Overview of European Union and EU Tax Law

Fairfield University, Stamford CT

International Tax Program

July 13, 2010

European Union: What Is It?

- Not a confederation of countries.
- Not a federal State.
- It is a unique legal, economic and political partnership among 27 democratic European Countries, based on a series of Treaties.
- Members States:
  - 1952: Belgium, France, Germany, Italy, Luxembourg and the Netherlands
  - 1973: Denmark, Ireland, UK
  - 1981: Greece
  - 1986: Portugal and Spain
  - 1995: Austria, Finland and Sweden
  - 2004: Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia
  - 2007: Bulgaria and Romania
  - Candidates: Croatia, Macedonia and Turkey.

How Did We Get There: the EU Treaties

- Treaty of Paris (4/18/1951): established the ECSC;
- Treaties of Rome (3/25/1957): established the European Economic Community (EEC) and European Atomic Energy Community (EURATOM);
- Merger Treaty (8/4/1965), signed in Brussels: provided a single Commission and Council for the three European Communities;
- Single European Act (7/1/1987): provided for the adaptations required for the achievement of the single internal market;
- Maastricht Treaty (2/7/1992): changed the name of the EEC into European Community (EC), and provided for intergovernmental cooperation to the existing community system in such areas as defense, justice and home affairs, thereby creating a structure with three pillars which is political as well as economic and is know as the European Union (EU);
- Treaty of Amsterdam (10/2/1997): it consolidated and renumbered the EU and EC treaties;
- Treaty of Nice (2/26/2001): reformed the EC institutions to better deal with the enlargement to 25 member states;
- Treaty of Lisbon (12/13/2007): amended and reorganized the previous treaties in one single treaty and officially established the EU which succeeds to the EC. It entered into force on December 1, 2009.

Treaty of Lisbon

- Signed on December 13, 2007 and entered into force on December 1, 2009.
- Amended the Maastricht Treaty and the Treaty of Rome which has been renamed Treaty on the Functioning of the European Union ("TFEU").
- Most important changes include qualified majority voting in the Council, involvement of the European Parliament in the legislative process through the co-decision process jointly with the Council, and the creation of a long term President of the European Council and a High Representative of the Union for Foreign Affairs and Policy ("speaking with one voice").
- The Treaty of Lisbon also incorporated by reference into EU law the Union's Bill of Rights, known as the Charter of Fundamental Rights (which provides for certain fundamental political, social and economic rights of Citizens and residents of the EU).
- Pact of Stability requires Member States' budget deficit not to exceed 3 percent of GDP.

The Single Currency: Economic and Monetary Union (EMU)

- Sixteen EU member states that have adopted the euro as their sole legal currency: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.
- Monetary Policy of EMU is responsibility of European Central Bank (ECB).
- Eleven EU Members met the convergence criteria in 1998 and the euro was launched on 1/1/1999.
- Greece was admitted in 2001.
- Physical coins and notes were introduced on 1/1/2002.
- Slovenia was admitted on 1/1/2007.
- Cyprus and Malta joined on 1/1/2008.
- Slovakia joined on 1/1/2009.
- Total population of EMU: 329 million people.
- Eleven EU member states do not use the euro.
- The euro zone is represented politically by its finance ministers known collectively as the euro group and is presided over by a president.

EU Objectives and Achievements

- Freedom and single market for people, workers, businesses, services and capital.
- Peace, security and stability (biggest democracy in the world).
- Justice and rule of law (uniformity and integration of laws on commerce, economy and trade across EU, recognition and respect of human rights, no discrimination and respect of diversity).
- Economic prosperity (largest economy in the world with a GDP of 11.806 trillion euros; largest trading area in the world with imports of 2.282 trillion USD and exports of 1.925 trillion USD; public debt 73% of GDP with extended welfare state systems, unemployment 7.7% compared to 9.5% in the U.S.).
- Single currency, EURO (=1.2641 USD) governed by the ECB.
- Pact of stability mandating budget deficit not exceeding 3 percent of GDP.
- Member States relinquished their sovereignty on budget and monetary policy (no increase in public spending, no devaluation of national currency as means to sustain economic growth or overcome economic recessions).
- What about income tax sovereignty: income taxes do not belong to the EU.

