TAX AVOIDANCE WITHIN A FRAGMENTED SINGLE MARKET

Maria Gregoriou

***Abstract**: The Six ascended the steps of the Capitol in Rome in 1957 to sign a "blank set of papers" which encapsulated their vision of creating an "even closer union* between the peoples of Europe". This Treaty acted as the basis to the expansion of the Eu*ropean Union to Twelve States which committed to "the great market without frontiers". Today, it is the "core of Europe's endeavour" but is fragmented between the 27 Member States and 500 million Europeans who are deadlocked between the national and supranational structures which govern them. For the visionaries of a United Europe who built the Union on the foundation of abolishing internal frontiers, it is but an oxymoron that Member States retained their competence in matters of direct taxation. As national fiscal disparities are accepted within the Union, then the battle against tax avoidance, an unquestionable predicament of the tax gatherer, will be lost at the whim of frail weapons.*

Introduction

The cornerstone of the establishment of the Single Market entailed the abolition of internal frontiers[1]. On signing a "blank set of papers"[2], the Member States may have surrendered their sovereign rights to the supranational regime of the European Union, but were adamant in preserving their fiscal sovereignty in matters of direct

1 The term "common market" was used in the original EEC Treaty without being defined in any way. The concept comprised not only the four freedoms but also various policy areas. After the introduction of the term "internal market" in Article 8A EEC (7A EC), the term common market was retained in the Treaty of Amsterdam as Art.2. "In Dutch (*interne markt*) and German (*Binnenmarkt*) one single term is used to denote the concept…the terms (internal market and single market) seem to be synonymous" p.107 "…the ECJ, too, uses both terms without appearing to be following a clear line…" ft.27; K. Mortelmans "The Common Market, the Internal Market and the Single Market, What's In a Market" 35 (1998) CMLR 101-136

2 It has been reported that the document signed by European leaders, considered to mark the birth of the European Union, "was signed as blank sheet of paper" as a result of the Italian state printer's delays in printing the full document; BBC Today of 24 March 2007 "What really happened when the Treaty of Rome was signed 50 years ago"

taxation. The blurring of territorial boundaries was both an achievement of the objectives of the Single Market and a loophole for taxpayers taking advantage of the disparities between national tax regimes. For the Single Market is fragmented[3] not through the territorial boundaries of each Member State but through the incongruent objectives of promoting a Unified Market which is comprised of Twenty-Seven direct taxation policies. For the visionaries of a United Europe who perceived the Single Market through the free movement of goods, workers, services and capital it remains unfathomable how individual Member States retained fiscal sovereignty in the absence of any provisions allocating taxing rights between the states.

One of the fundamental tenets of a successful tax system is that of certainty, as it ensures a taxpayer's precise knowledge as to his tax liabilities[4], for "clarity and legal certainty are essential for national courts, litigants, the governments of the Member States, the institutions and citizens in general"[5]. Over two centuries ago, reflecting on the words of Benjamin Franklin that "in this world nothing is certain but death and taxes"[6], one could state with certainty that the burden of tax cannot be avoided. However, the early 20th century witnessed a change in judicial attitudes as a taxpayer was commended for his ingenuity in arranging his tax affairs in such a manner as to reduce legally his tax liabilities. Today, the tax system is in a state of disintegration whereby judges have been in search of some 'spooky jurisprudence'[7] enabling them to master artificial tax schemes designed to deceive the revenue authorities.

This paper does not provide a historical account of the ECJ's jurisprudence in relation to tax avoidance. It purports to prove that through the fragmentation of the Single Market, taxpayers are exercising their Fundamental Freedoms in an attempt to take advantage of the disparities between national fiscal regimes. For tax planning has never been construed on a wider base than at the present time, as the discrepancies in every national tax system are unravelled to the schemes of conniving taxpayers.

