

CLOSER TO AN INTERNAL MARKET? THE ECONOMIC EFFECTS OF EU TAX JURISPRUDENCE

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The aim of this paper is to propose a new framework to assess the impact of Court of Justice of the European Union (CJEU) jurisprudence on Internal Market-related areas, by considering whether the jurisprudence of the Court on corporate taxation fulfils the constitutional mandate, as set-out in the European Treaties, of establishing such a market. It is shown that the Court's focus upon removing discriminatory obstacles to the fundamental freedoms does not necessarily lead to a more level playing field and increased tax neutrality, an instrumental objective towards attaining a European Internal Market. In order to assess whether the jurisprudence of the Court does indeed attain increased neutrality or level playing field, two rulings are used as case studies. The first ruling in Lankhorst-Hohorst regards the compatibility of thin capitalisation with free movement provisions; the second in Marks & Spencer concerns the compatibility of rules on group consolidation with those same provisions. An economic analysis demonstrates that, depending on the reaction of Member States to the ruling, tax induced differences in capital costs faced by firms operating within the European Internal Market may increase, whilst GDP and welfare may decrease. Consideration of actual legislative amendments introduced to thin capitalisation rules by Member States following Lankhorst-Hohorst, and to group consolidation rules following Marks & Spencer, appear to indicate that it is this negative scenario which has prevailed. Results demonstrate that it is not always or necessarily the case that decisions of the CJEU will lead to an increased level playing field and tax neutrality, thus contributing to the establishing of the EU Internal Market. The paper considers the constitutional implications of this conclusion, and the consequent breaking of the constitutional instrumental chain. In particular, it reflects on whether the Court's actions can be regarded as ultra vires, and whether they may constitute a violation of the rule of law and the principle of separation of powers. It concludes that the Court's lack of consideration of the constitutional instrumental chain might mean that we are heading in the wrong direction.

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1. Introduction

The influence of the CJEU over corporate direct tax matters is both significant and far reaching. Initiated just over two decades ago, this influence has been progressively increasing and has reached such an extent that today there is hardly any area of direct taxation which has not been affected. The Court's approach to direct tax matters is founded on the mandate attributed to the European institutions by the Treaty of Rome and its establishment of a European Internal Market.¹ In the absence of harmonising legislation the Court has taken the lead-role as regards corporate tax matters. Under the banner of ensuring free movement, it has consistently ruled on the removal of discriminatory tax treatment of European companies, or tax measures which impose restrictions upon intra-EU trade. Often neglected, however, is the fact that behind this stated objective there is a constitutional mandate to ensure the establishment of an Internal Market: ensuring free movement is instrumental to increasing the level playing field and to ensuring neutrality within Europe, which in turn is instrumental to achieving a European Internal Market. Yet, whilst much has been written about the Court's jurisprudence on tax matters, and indeed about free movement, little if anything has been said about the effects which that jurisprudence has had on the ultimate aim of establishing a European Internal Market and the instrumental objectives of ensuring a level playing field and fiscal neutrality. The fundamental question that should be asked therefore is whether the CJEU tax jurisprudence does indeed lead to an increased level playing field and neutrality, and thus contributes to the establishment of such a market.

The aim of this paper is to answer that question by adopting an interdisciplinary approach – law and economics. In Part Two consideration is given to what has been designated here as the constitutional instrumental chain, as originally set-up by the EEC Treaty. Particular attention is given to the ultimate constitutional aim of establishing a European Internal Market, and to the Court's option to concentrate upon the instrumental removal of discriminatory measures. It is further demonstrated how, that throughout its existence to date, this approach has created a methodological misgiving whereby the instrument – namely the removal of those measures – has often become confused with the over-arching aim itself. In Part Three attention shifts towards the CJEU and namely to its role within direct corporate taxes. Parts Four and Five focus on the impact of two rulings of the Court as case studies. In Part Four the ruling in *Lankhorst-Hohorst* regarding the compatibility of thin capitalisation with free movement provisions is used; this case study therefore concerns restrictions to intra-group loans in the form of thin capitalisation rules. It starts by providing the legal background, then presents an economic model that illustrates the possible economic effects of the ruling, and

¹ Whilst until the Single European Act (OJ L169, 29/07/1987) the term used within the Treaty was “common market”, this term has been progressively substituted since then by the preferred term “internal market”. See part 2 below. For the purposes of this paper the term internal market will be used, except where a clear distinction between the two terms is necessary.

finally considers the actual amendments introduced to thin capitalisation rules by Member States following *Lankhorst-Hohorst*, thereby establishing what are the most likely economic effects of the ruling. A similar approach is adopted as regards the second case study presented. In Part Five the ruling in *Marks & Spencer* concerning the compatibility of rules on group consolidation with the fundamental freedoms is analysed; this case study therefore focus on intra-group offsetting of losses in the context of group consolidation regimes. After providing the legal background, it presents a similar economic model that illustrates the possible economic effects of the ruling, and then considers the actual amendments introduced to group consolidation rules by Member States following *Marks & Spencer* to establish what are the most likely economic effects of this ruling. The paper concludes in Part Six with economic and legal considerations, including as regards the constitutional implications of the results which have been presented.

2. The Constitutional Instrumental Chain: From Economic Growth to Removal of Discriminatory Measures

In April 1951, France, Germany, Italy, and the three Benelux countries signed the Treaty of Paris establishing the European Coal and Steel Community.² The Community's aim was to create a common market for coal and steel (Articles 1 and 3 ECSC Treaty), placing the production of coal and steel under a common High Authority. Soon after, on the initiative of the Belgian Foreign Minister, Paul-Henri Spaak, the foreign ministers of the six member states of the ECSC gathered at Messina, in Sicily to discuss the possibility of extending the ECSC to a general common market. From the Messina Conference a Resolution emerged which established an Intergovernmental Committee under Paul-Henri Spaak's chairmanship;³ this would be responsible for elaborating a proposal for a treaty to establish a "common market". The report from the Intergovernmental Committee, which became known as the Spaak Report,⁴ was presented and accepted by the Foreign Ministers of the Six at the Venice conference in May 1956. It called for the creation of a common market, defined as the result of the fusion of national markets to create a larger unit of production, thereby stimulating greater economic growth.⁵ In turn, the advantages for economic growth of achieving a level playing field and

² For a more detailed description and analysis of the Schuman Plan and the political environment which led to the establishment of the European Coal and Steel Community see D. Weigall and P. Stirk, *The Origins & Development of the European Community* (London: Leicester University Press, 1992), at 55–70.

³ Resolution adopted by the Foreign Ministers of the Member States of the European Coal and Steel Community at the Messina Conference, 1–2 June 1955, in id. at 94–97, Document 6.1.

⁴ Report of the Heads of Delegation to the Ministers of Foreign Affairs, Brussels, 21 April 1956, hereafter "Spaak Report". Some sought to point to the injustice of this name, arguing that the report had, in reality, been mainly written by Pierre Uri, a French economist seen as Jean Monnet's right-hand man who was part of the Intergovernmental Committee, see M.J. Dedman, *The Origins and Development of the European Union 1945–95 – A History of European Integration* (London and New York: Routledge, 1996), at 99.

⁵ The expectation of economic growth was based on economic integration theories, in particular the so-called theory of preferences, or customs union theory. For an analysis of these theories in the context of European integration see J. Pinder, "Enhancing the Community's Economic and Political Capacity: Some Consequences

neutrality is expressed early in the report as a justification for the implementation of the Internal Market:

“Les protections qui éliminent la concurrence extérieure ont ailleurs pour le progrès de la production et le relèvement du niveau de vie une conséquence particulièrement nocive: ce sont les facilités et l’incitation qu’elles donnent à l’élimination de la concurrence interne. Dans un marché plus vaste, il n’est plus possible d’organiser le maintien de modes d’exploitation vieillissants qui déterminent à la fois des prix élevés et des salaires bas; cedes entreprises, au lieu de préserver des positions inunobles, sont soumises à une pression permanente pour investir en vue de développer la production, d’améliorer la qualité et de moderniser l’exploitation: il leur faut progresser pour se maintenir.

Telle est la raison fondamentale pour laquelle, si souhaitable que puisse apparaître en théorie une libération du commerce à échelle mondiale, un véritable marché commun n’est finalement réalisable qu’entre un groupe limité d’Etats, qu’on souhaitera aussi large que possible.”⁶

Although, the Report foresaw other strands to the development of the common market, the achievement of a customs union and the free movement of commodities and factors of production seemed to be key aspects of the proposal; instrumental to the creation of a level playing field and increased neutrality, instrumental also to the creation of the common market.

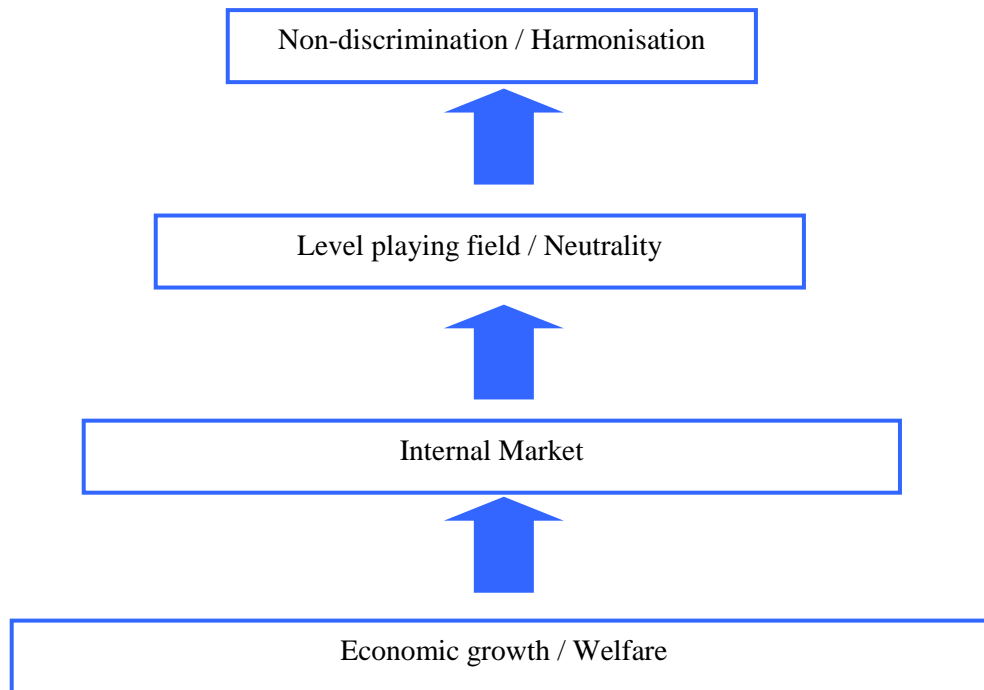
The Treaty of Rome establishing the European Economic Community (EEC) was finally signed by France, Germany, Italy, and the three Benelux countries in March 1957. Following the ethos of Report closely, the Treaty placed the concept of a common market at the centre of the new Community. As stated in Article 2 of the Treaty, the Community’s principal aim was the establishment of a common market, which would be achieved through the elimination of customs duties and quantitative restrictions between Member States, the adoption of a common customs tariff, the abolition of obstacles to the free movement of factors of production, and the adoption of common policies on various areas. The figure below attempts to illustrate what can be designated as the constitutional instrumental chain proposed by the Spaak Report and set-up by the EEC Treaty.⁷

of Completing the Common Market”, in R. Bieber *et al* (eds.), 1992: *One European Market? A Critical Analysis of the Commission’s Internal Market Strategy* (Baden-Baden: Nomos Verlagsgesellschaft, 1988), 55; and C. Barnard, *The Substantive Law of the EU – The Four Freedoms*, 3rd Edition (Oxford: Oxford University Press, 2010), at 3-9 Notwithstanding this, and despite the high level of expectation, there were dissenting voices like that of R. Bertrand, Economic Counselor for the OECD, arguing that the claims of greater economic growth made which preceded the signing of the EEC Treaty were unsubstantiated in economic terms, see “The European Common Market Proposal” (1956) *International Organization* X, 559–574, at 573.

⁶ Spaak Report, at 14. There is no official version of the Report in English language.

⁷ Whilst some may still argue that a Treaty is still a Treaty, the first statement that the Treaties had constitutional character came early in *Les Verts*, where the CJEU stated that the Treaty “basic constitutional charter”, Case 294/83, *Parti écologiste “Les Verts” v European Parliament*, [1986] ECR 1339, at para. 23. For a recent analysis of the significance of this statement in that ruling, see K. Lenaerts, “The Basic Constitutional Charter of a Community Based on the Rule of Law” and N. Walker, “Opening or Closure? The Constitutional

Fig. 1: The Constitutional Instrumental Chain



2.1 The ultimate constitutional aim of establishing a European Internal Market

Whilst references to the establishment of a common market as the ultimate aim of the European integration process abounded in the EEC Treaty, it was not always clear what were the boundaries of the concept, *i.e.* for constitutional purposes what actually constituted a common market. Further clarification was provided by the legislation following the approval of the Single European Act (SEA) in 1987, opening the door for new jurisprudential and doctrinal developments on this matter.

Under the SEA, the definition of the term internal market was given centre stage within the European integration process.⁸ That same amending Treaty also included provisions which entrusted the European institutions with the specific task of adopting measures with a view to establishing an internal market. The Community's competence as regards the internal market can be inferred from

Intimations of the ECJ" in M. Poyares Maduro and L. Azoulai (eds.), *The Past and Future of EU Law - The Classics of EU Law Revisited on the 50th Anniversary of the Rome Treaty* (Oxford: Hart Publishing, 2010), 295-315 and 333-342 respectively. At present, the fact that the European Treaties, and in particular the EC Treaty have constitutional status is almost universally accepted, see M. Poyares Maduro, *We, the Court – The European Court of Justice & the European Economic Constitution* (Oxford: Hart Publishing, 1998), at 7-12, and bibliography cited therein. For a different perspective, characterising the fundamental freedoms as "quasi-constitutional requirements" and "quasi-constitutional Treaty limits", see J. Englisch, "Tax Coordination Between Member States in the EU - Role of the ECJ" in M. Lang (ed.), *Horizontal Tax Coordination Within the EU and Within States*, papers presented at ESF Exploratory Workshop 2010, forthcoming.

⁸ OJ L169, 29/07/1987. Whether the terms "common market" and "internal market" are actually synonyms or not, however, is a deeply controversial matter. For a comprehensive analysis of the process which preceded the approval of the SEA and the introduction of the term "internal market", as well as the dynamic interaction between the two terms, see R. de la Feria, *The EU VAT System and the Internal Market* (Amsterdam: IBFD, 2009), at 3-6 and 29 *et seq.*

what were until recently Articles 3(1)(c),⁹ and 14(1) of the European Community Treaty (EC Treaty),¹⁰ and are now Articles 2(1) and (6),¹¹ and 26(1) of the Treaty on the Functioning of the European Union (TFEU), respectively.¹² Further details were set out in what was Article 95 of the EC Treaty, and is at present Article 114 of the TFEU, a residual provision which confers upon the Union the competence to approve legislative measures with a view to “the establishment and the functioning of the internal market”.

The impact of these provisions in the European legal system – and more generally of setting the Internal Market centre stage – is reflected in the contents and scope of the constitutional mandate which they imposed.¹³ The existence and characteristics of this mandate must be assessed through consideration of two preliminary points: the legal effect of these provisions, in particular Article 26(1) of the TFEU, which will determine the existence and nature of a constitutional mandate; and the legal definition of Internal Market, as set out in the same article, which will determine the contents of that mandate.

As regards the first point, namely the question over the legal effect of these provisions, and in particular Article 26 TFEU [ex Article 14 EC Treaty], this has been the subject of intense controversy since its introduction by the SEA. The fundamental query here is whether, rather than conferring competence on the Union as regards the internal market, that Article actually imposes an obligation upon the Union to approve legislation with a view to establishing or improving the functioning of the internal market. The compulsory nature of the old Article 14(1) has been denied by some commentators, their central argument being that the provision sets out a mere political aim that is not

⁹ This Article read: “1. For the purposes set out in Article 2, the activities of the Community shall include, as provided in this Treaty and in accordance with the timetable set out therein: [...] (c) an internal market characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital”. The expression “an internal market characterised by”, and the reference to “goods” were only included in this provision by the Treaty on the European Union. Prior to that Treaty, Article 3(1)(c) of the EEC Treaty only made reference to “the abolition, as between Member States, of obstacles to freedom of movement for persons, services and capital”.

¹⁰ This read as follows: “The Community shall adopt measures with the aim of progressively establishing the internal market over a period expiring on 31 December 1992, in accordance with the provisions of this Article and of Articles 15, 26, 47(2), 49, 80, 93 and 95 and without prejudice to the other provisions of this Treaty”.

¹¹ These paragraphs read: “1. The Union shall establish an internal market. [...] 6. The Union shall pursue its objectives by appropriate means commensurate with the competences which are conferred upon it in the Treaties”, OJ C83, 30/03/2010, p. 0047-0200. Article 3(1)(c) as it stood was repealed by the Treaty of Lisbon.

¹² This provision reads currently as follows: “1. The Union shall adopt measures with the aim of establishing and ensuring the functioning of the internal market, in accordance with the relevant provisions in the Treaties”. References to specific Articles were therefore removed by the Treaty of Lisbon.

¹³ Although the prevalence of economic aims in the Treaties has been increasingly challenged in recent times, see recently C. Semmelmann, ‘The European Union’s Economic Constitution under the Lisbon Treaty: soul-searching shifts the focus to procedure’ (2010) *European Law Review* 35(4), 516-541, arguing that market goals and social-policy goals enjoy equal status with the entry into force of the Lisbon Treaty. See also A.J. Menéndez, “European Citizenship after *Martínez Sala* and *Baumbast*: Has European Law Become More Human but Less Social?” in M. Poiares Maduro and L. Azoulay (eds.), n. 7 above, 363-393.

capable of creating legal effects.¹⁴ This was also the view adopted by several Member States in the famous *Wijsenbeek* case.¹⁵ Notwithstanding this, most authors have defended that Article 26 does indeed impose an obligation upon the Union to act.¹⁶ Whilst the Court has not ruled directly on the matter, this interpretation has been confirmed by Advocate General Cosmas in *Wijsenbeek*.¹⁷ There is therefore a constitutional mandate, characterised by a compulsory nature, that was bestowed upon the Union to establish a European Internal Market. Acting upon this obligation, however, presupposes an understanding of what the internal market actually is – and this is far from fully clear.

Within the Treaty, internal market is defined in paragraph two of Article 26 as “an area without internal frontiers in which the free movement of goods, persons, services, and capital is ensured in accordance with the provisions of the Treaties”. This definition has remained unchanged since its introduction in the EEC Treaty by the SEA.¹⁸ Yet, despite this definitional consistency, and as the Commission itself has implicitly acknowledged, its interpretation is far from clear.¹⁹ The definition has a dual component: first, “an area without internal frontiers”; and second, “in which the free movement of goods, persons, services, and capital is ensured”.²⁰

¹⁴ See C. Gulmann, “The Single European Act – Some Remarks from a Danish Perspective” (1987) *Common Market Law Review* 24, 31-40.

