EC Law and Protection of the Swedish Tax Base

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1 Introduction

This article seeks to explore the extent to which the current EC-law system permits Member States to adopt or maintain rules intended to protect the national tax base. The article is arranged as follows. We begin by describing the significance of the statutory provisions adopted by individual Member States within the framework of the EU sphere, i.e., in principle existing secondary law. We then describe the significance of the EU Treaty for income taxation. We conclude by discussing a) the role the EC Court plays in advancing integration; and b) the limits on the Court's powers to use interpretation to set aside rules which affect free movement but which also protect the national tax base. We shall also discuss whether the EC Court applies the principle of neutrality in tax cases out of economic considerations and, if so, which considerations specifically.

2 The Legal Framework Governing Tax Bases

2.1 Excise Duties

EC law permits in principle any and all excise duties. Free movement may not however be encumbered. Customs barriers and the like which result in excise duties on imports are forbidden. This is an effective means of preventing goods from being made subject to excise duties. Private purchases abroad of goods subject to excise duty in Sweden could not be taxed in Sweden. An exception is motor vehicles and aircraft, which must be registered in Sweden in order to be used here on a permanent basis. Excise duty can be levied in connection with registration. However, this regime only applies to new cars. Private cars can thus be privately imported without Sweden being able to levy excise duties. Private importation means, stated briefly, that a natural person has himself travelled to another Member State, acquired goods there and himself returned to Sweden with them.

The free movement of goods under EC law also implies limits on the imposition of Excise duties; they may not in any way have protectionist effects. Thus, foreign goods may not be disfavoured. Nor may a excise duty have the characteristics of a value added tax. To have an "extra" VAT is simply out of the question. Typical VAT-like features are that a tax is levied in several places in the production and distribution chain and that a deduction is allowed for a prior VAT amount. The case of *AMBI* involved a Danish "labour market fee". [1] That levy had yielded appr. seven billion ECU. The Danish state was ordered to repay the entire sum, since the EC Court deemed this "labour market fee" to be a disguised "extra" value added tax. Actually, Denmark had argued that it was not obliged to refund the money and has not, according to sources, done so either.

A special type of excise duty which is becoming ever more common is the environmental tax. Discussions have occurred in Sweden as to whether the carbon dioxide tax can be divided between two bases: production and consumption. This tax is without doubt a excise duty, which means that it is problematic to impose a carbon dioxide tax of the *value added tax type* on the consumption of certain goods and services. Nor may any border formalities be imposed.

The environmental excise duty must also be devoid of discriminatory or protectionistic features. The system may under no circumstances create problems for foreign company owners. Assume, for example, that environment friendly electricity is taxed at a lower rate. This is not in itself a problem as long as foreign producers of "environmental electricity" can compete on the same terms as Swedes. Actual competition is not necessary but the rules may not prevent such competition from coming into being. The case of *Outokumpu* concerned a Finnish system for energy taxation, within which perceived-to-be environmentally friendly electricity was taxed at a lower rate than other electricity.[2] At the same time, imported electricity was taxed at the same rate regardless of how it was produced. This was a clear breach of the EC Treaty. It is of course a problem to determine how imported electricity has been produced (actually the same problem applies to all electricity). In summary, rules are not permitted if they would favour Swedish producers. Protectionism cannot be concealed behind ostensibly identical rules when such rules are in practice more difficult for foreign producers to fulfil. On the other hand, there is of course no obstacle to Sweden having rules in this area that favour foreign producers of environmentally friendly energy.

Some goods fall within extensive harmonisation: alcohol, tobacco and petroleum products. Harmonised taxation of petroleum products is not deemed to rule out other taxes, such as e.g., the Swedish sulphur tax. It is however rather unclear as to where the line is drawn. The case of *Braathens Safe* is interesting in this regard.[3] The Swedish environmental tax on domestic air traffic was deemed to violate the directive. The National Tax Board argued that the tax was not actually a tax on fuel but rather a tax on the emission of carbon dioxide and hydrocarbons. Therefore, Sweden was at liberty to impose such a tax. The tax

1 C-200/90 *Dansk Denkavit* [1992] ECR I-2217.

2 C-213/96 *Outokumpo Oy* [1998] ECR I-1777.

3 C-346/97 *Braathens Safe* [1999] ECR I-3419.

was not harmonised through the directive. The EC Court, for its part, took the view that persons in Sweden could directly invoke the directive before the Swedish courts (so called direct effect) and ruled in favour of the taxpayer, an airline. Therefore, the Swedish position is probably incorrect. The sulphur tax is probably a tax on fuel, at least in part.

Excise duties may of course be levied on the products covered by the harmonised rules and, what is more, an intricate system has been devised to ensure that excise duties are paid in the country of consumption. The system is known as the suspension regime, and means that these goods can move within Europe without a duty to pay excise duties. Excise duty is levied when the goods are released for consumption. The country where the goods are when this takes place decides the rate of tax. If the goods are released for consumption in Sweden, then Swedish excise duty is payable. Private importation is however possible without Swedish excise duty having to be paid. As regards alcohol, Sweden has received a temporary exemption. The exemption entails a successive escalation of the permitted quantity of alcohol that may be imported privately without Swedish tax being payable. As of 2004, all private importation, i.e., acquisition in another Member State for one's own or one's family's use, will be permissible without Swedish excise duty being payable.

In the important *Man-in-Black* case, however, the EC Court has shown itself to be prepared to defend the Member States' right to protect their tax base.[4] Simply stated, the issue was whether the rules for private importation could be applied to distance purchases, where the ultimate purchaser (the consumer) had purchased cigarettes through an agent. The EC Court interpreted the somewhat ambiguous horizontal excise duty directive and stated that the private importation rules were not applicable in such a case.[5] The consumption country's excise duty was to be used. The EC Court was clearly influenced by the fact that the companies in question tried to use artificial transactions to gain tax advantages. Actually, the EC Court's interpretation in *Man-in-Black* did not create any obstacle to the free movement of goods other than what already follows generally from the horizontal excise duty directive. On the other hand, it is still unclear what applies if a person resident in Sweden asks a friend, who intends to travel to another EU country, to return to Sweden with alcohol or tobacco. Swedish excise duty is payable under Swedish law but that might actually be contrary to what follows from the directive.

It must therefore be concluded that legal protection for the tax bases of alcohol, tobacco and petroleum products is limited, since importation for one's own consumption is permitted without Sweden being able to impose excise duty. This limits the possibility to impose high tax on these products upon sale in Sweden. How serious this actually is can only be ascertained through an economic analysis of the extent of border trade. The protection will of course remain, however, if the excise duty on the goods in our closest neighbouring countries is as high as, or higher than, the Swedish. This applies mainly to petroleum products.

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4 C-296/95 *Man-in-Black* [1998] ECR I-1605.

5 Council Directive 92/12/EEC of 25 February 1992 on the general arrangements for products subject to excise duty and on the holding, movement and monitoring of such products.

2.2 The Value Added Tax

Value added tax is to a great extent harmonised within the EU. Although the Member States may themselves decide the level of the tax, the tax base itself is regulated by the sixth value added tax directive.[6] This means quite simply that Sweden can no longer decide which persons are liable to pay VAT, on which transactions VAT can be levied, at which point in time tax can be levied, at what value the tax can be levied or which so-called input value added tax can be deducted. Membership in the EU has in several cases resulted in tax hikes in Sweden. For example, Sweden had certain exemptions which were not permitted. Another example is that the right of deduction for input value added tax is considered to be more limited in EU law than in Swedish law, etc. This broadening of the tax base is, however, probably of relatively minor significance.

Today's system means in principle that consumption in Sweden of VAT-subject goods or services shall also be taxed in Sweden. The country of destination principle applies. Sweden's membership in the EU did not entail major differences compared to its pre-EU period. Private importation is however subject to the country of origin principle (see further immediately below).

The protection of the VAT-base is generally good. The EU deems this tax base to be very important. Another question is which tax base is most important: Is it the Member State's tax base or the Union's tax base. There are actually no known VAT-cases where the EC Court has used the argument that a specific country's tax base must be protected. On the other hand, there is extensive case law to the effect that the EC Court, via interpretation, ensures that a European taxpayer is taxed somewhere within the area of the European Union. This means in essence that the EC Court views the EU as one single territory for purposes of value added tax.

