Tax Competition and EU Law

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CHAPTER 5 - UNILATERAL COUNTERMEASURES AGAINST HARMFUL TAX COMPETITION AND EU LAW

5.1 Introduction and scope

This chapter analyses the compatibility with EC law of countermeasures available for Member States against other (EU) countries’ harmful tax measures. It first describes in general what the main such countermeasures are, distinguishing between special (or targeted) and general countermeasures. It then focuses on the compatibility of the described countermeasures with the EC Treaty as well as with EC secondary law as interpreted by the European Court of Justice (hereinafter: “ECJ” or the “Court”) case law. The last two sections deal with the issue of the application of countermeasures against tax regimes authorised or not assessed under the Treaty (fiscal) State aid rules and/or falling within the scope of the Code of Conduct (and blacklisted by the Primarolo Report).

This chapter only addresses unilateral countermeasures to undo harmful tax competition, that is uncoordinated measures adopted by the various Member States individually. Bilateral remedies contained in tax treaties as well as multilateral or global approaches to counter harmful tax competition will be covered in the next chapter on the main policy options to eliminate or minimise this phenomenon (see Chapter 6, section 6.3). What is also outside the scope of this chapter is the issue of the compatibility of unilateral countermeasures with tax treaties, which goes beyond the object of this research (on this issue, see briefly at 5.4.1.5).

5.2 Description of most common unilateral countermeasures to undo harmful tax competition

5.2.1 Overview

This section briefly describes the main unilateral countermeasures available for Member States inter alia to undo or reduce the effects of harmful tax regimes implemented by other Member States. The countermeasures are divided into general versus specific (or targeted) countermeasures. The former are measures contained in a Member State’s ‘benchmark’ tax system and apply indiscriminately as a consequence of an explicit tax policy pursued by that country. The latter are measures specifically targeted at a reduction or elimination of the harmful effects of certain

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1 Some of the measures analysed in this chapter have been touched upon in Chapter 4, especially in sections 4.3, 4.6, and 4.8. The latter section deals with the OECD project on harmful tax competition, which focuses on countermeasures against harmful tax practices especially in the 1998 OECD Report and in the 2000 OECD Report (see at 4.8.3 and 4.8.5). For an in-depth analysis of both specific and general countermeasures covered in this chapter: Cahiers de droit fiscal international, Limits on the use of low-tax regimes by multinational businesses: current measures and emerging trends, Proceedings of a seminar held in San Francisco in September 2001 during the 54th Congress of the International Fiscal Association (“IFA”), Vol. 86b, 2001 (hereinafter: “IFA 2001 Report”); European Association of Tax Law Professors (“EATLP”), Tax competition in Europe, 3rd annual conference held in Lausanne on 7-8 June 2002, whose general report written by Prof. W. Schön and the national reports are available on the Association’s web site at http://www.eatlp.org (hereinafter: “EATLP 2002 Report”).
competitive tax regimes in effect in other (EU) States mainly used by domestic taxpayers to minimise the internal tax burden on foreign-source (EU) income. As will be seen, this categorisation is important for the actual evaluation of the compatibility of countermeasures with EC law, which is different to a certain extent. This chapter focuses at first on the specific countermeasures due to their common use and the fact that they are specifically targeted at harmful tax competition. It then deals with the general countermeasures (also) able to counter other (EU) countries’ harmful preferential tax regimes.

5.2.2 Specific (or targeted) countermeasures: CFC legislation and restriction of deductibility of payments to low-taxed entities

The most common and probably effective countermeasure against harmful tax competition is a comprehensive Controlled Foreign Corporation (hereinafter “CFC”) legislation. The broad aim of this legislation is the prevention of income shifting and achieving tax deferral by resident taxpayers through the use of a foreign corporation subject to low or no taxation abroad. Under most CFC regimes, taxpayers resident in high-tax countries are obliged to report currently (i.e. at the end of each fiscal year) their pro rata portion of profits derived by the foreign corporation and are taxed on them year regardless of an actual profit distribution. In essence, CFC rules serve to apply the home neutrality principle by countries using the credit method mostly only with regard to foreign passive income earned by resident taxpayers.

Below, there will be an analysis on the compatibility of CFC regimes with EU law from a twofold point of view. The first concerns their application to resident companies holding EU subsidiaries entitled to preferential EU regimes. The second concerns their application to domestic companies controlling a non-EU tax haven entity through an intermediate EU subsidiary not itself caught by the CFC rules.

A second set of specific (or targeted) countermeasures is usually closely linked to CFC legislation. They provide for a denial of a deduction from domestic income for any payments (e.g. fees, interest, royalties, etc.) effected by resident companies to entities or recipients established in low-tax countries. Usually, these countries are the same as those targeted by CFC legislation. The denial may apply either exclusively if the payment is made between related parties or regardless of the degree of control between them. In some cases, these regimes allow the domestic taxpayer to submit evidence that the payments arise in connection with a genuine transaction concluded pursuant to real business reasons. Once again, the issue regards the compatibility with EC law of the application of this type of countermeasures to domestic entities resident in a Member State and making payments to EU entities. The compatibility assessment in this chapter will focus on CFC legislation, but the same analysis and considerations hold true also for these countermeasures.

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3 For a survey of the (EU) countries in which this specific countermeasure applies, see especially the IFA 2001 Report, cit., and the EATLP 2002 Report, cit.
5.2.3 General countermeasures: Denial of participation exemption (for EU subsidiaries) and other statutory anti-abuse rules

A first general unilateral measure to counter the harmful effects of beneficial tax regimes is the denial of the participation exemption by EU countries adopting this method to relieve international economic double taxation (on this issue, see in detail Chapter 4, section 4.6). This countermeasure must be considered general as it is part of the 'benchmark' tax system to relieve international double taxation. Unlike CFC legislation, it does not specifically target certain countries or certain countries' tax regimes but it applies generally if the required conditions for the application of the participation exemption are not met.

Within the EU, a majority of Member States currently uses the participation exemption method for dividends (and in some cases capital gains) distributed by a subsidiary to its resident parent company. Under most systems, the application of the exemption is subject to a number of conditions, the most common of which are: (i) a certain minimum ownership percentage in the subsidiary; (ii) a certain minimum taxation on the underlying profits distributed by the subsidiary in its jurisdiction (i.e. the subject-to-tax requirement); (iii) the requirement that the foreign subsidiary has sufficient substance and/or does not derive mainly or exclusively passive income; (iv) the requirement that the resident parent performs certain functions and control (e.g. is actively involved in the management) with respect to the foreign subsidiary.

Linked to the denial of the participation exemption, there may be a provision denying the deductibility of costs incurred by the domestic corporation and relating to its foreign participations, which is necessary to prevent the potential erosion of the domestic taxable base of the parent company's Member State. The issue in this case is the compatibility of the denial of the participation exemption with EC law. In particular, it is well possible that under some EU countries' tax systems the participation exemption does not apply to e.g. Madeira 'ZFM' companies.

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4 On this issue of the participation exemption and anti-abuse measures, see also in detail Chapter 4, at 4.3.6 and in section 4.6. On the denial of the participation exemption under Netherlands law, see at 4.6.2 (and below in the text). On the Luxembourg's denial of the participation exemption, see at 4.6.4.

5 Interestingly, Austria has enacted an anti-abuse provision denying the participation exemption based on a combination of criteria (ii) and (iii). In particular, the credit method applies where the foreign subsidiary mainly earns passive income subject to low taxation (i.e. less than 15% tax), and in addition its shareholders are not mostly foreigners: see F. P. Sutter, Austrian national report on tax competition in Europe, EATLP 2002 conference, cit., at 4, also stressing that the latter criterion has raised criticism on the harmfulness of the Austrian participation exemption at EU level and has most probably caused itsblacklisting by the Primarolo Report.

6 See in detail Chapter 4, in Section 4.6. In some cases condition (ii) is structured in conjunction with CFC legislation so that the participation exemption does not apply if the foreign subsidiary distributing the dividends is located in a black- or grey-listed country (this is the case of the recently introduced Italian participation exemption (see e.g. C. Caumont and R. Franzé, Participation exemption for inbound dividends and anti-tax-haven rules, 41 European Taxation, 5/2001, p. 187). This kind of system might be considered a hybrid one, since it is both general and specific due to its application to certain countries included in the list. However, even in this case this measure must be considered predominantly general because the lists are a practical tool to apply the general system of application of the participation exemption. Instead, the special countermeasure is the CFC regime, which relies on the use of such lists.

7 This is the case in the Netherlands, whose non-deductibility provision is currently under scrutiny by the ECJ for its potential infringement of the rules on the freedom of establishment and/or of capital movement: see Case 186/01, Bosal Holding BV, pending, and also Chapter 4, at 4.6.2. For a preliminary comment on this case and more in general on this issue, see F. Snel, Non-Deductibility of Expenses Relating to the Holding of Foreign Participations: Preliminary Ruling Requested from ECJ, European Taxation, 10/2001, p. 403; B. J. M. Terra and P. J. Wattel, European Tax Law, Fed, 2001 (hereinafter: "Terra & Wattel"), at 92-94.
Luxembourg '1929 Holding companies', Belgian 'Co-ordination Centres', Irish IFSC companies, etc. (on these regimes, see Chapters 3 and 4). In these cases, dividends (and capital gains) might be fully taxed in the hands of the recipient parent with a credit possibly granted for the underlying (corporate) taxes paid by the subsidiary on the profits out of which the dividends are paid.

In addition to the above, there exist a number of general statutory anti-avoidance measures which vary depending on a country's tax system (i.e. of common or civil law) as well as on all the facts and circumstances of the case. One general, but very fact-dependent method for the tax authorities to prevent tax avoidance is to use the residence provisions of domestic tax law to assert that a foreign company established in a low-tax jurisdiction is effectively managed from its territory and therefore is resident in that country for tax purposes. In practice, these provisions are not used very often as it is very hard for a country's tax authorities to gather the necessary evidence, especially since taxpayers nowadays use sophisticated tax planning techniques difficult to attack on these grounds.

A more common anti-avoidance tool used by tax administrations are general anti-abuse rules ("GAAR"). In civil law countries, these are contained either in the civil or in the tax law and are meant to disregard transactions concluded by domestic taxpayers with foreign (EU) entities entitled to preferential tax treatment where the only or predominant goal of these transactions is the minimisation (i.e. avoidance) of domestic taxes and they lack genuine business purpose. In common law countries, 'sham' or 'step' transaction doctrines are used to the same effect, mainly to disregard transactions having the only purpose of avoiding taxes or to disregard the existence itself of the entity benefiting from a special tax regime. In the EU, several countries apply GAARs to counter tax avoidance, such as Germany, Austria, and Italy.

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8 It is interesting to note that the Netherlands Supreme Court recently ruled that the use by a Netherlands company of an Irish IFSC entity for finance activities may not be considered abusive as the Netherlands company may achieve a similar low-tax result through the use of the CFM regime: see Hoge Raad, 8/2/2002, BNB 2002/118, § 3.10.

9 For a broad overview on the main general countermeasures, see e.g. B. J. Arnold and M. J. McIntyre, International Tax Primer, Kluwer, at 69 ff., and more in detail the IFA 2001 Report, cit., and the EATLP 2002 Report, cit., and the national reports contained in both reports.

10 In order to avoid residence issues companies resident in high-tax jurisdictions take a number of precautions with regard to the foreign subsidiary, such as appointing local directors and providing enough substance (e.g. office facilities and (part-time) staff) locally.

11 Sec. 42 of the General Tax Act applies to disregard the existence of foreign entities lacking economic purpose and merely set up to avoid German taxation, and its consequence is the attribution of their income to the German resident taxpayer. For a thorough comment on the state of affairs in Germany, see J.D. Kramer, Tax Avoidance, Tax Evasion, and Tax Fraud - German National Rules, Tax Notes International, 27/8/2001, p. 1085, and J. Hey, National report on tax competition in Europe - Germany, paper submitted for the EATLP 2002 conference, at 21-23, available on the web site at www.eatlp.org, also stressing that the German Bundesfinanzhof has ruled that Sec. 42 supersedes German CFC legislation in case of overlap.

12 Sec. 21 of the Austrian Federal Tax Code endorses a substance-over-form approach under which the actual economic purpose rather than the formal appearance of a certain transaction must be taken into account to establish whether abuse of Austrian tax law is afoot. The subsequent Sec. 22 provides that Austrian tax liability is determined according to the real economic purpose, disregarding the transaction as the case may be: see Sutter, Austrian national report on tax competition in Europe, EATLP 2002 conference, cit., at 2-3.

13 In Italy, tax avoidance is countered either through the general Civil Code concept of simulation, similar to the 'sham transaction' doctrines, or through an anti-avoidance provision included in Art. 37 bis of the Assessment Tax Act, which applies to a number of specified transactions concluded with a view to avoiding Italian tax: see a.o. D. Busetto and A. Russo, Italy - Final controlled foreign companies legislation enacted, 41 European Taxation, 1/2001, p. 32, at 33 (note 4).
The analysis on the compatibility of these general (counter)measures with EC law is important because of the frequent attempts by EU states' tax authorities to use them also in an EU context.

5.3 EC Treaty Freedoms and Countermeasures

5.3.1. Introduction

This section describes the main EU law provisions affecting the applicability and validity of Member States' countermeasures against (harmful) preferential tax measures of other Member States. As will be seen in the compatibility analysis, these provisions are contained in both primary and secondary EU law (i.e. in the Treaty and in EC Directives). The former do not specifically deal with tax law but embody fundamental principles of EC law (e.g. the fundamental freedoms and the loyalty principle).\(^{14}\) The latter do focus on tax law but their relevance is more limited due to their specific purpose in the context of a specific directive (i.e. the Mutual Assistance, the Parent/Subsidiary, and the Merger Directive).

This section focuses on the Treaty provisions on the fundamental freedoms. In particular, the rules on the freedom of establishment and on the free circulation of capital will be illustrated, with reference to the relevant case law of the ECJ. These freedoms are both crucial in determining the compatibility of countermeasures against harmful tax competition with EU law. The analysis in this section also touches upon the other two freedoms (i.e. of circulation of workers and of provision of services) and more general EU law issues (e.g. abuse of EC law), which all affect the compatibility assessment.

5.3.2 Freedom of establishment and Member States' anti-abuse (tax) laws

5.3.2.1 Arts. 43-48 EC Treaty: freedom of primary and secondary establishment

The Treaty provisions mostly applied in the corporate tax area are the ones on the freedom of establishment, which are contained in Arts. 43 through 48.\(^ {15}\) They establish the right for nationals of a Member State, both self-employed and corporations, to establish themselves into another Member State. In particular, Art. 43 reads:

"... Restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition 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..."

\(^{14}\) On the application of the Treaty rules on the fundamental freedoms and of the loyalty principle, see Chapter 2, respectively at 2.3.2 and 2.2.3.

Art. 48 states:

"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 shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States".

The right of establishment includes both primary and secondary establishment. The former entails the possibility for nationals of an EU country to undertake an economic activity in another EU State directly or through a local entity, which also includes as a corollary the right to establish residence therein. The latter implies that EU nationals can exercise an economic activity also in another Member State through a local legal entity, which can be an agency, a branch, or a subsidiary of the entity carrying out the economic activity in the residence (i.e. home headquarters') Member State.

The concepts of discrimination and restriction within the meaning of Art. 43 are quite broad. Discrimination consists of treating differently comparable situations or treating alike different situations without justification. A restriction refers to a mere hindrance to the right of (primary and secondary) establishment and encompasses measures that, although not treating differently comparable situations or similarly different situations, make more burdensome the exercise of this right in an EU situation as compared to a purely internal situation. These concepts include (tax) measures giving rise to both overt (or direct) discrimination or restriction explicitly based on nationality (or origin for products and goods) and covert (or indirect) discrimination or de facto restriction.

In direct tax matters, the concept of nationality plays a limited role, the most important factor being the taxpayer's residence for tax purposes. In this respect, the ECJ has repeatedly ruled that whenever provisions of direct tax law based on residence act mainly or exclusively to the detriment of foreign nationals without there being a justification, they are caught by the prohibition of Arts. 43 and 48. Nonetheless, restrictive or even indirectly discriminatory measures (based on residence) may be enacted if there is a justification in the form of a mandatory requirement of public interest overriding the need to ensure the Treaty freedom. There are two sets of such justifications. The first set of 'written' justifications is contained in Art. 46:

"The provisions in this Chapter ... shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for special treatment for foreign nationals on grounds of public policy, public security or public health."

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17 This is confirmed by a number of cases, e.g. Case 13/63, Italian Refrigerators, [1963] ECR 165; see the other case law cited by Bater, cit., at 8.

These are the statutory justifications, which apply in all cases of discrimination and restriction to the freedom of establishment. In addition, there are ‘unwritten’ justifications recognised in the so-called rule of reason elaborated by the ECJ in the landmark case Cassis de Dijon.¹⁹ These are based on mandatory requirements of public interest that the Court considers worthy of protection even though they hinder the right of establishment. They include consumer protection, prevention of unfair competition, effectiveness of fiscal supervision, coherence of the fiscal system, protection of the environment and public health, promotion of culture, improvement of working conditions, and also the prevention of abuse of law. It is important to stress that according to ECJ case law the unwritten justifications under the rule of reason are only able to justify a restriction but not a discrimination directly or indirectly based on nationality. The reason for this is that a restriction does not impede the right of establishment but only imposes more burdensome conditions to its exercise, and thus the Court is slightly more lenient in tolerating it as opposed to a discrimination, which in principle can only be justified on the basis of the statutory justifications laid down in Art. 46. Nonetheless, especially in direct tax matters the Court allows - inconsistently - indirectly discriminatory measures (i.e. residence-based measures) to be justified by the rule of reason.²⁰

5.3.2.2 Applicability in the direct tax area

In the absence of specific tax provisions in the Treaty, the ECJ has repeatedly affirmed that Arts. 43-48 also apply to restrictions imposed by the home state by way of direct tax measures against its own nationals, including companies having their legal seat (and/or effective management) within their territory. The Treaty freedoms guarantee not only market access and equal treatment in the target State, but also the right to exit the State of origin. As will be seen, unilateral countermeasures used by Member States to undo harmful tax competition within the EU potentially constitute a home state restriction to the right of secondary establishment by a domestic entity into another Member State. They may also be at odds with the rules on the free movement of capital (see at 5.3.3). The Court uses three tests in its assessment of the compatibility of national (direct tax) provisions, including countermeasures, with Arts. 43-48 of the Treaty. They will be analysed separately below in particular in the light of Member States’ unilateral anti-abuse provisions contained in domestic (tax) law. The findings of this analysis will then be applied in the compatibility analysis of their specific and general countermeasures with the Treaty freedoms of establishment and of capital circulation.

5.3.2.3 Is the situation submitted to the Court (and the national provision regulating it) covered by the scope of the Treaty?

In order to have access to the EC Treaty, a certain situation must involve a cross-border activity of an economic nature. As confirmed by the Court, cross-border situations not arising from the exercise of an economic activity and/or lacking an economic nexus with the host State are denied Treaty access, being “internal situations.”21 The Court has progressively interpreted less strictly this requirement and currently tends to apply the Treaty freedoms much more broadly than in the early years. With the advent of the Union and the concept of European citizenship it has been questioned whether the Treaty still requires a cross-border economic situation to be at stake for its applicability.22 Instead, it has been argued that the general non-discrimination principle in the Treaty, i.e. Art. 12, coupled with the concept of EU citizenship would imply that the Treaty should apply in each cross-border situation involving two Member States regardless of the presence of an economic purpose or merely a personal reason for the exercise of the freedoms. In other words, the underlying reason for the occurrence of a cross-border situation would no longer matter as a result of these provisions. This test bears relevance also for the opposite case of cross-border economic situations involving a Member State and a third country. This would be considered an ‘external’ situation not falling within the scope of the Treaty as it would take place outside the territory of the Union.

For our analysis, this test bears relevance in both its aspects. For the applicability of countermeasures (e.g. CFC rules) to entities resident in another EU State, the issue is whether there is a cross-border economic situation or a purely internal situation, especially in those cases in which the EU entity is passive and lacks substance and genuine business purpose. In the case of countermeasures (i.e. CFC legislation) applying to non-EU entities held through an EU intermediary entity the question arises as to whether there is a cross-border situation covered by the Treaty, as this may be considered an external one in that the entity caught by it is located outside the EU.

