CHAPTER 6 - SYNTHESIS AND PROPOSAL

6.1 Overview

This chapter is divided into three parts. The first part contains a synthesis of the main findings of this research based on the analysis contained in the previous chapters. Three basic questions may be framed for this purpose:

- What is tax competition and is there a need to regulate this phenomenon in the EU?
- What is 'harmful' tax competition and where is the dividing line with 'desirable' tax competition from an internal market point of view?
- Is the current EU legal framework appropriate and effective to deal with harmful tax competition or is there a need for a new approach?

From the analysis it appears that tax competition may have both beneficial and harmful effects for the internal market and that the former must be promoted while the latter must be curtailed. The subsequent focus on harmful tax competition and on the various remedies provided by the Treaty and by EU soft law instruments shows the inadequacy and/or ineffectiveness of the latter, which is due to a number of shortcomings and to the lack of coordination of these remedies. The conclusion is that there is a need for a new approach.

The latter aspect is dealt with in the second part of the chapter, which contains an overview of the Commission strategy in the corporate tax area for the coming years as set out in two communications and in the comprehensive study of Member States' corporate tax systems, all released in 2001. In particular, there will be an analysis of the impact of the new Commission strategy on harmful tax competition. The focus will be on the issue of anti-avoidance provisions and countermeasures in bilateral tax treaties and on the issue of comprehensive taxation of EU-wide profits of companies active in several Member States on a consolidated basis.

The last part of the chapter sets out a proposal for a new comprehensive framework to deal with harmful tax competition in the EU. This proposal seeks to resolve the flaws of the current framework taking into account the lessons learned so far. It relies on a new soft-law act setting out a concept of harmful tax competition consistent with the EU legal framework and providing for a new procedure that should guarantee both effectiveness and appropriateness of the remedy. A draft document illustrating how the proposal could be framed in practice follows. The conclusions summarise the proposal in the light of the likely developments in EU corporate tax law in the coming years.

6.2 Synthesis of the main findings

6.2.1 Concept of tax competition and the economic model in the EU

The first question addressed by this research concerned the concept of tax competition and whether there is a need to do something about it in the EU. For the purpose of our analysis, tax competition has been defined as the endeavour by
sovereign (EU) countries to gain a higher share in the international division of the taxable base yielded by inbound investment through a reduction in the direct tax burden. An array of economic literature shows that tax competition may have both beneficial and harmful effects for the competing countries. Beneficial effects include a reduction of governments’ size and a corresponding increased efficiency, a spontaneous downward alignment of tax burdens, and ultimately an optimal equilibrium between level of public services provided by a country and a bearable corporate tax burden imposed on taxpayers. Harmful effects are a potential ‘race to the bottom’ caused by a significant decrease in corporate tax revenue and ‘beggar-thy-neighbour’ policies, a drastic reduction in public services and social security benefits associated with an increased burden on alternative tax bases such as consumption, which causes regressive effects on income redistribution, or labour, which may bring about higher unemployment, and a misallocation of resources.

The main unresolved issue is whether tax competition causes prevalently beneficial or harmful effects, which is fundamental in establishing whether and how to regulate this phenomenon. Economic literature is inconclusive in this respect, due to the absence of an adequate methodology and the difficulty to single out and weigh the relevant elements coming into play. In the context of the EU, there has been a fair amount of economic studies especially in the last decade seeking to assess the impact of the differences in Member States’ corporate tax systems on the internal market and the main effects of tax competition. A consistent finding shown by these studies is that there has been a constant downward trend in the levels of nominal as well as effective corporate tax burdens throughout the EU and a fundamental stability of Member States’ corporate tax revenue as a percentage of GDP. This suggests that tax competition in the EU has indeed been beneficial for Member States and economic operators alike in terms of improved efficiency in government size and public spending as well as a reduced tax burden on business activities. In the absence of convincing economic evidence showing significant harmful effects brought about by tax competition in the EU, the best option would seem not to regulate this phenomenon at all. The question then arises as to why Member States have embarked on an EU project meant to limit harmful tax competition and whether this move serves the internal market.

The answer is most probably found in the economic model endorsed by the EC Treaty and is illustrated by a comparison between competition in a microeconomic perspective and in a macroeconomic one. As to the former, the main Treaty economic objectives are to favour economic growth, reduce unemployment, ensure a high level of social protection, and raise the standard of living in the EU. They are pursued inter alia through the setting up of a truly internal market among the Member States without obstacles and as close as possible to a domestic market of a single sovereign country. The Treaty provisions on this fundamental means are based on a microeconomic perspective focusing on the market operators and beneficiaries (i.e. private individuals and firms), as they are aimed at protecting these in order to establish an internal market. This translates inter alia into the freedoms of circulation of goods, persons, services, and capital, and into the removal of barriers able to jeopardise these freedoms, subject to a few specific exceptions. Linked to this is the

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1 On the fundamental aims and means, contained in Arts. 2 through 4 of the EC Treaty, see Chapter 2, Section 2.2.
model of perfect competition among firms endorsed by the Treaty, which contains specific rules to counter unduly distortions of competition ("level playing field"). This brings us to the parallel between the concept of competition in a microeconomic and in a macroeconomic perspective. The former focuses on the bidding by private individuals and firms engaged in the same or similar business activities to get more customers or clients to purchase their products or services. For this purpose, they may rely on the quality of their products or services, on low prices, or on efficient after-sale assistance. The main problems associated with a perfect competition model are the potential market failures due either to unfair practices of certain firms or to the natural consequences of the market forces driving out of business the most inefficient firms not able to compete in the market. The former phenomenon (e.g. abuse of dominant position, cartels, predatory practices) amounts to unfair competition, which is strongly fought on the grounds that there must be a level playing field in which all firms are equal and are able to compete under the same conditions regardless of their size, location and other factors. The latter brings about bankruptcy for the inefficient firms, which is not unfortunate for the (internal) market and the consumers given that there are other more efficient firms delivering better or cheaper products or services.

From a macroeconomic point of view, competition among sovereign (Member) States refers to bidding for individuals, corporations and capital to (re)locate into their territory. For this purpose, these (EU) countries offer different bundles of public goods and impose different burdens and charges (i.e. taxes, social security contributions etc.) on individuals and firms located within their territory. In this case, the effects brought about by a model of perfect competition must be avoided in any event. Unfair competition is linked to (Member) States’ behaviours related to the economic theories of the prisoner’s dilemma and the assurance game, leading either to a cartel or to harmful practices potentially giving rise to ‘race to the bottom’. In the direct tax area, if (Member) States are able to find consensus on the same or similar tax treatment of certain transactions or taxpayers and on the tax rate(s), this may cause dangerous collusive behaviours or cartels leading to an upward levelling of the tax burden, to inefficiency of the public sector, and to a limited choice of bundles of public goods and tax levels for individuals and firms. If there is no such consensus, then (Member) States tend to engage in heavy tax competition in order to attract individuals and businesses, which is likely to bring about the said harmful effects of fiscal degradation, over-taxation of labour and higher unemployment, etc. As for the second consequence of perfect competition, Member States not competitive enough may experience emigration of individuals, firms, and capital, which may have a very negative impact on their ability to finance public goods, and ultimately on their economic growth and employment. This could eventually mean significant budget deficits, similar to what causes private firms to go into bankruptcy.

Transposed into the EU reality, this parallel suggests that even though in principle tax competition is desirable for the internal market as economic evidence shows, Member States are aware that the interests at stake are simply too high to allow unbridled tax

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2 See on this Chapter 1, especially at 1.2.5. The cartel and the ‘race to the bottom’ mentioned in the text may occur in any legal area, not only in the direct tax area. For instance, competition in the corporate law area may lead to lax regulatory standards that can eventually affect the protection of a corporation’s shareholders or creditors due to these lax standards, which the US literature refers to as ‘Delaware effect’ in the US reality.
competition. The fear that sooner or later these market failures could indeed occur supports the case for intervention to limit (excessive) tax competition. This fear was probably reinforced by the Ruding Report, which showed empirical evidence that companies' decisions were affected by favourable tax systems implemented by Member States especially for the location of intra-group centres and other mobile activities and concluded that even in the absence of indisputable evidence in this respect there were sufficient elements pointing at welfare losses caused by excessive tax competition in the EU (see Chapter 1, Section 1.4.2). The Commission reports released in 1996 further fuelled this fear by linking the rising unemployment throughout the EU to the progressive increase in the tax burden on employed labour caused *inter alia* by a decreased tax burden on mobile capital.3 The above reasons, although supported by weak and inconclusive economic evidence on the existence of harmful effects for the internal market or of their prevalence over desirable effects, do justify some (limited) form of intervention to regulate tax competition in the EU. From a macroeconomic point of view, this is supported by the need to preserve the aims pursued by the Treaty, namely steady economic growth, high employment, and ultimately a high standard of living in the EU, all of which would be threatened by the proliferation of unfettered tax competition. Reasoning *a contrario*, the absence of intervention could ultimately force Member States to surrender to the market and making them ultimately lose their sovereignty, causing the market failures that should be prevented in the light of the EU internal market.

6.2.2 EU legal framework and 'harmful' tax competition

The next question is how to distinguish between desirable and harmful tax competition in the light of the economic justifications (and limited evidence) for countering the latter. The analysis of the relevant EU legal framework is necessary to delineate a concept of harmful tax competition *for the purpose of EU law*. By and large, the Treaty recognises the sovereignty of Member States in direct tax matters as it requires the adoption of directives necessary for the correct functioning of the internal market by unanimous voting in tax matters (Arts. 94 and 95(2)), thus acknowledging as a matter of principle that tax competition is desirable. The subsidiarity principle laid down in Art. 5 reinforces this by requiring that the decisions in the areas covered by it, which also include direct taxation, be taken as closely as possible to the citizens. An exception to this principle occurs, however, where decentralised exercise of power undermines the pursuit of the Treaty objectives or is incapable of achieving consistent results, in which case Community action is justified but only to the extent necessary for the achievement of these objectives. Moreover, the Treaty provisions on the fundamental freedoms (as interpreted by the ECJ) entail competition between Member States' legal systems, including their corporate tax systems, on the ground that such competition allows individuals and firms to choose the most suitable tax system in the EU (as long as there is no abuse of EC law). A corollary is that Member States are in principle not allowed to impose a higher tax burden or compensatory charges to undo the

3 See Chapter 1, at 1.4.3, especially the quote from the Monti Memorandum.
favourable effects of another Member State's favourable tax regime.\(^4\) The underlying idea is that tax competition is desirable in a truly internal market as it leads to a variety of different 'offers' by Member States of bundles of public services, economic opportunity and tax burdens to the benefits of its economic operators.

However, the Treaty contains limits to Member States' sovereignty in direct tax matters, and thus to unfettered tax competition causing harmful effects. The general loyalty principle enshrined in Art. 10 provides that Member States must cooperate for the achievement of the EU objectives and must abstain from any behaviour jeopardising their attainment, including the adoption of direct tax measures at odds with the Treaty. This entails a limit to tax competition undermining the Treaty objectives, such as undistorted competition in the internal market, a sustainable economic development, an adequate degree of social protection, and promotion of employment. In these situations, Member States' tax sovereignty is affected to the extent necessary to preserve the achievement of the EU objectives, and the Treaty provides for several instruments that together give an idea of what is considered harmful by the current EU legal framework.

An effective Treaty instrument to limit excessive tax competition between Member States is the application of the State aid provisions in the direct tax area (i.e. Arts. 87-88 of the Treaty and relating documents, see Chapter 3). These rules prohibit Member States from granting tax advantages to a specific (category of) recipient(s) in so far as they distort competition in the internal market. The main condition for the prohibition is that these tax advantages are special in that they are only granted to certain taxpayers (e.g. foreign-based multinational companies), to certain sectors or activities (e.g. financial services or intra-group activities), or certain regions (e.g. in 'offshore' areas or tax-free centres). In some cases, however, these special tax advantages are considered compatible with the Treaty if they pursue desirable fiscal policy objectives (e.g. income redistribution, prevention of double taxation) or other social or economic objectives consistent with the Treaty (e.g. boost economic development or reduce unemployment in certain depressed areas). From these rules it may be inferred that tax competition is considered harmful where Member States enact special tax measures deviating from their general tax system, not pursuing desirable fiscal, economic or social objectives consistent with the EC Treaty.

Another Treaty limit to Member States' sovereignty in direct taxation and thus to excessive tax competition is set out in the provisions on internal market distortions (i.e. Arts. 96 and 97, see Chapter 2, at 2.4). They cover situations similar to the ones targeted by the state aid rules, but they also apply to Member States' general tax measures as long as they are different from those enacted by (the majority of other) Member States and cause serious distortions of competition in the internal market that must be eliminated. This once again implies that tax competition is considered beneficial in the EU only to the extent it does not cause significant distortions to the internal market likely to jeopardise the achievement of the Treaty objectives. These provisions also entail that harmful tax competition arises where Member States' general or special (preferential) tax measures deviate from the majority of other EU States' tax measures and/or pursue objectives incompatible or inconsistent with the Treaty objectives.