The Taxing Power

In the quest for the fiscal sovereign between the national and supranational structures, one must ascertain the chain of authority for he "who in turn looks to a

3 "fragment" Origin ME: from Fr., or from L. *fragmentum*, from *frangere* 'to break', detached; Oxford English Dictionary

4 Smith, A. *'The Wealth of Nations'* London, Dent, 1910; *'Towards a Better Tax System'*, Institute of Chartered Accountants of England and Wales, May 2000

5 Case C-136/00 *Danner* [2002] ECR I-8147, Opinion, para.37

6 Benjamin Franklin (1706-90) in a letter to Jean- Baptiste Leroy, 1789

7 *Norglen Ltd v Reeds Rains Prudential Ltd* [1999] 2 AC 1, per Lord Hoffmann at 13

higher one, the holder of sovereignty is highest. No one may question it; no one may legitimately oppose it"[8]. For the supremacy of Community law may have been emphasized on the brink of the evolution of the Union[9], but fiscal sovereignty has been in a constant tug of war between national Member States and the Community where eventually it just falls flat within the chasm of the two. Indeed, the paradox rests in the fact that Member States had surrendered their rights in matters of indirect taxation in exchange for an unwritten pledge that the Community would not attempt to encroach on their fiscal sovereignty regarding direct taxation.

On contemplation of the axiom of the 50th anniversary of the signing of the Treaty of Rome of "Together since 1957", one questions the ambiguity of the Union's spirit of "togetherness". It is an undoubted fact that this juxtaposition sits uneasily, for neither has today's Union of Twenty-Seven states been entwined since 1957 nor has the founding Treaty remained in its initial form. In fact, it is this precise concept of enlargement which triggered the need for ensuring the enforcement of the rights and obligations granted under the Treaty and preventing anarchy within the Union. The realm of taxation unfortunately, hovers in this lacuna. For when the Six envisioned an area of free trade with the abolition of indirect taxes, they failed to predict that direct taxation may have subsequently acted as an obstacle to the enshrined freedoms and claimed protection under the Treaty. Thus, without the Treaty tools or the intention of the Member States, fiscal sovereignty remains fragmented within the Union.

As the European Economic Community was instigated as an area of free trade, it was without doubt that Member States were obliged to yield their fiscal autonomy in indirect taxes to the Community. The harmonisation of indirect taxes acted as a cornerstone to the establishment of the Single Market as customs duties and discriminating domestic taxation of foreign goods and services are unquestionable impediments to the functioning of the common market. Indeed it was only after the Community had secured the abolition of restrictions to the freedom of trade that the Commission "watchdog" was alerted as to the discriminatory practices of Member States in direct tax matters[10].

The Treaty orchestrators eagerly asserted their indirect tax policies, providing that the Community shall be based upon a Customs Union[11], where a total prohibition was imposed of import and export duties and of any charge having an equivalent

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8 D. PHILPOTT, *Revolutions in Sovereignty*, (2001) at 16

9 Case 6/64 *Costa/ENEL*

10 The Commission has brought a "limited number of infringement proceedings against Member States in the area of direct taxation", p.21 Communication "Tax policy in the European Union – Priorities for the years ahead" COM(2001) 260 final; Communication "Matching the Commission's activities with its human resources" SEC(2000) 2000.

11 Art 23 EC Treaty

effect to a customs duty[12]. Within each Member State direct and indirect discrimination against foreign products was prohibited and direct and indirect fiscal protection of domestic production was ensured[13]. Insulating the Union from the impact of third countries, the Common Customs Tariff was established in 1968 as the external border of the Community[14]. In compensation for the abolition of customs duties, the Treaty provided for harmonization of turnover taxes through the imposition of internal taxes on goods and services by Member States[15].

On flipping the taxation coin on its other face, the Member States perceived any attempt on harmonising direct taxes as a blatant interference with their fiscal sovereignty. Indeed, the only Treaty empowerment for the harmonisation of direct taxes is Art. 308, which permits the adoption of "appropriate measures…if action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community and the Treaty has not provided the necessary powers"[16]. The shield against any Community intervention in direct taxes is Art. 95(1) which does not apply to fiscal matters and provides for qualified majority decisions on matters concerning the establishment and the functioning of the internal market[17]. Thus, the only binding instrument for the harmonization of direct taxes is through a unanimous voting of 'directives' on the basis of Art. 94 which provides for the approximation of domestic laws directly affecting the establishment or the functioning of the common market[18].

As "taxing power stems from sovereignty and sovereignty is omnipotence"[19], it is without doubt that regardless of the fact that the Treaty remains silent in allocating fiscal jurisdiction to the Community in direct taxes, the Community would nevertheless thrive in asserting its supremacy within its dominion. In an attempt to decipher the Court's jurisprudence in the area of direct taxation, undeniably, the

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12 Art 25 EC Treaty

13 Art 90-93 EC Treaty

14 Art 26, 27 EC Treaty

15 Art 93 EC Treaty

16 No tax measures have been adopted under this provision. Has been the basis for the EC Regulation on the European Economic Interest Grouping and the Statute for a European Company (*Societas Europaea*)

17 Art 95(2) EC Treaty

18 Parent – Subsidiary Directive, the Merger Directive, the Interest and Royalty Directive and the Savings Interest Directive; note that although both direct and indirect taxes require unanimity, indeed the extended harmonising provisions of indirect taxes are apparent in the fact that through Art. 93 'provisions' and 'measures' such as regulations may be adopted.

