In memoriam
Kari S. Tikka
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Tax provisions of the Treaty of Rome – Lost in transition

We all keep an excellent memory of our dear colleague and friend Kari S. Tikka who left us so suddenly. He was not only a most learned and eminent scholar of great international reputation but also a very good personal friend. Together with modern art, taxation was one of his great interests in life, particularly taxation in the European Union which Finland joined in 1995.

I would also like to mention that he had an excellent knowledge of German and he had several good contacts to German universities; I remember very well we where sitting next to each other at the symposium in honour of Prof. Otto Jacobs in Mannheim on 22 October 2004.

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In 2007 we celebrate the 50th anniversary of the signing of the Treaty of Rome. Then, on 1 January 1958 the European Economic Community (EEC) became reality. This anniversary is a good reason to look back.

Starting point: Member States and their retained sovereignty on direct taxation

Today, taxation within the European Union, particularly direct taxation, is seen in a quite contradictory way.

On the one hand the Member States of the European Union try to formally stress their unrestricted or even regained *sovereignty* in the field of direct taxation. Regaining sovereignty would be a consequence of some recent decisions of the European Court of Justice concerning capital market neutrality, such as the D case.[1] This would more or less include the unrestricted right of the Member States to agree in tax treaties between themselves to whatever they like.[2] The same would be true of course for tax treaties with third countries. This privileged place of taxation is explicitly seen in the need of unanimity in the Council whenever tax matters are

[1] ECJ, 5 July 2005, Case C-376/03, see in particular Kofler – Schindler: "Dancing with Mr. D": The ECJ's denial of Most-Favourite Nation Treatment in the "D" case, European Taxation 2005, p. 530–540.

[2] See, for example, D. Weber: In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC, Deventer 2006, p. 8.

legislated by the EU institutions.[3] This rule certainly increases the confidence of the Member States. Direct taxation has a particular position compared to indirect taxation because direct taxation, contrary to Art. 93 for indirect taxation, is not expressly mentioned within the Treaty other than in the final provision of Art. 293 which proposes that Member States should engage in concluding tax treaties between themselves for the elimination of double taxation. Tax law is also mentioned in Art. 58, whereby direct taxation is meant. Under certain conditions Member States may continue to apply their tax law distinguishing between investment at home and abroad.[4]

On the other hand Member States are reminded that even though direct taxes are not explicitly mentioned in the *Treaty*, direct taxes are not excluded from its reach. Most recently in the *Meilicke* case[5] the ECJ confirmed that it is settled case law that "although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with Community law (Case C-311/97 *Royal Bank of Scotland* (1999) ECR I-2651, paragraph 19, and *Manninen*, paragraph 19)". For example, whenever legal provisions of the Member States are mentioned in the Treaty, they of course also include direct taxation. The fact that any change of EU-rules concerning taxation needs a unanimous decision does not exclude it from the Treaty. In fact as will be explained later, the Treaty provides for a special situation, in which direct tax legislation can be implemented even by a qualified majority.

In recent years the EU-wide discussion concerning direct taxation in Europe was dominated by the application of the *fundamental freedoms* to direct taxation following the decision *avoir fiscal* in 1986.[6] 20 years ago it took a number of years and some subsequent decisions until the European tax world took full notice and recognized the revolutionary character of this innovative approach. Particularly the Member States accepted the importance of "avoir fiscal" and the subsequent decisions rather slowly. "Avoir fiscal" had come as a great surprise to them.