¹⁵ Case C-378/97, [1999] ECR I-6207. The Governments of Spain, Netherlands, Ireland, and United Kingdom all defended the political nature of Article 14 [now Article 26 TFEU], see Opinion of Advocate General Cosmas at paragraph 37.

¹⁶ See H.G. Schermers, “The effect of the date 31 December 1992” (1991) *Common Market Law Review* 28, 275–289, at 278; P. Craig, “The Evolution of the Single Market”, in C. Barnard and J. Scott (eds.), *The Law of the Single European Market – Unpacking the Premises* (Oxford and Portland, Oregon: Hart Publishing, 2002), at 16; and F. Schockweiler, “Les conséquences de l’expiration du délai imparti pour l’établissement du marché intérieur” (1991) *Revue du Marché Commun et de l’Union Européenne* 353, 882-886, at 884-885.

¹⁷ According to the Advocate General “the Article in question [Article 26] has a compulsory content. It created an obligation on the Community to progressively establish an internal market, with a view to creating a ‘space without internal frontiers’” (authors’ translation from the Spanish version of the Advocate General’s Opinion).

¹⁸ Several amendments were suggested during the discussions held by the European Convention for the European Constitution, most of which maintained the essence of the definition but added other elements to it, such as reference to approximation of laws and free competition. See the suggestions put forward by an independent group of lawyers at Cambridge University, so-called “Cambridge Text”, released as European Convention, *Contribution by Mr. P. Hain, member of the Convention – Constitutional Treaty of the European union*, CONV 345/1/02, 16 October 2002; the suggestions of a Franco-German research working group, known as “Freiburg Draft”, released as European Convention, *Contribution submitted by Mr. Erwin Teufel, member of the Convention: “Freiburg Draft of a European Constitutional Treaty”*, CONV 495/03, 20 January 2003; and the contribution of Mr. Elmar Brok, member of the European Convention, released as European Convention, *Contribution by Mr. Elmar Brok, member of the Convention: “The Constitution of the European Union”*, CONV 325/2/02, 7 March 2003. Ultimately, however, Article III-130(2) TCE only included a minor change to the current text: the substitution of expression “this Treaty” by “the Constitution”, OJ C310, 16/12/2004; and the same approach was adopted by the Treaty of Lisbon with the substitution of expression “this Treaty” by “the Treaties”.

¹⁹ See A.A.M. Schrauwen, *Marche Interieur – Recherches sur une notion*, Doctorate Thesis, University of Amsterdam, 1997, at 138. Equally, G. de Búrca comments that “internal market” is one example of “terms which are highly significant within the EU legal and political context, but which remain nonetheless or even deliberately uncertain in scope and meaning”, in “Reappraising Subsidiarity’s Significance After Amsterdam”, *Harvard Jean Monnet Working Paper Series*, WP 7/99, at 9.

²⁰ Some add a third part to this formulation: “in accordance with the provisions of the Treaty”, see A.A.M. Schrauwen, *id.* at 144-145. However, even if regarded as a separate part of the definition, this sentence is of considerably less importance, as accepted by the author herself.

The expression “an area without internal frontiers” has been subject of intense controversy. Severely criticised by some,²¹ regarded as the “key part of the definition” by others,²² its origins seem to be rooted in the Commission’s Internal Market Programme,²³ which revolved around the idea of “abolition of frontiers”, divided into physical, technical, or fiscal frontiers. The Intergovernmental Conference’s discussions seem to confirm this assumption, to the extent that the expression was included in the SEA on the basis of the Commission’s proposals.²⁴ It has been suggested that the expression was put forward by the Commission in order to include within the scope of the internal market other aspects, which might not be covered by the Treaty provisions relating to free movement, in particular as regards free movement of persons.²⁵ This would seem to indicate that the scope of “an area without internal frontiers” is broader than that of free movement. If this was in fact the Commission’s intention, the tactic might have worked slightly too well: the expression is potentially so broad that both most commentators and the Court alike, have tended to concentrate on the other aspect of the definition of internal market: the fundamental freedoms.²⁶ One of the most significant exceptions to this tendency has been the Court’s ruling in *Rundfunk and Others*, where it stated that the recourse to Article 95 EC Treaty [now Article 114 TFEU] as a legal basis for Community legislation did not presuppose the existence of an actual link with free movement.²⁷ Implicitly, therefore, the Court is acknowledging that there is more to the “establishment and the functioning of the internal market” than just free movement.

The separate reference to the freedoms in Article 26 TFEU too has been the target of criticisms. It has been argued that the separate reference to the free movement without mention of fair competition and unity of market constituted an “artificial separation”, which could but create “practical, political, and legal problems”.²⁸ Thus, some conclude that the reference to free movement is merely informative

²¹ See Pescatore, who comments “what does Article 8A mean when it speaks of ‘an area without internal frontiers’? What are frontiers in this context?” in “Some critical remarks on the ‘Single European Act’” (1987) *Common Market Law Review* 24, 9-18, at 16.

²² See C.D. Ehlermann, “The Internal Market following the Single European Act” (1987) *Common Market Law Review* 24, 361-409, at 364.

²³ *Completing the Internal Market – White Paper from the Commission to the European Council*, COM(85) 310, 14 June 1985.

²⁴ However, the formula suggested by the Commission was slightly different: it referred to “an area without internal frontiers ... under conditions identical to those obtaining within a Member State”, see C.D. Ehlermann, n. 22 above, at Annex III and 408. The final sentence was ultimately omitted and substituted by “in accordance with the provisions of this Treaty”.

²⁵ See C.D. Ehlermann, n. 22 above, at 366.

²⁶ See A.A.M. Schrauwen who comments “les horizons de l’espace sans frontiers etant larges, ses limites devront venir des autres carateristiques essentielles”, in n. 19 above, at 142.

²⁷ Joined cases C-465/00, C-138/01, and C-139/01, [2003] ECR I-12971. For an analysis of this case in the context of the Union’s internal market competence, see D. Wyatt, “Community Competence to Regulate the Internal Market”, *University of Oxford Faculty of Law Legal Studies Research Paper Series*, Working Paper No. 9/2007, July 2007, at 36-40.

²⁸ See P. Verloren van Themaat, former Advocate General at the CJ, in “The Contributions to the Establishment of the Internal Market by the Case Law of the Court of Justice of the European Communities”, in R. Bieber *et al* (eds.), *1992: One European Market? A Critical Analysis of the Commission’s Internal Market Strategy* (Baden-Baden: Nomos Verlagsgesellschaft, 1988), at 115.

and does not merit the qualification as legal definition.²⁹ Once again, as with the expression “an area without internal frontiers”, the main difficulty seems to be the lack of precision, *i.e.* when can it be said that goods, persons, services, and capital move freely within the Community?

The CJEU case law as regards the Community’s legislative competence on internal market matters has provided further guidance as regards its concept. In *Titanium Dioxide* the Court stated that “in order to give effect to the fundamental freedoms in [Article 26 TFEU], harmonising measures are necessary to deal with disparities between the laws of the Member States in areas where such disparities are liable to create or maintain distorted conditions of competition”.³⁰ The Court’s ruling in *Titanium Dioxide*, and in particular the adoption of such a wide interpretation of the concept of the internal market, gave rise to intense controversy at the time of its release.³¹ It was said at the time that it endangered the rule of law,³² and that it constituted a clear sign of the decline of the principal of conferral of powers.³³ A few years later, in *Tobacco Advertising*, the Court attempted to put those fears at rest by establishing some boundaries to the internal market concept, albeit keeping the elimination of distortions of competition within its scope.³⁴

It ruled in that case that measures referred to in Article 114 TFEU [ex Article 95 EC Treaty] must be intended to improve the conditions for the establishment and the functioning of the internal market, and that the Article did not vest in the Union a general power to regulate the internal market.³⁵ Implicit in this judgment, therefore, was a distinction between measures intended to improve conditions for the establishment and functioning of the internal market, on the one hand; and measures intended to regulate the internal market, on the other hand. The Union’s competence under the old Article 95 was limited to the first aspect.³⁶ Moreover, according to the Court “the mere finding of disparities between national rules and of finding abstract risk of obstacles to the exercise of fundamental freedoms or of distortion of competition” was insufficient to justify the choice of Article 95 as a legal basis.³⁷ On the specific aspect of distortion of competition, the Court limited the

²⁹ See comments by P. Pescatore noted in A.A.M. Schrauwen, n. 19 above, at 142-143.

³⁰ Case C-300/89, *Commission v Council*, [1991] ECR I-2867, at paragraph 15.

³¹ Although the reference to elimination of distortions to competition as part of the concept of internal market was not original, see J. Usher, “Case C-376/98, *Germany v European Parliament and Council (tobacco advertising)*. Judgment of the Full Court of 5 October 2000, [2000] ECR I-8419” (2001) *Common Market Law Review* 38, 1519-1543, at 1527 et seq.

³² See S. Crosby, “The Single Market and the Rule of Law” (1991) *European Law Review* 16, 451–465.

³³ See R. Barents, “The Internal Market Unlimited: Some Observations on the Legal Basis of Community Legislation” (1993) *Common Market Law Review* 30, 85–109; although the author’s comments seem to come as praise, rather than criticisms, for the Court’s ruling.

³⁴ Case C-376/98, [2000] ECR I-8419.

³⁵ Id at paragraphs 83 of the judgment.

³⁶ The same rationale should apply *mutatis mutandis* to Article 113, as well as to all other Treaty provisions, which refer to adoption of measures with a view to “the establishment and functioning of the internal market”.

³⁷ Case C-376/98, [2000] ECR I-8419, paragraph 84 of the judgment. D. Wyatt argues that in order for the measure to fall within the scope of Article 95 *obstacles* must be “actual or potential, direct or indirect (but not, it seems, if the effect is too remote and indirect to hinder trade)”, in “Constitutional Significance of the Tobacco Advertising Judgment of the European Court of Justice”, *CELS Occasional Paper* 5, July 2001, 19-31, at 23.

interpretation adopted in *Titanium Dioxide* by ruling that only where the distortion is “appreciable” can a measure be adopted on the basis of Article 95 as “in the absence of such a requirement, the powers of the Community legislature would be practically unlimited”.³⁸ Advocate General Fennelly had further suggested in his Opinion that in order to determine whether a Community measure pursues internal market objectives, a two-part test should be fulfilled: first, it must be ascertained whether the “preconditions for harmonisation exist”, *i.e.* disparate national rules which either constitute barriers to the exercise of the four freedoms or distort conditions of competition in an economic sector; and second, the action taken by the Community must either intend to eliminate those barriers or intend to eliminate the distortions of competition.³⁹ Although not explicitly referring to it the Court essentially follows this test with some important qualifications, namely to the first requirement: the existing obstacles to the four freedoms must be *concrete* and existing distortions of competition must be both *concrete* and *appreciable*.⁴⁰

In *Tobacco Advertising* these criteria were scattered throughout the judgment – and the Opinion – in a relatively unsystematic fashion, but the Court has moved towards a more consistently expressed formula in the very recent judgment in *Vodafone*.⁴¹ Yet, many felt that the *Tobacco Advertising* formula has left key questions unanswered, namely what is the scope of harmonisation envisaged by the EC Treaty, or how much harmonisation is constitutionally required?⁴² In other words, how far does the constitutional mandate go?

Whilst answers to these questions are far from obvious, what is clear is that, the ideas of increasing neutrality and establishing a level playing field within Europe are implicit in the elimination of concrete obstacles to free movement and the elimination of concrete and appreciable distortions of competition, either through jurisprudential removal of national measures or through harmonisation. In this context, these objectives can be seen as instrumental to the objective of attaining increased neutrality and a level playing field; in the same manner that increased neutrality and a level playing field should be seen as instrumental to the ultimate constitutional objective of establishing a European Internal Market. From a pure legal perspective, the existence of this instrumental chain might not be

³⁸ Case C-376/98, [2000] ECR I-8419, paragraphs 106 and 107 of the judgment; see also paragraphs 89 and 90 of the Advocate General’s Opinion.

³⁹ *Id.* at paragraph 93 of Advocate General’s Opinion.

⁴⁰ The use of the expression “distortion of competition” in this ruling has been the target of criticism, namely that it does not “adequately capture the normative concern that the Court of Justice is plausibly trying to address”, see M. Kumm, “Constitutionalising Subsidiarity in Integrated Markets: The Case of Tobacco Regulation in the European Union” (2006) *European Law Journal* 12(4), 503–533, at 505 and 508–515.

⁴¹ Case C-58/08, *Vodafone, O2 et al v. Secretary of State*, Judgment of 8 June 2010, nyr, paras. 32–33. See S. Weatherill, “The limits of legislative harmonisation ten years after *Tobacco Advertising*: how the Court’s case law has become a ‘drafting guide’” (2011) *German Law Journal* 12, 827.

⁴² See S. Weatherill, “Supply of and demand for internal market regulation: strategies, preferences and interpretation”, in N. Nic Shuibhne (ed.), *Regulating the Internal Market* (Cheltenham and Northampton: Edward Elgar, 2006), 29–56, at 29–38. The concept of harmonisation is itself unclear, see for an analysis P.J. Slot, “Harmonisation” (1996) *European Law Review* 21, 378–397; M. Dougan, “Minimum Harmonisation and the Internal Market” (2000) *Common Market Law Review* 37, 853–885; and D. Vignes, “The Harmonisation of National Legislation and the EEC” (1990) *European Law Review* 15, 358–374.

terribly helpful: neutrality or a level playing field might be as difficult to define as concrete obstacles to free movement and concrete and appreciable distortions to competition. However, not only do these concepts have a specific significance in economic terms but they can also be quantified through economic analysis. Thus – considering that as has been highlighted above,⁴³ it is precisely this economic perspective that underlines the constitutional mandate for the establishment of an Internal Market – it is only reasonable to resort to such analysis as the appropriate method of assessing whether the elimination of obstacles to the freedoms or distortions of competition is indeed increasing neutrality and creating a level playing field, and consequently fulfilling the constitutional mandate that they are meant to address – namely establishing a European Internal Market.

2.2 The methodology: centralised and decentralised models

Having established both the existence and the centrality of a constitutional mandate for the European Internal Market, the question which arises from a practical perspective is: what is the constitutional method for attaining this ultimate aim? In principle, three ideal constitutional models are possible within the European Economic Constitution: a centralised constitutional model; a competitive constitutional model; and a decentralised constitutional model. The centralised model favours a process of market regulation by the replacement of national laws with EU legislation. The basic principle behind this is that Member States' domestic legislation is incompatible with the aims of an Internal Market and should therefore be replaced by harmonised EU legislation. The competitive model promotes competition between legal orders, namely through the principle of mutual recognition. The basic idea here is that market forces will work to create an integrated and more efficient market. In the decentralised model, Member States will retain regulatory powers, but are prevented from developing protectionist policies. Discriminatory and/or restrictive measures will be struck-down, namely by the Court.⁴⁴

In practice, however, these constitutional models are not applied separately in their pure form within the Treaties; instead there is an interaction, a continuous interplay between them in different policy areas. Leaving aside the competitive model, which relies primarily on the inaction of the European institutions,⁴⁵ actions by the various institutions operate within both the centralised and decentralised models, either pursuing harmonising legislation or striking-down national discriminatory and/or restrictive measures, depending on legal, or perhaps more frequently, political constraints.

By substituting different national legislation with a single set of rules, harmonisation under the centralised model has many advantages, when compared to the decentralised model, even considering

⁴³ See point 2 above.

⁴⁴ See M. Poiares Maduro, n. 7 above, at 108–149.

⁴⁵ Although its increase relevance has been strongly defended, see N. Reich, “Competition between Legal Orders: A New Paradigm of EC Law?” (1992) *Common Market Law Review* 29, 861–896.

the current trend towards flexibility and differentiation.⁴⁶ In particular it is a more effective way of ensuring that barriers to free movement and distortions of competition are indeed removed: it guarantees a higher level of compliance from Member States than intervention by the CJEU under the decentralised model; it ensures that the measures put in place by domestic legislators are uniform and in line with the objective of removing barriers and distortions within the European market; and it increases legal certainty for operators, thus diminishing costs and ensuring better allocation of resources.⁴⁷ Yet, harmonisation is often unattainable. Legal constraints may apply, such as the respect for subsidiarity or proportionality, but more importantly there are frequent political constraints. In some sensitive areas Member States are less than willing to transfer sovereignty and even when the legislative process is initiated, sufficient political consensus to see legislation approved might prove impossible to reach.

Historically, it was precisely this lack of legislative progress that led the Court to adopt the central role in enforcing the decentralised model, striking-down national measures that discriminate or restrict the fundamental freedoms. The process started in the late 1960s, with the establishment that Article 25 EC Treaty [now Article 28 TFEU], regarding free movement of goods, had direct effect and could thus be enforced before national courts.⁴⁸ Since then the Court has developed a massive body of case law regarding the incompatibility of national measures with the freedoms' provisions, on a variety of different topics. The methods that the Court has developed over the last fifty years essentially follow two approaches: the removal of discriminatory measures (discrimination approach); and, more recently, of the removal of restrictive measures (restriction approach). The discrimination approach – developed first by the Court – seeks to remove measures which directly or indirectly discriminate on grounds of nationality (or residence). Under this approach Member States remain free to regulate within their borders, on the condition that their regulation applies equally to home and host State goods and persons. The restriction or market access approach was developed by the Court more recently, and seeks to remove measures likely to hinder or create an obstacle to the exercise of a freedom. This approach will apply irrespectively of whether the measures actually discriminate against imports or non-residents, so its scope is much wider than that of non-discrimination. The advantage of this approach is that it might be more suited to attaining the ultimate aim of establishing

⁴⁶ These can be understood at macro and micro levels, see G. de Búrca “Differentiation within the Core: The Case of the Common Market”, in G. de Búrca and J. Scott (eds.), *Constitutional Change in the EU – From Uniformity to Flexibility?* (Oxford: Hart Publishing, 2000), 133–171.

⁴⁷ What has been designated somewhere else as “the shortcomings of jurisprudential developments vs. legislative measures”, see R. de la Feria, n. 8 above, at 278 *et seq.*

⁴⁸ Case 26/62, *Van Gend en Loos*, [1963] ECR 1. The case famously established for the first time the principle of direct effect, thus becoming one of the most important rulings in European integration history. For a recent perspective on its significance see M. Poiares Maduro and L. Azoulai (eds.), n. 7 above, Part I, Chapters 1 to 4.

an internal market; the disadvantage is that it encroaches more strongly upon the regulatory autonomy of Member States.⁴⁹

Notwithstanding some nuances given the particularly sensitivity of the area, the rationale that has guided the Court's into adopting the above method as regards application of the fundamental freedoms' provisions over the last four decades to various policy areas, mirrors broadly the one which it has also taken as regards corporate tax matters.

