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Corporate Income Taxes in the EU: An Economic Assessment of the Role of the ECJ

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Abstract

The aims of this paper are twofold. First, to review the implications for corporate income taxes in the EU of full compliance with Community law, in the light of the decisions of the European Court of Justice (ECJ). Second, to provide an economic assessment of actual and prospective changes to corporate income taxes in the EU that follow from the requirement to comply with Community law. In our view, this requirement is unlikely to result in either effective harmonization or abandonment of corporate income taxes in EU member states. Some of the more significant distortions to the efficient allocation of business activity and investment within the EU are likely to remain intact.

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1. Introduction

Corporate income taxes in the member countries of the European Union (EU) are in a state of flux. Initiatives aimed at greater coordination or harmonization have attracted limited political support and, to date at least, have had little impact. Member states continue to operate separate national corporate income taxes, each with their own tax rates and their own definitions of taxable profits, administered by their national tax authorities. Of more significance in recent years has been pressure to make these corporate income taxes compliant with Community law as enshrined in the articles of the EC Treaty.¹ Provisions of national tax systems have been subject to legal challenge, with rulings on the requirements of Community law being made by the European Court of Justice (ECJ).

It is unclear whether the governments of EU member states – certainly the 15 that comprised the EU prior to May 2004 – fully appreciated the implications for their direct tax systems of EU membership.² Under the EC Treaty, member states retain competence in matters of direct taxation. They also have the right of veto over any taxation proposals as such proposals require unanimous agreement in the Council of Ministers.³ However member states are obliged to implement their direct tax systems consistently with Community law.⁴ It is this seemingly innocuous requirement that has had profound implications for the operation of corporate income taxes within the EU.

The ECJ has dealt with over a hundred direct tax cases. In most of these it has ruled that the tax provisions challenged are contrary to Community law, either because they discriminate on grounds of nationality, or because they violate the freedoms enshrined in

¹ The term ‘European Union’ comes from the Maastricht Treaty on European Union of 1 November 93. The Treaty establishing the Community, however, is referred to as the EC Treaty.

² The fifteen members states prior to May 2004 comprised Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Portugal, Spain, Sweden, The Netherlands, the United Kingdom, The 10 accession states in May 2004 comprised Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Czech Republic, the Slovak Republic, Slovenia, Not within the EU but within the European Economic Area (and therefore similarly affected by the legal principles outlined in this paper) are Iceland, Norway and Liechtenstein.

³ Articles 94 and 95(2) EC Treaty.

⁴ Case C-279/93 *Finanzamt Köln-Altstadt v Roland Schumaker*, paragraph 21.

the EC treaty. One distinguished political scientist has described the ECJ as “the most effective supranational judicial body in the history of the world”.⁵

The ECJ is now a major influence on how corporate income taxes are implemented in the EU member states. In the UK, for example, compliance with EU law has been a significant factor in recent changes to group loss relief, transfer pricing rules, and the taxation of finance leases. Recent and pending cases may require further changes in areas such as dividend taxation, Controlled Foreign Company rules, and the credit system for relieving double taxation of profits earned abroad.

National governments within the EU are now in a responsive mode, reacting to decisions taken at the ECJ, and in some cases anticipating legal challenges to elements of their corporate income taxes. Discussion of reforms that could make national corporate taxes economically more efficient has largely been overtaken by the need to make these taxes consistent with Community law.

This paper has two main aims. The first is to review the implications for corporate income taxes in the EU of full compliance with EC treaty articles, in the light of recent case law at the ECJ. There is no reason to believe that compliance with Community law will produce effective harmonization of EU corporate income taxes, with a single level playing field in the application of corporate tax rules across all 25 EU countries. Nor do we believe that compliance with EC treaty obligations will make it impossible or prohibitively expensive for national governments to raise significant tax revenues from their corporate income taxes. The likely outcome will be a patchwork of 25 not necessarily completely level playing fields in the 25 member states, with differences in their heights principally due to different national tax rates, and uneven surfaces within countries stemming from interactions between the tax rules applied by different countries.

Our second aim is to provide an economic assessment of the actual and prospective changes to corporate income taxes in the EU that follow from the need to comply with Community law. We do this in two parts, first looking at the big picture, and then

⁵ Alec Stone Sweet, *The Judicial Construction of Europe* (2004).

focusing on some specific areas where reforms have been required. In our view, some of the more significant distortions to the efficient allocation of business activity within the EU are likely to remain intact at the end of this process. Investment will continue to be attracted to countries with low corporate tax rates, even if production would be more efficient elsewhere. In some areas, such as the application of transfer pricing rules, insistence on non-discrimination has led to an increase in administrative costs and compliance burdens.

Advocates of more extreme positions, such as complete harmonization of corporate taxation within the EU, or big reductions in corporate tax rates, seem likely to be disappointed by the outcome of this legal process. National corporate income taxes in the EU countries will certainly be different when they are fully compliant with Community law, but it is not clear that they will be significantly improved from the perspective of the EU single market. The legal pressure that is currently driving changes to corporate income taxes within the EU is a poor substitute for serious political debate at the EU level on corporate tax reform.

The ECJ has created its own form of pressure for change in national corporate income tax systems. Its pressure, however, is directed towards the adoption of single market solutions at a national level. As such the ECJ does not represent pressure for either more uniform corporate income tax treatments across the EU, or for lower corporate tax rates. It is the increased mobility of capital and business activities, not the ECJ, that are proving to be the powerful long-term pressures for more uniform corporate income tax treatments within the EU and for lower corporate tax rates.

