

**Tax Competition — Current  
Trends for Company Taxation in  
Europe**

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# Tax Competition — Current Trends for Company Taxation in Europe

by Sandrine Degrève and Roger Molitor

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**T**ax competition had been in existence for many years — and had been regarded as a legitimate instrument used by governments as part of their sovereignty to attract investments — before being challenged by the European Union and the OECD, respectively, in the 1990s.

As far as the EU action is concerned, the Ruding Report,<sup>1</sup> issued in 1992, already mentioned that “tax differences among Member States distort foreign location decisions of multinational firms, and cause distortions in competition, especially in the financial sector.”<sup>2</sup> The Ruding committee was “concerned about the tendency of Member States to introduce special tax regimes designed to attract internationally mobile business.”<sup>3</sup> To cope with those distortions, the report even suggested a harmonization of corporate tax rates (somewhere between 30 percent and 40 percent), which was subsequently rejected by the European Commission.

This article assesses how the tax environment has evolved over the past 10 years, based on the evolution of the approach adopted by the European Union and the OECD, as well as on measures adopted by governments in reaction to the EU and OECD actions. In particular, the article reviews, on one hand, circumstances under which tax competition may exist in competitive markets and, on the

other hand, to what extent attractive tax regimes may be challenged with antiabuse measures.

The article does not seek to provide an exhaustive analysis of tax competition matters, but focuses only on specific aspects to identify some important trends affecting the current global corporate tax environment in which both governments and companies strive to preserve their competitiveness.

## EU and OECD Actions in the 1990s

The starting point of both EU and OECD actions in identifying harmful tax measures was the effective tax rates and their effect on the location of business activities and, hence, on tax revenue.

The OECD focuses on practices that “affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally,”<sup>4</sup> and that “redirect capital and financial flows and the corresponding revenue from the other jurisdictions by bidding aggressively for the tax base of other countries.”<sup>5</sup>

According to the EU Code of Conduct, potentially harmful tax measures are those that “affect, or may affect, in a significant way the location of business activity in the Community” and that “lead to a significantly lower effective level of taxation, including zero taxation, than those levels which generally apply in the EU Member State in question.”<sup>6</sup>

Based on that starting point, several criteria have been established by both the European Union and the OECD to identify harmful tax regimes (as well as tax havens, in the case of the OECD).<sup>7</sup> The criteria provided by the European Union and the OECD were quite similar and focused on a low or zero effective tax rate, combined with “ring fencing” (whereby a tax regime is partially or fully isolated

<sup>1</sup>“Report of the Committee of Independent Experts on Company Taxation,” March 1992. The committee, led by former Dutch Finance Minister Onno Ruding, was formed to evaluate the need for greater harmonization of business taxation within the European Union.

<sup>2</sup>“Conclusions and Recommendations of the Committee of Independent Experts on Company Taxation,” Office for Official Publications of the European Communities, 1992, p. 10.

<sup>3</sup>*Id.*, p. 26.

<sup>4</sup>“Harmful Tax Competition — An Emerging Global Issue,” OECD, 1998, p. 8, section 4.

<sup>5</sup>*Id.*, p. 16, section 29.

<sup>6</sup>*EU Code of Conduct for Business Taxation*, Official Journal C 002, Jan. 6, 1998, p. 3, para. B.

<sup>7</sup>See the report of the Primarolo Group, released in 1999, and the OECD report issued in 2000.

from the domestic economy — for example, by granting a tax advantage exclusively to nonresidents) and a lack of tax transparency. The OECD focus in the field of company taxation seems to assign increasing importance to the exchange of information, which is covered by specific legislative instruments at the EU level.<sup>8</sup>

The OECD action was strongly criticized in the 1990s by the United States, which argued that the OECD should accept tax competition and should not oppose reduced tax rates. Today, the OECD argues that low or zero tax rates are acceptable as such, provided that they are combined with an appropriate level of tax transparency and exchange of information, and with appropriate defensive measures (particularly controlled foreign corporation legislation).