3. The Role of the Court of Justice in Direct Taxation

As opposed to indirect taxation, EU legislation on direct taxation is very sparse.⁵⁰ At present there are six EU legislative instruments on direct taxes – which are of rather limited scope – dealing with either specific problems arising from cross-border transactions, or forms of cooperation between Member States' tax authorities.⁵¹ This limited scope of application, as well as their somewhat limited aims have even led to questions over the extent to which these legislative instruments can be classified as truly harmonising legislation.⁵² This lack of secondary EU direct tax (harmonising) legislation can be attributed to various factors. Although harmonisation of corporate tax law as a necessary step towards the establishment of a European Internal Market was debated as early as 1962,⁵³ no legal basis was ever introduced within the Treaties for that purpose. The very limited EU direct tax legislation that does exist has therefore been proposed and approved on the basis of Article 115 TFEU [ex Article 94

⁴⁹ The bibliography documenting and commenting upon this process is too long to list here. See generally C. Barnard, *The Substantive Law of the EU – The Four Freedoms*, 3rd Edition (Oxford: Oxford University Press, 2010); and D. Doukas, "Untying the Market Access Knot: Advertising Restrictions and the Free Movement of Goods and Services" (2006-2007) *Cambridge Yearbook of European Legal Studies* 9, 177-215.

⁵⁰ For a compilation of all EU legislation ever approved within indirect taxation, namely VAT, see R. de la Feria, *A Handbook of EU VAT Legislation*, Volumes 1, 2 and 3, Loose-leaf updated bi-annually (The Hague: Kluwer Law International, 2004-).

⁵¹ They are as follows: Council Directive 90/434/EEC of 23 July 1990 on the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares concerning Companies of Different Member States, OJ L225, 20/8/1990, p. 1-5, known as the "Merger Directive"; Directive 90/435/EEC of 23 July 1990 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries in Different Member States, OJ L16, 18/01/1997, p. 98-98, known as the "Parent-Subsidiary Directive"; Council Directive 2003/48/EC of 3 June 2003 on Taxation of Savings Income in the Form of Interest Payments, OJ L157, 26/06/2003, p. 38-48, known as the "Savings Directive"; Council Directive 2003/49/EC of 3 June 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made Between Associated Companies of Different Member States, OJ L 157, 26/06/2003, p. 49-54, known as the "Interest-Royalties Directive"; Council Directive 76/308/EEC of 15 March 1976 on Mutual Assistance for the Recovery of Claims Resulting from Operations Forming Part of the System of Financing the European Agricultural Guidance and Guarantee Fund and of Agricultural Levies and Customs Duties and in Respect of Value Added Tax and Certain Excise Duties, known as the "Mutual Assistance Directive for the recovery of taxes", OJ L 306, 30/11/1977, p. 34-34; and Council Directive 77/799/EEC of 19 December 1977 Concerning Mutual Assistance by the Competent Authorities of the Member States in the Field of Direct Taxation, OJ L336, 27/12/1977, p. 15-20, known as "Mutual Assistance Directive for the exchange of information".

⁵² See M. Aujean, "Tax Policy in the EU: Between Harmonisation and Coordination" (2010) *Transfer: European Review of Labour and Research* 16(1), 11-22.

⁵³ See *The EEC Reports on Tax Harmonisation – The Report of the Fiscal and Financial Committee and the Report of the Sub-Groups A, B and C* (Amsterdam: IBFD Publications, 1963), known as the "Neumark Report".

EC Treaty], which together with Article 114 TFEU [ex Article 95 EC Treaty] constitute the fall-back, residual, legal basis for approval of all legislation deemed necessary for the establishment and the functioning of the internal market. As opposed to Article 114, however, Article 115 requires unanimity voting. Whilst other reasons have been put forward to explain the lack of progress as regards harmonisation of direct corporate taxes, it is arguably the lack of specific legal basis for harmonisation and the need for unanimity voting which remain the most significant reasons for the sparse legislation in this area.⁵⁴

Approving harmonising legislation within direct taxation still remains on the European policy agenda, with the ongoing discussions over the introduction of a common consolidated corporate tax base (CCCTB) constituting an archetypical example.⁵⁵ However, the well-known difficulties in approving direct tax legislation at EU level – and with qualified majority voting in this area remaining a distant dream –⁵⁶ created the space for other methods of perceived European integration to be pursued. Many have advocated coordination, rather than harmonisation, as a method of eliminating the existing tax obstacles to the establishment and the proper functioning of the internal market.⁵⁷ In the last decade, the European Commission itself seems to have been favouring the soft law approach as a second best

⁵⁴ For additional reasons see M. Aujean, n. 52 above and C. Panayi, “European Tax Law: Legislation and Political Initiatives” in S. Fleet and G. Brown (eds.), *Gore-Brown on EU Company Law* (Jordan Publishing), Loose-leaf, Chapter 18, at 18-1.

⁵⁵ See European Commission, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*, COM(2011) 121/4, 16 March 2011. Even before the proposals were out, much had been written about this topic over the last three years. For a legal perspective on the various aspects of a CCCTB, see in particular M. Lang *et al*, *Common Consolidated Tax Base* (Vienna: Linde, 2008) and W. Schoen *et al*, *A Common Consolidated Corporate Tax Base for Europe* (Springer, 2008). For an economic analysis of the consequences of a CCCBT, see L. Bettendorf *et al*, “Corporate tax consolidation and enhanced cooperation in the European Union” (2010) *Oxford University Centre for Business Taxation Working Paper Series*, WP 10/01; L. Bettendorf *et al*, “Corporate tax harmonization in the EU” (2009) *Oxford University Centre for Business Taxation Working Paper Series*, WP 09/32; C. Fuest, “The European Commission’s Proposal for a Common Consolidated Tax Base” (2008) *Oxford University Centre for Business Taxation Working Paper Series*, WP 08/23; M. Devereux and S. Loretz, “Increased efficiency through consolidation and formula apportionment in the European Union? (2008) *Oxford University Centre for Business Taxation Working Paper Series*, WP 08/12; M. Devereux and S. Loretz, *The Effects of EU Formula Apportionment on Corporate Tax Revenues* (2008) *Fiscal Studies* 29(1), 1-33; and C. Spengel and C. Wendt, “A Common Consolidated Corporate Tax Base for multinational companies in the European Union: some issues and options” (2007) *Oxford University Centre for Business Taxation Working Paper Series*, WP 07/17.

⁵⁶ At the Intergovernmental Conference which preceded the European Constitution in 2003 the European Commission proposed to extend qualified majority voting to special situations. Reportedly, however, none of these were acceptable to Member States, although some Member States pushed for majority voting specifically as regards free movement of capital when there is a serious risk of fraud, see M. Aujean, n. 52 above.

⁵⁷ See M. Aujean, n. 52 above. On the use of soft law within the tax area, see H. Gribnau, “Improving the Legitimacy of Soft Law in EU Tax Law” (2007) *Intertax* 1, 30-44; and H.M. van Arendonk, “Fifty Years of European Co-operation and the Tax Policy of the European Commission” in L. Hinnekens and P. Hinnekens (eds.), *A vision of taxes within and outside European borders. Festschrift in honor of Prof. Dr. F. Vanistendael* (Alphen aan den Rijn: Wolters Kluwer, 2008), 1. The phenomenon is not exclusive to the tax area, with the usage of soft law exploding since 2000. For an analysis of the role of soft law within European integration more generally, see L. Senden, *Soft Law in European Community Law* (Oxford: Hart Publishing, 2004); and D. Trubek, P. Cottrell and M. Nance, “‘Soft Law’, ‘Hard Law’ and European integration: toward a theory of hybridity” (2005) *Jean Monnet Working Paper* 02/05.

solution.⁵⁸ Like in other (sensitive) areas, however, it has been the Court that has primarily filled the gap on direct tax through extensive case law.⁵⁹

3.1 Applying the non-discrimination instrument to direct taxation

Whilst the process of striking-down national measures which violate the fundamental freedoms started over two decades earlier, its extension to national tax measures is a relatively new phenomenon.⁶⁰ The CJEU ruling in *Avoir Fiscal* in 1986 might have appeared at the time to be a natural progression,⁶¹ but its impact can be likened to the opening of Pandora's Box.⁶² Similar to other areas, the space left empty by the lack of secondary harmonising legislation within corporate tax matters has meant that over the last twenty-five years, case law has gained both momentum and significance.⁶³ Under the often repeated mantra that "although direct taxation is a matter for the Member States, they must nevertheless exercise their direct taxation powers consistently with Community law",⁶⁴ the CJEU has become the principal source of European corporate tax policy.

⁵⁸ This approach can be said to have come to the fore in 2001 with the publication of *Tax Policy in the European Union – Priorities for the years ahead*, Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, COM(2001) 260 final, 23 May 2001. Since then the Commission has published several communications highlighting the same shift from hard law to soft law, see P. Wattel and B. Terra, *European Tax Law* (The Hague: Kluwer Law International, 2008), at 163-169. For a recent evaluation of the importance of soft law in direct taxation, see also H. Gribnau, "The Code of Conduct for Business Taxation: An Evaluation of an EU Soft-Law Instrument" and P. Pistone, "Soft Tax Law: Steering Legal Pluralism towards International Tax Coordination", both in D. Weber (ed.), *Traditional and Alternative Routes to European Tax Integration* (Amsterdam: IBFD, 2010), 67-96 and 97-116, respectively.

⁵⁹ In a recent study P. Genschel and M. Jachtenfuchs show, through analysis of a comprehensive data set to include all EU tax jurisprudence between 1998 and 2007, that tax policy choices are increasingly constrained by EU institutions, and that it is often the EU which determines the shape and even the level of taxation within Member States, see "The Fiscal Anatomy of a Regulatory Polity: Tax Policy and Multilevel Governance in the EU" (2009) *Hertie School of Governance Working Paper* 43, October 2009.

⁶⁰ For an analysis of the causes for the slow jurisprudential development in this area see F.C. de Hosson, "On the controversial role of the European Court in corporate tax cases" (2006) *Intertax* 34(6/7), 294-304, at 298 et seq.

⁶¹ As F.C. de Hosson states, in some Member States legal commentators immediately assumed – as far back as 1960 – that the EC Treaty would have consequences for the manner in which Member States could impose direct taxes, see n. 60 above, at 297. On the contrary, Member States had been arguing that absent specific Treaty provisions concerning direct taxes, they had exclusive power in this area and primary EU law did not apply – the so-called "strict sovereignty exception", see S. van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in Search of Principles* (IBFD, 2002), at 21 et seq; and M. Isenbaert, *EC Law and the Sovereignty of the Member States in Direct Taxation* (IBFD, 2010), at 193 et seq.

⁶² See Case 270/83, [1986] ECR 273. As recently stated by F. Vanistendael "by submitting his opinion in the case *Commission v France* on October 15th 1985, advocate-general Mancini very probably did not imagine what kind of revolution he had unleashed in the tax systems of the Member States" in "Introduction", in F. Vanistendael (ed.), *EU Freedoms and Taxation* (Amsterdam: IBFD, 2006), xxv-xxvi.

⁶³ At present tax cases reportedly constitute approximately 10% of all cases decided by the CJEU, see R. Mason, "Made in America for European Tax: The Internal Consistency Test" (2008) *Boston College Law Review* 49, 1277, at 1281. However, the majority of these – close to 7% – concerns indirect taxation, particularly VAT, rather than direct taxation, see R. de la Feria, n. 8 above, at 259-261. For a data set providing exact numbers divided by topic see also P. Genschel and M. Jachtenfuchs, n. 59 above.

⁶⁴ Case C-264/96, *ICI*, [1997] ECR I-4695, at paragraph 19. See also amongst others: C-279/93, *Schumaker*, [1995] ECR I-225, paragraph 21; C-80/94, *Wielockx*, [1995] ECR I-2493, paragraph 16; C-311/97, *Royal Bank of Scotland*, [1999] ECR I-2651, paragraph 19; C-251/98, *Baars*, [2000] ECR I-2787, paragraph 17; C-324/00, *Lankhorst-Hohorst*, [2002] ECR I-11779; and C-446/03, *Marks & Spencer*, [2005] ECR I-10837, paragraph 29.

Applying the familiar discrimination and restriction approaches,⁶⁵ it has since then consistently intervened to strike down corporate tax measures deemed to be obstacles to the fundamental freedoms.⁶⁶ This role has resulted in the Court's jurisprudence as regards direct taxation being commonly designated as "negative harmonisation",⁶⁷ a classification which lacks accuracy somewhat, insofar as harmonisation and the removal of national discriminatory and/ or restrictive measures are in essence different constitutional methodologies for attaining the Internal Market aim.⁶⁸

Away from terminological considerations, however, and whilst certainly progressive,⁶⁹ the adoption of such a role by the Court can hardly be said to have been a smooth progression. A parallel development was a growing and persistent criticism to the Court approach as regards direct taxation cases. This criticism ranges from the very specific – concentrating on particular decisions and on specific cases – to a general disapproval of the Court's fundamental decision of applying its traditional free movement jurisprudence to direct tax matters.⁷⁰ The basis for this criticism tends to be: the Court's lack of sovereignty or the Court's threat to national tax sovereignty;⁷¹ its lack of awareness of the particularities of tax law when making its decisions;⁷² its lack of concern for the potential budgetary implications of its decisions;⁷³ or controvertibly its under-zealousness when applying the

⁶⁵ Although these approaches have not only evolved over time but arguably depend on the subject matter. For a comprehensive analysis of the concepts and their evolution as applied to the tax area, see A. Cordewener, "The Prohibitions of Discrimination and Restriction within the Framework of the Fully Integrated Internal Market" and M. Gammie, "The Compatibility of national tax principles with the single market" in F. Vanistendael (ed.), *EU Freedoms and Taxation* (Amsterdam: IBFD, 2006), 1-46 and 105-165, respectively; and P. Pistone, *The Impact of Community Law on Tax Treaties. Issues and Solutions* (The Hague: Kluwer Law International, 2002).

⁶⁶ The jurisprudence of the Court on corporate taxation is of course not limited to the application and interpretation of the freedoms – some cases in particular concern the application and interpretation of secondary tax legislation, see generally see P. Wattel and B. Terra, n. 58 above, Chapters 9, 10, 13 and 14. However, the overwhelming majority of cases decided by the Court in this field are of the first type.

⁶⁷ See generally P. Wattel and B. Terra, n. 58 above, where the chapters are divided in "positive harmonisation", dedicated to secondary harmonising legislation, and "negative harmonisation", dedicated to the case-law of the CJEU; and A.J. Martín Jiménez, *Towards Corporate Tax Harmonization in the European Community: An Institutional and Procedural Analysis* (The Hague: Kluwer Law International, 1999).

⁶⁸ See point 2.2 above. Although it is note worthy that the use of this or other equivalent terms is not exclusive to taxation matters; commenting on the wider role of the Court, M. Poiares Maduro has characterised it, for example, as "judicial harmonisation", see n. 7 above, at 68.

⁶⁹ Not only have the number of decided cases been growing annually, but also the number of areas of direct taxation under scrutiny, see J. Malherbe *et al*, *The Impact of the Rulings of the European Court of Justice in the Area of Direct Taxation*, Study commissioned by European Parliament, Policy Department – Economic and Scientific Policy, IP/A/ECON/ST/2007-27, March 2008, at iii.

⁷⁰ See S. Kingston, "The Boundaries of Sovereignty: The ECJ's Controversial Role Applying Internal Market Law to Direct Tax Matters" (2006-2007) *Cambridge Yearbook of European Legal Studies* 9, 287-311.

⁷¹ See D. Weber, "In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC" (2006) *Intertax* 34, 585; and G. Bizioli, "Balancing the fundamental freedoms and tax sovereignty: some thoughts on recent ECJ case law on direct taxation" (2008) *European Taxation* 3, 133. On the contrary, M. Isenbaert has alerted for the distinction between sovereignty and competence, arguing that "direct taxation still falls exclusively within the Member States' function sovereignty, they have not retained absolute or exclusive competence on the matter", see n. 60 above, at 197.

⁷² See J. Avery Jones, "Carry on Discriminating" (1995) *British Tax Review* 6, 525; D. Williams, "Asscher: The European Court and the Power to Destroy" (1997) *EC Tax Review* 6, 4; and P.J. Wattel, "Red Herrings in Direct Tax Cases Before the ECJ" (2004) *Legal Issues of Economic Integration* 31(2), 81-95.

⁷³ See O. Thömmes, "Effect of ECJ Decisions on Budgets of EU Member States: EC Law Without Mercy?" (2005) *Intertax* 33(12), 560-561.

fundamental freedoms to tax matters.⁷⁴ All tend to point to the inconsistency and unpredictability of the Court's decisions, with serious consequences for legal certainty. The controversy caused by the tax jurisprudence of the Court is such, and its budgetary consequences so considerable, that at the Intergovernmental Conference which preceded the defunct European Constitution in 2003 the representatives of some Member States reportedly considered stripping the Court of its jurisdiction over tax cases –⁷⁵ and not for the first time.⁷⁶

3.2 (Not)Applying the constitutional instrumental chain to direct taxation

Notwithstanding the above, and amidst all the criticism to the Court's role as regards direct taxation, very few, if any, have asked the fundamental, somewhat preliminary, question: is it working? Regardless of any other parallel considerations, the ultimate aim remains the establishment of an EU Internal Market as defined in the Treaties – a legal term with economic significance and rationale, namely that of establishing a level playing field and increasing neutrality within the EU.⁷⁷ So the key question must be asked, is the tax jurisprudence of the Court of Justice contributing towards the ultimate aim of establishing an European Internal Market, as per the constitutional mandate prescribed in the Treaties?⁷⁸ Some simply assume that the Court's rulings are effective steps towards achieving an Internal Market,⁷⁹ without any actual assessment of its overall effects beyond the specificities of each case. Others seem to implicitly,⁸⁰ or explicitly,⁸¹ assume that for the Court non-discrimination is

⁷⁴ See G. Kofler and R. Mason, "Double Taxation: A European 'Switch in Time?'" (2007) *Columbia Journal of European Law* 14, 63.

⁷⁵ See F. Vanistendael, "The ECJ at the crossroads: balancing tax sovereignty against the imperatives of the Single Market" (2006) *European Taxation* 9, 413-420.

⁷⁶ See Memorandum presented by the United Kingdom and Germany during the Intergovernmental Conference which preceded the adoption of the Treaty of Amsterdam in 1997. Indeed, some Member States are said to have initially supported the view that either direct taxation was *a priori* excluded from the scope of EU law (*strict sovereignty exception*), or that the Treaty only applied to direct taxation insofar as a certain degree of harmonisation had been reached (*moderate sovereignty exception*), see G.W. Kofler, "Austria", in C. Brokelind (ed.), *Towards a Homogeneous EC Direct Tax Law* (Amsterdam: IBFD, 2007), 59-100, at 59.