\(^4\) See on this issue Chapter 2, at 2.3.3, especially the Eurowings case explained therein.
A last set of rules affecting Member States’ direct tax policy are the Treaty provisions on the economic and monetary union (EMU) for the EMU countries (i.e. Arts. 99 ff., see Chapter 2 at 2.5). They require that their budgetary and fiscal policies are consistent with the monetary policy pursued at EU level and its objectives of achieving price stability and sound public finances. This implies that harmful tax competition under the current EU legal framework also includes Member States’ general or special tax measures (as part of their budgetary measures) likely to cause inflation in the ‘euro zone’ and/or excessive budget deficits jeopardising the stability of the single currency. In broader terms, this means that excessive tax competition is also deemed to occur where the underlying policy of EMU States’ general or special tax measures is inconsistent with the Treaty EMU policy, which is fundamental to achieve the Treaty objectives.

In sum, as a matter of principle the EU legal framework acknowledges tax competition as the norm since it is desirable for the internal market and its actors. However, the Treaty contains an inherent prohibition to excessive tax competition distorting the internal market and jeopardising the attainment of its objectives and a number of instruments to counter it. From their combined reading and analysis it appears that under EU law ‘harmful’ tax competition occurs where a Member State’s tax measure provides for a low tax burden and:

(i) deviates from the general (i.e. ‘benchmark’) tax system as to the beneficiary(ies), the sector or business activity, or the region covered, or deviates significantly from the large majority of other Member States’ measures covering the same or similar situation(s); and/or

(ii) pursues policy objectives inconsistent with the Treaty or able to jeopardise its fundamental (economic) objectives.

The first criterion is objective and focuses on the specificity of a certain tax measure either with regard to the Member State’s own tax system or to (the large majority of) other Member States’ tax system. Such specificity may regard the income of a certain taxpayer (e.g. a large multinational company), of a certain sector or activity (e.g. manufacturing, finance, coordination or intra-group activities) or of a certain area (e.g. an offshore centre). The second criterion is subjective and requires an assessment of the policy objectives pursued by that measure. These objectives must be weighed against each other to ascertain which one(s) prevails and then considered in the light of the Treaty fundamental objectives (i.e. those contained in Arts. 2 through 4) and those laid down in specific provisions (e.g. those on state aid, on the EMU, or on the fundamental freedoms). It is a combination of both criteria that determines harmful tax competition under the current EU legal framework: the objective one catches Member States’ measures causing a distortion of competition in the internal market due to their deviation from the benchmark tax system or from other Member States’ systems and the subjective one catches more in general measures jeopardising the achievement of the Treaty objectives.
6.2.3 Assessment of the existing framework to deal with harmful tax competition and need for a new comprehensive approach

The third question is whether the current framework to deal with harmful tax competition in the EU is effective and appropriate to achieve a balanced result to promote desirable tax competition and counter harmful tax competition. To answer this question, both EC primary law (and corresponding documents) and ‘soft’ law must be taken into account, in particular their application.

As seen above, the Treaty prohibits Member States’ harmful tax measures providing for a low tax burden and:

i) Distorting competition in the internal market, if they deviate from the general tax system in that they are limited to certain taxpayers, sectors, or regions, and are not justified by acceptable fiscal, economic, or social policy objectives consistent with the Treaty;

ii) Distorting competition in the internal market, if they lay down a different tax treatment than that applicable in (most) other Member States and are contrary to the Treaty objectives;

iii) Jeopardising the EMU policy as they are likely to undermine price stability in the ‘euro zone’ or to cause excessive public deficits.

Tax measures falling under (i) are caught by the Treaty state aid rules and must be repealed by the Member State concerned as a result of an investigation by the Commission and of the issuance of a decision to this effect, with recovery of the tax aid granted plus interest in case of failure by the Member State to comply with the Treaty procedural rules. As a result of the approval of the “Package” to tackle harmful tax competition in the EU (see Chapter 4, at 4.2.1), in 1998 the Commission released a notice dealing with fiscal state aid and in 2001 opened a large-scale investigation to counter Member States’ harmful tax regimes. Even though part of a comprehensive strategy undertaken in conjunction with the Package and the Code of Conduct (see below), the Commission effort seems flawed as it targets only 15 measures mainly covering intra-group and coordination centre regimes, while ignoring other categories of regimes (e.g. on intra-group service and distribution centres or special holding company regimes). Furthermore, it is limited due to the fact that it can only target special tax measures and not general ones potentially able to cause harmful effects (see below). This piecemeal approach inevitably leads to inconsistent treatment of similar regimes and ultimately to uncertainty for both Member States and taxpayers recipient of the potential tax aid.

The Commission’s effort under the state aid rules also seems an inappropriate instrument against harmful tax competition, which is a consequence of the fact that this was not the goal for which they were intended. In particular, it may lead to harsh repercussions on the firms recipient of unlawful tax aid and on Member States in terms of their credibility and international reputation. Ultimately, this remedy may turn out to be worse than the disease it seeks to cure because it negatively affects the competitiveness of the EU as a whole (see Chapter 3, especially the conclusions at 3.9). The inappropriateness of this approach also lies in the different consequences for the Member States’ regimes under investigation depending on whether they are considered existing aid (e.g. the Belgian coordination centre regime) or new aid (e.g. the Netherlands CFM) in terms of repeal of these regimes respectively ex nunc or ex
tunctunc with recovery of illegal tax aid plus interest. It is true that the Treaty is binding on Member States and that they should comply with its rules to prevent the (potentially harsh) consequences for failure to do so. However, it is also true that direct taxation is something different from other areas, and thus more flexibility would be needed in this case. For this purpose, the Code of Conduct is a more appropriate instrument, as it strives to reach political compromise leading to less harsh and more equitable consequences for both Member States and companies involved. This suggests that the Commission may have awaited the result of the Code discussions and used the Treaty state aid rules only as a last resort.

The internal market distortion provisions, relevant in situations under iii) above, seem an appropriate instrument to counter harmful tax competition in the EU, at least from a theoretical point of view. They apply to both general and special tax measures adopted by Member States and envisage a more flexible procedure involving negotiations between the Commission and the Member State concerned, and possibly an intervention by the Council through a legally binding directive or any other appropriate act. However, from a practical point of view this instrument is ineffective as it has (almost) never been used mainly due to the political ramifications it entails and its (interpretative) uncertainty. Nonetheless, recent trends show that time might be ripe for these provisions to be used, due to their appropriateness to counter harmful tax competition.5

The Treaty EMU rules relevant under iii) above seem neither effective nor appropriate to deal with harmful tax competition. The reason for the ineffectiveness is their limited applicability to the EMU States and to (harmful) tax measures likely to undermine price stability and/or their public finances, which supposedly occurs only in exceptional situations. Furthermore, these rules are relatively recent and have been used only once to a Member States' corporate tax system (see Chapter 2, at 2.5.2). As to their inappropriateness, this instrument usually leads to the issue of broad recommendations on the EMU State's budgetary policy in the light of the said goals, and thus have only an indirect incidence on the fiscal policy part of it but do not (and cannot) address the substantive aspects of specific harmful tax measure(s).

The above shortcomings of EU primary law led Member States to a comprehensive soft-law approach against harmful tax competition in the EU with the adoption of the 'Package' including the Code of Conduct on business taxation (see Chapter 4). This instrument has a number of merits, such as the mentioned flexibility with regard to the remedies to counter harmful tax measures and the timeline to dismantle them progressively. Moreover, its broad scope has resulted in a truly comprehensive evaluation of all Member States' corporate tax systems, resulting in the blacklisting of 66 measures in 1999 by the Primarolo Report. However, the Code of Conduct has also shown several drawbacks, such as its lack of binding force, the fact that its implementation depends on the adoption of the other two measures part of the Package, the interpretative issues concerning the criteria to identify harmful tax competition, the erroneous blacklisting of a number of tax measures by the Primarolo Report, and the interpretative issues raised by certain criteria contained in this Report.

5 See on this in Chapter 2, at 2.4.5, especially the quote from the Commission and the recent case law on fiscal state aid. This is also the reason why the proposal contained below is based on these provisions: see at 6.4.2.
and the 2000 Guidelines and their possible conflict with EC law (as well as international tax law). In one word: uncertainty.

The current situation is even more complicated if one considers the issue of anti-abuse provisions and countermeasures applied by Member States pursuant to domestic laws and bilateral tax conventions against other Member States’ harmful tax regimes. The lack of specific guidance by EU institutions or the ECJ leaves doubts as to the compatibility of these measures with the EC Treaty provisions on the fundamental freedoms. Another unresolved issue is the impact of Commission approval of Member States’ special tax regimes under the Treaty state aid provisions on the application of countermeasures against such regimes by other Member States. Last but not least, there is the issue of the relationship between EC law and bilateral tax conventions concluded by Member States which explicitly allow the application of anti-avoidance provisions (e.g. CFC legislation or denial of the exemption method) against entities or income benefiting from preferential (harmful) tax regimes.

All the above calls for a few conclusions. First, the current EU framework acknowledges the desirable effects of tax competition for the internal market but it also embodies a prohibition of excessive competition. Second, the EC Treaty provides three main remedies to counter harmful tax competition, but none of them seems to be very appropriate, nor very effective. Third, the comprehensive approach adopted by Member States relying on soft law is certainly an important step forward, but still has a number of flaws undermining its effectiveness. Fourth, the adoption of countermeasures by Member States, while in principle justified in the light of these shortcomings of the current EU framework, poses a number of unresolved issues as to their compatibility with the Treaty. These conclusions suggest that there still is a long way to go in fight against harmful tax competition in the EU and highlight the need for an effective and consistent comprehensive approach.

6.3 Commission direct tax policy in the 21st century and impact on (harmful) tax competition

6.3.1 Commission strategy in corporate taxation for the coming years

In 2001, the Commission released two communications on the future strategy in EU corporate tax policy. The communication of May 2001 outlines the policy objectives and principles the Commission intends to pursue in the following years in the whole tax area, both direct and indirect taxation as well as other areas (e.g. environmental and vehicles taxation). It also lists the instruments the Commission plans to use, which vary depending on the topic and the subject area. As for the corporate tax area, the Commission states the need to continue its approach towards coordination of Member States’ tax policies through soft law supported by a constant constructive dialogue with them. With regard to tax competition, the communication calls for a


7 See the Communication, cit., point 4.3, at 23: “The use of non-legislative approaches or “soft legislation” may be an additional means of making progress in the tax field. For example, peer pressure ... could be applied in other areas... Commission recommendations ... but also guidelines and interpretative notices could be considered...”
continuation of the process initiated in 1997, preserving some degree of competition that leads to a lower tax burden.\textsuperscript{8} However, it also warns that the Commission will be strict in the application of the Treaty State aid rules to strike down Member States' harmful tax regimes, and that if necessary it will consider resorting to the use of the internal market distortion provisions.\textsuperscript{9}

The second communication was released in October 2001\textsuperscript{10} together with a thorough study on Member States' corporate tax systems (hereinafter: the "Study").\textsuperscript{11} As seen above (in Chapter 1), the Study contains a detailed qualitative and quantitative analysis of the various systems and highlights a number of internal market distortions created by their differences. The main such distortions are double taxation on intra-EU payments of dividends, interest and royalties between associated companies, double taxation and uncertainty created by the inconsistency or differences in the application of the transfer pricing rules, adverse tax consequences associated with mergers and acquisitions and corporate restructurings, and a number of issues deriving from the interrelationship between Member States' tax treaties and EC law and the fact that not all bilateral relationships between Member States are covered by tax treaties. In its Communication, the Commission endorses a 'twin-track' strategy and sets out a number of recommendations on how to deal with the distortions highlighted by the Study. The faster track, which requires less time for implementation but is only a 'first-aid' remedy to improve in a short time the current situation, relies on a piecemeal strategy to eliminate or reduce the various distortions with different instruments for each of them. The slower track, which requires significant additional time for its realisation but is meant to eradicate all or most of the distortions 'at a stroke,' is based on a comprehensive approach adopted at EU level to tax on a consolidated basis (multinational) companies' EU-wide profits under one of four proposed systems.

In the absence of specific focus by either of the 2001 Commission communications on (harmful) tax competition, this section analyses the impact of the two most significant proposals in this respect in the light of the EU legal framework as described above. The first concerns the issue of tax treaties and EC law as part of the piecemeal approach suggested in the October communication and developed more in detail in the Study. The second proposal regards the two main comprehensive solutions suggested for a consolidated tax base at EU level. The last paragraph of this section wraps up the main findings of the new Commission strategy and the most recent developments in view of the proposal contained in the next two sections of this chapter.

6.3.2 New tax treaty policy and countermeasures against harmful tax competition

As part of its new strategy in the corporate tax area, the Commission deals with the potential obstacles to the internal market created by the different double tax

\textsuperscript{8} See the Communication, \textit{cit.}, point 2.3, at 8.