On the other side, the European Union promotes the elimination of the harmful features of earmarked tax regimes under the assumption that tax transparency and exchange of information are not always sufficient to eliminate harmful tax competition. Tax transparency and exchange of information are certainly helpful insofar as they may document the shifting of a tax base into preferential tax regimes, and consequently provide governments with valuable information on the eventual erosion of their own tax bases as a result of harmful tax competition. Indeed, the European Union considers certain types of tax competition harmful because they distort the internal market. Consequently, it promotes a policy removing the harmful features of such preferential tax regimes.

This article will show that this difference in the approaches adopted by the European Union and the OECD has intensified over the past five years.

## Forms of Tax Competition

### Corporate Tax Rates and Tax Revenue

As mentioned above, effective tax rates and tax revenue constitute a major concern of governments in the field of tax competition. The importance of tax revenue is another salient feature of the EU action in the field of tax competition, and was highlighted during the informal meeting of the EU Council of Economic and Finance Ministers (ECOFIN) in Mondorf-les-Bains, Luxembourg, in 1997.<sup>9</sup>

<sup>8</sup>For example, the EU savings tax directive and the EU mutual assistance directive.

<sup>9</sup>The resolutions taken by the EU Council before adopting the Code of Conduct were based on the conclusions of informal ECOFIN meetings in Verona in 1996 and in Mondorf-les-Bains in 1997.

Although corporate tax rates are only part of the picture (in particular, the tax base must also be taken into account), the comparison of global tax rates provides for a useful overview of international tax burdens.

The table below reflects the diversity of corporate tax rates within the European Union and shows that the global trend of decreased tax rates persists in Europe. In 2005 the average corporate tax rates decreased to 23.29 percent in EU member states (from 25.75 percent in 2004) and to 26.49 percent in OECD countries (from 29.7 percent in 2004). The table also shows that the statutory corporate tax rate of most EU member states is below 30 percent. In that respect, it is worth noting that Luxembourg has reduced its municipal business tax rate for Luxembourg City, effective January 1, 2006, thereby reducing its statutory corporate tax rate from 30.38 percent to 29.63 percent for companies established in Luxembourg City.

***In response to the EU and OECD actions against harmful tax competition, a fair number of jurisdictions have set up new tax regimes.***

It is interesting to note that this trend of decreased rates seems to be in line with the current OECD approach, which favors “fair tax competition with rate reducing and base broadening tax reforms.”<sup>10</sup>

We note significant differences in corporate tax rates and a continued trend of reduced tax rates under both the EU and OECD approaches.

Finally, although a low tax rate does not necessarily mean a low tax burden, it must nevertheless be mentioned that the 2004 OECD<sup>11</sup> and Eurostat<sup>12</sup> revenue statistics show that tax revenue on corporate income represents only 8.6 percent of total taxation within the European Union. That average covers a broad bandwidth, for example, Germany at 3.5 percent and Luxembourg at 19.1 percent in 2003.

<sup>10</sup>“Fair Tax Competition — A Pillar of Positive Economic Reform,” a presentation given by Jeffrey Owens, head of the OECD Centre for Tax Policy and Administration, during the INEKO (Institute for Economic and Social Reforms) International Conference on Economic Reforms for Europe, held in Bratislava in December 2004. See OECD Web site: <http://www.oecd.org>.

<sup>11</sup>*Revenue Statistics 1965-2004*, OECD, 2005 edition.

<sup>12</sup>[http://epp.eurostat.cec.eu.int/portal/page?\\_pageid=1090,30070682,1090\\_33076576&\\_dad=portal&\\_schema=PORTAL](http://epp.eurostat.cec.eu.int/portal/page?_pageid=1090,30070682,1090_33076576&_dad=portal&_schema=PORTAL)

