Chapter 1 – The Sources of EU Law Relevant for Direct Taxation

Łukasz Adamczyk/Alicja Majdańska

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I. General Overview

A. Background

1 The roots of the EU can be traced back to the 1950s when three communities were created: the European Coal and Steel Community, the European Economic Community and the European Atomic Energy Community. The European Coal and Steel Community was formed for only a period of 50 years and ceased to exist in 2002. The European Economic Community was set up by the European Economic Community Treaty, signed in Rome on 25 March 1957, also known as the EC Treaty. The European Atomic Energy Community was established by the Treaty establishing the European Atomic Energy Community on 25 March 1957 (hereinafter EAEC Treaty). The European Union was not established until 1992 by the means of the Treaty of Maastricht (hereinafter TEU), which placed all the communities under one umbrella of policies and forms of cooperation. Subsequently, the Treaties of Amsterdam and Nice entered into force in 1999 and 2003, respectively, reforming the EU institutions. The latest package of fundamental changes to EU functioning was adopted by means of the Treaty of Lisbon (which was agreed to in 2007 and entered into force in 2009). Among various changes, the Treaty of Lisbon merged the EU and the European Community (previously the European Economic Community) into the 'Union'. It also subjected the actions of the EU institutions and the Member States, insofar as they apply and implement EU law, to the Charter of Fundamental Rights of the European Union (hereinafter the Charter of Fundamental Rights or the Charter), which enshrines certain fundamental rights that are legally binding at the EU level.

2 As a result, the following four instruments form the foundation of the EU legal system: TEU,[1] TFEU[2] (which is an updated version of the EC Treaty), EAEC Treaty (updated version), and the Charter. Together, the treaties and the Charter form EU primary law. An inherent aspect of EU primary law is the general principles on which the EU legal system is based. They play a key gap-filling role that ensures the coherence of the EU legal system and are taken into account when EU law, as well as national law, measures are interpreted.[3] Notably, in the controversial *Mangold* case, the Court declared the principle of equal treatment to be a general principle of EU law that should guide the interpretation process. Although there has been no specific post-*Mangold* case law developed in the taxation area, this line of reasoning has contributed to the interpretation of the Charter provisions. EU primary law is supplemented by secondary law, which is law made by

1 Consolidated version of the Treaty on European Union, OJ C 326 of 26 October 2012.
2 Consolidated version of the Treaty on the Functioning of the European Union, OJ C 326 of 26 October 2012.
3 Lenaerts/Gutiérrez-Fons, The Constitutional Allocation of Powers and General Principles of EU Law, *Common Market Law Review* 47/6 2010, pp. 1629–1669.

the EU institutions in the exercise of the powers conferred on them by primary law. It consists of legislative acts (regulations, directives and decisions). Another important element of the EU legal system is soft law, which consists of non-legislative acts (recommendations, opinions, etc.). In addition, the case law of the CJEU and international treaties signed by the EU are also considered to be a part of the EU legal system.

3 At the centre of the EU legal system is the concept of an internal market. It is the fundamental EU concept on which the EU legal system rests. It is defined in Art. 26 TFEU as "*an area without frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties*." Achieving an internal market depends on the four freedoms: the free movement of goods, capital, services, and labour. In addition to the four freedoms, the prohibition on cartel agreements, abuse of dominant market position and State aid prohibition are also aimed at ensuring the protection of the internal market. Finally, 'positive' integration, which implies policy integration (i.e. integration through legislation), plays an important role as well.

4 Taxation is often seen as a potential obstacle to achieving an internal market and, as a result, is susceptible to infringing the fundamental freedoms. It may distort competition. This is the main reason for a number of directives and regulations in the area of taxation in the EU.

5 This textbook focuses on an analysis of EU direct taxation. Nevertheless, to ensure a better understanding of its object, especially in respect of structural issues of tax integration in harmonized and non-harmonized fields, and in connection with the implementation of EU law for the purposes of the Charter of Fundamental Rights, when necessary, this chapter also refers to VAT issues.

