[23] showing that the EC Commission could overcome the barriers to harmonization of direct taxation. Member states are understandably jealous of their sovereignty over national taxation because it is an instrument of economic policy, and economic policy is not yet a matter which is required to be harmonized by the Treaty of Rome. The Treaty simply requires that, "[e]ach Member State shall pursue the economic policy needed to ensure the equilibrium of its balance of payments and to maintain confidence in its currency, while taking care to ensure a high level of employment and a stable level of prices."[24] Thus, each member state is responsible for its own economic policy.

Article 105 of the Treaty of Rome does require (1) the member states to coordinate their economic policies, (2) the EC Commission to submit recommendations on how this should be done, and (3) the creation of a Monetary Committee with advisory status. However, article 105 has no teeth. In recognition of this

---

19. *Proposal for a Council Directive concerning the harmonization of income taxation provisions with respect to freedom of movement for workers within the Community*, 23 O.J. EUR. COMM. (No. C 21) 6 (1980) [hereinafter Income Tax Directive].

20. *Proposal for a Council Directive on the harmonization of the laws of the Member States relating to tax arrangements for the carry-over of losses of undertakings*, 27 O.J. EUR. COMM. (No. C 253) 5 (1984) [hereinafter Loss Carryovers Directive].

21. *Amendments to the Proposal for a Council Directive on the harmonization of the laws of the Member States relating to tax arrangements for the carry-over of losses of undertakings*, 28 O.J. EUR. COMM. (No. C 170) 3 (1985) [hereinafter Amendments].

22. For recent developments, see *infra* note 104.

23. (COM(85)310). The Parent/Subsidiary Directive, the Mergers Directive, and the Arbitration Procedure Directive were included in the original White Paper and the Loss Carryovers Directive was added subsequently.

24. Treaty of Rome, *supra* note 1, art. 104.

problem, the European Council[25] set up the Delors Committee to examine ways in which economic and monetary union could be achieved in the Community. The Delors Committee has drawn up a three stage plan for achieving economic and monetary union. The first stage was planned for 1 July 1990—the date already fixed for liberalization of capital movements between the member states.[26] The first stage would involve more transparency in the coordination of economic and monetary policies of the member states through multilateral surveillance and a reinforced role of the Committee of Governors of the Central Banks of the member states.[27] The second stage would see the setting up of an intergovernmental conference to review the Treaty of Rome and set up new institutions responsible for economic and monetary matters. The third stage would see a move towards fixed exchange rates between the currencies of the member states, the introduction of an EC currency, and the establishment of an EC central bank.

One can debate whether or not the three stage plan for economic and monetary union is a case of putting the cart before the horse. The United Kingdom is overtly jealous of its sovereignty over its own economy, and no doubt some of the other member states have the same feelings deep down. Arguably it would be more realistic to concentrate on achieving a single market for goods and services first, and wait for trade and investment across internal frontiers to grow as a consequence. Such growth will inevitably bring about a certain alignment in economic performance of the different member states, and the reluctant member states will find it easier to swallow the bitter pill of economic and monetary union.

The third stage of economic and monetary union planned by the Delors Committee is not likely to be in place by 31 De-

---

25. Established by the Single European Act, BULL. E.C., Supp., Feb., 1986 [hereinafter SEA]. Article 2 of the SEA says that "the European Council shall bring together the Heads of State or of Government of the Member States and the President of the Commission of the European Communities. They shall be assisted by the Ministers of Foreign Affairs and by a Member of the Commission. The European Council shall meet at least twice a year."

26. *See Council Directive of 24 June 1988, supra* note 5.

27. *See Proposal for a Council Decision on the attainment of progressive convergence of economic performance during stage one of Economic and Monetary Union*, 32 O.J. EUR. COMM. (No. C 283) 6 (1989); *Recommendation for a Council Decision amending Decision 64/300/EEC on co-operation between the Central Banks of the Member States of the European Economic Community*, 32 O.J. EUR. COMM. (No. C 283) 8 (1989).

cember 1992, the date fixed for achieving the single market.[28] It is also difficult to believe that directives on the harmonization of direct taxation can realistically be adopted prior to the harmonization of economic policy.

The foregoing discussion raises uncertainties for the single market of 31 December 1992. The theory of the single market is that the internal frontiers between the member states (many of which were drawn arbitrarily by statesmen and generals in the nineteenth century) should not have any legal or administrative influence on the movement of goods, services, workers, companies or capital across the Community. If direct taxation remains the only area of law that is not adequately harmonized by 31 December 1992, differences in tax regimes are going to have an important influence on business decisions about the location of production, distribution, and administrative activities as well as the corporate and financial structures of such activities.

The influences of direct taxation on business decisions concerning the location of activities can be analyzed into three categories. This article designates the state of a company's residence as the "home state," and the state where the company plans to do business by providing cross-border services, by establishing a branch, or by setting up a subsidiary as the "host state." Category I includes cases in which the host state imposes more burdensome taxation on the activities of foreign companies than those of domestic companies. Category II comprises cases in which the home state places tax obstacles in the way of resident companies seeking to do business in other states. Category III involves cases in which the diversity of the tax legislation of the member states makes it more favourable for a company to locate its foreign activities in a particular host state.

Solutions to the problems arising in the first two categories can often be found in the general provisions of the Treaty of Rome on the free movement of persons and services. However, the third category of problems cannot be solved so easily under the Treaty of Rome alone. This article examines the three categories of tax problems outlined above with particular reference to the Treaty of Rome and to the relevant decisions of the EC Court of Justice. It also analyzes the proposed directives to determine the extent to which they solve the problems that cannot be solved under the Treaty of Rome alone.

---

28. SEA, *supra* note 25, art. 13.

II. Category I—Discrimination in the Host Member State

The EC Court of Justice has issued two judgments, discussed below, which show clearly that any tax discrimination by the host state that obstructs the exercise of rights of establishment conferred by articles 52 of the Treaty of Rome, or the right to provide services conferred by articles 59 of the Treaty, is illegal. Article 169 provides that an illegal measure can be challenged directly before the EC Court of Justice by the EC Commission or indirectly before a national court by a private litigant. Pursuant to article 177, a national court may—and in some cases must—refer any relevant question of interpretation of the Treaty of Rome to the EC Court of Justice.