## Corporate Tax Rates in the European Union

Country	Jan. 1, 2004	Jan. 1, 2005	Country	Jan. 1, 2004	Jan. 1, 2005	Country	Jan. 1, 2004	Jan. 1, 2005
Austria	34%	25%	Greece	25%-35%	24%-32%	Poland	19%	19%
Belgium	33.99%	33.99%	Hungary	16%	16%	Portugal	27.5%	27.5%
Cyprus	10%/15%	10%	Ireland	12.5%	12.5%	Slovak Republic	19%	19%
Czech Republic	28%	26%	Italy	37.25%	37.25%	Slovenia	25%	25%
Denmark	30%	30%	Latvia	15%	15%	Spain	35%	35%
Estonia	26%	26%	Lithuania	15%/13%	15%/13%	Sweden	28%	28%
Finland	29%	26%	Luxembourg	30.38%	30.38%	United Kingdom	30%	30%
France	34.33%	33.83%	Malta	35%	35%			
Germany	38.29%	38.31%	Netherlands	29%-34.5%	27%-31.5%			

Source: KPMG, <http://www.kpmg.com>

## Tax Incentives Adopted by EU Member States

In response to the EU and OECD actions against harmful tax competition, a fair number of jurisdictions have not only adapted their existing tax regimes, they have also set up new tax regimes to replace the old regimes and to sustain their tax competitiveness within the framework designed by the European Union and the OECD.

As an example, Ireland was the first EU member state to catch on to the benefit of setting up a competitive tax regime based on a very low tax rate<sup>13</sup> applicable to all taxpayers, so that it would not be challenged under the EU Code of Conduct or EU state aid rules.

In Gibraltar, the government is considering new tax legislation to replace the tax-exempt company legislation with a nondiscriminatory, nil corporate tax regime. The proposed regime, which has the full support of the U.K. government, has been challenged by the European Commission based on “regional” and “material” selectivity. Gibraltar is litigating the EC’s challenge in the European courts, and interim measures,<sup>14</sup> agreed to by the EC, have

been put into place while the litigation takes place. (For prior coverage, see *Tax Notes Int’l*, Feb. 28, 2005, p. 754.)

A more recent example is the Belgian notional interest deduction regime, which was adopted on June 23, 2005. (For prior coverage, see *Tax Notes Int’l*, Mar. 14, 2005, p. 963.) Under that new tax regime, which is intended to encourage the strengthening of companies’ equity funding, companies are allowed to deduct from their taxable profits any interest they would have paid in the event of debt financing. That notional interest deduction is calculated by multiplying the total adjusted equity by the interest rate for 10-year government bonds (OLO) — approximately 3.4 percent in October 2005. In support of that tax regime, the 0.5 percent proportional capital duty was abolished (the contribution of capital being subject only to a duty of €25) as of January 1, 2006. As a result, all taxpayers benefit from very attractive, innovative rules. Incidentally, that system will constitute an attractive replacement of the coordination center regime that was challenged by the OECD, the EU Code of Conduct, and under the EU state aid rules.

Furthermore, the Dutch government has announced the introduction of a “group interest box” that would give taxpayers the option of having interest on group loans taxed at a low rate (possibly 10 percent). Group interest would be the balance of

<sup>13</sup>As a replacement for the IFSC (International Financial Service Centre) regime, which provided for a 10 percent corporate tax rate for IFSC companies (which was challenged by both the European Union and the OECD), Ireland progressively reduced its corporate income tax rate from 35 percent to 12.5 percent between 1995 and 2003.

<sup>14</sup>The European Community started challenging the legality of the tax-exempt company status in 2001, and finally decided to extend the life of Gibraltar exempt-status companies until Dec. 31, 2010. The EC also has allowed new

(Footnote continued in next column.)

exempt-status companies to be formed until June 30, 2006 (subject to some limitation in terms of number). The new exempt companies can benefit from their status until Dec. 31, 2007.

interest received from group companies and interest paid to group companies. The low rate would apply only if, and to the extent that, the net group interest income exceeds the net interest paid to third parties. The tax regime would replace the current Dutch financing regime, which has been challenged by the European Union and the OECD. (For prior coverage, see *Tax Notes Int'l*, May 9, 2005, p. 473.)

Finally, under the current Estonian tax regime, corporate profits remain untaxed as long as they are not distributed. A 26 percent corporate income tax is imposed on the portion of income distributed as dividends. Estonia, as a new EU entrant, has been granted a transitional period (ending on December 31, 2008) to change its tax regime and comply with the EU parent-subsidiary directive. It will be interesting to see how Estonia adapts its corporate tax regime within the EU tax framework.

