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OPINION OF THE LEGAL SERVICE¹

Subject: Proposal for a Council Directive on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (recast)
- Compatibility of a minimum effective taxation requirement with EU law

I. INTRODUCTION

1. Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States (Directive)² eliminates double taxation on cross-border payments by obliging the Member State of source to exempt the relevant income from any national withholding tax³.

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² OJ L 157, 26.6.2003, p. 49.

³ Article 1 - Scope and Procedure.

2. Following several amendments of the Directive, the Commission presented in 2011 a recast proposal⁴ with a view, inter alia, to extend its scope⁵ and to insert a new requirement for the tax exemption: tax exemption is not granted by the Member State of source where the corresponding income is not "subject to tax" in the Member State of the beneficial owner. The aim of this proposed amendment is to ensure that the relevant income is taxed once within the Union and thus to close a loophole that has been used for purposes of tax evasion.⁶
3. During the meeting of the Council Working Party on Tax Questions on 30 September 2015, some delegations considered that the introduction of a minimum effective taxation requirement (hereinafter "MET") for applying the Directive would be a more appropriate way for tackling "aggressive tax planning". The introduction of MET would restrict even more the scope of application of the Directive, by giving to the Member State of source the power to apply withholding taxes even where tax is effectively paid in the Member State of the beneficial owner but below a certain minimum effective level.
4. Some other delegations expressed concerns about the compatibility of a MET with EU law on the grounds first, that there is no Union competence to harmonise the levels of taxation and second, that the introduction of a MET in the Directive would result in applying withholding taxes to cross-border payments - but not to domestic ones - contrary to the internal market freedoms. Subsequently, the Council Legal Service was requested to give its opinion on whether the legal basis of the proposal, that is Article 115 TFEU, would be suitable for introducing MET and whether such introduction would be compatible with the internal market freedoms.

⁴ Doc 16907/11 of 14 November 2011.

⁵ The proposal extends the list of companies (Article 2(c) (i) and Annex I, Part A) and reduces the shareholding requirements from 25% to 10% (Article 2(d)).

⁶ See explanatory memorandum, page 2 and recital (5) of the proposal.

5. This opinion is drafted on the basis of a general orientation debate without any particular legislative text having been yet drafted and has to be read against this particular background. The Council Legal Service will, at this preliminary stage, limit its examination to the question whether Article 115 of the Treaty on the Functioning of the European Union (TFEU), i.e. the legal basis for the proposal, is appropriate for introducing a MET. It will also offer some general comments regarding compatibility with the internal market freedoms. The Council Legal Service may answer more concrete legal questions once a specific legislative draft on MET is available.

II. LEGAL BACKGROUND

A. Relevant Treaty provisions

6. Article 115 TFEU reads as follows:

“Without prejudice to Article 114, the Council shall, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the internal market.”

B. Secondary legislation

7. Article 1 (1) (Scope and procedure) of the current IRD Directive reads as follows:

“1. Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State.”

C. Commission proposal

8. The Commission proposed modification for Article 1 (1) reads as follows:

“1. Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that ~~Member~~ ~~State~~, whether by deduction at source or by assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State ~~⇒ and is effectively subject to tax on the income deriving from those payments in that other Member State ⇐.~~”⁷

III. LEGAL ANALYSIS

A. Existence of Union competence under Article 115 TFEU

9. It has been argued by some delegations that the introduction of a MET in the Directive would equal to harmonisation of the levels of direct taxation among Member States, although there is no such Union competence. With regard to that argument, it should, first of all, be said that the aim of the envisaged amendment is not to harmonise the levels of direct taxation but to apply the benefits of the Directive only when the income derived from the payment is effectively subject to a minimum level of taxation in the Member State of the beneficial owner⁸. Therefore, the question to be elucidated is whether there is Union competence for the introduction of a MET for the purposes of the Directive.

⁷ This being a recast proposal, the substantive amendments proposed by the Commission are distinguished clearly from the provisions that remain unchanged, pursuant to the interinstitutional agreement between the European Parliament, the Council and the Commission of 28 November 2001 on a more structured use of the recasting technique for legal acts (OJ C 77, 28.3.2002, p. 1). Article 1 which relates to the scope of the Directive is substantively amended in the Commission proposal.

⁸ For simplification purposes, references to the member state of the beneficial owner should be construed as including also the Member State where the recipient permanent establishment is situated.