This view is probably shared by the Commission, as is not least evident from the Commission's view of how e-trade should be regulated.[7] The Commission has proposed that the place of an e-trade company's registration shall determine which value added tax shall be leviable on consumer e-services. This would for example mean that a consumer in Sweden who uses "Video-on-Line" or "Music-on-line" would in the future pay the value added tax of the country of registration. Clearly, such a company would establish itself in the country where the value added tax is lowest. Sweden and some other Member States have, however, opposed against this proposal in the Council of Ministers.[8]

The problem is however that today's method of dealing with value added tax on digitalised services is hardly sustainable in the long term. Sweden will

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6 Sixth Council Directive 77/388/EEC of 17 May 1977 on the harmonization of the laws of the Member States relating to turnover taxes - Common system of value added tax: uniform basis of assessment.

7 COM/2000/0349 final. Proposal for a Council Directive amending Directive 77/388/EEC as regards the value added tax arrangements applicable to certain services supplied by electronic mean.

8 The result is the Council Directive 2002/38/EC of 7 May 2002 amending and amending temporarily Directive 77/388/EEC as regards the value added tax arrangements applicable to radio and television broadcasting services and certain electronically supplied services.

presumably be unable to protect the “Internet consumption” tax base with today’s rules. The problems of administration are too great. A common view today is that consumption of e-services is small scale, and therefore, the problem is minor. But in the future, this consumption is certain to increase and that will probably result in problems for Sweden to tax this phenomenon. In the Commission there is a desire, simply stated, to ensure that this consumption is taxed somewhere in the EU, but in which Member State this occurs is less important.

In summary, the VAT system, as currently devised, is based on the principle that Swedish non-business consumption shall be subject to Swedish VAT. There are no large legal gaps. There are exceptions for private importation from another EU Member State in the same manner as applies to excise duties. Unlike the case of excise duties, however, there is a provision entailing that a foreign company can sell to a Swedish consumer in Sweden without Swedish VAT applying. It is, however, required that sales to Sweden as a whole do not exceed a certain threshold, currently appr. 32 000 Euro. This provision is known as the distance sales rule. The rule acknowledges the problems of requiring foreign companies to register VAT in Sweden unless their turnover here is of a certain significance. This rule is perhaps abused today, although the extent of any such abuse is difficult to ascertain.

That private importation is permitted entails a limitation on the level of value added taxation. The sensitivity can only be determined by an economic analysis, but it is obvious that so-called rarely bought commodities are most sensitive (i.e. domestic appliances). Base consumption is not of course under any great pressure. On the other hand, an important base consumption, namely food, is today taxed at a lower rate for reasons of wealth distribution.

The Commission desires, however, that the country of origin principle be introduced generally. That would mean that all acquisitions of goods, etc. in other EU countries would be taxed in the country of purchase. A Swede who purchases goods by post order in Germany would always pay German VAT and excise duties. A businessman who acquires goods would also pay German tax which he would deduct from Swedish tax. Such a system would require some kind of tax revenue distribution among the Member States. This would entail very difficult practical problems and we might therefore expect the current rules to continue well into the future. The Commission also desires a uniform level for value added tax, which would of course facilitate a transition to the country of origin principle.

2.3 Income Taxation

2.3.1 Corporate Taxation Directives

Unlike the fields of VAT and excise duty, harmonisation efforts have not progressed very far in the field of corporation taxation. At the initial stage of EC cooperation, the Commission desired extensive harmonisation in this area.. For example, several proposals were presented for common corporate tax rules both regarding tax base and tax rates, which included questions such as choice of company tax system (single or double taxation of the companies' profits), rules on accrual accounting for tax purposes, tax incentives, etc. However, these proposals never came close to being adopted by the Council. An important reason for the Member States' lack of will to introduce binding income tax legislation at the EU level was clearly the great significance income taxation is perceived to have for the national economy. The Member States wanted to retain as much freedom of action as possible and did not wish to bind themselves to common legislation. And perhaps the successful efforts to harmonise VAT and excise duties have reduced the prospects of reaching results in the field of income taxes. As the margin of national self-determination decreased with regard to VAT and excise duties, the Member States may have found it all the more important to retain their self-determination as regards income tax.

The Commission has also gradually altered its orientation on harmonising income taxation. The previous years' fanciful plans have been replaced by a more pragmatic view. The Commission has in recent years focused its efforts on harmonising tax rules that are of special significance to international transactions and situations and has left tax rules concerning essentially domestic phenomena outside its work. Some success was achieved in 1990 when the very first directives for corporate taxation, the merger directive[9] and the parent company/subsidiary directive,[10] were adopted. There are also a couple of draft directives being discussed in the Council but it is still too early to say if and when they will be adopted.[11] As we see it, the Commission's new strategy is presently the only realistic one, but even it has proven difficult to win approval in the Council.

The parent company/subsidiary directive governs taxation of dividends in international corporate groups.[12] The directive provides that dividends from subsidiaries in one Member State to a parent company in another Member State shall not be taxed. The directive thus prescribes tax exemption for a certain transaction, in other words, a limitation of the tax base. It should however be noted that a corresponding tax exemption existed in the internal laws of many countries - as well as in double taxation treaties to which they were parties - already before the directive was adopted. The Member States are also given the option to partially or completely refrain from applying the directive's beneficial provisions in tax evasion situations, which reflects a desire to balance the tax subject's interests against the legitimate interests of the Member States to protect their tax base.[13] The directive also provides the option of replacing tax

9 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.

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

11 COM(90) 595 final proposes common rules for cross-subsidization between group companies in various countries and COM(98) 67 final, regarding taxation of interest and royalty payments between closely related companies in different Member States.

12 The directive was recently addressed in a doctoral dissertation at Lund University, *see* Brokelind, "Une interprétation de la directive sociétés mères et filiales du 23 juillet 1990", Studentlitteratur 2000.

13 *See* Article 1.2 of the directive.

exemption for dividends received with an indirect credit system, i.e., a system whereby the dividends are taxed but where credit is granted for company tax paid in the country of the subsidiary.[14] Sweden has exercised this option for dividends from companies resident in low tax countries.[15] Once again, we see that there exist certain possibilities for the Member States to protect their tax bases and still be in full compliance with the directive.

The Merger directive governs taxation of certain types of international company reorganisations. This directive too prescribes that certain enumerated transactions should be possible without taxation, i.e., even here we find a directive whose rules can result in a limitation of the tax base. The directive does not however seek to grant a definite tax exemption but merely postpones taxation to a later point in time. This occurs through application of a basis carry-over method.[16] That method requires that the untaxed values that are transferred through the reorganisation remain in the country where they arose. Thus, the reorganisation must not result in a Member State definitely losing a basis of taxation. The directive also contains a special tax evasion provision.[17] The Merger directive too desires to strike a balance between promoting the internal market by introducing tax rules that facilitate international enterprise and at the same time protecting the Member States' tax bases.

2.3.2 Countering Tax Competition

The Commission and the Council have in recent years dealt specifically with the issue of how the Member States' tax bases shall be protected against the threat which an integrated internal market can pose. As the internal market has forged ahead and obstacles to free movement have been removed, the issue of tax competition between the Member States has increased in intensity. Tax competition means that countries, e.g., in order to attract foreign capital or to increase the competitiveness of their own companies, reduce taxes to ever lower levels. Tax competition can manifest itself both in a generally reduced tax level and in a beneficial taxation of selected income categories and/or tax subjects.

Certain forms of tax competition appear to be forbidden under the state support provision of Article 87 of the EU Treaty. In order to initiate a more systematic effort to reduce tax competition within the EU, the Council has also adopted a resolution containing a so-called code of conduct for company taxation.[18] The resolution is a political document and thus not legally binding on

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14 *See* Article 4.

15 Tax exemption in chapter 24:20 and 22 of the Income Tax Act only applies if the income taxation which the subsidiary is subject to is on a par with the income taxation which would have applied under Swedish law if the income had been acquired by a Swedish company. Otherwise, the dividend is taxed, but under § 1 of the Deduction Act, deduction is granted at a standardized amount of 13 % of the dividend's gross amount.

16 *See* Articles 4-10 of the directive.

17 *See* Article 11.

18 Resolution of the Council and the Representatives of the Governments of the Member States, meeting within the Council of 1 December 1997 on a code of conduct for business taxation, Official Journal C 002 , 06/01/1998 at 0002 - 0005.

the Member States. The code of conduct states which type of tax rules are “harmful” and how the effort for their long-term elimination shall be realised.

The code of conduct covers tax rules that affect, or can affect, localisation of business operations within the Union. If such a tax rule prescribes a much lower tax for certain situations than does the one that applies generally in the Member State in question, the tax rule shall be deemed to be potentially harmful and thus covered by the resolution. The tax relief might be a result of the applicable tax rate, a tax base or some other relevant factor. The resolution is thus aimed at those countries which, within an otherwise “normal” tax system, create certain tax-exempt or low-tax “islands”. On the other hand, the directive does not apply to a situation where a country applies low taxes generally for all incomes. That the directive does not apply in such cases is natural, since there are no pure tax havens among the EU Member States. It may however be noted that EC law does not establish legal obstacles for a Member State that wishes to become a tax haven. From a strictly political perspective, however, such a choice would hardly be possible.