\textsuperscript{9} See previous footnote and especially point 4.2 of the Communication, at 23, quoted in Chapter 2, at 2.4.5.


conventions (hereinafter: "DTC") concluded by Member States. According to the Study and the communication of October 2001, these obstacles stem from the incompatibility of certain DTCs with the provisions of the EC Treaty on the fundamental freedoms and on the elimination of double taxation as recommended by its Art. 293. Given the existence of 97 DTCs between Member States, of which 36 are more than 20 years old, the Commission recommends adopting a coordinated tax treaty policy at EU level. For this purpose, three alternative approaches are indicated, culminating in a multilateral tax treaty signed by all Member States, or in an EU Model Convention shaped on the OECD Model Convention (hereinafter: "MC") but complying with the principles of the EC Treaty, or in a recommendation specifying the meaning of crucial concepts such as ‘residence’ and ‘non-discrimination’ for the application of the OECD MC (and the DTCs based thereon) by Member States in their bilateral relations and in those with third countries. The Commission also recommends that the EU High Level Group of Member States’ representatives, acquainted with the main issues and active since the start of the process leading to the adoption of the ‘Package’ to tackle harmful tax competition, be in charge of this effort so as to coordinate Member States’ tax treaty policies in the most adequate way.

Without going into detail of the issues dealt with, it is interesting to focus on the potential conflict with the EC Treaty freedoms of DTCs’ limitation-on-benefit clauses and domestic anti-avoidance provisions (e.g. CFC legislation) explicitly allowed by them against Member States’ harmful tax regimes. In this respect, with regard to general non-discrimination clauses of DTCs based on Art. 24 of the OECD MC, the Study stresses that “any statement that anti-abuse legislation is not prohibited under this Article would have to reflect the restrictions on anti-abuse legislation to be inferred from the EC Treaty.” Moreover, the Study calls for compatibility with the Treaty of Member States’ anti-abuse provisions concerning Art. 23 of the OECD MC (i.e. methods to prevent double taxation) and Art. 24 of the MC on income benefiting from a low-tax rate arising in the other contracting Member State. A coordinated policy at EU level implies that Member States may conclude double tax treaties allowing domestic anti-avoidance rules (e.g. denial of the exemption method or CFC legislation in Arts. 23 and 24 DTCs) to cover entities and income enjoying a (harmful) preferential tax regime in another Member State only in so far as they comply with the EC Treaty freedoms. Moreover, Member States will have to take into account possible Commission approval of these preferential regimes under the Treaty (fiscal) state aid rules, which would most probably prevent the application of


13 See the Study, at 357-363.

14 See the Study, at 288. On this issue, see in detail Chapter 5, especially at 5.4.1.5. Interestingly, the Study stresses that other provisions of DTCs, such as those on interest and royalty payments, might be contrary to the proposed EC directive on interest and royalty payments, between associated enterprises forming part of the ‘Package’ to tackle harmful tax competition (see Chapter 4, at 4.2.1). In this respect, it recommends that DTCs’ provisions on payments interest and royalty payments based on Arts. 11 and 12 of the OECD MC will have to comply with this directive (if ever adopted). See also on the current situation in the EU W. Schön, Tax competition in Europe - General Report, 3rd annual conference of the European Association of Tax Law Professors (“EATLP”, Lausanne, 7-8 June 2002, at 34-35.

15 See the Study, Box 56, at 361.
domestic anti-abuse provisions under double tax convention in the light of EU law. The recommended solution is an alignment of the concept of non-discrimination under double tax conventions with the concept of discrimination (and restriction) to the fundamental freedoms as set out in the EC Treaty. For this purpose, in the absence of common guidance at EU level the communication and the Study anticipate the development of joint principles based on the relevant ECJ rulings in this area.\textsuperscript{16} This task should be carried out by the EU High Level Group and should be transposed in the multilateral treaty, the EU MC, or the recommendation, depending on the approach chosen (see above). As the Study puts it, an EU coordinated policy in the DTC area "would eliminate distortions in tax competition in the relations between Member States and third countries, specifically with respect to the transfer of investment income from the European Community to third countries."\textsuperscript{17} A level-playing field between all Member States (also) in this area is desirable as a means to preserve the international competitiveness of the EU and prevent investment flight. Such a coordinated policy would also reduce distortions of competition between firms depending on their country of establishment and the influence on their locational decisions by treaty-shopping considerations to take advantage of the most beneficial tax treaty concluded by EU states.

6.3.3 The Netherlands/Portuguese Tax Treaty

The recent Netherlands/Portuguese DTC\textsuperscript{18} contains a specific limitation-on-benefit provision (hereinafter: "LOB") aimed to counter harmful tax competition in the EU. Its analysis is interesting in view of the proposal set out below as it might constitute a model in the light of the new Commission policy (see at 6.3.2). The Protocol to the DTC contains two LOB clauses concerning the concept of residents entitled to its benefits under Art. 4. Art. II (3) of the Protocol denies the DTC benefits to residents of a contracting state benefiting from a specific tax regime not available for similar domestic transactions and thus ‘ring-fenced’ from the domestic economy. Apparently, this provision is based on the Code of Conduct, which uses ‘ring-fencing’ as one of the criteria to identify harmful tax regimes (see Chapter 4, at 4.2.2). The second LOB clause is contained in Art. II (4) of the Protocol and provides that residents of a contracting state enjoying a tax measure considered harmful under the Code of Conduct are not entitled to the benefits of the DTC. In practice, this clause will catch the Member States’ regimes included in the final black list based on the Code.\textsuperscript{19} The Protocol also contains a safe-harbour provision in Art. II (5), under which tax regimes falling into either of the LOB clauses will not be denied the Convention benefits if they are approved by the EU institutions as a means to boost economic

\textsuperscript{16} In particular, the anti-abuse doctrine stemming from the ECJ cases \textit{Leur-Bloem, Centros, ICI,} and \textit{Eurowings} should be taken into account, as well as all the other cases analysed in detail in Chapter 5, at 5.3.2.7.

\textsuperscript{17} See the Study, at 362-363.

\textsuperscript{18} The DTC was signed on 20 September 1999 and entered in effect 1 January 2001. For an in-depth comment on this treaty, see R. J. S. van den End and P. M. Smit, \textit{Netherlands/Portugal - European Tax Law influences the New Tax Treaty}, in European Taxation March 2001, pp 98 ff.

\textsuperscript{19} The Netherlands authorities have stated that they will rely on a resolution of the Finance Under-Minister containing the list of harmful tax regimes within the meaning of the Code of Conduct, which will supposedly be based on the final black list stemming from the Code and approved by Council: see van den Ende and Smit, \textit{cit.}, at 101.
development of a certain region and as long as they are coherent with EU law. This means that taxpayers benefiting from ring-fenced or other harmful tax regimes under the Code of Conduct will nevertheless be able to claim the application of the DTC if these regimes have been approved under the EC Treaty state aid rules and are coherent with the internal market and the common policies. In these cases, the desirability of the goals pursued by these regimes and their consistency with the EC Treaty is considered sufficient to justify the application of the DTC despite their ring-fencing or blacklisting under the Code of Conduct.

The above clauses pose a few interpretative problems. The first is the relationship between the first and the second LOB clauses contained in Paras. 3 and 4 of Art. II of the Protocol. At first sight, the former would seem useless as it is just a specification of the latter. In fact, if ring-fencing is one of the criteria contained in the Code of Conduct, all the ring-fenced regimes would be considered harmful tax competition in any event and therefore would fall into the general clause contained in Para. 4. Perhaps, the drafters included Para. 3 to stress the ring-fencing criterion as giving rise to the most harmful form of tax competitive regimes and ultimately to reinforce the ban of Para. 4. However, one might also surmise that the two clauses are not linked by a relationship of general (i.e. Para. 4) to special (i.e. Para 4) as the inclusion of ring-fencing as a stand-alone criterion in Para. 3 supports that they are unconnected to each other. This would make sense in situations in which a certain tax regime implemented by Portugal or The Netherlands, despite ring-fenced, would not be deemed harmful under the Code of Conduct for any reason, and as a result Para. 3 would be necessary to deny the benefits of the DTC.

Another interpretative issue regards the applicability of Para. 5 of Art. II of the Protocol and the actual identification of the tax regimes harmful under the Code of Conduct. As mentioned above, this application should be based on the final black list agreed upon by all Member States and possibly approved by the Council. The question arises as to what happens if no final list is issued for instance due to the lack of consensus on the other parts of the “Package” or it is not approved by all Member States (e.g. including Portugal and/or The Netherlands). In this case, in order to avoid rendering this clause meaningless the Netherlands and Portuguese authorities could negotiate and agree on a list of harmful tax regimes under the Code of Conduct applicable for the purpose of their DTC, which would be legitimate under their sovereignty regardless of the implementation of the Code. Otherwise, they could only rely on the other LOB clause to deny the DTC benefits exclusively with regard to ring-fenced regimes.

A last interpretative issue stems from the safe-harbour clause contained in Para. 5 of Art. II Protocol. In particular, there is no specific mention of the application of the Treaty (fiscal) state aid rules as a justification for the non-applicability of the two LOB clauses, but merely a reference to the approval by the EC competent authorities on grounds of economic development. While it is difficult to think of the approval of a certain tax measure other than under the state aid rules, what if such approval were based on the need to boost employment, R&D, or investment in environment-friendly goods, which do not necessarily entail economic development? Furthermore, the additional requirement that, even if authorised, this measure should not be in conflict with other EC legal principles and common policies may give rise to uncertainties.
For instance, what if the Netherlands or Portuguese authorities consider a fiscal state aid regime approved by the Commission under Art. 87(3)(a) or (c) contrary to other Treaty provisions, such as those on the fundamental freedoms or on internal market distortions, and deny the benefits of the DTC? This exception to the application of the safe-harbour provision offers a powerful tool for the local authorities to deny the benefits of the DTC, whose repercussions might be far-reaching if it were not used in a sensitive way.

To sum up, the new Dutch/Portuguese DTC contains innovative clauses which represent an additional tool to fight harmful tax competition in the EU through bilateral tax conventions. The LOB clause covering blacklisted regimes under the Code of Conduct is an objective and clear provision, even though its application depends on the actual implementation of the Code and of the ‘Package’ as a whole. The other LOB clause that refers to ring-fencing seems a useful tool especially in case of failure of the Code implementation, but de jure condendo its scope could be broadened by reference to the other criteria contained in the Code of Conduct. The safe-harbour clause rightly justifies harmful tax measures on the basis of Commission approval under the state aid rules, but in order to avoid the above-mentioned interpretative issues it should specifically refer to any grounds for approval under Art. 87 of the Treaty and it should not contain reference to consistency with other Treaty objectives.

In light of the above, the LOB clauses and the safe-harbour provision of the Netherlands/Portuguese DTC might become a model for the future coordinated tax treaty policy recently embarked upon by the Commission as an effective instrument to counter harmful tax competition in the EU through bilateral tax conventions compatible with EU law. Recent developments concerning DTCs between Member States point towards this direction, such as the new Austria/Germany DTC, which allows the application of domestic anti-abuse provisions against taxpayers taking advantage of unfair tax competition as understood under the EU and the OECD projects.

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20 On the issue of the relationship between state aid rules and fundamental freedoms provisions, see in Chapter 3, at 3.4.3. Also the relationship between (fiscal) state aid rules and internal market distortion provisions is a relevant one, at least from a theoretical point of view, as tax incentives approved under the former may indeed also be caught by the ban of Art. 96.

21 An example of these far-reaching consequences of this clause could concern the approval by the Commission of the Madeira ZFM regime as recently amended under Art. 87 (3)(a) of the Treaty (see Chapter 3 at 3.7.5 and Chapter 4 at 4.4.2). The Netherlands authorities could consider that this regime is able to cause a serious distortion of competition within the meaning of Art. 96 as well as to jeopardise the fundamental Treaty objectives due to the harmful effects for the internal market to deny the DTC benefits to Netherlands companies with a Madeira ZFM subsidiary. The next question would be whether this denial by the Netherlands authorities would in turn be compatible with the Treaty provisions on the fundamental freedoms, which would be further complicated by the issue of the relationship between double tax conventions and EC law (see also at 6.3.2).

22 This provision is contained in Art. 28 (2) of the German/Austrian DTC and the reference to the EU and the OECD projects is contained in its Protocol: see F. P. Sutter, Austrian national report on tax competition in Europe, paper submitted for the conference of the EATLP, cit., at 7.
6.3.4 Comprehensive approaches to tax EU-wide corporate profits: impact on harmful tax competition

The second set of Commission proposals contained in the communication and in the Study of October 2001 relies on tax policy coordination to reduce or eliminate the obstacles to the internal market by adopting a comprehensive approach at EU level.23 The goals of this approach are to lower the high tax costs borne by multinational companies active in several EU countries as a result of different transfer pricing legislation or applicable methodologies, of taxes and charges on corporate reorganisations, of the impossibility or very limited possibility to offset losses arising in an EU jurisdiction with profits earned in another EU jurisdiction, and of having to comply with up to 15 Member States' tax laws. The Commission calls for the adoption of a system allowing companies to calculate their EU-wide profits and leaving intact the Member States' sovereignty in the setting of corporate tax rates. Four systems put forward for this purpose are: (i) home state taxation (hereinafter: "HST"); (ii) Common (consolidated) tax base (hereinafter: "CBT"); (iii) European Union company income tax (hereinafter: "EUCIT"); and (iv) a single compulsory harmonised tax base. The Study focuses in detail on the first two systems, as the last two are politically unfeasible. Therefore, also the following analysis on the impact on (harmful) tax competition will exclusively deal with the first two systems.