⁷⁷ As A. Cordewener also points out "more or less formalistic problems should, however, not obstruct the view to the fact that the ECJ is continuously pursuing one major aim in substance, and that is the integration of several domestic markets into one EU-wide single market", in n. 65 above, at 4.

⁷⁸ Although some commentators have acknowledged the instrumental and subordinate nature, from a constitutional perspective, of taxation and non-discrimination to the concept of internal market, see C. Sacchetto, "ECJ Direct Tax Cases and Domestic Constitutional Principles: an Overview" in R. Avi-Yonah, J.R. Hines Jr., and M. Lang (eds.), *Comparative Fiscal Federalism – Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence* (The Hague: Kluwer Law International, 2007), 1-9.

⁷⁹ As J. Malherbe *et al* state "As to corporate income tax, landmark rulings [...] can be seen as significant steps towards the achievement of the Internal Market", see n. 69 above, at iv.

⁸⁰ See F.C. de Hosson, n. 60 above, particularly at 297 and 302; M. Lang, "Double Taxation and EC Law" in R. Avi-Yonah, J.R. Hines Jr., and M. Lang (eds.), n. 78 above, 11-53; K. van Raad, "Nondiscrimination from the Perspective of the OECD Model and the EC Treaty – Structural and Conceptual Issues" in R. Avi-Yonah, J.R. Hines Jr., and M. Lang (eds.), n. 78 above, 55-66; and M. Aujean, "The Future of Non-Discrimination – Direct Taxation in Community Law" in R. Avi-Yonah, J.R. Hines Jr., and M. Lang (eds.), n. 78 above, 321-330. Although criticising this approach, see also R. Mason and M.S. Knoll, "What is Tax Discrimination?" (2011) *Yale Law Journal* 121.

⁸¹ S. van Thiel argues that the Court does not rule on the basis of neutrality objectives, "what the ECJ has done, up to now, is to prohibit the tax system of one single Member State from discriminating against cross border as compared to domestic economic activity, either by imposing a higher tax on an incoming economic activity

in itself the objective. Both assumptions are, however, unjustified. Assuming that the objectives of the Internal Market are being achieved by the jurisprudence of the Court, without questioning this process, seems rather naïve. On the other hand, and as demonstrated above, from a constitutional perspective non-discrimination is not in itself the objective but rather *an instrument towards the achievement of the ultimate objective* of establishing a European Internal Market. The fact that in tax cases the Court often just refers to non-discrimination and the removal of obstacles to the fundamental freedoms is not an impediment to drawing this conclusion – rather it appears to provide an archetypal example of method being confused with the objective itself. Such confusion is not only contrary to the constitutional mandate set out in the Treaties, but it can also be traced-back to the source of some of the frustration caused by the CJEU tax jurisprudence.

Notwithstanding the above, in recent years a few authors have proposed a different approach to assess the CJEU jurisprudence on direct taxation, namely by resorting to economic concepts and analysis. The first study, published in 2000, focuses upon the interaction between free movement and direct taxation of individuals.⁸² It argues that, whilst there are issues in direct tax cases that are amenable to analysis through the discrimination test, the type of interaction between different national tax systems that characterises these cases often makes non-discrimination an inappropriate test. The author therefore proposes a new methodology, grounded in economic analyses and capable of identifying, with more precision, situations where tax systems interfere with the free movement of persons: the cross migration test. This test would operate as a complementary criterion to non-discrimination, *i.e.* as a means to identify costly taxation – national tax measures which create costs to potential migrants, and consequently constitute obstacles to free movement – where the discrimination approach would be unsuitable. According to the author the test has the advantage of offering a precise approach to understanding where taxation constitutes a real obstacle to the free movement of individuals, in particular providing a way of distinguishing those situations from others where taxation actually creates an incentive for migration.

A second study, published in 2006, proposes that – in the absence of further legislative harmonisation – the CJEU should display more restraint in its interpretation and its application of the concept of non-discrimination.⁸³ The authors argue that the requirement of non-discrimination is too one-dimensional for many issues of income tax design, and making it the sole decision criterion in tax cases necessarily suppresses other relevant considerations of efficiency, fairness, and administrability that should inform tax policy choices. They conclude that the CJEU approach is ultimately incoherent

(discriminatory market access restriction) or a higher tax on an outbound economic activity (discriminatory exit restriction)”, see “The Future of the Principle of Non-Discrimination in the EU” in R. Avi-Yonah, J.R. Hines Jr., and M. Lang (eds.), n. 78 above, 331-400, at 344.

⁸² See I. Roxan, “Assuring Real Freedom of Movement in EU Direct Taxation” (2000) *Modern Law Review* 63(6), 831-876.

⁸³ M.J. Graetz and A.C. Warren, Jr, “Income Tax Discrimination and the Political and Economic Integration of Europe” (2006) *Yale Law Journal* 115, 1186-1255.

because it is a quest for an unattainable goal: to eliminate discrimination based on both origin and destination of economic activity in the absence of harmonised corporate income tax bases and rates amongst Member States. In this context, the authors consider that there are only two options, either greater harmonisation of corporate tax bases and rates – which they consider unlikely – or the exercise of greater restraint by the Court when interpreting and applying the concept of non-discrimination. The article therefore proposes the adoption of one of two possible, and more modest, approaches. The first approach would be to view the fundamental freedoms as only precluding a Member State from taxing more heavily income that crosses its borders than income that does not.⁸⁴ Member States would therefore be required to only apply capital import neutrality to incoming investment and capital export neutrality to outgoing investment.⁸⁵ The second approach would be based on the manner in which double taxation treaties operate: source countries would agree to apply the same rates to incoming investment as they apply to domestic investment, while resident countries would apply the same rates to outgoing investment that they apply to domestic investment.

Even more recently, it has been proposed that in common market contexts, such as the EU, non-discrimination provisions should be interpreted to promote competitive neutrality.⁸⁶ The authors' start-up point is the fact that despite its continuing and indeed expanding influence, a clear definition of tax discrimination has failed to emerge. They identify the failure to articulate the underlying principle, or principles, behind the Court's application of the concept of non-discrimination to tax as the main limitation, and therefore aim to present coherent guidelines for interpreting that concept. Drawing on traditional and modern economic theory they consider three alternative formulations of tax discrimination, namely locational, savings / leisure, and competitive neutrality. Of these the authors propose competitive neutrality as the benchmark that should be adopted by the CJEU when applying the concept of discrimination to direct tax cases.⁸⁷ They present two main arguments for their proposition. First the fact that, courts already tend to invoke neutrality as a motivation for their tax discrimination decisions, and indeed the CJEU has been intuitively interpreting non-discrimination in a manner which is broadly consistent with competitive neutrality. As such,

⁸⁴ Also pointing towards a similar approach, see W. Schön, "Tax Competition in Europe – The Legal Perspective" (2000) *EC Tax Review* 9, 90-105.

⁸⁵ These concepts were first introduced by P. Musgrave (née Richmond), see P. Richmond, *Taxation of Foreign Income: An Economic Analysis* (Baltimore, Johns Hopkins Press, 1963); and P. Musgrave, "United States Taxation of Foreign Investment: Issues and Arguments", International Tax Program, Harvard Law School, 1969. For more recent developments to these concepts see in particular M. Devereux, "Capital Export Neutrality, Capital Import Neutrality, Capital Ownership Neutrality and All That", Institute for Fiscal Studies, 1990; and M. Desai and J.R. Hines, Jr., "Evaluating International Tax Reform" (2003) *National Tax Journal* 56, 487-502.

⁸⁶ See R. Mason and M.S. Knoll, n. 80 above. A connection between the Treaty's aim of establishing an Internal Market, and the need to promote tax neutrality has also been advocated by other commentators, see J. Englisch, n. 7 above.

⁸⁷ For a recent study on the concept of neutrality as applied to tax see M.P. Devereux, "Taxation of outbound direct investment: economic principles and tax policy considerations" (2008) *Oxford Review of Economic Policy* 24(4), 698-719. See also M.S. Knoll, "Reconsidering International Tax Neutrality" (2011) *Tax Law Review* 44.

expressly identifying its endeavour as one seeking to maintain competitive neutrality could help bring predictability and coherence to an area that is generally viewed as lacking both. Second, application of the concept of tax discrimination is intended to root out tax policies that distort competition between domestic residents and residents of fellow Member States, and competitive neutrality is the benchmark most concerned with maintaining a level playing field between resident and non-resident taxpayers. Adopting a competitive neutrality construction of non-discrimination would also, they argue, be welfare-enhancing.

These studies make important contributions, correctly pointing towards the need to consider the economic consequences of the CJEU direct tax jurisprudence. However, the difficulty with these works is a degree of disregard for the constitutional dimension of the issue. There seems to be a – widespread – assumption that non-discrimination is the focal concept within the Treaties, to be interpreted as an aim in itself, without any formal constitutional connection between it and economic concepts such as neutrality and a level playing field. On the basis of that presumption, the authors appeal to a jurisprudential construction of non-discrimination that is in line with those concepts, or a jurisprudential development of a parallel test, which would in turn result in a (more) consistent and coherent approach by the Court to direct tax cases. This is, however, an erroneous assumption. As highlighted above, not only do the Treaties establish a clear connection between non-discrimination – and harmonisation – neutrality, a level playing field, and the establishment of an EU Internal Market, but this connection assumes the characteristics of a constitutional mandate. The difference might appear to be inconsequential, but it is in fact fundamental: the Court’s interpretation and application of the concept of non-discrimination in a manner which increases neutrality and a level playing field is not optional, it is a constitutional imperative. Applying the concept as an instrument to attain those objectives would not be a jurisprudential construction, but merely a reflection of the respect for that imperative; on the contrary, interpretation and application in a manner that fails to achieve increased neutrality or a level playing field, and therefore does not contribute to the establishment and the functioning of the Internal Market, is not a prerogative of the Court, and it would be fundamentally unacceptable under the Treaties.

That this constitutional instrumental chain applies to direct tax matters is clear. As highlighted above, the Treaty itself establishes the connection between taxation and the aim of establishing an EU Internal Market. Moreover this connection has been expressly accepted, and indeed consistently invoked by the various European institutions, including the Court, since the initial stages of the European integration process. Whilst there is no universally accepted definition of what an internal market requires in terms of taxation, the need to respect the constitutional instrumental chain has been a continuous presence, either explicitly or implicitly, in European tax initiatives since the Neumark Report, which established a clear connection between harmonisation, neutrality and the establishment

of a European Internal Market.⁸⁸ Significantly a large section of the Ruding Report was devoted to investment distortions caused by differences in national corporate tax systems – *i.e.* the establishment of a level playing field in so far as taxation was concerned – with an ultimate view to establishing an Internal Market.⁸⁹ A similar approach was adopted by the European Commission in its 2001 report on company taxation in the Internal Market.⁹⁰

It is thus argued here, that from a constitutional perspective achieving non-discrimination within direct taxation is not enough *per se*. Like harmonisation, non-discrimination is merely an instrument, the application of which should result in the level playing field and increased neutrality that characterises an Internal Market. If the tax jurisprudence of the CJEU is not fulfilling that objective, if striking-down discriminatory national measures is not creating a more level playing field and / or increasing the level of neutrality, then important issues must be considered and re-evaluated. First, and from a more formalist perspective, it is questionable whether this jurisprudence can still be regarded as harmonisation – albeit negative. Second and more importantly, from a substantive perspective, legitimacy issues and important constitutional implications should be considered, namely whether it is legitimate for the Court to intervene by repealing national corporate tax measures, under the constitutional mandate of establishing an EU Internal Market, if its decisions in that regard do not actually contribute to achieving that aim.

In the next two parts we attempt to address these questions through an economic analysis of the Court’s tax jurisprudence. In this context, we present two cases studies which are aimed at assessing the economic effects of the Court’s rulings, and in particular on improving the level-playing field and on increasing neutrality. These case studies have in common the fact that they both concern intra-group transfers; but are distinct insofar as one concerns norms limitation of taxpayers rights and source-country discrimination against incoming investment, namely thin capitalisation rules, whilst the other focuses on a preferential regime and residence-country discrimination against outgoing investment, namely rules on transfer of cross-border losses under group consolidation regimes.

⁸⁸ For an analysis of the Neumark Report from a corporate taxation perspective, see A.J. Martín Jiménez, n. 67 above, at 107.

⁸⁹ See Ruding Committee, *Conclusions and Recommendations of the Committee of Independent Experts on Company Taxation*, Luxembourg: Commission of the European Communities, 1992. For comments on the report see amongst others, M. Devereux, “The Ruding Committee Report : An Economic Assessment” (1992) *Fiscal Studies* 13(2), 96-107; and A.L. Bovenberg and S. Cnossen “Company tax harmonization in the European Union: Some further thoughts on the Ruding Committee report” in M.I. Blejer and T. Ter-Minassian (eds.), *Macroeconomic Dimensions of Public Finance. Essays in Honor of Vito Tanzi* (London: Routledge, 1997).

⁹⁰ “As non-tax impediments to the functioning of the Internal Market have been mostly removed and the EU markets for goods, labour and capital become integrated, the *allocation of capital (economic activities and investment) is increasingly sensitive to taxation*. Firms and individuals benefit from the freedom to move their capital to locations where the *highest after-tax returns* can be obtained and their investment decisions are thus more responsive to differences in effective tax rates between countries than without the Internal Market. At the same time, however, tax obstacles may still hamper the exercise of this freedom. It is therefore logical for the mandate to call for the analysis of these two - different but related - *factors jeopardising allocational efficiency in the Internal Market*.”, see European Commission, *Company Taxation in the Internal Market*, COM(2001) 582 (final), 23 October 2001, at 15.

4. Thin Capitalisation Rules and the Judgment in *Lankhorst-Hohorst*: Case Study One

A company is said to be ‘thinly capitalized’ when it has a high proportion of debt capital in relation to its equity capital. The significant differences that apply in most countries to the tax treatment of debt on one hand, and equity on the other,⁹¹ have made thin capitalisation a popular method of international tax planning, often also designated as profit shifting. As a result, many Member States – although not all – apply anti-thin capitalisation rules.⁹² For years this divergence in Member States’ treatment of thin capitalization had been acknowledged as a potential source of difficulties, not least double taxation. However, the potential incompatibility of these rules with the Treaty was left almost untouched until 2004 with the Court’s ruling in *Lankhorst-Hohorst*.⁹³

Lankhorst-Hohorst was not the first ruling to impact on the phenomenon – the Netherlands, which until 2003 did not apply a thin capitalisation rule, introduced one that year reportedly in response to the CJEU ruling in *Bosal Holding*.⁹⁴ It was *Lankhorst-Hohorst*, however, which had the most significant impact. Until 2002, most Member States applying thin capitalisation rules – similarly to other OECD countries – limited its scope of application to situations of “inbound investment”, *i.e.* where the lender is a non-resident company. However, the release of the Court’s ruling in *Lankhorst-Hohorst* that same year fundamentally changed this approach. The Court held in that case that German thin capitalisation rules, insofar as they applied exclusively to non-residents, contravened the freedom of establishment, as set out in the Treaties. The decision had an overwhelming impact within the Union as a whole. Following the decision in *Lankhorst-Hohorst* it became clear to many Member States that their own thin capitalisation rules would not pass the ‘EU test’, and would be deemed to be in contravention of EU law, if they were so challenged.⁹⁵ Moreover, under Article 4(3) TEU [ex Article 10 EC Treaty] Member States have the obligation to apply EU law as interpreted by the Court, and thus adapt their domestic rules accordingly.⁹⁶

⁹¹ For a recent study on this discrepancy in treatment see J. Vella, “The Asymmetrical Treatment of Debt and Equity Finance Under UK Tax Law” in D. Prentice and A. Reisberg (eds), *Corporate Finance Law: UK and EU Perspectives* (Oxford: Oxford University Press, 2010).

⁹² For a survey of Member States’ approach to thin capitalisation see A.P. Dourado and R. de la Faria, “Thin Capitalization in the Context of the CCCTB” in M. Lang *et al*, *Common Consolidated Corporate Tax Base* (Vienna: Linde Verlag, 2008), 817.

⁹³ Case C-324/00, [2002] ECR I-11779.

⁹⁴ Case C-168/01, *Bosal Holding BV v Staatssecretaris van Financiën*, [2003] ECR I-9409. See M. de Wit and V. Tilanus, “Dutch Thin Capitalisation Rules ‘EU Proof’?” (2004) *Intertax* 32(4), 187-192; and A.C.P. Bobeldijk and A.W. Hofman, “Dutch Thin Capitalisation Rules from 2004 Onwards” (2004) *Intertax* 32(5), 254-261.

⁹⁵ See N. Vinther and E. Werlauff, “The need for fresh thinking about tax rules on thin capitalisation: the consequences of the judgment of the ECJ in *Lankhorst-Hohorst*” (2003) *EC Tax Review* 2, 97-106

⁹⁶ On the relevance of this provision and its status as a general principle of EU law, see J. Temple Lang, “Article 10 EC – The Most Important ‘General Principle’ of Community Law”, and L.W. Gormley, “Some Further Reflections on the Development of General Principles of Law Within Article 10 EC” in U. Bernitz, J. Nergelius

In order to ensure compatibility with EU law in a post *Lankhorst-Hohorst* world, two avenues of action seemed to be available to Member States: either to extend the scope of application of thin capitalisation rules, in order to include resident companies;⁹⁷ or to limit the scope of application of thin capitalisation rules, in order to exclude EU resident companies. Immediately following *Lankhorst-Hohorst*, a third avenue was suggested: that Member States might react simply by dropping thin capitalisation rules altogether and thus face “the full risk of base erosion”,⁹⁸ which seen from a different perspective, could offer a very attractive tax environment for corporate investment. This concern, however, never seemed to materialise – indeed quite the opposite, as the overall number of Member States with thin capitalisation rules has increased since 2002, rather than decreased. This essentially left Member States with the two previous avenues of action. Opting for one of the other, however, is not inconsequential. Different possible reactions of the Member States have very different implications for tax neutrality and level playing field in the EU market. In the following section, an economic model is developed which offers a framework for analysing this impact.

4.1 The economic effects of *Lankhorst-Hohorst*: an economic model

In this section, a simple economic model is developed which permits an analysis of the impact of the *Lankhorst-Hohorst* ruling on tax neutrality and the level of playing field in the EU market. The model focuses upon the neutrality of taxation for the investment activity of different types of firms. Tax rates as well as tax bases differ across countries, and these differences distort the choice of firms where to invest (capital export neutrality), as well as the choice who invests in a given country (capital import neutrality).⁹⁹ Whilst the CJEU rulings address specific discriminations between domestic and border crossing economic activity, they do not call into question corporate tax rate differences between countries. In this framework, forcing countries to remove certain types of discrimination between the tax treatment of domestic and border crossing economic activity does not necessarily reduce overall tax distortions in the EU market, as the following analysis shows.