A. *Freedom of Establishment*

Article 52 of the Treaty of Rome provides:

> Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be abolished by progressive stages in the course of the transitional period. Such progressive abolition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State. Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of article 58, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital. [29]

The rights conferred on individuals by this article can also be invoked by "companies or firms formed in . . . a Member State and which have their registered office, central administration or principal place of business within the Community."[30] "Companies or firms" for this purpose means those "constituted under civil or commercial law, including co-operative societies, and other legal persons under by public or private law, save for those which are non-profit making."[31]

29. Treaty of Rome, *supra* note 1, art. 52.
30. *Id.* art. 58.
31. *Id.*

In *Reyners v. Belgium*,[32] the EC Court of Justice ruled that, since the end of the transitional period on 31 December 1969, article 52 of the Treaty of Rome is a directly applicable provision notwithstanding the absence of EC Council directives giving effect to such a right of establishment. In other words, a member state may not enforce tax provisions which obstruct exercise of the right of establishment and then argue that such provisions are permissible until the EC Council has adopted the necessary directives harmonizing member states' laws on direct taxation.

Thus, in *Commission v. France*[33] the EC Commission brought proceedings against France under article 169 of the Treaty of Rome. The Commission alleged that, the French Republic had failed to fulfil its obligations under article 52 of the Treaty of Rome by withholding the benefit of shareholders' tax credits enjoyed by French companies from insurance company branches in France which were established in another member state.

At the time the proceedings were brought, the French corporation tax was charged at the rate of fifty percent on the profits of companies operating in France or liable to taxation in France by virtue of a double taxation treaty. In order to limit the cumulative taxation of profits taxed in the corporation and then distributed to and taxed in the hands of shareholders, France granted a tax credit or *avoir fiscal* in favour of the shareholder recipients of dividends paid out of corporate profits which had been taxed in France. The amount of the tax credit was equal to half the sum actually distributed by the company, as demonstrated by the following:

Company profits	1,000
Corporate tax	500
Net profits	500
Dividend	500
Tax credit	250

The benefit of the tax credit was granted only to those persons who had their habitual residence or registered office in France. However, the benefit of the credit could be extended to persons resident in countries that had entered into a double taxation treaty with France. It follows that the tax credit was available to the French subsidiaries of foreign companies but was not gener-

32. 1974 E. COMM. CT. J. REP. 631, 2 COMM. MKT. L.R. 305.
33. No. 270/83 (EC Ct. of Just. Jan. 28, 1986), Op. Advoc. Gen. (Oct. 16, 1985).

ally available to branches established in France by foreign companies. Moreover, the French Tax Administration had issued instructions that a foreign company having a branch in France was not to have the benefit of the tax credit even if the dividends in question were included in the branch's income which was subject to taxation in France.

The EC Commission argued that, by not granting the tax credit to branches of companies having their registered office in other member states, France had created an indirect restriction on the freedom of such companies to establish branches in France and thereby had failed to fulfill its obligations under article 52 of the Treaty of Rome.

The problem was particularly acute for the insurance sector because branches of insurance companies were obliged to maintain technical reserves located in France and so had more reason to invest in French equities. The EC Commission had received complaints only from insurance companies, and consequently formulated its proceedings only in respect of the insurance sector. However, the EC Commission enlarged the scope of the case to include other types of companies. France objected to the EC Commission's proposed enlargement, and while the EC Court of Justice expressed regret that the case was limited to the insurance sector, the court was bound by the parameters of the case. However, contrary to France's argument, the EC Court of Justice held that this did not warrant a dismissal of the case and proceeded to review the case and arguments.

The argument of the EC Commission in this case was twofold. First, it argued that the differential tax treatment discouraged "branches from holding French shares and [placed] them at a disadvantage in the pursuit of their activities in France."[34] This is exemplified by the following:

	French Company	Branch
Dividend received	100	100
Tax credit	50	—
Taxable amount	150	100
Tax 50%	75	50
Less tax credit	50	—
Net tax payable	25	50
Net dividend	75	50

34. *Id.*

This differential tax treatment was all the more remarkable because, in all other respects, the taxable income of French companies and of branches was determined in the same way. Second, the Commission argued that the unfavourable treatment of branches by the tax rules indirectly restricted the freedom of choice of a foreign insurance company by creating an inducement to set up a subsidiary rather than a branch.

The French Government had two lines of defense. First, it argued that the difference in tax treatment between French companies and foreign branches was based on the distinction between "residents" and "non-residents." This distinction is found in all tax systems and is generally accepted internationally. The distinction is also based on the objective difference between the position of a national company and that of a branch of a foreign company and therefore does not constitute discrimination on the grounds of nationality.

France's second argument was that the differential tax treatment resulted from variations in the tax systems of member states and also the existence of double taxation agreements. Different measures are needed in each case to accommodate the different tax systems and are justified under article 52 of the Treaty of Rome. Moreover, article 220 recognizes expressly that double taxation agreements are necessary to deal with the taxation of individuals and companies who pursue their activities in different member states.

The EC Court of Justice had little difficulty in disposing of France's arguments. It pointed out that article 52 of the Treaty of Rome does not permit differences in treatment based solely on the fact that a company has its registered office in another member state. Moreover, the French rules for determining the taxable income were indeed the same for French companies and for branches. Thus, by treating the latter differently with regard to the tax credit, there was clear discrimination on the grounds of nationality, in violation of article 52 of the Treaty of Rome.

In reply to France's second argument, the EC Court of Justice observed that the differences in tax treatment were not, in fact, the result of double taxation agreements, but of dispositions of French domestic tax law. Furthermore, the rights conferred by article 52 of the Treaty of Rome are unconditional and could not therefore be made subject to the contents of a bilateral agreement with another member state.

Following *Commission v. France*, it is likely that the EC

Court of Justice will condemn an interpretation of a member state's tax legislation that provides less favourable tax treatment to a permanent establishment of a company from another member state than it does to a domestic company. Although simple to enunciate, this principle will not always be easy to apply. In *Commission v. France,* the rules for determining the tax base of a French company and of a foreign branch were the same, so that different treatment of the tax credit stood out as a clear case of discrimination. However, from a more sophisticated perspective, discrimination is not so easy to demonstrate if one compares the total economic tax burden for both a French company and a branch. The profits of the branch could be moved out of France back to the head office without any further tax charge, whereas the profits of the French company would be subject to withholding tax if distributed to a foreign company. The court did not raise this point, implying that it will, in the future, take a fairly straightforward approach—if there is discrimination at a particular point of the economic cycle, it is not necessary to examine the tax costs over the whole cycle.