Under HST, the tax base of multinational companies is determined according to the tax rules of the Member State where its headquarters are located.24 This system relies on the mutual recognition principle, under which Member States recognise and accept the application of (similar) tax rules adopted by fellow Member States.25 The tax base is allocated to each Member State in which the group has a presence, whether through a subsidiary or a branch, according to a predetermined formula agreed upon at EU level.26 Each Member State then applies on its portion of profits the corporate tax rate chosen under its sovereignty. The Study stresses that HST could be adopted by all Member States having a similar tax base, and that they could leave it up to each company to opt to be taxed under HST or to opt out and choose the ordinary tax system instead. Furthermore, the possibility provided by the Treaty of Nice and restated by the Commission communication of May 2001 to rely on the 'enhanced cooperation' process would allow a forefront group of as little as 8 Member States to agree on its adoption, leaving the choice to other Member States to join at a later stage.27

24 For the details on HST, see the Study, at 373 ff. See also S. O. Lodin and M. Gammie, Home State Taxation, IBFD Publications, Amsterdam 2001.
25 This is one of the main advantages of HST, which would not require a unanimous consensus on the drafting of new common rules but merely the application of existing rules on an extraterritorial basis, and therefore could be implemented (relatively) shortly.
26 The formula to be used for the profit allocation under HST and CBT would be based on: (i) a US-like formulary apportionment taking into account sales, assets, and payroll in each Member State; (ii) a microeconomic approach based on the value added by each of the group entities in each Member State relying on the data collected for VAT purposes; and (iii) a macroeconomic approach based on each Member State’s VAT base or GDP (with some adjustments). For more details on the formulae and their advantages and disadvantages, see the Study at 407 ff.
27 See the Commission communication of May 2001, cit., point 4.4, at 24.
What is the impact of HST on (harmful) tax competition? In principle, the current situation would seem unaffected by its introduction, as Member States would still be able to compete through the rules for the computation of the taxable base and the setting of tax rates. However, in practice its introduction could spur harmful tax competition among them. Despite the mutual recognition principle and the similarity of the rules on the computation of the taxable base of States joining HST, there would still be room to enact tax incentives via their benchmark tax system in compliance with the Treaty state aid rules. However, any such incentive would also have an impact on other Member States' tax bases and would ultimately decrease also their tax revenue, as it would automatically apply in each Member State in which the company is present. In other words, HST could be seen as a multiplier of competitive effects in the internal market, which would mean that the sovereignty of each Member State in direct taxation would be directly affected by tax policy decisions taken by other Member States.28

HST would also not be desirable from an internal market point of view and in particular from a microeconomic perspective of competition. Companies competing in the same local market could be subject to different tax rules depending on the location of their headquarters and thus their home state, which could distort competition as a result of different tax levels borne by them.29 In the end, HST would mean significant tax savings and a competitive advantage for multinational companies able to cherry-pick the EU home state with the most reduced taxable base as opposed to local small companies and extra-EU companies subject to less favourable tax provisions in the source country. Furthermore, multinational companies would still be able to shift the factors used for the profit allocation (e.g. call centres, finance centres, and intangibles if a US-like formula apportionment was adopted) to the EU country with the lowest corporate tax rate, limiting as much as possible their presence in the high-tax jurisdictions. This would cause an establishment or a relocation of such factors in the most favourable home state, which would mean a misallocation of resources in the internal market. Moreover, the consequence for EU high-tax jurisdictions in terms of potential tax revenue losses are easily imaginable, as are the other negative effects jeopardising the attainment of the EU objectives.

The main alternative comprehensive system recommended by the Commission for a consolidated taxation is CBT.30 Under this system, the rules for the computation of the tax base would be harmonised at EU level and transposed into a common tax code. The starting point for the drafting of this code could be the European Accounting Standard, which would constitute the basis to agree on the common rules.31 The rules laid down in the new tax code would be administered by the Member State where the

28 In this respect, the Treaty State aid rules and the Code of Conduct would not be of help as long as the tax for base reductions did not deviate from the benchmark tax system. See also S. O. Lodin and M. Gammie, The taxation of the European Company, European Taxation, 8/1999, at 293, suggesting that Member States joining HST should explicitly commit to the principles of the Code of Conduct and possibly of the OECD Reports, but this would probably not guarantee a proliferation of harmful tax competition.

29 See in particular the example in the Study, at 400.


31 Perhaps, the mandatory adoption of the International Accounting Standards for all EU companies listed on a stock exchange, likely to be effective as from 2005 in the EU, will make them the basis for the drafting of the common tax code under CBT: see the Commission Proposal for a regulation of the European Parliament and of the Council on the application of international accounting standards, COM (2001) 80, Brussels, 13/2/2001.
multinational company has its headquarters. Like under HST, the EU-wide profits of the company would be allocated to the various Member States in which it is present on the basis of a predetermined formula and would be subject to the local corporate tax rate chosen by each Member State. Also in this case a smaller group of EU countries could decide to adopt this system according to the mechanism of ‘enhanced cooperation’ at the beginning, and its application could be made optional for companies.

From a tax competition perspective, CBT would do away with tax base competition as a result of the harmonisation at EU level. This system, however, appears to limit too much Member States’ direct tax sovereignty and desirable tax competition between their benchmark tax systems and thus it may be in breach of the current EU legal framework. An important issue in this respect would be whether there would still be the possibility for Member States to introduce special tax incentives acting through the tax base in derogation to the common tax code if justified under the (fiscal) state aid rules in order to pursue regional development and/or employment policies. Even if this were possible, one would still doubt that Member States would have enough room to pursue their economic and social objectives and to correct possible market failures through the tax system exclusively through their sovereignty in setting the corporate tax rate. In this latter respect, the Study points out that under CBT there would be “an opportunity for an appropriate element of transparent tax competition between Member States.”

Furthermore, it stresses that the main drawback of HST would be eliminated by a system of CBT since “the ‘netting off’ of profits and losses would be the same for all enterprises and would not depend on the rules in the ‘home’ or headquarter state.”

The doubt still remains as to whether mere tax rate competition would offer enough room to manoeuvre for Member States to pursue their policies and/or to correct market failures, which is fundamental from an internal market perspective. The Study acknowledges that “the possibility of a Member State addressing a perceived failure in the market, which can at present be achieved via a tax incentive applied as an adjustment to the tax base, would disappear. The only corrective adjustment would be via the rate, which would be more transparent, and therefore perhaps reduce the risk of unfair or unwarranted incentives being introduced.” However, the fear remains that this rate competition might lead to a race to the bottom spurred by a few Member States, especially the small countries with a healthy economic situation, which might eventually hurt the large economies and the internal market as a whole.

The main above issues have also come up in a global conference on the new Commission strategy held shortly after the release of its communications and the Study. Ruling out the EUCIT and the system of a single compulsory tax base as
politically unfeasible, consensus has been reached on focusing the future debate and research on the systems of HST and CBT. Interestingly, CBT appeared to be the preferred approach, mainly due to the potential loss of national sovereignty and the uncertain impact on Member States’ tax revenue implied by HST. As for the allocation formula, there was a (limited) agreement on a US-like unitary apportionment based on sales, payroll, and assets, despite the problems and the potential abuses linked to its adoption. The main result from the conference was the awareness of the number and the magnitude of the issues surrounding HST and CBT and the need for additional research in order for the Commission to put forward an actual proposal. Apparently, this will only happen if and when there is sufficient scientific evidence and political support for its adoption.

6.3.5 Prospects

The Commission policy in the corporate tax area for the 21st century based on coordination among Member States’ tax systems and EU soft law instruments is to be praised as a flexible yet effective means to eliminate or reduce tax obstacles to the correct functioning of the internal market. The main issue is to ensure an appropriate balance between the elimination of these obstacles and respect for the Member States’ sovereignty. In the tax competition area, this translates into the need to achieve an appropriate balance to promote desirable tax competition while limiting excessive competition creating distortions to the internal market in accordance with the current EU legal framework.

The recommended policy concerning double tax conventions does seem to achieve such an appropriate balance regardless of what instrument is finally chosen (i.e. multilateral EU Model Convention, EU Model Convention, or recommendation on the interpretation of certain concepts of the OECD Model Convention in compliance with EU law). With regard to tax competition, the adoption of specific limitation-on-benefit clauses or domestic anti-abuse rules allowed under double tax conventions to undo the effects of Member States’ harmful preferential tax regimes to the extent that the EC Treaty provisions are not frustrated seems to go in the right direction. The specific example of the recent tax conventions between The Netherlands and Portugal and between Austria and Germany are a good starting point and may constitute a model for the future if the interpretative issues explained above are resolved.

As for the comprehensive approaches for consolidated taxation at EU level, the two main systems recommended by the Commission do not seem to achieve the same appropriate balance with regard to tax competition.36 HST extends the effects of reductions of the tax base implemented by the headquarters’ Member State to the other Member States and therefore is likely to exacerbate harmful tax competition so that the current instruments used to limit it (namely the Code of Conduct and the Treaty fiscal state aid rules) could lose their (already limited) effectiveness. By contrast, CBT, although not showing this drawback, reduces to a significant extent

desirable tax competition and Member States' sovereignty in the achievement of social and economic goals by relying on harmonisation of their tax bases. Furthermore, unbridled tax rate competition under both HST and CBT might have negative consequences for the internal market if it ignites a race to the bottom. The Study points out that "depending on an individual Member State's position ... it could either raise its tax rate in the hope that it could retain a 'non mobile' base or decrease its rate to attract an increased mobile tax base. Such an approach would not be very different from the situation today, but it would clearly be more transparent, and therefore provide a more open 'non-harmful' form of tax competition." Remarkably, however, the Study also states that "whether a minimum rate of tax would be required to avoid a 'race to the bottom' is an open issue," indirectly acknowledging the existence of this issue and recommending a 'floor' tax rate that would further limit Member States' sovereignty in the direct tax area.

The feeling is that a comprehensive approach might end up favouring only multinational companies. Under HST, they would be able to cherry-pick the Member State's most favourable domestic tax system to locate their headquarters and elect as home state. Furthermore, the allocation of profits among Member States under a predetermined formula as envisaged by both HST and CBT could be abused by companies through tax-planning techniques meant to locate the relevant factors in low-tax-rate jurisdictions, consequently eroding the revenue of high-tax-rate jurisdictions. This would be true regardless of the formula chosen, as the Study also acknowledges: "the choice of factors remains important ... any formula which includes profits reintroduces a potential problem related to transfer pricing ... will inevitably retain some location incentives but it should be possible to minimise these. The degree to which they distort location decisions will ultimately depend on the combination of both the base allocation method and the rate." Furthermore, companies might be able to use losses arising in low-tax jurisdictions against income earned in high-tax jurisdictions, more easily than under the current transfer pricing planning techniques.

The above suggests that the comprehensive approaches recommended by the Commission might do more harm than good to the Member States in terms of loss of sovereignty and of tax revenue as well as to the internal market in terms of tax-driven distortion of competition and misallocation of resources. The Study suggests that the Commission plan is to push for HST as a first, preparatory step towards CBT, which seems a means to gradually reduce Member States' sovereignty regarding the rules on the tax base and ensure a smoother transition towards tax base (and possibly rate) harmonisation.40 However, neither approach seems to be consistent with the EU legal

37 See the Study, at 417.
38 See the Study, at 420.
39 See the Study, at 412. In addition to the above example on tax planning under a US formulary approach (see at 6.3.4), if a formula based on VAT were chosen, whether at microeconomic or at macroeconomic level, companies might be able to minimise their tax burden through e-commerce and manipulation of the place-of-supply rule. Perhaps, the method relying on GDP would be the least difficult to abuse, but it implies a number of issues especially relating to inter-nation equity that make it close to impossible to adopt it, unless consensus is reached on a global clearing system. On the US scenario, see Chapter 1, especially at 1.3.2 and 1.3.3, and bibliography cited there.
40 See the Study, especially at 381-383.
framework concerning direct taxation and more specifically desirable tax competition in the EU.

At the moment, the only certainty is that there are still too many unresolved issues and that Member States are not prepared to endorse an approach entailing base harmonisation anytime soon. At best, such an approach could be adopted by a smaller group of Member States under the 'enhanced cooperation' procedure, which would mean that there would still be (harmful) tax competition between (i) Member States not joining and the new comprehensive approach, and (ii) the new system and the old Member States' tax systems for companies opting out. What this boils down to is that the issue of (harmful) tax competition will remain for the coming years, and that extending a choice to multinational business to opt in or out a possible comprehensive approach is not wise. Harmonisation should be harmonisation.