5.3.2.4 If so, is there a discrimination or a restriction covered by Arts. 43-48 of the Treaty?

In direct tax matters this test is important especially with regard to discriminatory or restrictive provisions applicable in the host state. In this respect, the Court usually assesses the comparability of the situation submitted to it with the same hypothetical situation in a domestic context in order to judge whether there is a discrimination or a restriction to the freedom of establishment within the meaning of Art. 43.23 As for home state restrictions, the Court assesses whether a certain direct tax measure does have the effect of hindering the right of primary or secondary establishment of a

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22 On this issue, see Terra & Wattel, especially at 23 and 24. See also in Chapter 2, at 2.3.2.
domestic (individual or) entity in another Member State. In this situation, the concept of restriction focuses on any tax provision making it more difficult or burdensome for a resident individual or company to establish itself (or to invest) in another Member State as opposed to a purely domestic situation.

The first case specifically dealing with home state restrictions potentially imposed by direct tax measures to the freedom of (primary) establishment of companies in other Member States was *Daily Mail*. Daily Mail was a UK public limited company willing to move its residence to the Netherlands mainly for tax reasons. However, UK law required the consent of the Treasury to move the tax residence abroad, which would have been granted only upon Daily Mail settling the tax claims on its hidden gains in the UK. Daily Mail challenged this provision as an impediment to the freedom of primary establishment in another Member State. Unfortunately, the Court did not focus on the tax aspect but rather on the corporate aspect of the issue to rule that the freedom of primary establishment of companies in other jurisdictions was still subject to home state control as long as corporate law rules were not harmonised. The ECJ concluded that nothing prevented the UK from enacting rules to check companies’ migrations by e.g. requiring previous Treasury consensus to transfer their residence into another Member State.

For our analysis, what matters is that in *Daily Mail* the ECJ specifically stated that also home state restrictions fall within the scope of Arts. 43 and 48. As will be seen, the applicability of countermeasures may constitute a home State (discrimination or) restriction to the freedom of secondary establishment in another Member State.

### 5.3.2.5 If so, is this (discrimination or) restriction justifiable on the basis of written and/or unwritten justifications?

Restrictive measures imposed by the (host or) home state may be justified on the basis of the written justifications contained in Art. 46 of the Treaty or of the unwritten justification relying on the rule of reason. If it does find a justification applicable, the Court assesses in particular whether the restrictive measures are: a) appropriate to achieve the goals potentially able to justify them, i.e. due to the absence of other rules, existing or to be implemented, better suited for such goal(s), and b) proportionate to their goal(s), i.e. due to the absence of less restrictive measures to reach the same goal(s) (the so-called proportionality principle).

Below, there will be an analysis of the most important cases dealing with home state restrictions in tax matters. It will cover both tax cases and non-tax cases relevant for the compatibility assessment. Its purpose is to summarise the main principles to be applied in the assessment of the possible justifications put forward by Member States for the implementation of CFC regimes and general countermeasures against harmful tax competition (in the EU).

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25 See e.g. *Terra & Wattel*, at 41 ff.
5.3.2.6 Applicability of justifications in direct tax matters: the ICI case

The ECJ accepts a few justifications for discriminatory or restrictive tax measures enacted by Member States, mainly based on the rule of reason. The most relevant ones are the need to preserve the coherence of the fiscal system, the need to ensure effectiveness of fiscal supervision, and the need to prevent tax avoidance. The justification of the coherence concerns the need to ensure consistency between the granting of deductions and the taxation of the underlying items of income relating to the same situation, or vice versa the denial of deductions where there is no subsequent taxation of that income. It was accepted for this first time in the Bachmann case, but since then the Court has not yet accepted it again in the cases referred to it, mainly on the basis of lack of a direct link between deduction and item of income subject to taxation. The justification based on the need to ensure effectiveness of fiscal controls can be invoked in cases in which a certain restrictive measure is needed to provide the tax administration with the necessary elements to ascertain a situation giving rise to items of taxable income or deductions claimed by taxpayers. The Court has accepted it only in exceptional circumstances where for instance the Mutual Assistance Directive was no help, such as in the Futura case (see at 5.3.2.8).

The most relevant justification for home state restrictive tax measures for the purpose of our analysis is the need to prevent tax avoidance. The Imperial Chemical Industries (ICI) case contains the most notable illustration of how the Court interprets it in direct tax matters. ICI was a UK company with a 49% stake into another UK holding company. This holding company owned shareholdings in 23 subsidiaries, of which 4 were established in the UK, 6 in other EU countries, and 13 in non-EU countries. Under UK tax law, resident companies owning at least 90% of the shares in other resident trading companies were entitled to the so-called consortium relief, which allowed the holding company (or its shareholders) to offset the operating losses of the resident subsidiaries against their own income. In this case, ICI sought to offset 49% of the losses borne by one of the 4 UK subsidiaries against its taxable income under the consortium relief. However, the UK tax authorities denied its application on the grounds that the condition that no more than 25% of the subsidiaries held by the UK consortium was established outside UK territory was not satisfied.

ICI claimed that this provision had the effect to hinder the establishment of subsidiaries in other EU countries because for the consortium relief to apply the overwhelming majority of subsidiaries was required to be located in the UK. The Court agreed and ruled that the UK tax law provision did hinder ICI’s right of secondary establishment in the EU by denying consortium relief merely on the basis

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26 The Court is so reluctant to accept this justification that one must doubt it is still applicable in tax matters: see Terra & Wattel, especially at 63-64 and at 71 ff. It has also been observed that it should be formally buried by the Court in view of some of its judgement: see T. Lyons, Royal Bank of Scotland: Implication for Bachmann?, EC Tax Journal, 3/1999, at 166-167.
of these subsidiaries being located (also) in other EU (and non-EU) countries, and thus it was a home state restriction forbidden by the Treaty. The UK government submitted two main justifications for the denial of the consortium relief: (i) the need to prevent a loss in tax revenue possibly caused by the impossibility of the UK Treasury to tax profits of foreign subsidiaries versus the granting of loss relief at the level of the UK companies, and (ii) the need to prevent tax avoidance caused by domestic taxpayers’ schemes meant to shift (also) foreign losses to the UK entity and profits outside the UK.

The Court dismissed both of them. With regard to the need to prevent loss of tax revenue, the Court briefly referred to its previous judgements to stress that it did not consider it as one of the written justifications laid down in Art. 46 of the Treaty. In this respect, the Court has repeatedly held that this is a purely economic aim, which is not enough to be encompassed in the concept of ‘public policy.’

As for the need to prevent tax avoidance, the Court stressed that the denial of the consortium relief applied in all situations without a distinction between cases in which there was primarily a tax avoidance intent and cases in which this intent was missing:

“the legislation at issue ... does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits, but applies generally to all situations” (our emphasis).

Furthermore, it stressed that the risk of loss- and profit- shifting was also present in case of just one foreign subsidiary, which was allowed under UK tax law, meaning that the denial of the relief was not appropriate to achieve this goal.

From this case one may infer the following principles: (i) the need to prevent the loss of tax revenue or tax base erosion cannot be invoked as written justification under the ‘public policy’ exemption laid down in Art. 46 as this does not refer to objectives of an economic nature; and (ii) the need to prevent tax avoidance (i.e. wholly artificial situations) can constitute a valid unwritten justification, provided it is sufficiently targeted and is proportionate to this objective.

5.3.2.7 The Treaty freedoms, abuse of (EC) law, and national anti-abuse (tax) measures

The issue analysed here is to establish when the freedom of establishment under Art. 43 is deemed to be lawfully exercised and where is the borderline with abusive situations in which this freedom is exercised merely or mainly to circumvent provisions of domestic (tax) law.

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30 See ICt, cit., Para. 26.

31 For a detailed analysis of the issues (and ECJ case law) covered in this section, see Terra & Wattel, at 77-84. See also M. de Kleer, Towards a European anti-abuse doctrine in direct taxation?, InterTax 4/1996, p. 137, and F. Harris, The notion of “abus de droit” and its potential application in fiscal matters within the EU legal order, EC Tax Journal, 2001, p. 187.
In *Factortame* the issue was the compatibility with the freedom of establishment of UK domestic anti-avoidance legislation which imposed a number of requirements for fishing vessels to obtain UK registration and the right to fish within UK fishing quotas. Some of these requirements were that the legal and beneficial owners and the managers of the vessels had to be UK nationals, or in case of corporations they had to be owned for at least 75% by UK nationals and managed for at least 75% by UK directors. The main reason for this restrictive legislation was the attempt to avoid the phenomenon known as ‘quota hopping’, that is the plundering of the fishing quotas in UK seas by foreign-based vessels, mainly Spanish ones, lacking any connection with the UK territory.

The Court held that UK legislation was discriminatory against non-nationals by imposing such strict requirements for registration of their vessels in the UK registry and thus was caught by the ban of the then Art. 43. As for the justification put forward by the UK government to prevent abusive practices via a claim of the applicability of EC law, the Court ruled that nothing prevented the UK to lay down as a requirement for registration that the vessel had to be operated and managed from the UK territory. In this respect, the Court noted that “the concept of establishment within the meaning of Art. 52 [now Art. 43] et seq. of the Treaty involves the actual pursuit of an economic activity through a fixed establishment in another Member State for an indefinite period.” As the said requirement “essentially coincides with the actual concept of establishment ... it follows that those articles, which enshrine the very concept of establishment, cannot be interpreted as precluding such a requirement.”33 This case implies that the Treaty rules on the freedom of establishment are at stake only where there is integration by the legal or natural persons in a Member State’s economic activity through a fixed establishment for an indefinite period.

Another important, and apparently contrasting case for our purposes is *Centros*.34 Centros was a UK company set up by two Danish citizens with a capital of GBP 100. It was a non-trading company completely lacking substance in the UK and was registered at the home address of some English friends of the Danish shareholders. Centros was refused registration of a branch in Denmark by the competent authorities mainly on the grounds that it was trying to effect a primary establishment in Denmark seeking to avoid the minimum capital requirements of DKK 200,000 laid down under Danish corporate law to set up local companies.35 Centros challenged this refusal as incompatible with the Treaty freedom of establishment despite the fact it was a ‘brass plate’ company in the UK. Its claim was based mainly on the previous *Segers* case,36 in which the Court had ruled that a Member State could not deny a

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32 Case C-221/89, *The Queen v Secretary of State for Transport, ex parte Factortame Ltd and others*, 25 July 1991 [*1991*] *ECR* I-3905 (referred to as “*Factortame*”).
33 See *Factortame*, *cit.*, Paras. 20 and 34.
35 The difference with the UK minimum capital requirements of GBP 100, or about DKK 1,000 was therefore quite substantial.
company director domestic social security benefits on the grounds that the registered office of the company was established in another Member State with no substance and no business activity carried on therein. By contrast, the Danish authorities submitted that their refusal was legitimate given the need to prevent avoidance schemes meant to circumvent domestic minimum capital requirements, and the need to protect creditors and other parties from a potential (fraudulent) insolvency of Centros.

The ECJ based its decision on the principles of abuse of EC law elaborated in its previous case law. In particular, it focused on whether Member States are entitled to adopt unilateral countermeasures to prevent its nationals from circumventing domestic legislation by exercising rights granted by the Treaty. Referring to its case law, the Court stated that in principle Member States have the right to take all the appropriate measures to this effect. However, the Court also pointed out that domestic courts can in principle deny Treaty benefits only in situations in which there is objective evidence of the abuse or fraudulent conduct of the persons concerned and that their final decision must take into account the objectives pursued by the EC provisions concerned. In the case at hand, the ECJ found that in the absence of harmonisation of corporate law in the EU, EC citizens enjoyed full freedom to shop for the most flexible and suitable corporate legislation available in the EU.37 This view was backed by the Advocate General, who stressed that in a system of competition of corporate systems such right to pick and choose was inherent to an internal market as a consequence of the freedom of movement and establishment. Furthermore, the Court found that in accordance with Segers the fact that Centros did not carry on any business activity in the state of primary establishment (i.e. the UK) did not have any relevance for the application of the rules on the freedom of establishment.

Turning to the justifications, the ECJ focused on the unwritten justifications based on the rule of reason. In this case, the Court highlighted that the need to protect creditors failed to meet the necessary standards required by its case law, noting that: (i) had the UK headquarters conducted an active business, the Danish authorities would not have denied the registration of the branch, although the same contended abuse would have been possible; (ii) the Danish authorities could have adopted more appropriate and less restrictive measures to achieve the same result; and (iii) in any event creditors would have been aware that they were dealing with a UK company possibly subject to different rules and thus would have been able to take all precautions deemed necessary.

The ECJ seems to lay down different principles in Factortame and Centros. Specifically, in the former it states that for the freedom of establishment to be at stake an economic activity must be carried out through a fixed presence in the host State, whereas in the latter it rules that a mere incorporation of a (letter-box) company lacking any local substance in the State of primary establishment is sufficient. How do we reconcile these holdings for the purpose of our analysis? In Factortame, there was an abusive situation in which circumvention of legislation on fishing quotas was fought by the host state (i.e. the UK) looking at a number of criteria, among which the Court recognised those aimed at proving the lack of economic integration in the domestic economy necessary to claim the right to fish in UK waters (and thus to have access to

UK fishing quotas). In other words, the UK anti-abuse legislation was deemed appropriate and (some of) its criteria well targeted to prevent circumvention of the object and purpose of the (EC) legislation on fishing quotas. In Centros, the host state (i.e. Denmark) adopted an inappropriate and disproportionate measure against the circumvention of domestic corporate law on minimum capitalisation requirements, which could have been achieved with a less restrictive means (e.g. the provision of an adequate guarantee by the company requesting to establish a branch). Unlike Factortame, in this case there was no issue of carrying out an actual economic activity and thus of being integrated in the economy of the host state (Denmark), as this was exactly what Centros wanted to do. Therefore, the different principles laid down in the two judgements must be seen in the light of the different facts of the potentially abusive situations at stake, despite in both cases the establishment of companies lacking substance was the means used to circumvent legal rules through the (supposed) exercise of a Treaty freedom.38

The following non-tax cases shed light on this very issue, and in particular as to what extent it is possible to invoke Treaty provisions to (legitimately) avoid the application of domestic anti-abuse provisions.

In Kefalas,39 the dispute concerned a Greek public limited company in financial distress whose management was taken over by a public body with the supervision of the competent minister under a Greek law on the administration of companies in financial difficulty. This law granted special powers to this public body, among which the possibility to increase the capital of a company with the consent of the minister and without prior approval by the general shareholders meeting. The company’s shareholders went to court, claiming that the capital increase decided by the public body was in breach of an EU directive40 which required any capital increase of companies to be approved by the general shareholders meeting. The Greek State sought to dismiss this argument under a general domestic anti-abuse provision of the Greek civil code as an abusive exercise of rights granted by EC law, damaging the interest of the company.41

The ECJ referred to its previous case law stating in general that EC law cannot be invoked for abusive or fraudulent purposes, which does not preclude a Member State from using a domestic anti-abuse provision to ascertain whether in a certain situation there exists an abusive intent. The ECJ also ruled that national courts must assess all the facts and circumstances of the case and may not apply the domestic anti-abuse provisions so as to frustrate the full effect and uniform application of EC law, recognising that “Community law does not preclude a national court ... from examining whether ... a shareholder is seeking to derive ... an improper advantage,

38 The main difference is that in Factortame a company lacking substance was established in the host State, whereas in Centros it was established in another home State (the UK) to carry out business through a branch in a different host State (i.e. Denmark).
40 This was the Second Council Directive 77/91/EEC of 13 December 1976 on the coordination of safeguards for the protection of the interests of members and others in respect of the formation of public limited liability companies and maintenance and alteration of their capital.
41 The translation of this Civil Code provision as indicated in the judgement (Para. 12) is: “the exercise of a right is prohibited where it manifestly exceeds the bounds of good faith, morality or the economic or social purpose of that right.”
manifestly contrary to the objective of that provision” (emphasis added).42 However, the Court concluded that the decision of the domestic court could not be merely based on the fact that the company’s shareholders had not used their right to preferential subscription to the capital increase or that the decision taken by the public body proved adequate to save the company in financial distress, a more thorough evaluation of all circumstances of the case having to be taken into account.

Another important non-tax case for our analysis is Emsland-Stärke,43 which involved abuse of EC law connected to the granting of export refunds in the agricultural sector. Emsland-Stärke GmbH was a German company exporting agricultural products outside the EU (i.e. to Switzerland). The same products were then immediately re-imported into Germany or in another EU country (i.e. Italy) for resale. The whole (completely legal) operation was arranged because the export refund claimed by Emsland-Stärke happened to be higher than the customs duty applicable upon re-importation into the EU. The issue was whether there had been an abuse of rights by Emsland-Stärke, which although fulfilling all the conditions required to receive a refund and not formally violating EC law, had achieved through the transaction a result contrary to the purpose of the EC legislation granting the export refund.

Having referred to previous case law, the ECJ ruled that for an abuse of EC law to be present there have to be two elements, an objective and a subjective one. As to the former, the Court pointed out that “a finding of an abuse requires … a combination of objective circumstances in which, despite formal observance of the conditions laid down by the Community rules, the purpose of those rules have not been achieved.” With regard to the latter, the ECJ referred to “the intention to obtain an advantage from the Community rules by creating artificially the conditions laid down for obtaining it” (i.e. the export refund).44 The Court then reaffirmed that national courts must assess the existence of both elements in each specific case, the only limit being to ensure effectiveness of EC law.

To sum up, in the non-tax cases Kefalas and Emsland-Stärke the ECJ seems to accept domestic countermeasures aiming to prevent circumvention of domestic (tax) law by way of a resort to EC law provided that: (i) their application is carefully assessed by national courts whenever there is an alleged exercise of EC legal provisions in the light of their object and purpose, (ii) the abuse is objectively evidenced by the fact that even though all the requirements for the application of EC provisions are formally fulfilled, their object and purpose are in fact frustrated, or not achieved, and (iii) there is a wilful intention on the part of the legal or natural person to achieve this result through the artificial creation of the conditions to fulfil the said requirements.

The above brings us to the more general subject of whether it is possible to deduce a consistent anti-abuse doctrine from cases specifically dealing with the direct tax area in order to assess the compatibility of Member States’ countermeasures with EC law. The Eurowings case45 dealt with the compatibility of a provision of German tax law with the free circulation of services laid down in Art. 49 (ex Art. 59) of the Treaty. In Germany, a trade tax is imposed in general on industrial and commercial activities.

42 Kefalas, cit., Para. 28. See also Paras. 20 and 22 of the judgement.
44 The objective and subjective elements are so defined in Paras. 52 and 53 of the judgement.
carried out within the country, which does not usually apply to foreign companies providing services from their country. In the case at hand, the airline Eurowings was leasing aircraft from an Irish company and paid rental fees to it. As the Irish lessor was not subject to German trade tax, Eurowings was subject to a more burdensome trade tax in Germany on the lease of these aircraft than it would have been had it leased aircraft from a domestic lessor. Eurowings challenged the German trade tax provision as incompatible with the Treaty freedom to provide services since it resulted in a higher tax liability for German taxpayers if the service provider was not liable to this tax in Germany due to its residence in another Member State. The ECJ found that the German provision on trade tax did impose a restriction to the free circulation of services as the German recipients of services would have had an advantage to prefer German providers versus foreign EU ones in order to avoid incurring a higher tax burden domestically.

The German government put forward two justifications: the need to preserve the coherence of the fiscal system and the prevention of distortions of competition caused by the German trade tax provision due to the low tax burden enjoyed by the Irish lessor under Irish tax law. In particular, the Irish company was entitled to the special 10% tax rate available for eligible entities established in Shannon Airport, which had been approved by the Commission under the Treaty state aid rules. The Court rejected both justifications. Focusing on the latter, interesting for our purposes is the ECJ statements that “any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used to justify less favourable treatment in tax matters given to recipients of services established in the latter State ... such compensatory tax arrangements prejudice the very foundations of the single market.”

Hence, the fact that a non-resident entity enjoys a low tax burden in its country of residence is not an acceptable justification for imposing a harsher tax treatment meant to indirectly compensate the lower foreign tax burden. Applied to the compatibility analysis of countermeasures with EC law, this means that as a matter of principle Member States may not justify their use against preferential tax regimes of other Member States if the resident taxpayer is doing business with a non-associated company in a foreign low-tax regime, as the lessee and the lessor in Eurowings were unrelated. No conclusions can be drawn from the Eurowings case with regard to the situation of a resident taxpayer making payments to, or otherwise dealing with, a wholly owned or at least controlled foreign company.