B. *Freedom to Provide Services*

Article 59 of the Treaty of Rome provides as follows:

> Within the framework of the provisions set out below, restrictions on freedom to provide services within the Community shall be progressively abolished during the transitional period in respect of nationals of Member States who are established in a State of the Community other than that of the person for whom the services are intended.

In *J.H.M. Van Binsbergen v. Bestuur Van de Bedrijfsvereniging voor de Metaalnijverheid,*[35] the EC Court of Justice held that, like article 52 on freedom of establishment, article 59 could be invoked by individuals in the national courts after the expiration of the transitional period on 31 December 1969.

The application of article 59 in matters of direct taxation arose in *Van Eycke v. A.S.P.A.,*[36] which was referred to a local Belgian Court for a preliminary ruling on an interpretation of EEC law. This was not a case of the EC Commission enforcing the Treaty, but rather a case arising out of private litigation. In

35. 1974 E. Comm. Ct. J. Rep. 1299, 1 Comm. Mkt. L.R. 298.
36. No. 267/86 (EC Ct. of Just. Sept. 21, 1988); Op. Advoc. Gen. (Apr. 28, 1988).

the absence of any directives harmonizing direct taxation in the Community, Mr. Van Eycke, a private citizen, sought a remedy for what he considered an infringement of article 59 of the Treaty of Rome.

Mr. Van Eycke worked as an employee at the A.S.P.A. savings bank. He noticed that the bank was offering a rate of 5.25% per annum plus a fidelity premium of 2% on ordinary savings deposit books. On 17 March 1986, he applied to the bank to open a deposit bank account and to deposit 25,000 BF (about $600). The bank informed Mr. Van Eycke that the rate of interest offered would only be 4.75% per annum and a fidelity premium of 1.5% by virtue of a Royal Decree of 13 March 1986. He brought proceedings in the local court challenging the bank's refusal to accept deposits at the previous rate on the grounds that the Royal Decree of 13 March 1986 was illegal under Community law. He argued that the Royal Decree reinforced an interest-rate- fixing cartel of the Belgian banks and was contrary to article 59.

Article 19,7 of the Belgian Tax Code,[37] combined with article 3 *bis* of the Implementing Decree,[38] exempts from income tax (and therefore from the 25% withholding tax) the first 50,000 BF of income from bank deposits provided the following conditions are satisfied:

1. the deposit has no contractual term or notice period;
2. the deposit is denominated in Belgian francs;
3. transfers from the deposit account to current accounts are limited in accordance with article 3 *bis*, Implementing Decree;
4. the bank may require at least five days notice of withdrawals above 50,000 BF and may limit total withdrawals to 100,000 BF per half-months;
5. the interest rate is made up exclusively of a base rate and a fidelity premium or a growth premium or both premiums to be credited once a year and calculated in accordance with article 3 *bis*, Implementing Decree;
6. the base rate does not exceed the base market rate published by the Banking Commission in the Belgian State Gazette subject to a maximum threshold laid down from time to time by royal decree; and

37. 4 LES CODES LARCIER, *Droit Economique et Fiscal* 440, 495 (1985) [hereinafter LES CODES LARCIER].
38. *Id.*

7. the fidelity premium and the growth premium cannot exceed 35% of the maximum base rate in condition six rounded down to the nearest 0.25%.

Mr. Van Eycke asked the EC Court to rule whether the above tax regime was compatible with the competition rules contained in article 85 of the Treaty of Rome and with provisions in articles 59 of the Treaty of Rome on the freedom to provide services, and article 95 which prohibits member states from subjecting products from other member states to a higher level of internal taxation than that imposed on similar domestic products.

The Belgian State intervened to argue that the whole case had been staged, that no actual dispute existed between the parties, and that therefore the EC Court of Justice had no jurisdiction. Because there was no obvious element of fact which tended to show that the case had been staged, the court considered the substantive questions.

The first question above, involving article 85, is not relevant to the present discussion. Considering the second question about direct taxation, the EC Court of Justice observed that the liberalization of cross-border banking services between member states was conditioned on the prior liberalization of capital movements pursuant to article 61(2) of the Treaty of Rome. Article 61(2) provides: "The liberalization of banking and insurance services connected with movements of capital shall be effected in step with the progressive liberalization of movements of capital." However, the placing of private deposits is a capital movement which was not liberalized at EEC level until 1 July 1990.[39] Until liberalization occurred, no freedom to provide cross-border deposit services existed. Thus the Belgian tax scheme could not infringe upon a nonexistent freedom.

The EC Court of Justice dismissed the third argument on the grounds that article 95 prohibits member states from imposing discriminatory internal taxation on the imports of goods from other member states and that it does not apply to financial services.

Consequently, the court ruled that the special tax regime for deposit interest was not then incompatible with articles 59 and 95 of the Treaty of Rome. However, once the proposed Sec-

39. *See Council Directive of 24 June 1988, supra* note 5.

ond Banking Coordination Directive[40] is implemented in member states on 1 January 1993, the EC Court of Justice's answer to the second question above would likely change. Applying this Directive, the court would probably hold that the Belgian special tax regime does discriminate against banks established in other member states seeking to offer cross-border deposit account services.

The case of *Van Eycke v. A.S.P.A.*[41] affirms the right of a private party to bring proceedings in the national courts challenging a law which taxes the provision of services by a national of another member state less favourably than similar services provided by a national of the member state in question. Whether or not one finds discrimination depends on the sophistication of the analysis concerning the total economic cost. For example, in *Van Eycke*, the income paid on deposit accounts is a deductible expense for the Belgian bank. Thus the total budgetary revenue for the Belgian State is in fact the personal income tax liability of the depositor. In the absence of any special exemption, this tax liability is theoretically the same whether the deposit interest originates in Belgium or elsewhere. If the payor of the interest is a Belgian bank, it is obliged to withhold tax at the rate of twenty-five percent. In most cases this is a final tax and the income does not have to be declared by the recipient.[42] If the payor is a foreign bank which pays directly to the depositor rather than via a Belgian paying agent, the depositor is obliged to declare the income and pay tax at the rate of twenty-five percent,[43] which raises the problem of non-disclosure of income.

Many of the member states were concerned that the liberalization of exchange controls on 1 July 1990 would encourage individuals to deposit their savings abroad and not declare the interest earned. In recognition of this problem, the EC Commission proposed a directive establishing a standard rate of withholding tax on deposit interest earned by individuals.[44] The

---

40. *Second Council Directive of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780/EEC*, 32 O.J. Eur. Comm. (No. L 386) 1 (1989).