The European Parliament

- It is the directly elected parliamentary institution of the EU and represents the people of the EU. Together with the Council of the EU it forms the by-cameral EU legislative branch. It includes 751 members, elected in the various member states under national electoral rules, who serve for a five year term. Member states are allocated seats based on population under a regressive proportionality system.
- Legislative power: the Parliament shares the legislative power with the Council in almost all areas, under the ordinary legislative procedure (previously referred to as "co-decision procedure") putting Parliament and Council on equal footing. In some special areas including justice and home affairs, budget and taxation and fiscal aspects of environmental policy Parliament and Council acts alone under the special legislative procedure. In the area of taxation the Council exercises legislative power.
- Control over EU budget: the Parliament with the Council approves the EU budget.
- Control of the executive: the President of the European Commission is appointed by the Council and approved by the Parliament. The members of the European Commission are appointed by the President of the Commission and approved by the Parliament (through parliamentary committee hearings under a procedure similar to the advice and consent of U.S. senate).

The Council of the EU

- The Council represents the EU Member States and is the second legislative branch of the EU.
- Its meetings are attended by one minister from each of the EU national governments (which minister attends depend on the subjects on the agenda). Each minister with his or her vote commits his or her own national government.
- Decisions are taken by vote, with number of votes allocated to each Member State on the basis of country's population but weighted in favor of countries with less population. In some areas, such as taxation, the Council decide by unanimous vote. On most issues however it acts by way of a qualified majority vote, which requires the approval of a majority of Member States (some time up to two thirds) and a minimum of 255 votes (equal to 73.9 percent of the total).
- Its responsibilities include:
  - Legislation: the Council passes EU laws jointly with the European Parliament on matters falling within EU jurisdiction;
  - Budget: the Council approves the EU budget jointly with the European Budget;
  - Coordination of economic policies of Member States;
  - Signature of international agreements;
  - Development of EU common foreign policy;
  - Coordination of cooperation between national courts and polices forces in criminal matters.

The European Commission

- The European Commission is the executive body of the EU. It is responsible for proposing EU legislation, implementing EU decisions, upholding the EU treaties and general day-to-day running of the Union.
- It operates as a cabinet of 27 commissioner chosen individually by the member States (one per Member State). The President and the commissioners are appointed by the Council and approved as a single body by the European Parliament.
- The Commission alone has legislative initiative in the EU, meaning that only the Commission can make formal proposals of legislation to the Council and the Parliament (legislative proposals do not originate in the legislative branch).
- The Commission's powers in proposing laws are centered on economic legislation needed to achieve the single internal market in the EU.
- The Commission is responsible to make sure that EU legislation, once passed, is implemented. More generally, the Commission has the duty and power to enforce EU law and EU treaties and it does so by starting "infringement procedures" and taking non fulfilling Member States to EU Court of Justice in a dispute for breach of EU law.

The European Court of Justice

- The European Court of Justice (ECJ) is the highest court in the EU on matters of EU law and is responsible for the correct interpretation and equal application EU law across EU Member States.
- It is composed of one judge for each Member State for a total of 27 judges appointed by Member States' governments holding office for a renewable term of six years. The are assisted by eight Advocate Generals who are responsible for presenting a legal opinion on cases assigned to them.
- The ECJ normally hears cases in panels of three, five or thirteen judges but may decide to sit in full in cases of exceptional importance. Decisions are those of the Court rather than individual judges and no minority, concurring or dissenting opinions are issued. The Court received 1,300 cases in 2008.
- The Court rules on cases that are brought under five different types of actions:
  - <u>Action for failure to fulfill obligation ("infringement procedures")</u>, under article 258 (former article 226) of the Treaty, brought by the European Commission when a Member State has failed to fulfill its obligations under EU law, by enacting and apply nationals laws that are in contrast with EU law.
  - <u>Action for annulment</u>, under article 263 (former article 230) of the Treaty, whereby the applicant seeks the annulment of an action (regulation, directive or decision) of a EU institution.