As discussed below, the principles of nondiscrimination promoted and defended by the European Court of Justice may also affect EU member states' tax policies.

### Antiabuse Measures

On one hand, the previous paragraphs show that governments try to attract investors by adopting preferential tax regimes; on the other hand, the governments also adopt antiabuse measures to avoid capital emigration and preserve their tax base. We will therefore analyze the EU and OECD approaches in terms of antiabuse measures.

In its 1998 report, the OECD suggested several tax measures — particularly controlled foreign corporation rules — to counteract the adverse effects of harmful tax competition. The EU Code of Conduct did not contain explicit recommendations in that respect, although it acknowledged that “anti-abuse provisions or countermeasures contained in tax laws and in double taxation conventions play a fundamental role in counteracting tax avoidance and evasion.”<sup>15</sup>

#### The OECD Approach — The 2004 Progress Report<sup>16</sup>

The 2004 progress report identifies a series of measures that may be helpful in neutralizing the adverse effects of harmful tax practices. The proposed measures focus on payments made to persons in jurisdictions engaged in harmful tax practices

(such as restrictions on deductions or other allowance on such payments, thin capitalization provisions, compulsory reporting of such payments, and the application of withholding taxes), as well as on income received from persons in those jurisdictions (such as CFC rules, the denial of an exemption or modification to the credit method, and limiting or not entering into double tax treaties).

The report provides a framework for coordinating defensive measures not only among OECD countries, but also with third countries. It also concludes that future work should focus not only on cooperation with third countries, but also on the implementation of transparency and exchange of information standards. Regarding the exchange of information, a model agreement on exchange of information on tax matters is being developed, covering information requests in both civil and criminal tax matters. That model is also being used by the Committee's Working Party on Tax Evasion and Avoidance as a basis for reviewing article 26 of the OECD Model Tax Convention on Income and Capital.

It is remarkable that the 2004 progress report focuses on defensive measures and on tax transparency and exchange of information, rather than on eliminating harmful tax practices as such (apart from a short follow-up on the tax measures identified as potentially harmful in 2000). In the same perspective, the meeting of the OECD Global Forum on Taxation in Berlin in June 2004 endorsed specific proposals “for moving towards a global level playing field consistent with the objective of high standards of transparency and information exchange in tax matters in a way that is fair, equitable and permits fair competition between all countries, large and small, OECD and non-OECD.” As a follow-up to that forum, the 2005 OECD Global Forum on Taxation,<sup>17</sup> which took place in Melbourne in November 2005, discussed the outcome of a review of legal and administrative frameworks in place in more than 80 countries. Those discussions indicated that considerable progress has been made toward creating a global level playing field in the areas of transparency and effective exchange of information in tax matters.

#### The EU Approach — ECJ Case Law

Within the European Union, antiavoidance measures must comply with internal market legislation. The main function of the ECJ is to interpret EU law (especially the four fundamental freedoms characterizing the internal market, as laid down in the EC

<sup>15</sup>Para. L of the Code of Conduct.

<sup>16</sup>“The OECD's Project on Harmful Tax Practices: The 2004 Progress Report,” OECD, 2004. The OECD Council has said that the work of the Forum on Harmful Tax Practices should be reviewed five years after its establishment, giving rise to the 2004 progress report.

<sup>17</sup>“Outcomes of the OECD Global Forum on Taxation, Melbourne, November 2005”; see OECD Web site: <http://www.oecd.org>.