2. Legal Background

The EC Treaty is silent on the subject of direct taxes.⁶ Member states retain their sovereignty over direct taxation, allowing them to determine their own tax rules and tax

⁶ Article 293, second indent, requires the abolition of double taxation within the Community but this requires the agreement of member states and is not directly enforceable by the Commission or Community nationals, Case C-336/96 *Gilly v Directeur des Services Fiscaux du Bas-Rhin*.

rates. Such Community measures as there are on corporate taxation – the Merger Directive and the Parent Subsidiary Directives on cross-border dividends, interest and royalties⁷ – have taken effect under the EC Treaty provisions for the approximation of laws affecting the establishment or functioning of the common market.⁸ As unanimous agreement is required in the Council of Ministers to carry any EU tax measures, each member state retains an effective right of veto on the adoption of income tax measures that would apply across the EU.⁹

Member states, however, may only exercise their competence over direct taxation in accordance with Community law. The EC Treaty enshrines ‘four freedoms’: the free movement of goods, persons, services and capital between EU countries.¹⁰ The freedom of movement of persons includes the right for business entities from one member state to establish themselves in the territory of another and conduct business there. The EC Treaty also prohibits discrimination within the EU on grounds of nationality,¹¹ and the use of state aids, which may prevent member states using their tax systems to deliver specific incentives.¹²

⁷ The Arbitration Convention on transfer pricing disputes is a separate convention agreed by the member states and is not Community legislation.

⁸ Article 94 EC Treaty.

⁹ Article 96 allows the adoption by qualified majority voting of measures to eliminate distortions in competition within the common market. To date, this has not been regarded as providing a legal basis for the adoption of direct tax measures. The Treaty of Nice, however, includes an enhanced co-operation procedure that allows a minimum number of member states (currently 9) to adopt measures within their territories where the measures cannot otherwise be agreed by the 25 member states. The Commission has suggested that this procedure might be used if the 25 member states cannot all agree on the adoption of a common consolidated corporate tax base.

¹⁰ Article 56 of the EC Treaty prohibiting any restrictions on the free movement of capital and payments also extends to movements of capital and payments between member states and third countries. Article 18 enshrines the right of every EU citizen to move and reside freely within the EU. This may be relevant to the imposition of direct taxes that have the effect of restricting the movement of individuals who are not otherwise seeking to exercise their economic freedoms to work, establish, provide services or invest within the EU, see Case C-470/04 *N v Inspecteur van de Belastingdienst Oost/Kantoor Almelo*.

¹¹ The basic non-discrimination principle is found in Article 12 EC Treaty. The prohibition of discrimination on grounds of nationality is incorporated into the relevant Treaty articles dealing with the free movement of goods, persons, services and capital, which therefore provide the basis for enforcing both the non-discrimination and market access principles of Community law against member states.

¹² Articles 87 to 89 EC Treaty. The state aid provisions form part of the Community’s competition rules. The EC Treaty grants the EU Commission specific powers to enforce the state aid provisions of the Treaty against member states.

Both national courts and the European Commission can refer cases to the ECJ to test the compatibility of national rules with Community law. With no progress in the Council of Ministers to resolve the direct tax issues of a common market, the last decade has seen a proliferation of legal challenges by taxpayers to important elements of national corporate income taxes. This period of judicial activism has identified the need for major changes to national direct tax systems, both in the way they treat non-resident taxpayers and in the taxation of resident taxpayers in respect of their cross-border transactions.

The ECJ case law enshrines two key principles – the non-discrimination principle and the market access principle – which the Court has applied to determine whether particular tax provisions are contrary to Community law.¹³

The non-discrimination principle requires that tax measures imposed by one EU country should not discriminate against nationals of another member state. In the corporate tax field, this primarily affects how firms from different countries are taxed within a national market. For example, UK corporation tax rules may not treat a UK branch or subsidiary of a French company less favourably than a UK subsidiary of a UK company.

The market access principle requires that tax measures imposed by one country should not act as barriers to the exercise by Community nationals of the freedoms guaranteed by the EC Treaty, i.e. the free movement of goods, persons, services and capital and the freedom to establish business activities and subsidiary companies anywhere within the EU. In the corporate tax field, this primarily affects how firms resident in one country but operating in other member states are taxed by their home country. For example, UK corporation tax rules may not treat a UK firm contemplating establishment or investment in France less favourably than if it establishes or invests in the UK.

Tax measures that violate these principles will be struck down by the Court and may not be enforced.¹⁴ A government may, however, be able to justify the adoption of particular

¹³ See Gammie (2003, 2004) for a more detailed analysis. The principles are of general application and are not specific to the direct tax field.