The European Court of Justice

- Action for failure to act, under article 265 (former article 232) of the Treaty, for the review of the legality of a failure to act on part of a EU institution;
- Action for compensation based on non contractual liability, under article 235 of the Treaty, for damages to citizens or legal entities caused by EU institutions or servants in the performance of their duties;
- References for preliminary ruling from a national court, under article 267 (former article 234) of the Treaty.

- Under the reference for a preliminary ruling, national courts refer a case to the ECJ in order to obtain from the ECJ the official interpretation or meaning of a provision of EU law that they applies to the case. In order to ensure the effective and uniform application and to prevent divergent interpretation of EU law, national courts may, and sometimes (in case of the highest court in the state) must refer the case to the ECJ.
- The ECJ issues a judgment or preliminary ruling which sets forth the official interpretation of the provision of EU that has been submitted to the Court, and its judgment is binding on the national court that referred the case and any other national courts hearing a similar case or ruling on similar facts or issues of law in the future.
- ECJ rulings have the same ranking as the EU law that they interpret and apply and have the force of binding precedents.

EU Law

- Primary source of EU law: EU Treaties.
- Secondary sources of EU law: regulations and directives.
- Regulations become law in all Member States and are effective when they come into force without the requirement of any implementing legislation and prevail over domestic conflicting domestic provisions.
- Directives are implemented into national laws by implementing legislation enacted by each Member States.
- Directives can be self executing when (a) the term for their implementation has elapsed, (b) their provisions are sufficiently specific and detailed, (c) they set forth rights or claims that can be pursued against national governments or administrative agencies.
- Recommendations and advice from Parliament have only advisory power.

The Fundamental Principles of EU Law

- General non discrimination principle: article 18 of TFEU (former article 12 of EC Treaty);
- Free movement and residence of EU citizens: article 21 of TFEU (former article 18 of EC Treaty);
- Free movement of workers: article 45 of TFEU (former article 39 of EC Treaty);
- Freedom of establishment: article 49 of TFEU (former article 43 of EC Treaty);
- Freedom to provide services: article 56 of TFEU (former article 49 of REC Treaty);
- Free movement of capital and payments: article 63 of TFEU (former article 56 of EC Treaty);
- Prohibition of staid aid: article 107 of TFEU (former article 87 of EC Treaty);
- Prohibition of restriction of free competition and abuse of dominant position: articles 101 and 102 of TFEU (former 81 and 82 of EC Treaty).
- Limited conferral of power to harmonize the direct tax rules of EU member states: article 114 of TFEU (former article 94 EC Treaty);
- Infringement procedures of the European Commission against member states: article 258 TFEU (former article 226 EC Treaty);
- Referral by national courts to the ECJ: article 267 of TFEU (from article 234 of EC Treaty).

EU Tax Law - Indirect Taxes

- The EU has jurisdiction on the harmonization of indirect taxes on transfer of goods and services.
- For the above purposes the EC enacted common VAT rules in a directive adopted in 1977.
- Article 90 of EC Treaty (now art. 100 of TFEU) prohibits a Member State to impose on the products of other Member States any internal taxation in excess of that imposed of similar domestic products or of such nature as to afford indirect production to such products.
- Article 91 of EC Treaty (now art. 111 of TFEU) prohibits the grant of indirect subsidies on the export of goods to other Member States in form of internal tax rebates exceeding the amount of internal taxes on such products.
- Article 93 of EC Treaty (now art. 113 of TFEU) grants the Council of the EU (acting unanimously on a proposal from the Commission and after consulting the European Parliament) the power to adopt provisions for the harmonization of legislation concerning excise duties, transfer taxes and other indirect taxes, to the extent that they are necessary to ensure the establishment and functioning of the internal market.

EU Tax Law - Direct Taxes

- Direct taxes do not fall within the jurisdiction of the EU.
- Article 94 of EC Treaty (now art. 115 of TFEU) provides that the "Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the <u>approximation</u> of such laws, regulations or administrative provisions of the Member States <u>as directly affect</u> the establishment or functioning of the internal market".
- Under the narrow authority of article 94 of EC Treaty the Council adopted the parent subsidiary directive and merger directive in 1990, and the interest and royalties directive and savings directive in 2003.