The Member States undertake in the code of conduct to refrain from introducing new harmful tax provisions and to remove any harmful provisions which might already exist. The harmful provisions should be eliminated by the end of 2002, but it is stated that a longer period might be justified in certain cases. A special group, comprising representatives of the Member States, has been given the task of examining and assessing national tax rules which might be forbidden by the resolution. It is that group that will do the hard work and whether the code of conduct proves to be a success will therefore largely depend on how the group’s efforts are received in the Member States. The group has submitted a report listing the potentially harmful measures that could arise from the Member States’ tax legislation.

As part of the efforts against harmful tax competition, the Commission has also produced a draft directive on taxation of savings.[19] The draft covers private persons who have placed money in bank accounts, etc. in other Member States. According to the draft, the Member States shall provide information on interest income to the tax authorities in the account holder’s country of domicile. Under the draft, three Member States (Belgium, Luxemburg and Austria) are given the option to apply, for a limited period, a source tax to the interest . An agreement on principles has been reached within the Council to adopt this directive, but the agreement is conditioned on the premise that corresponding rules are also introduced in certain non-Member States (tax havens, i.e. Switzerland). Whether the EU will be able to persuade these countries to adopt such rules is very uncertain.

2.3.3 Concluding Remarks

Our overall assessment is that the EU, within the framework of its legislative efforts, respects and cares about the Member States’ tax bases. The interest in

19 COM/2001/0400 final. Proposal for a Council directive to ensure effective taxation of savings income in the form of interest payments within the Community.

adopting tax rules that promote the internal market are consistently balanced against the interest of the Member States in protecting their revenue base. This is of course understandable, the legislator is the Council which is the congregation of the Member States. The States naturally seek to protect their interests. The desire of the Member States to protect their tax bases is to some extent contrary to the case law that has concurrently unfolded within the EC Court. We shall now examine that question.

3 What Limitations does the EU Treaty Entail for the Tax Sovereignty of the Member States?

3.1 Introduction

The EU Treaty contains provisions prescribing that obstacles to the free movement of goods, services, persons and capital shall be eliminated.[20] As regards the free movement of goods, the Treaty specifically provides that such freedom also applies to fiscal obstacles, e.g., in the form of discriminatory taxation of goods from other Member States.[21] As to other Treaty freedoms, there is however no corresponding reference to fiscal provisions as such. Nor is it likely that the Member States intended that the Treaty's articles, outside the area for the free movement of goods, should as such have an impact in the area of tax. Indeed, it appears that the Member States have long considered that the Treaty's provisions did not in themselves encroach on the right of national self-governance regarding tax questions, but rather that this self-governance could only be curtailed through adoption of binding secondary legislation.

The EC Court would, however, eventually reveal that it was of a different opinion. The Court established in the landmark *avoir fiscal* case in 1986 that tax provisions that impede the free right of establishment can be challenged with the support of the Treaty.[22] The fact that the tax rules had not been harmonised did not thus mean that these fundamental treaty rights could be disregarded. Since then, the Court has expanded on this case law through several judgements also regarding other Treaty freedoms. Therefore, it is presently quite clear that taxation is not at all a "free zone"; instead, tax rules too must be drafted in compliance with the Treaty's provisions.

In the following sub-section, we shall briefly recapitulate the main features of the EC Court's case law regarding tax rules that violate the provisions on free movement. The main purpose of this presentation is to provide background to the ensuing discussion on the EC Court's significance for development of the relevant law and for the Member States' possibilities to protect their tax bases. Before we address the individual Treaty freedoms, it should perhaps be stressed that a tax subject must have *de facto* exercised a Treaty freedom in order to

20 Articles 39, 43, 49, 56 and 90 of the EU Treaty.

21 *See* Article 90 of the EU Treaty.

22 Case 270/83 *avoir fiscal* [1986] ECR 273.

invoke the Treaty.[23] The Treaty only protects a party who exercises the right of free movement, not a party who refrains from doing so. It is thus only tax rules that are unfavourable to cross-border situations and transactions which conflict with the provisions on free movement. On the other hand, those provisions do not prevent a Member State from treating foreign persons and income in a more favourable manner than domestic ones.

3.2 Companies' Freedom of Establishment

Now, what types of tax rules has the Court disapproved? The *avoir fiscal* case applied to the French system of tax credit for share dividends. Such a system entails that all or part of the company tax that has burdened the disbursed profits may be credited from the shareholder's tax on the dividend. Only French companies had this right, however. Foreign companies with permanent places of business in France were actually taxed in full for dividends which their French places of business accrued. These rules were found to discriminate against foreign companies conducting business activities in France. One could say that the rules prevented foreign companies from establishing themselves on the French market by taxing them more heavily than French companies conducting the same kind of business activities.

Even discrimination of an indirect kind is subject to challenge under the Treaty. In the recently decided *Hoechst* case, the EC Court found, e.g., that a taxation that was applied to a domestic subsidiary could be considered to discriminate indirectly against its foreign parent company.[24] Since the case is rather recent, we will comment on it in some detail. Also this case concerned application of a tax credit system applied to share dividends, but this time British rules were under consideration. Until April 1999, the British tax credit system contained a sort of advance levy of company tax, so-called Advance Corporation Tax (ACT), when a company disbursed share dividends. The rules surrounding ACT were very technically complicated and will therefore only be described in very broad terms. The system was in principle devised in such a way that when a company disbursed a dividend it was at the same point in time obliged to pay ACT calculated on the amount of the dividend. The ACT could then be credited from the annual, ordinary company tax. ACT was not thus a definite tax levy but rather an advance payment of the company tax that would in any case be payable. In the case of dividends paid from British subsidiaries to their British parent companies, there was however the possibility to avoid payment of ACT by choosing to be covered by the rules on voluntary corporate group taxation. This possibility was not available to subsidiaries of parent companies domiciled in other Member States. The EC Court held that the rules described here entailed that British subsidiaries were treated differently depending on whether the parent company had its domicile in or outside the United Kingdom and that such differential treatment entailed a disadvantage from the liquidity standpoint for

23 This appears, e.g., in Case C-112/91 *Werner* [1993] ECR I-429.

24 Joined cases C-397/98 and C-410/98 *Hoechst* [2001] ECR I-01727.

the subsidiaries of foreign parent companies. The rules were therefore deemed discriminatory.

The Court's case law also establishes that discrimination against foreign legal subjects, in violation of the Treaty, might also occur when the rules of the source state are not involved. Thus, rules of the state of domicile that impede domestic subjects from establishing themselves abroad can also be challenged under the Treaty. The *ICI* case applied to the British corporate group taxation rules.[25] Under these rules, corporate groups that comprised several British companies were permitted to set off profits that had arisen in one company against losses that had arisen in another company (group relief). In that manner, the company tax could be reduced. If the corporate group also comprised companies in other countries, then the right of set-off did not apply. The British companies that made up the group thus lost the right to set off profits against losses between themselves solely because there also existed foreign companies within the group. The EC Court opined that these rules could deter British corporate groups from establishing subsidiaries in other EU countries and that the rules therefore violated Treaty provisions on the free right of establishment.

A preliminary survey has recently been made of Swedish tax legislation in order to identify features that conflict with the EC Treaty.[26] The survey resulted in certain adjustments which entered into force on 1 January 2001. Additional adjustments will however certainly be necessary. The Supreme Administrative Court has, e.g., in RÅ 2000 ref 38 and 47 found that certain features of the close company in Chapters 43 and 57 of the Income Tax Act violated the EC Treaty, which will probably lead to legislative measures at a later point. The rules of Chapter 53 of the same Act, concerning below-market-price transfers to foreign companies, have also been put in question in case law. Thus, the Supreme Administrative Court has sought a preliminary ruling regarding whether these rules comport with the Treaty.[27]

Sweden also has so-called CFC-rules.[28] Such rules also exist in various other Member States. The express purpose of these rules is to protect the national tax base by addressing the problem of corporate establishments in low-tax countries. However, as the Swedish rules are framed, a business in a foreign country can be more heavily taxed than would have been the case if the same business had been conducted in Sweden. These rules thus have the potential to stop certain non-Swedish establishments altogether. This is due to a host of factors, the most important of which is perhaps that CFC-companies are treated as trading partnerships and that a natural person *qua* owner is taxed at a higher rate of acquisition income tax. Nor are foreign taxes deductible or creditable, which can in certain cases result in an unjustified increase in tax. These features of the rules

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25 Case C-264/96 *ICI* REG 1998 at I-4695.