41. No. 267/86 (EC Ct. of Just. Sept. 21, 1988); Op. Advoc. Gen. (Apr. 28, 1988).

42. Les Codes Larcier, *supra* note 37, art. 93 § 1.1 *bis* at 460 (as inserted by the law of the 28 December 1983).

43. Les Codes Larcier, *supra* note 37, § III A.2.

44. *Proposal for a Council Directive on a Common System of Withholding Tax on*

proposal met with strong opposition from member states, notably Luxembourg, the Netherlands, and the United Kingdom, which do not generally withhold tax on deposits made by non-residents. As a result, the proposal has been shelved, and the Commission is seeking an alternative solution based on closer cooperation between tax authorities and on a general public relations campaign against tax evasion.[45]

If an effective solution cannot be found, member states like Belgium argue that they should be allowed to discriminate in situations like *Van Eycke* to protect national revenue by encouraging investment in deposit accounts in which tax is automatically withheld. Article 56 of the Treaty of Rome allows member states to take steps warranted by public policy, even if they obstruct the freedom to provide services, and arguably the protection of national revenue is a matter of public policy. Given the court's restrictive interpretation of the exception in article 56, such an argument would be unlikely to succeed. Nevertheless, this problem illustrates that the EC Commission's proposals on taxation play a complementary role to that of articles 52 and 59 of the Treaty of Rome. The member states' inability to agree on these proposals is a matter for serious concern.

III. Category II—Tax Obstacles in the Home Member State

This section shows that it is not absolutely necessary to prove discrimination in the host state in order to succeed in an action based solely on articles 52 and 59 of the Treaty of Rome. Another possible approach is to show that the tax regime in the home state acts as an obstacle to the opening of a branch or subsidiary, or to the provision of services in another member state.

A cursory reading of article 52 of the Treaty of Rome might suggest that its purpose is to prevent only the host state from imposing restrictions on the arrival of nationals of other member states. The only language of article 52 which can be interpreted as prohibiting restrictions in the home state is the general statement in the first paragraph which states that "restrictions on the freedom of establishment by nationals of a Member State in

---

Interest Income, 1989 Eur. Comm. Doc. (COM No. (89)60) 1 (1989).

45. *Company Taxation: Commission Proposes Simple Approximation*, European Report, Apr. 21, 1990, § 2, at 1, col.2.

the territory of another Member State shall be abolished." This sentence is not very explicit. Thus, interpretation in light of the purpose of article 52 is helpful. Article 52's purpose is to ensure that self-employed persons and companies can move over internal frontiers to provide economic activity and employment anywhere in the common market. A helpful case in this area, *Luisi v. Ministero del Tesoro*,[46] concerned the freedom to provide services under article 59 of the Treaty of Rome. In *Luisi* the EC Court of Justice ruled that the freedom to provide services includes the freedom, for the recipients of services, to go to another Member State in order to receive a service there, without being obstructed by restrictions.[47]

Extrapolating from this, one can argue that restrictions on the exercise of any of the freedoms conferred by the Treaty must not be imposed by either the host state or the home state.[48]

Until recently, all the decided cases concerning obstacles to freedom of establishment and freedom to provide services have arisen out of discrimination in the host Member State. However, in *The Queen v. H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust P.L.C.*,[49] the question arose as to whether a requirement of UK tax law which made it an offense to transfer a company's fiscal residence abroad without the prior consent of H.M. Treasury infringed article 52 of the Treaty of Rome.

Although the case appears at first sight to be a case about taxation, it was decided by the EC Court of Justice on a point of company law. Until recently it was possible to transfer the fiscal residence of a UK company outside the jurisdiction without having to wind up the company and reincorporate in a new jurisdiction. The court decided that the rights of establishment under article 52 did not apply to the transfer of a company's residence. Referring to article 220 of the Treaty of Rome, the court observed that the transfer of residence of companies is a matter

46. 1984 E. Comm. Ct. J. Rep. 377, 3 Comm. Mkt. L.R. 57.

47. *Id.*

48. It should also be observed that Article 2 of Council Directive 73/148/EEC requires member states to give self-employed persons the right to leave the territory for the purposes of establishing themselves in another member state, although this directive does not confer rights on corporate bodies. *See* The Queen v. H.M. Treasury and Comm'r of Inland Revenue, ex parte Daily Mail and Gen. Trust P.L.C., No. 81/87 (EC Ct. of Just. Sept. 27, 1988); Op. Advoc. Gen. (June 7, 1988).

49. No. 81/87 (EC Ct. of Just. Sept. 27, 1988); Op. Advoc. Gen. (June 7, 1988).

which falls outside the Treaty and must therefore be dealt with by multilateral convention.

The decision of the EC Court of Justice is particularly striking because the EC Commission had intervened in the case in support of the argument that there was an infringement of article 52. The Advocate-General's opinion was that article 52 would be infringed if the transfer of residence reflected a genuine integration of the company into the economic life of the host member state.[50] Even before the Court gave judgment, the UK amended its law to replace the contentious consent requirement with an automatic capital gains tax charge. In this way, a company transferring its residence would be taxed as though it had gone into voluntary liquidation and been reconstituted in another member state, which is the procedure in most other member states.

The court discussed the question of restrictions on establishment in the state of departure, stating:

> Even though [articles 52 of the Treaty of Rome] are directed mainly to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation which comes within the definition contained in article 58.[51]

One can safely conclude that, in the future, dispositions of home state national tax law which have the effect of preventing or restricting a resident taxpayer from doing business in the host state can be challenged under articles 52 and 59.