Treaty),<sup>18</sup> as it applies to a particular case, based on the specific circumstances of that case. In a considerable number of cases, the ECJ has addressed the compatibility of an EU member state's specific tax practices with the EC Treaty. The justificatory grounds generally put forward by member states to sustain their tax practices include, among other things, preventing tax avoidance.<sup>19</sup>

**The ECJ points out the need to examine every single case in order to establish whether a tax regime is deemed to be abusive.**

The ECJ defines tax avoidance as “artificial arrangements aimed at circumventing tax law.”<sup>20</sup> The ECJ also points out the need to examine every single case in order to establish whether a tax regime is deemed to be abusive. As an example of that case-by-case analysis requirement, in the *Lankhorst-Hohorst* case (point 37), the Court notes that the legislation at issue does not have the specific purpose of preventing tax evasion, but applies generally to any situation in which the parent company has its seat outside of Germany, and therefore tax evasion may not be accepted as a justificatory ground. (For prior coverage, see *Tax Notes Int'l*, Dec. 23, 2002, p. 1163; for the text of the judgment, 2002 WTD 241-23 or *Doc 2002-27361*.)

In particular, one may wonder to what extent the ECJ will sustain its definition of tax avoidance in the pending *Cadbury-Schweppes* (C-196/04) case. This is the first case in which the ECJ has been asked to settle a question about the compatibility of a member state's CFC rules with the EU fundamental freedoms. Cadbury Schweppes plc, a U.K. resident corporation holding two Irish unlimited companies taxable at the rate of 10 percent under the old International Financial Service Centre regime, has been required to pay more than £8.6 million on the profits of its Irish subsidiaries in application of the U.K. CFC rules. The questions referred to the ECJ are whether:

- the establishment of subsidiaries in another member state solely because of a more favor-

able tax regime in that member state is an exercise of the EU freedoms or an abuse of those freedoms;

- assuming that such establishment is covered by the EC freedoms, the U.K. CFC rules lead to a restriction on investment in another member state or to discrimination; and
- such restriction or discrimination caused by the U.K. CFC rules can be justified by the prevention of tax avoidance.

While the ECJ has not ruled yet on the *Cadbury-Schweppes* case, it is worth noting that France and Spain recently adapted their CFC rules in apparent anticipation of potential changes in the application of CFC rules within the European Union. Indeed, article 209 B of the French tax law, which establishes conditions for the application of the French CFC rules, was amended in 2005 and refers to the ECJ definition of tax avoidance. As a result of that amendment, article 209 B no longer applies to EU resident companies unless there is an artificial arrangement circumventing national tax legislation. The amendment seems to suggest that French tax law basically recognizes the legitimacy of tax competition within the European Union, with CFC rules applying only in exceptional circumstances involving tax avoidance. A case-by-case analysis is thus required under the new rules. The 2005 legislative change replaces the previous wording of article 209 B, which was subject to a challenge under the ECJ jurisprudence.

Spain also has adapted its CFC rules so that, effective from January 1, 2004, they no longer apply within the European Union, except for entities resident in member states listed on the Spanish tax haven list (Malta and Cyprus).

It is interesting to note that Sweden also amended its CFC rules with effect from January 1, 2004, but in a more restrictive way. EU (direct and indirect) subsidiaries are covered by the new CFC rules, unless they are subject to an income tax rate of at least 15.4 percent of their net income, computed in accordance with Swedish tax rules, or unless their country of residence and their activities are covered in the Swedish “white list” of approved jurisdictions. It remains to be seen whether such a definition can be upheld under the ECJ standards.

Thus, some EU member states reinforce their CFC legislation to cope with low tax rates applied by other member states, while other EU member states (Spain, for example) simply withdraw their CFC rules for structures in which other EU entities are involved. The amendments made to the French and Spanish CFC rules seem to reflect a trend that has emerged over the past few years whereby certain CFC rules have been under increasing scrutiny and debate as being incompatible with EU law.

<sup>18</sup>The freedom of establishment, the free movement of persons, the free movement of services, and the free movement of capital.

<sup>19</sup>Other justificatory grounds include cohesion of the tax system, loss of tax revenue, territoriality, and the effectiveness of fiscal supervision.

<sup>20</sup>That definition was mentioned, among others, in the *Lankhorst-Hohorst* case (C-324/00) (point 37) and the *ICI* case (C-264/96) (point 26).

If the ECJ rules on the *Cadbury-Schweppes* case in line with its past case law, it should conclude that certain provisions of the U.K. CFC legislation discriminate against investment in a lower-taxed foreign subsidiary (compared with domestic investment or investment in a member state with the same level of taxation), or contain an unacceptable restriction against foreign investment.