¹⁴ Tax collected in breach of Community law may have to be repaid and a member state may also be liable in damages for the breach.

measures and avoid these consequences in certain circumstances. One defence is that a particular measure is required to maintain the ‘cohesion’ or integrity of the country’s tax system as a whole, and constitutes a ‘proportionate’ response to problems that would arise if it was not present.¹⁵ Another possibility is that the measure is required to prevent a serious risk of tax evasion or tax avoidance.¹⁶

An important limitation on the scope of these legal requirements is that they apply only to the tax rules imposed by one member state. There is no breach of Community law, for example, if the rules of one member state (State A) impede establishment or investment by its nationals in another member state (State B) because State A’s rules are less favourable than State B’s rules. What matters is that from State A’s perspective, State A’s rules should treat establishment or investment in State A equally with establishment or investment in State B. Furthermore, Community law does not necessarily guarantee that two firms from different countries operating in the same national market will face the same overall tax treatment. This is because the differences may result from the interaction of the two national tax systems and may not be a fault of either system when viewed from its perspective alone. This point has been emphasised in recent Opinions of Advocate General Geelhoed.¹⁷

For example, a UK firm investing in Ireland may face a higher overall tax rate than a domestic Irish firm. This is because Community law does not prevent different member states choosing different corporate tax rates and different tax bases, so long as each

¹⁵ Case C-204/90 *Hanns-Martin Bachmann v Belgian State*. The ‘cohesion’ justification, however, is limited to cases where, in the light of the objectives pursued by the tax legislation in question, a government can show that there is a direct link, for the same taxpayer in relation to the same tax, between a tax advantage he receives and the offsetting of that tax advantage, see Case C-319/02 *Petri Manninen*, paragraphs 40 to 43. In other words, given the existence of some cross-border aspect to the situation, the different tax treatment accorded a taxpayer in that situation must be a different way of achieving the same result consistent with the legislation’s objectives from that usually adopted where no cross-border aspect is involved.

¹⁶ Case 446/03 *Marks & Spencer plc v Halsey*, paragraph 57. Tax avoidance measures designed to protect the national tax base are rarely justified, however, because tax avoidance cannot usually be inferred from the exercise of a Community freedom and the ECJ does not accept the diminution of national tax revenues as justification for a breach of Community law, Case C-9/02 *Hughes de Lasteyrie du Saillant v Ministère de l’Économie, des Finances et de l’Industrie*, paragraph 60.

¹⁷ Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation (Pirelli, Essilor, Sony and BMW) v Inland Revenue Commissioners*; Case C-446/04 *Test Claimants in the FII Group Litigation v Inland Revenue Commissioners*; Case C-513/04 *Mark Kerckhaert and Bernadette Morres v Belgian State*.

country's corporate income tax does not discriminate on the basis of nationality or impede the exercise of Treaty freedoms.¹⁸ Thus, the UK maintains a worldwide basis of taxation and therefore taxes the profits of any establishment that a UK firm maintains in Ireland or any dividend income that a UK parent company receives from its Irish subsidiary, subject in either case to credit for the Irish corporation tax paid. Because the UK tax rate is higher than the Irish tax rate, there will be a UK corporation tax charge on any branch profits or if the Irish subsidiary's profits are repatriated in the form of dividends.¹⁹

There is no discrimination in Ireland, because the Irish establishment or subsidiary of the UK firm pays the same corporate tax rate in Ireland as other firms operating there. And the UK does not violate the market access principle just by choosing to maintain a worldwide basis of taxation with credit for foreign taxes.²⁰ The higher tax burden that arises for a British-owned firm operating in Ireland as compared to an Irish-owned firm results from the interaction of the UK and Irish corporate taxes and not necessarily from any fault of the UK or Irish tax systems.

Similarly, a UK firm investing in Ireland may face a higher overall tax rate than a German firm investing in Ireland. This can arise because the German corporation tax adopts a territorial tax base, and exempts dividend income received by the German parent company from its foreign subsidiary. Again this difference in treatment arises from different interactions between national tax systems.

¹⁸ It should also be noted that there is no proposal under any of the Commission's tax initiatives to establish a common EU corporate tax rate or range of corporate tax rates.

¹⁹ Under the UK's CFC rules, the UK may seek to impose its corporate tax rate on Irish profits irrespective of repatriation. Whether in doing so the UK is in breach of Community law is being tested in Case C-196/04 *Cadbury Schweppes plc v Inland Revenue Commissioners*, in which the Advocate General's Opinion is due on 2 May 2006.

²⁰ The taxation of foreign income under a worldwide basis of taxation may well, however, represent a market access breach if, as a result of that taxation, foreign establishment or investment is treated less favourably than domestic establishment and investment, see Case 446/03 *Marks & Spencer plc v Halsey* and Case C-446/04 *Test Claimants in the FII Group Litigation v Inland Revenue Commissioners*.

3. Economic Background

In the absence of compelling reasons for wanting to distort patterns of international investment, economic efficiency is usually associated with the absence of tax distortions to international investment decisions. For a bloc of countries like the EU, this presupposes that the objective of the bloc's tax policy is to achieve the highest level of welfare for the group as a whole. For any single country, tax measures that divert capital and/or taxable profits from other members of the group may achieve a better outcome for that country. We first simplify by focusing on the location and ownership of capital within the EU, abstracting from the total level of investment in the EU as a whole, and on issues affecting inward and outward investment between the EU and the rest of the world. We also focus on the effects of corporate income taxes, abstracting from the taxation of dividend income and capital gains at the shareholder level.

In this context, two important concepts are capital export neutrality (CEN) and capital import neutrality (CIN).

Capital export neutrality requires the same tax treatment for domestic investment and outbound foreign investment. If, for example, outward investment was taxed more favourably than domestic investment, domestic firms would tend to choose relatively more foreign investment and relatively less domestic investment than they would have chosen in the absence of tax.

Capital import neutrality requires the same tax treatment for domestic investment and inbound foreign investment. If, for example, domestic investment was taxed more favourably than inward investment, a higher share of domestic assets would tend to be owned by domestic firms, and a lower share would tend to be owned by foreign firms, than would be the case in the absence of tax.