The next question is whether this conclusion is valid in all cases or Member States are allowed to a certain extent to adopt unilateral countermeasures against other EU countries’ tax regimes. In Eurowings, one must consider that most probably the Court reached that conclusion since (i) the contracting parties were unrelated, and (ii) the favourable Irish tax regime enjoyed by the lessor (i.e. the 10% Shannon Airport relief) had been approved by the EC Commission under the Treaty state aid rules. Furthermore, one must take into account that in Eurowings the Irish lessor was a real company actively engaged in business from Ireland, meaning that there was no tax

46 On the approval of the Shannon Airport regime and more in general the 10% manufacturing relief by the Commission under the state aid rules, see in detail in Chapter 3, section 3.5.
47 See Paras. 42 and 43 of the judgement.

250
abusive conduct by (neither the Irish lessor nor) Eurowings. Therefore, this case does not imply that in all situations Member States are a priori prevented from taking unilateral countermeasures to undo the effects of other Member States’ favourable tax regimes, but only that they are not allowed to do so where there is no abusive situation (i.e. a wholly artificial arrangement) at stake and such regimes have been authorised by the Commission under one of the exemptions laid down in Art. 87 (3) (see in Chapter 3).

These conclusions are also supported by another important tax case for our analysis, the Leur-Bloem case. This dealt with the application of the anti-avoidance provision contained in the EC Merger Directive as transposed into Dutch tax law and applied by the Dutch tax authorities. Mrs Leur-Bloem was the sole shareholder and director of two Dutch companies. She planned a merger by exchanging the existing shares in these companies for those of a new Dutch holding company of which she would become the sole shareholder and director. Apparently, the execution of this transaction was (almost exclusively) driven by the fiscal goal to horizontally offset the losses of the existing entities through the use of the new entity without at the same time incurring tax liability on the hidden gains on the participation of the companies contributed into the newly formed holding company.

The Dutch tax authorities denied Mrs Leur-Bloem the tax deferral on such latent gains on the grounds that no genuine merger had taken place due to the absence of valid commercial reasons. They relied on an anti-abuse provision denying the Directive benefits where the merger did not entail a desirable combination of undertakings, and they referred to the abuse reservation laid down in Art. 11 (1) of the Directive. Having asserted its competence to deliver a ruling on the case despite the situation seemed a purely internal one, the ECJ made it clear that the pure or exclusive goal of tax (evasion or) avoidance in a merger covered by the Directive was to be ascertained in detail on a case-by-case basis taking into account all the relevant facts and circumstances and not relying (only) on predetermined criteria. Furthermore, the ECJ stressed that this assessment should be subject to domestic judicial review. Lastly, the Court reasserted the need to comply with the principle of proportionality also in view of the purpose of the anti-avoidance rule.

All in all, this case is fundamental not only to understand the Court’s interpretation on the application of anti-avoidance legislation with regard to EC secondary law (i.e. the Merger Directive), but also more in general the Court’s line of thinking in abusive situations. This is confirmed by the ECJ case law on the freedom of circulation of capital, in which the Court specifically referred to Leur-Bloem in setting out the conditions under which domestic anti-abuse provisions may be justified under the Treaty, implying that it is a more general expression of the Court’s doctrine of abuse of law in an EC (and domestic) context. To sum up, in the assessment of compatibility of unilateral countermeasures with EC law the ECJ will consider anti-tax-avoidance rules enacted by Member States compatible with the Treaty if they: (i) do not apply

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50 See the Case C-479/98, Commission v Belgium, dealt with at 3.3.3.4.
automatically on the basis of predetermined factors but are based on a thorough examination of the actual facts and circumstances of the individual case, (ii) are subject to judicial review, and (iii) comply with the principle of proportionality (see below).

5.3.2.8 The principle of proportionality and direct taxation

The appropriateness of a restrictive (tax) (counter)measure to achieve one of the objectives recognised by the rule of reason is not sufficient for its compatibility with the Treaty. The Court also requires the measure to be proportionate with the justified goal pursued. The proportionality test means that the restriction to the Treaty freedom must be necessary and not go beyond what is needed to accomplish this goal. The following case law shows how the Court applies this test in direct tax matters.

The Futura case51 concerned a requirement under Luxembourg tax law to have local permanent establishments (hereinafter: "PE") of foreign companies had to hold bookkeeping compliant with Luxembourg accounting principles in order to claim a loss carry-forward. This constituted a procedural requirement making it more burdensome for local PEs to use their Luxembourg losses in subsequent tax years and was considered by the Court a restriction to the freedom of establishment. The Luxembourg government sought to justify this provision on the basis of the need to ensure the effectiveness of fiscal supervision, as it was necessary to ascertain that the amount of loss deductible in Luxembourg was calculated properly and was economically related to the Luxembourg activities carried out by the PE. The Court held that the Luxembourg restrictive provision was not only appropriate with these two goals but also proportionate as there was no other less burdensome (procedural) means to achieve them. The Court based its decision on the lack of harmonisation in the fiscal and accounting area at EU level and the absence of other EC provisions, namely the Mutual Assistance Directive, allowing the Luxembourg tax authorities to gather the information needed.

The Vestergaard case52 concerned an alleged restriction by Danish tax law to the freedom to provide services contained in Art. 49 of the Treaty. Under Danish legislation, costs borne by companies for the attendance of professional courses by their employees in foreign tourist destinations were deductible only upon proof by the taxpayer that the professional rather than the tourism element prevailed. This rebuttal of the onus of proof on the taxpayer was not in place with regard to courses attended in Danish tourist destinations. The main question was whether such a different procedural rule constituted a restriction to the freedom of circulation of services.

The ECJ concluded that the presumption of Danish legislation was indeed a restriction to the provision of services on the grounds that Danish providers were indirectly favoured due to the easier deduction of the costs of domestic courses, which deduction was highly uncertain for the attendance of courses in other EU

tourist locations. The judgement was mainly based on the Danish tax authorities' practice to systematically deny the deduction for courses attended in (EU) tourist destinations.

The next step was the analysis of a possible justification to this restriction, which the Court did by focusing on the need to ensure the effectiveness of fiscal supervision accepted earlier in *Futura*. The ECJ rejected this justification as disproportionate with the need of the Danish tax authorities to gather information on the courses and to prevent potential abuses by local taxpayers trying to deduct expenses connected to personal rather than business reasons. The Court reasoned by referring to the possibility for the Danish authorities to rely on a less burdensome instrument for the taxpayer, i.e. the Mutual Assistance Directive, whose very objective is to facilitate the exchange of information for tax purposes in cases like the one at hand. In the Court's view, the Danish authorities' observation that this instrument had proven virtually ineffective for this purpose was not decisive because it was available to them anyway.

The conclusion one can draw for the purposes of our analysis is that the ECJ considers a rebuttal of the onus of proof in cross-border situations a restriction to the Treaty freedom of establishment (and also of circulation of workers and provisions of services). This restriction is usually not justifiable on the basis of the need to ensure effective fiscal supervision because it is disproportionate in all cases in which the Mutual Assistance Directive applies, even if that may prove a very cumbersome way for the tax administration to gather the necessary information from abroad. As will be seen, this is important when considering the compatibility of CFC legislation with EC law, especially with regard to the exemptions to its application relying on a rebuttal of the onus of proof on the taxpayer.

5.3.2.9 Summary

The ECJ case law analysed above can be summarised as follows for the purpose of our analysis. Generally speaking, one has to assess whether the applicability of unilateral countermeasures by Member States (i) falls into the scope of the EC Treaty, (ii) involves a discrimination or a restriction within the meaning of Arts. 43-48 EC Treaty, and (iii) is justifiable on the basis of the written justifications contained in Art. 46 Treaty or of the unwritten justifications based on the rule of reason if a restriction is at stake.

With regard to step (i), a cross-border economic situation involving at least two Member States is necessary for the Treaty to apply. In our case, if a company based in a Member State has a subsidiary (or a branch) in another Member State, then generally the situation falls into the scope of the Treaty.

With regard to step (ii), the Treaty rules apply to discriminations and restrictions caused by the (tax) law of (both the host state and) the home state (*Daily Mail, ICI*). For the freedom of secondary establishment to be exercised, ECJ case law does not in principle require that a subsidiary established in Member State other than that of its parent has substance in that country, nor is the goal pursued by the parent for its use relevant (*Centros, Segers*), but in abusive situations it allows Member States to check that a fixed establishment within their economic reality is present in order to prevent circumvention of domestic law, provided appropriateness and proportionality are respected (*Factortame*).
As for step (iii) and in particular the unwritten justification of the need to prevent tax abuse by the home state of a company exercising the freedom of (secondary) establishment, the ECJ case law implies the following principles:

- in the absence of (corporate) tax harmonisation in the EU and in a system of jurisdictions' competition, companies can take advantage of the best (tax) regime suitable to them (Centros) and Member States cannot simply undo the benefits of other Member States' favourable tax regimes by imposing compensatory charges, especially where these regimes comply with the Treaty, e.g. because they have been authorised under the fiscal state aid rules (Eurowings);
- the application of unilateral anti-avoidance provisions is justified only where they: (i) are specifically targeted to counter abusive situations only, i.e. "wholly artificial arrangements" (ICI) set up to achieve results "manifestly contrary" to the objective of the EU law rule invoked (Kefalas), (ii) are based on a thorough examination of all facts and circumstances on a case-by-case basis (ICI, Leur-Bloem), proving (iii) the frustration of object and purpose of the EC rule invoked (objective element, ICI, Emsland-Stärke), and (iv) the intent to obtain through artifice advantages not intended for the economic operator (subjective element, Leur-Bloem, Emsland-Stärke), (v) are subject to judicial review (Leur-Bloem), and (vi) respect the proportionality principle (Futura, Vestergaard).

5.3.3 Free circulation of capital

5.3.3.1 Arts. 56-58 EC Treaty

The freedom of movement of capital is laid down in Art. 56 of the Treaty, which contains a general prohibition on all restrictions to the free circulation of capital not only between Member States, but also between Member States and third states. This provision is directly applicable and can thus be relied upon also by individuals against Member States. This freedom covers the transfer of capital and money by a resident of a Member State to another Member State (or also third countries) with the purpose of effecting an investment through any financial transaction. Its scope is quite broad as it includes capital contributions or the acquisition of (minority) shareholdings into companies as well as other forms of investment, such as the provision of capital in the form of loans. For the purpose of our analysis, this provision encompasses any direct tax measure implemented by Member States hindering the free flow of capital connected to any investment transaction like the ones just mentioned.

59 The freedom of movement of capital has been gaining further importance over the years since the Treaty of Rome. The current rules are based on a number of directives approved to implement such freedom, especially the Fourth Directive 88/361/EEC of 24 June 1988, and the rules of the Maastricht Treaty, which endorsed the principles contained in these directives and introduced some new provisions, such as the exceptions contained in Art. 58. On the free circulation of capital, see in particular K. Stahl, Dividend taxation in a free capital market, EC Tax Review, 4/1997, p. 227; M. Peters, Capital movements and taxation in the EC, EC Tax Review, 1/1998, p. 4; M. Sedlacek, Capital and Payments: the Prohibition of Discrimination and Restrictions, European Taxation, 01-02/2000, p. 14; and Terra & Wattel, cit., at 39 ff.
In general, the compatibility assessment with this freedom is analogous to the one relating to the freedom of establishment. In particular, one has to first see whether the situation at stake is covered by the Treaty, which test is easily fulfilled given the broad scope of this freedom as well as its applicability also to non-EU States. Second, one must consider whether there is a discrimination or restriction to the free flow of capital, for which purpose the same considerations made with respect to the freedom of establishment hold true. Lastly, if there is a (discrimination or) restriction one must see whether there is a written or unwritten justification appropriate to achieve its intended goal and proportionate with the restriction imposed. Below we will focus on the application of the justifications, as there are some differences with the rules on the freedom of establishment analysed above.

5.3.3.2 Justifications for restrictions

Two sets of exceptions to the general prohibition of restrictions to the free circulation of capital are contained in Art. 58. The first is laid down in paragraph (1) (a), which provides the right of Member States “to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested.” The second is laid down in paragraph (1)(b), which states that Member States may “take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation...or to take measures which are justified on grounds of public policy or public security.” However, the Treaty also makes it clear that this right to impose restrictions “shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital” (Art. 58 (3)).

Much has been written by eminent legal scholars on the interpretation of the above provisions. To sum up, there is widespread consensus that the rules on the freedom of capital are to be interpreted consistently and in conformity with the rules on the other freedoms and relating ECJ case law, especially the freedom of establishment. In other words, they constitute no exception to the principles concerning the other freedoms but in this case there is merely a more precise codification of such principles into the Treaty. By and large, the exceptions laid down in the Treaty must be interpreted narrowly also with regard to the free circulation of capital. A more detailed analysis on the two sets of justifications for restrictions to the circulation of capital will follow below, based on ECJ case law as well as the relevant literature on the subject.

5.3.3.3 Case law on Art. 58 (1)(a)

The exception contained in Art. 58(1)(a) allows restrictions to the free flow of capital provided in tax laws distinguishing between resident and non-resident taxpayers or the place where the capital is invested. At first sight, the scope of this exception seems broad enough for the Member States to be entitled to take all tax measures they deem appropriate with regard to capital restrictions. However, this is not true if one reads this provision in conjunction with paragraph 3 of Art. 58, which states that such

54 See literature cited in previous footnote.
restrictions must not constitute an arbitrary discrimination. The prevailing interpretation is that Member States may lay down different tax rules concerning investments of resident and non-resident taxpayers or domestic and foreign investment, but only insofar as there is a factual difference justifying the difference in tax treatment.

As for the legislative history of Art. 58 (1)(a), Member States probably included this rule mainly to preserve their imputation systems of taxation of dividend distributions from corporations to individuals in view of their discriminatory effects against foreign dividends or foreign recipients in cross-border situations. In particular, it was introduced in response to the Avoir Fiscal case, in which the ECJ held that Member States' tax laws cannot lay down a different tax treatment for branches versus locally-incorporated subsidiaries of foreign corporations denying the tax credit (i.e. avoir fiscal) for underlying corporate tax paid by the distributing company. However, it is highly uncertain at the moment whether this provision is able to justify imputation systems a priori, i.e. regardless of whether the situation of residents and non-residents is the same.

This uncertainty is mainly caused by the Verkooijen case, in which the issue was the compatibility of a Dutch tax law provision limiting an exemption of dividends received by Dutch individuals to those distributed by Dutch-established companies. In this case, Mr. Verkooijen had received dividends on shares acquired in a stock option plan by his company/employer established in Belgium. The exemption was therefore not available for him. The ECJ considered the Dutch measure incompatible with the freedom of capital circulation as it constituted an unjustified restriction to the movement of capital from a Member State to another. The Court also found that the exemption of Art. 58 (1)(a) was not applicable, as the restriction was considered arbitrary since non-Dutch vs. Dutch companies distributing dividends are not in a relevantly different position. However, it has been argued that probably imputation systems would still be unaffected by this case, since their two said discriminatory effects are not at odds with the Treaty due to the non-comparability of the underlying situations.

To sum up, the exception laid down in Art. 58(1)(a) in conjunction with the limits set out in Art. 58(3) constitutes nothing more than a codification of principles applying to the other fundamental freedoms (also) in tax matters as interpreted by the ECJ. As a result, Member States may apply tax (counter)measures distinguishing between residents and non-residents or between domestic and foreign investment only to the extent that there is an objective distinction in the underlying factual situations justifying such different tax treatment.

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58 See on this Terra & Wattel, at 73-74 and 173-174, stressing that (i) domestic dividends relate to profits subject to domestic tax (or to an equalisation tax upon distribution in case they were exempt or subject to lower taxation domestically) whereas foreign dividends relate to profits not subject to domestic tax, and (ii) domestic recipients are subject to (another level of) domestic tax, whereas foreign recipients are not subject to domestic tax upon distribution.

256
5.3.3.4 Case law on Art. 58 (1)(b)

The second set of exceptions allows Member States to implement domestic anti-avoidance provisions in their tax laws or imposing restrictions justified by *inter alia* reasons of public policy. Also these exceptions are subject to paragraph (3) of Art. 58, prohibiting Member States from enacting (tax) measures giving rise to arbitrary discriminations or disguised restriction of capital movement.

Starting with the last part of Art. 58(1)(b), it refers to the possibility for Member States to enact measures restricting the free circulation of capital on the basis of public policy or security reasons. This provision may be interpreted consistently with the ‘written’ justifications laid down for the freedom of establishment in Art. 46. Suffice it to mention that in the Court’s interpretation economic grounds such as the need to ensure tax revenue and to prevent tax base erosion do not fall into the concept of ‘public policy’ (see at 5.3.2.6). As a result, these justifications cannot be claimed by Member States to justify a restriction to the freedom of establishment and of capital circulation.

The first part of Art. 58 (1)(b) specifically states that Member States are allowed to enact measures necessary to avoid the circumvention of *inter alia* their domestic tax laws. This wording may be interpreted to encompass the unwritten justifications based on the Cassis de Dijon’s rule of reason, including the need to ensure fiscal cohesion, the effectiveness of fiscal supervision, as well as the prevention of tax avoidance. Once more, one may surmise that this provision is a mere codification of existing law. As a result, tax provisions of Member States imposing a restriction to the free circulation of capital must be appropriate to achieve the objective(s) giving rise to the restriction as well as proportionate to this objective(s).

This is confirmed by the ECJ, which in *Commission v Belgium* had to decide on the compatibility with Arts. 56 and 58 of the Treaty of a provision contained in a Belgian Decree which prevented Belgian residents from acquiring securities of a Eurobond loan issued by Belgium in the German market. The Belgian government referred to the unwritten justifications of fiscal coherence, effectiveness of fiscal supervision, and the need to prevent tax evasion to justify this exclusion, pointing out that Eurobonds are exempt from withholding tax on the interest paid whereas other government-issued debt instruments are subject to withholding tax for Belgian tax residents. The ECJ confirmed the applicability of the said justifications on the basis of Art. 58 (1)(b) and referred to its case law on the other freedoms. Interesting is the focus on the justification of the need to prevent tax evasion (and avoidance) and the explicit reference to the Leur-Bloem case to assess this justification, implying that this case is not limited to secondary law but it also applies in general to the four freedoms and is thus expression of a general anti-abuse doctrine by the ECJ. The Court concluded that the Belgian measure was neither appropriate to achieve the goal to prevent tax evasion by resident taxpayers nor proportionate to this goal. In fact, nothing prevented Belgian residents to subscribe to Eurobonds issued by other governments to avoid the payment of the Belgian withholding tax on interest from Belgian-issued bonds, and in any event the prohibition of acquisition of these securities went well

60 See *Commission v. Belgium*, cit., para. 45.
beyond the goal of preventing tax evasion, which could be achieved through a more targeted and hence less restrictive measure.

In conclusion, the exception provided in Art. 58 (1)(b) juncto Art. 58 (3) must be interpreted as allowing Member States to lay down tax countermeasures imposing a restriction to the free circulation of capital only on the basis of a proportionately applied justification based on the rule of reason. For this purpose, one may rely on the ECJ case law with regard to the other freedoms as well as EU secondary (tax) law.

5.3.3.5 Relationship with the freedom of establishment

A last interesting issue is the relationship between the freedom of establishment and the freedom of movement of capital as they are not (yet) quite congruent. The following cases are worth analysing for this purpose.\(^{61}\)

In *Baars*,\(^{62}\) Mr. Baars was a Dutch citizen and resident owning 100% of the shares into an Irish company. At that time, Dutch resident individuals were subject to a net wealth tax based on the value of their assets, with some exclusions relating *inter alia* to the ownership of substantial shareholdings in Dutch companies. Mr. Baars claimed an exclusion for net wealth tax purposes also with regard to his Irish participation, but the Dutch tax authorities denied it on the grounds that the exclusion only applied to shareholdings of companies resident in the Netherlands.

The ECJ was requested a preliminary ruling on the compatibility of this Dutch tax provision with the Treaty articles on the freedom of establishment and on the freedom of movement of capital. It held that such provision violated Art. 43 of the Treaty as it provided for a more burdensome tax treatment with regard to companies established in other Member States as opposed to Dutch resident companies due to the limitation of the exclusion for shareholdings in Dutch companies. Given this conclusion, the ECJ did not answer the second preliminary question on the compatibility with the Treaty's free movement of capital, clarifying that the freedom of establishment is at stake whenever an individual of a Member State has decisive influence on the management of a company in which he holds a participation.

