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Abstract

Corporation tax rates significantly influence the location of foreign direct investment (FDI) as well as company decisions on corporate borrowing, transfer pricing, dividend and royalty payments, and research and development. While direct taxation remains within the competence of individual EU member states, the European Court of Justice (ECJ) has faced an increasing number of corporation-tax-related cases over recent years and its judgements have significantly redrawn the European tax landscape. The present paper reviews and synthesises these ECJ decisions and analyses their implications for the FDI decisions of Multinational Corporations.

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Introduction

There is a substantial body of evidence showing that effective corporation tax rates and the general tax landscape have a strong influence on the level of foreign direct investment (FDI) that a location can attract and on financing decisions associated with these investments.[1] In an early review of the empirical literature, Hines (1999) concludes that the evidence indicates that "taxation significantly influences the location of foreign direct investment, corporate borrowing, transfer pricing, dividend and royalty payments, and R&D performance."

Work done since then has confirmed and strengthened these findings. Desai, Foley and Hines (2003) use affiliate-level data for US companies investing abroad between 1982 and 1997 to examine the relationship between effective corporation tax rates and investments by foreign-affiliate companies. They find a strong negative effect, with an elasticity of around -0.5. Allowing for elasticities to differ by host country/region, they find that tax effects are particularly strong in Europe, for which an elasticity of -0.77 is found. The work of Altshuler *et al.* (2001) suggests that the relevant elasticity has been growing over time.

Grubert and Mutti (2000) and Slaughter (2003) also concentrate on the location decisions of US firms, while Gropp and Kostial (2000) present evidence on total FDI inflows and outflows.[2] The evidence is unequivocal that in circumstances where other locational factors – such as the existence of a pool of well qualified labour, reasonable infrastructure, business-friendly and robust political structures and membership of wider economic unions such as the EU – are similar, a lower rate of corporate tax can serve as a powerful tool to attract mobile international capital.

Tax policy also affects the financing decisions of Multinational Corporations. For example, if a US company investing abroad finances the investment with equity, its active profits in this case are taxable in the host country but free from tax in the US until repatriated. Financing the investment through a loan from the parent company, on the other hand, gives rise to tax-deductible interest payments in the host country and taxable interest receipts in the US. Thus there is an incentive to finance investments in high tax countries through debt and in low tax countries through equity. The empirical evidence is consistent with this hypothesis (Grubert 1998, 2000). These financial considerations can greatly influence the amount of tax paid in a low-tax host country independent of the actual activity carried out there. To satisfy taxing authorities in the donor country, however, some evidence of real activity in the host country is typically required.

Transfer pricing, though strictly policed, is thought to allow some scope for firms to shift profits to low-tax locations by setting favourable intra-group trade prices. As Desai, Foley and Hines (2006) point out, "OECD governments require firms to use transfer prices that would be paid by unrelated parties, but enforcement is difficult, particularly when pricing issues concern differentiated or proprietary items such as

[1] The effective tax rate is calculated by combining *tax rates*, which have been declining in most industrialised countries over recent decades, and the *tax base*, which has generally widened. The literature also distinguishes between effective *average* and effective *marginal* tax rates; see e.g. Devereux, Griffith and Klemm (2002).

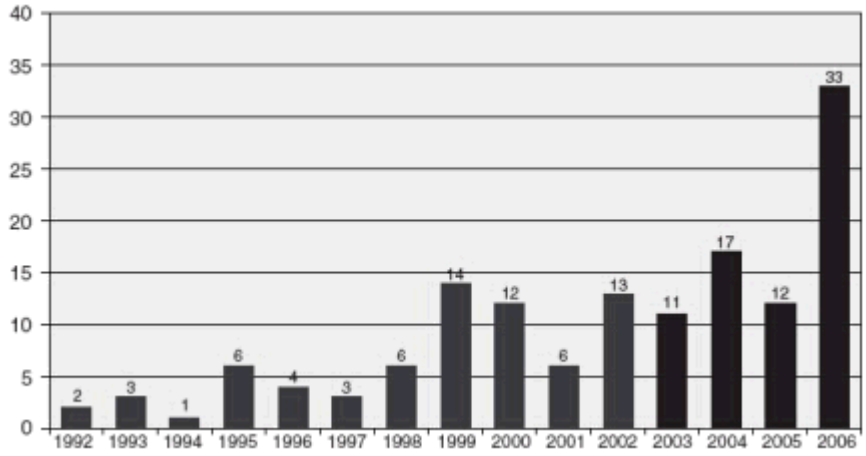
[2] Devereaux and Griffith (2002) present a survey of other work on the topic.

patent rights. Given the looseness of the resulting legal restrictions, it is entirely possible for firms to adjust transfer prices in a tax-sensitive fashion without violating any laws." Their analysis of affiliate-level data for American firms indicates that larger, more international firms, and those with extensive intra-firm trade and high R&D intensities, are the most likely to use low-tax environments.

Hines (1995) argues furthermore that differences in royalty withholding taxes can partly explain differences in R&D activity by multinationals in different locations. His empirical analysis shows that affiliates of US multinationals are more R&D intensive if located in countries that impose high withholding taxes on royalty payments, suggesting that local R&D and imported foreign technology are substitutable to some extent.