6.4 Proposal to deal with harmful tax competition in the EU

6.4.1 Summary and main thrust

The proposal set out in this section contains a comprehensive framework to deal with harmful tax competition in the EU in the form of a non-binding Council resolution. By and large, the proposal seeks to achieve an equitable balance between the need to retain desirable tax competition and the necessity to limit excessive competition leading to harmful effects and distortions to the internal market. The new framework is based on the Code of Conduct and its related documents, but it also takes into account the other instruments contained in the Treaty which affect tax competition. In particular, it tries to integrate the political commitment enshrined in the Code of Conduct and the subsequent progress work culminated in the Primarolo Report and in the 2000 Guidelines, the Commission strategy in the application of the Treaty state aid rules to the direct tax area, and the Treaty provisions on the fundamental freedoms, on internal market distortions, and on EMU. The main aim of the proposal is to eliminate or reduce the shortcomings, inconsistencies, and flaws experienced in the fight against harmful tax competition through these different sets of partly inappropriate or partly ineffective provisions for this purpose. It should be effected without prejudice to the process occurred so far and build on the experience gained over the years, while tallying with the EU corporate tax policy for the coming years as set out by the Commission.

The basic idea underlying the proposal is that tax competition among Member States is positive for the internal market, as also showed by the economic and empirical evidence available. This idea recognises that direct taxation is the last effective policy tool for Member States to achieve budgetary, economic, and social goals, as well as to correct market failures where necessary. It is also consistent with the Treaty and the subsidiarity principle, which allocates competence to Member States in this area as a means to pursue these goals effectively and as close as possible to their citizens. However, the proposal also acknowledges that Member States' sovereignty in direct tax matters should not be completely unrestricted, as competing policies may lead in some instances to adverse results for the internal market and more in general the Treaty objectives. Thus, it contains rules meant to counter excessive tax competition, seeking to interfere as little as possible with Member States' tax sovereignty and leave
unaffected to a significant extent their fundamental fiscal policy choices. In short, the proposal strives to provide a flexible framework for coordination of Member States’ policies only in certain areas of corporate taxation and for the rest to promote tax competition in the EU in order to maximise the potential benefits of the internal market.

6.4.2 Choice of instrument and legal basis

The choice of the legal instrument for the new framework on harmful tax competition determines its force, the body(ies) in charge of its interpretation (and enforcement), and the applicability of certain principles of EU primary and secondary law. The main choice is between a legally binding directive and a soft law instrument belonging to the EU acts *sui generis*. A directive would imply harmonisation of Member States’ tax laws in the areas covered by the document. Failure to do so could trigger an infringement procedure by the Commission or other Member States before the ECJ, and direct effect and State liability. However, in the area of harmful tax competition a directive would not be an appropriate instrument, as it is mostly used for *positive* integration (i.e. harmonisation) where necessary for the correct functioning of the internal market on the basis of Arts. 94 and 95(2) (see Chapter 2, at 2.2.2.), and not for *negative* integration, in our case prohibition of excessive tax competition as defined in the new framework. Furthermore, a directive in tax matters is only likely to be adopted (because of the unanimity requirement and of the legal consequences) if it is watered down to a negligible level of harmonisation, full of opt-outs.

Therefore, the proposal relies on a soft law instrument or a *sui generis* act aiming at coordination of Member States’ corporate tax laws. A resolution seems an appropriate instrument for a framework specifying what constitutes harmful tax competition and laying down broad criteria Member States must comply with when framing of their corporate tax systems. It would also be consistent with the Commission strategy for EU tax policy in the 21st century to pursue coordination but ensuring a sufficient degree of sovereignty and flexibility for Member States to shape their systems within the boundaries set out therein. Like the Code of Conduct, this resolution would embody a political commitment by Member States, which should make it relatively easy to be adopted with unanimity. The main drawback implied by the lack of its legally-binding force would be the lack of jurisdictional and interpretative competence by the ECJ and the lack of sanctions in case of failure of compliance. However, the experience with regard to the Code of Conduct and the Primarolo Report learns that EU soft law may turn out to be as effective as legally binding instruments and thus that this should not represent a major obstacle to its effectiveness.41 Moreover, the procedure for its implementation and monitoring should be able to make up for its lack of binding force and ensure compliance by Member States (see at 6.4.7).

The legal basis for the adoption of this resolution should be Article 96 (2) of the Treaty, which provides that the Council (and the Commission) may take any appropriate measures to prevent serious internal market distortions (see in detail Chapter 2, Section 2.4). Indeed, the new framework contained in the resolution would

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41 See in Chapter 4, especially at 4.2.4 and 4.6.6.
aim at preventing Member States’ aggressive tax measures deviating from most other Member States’ corresponding measures with harmful effects for the internal market (see also at 6.4.4), including distortions of competition (see the analysis at 2.4.4 and 2.4.5). The findings of the Commission Study of October 2001 on Member States’ corporate tax systems and of the other studies provide enough evidence to warrant application of this mechanism (see Chapter 1, Section 1.4). Furthermore, the Commission itself has called for the use of Art. 96 of the Treaty as part of its new strategy in the direct tax area in its Communication of May 2001, and there is some indication that also Member States are well aware of this instrument in these cases (see in particular at 2.4.5 and also at 6.3.1), which further supports the use of a soft law instrument in this case.

6.4.3 Scope

The scope of the new framework would largely coincide with that of the Code of Conduct from both a geographical and substantive perspective. As for the scope ratione loci, the resolution would apply not only to the EU Member States but also to their dependent and associated territories to the extent allowed by the respective Constitutions and laws regulating their relationship. Furthermore, its application should be extended to the new Member States joining the EU by having these adhere to it as a condition of the accession agreement. The resolution should also call for the EU institutions to enter into negotiations with third countries to gain their political commitment to follow its principles, perhaps as a part of the negotiations already undertaken to extend the scope of the proposed savings directive (see Chapter 4, at 4.2.1).

Also the scope ratione materiae would be the same as the Code of Conduct’s, as the resolution would apply to the whole area of corporate taxation. Provided there would be sufficient consensus among Member States, it would be recommendable to extend its scope to other areas in which harmful tax competition may arise, such as individual taxation and in particular the special incentives in favour of expatriates currently available in several Member States. A viable solution might be to extend the scope of the resolution to the individual tax regimes only if they were related to harmful corporate tax regimes caught by it. Furthermore, it would be recommendable to clarify the scope of the resolution with regard to corporate tax regimes in certain sectors such as shipping, collective investment funds, and oil activities. Based on the Member States’ decision in the context of the Primarolo Report, it would probably be preferable to leave these sectoral regimes outside the scope of the new resolution on the ground of the need to preserve the international competitiveness of the EU in these areas vis-à-vis third states’ tax regimes. Indeed, harmful tax competition in these sectors could still be struck down through the Treaty state aid rules, which take into account the peculiarities of certain sectors (e.g. shipping), including the need to safeguard the international competitiveness of EU operators engaged in these sectors.
6.4.4 Concept of harmful tax competition: objective and subjective aspect

The resolution should clearly specify the concept of harmful tax competition falling within its geographical and substantive scope. This concept should reflect the theoretical findings explained above (see especially Chapter 1, at 1.2.4 through 1.2.6) and the analysis of the current EU legal framework (see at 6.2.2), which both stress that there are an objective and a subjective aspect to take into account. Specifically, harmful tax competition should be defined to encompass Member States’ special tax measures providing for a low tax burden and pursuing policy objectives incompatible and/or inconsistent with the objectives of the EC Treaty.42

The objective element of the concept of harmful tax competition would be based on two main factors. The first, implied by the word ‘special’, would be the deviation of the Member State’s tax measure either from its own general tax system or from the tax system of the majority of Member States. The former type of deviation would be ascertained in practice with reference to the specificity criterion as interpreted under the fiscal state aid rules (see Chapter 3, 3.3.1, 3.6.3, and 3.6.4) and to the criteria contained in the Code of Conduct, which would also be included in the resolution. As a consequence, Member States’ tax measures deviating from their benchmark would be those limited to income earned by certain taxpayers (e.g. entities belonging to multinational groups or foreign-based), derived from certain activities or sectors (e.g. manufacturing, financial or insurance services, intra-group services), or arising in certain areas (e.g. offshore centres) only. The latter type of speciality of a Member State’s harmful tax measure would regard a different tax treatment as compared to the tax treatment of the same taxpayers or income by the (majority of) other Member States and causing market distortions, as set out in Arts. 96-97 of the Treaty.

As for the other specific criteria to include in the resolution for the practical assessment of the two said types of deviation, they would be based on those contained in the Code of Conduct. The ‘ring-fencing’ criterion could be expression of either type of deviation, as tax measures not having an impact on the domestic tax base are by definition an exception to the Member States’ benchmark tax system and contain a disparity compared to most other Member States’ systems. Also the criterion of the departure of a measure from internationally-accepted (i.e. OECD) transfer pricing principles could indicate a twofold deviation from a Member State’s own general system, if this followed the OECD rules as a matter of principle, and from the overwhelming majority of other Member States, which do adhere to these rules in their tax systems. The last criterion of tax measures applying pursuant to discretionary practices of the tax authorities would mainly point at potential deviations from that country’s tax system, consistently with the interpretation of the specificity criterion under the fiscal state aid rules (see Chapter 3, at 3.4.5 and 3.6.5), but it could also indicate a deviation from the tax practices of other Member States that do not involve (a high degree of) discretion and/or non-transparency.

42 This concept would not purport to be the correct concept of harmful tax competition in absolute terms and to become the standard universally endorsed, given its limited applicability in the EU context and the lack of conclusive theory and evidence on what constitutes harmful as opposed to desirable tax competition (see in Chapter 1 and at 6.2). Instead, it would indicate that for the purpose of the new resolution the line has arbitrarily been drawn according to the objective and subjective elements explained in the text mainly on the basis of the current EU legal framework, but it could also have been drawn differently (e.g. on the basis of the distinction between active and passive/mobile income as set out in the OECD 1998 Report, see Chapter 4 at 4.8).
The other objective parameter showing the harmful character of a tax measure would be its nil or significantly low tax burden. This effective tax burden would have to be compared either with the ordinary tax burden resulting from that Member State’s tax system or with the tax burden usually applicable in (the majority of) other Member States on the same taxpayer or item of income, depending on the type of deviation the measure entails. The first issue to clarify would be what is meant by ‘significantly low’ tax burden. For this purpose, it would be recommendable to indicate an objective parameter, such as a specific deviation in terms of percentage points or on a ratio linked to the ordinary tax burden in that Member State or on the average tax burden in the EU. A difference of 10-15 % or of more than 1/3rd between the tax burden provided by the special tax measure and the Member State’s ordinary tax burden or the EU average tax burden could be appropriate in this respect. The actual percentage or ratio could also be based on the average deviation in terms of percentage or ratio Member States use for the blacklisting of special regimes for the purpose of their domestic CFC legislation. Another issue would be whether the tax burden of the measure scrutinised should be compared to the statutory or to the effective tax burden in that Member State or in other Member States. If the latter option were chosen, Member States would also have to agree on the methodology and on the same underlying assumptions to use for this purpose, such as the King & Fullerton methodology or the European Tax Analyser used in the Commission Study’s quantitative analysis (see Chapter 1, at 1.4.5.4). It should also be clarified which statutory tax rate should be taken into account if a Member State has different tax rates (e.g. a lower rate for SMEs or active income and a higher rate for ordinary companies or for passive income). The logical solution would be to take into account the tax rate most commonly used in that country (e.g. the higher rate for ordinary companies) or the rate that would be applicable if the special measure scrutinised did not apply (e.g. if this measure covered passive income, then the higher rate should be taken into account in the comparison).

The subjective aspect of the concept of harmful tax competition as laid down in the new resolution would call for an evaluation of the policy objectives pursued by a Member State’s tax measure in the light of the EC Treaty objectives. This would entail a weighing of the desirable economic or social goals or the need to correct market failure against the harmful goals to attract (mainly passive) investment at the expense of other Member States. If the former were the exclusive or prevalent objectives, then the Member State’s measure could be considered consistent with the Treaty and thus not harmful (or at least not harmful enough), and vice versa (see below). Last but not least, it would be possible to take into account the size of each country and its market by making the necessary distinctions between large and small home markets. As a result, the viability and appropriateness of each policy goal underlying the tax measure scrutinised would also have to be considered in the light of the handicaps suffered especially by small countries or of the potentially significant market failures experienced especially by large countries.