This conclusion had been suggested by the Advocate General, who relied on the concept of control in order to decide which freedom is at stake. In this respect, an objective and clear-cut criterion with regard to when a substantial decisional power, and hence the freedom of establishment is at stake, has been indicated by literature with reference to the Fourth Directive on Corporate Law, which provides that entrepreneurial risk of a company's operations is borne by participations of more than 20% in their share capital.\(^{63}\) Furthermore, this Directive also considers that there is a direct investment (rather than a portfolio investment) whenever a shareholding confers influence in the management of the company, suggesting that in this situation the freedom of establishment rather than of capital movement is at stake, consistently with the *Baars* judgement.

These conclusions are indirectly confirmed by the *Verkooijen* case (see at 5.3.3.3). This case was more or less the opposite of *Baars*, as it touched only on the free movement

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\(^{61}\) See on these cases A. Lupo, *Reliefs from Economic Double Taxation on EU Dividends: Impact of the Baars and Verkooijen Cases*, European Taxation, 7/2000, p. 270.


\(^{63}\) See especially Sedlaczek, *cit.*, at 17.
of capital and not the freedom of establishment since the percentage of ownership held by Mr. Verkooijen in the share capital of his Belgian company/employer was negligible in terms of influence on the company’s management decisions. As a result, the Court reached the conclusion of incompatibility based only on the freedom of capital circulation.

From these cases one may conclude that whenever an EU (individual or) corporation holds a participation in a company established in another Member State which (i) is higher than 20% of its share capital, or (ii) entitles the owners/shareholders to a relevant influence on the company’s management, the freedom of establishment is exercised rather than the free circulation of capital. This leads to the application of the Treaty rules on the freedom of establishment and to the simultaneous application of the rules on the free circulation of capital only insofar as necessary to achieve a full exercise of the freedom of establishment. A contrario, in all cases in which there is a mere portfolio investment or any other transfer of capital e.g. in the form of loan to another EU (or even non-EU country), the rules on the free movement of capital are exclusively applicable.

5.4 Compatibility of CFC legislation (and other specific countermeasures) with the freedoms of establishment and capital

5.4.1 Main features of CFC legislation

5.4.1.1 Introduction

This section contains a more extensive description (than at 5.2.2) of CFC legislation in order to evaluate its compatibility with EC law. Even though exclusively focusing on CFC legislation, this evaluation is also valid for other specific countermeasures, such as the denial of deductibility of payments to entities benefiting from a preferential tax regime. A distinction will be made between the situation in which CFC regimes apply to companies established in other Member States and that in which they apply to entities outside the EU held by an intermediate EU company. This distinction is needed as the assessment on their compatibility with EC law is somewhat different.

5.4.1.2 CFC regimes: jurisdictional vs. global approach

Generally speaking, CFC legislation applies to resident shareholders with regard to non-resident corporations directly or indirectly controlled by them. It taxes the undistributed profits of the CFC in the hands of the resident shareholders. Even though there are some differences in the ownership thresholds of the foreign entity required for its application, a minimum degree of connection with the CFC at least sufficient to confer a certain decisional power on the domestic shareholders is necessary to justify current taxation on the basis of their influence on the decision to repatriate its profits.

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64 For the main literature on CFC legislation, see at 5.2.2 (in the footnotes).
There are two main approaches used to design effective CFC regimes: the jurisdictional and the global approach. Under the former, CFC legislation covers all of the income derived by resident taxpayers in certain jurisdictions considered tax havens and usually included in a 'black list' or in a 'grey list' of preferential tax regimes. The main difference between the lists is that black lists refer to low-tax jurisdictions considered tax havens altogether, whereas grey lists only contain specific foreign low-tax regimes without labelling the foreign country as a tax haven. In some cases, there are (also) 'white lists' of jurisdictions to which CFC legislation does not apply as they impose a high corporate tax burden or have concluded a tax treaty with that country. Under the global approach, the jurisdiction in which a CFC is established is irrelevant, since this legislation applies on a global basis regardless of the tax regime of the foreign country. This approach looks merely at the low effective taxation of the foreign (passive) income earned by resident shareholders, which suffices for the application of CFC legislation without the need of black, grey, or white lists.

The advantage of the jurisdictional approach is that it is relatively easy to administer and limits compliance costs on taxpayers. Its main drawback is the arbitrariness of the criteria chosen to draw up the lists, which may lead to unjustified differences of treatment of CFCs depending on the jurisdiction they are located in. On the other hand, the global approach is fairer as it applies in general to all CFCs' low-taxed (passive) income irrespective of their country of establishment and thus it does not give rise to inconsistent results. Its main drawbacks are the high costs, mirrored into high compliance costs for taxpayers having CFCs in any foreign jurisdiction caught by these rules.

5.4.1.3 Entity vs. transactional approach

This distinction focuses on the active or passive nature of the foreign corporation's income caught by CFC legislation. The entity approach focuses on the foreign entity, and in particular on the nature of its income: if this entity mainly earns passive income (e.g. more than 50% of its total income), then it is subject to current taxation under the CFC rules. In the opposite case, it is excluded from CFC rules altogether also with regard to the (limited) passive income derived in the foreign jurisdiction. The transactional approach focuses on the nature of the income generated by the CFC transaction by transaction. If a certain transaction gives rise to passive or 'tainted' income, this income will be subject to the current inclusion rule. On the other hand, if the transaction concluded by a CFC, generates active income, this income is not caught by CFC legislation and may enjoy tax deferral.

The entity approach is easier to apply and involves less administrative and compliance costs than the transactional approach. Its main problem is that it is an all-or-nothing approach, as it either subjects to current taxation all of the income of the entity caught by CFC legislation, including its active income, or exempts it altogether. Contrarily, the transactional approach is much more precise as it targets exclusively passive income leaving unaffected all active income of CFCs. Its main drawback is the

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65 The criteria used to draw up the black or grey lists are nil or significantly low tax burden on corporate profits or may refer either to the statutory tax rate or to the effective tax burden imposed in the foreign jurisdiction.

260
substantial administrative and compliance costs associated with ascertaining the nature of the income generated by each transaction entered into by the CFC. Both approaches ultimately aim at subjecting to current taxation under the CFC rules only passive income of CFCs subject to nil or low taxation in the foreign jurisdiction. By contrast, active income is usually not subject to current inclusion, and neither is passive income subject to high taxation in the foreign jurisdiction. Technically, this result is achieved through a number of exceptions to the application of the CFC regimes depending on the approach chosen. The most common exemption under the entity approach is the mentioned ‘active income’ exemption, under which CFC legislation does not apply if the foreign entity derives mainly active income from genuine business activities carried out in the black- or grey-listed countries. Another common exemption is the subjective ‘motive’ exemption, pursuant to which CFC rules do not apply if the resident taxpayer proves that there were sound underlying economic reasons for using a CFC in a blacklisted country and that the reason for its use was not to obtain domestic tax deferral on the foreign income. Other less common exemptions are the so-called distribution exemption, under which the CFC legislation does not apply if a significant portion of the CFC profits are distributed currently, and the listing on a recognised stock exchange of the foreign corporation to which the CFC legislation would otherwise apply. Similar exemptions are also contained in CFC regimes relying on the transactional approach. In particular, they usually do not apply to CFCs established in high-tax jurisdictions imposing a significant tax burden on passive or ‘tainted’ income.

5.4.1.4 Tax policy considerations

A policy goal of CFC regimes is preserving capital export neutrality. Generally speaking, neutrality of a fiscal system means that there should be no distortions and efficiency losses created by the imposition of taxes and the taxpayers should be left free to take business decisions without being affected or being affected by tax considerations. There are two major ways of interpreting this concept in an international context: capital import neutrality ("CIN") and capital export neutrality ("CEN"). According to the former, resident investors should be competing in foreign markets on local tax conditions bearing the same tax burden borne by the other competitors doing business in that country. By contrast, under CEN residents investing abroad should be subject to the domestic level of taxation, the idea being that it should not have to make any difference for them to invest domestically or abroad taxwise. The consequence is that countries which endorse CIN do not take into account income earned abroad and use the exemption method to avoid international double taxation, whereas countries adopting CEN do tax foreign income at the same rate as the domestic-source income and apply the credit method. By currently taxing undistributed indirect foreign-source income of resident investors, CFC regimes aim at preventing taxpayers from achieving CIN by simply using a CFC. These rules safeguard sovereign tax policy objectives pursued by a country. Another policy objective is prevention of tax avoidance pursued by taxpayers by

66 For instance, the proof that the income of a CFC located in a blacklisted jurisdiction has been subject to a significant tax burden locally is usually sufficient for the application of this exemption.

67 See e.g. Arnold and McIntyre, cit., at 7.
diverting domestic income to foreign CFCs and of the subsequent tax deferral achieved on that income. Since CFC rules are a bolstering of the CEN principle, the resident shareholder, being currently taxed on the CFC income, is also granted a credit for possible corporation tax paid on that income by the CFC in the foreign jurisdiction.

5.4.1.5 CFC legislation and international tax principles

How do CFC regimes reconcile with generally accepted international tax principles? It is common ground that the taxing right of a certain country in cross-border situations is based either on the link between that country and the taxpayer earning income abroad (i.e. residence jurisdiction) or on the link between that country and the income earned within its territory (i.e. source jurisdiction). In the CFC area, a country taxes the resident shareholders of a foreign corporation on the undistributed income of such CFC. The issue arises as to whether this country has sufficient jurisdiction to tax.

The answer depends very much on the interpretation of the underlying mechanism as well as on the objectives pursued by the CFC rules. First, current taxation of resident shareholders on the CFC's income may be viewed as a deemed dividend distributed by the CFC. The effect of these rules would be to pretend that there has been a distribution on the basis of a legal fiction. This situation would be analogous to that of actual dividend distributions from foreign companies not subject to the CFC regime to resident shareholders. In this case, the country's jurisdiction to tax would be justified by the residence of the shareholder receiving the foreign-source dividend. Thus, under this theory CFC rules would not violate the general international tax law principles on the jurisdiction to tax.

An alternative view on the application of CFC legislation focuses on its look-through approach. It stresses that in fact this legislation disregards the legal personality of the CFC and thus pierces the corporate veil by currently allocating its profits to the resident shareholders. In this case, the corporation is treated as a partnership with flow-through taxation of its profits in the hands of the (non-resident) partners. The underlying assumption is that as the CFC is not subject to tax locally or is subject to little tax, it is reasonable to tax currently its profits to the resident shareholders by ignoring its existence.

Another similar approach is based on the fact that CFC rules aim to tax the capital return of a foreign investment effected by a resident taxpayer through a CFC. This would be consequence of the fact that the yield generated by this investment is available for distribution by the CFC as it has already accrued to the resident shareholder from an economic perspective. According to this view, a distribution would be irrelevant in consideration of the accrual of the capital return to the resident shareholder, which should pay current tax domestically due to its choice not to repatriate the return on his investment.

One may argue that taxing income earned by a foreign corporation validly set up under the laws of the foreign country and inter alia subject to its taxing power would

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68 On this issue addressed in this paragraph and the main theories on CFC legislation, see all literature cited in footnote 2.

262
mean extraterritorial taxation by the country applying the CFC rules. In other words, this country would in fact be taxing directly income earned by a foreign company in a foreign jurisdiction, with neither residence nor source jurisdiction to tax such income. The fact that the CFC rules would apply towards resident shareholders by imposing the reporting obligations on the CFC's foreign income would not change the substance of the situation, i.e. extraterritorial taxation of business profits allocated to another jurisdiction.

These considerations also raise doubts as to the compliance of CFC rules with international tax principles, especially with OECD-modelled tax treaties not specifically allowing CFC rules. Art. 7 of the OECD Model Convention allocates the taxing rights in regard of company profits exclusively to the country of establishment of the company (i.e. the CFC jurisdiction). Furthermore, Art. 10 only allows the shareholder's country to tax dividends "paid by" the CFC, which is not the case where a dividend has not been actually been distributed but is only deemed to have been distributed on the basis of a legal fiction. These arguments are not shared by countries adopting CFC rules, although most of them include special provisions in their tax treaties specifically allowing CFC rules or are renegotiating existing tax treaties to this effect. Regardless of the interpretative approach endorsed (see above), they stress that the result of CFC regimes is the taxation of passive, low-taxed income of resident shareholders rather than that of the CFC itself. This view is supported by the fact that the income is already available for distribution to resident shareholders, who have the power to decide whether to distribute it and thus pay domestic tax, or not. Therefore, they claim to have jurisdiction to tax this income and that no violation of international tax law principles occurs.

5.4.1.6 CFC regimes and EU Member States

Within the EU, up to the year 2002 nine Member States adopted CFC rules, i.e. Germany, France, UK, Sweden, Denmark, Finland, Portugal, Spain, and Italy. All these CFC regimes rely on the jurisdictional approach, and use black and grey lists of tax havens or preferential tax regimes to which they apply or white lists of countries exempt from their application. Most Member States' CFC regimes are based on an entity approach, whereas three (i.e. the Danish, German, and Spanish) systems adopt...
a transactional approach. Sweden has recently proposed switching from the entity to the jurisdictional approach (see below).

While the patterns of Member States' CFC regimes largely follow the ones summarised in general above, there are a few special cases worth mentioning. With regard to the requirement of 'control' of the foreign corporation, usually the resident shareholder must hold at least 50% in the foreign company for the CFC rules to apply. However, under the French CFC regime a mere 10% shareholding is sufficient to trigger its application, or alternatively an ownership interest in the foreign corporation worth €22.8 million regardless of the actual percentage ownership. Also Denmark and Portugal use a lower ownership percentage of 25%. This means that in fact these countries may apply CFC legislation even in the absence of a real control of the foreign subsidiary by the resident shareholders, which in turn implies that portfolio investments by the latter are subject to current taxation even regardless of decisive influence on the distribution of the profits accumulated in the CFC. For the purpose of our analysis, the threshold concerning the requirement of control is important (i) to determine whether the Treaty rules on the freedom of establishment or on the free circulation of capital apply, and (ii) to determine whether CFC rules violate the proportionality principle.

As for Sweden, the special feature of its (former) entity approach was the absence of any relief for CFCs deriving mainly or entirely active income in blacklisted countries. In other words, the nature of the CFC's income did not matter for Swedish purposes, as the mere establishment in a tax haven was considered sufficient to trigger the application of the CFC regime. The new proposed Swedish CFC system would rely on the transactional approach, which would only catch passive income of CFCs while excluding their active income. The peculiar features of the new Swedish regime would be a low 10% ownership threshold for its application and the use of a white lists of countries excluded from the application of this regime, which would probably not include Portugal, Luxembourg, Spain, and Ireland. However, due to a host of public criticism in Sweden linked to the harshness of the new approach as well as possibly its incompatibility with EU law, it is unlikely that it will be implemented along the said lines, and the government is expected to put forward a new revised proposal shortly.

A special and aggressive kind of CFC legislation is present in the Netherlands tax system, under which resident companies are obliged to report in their financial accounts the fair market value of participations in foreign finance subsidiaries (i.e. deriving mainly passive portfolio income) at the end each fiscal year under the mark-

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73 Furthermore, under German CFC legislation the required threshold is set at 1% (versus the regular 50% threshold) if the foreign income earned by the German shareholder is passive income from capital investment: see e.g. J. Hey, National report on tax competition in Europe - Germany, EATLP 2002 conference, cit., at 16.

74 See on this also M. Dalberg, National report on tax competition in Europe - Sweden, paper submitted for the EATLP 2002 conference, at 20.
to-market method (see also Chapter 4, at 4.6.2). This ensures current Dutch taxation on the underlying portfolio income in the hands of the Dutch parent company, and may even lead to double taxation as no credit is granted for corporation tax paid by the CFC in the foreign jurisdiction (if any). It is worth noting that up to 2001 this system did not apply to finance portfolio companies resident in the EU, as long as at least 25% of their share capital was held by the Dutch company and the other conditions for the application of the Parent/Subsidiary Directive were met, which was necessary to ensure compliance with EU (secondary) law. However, as a result of an amendment entered into force in 2002 this Netherlands provision applies also to EU intermediary subsidiaries owned for more than 25% if their ultimate non-EU subsidiaries do qualify as finance companies caught by this provision.

To the best of our knowledge, there is no EU country included in the black lists of tax havens under Member States’ CFC regimes. There are, however, specific EU regimes included in grey lists or excluded from white lists, such as the Luxembourg ‘1929 Holding Company’ regime, the Irish ‘IFSC’ regime, and the Madeira ‘ZFM’ regime, which are caught by the CFC regimes of some Member States. For instance, the Italian (grey) list of preferential tax regimes for the purpose of CFC legislation explicitly includes the Luxembourg 1929 holding company regime. In Germany, there have been several attempts to use CFC legislation against German companies with respect to Irish subsidiaries established in the Irish IFSC mainly carrying out banking activities (see also at 5.6 and at 5.5.4). Even more striking is the French example, where the local tax authorities have sought to apply the CFC rules with regard to French parent companies on the capital gains realised by a German subsidiary and exempt from tax in Germany, or with respect to a Netherlands subsidiary entitled to more favourable depreciation rules in the Netherlands. The above shows that the issue of the applicability of CFC regimes to companies established in other Member States is not a merely theoretical one, but it is frequent in practice. Due to the potentially far-reaching consequences of the attitude by the tax authorities of certain (high-tax) EU jurisdictions, assessing the compatibility with EU law becomes crucial.

5.4.2 CFC rules applying to Member States’ regimes: Compatibility with EC Law

5.4.2.1 Compatibility of CEN with the Treaty

A preliminary issue is the compatibility with the EC Treaty of one of the two main tax policy goals pursued by CFC regimes, that is the safeguarding of capital export neutrality (CEN) and the need to prevent domestic tax avoidance. Even though both objectives are accepted under international tax law standards, they must be assessed

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75 It is worth noting that neither the IFA 2001 Report nor the Commission internal working paper of 1999 cited above considers this Netherlands rule as CFC legislation "stricto sensu."

76 On the recent amendment, see also in Chapter 4, at 4.6.2. See also G. T. K. Meusser, National report on tax competition in Europe - Netherlands, paper submitted for the EATLP 2002 conference, at 16. As a result of this anti-abuse rule, the mark-to-market principle (and the denial of the participation exemption) applies to non-EU finance subsidiaries even if held through EU intermediate (sub)holding companies.

77 In this latter case, the French authorities recalculated the depreciation deduction on the Netherlands subsidiary’s assets under French rules and taxed the difference to the French parent currently under the French CFC rules.
in the light of EC (tax) law. Leaving aside for the moment the goal of preventing tax avoidance (see at 5.4.2.2), this section focuses on the compatibility of the principle of CEN with the internal market.76

Legal scholars question the compatibility of CEN with the very idea of a common market.79 It has been stressed that CEN violates the national treatment principle as it subjects to the home tax burden income earned in another Member State possibly offering a lower level of services and infrastructure than the home State. In short, CEN protects the domestic market and budgetary needs of the home state of the investor, which would be contrary to the freedom of establishment and of capital movement due to the intrinsic disincentive to invest in another Member State where there is lower taxation combined with poorer infrastructures or lower quality of public services while having to bear the higher domestic tax burden on the return on such investment.80 A corollary of this view is that the capital import neutrality (CIN) principle should be adopted in the EU instead, which allows host State treatment and competition on local conditions, tax burden included. This would also encourage desirable tax competition and would leave the choice to the internal market actors as to where to invest taking into account inter alia the local tax burden and infrastructures and ultimately the mix of taxes and public goods provided in that country.

This view seems convincing in consideration of the very idea of a common market and seems also supported by the ECJ. The same scholars advocating the incompatibility of CEN with EU law refer to various cases to support this view. In particular, it has been maintained that the Verkooyen case (see at 5.3.3.3) would prove the national treatment and especially the mutual recognition principle with respect to direct taxation, which would have consequences for imputation countries as well as exemption countries.81 Furthermore, this view would be strengthened by the Eurowings case, in which the ECJ stated the incompatibility with the very foundations of the common market of compensatory duties or of an unfavourable tax treatment imposed by a Member State in order to undo a lower tax burden applicable in another Member State. Also relevant to support this opinion seems the Centros case, in which the ECJ specifically maintained that in the absence of harmonisation in a

76 The example of the German CFC legislation is an interesting one in this respect. This legislation has undergone substantial changes in 2000 and in 2001 in order with the comprehensive reform of German corporate tax law. While before the 2000 amendment the (main) goal of this legislation was to prevent tax evasion and avoidance by domestic taxpayers, the stated policy goal of the 2000 amendment was to subject the foreign-source passive income earned by German residents to the same German corporate tax burden, or in other words to pursue CEN. As a result of the 2000 amendment, it seems that the original goal of prevention of tax avoidance is again the principal one: see on this J. Hey, National report on tax competition in Europe - Germany, EATLP 2002, cit., at 16-17.


