Budapest, 5 July 2005

Workshop on EC law and tax treaties
(5 July 2005, Charlemagne Building, meeting room S2, Rue de la Loi 170, 1040 Brussels)

RE: Consumption-oriented company taxation: a Central European perspective

Highlights:

(i) Deferred corporate tax versus the EC prohibition of dividend withholding taxation [Article 10 (2) of the OECD model double income tax convention]

(ii) International law principle of the prohibition of extraterritorial taxation [Article 10 (5) of the OECD model double income tax convention] in line with the EC law

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	Sovereignty in national fiscal legislation	Approximation of national fiscal laws
Deferred company tax	Foreign tax authorities – like Austria – were hesitant in accepting the official Hungarian qualification for treaty purposes of the 1995 supplementary corporate tax as a withholding tax payable by the foreign parent; this qualification challenged for the reason that – not to mention that it was the company that incurred the legal and financial burden of paying tax – the Hungarian national law provided for genuine withholding tax on dividends, although at a zero corporate tax-rate at that time	To the extent that the company tax to be levied on distribution only can be seen as a type of withholding tax on cross-border dividends, which is prohibited in certain conditions by the Parent and Subsidiary Directive, the national company tax policy can be hampered by the harmonized Community law; countries like Estonia can be prevented by the Community law from applying a direct tax on distribution to be considered as – prohibited -- withholding tax on outbound dividends
	In the Océ case C-58/01, neither the British ACT, nor the British tax credit was prejudiced by the EC Court; however, the 5 percent UK withholding tax, to be levied on the dividends paid out grossed up by the ACT, was seen as prohibited by the Directive in respect of the withholding tax levied on dividends	The EC Court realized (in case C-294/99) that the Greek tax on distribution was isolated from the normal corporate tax liability; e.g., it was not effected by loss carry over; it was not accepted that - it was the company itself that was obliged by law to pay the tax on distribution; and - the company was not only to effect distribution but it was also obliged to finance the tax on it

	Sovereignty in national fiscal legislation	Approximation of national fiscal laws
Low-rate company tax	CFC legislation can be a reaction of high-tax member states, adverse to the treasury interests of the low-tax member states; this way, the low-tax countries could be invited to accept moderation in their fiscal policies even in the absence of Community-wide measures; it is doubtful, however, whether the CFC measures of single member states can be reconciled with the fundamental freedoms	A double tax treaty can be interpreted as a legal instrument one of the basic functions of which is to combat the abuse of law; accordingly, in a Finnish decision, the Finnish CFC rule was applied to a Belgian co-ordination centre, notably, the principle of the prohibition of extraterritorial taxation applies to the source country (and not the residence country) and to the local subsidiary (and not to the foreign parent); see: OECD Commentary on Article 10, Para 37
	National law restrictions on fundamental freedoms could be legitimized by relying on the single Community law only that would be targeted at structural issues; any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State (Eurowings in case C-294/97)	

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Background: increasing influence of ECJ

The EC Court has increased its influence on national direct tax legislation while moving from the enforcement of the principle of non-discrimination to that of non-restriction. In Saint-Gobain, it is still the fiscal law positions held by domestic and foreign resident taxpayers that are discussed before the EC Court. In contrast, in Gerritse it is the different taxation regimes (progressive tax rates versus low-rate withholding tax, depending on whether the taxpayer is resident in the host country) that are compared to each other. The non-restriction principle can thus be applicable not only to a home country (Bosal, de Groot, etc.), but also to a host country.

Another factor with a likely impact on broadening the ECJ scope of influence is the “Open sky” agreements. The nationality clause of Open skies and LOB provisions in American bilateral tax treaties are very similar in their legal structure. These institutions, even though seeking to combat treaty abuse, could be incompatible to the fundamental freedoms as enshrined in the EC Treaty to the extent that they are not special in their nature (they would infringe the proportionality principle). As a means of solution would be structural (positive) harmonization only.

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Interaction of treaty law and Community law and CE member states

There are a few particular considerations of the relationship between the law of double tax treaties and the Community law that can be relevant to the Central European member states only. In this respect, it is important to take into consideration the interaction of the two layers of fiscal law legislation. Therefore, one has to focus not only on certain tax treaty provisions, but also on the national law. A particular reason why national law cannot be neglected is that the law of double tax treaties is “lex imperfecta”. Taking into account that a number of CE member states have introduced low corporate tax rates, the same treaty provisions may have an impact on taxpayers in a CE source-country context significantly different from that on taxpayers in a non-CE source-country context. A “communitization” directive would be useful in which the national rules of a deferred company tax could be brought into conformity with Community law and high-tax member states could be prevented from legislating CFC rules that restrict on fundamental freedoms.

EC law and tax treaties

Impact on CE member states

Both the difference in taxation regimes and anti-avoidance measures can be subject to ECJ scrutiny for the purpose of applying the non-restriction principle. The CE member states can be affected in the first case in terms of their levy of withholding tax to be limited by EC law, in the second case in respect of suffering from CFC sanctions coming from other member states. As far as the fist case is concerned, a deferred company tax can be interpreted as a non-restriction issue. It can be prejudiced on the grounds that those who claim distribution may suffer from arbitrary tax treatment in the host country, even if the dividends received are re-invested. Restriction cannot be legitimized where the profits distributed may well be used for financing further development, although in terms of another company, in the same way as if the subsidiary’s profits had been retained. In the second case, in contrast to the first one, the Central European countries may be protected by the Community law preventing high-tax member states from applying CFC rules.

EC law and tax treaties

Uncertainties in applying EC law to CE member states

The impact of the Community law on the national legislation, affected by the prohibition of taxing cross-border dividends, and expected now to introduce normal company tax, is not the result of a deliberate Community-policy. The withholding tax on cross-border dividends has been introduced in order to eliminate international double taxation. It has been introduced in the milieu in which the tax policy was inclined to eliminate economic double taxation as well. In this respect, the tax policy is designed not to encourage the retention of profits. On the contrary, the basic idea is to stimulate distribution (e.g., by applying in Germany split-rate corporate tax until the 2000 tax reform). In this context, the application of Article 5 (1) of the P & Sub Directive is dysfunctional to a deferred company tax. Besides, one can be successful in referring to Article 7 (2) to the extent that economic double taxation of dividends can be mitigated by a kind of deferred company tax.

CFC measures or LOB provisions of high-tax member states should not prevent investors from entering a CE member state while exercising the right of establishment. CFC rules that constitute special regulations for low-taxed entities with passive income are likely not justifiable under Community law. Notably, a breach of a fundamental freedom can be condemned if the legal regulation is not special in nature which is clearly not the case with a typical CFC law.