IV. Category III—Diversity of Tax Regimes in All the Member States

No provision of the Treaty of Rome applies specifically and expressly to the distortions of competition caused by differing tax regimes in an international context. This section does not consider the obstacles in the home or the host state as such, rather it examines on a multi-national level the artificial distor-

50. Op. Advoc. Gen. point 15 (June 7, 1988).

51. *H.M. Treasury*, No. 81/87 (EC Ct. of Just. Sept. 27, 1988). For the definition of "companies" see *supra* note 31 and accompanying text.

tions of investment and marketing decisions caused by the differences in the member states' tax regimes.[52]

Articles 92 and 93 of the Treaty of Rome taken together prohibit aid by a member state in any form that distorts or threatens to distort competition in interstate trade by favouring certain businesses or the production of certain goods. These provisions have been invoked by the EC Commission to prohibit tax rules that create regional preferences within a member state.[53] However, when the basic tax regime that applies throughout a member state is more favourable than the tax regime of another member state, the EC Commission has not challenged the favourable tax regime. The theory is that measures taken by a member state as part of national economic and monetary policy which apply throughout the state without discrimination do not constitute "aid" within the meaning of articles 92 and 93.[54]

Article 95 of the Treaty of Rome prohibits any internal taxation that discriminates against products imported from other member states. Article 95 generally does not apply in the area of income and corporate taxation since these taxes are usually levied on production without discrimination as to products. However, measures such as special depreciation allowances which are available for investment in national products, but not for investment in imported products, would appear to infringe article 95.

V. Examination of the Proposed and Adopted Legislative Measures

The discussion so far has demonstrated that there are fairly powerful means of attacking discriminatory tax provisions under articles 52 and 59 of the Treaty of Rome. However, this approach has two disadvantages. First, it carries an element of uncertainty for a person who litigates the matter or who makes a complaint to the EC Commission hoping that the Commission will bring a proceeding under article 169. Second, articles 52 and 59 cannot resolve all the problems that arise in multinational tax

52. For a recent discussion of the economic and business aspects of this problem, see M. Devereux & M. Pearson, Corporate Tax Harmonization and Economic Efficiency (Institute for Fiscal Studies (London) Report Series No. 35, 1989).

53. *E.g.*, EC Commission's Thirteenth Report on Competition Policy, point 269, at 174 (1984) (discussion of Belgian employment zones).

54. D. Wyatt & A. Dashwood, The Substantive Law of the EEC 325-26 (2d ed. 1980).

situations. It is therefore important to examine the proposed and adopted legislative measures in matters of direct taxation.

A. *The Parent/Subsidiary Directive*

For the purposes of the Parent/Subsidiary Directive,[55] a parent company is defined as a company incorporated in one member state that holds at least twenty-five percent of the capital of a company incorporated in another member state.[56] As of 1 January 1992, the Parent/Subsidiary Directive will abolish withholding tax on profit distributions by a company of one member state to its parent company in another member state.[57] The Parent/Subsidiary Directive will also require the member state of a parent company to either exclude the subsidiary's dividend from the parent company's taxable base, or include the dividend in the taxable base, but grant a tax credit for the proportion of the subsidiary's corporation tax attributable to the dividend up to the limit of the corresponding domestic tax.[58] Similarly, the member state of the parent company may not charge withholding tax on the incoming dividend.[59] The following three countries benefit from temporary exemptions from the obligation to not withhold tax on subsidiary to parent dividends: (1) Germany may withhold tax at the rate of five percent until mid-1996, but only so long as it continues to charge corporation tax on distributed profits at a rate which is at least eleven percent lower than the rate it charges on undistributed profits; (2) Greece may levy withholding tax on dividends up to the rate provided in its double tax treaties for so long as it does not impose any corporation tax on distributed profits; and (3) Portugal may levy withholding tax at the rate of fifteen percent until 31 December 1996 and then at the rate of ten percent until 31 December 1999 (subject to existing double tax treaties).[60]

The Parent/Subsidiary Directive principally solves Category II type problems.[61] It abolishes the double taxation of profit dis-

---

55. 33 O.J. EUR. COMM. (No. L 225) 6 (1990); *see also supra* note 14.

56. *Id.* art. 3(1)(a). *But see* art. 3(2) for minor derogations.

57. *Id.* art. 5(1).

58. *Id.* art. 4. The Parent/Subsidiary Directive also requires the member state to grant a tax credit for the withholding tax levied by virtue of the three exceptions described *infra* note 60 and accompanying text.

59. *Id.* art. 6.

60. *Id.* art. 5, ¶¶ (2)-(4).

61. *See supra* notes 46-51 and accompanying text.

tributions, thereby removing a disincentive to form subsidiaries in other member states. It can also be applied to Category III cases[62] to the extent that it harmonizes the rules on withholding tax on dividends paid between subsidiary and parent of any two member states.

If the Parent/Subsidiary Directive were not fully implemented, the ability of the EC Court of Justice to provide a remedy to the parent company seeking relief from double taxation would be questionable. The parent company could argue that the setting up of a subsidiary is an exercise of the right of establishment within the express terms of article 52 of the Treaty of Rome. The refusal by both the host state and the home state to grant relief from double taxation amounts to a restriction on the freedom of establishment. However, resolving the dilemma would require that one member state relinquish its right to tax in favour of another member state.

No rule in the Treaty of Rome gives priority to the state of residence over the state of source of the income or vice versa. On the contrary, article 220 relegates the problem of double taxation to the domain of multinational treaties to be negotiated by the member states. Needless to say, no such treaties presently exist and residents of the member states have to rely on the network of bilateral treaties between the member states of the EEC. The Parent/Subsidiary Directive is necessary to provide a solution where the Treaty of Rome is probably insufficient.

B. The Mergers Directive

The Mergers Directive[63] will address tax problems involved in transnational mergers as of 1 January 1992. For example, a company in Brussels may be considering merging with a company in Liege, a company in Breda, or a company in Lille. The merger with the company in Liege is a domestic matter as far as Belgian taxation is concerned. Under articles 123 and 124 of the Belgian Tax Code,[64] such a merger can take place in a tax neutral fashion. Any accrued or hidden gains in the assets of the merging companies will not be taxed provided certain conditions are met—notably that no assets or cash are distributed to share-

---

62. *See supra* notes 52-54 and accompanying text.

63. 33 O.J. Eur. Comm. (No. L 225) 1 (1990); *see also* Mergers Directive, *supra* note 15, art. 7.

64. Les Codes Larcier, *supra* note 37, arts. 123 & 124, at 465.

holders as part of the merger and that all the companies involved are Belgian companies. The Belgian State is prepared to make this concession because it encourages corporate restructuring to take place and, in any event, the Belgian state will collect its tax on the accrued gains upon the winding up and disposal of the assets of the company.