The actual criteria showing a country’s prevalent goal to engage in harmful tax competition be for instance the application of the measure regardless of the taxpayer having local substance, its lack of transparency (secret rulings, see above and at 6.4.6), or the lax attitude by that Member State in taking appropriate steps against abuse of
this measure by (multinational) companies. By contrast, the assessment of the compatibility and/or consistency of the (prevalently) desirable goals of that measure with the Treaty objectives would have to be carried out in the light of the Treaty specific provisions (e.g. the state aid rules, the internal market distortion provisions, and the EMU rules) and of the Treaty goals (i.e. Arts. 2 through 4). More specifically, each potentially harmful tax measure (i.e. 'special' as specified above) should be evaluated on the basis of the Commission's (and the ECJ's) practice regarding the justification of the "nature or general scheme" of a tax measure under the Treaty fiscal state aid rules (see in detail Chapter 3, at 3.6.4). This would require taking into account its "external objectives," such as favouring the development or the employment in depressed areas under the exemption laid down in Art. 87(3) of the Treaty, and its "internal objectives" aiming for instance to ensure progressivity of the tax system, to establish a certain 'tax mix,' or to prevent economic or international double taxation. Furthermore, every such measure would have to be analysed in view of its effects so as to ascertain whether it would be likely to cause significant distortions of competition in the internal market, to undermine price stability and/or bring about a budget deficit for that Member State, or to spur a 'race to the bottom' or a higher tax burden on labour so that it would be inconsistent with the Treaty objectives.

The assessment of the subjective aspect would be a fundamental factor to determine whether a 'specific' tax measure in the two explained meanings under the objective aspect indeed constitutes harmful tax competition. For instance, if a Member State's tax measure deviating from its benchmark system was aimed at attracting mobile investment at the expense of other Member States, such as a 0% corporate tax rate on intra-group finance income only available for multinational companies even in the absence of local substance, it would certainly be considered harmful. By contrast, a measure providing for a lower tax rate aimed at foreign direct investment would not be considered harmful tax competition if it were covered by the Treaty exemptions laid down in Art. 87(3) or were otherwise compatible with the Commission notice on fiscal state aid in view of its external or internal objective(s). Furthermore, Member States' general tax measures deviating from most other Member States' measures would be considered harmful where it would be clear that their goal was mainly to lure mobile investment and that they would likely erode the latter's tax revenue and cause a race to the bottom, such as in case of a low general corporate tax rate (also applying) on passive income (e.g. 5%). Since the assessment, especially of the subjective aspect, is not an easy one and bound to be polluted by mutual political arm-twisting, there should be an independent advisory body issuing opinions on the question whether a certain measure falls foul of the criteria set by the resolution (see at 4.6.7).

To sum up, the approach followed by the new resolution with regard to the concept of harmful tax competition would aim at an appropriate balance between promoting desirable tax competition and countering excessive tax competition. It would reinforce the current EU legal framework and ensure consistency in the light of the fundamental aims and means of the Treaty, but also of the specific goals pursued by the various more specific Treaty provisions analysed above (see Chapter 2). Furthermore, it would mainly rely on objective parameters, yet it would provide
flexibility in the final judgement on the actual harmful character of Member States' tax measures by also taking into account their policy objective(s). The procedure laid down in the resolution (see at 4.6.7) should ensure a correct assessment of each tax measure carefully analysing its effects in the broader context of EU law.

6.4.5 Categories of harmful tax measures

In order to make the actual evaluation of potentially harmful tax measures easier, the new resolution should set out specific criteria according to the categories of income they target. A categorisation would be helpful in the evaluation of the most common potentially harmful measures implemented by Member States. These category criteria should be seen as expression of the general factors to assess the objective and subjective aspect of harmful tax competition as explained above and not as new criteria only applying to the categories covered. For this purpose, the categorisation and the criteria contained in the Primarolo Report and in the 2000 Guidelines should be relied on, with the adjustments necessary to eliminate the flaws of these documents (see Chapter 4, especially Section 4.3).

The first category would encompass Member States' tax measures covering income from financial services and other mobile activities (e.g. the easily movable intangibles giving rise to royalty income). Both third-party and intra-group 'finance company' and 'finance branch' regimes would be targeted by this category. With regard to the latter, the resolution would make clear that they are considered harmful only if they deviate from the OECD transfer pricing rules e.g. by providing for an artificial reduction of the taxable base or for the use of fixed margins not reflecting the arm’s length principle. The practical application of these criteria should rely on the analysis carried out above (see Chapter 4, Section 4.4). The criterion contained in the 2000 Guidelines with respect to finance branch regimes of the denial of the exemption method depending on the tax burden borne by the finance branch would not be contained in the resolution due to its breach of Member States' tax sovereignty and the possible contrast with EU law and tax treaties (see in detail Chapter 4 at 4.4.5). However, the general provision on the use of countermeasures laid down in the resolution (see at 6.4.8) would also apply to finance branch regimes to discourage the use of the exemption method in situations in which foreign (finance) profits have not been subject to tax.

The second category would encompass Member States' 'headquarter company' regimes covering income from intra-group services performed by coordination, distribution, and service 'centres.' These regimes would be considered harmful if they would deviate from the principles laid down in the OECD Transfer Pricing Guidelines, consistently with the Primarolo Report and the 2000 Guidelines. The new resolution would specify that such deviation could lie either in the use of a method for the computation of profit other than that normally applicable under OECD standards, or in an unjustified reduction of the relevant tax base through the exclusion of certain costs (e.g. personnel and/or financial costs). Also the application of mark-ups not reflecting the arm’s length principle (e.g. not taking into account all relevant facts and circumstances) and not constantly reviewed by the local authorities under market criteria would represent a relevant deviation for the harmfulness of
these regimes. These criteria are self-explanatory and would constitute an application of the general (specificity) criterion concerning the objective aspect as set out above (see at 6.4.4). Hence, no further comment is needed (on their practical application, see also Chapter 4, Section 4.5).

The third category would regard the tax treatment of holding companies. The main assumption of the resolution would be that Member States are in principle free to prevent international economic double taxation on dividends and/or capital gains distributed by, or realised on the sale of, foreign subsidiaries either through a credit mechanism or through a participation exemption. The criteria contained in the resolution would have to do mainly with the subjective aspect of harmful tax competition. In particular, it should be investigated whether there is harmful motive or effect to attract mobile investment by allowing the use of holding companies as passive conduit entities merely for tax reasons to channel dividends (and/or capital gains) subject to little or no taxation in the hands of the subsidiary as opposed to sound tax policy objectives linked to the adoption of the exemption method to relieve international economic double taxation and to secure capital import neutrality. The criterion of the limited applicability of the exemption to holding companies belonging to foreign-based multinational companies and/or exclusively available to dividends (and capital gains) distributed from foreign subsidiaries would imply ring-fencing and thus it would target special holding company regimes. In this case, the assessment of the subjective element would have to be much stricter than with regard to general participation exemption regimes, which may be justified in the context of the nature and design of a country’s corporate tax system (see for the application of these criteria Chapter 4, at 4.6).

A savings clause should be included in the resolution to ensure that the application of its criteria would not be in breach of EU primary and secondary (tax) law (i.e. the Parent/Subsidiary Directive): in this way the interpretative issues arising from the 2000 Guidelines would be avoided (see Chapter 4, especially at 4.6.2 and 4.6.6). For the same purpose, there should be no reference in the resolution to CFC legislation (or any other countervailing measure) in the assessment of harmfulness of holding company regimes, as the general provision on countermeasures would be considered sufficient for this purpose (see at 6.4.8). Lastly, the criterion of the asymmetrical treatment of capital gains and losses as set out in the Primarolo Report and the 2000 Guidelines would be included also in the resolution, with an exception where the asymmetry were only present with regard to liquidation losses for genuine business reasons (see Chapter 4, at 4.6.2).

The last category would catch tax measures covering insurance and reinsurance income (see Chapter 4, at 4.3.4). It would rely on the same criteria laid down in the Primarolo Report. Their substantial similarity to those concerning the first category of regimes on finance and other passive income makes further explanation unnecessary.

### 6.4.6 Administrative practices

In addition to the resolution's general criterion under which administrative practices should be considered harmful if they are discretionary or non-transparent (see at 6.4.4), there should also be a specific provision regarding this issue so as to achieve
coordination among Member States’ policies in this area. The resolution should set uniform standards that tax authorities of all EU countries should follow in dealing with taxpayers and ultimately leading to the issue of advance rulings or advance pricing agreements (i.e. “APA”). In particular, Member States should commit to allow rulings and/or APAs to be issued only if in compliance with, and within the borders of, statutory tax law, with the local tax authorities enjoying a very limited discretionary power. This would guarantee objectivity and equality of treatment between taxpayers in the same or similar situations. Furthermore, this would automatically ensure that administrative practices would not be caught by the ‘specificity’ criterion of harmful tax competition (see at 6.4.4) and of the fiscal state aid rules (see Chapter 3, at 3.4.5 and 3.6.5). As for APAs, if they were granted in accordance with the OECD Transfer Pricing Guidelines, they would also automatically not be considered harmful under the resolution as the criterion of the deviation from generally-accepted transfer pricing principles would not be met.

In order to achieve transparency, horizontal application, and accountability, publication of administrative policy laying down the conditions for the granting of rulings would be needed. As for advance rulings not granted under a published administrative practice or APAs not explicitly following the OECD Transfer Pricing Guidelines, Member States should commit to their individual publication. In order to protect taxpayers’ confidentiality, these should be published in an anonymous form and with a limited indication of the facts potentially disclosing business secrets or processes or making the taxpayer potentially recognisable (for its competitors). If these non-standard rulings and/or APAs would be kept secret, this would imply a presumption of their deviation from a country’s standard tax system or from generally accepted transfer pricing principles. If publication were not possible due to constitutional or other legal constraints or opposition by Member States, an alternative could be the involvement of the body in charge of the application of the resolution in the review of advance rulings and/or APAs (see at 6.4.7). This body could be granted access to the relevant information to carry out the necessary investigation on their harmfulness under the resolution.43

6.4.7 Procedural rules: black list and body in charge of its administration

The procedural rules are crucial to ensure the implementation and effectiveness of the new resolution. In particular, it should contain a standstill and a rollback clause analogous to those of the Code of Conduct under which Member States would commit to abstain from implementing new tax regimes falling within the meaning of the resolution and to repeal or amend their existing tax measures caught by it. Furthermore, the resolution should provide that a black list of harmful tax measures be issued by the body in charge of its administration and be constantly updated after

43 The Technolease case in the fiscal state aid area suggests that this last solution would not be unfeasible (see Chapter 3, at 3.4.5). In that case, the Netherlands tax authorities submitted to the Commission confidential information on the denial of rulings for situations similar to the one investigated. This information, obviously treated as confidential and not disclosed in the final decision published, apparently has been thoroughly examined by the Commission in its evaluation on the ruling issued by the Dutch tax authorities. This suggests that Member States might be willing to disclose information on the granting of non-standard rulings and APAs to an impartial body like the Commission and agree on a standardised procedure for the purpose of the new resolution.
completing each investigation (see below). The first black list would be based on the rollback clause and would update and correct the black list of the Primarolo Report to reflect the erroneous blacklisting of certain measures (see in Chapter 4), the amendments by Member States in the meantime, and the measures to be or not to be considered harmful under the new rules. This first list would be in fieri, as it would reflect any new procedure of Member States’ potentially harmful tax measures under the new resolution.

The black list would have a threefold aim. First, it would exercise pressure on Member States reluctant to repeal or amend certain regimes. Second, it would legitimise application of anti-avoidance measures and countermeasures included in Member States’ domestic tax laws and in tax treaties (see at 6.3.2 and at 6.4.8). Third, it would guarantee transparency with regard to the investigation of new potentially harmful measures, which would be an innovation consistent with the new attitude endorsed by the Commission with regard to EU corporate tax policy.

The body in charge of the implementation of the resolution and of the accurateness of the black list should be as impartial as possible and thus independent of the Member States whose measures would be scrutinised. The experience with the implementation of the Code of Conduct and with the functioning of the Primarolo Group have shown that if such a body is not independent but exclusively formed by representatives of Member States defending their national interests, the chances of effective and impartial implementation are slim. The main consequence is the stagnation of the process due to non-transparent negotiations and bargaining among Member States and the disagreement on the blacklisting of their own regimes if the said negotiations are unsuccessful.

To overcome these problems, the resolution should rely on a two-step procedure involving a new impartial body in the first step. This new body would be for its half composed by the Commission in its function of “guardian of the Treaty,” and in particular by its specialised staff in corporate tax matters and harmful tax competition, in fiscal state aid, and in EMU matters. There would be prevalence of representatives of the DG on Taxation and Customs Union, especially those involved in the process leading to the adoption of the Code of Conduct and its implementation through the Primarolo Report (and the 2000 Guidelines), and of representatives of the DG on Competition and State Aid, especially those in charge of the broad investigation of Member States’ harmful tax measures under the fiscal State aid rules, but also personnel of the DG on Economic and Financial Affairs supervising the compliance of Member States’ budgetary and tax policy with the Treaty EMU rules. To strengthen the prestige and the impartial character of this body, the other half would be composed of independent experts in the area of EU direct tax law, such as professors, researchers, retired advisers, and former judges of the ECJ, or Member States’ domestic tax courts. Ideally, there should be at least one expert for each Member State.