B. Effects of EU Law

1. Supremacy

6 As the EC Treaty (the predecessor of the TFEU) was silent on the issue of the relationship between EU law and national legal orders, the CJEU has had to provide clarification. In the Costa v E.N.E.L. case, the Court made it clear that "… *the law stemming from the Treaty … could not … be overridden by domestic legal provisions* …" and in the event of a conflict between an EU law provision and a national provision, the former takes precedence over the latter.[4] Later, the Court further clarified that every national court is obliged to apply EU law "in its entirety and protect rights which the latter confers on individuals and must accordingly set aside any provision of national law which may conflict with it, whether

4 CJEU, 15 July 1964, Case C-6/64, *Costa v E.N.E.L.*, EU:C:1964:66.

prior or subsequent to" the EU law provision.[5] In addition, the Court held that an EU law provision even takes precedence over a national constitutional provision.[6] According to the subsequent jurisprudence of the CJEU, the national administration is also required to ensure the supremacy of EU law over national law.[7]

2. Direct Effect

7 A **directly effective provision** of EU law confers **legally enforceable rights** on an individual such that that individual may rely on those rights before a national court or a national administrative authority. As a result of the supremacy theory, a national provision that is in conflict with a directly effective EU law provision has to be set aside.

8 A **directly applicable provision** of EU law is **automatically effective** in the national legal order without needing to enact implementation measures. The TFEU expressly recognizes the direct applicability of provisions of EU Regulations. However, the TFEU remains silent on the direct effect of treaty provisions, directives and international agreements concluded by the EU. For this reason, the Court has had to elaborate on these issues.

a) Direct Effect of the TFEU Treaty Provisions

9 The conditions for TFEU provisions having direct effect were spelled out in the landmark case of *Van Gend & Loos*.[8] In the judgment, the Court held that the **EC Treaty (now the TFEU) constitutes more than an international agreement** since the Member States have limited their sovereign rights in certain fields by transferring powers to the EU institutions, creating thereby a new, *sui generis*, system of law. The Court recognized that the provisions of the Treaty are directly effective and that there is no need to implement them into domestic law. As a result, TFEU provisions confer rights and obligations not only on Member States but also on individuals.

10 In order to be directly effective, a TFEU provision has to fulfil the following conditions:

- it must be **clearly** and **precisely** worded; and
- it must be **unconditional** and **independent** from any national implementation measure.

11 Individuals and other persons can therefore directly invoke the TFEU provisions, but only if the provisions meet the above-mentioned conditions.

5 CJEU, 9 March 1978, Case C-106/77, *Simmenthal,* EU:C:1978:49, para. 21.
6 CJEU, 17 December 1970, Case C-11/70, *Internationale Handelsgesellschaft,* EU:C:1970:114.
7 CJEU, 29 April 1999, Case C-224/97, *Erich Ciola and Land Vorarlberg,* EU:C:1999:212.
8 CJEU, 5 February 1963, Case C-26/62, *Van Gend en Loos,* EU:C:1985:104.

b) Direct Effect of the EU Directives' Provisions

12 Since Member States are responsible for implementing the directives into domestic law, there is an inherent risk that they will not be implemented or at least not correctly, which might undermine the uniformity of EU law application. Therefore, it is important for individuals to be entitled, in any event, to rely on the 'true meaning' of a directive provision. In the *Van Duyn* case, the Court ruled there that "*it would be incompatible with the binding effect attributed to a directive […] to exclude in principle, the possibility that the obligation which it imposes may be invoked by those concerned. […] It is necessary to examine in every case, whether the nature, general scheme and wording of the provision in question are capable of having direct effects on relations between Member States and individuals.*"[9] In the *Ratti* case, the CJEU established that Member States may not rely on a non-implemented directive against its own citizens (the *estoppel* principle).[10]