26 Ds 2000:28 and prop. 2000/01:22.

27 Case C-436/00 *X & Y v. Riksskatteverket* (judgement pending). The General Advocate Mischo has in his opinion found that the rules in question breaches the Treaty.

28 *See* 6:15-16 Income Tax Act.

run the risk of being set aside by the EC Court since they can be deemed to entail an unjustified restriction on the establishment of companies abroad.[29]

3.3 Free Movement of Persons

As regards natural persons, both the free movement of persons (as regards employees) and the free right of establishment (as regards businessmen) are applicable. It is however very rare that tax rules for natural persons directly discriminate against citizens in other countries, since distinctions for tax purposes between foreign citizens and a country's own citizens hardly ever occur. This is not to say that EC law is without significance regarding the taxation of natural persons. After all, even indirectly discriminatory tax rules can be prohibited. Tax rules often distinguish between persons resident in the country and those resident abroad. If such rules disfavour persons resident abroad, this could constitute, according to the EC Court's case law, an indirect discrimination of foreign citizens and thus a violation of the Treaty.

An illustrative example is the *Schumacker* case.[30] Germany offers certain special tax exemptions linked to a person's support obligations, etc. In order to avail oneself of these exemptions, one must have previously been resident in Germany. A person who had merely worked in Germany but resided in another country could not thus take advantage of these beneficial tax rules and was therefore more heavily taxed than someone who had also lived in Germany. Formally, the rules were neutral in relation to the taxpayer's nationality, since even German citizens who lived abroad were denied access to the tax benefits. Despite this, the EC Court found that the rules indirectly discriminated against foreign citizens, since mainly foreign citizens live abroad.

Thus, this particular case concerned tax rules in the country of work that were less favourable for persons from other countries. The rules could therefore be expected to prevent such persons from taking employment or conducting their own business in the country. As in the case of legal persons, however, it is not solely discriminatory rules in the country of doing business that can impede natural persons from taking employment or establishing business activities in other Member States. Even measures in the home country can have such an effect. The case of *Terhoeve* concerned a Dutch citizen who worked and had lived in another Member State during a part of the tax year.[31] Under the Dutch rules, separate calculations of tax and national insurance contributions were made for the parts of the year he had been resident and not been resident, respectively, in the Netherlands. This resulted in his total national insurance contributions being higher than it would have been if he had been resident in the country during the entire year. The EC Court found that the Dutch rules could impede or deter Dutch citizens from moving and taking work in other EU Member States and that the rules were not therefore permissible.

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29 The question of CFC-rules' conformity with the EC Treaty has been addressed in Schön, *CFC legislation and European Community Law* British Tax Review 2001 at 250 ff.

30 Case C-279/93 *Schumacker* [1995] ECR I-225.

31 Case C-18/95 *Terhoeve* [ECR] I-345.

Among Swedish, possibly Treaty-violative, rules in this area we can mention the SINC (Special Income Tax for Persons Resident Abroad Act). The SINC is problematic since it does not allow for deductions of expenses related to earned income. The reason why it is devised as a withholding tax is administrative: it is too complicated to apply a tax return procedure to foreigners. Even reasons of enforcement lie behind the system of a definitive source tax instead of a customary tax assessment. It has however been questioned in various contexts whether SINC perhaps violates the EU Treaty and a study is now under way to review this legislation from that and other standpoints.[32] Another example of rules that could conflict with the EU Treaty is the provisions on standard deduction in Chapter 63 of the Income Tax Act (appr. 1 800 Euro). A standard deduction is only granted for taxpayers who have been resident in Sweden during the tax year. A person who receives earned income from Sweden without being resident there is however taxed on that income down to the very last *krona*. Even this could be seen as an impermissible and indirect discrimination.

The SINC rules were recently under consideration in a case before the administrative court of appeal.[33] That case concerned a German student who lived and worked in Sweden during a summer. He was taxed according to the SINC and could not therefore claim a standard deduction. The lower court found this to violate the EC Treaty and therefore overturned the tax authority's decision. The administrative court of appeal reached the opposite conclusion, however. That court opined that the tax payable under the SINC was lower than the tax that would have been imposed in the hypothetical event of an application of the ordinary income tax rules. The standard deduction would have in such a case only been allowed for the period when the taxpayer had been resident in the country and not for the entire year, and the tax rate would have been higher than the 25 % that applies under the SINC. The court thus found that the taxpayer was not on the basis of EU law entitled to a full standard deduction when he had only been resident here for a short period of time. That conclusion is in our opinion open to question. The EC Court has in its case law clearly stated that the fact that a person is resident in a country for only part of the year may not result in his being more heavily taxed than someone who resides in the country during the entire year.[34] Regardless of which conclusion is correct, however, the case provides a good illustration of how the EU Treaty very concretely affects the application of Swedish law.

3.4 Freedom to Provide Services

Also Sweden has in a couple of cases been reproached by the EC Court for its tax rules. The best known case is probably *Safir*, which concerned a tax which Swedish insured parties must pay on their foreign life insurance.[35] A person who takes out life insurance in a Swedish insurance company does not have to pay tax

32 Directive 2001:46.

33 Administrative Court of Appeal in Sundsvall, case no. 2208-1998, judgment of 2 August 2001. The judgment has been appealed to the Supreme Administrative Court.

34 *See* Case C-175/88 *Biehl* [1990] ECR I-1779.

35 Case C-118/96 *Safir* [1998] ECR I-1897.

on the insurance. Instead, the insurance company pays a special tax on its insurance capital.[36] However, as regards foreign insurance companies who, without establishing a permanent place of business here, sell insurance on the Swedish market, Sweden has no possibility to tax the insurance company itself. Instead, the insured party had to pay a tax on the insurance premium.

The EC Court concluded that a tax levied on the insured party is in various ways more onerous than a tax levied on the insurance company. According to the EC Court, the Swedish rules could therefore result in the insured party refraining from contracting insurance with foreign insurance companies as well as in such companies refraining from providing their services on the Swedish market. The provisions were therefore in violation of the EC Treaty.

The Swedish Government had anticipated the EC Court's decision and had amended the Swedish insurance premium tax rules already prior to the decision. It is however doubtful that the amended rules would withstand a possible renewed review by the EC Court. The rules have of course been lightened a bit and made somewhat more favourable for a party who contracts insurance with foreign insurance companies. But it is still the insured party him/herself who must pay the tax if he/she chooses to take out a foreign insurance, whereas tax on Swedish insurance is payable by the insurance company alone. If also these rules were to be set aside, it could entail significant problems for Sweden to protect this particular tax base. The pivotal question is whether Sweden is entitled to subject different types of capital investments (in this case in the form of insurance investments) undertaken in other Member States to a tax which is as high as if the investments had occurred in Sweden. On this issue, EC law is not crystal clear. *Safir* can perhaps be understood as a yes in principle but a no in practice. The practical implementation of the principle in Swedish legislation can after all create such problems for a foreign insurer that its possibilities to provide services beyond its country's borders are so curtailed that a violation of the EC Treaty is deemed to exist. The result of Sweden being in practice denied the possibility to maintain a principle of equally heavy taxation of foreign and domestic investments could be that foreign insurers receive a competitive edge in relation to Swedish insurers. That will be the case if the tax on the insurer is lower in the other country. This could open the door for states to compete with lower taxes in a legally unimpeachable manner, notwithstanding the principle that Sweden may tax those who have domicile here.[37] The rules that can counteract such conduct appear in the EC Treaty's state subsidiary provisions. The code of conduct might also constitute an impediment, even though it is not binding.

3.5 Free Movement of Capital

An interesting case involving tax rules that infringe upon the free movement of capital is *Verkooijen*.[38] The case concerned the Dutch rules governing taxation of

36 Under the Act on Yield Tax on Pension Funds (1990: 661).

37 One alternative would be to amend the rules so that the appreciation on so-called C-insurance is subject to income tax.

38 Case C-35/98 *Verkooijen* ECR 2000 at I-4071.

share dividends. A person with domicile in the Netherlands who owned shares in a Dutch company was entitled under these rules to receive a certain amount in share dividends tax-free each year. No corresponding tax exemption was granted for dividends from companies in other Member States. The issue under consideration was whether this difference of treatment between domestic and foreign dividends violated EC law. The EC Court specifically stated that the Dutch provisions could deter persons residing in the Netherlands from investing their capital in companies in other Member States. The fact that the preparatory works of the Dutch legislation clearly stated that one of the purposes of the provisions was in fact to promote investments in Dutch companies did not make things easier for the Netherlands' case. The court therefore found that the Dutch rules were not in conformity with the provisions on free movement of capital.