One may get the impression that the Commission follows the Member States in a similar way. Is it merely accidental that in its most recent communication of 19 December 2006 on coordinating Member States' direct tax systems in the Internal Market[7] there is no mentioning of any other Treaty provision than article 293, dealing with direct taxation? I miss it, because communications are usually set up like text books. The Commission starts out by saying: "As Community law currently stands, Member States remain largely free to design their direct tax systems so as to meet their domestic policy objectives and requirements".[8] My question would rather be why Member States should not be ready for compromise in respect of their domestic policy objectives when seeing the grave tax problems within the European Union, existing for example in connection with shareholder financing, inter-company dividends, interest deduction for treatment of loans concerning the acquisition of a subsidiary, losses of foreign

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3 Art. 95 para. 2.
4 See however Cases C-358/93 and C-416/93, Bordessa, of 23 January 1995, ECR 1995, p. I-369.
5 Case C-292/04 of 6 March 2007.
6 Case 270/83 of 28 January 1986, Comm. v. France – avoir fiscal, ECR 1986, p. 273.
7 Brussels 19 December 2006, COM (2006) 823 final.
8 Op.cit. p. 3.

subsidiaries or permanent establishments, group taxation domestically, within the EU and in case of third countries etc.[9] In my view, in these areas a detailed common European approximation of laws would be helpful. Would this be harmonisation or still co-ordination? A rose is a rose is a rose…

A visitor from space would be quite surprised that this is the same states' system described two pages further on that "there are numerous aspects of Member States' rules that conflict with the Treaty, including taxation of gains (e.g. exit taxes), dividend taxation (i.e. withholding taxes), group taxation (e.g. lack of cross-border loss relief), taxation of branches and anti-avoidance rules."[10]

There has been a long discussion of the underlying *linguistic terms*. The Commission seems to follow the Member States in preferring the term *co-ordination* for the mutual or unilateral approximation of tax laws, particularly of direct taxation.[11]

It is my impression that the original term of harmonisation which fits perfectly from its linguistic roots has turned into a devil's word. Keeping national tax rules in tune with each other perfectly describes the objective. The Commission seems to restrict the use of harmonisation to large-scale approximation of tax laws whereas co-ordination should do the same in a smaller area and in a less organized way.

Another interpretation seems to be that *harmonisation* would be based on Treaty law like the approximation of laws whereas co-ordination may also be based on informal soft law arrangements with a Member State or several of them. Harmonisation of indirect taxes is dealt with in Art. 93. Similarly "harmonisation measures" are mentioned in paragraph 4, 5, 7, 8, und 10 of Art. 95.

In this sometimes quite emotional discussion concerning the fundamental freedoms it is my impression that other provisions of the Treaty of Rome were at least temporarily put aside. Subsequently, I will discuss whether the right of the Member States to arrange their own direct tax law has any other limits than fundamental freedoms.

The following discussion of approximation of direct tax laws will show that there is an area in which even non-unanimous decisions by the Council of Ministers concerning the direct tax law of a Member State are possible. In a State tax aid situation the Commission itself can even decide over direct tax provisions.

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[9] See A. Rädler: Gedanken zur deutschen Steuerreform zu Beginn 2006, in Kirchhof – Schmidt –Schön –Vogel (eds), Festschrift A. Raupach, Köln 2006, p. 100 seq.
[10] COM (2006) 823 final, p. 5.
[11] COM (2006) 823 final, p. 5.

The time before avoir fiscal: Approximation of legislation

Before the fundamental freedoms as guaranteed in the Treaty, gained their importance to direct taxation, i.e. before the "avoir fiscal" decision of 1986,[12] there was more or less consensus that the differences in direct taxation between the Member States have to be solved by the general provisions of the Treaty, i.e. the then Articles 100 to 103 which deal with approximation of laws, which are today (after amendments) Articles 94 to 97. Subsequently, the impact of those provisions on direct taxation is briefly analysed.

Article 94 of the Treaty (formerly Article 100) provides the general basis for approximation of laws by issuing directives in areas "as directly affect the establishment or functioning of the common market". This requires a unanimous decision by the Council.

This is supplemented by *Article 95 para. 1* of the Treaty which allows the issuance of directives by a qualified majority in areas "which have as their object the establishment and functioning of the internal market". However, directives concerning *fiscal provisions* as well as the free movement of persons and the rights and interests of employed persons are explicitly excluded in *Article 95 para. 2*. They can only be adopted by using *Article 94* with requires *unanimity* in the Council.