19 H. WURZEL, 'Foreign Investment and Extraterritorial Taxation', (1938) 38 *Columbia Law Review* 809-857 at 812

phrase most cited is "*although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law*"[20]. Thus, the ECJ emphasizes that the supreme taxing power rests with the Community, as the European Community entails "the transfer by the states from their domestic legal system to the Community legal system of the rights and obligations arising under the Treaty carries with it a permanent limitation of their sovereign rights'[21]. Even though the Community has consented to the attainment of fiscal sovereignty in direct taxation by the Member States, due to the lack of transferring such rights to the Community, nonetheless this authority is limited for the overriding obligation owed to the Community is paramount.

As fiscal jurisdiction is limited to the territorial sphere in which it is enforced, tax avoidance has been perceived as a domestic predicament as taxpayers evade their legal liabilities within the jurisdiction of the tax gatherer. For linguists, tax evasion and avoidance may imply the same escaping of the fiscal millstone[22] but for tax lawyers the difference is apparent, for one entails a criminal act and the other a legitimate reorganisation of one's affairs. It must be noted that as penal acts and fiscal dues are within the realm of public law, such state prerogatives are shielded from foreign intervention[23]. However, as the scales of fiscal sovereignty are balanced between the limitation of State sovereignty and the supremacy of Community law, it remains a paradox as to who should bear the burden of fighting the foe of tax avoidance which disintegrates the tax bases of Member States. It seems that Member States now bear the dual yoke of both legislating in conformity with the Treaty provision and devising efficient domestic safeguards against tax avoidance.

The ECJ has proved cautious in accepting any justification of tax avoidance for provisions which restrict or distort the Fundamental Freedoms of the Treaty. Disparities within tax systems are accepted as an unavoidable consequence of the lack of harmonising direct taxes and thus measures which are aimed at combating tax avoidance should only be struck down in instances of manifest abuse. Perhaps the Community had perceived that a fragmented Single Market may have acted as a new gameboard on which tax evaders could plan their schemes, but the plurality of the fragmentation proves that preserving the Single Market is an unachievable task for the Community. Even in the sphere of indirect taxation, the abuse of the Single

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20 Case C-279/93 *Schumacker*, para.21 reference made to judgment in Case C-246/89 *Commission v United Kingdom* [1991] ECR I-4585, para.12

21 Case 6/64 *Costa/ENEL*

22 "evade" Origin from Fr. *evader*, from L. *evadere* from e-'out of' + *vadere* 'go' – escape or avoid, especially by guile or trickery; "avoid" Origin from OFR. *evuider* 'clear out, get rid of' – repudiate, nullify or render void; Oxford English Dictionary

23 Rule 3, pp.100-119 in L. COLLINS (gen. ed.), *Dicey, Morris and Collins on the Conflict of Laws*, 14th edn. (2006) and *Government of India v. Taylor* [1955] A.C. 491 (H.L.)

Market has generated millionaires[24]. For the 'elegant tax' of VAT was insulated from exploitation through being designed on a destination country principle, where the tax is paid in the State of final use thus determining the exact amount of tax on a product at every stage of production and clears exactly that amount upon exportation. This tax was intended to be internationally neutral in an attempt to eliminate the possibility of Member States hiding export subsidies in arbitrary refunds upon exportation. Despite its intentions, the Community has failed at an unprecedented level for today, 'carousel fraud' thrives through the fragmentations of the Single Market.

