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1. *The role of the Court of Justice in the field of direct taxation. Impact on the single market and Member State sovereignty*

1.1. As you are all aware, in the area of taxation the unanimity requirement - in other words, the power of veto held by each individual Member State - has largely blocked action by the Council. Only a few directives, of limited scope, deal with matters relating to direct taxation. The Council has not harmonised company taxation and there is little likelihood of its doing so in future.

1.2. As a result of the Council's immobilism the Court of Justice is increasingly faced with disputes relating to national direct tax laws incompatible with the Treaty. It has therefore become something of a force for integration, albeit within the limits imposed by its powers of jurisdiction, since it can do more than rule on the incompatibility of national rules with those of the single market ("negative" integration).

1.3. The rules governing direct taxation fall within the national competence, subject to compliance with the Treaty. This principle, asserted for the first time by the Court in 1991 (case C-246/89, *Commission vs United Kingdom),*was reaffirmed four years later by the *Schumacker* judgement and has been regularly confirmed in later rulings.

1.4. The Court is essentially relying on two Treaty rules: (i) the principle of non-discrimination, and (ii) the principle that the basic freedoms may not be restricted. The provisions underpinning these principles can be found in Article 12 of the Treaty, and in the articles giving sanction to the freedoms: Article 39 forbids discrimination and Articles 43, 49 and 59 all provide that the freedoms should not be restricted. The Court applies both the non-discrimination and the non-restriction principles, whichever is more appropriate to a particular case.

1.5. The Court has steadily become more explicit in its rulings, shifting from an essentially non-discrimination based approach to a reliance on the prohibition of restriction, a more powerful concept and hence a more effective tool for removing barriers to the single market.

1.6. To appreciate the significance of the Court's role it is enough to note that from the *Avoir fiscal* case in 1986 to this year's *Lindman* and *Schilling* cases it has ruled no fewer than 37 times on the application of the fundamental freedoms to direct taxation; from *Avoir fiscal* in 1986 to *Saint-Gobain* in 1999 the impact of the freedoms on national tax law gradually broadened to embrace any and all of the rules that go to make up a Member State's tax system (domestic tax law, international tax law, and tax-related international law).

1.7. Here in outline is how the case-law developed. Until the *Avoir fiscal* case the fundamental freedoms had not been applied to direct taxation; from *Avoir fiscal* to *Schumacker* in 1995 they were applied to direct taxation but not to national or treaty-based rules governing trans-national matters; from *Schumacker* to *Saint-Gobain* (1999) the freedoms also influenced national tax rules applying to trans-national dealings ("international tax law"); and from *Saint-Gobain* onwards they have been extended again to treaty-based tax rules ("tax-related international law").

2. *The Court's methodology and reasoning*

2.1. In applying the fundamental freedoms to direct taxation using the non-discrimination and non-restriction principles the Court follows a logical progression based on a fourfold test: (i) "Community citizenship" of the party to the proceedings calling for application of the fundamental freedoms; (ii) exercise of the freedoms for economic purposes; (iii) the existence of discriminatory tax treatment and/or another obstacle to exercise of the freedoms and hence to intra-Community movements as a result of tax law; and (iv) the existence of justification.

2.2 Only EU citizens and equivalent companies (Article 48) have the right of establishment. The protection accorded to free movement of capital, on the other hand, is objective: capital movements are protected as such without regard to the nature of the person claiming the right, even in dealings with non-EU countries (cf. the *Ospelt* judgment of 23 September 2003, on a non tax-related issue). It is therefore likely that in the not too distant future a case will arise in the direct tax field where the critical issues will involve intra-Community economic transactions involving non-EU nationals. The basis of the principle just outlined in respect of the free movement of capital could be invoked for example by a non-EU parent company with a branch in a Member State against a national law impeding the free movement of (its) non-European capital invested in the branch.

2.3 *Exercise of the freedoms for economic purposes*. So far the Court has confined itself in its rulings to issues involving the exercise of the fundamental freedoms for economic purposes. Since Maastricht, however, Article 18 of the Treaty applies not only to the economic aspect of those freedoms but protects every EU citizen's right to move and reside freely within the territory of the Member States. The absolute right represented by the fundamental freedoms is shortly likely to recognised by the Court in the *Barbier* case currently before it (C-364/01; Advocate-General Mischo delivered his own conclusions on 12 December last year), which concerns a dispute involving inheritance taxes

2.4. Such a development would be a first step towards extending the fundamental freedoms to cover "reverse" discrimination, hitherto not subject to Community protection. But discrimination by a Member State *against* its own citizens is also a disparity of treatment which conflicts with the concept of the single market and the non-discrimination principle, creating distortions of competition.