Parent-Subsidiary Directive

- Council Directive 90/435/EEC of July 23, 1990, as amended by Council Directive n. 2003/123/EC of December 22, 2003.
- It exempts from withholding tax the distributions of profits made by a subsidiary based in a EU Member States to its parent based in another EU Member State.
- For the purposes of the withholding tax exemption, the distributing company and the receiving company must be organized in a corporate form, be resident in a EU member State under the tax laws of that State, and be subject to a corporate income tax in their state of residence.
- Also, the receiving company must own at least 10 percent of the stock of the distributing company for one year as of the date of declaration of dividend.
- The exemption applies also to profit distributions made to a permanent establishment in a Member State of a company based in the same or another EU Member State.

Merger Directive

- Council Directive 90/434/EEC as amended by Council Directive 2005/19/EC.
- It applies to mergers, divisions (“spin offs”), contribution of assets, and exchange of shares (whereby a majority of voting rights is acquired) between companies of EU Member States (where no more than 10 percent of the consideration is boot).
- It defers the corporate level tax on gain from the transfer of assets ands liabilities in the merger, contribution or split off, provided that the transferred assets of the acquired company are effectively connected with a permanent establishment of the acquiring company in the Member State of the target or acquired company.
- It also provides for carryover of losses, provisions and reserves of the acquired company.
- Finally, it defers shareholder level tax on gain from the exchange of stock of the acquired company in the transaction.
- The acquiring company takes a carryover basis in the acquired assets.
- Equally, acquired company’s shareholders take a carryover basis in the acquiring company’s stock received in the transaction.

Merger Directive

- Council Directive 2005/19/EC amended the Merger Directive in the following respects:
  - It added new legal entities to to the original list of entities to which the Directive applies;
  - It extended the Merger Directive to a special division know as "split off", in which the distributing company, which does not dissolve but remains into existence, distributes part of its assets constituting one or more branches of activities to another company in exchange of shares of the receiving company that it immediately distributes up to its shareholders;
  - It introduced specific provisions granting relief in case of incorporation of branches into subsidiaries;
  - It provides for tax deferral in case of the transfer of registered office of the European company.

Interest and Royalty Directive

- Council Directive 2003/49/EC of June 3, 2003.
- It exempts from source based withholding tax the interest and royalty payments made by a company or a permanent establishment situated in a EU Member State, to a a beneficial owner who is a company of a EU Member State State or a permanent establishment situated in another Member State of a company of a Member State.
- For the above purposes, the paying company (or the company owning the paying PE) and the receiving company (or the company owning the receiving PE) must be associated companies, which means, one company owns at least 25 percent of the capital of the other or a third company (also based in a EU Member State) owns at least 25 percent of the capital of each of them.
- Also, paying and receiving companies must be comprised in the list of entities to which the directive apply, be resident in a Member State under internal tax laws of that State and be subject to a corporate income tax in their state of residence.
- The relief from withholding is subject to domestic anti fraud or abuse provisions.

Savings Directive

- Council Directive 2003/48/EC of June 3, 2003.
- It provides for an automatic exchange of information in respect of interest paid by a paying agent based in a Member State to a beneficial owner who is an individual resident in another Member State.
- On the basis of the automatic exchange of information, the source state does not apply any withholding tax and interest is taxable exclusively in the beneficial owner’s state of residence.
- During a transitional period and until the exchange of information system is duly implemented, Luxembourg, Austria and Belgium apply a back up withholding tax of 15 percent fort the first three years, 20 percent for the next three years, and 35 percent thereafter.

Mutual Assistance Directive

- Council Directive 77/799/EEC of December 19, 1977.
- Under this Directive, Member States' competent authorities are required to exchange any information which appears relevant for the correct assessment of taxes on income and on capital and the assessment of indirect taxes: value added tax; excise duty on alcohol and alcoholic beverages; excise duty on manufactured tobacco.
- Council Directive 2004/56/EC is designed to speed up the flow of information between Member States' tax authorities. On direct taxation (income tax, company tax and capital gains tax), in conjunction with taxes on insurance premiums, it permits the Member States to coordinate their investigative action against cross-border tax fraud and to carry out more procedures on behalf of each other.
- Council Directive 2010/24/EU of March 16, 2010 is a new directive adopted by the EU for mutual assistance for ther recovery of taxes. It replaces previous Council Directives 76/308/EEC and 2008/55/EC. At article 24(1) it provides that the directive "without prejudice to the fulfillment of any obligation to provide wider assistance ensuing from bilateral or multilateral agreements or arrangements."