80 See Terra & Wattel, cit., at 153-165.

81 See in particular the reply of Wattel to Avery Jones in European Taxation 8/2000, cit., and Schön, cit., at 255 ff.
certain field of law (i.e. corporate law), Member States' systems compete with each other and EU citizens are free to choose the system best suited to their needs. One may surmise that the ECJ supports (desirable) tax competition among Member States in the fields not harmonised at EU level, indirectly implying that CIN should be endorsed in the EU and CEN should be considered incompatible with the common market (see also Chapter 2, at 2.3.3). Another argument in favour of CIN is that it is difficult to see why one Member State should grant national tax treatment to residents of another Member State if that other Member State is allowed to tax away any benefits ensuing from that national treatment in the source state. Lastly, authoritative literature submits that CEN violates the loyalty principle enshrined in Art. 10 of the Treaty.\footnote{See Terra & Wattel, cit., at 164.}

However, there is more to the story to simply reach the conclusion of incompatibility of CEN, and \textit{a fortiori} of general (untargeted) CFC legislation, with EU law. A first consideration is that in principle Member States are sovereign to set their fiscal policies with regard to profits earned by resident companies in another (EU) state, i.e. whether to tax them (with a credit for the foreign taxes paid) or exempt them from domestic tax. This is confirmed by the Parent/Subsidiary Directive,\footnote{Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225, 20/8/1990, p. 6.} which leaves it up to the States to choose between the credit and the exemption method to relieve economic double taxation, implicitly acknowledging both the CEN and the CIN principles as compatible with the common market. Moreover, according to the same Directive both credit and exemption countries are allowed to take appropriate anti-avoidance measures to prevent the abuse of the Directive.\footnote{It is worth noting that the Parent/Subsidiary Directive is concerned with prevention of international economic rather than legal double taxation, whereas the CEN or CIN principles are in principle mainly concerned with the method to prevent international legal double taxation. The conclusion in the text is true if one considers a multinational corporation as one single entity from an economic point of view. This is also the underlying assumption of CFC regimes, which consider the income earned abroad by the CFC as belonging to the same economic entity headquartered in the country applying this legislation. This parallel suggests that the dichotomy CEN vs. CIN may and should also be considered more broadly in a context of international economic rather than merely legal double taxation.} The same is provided for in both the Merger Directive and the recent draft Directive on Interest and Royalties. This supports the idea that even exemption countries may in certain circumstances protect themselves against possible abuses of taxpayers concluding transactions lacking a genuine economic purpose with the mere intent to benefit from these Directives' benefits. In other words, rejecting CIN as incompatible with a genuine internal market does not imply that all CFC rules are prohibited.

One may object that these principles are contained in EU secondary law, which must not offend EU primary law (i.e. the EC Treaty provisions). Nevertheless, even legal scholars advocating CIN as a matter of principle point out that in some instances the Treaty allows Member States to adopt countermeasures to prevent tax abuses.\footnote{See in particular Terra & Wattel, cit., at 155 ff.} It is common ground in the relevant literature that whatever system of prevention of double taxation a country adopts, and whatever the Treaty freedoms entail, a country is allowed under the rule of reason to enact CFC-like rules proportionally aimed at wholly artificial abusive arrangements of resident taxpayers (see at 5.3.2 and below at 5.4.2.2). Put it differently, CFC rules are allowed as proportionate anti-abuse
measures but not as bolstering of the CEN principle, since that amounts to bolstering a restrictive and protecting system. In this respect, it has been stressed that the ECJ itself has shown to accept CEN as a viable principle not affected by the Treaty, such as in the landmark Schumacker and in the subsequent cases on the free of movement of persons in which the Court has never questioned the principle of global taxation by the home State in an EU cross-border situation.\(^{86}\) This would especially be confirmed by the Gilly case, in which the Court has indirectly accepted the OECD principles underlying tax treaties and the international allocation of taxing powers achieved through the credit or the exemption method.\(^{87}\)

What conclusions can be drawn from the above remarks? The first is that even in the absence of a clear legal answer to the issue of compatibility of CEN with EC law, probably at the present stage of EU law the Court would not rule against CEN as a matter of principle, as Art. 10 of the Treaty has no direct effect, and technically CEN does not treat a cross-border situation differently from a domestic situation.\(^{88}\) The second is that a truly internal market based on the national treatment principle, reciprocity, mutual recognition, and (tax) competition among Member States, in the absence of harmonisation would require the endorsement of CIN at EU level as a matter of principle. The third is that Member States should nevertheless be free to adopt the CEN principle in cases of abuse, and possibly in general with regard to passive income regardless of abuse being afoot, because in these cases the main CIN’s rationales concerning competitiveness at local conditions and local level of infrastructures and public services matter to the investor only to a very limited extent, given the mobility of this kind of income and the lack of physical presence in the EU host State. CEN should in any event be justified when a foreign company has been set up for the sole purpose of tax avoidance by taking advantage of EC primary and/or secondary (tax) law for purposes wholly alien to EU law (see at 5.4.2.2).

To sum up, it may be affirmed that the CEN principle might be justified in the EU in certain situations, and hence that CFC legislation is not as such \textit{a priori} incompatible with EC law. In certain circumstances, it is necessary as a means to prevent abuses in the internal market, which is considered a prevalent goal even by authors advocating CIN as a matter of principle. This conclusion is true especially considering that not only credit/CEN countries, but also exemption/CIN countries in certain circumstances switch to the credit method on a residual basis as an anti-avoidance tool where there is no longer any rationale for not taxing the foreign (passive) income of resident taxpayers, whether earned directly or through a locally-incorporated entity.

\(^{86}\) See in particular Schön, \textit{cit.}, at 256

\(^{87}\) See Gilly, \textit{cit.}, especially paras. 24 and 47-48.

\(^{88}\) However, it has been argued that CEN offends the EC non-discrimination rules precisely because it treats alike two significantly different situations, namely domestic investment and foreign investment possibly undertaken into a much poorer public services infrastructure: see Terra & Wattel, \textit{cit.}, at 163, and also Prof. Wattel’s opening lecture on “the compatibility of the tax credit as mechanism to prevent international double taxation with EU Law,” Master Program in International tax law, University of Naples II, 6 April 2001.
5.4.2.2 Compatibility of CFC rules with the freedom of establishment

5.4.2.2.1 Introduction

This subsection deals with Member States' CFC legislation (also) covering subsidiaries established in other Member States and enjoying preferential tax regimes included in their 'grey' lists or excluded from the 'white' lists of countries exempted from CFC rules.\(^8^{9}\) The analysis below is meant to assess whether this situation is compatible with the freedom of (secondary) establishment enshrined in Arts. 43 and 48 of the Treaty. For this purpose, the existing ECJ case law on the application of these provisions in the direct tax area and the principles summarised above (at 5.3.2.9) will be taken into account.

5.4.2.2.2 Is CFC legislation covered by the Treaty?

The first question is whether the application of CFC rules to foreign EU entities falls within the scope of the EC Treaty. In this respect, it might be argued that these rules are applied domestically by a Member State to a resident company and therefore it concerns a purely internal situation not covered by the EC Treaty. This reasoning does not seem correct since even though CFC legislation is directed towards resident corporations, it nevertheless affects a corporation's freedom of secondary establishment in another Member State through a local subsidiary. Thus, one may safely conclude that this situation is not a purely internal one, as it regards an economic entity present in more than one EU jurisdiction. Therefore, an EU economic cross-border situation covered by the Treaty is at stake in this case.

However, one might cast a doubt in situations in which the CFC is an entity lacking economic substance and any business purpose and has been set up merely for the purpose to achieve profit-shifting and tax deferral. In this case, as seen above ECJ case law seems conflicting as to whether the freedom of establishment has been exercised and hence the Treaty Arts. 43-48 are at stake. Based on Centros, it would seem that the mere incorporation of the CFC would suffice for the application of the freedom of establishment rules, and that the actual purpose for its establishment as well as the lack of substance would not be relevant in excluding their application. On the other hand, considering Factortame, one might argue that in the absence of an actual economic integration of the CFC in the host State through a fixed establishment and of sufficient substance and links with that country, Arts. 43 and 48 could not be invoked by the taxpayer. From the TV 10 case, it can be concluded that the mere incorporation in principle grants access to the Treaty, but recourse to its benefits may be denied on the basis of the rule of reason, especially the need to prevent abuse of law (see at 5.4.2.2.4).\(^9^{0}\) In any event, even if the absence of enough substance and of a close link of the CFC with the host EU country would mean that the freedom of

\(^{89}\) In addition to the bibliography cited above (especially at 5.2.2 and 5.4.2.1), see also R. H. C. Luja, Anti-avoidance rules and fiscal trade incentives, 28 Interfax, 6-7/2000, p. 226, at 231-232, and F. Steingen, Are controlled foreign company rules compatible with the European Union?, EC Tax Journal, 2002, p. 21; S. Kirkell, EU Commission urged to remove CFC barriers between Member States, 26 Tax Notes International, 17/6/2002, p. 1256.

establishment did not apply, the Treaty provisions on the free circulation of capital would most probably apply, as these require no integration with the local country but merely an investment in any form (see at 5.4.2.3).

**5.4.2.2.3 Is there a discrimination or restriction?**

The second question is whether the application of CFC legislation by a Member State constitutes a discrimination or restriction to the exercise of the freedom of (secondary) establishment within the meaning of Arts. 43-48 of the Treaty. As for a potential discrimination, this could lie in that the resident company establishing a subsidiary in another EU country covered by CFC legislation is treated less favourably than a resident company with a domestic subsidiary, which is not caught by the CFC rules. One may wonder whether this comparison is meaningful, since in a purely domestic context no question of profit-shifting and tax deferral, and thus of avoiding domestic taxes, is at stake. Therefore, the cases would not be comparable and would not need to be treated alike. A well-founded objection would be that this conclusion is only valid if the domestic subsidiary pays full domestic tax, because in cases in which it enjoys a preferential domestic tax treatment making it comparable to a foreign low-taxed entity the CFC rules would not apply, and therefore there would indeed be a discrimination.

Another meaningful comparison possibly showing a discrimination would be between the case in which CFC legislation applies to the domestic corporation with regard to a certain EU subsidiary versus the case of its non-application to other EU subsidiaries established in non-grey-listed or in white-listed Member States. In other words, the issue is whether a discriminatory treatment must be assessed merely from a ‘vertical’ perspective, i.e. situation in the home State versus situation in the host State, or it may also arise from a ‘horizontal’ perspective, i.e. situation in EU host State X versus situation in EU host State Y versus situation in EU host State Z etc. Elaborating further on the horizontal application of the Treaty rules on the freedom of establishment, one may wonder whether the distinction between an EU subsidiary subject to the ‘benchmark’ tax system in the host Member State versus a subsidiary subject to a special tax regime caught by the CFC legislation of the home Member State would be meaningful for our analysis.

Without going into the details of this rather theoretical and complicated discussion, suffice it to say that in any event the application of CFC legislation by a Member State seems to cause a restriction within the meaning of Art. 43 of the Treaty. In fact, the result of this legislation is that the resident corporation is taxed currently on the undistributed (passive) profits accumulated in an EU CFC by its home State. As a result, CFC regimes cause a harsher tax treatment in respect of certain EU subsidiaries merely based on their place of establishment (and/or the tax regime they enjoy) in a grey-listed EU country or in an EU country excluded from the white list, which constitutes a restriction within the scope of Art. 43 juncto Art. 48 of the Treaty.

**5.4.2.2.4 Is there a justification?**
Since the application of CFC rules to other Member States' regimes involves a home state restriction, both the written and unwritten justifications might apply. Starting with the written justifications of Art. 46, one of the underlying goals of CFC rules is to prevent a loss of tax revenue stemming from the use by a resident company of an EU subsidiary benefiting from a local favourable tax regime (on passive income). This justification would most probably not be accepted by the ECJ, which also in ICI held that "diminution in tax revenue occurring in this way is not one of the grounds listed in Article 56 [now Art. 46] of the Treaty and cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify unequal treatment." Also in the situations covered by CFC legislation the loss of revenue suffered by the Member State of the parent company would not seem to constitute one of the overriding interests of public policy falling within Art. 46. Indeed, the ECJ has consistently stated in more general terms that the written justifications cannot be interpreted as referring to purely economic objectives, such as a loss of tax revenue. For the written justifications to apply, in the ECJ's view there must be a compelling case of damage to a country's public policy (or public security or public health), which require much more than profit-shifting or tax deferral caused through the use of a low-taxed EU subsidiary.

Turning to the unwritten justifications, the need to prevent tax avoidance pursued by resident taxpayers might be eligible. In effect, the result of the use of an EU subsidiary entitled to a favourable tax regime is the avoidance of domestic tax through a (potentially) artificial shift of (otherwise domestic (passive)) income to EU low-tax jurisdictions, followed by deferral of domestic taxes caused by failure to repatriate currently such income. The argument that the main goal of CFC rules is the prevention of tax avoidance seems to have a solid foundation as a justification for a restriction to the right of secondary establishment within the EU, due to the said appropriateness for this purpose (and provided they were sufficiently targeted, see at 5.4.2.2.5). This would also be supported a contrario by the ICI decision, in which the Court did not rule out the viability of this justification with regard to specific cases in which the main or only purpose for the resident consortium claiming the tax relief was the avoidance of UK tax. The difference between the denial of the consortium relief in ICI and a targeted CFC regime lies in that the former was a general inappropriate (blind) measure to prevent abuse by taxpayers, whereas the latter in principle is not, but it might turn out being too appropriate in that it contains an overkill remedy for this purpose (see in next paragraph). However, in this respect the balance seems (partly) (re)established by the non-application of CFC regimes if the foreign (EU) subsidiary carries out business activities in the market in which it is established, or if the resident taxpayer can prove that the motive for its use was not merely or predominantly the avoidance of domestic taxes. As a result of their exclusive application to Member States included in grey lists or excluded from white lists, it seems reasonable to conclude that these regimes are sufficiently targeted to prevent the avoidance of domestic taxes and to achieve capital export neutrality (CEN).

91 See ICI, at., Para. 28, and more in general on this justification at 5.3.2.6.
Indeed, this line of reasoning seems consistent with the *Leur-Bloem* judgement (see at 5.3.2.7), in which the Court stressed that for restrictive domestic anti-avoidance legislation to be justifiable a number of factors should prove the existence of an exclusive or predominant intent to avoid domestic tax by the resident taxpayer. The Court went on to state that the assessment of such factors in each specific situation was to be carried out by the domestic tax authorities thoroughly on a case-by-case basis, observing the principle of proportionality, and in any event to be subject to judicial review. In this respect, one notes that (i) the requirements for the application of CFC legislation are numerous and objective, (ii) the exceptions imply a thorough evaluation of all relevant facts and circumstances (especially the mentioned ‘motive’ exemption), and (iii) their application is usually subject to judicial control.

It should also be noted, however, that even though the Court has in principle accepted the justification of the need to prevent tax avoidance, in practice it has never used it to justify a restrictive tax measure implemented by a Member State. Furthermore, looking at the *Centros* decision one has to doubt whether the Court would be prepared to accept this justification for CFC legislation. In that case, the ECJ ruled that given the lack of harmonisation of corporate laws in the Union EU citizens are allowed to take advantage of Member States’ policy competition to use the most suitable corporate system for their needs (see at 5.3.2.7, and Chapter 2, at 2.3.3).

Moreover, in *Eurowings* the Court held that the undoing of competitive foreign tax regimes by way of compensatory measures would “prejudice the very foundations of the single market.”

In the light of these judgements, it is difficult to conclude that the taking advantage of other EC tax jurisdictions is an abuse, yielding an appropriate justification for CFC legislation applying to other EU regimes.

However, there are also a number of reasons that support the conclusion of compatibility of CFC regimes with EC law. In particular, *Centros* did not concern a case of special regimes designed to lure away from their home States investors and capital, potentially giving rise to internal market distortions prohibited by the Treaty. Furthermore, as already observed *Eurowings* concerned unrelated parties and there was no abusive behaviour by the taxpayers whatsoever, as an active business was carried out in both Germany and Ireland by the parties involved. Moreover, although the Court held that Member States cannot undo special tax regimes implemented by other EU countries through discriminatory (direct tax) measures, one must admit that sophisticated CFC legislation is in itself not discriminatory but merely restrictive of the use of special EU low-tax regimes. Lastly, *Eurowings* does not seem decisive for our analysis not only because it concerned a discriminatory rather than a restrictive measure, but also because it applied against a regime approved under the EC state aid rules. The ECJ did not analyse the possibility for Member States to adopt (restrictive) countermeasures against special regimes adopted by other Member States and not scrutinised and approved by the Commission, and against arrangements between associated companies (parent and subsidiary or at least companies belonging to the same group).

Further considerations supporting the compatibility of CFC regimes with the Treaty freedoms are based on that they act in principle against special tax regimes implemented by other Member States and catch (usually only) passive income of

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93 See *Eurowings*, cit. Para. 45, and its explanation at section 5.3.2.7.

272
controlled companies. Tax avoidance through artificial base erosion of the home State is an object manifestly contrary to the EC Treaty freedoms, and within the reasoning of the Kefalas case Member States are allowed to (proportionally) combat such artificial base erosion. Moreover, the use of foreign entities with little or no substance merely to stack passive income would not seem to meet the Factortame requirement that genuine economic activity is pursued through a fixed establishment for an indefinite period of time in another Member State.\(^\text{94}\) Lastly, if the foreign entity can be proven to serve solely or predominantly to achieve artificial tax avoidance in the home State, then probably both the Emsland-Stärke requirements are met, i.e. objective disfunctionality and subjective intent, as well as the artifice requirement of the ICI case. This would imply that Member States are allowed to take (proportional) countermeasures in order to protect their taxable base and ultimately to pursue the fiscal policy objective of the CEN in case of abuse.\(^\text{95}\)

Based on all the above, it may be concluded that Member States’ CFC regimes covering (also) other Member States’ tax regimes are probably compatible with EC law, as the majority of them apply only if the CFC lacks substance and is not active in the local market (i.e. constitutes merely a ‘base’ to defer domestic taxes), and there is no genuine business motive for its use.

5.4.2.2.5 Is there a less restrictive means to achieve the same objective? The proportionality principle

The last question is whether the CFC rules’ mechanism and effects comply with the proportionality principle, i.e. whether they are proportionate with the goal of preventing profit-shifting and tax deferral exclusively in situations of abuse and do not go further than just pre-empting or compensating for such abuse. Indeed, it is hard to think of another less restrictive way of achieving the same objective. The mechanism of the current inclusion of the CFC’s income in the taxable income of the parent company regardless of a (dividend) distribution seems in principle proportionate with the aim to undo the benefits of profit-shifting and tax deferral improperly obtained. As there is no legitimate reason for the domestic company to use an intermediate CFC in cases in which there clearly is an abuse, it seems that the easiest way for the Member State of the parent company to undo the effects of this abuse is to use the current inclusion rule. Furthermore, under Member States’ CFC regimes this consequence can be rebutted if the resident parent shows that the CFC is mainly active (in the local market) and/or has enough substance therein, and that the main purpose for its use is not to avoid domestic tax. However, a few objections arise on the compliance of CFC legislation with the proportionality principle. The first is that this mechanism can lead to harsh results, for instance in cases in which the domestic company’s financial position is feeble and

\(^{94}\) See Factortame, cit., Para. 51.