13 Generally, directives should not be applied directly in substantiating obligations to the detriment of an individual (**no reverse vertical direct effect of directive provisions**), however, when there is an abuse of law situation, an individual can be deprived of the EU law rights provided even if there is no specific legal basis under national law for such a denial. This is a new phenomen as regards direct taxation, an area in respect of which, initially, the Court, referring to the anti-abuse provisions of the Merger Directive (art. 15 thereof), ruled that a Member State that has failed to transpose the provisions of a directive into national law cannot rely, as against individuals, upon limitations that might have been laid down on the basis of those provisions.[11] In an apparently striking departure from its previous case law, the Court in the 'Danish' cases[12] acknowledged that "*in the light of the general principle of EU law that abusive practices are prohibited and of the need to ensure observance of that principle when EU law is implemented, the absence of domestic or agreement-based anti-abuse provisions does not affect the national authorities' obligation to refuse to grant entitlement to rights provided for by [the PS Directive and the IR Directive] where they are invoked for fraudulent or abusive ends.*"[13] This decision leads to a convergence with VAT case law, in particular the seminal *Halifax* decision, wherein similar Member State rights were recognized.[14] Moreover, in *Italmoda*,[15] the CJEU ruled that Member States may

9 CJEU, 4 December 1974, Case C-41/74, *Van Duyn v Home Office*, EU:C:1974:133.

10 CJEU, 5 April 1979, Case C-148/78, *Publico Ministero v Ratti,* EU:C:1979:110.

11 CJEU, 5 July 2007, Case C-321/05, *Kofoed*, EU:C:2007:408, para. 33.

12 CJEU, 26 February 2019, Joined Cases C-116/16 and C-117/16, *Skatteministeriet v T Danmark* (C-116/16), *Y Denmark Aps* (C-117/16), paras. 70–83.

13 CJEU, 26 February 2019, Joined Cases C-116/16 and C-117/16, *Skatteministeriet v T Danmark* (C-116/16), *Y Denmark Aps* (C-117/16), para. 83.

14 CJEU, 21 February 2006, C-255/02, *Halifax and Others*, EU:C:2006:121.

15 CJEU, 18 December 2014, Joined Cases C-131/13, C-163/13 and C-164/13, *Staatssecretaris van Financiën, v Schoenimport 'Italmoda' Mariano Previti vof* (C-131/13), *Turbu.com BV* (C-163/13) and *Turbu.com Mobile Phone's BV* (C-164/13), EU:C:2014:2455. Similarly, in: CJEU, 22 November 2017, Case C-251/16, *Edward Cussens, John Jennings, Vincent Kingston v T.G. Brosnan*, EU:C:2017:881.

deny rights granted under EU VAT law if the taxable person is participating, or could have known it is participating, in VAT evasion, even if national law contains no basis for such denial.

14 In addition, the Court clarified that an individual may rely on an unconditional and sufficiently precise provision of a directive if the time limit for implementation has elapsed and the Member State has not implemented the directive[16] or has failed to do so correctly.[17] Consequently, Wattel argues that taxpayers are given a choice: they can either apply a national provision that is contrary to EU law or refer directly to a directive provision. As a result, non-compliance of Member States may result in 'provision shopping'.[18]

15 In principle, an individual may not rely on a non-implemented or incorrectly implemented directive against another individual ('**horizontal direct effect**'). This possibility has been explicitly rejected by the CJEU. Two main arguments support this conclusion. First, the Court emphasized that a directive binds states and not private parties.[19] Second, the requirement for legal certainty prevents the directives from creating obligations for individuals without first being implemented into national law.[20] Nevertheless, a directive might have horizontal and/or inverse vertical effect.[21] This would happen if e.g. an individual brought an appeal on the basis of an EU environmental directive against an environmental permit granted to an undertaking.