EU Tax Arbitration Convention

- Convention 90/436/EEC also known as the EU Arbitration Convention establishes a procedure to resolve disputes where double taxation occurs between enterprises of different Member States as a result of an upward adjustment of profits of an enterprise of one Member State.
- Whilst most bilateral double taxation treaties include a provision for a corresponding downward adjustment of profits of the associated enterprise concerned, they do not impose a binding obligation on the Contracting States to eliminate the double taxation.The Convention provides for the elimination of double taxation by agreement between the contracting states including, if necessary, by reference to the opinion of an independent advisory body. The Convention thus improves the conditions for cross-border activities in the Internal Market.
- The Convention was in force from January 1, 1995 to December 31, 1999, reentered into force on November 1, 2004 with retroactive effect to January 1, 2000 and is subject to extension every five years.

ECJ Case Law (Direct Taxes)

- ECJ affirmed is power of judicial review on national tax legislation on direct taxes, to determine if it confirms to EU law (Commission v. France, C-270/83).
- ECJ tests the compatibility of national tax laws against the four freedoms of the EU Treaty: freedom of movement of workers, freedom of establishment, freedom of services and free movement of capitals.
- Direct investments that grant a “definite influence” over a company’s decisions and the ability to determine its activities fall under the freedom of establishment clause, which applies only within the EU.
- Portfolio investments are covered by the freedom of movement of capital clause, which applies also to third countries.
- ECJ applies a three prong test:
  - does the national tax law restrict a fundamental freedom?
  - Is the restriction justified by overriding principles of public interest?
  - Is the restriction proportional to its objective?
- ECJ decision have retroactive effects unless limited by the Court.

Cadbury Schweppes (C-196/04)

- Facts: Cadbury Schweppes PLC (Cadbury), a UK Company, indirectly owns 100 of the stock of two Irish finance subsidiaries, Cadbury Schweppes Treasury Services (CSTS) and Cadbury Schweppes Treasury International (CSTI).
- CSTS and CSTI provides financing to Cadbury and earn interest on inter-company loans. Interest income of CSTS and CSTI is subject to corporate income tax in Ireland at the tax rate of 10 percent.
- Since Irish corporate tax rate is significantly lower that UK corporate tax rate, CSTS and CSTI are subject to UK controlled foreign company (CFC) rules, pursuant to which their Irish profits are subject to tax currently upon the UK parent company in the UK. CFC losses are not allowed to offset UK parent's taxable income in the UK.
- In a comparable situation, the profits of a wholly owned UK subsidiary of a UK parent are not taxed currently upon its UK parent.
- Taxpayer claimed that UK CFC rules constitute an unlawful restriction of its freedom of establishment through the establishment and operation of a subsidiary in Ireland and are invalid since in violation of EU law.

Cadbury Schweppes (C-196/04)

- ECJ ruling issued on 9/12/2006.
- Does establishing a subsidiary in another EU Member State solely because of the more favorable tax regime that applies in that State constitute an abuse of the fundamental freedom of establishment granted by the EC Treaty? No, seeking to profit from tax advantages in another member state does not deprive taxpayer from the right to rely on EC Treaty.
- Do UK CFC rules constitute a restriction of freedom of establishment? Yes, because they put a UK parent with a EU subsidiary in a low tax Member State at a disadvantage over a UK parent with a subsidiary in the UK or another EU Member State with an equivalent level of tax.
- Is the restriction justified by overriding principles of public interest, that is, the need to contract tax evasion? Contrasting tax evasion or preventing tax abusive practices can justify a restriction, however the restrictive provisions must be proportional in relation to their goal.
- Is UK tax legislation aimed at avoiding tax fraud proportional? Maybe, if they apply only to "<u>wholly artificial arrangements</u> - without economic reality - whose purpose is <u>to circumvent or escape national tax</u>".