\(^{95}\) Back to the issue of compatibility of CEN with EC (tax) law, this conclusion would also reconcile with the prevalent legal opinion as explained above (at 5.4.2.1). In particular, even commentators not convinced that CEN is in general a goal compatible with the internal market due to the fact that it is always protective of the home State’s tax base and policy, do agree that in case of abuse it would at any rate seem justified. This would be the case if the CFC rules were targeted enough in such a way that they would not apply if the normal tax burden and not special regimes were suffered by the corporate group in the host State of the subsidiary.
the profits earned through the CFC are planned to be reinvested for genuine business purposes abroad (e.g. the acquisition of business assets or of another subsidiary). The result of CFC legislation would thus be an unduly cash flow disadvantage undermining the company's business and competitiveness. The impact of the current inclusion rule in cases like this might be mitigated by a later recapture of the tax burden due from the parent company, i.e. at the moment of the sale of the CFC or of its winding up, possibly with an interest charge on top of the tax liability to offset the negative cash flow suffered by that Member State on the tax revenue otherwise due by the parent company in the meantime.\footnote{This mechanism is provided for by US tax law in the framework of the Passive Foreign Investment Company (i.e. "PFIC") regime. Under this regime, US persons are taxed on their pro-rata share of profits of the PFIC upon sale of the participation at the highest individual tax rate plus an interest penalty on the tax liability that should have been reported in the year in which the PFIC's profits arose. This harsh consequence can be avoided by US shareholders opting for "qualified elected fund" (i.e. "QEF") status: see e.g. H. J. Ault, Comparative income taxation, Kluwer Law International, 1997, at 422-423.} Whatever the approach chosen, given the abusive situation at stake it still seems that the CFC mechanism should be considered proportionate with its goal as expression of Member States' sovereignty to lay down the most appropriate remedy the said purpose, even a harsh one.

Another objection would be that the reversal of the burden of proof on the taxpayer might be considered not proportionate by the ECJ given the availability of the Mutual Assistance Directive for the home State's tax authorities (see at 5.3.2.8). From the Vestergaard case it is clear that the position of a domestic company operating a CFC may not be disadvantageous as compared to a domestic company operating a non-listed CFC entity or a domestic subsidiary from a procedural point of view, especially the burden of proof, unless there is a factual difference in these positions justifying the difference in this procedural burden. Furthermore, in Leur-Bloem the Court makes clear that a reversal of this burden amounts to the same as an exclusion of a category of cases, incompatible in itself with the Treaty freedoms.

However, also this objection can be overcome. In the first place, there is a basic distinction between the CFC situation and the Vestergaard case, since in principle there is no comparable domestic situation in which CFC-like rules could be applied.\footnote{However, as mentioned above (at 5.4.2.2.2) there might also be a comparable situation in which a domestic subsidiary enjoys a preferential domestic tax treatment and is nevertheless not subject to CFC rules, implying a discriminatory treatment. This situation would be an exceptional one and does not impair the general considerations in the text regarding the ordinary case in which there is no comparable subsidiary subject to a preferential tax treatment domestically.} Consequently, one may conclude that it would be legitimate for Member States to use CFC regimes based on this mechanism, as long as rebutting the assumption is not practically impossible or factually so burdensome to result in an (almost) certain denial of the exemption by the local tax authorities.\footnote{See Vestergaard, cit., Paras. 26 and 28.} It is true that the Mutual Assistance Directive could be used by the tax authorities of the parent company's State. However, in practice using this Directive in the countless cases in which CFC legislation applies would be an administrative nightmare, which would ultimately render this legislation ineffective. This is further supported by the consideration that the Member State from which the information needs to be obtained has no interest whatsoever in helping out accurately and swiftly the other fellow State, especially where it considers the other State's CFC legislation at odds with a bilateral tax treaty in force or with the EC Treaty itself (see at 5.4.1.5 and 5.4.2.1): it is difficult to see why
any country should help a fellow EU country its treaty partner to override the bilateral tax treaty or the EC Treaty. Therefore, it may be concluded that the current mechanism relied on by Member States’ CFC regimes should in principle be considered to comply with the proportionality principle. However, in cases in which the requirement of control is set at a low threshold (e.g. 10%), CFC legislation might be considered disproportionate (and probably also inappropriate) on the grounds that the resident shareholder would have great difficulty in gathering the necessary evidence and that the decisional power would be too limited to justify this procedural burden (as well as probably the application of this legislation as a whole).

5.4.2.3 Compatibility of CFC rules with freedom of capital movement

The assessment of compatibility of CFC regimes with EC law must also be carried out in the light of the rules on the free circulation of capital, i.e. Arts. 56 and 58 of the Treaty. In principle, as the ECJ has pointed out, the rules on the freedom of establishment have priority over the rules on the freedom of capital movements, and their application excludes the application of the latter (see at 5.3.3.5). This means that in normal circumstances the compatibility of CFC regimes need only be assessed with regard to the rules on the freedom of establishment. However, there are at least two situations in which the rules on the free circulation of capital may apply due to the non-applicability of the freedom of establishment. The first concerns CFC regimes setting a low ownership threshold with regard to the requirement of control of the foreign corporation (e.g. 10%). In these cases, due to the minimal decisional power by the resident company, there is no issue of freedom of establishment but merely an issue of free circulation of capital, as also confirmed by the ECJ jurisprudence (e.g. in the Verkooijen case, see at 5.3.3.5). The second situation has to do with the abuse of (EC) law doctrine, under which in the absence of substance and thus of a fixed integration of the CFC in the economy of its Member State (see especially the Factortame case at 5.3.2.7), there is no establishment within the meaning of Art. 43 juncto 48 of the Treaty. If one would rule out the application of these latter provisions, then the Treaty rules on the free movement of capital would most likely apply, as long as there would be no abuse by the taxpayer also of these rules (see also at 5.4.2.2.2).

The compatibility analysis in this case is quite similar to the analysis carried out with regard to the rules on the freedom of establishment. The first question is whether CFC legislation imposes a restriction to the free circulation of capital as it makes it more difficult to invest in another Member State. Following the same reasoning used with respect to the freedom of establishment rules, one should conclude that CFC legislation in principle does restrict investment of capital into another Member State (or a third country) as it subjects to current domestic taxation the return on that investment regardless of a distribution of such return merely based on the place where the capital is invested. Furthermore, it may also entail discrimination as compared to those (rare) domestic situations in which capital invested into a resident subsidiary enjoys a low tax burden, to which CFC legislation does not apply.

The next question is whether this restriction would be justified on the basis of Art. 58 of the Treaty. As seen above, para. (1)(a) of this provision allows Member States to
adopt tax laws providing for a different treatment also depending on where capital is invested, as long as this does not constitute an arbitrary discrimination within the meaning of para. (3). It is true that CFC legislation is part of a country’s tax laws and thus it would seem possible for the Member States to claim the applicability of the Art. 58(1)(a) exemption. However, the ECJ has interpreted it narrowly by virtue of the limitation contained in Art. 58 (3), denying its application as a matter of principle in cases in which the only reason for the more burdensome tax treatment was the place of investment of capital (e.g. in Verkooijen) and in all other cases in which there was no objective difference between resident and non-resident shareholders, both situations constituting an unjustified arbitrary discrimination. This would seem to rule out the applicability of this exemption to the use of CFC legislation in EU situations.

As for the Art. 58 (1)(b) exemption, Member States might assert that CFC rules are anti-abuse measures needed *inter alia* to prevent the tax avoidance caused by artificial profit-shifting and deferral obtained through the use of the EU CFC. As pointed out above (at 5.3.3.4), the same case law relating to the other freedoms is applied by the ECJ also to the free circulation of capital. By analogy with the reasoning concerning the compatibility of CFC regimes with the freedom of establishment under this very same justification (see 5.4.2.2.4 and 5.4.2.2.5), one has to conclude that probably the ECJ would accept it as appropriate and proportionate to this aim conditional upon the CFC regime being specifically targeted against special tax regimes implemented by other Member States, artifice being afoot, the recourse to EC law being alien to its object and purpose, as long as there would be a thorough evaluation of all the facts and circumstances (objective element) as well as of the intent of the taxpayer (subjective element) for making that investment caught by the CFC rules, and domestic judicial review would be available for the taxpayer. Also in these cases doubts arise with regard to the reversal of the burden of proof for the application of the exemption as to the respect of the proportionality principle, and the same remarks based on ECJ case law are equally true (see at 5.4.2.2.5).

5.4.3 CFC regimes applying to non-EU Member States

5.4.3.1 Scope

This section deals with the compatibility with the EC Treaty freedoms of (secondary) establishment and/or capital circulation of the application of CFC legislation to entities located outside the EU but held by an intermediate company established in a Member State.99 Even though one might be tempted to apply the same reasoning used for the compatibility assessment of CFC legislation applied to other EU entities/ regimes, this situation shows some relevant differences calling for different considerations.100


100 Given the above conclusion that (probably) the application of CFC legislation to other Member States' tax regimes is compatible with Arts. 43-48 and 56-58 of the EC Treaty, one might consider *a fortiori* that its applicability outside the EU would be compatible with the Treaty.
Given the complexity of the compatibility assessment of this situation, it is easier to analyse it by reference to a practical example. The paradigm case is the existence of an entity located in a non-EU tax haven indirectly controlled by a Member State’s parent company (hereinafter: “PARCO”) through an intermediate entity located in another EU country (hereinafter: “CFCEU”) which does not itself has CFC legislation in place. PARCO’s Member State would currently include in its profits the underlying (passive) income accumulated in the tax-haven entity as CFC regimes apply to CFCs both directly and indirectly held by resident companies. The issue of compatibility with EU law arises due to the interposition of an intermediate EU holding company and regards especially the situation in which the ultimate tax-haven entity is a branch rather than a subsidiary of CFCEU, which situation will be the focus of our analysis in this section (the tax-haven entity will be referred to as “CFBTH”).

5.4.3.2 Is this situation covered by the freedom of establishment?

The answer to this question is not easy, as the ECJ has never specifically dealt with this issue in similar circumstances. Starting with case law addressed above (see at 5.3.2.6), in the ICI case one of the arguments put forward by the British government was that the situation at hand was outside the scope of EC Law as the UK-based consortium held a majority of subsidiaries located outside the EU. Unfortunately, neither the Court nor the Advocate General dealt with this issue in general terms. On the contrary, they merely focused on the ECJ competence to issue a ruling and referred to previous case law under which it is up to the referring national courts to decide whether they need a preliminary ruling from the ECJ. The Court went on to recall that only in case it is abundantly clear that EC law does not have any link whatsoever with the object of the domestic dispute, is the ECJ entitled not to rule on the substance of the case. Since a (possible) EC link was present in ICI, the Court decided that it had competence also on the substantive issue.102

In the Centros case (see at 5.3.2.7), one of the arguments put forward by the Danish authorities was that no freedom of establishment was actually involved since (i) the company’s sole shareholders were Danish citizens and residents, and (ii) the company was a mere ‘letter box’ in the UK, being active only in Denmark. The Court answered by first referring to the general principle laid down in Art. 48 (1) Treaty that legal persons having their registered seat, principal place of management, or principal place of business in a certain Member State have the same rights as natural persons having the nationality of that Member State. It further considered that the connecting factor with a certain Member State’s legal order is the location of one of the above (in Centros, it was the legal seat). Based on this, the Court concluded that Centros was a UK body exercising its freedom of secondary establishment in Denmark despite the absence of substance in the UK.

101 See on this in detail at 5.4.3.2. It also needs to be stressed that this paradigm case frequently occurs in practice. Imagine a PARCO located in a EU high-tax jurisdiction (e.g. Germany, Italy) with a holding CFCEU located in a (participation) exemption jurisdiction without CFC legislation (e.g. Luxembourg) and a non-EU finance branch CFBTH located in a low-tax country (e.g. Switzerland).

102 See ICI, cit., Paras. 15-16.
Given the limited relevance of these cases for our analysis, it is necessary to assess other relevant ECJ case law. Two cases shed light in this respect, the Gebhard\textsuperscript{103} and the Boukhalfa\textsuperscript{104} cases, dealing respectively with free circulation of self-employed persons and of workers. Mr. Gebhard was a German lawyer practising in Italy for more than ten years in collaboration with a local law firm. He then decided to quit this collaboration and assist his clients through his own office. The National Council of the Bar Association tried to bar him from opening a separate office and from using the Italian title of ‘avvocato’ (i.e. attorney-at-law) on the grounds that he was a German national not admitted to the Italian Bar. Mr. Gebhard challenged his exclusion on the basis of the EC Treaty rules on the freedom of establishment as well as on the freedom to provide services. The ECJ first made it clear that the difference between these two freedoms, which determines the set of applicable rules, lies in the duration, regularity, periodicity and continuity of a certain activity performed by a Member State’s national into another Member State. It recalled that ‘establishment’ within the meaning of Arts. 43 and 48 entails the participation of a Community national “on a stable and continuous basis, in the economic life of a Member State ... and to profit therefrom”, whereas provision of services within the meaning of Art. 49-50 implies the carrying out of an activity in the host state on a temporary basis. Hence, the Court concluded consistently with Factortame that in this case the freedom of establishment was at stake due to the integration in the national economy by Mr. Gebhard, as shown by the numerous years spent in Italy and the use of a permanent fixed base to exercise his legal profession there.

The Boukhalfa case\textsuperscript{105} had to do with an employment relationship between Ms. Boukhalfa, a Belgian national, and the German embassy located in a non-EU country (Algeria). Feeling she was being treated less favourably than her German colleagues, Ms. Boukhalfa claimed the application of the Treaty provisions (and secondary law) on the freedom to take up employment in another Member State. The main issue was whether this situation was covered by the EC Treaty or it was outside its scope as an extraterritorial one. The ECJ restated the principle that in order to be covered by the Treaty a certain situation must have a ‘sufficiently close link’ with the EC. In the case at hand, the Court found the existence of such a close link between Germany and Ms Boukhalfa as her employer was the German embassy, the agreement contained a clause concerning resolution of disputes by German courts, and she was subject to the German social security system and partially to taxation on her income in Germany. Therefore, the Court found that the case fell within the scope of the Treaty, despite a number of elements of extraterritoriality, such as the place of employment, the residence of Ms Boukhalfa, and the place where the contract was signed, all of which took place in Algeria, as well as the fact that the employment contract was governed by Algerian law. Apparently, in the balance of these factors the ECJ considered that Ms. Boukhalfa had always performed economic activities outside EC territory.\textsuperscript{106}

\textsuperscript{105} For an explanation and comment of these cases in the light of Treaty access, see D. Weber, Applicability of the EC Treaty: the first limitation of Treaty freedoms, survey of this limitation in tax matters, cit. On their impact on the compatibility analysis in our paradigm case, see Rotondaro, cit.
\textsuperscript{106} See Weber, cit., at 296.
From these two cases one may infer two main principles relevant to our analysis. In the first place, the freedom of establishment is at stake whenever a certain (self-employed) individual and by analogy any legal entity with EU citizenship is integrated in an EC country's economic life continuously and with a sufficient degree of stability, as already seen in the Factortame case. In the second place, even if the economic activity is virtually entirely outside the EC, there may still be a sufficiently close link with the EC territory for the Treaty to apply.

It is now time to apply these principles to our paradigm case of the application of a Member State's CFC legislation to PARCO with regard to the (passive) income of CFBTH held by CFCEU. The first question is whether the freedom of establishment is at stake. Based on the above case law, the answer must be that in principle this freedom covers PARCO's right of secondary establishment in another EU country. However, the issue is whether this freedom also covers anti-abuse rules applied by PARCO's State against the use, through CFCEU, of a non-EU branch, i.e. CFBTH.

The wording of the Treaty does not help much in this respect, as Art. 43 prohibits restrictions to the establishment of branches and subsidiaries in another Member State by stating that the freedom of establishment includes "the right ... to set up and manage undertakings ... under the conditions laid down for its own nationals by the law of the country where such establishment is effected." It is unclear whether this freedom encompasses the right to establish not only a subsidiary in the foreign Member State, but also a foreign branch of this subsidiary in a non-Member State, as Art. 43 does not clearly define its territorial scope.\footnote{See on this Rotondaro, \textit{cit.}, at 531, referring to a literary interpretation of the wording of Art. 43 of the Treaty in different EC languages.}

From Gebhard, it may be concluded that our paradigm case involves the freedom of establishment with regard to CFCEU, at least where this has sufficient substance locally.\footnote{The opposite case of the lack of substance will be dealt with below in this paragraph. It is worth noting that nowadays companies use sophisticated tax-planning techniques and make all the necessary arrangements in order to be able to circumvent the application of anti-avoidance tax law such as CFC regimes by establishing themselves in the other (Member) State and providing the (EU) CFC with sufficient local substance.} The doubt though arises as to whether this test must be met by CFCEU itself or by its non-EU branch CFBTH. If one endorses the latter option, then in all likelihood there is no freedom of establishment at stake in this case because CFBTH is not continuously integrated with CFCEU's country unless it carries out an active and genuine business activity therein. However, based on Bouklialfa one must carefully assess each connecting factor of CFBTH with the EC territory and each extraterritorial factor. First, since CFBTH is a branch of CFCEU, it lacks legal personality distinct from CFCEU's, and therefore it has EU 'nationality' or 'citizenship' of the Member State of CFCEU. An additional connecting factor with this Member State is the potential taxation of CFBTH's profits in the hands of CFCEU, unless this country applies a full (base) exemption method on the profits of foreign branches of domestic companies, which would mean exemption of CFBTH's income in CFCEU's hands (including its passive income). As for the extraterritorial factors, these are mainly CFBTH's establishment in a non-EU country and the prior tax claim on its profits by this foreign country under generally accepted international tax law principles. As inferred from Centros and Bouklialfa, other important factors to be ascertained on a case-by-case basis would be the nationality and residence of CFCEU's and CFBTH's
directors and key managers, their main place of business activity, the place of
signature and/or execution of the contracts concluded by these entities, and any
other relevant factor showing a connection with each EU and non-EU country
involved.

What conclusions may be drawn on the applicability of EC law to our paradigm case?
The Treaty rules on the freedom of establishment are certainly applicable with regard
to CFCEU and would also seem applicable to its foreign branch CFBTH based on its
connecting factors with CFCEU’s Member State. The three main such factors are the
(unclear) wording of Art. 43 Treaty, which should probably be interpreted
extensively as to its (extraterritorial) scope, the EU nationality (i.e. citizenship) of
CFBTH, and the potential liability to tax of CFBTH’s (passive) income in CFCEU’s
Member State (with prevention of double taxation by it). One may object that this
situation is not covered by the Treaty mainly on the grounds that CFBTH is a branch
in fact established outside EC territory and is not integrated in the economic life of a
Member State (i.e. CFCEU’s country) since it carries out its business activity (if any)
outside the EC. However, the fact that CFBTH has EU nationality could alone be
considered a sufficient connecting factor with the EC, especially after the Maastricht
Treaty and the introduction of a number of rights connected to EU citizenship.
Furthermore, CFBTH’s headquarters is located within the EU and CFBTH is also
liable to tax in the EU (unless CFCEU’s country exempts foreign-source income of
resident companies under a full territoriality principle, i.e. including passive income),
which should be considered a sufficient link with the EU for this purpose. This
conclusion would be reinforced in case CFBTH’s directors were the same as CFCEU’s
directors and/or were EU citizens/residents, and in cases in which there would be
additional connecting factors with the EU territory. Nor is this affected to a decisive
extent by the circumstance that CFBTH is not integrated in the economic life of the
EU, especially in the light of the EC jurisprudence showing a tendency to extend the
scope of the Treaty (e.g. in Boukhalifa).

Based on this, it seems safe to conclude that the paradigm case does fall into the scope
of the Treaty freedom of establishment. However, even if this conclusion were not
true, the Treaty rules on the free circulation of capital would still be applicable, given
their territorial scope also covering non-EU countries (see at 5.3.3.1).109

5.4.3.3 Is there a discrimination or restriction?

The next issue is whether the applicability of CFC legislation in our paradigm case
constitutes a restriction to the freedom of establishment prohibited by the Treaty. This
case concerns a potential home state restriction to PARCO’s freedom to set up its
secondary establishment in CFCEU’s country or to invest capital outside the EU.
As for the freedom of establishment, CFC legislation does not seem to restrict
PARCO’s right of secondary establishment in CFCEU’s Member State since it applies
regardless of the place or places of (secondary) establishment of PARCO. In other

109 A related issue is whether it should be made a distinction between CFC regimes introduced before and after the
Maastricht Treaty, as the former might be considered outside the scope of Art. 73 B and Art. 73 D in the old
wording, and also the argument linked to CFBTH’s EU citizenship would lose relevance (see above in the text). In
practice, this distinction is irrelevant as the majority of Member States’ CFC regimes have been introduced or
substantially amended after the Maastricht Treaty (see also at 5.3.3.1).
words, the harsher tax treatment of PARCO triggered by the application of the CFC rules in connection with CFBTH’s profits is not (purely) based on the location of the secondary establishment of PARCO in another EU country. Instead, these rules apply whether PARCO owns CFBTH directly or through one or more foreign subsidiaries or other entities, whether established within or outside EC territory. Therefore, no restriction to the freedom of movement within the meaning of Art. 43 seems to occur in the paradigm case.