The Fragmented Single Market

In an utopian world, the Single Market could be described as "the commitment of implementing simultaneously the great market without frontiers"[25] for the blurring of state boundaries proposes not only the Unity of States under the umbrella of Community law but insulates the outer-core of the Union "beyond which lies wilderness"[26]. In particular, the internal market is enshrined in the Treaty and commands the "abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital"[27]. However, on extending the Freedom of Capital to third states one questions where the outer-frontier of the market lies[28]. It may be an accepted fact that "…laws and institutions must go hand in hand with the progress of human mind"[29] but such discrepancies and

24 International VAT Association, "Combating VAT fraud in the EU – The way forward" March 2007

25 Jacques Delors, President of the European Commission summarizing the objectives of the Single European Act 1986

26 "Frontier" 1. a border separating two countries, 2. the exreme limit of settled land beyond which lies wilderness… Origin from OFr. *frontiere*, based on L. *frons, front-* 'front'; Oxford English Dictionary

27 Art.3(1)(c) EC Treaty

28 Is there a curbing of the Treaty Freedoms or has the Court already accepted the extension to third countries? See Case C-446/04, *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue* para.166, and Christiana HJI Panayi, "The Protection of Third-Country Rights in Recent EC Case Law", Tax Notes International, February 19, 2007, p 259

29 "I am not an advocate of frequent changes in laws and constitutions, but laws and institutions must go hand in hand with the progress of the human mind. As that becomes more developed, more enlightened, as new discoveries are made, new truths discovered, and manners and opinions change, with change of circumstances, institutions must advance also to keep pace with the times. We might as well require a man to wear still the coat which fitted him when a boy, as civilised society to remain ever under the regime of their ancestors" Thomas Jefferson; Report on the Treaty Establishing a Constitution for Europe, Dec 9th 2004, Committee on Constitutional Affairs, European Parliament UK Office

fragmentations increase the "cracks" within the Single Market and increase its susceptibility to abuse.

Thus, the Single Market with undeniable fiscal borders attempts to eliminate national tax disparities on the basis that such policies act as obstacles to the Fundamental Freedoms of the Treaty. Indeed, the Unity of the States within the Single Market is emphasized by the fact that this internal market "shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty"[30]. In the sphere of taxation, such an internal Single Market is absent. For if a Single Market existed in the realm of direct taxation, then in the event of a taxpayer's crossing of an internal border in the exercise of his Fundamental Freedoms, there should be no dilemma as to which State attains the ultimate taxing right. The lack of any Treaty provisions as to the allocation of taxing rights between Member States has led to the creation of a fragmented market, as it is an undeniable fact that one of the two tax gatherers needs to surrender their right to tax[31]. Indeed, acknowledging **"the fact that a taxable event might be taxed twice is the most serious obstacle there can be to people and their capital crossing internal borders"**[32] and presupposes the existence of a fragmented Single Market. For this precise existence of an internal border which triggers a further tax impediment deprives the exercising of Fundamental Freedoms and the notion of the internal Single Market of all meaning.

The ECJ has been heavily criticised for enhancing its role to that portayed by the legislative branch of the Community[33], and thus encroaching on the fiscal sovereignty of Member States and attacking their impenetrable unanimity shield. Through its interpretation of Treaty provisions the Court has defined national direct tax policies, as States are bound to abide by its judgments. It is an unequivocal fact that although the Treaty substantiates that any obstacles should be abolished, States proceed unheeded without specific judgments directed at their own national policies[34].

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30 Art 14(2) EC Treaty

31 This statement is made subject to an absence of any Double Taxation Convention on Income and Capital (DTC) between the Member States concerned. Indeed, such DTC's are concluded for the purpose of allocating taxing rights between two States.

32 Case C-376/03 *D v Inspecteur van de Belastingdienst* AG Ruiz-Jarabo Colomer, [2005] ECR I-5821, para 85

33 F.C.HOSSON "On the controversial role of the European Court in corporate tax cases" 2006 Intertax 294

34 Despite the judgment in Case C-324/00, *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt,* UK practices were specifically condemned in Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*

The Crack: The disparity as a Tax Advantage

The fragmented Single Market is identified through the "crack", or else the jurisdictional internal borders which differentiate the national tax regimes. The lack of harmonising direct taxes within the Union has unleashed taxpayers in a quest for the most advantageous tax disparity. However, the use of such disparities does not necessarily entail tax avoidance as competition between legal systems is merely a consequence of the realisation of an internal market without common rules. The Court has nevertheless resorted to clarifying that although such disparities are accepted within the Union, any conduct where a party attempts to derive "an improper advantage, manifestly contrary to the objective of that provision"[35] must not act as a justification to potential discrimatory provisions by Member States[36].