In the case of a merger between companies in different member states, the analysis is different. Under current law, it is generally necessary to wind up the merging companies, satisfy their creditors, and then contribute the balance of the assets to a new company. Alternatively, the merging companies have to be maintained as separate entities and transferred to a common holding company.[65] The member states are currently discussing the EC Commission's proposal for a Tenth Company Law Directive which would enable such cross-border mergers to take place.[66] However, the Tenth Company Law Directive does not deal with the tax consequences of a cross-border merger. Tax consequences are regulated under the Mergers Directive, an essential counterpart to the Tenth Company Law Directive. This situation involves a Category II problem because the home state of the merged company is imposing a tax obstacle to the departure of the company into the foreign absorbing company.

The objective of the Mergers Directive is to ensure that the system of tax neutrality, which applies to most national mergers, also applies to cross-border mergers involving companies of different member states. Technically this presents no problem; any accrued gains on assets contributed at the time of the merger will be taxed only upon subsequent disposal of the asset. Thus, the state in which the acquired or merged company is established does not lose the ultimate right to tax the hidden and accrued gains when they are realized.[67]

From a political point of view, however, matters are not so simple. Many member states fear that tax neutral cross-border mergers is an incentive for companies to be absorbed into companies constituted in member states with comparatively low corporate tax rates. Although the home state has the ultimate right to tax accrued gains, the gains may never be realized. For this

65. *See generally*, 3 BULL. E.C. 5 (1985).

66. *Proposal for a Tenth Council Directive based on Article 54(3)(9) of the Treaty concerning cross-border mergers of public limited companies*, 28 O.J. EUR. COMM. (No. C 23) 11 (1985).

67. Mergers Directive, *supra* note 15, at recital 6.

reason, among others, agreement on the Mergers Directive was not yet reached, until after fourteen years.

Even if the Mergers Directive were not fully implemented, the merged company faced with a tax charge may be remedied under the Treaty of Rome. The first step toward such a remedy would be a declaration that a merger with a company in another Member State is an exercise of the right of establishment. In *Daily Mail and General Trust*,[68] Advocate General Darmon seemed to favour an interpretation of the term "establishment" broad enough to include a transfer of the central management which reflects a genuine integration of the company into the economic life of the transferee state.[69] This approach goes beyond the express terms of article 52, and it is uncertain whether the court would be inclined to follow.[70] However, assuming that this analytical step can be achieved, the next step in the argument would be to demonstrate an element of discrimination (*e.g.*, that the member state of the merged company allowed mergers to take place between two domestic companies without a capital gains charge arising). The third step would be to point out that this does not require one member state to relinquish its right to tax. Member states of the merged company would still be able to tax accrued or hidden gains upon the disposal of the assets of the original company.

C. The Corporate Taxation Directive and the Collective Investment Directive

The Corporate Taxation Directive would require each member state to have a single corporate tax rate on profits, whether distributed or undistributed, in the range of forty-five to fifty-five percent.[71] Dividends distributed by a company would have to carry a tax credit in the corporate tax range on the net dividend increased by the tax.[72] The following example assumes that

---

68. The Queen v. H.M. Treasury and Comm'r of Inland Revenue, ex parte Daily Mail and Gen. Trust P.L.C., No. 81/87 (EC Ct. of Just. Sept. 27, 1988); Op. Advoc. Gen. (June 7, 1988).

69. Op. Advoc. Gen., point 15 (June 7, 1988).

70. The Advocate General avoided the question in the *Daily Mail and General Trust* case and based its decision on Article 220 of the EEC Treaty. *Id.*

71. Corporate Taxation Directive, *supra* note 16, art. 3(1). Curiously, many Member States have reduced their tax rates to less than 45% since this proposal was made. *See also infra* note 104.

72. Corporate Taxation Directive, *supra* note 16, arts. 4, 5 & 8.

the member state adopts the highest corporation tax rate and the lowest tax credit rate:

Gross company profits	1000
Less corporation tax at 55%	550
Net profits	450
Dividend	450
Plus tax credit 45% of 550	247.5
Taxable income for shareholder	697.5
Tax on shareholder (assume 50%)	348.75
Less tax credit	247.5
Tax to be paid by shareholder	101.25

The tax credit would be available to all residents of member states subject to tax on dividends. Member states would be allowed to extend the credit to residents of non-ECC countries under double taxation treaties, provided that residents of such countries were not treated more favourably than persons in the EEC.[73]

This directive applies principally to Category III cases because it seeks to harmonize corporate tax rates and tax credit rates throughout the EEC. It could also be placed in Category I on the grounds that the tax credit mitigates some of the double taxation involved in the home state when a parent receives dividends from a subsidiary in another member state. However, in such a case, the Parent/Subsidiary Directive will usually provide a more appropriate solution.[74]

In economic terms, the Corporate Taxation Directive provides that the budgetary cost of the tax credit shall be borne by the member state of the corporation which distributes the dividends. This principle is to be applied liberally along the corporate chain.[75] Thus, if a subsidiary distributed dividends to a parent which then distributed dividends to its shareholders, the member state of the subsidiary would have to pay the parent's member state the amount of tax credit attaching to the subsidi-

73. *Id.* art. 6.
74. *See supra* notes 55-60 and accompanying text.
75. Corporate Taxation Directive, *supra* note 16, art. 13.

ary's dividend and, in turn, the parent's member state would have to bear the cost of the tax credit on the parent's dividend. However, if the rate of tax credit in the first member state were higher than in the second, the payment which the first member state made to the second would have to be reduced to correspond to the tax credit that would result from applying the second member state's tax credit rate to the subsidiary's dividend.[76] The second member state would be unable to make budgetary gains by having a lower rate of tax credit than the first member state. A parallel rule would apply when a corporation of the second member state distributed dividends that were derived from profits realized by a permanent establishment in the first member state.[77]

When the dividends were derived from profits which, for one reason or another, had not borne corporate tax, or had borne corporate tax at a reduced rate, the member state of the corporation would be obliged to charge a compensatory tax in order to recover any tax credits claimed by shareholders that were not backed by a corresponding amount of corporate tax on the corporation's profits. Special and complex rules would apply to the levy of the compensatory tax when dividends are derived from the profits of a subsidiary or a permanent establishment in another member state.[78]

The proposed directive would fix a uniform rate of withholding tax on dividend distributions, although this rate could be reduced by tax treaty.[79] The withholding tax would apply irrespective of the identity of the recipient, subject to three exceptions. First, no member state would be allowed to withhold tax on distributions between parent and subsidiary.[80] Second, a member state would not be obliged to withhold tax on dividend payments to residents when the amount of the dividend and the name and address of the recipient were communicated automatically to the tax administration.[81] Finally, a member state would not be obliged to withhold tax on dividend payments to resident holders of registered shares.[82]