Taxes will thus distort patterns of international investment unless both capital export neutrality and capital import neutrality hold. These distortions may affect both the location of capital - for example, how much investment occurs in Ireland and how much

occurs in the UK - and the ownership of capital - for example, how much investment is done by Dutch firms and how much is done by German firms. In the absence of clear reasons why too little investment would otherwise be located in Ireland, or too little investment would otherwise be undertaken by Dutch firms, minimising such tax distortions would increase economic efficiency (for the EU as a whole).

An important point about these definitions is that, for cross-border investments, the tax treatment that matters for investors is the overall tax treatment, combining taxation in the country where the assets are located (the source country) and taxation in the home country of the investor (the residence country). Investing firms are likely to care much more about the total level of tax they pay than about the identity of the revenue authorities they pay this tax to. Similarly, protection from discrimination in either the source country's tax system or in the residence country's tax system will be insufficient to achieve neutrality in relation to international investment decisions, if different tax rates prevail in different locations or if different effective tax rates arise from interactions between different national taxes.

Given that there are different corporate tax rates in different EU countries, capital export neutrality within the EU would require all countries to adopt a system of pure residence-based taxation. In such a system, a UK firm that invests in France would not be taxed in France, and would only be taxed in the UK. Adopted by all countries, this would ensure that domestic investment and outbound foreign investment always face the same tax treatment. Proposals for Home State Taxation (HST) have something in common with residence-based taxation, in that the tax base would be calculated according to the tax rules of the residence country.²¹ Pure residence-based taxation would tax this base at the home country's tax rate and collect the tax through the home country's tax authority.²² HST could operate on this basis but the specific proposal divides the tax base between residence and source countries under an agreed formula and allows each to tax its share at its own tax rate. In either case, however, different firms operating in France would be

²¹ See Lodin and Gammie (2001) and Commission Recommendation December 2005.

²² The tax revenues so collected could always be shared between the different member states in which the firm operated.

subject to different tax treatments, depending on their ownership. Furthermore, standard international tax rules in fact give the primary taxing right to the source country, not the residence country.

In contrast, achieving capital import neutrality within the EU would require all countries to adopt a system of pure source-based taxation. In this case, a UK firm investing in France would not be taxed in the UK, and would only be taxed in France. This is certainly closer to current practice, and could be achieved if all countries were to adopt a territorial tax base, exempting foreign-source income. This would ensure that domestic investment and inbound foreign investment always face the same tax treatment. However UK firms operating in different EU countries would be subject to different tax treatments, depending on the location of activities.

Achieving both capital export neutrality and capital import neutrality within the EU - or avoiding tax distortions to both location and ownership of capital - would essentially require both a common tax rate and a common tax base, as well as common rules for the administration and enforcement of corporate taxes. This would certainly require a much greater level of cooperation between the member states on corporate taxation than we have seen to date. In practice, this could probably only be achieved by a single, EU-level corporate income tax, or by agreement to abandon corporate income taxes in each member state.

We should note, however, that this standard of tax neutrality is not met in many countries that are regarded as large single markets. Focusing solely on corporate income tax, both capital import neutrality and capital export neutrality are achieved within the four countries of the United Kingdom (i.e. England, Scotland, Wales and Northern Ireland). This is not the case within the USA, where variation in state level corporate taxes favours the location of investment and the legal residence of firms in particular states. Nor is it the case within member states of the EU, such as Germany, which have different corporate tax rates at state or local level.

Whether the EU countries should tax corporate profits at all, and if so, at what rate, raises different issues on which we do not take a stand here. In theory, source-based corporate income taxes can be shown to be inefficient in a ‘small open economy’ with ‘perfect capital mobility’. A ‘small open economy’ is one whose production or consumption of goods and services are too small to have any effect on prevailing world prices. With ‘perfect capital mobility’, this country’s levels of saving and investment are also too small to have any effect on the prevailing world interest rate. With suitable adjustments for risk, this world interest rate is the required rate of return for all investment projects.

Under these conditions, a source-based corporate income tax which lowers the post-tax return on investments located in that economy will result in lower investment; only investment projects with high enough pre-tax returns to pay the required world rate of return on a post-tax basis will continue to be attractive to investors. This in turn results in less capital per worker, lower labour productivity, and lower real wages. Owners of capital, on the other hand, continue to earn the prevailing world rate of return. But if the source-based corporate income tax is borne entirely by workers, through lower real wages, and not at all by owners of capital,²³ the same revenue could be raised more efficiently by taxing labour income directly. This would avoid the distortion to investment decisions and the capital-labour ratio in the economy that results from taxing corporate income.

The relevance of this ‘small open economy’ argument for the abolition of source-based corporate income taxes in individual EU countries is open to debate. As an empirical matter, corporate tax rates have tended to fall over time, as economies have become more integrated, and smaller countries tend to have lower corporate tax rates than larger countries.²⁴ But all EU countries have positive corporate tax rates, at least on distributed profits.²⁵

²³ In this case, the ‘effective incidence’ of the source-based tax on capital income is said to be shifted fully from owners of (perfectly mobile) capital onto (relatively immobile) domestic workers.

²⁴ See Devereux (2006).

²⁵ Estonia has a zero rate on retained profits.

This argument would certainly be less relevant for the EU as a whole, if coordination of corporate income taxes across the EU were ever achieved. But what the optimal tax rate on corporate income would be for a bloc the size of the EU is far less clear. Many economists have suggested that corporate income should not be taxed even in a closed economy setting;²⁶ this view is implicit in arguments for taxing consumption rather than income.