The Court has resorted to an array of preliminary rulings whereby it has used the notion of abuse and any conceived synonym which may suggest such artificial practice in an attempt to emphasize that "Community law cannot be relied on for abusive or fraudulent ends"[37]. It must be noted however, that although the need to prevent abuse of law has been recognised by the ECJ, it has failed to save restrictive national measures brought before the Court. In the 1986 host state case of *Avoir Fiscal*[38], France applied an imputation system in order to prevent economic double taxation of distributed company profits. This right to credit the corporation tax levied from the distributing company against the income tax of the shareholder receiving the dividends was extended however, only to resident shareholders and, depending on concessions made by a treaty partner, under bilateral tax treaties to certain foreign shareholders. Thus, the differentiation of treatment lay in the fact that the French branches of the German insurers were denied the credit, where in the same circumstances domestic insurers were granted the credit. The Court however, firmly rejected the argument of the French Government that this measure was an attempt to prevent tax avoidance and stipulated that the Freedom of Establishment "does not permit any derogation from the fundamental principle of freedom of establishment on such a ground"[39].

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35 Case C-367/96, *Kefalas and Others* [1998] ECR I-2843, para 20

36 Must be recalled that the Rule of Reason test adopted by the Court for all Treaty Freedoms were outline in its *Gebhard* judgment (Case C-55/94, [1995] ECR I-4165, para 37. Measures must be non-discriminatory, justified by imperative requirements in the general interest, suitable for securing the attainment of the objective which they pursue, must not go beyond what is necessary to attain it.

37 Case C-255/02, *Halifax plc, Leeds Permanent Development Services Ltd, County Wide Property Investments Ltd v Commissioners of Customs & Excise* at para 68

38 Case 270/83 *Commission v French Republic*

39 Ibid para. 25, also AG Opinion, para 8

In addition, Member States are prohibited from restricting the exercise of a fundamental freedom to access a more advantageous tax jurisdiction by means of anti-avoidance measures. Thus, a portrayal of such a greedy attitude at not only restricting national fiscal benefits to their own residents but raising barriers of access to the fragmented Single Market is eagerly condemned. In *Eurowings*[40], a German levy of tax on the capital and earnings of companies provided that a lessee of capital goods could deduct the entire lease payment only if the lease was in the hands of a German lessor who was duly taxed under the rule. The differentiation rested in the fact that if the lessor was non-resident, the leasing payments were never entirely deductible in the hands of the German lessee. Thus, German companies leasing assets from a foreign lessor were not eligible for the tax relief. Such a restriction on the freedom to purchase services from other Member States was evident, as leasing from foreign providers was made less attractive. Eurowings had leased its aircraft from a lessor which was established in Ireland and subject there to a favourable tax regime of 10%. The Court recognised that had it accepted the argument of the German tax administration that the Irish company did not pay tax that was comparable to the German company tax, this would have clearly interfered "with the foundations of the internal market. If differences in the direct taxation of undertakings could be 'neutralised' by compensatory levies imposed by Member States on intra-community movements of goods, services and capital, little would remain of those fundamental freedoms"[41]. Indeed, the benefit derived from such a disparity is neither abuse nor can it "be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State"[42]. In the aftermath of *Eurowings*, the Court sought for the abusive legislative provision in *Danner*[43] where Finland refused to allow the deduction of pension premiums when these were paid to non-resident life insurance companies. The Court considered this to be a restriction of the Freedom to provide Services, hastely rejected Finland's badly argued tax avoidance justification and reasoned that the discriminatory measure was not proportionate to any allegations that such a measure would lead to artificial arrangements and utilise the effects of tax jurisdiction shopping. Lastly, in *Skandia*[44] Sweden sought to justify a restrictive obstacle to the Freedom to provide Services for it provided a disadvantageous tax treatment of the deduction of pension premiums when these were paid to insurance companies resident abroad. Its weak defence that without such a provision taxpayers in Member States would otherwise have the possibility "to make unacceptable profit

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40 Case C-294/97 *Eurowings Luftverkehrs AG v Finansamt Dortmund-Unna*

41 Ibid AG para 59, on sharing the Commission's opinion

42 Also *Commission v France* para 21, *Asscher* para 53; in Case C-294/97 *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna,* para 44

43 Case C-136/00, *Rolf Dieter Danner*

44 Case C-422/01, *Forsakringsaktiebolaget Skandia (publ), la Ramstedt v Riksskatteverket*

from the differences between the tax systems of the Member States"[45] was merely buried along with preceding regurgitations to the same effect.