Consider a world of three countries called A, B, and C. All three countries are member states of an economic union (the European Union). The supply of savings in the union is fixed and denoted by \bar{K} . We abstract from capital market integration with the rest of the world. There are four groups of firms,

and C. Cardner (eds.), *General Principles of EC Law in a Process of Development* (Alphen aan den Rijn: Wolters Kluwer, 2008), 75-114 and 303-314, respectively.

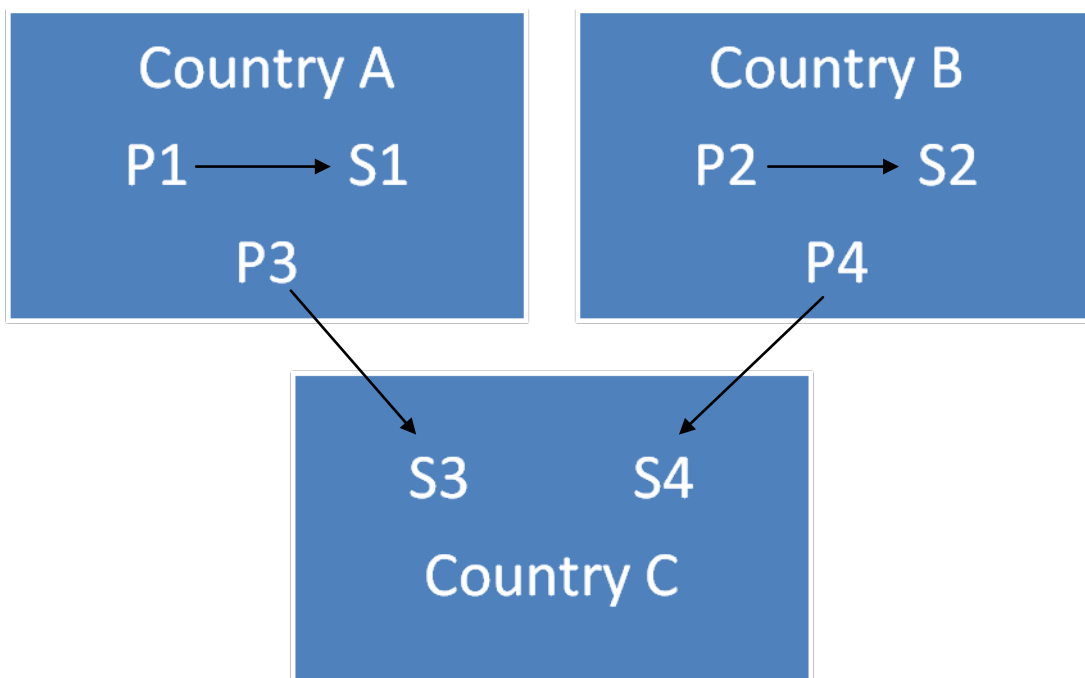
⁹⁷ Although some commentators were sceptical at the time on whether this approach would indeed bring domestic laws in line with EU law, see O. Thoemmes *et al*, “Thin Capitalisation Rules and Non-Discrimination Principles – An analysis of thin capitalisation rules in light of the non discrimination principle in the EC Treaty, double taxation treaties and friendship treaties” (2004) *Intertax* 32(3), 126-137, at 135; and “The New German Thin Capitalisation Rules: Tax Planning; Incompatibility with European Law” (2004) *Intertax* 32(8/9), 401-415. Others continue to question the compatibility of legislation adopting this type of approach with the Treaty, see J. Vella, n. 91 above.

⁹⁸ See D. Gutmann and L. Hinnekens, “The *Lankhorst-Hohorst* case. The ECJ finds German thin capitalization rules incompatible with freedom of establishment” (2003) *EC Tax Review* 2, 90-97, at 96.

⁹⁹ On these concepts see in particular references cited in n. 86 above.

two national groups and two multinational groups. Group 1 is a national group and consists of a parent company (P1) and a subsidiary (S1), both located in country A. Group 2, located in country B, is also a national group and consists of a parent company (P2) and a subsidiary (S1), both located in B, i.e. it has the same structure as group 1. Groups 3 and 4 are multinational groups. The parent company of group 3 (P3) is located in country A, its subsidiary (S3) is located in country C. The parent company of group 4 (P4) is located in country B, its subsidiary (S4) is also located in country C. In all four groups, only the parent companies engage in production while the subsidiaries have the task of financing the investment of their parents. For this purpose, they issue equity in the international capital market and pass on these funds to their parents in the form of an intra company loan. This implies that the parents pay interest to their financing subsidiaries. For groups 1 and 2, these interest payments remain within national borders whereas the intra firm interest payments in the multinational groups 3 and 4 flow from countries A and B to country C. The structure of the model is illustrated by figure 2. The arrows illustrate the interest payments.

Fig. 2



Assume that output of parent j ($j=P1, P2, P3, P4$) is given by the production function $Q_j(K_j)$, with $Q'_j(K_j) > 0, Q''_j(K_j) < 0$, where K_j is the parent's capital stock. For simplicity, we abstract from other production factors like labour. Adding them would complicate the notation without changing the results. This production function implies that the marginal productivity of capital declines as the capital stock increases. The goods produced by the parents are sold in the common product market, at a given price. To simplify notation, we assume that the price is equal to one. As a result, the profit of group j can be expressed as

$$P_j = Q_j(K_j) - iK_j - T_j^P + i_jK_j - r_jK_j - T_j^S \quad (1)$$

On the right hand side of (1), $Q_j(K_j)$ is the revenue of the subsidiary, i_jK_j is the interest the parent company of group j pays to the subsidiary, T_j^P is the corporate income tax paid by the parent, T_j^S stands for corporate income tax paid by the subsidiary, r_jK_j is the after tax return the subsidiary must offer to be able to raise funds in the union's capital market. The corporate tax payment of the parent, T_j^P , is given by

$$T_j^P = t_j^P (Q_j(K_j) - s_j i_j K_j)$$

where t_j^P is the corporate tax rate of the country where parent j is located and s_j is the share of interest payments which can be deducted from the corporate tax base. The corporate tax payment of the of group j, T_j^S , is given by

$$T_j^S = t_j^S i_j K_j$$

where t_j^S is the corporate tax rate of the country where the subsidiary resides.

In order to focus on the impact of international tax differences on the cost of capital of different groups, we assume that, in the absence of taxes, all groups would face the same cost of capital. This implies that the interest rate on intra group interest payments, i , as well as the non-tax refinancing cost of the different parent companies, r , are the same for all groups.

Given this, we can express (1) as

$$P_j = Q_j(K_j) - iK_j - t_j^P (Q_j(K_j) - s_j i K_j) + iK_j - rK_j - t_j^S i K_j \quad (2)$$

All groups choose the profit maximizing investment levels for their subsidiaries, which means that they will increase their capital stock until the increase in revenue generated by the last unit of investment equals the capital cost. Formally, the profit maximizing capital stock of subsidiary j is derived by maximizing the right hand side of (2). The result can be expressed as:

$$Q'_j(K_j) = C_j \quad (3)$$

with

$$C_j = \frac{1}{(1-t_j^P)} (r + i(t_j^S - t_j^P s_j)) \quad (4)$$

where C_j is the capital cost of group j. The capital cost C_j is the return the group must generate to pay taxes and the after tax return required by the investors.

Taxes paid by any individual group depend on the location of the parent company, and the location of the subsidiary. If two parent companies are located in different jurisdictions or if their subsidiaries are located in different countries, their cost of capital may differ due to tax differences across jurisdictions, so that their optimal investment levels differ, too. Other things equal, parent companies with low capital costs will invest more and vice versa. It is important to note that our model is deliberately constructed so that differences in capital costs across groups can only be caused by differences in taxes. All non-tax factors affecting the cost of capital are assumed to be equal, as our analysis focuses upon the impact of tax differences. Where there are such differences, there is no level playing field in taxation, and as a result the allocation of capital in the EU market in our model is distorted. The larger the tax differences, the larger the economic distortions caused by the tax system. Put differently, differences in the cost of capital in our model imply that *capital export neutrality* is violated – taxes distort the location of investment.

In our model, differences in the cost of capital between groups can be caused by differences in the relevant tax parameters t_j^P , s_j and t_j^S . Equation (4) shows that the cost of capital is higher, the higher the tax rates faced by the subsidiary, t_j^S , and the smaller the share of interest costs which can be deducted from the parent's tax base, s_j . The impact of the parent's tax rate, t_j^P , is slightly more complicated. In most cases, an increase in this tax rate will also increase the cost of capital. The opposite can only occur in rather special cases like e.g. a situation where the interest rate for intra group borrowing, i , is higher than the cost of raising funds faced by the parent company, r , the deductibility of intra group interest payments, s_j , is large, and the tax rate of the subsidiary, t_j^S , is small. In this case, an increase in t_j^P may increase the value of interest deductions by so much that the cost of capital declines. But we will focus on situations where these anomalies are excluded.

In the following, we will consider and compare six different tax regimes. A tax regime is a combination of corporate income tax policies (t_j^S, s_j, t_j^P) , $j=S1, S2, S3, S4$. The tax rates are the same in all regimes whereas the deductibility of interest payments differs. Therefore each regime can be characterized by referring only to the values of the interest deductibility parameters of the four subsidiaries: s_1, s_2, s_3, s_4 .

We start by considering a regime representing the situation before the intervention of the CJ ruling – we refer to this as the benchmark regime. In this situation, we assume that countries A and B both restrict the deductibility of border crossing interest payments, but not of interest payments between domestic firms. In the notation of our model, this is expressed as: $s_1, = s_2 = 1, s_3, s_4 < 1$.

As results from the CJEU jurisprudence, this combination of interest deduction rules is in conflict with EU law insofar as border crossing investment is discriminated relative to domestic investment. We therefore measure the impact of Court's ruling by comparing the benchmark situation to different

possible scenarios of how the Member States may react to the ruling. In the simple framework of our model, countries A and B essentially have two options to comply with the Court’s ruling: they may either abolish all restrictions on interest deductibility, or they may extend the restriction to interest payments between domestic firms.¹⁰⁰ Since there are two countries in our model and two possible reactions of national tax policy to the CJEU ruling, we have to consider four possible scenarios where Member States comply with it. The first two scenarios involve symmetric reactions by the two countries: either both countries abolish restrictions on deductibility, or they both extend the restrictions to domestic payments. These scenarios are represented by tax regimes 2 and 3. The other two scenarios involve asymmetric reactions, represented by regimes 4 and 5.

Finally, we also consider a scenario where governments do not comply with the Court’s ruling, and thus implicitly with EU law. We do so in light of the fact that it is clear from empirical analysis that Member States do sometimes preserve tax rules, which are potentially in conflict with EU law. In these cases, Member States seem to take the risk that this particular rule will (not) be struck down by future CJ rulings.¹⁰¹ We account for these cases by assuming that there is a sixth tax regime where firms face some uncertainty about the tax law that will finally apply. In this regime, the tax rules of the benchmark scenario will continue to apply with some probability denoted by q , with $0 < q < 1$. With probability $(1-q)$, the restriction of interest deductibility will be struck down, though, and the restriction on border crossing interest deductibility will not be applied. In order to avoid multiplying the number of scenarios under consideration, we only consider the case where country A (the country with the higher tax rate) does not comply and country B complies by abolishing border crossing interest deductibility. In this case, the formula for the (expected value of) the cost of capital is given by

$$C_j^{R6} = \frac{1}{(1-t_j^P)} (r + i(t_j^S - t_j^P [q s_j^{R1} + (1 - q) q s_j^{RR}])) \quad (5)$$

where s_j^{R1} is the interest deduction in the benchmark regime and s_j^{RR} is the interest deduction which applies in country j after all non-complying countries have been forced to comply. The six tax regimes are summarized in table 1.

¹⁰⁰ See point 4.1 above.

¹⁰¹ This might indeed be a rational risk, as whether or not a specific domestic tax rule is attacked for its incompatibility with EU law is a relatively random and unsystematic approach, since it depends on either a case being litigated in the national courts and then being referred to the CJEU, or on the Commission launching infringement proceedings – none of which is a reliable occurrence; see C. HIJ Panayi, “Reverse Subsidiarity and EU Tax Law: Can Member States be Left to Their Own Devices?” (2010) *British Tax Review* 3, 261-301, at 297 *et seq.*

Table 1: Tax Regimes and Restrictions on Interest Deductibility

	COUNTRY A		COUNTRY B	
	NATIONAL INTEREST PAYMENTS	BORDER INTEREST PAYMENTS	CROSSING INTEREST PAYMENTS	NATIONAL INTEREST PAYMENTS
REGIME 1 (BENCHMARK)	$s_1 = 1$	$s_3 < 1$	$s_2 = 1$	$s_4 < 1$
REGIME 2 (SYMMETRIC)	$s_1 = 1$	$s_3 = 1$	$s_2 = 1$	$s_4 = 1$
REGIME 3 (SYMMETRIC)	$s_1 < 1$	$s_3 = s_1 < 1$	$s_2 < 1$	$s_4 = s_2 < 1$
REGIME 4 (ASYMMETRIC)	$s_1 = 1$	$s_3 = s_1 = 1$	$s_2 < 1$	$s_4 = s_2 < 1$
REGIME 5 (ASYMMETRIC)	$s_1 < 1$	$s_3 = s_1 < 1$	$s_2 = 1$	$s_4 = 1$
REGIME 6 (ASYMMETRIC)	$s_1 = 1$	s_3 <i>uncertain</i>	$s_2 = 1$	$s_4 = 1$

What are the implications of these different regimes for tax distortions and economic welfare in the Union? In order to be able to compare the different possible regimes, we use a simple numerical version of our model. The numerical model allows for comparison between the differences in the cost of capital emerging in the different regimes. It also allows for a calculation of the costs of tax distortions and overall welfare levels.

4.2 Numerical version of the economic model

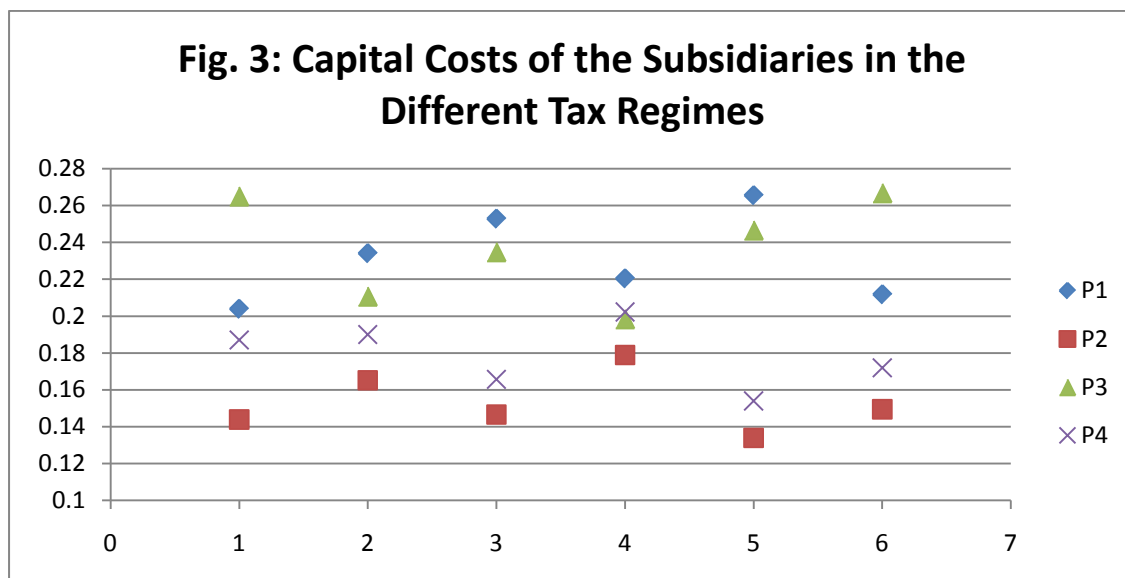
In order to better analyse the implications of the different tax regimes described in the preceding section, this section develops a simple and slightly extended numerical version of our model. Firstly, we assume that the marginal utility of public funds, which we denote by the variable η , is higher than the marginal utility of private funds. Where this was not the case, the best policy in our model would be not to levy taxes at all. To make things simple, we further assume that the marginal utility of public funds is equal to 1.1 in all countries whereas the marginal utility of private funds is equal to unity. In addition, we assume that the production function takes the quadratic form $Q_j(K_j) = \alpha_j K_j - \beta_j K_j^2$. The parameter values are given in table 2.

Table 2: Parameter Values

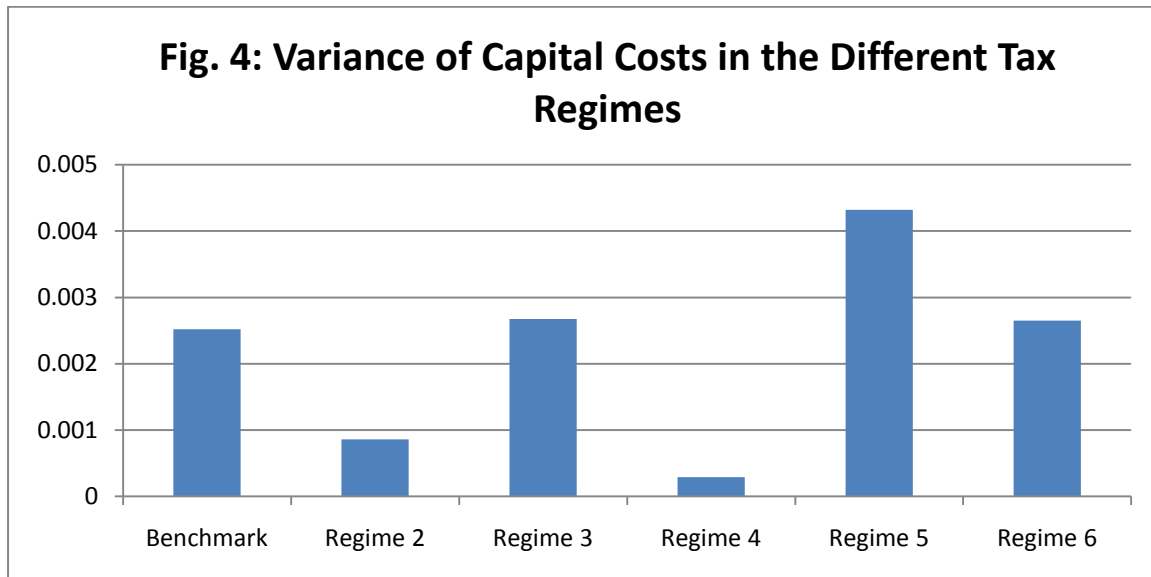
BASE MODEL	NUMERICAL MODEL (BASE CASE)
α_j	1
β_j	0.04
t_A	0.4
t_B	0.15
t_C	0.3
η	1.1
q	0.1
\bar{K}	40

The numerical model allows us to calculate capital costs, investment levels, tax revenues, and overall production for each of the tax regimes under consideration. It should be kept in mind that the parameters used are not derived from estimates of what the true parameters might be, and that therefore the numerical model merely provides an example which illustrates the underlying theoretical model.