We make no attempt to resolve these questions here. Rather we assess the impact of EU law on corporate income taxes both from the perspective of an observer who favours harmonization of corporate taxes within the EU, at a positive tax rate; and from the perspective of an observer who favours the abolition of corporate income taxes. This choice merely serves to provide us with an organizing framework, and should not be taken to imply that we endorse either of these positions.

4. Requirements of EU Law

In our view, there is no reason to believe that compliance with Community law will produce effective harmonization of corporate taxes, with a single level playing field across all 25 EU countries. That could only be achieved with the agreement of all member states. This is consistent with a negative integrationist view of the ECJ's role in enforcing Community law and reflects the separation of legislative and judicial powers within the EU. In other words, the ECJ can only give effect to the Treaty freedoms by striking down rules that are an obstacle to the creation of a single market. The ECJ cannot dictate what changes member states should make to their tax systems or provide the legal content of a Community regime establishing a single market. There is no reason to believe, however, that this negative integrationist view or the 'destructive' nature of the ECJ's role will make it impossible or prohibitively expensive for national governments to raise significant tax revenues from their corporate taxes.

²⁶ At least, not using conventional corporate income taxes.

To illustrate this, we first consider a territorial system of corporate taxes in which each member state taxes only the profits earned within its jurisdiction, exempting profits of foreign establishments and dividend income received by resident firms from subsidiaries in other countries. Community law prohibits discrimination within national markets. The UK government could not impose a higher corporate tax rate on a French firm operating in the UK than it charges a comparable UK firm. Other tax measures which covertly favour domestic firms are also inconsistent with Community law. This would then produce a level playing field within each country.

But national governments retain competence to determine their own tax rules and tax rates, subject to compliance with Community law. Each member state may therefore define corporate profits differently and, most obviously, countries such as Ireland can choose low corporate tax rates, provided the low tax rate is applied to all comparable firms operating in Ireland. Other countries are free to impose much higher corporate tax rates. Similarly governments may choose to offer more generous or less generous depreciation allowances and other tax incentives, for example for R&D, provided these are available to both domestic and foreign firms and comply with EU state aid rules.

The effect, then, would be to produce not a single level playing field of tax treatments across the EU, but rather a patchwork of 25 level playing fields, each at different heights and of different sizes, depending on the tax base and tax rate applied within the national market.

We believe that it would be possible to design a corporate tax system with these characteristics that would be fully consistent with the requirements of Community law.²⁷ The system could be expected to satisfy the requirements of capital import neutrality,

²⁷ It is apparent, however, that a tax system is not automatically compliant with Community law just because it taxes only on a territorial basis. This is because Community law does not allow a member state to draw a line between its domestic and foreign tax treatment solely by reference to whether or not it chooses to tax the activity. Within a single market that allows each state competence to tax, each state must respect the tax choices of other member states and give effect to them in a manner that is consistent with the objectives of its own tax system, see Case C-141/99 *Algemene Maatschappij voor Investering en Dienstverlening NV v Belgian State*; Case C-168/01 *Bosal Holding v Staatssecretaris van Financiën*; Case C-319/02 *Petri Manninen*; Case 446/03 *Marks & Spencer plc v Halsey* and Case C-471/04 *Finanzamt Offenbach am Main-Land v Keller Holding GmbH*.

since all countries adopt the exemption system and there can be no discrimination within national markets. It would not satisfy capital export neutrality. Firms investing in member states with low corporate tax rates would be taxed more favourably than firms investing in member states with high corporate tax rates, and firms resident in high tax countries could clearly obtain a more favourable treatment by investing abroad than by investing at home. Different definitions of taxable profits - for example, more or less generous depreciation allowances or R&D tax credits - would also continue to influence investment and location decisions.

Effective harmonization is thus not required for EU corporate taxes to comply with Community law. Subject to some concerns about enforcement that we discuss in section 6 below, it is likely that significant tax revenues could be raised using a system of this kind, without excessive compliance or administrative costs.

Moreover, as noted in section 2, Community law does not require that two participants in a domestic market should face equal tax burdens, so long as any differences result only from the interactions of different national corporate taxes. For example, the EU Parent-Subsidiary Directive²⁸ allows the credit method, as well as the exemption method, to be used to relieve cross-border double taxation of dividend income received by a parent company from a subsidiary that has paid corporate tax on the underlying profits in another member state.²⁹ Thus profits earned by an Irish subsidiary of a UK company may face a higher overall tax rate than profits earned by a domestic Irish firm, or by an Irish subsidiary of a German company. This does not result from the Irish government taxing the UK firm at a higher rate. Nor does it result from the UK government taxing Irish-source income at a higher rate than UK-source income. It results only from the interaction between the two taxes.

²⁸ Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (90/435/EEC).

²⁹ The legality of the credit method used in the UK is subject to challenge in the Case C-446/04 *Test Claimants in the FII Group Litigation v Inland Revenue Commissioners*. The Opinion of the Advocate General, delivered on 6 April 2006, suggests that the credit method is in principle consistent with EU law, although the particular way it is implemented in the UK may not be. The Court is not bound to follow this Opinion when it decides this case in due course.

The credit system chosen by the UK may place UK firms investing in Ireland at a disadvantage compared to firms investing in Ireland from countries that choose the exemption system, or compared to domestic Irish firms. If the principle of the credit method is held to be consistent with Community law, the implication is then that compliance with Community law does not even require playing fields to be entirely level within national markets. Some departures from capital import neutrality are permitted, provided these result from interactions between the tax rules applied by different countries, and not from discrimination within the tax rules of a single member state.