The *Verkooijen* case could have very far-reaching implications for the European systems of company taxation. The tax exemption under consideration in that case for a certain portion of the received share dividends is a way to provide relief from the so-called economic double taxation of share dividends. Corresponding, and in many cases much greater, relief is granted in most of the other Member States. Such relief is usually only granted for dividends from domestic companies to domestic shareholders. If the EC Court were to find that the conclusions in *Verkooijen* can also be applied to the so-called tax deduction systems applied in many Member States, i.e., the systems that allow deduction for company tax that has been levied on disbursed profits when the tax is payable by the shareholder, it would have dramatic consequences for the European system of company tax. The countries that wish to continue to apply such tax relief must in the future also allow dividends from foreign companies to enjoy the relief. Perhaps a more likely outcome of the Court's case law is however that many Member States simply feel compelled to abandon their tax relief systems in favour of a double taxation system of the classical type. That would in such case be a very illustrative example of how the case law of the EC Court *de facto* produces a harmonisation of the Member States' income taxes. The example also demonstrates that the amendment of rules precipitated by the EC Court's case law need not at all be limited to rules concerning international transactions and situations. A shift to the classical double taxation system could on the contrary have its greatest impact in purely domestic situations.

3.6 Surviving Options to Retain Tax Rules that Impede Free Movement

Does the EC Court's case law entail that the Member States completely lack the possibility to protect their tax bases by treating domestic and foreign persons and income differently for taxation purposes? The EC Treaty states that national provisions are in certain cases acceptable even though they impede free movement. This is allowed when the national rule is based on grounds of public policy, public security and public health.[39] It is however very difficult to envisage income tax rules that could be justified on the basis of these grounds, nor has the EC Court ever approved income tax rules on these grounds. Since the

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39 *See* Articles 39, 46 and 55 of the EC Treaty.

Court has also stated that tax rules which directly discriminate against foreign legal subjects can *only* be accepted on the grounds stated in the Treaty, a Member State has exceedingly little room to protect its tax base by applying such rules.[40]

Of greater significance is thus the case law of the EC Court with regard to the possibility to justify tax rules which are only indirectly discriminatory or which in some other manner impede free movement. As concerns such tax rules, the EC Court has in fact accepted also other grounds for retaining the rules than those that are expressly stated in the Treaty provisions. That can e.g., occur if the rules are necessary to prevent tax evasion.[41] In order for such an argument to succeed, however, the Member State must demonstrate that it has actually exhausted all other means of preventing tax evasion and that the challenged tax provision is no more intrusive than is necessary to stop the undesired tax evasion. The Member States have thus far without exception failed to fulfil the Court's requirements in these regards. One ground for justification which has, however, actually been accepted in a specific case is consideration of the cohesion of the tax system. This argument saved Belgium from losing its case before the EC Court in *Bachmann*.[42] In that case, it was deemed that a bar on deduction for premiums relating to insurance that had been contracted with foreign insurance companies conflicted in principle with the free movement of services, since it made it more difficult for foreign companies to sell insurance in Belgium. Despite this, the Court found that the bar on deductions could be accepted. The Court stated that the cohesion of the Belgium system required that deductions would only need to be granted if it could be guaranteed that paid-out sums could be taxed in Belgium. Such was not the case if the insurance had been contracted with a foreign company.

Thus, although it is possible to persuade the EC Court to accept tax provisions that conflict with the Treaty's provisions on free movement, this only occurs by way of the rarest exception. In the vast majority of cases considered by the Court, the taxpayer has won and the Member State has had to amend its legislation. After the judgment in the *Bachmann* case, the Member States have, e.g., in subsequent tax cases, almost always tried to defend the tax rule under consideration by claiming it to be justified by the tax system's structure and cohesion. The EC Court has however consistently rejected that argumentation.[43] What is more, the EC Court has gone even further and accorded the Treaty's provisions on free movement an ever greater impact at the expense of national tax sovereignty. It is not at all unlikely that the *Bachmann* case would have been adjudged differently if the case had been heard today. The manner in which the EC Court categorically rejected the principle on the tax system's cohesion as a basis for justification seems to indicate that it regrets ever having "invented" this

40 *See* Case C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651. The picture is, however, not cristalclear. *See* the General Advocate Francis Jacobs opinion in case C-136/00 *Danner* (judgement pending).

41 Case C-250/95 *Futura* [1997] ECR at I-2471 and Case C-254/97 *Baxter* [1999] ECR I-4809.

42 Case C-204/90 *Bachmann* [1992] ECR I-249.

43 The latest example is the General Advocate Francis Jacobs opinion in case C-136/00 *Danner* (judgement pending).

principle. It thus appears very unlikely that Member States' tax rules that impede free movement will win approval on the basis of the above argument.

4 What Importance does the EC Court have for Development of the Law?

4.1 Introduction

It is important to recall that the EC Court sees as one of its most important tasks to uphold the Treaties and to carry the integration process further. Therefore, it is perhaps not especially surprising that the Court regularly gives priority to realisation of the goals of the Treaties over the Member States' interest in maintaining an established tax structure. If the development of the EC Court's case law continues along these lines, it could, however, pose a rather serious threat to the Member States' tax bases. In this section, we shall focus especially on why the EC Court has been able to operate in this fashion and which methods the EC Court has used. We shall also discuss whether there are any limits on the EC Court's "activistic" approach.

To begin with we should stress that the EC Court's role in developing the applicable law can hardly be overstated. Its significance is enormous. Remarkably, the EC Court has in principle established its own competence and still considers itself to have the power to decide such competence; this represents a major difference from the national supreme courts. The international legal literature usually calls this the Court's "Kompetenz-Kompetenz".[44] A court's competence is ordinarily provided by a legislative body, e.g., the Swedish Parliament. The constitution, and laws derivable from the constitution, clearly set the contours of the court's competence. The fundamental legal document of the EU, the EU Treaty, contains however few guidelines for the Court. The former Swedish judge Ragnemalm has stated that the norms "provide the [EC] Court with a wholly different latitude than is usually the case at the national level. Usually the direct application of a 'constitution' is concerned … which to a great extent is more in the nature of a political document than a legal regulation. The EC's secondary law [e.g., the VAT directives] can for their part be quite detailed but often bear the mark of compromise or – at worst – of a resigned sigh after an unresolved conflict, which the Court can, when it applies the law, hopefully settle through the constructive use of its imagination."[45]

Already in the case of *Costa v. Enel* (6/64), the EC Court took the decisive step and found EC law to be superior to national law.[46] The Court formulated the doctrine of EC law's *absolute priority*. That doctrine is at the very centre of the notion of integration. EC law cannot of course be an effective tool for harmonisation and integration if the Member States are free to obstruct or

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44 *See* e.g., Weiler, J.H.H., *The Constitution of Europe* 1999 (CUP) at 311. The term originated in German constitutional doctrine.

45 *EG-domstolen inifrån* JT 1998/99 at 297.

46 6/64 [1964] ECR 585; In 11/70 *Internationale Handelsgesellschaft* [1970] ECR 1125 the EC Court declared that the priority applies to all national legislation, including constitutions.

undermine the efficacy of that law. According to the Court, the Member States have once and for all divested themselves of constitutional power or, to put it another way, sovereignty. It should be noted that the EC Court considers that this divestment is in principle irrevocable.

Europe's decision-making politicians might be critical about this but at the same time we must note that the EU's legislative body, the Council of Ministers, which consists of Europe's elected Government representatives, has, through its actions at least, accepted the EC Court's self-acquired competence. Not once has the EC Treaty been amended to curtail the Court's competence. There are probably many and complex explanations for this. One thesis is that in reality politicians desire an integration and are therefore contented with the Court's self-acquired role. Politicians are uncertain about the voters' enthusiasm for the integration project and do not therefore dare to seek the mandate of the electorate. Another thesis is that politicians realized only belatedly what the consequences of the EC Court's activities were to be. *Costa v. Enel* was decided as early as 1964. Hardly anyone can have envisaged the scope of the doctrine of absolute priority for EC law.[47] After a somewhat slow start, it must be said that the Member States' judicial bodies and authorities came to accept this doctrine. The Member States' supreme courts now follow in principle the EC Court's judgments. It is in any case quite clear that Sweden's courts have dutifully followed the EC Court and EC law. For Sweden's part, this follows from § 2 of the EU Act which entails that the EC Treaty and all legal acts adopted by the EU apply in Sweden "with the force that follows from them".