---

76. *Id.* art. 13(4).
77. *Id.* art. 13(4).
78. *Id.* arts. 9, 10 & 11.
79. *Id.* art. 14(1) (suggesting a rate of 25%).
80. *Id.* art. 14(2).
81. *Id.* art. 14(3).
82. *Id.*

The withholding tax is to be treated as a partial prepayment of the shareholder's income tax, set off against the recipient's tax liability, and repayable to the extent that it exceeds such liability. If the recipients reside in a member state other than that in which the withholding tax is collected, they would be entitled to set off or claim repayment of the withholding tax in respect to their tax liability in their state of residence. To the extent that the recipients make such set offs or claims, the member state that withheld the tax would have to refund it to the other member state.[83]

A second and related proposed directive, the Collective Investment Directive, would ensure that the benefits of the tax credit and the right to impute withholding tax under the Corporate Taxation Directive would be transferred by Collective Investment Institutions to their members.[84]

D. *The Arbitration Procedure Convention*

The recently adopted Arbitration Procedure Convention[85] concerns the taxation of transfers between closely related taxpayers. Most member states have provisions in their tax legislation enabling them to deal with transfer pricing problems arising from transactions between two related taxpayers in the same member state. For example, if two corporate taxpayers have a common majority shareholder, any transaction between the two taxpayers is naturally suspect. The tax controller has the power to adjust a price charged by one taxpayer to the other if the price does not represent a price that would be negotiated between unrelated and independent parties.[86]

The tax controller does not always need to resort to this power. If both taxpayers are companies paying tax at the full rate of corporation tax, any manipulation of the transfer price between the two companies does not produce any more tax revenue for the state. However, the position is different if one of the companies is subject to a special tax regime, has accrued losses which it can set off against profit, or is quite simply a foreign company.[87]

---

83. *Id.* arts. 16(1) & 17(1).

84. Collective Investment Directive, *supra* note 18.

85. 33 O.J. EUR. COMM. (No. L 225) 10 (1990); *see also* Arbitration Procedure Directive, *supra* note 17.

86. LES CODES LARCIER, *supra* note 37, at 451, 464.

87. *Id.* arts. 53 & 115, at 451 & 464.

Tax authorities use the same techniques when a domestic taxpayer enters into transactions with persons in tax havens. The burden of proof in these cases is often on the domestic taxpayer to demonstrate that the price of the transaction does represent a proper price that would be charged between unrelated independent parties.[88]

When the two related parties are established in two different countries (neither of which is a tax haven) the same techniques apply. However, a risk of double taxation arises, in such cases, unless the tax administrations of the two countries coordinate their efforts. For example, suppose that a company in France is related to a company in Greece. The French company sells a consignment of goods to the Greek company for a total price of ten million francs, although a proper price between unrelated parties would be more in the range of twelve million francs. Upon discovering the underpricing, the French tax controller adds an extra two million francs to the taxable profits of the French company. Meanwhile, the Greek company has been able to deduct the drachma equivalent of only ten million francs as a business expense. The Greek tax controller is not a party to the French tax controller's efforts to increase the French Republic's revenue. As far as the Greek controller is concerned, the commercial documentation shows a transaction price of ten million francs, not twelve million francs. Thus there will be double taxation unless the Greek controller can be persuaded to allow the Greek company to increase its business expense from ten million francs to twelve million francs. This is both a Category I and Category II problem because both states are imposing tax obstacles to cross-border business by refusing to come to an arrangement that avoids double taxation.

Most double taxation treaties have an article based on article 25 of the Organization for Economic Co-operation and Development (OECD) Model, establishing a mutual agreement procedure for dealing with double taxation on transfers. Article 25 of the OECD Model provides as follows:

> 1. Where a person considers that the actions of one or both of the Contracting States results or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority

88. *Id.* art. 24, at 444.

of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

Such a procedure does not solve the problem for the taxpayer if the two contracting states are unable to agree under the mutual agreement procedure. The Arbitration Procedure Directive takes the matter further by providing that the two states concerned must appoint an arbitration commission to decide the matter definitively.[89] The commission is to be comprised of an equal number of representatives from each of the tax authorities concerned and an uneven number of independent persons of standing who were not members of the tax authorities concerned and were not engaged in the performance of tasks or duties for or on behalf of the tax authorities. The independent persons of standing are to be appointed by mutual agreement or, in the absence of agreement, by the drawing of lots.[90]

The Arbitration Procedure Convention represents a significant step for the member states because each one surrenders its sovereignty in certain areas of fiscal administration. This concession is necessary to further the single market. Moreover, it is unlikely that the number of arbitrations under the directive will be so large as to seriously endanger the budgetary stability of a member state.

If this directive is not fully implemented, it is difficult to see how, in the general case, a company could find a remedy before the EC Court of Justice. Under the Treaty of Rome, this double taxation problem is governed by article 220. Only if a member state's refusal to grant relief from double taxation is based on unjustifiable criteria is it possible to argue that the Member

---

89. Arbitration Procedures Directive, *supra* note 17, arts. 7 & 12.
90. *Id.* art. 9.

State was infringing articles 52 or articles 59 of the Treaty of Rome. Thus, the Arbitration Procedure Directive is necessary to provide a remedy because the Treaty of Rome is insufficient.

E. The Income Tax Directive

The Income Tax Directive,[91] which applies to problems in Categories I and II, does not appear to extend substantially beyond the present state of the law. Concerning frontier workers, it provides that the state of residence shall have the principal right to tax the individual. However, the state where the employment is carried out may withhold tax at the source provided such withholding is not greater than it would be for a resident in the same circumstances.[92] This principle could be enforced by the EC Court of Justice under article 48 of the Treaty of Rome.[93] The withholding tax is to be credited against tax liability in the state of residence.[94] The member states concerned are exhorted to agree on the budgetary sharing of the tax collected by both of them. The directive provides that in the absence of any agreement the withholding tax is to be shared in such way as to produce the result that would arise out of application of existing double taxation treaties.[95] This means no more than that member states may agree to modify their bilateral tax treaty arrangements on frontier workers.