16 Moreover, national courts are obliged to ensure that the directive at issue is fully effective. This is achieved through **the principle of interpretation in conformity with EU law**. National courts should follow the method of interpretation that best avoids inconsistency with EU law,[22] both before and after the implementation period has expired.[23] In the doctrine, the principle is also known as the principle of consistent interpretation or of indirect effect. They are required to interpret national law "*as far as possible, in the light of the wording and the purpose of the directive in order to achieve the result pursued by the latter.*"[24] As such, it may effect private to private relationships. This principle is subject to restrictions. The principle of interpretation in conformity with EU law applies *"in so far as it is given*

16 CJEU, 19 January 1982, Case C-8/81, *Becker*, EU:C:1982:7.
17 CJEU, 17 October 1996, Joined Cases C-283/94, C-291/94 and C-292/94, *Denkavit International, VITIC Amsterdam and Voormeer*, EU:C:1996:387.
18 Terra/Wattel, *European Tax Law* (2012) p. 82.
19 CJEU, 14 July 1994, Case C-91/92, *Paola Faccini Dori v Recreb Srl.*, EU:C:1994:292, paras. 22–23.
20 CJEU, 7 January 2004, Case C-201/02, *The Queen, on the application of Delena Wells v Secretary of State for Transport, Local Government and the Regions*, EU:C:2004:12, para. 56.
21 Terra/Wattel, *European Tax Law* (2012) p. 82.
22 CJEU, 5 October 2004, Joined Cases C-397/01 to C-403/01, *Pfeiffer a. o.*, EU:C:2004:584, paras. 114–119.
23 CJEU, 4 July 2006, Case C-212/04, *Konstantinos Adeneler*, EU:C:2006:6057, paras. 114–117.
24 CJEU, 13 November 1990, Case C-106/89, *Marleasing SA v La Comercial Internacional de Alimentacion SA*, EU:C:1990:395, para. 8.

discretion to do so under national law."[25] Therefore, an EU-conforming *contra legem* interpretation of national law is not permitted. Moreover, there is no obligation of consistent interpretation if such is contrary to general principles of law, particularly those of legal certainty and non-retroactivity.[26]

3. Direct Effect of the Provisions of EU International Agreements

17 As regards international agreements, the Court has drawn on the doctrine developed in *Van Gend & Loos*. It confirmed the direct effect of specific provisions of EU international agreements as long as they are self-executing, i.e. they meet the two conditions outlined in the case. In addition, the Court added a third requirement, which addresses the spirit, structure and nature of the agreement, which cannot preclude their direct effect.[27]

18 In the context of the special role granted to the ECHR in the EU legal system[28] the CJEU has recently reopened the debate on the relationship between international law and EU law. In addressing the effect of international agreements, the Court examines, among other things, whether a sufficient level of protection of the fundamental rights exists.

19 In the *Kadi I* case, the CJEU reviewed the lawfulness of a legal act transposing a UN resolution, highlighting the insufficient protection of fundamental rights at the UN level.

20 Then, the balance between the need to combat international terrorism and the protection of the fundamental rights and freedoms of suspected terrorists within the EU legal framework was once again considered in the *Kadi II* case. The CJEU ascertained that "*none of the allegations presented (…) are such as to justify the adoption, at European Union level, of restrictive measures (…) either because the statement of reasons is insufficient, or because information or evidence which might substantiate the reason concerned, in the face of detailed rebuttals submitted by the party concerned, is lacking*."[29]

4. EU Institutions

21 Art. 13 of the TEU establishes, inter alia, the following EU institutions: the European Parliament, the Council and the European Commission. These institutions help shape EU direct taxation, although the powers in the field of direct taxation remain mostly in the hands of the Member States.

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25 CJEU, 10 April 1984, Case C-14/83, *Sabine von Colson and Elisabeth Kamann v Land Nordrhein-Westfalen,* EU:C:1984:153, para. 28.

26 CJEU, 8 October 1987, Case C-80/86, *Kolpinghuis Nijmegen*, EU:C:1987:431, para. 13; CJEU, 4 July 2006, Case C-212/04, *Konstantinos Adeneler and Others v Ellinikos Organismos Galaktos*, EU:C:2006:443, para. 110.