That would highlight another major difference between the EU and OECD actions, whereby the OECD would promote (fair) tax competition — involving tax transparency, exchange of information, and defensive measures such as CFC rules — while the European Union would promote an internal market without distortions and would restrict the scope of CFC rules within the European Union. Such an outcome would imply that the EU Code of Conduct would fully eliminate harmful tax practices.

### EU Tax Policy and the OECD Model Tax Treaty

Another area that is of interest when comparing the EU and OECD approaches in terms of tax competition and antiavoidance is double tax treaties.

Antiavoidance provisions have been expanded in the 2003 update of the OECD model income tax treaty. Many countries have included such rules in their own tax treaties, the most sophisticated ones being the U.S. limitation on benefit clauses. It is worth noting that the OECD has changed its philosophical approach by attaching the same importance to the avoidance of double taxation as to the avoidance of nontaxation. The commentaries on article 1 of the OECD model contain a section (significantly amended in 2003) regarding the improper use of tax treaties, in which it is stressed that the purpose of double tax treaties is also to prevent tax avoidance and evasion. Article 8 of the commentaries refers to the use of “artificial legal constructions aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in double tax conventions.” In substance, that definition of tax avoidance is similar to the one provided by the ECJ and article 209 B of French tax law. Regarding CFC rules, article 23 clearly provides that CFC rules are regarded as a legitimate instrument to protect the domestic tax base, and that they do not conflict with article 10 of the OECD model.

The European Union has taken a more cautious approach regarding antiavoidance provisions in tax treaties. More generally, although the European Union recognizes that the existing network of tax treaties should achieve the objective of preventing double taxation, as explicitly specified in the EC Treaty, the EC has already challenged tax treaty

provisions on the ground that they conflict with the fundamental freedoms of the EC Treaty. The EC is now analyzing how to prevent and remedy incompatibilities between EU law and the provisions of double tax treaties. In June 2005, it presented a working document that provided for a general legal analysis of problems associated with double tax treaties, including the consequences of certain ECJ judgments in that area.<sup>21</sup>

**The OECD would promote (fair) tax competition while the European Union would promote an internal market without distortions and restrict the scope of CFC rules within the EU.**

The ECJ ruled in a considerable number of cases<sup>22</sup> on the interaction of EU law with double tax treaties. In particular, a recent case that may be mentioned regarding tax competition is the *D* case (C-376/03), which interestingly shows that the fundamental freedoms of the EC Treaty do not necessarily preclude EU member states from applying different treatments or tariffs in their respective double tax treaties. (For prior coverage, see *Tax Notes Int'l*, July 18, 2005, p. 203.)

The plaintiff was a German resident who owned immovable property in the Netherlands and who was not entitled to a net wealth tax allowance under the Germany-Netherlands tax treaty, whereas a Belgian resident owning immovable property in the Netherlands was entitled to such an allowance under the Belgium-Netherlands tax treaty. One argument put forward by the plaintiff was the “most favored nation” (MFN) treatment, according to which a jurisdiction is, in principle, not authorized to introduce discriminatory treatment among its international partners.<sup>23</sup> The ECJ has rejected the MFN argument, holding that a Belgian resident is not in the same situation as a taxpayer resident

<sup>21</sup>See working document “EC Law and Tax Treaties” on the European Community’s Web site: [http://www.europa.eu.int/comm/taxation\\_customs/taxation/personal\\_tax/double\\_tax\\_conventions/index\\_en.htm](http://www.europa.eu.int/comm/taxation_customs/taxation/personal_tax/double_tax_conventions/index_en.htm).

<sup>22</sup>See, for example, *Schumacker* (C-279/93) and *Saint-Gobain* (C-307/97).