It should also be noted that the question of EC law's absolute priority has not yet been addressed head-on in any national court. Nor has the EC Court had reason to reprobate any Member State's constitution. To do so would naturally have very awkward political ramifications. The Supreme Court of Germany, Bundesverfassungsgericht, has also in the so-called *Solange* cases taken the position that the German constitution is higher than EC law but still accepted EC law since it has not (so far: solange) been deemed to conflict with the German constitution.[48] The German Supreme Court opined that it is the Member States who are masters of the EC Treaty. Neither the European Union (nor its court) can itself expand its competence. Even among lawyers in the Member States there exist divergent opinions about the doctrine of absolute priority. This can hardly be attributed to the manner in which the various Member States' constitutions are drafted; instead, it is simply a question of differing opinions about the actual scope of the nation-state's sovereignty.

Although somewhat unclear in Sweden, from the preparatory works of Ch.10 §5 of the Instrument of Government it can be inferred that Sweden's legislature holds a view similar to the German one. Membership in the EU is subject to conditions and Sweden appears to consider that it can leave the EU if the conditions for membership are not fulfilled.[49] The Constitutional Committee stated in the preparatory works on the issue of Swedish membership in the EU

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47 For more hypotheses, *See* Dehousse, *The European Court of Justice* Macmillan 1998 at 114 ff.

48 Wünsche Handelsgesellschaft [1987] 3 CMLR 225, Brunner [1994] 1 CMLR 57.

49 Prop. 1993/94:114 at 17 ff.

that: "For Germany's part, the Court concluded that if an EU body were to adopt legal acts which exceed the EU Treaty, such legal acts would lack legal force and the German organs of state would be precluded under the constitution to apply them. The Committee considers, like the Government, that this view should also apply for Sweden's part."[50] Somewhat inconsistently, the Committee added that : "On the basis of the formulation which the rule is proposed to be given, it appears that it is the Parliament which, in connection with decisions on transfer of powers, should make the assessment that the European Communities' protection of civil rights and liberties corresponds to the protection provided in the Instrument of Government and the European Convention. Courts and public authorities are thus obliged to apply an EC rule which has been promulgated in an area where the EC through the transfer of powers has received competence to legislate, even if that competence would restrict an individual right stated in the Instrument of Government."

The Swedish preparatory works thus appear to assume that Swedish courts shall not examine EC law's conformity with the Swedish Constitution. In the event of a conflict with the constitution, a Swedish court shall thus apply EC law. This view is also confirmed by Sweden's official position on the freezing of al Baraakat's assets. The freezing of those assets could not be effected in conformity with the Swedish Constitution and, therefore, the case raises some prickly questions about the doctrine of absolute priority of provisions of Community law.

4.2 Positive and Negative Integration

As appeared in Section 3, above, the EC Court has in several cases set aside national income tax rules as violative of the EC Treaty. The Court's rulings have thus compelled legislative amendments in several areas, thus levelling out certain differences between the countries' tax legislation. Therefore, lack of success in adopting harmonised income tax rules by legislative means has to some extent been compensated for by judicial means. And yet judicial case law never produces the same far-reaching legal approximation which is possible through legislation. The EC Court can merely note that existing tax rules violate EC law, but cannot prescribe in detail what other rules should be introduced instead. After all, the EC Court, although often a driving force behind developments and particularly integration, is at the end of the day a court and not a legislature. This means that the EC Court's role entails a *negative integration* through the Court's elimination of encumbering rules.

Even if the case law of the EC Court can never fully replace legislative measures, the Court's activism in the field of tax can in itself speed up the legislative work in this field. The judgments of the EC Court have not always been well received in the Member States. Many critics have accused the Court of going too far and of reading much more into the treaties than what appears in the treaty texts themselves. According to these critics, the Court has through its

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50 Concerning this proposal, *See* prop. 1993/94:114 and Konstitutionsutskottets betänkande 1993/94:KU21 at 27 ff.

decisions given the treaties a content that the contracting Member States had never intended them to have. One possible way for the Member States to retake the initiative in the tax field would undoubtedly be to promulgate more EU legislation. In that way, they could themselves establish the criteria for taxation and would not, unlike now, be completely in the hands of the Court's assessments. Therefore, it is not unlikely that the irritation which some of the Court's judgments have aroused in the Member States will in fact catalyse harmonisation efforts in the future. Such harmonisation efforts can result in a *positive integration*.

The Commission too is of the view that Community law, as regards which taxes and fees are to be deemed contrary to the goals of the internal market, shall to a greater extent be developed within the framework of the political process. The view is that this is preferable to legal developments that occur *ad hoc* on the basis of the cases arising before the EC Court. The Commission has therefore proposed the introduction of a qualified majority for decisions on common legislation in this area to replace the current requirement of unanimity. However, given the sizable opposition of certain Member States against surrendering the right of veto, it is unclear if and when this proposal will be adopted.

4.3 The EC Court's Doctrine of Interpretation and its Effects

4.3.1 Introduction

As stated above, the EC Court can without doubt be classified as integration-friendly. It is the doctrine of interpretation that constitutes the engine of the legal machinery that drives harmonisation forward. It is hardly surprising that the interpretation is integration-friendly. The EC Court's interpretation of the Treaty is actually based on its wording: according to Article 1, the EU Treaty intends to create "an ever closer union among the peoples of Europe".[51] It seems however likely that the Court's very active era is now over.[52] This is probably because the legal and economic integration has come very far. The big steps, such as establishing the priority of EC law, have already been taken. The EC Court is now implementing and refining its system. However, leaps in the development of EC law are still taken, the most recent of which is probably the EC Court's decision that Member States can be liable to pay damages if their legislation is contrary to EC law (the *Francovich* case and others).[53] This damages liability is not stated in the Treaty and no Member State can be assumed to have desired such liability. In the cases mentioned, Germany, among others, argued that such liability cannot exist without clear legal support and that the Court cannot act as a legislature. Despite this, the EC Court did not hesitate to find that damages liability existed. The Court's apparent tendency to strengthen the so-called

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51 *See* also Due, *EF-domstolens retspraksis som integrationsfremmende faktor*, JT 1991-92 at 412.

52 Dehousse *idem*, at 176, cf. however Ragnemalm *idem* at 297 ff.

53 Joined cases C-6/90 C-9/90 *Francovich* [1991] ECR I-5357, joined cases C-46/93 C-48/93 *Brasserie du Pechueur* [1996] I-1029.

horizontal direct effect of the legal acts has also aroused much attention.[54] This is an example of how the EC Court is steered by the superordinate goal of making EC law as *effective* as possible.

This doctrine of effectiveness is also a cornerstone of legal integration. Violations of EC law must be made punishable and the person or company that suffers loss as a result of the Member State's violation must be granted redress. Otherwise, the Member State could of course flout EC law altogether. There are also signs that the Court's once active role regarding the free movement of goods can now instead be seen regarding free movement for persons and free establishment. This could be due to the harmonisation of indirect taxation and removal of border controls. Many fiscal obstacles for the movement of goods have been eliminated. Instead, many persons and companies have become aware that certain income tax problems, which they see as obstacles to establishment, etc., might violate EC law. The development of EC law is, as a result of the preliminary ruling institute, often driven by individuals.

An important question is of course what the EC Court really wishes to accomplish. First, it should be noted that the EC Court sees as its most important task to ensure that *EC law is implemented and has the intended effects*. Ragnemalm has pointed out that the EC Court sees as a very important task to ensure that the positive rights recognized for EU citizens in EC law can be effectively exercised. The principle establishing EU directives' *direct effect* is a direct result of that notion. A directive that grants a citizen a right, but which is not implemented by a Member State, can under certain circumstances in any case be invoked by the citizen. It is completely clear that the EC Court takes the Treaty's words "to create an ever closer union among the peoples of Europe" very seriously. It is this fundamental notion that the EC Court has given effect to.

4.3.2 Some Comments on Principles of Interpretation and Especially on the Tax Law Principle of Neutrality

The EC Court's tool chest contains a limited number of principles of interpretation. These are the textual, the historical ("interpretation of preparatory works"), the systematic and the teleological. The last two are by far the most important. The teleological method is the EC Court's primary integration-promoting tool, since the Court actively considers that the EC Treaty seeks to integrate the European Union.

Certain initiated commentators point to the fact that the historical interpretation has increased in significance and they reckon that it will continue to do so. The reason for this is the increased transparency of the legislative process within the Union. The quality of the preparatory works will increase and they will become more easily accessible. This will facilitate the work of legal artisans of every description.

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54 *See* the joined cases C-240/98 C-244/98 *Océano Grupo Editorial and Salvat Editores* [2000] ECR I-4041, C-456/98 *Centrosteel* [2000] ECR I-6007.

Within the framework of this article, we wish to raise an especially interesting question for discussion: Which tax law principle of neutrality does the EC Court apply? We shall discuss whether the principle is used as a tool for creating integration and we shall see whether it is applied by the EC Court in tax questions pertaining to secondary law and tax questions pertaining to the EC Treaty.