The first stage of the procedure would be a combination of the procedures laid down in the Treaty (fiscal) state aid rules and the internal market distortion provisions. The new body would investigate Member States’ potentially harmful tax measures on the initiative of the Commission, or on a Member State’s notification of its own suspect measures, or on a denunciation by any other Member State. It would first consult the
Member State concerned and would also invite all other Member States to submit their observations. For this purpose, ad hoc or regular meetings could be scheduled between the new body and the existing Group of high-level tax experts representing the Member States within the (ECOFIN) Council, which has been active in the area of harmful tax competition since the start (see Chapter 1, at 1.4.3, Chapter 4, at 4.2.1). At the end of the investigation, the new body would issue an opinion on the actual harmful character of the measure scrutinised deciding under majority voting, which would be transposed into a non-legally binding recommendation issued by the Commission. If the measure scrutinised were considered harmful, the recommendation would also order its inclusion in the black list and provide that it would be taken off the list only on the condition that the Member State concerned complied with the recommendation by repealing its harmful measure or amending it in a way compatible with the resolution. For the latter purpose, the advisory body should to the extent possible suggest amendments to measures found harmful in order to lift their harmfulness. The Commission recommendation would be based either on Art. 96(2) of the Treaty, if the procedure started on its initiative or upon other Member States’ denunciations, or it would be based on Art. 97(1) if the Member State concerned had notified its tax regime to the Commission. Given the lack of binding force of the Commission recommendation, it would be up to the Member State concerned whether or not to comply with it. The loyalty principle enshrined in Art. 10 of the Treaty, juncto Arts. 96 or 97 of the Treaty, would reinforce the effectiveness of the recommendation by exercising additional pressure on this Member State, as would the blacklisting of the harmful measure.

The second step of the procedure would only occur in case of non-compliance by a Member State with the Commission recommendation blacklisting its harmful tax measure. If such Member State disagreed with the recommendation, it could refer the matter to the Council, which would take a final decision on the harmful character of the measure scrutinised and on the remedy under Art. 96 (2). This step could also be initiated on the initiative of the Commission, which could propose to the Council the adoption of a directive to be adopted under qualified majority voting or of any other appropriate measure on the basis of Art. 96 (2). The matter would thus be shifted to from the more legal technical matter to the more political level. The Council would have to review the Commission recommendation and the arguments and observations put forward by all parties concerned. The final act issued by the Council, whether a directive or a non-binding instrument, would supersede the Commission recommendation and would be the result of a political compromise reached by the Member State concerned and the other Member States. In the end, this act would determine whether the Member State’s measure stays on the black list, and whether repeal of the measure, if its blacklisting is maintained, becomes legally enforceable (if a directive is issued).

Another issue would be the relationship between the new procedure and the state aid rules. Such relationship should be similar to the one between these rules and the Code of Conduct (see Chapter 4, section 4.2). In principle, the resolution would not affect the application of the state aid rules, which would be independent of it. However, in practice it would be left to the Commission discretion to resort to the use of the state aid rules against Member States’ harmful tax measures (also) caught by

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the resolution. As the Commission would play a major role in assessment of each potentially harmful measure and in reaching a compromise with the Member State concerned under the new resolution, the use of the State aid rules would have to constitute a last resort. In particular, the Commission would have to use them only where the procedure envisaged here would not yield an appropriate result after neither the first nor second stage. This would be the logical consequence of the new resolution being specifically tailored to deal with (harmful) tax competition, whereas the state aid rules apparently are not.

In sum, the procedure envisaged in the resolution seems appropriate to ensure its effectiveness despite the lack of binding force, because the matter may be lifted to the legally binding level through the application of the existing Arts. 96 and 97 of the EC Treaty. It should also provide an adequate balance to preserve Member States’ sovereignty and sufficient flexibility deciding the most appropriate remedy to take in each situation. The new body would function as an EU ‘watchdog’ in the tax competition area under the auspices of the Commission, and its high specialisation, enriched by the presence of independent experts, should constitute a sufficient guarantee for Member States that the investigation and assessment on their tax measures would be competent and impartial. This ‘watchdog’ would also have a crucial role in ensuring a consistent application of the various Treaty provisions in the overall assessment of each potentially harmful tax measure, thereby significantly improving the current situation (see at 6.2.3). The transparency and openness of its work would further strengthen the importance of this body, which could eventually become fundamental also in the framing of EU tax policy in the future.

6.4.8 The issue of countermeasures in domestic laws and tax treaties

The resolution should address separately the issue of the application by Member States of anti-abuse provisions and countermeasures against harmful tax measures. The reason is the question of their compatibility with EC law. As seen above, the Code of Conduct only mentions anti-abuse provisions and countermeasures contained in domestic laws or tax treaties as being a fundamental tool against tax evasion and avoidance, whereas the Primarollo Report specifically looks at the existence of comprehensive CFC legislation as a criterion for not blacklisting holding company regimes (see Chapter 4, especially at 4.3.6). The 2000 Guidelines go even further by stating that finance branch and holding company regimes must be considered harmful if they grant the exemption method even if profits of finance branches or foreign subsidiaries have been subject to low local taxation and are not coupled with adequate anti-abuse legislation or countervailing measures. This seems to unduly impinge on Member States’ sovereignty and seems incompatible with EC law, especially the four freedoms (see Chapter 4, especially at 4.4.5 and 4.6.2). Therefore, the resolution should follow the milder approach of the Code of Conduct, merely recognising the importance that Member States adopt anti-abuse legislation and countermeasures to fight harmful tax competition but only to the extent these are not contrary to EC law, especially the freedom of establishment and of capital movement. In this respect, their application against harmful tax measures included in the new black list would most probably be compatible with the Treaty, given that the
blacklisting takes into account the principles of EU law (see also below). Furthermore, the resolution should contain a commitment by Member States to work together with the Commission in developing a set of guidelines clearly indicating the conditions on which countermeasures are compatible with EC law. This approach would leave untouched Member States’ sovereign choices on the expediency of this kind of legislation and on the (tough or lenient) stance to follow, while encouraging them to develop together an appropriate framework consistent with EU law (and international tax law). Perhaps, the study undertaken by the Commission with regard to the work on bilateral tax treaties as part of its new approach on the EU tax policy and its commitment to issue a recommendation in this respect (see at 6.3.2) might also be relied on for the purpose of the resolution.

As for the countermeasures against harmful tax competition, some guidelines may be singled out from the above analysis on their compatibility with EC law (see in Chapter 5, especially the synthesis at 5.4.4). In general, such countermeasures would be likely incompatible with the Treaty provisions on the fundamental freedoms in conjunction with the loyalty principle if targeted at (i) measures part of Member States’ general tax system (such as a low statutory corporate tax rate), or (ii) special tax regimes approved by the Commission under the (fiscal) state aid rules (see also Chapter 2, at 2.3.2, and Chapter 5, section 5.6). In all other cases, the new guidelines should specify the conditions of compatibility of these countermeasures with EC law, whether included in DTCs or in domestic tax laws, possibly distinguishing between general and specific countermeasures.

With regard to anti-avoidance measures contained in tax treaties, it would be recommendable to agree on a model LOB clause compatible with EU law against blacklisted tax regimes. This would be transposed into the EU multilateral tax treaty, in the new EU Model Convention, or in the recommendation on the OECD Model Convention, depending on the approach adopted by the Commission (see at 6.3.2). Perhaps, this model LOB clause could be based on that contained in the Netherlands/Portuguese or in the Austrian/German tax treaty (see at 6.3.3), denying the benefits of the DTC to entities or items of income benefitting from a regime blacklisted under the resolution.44 The new guidelines should also address the possibility to extend the application of this model LOB provision to residents of a contracting (Member) State benefiting from a harmful tax regime in any Member State (not only in the DTC partner State), which would constitute a strong disincentive for (multinational) companies to use these regimes.45 In alternative, a more general LOB provision might deny the benefits of the DTC to entities enjoying a preferential tax regime referring to (some or all of the) criteria contained in the resolution, e.g. ring-fencing, limited applicability to finance income or to intra-group centres, or departure from the OECD Transfer Pricing Guidelines (see at 6.4.4). This provision would be

44 There would be no need to include a safe-harbour provision like the one of the Netherlands/Portuguese DTC to exclude from the scope of the standard LOB harmful tax regimes approved under the Treaty state aid provisions, as under the resolution these regimes are not considered harmful tax competition in any event (see at 6.4.4).

45 If not limited to the two contracting states, the scope of the LOB would look through the entity established in the other contracting state to ascertain whether there would be any other group entity up or down in the corporate chain benefiting from an EU harmful tax regime. In these cases, the application of the LOB would be justified by the use of the entity claiming treaty benefits as a conduit. The main issue to clarify would be the compatibility of this LOB provision with EU law, and in particular with the infringement of the freedom of establishment and/or capital (see on this also in Chapter 5).
similar to the anti-ring-fencing LOB clause included in the Netherlands/Portuguese DTC and could be based on the wording included in the new draft OECD Model Tax Convention and its Commentary. With regard to unilateral countermeasures, based on the above findings (in Chapter 5) the new guidelines should distinguish between general and specific countermeasures applicable against Member States’ regimes blacklisted under the new resolution. General anti-avoidance provisions relying on fraus legis or abuse of law doctrine would disregard the effects of transactions or arrangements with entities benefiting from harmful tax regimes entered into merely or preponderantly to circumvent domestic tax law. Other general provisions could attach the residence of entities benefiting from blacklisted regimes on the basis of the place of effective management or consider the existence of a local permanent establishment of such entities to which (most of) the profits enjoying low taxation would be attributable. These general countermeasures would probably have to be considered compatible with the Treaty where a number of requirements were met, namely their application in an objective and proportionate way, based on a thorough examination of all facts and circumstances, and subject to jurisdictional control. At first sight, the above provisions would seem to meet these requirements, and would probably also comply with the proportionality principle as the burden of proof for their application is generally on the tax authorities rather than on the taxpayer. Specific countermeasures would be expressly targeted at Member States’ tax measures blacklisted under the new document. The most common countermeasure would be a comprehensive CFC legislation relying on a jurisdictional approach, i.e. subjecting to current taxation foreign-source income benefiting from one of the blacklisted measures. Member States would no longer draw up a black list including EU States’ preferential regimes, but would simply rely on the common black list envisaged by the new resolution. It would be open to question whether under the CFC regimes there would still be the need for exemptions covering subsidiaries mainly active in the local EU market in which it enjoyed the blacklisted regime, or not having been set up exclusively or predominantly to benefit from it. Another unilateral countermeasure would be the denial of the exemption method and instead the use of the credit method to prevent double taxation on domestic taxpayers’ foreign income entitled to a blacklisted tax measure. Member States may also deny the deductibility of payments (e.g. fees, interest, royalties, rents) effected by resident taxpayers to entities enjoying a blacklisted regime, which denial may be either unrestricted or possibly lifted by the tax authorities upon proof of an underlying genuine business purpose for the payment or an active presence in the local market. An alternative

46 See the OECD, Draft Contents of the 2002 Update to the Model Tax Convention, 2 October 2001, especially draft Para. 21, entitled "Provisions which are aimed at entities benefiting from preferential tax regimes" and based on the OECD project to counter harmful tax competition, available on the internet at http://www.oecd.org.

47 On this distinction, see the analysis in Chapter 5. For a more thorough description of the general and specific countermeasures summarised in the text, see the International Fiscal Association - 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 2001 during the 54th Congress of the International Fiscal Association, IFA, Vol. 86b, 2001. See also the 1998 OECD Report on harmful tax competition, and its analysis in Chapter 4, Section 4.8.

48 These provisions could also be included in bilateral tax conventions: see the Draft 2002 OECD Model Convention, at., and in particular the Commentary to Article 1, draft Paras. 10.1 and 10.2.

49 See the Leur-Bloem case and the other case law analysed in Chapter 5, at 5.3.2.7.

329
measure would be the imposition of a withholding tax on all payments to taxpayers benefiting from blacklisted regimes, which may also be unrestricted or waived on the same conditions as the previous countermeasure. Lastly, there could be a countermeasure relying on the mark-to-market principle, requiring a re-evaluation of the blacklisted subsidiary at fair market value in the hands of their resident parent companies.