The concept of abuse evolved into the pronouncement that national tax avoidance legislation should be directed at wholly artificial arrangements. The *ICI*[46] case regarded corporation tax rules which made consortium relief possible if all companies in the group were resident in the UK. Thus, such a relief was not available if the holding company had too many non-resident subsidiaries. The Court sought the objective justification for the prohibited differentiation and construed this as "the possibility for members of a consortium to channel the charges of non-resident subsidiaries to a subsidiary resident in the United Kingdom and to have profits accrue to non-resident subsidiaries". However, the legislation was not restricted to "wholly artificial arrangements…but applies generally to all situations in which the majority of a group's subsidiaries are established, for whatever reason, outside the United Kingdom"[47]. It was precisely this probable existence of an artificial arrangement that kept tax authorities awake until the determination of the Court in *Cadbury Schweppes*[48]. Following its earlier judgments the Court struck down the UK's CFC legislation as being contrary to the Freedom of Establishment, for its restrictive effects had applied not only to wholly artificial arrangements but failed to exempt controlled companies established in the host Member State which carried on genuine economic activities.

As a result, the triumphant taxpayers fervently seized the powerful weapon granted to them under the Treaty and sought its protection against the foes of Discrimination and Restriction. The direct applicability of the Fundamental Freedoms have been called into question by taxpayers whether they are merely "crossing internal borders" or intellectually devising a scheme. Due to the perplexity of such cases and the fact that their legal basis rests on the foundations of negative integration and the ECJ's interpretation of the applicability of the Freedoms, taxpayers have been dumbfounded by the Court's ingenuity and uncompromising stance of knocking down any provision which may insinuate a potential obstacle to the enshrined Treaty Freedoms.

It has been accepted that using the fragmented Single Market and the Twenty-Seven tax regimes which comprise it in choosing a most favourable tax regime, does not consitute a form of tax avoidance for "…a Community national cannot be deprived of the right to rely on the provisions of the Treaty on the ground that he is profiting

45 Ibid. at para 48

46 Case C-264/96, *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)*

47 Ibid at para 26

48 Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*

from tax advantages which are legally provided by the rules in force in a Member State other than his State of residence"[49]. The reasoning for such a justification was given by the Court in *Metallgesellschaft*[50] whereby it was held that the use of group companies in other Member States cannot be regarded as abusive, as "the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment"[51]. It is undeniable that the Court accepts 'tax jurisdiction shopping' as a legitimate activity in an internal market for the corporate tax regime of other Member States has to be recognised as equivalent. Indeed, abusing such a determination would be as obvious as the presence of an elephant in a room. An example of such conduct was apparent in *Emsland- Starke*[52] where products were first exported and then immediately re-imported in order to receive an export refund that was higher than the customs duty[53].

Indeed, the choice of jurisdiction has been endorsed even if based solely on the wish to circumvent unwelcome domestic tax rules, as long as the economic activity is real. Thus, in *Centros*[54] it had been accepted that Danish individuals had used a UK limited company to circumvent Danish minimum capital contribution requirements. The only distinction made by the Court was that a justification of restrictive measures could only be accepted if a degree of artifice was present. Moreover, it should be objectively and subjectively verified that a taxpayer sought to utilise Community law in conflict with its objective and scope in an attempt to achieve improper advantages. The rights guaranteed to a taxpayer under the Freedom of Establishment encapsulates the right to form a company in a certain Member State, even though by doing so the taxpayer is circumventing the legislation of the other state. The fact that such an activity remains entirely or principally directed at the State of Establishment does not indicate that the transaction is artificial. This principle was reiterated in *Inspire Art*[55] as "the fact that a company does not conduct any business in the Member State in which it has its registered office and pursues its

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49 Case C-364/01, *The heirs of H. Barbier v Inspecteur van de Belastingdienst Particulieren/ Ondernemingen buitenland te Heerlen* at para 71

50 Joint Cases C-397/98 and C-410/98, *Metallgesellschaft Ltd and Others, Hoechst AG, Hoechst UK Ltd v Commissioners of Inland Revenue, H.M. Attorney General*

51 Ibid. at para 57

52 Case C-110/99 *Emsland Starke* [2000] ECR I-11569

53 Ibid; Abuse was described as a two-tier test by the Court: a) the economic operator intends to obtain an EC benefit which was not intended for him, through artificial creation of a situation meeting the EC criteria (subjective element) and b) although formally the critieria are met, object and purpose of the EC rule are frustrated rather than served (objective element)