10. The legal basis of the Directive and the proposed legal basis for the Commission proposal is Article 115 TFEU. As Article 113 TFEU concerns only indirect taxation and Article 114 TFEU excludes fiscal provisions, Article 115 TFEU remains the only possible legal basis in the field of direct taxation for the adoption of directives directly affecting the establishment or functioning of the internal market.
11. The Court has applied by analogy to Article 115 TFEU the criteria for the use of Article 114 TFEU⁹ (which confers upon the legislator the power to adopt measures for the approximation of national laws, which have as their object - and do not only affect, as is the case for Article 115 TFEU- the establishment and functioning of the internal market). According to this case law, the object of the concerned measure must genuinely be to improve the conditions for the establishment or functioning of the internal market¹⁰. The EU legislature may have recourse to Article 114 TFEU where the differences between national rules are such as to obstruct the fundamental freedoms and thus have a direct effect on the functioning of the internal market or to cause appreciable distortions of competition¹¹. Recourse to this provision is also possible for preventing the emergence of future obstacles to trade in case Member States are about to take divergent measures¹². However, the emergence of such obstacles must be likely and the measure

⁹ Regarding the attainment of the internal market, Articles 114 and 115 TFEU are equated, see Case C-183/00, *González Sánchez v Medicina Asturiana*, EU:C:2002:255, paragraph 24. To be noted that, differently from Article 114 TFEU, Article 115 TFEU provides for a special legislative procedure - consultation of the European Parliament and unanimity in Council - for the adoption only of directives for the approximation of laws.

¹⁰ See C-376/98, *Germany v Parliament and Council*, EU:C:2000:544, paragraphs 83, 84; C-491/01, *British American Tobacco*, EU:C:2002:741, paragraph 60; C-58/08, *Vodafone and others*, EU:C:2010:321, paragraph 32 and case law cited.

¹¹ See Cases C-376/98, *Germany v Parliament and Council*, paragraph 106; C-300/89, *Titanium dioxide*, EU:C:1991:244, paragraph 23.

¹² See Cases C-154/04 and C-155/04, *Alliance for Natural Health*, EU:C:2005:449, paragraphs 29-32; C-210/03, *Swedish Match*, EU:C:2004:802, paragraph 30; C-350/92, *Spain v Council*, EU:C:1995:237, paragraph 35; C-376/98, *Germany v Parliament and Council*, paragraph 86; C-377/98 *Netherlands v Parliament and Council*, EU:C:2001:523, paragraph 15; C-491/01, *British American Tobacco*, paragraph 61.

in question must be designed to prevent them¹³. It should also be observed that the distortions of competition need to be appreciable in order to justify the adoption of a Union measure¹⁴. The two criteria referred - i) the removal of obstacles and ii) the elimination of distortions of competition - are applied by the Court alternatively, i.e. it is sufficient that a measure has as its main aim or content either the removal of obstacles or elimination of distortions of competition, for having recourse to Article 115 TFEU.

12. Moreover, it is settled case law¹⁵ that, even where a provision of Union law guarantees the removal of all obstacles to trade in the area it harmonises, that fact cannot make it impossible for the Union legislature to adapt that provision in step with other considerations. In other words, legislative activity has a dynamic character¹⁶: it is not solely the task of the legislature to adopt harmonising legislation but also to amend that legislation to take account of changes in perceptions or circumstances or to adopt a different conceptual approach for harmonisation when the original one proved to be inadequate.¹⁷
13. It is in the light of these considerations, that the Council Legal Service will examine, in turn, whether introducing MET in the Directive complies with the conditions for the use of Article 115 TFEU.

¹³ See C-58/08 *Vodafone and others*, EU:C:2010:321, paragraph 33 and case law cited.

¹⁴ C-376/98, *Germany v Parliament and Council*, paragraph 106; C-58/08, *Vodafone and others*, paragraph 32.

¹⁵ Cases C-491/01, *British American Tobacco*, paragraphs 77-78 and C-58/08, *Vodafone and others*, paragraph 34.

¹⁶ See also Article 1 of Protocol (No 2) on the application of the principles of subsidiarity and proportionality annexed to the Treaties providing that institutions shall ensure constant respect for those principles.