27 CJEU, 9 February 1982, Case C-270/80, *Polydor Limited and RSO Records v Harlequin Records Shops and Simons Records,* EU:C:1982:43, para. 12; CJEU, 11 May 2000, Case C-37/98, Savaş, EU:C:2000:224.

28 CJEU, 18 December 2014, Case Opinion 2/13, EU:C:2014:2454, para. 37 et seq.

29 CJEU, 18 July 2013, Joined Cases C-584/10 P, C-593/10 P and C-595/10 P, *Kadi II*, EU:C:2013:518, para. 163.

22 The **European Parliament** and the **Council** can be seen as two chambers of the legislative branch of the EU with its competences being officially distributed between both institutions. The Treaty of Lisbon has somehow also strengthened the powers of the European Parliament in fields that may be relevant for direct taxation, as the amendment to Arts. 64 and 65 TFEU (ex Arts. 57 and 58 EC) proves. However, some relevant differences can still be noted in comparison to powers given to national legislatures, such as, for instance, the fact that, in principle, the power of legislative initiative is neither for the European Parliament, nor for the Council, but is instead exclusively reserved to the European Commission. Therefore, while the European Parliament can amend and reject legislation, the Commission has to initiate the legislative procedure. A special procedure applies to direct tax matters and requires the unanimity of the Council to issue a directive on direct taxes (Art. 115 TFEU). The European Parliament plays only a consultative role (under the so-called special legislative procedure). According to many, this procedure is seen as hampering progress on important tax initatives. In 2019, the European Commission issued a communication on how to move to Qualified Majority Voting via the use of the general passerelle clause (Art. 192(2) TFEU), or by applying policy-related passerelle clauses. As a result, the Council would share its legislative power with the Parliament, as under the ordinary legislative procedure. Furthermore, a decision at the Council level would be made if consented to by the so-called 'qualified' or 'double majority', i.e. 55% of Member States voting and provided such Member States represent 65% of the European population.[30] As some say, the move to Qualified Majority Voting would make tax policy consistent with the internal market and full accountability of the European Parliament.[31]

23 Besides its competences in the legislative process, the **European Commission** monitors the Member States' compliance with EU law. Whenever it finds that a Member State has not complied with EU law, it may initiate an infringement procedure. This special role has been conferred on the European Commission within the area of State aid. All new aid measures have to be notified to the European Commission. Following the notification, the European Commission initiates a preliminary investigation to decide if a measure may be implemented. The European Commission also has competence to review the authorized aid schemes. In addition, it can examine aid granted without prior authorization (e.g. unlawful aid). If it has serious doubts about the aid's compatibility with EU State aid rules, or where it faces procedural difficulties in obtaining the necessary information, it can initiate a formal investigation procedure (Art. 108(2) TFEU). Moreover, the Commission often issues non-binding soft law measures directed to the Member States.

30 European Commission, Communication from the Commission to the European Parliament, the European Council and the Council. Towards a more efficient and democratic decision making in EU tax policy, Strasbourg, 15 January 2019, COM(2019) 8 final.

31 See Pistone, A Plea for Qualified Majority Voting and the Ordinary Legislative Procedure in European Tax Law, in: van Thiel/ Valente/Raventós-Calvo (eds.), *CFE Tax Advisers Europe – 60th Anniversary Liber Amicorum* (2019) p. 11.

In its capacity as a single judicial body competent to interpret EU law, the role of the **Court of Justice of the European Union** is to ensure that EU law is observed. In doing so, the Court reviews the legality of the acts of the institutions of the European Union (including when it acts as an appellate body in respect of the decisions of the European General Court in domains such as, for instance, State aid), controls the Member States' compliance with obligations under the Treaties and interprets EU law at the request of national courts and tribunals with the aim of ensuring the uniform application and interpretation of EU law. In selected cases it may also decide on the interpretation of a double taxation convention (hereinafter: DTC) as an arbitrator. This is only possible, however, when three conditions are met, namely: the dispute brought before the CJEU is between Member States, the dispute relates to the subject matter of EU law and the dispute is submitted to the CJEU under a special agreement between the parties.[32] To date, the CJEU has acted as an arbitrator in respect of a DTC only once.[33] **24**