54 Case C-212/97, *Centros Ltd v Erhvervsog Selskabsstyrelsen*

55 Case C-167/01 *Kamer van Koophandel en Fabrieken voor Amsterdam v Inspire Art*

activities only in the Member State where its branch is established is not sufficient to prove the existence of avoidance or fraudulent conduct"[56] for "that company will in any event be subject to the tax legislation of the State of establishment"[57]. Thus, the Community recognises the existence of internal borders, for it is due to this crossing of a frontier and the exercise of the Freedom of Establishment within another State, which entails the justification as to taking advantage of a tax disparity and not merely avoiding national legislation. Indeed, such a pronouncement rests on the principle of mutual recongition in the avoidance of the imposition of a double burden and the acceptance that the right to tax must be allocated, as within the Single Market there can only exist a single taxing authority for a particular taxable event. The paradox lies in the fact that the principle of mutual recongition was founded on the jurisprudence of the Court in relation to the Free Movement of Goods. Indeed, it sits uneasily when applied to the fiscal allocation of power, as the principle presupposes that on the imposition of a State's practices, the receiving State is obliged to accept that such practices are sufficient. In the face of taxation however, there is no tax priority as with the absence of any allocation of taxing power it seems incongruent that any priority could indeed be either asserted or even ascertained.

The benefits of the fragmented market are dual in that a taxpayer may avoid his national fiscal obligation for a more favourable scheme and Member States are obliged to abolish discriminatory practices to provide equal treatment to residents and non-residents and mutual recongition to foreign practices. Although avoiding national legislation is a logical consequence of making use of the advantages of the internal market, it must be noted that such disparities may result in a justified higher tax burden on the taxpayer as in *Gilly*[58] as "in relation to direct taxes, the situations of residents and non-residents are not, as a rule, comparable, since income received in the territory of a State by a non-resident is in most cases only a part of his total income, which is concentrated at his place of residence"[59].

Schemes by Member States to avoid the

The supremacy of EC law and the application of the Single Market pressuposes that tax avoidance should not arise as a result of a taxpayer's exercise of his Fundamental Freedoms. However, as tax avoidance is the lack of fiscal enforcement, a burden imposed on each Member State, any provision imposed by a Member State as an attempt to protect their tax base from abusing the disparities in the different tax

56 Ibid. at para.139

57 Case C-264/96 *ICI v Colmer* [1998] ECR I-4695 at para.26, also in Case C-324/00, *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* at para.37

58 Case C-336/96, *Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas-Rhin*

59 Ibid at para.49, also see Case C-279/93 *Finansamt Koln-Altstadt v Schumaker* [1995] ECR I-225, para.31, 32

regimes may be considered an obstacle to the Fundamental Freedoms. Indeed, the Member States have been strongly criticised and duly penalised for pursuing practices which are discriminatory both internally (origin) and externally (host). Thus, Member States have devised schemes in their attempt to lower their tax rates, broaden their tax base and minimize the effects of tax avoidance through the abuse of the disparities between national tax systems by imposing certain safeguards.

The distortive effects of national CFC rules were duly portrayed, as such legislation takes the form of the fiercest foe to the rights guaranteed under the Treaty Freedoms. In *Cadbury Schweppes*[60] the adoption of such rules were designed to protect the domestic tax base as resident parent companies may establish wholly owned subsidiaries in Member States with a lower taxation regime, in an attempt to circumvent the high tax rate of their domestic legislation. In the present case, such UK CFC legislation applied as regards two Irish subsidiaries of the UK's Cadbury Schweppes group which were established in Ireland in order to shift profits of intragroup financing and treasury activities from the UK into the Irish IFSC low-tax scheme. The UK tax administration assessed UK corporation tax on the UK parent company of over £8 million in respect of the Irish subsidiary profits and refused to exempt the company from the application of the CFC legislation even though, on the face of the facts, they fulfilled the 'motive test' in that the subsidiary was genuine and not set up for the sole purpose of escaping UK tax. The Court found that such a measure was not proportionate, for such a measure should not apply to companies objectively pursuing a genuine economic activity.