When in the view of the Commission the domestic rule is distorting competition then *Article 96 para. 1* (formerly Article 102 para 1) may apply:

> "Where the Commission finds that a difference between the provisions laid down by law, regulation or administrative action in Member States is distorting the conditions of competition in the common market and that the resultant distortion needs to be eliminated, it shall consult the Member States concerned.
>
> If such consultation does not result in an agreement eliminating the distortion in question, the Council shall, on a proposal from the Commission, acting by a qualified majority, issue the necessary directives. The Commission and the Council may take any other appropriate measures provided for in this Treaty."

This provision turns directly to the Commission for the protection of the free competition within the internal market. The procedure is started by the Commission when it determines a distortion of competition based on different legal or administrative provisions of a Member State. The Treaty empowers the Commission to start consultation with the Member State which thus distorts competition. If these discussions do not result in the Member State stopping the distortion, the Commission may propose to the Council one or more directives in accordance with Article 96 para. 2. These directives are exclusively to be addressed to the Member State or the Member States whose provisions result in the distortion of competition. It is very remarkable that the Council may adopt the required directives by *qualified majority even in tax matters*.

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[12] Case 270/83 of 28 January 1986, ECR 1986 p. 273.

It is reported that consultations concerning tax matters according to Article 96 para. 1 happened many years ago. On 13 June 1967 the Commission submitted to the Council a proposal for a directive according to Article 96 para. 2 which, however, was not adopted. It also is discussed what kind of distortions fall under Article 96. Whereas some authors think it concerns only specific distortions, others see a more general application.[13]

Although this Treaty provision has not been used very often and probably never successfully in tax matters, its existence is very important with respect to the claimed special position of tax law provisions in Treaty law. It is understandable that *DG Taxud*, the tax arm of the Commission, avoids procedures according to Article 96 in favour of infringement procedures against Member States. The infringement procedure is only a matter between the Member State concerned and the Commission before it goes to the Court.

Tax benefits as state aid – outsourced to a different Commissioner

Today, it is generally accepted that the principle interdiction of state aid according to Article 87 of the Treaty also applies to taxes of any kind. The general prohibition of Member States gives to the Commission one of its most powerful instruments to be used to guarantee a truly common market. This power is directed not only against companies and businesses but mainly against the Member States.

Within the Commission state aids belongs today to the Commissioner responsible for competition matters. This might be a reason why the elaboration of the impact of state aid on tax subsidies has taken a long time. State aids including tax subsidies have to be notified to the Commission by the Member State concerned. Still today, this is quite often missed. Prohibited state aid has its own definition: It must be (1) granted by the state or by state resources, (2) it must distort or threaten to distort competition, (3) by favouring certain businesses or industries regionally or sectorally, and (4) it must affect trade between Member States. The advantage granted must be specific. Thus the fact that a country does not levy a corporation tax or levies it at a low rate (as for example Ireland) does not make it a state aid, because it is not sectorally or regionally specific. It could, however, create a distortion of competition in the common market, against which Articles 96 or 97 might apply (see above).

This article should not go into detail. The important finding is that the Member State's remaining sovereignty does not protect it even in case of direct taxation against the activities of the *DG Competition* of the Commission.

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[13] See J. Hoffmann: Besteuerung von Kapitalgesellschaften und ihren Anteilseignern in Irland im Vergleich zu Deutschland – zugleich ein Beitrag zu den Grenzen des Steuerwettbewerbs in der Europäischen Union, Frankfurt, 2005.

Conclusions

The objective of this article was to show that direct taxes do not enjoy a privileged treatment under EU law other than that a Member State must not be afraid that its tax provisions, which are otherwise consistent with EU law, may be changed against its will by majority vote. A further restriction which is claimed by some Member States cannot be seen. If Europe wishes to be as strong as possible, it must be ready to make compromises also in tax matters; it does not matter whether it calls those compromises co-ordination or harmonisation.

In reality, as some of the cases decided by the ECJ show, there are greater intrusions into the sovereignty rights of Member States than the Member States seem to be willing to accept. Such ideas may also be supported by the arrival of the soft law approach generated by the Code of Conduct adopted by the Council on 1 December 1997.

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