While direct taxation within the European Union remains within the competence of individual Member States, Member State powers must be exercised in accordance with Community law, and the European Court of Justice (ECJ) has been growing in importance as an arena in which jurisdictional battles over corporation tax matters are fought (Figure 1).[3]

Figure 1. Number of ECJ Cases Involving Direct Taxation, 1992-2006



Source: European Commission, Taxation and Customs Union

The present paper reviews and synthesises these ECJ decisions and analyses their implications for the FDI decisions of Multinational Corporations. Section 2 provides background detail on the role and procedures of the ECJ while Section 3, which comprises the bulk of the paper, discusses ECJ decisions under a number of headings, including controlled foreign company legislation, treatment of cross-border losses, cross-border transfer of assets, thin capitalisation/transfer pricing rules, cross-border transfer of assets, taxation of dividends, exit taxes and double taxation treaties. The FDI implications of the ECJ decisions reached are discussed at the end of each sub-section. The final section of the paper offers some concluding comments.

[3] The classic statement from the ECJ in relation to direct taxation was set out in *Schumaker* where the Court stated 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 the Member States must nevertheless be exercised consistently with Community law"; (Case C-279/93) [1995] ECR I-225, para.21.

2. The Role and Procedures of the European Court of Justice

The role of the ECJ is to uphold the Treaties of the European Union and to ensure that European law is uniformly interpreted and applied throughout the Union. It has jurisdiction in disputes involving Member States, EU institutions, businesses and individuals. Over recent years it has played an increasingly significant role in shaping Member States' tax regimes.

While direct taxation remains outside the competence of the Community, the Court has consistently reaffirmed that national tax laws must respect the fundamental freedoms which are provided for by the EC Treaty and which seek to prohibit discrimination based on nationality.[4] If a conflict arises between Community law and the law of a Member State, Community law prevails. If national courts experience difficulty in interpreting Community law, they may require a ruling from the ECJ on the issue in question.

When faced with referrals from Member States regarding the compatibility of national tax provisions with Community law, the ECJ uses certain criteria to weigh the measures in question. The two cornerstone principles of the ECJ's approach to safeguarding the EC Treaty are (1) the prohibition of discrimination, direct or indirect, and (2) the prohibition of restrictions on the exercise of the fundamental freedoms, which include:

- Freedom from discrimination on grounds of nationality (Article 12)
- Free movement of goods (Articles 28 and 29)
- Free movement of persons (Article 39 to 42)
- Freedom of establishment (Article 43 to 48)
- Freedom to provide services (Article 49 to 55)
- Free movement of capital (Article 56 to 60)

Any national tax measures which infringe on these freedoms are invalid unless they can be justified by the relevant Member State.

2.1 Non-Discrimination

One of the fundamental principles in Community law is the principle of non-discrimination. Direct discrimination involves differentiation based on nationality (of an individual or of the corporate seat of a company), while indirect discrimination involves differentiation based on criteria other than nationality. Once discrimination has been identified, the next step is to determine whether that difference in treatment can be justified on any grounds. In some instances, discrimination may be justified on the basis of the public interest, though it has become almost impossible for Member States to succeed in justifying measures which the ECJ has found to be contrary to the principles enshrined in the EC Treaty.

When determining whether or not a particular measure is discriminatory, the ECJ typically compares the situation of residents and non-residents. It is only in cases where a resident and non-resident are in 'objectively comparable situations' that discrimination may be at issue. The *Schumaker* case was important because it

[4] By way of contrast, the EC Treaty (Article 93) contains specific provisions in relation to the harmonisation of indirect taxes, to ensure the establishment and effective functioning of the internal market. This has resulted in a strong harmonisation of indirect taxes, particularly VAT.

established the ECJ view that residents (subject to unlimited or worldwide taxation) and non-residents (subject only to limited or source taxation) do not normally find themselves in comparable situations, as a result of which they do not have to be treated in the same way. [5]

The issue of whether companies are in 'objectively comparable situations' is somewhat different however and the comparison has tended to focus on whether a non-resident company is granted the same beneficial tax treatment as a resident company. For example, in the case of the *Royal Bank of Scotland* the ECJ ruled that a higher rate of tax could not be imposed on the profits of a branch of a foreign company as opposed to that applied to domestic companies. This was seen as an example of direct discrimination.[6]

The ECJ has also compared and provided equal treatment to:

- Two resident subsidiaries, one with a resident parent company and the other with a parent company resident in another EU Member State.[7]
- Two resident parent companies, one with domestic subsidiaries and the other with foreign subsidiaries.[8]
- Two resident companies, one with a domestic branch and the other with a foreign branch.[9]

2.2 Fundamental Freedoms

Apart from the prohibition against discrimination, the ECJ has held that any measures which apply without distinction but which restrict the exercise of the fundamental freedoms are also prohibited. These are known as non-discriminatory restrictions and are often referred to as hindrances, obstacles or barriers. In the context of corporation tax, the most important of the freedoms are the freedom of establishment provisions contained in Articles 43 and 48 and the free movement of capital provisions in Articles 56 and 58.

Freedom of Establishment

Article 43 of the EC Treaty provides that restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State are prohibited. Article 43 includes the right to set up companies (primary establishments) and agencies, branches or subsidiaries (secondary establishments) in any of the Member States. Article 48 provides that companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community must be treated in the same way as natural persons who are nationals of Member States.