2.5. The Court's application of the fundamental freedoms has traditionally relied on the prohibition against discrimination, but in recently years it has increasingly made use of the prohibition on restrictions, which has enabled it to apply those freedoms in circumstances where the comparative approach inherent in the non-discrimination rule would have been inappropriate. The "no-restriction" rule is particularly effective against tax barriers of the "home-state restriction" type, such as exit taxes. The pending *Laysterie du Saillant* case (C-9/02; Advocate-General Mischo delivered his own conclusions on 13 March) offers a suitable opportunity. The same principle could then be extended to companies, since the *Überseering* judgement of 5 November last year (C-208/00) should now have removed the obstacles involving the failure to harmonise company law cast up by the much earlier *Daily Mail* ruling (C-81/87, 27 September 1988).

2.6. *Justifications: (a) cohesion*. The Court acknowledges the existence of "unwritten" justifications not provided for in the Treaty (Article 58), including the principle of cohesion. However, it has progressively restricted the scope of that principle, and since *Bachmann* (1991) has rejected Member States' arguments based on the concept of "cohesion of the tax system" (see e.g. *Wielockx*, *Verkkoijen* and more recently *Danner*). The Court will only give weight to the cohesion argument if there is a "direct link" between the discrimination element (e.g. a deduction) and the taxation element (e.g. a pension), and when the same tax is applied to the same taxpayer. This amounts to a ban on double taxation. The Court has rejected Member States' attempts to plead the cohesion

principle in defence in a whole series of cases involving citizens (*Asscher, Vestergaard, Baars* and recently *Ole Ramsted*) and companies (*ICI, Metallgesellschat and Hoechst* and recently *Lankhorst* and *XY*).

2.7. *b) other justifications*. Still following the restrictive approach the Court recognised in *Futura* that the need for effective tax controls might, in the abstract, offer a general interest argument strong enough to justify discrimination, but strictly on condition that the "restrictive measure" is appropriate and proportional to the interest to be protected (the proportionality principle). This position is echoed in the very recent *Bosal Holding* case, in which the Court rejected a defence based on the territoriality principle, in distinction to its ruling in *Futura* and *AMID*. In the *ICI* and *XY* judgments it does not automatically rule out the need to counteract tax avoidance and tax evasion as a justification, but it was careful there too to set strict limits: the anti-abuse clause must not be general and absolute, but must be proportionate and specifically tailored to its purpose. Revenue requirements (i.e. the need to prevent reduction of the tax yield) could not be regarded as a national interest sufficient to justify restrictions on the fundamental Community freedoms (the *ICI*, *Saint-Gobain*, *Verkooijen, Metallgesellschaft and Hoechst* judgments and recently *Danner* and *Lankhorst*).

2.8. The Court's consistently restrictive approach is commendable. It is to be hoped that the scope of the cohesion principle will be still further circumscribed. The internal cohesion of national tax systems cannot take precedence over their compatibility with Treaty rules.

3. *The implications of recent case law on individual Member States' corporate taxation systems*

3.1. The effect of Court of Justice rulings, over and above their influence on domestic legislation and case law, goes beyond the immediate case and the law of the Member State party to the proceedings. The Court thus helps to coordinate national tax law at Community level and hence to eliminate tax barriers to the single market. The Court's evolving attitude to right of establishment as it affects company taxation will become clearer if we focus on three questions: equal treatment of branches and subsidiaries; (ii) recognition of losses and costs within "groups"; and (iii) "thin capitalisation".

3.2. *Equal treatment of branches and subsidiaries*. The branch/subsidiary comparison was laid down in the *Avoir fiscal* judgment (the issue being whether branches can qualify for tax credits on dividends). It was confirmed in *Commerzbank* and *Royal Bank of Scotland.* The equivalence was fully realise with *Saint-Gobain*, where the Court ruled that foreign dividends paid to branches and resident companies should be treated alike.

3.3. The criteria set out in point 47 of the *Saint-Gobain* judgement would support the extension of equal treatment for branches/subsidiaries to cover other receipts, e.g. interest and royalties.

3.4. The recent entry into force (on 3 June this year) of Directive 2003/49/EC on intra-Community interest and royalty payments by no means renders this likely extension of the case law pointless. The Directive's scope is limited, and in any case it must itself comply with Treaty rules and the fundamental freedoms. It is up to the Court to interpret the directive in a manner compatible with the Treaty; and in the *Bosal* judgment it did in fact interpret the parent/subsidiary directive in such a way as to make it Treaty-compliant.