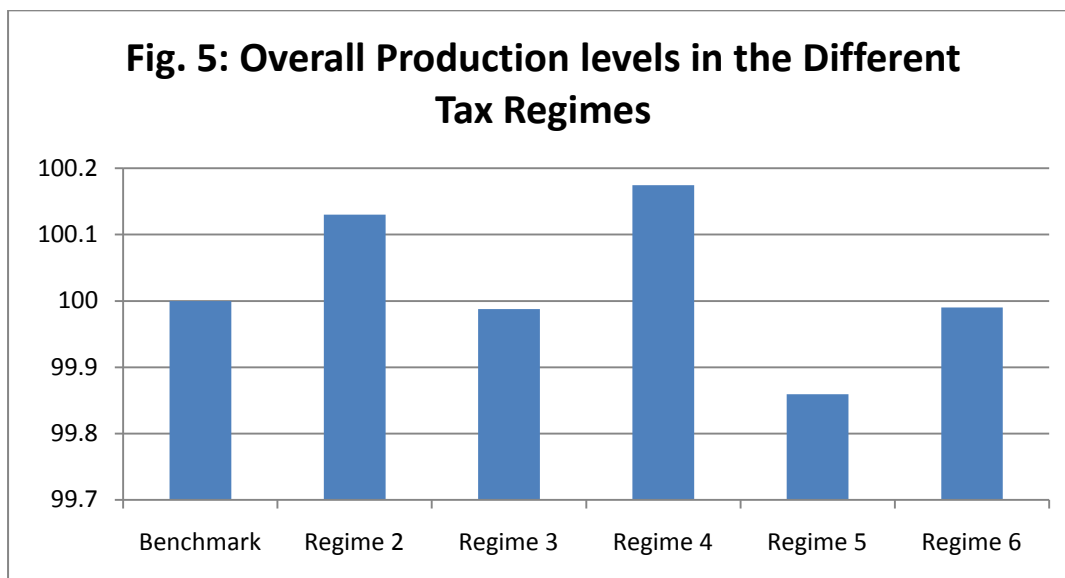
Consider first the capital costs of the different subsidiaries in our model. If all subsidiaries in the model faced the same capital costs, there would be no tax distortions within the EU market, but as a result of tax rates differences across countries, capital costs will differ both before the CJEU ruling (benchmark regime) and after the ruling. The interesting question, however, is whether the CJ ruling increases or decreases differences in capital costs caused by taxation. In our model, we investigate this by considering the variance of the capital costs before and after the ruling. Figure 3 gives an overview over the capital costs of the individual subsidiaries in each of the six tax regimes.



Consider first the move from the benchmark regime, to regime 2, where countries A and B abolish the restrictions on the deductibility of border crossing interest payments. The result in this case is that differences in capital costs decline. In the benchmark regime, the subsidiary of the multinational group operating in the high tax country (country A) faces the highest capital costs. This subsidiary benefits most from the abolition of the restrictions, so that its capital costs decline significantly. The overall differences in capital costs, measured by the variance, decline, as is shown by Figure 4.



It thus turns out that the CJEU ruling had the presumably intended effect,¹⁰² a move towards a more level playing field in corporate taxation, and as such a confidence step towards achieving an Internal Market. Figure 5 summarizes the impact on overall production. Comparing the benchmark regime and regime 2 again shows that the impact is positive – the move therefore also increases production.



¹⁰² See discussion below point 5.2.

However, as explained in the preceding sections, Member States may react to the Court's ruling not just by moving to regime 2, but rather by changing their tax policy and moving to / applying one of the other five tax regimes. Regime 3 is a regime where the Member States react symmetrically and abolish interest deductibility for both national and border crossing payments. Figure 4 shows that, perhaps surprisingly, this reaction increases the capital cost differences. This happens because given tax rate differences have a larger impact if the tax base is broadened, as is the case when the deductibility of interest payments is restricted. Here, production declines.

Consider next the asymmetric regimes 4 and 5. Regime 4 has positive effects: differences in capital costs decline and production and welfare increase relative to the benchmark scenario. This happens because the low tax country broadens its tax base, whereas the high tax country narrows the base that in turn leads to a convergence of effective tax burdens. The existing asymmetry in tax rates is therefore mitigated by another, diametrically opposed asymmetry in the tax base. The high tax country (country A) compensates firms for the higher tax rates by offering a full deductibility of interest payments whereas the low tax country (country B) goes along with limited interest deductibility. In regime 5 the opposite happens. If the country with the higher tax rate reacts to the ruling by extending the restriction on interest deductibility to purely national tax payments whereas the low tax country abolishes all restrictions, the effective tax burdens in these countries drift further apart. As a result, overall production in the Union declines. Finally, regime 6 is a scenario where the low tax country allows for full interest deductibility both nationally and across borders; whilst the high tax country also allows for full domestic deductibility, but restricts border-crossing deductibility. There is some probability, however, that such a discrimination will be struck down by a CJEU ruling, so that full deductibility is granted for border-crossing payments as well. In this regime, we have two countervailing effects on tax distortions: the fact that the low tax country extends full deductibility to border crossing interest payments increases the differences in effective tax burdens between the two countries, compared to the benchmark case; the fact that the high tax country will also have to grant deductibility with some probability tends to reduce the tax gap. Note that an extension of interest deductibility in the high tax country leads to a stronger reduction in effective tax burdens than the same increase in deductibility in the low tax country, because the value of deductions is higher if the tax rate is higher. In the example considered here, the probability that a CJEU ruling enforces deductibility of border crossing interest payments is assumed to equal only 10 per cent. This is why the tax burdens drift further apart. Nevertheless it can be shown that, if a higher probability of CJEU intervention is assumed, the result may change and effective tax burdens may actually converge.

To summarize, the numerical version of our economic model shows that the impact of CJEU rulings on tax distortions and, hence, on the efficiency of the capital allocation in the EU market depends upon the way in which Member States react to the ruling. Depending on those reactions tax distortions may increase. This happens in particular where the high tax country reacts by extending restrictions on interest deductibility to national payments, whilst the low tax country reacts by extending full deductibility to border crossing payments as well. Of course, these results must be seen in the light of the highly stylised nature of the model we use – we come back to the limitations of the economic analysis further below. Before we do so, however, it is interesting to confront our theoretical results with the observed reactions of Member States to the *Lankhorst-Hohorst* ruling.

4.3 Member States’ reactions to *Lankhorst-Hohorst*

Whether the implicit aim of the CJEU in *Lankhorst-Hohorst* – by determining that thin capitalisation rules contravened EU law insofar as they applied to EU residents – was essentially to put all debt investment within Europe on an equal position insofar as tax restrictions were concerned, *i.e.* to level the playing field, or merely to abolish discrimination, is unclear.¹⁰³ What is clear, however, is that, as a result of Member States’ reaction to the ruling, non-discrimination in itself might have been achieved, but a level playing field and increased neutrality was not.

First, it is relevant to note that, approval of amendments in order to bring national legislation in line with Court’s rulings is far from automatic.¹⁰⁴ Levels of compliance vary across Member States and on the specific ruling. Some Member States have a better track record of compliance than others – with non-compliance often characterised as a more evident phenomenon in southern Member States –¹⁰⁵ and certain rulings result in higher levels of compliance than others.¹⁰⁶ Moreover, even where compliance takes place, implementation of these rulings can vary greatly amongst Member States for numerous reasons, including ignorance and lack of awareness on the part of domestic legislators, budgetary concerns, unclarity of the rulings themselves, and even cultural differences. It is unsurprising, therefore, that the reaction to *Lankhorst-Hohorst* was far from uniform. Some Member States, such as Spain and Portugal, did restrict their thin capitalisation rules, removing intra-EU situations from their scope. Other, however, such as Germany and Denmark, followed the first approach set out above, *i.e.* they extended the scope of thin capitalisation rules to apply to purely domestic situations. This led to further discrepancies in the scope of application of the various thin capitalisation rules within the EU.

¹⁰³ See above point 3.2.

¹⁰⁴ This phenomenon has been designated of “reverse subsidiarity”, see C. HIJ Panayi, n. 101 above.

¹⁰⁵ See F. de Hosson, n. 60 above, at 299; and M. Wathélet, “Direct Taxation and EU Law: Integration and Desintegration” (2004) *EC Tax Review* 13(1), 2-4, at 3.

¹⁰⁶ See generally P. Farmer and A. Zalasinski, “General Report” in X.L. Xehopoulos (ed.), *Direct Tax Rules and the EU Fundamental Freedoms: Origin and Scope of the Problem; National and Community Responses and Solutions* (Nicosia: FIDE, 2006); C. Brokelind, n. 76 above, including country reports therein; and C. HIJ Panayi, n. 101 above.

Table 3: National Reactions to *Lankhorst-Hohorst*

SCOPE OF APPLICATION OF THIN CAPITALISATION RULES (X= thin capitalisation rule applies; – = no thin capitalisation rule applies)						
BEFORE RULING			AFTER RULING			
NATIONAL	EU MEMBER STATES	THIRD COUNTRIES	NATIONAL	EU MEMBER STATES	THIRD COUNTRIES	
AUSTRIA	–	–	–	–	–	
BELGIUM	–	X	X	–	–	X
BULGARIA				X	X	X
CYPRUS	–	–	–	–	–	–
CZECH REPUBLIC				X	X	X
DENMARK	–	X	X	X	X	X
ESTONIA	–	–	–	–	–	–
FINLAND	–	–	–	–	–	–
FRANCE ¹⁰⁷	–	X	X	X	X	X
GERMANY	–	X	X	X	X	X
GREECE	–	–	–	X	X	X
HUNGARY				X	X	X
IRELAND	–	X	X	–	–	X
ITALY	–	X	X	X	X	X
LATVIA	–	–	–	–	–	X
LITHUANIA	–	–	–	X	X	X
LUXEMBOURG	X	X	X	X	X	X
MALTA	–	–	–	–	–	–
NETHERLANDS	–	–	–	X	X	X
POLAND	–	X	X	X	X	X
PORTUGAL	–	X	X	–	–	X
ROMANIA				X	X	X
SLOVAK REPUBLIC				–	–	–
SLOVENIA				X	X	X
SPAIN	–	X	X	–	–	X
SWEDEN	–	–	–	–	–	–
UNITED KINGDOM ¹⁰⁸	–	X	X	X	X	X

¹⁰⁷ Thin capitalisation rules have been recently amended in France, where the Finance Bill 2011 extended their scope to include loans guaranteed by a related party, such as bank loans.

¹⁰⁸ Although the amendments introduced by the United Kingdom to their cross-border group relief system seems to comply with the Court's ruling insofar as it applies to EU Member States, doubts still linger over its *de facto* compatibility, since the conditions imposed for relief by the amended rules are much stricter than those set out in the *Marks & Spencer* judgment, see C. HIJ Panayi, n. 101 above. As a result the European Commission announced in late 2009 that it had initiated infringement proceedings against the United Kingdom, see

Table 3 above summarises the territorial scope of application of these rules – or rules to the same effect – before and after the ruling in *Lankhorst-Hohorst*. Consideration of the amendments introduced by Member States following *Lankhorst-Hohorst* seems therefore to indicate that it is Regime 5 above, which has prevailed. Not only did Member States react asymmetrically, *i.e.* some opted to extend the scope of their thin capitalisation rules, whilst others opted to restrict them; but it was those Member States which apply higher rates of corporate tax that tended towards widening the scope of their thin capitalisation rules, in order to encompass domestic situations, whereas it was those Member States which apply lower rates of corporate tax tended to limit the scope of their thin capitalisation rules, excluding intra-EU situations from their scope. The asymmetry of Member States’ reaction to *Lankhorst-Hohorst* is hardly surprising – indeed some commentators have challenged the use of the term negative harmonisation to characterise the CJEU tax jurisprudence precisely on the basis of the asymmetry of Member States’ reaction to the rulings.¹⁰⁹ Unsurprising too are the negative economic effects of such asymmetry. Less intuitive perhaps is the fact that a symmetric reaction by Member States can also give rise to negative economic effects, namely a decrease in neutrality and in the level-playing field, as Regime 3 above demonstrates. It follows therefore that whilst symmetry does indeed imply elimination of discrepancies between national tax legislation, it does not necessarily bring the EU closer to an Internal Market.

5. Group Consolidation Regimes and the Judgment in *Marks & Spencer*: Case Study Two

Virtually all Member States within the EU treat profits and losses asymmetrically: profits are taxed in the year in which they are earned; while losses are not refunded where they are incurred, but rather offset against future profits.¹¹⁰ In general, domestic relief of losses is automatically available within the same company, and available under specific rules within a group of companies in most Member States. In most cases, cross-border relief is also available within the same company (permanent establishments); on the contrary however traditionally cross border relief of losses was usually not available within a group a companies (subsidiaries).¹¹¹

Corporate Taxation: Commission requests the United Kingdom to properly implement an ECJ ruling on cross-border loss compensation, Press Release IP/09/1461, 8 October 2009.

¹⁰⁹ See J. Malherbe *et al.*, n. (.69 above, at 78. See also C. Brokelind, “Conclusions” in C. Brokelind (ed.), n. 76 above, 401-406.

¹¹⁰ See generally European Commission, *Tax Treatment of Losses in Cross-Border Situations*, Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee, COM(2006) 824 final, 19 December 2006.

¹¹¹ *Ibid* at 3.

Whilst there had been previous cases regarding cross-border relief of losses within the same company,¹¹² none had such a significant impact as *Marks & Spencer*, the first to focus upon cross-border relief within a group.¹¹³ The case, concerning the compatibility of UK rules limiting the right of parent companies to deduct losses incurred by non-resident subsidiaries with the Treaty provision on freedom of establishment, generated massive controversy from the outset.¹¹⁴ The potential revenue impact of the ruling was the main reason for such controversy: as most Member States had in place rules similar to those of the UK and feared significant revenue losses if the Court was to find them incompatible with the Treaty.¹¹⁵ Their fears would turn out to be only half-justified. The Court found on the case that the UK group relief system was only in violation of the Treaty insofar as it did not allow losses incurred by subsidiaries in other Member States to be taken into account, where the possibilities for having those losses considered in the subsidiary's state of residence had been exhausted. Even then, despite its rather restrained scope, the ruling required significant amendment to most EU group relief systems. In this context, and similarly to the situation post *Lankhorst-Hohorst*, following the decision in *Marks & Spencer* Member States essentially had two avenues of action available in order to bring their group consolidation regimes in line with the ruling: either to extend their consolidation regime to non-resident subsidiaries established within the EU; or, to do away with consolidation altogether. Alternatively, a further avenue was also available to Member States: non-compliance with the ruling. In the next section, we briefly consider the relevance of the *Marks & Spencer* ruling for tax distortions of investment in the EU market.

5.1 The economic effects of *Marks & Spencer*

How may CJEU jurisprudence on cross-border losses offset affect tax distortions of investment in the EU Market? Consider the following variant of the model introduced in section 4.1. It is now assumed that the financing subsidiaries of the four groups face some economic risks in their activity, and that

¹¹² See in particular Cases C-250/95, *Futura Participations SA and Singer v Administration des contributions*, [1995] ECR I-2492; and C-141/99, *Algemene Maatschappij voor Investeren en Dienstverlening NV (AMID) v Belgische Staat*, [2000] ECR I-11621.

¹¹³ Case C-446/03, [2005] ECR I-10837.

¹¹⁴ In addition to the references included below, see also M. Gammie, "The Impact of the *Marks & Spencer* Case on US-European Planning" (2005) *Intertax* 33(11), 485-489; P. Martin, "The *Marks & Spencer* EU group relief case - a rebuttal of the 'taxing jurisdiction' argument" (2005) 14 *EC Tax Review* 14(2), 61-68; M. Lang, "*Marks and Spencer* - more questions than answers: an analysis of the Opinion delivered by Advocate General Maduro" (2005) *EC Tax Review* 14(2), 95-100; G. T.K. Meussen, "The *Marks & Spencer* Case: The Final Countdown Has Begun" (2005) *European Taxation* 45(4), 160-163; M. Persoff, "*Marks & Spencer*: more questions than answers" (2006) *British Tax Review* 3, 260-267; T. Lyons, "Marks & Spencer: something for everyone?" (2006) *British Tax Review* 1, 9-14; M. Isenbaert and C. Valjemark, "M&S judgment: the ECJ caught between a rock and a hard place" (2006) *EC Tax Review* 15(1), 10-17; T. O'Shea, "*Marks and Spencer v Halsey (HM Inspector of Taxes)*: restriction, justification and proportionality" (2006) *EC Tax Review* 15(2), 66-82; H. van den Hurk, "Cross-Border Loss Compensation – The ECJ's Decision in *Marks & Spencer* and How It was Misinterpreted in the Netherlands" (2006) *Bulletin for International Taxation* 60(5), 178-186; Sjoerd Douma and Caroline Naumburg, "*Marks & Spencer*: Are National Tax Systems Éclairé?" (2006) *European Taxation* 46(9), 431-442; and M. Lang, "The *Marks & Spencer* Case – The Open Issues Following the ECJ's Final Word" (2006) *European Taxation* 46(2), 54-67.