Marks and Spencer (C-446/03)

- Marks and Spencer is a UK based retailer operating outside of the UK through wholly owned subsidiaries established in various EU Member States.
- Its EU subsidiaries suffered huge losses that it wanted to import in the UK to offset UK taxable income from its UK operations.
- UK group relief allows consolidation or offset of profits and losses within resident companies in a domestic group, but do not allow import of losses from foreign subsidiaries.
- Taxpayer argued that UK group relief violates the EC treaty by creating an unlawful restriction to the freedom of establishment (through subsidiaries in other EU Member States).
- ECJ ruling issued on 12/13/2005.

Marks and Spencer (C-446/03)

- Is there a restriction on a fundamental freedom? Yes, group relief constitutes a tax advantage (offset of profits and losses), and the exclusion of such tax advantage in respect of the losses incurred by a subsidiary established in another Member State constitutes a restriction on freedom of establishment (UK parent with UK subs is advantaged over UK parent with EU subs).
- Is the restriction justified by an overriding principle of public interest, that is, the balanced allocation of taxing power and tax base, coherence of the tax system and avoidance of "double dip" (whereby a resident company is taxed on its worldwide income while a foreign subsidiary is only taxable on its UK source income and can use its losses in its own country of establishment). Yes, the proper allocation of taxing rights and need to prevent a double use of losses can justify a restriction on freedom of establishment.
- Is the restriction proportional to its goal? No, because denial of use of losses should be conditioned on losses not being deductible elsewhere, that is, on the subsidiary having exhausted all possible remedies as to the use of losses in its country of residence.

More On Tax Consolidation

- In *Societe Papillon* (C-418/07, ruling issued on 2/11/2008), the ECJ ruled that French tax consolidation rules that allow consolidation of French subsidiaries owned by a French parent not but not French subsidiary owned by a foreign parent not operating through a branch (permanent establishment) in France violate the EC treaty.
- The Court rejected the coherence of tax system justification on the ground of lack of proportionality, holding that there are less restrictive measures to prevent double use of losses or undue tax advantages, such as the exchange of information between tax administrations granted by Directive 77/799/CEE.
- In *X Holding* (C-337/08, ruling issued on), a Dutch parent wanted to be allowed to combine with its Belgian subsidiary to use the latter losses, which it would have been allowed to use had the latter been a branch (permanent establishment). The case resembles Mark & Spencer, except that the Dutch fiscal unit system, which ignores intra group transactions, is consolidation. The subsidiary could still use its losses in Belgium so the claim rests on a cash flow argument that the parent should be allowed to use the losses sooner in Holland. The AG filed an opinion concluding that the exclusion of foreign subsidiaries is justified by the balanced allocation of taxing powers, coherence of the tax system and need to protect the tax base.

More On Tax Consolidation

- The ECJ ruled in favor of the Member State and held that the restriction was justified under the coherence of tax system principle.
- The ECJ did not elaborate of the "exhaustion of all possible remedies" as to the use of losses in the subsidiary's state of residence.
- Any inconsistency with *Marks & Spencer*? *Societe Papillon*?

Conclusions

- The EU is a remarkable story and an amazing achievement.
- It puts a lot of political pressure on member states and additional progress towards a more political integration needs to be made.
- In the area of income taxes, the ECJ case law has had an unexpected and substantial impact on national tax laws.
- After an initial period in which the ECJ applied a very strict scrutiny and stroke down national tax laws on the ground of violation of the fundamental freedoms of EC treaty, the ECJ is now taking a more balanced approach, directed to safeguard Member States' sovereign powers and respect national laws' restrictions whenever needed to grant a balanced allocation of taxing powers, protect a member state's tax base and avoid tax evasion or fraud.

Contacts

New York Office
48 Wall Street, 11th Floor
New York, NY 10005
T. +1 212 918 4875
F. +1 212 918 4801

Italy Office
Corso Vercelli, 11
20144 Milan
T. +39 02 481 5751
F. +39 02 484 31721

E-mail address: mrossi@lawrossi.com
Web site: www.lawrossi.com
Blog: www.euitalianinternationaltax.com