3.5. *Treatment of losses and costs within "Community groups"*. The right of establishment has implications for the tax treatment (offsetting and/or carryover) of cross-border costs and losses.

This applies both to tax law in the country of origin and to the host country where the branch or subsidiary is situated.

3.6. In *Futura* and *AMID* (both cases relating to branches) the Court, relying on the territoriality principle, had ruled that refusal to allow the offsetting or carrying over of losses from foreign sources was compatible with the Treaty. Then in the *ICI* judgment it ruled against the consortium relief arrangements used by the UK to restrict deduction of losses by resident subsidiaries from the profits of the resident parent if the parent also had foreign subsidiaries. Finally in the recent *Bosal Holding* case (18 September 2003) the Court dealt with the issue of costs by finding that the tax law of a Member State that did not allow a resident parent company to deduct interest on loans contracted to finance subsidiaries resident in other countries was incompatible with the right of establishment.

3.7. The *ICI* and *Bosal* judgments suggest that the Court may take a similar position in the upcoming *Marks & Spencer* case where the point at issue is the use made by the British parent of losses made by Community subsidiaries for offsetting purposes. The Court seems inclined to favour the offsetting of "crossborder losses" by groups on the same basis as tax law provides for "national losses", in compliance with the freedom of establishment (see *ICI, Futura* and *AMID*).

In the *Bosal* case the Court went further, not admitting the territoriality principle as justification for the non-deductibility of costs incurred in another Member State. If the Court reaches a similar conclusion in the *Marks & Spencer* case, we will have a jurisprudence that upholds the principle of full and total transparency of groups' crossborder losses, something that will have a great impact on company taxation.

3.9. This could have a beneficial effect in terms of harmonisation or simply greater coordination of national tax law on the subject of crossborder losses. The Court's stance in recognising intra-group losses - whether made by branches or subsidiaries - may pave the way for Commission initiatives that have already been announced (COM (2001) 582) and will certainly go beyond a mere replication of the (longstanding) proposal for a Directive (COM (1990) 595), as Community tax law has changed so radically. As explained in COMM (2001) 582, the model will be Denmark's "worldwide" system.

3.10. *Thin capitalisation and anti-abuse rules*. A third strand in the case-law concerns anti-abuse rules. In the *Lankhorst* case the Court has adhered to its restrictive approach to justification and ruled that thin capitalisation rules that reclassified interest as dividend in the case of non-resident shareholders were incompatible with basic Community law. Such rules were judged to discriminate against persons (in the Community sense) established in Member States other than that of the subsidiary's residence, particularly in that they restricted the right to exercise freedom of establishment by setting up, acquiring or maintaining a subsidiary in the Member State of residence.

3.11. The effect of Community case law can impact on the tax legislation of Member States that have rules against thin capitalisation that are applied exclusively to non-resident shareholders, as in France (where the court of Cergy-Pontoise, referring to the *Verkooijen* case, ruled on 11 June 2002 that national law was incompatible with the freedom of establishment), Spain, Denmark and the UK.

3.12. To comply with the Court's rulings the Member States will have to treat shareholders resident in the Member State of the subsidiary and shareholders resident in another Member States on an equal footing, extending the application of the rules on thin capitalisation that were originally intended for non-resident shareholders to resident ones as well.

3.15. The Court's approach as outlined above is liable to impact on Member States' laws in a variety of ways, investing other domestic anti-abuse rules with international force, an example being transfer pricing rules when applicable in cross-border transactions but not between resident companies. The same is true of the CFC rules, when the downstream company is located in a Member State; a clause of this type applicable to subsidiaries resident in a Member State may be found incompatible with the free movement of capital and the right of establishment.

4. *The limits to the Court's "negative integration" and the importance of soft law*.

4.1. Court of Justice case law on direct taxation has been instrumental in eliminating tax barriers affecting the single market and coordinating tax law in the different Member States. The Court's rulings erect "prohibitions", in effect producing "negative tax integration".

4.2. However, this "negative" approach is insufficient, being related to individual cases and thus neither systematic nor organic. It needs to be expanded and put on a systematic footing. Rulings laid down for cases must be generalised. In other words, what we need now is "positive integration".

4.3. In the absence of binding rules, "positive integration" can flow from "soft law", which may represent the only way out of the direct taxation impasse. All soft law concepts and forms can be used: recommendations, opinions, guidelines, communications, interpretative notes, codes of conduct, political agreements between Member States and so on. The common denominator is their (legally) non-binding nature - their status is purely political.