The question of what level of holding or participation in a company is required for the freedom of establishment provisions to apply was considered in *Baars*.[10] The Court indicated that a national of a Member State who had a holding in the capital of a

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[5] (Case C-279/93) [1995] ECR I-225.
[6] *Royal Bank of Scotland plc v Ellinko Dimosio* (Greek State) (Case C-311/97) [1999] ECR I-2651.
[7] See *Lankhorst* (Case C-324/00) [2002] ECR I-11779 and *Metallgesellschaft Ltd. and Others* (Case C-397/98) *& Hoechst AG, Hoechst UK Ltd. (*Case C-410/98) [2001] ECR I-1727.
[8] See *Bosal* (Case C-168/01) [2003] ECR I-9409
[9] See *AMID* (Case C-141/99) [2000] ECR I-11619.
[10] *C. Baars v Inspecteur der Belastingdienst* (Case C-251/98) [2000] ECR I-2787.

company established in another Member State which gave him "definitive influence over the company's decisions and allowed him to determine its activities" was exercising his right of establishment.

In *X & Y v Riksskatteverket* and *De Baeck v Belgium*, the Court indicated that it was a matter for the referring court to establish whether the freedom of establishment (Article 43 EC) or the free movement of capital (Article 56 EC) applied.[11] If the required degree of participation for the purposes of freedom of establishment does not exist, then the refusal of a tax advantage may constitute a restriction on the free movement of capital.

Free Movement of Capital

Article 56 provides that all restrictions on the movement of capital between Member States and between Member States and third countries are prohibited. Restrictions on payments between Member States and between Member States and third countries are also prohibited.

In the context of companies, the ECJ looks at two questions to determine whether there is a restriction on the free movement of capital: (i) is the provision liable to *dissuade* residents of a Member State from investing their capital in companies established in other Member States?, and (ii) is the provision of the Member State liable to constitute an *obstacle* to companies established in other Member States wishing to raise capital in that Member State? If either or both of the above questions are answered positively, the provision constitutes a restriction on capital movements.

Article 58 provides for a limitation on the free movement stipulated in Article 56. It allows Member States to apply 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. It also allows Member States to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation 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, any such measures and procedures cannot constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments contained in Article 56.

In theory, therefore, Article 58 allows different tax treatment of residents and non-residents and of domestic and foreign source investment income. However, as we will see from the case law of the ECJ, this does not give Member States a *carte blanche* to introduce measures which lead to arbitrary discrimination or disguised restrictions on the free movement of capital.

Interaction between the Treaty Articles

To date, the case law of the ECJ in corporate tax matters has concentrated more on the freedom of establishment than on the free movement of capital. Both Article 43 on freedom of establishment and Article 56 on free movement of capital may be applicable in a case involving a direct investment. When cases are brought under

[11] (Case 436/00) [2002] ECR I-10829 and (Case C-268/03) [2004] ECR I-05961 respectively.

both headings, the ECJ tends to look at the case under the freedom of establishment principle first and, if it finds a breach of that freedom, it does not continue on to examine the case under the free movement of capital provisions.

3. Recent Relevant European Court of Justice Rulings

Controlled Foreign Company Legislation

A parent company resident in State A is generally not taxable on the profits of a subsidiary resident in State B until those profits are distributed back to the parent company in the form of dividends. Contrary to these principles, however, controlled foreign company (CFC) legislation is designed to tax the parent company on the profits of a CFC (for example a subsidiary) resident in another State. A CFC is a company which is resident outside the home country, controlled by persons resident in the home country and subject to a lower tax rate in the country in which it is resident. CFC legislation taxes in the home country the income that arises in the low-rate country as if that income had been distributed to the home country, even though it has not. The rules aim to protect the domestic tax base from erosion.

The UK introduced CFC legislation in 1984 to stop UK groups of companies from reducing their UK tax liabilities by diverting their profits to foreign group companies in low-tax territories. In April 2004, the Special Commissioners in the UK referred the *Cadbury Schweppes* case to the ECJ regarding the compatibility of the UK (CFC) legislation with the free movement of establishment, services and capital.[12] The issue concerned two Irish indirect subsidiaries of Cadbury Schweppes plc which were located in the International Financial Services Centre in Dublin and subject to a 10 percent rate of corporation tax in Ireland. Under its CFC rules the UK Inland Revenue had taxed the UK parent on the undistributed profits of the Irish subsidiaries.

Advocate General Léger issued his opinion in May 2006. He concluded that Articles 43 EC and 48 EC do not preclude such national tax legislation if the legislation applies only to wholly artificial arrangements intended to circumvent national law. According to the AG, such legislation must enable the taxpayer to be exempted by providing proof that the controlled subsidiary is genuinely established in the State of establishment and that the transactions which have resulted in a reduction in the taxation of the parent company reflect services which were actually carried out in that State and were not devoid of economic purpose with regard to that company's activities.

The AG rejected the UK view that the motives for establishing a subsidiary and for the choice of country in which to establish it can constitute a relevant criterion. In other words, the existence of a wholly artificial arrangement cannot be inferred from the parent company's avowed purpose of obtaining a reduction of its taxation in the State of origin.

The ECJ delivered its decision in September 2006. The Court agreed with the AG's view that the UK's CFC legislation could apply only to wholly artificial arrangements. The Court affirmed its earlier case law to the effect that the mere fact

[12] *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd. v Commissioners of Inland Revenue* (Case C-196/04).

that a resident company establishes a secondary establishment, such as a subsidiary, in another Member State cannot set up a general presumption of tax evasion and justify a measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty. The UK CFC legislation clearly constituted a restriction on the freedom of establishment. The Court held that in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory. The restriction must not go beyond what is necessary to achieve that purpose.