5. Economic Assessment I: The Big Picture

The ECJ has had a significant influence on developments in EU corporate taxes over the last decade, and this process is ongoing. It has forced member states to eliminate the discriminatory elements of their domestic tax rules by extending the benefit of those rules to non-resident as well as resident taxpayers. It has also affected particularly the taxation of cross-border flows of dividends, either between affiliated firms or between firms and their shareholders, and cross-border transactions between affiliated firms.

Ten years ago, the impact of the ECJ on the UK corporation tax had been minimal. Since then, there have been major changes to the imputation system (dividend tax credits) and the abolition of advance corporation tax (ACT). While these may not have been prompted by the need to comply with Community law, they were certainly required in order to do so. More obviously, recent changes to group loss relief, foreign tax credit rules, transfer pricing and thin capitalisation rules, and the taxation of finance leases, have been implemented to comply with Community law. Recent and pending cases suggest that further changes may be required to dividend taxation, Controlled Foreign Company rules, and the operation of the credit system.

Corporate taxes in EU countries have thus changed in significant ways to comply with the EC Treaty. However there is no clear trend, either towards more effective harmonization, or towards the abolition of corporate income taxes. As explained in the

previous section, we see no compelling reasons why either of these outcomes will be needed for corporate taxes in the EU to be fully consistent with Community law.

Observers who favour either complete harmonization or complete abolition of corporate income taxes are likely to be disappointed by the outcome of this legal process. More generally, we would contend that full compliance with Compliance law is likely to leave intact some of the most significant and costly distortions to the efficient allocation of business activity within the EU. Investment will continue to be attracted to countries with low corporate tax rates, even if production would be more efficient elsewhere. Firms operating in several EU countries will still seek to structure their operations in tax-efficient ways, and seek creative means of shifting taxable profits into jurisdictions with low tax rates. For inward investors into the EU, corporate taxation will still influence where they locate their European headquarters, as well as their R&D and investment activities.

Primarily as a result of differences between countries in their corporate tax rates, there continue to be substantial departures from capital export neutrality within the EU, and therefore significant tax distortions to the location of new investment and other business activities. In the absence of some agreement between countries to reduce these differences in corporate tax rates, these distortions are likely to remain.

At this macro level, it is difficult to discern any great improvement stemming from the volume of litigation at the ECJ. In the next section we consider whether a more favourable verdict can be reached on particular developments in the areas of EU corporate taxes that have been most affected by the pressure to comply with Community law.

6. Economic Assessment II: Specific Changes

In this section we focus on four areas where the ECJ has been, or is likely to be, influential:

- Integration of personal and corporate income taxes
- Transfer pricing and thin capitalisation
- Source or residence-based corporate taxation
- Credit or exemption systems of double tax relief

Integration of personal and corporate income taxes

Countries may choose a classical system of dividend taxation, under which dividends are subject to personal taxation at ordinary income tax rates without regard to any corporate tax on the profits out of which dividends are paid. Historically, however, most EU member states have sought to integrate personal and corporate income taxes by making some allowance at the personal level for corporate tax paid. In particular, imputation systems of dividend taxation have provided a credit for corporate tax on profits against the personal tax on dividends.

The basic design of imputation systems tend to be discriminatory in two particular respects:

- dividend tax credits are not usually given for foreign corporate income taxes, and
- dividend tax credits are not usually given to foreign shareholders.

Furthermore, under an imputation system, such as that in the UK between 1973 and 1999, in which a shareholder may be entitled to be repaid the tax credit, the company may have to pre-pay tax – a précompte – on paying a dividend. As a result firms with insufficient domestic taxable income may have to pay additional tax (e.g. surplus ACT) in distributing foreign profits.

In a series of cases, the ECJ has held that imputation systems impede cross-border establishment and investment and as a result infringe Community law.³⁰ In particular, it

³⁰ Cases C-397/98 and C-410/98 *Metallgesellschaft Ltd, Hoechst AG, Hoechst UK Ltd v Inland Revenue Commissioners*; Case C-319/02 *Petri Manninen*; Case C-374/04 *Test Claimants in Class IV of the ACT*

has now made clear that if a country provides resident shareholder with a tax credit on domestic dividends to recognise the corporation tax paid by its domestic firms, it must provide a tax credit on dividends paid by foreign companies to resident shareholders.³¹ This is even though the credit represents corporate tax paid to the Treasury of another member state.

In various other respects, domestic dividend taxation rules have been found to breach Community law; for example, the grant of a personal exemption for domestic dividends but not foreign dividends; the taxation of domestic dividends at a favourable rate as compared to foreign dividends, and subjecting share repurchases of resident shareholders to capital gains taxation while taxing the repurchase proceeds as a dividend in the case of non-residents shareholders.³²

Unsurprisingly, this case law has generated significant changes in dividend taxation systems.³³ Ireland has replaced its Imputation system with a classical system and Germany, France, Italy and the UK have replaced their imputation systems with forms of (partial) exclusion (from personal income tax). In Ireland, Germany and the UK, higher personal taxation of dividend income has been explicitly linked to reductions in corporate income tax rates.