4.4. In COM (2001) 582 def. of 23October 2001 the Commission suggested that guidelines and/or interpretative notes be issued setting out clearly and comprehensively the "general principles" laid down by the Court in relation to direct taxation. These would be accompanied by "communications" to coordinate application of the "principles". The idea is a sound one.

4.5. The "recommendations" on taxation of small and medium-sized enterprises published by the Commission in 1994, insofar as they are still pertinent and can be updated, are still valuable. The same applies to the Ruding Report, a careful study of the relationship between company tax regimes and the functioning of the single market. In COM (2001) 582 def., dealing with corporate taxation, the Commission in fact drew on those aspects of the Ruding Report which have continuing relevance.

4.7. This latter, substantial piece of soft law - COM (2001) 582 def. - provided valuable input for the legislator when framing the recent reform of Italy's tax system.

5. *Italy's tax reform: a case study of a Member State voluntarily taking on board the requirements of tax coordination*.

5.1. Here is a prime example of a Member State voluntarily adapting to the requirements of tax coordination deriving from soft law. Italy's experience, following the German reform carried out in 2000, illustrates the value and effectiveness of soft law.

5.2. In drafting tax legislation consistent either with Community law or with the tax systems of other Member states, Italy drew on various forms of soft law.

5.3. Italy has tackled the issue of cross-border offsetting of losses by adopting "global consolidation" and a "transparent taxation" regime, thereby anticipating in substance the terms of the directive adumbrated by the Commission in 2001 in the Communication mentioned above.

5.4. .By opting for global consolidation the Italian legislator has in effect adopted on of the two solutions to the problem suggested in the Communication: of those suggestions, it is the most effective in that it allows for symmetry between taxation of profits and offsetting of losses. The "transparent taxation" system has a similar effect, in that non-residents, who may only be companies situated in other Member States, are covered as well.

5.6. *The move from tax credits to exemption for dividends*. The two possible methods of eliminating economic double taxation of dividends - tax credits and exemption -were assessed in the light of the single market in the Ruding Report, which considered that allowing tax credits solely for dividends from domestic sources (resident companies and shareholders) would create international distortions. The Commission draws a similar conclusion in its Communication. The Italian legislator therefore took heed of the changes mooted in the soft law and abandoned tax credits in favour of the exemption of dividends, bringing our tax law into line with other Member States' systems and with Community law.

5.7. *Exclusion of domestic and international dividends received by resident companies.* For dividends from foreign sources, including Community ones not falling within the scope of the parent/subsidiary regime. there has always been the problem of the different regimes for domestic dividends received by companies. The recent Commission communication highlighted the limited scope of parent/subsidiary tax arrangements as a result of the minimum participation threshold, which makes it difficult to extend the scope of the Directive. Italian legislation, by introducing a general exclusion regime for dividends received by companies, has dealt with the first problem and taken on board a request of the Commission, though limited to dividends from abroad of Community origin. This has simplified the tangle of rules governing foreign dividends and made it into a unitary tax exclusion regime (up to 95%).

5.8. *Participation exemption*. The reformed Italian regime for capital gains from the sale of shareholdings is similar - and complementary - to the regime for "Community dividends". The introduction of this regime "aligns" the Italian tax system on that of most other EU Member States, which have long provided for *participation exemption* systems for *holding companies* (and which "competed" against us in tax terms).

5.9. *International ruling*. In its recent communication the Commission announced that it planned to oblige the Member States to introduce (or extend) agreements on transfer pricing. In response, Italian tax legislation has been amended to allow agreements between taxpayers and the tax authorities on transfer pricing, dividends, interest, royalties and the like. Such agreements will be notified to the tax authorities of other countries, thus involving them as well, as the Commission advocated.

5.10. Thin capitalisation. Following the reform Italian legislation also has a provision designed to stop *thin capitalisation*. The provision as formulated in the act of delegation was not compatible with Community law (following the *Lankhorst* judgment) and the wording of the draft law was amended in respect of the act of delegation in order to comply with Community rules. So we now have an implementing law whose constitutional "unsoundness" (because it does not adhere to the act of delegation) is made up for by compliance with Community law (Article 45 of the Treaty), which prevails over national law.

5.12. *Conclusions*. Overall the Italian tax reform has brought about a major alignment of the Italian tax system on the systems of other Community members. This has helped harmonise the Community corporate tax environment, so facilitating the adoption of common rules on tax bases advocated by the Commission in the famous communication of 2001 when arguing for a "global approach" to the abolition of tax barriers to the internal market' working and development.