Such tax measures must not be applied where it is proven – on the basis of objective factors which are ascertainable by third parties – that, despite the existence of tax motives, a CFC is actually established in the host Member State and carries on genuine economic activities there. Thus availing of a lower tax jurisdiction cannot *of itself* be grounds for CFC treatment The attractiveness of the tax regime is accepted to be as legitimate a factor as any other in a company's choice of location.

The *Cadbury Schweppes* decision meant that countries with CFC legislation would have to review these rules to ensure their compatibility with EC law. The FDI implications of the decision will clearly be to increase the attractiveness of lower-tax EU locations with licensing restrictions that prevent the establishment of brass-plate companies.[13]

Treatment of cross-border losses

Companies are generally regarded as separate legal entities for tax purposes. However, in recognition of the fact that groups of companies may comprise a single economic entity, many countries operate some form of "group relief" under which the losses of one company in a group may be set off against the profits of other group-member companies. The problem is that such off-set is generally confined to cases where the surrendering company and the claimant company are both tax resident in the relevant State. The general justification for denial of relief for cross-border losses is that the profits of foreign subsidiaries are not within the charge to tax in the relevant State.

In its 2003 Communication, the European Commission noted that the " current limits to cross-border relief within the EU, in particular as regards subsidiaries, can lead to (economic) double taxation and constitute significant obstacles to economic activity in more than one Member State." [14]

In *Futura Singer,* the ECJ appeared to accept that a tax rule confining compensation for losses to losses economically related to income received locally was justified by the principle of territoriality. However, the judgment did not elaborate on the

[13] Ireland is one such case, in that it does not meet the OECD (2001) criteria for a harmful tax haven. These are: (i) no or very low taxes, (ii) a lack of exchange of information, (iii) lack of transparency and (iv) no substantial activities in the country.
[14] COM (2003) 726 final.

principle of territoriality in this context and a number of questions therefore remained unanswered.[15]

In the case of *ICI*, the ECJ considered the UK's consortium relief (a form of group relief) which was available solely to companies which controlled subsidiaries whose seat was in the UK. [16] ICI claimed that the legislation represented a restriction on its right to establish subsidiaries in other Member States. The ECJ agreed that Article 43 of the Treaty precluded legislation such as the UK's which made this form of tax relief subject to the requirement that the holding company's business consisted wholly or mainly in the holding of shares in subsidiaries that were established in the UK. This case is argued to have spelled the "beginning of the end for the concept that the Member States retained total sovereignty over their direct tax affairs" (Craig, 2003).

The question of cross-border losses also arose in *AMID.*[17] AMID was a Belgian limited company which had its seat in Belgium but also carried on business in Luxembourg through a permanent establishment (i.e. a branch, office or agency as opposed to a subsidiary which is a separate legal entity). Under the terms of a double taxation treaty between Belgium and Luxembourg, AMID's income from its permanent establishment in Luxembourg was exempt from tax in Belgium. The Belgian business incurred losses in some years before returning to profitability, while the Luxembourg business made profits throughout the relevant periods.

Belgium refused to allow AMID to deduct losses incurred by its Belgian establishment in the previous year from the profits made by it in the subsequent year, on the ground that those losses should have been notionally set off against the profits made by its Luxembourg establishment in the previous year. The point was that if the permanent establishment had been established in Belgium, the losses could have been set off against the income of the company. The ECJ ruled that by notionally setting off domestic losses against profits exempted by the double taxation treaty, the Belgian legislation established a differentiated tax treatment as between Belgian companies having establishments only in Belgium and those having establishments in another Member State. Such legislation constituted a *hindrance* to Belgians wishing to invest outside Belgium and therefore contravened Article 43.

This case could be seen as the forerunner to the well-known *Marks & Spencers* case, on which the ECJ gave its decision in December 2005.[18] When the *Marks & Spencers* case was initially considered by the UK Special Commissioners they viewed it as different from *AMID* because *Marks & Spencers* concerned subsidiaries rather than permanent establishments.

Marks & Spencers had established retail operations in other EU member states including France and Belgium and these operations were carried on through locally-established subsidiaries. When these ventures proved unsuccessful, the company

[15] *Futura Participations SA and Singer v Adminstrationdes contributions* (Case C-250/95) [1997] ECR I-2471.
[16] *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer* (Her Majesty's Inspector of Taxes) (Case C-264/96) [1998] ECR I-4695.
[17] *Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v Belgian State* (Case C-141/99) [2000] ECR I-11619.
[18] *Marks & Spencer plc v HM Inspector of Taxes;* Case C-446/03.

wished to off-set losses arising from these subsidiaries against their UK taxable group profits. This was refused by the UK tax authorities on the basis that the subsidiaries were operating outside the UK, and the case went to the ECJ.

The UK tax legislation was doubly called into question; firstly, because it did not accord the same advantages to parent companies with foreign *subsidiaries* and parent companies with foreign *branches*, and secondly because it placed groups of companies wishing to establish themselves abroad at a disadvantage in relation to groups resident in the UK.

The Court noted that the UK group relief provisions constituted a tax advantage for the companies concerned. By speeding up the relief of the losses of the loss-making companies by allowing them to be set off immediately against the profits of other group companies, such relief conferred a cash advantage on the group. The exclusion of such an advantage in respect of the losses incurred by a subsidiary established in another Member State which did not conduct any trading activities in the UK was of such a kind as to *hinder* the exercise by that parent company of its freedom of establishment by deterring it from setting up subsidiaries in other Member States.