¹⁷ See Case C-58/08, *Vodafone and others*, paragraph 42.

i) Removing obstacles to the functioning of the internal market

14. As the Directive currently stands, the Member State of source is obliged to provide tax exemption¹⁸ without examining whether the relevant income is effectively subject to tax in the Member State of the beneficial owner. That obligation opens a possibility to pay tax in no Member State, contrary to the stated purpose of the Directive to have tax paid once within the internal market¹⁹. The aim of the Commission proposal is to apply the benefits of the Directive only when the income derived from the payment is effectively subject to tax in the Member State of the beneficial owner.²⁰
15. Introducing a MET would restrict even more than the Commission proposal the original scope of the Directive: it would render the tax exemption provided for therein applicable only to cross-border payments subject to tax at least at a level equal to MET. To put it differently, the Member State of source would be allowed to apply its national withholding taxes to cross-border payments that are subject to tax in the Member State of the beneficial owner at a level below MET.
16. The differences in tax rates as such have not been considered by the Court as restrictions to the exercise of the fundamental freedoms but merely as disparities; in the absence of any Union legislation in the field, the determination of tax rates is a matter for the Member States²¹. In this respect, it should be recalled that a mere finding of disparities between national laws is not sufficient to justify recourse to the Treaty provisions on approximation of laws; it is otherwise where the differences between the national provisions are such as to obstruct the fundamental freedoms and thus have a direct effect on the functioning of the internal market²².

¹⁸ Article 1 - Scope and Procedure.

¹⁹ See Recital (3) of the Directive

²⁰ See Recital (5) of the proposal.

²¹ See Cases C-336/06, *Gilly*, EU:C:1998:221, paragraph 47; C-194/06, *Orange European SmallCap Fund*, EU:C:2008:289, paragraph 30; C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*, EU:C:2006:773, paragraph 50; C-446/04, *Test Claimants in the FII Group Litigation*, EU:C:2006:774, paragraph 47.

²² See C-210/03, *Swedish Match*, paragraph 29 and case law cited.

17. It is likely that, in the light of most recent international tax trends and developments²³, Member States adopt national measures, including a MET, as allowed by Article 5 of the Directive for the prevention of fraud or abuse²⁴. A diverging development of national anti-abuse rules seeking to introduce a MET would put in danger the very application of the tax exemption provided for in the Directive and would thus lead to situations of double taxation contrary to the original aim of the Directive. Such a heterogeneous application of the Directive would fragment the internal market and would increase the number of obstacles to the exercise of the fundamental Treaty freedoms that the Directive originally seeks to remove²⁵.
18. The introduction of a MET in the body of the Directive would prevent the emergence of such obstacles, as a single MET would apply throughout the Union²⁶.

²³ See, for instance, a number of studies of the Organisation for Economic Co-operation and Development (OECD) related to base erosion and profit shifting (BEPS) that led to the release of the OECD Final Package of Measures on BEPS, <http://www.oecd.org/tax/beps-2015-final-reports.htm>

²⁴ “Article 5

Fraud and Abuse

1. This Directive shall not preclude the application of domestic or agreement-based provisions required for the prevention of fraud or abuse.

2. Member States may, in the case of transactions for which the principal motive or one of the principal motives is tax evasion, tax avoidance or abuse, withdraw the benefits of this Directive or refuse to apply this Directive.”

Recital (6) reads: “It is moreover necessary not to preclude Member States from taking appropriate measures to combat fraud or abuse.”

²⁵ It is worth mentioning that the Court does not accept the existence of lower tax rates in other Member States as a justification for a different treatment provided by unilateral national measures, see C-422/01, *Skandia and Ramstedt*, paragraph 52; C-294/97, *Eurowings*, paragraphs 44 and 45; C-107/94, *Asscher*, EU:C:1996:251, paragraph 53.

²⁶ See the Commission Staff Working Document accompanying the Commission Action Plan, doc 9949/15, ADD 2, page 4.

ii) Eliminating distortions of competition

19. Alternatively, as said above, a Directive based on Article 115 TFEU could aim at eliminating distortions of competition. Such distortions of competition must be appreciable.
20. The proposal starts from the assumption, stated in its explanatory memorandum, that "aggressive tax planning" of groups of companies in the framework of interest and royalty payments is susceptible of distorting competition within the internal market²⁷. That assumption could also be of relevance for the introduction of a MET.
21. It is not the role of the Council Legal Service to examine the economic and financial accuracy and plausibility of the elements relevant to the proposal. The Council Legal Service finds, at this very preliminary stage, that the Union legislature could conclude, while exercising the wide power of discretion inherent to it where it is called to make complex economic assessments²⁸, that a MET would contribute to eliminating appreciable distortions of competition.
22. It flows from the analysis under i) and ii) that Article 115 TFEU TFEU could be considered as a suitable legal basis for introducing a MET in the Directive as it directly affects the functioning of the internal market both with regard to the removal of obstacles and the elimination of appreciable distortions of competition.