The tax law concept of neutrality has to our knowledge only been used by the EC Court in interpreting secondary law, especially in value added tax cases.[55] The reason for the emphasis on neutrality in the VAT cases could be that in the preamble of the first VAT directive from 1967, it is specifically stated that the value added tax system should be neutral.[56] The preamble states, inter alia: "Whereas a system of value added tax achieves the highest degree of simplicity and of neutrality when the tax is levied in as general a manner as possible and when its scope covers all stages of production and distribution and the provision of services".

It should be noted that the EC Court's interpretation of the directives has an immediate impact in Sweden. When a Swedish court interprets the Swedish VAT Act, it must interpret it in conformity with the directive, i.e., the Act shall have the same meaning as the directive and if the EC Court has specified the meaning of the directive, this must be given effect in Sweden and all other Member States. This is yet another example of a principle established by the EC Court to ensure that EC law will be as effective as possible.

The argument of neutrality is also embodied in the two directives that apply to the company tax area, the so-called Merger directive and the so-called parent company/subsidiary directive. These have not yet been scrutinized by the EC Court to any great extent.

Generally, the term "principle of neutrality" is used in the tax law discussion in two different ways, either as a reference to socially effective taxation (ie. a taxation which not distort behaviour and thus cause excess burden) or as a reference to the "simpler" principle of equal treatment. The principle of equal treatment, or principle of uniformity, entails, briefly stated, that various types of corporate associations are to be treated alike and that transactions with the same real-economic significance shall be treated alike. The latter can result in higher societal effectiveness, but that need not always be the case. After all, the "principle of equality" can concern the application of a rule which is in itself non-neutral, e.g., a rule entailing that an investment in certain fixtures and fittings is immediately tax deductible. There is thus an inner tension in the terminology.

Alhager uses the term "internal neutrality" for this principle of equal treatment in EC law.[57] Alhager also uses the term external neutrality, which also includes the fundamental freedoms in the Treaty itself. Alhager also considers the EC Court's principle of neutrality within VAT taxation to be one principle, not several, but that it still includes the VAT principle, the principle of

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55 *Cf.* 142/77 *Statens kontroll med aedle metaller* [1978] ECR 1543.

56 First Council Directive 67/227/EEC of 11 April 1967 on the harmonisation of legislation of Member States concerning turnover taxes.

57 Alhager, *Mervärdesskatt vid omstruktureringar,* Iustus 2001 at 60.

reciprocity and the principle of equal treatment.[58] The VAT principle entails quite simply that the taxpayer is entitled to deduct prior tax amounts (this tax is a tax on the acquired extra value). The principle of reciprocity entails that that which is outgoing tax for a taxpayer is prior tax for another taxpayer and the principle of equal treatment means that "comparable situations shall not be treated differently, unless a difference in treatment is objectively justified".[59] The two first components are directly derived from the VAT directive. The directive's provisions are drafted so that taxpayers will be entitled to deduct prior tax and so that there will be a link between outgoing and prior tax. None of these partial components of neutrality is unfamiliar to a Swedish lawyer who has dealt with value added tax. Melz analysed these questions in detail in 1990.[60] The rules are naturally drafted in a way that reflects the legislature's position on a matter of principle and they can therefore be deemed to reflect considerations of principle. This is certainly not unique for VAT taxation.

The interesting question is instead whether the principle of neutrality has any independent significance: Does the principle add anything to the directive's rules? It can first be noted that there is nothing to suggest that the principle of neutrality could result in the EC Court interpreting the directive in a manner contrary to its wording. A clear example of this is the case of ORO.[61] Another illustrative case is Wellcome Trust.[62] The party considered himself to conduct an economic activity and wished to deduct prior VAT. From a strict neutrality standpoint, we think the party was justified in its position but the directive put obstacles in the way. On the other hand, the EC Court has in other cases interpreted economic activity in a broad manner and cited the principle of neutrality in that regard.[63] The EC Court appears to be of the view that neutrality, more specifically neutrality of competition, is promoted if a low threshold is applied to the requirement of conducting economic activity. In the EC Court's view, even completely failed projects can be deemed to constitute economic activity. Significantly, the EC Court's position is open to criticism from the standpoint of the principle of neutrality. An overly beneficial position by the EC Court can result in too great a risk but it can also result in abuse. Neutrality is thereby shaken.

The neutrality that the EC Court deals with is thus different from the strictly economic one. It does not seem to be the Court's goal to interpret the legal rules in a fashion that increases societal effectiveness in taxation. The EC Court simply proceeds from the frameworks, or objectives, stated, inter alia, in the VAT directives and applies these in such a manner that uniformity, as it is defined by the legislation, is achieved. If the legislation results in a lack of neutrality, the EC Court does not alter this (e.g., that certain companies are exempt from the duty to pay VAT, which can result in so-called cumulative

58 Alhager, *idem* at 73 and at 77.

59 Alhager, *idem* at 71.

60 Melz, *Mervärdeskatten – rättsliga problem och grunder,* Juristförlaget 1990.

61 C-165/88 *Oro* [1989] ECR I-4081.

62 C-155/94 *Wellcome Trust* [1996] ECR I-3013, especially points 38 and 39.

63 C-268/83 *Rompelman* [1985] ECR I-655, C-110/94 *Inzo* [1996] ECR I-857, C-400/98 *Breitsohl* [2000] ECR I-4321, especially point 42.

effects). What is more, the case law of the EC Court might conflict with the neutrality principle since an overly beneficial interpretation of "economic activity" could lead to too many persons initiating failed projects or abusing the rules.

This indicates that the EC Court, within the somewhat special area of indirect taxation, avoids operating outside the purview of positive law norms. The degree of "activism" is very low. The EC Court simply adheres to the rules of the game and acts very much like an ordinary national supreme court. To put it another way, the EC Court uses a tax-technical principle of neutrality or principle of equality which is quite familiar even from the Swedish Supreme Administrative Court's case law. The conclusion is that the use of the principle of neutrality in secondary law does not have any integration-promoting effects.

The next question of interest is whether the EC Court has applied a similar view in matters concerning non-harmonised tax law. In the tax areas that are not harmonised, the four freedoms of the EU Treaty are thus applied. As noted in Section 3, above, this entails that various types of obstacles in tax legislation, etc. to residing in one state and working in another, as an employee or as a businessman, or obstacles to a company establishing itself abroad, or obstacles to transferring capital abroad or to selling/marketing services in another state can be heard and eliminated by the EC Court. There is no known case involving direct taxation where the effectiveness of the national economy has been considered by the EC Court. Nor does it appear that any narrow legal principle of neutrality has been considered, for example, the risk of a company establishing itself in low tax countries within the EU and providing services from there by using the Treaty right to free movement of services. This conclusion appears to follow from the Safir case. We demonstrated above in Section 3.4 that the decision in that case can entail that such competition cannot be prevented.

Instead of allowing itself to be guided by a kind of neutrality perspective when interpreting the Treaty, the perspective of the EC Court simply stated is that the EU citizen, or the EU company, has strong rights which can only be curtailed in exceptional cases. Only if very important societal interests require the state's interests to be given priority over those of the individual, will the EC Court accept an interference in the right. The EC Court also considers these rights to be dynamic. Since the Treaty's objective is to create an economically integrated union, these rights are strengthened with time. The exceptions become fewer and fewer. The Member State's interest in obstructing cross-border activities will simply decrease over time.

This entails that the EC Court's activities when interpreting the Treaty can result in a lack of societal effectiveness (or non-neutral situations). Assume that a Member State completely abolishes the company tax for the purpose of attracting foreign investors. The Treaty and EC Court case law of today do not in principle prevent such measures. On the contrary, the case law of the EC Court on free movement and free establishment facilitates such measures. An interesting question is whether the rules on state subsidies in Article 87 could be applicable and prevent an overly favourable tax structure in a given country. A unilateral introduction of very favourable taxation should in principle be seen as a state subsidiary. The wording of Article 87 is not limited to attempts to protect domestic companies or domestic production. The problem is that the rules are considered to be applicable only when the state subsidies are selective. A general tax reduction in the company sector cannot according to the established view be challenged under these rules. The recently introduced Swedish “expert tax” has e.g., been accepted by the Commission. Paradoxically, a Member State can thus declare itself to be a tax haven without the EU being able to react legally. The code of conduct is the only weapon available. It should be acknowledged that, theoretically, a generally lower tax burden in a state can perhaps result in the private social costs, etc., being higher in that state and that salary levels are affected accordingly. Therefore, in theory, having generally lower taxes than what other states have will not entail a competitive advantage, not even if there are significant differences.