The Court then considered whether the restriction could be justified. The UK and other Member States had argued that in the context of the group relief system, resident subsidiaries and non-resident subsidiaries were not in comparable situations. They pointed out that in accordance with the principle of territoriality applicable both in international law and in Community law, the Member State in which the parent company was established (the UK) had no tax jurisdiction over non-resident subsidiaries. The ECJ was of the view that the fact that a Member State did not tax the profits of the non-resident subsidiaries of a parent company established in its territory did not in itself justify restricting group relief to losses incurred by resident companies.

The United Kingdom and the other Member States which submitted observations put forward three factors to justify the restriction. First, that in tax matters profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system in order to protect a balanced allocation of the power to impose taxes between the different Member States concerned. Second, if the losses were taken into consideration in the parent company's Member State they might well be taken into account twice. Third, if the losses were not taken into account in the Member State in which the subsidiary was established there would be a risk of tax avoidance.

The Court agreed, "in the light of those three justifications, taken together", that the restrictive provisions pursued legitimate objectives compatible with the Treaty, that they constituted valid public-interest reasons, and that they were apt to ensure the attainment of those objectives. The phraseology used by the Court however makes it difficult to discern the particular weight attached to each justification.

The Court nevertheless concluded that the measures were excessive, and that the member state of the resident company should allow relief for losses when the non-resident subsidiary had exhausted all the possibilities available for having the losses taken into account in its state of residence. The Court explained this caveat on the basis that to deny group loss relief in such circumstances would go beyond what was

necessary to attain the essential part of the objective of achieving a balanced allocation of tax jurisdiction. Advocate General Geelhead is of the view that this caveat should be applied extremely restrictively.[19]

The *Marks & Spencers* case was highly controversial and was watched closely by all Member States with corporation tax systems containing similar group relief provisions. Meussen (2005) indeed suggests that the case was "one of the most important, if not *the* most important, case concerning EU corporate tax".

By offering the possibility that a group of companies might be able to transfer their losses to the Member States which apply the highest rates of taxation, the judgement should serve to reduce the disincentive effect of high tax rates for FDI inflows.

Cross-Border Transfer Of Assets

Most Member States operate some form of group relief which allows intra-group transactions on a tax-free basis. The problem is that these provisions are not usually extended to cross-border situations. The thrust of EU rulings is that they should be.

X AB and Y AB concerned a Swedish group relief scheme that allowed tax-free transfers of assets between group companies.[20] Both companies had to be resident in Sweden, though relief was also available if the Swedish subsidiary was wholly owned by the Swedish parent indirectly by way of wholly-owned intermediate companies in another Member State. However, the relief was denied if the Swedish subsidiary was wholly owned by way of wholly-owned intermediate companies in more than one other Member State. The ECJ held that this was clearly in breach of the right of establishment under Article 43.

The case *Metallgesellschaft & Hoechst* was not directly concerned with the cross-border transfer of assets but rather related to the UK's advanced corporation tax (ACT) system.[21] A subsidiary member of a group did not have to pay ACT on dividends paid to its parent so long as both companies were resident in the UK. The ECJ held that groups of companies with a foreign parent company could not be treated differently from groups of companies with a domestic parent company.

The extension of group relief to cross-border situations is likely to enhance multinationality (i.e. the extent to which firms have operations outside their home location or are headquartered abroad) and lead to increased FDI flows.

Thin Capitalisation/Transfer Pricing Rules

If a parent company injects funds into a subsidiary in the form of a capital loan instead of a capital contribution (equity), the profits of the subsidiary are transferred to the parent company in the form of deductible interest rather than non-deductible dividends. If the two companies are in different countries, the tax debt can be transferred from one country to another at the will of the parties concerned. As noted earlier, similar considerations make it more attractive to use inter-company debt to expand in high-income-tax countries and to use equity to expand in low-tax countries.

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[19] Opinion on *Class IV ACT Group Litigation (*Case C-374/04) 23 February 2006 at para. 65.
[20] *X AB and Y AB v Riksskatteverket* (Case C-200/98) [1999] ECR I-8261.
[21] *Metallgesellschaft Ltd. and Others* (Case C-397/98) *& Hoechst AG, Hoechst UK Ltd. (*Case C-410/98) [2001] ECR I-1727.

Thin capitalisation rules are intended to prevent the arbitrary transfer of the tax debt from one country to another and to ensure that the tax is charged in the country where the profit is actually made. The rules operate by imposing an "arm's length" rate of interest, and disallowing for tax purposes any interest paid in excess of this. They also apply to companies whose capital structure is disproportionately biased towards loan capital rather than equity. The whole of the relevant interest charge is disallowed when such *fat debt financing* is found to occur.

Transfer pricing rules are similar to these thin capitalisation rules in imposing arm's length prices on cross-border transactions within a group. The application of transfer pricing rules solely to non-domestic transactions could be considered discriminatory and contrary to EC law.

The question arising in the case of *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* was whether subsidiaries established in Germany were treated differently depending on whether or not their parent company had its corporate seat in Germany.[22] The German company Lankhorst-Hohorst's sole shareholder was Lankhorst-Hohorst BV, which had its registered office in the Netherlands. The sole shareholder in Lankhorst-Hohorst BV was Lankhorst Taselaar BV, whose registered office was also in the Netherlands. The Netherlands (grand)parent company granted a loan to Lankhorst-Hohorst in Germany and the dispute concerned the interest paid by the German company on foot of this loan.