II. Sources of EU Law

A. Primary Law

1. Fundamental Freedoms and State Aid

For about three decades, the most relevant primary law provisions have been the **fundamental freedoms** as interpreted by the CJEU (see Chapter 3., m.no. 204 et seq.), which set limits as to the boundaries for exercising national tax jurisdiction (known as **negative integration**). **25**

More recently, the State aid rules (Arts. 107 and 108 TFEU, ex Arts. 87 and 88 EC) have grown in importance. They have played an increasingly important role in the field of direct taxes, while recent judgments from EU courts have determined the boundaries of the direct effect of such rules on direct taxes and have ensured an effective review of the EU Commission's activity in this domain. (see Chapter 4., m.no. 308 et seq.). **26**

The limited scope of EU law in respect of direct taxation is usually explained in two ways. First, at the time the Treaty of Rome was signed, direct taxes were not apparently seen as necessarily important to the establishment of the internal market and, consequently, were left outside the scope of the EC Treaty (the predecessor to the TFEU).[34] Second, having in mind that direct taxes may serve as useful tools in pursuing various economic or social aims, the Member States' reluctance to give up their competence is understandable. Consequently, direct taxation has **27**

32 Art. 273 TFEU.

33 CJEU, 12 September 2017, Case C-648/15, *Austria v Germany*, EU:C:2017:664.

34 It should be noted that the 1953 Tinbergen report, laying down the conceptual grounds for the creation of the EC, did not acknowledge harmonization of direct taxes as necessary in developing the single market.

remained within the competence of Member States. This does not prevent the European Union, however, from taking action in the field of direct taxation.

28 The European Union can only act within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein. This reflects the so-called principle of conferral. The competences of the European Union are divided into three categories: exclusive, shared and supporting competences. Exclusive competence covers areas in which only the European Union can adopt a legal act (e.g. customs). Shared competence covers areas in which either the European Union or Member States can adopt legal acts. If the European Union does not exercise its own competence or has decided not to exercise it, the competence remains with Member States. Among others, the competence over the internal market is shared. Given that direct taxation influences the internal market, it is subsumed under shared competence. Finally, supporting competences only allow the European Union to support, coordinate or complement the actions of Member States. This is true for, inter alia, the areas of culture and education.

29 The exercise of EU competences, also in the field of direct taxation, is limited by two fundamental principles laid down in Art. 5 TEU: proportionality and subsidiarity. The principle of subsidiarity refers only to shared competences and requires that the EU execute its competences "*only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States.*"[35] The principle of proportionality requires that EU action not exceed what is necessary to achieve EU objectives. These two principles are key to tax harmonization.

30 Harmonization of direct and indirect taxation is subject to two separate mechanisms that differ from those of an ordinary EU legislative procedure (so called 'fiscal exclusion' as set forth in **Art. 114 TFEU**). In terms of indirect taxation mechanisms, there is an explicit legal basis for EU competence. Art. 113 TFEU specifically provides for the Council, acting unanimously in accordance with a special legislative procedure and after consulting the European Parliament and the Economic and Social Committee, to adopt provisions for the harmonization of Member States' rules.[36]

31 **Art. 115 TFEU** is seen as the legal basis for harmonization in the field of direct taxation. Although it does not refer to direct taxation *expressis verbis*, it is the only provision that can be applied to harmonization of direct taxes. It authorizes the Council to issue directives to approximate laws, regulations and provisions directly affecting the establishment and functioning of the internal market. Such directives may only be adopted on the basis of **unanimity** in the Council. There-

35 Art. 5(3) TFEU.

36 Contrary to the other directives in the area of direct taxation, the recent Commission proposal for a directive on the common system of a digital services tax on revenues resulting from the provision of certain digital services relies on Art. 113 as its legal basis.