From an economic perspective, in closed economies, dividend taxation is likely to raise the cost of capital for investment financed by new equity. As a result dividend taxation favours the use of retained earnings over new equity finance. Consequently, dividend taxation may be relatively unimportant to the investment decisions of mature firms, which will have the retained profits to finance new investment. It will be more important for the investment decisions of high growth firms and start-ups who must rely on new equity finance. The position may be further complicated by the manner in which capital gains are taxed on share disposals.

Group Litigation v Inland Revenue Commissioners; Case C-466/04 *Test Claimants in the FII Group Litigation v Inland Revenue Commissioners*; Case C-292/04 *W Meilicke v FA Bonn-Innenstadt*.

³¹ Case C-319/02 *Petri Manninen*.

³² Case C-35/98 *Staatssecretaris van Financiën v Verkkoijen*; Case C-315/02 *Anneliese Lenz v Finanzlandesdirektion für Tirol*; Case C-265/04 *Margaretha Bouanich v Skatteverket*.

³³ See also the EU Commission's Communication on portfolio dividend taxation of December 2004.

In small open economies with perfect capital mobility, the link between dividend taxation and investment and financial decisions is much weaker. As we have previously noted, such economies are likely to have a small effect on the required rate of return for investment projects. The differential taxation of dividends and capital gains may nevertheless affect the company's choices as to how to finance its investments as compared to the overall level of investment it makes. Stock market valuations of corporate dividends, however, are likely to be insensitive to dividend taxes paid by domestic shareholders where shares are widely held.

As economies become more open and more integrated, the case for relieving double taxation of dividend income (e.g. by imputation) becomes weaker.³⁴ In this respect, dividend taxes have always tended to work on a classical basis cross-border, this being the corollary of the fact that residence countries have taxed foreign dividends with credit only for any dividend withholding taxes imposed by the source country and without credit for the foreign corporate tax on profits. The adoption of the classical system for domestic dividends, or the use of exemption or partial exclusion systems (which similarly take no explicit account of any corporate tax paid on profits), as a response to the issues raised by imputation systems, may therefore be seen as consistent with the increased openness of financial markets and the integrated of businesses within the EU.

To the extent that what Community law requires, and what the ECJ therefore demands, is that governments should accord domestic and foreign dividends equal tax treatment – in other words subjecting domestic and foreign dividends to the same effective tax burdens (subject only to the issue of any unrelieved double taxation) – Community law may be regarded as consistent with desirable economic objectives. What Community law cannot achieve, however, is to secure that the different ways of financing investment – debt and equity (in the form of new issues and retained profits) – are equally treated.

³⁴ Boadway-Bruce, 1992; Devereux-Freeman, 1994; Fuest-Huber, 2000.

Transfer pricing and thin capitalisation

The tax advantages of shifting taxable profits from high tax rate to low tax rate jurisdictions using transfer pricing or thin capitalisation are generally relevant only in a cross-border context.³⁵ Member states have therefore usually confined traditional transfer pricing anti-avoidance rules to cross-border transactions.

This approach is consistent with the international tax norms represented by Article 9 of the OECD's model tax convention and its transfer pricing guidelines for multi-national enterprises. The proper application of transfer pricing and thin capitalisation rules can also be seen to represent the basis upon which, internationally, countries agree to share the corporate tax base between different taxing jurisdictions. Community law allows member states to allocate taxing competence amongst themselves in accordance with the principles established by the OECD model tax treaty.³⁶ The proper allocation of the tax base may be seen as an adjunct to the allocation of taxing rights and therefore the restriction of transfer pricing rules to cross-border situations is arguably not a breach of Community law.

The ECJ, however, has not shared this view. Once a member state has asserted its right to tax it can only do so on a basis consistent with Community law. As transfer pricing and thin capitalisation rules result in cross-border transactions being taxed less favourably than the equivalent domestic transactions, those rules have been regarded as a *prima facie* breach of Community law which must be justified in terms of the objective pursued by the legislation in question and its appropriateness in achieving that objective. In a number of decisions, the ECJ has not accepted the grounds that member states have advanced to

³⁵ In a domestic context, there may be advantages to shifting profits between loss-making (zero CT rate) and profitable (positive CT rate) companies where relief for the loss is otherwise unavailable. In an international context, however, the transfer of profits by generating tax deductible payments (or higher payments) in a high tax jurisdiction in favour of a low tax jurisdiction may represent the straightforward shifting of part of the former jurisdiction's tax base to the latter.

³⁶ Case C-336/96 *Gilly v Directeur des Services Fiscaux du Bas-Rhin*.

justify arm's length transfer pricing and similar rules for taxing cross-border transactions.³⁷

The response to these defeats at the ECJ, e.g. in Germany and the UK, has generally been to extend the scope of these anti-avoidance rules to cover domestic transactions. This outcome raises administrative and compliance costs but without necessarily having any substantive effect on the application of the rules. To the extent that one objection to the rules from a Community law perspective has been the greater compliance costs that they involve for cross-border activities, the creation of comparable costs for domestic transactions avoids this discrimination, but not in any way that can be seen as beneficial. To the extent that the rules continue in practice to apply mainly in cross-border situations, it becomes an open question whether the new rules are fully compliant with Community law. Without effective transfer pricing rules, however, there could be significant erosion of corporate income tax bases, and (hence) more incentive for EU countries to coordinate (e.g. on some form of formula apportionment)

Source or residence-based corporate taxation

Community law clearly recognises the distinction between source and residence-based taxation. In a national context, member states cannot justify differences in taxation treatment of resident (worldwide taxation) and non-resident (source-based taxation only) taxpayers if there is no objective difference in their position, e.g. where they are subject to the same taxation in the host state. It will be clear from the discussion in section 2, however, that the adoption of residence-based taxation, taxing worldwide profits, is likely to raise significantly more difficult Community law issues than the adoption of source-based taxation.