The German tax authorities treated the interest paid to the Dutch company as a distribution of profits and taxed it as such. The German provisions were not directly linked to nationality, but to whether the taxable person enjoyed a tax credit. Lankhorst-Hohorst argued that the loan by the Dutch shareholder was a rescue attempt by it and that the interest paid to that shareholder could not be classified as a covert distribution of profits. It argued that the German provisions were discriminatory and consequently contrary to Article 43 in view of the treatment they afforded to German shareholders who were entitled to a tax credit (unlike the companies in the case, which had their corporate seats in the Netherlands).

The ECJ found that difference in treatment between resident subsidiary companies according to the seat of their parent company constituted an obstacle to the freedom of establishment which was, in principle, prohibited by Article 43. The tax measure in question made it *less attractive* for companies established in other Member States to exercise freedom of establishment and they may in consequence have refrained from acquiring, creating or maintaining a subsidiary in the State which adopted that measure.

The German government, supported by the Danish and UK governments and the European Commission, sought to justify the measure on the basis that it was intended to combat tax evasion in the form of 'thin capitalisation' or 'hidden equity capitalisation'. The ECJ again pointed out that a reduction in tax revenue did not constitute an overriding reason in the public interest which could justify a measure contrary to a fundamental freedom. It noted that the legislation in question did not

[22] (Case C-324/00) [2002] ECR I-11779.

have the specific purpose of preventing wholly artificial arrangements from attracting a tax benefit, but applied generally to any situation in which the parent company had its seat, for whatever reason, outside Germany. Such a situation did not, of itself, entail a risk of tax evasion, since such a company would in any event be subject to the tax legislation of the State in which it was established.

The Court also rejected the argument that the measure was needed to ensure the coherence of the applicable tax systems, ruling that coherence could only be used as justification of a discriminatory provision when discriminatory treatment of a taxpayer is linked to a benefit realised by the same taxpayer.

Following this decision, many Member States had to re-design their thin-capitalisation rules so as to eliminate unequal treatment of resident and non-resident EU companies. There were two different national responses. Spain, for example, amended its legislation to exclude EU companies from its thin capitalisation rules, while the UK extended its transfer pricing and thin capitalisation rules to cover domestic as well as international transactions. The FDI implications of these responses are complicated. The UK route will increase compliance costs within the UK and could drive investments away, while adoption of the Spanish model could increase the attractiveness of low-tax EU countries as holding-company locations for companies that benefit from thin capitalisation practices.

Taxation Of Dividends

All Member States levy some form of corporation tax on the profits of companies. When a company's profits are distributed in the form of dividends, the dividends are then taxed in the hands of the shareholder. This gives rise to what is referred to as "economic double taxation" – the same income is taxed twice in the hands of different taxpayers.

The different approaches of Member States in relation to the taxation of dividends can give rise to difficulties. Some Member States have had preferential tax arrangements that applied only to dividends from domestic shares, and the ECJ has found such provisions to be contrary to the free movement of capital.

The taxation of dividends received by companies is to some extent covered by the Parent-Subsidiary Directive which provides for exemption from withholding taxes on the outbound payment of a qualifying dividend by a subsidiary or branch to its parent in another EU Member State and the grant of a tax credit or exemption from tax to the company receiving the inbound dividend.[23]

In 2003, the European Commission produced a paper entitled "Dividend taxation of individuals in the Internal Market" in which it analysed the various dividend taxation systems of the then fifteen Member States.[24] The paper related to the dividend taxation of individuals only, noting that this is the area that is most problematic in practice. It concluded that

[23] Council Directive 90/435/EEC of 23 July 1990.
[24] COM 2003 810 final.

> *"An analysis of the ECJ case law leads to fundamental conclusions about the design of dividend taxation systems: Member States cannot levy higher taxes on inbound dividends than on domestic dividends. Likewise, they cannot levy higher taxes on outbound dividends than on domestic dividends."*

The provisions of the EU Treaties relating to the free movement of capital were implemented by various directives, including Directive 88/361.[25] The case *Staatssecretaris van Financien v B.G.M. Verkooijen* was referred by the Netherlands to the ECJ to determine whether Article 1(1) of Directive 88/361 precluded a Dutch legislative provision which treated inbound dividends received from companies resident in other Member States less favourably than dividends received from domestic sources.[26] The ECJ ruled that it did, and rejected justification arguments based on the promotion of the economy, cohesion of the tax system, loss of revenue, and a possible tax advantage for taxpayers receiving in the Netherlands dividends from companies with their seat in another Member State.

In *Lenz*, the ECJ examined the Austrian treatment of dividends received from capital invested in domestic companies and in other Member States.[27] Ms. Lenz, an Austrian resident, was unable to avail of the reduced tax rates applicable to dividends from Austrian companies because the dividends she received were from German companies. The ECJ found that the tax legislation at issue had the effect of *deterring* taxpayers living in Austria from investing their capital in companies established in other Member States. The legislation also produced a *restrictive effect* in relation to companies established in other Member States, in that it constituted an obstacle to their raising capital in Austria. The legislation therefore constituted a restriction on the free movement of capital.

The ECJ rejected submissions arguing that the measure was justified on the basis that the Austrian government was unable to levy tax on revenue from companies established outside their territory. The court also rejected submissions in relation to the need to maintain coherence of the national tax system. The aim of the Austrian legislation was to reduce the economic effects of double taxation of company profits (by way of corporation tax) and the taxation of a shareholder (by way of income tax) on the same profits distributed in the form of dividends. The ECJ noted that apart from the fact that personal income tax and corporation tax were two distinct taxes which affect different taxpayers, the Austrian legislation did not make the obtaining of the tax advantages at issue (enjoyed by Austrian residents on their domestic revenue from capital) dependent upon the taxation of the companies' profits.