In the case of other workers, the directive provides for non-discrimination in the taxation of workers who reside in one member state, carry out salaried employment in another member state. The directive provides specifically that the rate of taxation in the state of employment may not be more burdensome than if the employee were a resident of that state. Moreover, the employee is entitled to the allowances, exemptions, deductions and other general tax reliefs available to residents, reduced to the proportion that the income from employment in that state bears to the employee's total income.[96] Moreover, the tax is to be computed as though the taxpayer were a resident of the state of employment and, if the taxpayer so requests, as though his or her spouse and children were also resident in the state of em-

91. *Supra* note 19.
92. *Id.* arts. 4(1) & (2).
93. *See infra* note 98 and accompanying text.
94. Income Tax Directive, *supra* note 19, art. 4(3).
95. *Id.* art. 5.
96. *Id.* art. 7.

ployment. Thus, for example, the Member State of employment would be able to take into account worldwide income in determining the applicable tax rate, but at the same time, at the taxpayer's request, it would have to grant the same tax reductions in respect to spouses and children as are available to resident persons supporting a spouse or children.

Many of the objectives of the Income Taxation Directive could be achieved by invoking article 48 of the Treaty of Rome, which provides as follows:

> 1. Freedom of movement of workers shall be secured within the Community by the end of the transitional period at the latest.
>
> 2. Such freedom of movement shall entail the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment.

The EC Court of Justice has given a wide interpretation to these provisions in matters of social security, vocational training, etc.,[97] and would have little difficulty in applying article 48 of the Treaty of Rome to the problems addressed by the Income Tax Directive. This does not mean that the directive is unnecessary. Individual workers are unlikely to look forward to the prospect of having to litigate to enforce their rights and would much prefer to see the directive adopted and implemented by the member states. It is, however, reassuring that an alternative remedy will probably be available under the Treaty of Rome if the member states cannot agree on the Income Tax Directive.

F. *The Loss Carryovers Directive*

Under the Loss Carryovers Directive, member states would be obliged to allow losses to be set off against profits of the previous three years or of subsequent years.[98] When a loss was set off against profits which had been distributed and carried entitlement to a tax credit, a compensatory tax could be levied in respect of the tax credit.[99] As originally drafted, the proposal simply required each member state to allow the carry-over of

---

97. *E.g.*, *Gravier v. City of Liege*, 1985 E. COMM. CT. J. REP. 593, 3 COMM. MKT. L.R. 1.

98. *See* Loss Carryovers Directive, *supra* Amendments, note 20, art. 3(1) (amended 1985, *supra* note 21).

99. *Id.* art. 3(2).

losses in a purely domestic situation. The original text of the proposed directive defined profit and loss restrictively as the "positive or negative results of an undertaking ascertained, after any possible set-off against other income in accordance with the tax rules of the State . . . no account being taken of results recorded abroad by permanent establishments or subsidiaries of the undertaking."[100] This definition was amended in 1985 to define profit and loss as "the positive or negative results of an undertaking ascertained, after any possible set off against other income or against results recorded abroad by permanent establishments or subsidiaries, in accordance with the tax laws of the state in which it is subject to tax."[101]

If adopted, the Loss Carryovers Directive would introduce uniformity in member states' treatment of loss carryovers, thereby creating a level playing field. As originally drafted, the Loss Carryovers Directive would have allowed the losses of a permanent establishment to be carried over and set off against the profits of the establishment (a Category III consideration) but would not have required any losses of the permanent establishment to be carried over and set off against the profits of the head office in the home country (a Category II consideration). Thus, in its original form, the Loss Carryovers Directive did not seek to deal with any cross-border considerations. This would have allowed the home member state to discriminate against permanent establishments in other member states by allowing loss carryovers for losses of branches within the home Member State, but not for losses of permanent establishments in other member states. Arguably for these reasons, the Loss Carryovers Directive was not included in the EC Commission's White Paper on Completion of the Single Market, but was added subsequently to the program once the proposed directive had been amended.[102]

If the Loss Carryovers Directive is not adopted, it would not be possible to force member states to allow loss carryovers under the Treaty of Rome (a Category III consideration). However, if a

---

100. *Id.* art 2.

101. *See supra* Amendments, note 21, art. 2 (1985 amendment).

102. The Loss Carryovers Directive is not included in Part III, Section VI.3 of Timetable for completing the Internal Market by 1992 annexed to COM(85)310, but is included in subsequent reports on the implementation thereof. *E.g.*, *Third Progress Report of the Commission to the Council and the European Parliament Concerning the Implementation of the Commission's White Paper on the Completion of the Internal Market*, 1989 EUR. COMM. DOC. (COM No.(88)134).

member state did allow loss carryovers, but not in respect to losses of permanent establishments in other member states (a Category II consideration), this could probably be challenged as an obstacle to the right of establishment under articles 52 ff. of the Treaty of Rome. The basis for challenge would be that the home state was discriminating in favour of branches established within its territory as against branches opened in other member states.

VI. Conclusion

The problems in Categories I and II go to the root of the single market—a company in Brussels (Belgium) must be able to do business in Breda (Netherlands) as easily as it can do it in Charleroi (Belgium). Provided such problems can be solved, the Category III problems could, in theory, be allowed to solve themselves through competition between member states in their attempts to provide tax regimes which do not discourage investment from other member states. The EC Commission seems to have been influenced by considerations like these when it gave priority in its White Paper on Completion of the Single Market to the Parent/Subsidiary Directive, the Mergers Directive, the Arbitration Procedure Convention and the Loss Carryovers Directive (as amended). Apparently, the member states have been influenced by the same considerations as evinced by their adoption of the three directives.

ECC lawyers find more professional interest in debating new and untried actions before the EC Court of Justice than in applying the detailed provisions of directives. The layman however, is more interested in clear cut solutions than in fine points of legal science. This is perhaps the most compelling argument for adoption of the proposed directives. Other directives might also be valuable, such as a directive harmonizing the member states' rules for determining the corporate tax base.[103] However, although the EC Commission is enthusiastic, the political realities do not favour a rapid solution. It is important to note that because creative remedies can be found where directives lack the proper guidance, it is in the interest of the member states to come to agreement on the directives themselves, rather than leave the important matter of direct taxation open to attack

---

103. *See* M. Devereux & M. Pearson, *supra* note 52.

before the EC Court of Justice.[104] Progress made since July 1990 demonstrates that member states are taking this matter seriously at last.

104. The EC Commission is preparing a formal communication suggesting a common minimum corporation tax to stem further competitive tax-cutting among the Member States. Buchan, *Brussels Proposes Common Minimum Corporation Tax*, Financial Times, Feb. 21, 1990, § 1 (European News) at 21.