<sup>23</sup>MFN treatment has always been the pillar of the trade system for goods recommended by the General Agreement on Tariffs and Trade. MFN treatment was one possible alternative to reduce conflicts between EU law and double tax treaties. However, recognition of the MFN principle in the field of double tax treaties would imply a “race to the bottom.” The European Union is now analyzing other alternatives, such as a European model treaty (an EU version of the OECD

(Footnote continued on next page.)

outside Belgium regarding net wealth tax on immovable property located in the Netherlands, because the reciprocal rights and obligations of the Belgium-Netherlands tax treaty apply only to persons resident in one of those two contracting states (point 61); and also that the allowance granted to Belgian residents under the Belgium-Netherlands treaty cannot be regarded as a benefit separable from the remainder of the treaty, but is an integral part of it and contributes to its overall balance (point 62).

Many observers mentioned that the conclusions of the ECJ on the questions raised in the *D* case differed from the conclusions of the advocate general. It is rather unusual to observe a fundamental divergence between an ECJ judgment and the conclusion of the advocate general. Whether the fundamental ECJ judgment might indicate the emergence of a new ground for ECJ rulings is a new question of overwhelming importance.

## Conclusion

The European Union and the OECD each conduct an initiative on harmful tax competition. In the past couple of years, those initiatives have taken different directions.

### The EU Initiative

The European Union's policy is embedded in the single market. On one hand, harmful tax competition, discriminatory tax measures, and state aid based on tax incentives are not acceptable unless they fall under one of the exceptions defined by the European Community and are sanctioned by ECOFIN. On the other hand, differences in tax rates and tax systems between member states remain acceptable as long as they do not trigger any harmful, unjustified, or disproportionate distortions. Defensive measures such as CFC rules should be used only in specific cases in which there is evidence of tax avoidance.

ECJ case law currently plays a fundamental role in assessing distortions or abuses caused by tax systems. In particular, legislators and taxpayers alike are awaiting the ECJ judgment in *Cadbury-Schweppes* with great interest, as the ECJ might make a fundamental decision in determining what room is left for CFC rules within the internal market.

It would not come as a surprise if the ECJ decided to limit the scope of CFC legislation to artificial situations in which the taxpayer benefits from disproportionate tax benefits in comparison with the

underlying economic reality. Conversely, it would not be surprising if the ECJ opposed the application of CFC rules in situations in which the taxpayer conducts economically sound business transactions in a member state, and the business process would also make economic sense in the absence of tax benefits. In that scenario, taxpayers would fundamentally be allowed to benefit from tax competition between member states, and member states would not be allowed to erode tax competition by way of domestic CFC legislation. Ultimately, market forces would require taxpayers and national governments to conduct their respective business and tax policies within the limits imposed by sound tax competition.

Today, corporate tax rules are not harmonized within the European Union, with a few exceptions. The diversity of domestic tax legislation is part of the internal market, and taxpayers have a legitimate right to take advantage of that diversity, subject to the restrictions outlined above. At the end of the day, tax competition should force governments to adjust their existing tax laws, and to design models that are competitive within the single market, that ensure that the business world shoulders a fair share of the tax burden, and that let governments maintain financial stability as required by the Treaty of Amsterdam.