Similarly in *Manninen* the ECJ held that the Finnish tax credit system whereby individuals who received dividends from a Finnish resident company received a tax credit which was not available where the dividend was received from a company in another Member State (in this case Sweden) was a restriction on the free movement of capital and prohibited by Article 56 EC. [28]

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[25] Article 1(1) provided that Member States should abolish restrictions on movements of capital taking place between persons resident in Member States. To facilitate application of this directive, capital movements were classified in accordance with the Nomenclature in Annex I.
[26] (Case C-35/98) [2000] ECR I-4071.
[27] *Anneliese Lenz v Finanzlanddesdirekiton fur Titol* (Case C-315/02) [2004] ECR I-07063.
[28] (Case C-319/02) [2004] ECR I-07477.

The cumulative effect of the *Verkooijen*, *Lenz* and *Manninen* line of cases is that the less favourable treatment of inbound dividends is considered to be a restriction on the free movement of capital. Hintsanen and Pettersson (2005) furthermore suggest that the Manninen case does not merely cover individual shareholders but also has relevance for corporate taxpayers.

Equal treatment of domestic and inbound dividends could be ensured either by abolishing the exemption on domestic dividends or abolishing the corporation tax charge on foreign dividends. Abolition of the exemption on domestic dividends could lead to the restructuring of the financial architecture of companies in an attempt to avoid the resulting losses. In either case, multinationality is likely to be enhanced.

Exit Taxes

Many Member States seek to tax their resident individual and/or corporate taxpayers on capital gains in respect of their assets. In domestic situations, such capital gains will usually be taxed when realised, i.e. when the assets are sold or otherwise disposed of. However, if an individual taxpayer moves to another Member State before selling his assets, his original state of residence risks losing the taxing rights on the capital gains which have accrued on those assets. Similarly, if a company transfers its residence to another Member State or transfers individual assets to its branch (permanent establishment) in another Member State (or vice versa), the original state of residence risks the partial loss of its taxing rights on the gains which have accrued while the company was resident in its territory. Many Member States have attempted to deal with this issue by taxing such accrued but as yet unrealised capital gains at the moment of transfer of the residence by the taxpayer or of the individual assets to another Member State.

The European Court of Justice has stated that immediate taxation of latent capital gains on assets transferred to another Member State infringes the principle of freedom of establishment and has a *dissuasive effect* on taxpayers wishing to establish themselves in another Member State.[29]

Equivalent to the impact that employment protection regulations such as "firing costs" are found to have in reducing aggregate employment (see e.g. Scarpetta, 1996), removal of such exit charges on companies may be deemed likely to increase multinationality.

Double Taxation Treaties

Double taxation arises where two countries impose taxes on the same income or capital. This may arise where one country imposes taxes on the basis that an individual or company is tax resident there while another country imposes tax on the same item because the income arises there. Article 293 of the EC Treaty provides that Member States shall, so far as is necessary, enter into negotiations with each other

[29] According to a recent European Commission communication on this matter ("Direct Taxation: The European Commission proposes an EU-coordinated approach on exit taxation", IP/06/1829, Brussels, 19 December 2006), member states should provide for an unconditional deferral of collection of the tax due until the moment of actual realisation. It recognised however that this will not necessarily provide a solution for double taxation or unintended non-taxation which may arise due to mismatches between different national rules.

with a view to securing for the benefit of their nationals…the abolition of double taxation within the Community. Double taxation treaties seek to avoid or minimise such double taxation, typically by providing for an exemption or tax credit in respect of tax paid in the other contracting State. The ECJ has consistently held that while Member States are free to allocate their powers of taxation bilaterally they are bound by the EC Treaty freedoms when exercising those taxation powers.[30]

The study *Company Taxation in the Internal Market* identified the area of double taxation treaties as a potential source of obstacles and distortions for cross-border economic activities within the EU.[31] In view of this, the Commission intends, following technical discussions with the Member States, to come forward with a communication on the need to adapt certain provisions of double taxation conventions based on the OECD model to comply with Treaty principles.

One particular concern which has come to the fore recently concerns provisions in treaties which favour residents of one country over others. In the context of the EU, the adoption of the 'most-favoured nation' doctrine would mean that residents of a particular Member State should be able to avail themselves of tax advantages agreed between two other Member States with regard to their residents.

The ECJ has recently been called upon to determine whether favourable provisions in a tax treaty between two Member States which are not extended to persons in a third Member State may be seen as a form of discrimination between non-residents.

Normally only residents of the Contracting States to a tax treaty are covered by the provisions of the tax treaty. The ECJ ruling on the *Saint Gobain* case however placed branches of non-resident companies on the same footing as resident subsidiaries as regards tax treaty benefits.

While the *D* case involved an individual and was not directly related therefore to corporation tax matters, it is nonetheless relevant to the present discussion in that it raised the "most favoured nation" doctrine.[32] The Commission and the governments which submitted observations (clearly alarmed at the prospect of having to dismantle a whole plethora of bilateral tax treaties) argued that a Member State party to a bilateral convention was not in any way required, by virtue of the EC Treaty, to extend to all Community residents the benefits which it grants to residents of the Contracting Member State. They referred to the danger which the extension of the benefits provided for by a bilateral convention to all Community residents would entail for the application of existing bilateral conventions, and of those which the Member States might be prompted to conclude in the future, and to the legal uncertainty which that extension would cause. To their relief, the Court concluded that the fact that the reciprocal rights and obligations in the Netherlands-Belgium tax treaty applied only to persons resident in one of the two Contracting Member States was "*an inherent consequence of bilateral double taxation conventions"*.