Within corporate income taxes, pending cases at the ECJ may favour a shift towards source-based taxation in two particular areas:

- Controlled foreign corporation (CFC) rules³⁸

³⁷ Case C-436/00 *X and Y v Riksskatteverket*; Case C-324/00 *Lankhorst-Hohorst v Finanzamt Steinfurt*; Case C-524/00 *Test Claimants in the Thin Cap Group Litigation v Inland Revenue Commissioners*.

- Credit system for relief of international double taxation

Like imputation systems, CFC rules tend to discriminate between domestic and foreign investments, and between different foreign investments. From the residence country perspective, CFC rules may merely ensure that domestic and foreign investments are taxed equivalently and in that respect may not appear to involve any discrimination or any impediment to cross-border establishment or investment. On the other hand, to the extent that CFC rules are designed to protect national tax revenues by denying resident taxpayers the particular benefits available under another state's corporate tax system, the rules are incompatible with a single market which allows each member state freedom to tax as it chooses.³⁹ Without harmonisation of CFC rules, a decision by the ECJ restricting the application of CFC rules within EU could significantly weaken the effectiveness of national CFC rules against non-EU tax havens.

Credit or exemption systems of double tax relief

As previously noted, the Parent Subsidiary dividend directive contemplates that member states may adopt either an exemption or a credit system as the manner of dealing with foreign income. Either system is compatible in principle with Community law. Furthermore, the failure of a credit country to give relief (or full relief) for foreign tax may not amount to a breach of Community law where it merely reflects the interaction of two tax systems rather than the failings of a single tax system.⁴⁰

On the other hand, credit countries may not achieve consistent treatment of domestic and foreign income. In particular, the current UK system appears to be discriminatory on the basis that dividends from foreign subsidiaries are liable to tax, while dividends from domestic subsidiaries are not. In this respect, the Advocate General in his Opinion on the Franked Investment Income Group litigation has concluded that the UK's pre-1999 dividend taxation system did not comply with Community law and the post-1999 system

³⁸ See Case C-196/04 *Cadbury Schweppes plc v Inland Revenue Commissioners* (pending); Case C-201/05 *Test Claimants in the CFC and Dividend Group Litigation* (pending); Case C-203/05 *Vodafone v Inland Revenue Commissioners* (pending).

³⁹ See Case C-294/97 *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna*.

⁴⁰ Case C-513/04 *Mark Kerckhaert and Bernadette Morres v Belgian State*.

does not appear different in any respect.⁴¹ A similar conclusion may apply to aspects of the onshore pooling system for foreign tax credits that the UK put in place in 2001.

In this respect, there are two basic responses to a finding that difference treatment of domestic and foreign dividends is a breach of Community law that cannot be justified: to replace the credit method with the exemption method or to extend the credit method to dividends received from domestic subsidiaries. Neither option is especially attractive: the latter in terms of the unnecessary complications that it would introduce to the payment of domestic dividends; the former in terms of its impact on existing cross-border tax relationships when bilateral tax treaties have been negotiated on the basis of a credit rather than an exemption system.

Economic analyses do not decisively favour the credit method over the exemption method, or vice versa⁴² and some favour deduction over credit or exemption.⁴³ The potential simplicity of an exemption system as compared to the current credit system may one advantage.⁴⁴

7. Conclusions

The ECJ is now a major influence on the direction of corporate income taxes within the EU. For any member state, the immediate issue is what form of corporate income tax is compatible with Community law and achieves national tax policy objectives. Compliance with Community law on these terms by each member state is unlikely to produce either effective harmonization of corporate tax treatments within the EU, or the abandonment of corporate income taxes. A plausible outcome might be a predominantly territorial system, with exemption of foreign-source income, no discrimination on the basis of nationality, but different tax rates in different EU countries.

⁴¹ Case C-466/04 *Test Claimants in the FII Group Litigation v Inland Revenue Commissioners* (pending).

⁴² Horst, 1980; Janeba, 1995; Mintz-Tulkens, 1996; Devereux-Hubbard, 2003.

⁴³ Feldstein-Hartman, 1979.

⁴⁴ Federal Tax Commission, 2005.

What seems most likely, however, is a patchwork of 25 level playing fields, each at different heights and of different sizes, rather than a single level playing field that a single market demands where a corporate income tax is an integral feature of that market. The fact that member states do not have to deal fully with the interactions of their different tax systems also raises the question whether the playing fields need actually be level within countries, provided the unevenness reflects the interaction of two tax systems rather than the failings of one. In this respect, it is probably more correct to say that while the playing field must be level, the teams do not have to be equally matched: one may start with the handicap implicit in having to deal with the rules of two or more countries rather than playing on the pitch and under the rules of a single country.

The areas of corporate taxation that have been the focus of ECJ cases (imputation systems, anti-avoidance rules, systems of double tax relief) are not the chief suspect for significant economic distortions (which remains the differences in corporate tax rates). The legal pressure that is currently driving changes to corporate income taxes within the EU is a poor substitute for serious political debate on corporate tax reform. There are powerful long term pressures toward either more uniform corporate income tax treatments within the EU or lower corporate tax rates, but these pressures stem from the increased mobility of capital and business activities and not from the ECJ as such.