In addition, the Member States have failed to fill the void of the "crack" within the fragmented Single Market in relation to adopting Thin Capitalisation legislation. As in *Lankhorst*[61] such provisions are sought to protect the German tax base from covert distributions of profits whereby a parent company finances a subsidiary by way of loan capital rather than equity capital, subsequently allowing that subsidiary to transfer profits to the parent company in the form of deductible interest payments and not through non-deductible dividend payments. The Court denied the proportionality of such a regime as it did not have the purpose of preventing wholly artificial arrangements but applied "generally to any situtation in which the parent company had its seat, for whatever reason, outside Germany"[62]. Similarly, in the recent *Thin Cap*[63] case the UK national provisions gave rise to a differentiation between resident borrowing companies according to whether or not the related lending company was established in the UK, where there was "no assessment of

60 Case C-196/04, *Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue*

61 Case C-324/00, *Lankhorst-Hohorst GmbH v Finanzamt Steinfurt* at para.37

62 Ibid at para.37

63 Case C-524/04, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*

whether the loan satisfied a relevant criterion, such as that of being granted at arm's legnth, and without that subsidiary being given the opportunity to provide evidence as to any valid commercial justifications there may have been for the loan"[64]. Indeed, it was this precise lack of identifying elements sought to filter purely aritifical arrangements that failed to justify the discriminatory provisions.

The distillation duct of infiltrating schemes intended to abuse the Treaty provisions was once more applied in relation to the imposition of taxes on emigration. Member States were "inspired by the behaviour of certain taxpayers in temporarily transferring their tax residence before transferring securities with the sole aim of avoiding payment of the tax on increases in value"[65]. The Court however, held in *De Lasteyrie*[66] that the restrictive emigration tax imposed on a French shareholder was not justified neither on the basis of tax avoidance nor on that of fiscal erosion of the tax base. This clearly indicates that the "crack" is merely the bond which acts as an internal frontier to States and not a chasm which needs to be filled, as tax avoidance does not occur if the tax jurisdiction of one Member State is utilised and the tax jurisdiction of another Member State is avoided.

In the event that Member States had held a flicker of hope in relation to the Court's judgment on Group Loss Relief, the Court seemed impatient to extinguish it at the first opportunity. Group Relief legislation was restricted to group companies solely resident within their jurisdiction for there was a risk that "within a group of companies losses will be transferred to companies established in the Member States which apply the highest rates of taxation and in which the tax value of the losses is therefore the highest"[67]. In *Marks & Spencer* it must be noted that the non-applicability of cross-border loss relief was based on the justification of a balanced allocation of taxing right, and indeed, the pronouncement that such legislation was not restrictive of the Freedom of Establishment was very narrowly construed[68]. Thus, the Court lingered and pounced on the opportunity given in *Rewe*[69] clarifying that the non-extension of group loss relief to foreign establishments where the parent company was German resident was considered a restriction as such measures were

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64 Ibid at para.84

65 Case C-9/02, *Hughes de Lasteyrie du Saillant v Ministere de l'Economie, des Finances et de l'Industrie* para.25

66 Ibid; see also Case C-470/04, *N v Inspecteur van de Belastingdienst Oost/kantoor Almelo* where the Netherlands emigration tax was considered restrictive of the Freedom of Establishment

67 Case C-446/03, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* at para.49

68 Ibid at para.57, *ICI* para.26 and *De Lasteyrie* at para.50

69 Case C-347/04, *Rewe Zentralfinanz eG v Finanzamt Koln-Mitte*

"targeted generally, at any situation in which subsidiaries are established, for any reason, outside Germany"[70].

Conclusion

Member States may have perceived that a "crack" in their attainment of fiscal sovereignty would have subjected them to a Union where national direct tax policies would have been permanently surrendered. However, the Court's jurisprudence reveals that the fragmented Single Market does not serve as a territory on which an unsupervised cat-and-mouse game can be played without default. Perhaps there is no direction, no link and no prediction as to how future tax avoidance policies either by the Member States or by scheming taxpayers are to be construed. For the only sound basis rests on the enshrined Treaty Freedoms and the fact that the determination of fiscal policies is within the competence of Member States. Being a subject to the Single Market "*means operating on a domestic market of 500 million people, based on the rule of law, with mutual respect and trust. The single market is more important than ever*"[71], for if States were to further accept the encroachments of the Union on their fiscal sovereignty, then the Single Market will not only be fragmented but will be driven to a state of anarchy whereby it will disintegrate to its subjection to the Sovereign Union.

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70 Ibid at para.52

71 Commission President Manuel Barroso on the vision of the future of the EU's internal market 2007