One might disagree with this reasoning on the basis of paragraph 2 of Art. 43. This refers to the duty by a Member State not to restrict the freedom of establishment by its own nationals in another Member State “under the conditions laid down for its own nationals by the law of the country where such establishment is effected.” This provision might be interpreted in our case as meaning that if CFCEU’s Member State does not consider it necessary to impose any (tax) restrictive rules, such as CFC legislation, on domestic (i.e. national) companies investing in the same kind of branch in the same non-EU country of CFBTH, then Parco’s Member State is not entitled to do so in respect of PARCO’s subsidiary CFCEU and its foreign branch CFBTH. In this latter event, PARCO’s Member State would in fact be imposing a restriction on PARCO’s freedom to avail itself of an entity in, and use the legal system of, the CFCEU country, which has less restrictive conditions for the establishment and carrying on of business activities of domestic corporations inside or outside the EU, at odds with the Centros case. In other words, under this line of reasoning the restriction would lie in that other local companies resident in CFCEU’s country would not be subject to the same burdensome CFC rules as applied by PARCO’s Member State. The latter State would be ‘exporting’ its CFC legislation to entities established in other Member States, which would be a violation of the right of companies to pick and choose the best corporate tax system available in the EU.

However, this objection does not seem very convincing. The first reason is that it confuses home state with host state restrictions, not taking into account that Art. 43 applies to either host state or home state restrictions. In this respect, one has to choose whether to focus on the home State’s perspective and see whether its application of CFC legislation hinders the right of domestic entities to establish themselves in another EU state, which does not seem to be the case, or on the host State’s perspective and see whether this State causes a hindrance to this freedom, which does not seem to be the case either. There is no argument to combine these two perspectives to artificially extend the scope of the Treaty freedom to what in fact is a mere disparity. Furthermore, this reasoning would in fact mean loss of tax sovereignty for the home state, which would be prevented from enacting tax legislation best suited to achieve its fiscal policy goals and able to counter abusive situations. In other words, it would allow domestic taxpayers to easily escape the rules of their Member States by simply establishing a (secondary) presence in another EU Member State offering a different and more favourable tax law in the same situation. The EC Treaty does not include the right for taxpayers to claim ‘most-

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10 This reasoning would also be true if CFBTH were a locally incorporated company rather than a branch of the CFCEU: if the State of CFCEU had no CFC legislation and the State of PARCO did have second-tier CFC legislation, then this latter State would be hindering PARCO in using the legal system it prefers.
favoured-nation’ treatment, nor does it allow circumvention of domestic (tax) law via (fraudulent) exercise of the Treaty freedoms (see at 5.3.2.7).
The above leads to a conclusion that Member States applying CFC regimes to domestic entities with respect to controlled non-EU branches held through intermediate EU entities do not fall foul of a home State discrimination or restriction within the meaning of Art. 43 and 48 of the Treaty.

5.4.3.4 Is there a justification?

If there is no restriction, then no justification is needed. Nonetheless, it is theoretically interesting to make a few remarks on the question whether PARCO’s Member State would have a valid justification if a restriction were afoot. The conclusion drawn earlier that the application of CFC regimes to other EU special tax regimes is justified on the basis of the need to prevent tax avoidance, provided certain conditions linked to proportionality are met, are a fortiori valid in this case. In other words, if CFC legislation is justified within the EU, it must also be justified outside the EU via the EU. Furthermore, if the exercise of the EC freedom of secondary establishment (through CFCEU) would prevent the home Member State (of PARCO) from applying its CFC legislation in respect of a non-EU entity (CFBTH), this would completely frustrate its effectiveness. The consequence would most probably be that all companies earning passive income from abroad would use an intermediate EU subsidiary in another Member State with no CFC legislation to avoid the application of domestic CFC legislation by abusive recourse to the Treaty rules on the freedom of establishment. Thus, Member States would be entitled to claim the justification of the need to prevent tax avoidance and pursue CEN especially in these situations.

5.4.3.5 Compatibility with the free circulation of capital

The rules on the free circulation of capital are at stake if one concludes that the freedom of establishment is not applicable to the paradigm case, because under settled ECJ case law the former apply only to the extent the latter are not applicable. As the free circulation of capital is ensured with regard to investments in both EU and third countries, one may assume that the Treaty rules would apply in both cases in which the non-EU tax-haven entity is a subsidiary and a branch of CFCEU (see Section 5.4.2). The compatibility analysis concerning the rules on the free circulation of capital substantially mirrors the analysis carried out with regard to the applicability of CFC rules to EU subsidiaries.

In short, it can be affirmed that the application of CFC regimes to CFBTH (both branch and subsidiary) of CFCEU does constitute a restriction to this freedom as capital invested in the CFC is subject to a different tax treatment merely based on the (foreign) place of investment. This restriction might be justified on the basis of the exceptions contained in Art. 58(1)(a) or (b), as long as it would not constitute an arbitrary restriction. In this situation, it may be argued that the restriction is not arbitrary but a necessary tool for Member States to prevent artificial profit shifting and tax deferral on foreign (passive) income through a tax-haven entity. The appropriateness of CFC legislation for this purpose would especially be based on the
fact that most of the time these tax-haven entities lack substance and are exclusively used for tax avoidance purposes.

The proportionality test would also seem met in this case, especially in consideration of the fact that the Mutual Assistance Directive would not help in extra-EU situations and more in general that usually there is no adequate exchange of information with the tax authorities of the blacklisted tax havens due to strict banking secrecy legislation. In these situations, placing on taxpayers the burden to prove the active involvement in the domestic market by the tax-haven entity or the absence of tax-avoidance reasons for its use would be the only effective means for the home state’s tax authorities to gather the necessary information.

5.4.4. Synthesis: When is CFC legislation compatible with the Treaty?

The last interesting issue *de jure condendo* is what type of CFC regime would be compatible with EC law. The basic underlying assumption is that the pursuit of CEN is allowed in the internal market, at least as a residual tax policy objective limited to passive income and used as a tool to counter tax avoidance techniques implemented by resident taxpayers through the (ab)use of EC (tax) law. A further assumption is that CFC legislation is the most effective legal device for this purpose, and more broadly to counter harmful tax competition in the EU.

Under EU law as interpreted by ECJ case law, in principle CFC rules do impose a restriction to the freedom of establishment and/or of capital movement as such contrary to the Treaty. However, this restriction would be justified on the basis of the rule of reason as appropriate to counter tax avoidance and pursue CEN. The main issue would be the compliance with the proportionality principle, requiring CFC legislation to impose the least restriction possible to prevent tax avoidance.

In order to be compatible with EC law, CFC legislation should be as targeted as possible to catch other Member States’ (and third countries’) special tax regimes deviating from their benchmark tax system (and not approved under the state aid rules, see below in section 5.6). It should also set realistic control criteria and be targeted at passive income and at lack of substance in the CFC’s State of residence. Furthermore, CFC regimes should provide for a case-by-case evaluation on the basis of all relevant facts and circumstances as well as of the taxpayers’ purpose for the use of the CFC. Lastly, they should not put an onerous burden of proof on the taxpayer (in principle, no other division of the burden of proof is allowed from a purely domestic situation), and they should be subject to judicial control on the administration and application by the local tax authorities.

A CFC legislation based on the global approach would most probably be in breach of these principles, whereas the jurisdictional approach targeted exclusively at special tax regimes implemented by other Member States and third countries/tax havens would seem to be more in line with them. The choice between entity and transactional approach would not be affected by EU law considerations as long as the final result achieved would be to catch only passive income of (EU) CFCs. As regards the division of the burden of proof, the exemptions should not pose a significant procedural burden on taxpayers, given the possibility to apply the Mutual Assistance Directive in EU situations in order to ascertain all the relevant facts and
circumstances. More specifically, the exception relating to active business conducted locally by the CFC should not require a rebuttal of the onus of the proof, which might be considered a disproportionate burden on the taxpayer. In EU cases, the tax authorities should prove the tax abusive intent of the domestic taxpayer possibly relying on the Mutual Assistance Directive, without the reversal of the burden of proof. However, a more workable and effective alternative could be to require administrative cooperation between the tax administration and the taxpayer, e.g. through a (mandatory) ruling procedure in all these situations, which might be considered to comply with the proportionality principle. By contrast, in non-EU situations the burden of proof could still be placed on the taxpayer due to the non-applicability of the Mutual Assistance Directive and the lack of other less burdensome instruments available to the local tax authorities, such as tax treaties with an adequate exchange of information clause.

5.5 Compatibility of general countermeasures with EC Law

5.5.1 Scope

This section focuses at first on the denial of the participation exemption by Member States using this method to prevent international economic double taxation on dividends and/or capital gains. It then deals with the application of general anti-abuse rules by a country’s tax administration to challenge the validity of corporate structures set up to take advantage of favourable tax regimes available in other Member States. The issue of the applicability of general countermeasures to non-EU entities located in tax havens and held through intermediate will not be addressed for the limited relevance from a practical point of view. By and large, the compatibility analysis with the EC freedom of establishment and capital circulation rules has many points in common with the analysis concerning CFC legislation. Therefore, to avoid repetitions reference will be made to that earlier analysis and only the main differences will be focused on in this section.

5.5.2 Denial of Participation Exemption

When assessing the denial of the participation exemption for dividends paid by EU entities benefitting from a special tax regime locally (see at 5.2.3 and more in general Chapter 4, at 4.6), one has to consider not only the Treaty freedoms and related ECJ case law, but also the (anti-avoidance rules contained in the) Parent-Subsidiary Directive. As the Treaty (freedoms) provisions in principle do not affect Member States’ sovereign choice between the credit and the exemption method to relieve (international) double taxation on inter-company dividend distributions (see also the Gilly case in Chapter 2, at 2.3.3), the compatibility analysis should at first focus on the Parent/Subsidiary Directive.

111 This approach has recently been adopted by the Italian CFC regime, which provides for a mandatory ruling procedure for the application of the exemptions in cases in which the CFC is active in the local market or there is no abusive intent by the domestic taxpayer; see Busetto, cit., at 34 ff.

Generally speaking, provided the four main conditions for the application of the Directive are met (i.e. legal form, minimum ownership, subject-to-tax, and holding period), no withholding tax may be imposed on dividend distributions by the Member State of the subsidiary and an exemption or a credit must be granted by the Member State of the recipient parent company. The latter provision, contained in Art. 4 of the Directive, implies that Member States are free to choose between the exemption and the credit method on cross-border EU dividend distributions, consistently with their tax sovereignty ensured by the Treaty.

The present analysis focuses on the application of the exemption method, which is the case in the majority of EU states (see Chapter 4, at 4.6.6). Member States often lay down additional requirements for the application of the participation exemption also with regard to EU subsidiaries. Examples of these additional requirements are the involvement by the resident parent company in the management of the subsidiary and the requirement that the subsidiary does not exclusively or mainly earn passive income. If these additional requirements are not met, the participation exemption is denied and the credit method applies instead. For instance, the Member State of the parent company denies the more favourable exemption method generally applied only with respect to certain specific EU subsidiaries depending on the tax regime of another EU country (e.g. the 0% tax rate for Madeira ZFM entities, or the special taxation of Belgian coordination centres). Is this denial compatible with EU law? A preliminary consideration is that the use of the credit method in these cases would seem expression of Member States' tax sovereignty and would seem to comply with Art. 4 of the Directive. Furthermore, the Directive leaves it up to the Member States to apply internal anti-abuse provisions meant to prevent taxpayers otherwise not entitled to its application to benefit from it, but it fails to specify how anti-abuse measures must be drafted and what provisions Member States are allowed to implement for this purpose. Still, in cases in which the denial of the participation exemption is limited to certain EU subsidiaries only, it may amount to a restriction of the secondary freedom of establishment of the parent prohibited by the Treaty as it is based on the place of residence (and the favourable tax treatment) in the other country. Obviously, EC secondary law cannot validly authorise restrictions incompatible with EC primary law, and therefore the compatibility analysis must focus on the Treaty provisions in the first place. In this respect, the denial of the exemption may be justified for the need to prevent tax abuses of domestic taxpayers trying to avoid internal taxation on their foreign profits enjoying almost total exemption if they were not subject to tax in the foreign jurisdiction (e.g. the ZFM in Madeira) or only to very low notional taxation abroad (e.g. the Belgian coordination centre). On the basis of ECJ case law, probably the denial of the participation exemption in these circumstances would not be compatible with the Treaty on the grounds that it applies automatically on the basis of predetermined criteria regardless of the existence of a specific abuse to be ascertained on a case-by-case basis in each factual situation (i.e. ICI and Leur-Bloem) and that the

113 For a thorough explanation of the Parent/Subsidiary Directive, see Terra & Wattel, cit., at 335 ff.
114 It is worth noting that the analysis in this paragraph does not take into account the impact of the state aid rules on the denial. This issue will be dealt with in section 5.6.
application of countermeasures undoing favourable regimes implemented by other Member States is contrary to the internal market (Eurowings).

However, based on the fact that the denial of the participation exemption is a general (counter)measure, a number of other considerations lead to the opposite conclusion of compatibility with the Treaty. In particular, the denial is not only justifiable on the grounds of the need to prevent tax avoidance, but especially on the basis of the existence of national sovereignty, because if a Member State is allowed to use the credit method in general under both the Treaty and the Parent/Subsidiary Directive, then it is most certainly allowed to require a minimum level of taxation of the subsidiary’s profits to grant the participation exemption. Moreover, Art. 2 (c) of the Parent-Subsidiary Directive allows Member States to apply the Directive only to entities that are subject to tax “without the possibility of an option or of being exempt,” which might be construed as meaning subject to the normal, benchmark tax system. The fact that some Member States opt for the exemption method as a matter of principle does not mean that they are bound to it in all circumstances. First, the objection that once a Member State has chosen the exemption method it cannot deny it with respect to EU companies seems unfounded, as there is no obligation stemming from EC law for Member States to adopt the same method to relieve economic double taxation EU-wide, neither in the Parent/Subsidiary Directive nor in any other piece of EC (secondary) law, nor is this implied by ECJ case law. Furthermore, the exemption method is chosen to entirely relieve the economic double taxation on profits earned in one jurisdiction and distributed to a different but affiliated legal entity in another jurisdiction. This policy goal is no longer present in cases in which the requirements laid down for its application are not met, such as the subject-to-minimum-tax condition. In these cases there is hardly any economic double taxation to relieve as the subsidiary’s profits are themselves exempt or subject to very low tax and therefore it should be considered legitimate for the Member State of the recipient parent to deny the exemption and apply the credit method instead.

In other words, Member States are not required by EC primary and secondary law to apply the exemption method, not even if that is their benchmark system, to profits of foreign subsidiaries not subject to a more or less comparable taxation borne by domestic subsidiaries, especially if such foreign subsidiaries are not subject to the benchmark system but to a special low or no tax burden in their EU State of residence (provided they apply the same rules domestically and that the special regime was not authorised by the Commission under the fiscal state aid rules, see at 5.6). In those cases, the credit method suffices as incomparable situations do not have to be treated equally. Nor does the Eurowings case frustrate this conclusion, as it concerned another Member State’s tax regime explicitly authorised by the Commission under the state aid rules and a transaction between unrelated parties in which no question of abuse arose (see also at 5.3.2.7 and at 5.6).

The above considerations lend credibility to the conclusion that the denial of the participation exemption with respect to certain EU subsidiaries (under extension of an indirect credit), even if not justifiable on the grounds of the need to prevent tax abuse, is nevertheless compatible with EC law: being a general countermeasure, it is

115 This Member State should also deny the participation exemption in comparable domestic circumstances to comply with the Treaty.
expression of a fundamental choice of tax policy of exclusive competence of each Member State, as long as no discrimination arises and the requirements laid down in the Parent-Subsidiary Directive are not overstepped.

5.5.3 Application of general anti-abuse rules

The second set of general countermeasures analysed in this paragraph are general anti-avoidance rules ("GAAR", see at 5.2.3). From the ICI and Leur-Bloem cases, the need to prevent abuse pursued by GAARs seems able to justify their compatibility with the EC freedom of establishment. In fact, their application most of the times relies on the Member States’ tax authorities being able to substantiate that the main or only purpose for the conclusion of a certain transaction or the use of a certain EU entity entitled to a favourable tax regime by domestic taxpayers was the avoidance of domestic taxes. Furthermore, the application of a GAAR is subject to judicial control by domestic courts, which are to assess the evidence adduced by the tax administration and the overall results of the transaction(s) challenged. This also entails that both the objective element of abuse of EC law and the subjective element of the taxpayer artificially creating the conditions of application of EC law in order to circumvent its domestic legal tax system must be proven by the tax authorities as required in Emsland Stärke. This also entails compliance with the proportionality principle, as there is no procedural burden on the taxpayer within the meaning of the Vestergaard case. The remedy to disregard altogether the transaction concluded or the existence of the EU entity challenged seems appropriate in these situations, as it is hard to think of a less restrictive measure where the only or main purpose sought by the taxpayer was the avoidance of domestic tax.

Some doubt may stem from the Centros and Eurowings cases, in which the ECJ concluded that in the absence of harmonisation, EU (natural and legal) persons are free to take advantage of competition among Member States’ legal orders and that Member States are not allowed to impose compensatory charges to undo favourable tax regimes available in other Member States. These judgements might be interpreted as suggesting that the aim to prevent tax avoidance is not sufficient to justify the application of GAARs against other EU countries’ favourable tax regimes even in cases in which there would be a lack of business purpose for the use of these EC entities by a domestic taxpayer. However, these cases may also be explained as meaning that tax planning may not be restricted, whereas tax abuse may be curbed indeed. As stressed above, neither in Eurowings nor in Centros any actual abuse or abusive intent was established, and the respective tax authorities merely pointed in an abstract way to the risk of abuse.

In the absence of a specific case law on the relationship between tax sovereignty and the need to prevent tax abuse, there is no general conclusion as to whether the application of GAAR by a Member State is in breach of the Treaty rules on the freedom of establishment and/or capital movement. Based on the above case law, it may be surmised that a proportionate and balanced application of GAARs against wholly artificial arrangements created by domestic taxpayers, alien to the object and purpose of EC law, are allowed. That may not help Member States very much,
however, as tax planning techniques nowadays are very sophisticated in making sure that corporate arrangements do not appear as "wholly artificial."

5.6 Countermeasures against authorised or non-assessed state aid regimes

5.6.1 Issue

What is the impact of the (fiscal) state aid rules on the application of countermeasures? The issue is to what extent a Member State may apply unilateral countermeasures, either general (i.e. anti-abuse provisions) or specific (i.e. CFC legislation), against another Member State's tax regime, if this regime (i) was approved by the Commission under the EC state aid rules because it did not meet all the four criteria laid down in Art. 87 (1), or it was justified under the "nature or general scheme of the system" or under one of the exemptions contained in Art. 87 (3) (see in Chapter 3); or (ii) was not assessed by the Commission under the (fiscal) state aid rules even though these were applicable to it. These two different situations will be analysed in this section.

5.6.2 Countermeasures, loyalty principle and authorised aids

Starting with the application of unilateral countermeasures against a tax regime authorised under the (fiscal) State aid rules, in principle the Eurowings case rules out their application as incompatible with the Treaty freedoms on the grounds that "such compensatory arrangements prejudice the very foundations of the single market" (see at 5.3.2.7). However, as mentioned above this case concerned a real transaction between unrelated parties established in two different Member States and carrying on genuine business activities. In other words, there was no abuse at stake in Eurowings, which leaves open the main issue of the compatibility with EC law of countermeasures against authorised regimes in abusive situations of profit-shifting between related parties.