The new guidelines would have to recommend which of the above measures would be compatible with EU law and how they would have to be framed. In general, one would assume that these measures would have to be considered compatible with the Treaty fundamental freedoms where they would be well targeted at countering other Member States' blacklisted harmful tax regimes and proportionate with regard to the mechanism and the (procedural) burdens they impose on taxpayers. Based on the above analysis (see Chapter 5, especially at 5.4 and 5.5) it would seem that they could all be considered appropriate to achieve the goals of preventing tax avoidance and more in general of countering harmful tax competition in the EU. They would also seem sufficiently targeted given their limited application to regimes blacklisted after a thorough assessment by the Commission of their incompatibility and/or inconsistency with the Treaty. As for their proportionality, they should not contain mechanisms of rebuttal of the onus of proof on the taxpayer to avoid their application on the grounds of the local conduct of genuine business activity or of the absence of predominant or exclusive tax avoidance intent. A first option would be to simply exclude these exemptions on the same grounds that harmful tax regimes are contrary to the Treaty and thus the application of domestic anti-(tax-)abuse legislation should be in any event considered legitimate under EU law. If, however, Member States would still adopt these exemptions, they should place the onus of proof on the tax authorities, which should rely on the Mutual Assistance Directive to gather evidence from the other Member State’s tax authorities.  
50 Once again, given the complexity of the issues at stake clear guidance could only be provided by the new guidelines after thorough research and negotiations by the Commission and Member States.

6.5 Example of a resolution on harmful tax competition

This section contains an example of a resolution containing the framework on harmful tax competition following the principles set out above. This text is merely intended to provide a concrete example of what the resolution would look like in practice and does not cover all the issues addressed. The preamble should state that it embodies a political commitment by Member States to counter excessive forms of tax competition harmful for the EU, should reiterate as a matter of principle national sovereignty in the direct tax area, and should specify that its application is without prejudice to the principles of EU law. There should also be a reference to the Commission Study of October 2001 and its main findings concerning tax competition in the EU, as well as to the initiatives in the EU corporate tax area currently underway. The commentary that should be annexed to it might be based on the comments in the previous section and in the other relevant parts of this research.

50 See in detail in Chapter 5. As suggested at 5.4.4, a milder approach might also be considered proportionate for the purpose of the application of the rule of reason and the compatibility of these countermeasures with the Treaty, such as a mandatory ruling procedure like as required by the new Italian CFC legislation.
Council Resolution on a common framework for dealing with harmful tax competition in the European Union

A. Legal basis

This resolution aims at preventing serious distortions to the internal market caused by harmful tax competition and is based on Article 96, paragraph 2 of the EC Treaty.

B. Scope

(1) Without prejudice to the respective competences of Member States and the European Union in direct taxation, this resolution covers corporate tax measures implemented by Member States through laws, regulations, or administrative practices constituting harmful tax competition.

(2) The provisions of this resolution shall apply in the entire territory of the European Union. Each Member State shall strive to extend its application to its dependent and associated territories as far as the relevant laws regulating the relationship between them allows. The European Union shall enter into negotiations with third countries with a view to extending its geographical scope as broadly as possible.

C. Meaning of Harmful Tax Competition

(1) Within the scope as set out in Point B, harmful tax competition encompasses special tax measures providing for a nil or a low level of taxation having regard to the tax base, the tax rate, or any other relevant element in determining the final tax liability.

(2) A tax measure shall be considered special where:

(i) it departs from the general tax system of a Member State as it is limited to certain income, certain taxpayers, certain sectors, or certain areas only;
(ii) it provides for a treatment substantially different from that laid down for similar taxpayers or items of income by the majority of Member States;
(iii) it is ring-fenced from the domestic economy;
(iv) it departs from internationally-accepted transfer pricing principles as laid down in the OECD Transfer Pricing Guidelines;
(v) it applies pursuant to an administrative practice involving a high degree of discretion by the local tax authorities or lacking transparency.

(3) The assessment on the harmfulness of a tax measure must also take into account its main objectives. Where a measure pursues a desirable objective consistent with EU law and does not frustrate other provisions of the EC Treaty, it shall not be considered harmful.
D. Categories of harmful tax measures

(1) Income from financial services and other mobile activities

Within the meaning of Point C, a tax measure covering income from financial services or other mobile activities is considered harmful where it provides for a substantial reduction of the taxable base in breach of the OECD transfer pricing principles, in particular through:

(i) Fixed margins for pass-through financing, licensing, or other mobile activities without an assessment of all relevant facts and circumstances and without a constant review against commercial criteria; or

(ii) Allocation of profits between headquarters and foreign permanent establishments in a formulaic way without taking into account the real functions performed, and risks borne, by each of them; or

(iii) Creation of substantial provisions or reserves deferring taxation of significant amounts of income, unjustified or disproportionate to the goal for which they are allowed; or

(iv) Any other mechanism similar to the above.

(2) Income from intra-group activities

Within the meaning of Point C, a tax measure covering income from the provision of intra-group services shall be deemed harmful where it departs from the OECD transfer pricing principles through:

(i) the application of the ‘cost-plus’ or ‘resale price’ method in circumstances in which the ‘comparable uncontrolled price’ method could reasonably be used; or

(ii) a reduction of the expense base used for the computation of the taxable profits under the ‘cost plus’ method through the exclusion of relevant items such as financing and/or personnel costs; or

(iii) the application of a fixed mark-up or a narrow range of mark-ups without an examination of all relevant facts and circumstances and without a constant review of the mark-up against normal commercial criteria; or

(iv) a condition that eligible entities must belong to an international group of companies active in more countries and/or continents, or must be mainly based outside that country.
(3) Tax treatment of holding companies

The exemption of dividends received by a domestic company from a foreign subsidiary shall be considered harmful where it applies:

(i) subject to the condition that the domestic company does not carry out, or carries out only limited activities locally, or that it belongs to a multinational group active in more countries and/or continents; or

(ii) exclusively with regard to distributions by foreign subsidiaries; or

(iii) regardless of the condition that the foreign subsidiary be subject to a certain minimum effective tax burden on its profits, unless it is resident in another Member State; or

(iv) regardless of whether the domestic company has no or little substance and/or lacks a genuine business purpose.

The criteria under (iii) and (iv) shall apply without prejudice to the provisions set out in Point H below.

The above criteria shall also apply to assess the harmful character of the exemption of capital gains realised by a domestic company on the disposal of shares in foreign subsidiaries. The exemption shall also be considered harmful where capital losses on such disposal would be deductible by the domestic company, unless the deductibility would be limited to a real liquidation of the foreign subsidiary effected for a genuine business purpose.

(4) Insurance and reinsurance income

To the extent it does not fall into the category under paragraph (1) above, a tax measure applicable to insurance and/or reinsurance income is considered harmful where it provides for:

(i) An exemption or a substantially lower effective tax burden granted by way of a notional fixed taxable base, an exceptionally long tax deferral, or any other mechanism not complying with the OECD transfer pricing principles and leading to the same result;

(ii) The creation of substantial provisions or reserves not normally available under the ordinary tax system and not proportionate with the real underlying risks insured or reinsured.
E. Administrative practices

(1) Member States shall ensure that their tax authorities issue advance rulings, advance pricing agreements, and any other administrative act setting out the tax treatment of a certain taxpayer or a certain transaction within the boundaries of statutory tax law pursuant to a limited discretionary assessment and in a transparent way.

(2) Member States shall ensure that standard ruling practice be published, as well as individual rulings deviating from published standard practice.

F. Standstill and rollback; Black list

(1) Member States shall repeal their existing tax measures incompatible with this resolution or amend them in conformity with its provisions.

(2) Member States shall abstain from introducing any new measure which might be considered harmful within the meaning of this resolution. Any such measure shall be object of the procedure set out in Point G below.

(3) Tax measures considered harmful under this resolution shall be included on a list drawn up by the Commission and constantly updated after the conclusion of each investigation in conformity with Point G below.
G. Procedure

(1) The Commission shall set up an advisory board in charge of the administration and implementation of this resolution. This body shall be composed for half of representatives from the Commission’s Directorates General in Taxation and Customs Union, Competition and State Aid, and Economic and Financial Affairs. For the other half, the board shall be composed of independent experts in the field of EU tax law chosen by the Commission from a list of independent experts drawn up by Member States. No Member State shall have more than one independent expert in the board.

(2) The advisory board shall examine all existing and new tax measures potentially falling within the scope of this resolution upon notification by the Member State concerned, upon initiative by the Commission, or upon denunciation by any Member State. After consultation with the Member State concerned and review of the observations submitted by any other interested Member State, the board shall issue an opinion on the harmfulness of the measure investigated, as well as recommendations for amendments to bring the measure in line with this resolution.

(3) Based on this opinion, but not bound by it, the Commission shall issue a recommendation addressed to the Member State concerned on the basis of Article 96 paragraph 2 or Article 97 paragraph 1 of the EC Treaty as the case may be. In the event that the tax measure scrutinised is considered harmful, the recommendation shall request this Member State to repeal or refrain from introducing such measure and shall indicate ways to amend it in conformity with this resolution. At the same time, the recommendation shall order the inclusion of this measure in the black list as set out in Point F above where it is already effective or is otherwise enacted by the Member State concerned.

(4) In the event that the Member State concerned disagrees with the recommendation issued by the Commission under Paragraph 3, it may refer the matter to the Council. After reviewing the case and the written observations by the Commission and the Member State concerned as well as any other interested Member State, the Council shall adopt a directive or any other appropriate measure acting by qualified majority under Article 96 paragraph 2 of the EC Treaty.

H. Anti-abuse provisions and countermeasures

(1) Without prejudice to their sovereignty and to the obligations stemming from EU law, Member States acknowledge the importance to implement anti-avoidance measures and countermeasures in domestic tax laws or in double tax conventions against harmful tax measures included in the black list as set out in Point F.

(2) In the light of Paragraph (1), Member States shall collaborate with the Commission to develop common guidelines on the drafting of model anti-avoidance measures and countermeasures in domestic laws or double tax conventions in a way compatible with EU law.
6.6 Conclusion

The above proposal is based on the current EU legal framework affecting tax competition, which recognises the tax sovereignty of Member States and the desirable effects tax competition may bring about for the internal market, but also contains an implicit prohibition of excessive tax competition leading to erosion of Member States' tax bases, higher unemployment, and internal market distortions. These consequences are contrary to the fundamental aims and means of the EC Treaty and might in the long run entail a loss of sovereignty of Member States by surrendering to market forces. In order to avoid this, it is in their (as well as in the Union's) interest to coordinate domestic fiscal policies at EU level by establishing a common framework to limit excessive competition, as in this field decentralised decision-making and subsidiarity are ineffective if not dangerous.

The proposal seeks to establish a framework encroaching only where necessary on Member States' sovereignty and preserving as much flexibility as possible for them to implement their economic and social policies. This is best ensured through the adoption of a non-legally binding resolution whose outcome is also a soft law act, i.e. a recommendation issued by the Commission in the first stage, but with the possibility for the Council in the second stage to adopt either a legally binding directive by qualified majority or another recommendation on the basis of Art. 96 (2) of the EC Treaty. The proposal strives to achieve consistency with the Treaty objectives and provisions affecting tax competition and also to be broadly compatible with the Commission strategy in the corporate tax area for the coming years. The mechanism, invoking the assessment of each potentially harmful measure with the help of external experts and the constant involvement of the Member State concerned and the other Member States, should guarantee impartiality to reach fair decisions and flexibility in finding the most appropriate remedy. The second, possible stage of the procedure involving intervention by the Council would provide a further opportunity to reach a balanced solution in each situation considering all the interests at stake, culminating in a legally binding or in a soft law instrument. The system of a black list constantly updated would ensure legal certainty and transparency through public control on each measure scrutinised during the process. In the end, the issue of harmful tax competition in the EU would be treated under a single set of consistent principles, taking into account the Treaty (fiscal) state aid rules, the internal market distortion provisions, and the EMU rules, as well as the general Treaty provisions and EU (secondary) tax law. If successful, in the longer term the resolution would likely lead to a spontaneous approximation of Member States' corporate tax systems and transparency of their favourable tax measures, which could make the transition towards a more comprehensive approach at EU level easier.

This brings us to the more general question as to what relevance the proposal is likely to have in the light of the Commission comprehensive strategy in the corporate tax area for the 21st century. It would be especially important if an EU-wide home state taxation system were adopted, given its likely consequence to exacerbate (harmful) tax competition between (possible) home Member States. Perhaps this and the risk of leaving their sovereignty at the mercy of other Member States are the main reasons
why this approach will probably be ruled out in favour of a more far-reaching system of a common consolidated tax base at EU level. While this latter approach would seem to go too far in limiting Member States' sovereignty in direct tax matters and desirable tax competition, it would not mean the end of harmful tax competition altogether. As it would take a few years before its final implementation (if this ever happens), Member States would in the meantime most probably continue to engage in (harmful) tax competition in the attempt to attract foreign investment and multinational companies. Moreover, the circumstance that this system would likely be optional for companies and certainly for Member States would mean that the issue of (harmful) tax competition would not disappear at all in terms of competition between the common tax code adopted by a group of Member States and the domestic tax codes of the other Member States (and of the same States as well). The above suggests that the need to counter harmful tax competition in the EU will still be crucial for several years ahead. The enlargement of the Union to up to 28 countries will probably exacerbate tax competition also among old and new Member States, which implies that a framework to prevent the proliferation of harmful tax measures will be needed more than ever, whether the one recommended here or any other appropriate one. In the end, this will have a fundamental impact on the far-reaching objective of the EU to become “the most competitive and dynamic knowledge-based economy in the world” within the next decade.