There appears however to be a certain lopsidedness within EC law; market effects in the form of obstacles to free movement can be effectively challenged by legal means but market effects in the form of stimulation designed to increase free movement cannot be challenged. This state of affairs is a result of the notion that free and self-regulating markets are optimal. This notion is borne up by large segments of the Treaty.[64] It perhaps seems contradictory that the EC Court’s affirmation of a free market, which can in theory be viewed as effective, results in market disruptions. The problem is however that a negative integration can result in a so-called race to the bottom, whereby states compete with each other to offer the most favourable company tax environment. It is well known in Economics that the liberalisation of a sector in an otherwise heavily regulated economy can create new excessive burdens. It can of course be said that the European states have in principle a similar view of the welfare state, which mitigates the problem of “race to the bottom”. The relatively high tax quota in Sweden creates unique problems, however. The difference between Sweden and e.g., Portugal is not negligible. The problem may even get worse if the membership circle is expanded. The adjustment could be quite painful. Nor can it be ruled that that there is a political will in Sweden to retain the welfare state. Thus, a notion of neutrality based on economic theory is simply absent in the EC Court even when it interprets Treaty freedoms in the area of taxation. This absence has a significant effect: Negative integration moves more rapidly forward.

4.4 Does the Integration-promoting Interpretation have any Limit?

We demonstrated in Section 3, above, that the EC Court successively advanced its position and accorded the Treaty provisions on free movement an ever greater impact at the expense of national tax sovereignty. It would however hardly be fair to paint a picture of a court that does not take any other considerations than the integration of Europe. There are in fact signs that the EC Court accepts inroads into the inner market and actually takes account of tax sovereignty. Thus, for the sake of completeness, it should also be stressed that the EC Court

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64 Maduro, *Balancing Economic Freedom and Social Rights* in The EU and Human Rights (ed. Alston) OUP 1999 at 451 ff. and at 465.

does not in principle disapprove of tax sovereignty. This means that there is a limit on how far the EC Court considers that it can go. There are also several cases that show that the EC Court accepts international tax law principles that have emerged over a long period of time through cooperation between sovereign states.[65] The principles are thus based on tax sovereignty and are naturally often linked to protection of the tax base.

One of these cases is Futura.[66] The case demonstrates quite clearly that certain clear restrictions on establishment abroad, a fundamental right, cannot be declared violative of the Treaty. In that case, the Court considered and accepted the principle that only losses linked to an activity at the permanent place of business are deductible in the state of the permanent place of business. Let us clarify by an example. Assume that a person (residing in Denmark) has his main place of activity in Denmark and a subsidiary in Malmö, Sweden. Assume that the activity begins to go very poorly in Denmark and has accrued a deficit. Assume also that his subsidiary in Malmö is going well, in fact so well that he can just cover the loss in Copenhagen. From the Dane’s perspective, he has recorded a tax result of zero. However, Sweden, as the source state, will tax his surplus. From the taxpayer’s perspective this is doubly anomalous since, if the facts had been the reverse, loss in Sweden and profit in Denmark, the Danish tax authority would have considered the Swedish loss! And both of these perspectives follow from established international tax law principles.

The EC Court’s position was a consequence of tax law’s territorial principle. Since Sweden as the source state does not tax profits on the Dane’s global income, it cannot be required in any regard that Sweden take into account his global income status, such as e.g., the fact that his activities in total result in loss.[67] Nor is it Denmark that makes it more difficult for the Dane to conduct business in Sweden. But what good does that do the Dane? He has in practice two options: either terminate the activity in Sweden in order to consolidate his energies in Denmark or terminate the loss-generating activity in Denmark. There is one obvious restriction for him. In legal-logical terms, the phenomenon can be explained as follows: the restriction is the result of a lack of EU harmonisation in the income tax area. That which from the Dane’s perspective makes it more difficult to conduct his activities is a logical result of the territorial principle accepted by the EC Court. Also in the Gilly case the EC Court accepted established international tax law principles to resolve international double taxation, even though this inhibited freedom of movement.[68] A person worked abroad and was taxed both in that country (the source state) and in his country of domicile. Under the double taxation treaty, the country of domicile was to take into account the tax paid in the source state, but only in the amount paid in the country of domicile on the same income. As it turned out, the tax was higher in

65 Of special interest is that the EC Court appears to have accepted the OECD’s model contract as a source of law, *See* e.g., C-279/93 *Schumacker* [1995] ECR I-225.

66 C-250/95 *Futura* [1997] ECR I-2471.

67 Note however that if the taxpayer had not earned any significant income in his state of domicile and instead acquired the greater part of his taxable revenues from the source state, this main rule can be modified. C-279/93 *Schumacker* [1995] ECR I-225.

68 C-336/96 *Gilly* [1998] ECR I-2793.

the source state than in the country of domicile. But the EC Court accepted this with reference to tax sovereignty: a country can have whatever tax rate it desires. It would however have been better for the taxpayer to stay at home and work. Also this judgment can be explained in terms of legal logic, and perhaps the judgments are self-evident. The point is thus once again that the EC Court clearly sees limits on what it can do by means of interpretation to promote freedom of movement.

Yet another important observation is that the EC Court, with its “constructive imagination”, has actually demonstrated that it is prepared to protect a Member State’s tax base, which appears from the above cited case of Man-in-Black. But that protection appears mainly directed against an actual abuse of EC law. To generally take advantage of the Treaty rights can never be viewed as an abuse. This can be said to follow from the Centros judgment, which did not however concern tax law.[69] That case concerned Danes who wished to conduct business in Denmark in the form a share company. The Danes wished, however, to take advantage of the fact that the United Kingdom’s minimum share capital requirement is much lower than in Denmark. They thus formed the company in the United Kingdom. Denmark did not want to recognize the company, which was to conduct business in Denmark alone. The EC Court stated however that the formally British company’s right to establish itself in Denmark could not be abridged. The EC Court opined that the Treaty provides the British company with the right to establish itself in Denmark.

This can be understood to mean that Swedes who wish to conduct business in Sweden in the form of a company can form the company abroad and possibly take advantage of the resulting tax advantages. Such an establishment would however in many cases mean that the foreign company has a permanent establishment in Sweden and that this permanent establishment would be taxed at the company tax rate of 28 percent. The Centros judgment is not therefore in itself any direct threat to the Swedish tax base. Of interest is instead that the EC Court accepted a highly unusual company establishment, whose purpose was clearly to reap benefits which did not exist in the country where the business activities themselves were conducted. If a tax advantage were to arise in Sweden as a result of an establishment abroad, the EC Court would probably accept this. Service companies which sell their services in the future via modern information technology would thus be able to avail themselves of this possibility to establish themselves in other countries, if those countries have a lower company tax than Sweden’s. If also the Commission’s idea were to be accepted, whereby registration would determine where VAT on Internet-based service production shall be paid, that could entail substantial problems for the Swedish tax base. Perhaps a consideration of the Swedish CFC-rules would shed some light on the problem.

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69 C-212/97 *Centros* [1999] ECR I-1459.

5 Summary and Conclusions

The following can be stated by way of summary. In principle, the legal protection of the tax bases is good. The EU Treaty as it reads today and the EC Court’s case law entail however that obstacles to free movement within the EU are judged restrictively. Many rules that exist in the tax system and whose justification is to protect tax bases (control rules, CFC-rules, corporate group contribution rules, insurance tax rules), have consequences for free movement. The EC Court tends to set aside such rules. The integration that arises can be termed negative, i.e., rules are removed without being replaced by others. It can also be likened to a so-called race to the bottom where freedom from market disturbances constitutes a competitive advantage for a country. The alternative is positive integration, i.e., that new rules are introduced. The legislature at the EU level is the Council of Ministers. The Commission, which has an exclusive right to make proposals to the Council of Ministers, has abandoned the fanciful plans of previous years for harmonisation and now works in small steps. At present all Member States also have a right of veto against all proposals in the field of taxation, given the requirement of unanimity. Even the Commission’s more modest proposals have therefore proven difficult to get adopted in the Council. The EU’s complicated legislative procedure also has a negative effect. There is also great opposition among the Member States against introducing decision-making by majority in the area of taxation. The reason for this is however easily understood. First, the power of taxation is at the very core of state sovereignty. Few will relinquish that power. Secondly, responsibility for the welfare state in the EU remains with the Member States. A state that bears the burden of expenses naturally desires to have control over the income. Thirdly, there is no political consensus as to the direction of the EU. Abolition of the right of veto in the taxation field will inescapably result in greater features of federalism. The worrisome question is naturally whether such federalism is in any case unavoidable through the negative integration process that continues without interruption. A possible compromise solution would perhaps be the one that the Commission proposed, i.e., to abolish the right of veto for certain tax questions where the EC Court’s case law has already greatly curtailed national self-governance but to retain that right for tax questions generally.