¹¹⁵ See S. Kingston, n. 70 above, at 305; and G. Meussen, "The *Marks & Spencer* Case: Reaching the Boundaries of the EC Treaty" (2003) *EC Tax Review* 12(3), 144-148.

this risk is directly related to their activity of raising funds for their parent company – or alternatively it is also possible to consider risk being generated by some additional financial or non-financial business activity. To keep things simple, assume that, on average, this activity generates a profit denoted by the variable z_j per unit of capital K_j with probability 0.5 and a loss of the same amount otherwise. This implies that the expected value of the loss or gain is equal to zero. In the case of a loss, the subsidiary has the interest income from borrowing to its parent company which can be set against the loss. But if $z_j > i$, the interest income is not enough and the question arises of whether or not the losses of the subsidiary can be set against profits of the parent company. We therefore assume $z_j > i$, so that intra group loss offset becomes relevant. The loss offset regime has consequences for the tax burden faced by each group and, hence, for its costs of capital. The expected profit of group j can now be expressed as

$$P_j^L = Q_j(K_j) - t_j^P(Q_j(K_j) - s_j i K_j) - r K_j - t_j^S i K_j + 0.5 K_j (z_j - i)(m_j t_j^P - t_j^S) \quad (6)$$

where m_j is a parameter describing the loss offset regime. Given this, we can derive the capital cost, using the same approach as in section 4.1. as:

$$C_j^L = \frac{1}{(1-t_j^P)} (r + i(t_j^S - t_j^P s_j) - 0.5(z_j - i)(m_j t_j^P - t_j^S)) \quad (7)$$

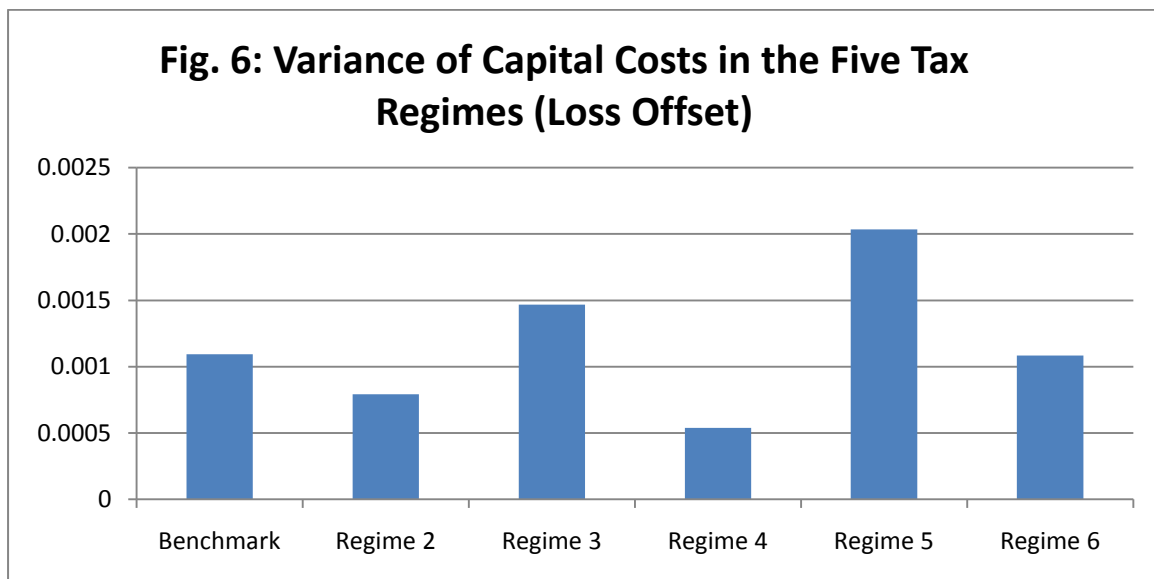
The possible impact of the loss offset regime is described by the last term on the right hand side of equation (6). With a probability of 50 per cent the subsidiary makes a loss $K_j(z_j - i)$. The tax consequences of this loss depend on the value of $(m_j t_j^P - t_j^S)$. The simplest case is the case of a purely national group in a world with unrestricted intra group loss offset ($m=1$). In this case, the loss of the subsidiary can be transferred to the parent and the deduction is at the same tax rate, so that $m_j t_j^P - t_j^S = 0$. In this case the existence of risky income z_j does not affect the cost of capital. In contrast, if intra group loss offset is restricted, the cost of capital increases in a purely national group. In an international group, things are more complicated. If the tax rate of the parent company is higher than that of the subsidiary the possibility that losses of the subsidiary may be set against income of the parent company may even reduce the cost of capital.

Considering the scenarios analysed above in the context of interest deductibility, we can summarise their application to losses relief / offset, as follows in Table 4:

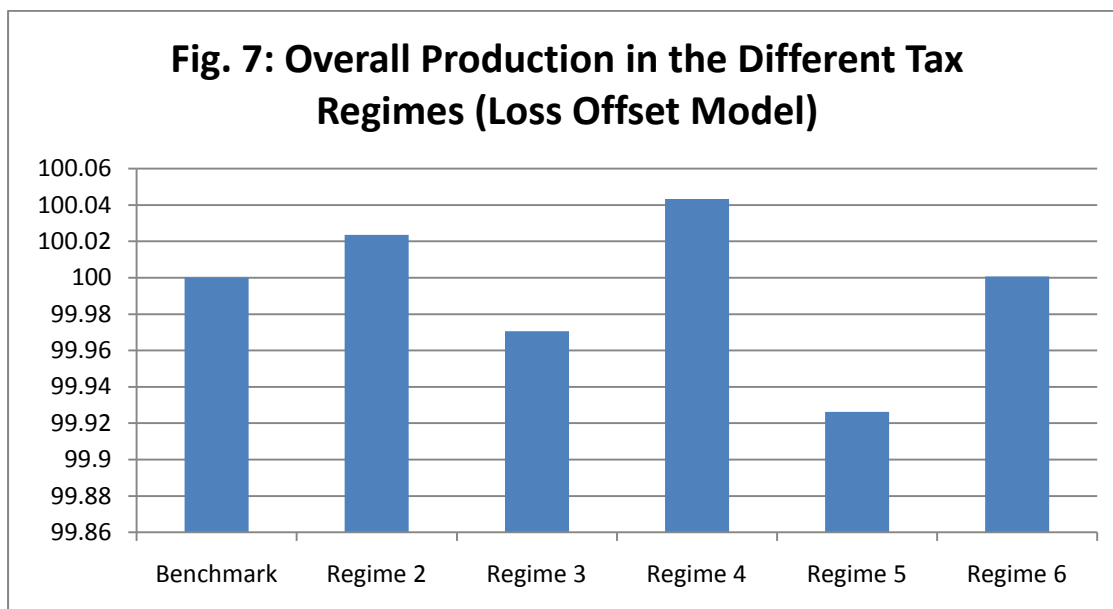
Table 4: Tax Regimes and Restrictions on Loss Offset

	COUNTRY A		COUNTRY B	
	NATIONAL INTEREST PAYMENTS	BORDER CROSSING INTEREST PAYMENTS	NATIONAL INTEREST PAYMENTS	BORDER CROSSING INTEREST PAYMENTS
REGIME 1 (BENCHMARK)	$m_1 = 1$	$m_3 < 1$	$m_2 = 1$	$m_4 < 1$
REGIME 2 (SYMMETRIC)	$m_1 = 1$	$m_3 = 1$	$m_2 = 1$	$m_4 = 1$
REGIME 3 (SYMMETRIC)	$m_1 < 1$	$m_3 = m_1 < 1$	$m_2 < 1$	$m_4 = m_2 < 1$
REGIME 4 (ASYMMETRIC)	$m_1 = 1$	$m_3 = m_1 = 1$	$m_2 < 1$	$m_4 = m_2 < 1$
REGIME 5 (ASYMMETRIC)	$m_1 < 1$	$m_3 = m_1 < 1$	$m_2 = 1$	$m_4 = 1$
REGIME 6 (ASYMMETRIC)	$m_1 = 1$	m_3 <i>uncertain</i>	$m_2 = 1$	$m_4 = 1$

A simple numerical version of our model as in section 4, with parameter values as described in Table 2, is then considered. The additional parameter z has a value of 2 and we assume full interest deductibility in all regimes. In cases where loss offset is restricted we set $m=0$. The results of the numerical analysis are displayed in figures 6 and 7, which reports the impact variance in the capital costs in the different regimes and the levels of production in the model.



Overall, the results are very similar to those of in case study one, as regards interest deductibility, and therefore confirm them. As would be expected, the differences in capital costs decline in regime 2, where all countries extend loss offset across borders, and they increase in regime 3, where loss offset within national groups is abolished. While the extension of loss consolidation to losses incurred abroad reduces the significance of tax rate differences across countries, abolishing national consolidation increases their impact. The variance of capital costs also declines in the asymmetric scenario 4 where the high tax country opts for the extension of loss offset across borders while the low tax country chooses to restrict loss offset for both national and international groups. The opposite happens in regime 5. Regime 6, where the high tax country chooses not to comply with EU law, but could with some probability face a CJEU ruling, leads to approximately the same variance in capital costs as the benchmark scenario.



As fig. 7 shows production is also at approximately the same level as in the benchmark regime. Here, the fact that the low tax country extends loss offset to border crossing operations increases the tax differences within the EU market. However, the fact that the high tax country might, with some positive probability, be forced to do it as well reduces the expected cost of capital in the high tax country. If this happens, the reduction in the cost of capital will be higher than in the low tax country, because the value of a given tax loss is higher in the high tax country.

5.2 Member States' reactions to *Marks & Spencer*

Similarly what was said as regards the ruling in *Lankhorst-Hohorst*, it is unclear whether the implicit aim of the CJEU in *Marks & Spencer* was essentially to put outgoing investment within the EU on a

more neutral and level playing field position from a tax perspective, or merely to abolish discrimination.¹¹⁶

Table 4: National Reactions to *Marks & Spencer*

	SCOPE OF APPLICATION OF GROUP RELIEF OF LOSSES RULES					
	BEFORE RULING			AFTER RULING		
	NATIONAL	EU MEMBER STATES	THIRD COUNTRIES	NATIONAL	EU MEMBER STATES	THIRD COUNTRIES
AUSTRIA	X	X	X	X	X	X
BELGIUM	-	-	-	-	-	-
BULGARIA	-	-	-	-	-	-
CYPRUS	X	-	-	X	-	-
CZECH REPUBLIC	-	-	-	-	-	-
DENMARK	X	X	X	X	X	X
ESTONIA	-	-	-	-	-	-
FINLAND	X	-	-	X	-	-
FRANCE	X	X	X	X	X	X
GERMANY	X	-	-	X	-	-
GREECE	-	-	-	-	-	-
HUNGARY	-	-	-	-	-	-
IRELAND	X	-	-	X	X	-
ITALY	X	X	X	X	X	X
LATVIA	X	-	-	X	X	-
LITHUANIA	X	-	-	X	X	-
LUXEMBOURG	X	-	-	X	-	-
MALTA	X	-	-	X	-	-
NETHERLANDS	X	-	-	X	-	-
POLAND	X	-	-	X	-	-
PORTUGAL	X	-	-	X	-	-
ROMANIA				-	-	-
SLOVAK REPUBLIC				-	-	-
SLOVENIA	X	-	-	-	-	-
SPAIN	X	-	-	X	-	-
SWEDEN	X	-	-	X	X	-
UNITED KINGDOM	X	-	-	X	X	-

X= Group relief of losses exists

- = Group relief of losses does not exist

¹¹⁶ What is clear however was the position of the European Commission, urging Member States to review existing national in order to consider different alternatives which would provide relief for losses within groups in cross-border situations, see n. 110 above, at 11.

As before, however, Member States' reaction to the ruling must be taken into consideration. As mentioned above, Member States' reactions to CJEU rulings tend not to be homogenous – and *Marks & Spencer* was no exception. Not solely there is a risk of non-compliance, but equally even where Member States comply with the ruling, its implementation can vary greatly. It is therefore unsurprising that the reaction to *Marks & Spencer* was so discrepant. Table 4 above summarises the scope of application of cross-border group relief of losses rules before and after the ruling.

It has been said that, when faced with the requirement to change their national tax legislations as a result of a judgment of the CJEU establishing the incompatibility of national rules with the Treaty, the reaction of Member States tends to be as follows: to extend application of norms limiting taxpayers' rights in cross-border situations to domestic cases, rather than to abolish them for intra-EU cases; or, to abolish preferential domestic regimes, instead of extending them to cross border situations.¹¹⁷ The reaction of Member States to *Lankhorst-Hohorst* certainly seems to confirm this assertion – whilst the reaction was asymmetrical, many Member States preferred to extend the scope of application of their thin capitalisation rules to domestic situations, rather than to exclude EU situations from their scope. The reaction to *Marks & Spencer* is less clear, due to the role played by non-compliance.¹¹⁸ The suspicion, however, is that if forced Member States would be more likely to abolish their group relief systems, rather than to extend them to cross-border situations, thus confirming the above statement. This empirical reality, coupled with the theoretical results presented above, will unavoidably give rise to particular concerns as regards the fulfilment of the constitutional mandate, set-out in the Treaties, of establishing an EU Internal Market.

6. Significance of Results: Breaking the Instrumental Chain

From the analysis undertaken in the two preceding sections it is clear that, the approach of the CJEU of striking down national tax provisions, which – in the language of the Court – are either discriminatory and/ or impose restrictions on the fundamental freedoms, does not necessarily increase neutrality or lead to a more level playing field, *i.e.* it does not reduce overall tax distortions in the European Internal Market. This is particularly likely in those cases where, as a reaction to CJEU rulings, countries with high tax rates extend restrictive tax rules from border crossing to purely national economic transactions, whilst low tax countries extend a more generous treatment of national economic activity to border crossing transactions. Empirically, this seems to have been precisely the

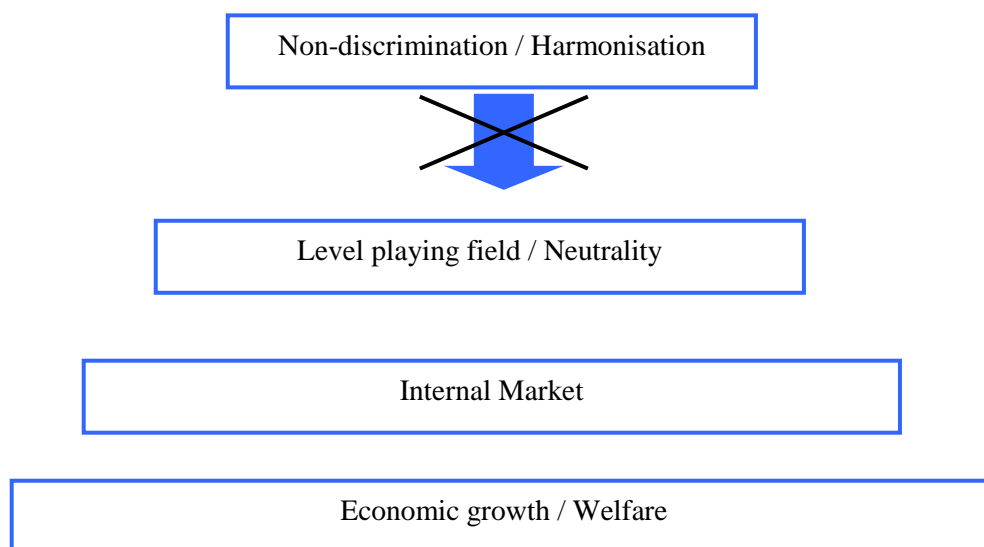
¹¹⁷ See P. Farmer and A. Zalasinski, n. 106 above.

¹¹⁸ It has been suggested that might be one of the main reasons for this non-compliance was the fact that the ruling itself left many question unanswered about its scope of application, which were probably not clarified by later cases dealing with different group relief arrangements, see C. HIJ Panayi, n. 101 above. Indeed the fact that more cases on this topic continue to arrive to the CJEU seems to be indicative of this lack of clarity, see Case C-18/11, *The Commissioners for Her Majesty's Revenue & Customs v Philips Electronics UK Ltd*, Reference for a preliminary ruling from Upper Tribunal (Tax and Chancery Chamber) (United Kingdom) made on 12 January 2011, OJ C 89, 19/03/2011, p. 11.

pattern of reactions by Member States to the *Lankhorst-Hohorst* ruling; the reaction of Member States to *Marks & Spencer* is less clear, however, with non-compliance seemingly playing a significant role.

The question which must be asked, therefore, is what is the significance of these results for assessing the Court's jurisprudence on direct taxation? From a terminological perspective, it is difficult to perceive how this jurisprudence can still be regarded and/or designated, as negative harmonisation. Despite the inaccuracy highlighted above, the terminology may nevertheless have been regarded as legitimate insofar as the Court's jurisprudence did indeed result in effective harmonisation, *i.e.* insofar as it led to increased neutrality and/or the establishment of a level playing field within Europe. Yet, this not being the case, the use of this classification loses any potential legitimacy. More importantly, from a substantive perspective, these results have significant constitutional implications, which in turn raise legitimacy issues. If the approach being adopted by the Court as regards direct taxation, of striking-down national measures deemed to be discriminatory/restrictive, has not led to an increase in neutrality and a more level playing field across Member States, then it must be concluded that it is not contributing to the ultimate aim of establishing an EU Internal Market – in essence, as demonstrated in Figure 8, the constitutional instrumental chain has been broken.

Figure 8: Broken Constitutional Instrumental Chain



Concluding that the constitutional instrumental chain has been broken has inescapable implications. The role adopted by the Court insofar as direct taxation is concerned should be considered in the context of the ongoing discussion since the 1980s over the legitimacy and constitutionality of what has been designated as the Court's judicial activism, or excessive activism.¹¹⁹ Defined broadly by critics as the Court's tendency to engage in contextual and teleological interpretation and its bias

¹¹⁹ The expression "judicial activism" seems to have been first used by H. Rasmussen, *On the Law and Policy in the European Court of Justice* (Martinus Nijhoff, 1986). Since then it has been widely used in EU law literature, albeit criticised by some, see T. Tridimas, "The Court of Justice and Judicial Activism" (1996) *European Law Review* 21, 199-210.

towards European integration, judicial or excessive activism is said to result in, either an assumption of competences by the EU vis-à-vis the Member States – so-called “competence creep” – or,¹²⁰ an assumption of powers which goes beyond the Court’s judicial function and can be characterised as the adoption of a quasi-legislative role. These two supposed manifestations of the judicial or excessive activism phenomenon are interconnected, but they are not identical: the first concerns the question of whether the Court’s actions are *ultra vires*, *i.e.* whether as an EU institution it has competence to act under the Treaties on a specific matter; the second is whether its actions respect the rule of law and the principle of separation of powers, *i.e.* whether the Court, as a judicial body, is usurping powers which should instead only be exercised by the EU’s legislative bodies. Insofar as direct taxation is concerned, the Court’s activities and its economic effects, raise questions as regards both these aspects.

6.1 *Ultra vires* action

Queries must be raised over the consequences of breaking the constitutional instrumental chain in the context of the mandate for establishing and improving the functioning of the Internal Market, set out in the Treaties, and particularly in Article 26(1) TFEU. Is it legitimate for the Court to intervene by repealing national corporate tax measures, under the constitutional mandate of establishing an EU Internal Market, when its decisions in that regard are not actually contributing towards achieving that aim? If the results of the Court’s actions insofar as direct taxation concerned are not fulfilling the Treaties’ aims, then it must be questioned whether the Court is acting *ultra vires*.

It results naturally from the principle of conferral of powers set out in the Treaties that, and EU institution will act *ultra vires* where it transgresses the limits of its competence. That transgression may take different forms, including an *ultra vires* interpretation of Treaty provisions or rules made thereunder by the CJEU.¹²¹ In fact, the issue of *ultra vires* action by the Court has been much debated and commented upon, particularly in the context of decisions by national constitutional courts claiming competence to engage in *ultra vires* review of CJEU judgments.¹²² Whilst revisiting that

¹²⁰ On “competence creep” see in particular S. Weatherill, “Competence Creep and Competence Control” (2004) *Yearbook of European Law* 25, 1-55; M.A. Pollack, “Creeping Competence: The Expanding Agenda of the European Community” (1994) *Journal of Public Policy* 14, 95-145; and A. Prechal, “Competence Creep and General Principles of Law” (2010) *Review of European Administrative Law* 3, 5-22.