The general thrust of ECJ decisions in this area appears then to be that double taxation treaties are not under threat, though the question remains as to whether the ECJ will

[30] See, for example, *Gilly* (Case C-336/96).
[31] SEC (2001) 1681
[32] D v Rijksbelastingdienst *(Case C-376/03).*

take a different view when faced with a company entitlement as opposed to that which it took in the '*D*' case which related to an individual.

Another potential problem that may arise in relation to double taxation treaties relates to the anti-"treaty shopping" or "limitation on benefit" clauses which are contained in many treaties with third countries. These clauses seek to confine treaty benefits to genuine residents of the two Contracting States only, and the Commentaries to the OECD Model Treaty specifically authorise their use. Terra and Wattel (2005) suggest that it may be possible for a Member State to justify existing clauses on the basis that no tax treaty would have been concluded at all if it had not agreed on the clause insisted upon by a third country.[33] The provisions generally exclude from treaty benefits, however, resident companies which are controlled by non-resident shareholders, even when these shareholders are resident in another EU Member State. While the "good residents" test in several Member State/US Treaties may safeguard the 'limitation on benefits' clauses from ECJ attack, it remains to be seen whether the reasoning in the *Open Skies* cases may be further extended. In these (non-tax) cases, the court struck down a similar nationality clause in the bilateral aviation agreements of eight Member States with the US.[34] Treaties concluded after the *Open Skies* case and containing limitation on benefit provisions may be found to be in violation of the fundamental freedoms.

Concluding Comments

When examining cases for compatibility with the provisions of the EC Treaty, the ECJ has been seen to adopt a three-step approach. It first asks if there has been a breach of one of the fundamental freedoms enshrined in the Treaty. If the answer is yes, it then asks whether the measure can be justified by pressing reasons of public interest. If the answer is again yes, it asks if the measure is proportionate, in the sense of not going beyond what was necessary to ensure achievement of the aim in question.

Member States have invoked justifications based on overriding public-interest reasons, but each of the following attempted justifications has been rejected, in one way or another, by the ECJ:

- the risk of tax avoidance. The ECJ consistently rejects this justification if the legislation at stake does not have the specific purpose of preventing wholly artificial arrangements.
- the loss of tax revenue. A reduction in tax revenue cannot be regarded as an overriding reason in the public interest to justify a measure which is in principle contrary to a fundamental freedom.
- other tax advantages. Unfavourable tax treatment contrary to a fundamental freedom cannot be justified by the existence of other tax advantages, even if those advantages exist.
- the existence of lower tax rates in other Member States.
- that harmonisation has not been achieved. In the absence of harmonisation at Community level, the Member States must nevertheless comply with Community law.

[33] The clauses are particularly common in treaties concluded with the US, indicative of US insistence on their inclusion.
[34] (Cases C471-472/98 and 475-476/98) [2001] ECR I-9427.

- the effectiveness of fiscal supervision/administrative difficulties;[35]
- the absence of reciprocal treatment under a double tax treaty: Treaty rights are unconditional and cannot be made subject to the contents of a tax treaty.
- aims of a purely economic nature, such as the intention to promote the economy of the country by encouraging investment by individuals in companies with their seat in that country.
- other advantages enjoyed by the person suffering from the restriction.

Other than in the Marks & Spencers case, where the ECJ accepted a combination of three justifications (broadly: territoriality, cohesion of the tax system and tax avoidance), ECJ decisions have almost invariably privileged EU rules on the freedom of capital movements over the attempts of national Finance Ministries and Tax Authorities to protect their corporate tax bases. Indeed challenges brought by taxpayers have had a success rate of more than 90 percent. These decisions therefore have potentially strong effects in facilitating and supporting further FDI flows and the transnationalisation of companies across the EU.[36]

The need to uphold Community law is the foundation stone for ECJ decisions which appear to encroach on the realm of Member States' sovereignty in relation to direct taxation matters. The ECJ does however recognise that "it is neither the intention nor the avowed aim of Community law to call in question the limits inherent in any power of taxation, or to disturb the order of priority of the allocation of tax competences as between Member States … and, in the absence of Community harmonisation, the Court is not competent to interfere in the conception or organisation of the tax systems of the Member States".[37]

ECJ judgements in these matters however have served to increase pressures for tax harmonisation at the EU level and have strengthened the determination of certain EU member states to push ahead with proposals for a Common Consolidated Corporate Tax Base.

[35] In *Futura (*Case C-250/95; 1997; ECR I-2471) the justification on the effectiveness of fiscal supervision was accepted in principle but the particular measure failed the proportionality test.
[36] Pavelin and Barry (2005) provide evidence on the geographic diversification ("transnationalisation") across the EU of the 300 or so largest manufacturing firms in Europe in 1987 and 1993. They show that the coming-into-being of the Single Market coincided with an increase in the number of these firms that were multinational (i.e. had production bases in other EU countries) and in the geographic diversification of firms that were already multinational. As predicted by the theory of the multinational corporation, furthermore, firms in R&D-intensive and advertising-intensive sectors were found to produce in a broader range of countries than firms in other sectors.
[37] *Bachmann* (Case C-204/90) [1992] ECR I-249, para.23.

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