²⁷ See doc 16907/11, page 3.

²⁸ The exercise of the legislator's discretion must comply with the principle of proportionality; in that respect, the Court recognises that the legislator has broad discretion in areas where its actions involve choices of a political, economic or social nature, and where it has to make complex assessments and evaluations (see Cases C-343/09 *Afton Chemical*, EU:C:2010:419, paragraphs 45-46; C-58/08 *Vodafone and others*, EU:C:2010:321, paragraph 52; C-34/08 *Azienda Agricola Disarò Antonio and Others*, EU:C:2009:304, paragraphs 76 to 83; C-558/07 *S.P.C.M. and Others*, EU:C:2009:430, paragraph 42; C-310/04, *Spain v Council*, EU:C:2006:521, paragraphs 96-99; C-210/03, *Swedish Match*, paragraph 48 and the case law cited).

B. Internal market freedoms: general comments

23. The other concern raised was that the introduction of a MET in the Directive would be contrary to the internal market freedoms, because it would oblige Member States to apply withholding taxes to cross-border payments but not to domestic ones.
24. In relation to this concern, it should be stressed that the Directive itself does not provide for disadvantageous treatment of cross-border payments. The benefits it grants, i.e. tax exemption from withholding taxes, apply to all companies falling within its scope of application.²⁹ The envisaged MET would not lay down an obligation for the Member State of source to tax cross-border payments. It would merely restrict the scope of application of the Directive. Cross-border payments falling outside that scope would be subject to national withholding taxes, if any.³⁰ In these terms, MET is of the same nature as the existing 25% (proposed to reduce to 10%) participation requirement³¹: it enounces the conditions upon which the exemption may be applied. In doing so, it delimits the scope of application of the Directive which is a matter of political and technical judgment that belongs to the discretion of the Union legislature³².
25. Consequently, any restriction in the exercise of the internal market freedoms would derive from the national tax legislations and not from the Directive. In that respect, it is important to stress that a Member State may not rely on the Directive for levying a withholding tax on the relevant cross-border payments where no corresponding tax is levied in domestic situations³³. The power given to Member States will have to be exercised in compliance with the internal market freedoms³⁴, which are not, as such, affected by the Directive.

²⁹ See for instance, C-397/09, *Scheuten Solar Technology*, EU:C:2011:499, paragraph 34.

³⁰ Relief of double taxation is provided at any event by national law or bilateral treaties.

³¹ Article 2(d).

³² See footnote 28.

³³ Equal treatment does not necessarily impose the levy of a withholding tax also on domestic situations: a comparison could be made between the withholding tax on cross-border payments and the corporate tax paid by companies, see C-282/07, *Truck Center*, EU:C:2008:762, paragraph 49.

³⁴ See C-386/14, *Groupe Steria SCA*, EU:C:2015:524, paragraph 39; C-170/05, *Denkavit*, EU:C:2006:783, paragraph 19; C-168/01, *Bosal*, EU:C:2003:479, paragraph 26; C-471/04, *Keller Holding*, EU:C:2006:143, paragraph 45; C-446/04, *Test Claimants in the FII Group Litigation*, EU:C:2006:774, paragraph 46.

26. Last, it should also be mentioned that the case law on national anti-abuse rules³⁵ is not of relevance in this context, as MET would not be part of an anti-abuse rule for denying the benefits of the Directive, but would be, as said, a criterion for delimiting the scope of the Directive. Adding more requirements for the application of the Directive leads to narrowing the space left for the application of an anti-abuse rule and this is in favour of the principle of legal certainty.
27. It flows from the above that the introduction of a MET in the Directive is not as such incompatible with the internal market freedoms.

IV. CONCLUSIONS

28. In the light of the above, the Council Legal Service is of view that:
- Article 115 TFEU offers a suitable legal basis for the requirement of a minimum effective taxation for the purposes of the Directive;
 - the requirement of a minimum effective taxation for the purposes of the Directive is not as such incompatible with the internal market freedoms.

³⁵ C-196/04, *Cadbury Sweppes*, EU:C:2006:544.