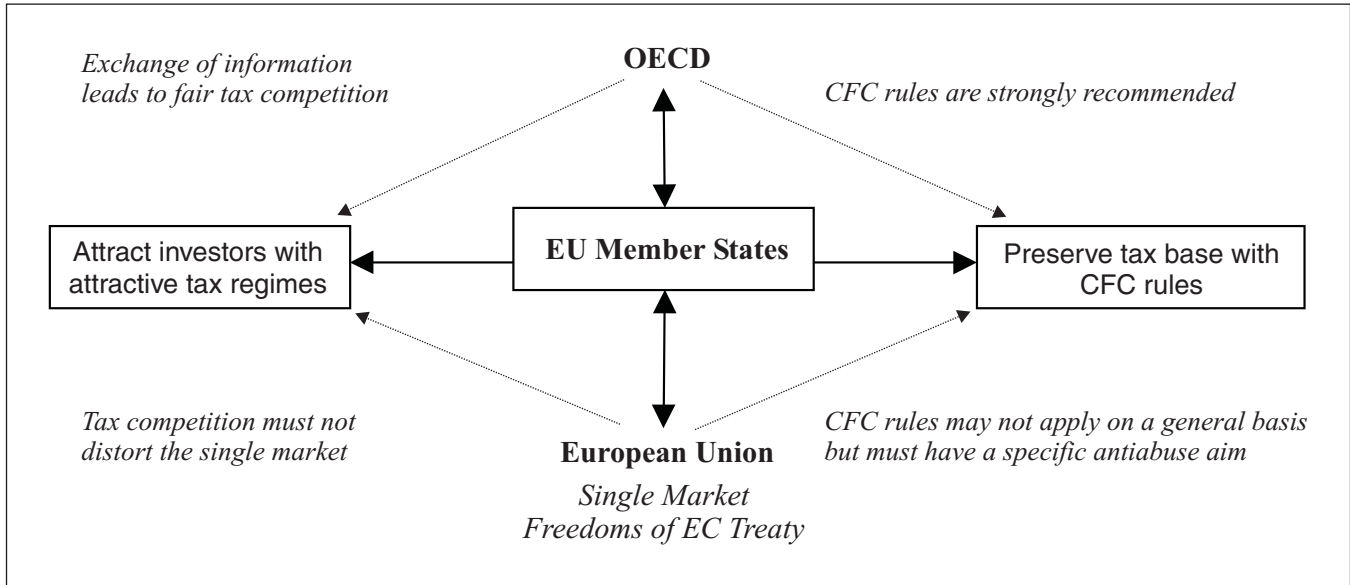
**Each EU member state should follow two fundamental rules in its corporate tax policy in the future.**

Tax legislation enacted by the EU member states should not distort the single market. The acid test for identifying whether a specific tax measure adopted by an EU member state triggers distortions might consist of determining whether the specific tax measure would still distort the internal market (and thus qualify as harmful tax competition) within the European Union if all the member states were to enact the same tax measure under identical terms. If that would be the case, then it arguably could be concluded that the tax legislation intrinsically distorts the internal market.

As an example, that test could be applied to a measure instituting tax relief on exports to other member states: Such tax relief should be regarded as distorting the internal market because, even if all the member states adopted such a tax measure, a company established in a first member state and selling its products within the market of that member state would still have an incentive to migrate to a second member state, from which it would export its products to the first member state in order to benefit from the tax relief on exports. As a result, even if each member state implemented that specific

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model) or a multilateral EU treaty. For example, the Nordic countries apply a multilateral Nordic tax treaty for the prevention of double taxation.



tax rule under identical terms, business location would continue to be driven by tax rules rather than by market forces.

Now let's consider a second example: If a member state applied lower corporate tax rates, or even a zero rate, to all business income, such an attractive tax regime would not, per se, be harmful. However, under the test as defined above, let's assume that all member states agreed to reduce their corporate income tax rate to the same level, or even to zero. If so, business would be treated under the same terms within the European Union, competition would operate under fair terms within the internal market, the internal market would not be distorted by specific tax incentives, and consequently, the favorable tax regime would not qualify as harmful tax competition.

**The OECD Initiative**

The OECD seems to concentrate its efforts on promoting tax competition (by way of a rate reduction with base broadening), as well as tax transparency, exchange of information, and defensive measures such as CFC rules.

As a result, each EU member state should follow two fundamental rules in its corporate tax policy in the future: On one hand, corporate tax policy should

enhance the competitiveness of the member state's economy within the internal market and, on the other hand, each member state should have an interest in adopting protective measures — particularly CFC rules — to discourage the relocation of business activities into low-tax non-EU jurisdictions and to prevent the erosion of its tax base. These mechanisms could be represented in the above diagram.

The 25 EU member states operate under divergent economic and social environments. Some operate at a higher level of public spending than others. Consequently, some also need a higher level of taxation. It is therefore not surprising that some member states have a more competitive corporate tax policy than others. As documented above, a review of corporate tax rates and of new tax incentives adopted by several jurisdictions interestingly shows how the latter manage to preserve or enhance member states' competitiveness while complying with EU and OECD requirements.

Under the assumptions defined in this analysis, this trend should continue in the foreseeable future: The internal market will operate most efficiently if all 25 member states actively support sound competition in all areas, including tax matters. ♦