A crucial question debated by legal commentators is whether a Commission authorisation under the state aid rules implies that there is an EC objective at stake within the meaning of Art. 10. If so, the loyalty principle would require Member States to refrain from measures likely to jeopardise its attainment, such as unilateral countermeasures against authorised tax regimes authorised under the Treaty state aid rules. As seen above (in Chapter 3, at 3.3.3), the EC act through which the Commission grants its authorisation under the exemptions laid down in the (fiscal) state aid rules is a decision addressed to the Member State concerned, which is legally

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116 For a detailed comment on this issue with a focus on the application of the general anti-avoidance provision of German tax law (i.e. Sec. 42 of the German Tax Act, see at 5.2.3) against the Irish IFSC regime, see A. Räddler, M. Lausterer, J. Blumenberg, Tax abuse and EC law, EC Tax review, 2/1997, p. 86. See also on the same issue and on the relationship between German CFC legislation and the said general anti-avoidance provision G. Kraft, German-Controlled IFSCs Not Abusive - Decisions of the Supreme Tax Court of 19 January 2000, European Taxation, 7/2000, p. 288.

binding on that State pursuant to Art. 249 (5) of the Treaty.\textsuperscript{118} If the authorisation is based on the Art. 87 (3) (a) and (c) exemptions, the EC objective pursued is usually to favour the economic development and boost the employment of the particular area to which the authorised measure applies. The same is true for horizontal or sectoral state aids, whose authorisation is based on the compliance with Art. 87 (1) of the Treaty because the four required conditions are not cumulatively met (see Chapter 3 at 3.3.1) or because they are justified by the “nature” of the system as pursuing a desirable “internal” or “external” objective (see Chapter 3, at 3.6.3 and 3.6.4). In other words, they are in these cases authorised as a means to encourage for instance R&D activities, environmental goals, or the development of a certain sector of the economy. The Commission authorisation means that a certain (tax) regime is consistent with the Treaty objectives. This might lead to the conclusion that in all cases of authorised fiscal state aids the loyalty principle applies, and as a consequence that Member States cannot apply unilateral countermeasures to undo their effects.\textsuperscript{119} However, doubt arises especially because the Commission decisions do not usually go into the question of the possible draining and therefore distortive effects of the notified tax measure in other Member States. Furthermore, the Commission decision is binding only on the addressee Member State and it does not extend its force to the other Member States.\textsuperscript{120} The authorisation decision would thus not create any obligations towards them, which would make the loyalty principle inapplicable to their use of countermeasures.

Indeed, this objection seems feeble from a legal point of view. First, the Commission decisions may have some effect also towards the other Member States. The procedure for the authorisation of (fiscal) state aid provides the possibility for all Member States to submit observations upon opening of the Commission investigation. Member States may furthermore directly appeal before the ECJ a Commission decision granting an authorisation pursuant to Art. 88 (2). The outcome of this procedure is an informed Commission decision authorising the (fiscal) State aid either not challenged before the ECJ by any Member State (or any other interested parties), or a decision that, challenged before the Court by one or more Member States, has been upheld and thus ruled compatible with Treaty. This shows that the Commission decision, although formally addressed to one Member State only, most probably indirectly extends its force also towards other Member States, which have not objected to it or are bound to agree in case of an ECJ ruling upholding it.\textsuperscript{121} Secondly, this objection confuses the positive aspect of the loyalty principle, for whose application a legal obligation is indeed required, and the negative aspect at stake here. The latter does not postulate any such legal obligation to apply, what counts being the jeopardy to the attainment of the Treaty objectives.

\textsuperscript{118} For the procedural rules on the application of the (fiscal) state aid rules, see above in Chapter 3 at 3.3.3. See on this also Rädler, cit., at 93-95.

\textsuperscript{119} In this respect, De Hosson, cit., argues that on the basis of Art. 159 of the EC Treaty Member States are prevented from undoing the effects of other Member States’ special regimes authorised by the Commission on the basis of the Art. 87 (3) exemptions, including through the use of unilateral countermeasures.

\textsuperscript{120} In this respect Wattel, cit., argues that the authorisation of fiscal aid measures does not mean incompatibility of anti-avoidance measures used by other Member States, since such measures do not affect the Commission authorisation or eliminate the measure in itself.

\textsuperscript{121} See Rädler, cit., at 95.
From these considerations it seems safe to conclude that the loyalty principle in its negative aspect does apply in the event a Member State is willing to use a unilateral countermeasure against another Member State's tax regime approved by the Commission under the Treaty (fiscal) state aid rules, as acknowledged as a matter of principle in Eurowings. However, EC law cannot be construed so as to require Member States to refrain from combating abuse through wholly artificial arrangements for purposes alien to Commission decisions (in the fiscal state aid area), such as mere tax avoidance and artificial profit-shifting not entailing a genuine and lasting economic involvement in the host State. As Emsland-Stärke shows, a Commission decision based on the (fiscal) state aid rules may be just as well abused as an export subsidy regime for a different object and purpose. Put it differently, if an authorised tax regime (e.g. the Madeira ZFM) is (ab)used by a taxpayer for the mere purpose of shifting abroad otherwise domestic-source (passive) profits subject to high tax and of achieving tax deferral through an entity lacking substance and not carrying out genuine business activities, this would amount to a wholly artificial arrangement showing both objectively and subjectively the taxpayer’s abusive intent that would justify the application of a countermeasure despite the Commission authorisation. In these very situations, the use of both specific and general countermeasures complying with the proportionality principle would probably have to be considered compatible with EU law.

5.6.3 Countermeasures and tax regimes not assessed under the fiscal state aid rules by the Commission

If the Commission does not assess a tax regime under the (fiscal) state aid rules, one might think that the compatibility with EC law should only be ascertained on the basis of the rules on the freedom of establishment and of capital movement (see at 5.4 and 5.5) and possibly of the Code of Conduct (see at 5.7). However, it is questionable that the state aid rules do not play any role in the event that a certain tax regime, although not assessed by the Commission, clearly falls into their scope and might therefore be incompatible with the Treaty. This is not a merely theoretical question, as shown for instance by the Irish corporation tax case and the large-scale investigation initiated by the Commission in 2001.122 In these cases, a Member State adopting a general or specific countermeasure (also) catching such a Member State’s (state aid) tax regime might claim that its countermeasure is compatible with the Treaty because that regime is incompatible with the state aid rules. In these situations, a subsequent Commission decision (possibly subject to ECJ review) may confirm or dismiss this claim, just like in the Irish corporation tax case or in the recent large-scale investigation. The starting point for this analysis is that in principle Member States do not have the authority to judge whether a certain (tax) regime -- their own or another Member State’s -- falls under the state aid rules and/or is covered by one of the Treaty exemptions. This assessment rests exclusively with the Commission, with judicial review by the ECJ. This means that in principle the use of countermeasures may not

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122 On the Irish corporation tax system, which the Commission declared incompatible with the state aid rules after almost 20 years, see extensively in Chapter 3, section 3.5. On the Commission large-scale investigation launched in July 2001, see Chapter 3, section 3.8.

290
be justified on the grounds that it is needed to undo the effects of another Member State's tax regime violating the state aid rules. Even if this violation were crystal clear, the Member State could not just rely on the (positive) loyalty principle and claim that its countermeasure would aim to ensure the achievement of Treaty objectives. Instead, such Member State should inform the Commission of the presumed incompatibility of another State's tax regime with the EC state aid rules to open an investigation and possibly issue a negative decision to declare its incompatibility with the Treaty.

From the above it may be concluded that a Member State cannot justify the application of unilateral countermeasures against other EU states' tax regimes solely on the basis of their contravention of the EC (fiscal) state aid rules if these countermeasures amount to a restriction of any Treaty freedom. In this case, that Member State would need a separate justification, such as the need to combat artificial tax-driven capital and profit shifting. If the use of countermeasures does not amount to a restriction (or discrimination) of a Treaty freedom, then there is no EC law preventing that Member State from applying its countermeasure, as there is no Commission decision authorising the other State's scheme either.

In this respect, even if from a theoretical point of view the application of the state aid rules is the exclusive competence of the Community institutions, from a practical point of view this does not prevent a Member State from applying a unilateral countermeasure in the meantime. If the Commission subsequently decides that an EU country's tax regime against which another Member State's countermeasure is targeted is compatible with the (fiscal) state aid rules, then the countermeasure may have to be repealed. A Member State cannot be required, however, to refrain from or withdraw anti-abuse measures targeting foreign fiscal state aid schemes which have been illegally implemented by another Member State without prior notification to, let alone authorisation by, the Commission: even if the Commission later finds that such scheme is compatible with the Treaty, it should not have been implemented prior to the Commission authorisation in any event.

The example of the Irish 'manufacturing' relief may clarify this point (see Chapter 3, at 3.5). Assume that a Member State applied its CFC legislation to companies benefiting from the special Irish 10% corporate tax rate (i.e. the "manufacturing relief") prior to the Commission decision.\(^{123}\) This Member State could justify the application of the CFC regime \textit{inter alia} on the grounds that the Irish relief was clearly in breach of Art. 87 (1) Treaty. From a theoretical point of view, this justification should be considered irrelevant as the Member State concerned should have pressed the Commission to analyse the Irish relief in the light of the state aid rules (or take Ireland to Court on the basis of Art. 227). However, from a practical point of view the subsequent Commission decision formally acknowledging the incompatibility of the Irish relief with the state aid rules for the entire period of its existence (i.e. more than 20 years) implicitly acknowledged the legitimacy of the application of the other Member State's CFC legislation. This might be thought of as an \textit{ex post} validation of

\(^{123}\) This is not a purely theoretical case. It is true that this relief applied by definition to active income from manufacturing (and similar) activities, but most CFC regimes catch foreign 'base' companies not active in the local market but exporting most or all of their products to other final destination markets. This is indeed what happens in the case of Irish manufacturing companies, which are mostly used to divert active profits otherwise subject to higher taxation in the domestic country of the parent (or in the host state where the product is sold).
this Member State's behaviour, which could be justified from a practical point of view on the basis of the Commission inertia in opening an investigation on the Irish manufacturing relief and declaring its incompatibility with the Treaty for such a long period of time. From a legal point of view, one has to consider that the loyalty principle in this case would not be decisive in reaching the opposite conclusion, as there is a limit to its application whenever other Member States' behaviours may be labelled as disloyal (this is also shown e.g. by Art. 97 (2) Treaty, see Chapter 2, Section 2.4).

5.7 Application of countermeasures to Code of Conduct Blacklisted Regimes and the Loyalty principle

5.7.1 Issue

A last interesting issue is the impact on the compatibility assessment of countermeasures with EC law of the Code of Conduct and its black list of harmful EU tax regimes. The question arises as to what role, if any, the Code plays where Member States' countermeasures apply to harmful regimes either included or not included in the Primarolo black list (or in the final black stemming from the Code, see in Chapter 4, section 4.3). More specifically, the issue is whether a Member State may derive a justification for tax restrictions to the use of entities enjoying EU low-tax regimes by domestic taxpayers from the blacklisting of such regimes, and, vice versa, whether it is less likely that such use may be considered abusive if the regime concerned was not blacklisted. The analysis below does not affect the above general analysis on the compatibility of unilateral countermeasures with the Treaty freedoms of establishment and capital circulation.

5.7.2 Evaluation

The starting point for this analysis is the legal force of the Code of Conduct. As clarified above (see Chapter 4, at 4.2.2 and 4.2.4), the Code is a political commitment lacking legally binding force under EU law. This means that as a matter of principle the fact that a certain tax regime has or has not been blacklisted under the Code does not affect the legal right of Member States to apply unilateral countermeasures against these regimes, as the only potential EC legal impediment in this respect are the Treaty rules on the freedom of establishment and of capital movement. Moreover, the Primarolo black list has not been adopted by the Council (yet) and has been contested by several Member States (see Chapter 4, section 4.3). One must also consider that there appears to be no consensus among Member States on the use of countermeasures against (harmful) tax competition, and that the Code of Conduct under the heading "Action to combat tax avoidance and evasion" vaguely states that "the Council notes that anti-abuse provisions or countermeasures contained in tax laws ... play a fundamental role in counteracting tax avoidance and evasion" (Para. M of the Code, see Chapter 4, at 4.2). The 2000 Guidelines, despite referring to Member States' application of CFC legislation and denial of the exemption method in evaluating the harmfulness of holding company and finance branch regimes, do not
systematically deal with this issue and raise several doubts as to their compatibility with EU primary and secondary law (see in detail Chapter 4, at 4.3.5 and section 4.6). Nonetheless, the Code of Conduct might have a certain impact on the compatibility analysis of unilateral countermeasures in the (near) future. This is the case if the Primarolo black list is explicitly approved by the Council, or a revised black list (under the 2000 Guidelines and subsequent documents) is issued with the consensus of all Member States, and the entire ‘Package’ to tackle harmful tax competition (i.e. including the proposed Savings and the Interest and Royalty Directives) is finally approved, supposedly by the end of the year 2002 (see Chapter 4, section 4.2). In this event, the question is whether the fact that two binding Directives are adopted as a part of a Package, and a black list is agreed upon unanimously, upgrades the legal force of the non-legally-binding third part of the Package, i.e. the Code of Conduct (and consequently the black list based on its criteria).

In principle, if Member States wanted the black list or a list of criteria to be binding, they should have given it the legal form of a Directive under Arts. 94 and 95 (2) of the Treaty or possibly Art. 96 (2) (see in Chapter 2, sections 2.2 and 2.4). However, one is also to consider the loyalty principle (see at 2.2.3). The crucial point would be whether consensus of the Member States on the implementation inter alia of the Code of Conduct and the final black list would imply an obligation to comply with it on the basis of the loyalty principle, or at least a justification for countermeasures in case of non-compliance. The argument could be that if the Member States have reached consensus on harmful tax regimes to be eliminated on the basis of the Code of Conduct, and moreover as part of a Package including legally binding instruments on harmful tax measures, they have also acknowledged that the blacklisted tax regimes are incompatible with the internal market due to the distortive effects they bring about. By contrast, regimes not included in the black list, either because not causing harmful effects or because justified on the grounds that they are needed to stimulate the development of certain depressed areas in the EU, are implicitly compatible with the internal market.\textsuperscript{124}

If this premise is correct, then the loyalty principle would apply in its negative aspect to Member States in that it would prevent them from using unilateral countermeasures against other EU countries’ regimes excluded from the black list. Reasoning \textit{a contrario}, the application by Member States of unilateral countermeasures against blacklisted tax regimes, far from constituting a breach of the loyalty principle in its negative aspect, would probably be legitimate and justified as an additional tool to fight harmful tax regimes distorting the internal market. This would be based on the fact that the positive loyalty principle enshrined in Art. 10 (1) of the Treaty entitles Member States to take appropriate measures, whether general or particular, to achieve the Treaty objectives, especially the level playing field and the prevention of internal market distortions (caused by other Member States’ harmful tax measures). The loyalty principle would thus be a legal reinforcement to ensure the implementation of the Code of Conduct, in principle lacking binding force.

\textsuperscript{124} Needless to say, this justification contained in Para. G of the Code is similar to those provided under the EC State aid rules for the authorisation of (fiscal) state aids under the exemptions of Art. 87 (3) (a) and (c) (see Chapter 4, at 4.2.1). Therefore, if a certain regime has also been authorised under these provisions, the analysis on the impact of the application of the fiscal state aid rules on the countermeasures carried out above (see at 5.6) is also valid.

293
In summary, in itself the Code of Conduct does not legally affect the application of Member States’ unilateral countermeasures against other EU States’ (harmful) tax regimes. However, the release of the final black list of harmful measures agreed on by all Member States under the auspices of the Council, and as a part of the implementation of a ‘Package’ to curtail harmful tax competition in the EU, would show a consensus as to which regimes are harmful and a link to the legally binding parts of the Package. As a consequence, under the loyalty principle Member States: (a) would no longer be entitled to apply unilateral countermeasures against tax regimes which do not answer to the blacklisted criteria, and (b) would be entitled or even encouraged to apply countermeasures against blacklisted regimes.

5.7.3 Impact on the fundamental freedoms and possible justifications

When applying the Treaty rules on the freedom of establishment and/or capital movement, the ECJ has repeatedly pointed out that in the absence of harmonisation, EU citizens and companies are free to take advantage of the legal (and therefore also tax) system best suiting their needs, which is the very foundation of an internal market (see Centros and Eurowings, at 5.3.2.7). On these grounds, the ECJ might consider the use of unilateral countermeasures by Member States incompatible with the Treaty, especially the general anti-abuse clauses applied to other EU countries’ special tax regimes (see at 5.5.3).

However, given the Code of Conduct it is debatable whether the assumption of a lack of direct tax harmonisation in the EU is still true. One might argue that at least within the scope of the Code there no longer is unfettered tax competition among Member States, but (a certain degree of) coordination is pursued instead, as shown by their consensus to implement the Code and issue a (final) black list of harmful tax regimes. This would in turn mean that in the various fields of corporate taxation covered by the Code, mainly the regimes for finance, headquarters, and holding companies, Member States would not be free to choose their systems in autonomy but should comply with the principles contained in the Code. Moreover, both Art. 10 and Arts. 96 and 97 (and, as the case may be, Art. 87) are the expression of a general EC principle that policy competition between Member States is fine as long as it serves the internal market and other goals of the EC, but it should nevertheless be curtailed where it causes market distortions. Based on the above, unilateral countermeasures may be justified especially against regimes answering to the criteria laid down in the Code of Conduct. This may not imply a significant departure from allowing proportionate anti-abuse measures, however, as real abuse (i.e. “wholly artificial” arrangements) does not serve the internal market but on the contrary causes arbitrary, economically-irrational wholesale capital shifts, and therefore market distortions. In this respect, one may think that the Court could not use the argument that there still is full competition in the particular areas covered by the Code. Instead, if blacklisted because of breach of the Code principles, special tax regimes favouring these coordinated areas could probably not be claimed (rectius, abused) by companies established in another Member State simply to achieve a tax advantage.
5.8 Conclusion

The analysis on the compatibility with EC law of general and specific countermeasures used by Member States catching other Member States’ (harmful) tax regimes calls for a few conclusive remarks. These concern the impact of the main EC law provisions considered for this purpose, i.e. the Treaty rules on the freedom of establishment laid down in Arts. 43-48 and on the free movement of capital set out in Arts. 56-58, and of the loyalty principle contained in Art. 10, on the Member States’ sovereignty to use such countermeasures in EU cross-border situations. As in principle such countermeasures, whether general or special, do cause a restriction to the freedoms of establishment and capital, the crucial issue becomes the possibility for Member States to claim a justification to this restriction acceptable by the ECJ.

As for the unwritten justifications, from ECJ case law in direct tax matters, which up till now did not specifically focus on the acceptability of countermeasures against harmful tax regimes, it appears that the need to prevent abuse does not leave Member States much room to restrict the Treaty freedoms. In particular, any restrictive (counter)measure must be (i) appropriate to prevent an abuse, which must really exist (the Court does not consider abusive the wish of an economic operator to choose the legal system of his preference (Centros) or to do business with an unrelated party established in a low-tax regime (Eurowings)), and (ii) proportionate to the goal of countering genuine abuse without imposing an unduly (procedural) burden on the taxpayer (Vestergaard). From the (non-tax) cases Kefalas, Emsland Stärke, and Factortame it appears that frivolous recourse to EC law, at odds with its object and purpose and with abusive intent, is not accepted. However, Member States’ anti-abuse measures must rely on several objective criteria taking into account all the facts and circumstances, and be subject to judicial review (Leur-Bloem).

Countermeasures adopted by Member States to undo benefits of general tax systems implemented by other Member States must be considered incompatible with EC law, as Member States have to respect other Member States’ general tax systems (mutual recognition). This follows from their cherished tax sovereignty and from the idea of an internal market, which should make available for the benefit of all EU citizens the competition between general tax (and legal) systems in the EU. From this point of view, it appears that the credit method as a general method to prevent double taxation, and hence the general pursuit of CEN, is at odds with the idea of an internal market: it takes away the (tax) benefit of investing in another Member State, even if in the other State no tax incentives apply whatsoever, and even if the contracting parties are unrelated and no artifice or abuse is afoot whatsoever. The credit system is a countermeasure against any foreign tax competition, even against all general tax systems of other Member States. In short, it is protective.

Nonetheless, as a targeted anti-abuse measure the credit method (bolstered by appropriate and proportionate CFC-like rules) is a valid method for Member States to (proportionally) protect themselves and the internal market against artificial base erosion. If resident taxpayers artificially shift their tax base to special foreign tax regimes for which they would have had no interest whatsoever if it were not for the tax avoidance purpose, the credit method instead of an exemption is an appropriate and proportionate response. In these circumstances, the adoption of CEN seems justified as a residual principle even in a truly internal market. In other words, the use
by a Member State of tax countermeasures against special tax regimes implemented by other Member States that sponge on their tax revenue would have to be considered legitimate from an EC law point of view.

The test of whether national (counter)measures work to the detriment of foreign general tax systems or are proportionately aimed at special regimes that sponge on other Member States seems a valid one from a legal point of view, especially in the light of the Code of Conduct and of the fiscal state aid rules. They show that harmful tax competition and internal market distortions are almost exclusively caused by specific tax regimes deviating from a country’s benchmark tax regime rather than by general ones. Also the loyalty principle would be respected if this test was used, as Member States would be in their right to use countermeasures against other Member States only in the event of negative effects caused in the internal market by the latter’s special tax schemes, whereas they would be barred from doing so in cases in which the Treaty objectives are respected.