¹²¹ See P. Craig, “The ECJ and *Ultra Vires* Action: A Conceptual Analysis” (2011) *Common Market Law Review* 48, 395-437, at 395.

¹²² See M. Kumm, “Who is the Final Arbiter of Constitutionality in Europe?: Three Conceptions of the Relationship Between the German Federal Constitutional Court and the European Court of Justice” (1999) *Common Market Law Review* 36, 351; K. Høegh, “The Danish Maastricht Judgment” (1999) *European Law Review* 24(1), 80-90; A. Arnulf, *The European Union and its Court of Justice*, second edition (Oxford, OUP, 2006), at 255-266; D. Doukas, “The Verdict of the German Federal Constitutional Court on the Lisbon Treaty: Not Guilty, but Don’t Do It Again!” (2009) *European Law Review* 34(6), 866-888; D. Thym, “In the Name of Sovereign Statehood: A Critical Introduction to the Lisbon Judgment of the German Constitutional Court” (2009) *Common Market Law Review* 46, 1795-1822; I. Pernice, “*Costa v ENEL* and *Simmenthal*: Primacy of European Law” in M. Poiras Maduro and L. Azoulai (eds.), n. (...) above, Part II, Chapter 2, 47-59, at 54-57; A. Pliakos and G. Anagnostares, “Who is the Ultimate Arbiter? The Battle Over Judicial Supremacy in EU

debate is outside the scope of this paper, it is important to note that there may be different reasons why a specific judicial action may be regarded as *ultra vires*: the claimant may seek to argue that the judicial interpretation of the Treaties is too broad, or that the judicial interpretation adopted as regards a particular Treaty provision does not pay sufficient attention to internal limits expressed therein.¹²³ The key difficulty here, however, is of course how to assess whether a specific action falls into these categories, what are the criteria to determine whether that action is *intra* or *ultra vires*. Clearly determining the scope of *intra vires* action will always be problematic in a polity such as the EU, where the range of powers granted is broad and the language used vague. Moreover, often the CJEU will invoke, either explicitly or implicitly, background normative precepts that shape its vision of what it can legitimately do under the Treaty provisions.¹²⁴ Alongside the judicial positions adopted by the national constitutional courts as regards the scope of the *ultra vires* review, other criteria have also been proposed at the doctrinal level to determine whether such CJEU decisions are within the limits imposed by the Treaty. In this article we present the constitutional instrumental chain as the most adequate criterion, at least insofar as direct taxation is concerned: it is argued that the Court's jurisprudence in this area should only be regarded as *intra vires* where it is actually contributing to the establishment of an EU Internal Market.

As highlighted above, the powers granted by the Treaty as regards the removal of national discriminatory provisions – as well as the approval of harmonising legislation – are instrumental to the aim of establishing and improving the functioning of the EU Internal Market; indeed they are conditional to attaining that aim. If the aim is not being achieved and, therefore, the condition is not being fulfilled, then it would seem reasonable to conclude that there is a risk that the Court's actions will be regarded as being outside the limits imposed by the Treaties and transgressing the limits to its competences imposed therein – ultimately as *ultra vires*. Whether such a claim would be successful, if even attempted, as regards the Court's jurisprudence on direct taxation is, of course, impossible to predict. Nevertheless, it is noteworthy that the argument has already been presented by national governments in cases involving other areas of law. The CJEU has so far rejected these claims, stressing that the interpretation of Treaty provisions in question were within the limits of what was absolutely necessary for the attainment of the objectives pursued by the Treaty.¹²⁵ Such a conclusion may, however, be difficult to sustain insofar as direct taxation is concerned in the face of evidence regarding the breaking of the constitutional instrumental chain.

Law" (2011) *European Law Review* 36(1), 109-123; and M. Payadeh, "Constitutional Review of EU Law After *Honeywell*: Contextualizing the Relationship Between the German Constitutional Court and the EU Court of Justice" (2011) *Common Market Law Review* 48, 9-38.

¹²³ For a full list of potential reasons for an *ultra vires* claim see P. Craig, n. 121 above, at 397.

¹²⁴ P. Craig, n. 121 above, at 407 and 436-437.

¹²⁵ See Case C-518/07, *European Commission v Federal Republic of Germany*, Judgment of 9 March 2010, nyr, known as the *Data Protection Supervisory Authorities* case, on the protection of individuals with regard to the processing of personal data. See also Case C-555/07, *Seda Küçükdeveci v Swedex GmbH & Co. KG*, Judgment of 19 January 2010, nyr, on the principle of non-discrimination on grounds of age, following on the controversial *Mangold* decision, Case C-144/04, *Werner Mangold v Rüdiger Helm*, [2005] ECR I-9981.

6.2 Rule of law and separation of powers

The judicial activism debate has been intensifying over the last three decades, and the literature on the topic is now extensive.¹²⁶ Whilst there is no intension of revisiting that debate here, it is important to reflect upon the quasi-legislative role adopted by the CJEU insofar as direct taxation is concerned. In particular, it should be considered whether adopting such a role is all the more questionable where the ethos underlying it – the aim of furthering European integration and achieving an EU Internal Market – is not actually being accomplished through the adoption of that same role.

Under Article 2 of the Treaty on European Union (TEU) the rule of law is one of the founding values of the Union.¹²⁷ Whilst some have pointed out the difficulties of reconciling the idea of a state governed by the rule of law with a legal framework which does not establish a state *per se*, it is nevertheless accepted that the very foundation of the European project was based on that general notion.¹²⁸ On this basis the CJEU has elaborated significantly on the idea of rule of law, developing it as a supra-constitutional principle,¹²⁹ which arguably prevails even over the “black-letter” of the Treaty.¹³⁰ As acknowledged by the Court, the notion is also inextricably linked to that of separation of powers.¹³¹ Indeed whilst generally the notion of rule of law carries many of the virtues that a legal system may possess,¹³² and has had many qualities associated with it depending on the particular

¹²⁶ Whilst the arguments put forward by both parties in the discussion will not be analysed here, extensive literature is available on the topic. For a critical view of the Court of Justice see amongst others: H. Rasmussen, “Between Self-Restraint and Activism: A Judicial Policy for the European Court” (1988) *European Law Review* 13, 28; P. O’Neill, “The European Court of Justice: A Case Study in Judicial Activism”, Lords Selected Committee on the European Communities, Minutes of Evidence (Session 1994-95, 18th Report, H.L. Paper 88); T.C. Hartley, *The Foundations of European Community Law* (Oxford: Oxford University Press, Sixth Edition, 2007), at 74-78. For a supportive view of the Court of Justice see amongst others: M. Cappelletti, “Is the European Court of Justice ‘Running Wild’?” (1987) *European Law Review* 12, 3; J. Weiler, “The Court of Justice on Trial” (1987) *Common Market Law Review* 24, 555; F. Mancini and Keeling, “Democracy and the European Court of Justice” (1994) *Modern Law Review* 57, 186; A. Arnull, “The European Court and Judicial Objectivity: A Reply to Professor Hartley” (1996) *Law Quarterly Review* 112, 411-423; G. Howe, “Euro-Justice: Yes or No?” (1996) *European Law Review* 21(3), 187-198; T. Tridimas, n. (...) above; and W. van Gerven, “The Role and Structure of the European Judiciary Now and in the Future” ” (1996) *European Law Review* 21(3), 211-233.

¹²⁷ Article 2 reads: “The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights (...)”. The same notion was previously expressed in Article 6(1) TEU introduced by the Maastricht Treaty.

¹²⁸ O. Zetterquist, “The Judicial Deficit in the EC – Knocking on Heaven’s Door?” in U. Bernitz, J. Nergelius and C. Cardner (eds.), n. 96 above, 115-137, at 116 and 122; and L. Pech, “The Rule of Law as a Constitutional Principle of the European Union” (2009) *Jean Monnet Working Paper Series* 04/09.

¹²⁹ The first time the principle of rule of law was mentioned by the Court was in *Les Verts*, significantly before the principle was set out in the Treaty, see Case 294/83, *Parti écologiste “Les Verts” v European Parliament*, [1986] ECR 1339, at para. 23. For a complete list of recent cases where the Court invoked rule of law, see L. Pech, n. 128 above, at Annex.

¹³⁰ O. Zetterquist, n. 128 above, at 122. As T. Tridimas states: [Article 2] occupies a distinct position in the Constitutional Treaty and features at the top tier of the hierarchy of norms of EU law. It thus provides a prime point of reference for the interpretation of other provisions of the Constitution” in *The General Principles of EU Law* (Oxford: OUP, 2006), at 16.

¹³¹ See recently Case C-279/09, *DEB Deutsche Energiehandels- und Beratungsgesellschaft mbH v Bundesrepublik Deutschland*, judgment of 22 December 2010, nyr, paragraph 58.

¹³² See J. Raz, “The Rule of Law and Its Virtue” in R.L. Cunningham (ed.), *Liberty and the Rule of Law* (Texas A&M University Press, College Station, 1979), 3-31.

vision of the concept adopted,¹³³ the principle of separation of powers is certainly amongst these.¹³⁴ This principle should in turn be understood as having serious implications for the nature and limitations of the judicial role.¹³⁵ Indeed, it often concerns the boundaries between judicial and legislative powers that have traditionally sparked discussions over the relevance and potential disrespect for the principle of separation of powers.¹³⁶ As recognised by the Court, this is equally true insofar as the EU legal system is concerned, despite the fact that the EU institutional framework has been often characterised as *sui generis* and not based on a strict separation of powers.¹³⁷ Early references by the Court to this principle can be traced back to the beginnings of the European integration process,¹³⁸ and are today a regular feature within the Court’s rhetoric. Acknowledgement of the limits imposed by it upon the exercise of the Court’s judicial power can equally be found in the jurisprudence, with the CJEU stating that it only has jurisdiction to fill a legal vacuum, not to correct acts of the legislature,¹³⁹ that it should exercise restraint in reviewing the legality of legislative acts,¹⁴⁰ or more explicitly that the Court should respect the policy responsibilities which belong to the Union’s legislative and administrative organs and, consequently refrain from assuming their role in the policy sphere.¹⁴¹

In this context, the quasi-legislative role of the CJEU insofar as direct taxation is concerned would be susceptible of being questioned, as possibly overstepping the – admittedly blurry – line that divides judicial and legislative powers within the EU. In fact, whilst analyses of the Court’s role, or even of

¹³³ See A.T. Williams, “Promoting Justice After Lisbon: Groundwork for a New Philosophy of EU Law” (2010) *Oxford Journal of Legal Studies* 30(4), 663-693, at 667. For a comprehensive review of the main conceptualisations of rule of law proposed by legal theorists, see P. Craig, “Formal and Substantive Conceptions of the Rule of Law: An Analytical Framework” (1997) *Public Law*, 467-487.

¹³⁴ See in particular the work of T.R.S. Allan, namely: T.R.S. Allan, “Legislative Supremacy and the Rule of Law: Democracy and Constitutionalism” (1985) *Cambridge Law Journal* 44(1), 111-143, at 125-129; T.R.S. Allan, “The Rule of Law as the Rule of Reason” (1999) *Law Quarterly Review* 115, 221-244; and T.R.S. Allan, “Judicial Deference and Judicial Review: Legal Doctrine and Legal Theory” (2011) *Law Quarterly Review* 127, 96-117, at 117. See also B. Tamanaha, *On the Rule of Law: History, Politics, Theory* (Cambridge; CUP, 2004), at 37.

¹³⁵ See T.R.S. Allan, *Constitutional Justice: A Liberal Theory of the Rule of Law* (Oxford: OUP, 2001), at chapters 2 and 5.

¹³⁶ As Lord Hoffmann has stated: “It is the power to give decisions which are legislative in character and which carry a provisional finality, subject only to amending legislation which is in many cases not a practical possibility, which causes the alarm sometimes expressed about encroachment of judicial power”, see “The COMBAR Lecture 2001: Separation of Powers” (2002) *Judicial Review* 7, 137-145, at 138.

¹³⁷ See F. Mancini and D. Keeling, n. 126 above, at 181; and J.P. Jacqué, “The Principle of Institutional Balance” (2004) *Common Market Law Review* 41, 383-391, at 388.

¹³⁸ See Joined cases 14, 16, 17, 20, 24, 26 and 27/60 and 1/61, *Meroni & Co. and others v High Authority of the European Coal and Steel Community*, [1961] ECR 321; and Case 25/70, *Einfuhr- und Vorratsstelle für Getreide und Futtermittel v Köster and Berodt & Co.*, [1970] ECR 1161. Although the Court has often used a different terminology, referring to the “principle of institutional balance”, see G. Conway, “Recovering a Separation of Powers in the European Union” (2011) *European Law Journal* 17(3), 304-322, at 319.

¹³⁹ Case C-352/09P, *ThyssenKrupp Nirosta GmbH, formerly ThyssenKrupp Stainless AG v European Commission*, Judgment of 29 March 2011, nyr, paragraph 54.

¹⁴⁰ Case C-161/04, *Republic of Austria v European Parliament and Council of the European Union*, [2006] ECR I-7183, Opinion of Advocate General Geelhoed, paragraph 40.

¹⁴¹ Case C-317/04, *European Parliament v Council of the European Union*, [2006] ECR I-4721, Opinion of Advocate General Léger, paragraph 233.

direct tax matters in general, in the context of the constitutional principles such as rule of law or the separation of powers as its corollary are relatively rare,¹⁴² accusations that its rulings display a disregard for the dividing line between judicial and legislative roles are not infrequent within EU tax literature. These accusations are made even under the assumption that either the Court's rulings are either effective steps towards the achievement of an Internal Market, or that for the Court non-discrimination is the objective in itself. They seem much more pertinent, however, in the context of an eventual breaking of the constitutional instrumental chain. Assumption of a quasi-legislative role by the Court has essentially been defended on the basis of the nature of the EU legal framework, the need to further the European integration process, and the ineffectiveness of the EU legislature to do so. These arguments are hardly applicable where the constitutional mandate is not fulfilled, and in face of evidence that, insofar as direct taxation is concerned, the Court's quasi-legislative role might unwillingly have resulted in the fulfilment of the constitutional aim of establishing an EU Internal Market being further away today than it had been before its intervention in this process.

7. Conclusion

In this paper we have assessed the economic effects of the CJEU direct tax jurisprudence in order to determine whether this jurisprudence leads to a more level playing field and increased tax neutrality, thus fulfilling the constitutional mandate of establishing an EU Internal Market. Using the rulings in *Lankhorst-Hohorst* – regarding the compatibility of thin capitalisation rules with free movement provisions – and in *Marks & Spencer* – concerning the compatibility of rules on group consolidation – as case studies, we conclude that, depending on the reaction of Member States to the Court's interference, differences in capital costs faced by firms operating in the European Internal Market may increase and the level playing field and neutrality may decrease.

The results presented may appear counter-intuitive for many lawyers – in particular the conclusion that, Court-induced uniformisation of tax provisions does not necessary lead to increased neutrality and a more level playing field, but may actually steer the EU further away from establishing an Internal Market.¹⁴³ In practice the results may be explained in a relatively simple fashion: when only one aspect of the tax systems is made uniform – such as thin capitalisation rules, or rules regarding group losses – without systematic harmonisation of tax bases or tax rates, these differences at bases

¹⁴² For a recent study of the exercise of tax powers in the context of constitutional principles, including the rule of law, see J. Freedman and J. Vella, 'HMRC's Management of the U.K. Tax System: The Boundaries of Legitimate Discretion' in J. Freedman, C. Evans and R. Krever (eds.), *The Delicate Balance: Revenue Authority Discretions and the Rule of Law*, IBFD, (forthcoming 2011). See also G.T. Loomer, "Taxing Out of Time: Parliamentary Supremacy and Retroactive Tax Legislation" (2006) *British Tax Review* 1, 64-90.

¹⁴³ As R. Mason and M.S. Knoll comment "lack of a sophisticated understanding of what competitive neutrality requires is problematic (...). Non-economists – including members of the Court of Justice – tend to believe that we can understand a tax's impact on competitiveness simply by comparing competitors' tax rates on a given asset. (...) This reasoning is intuitive but wrong", in n. 80 above.

and rates level may become more significant, to the effect that there may be a decrease in neutrality and the level playing field. This possibility arises due to the dynamics of Member States' reactions to the Court's intervention, whereby some may choose to eliminate non-discrimination through extension of tax restrictions to investment. Such a reaction, whilst probably not the one envisaged by the Court, is hardly surprising – in fact a few commentators had already alerted to this potential outcome, based on the United States experience.¹⁴⁴ Unfortunately, our empirical analysis of two cases studies indicates that, insofar as thin capitalisation rules are concerned, the Court's intervention has indeed resulted in the most negative scenario prevailing; whilst as regards rules on group losses the situation is less clear only because most Member States seem to have opted not to alter their tax legislation following the Court's intervention.

The above conclusions do not, of course, take-away from the very real difficulties of dealing with tax cases in a manner which respects the constitutional instrumental chain. Reaching increased neutrality and a level playing field through jurisprudential intervention, in the presence of very distinct national tax systems and in the absence of harmonising legislation, can hardly be qualified as an easy task – and might even be an impossible one. However, in the face of the economic results presented here, one cannot but wonder what has it been all about, *i.e.* what has been achieved by the last twenty-five years of EU tax jurisprudence? It was obviously impossible to assess within the framework of this paper the economic effects of all individual tax decisions made by the CJEU. It is therefore possible, even likely, that many of those decisions will have indeed led to an increased level playing field and tax neutrality, thus contributing to the establishing of the EU Internal Market. However, what has been clearly demonstrated, and what must be strongly emphasized, is that this is not always or necessarily the result. It is fundamental therefore to raise awareness, not only of the fact that lack of consideration of the constitutional instrumental chain as set out in the Treaties might mean that we are heading in the wrong direction but also the potential constitutional consequences of taking that route. If effects do not correspond to the Union's ultimate aim, what is the Court's legitimacy to act in this matter? There is, in particular, a risk that the Court's decisions as regards direct taxation may be regarded as *ultra vires*, and/or in violation of the rule of law and its corollary the principle of separation of powers.

Direct taxation is only one of the many areas, which broadly fall under the so-called “European Economic Constitution”, where the CJEU has chosen to intervene intensively through the application of the fundamental freedoms. This raises the further question as to whether the analysis undertaken above as regards taxation – namely assessing through economic analysis whether the constitutional instrumental chain is being respected – could, and indeed should, be equally applied to those areas.

¹⁴⁴ M.J. Graetz and A.C. Warren, Jr., point out that “extending restrictions to intrastate transactions is how US states have sometimes responded to adverse US Supreme Court decisions”, see n. 83 above, at 1234.

This is a question which we do not propose to answer here, but that we rather leave open to potential future investigation.

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