



*The Sources of EU Law and their Relationships. Lessons for the Field of Taxation*

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## Summary

This thesis sets out to provide a systematic analysis of the relationship of the various sources of EU law with the aim of taking a more theoretical and conceptual approach to the subject than the one currently prevailing in English language academic literature. The systematic method of analysis is based on an in-depth and detailed examination of the Union Courts' case law which plays a crucial role in defining the relationships of the different sources of law within the system of EU law. In other words, the purpose of the thesis is to deduce, primarily, from the Union Court's case law rules and principles governing the interactions, conflicts and overlaps of the various EU law norms and advocate for their systematic and consistent application. The basic assumption which underlies this approach is that EU law is a system, that is, a coherent unity of legal norms. More than that EU law is, in fact, perceived in this thesis as the legal system of a federal-type political formation, which is characterized by constitutional consistency and a hierarchical order of norms.

The basic tenet that EU law is a hierarchical order of norms must be qualified in certain respects. First, there are norms under EU law which are located at the same level of the normative hierarchy and therefore, they are not in a hierarchical relationship with one another. This is the case with the different acts of the Union institutions which all constitute secondary Union law. Regulations, directives and decisions all have the same rank in the normative hierarchy. This means that the democratic legitimisation of the authors of these acts and the procedure through which they are adopted do not influence the place of these acts in the legal order. The only exception to this is the hierarchical relationship between a basic act and a delegated/implementing act which was adopted on the basis of the basic act. Another conflict between EU law norms which are at the same level of the hierarchy is where different norms of primary law, such as a fundamental right and a Treaty freedom, collide with each other. The Court perceives this situation as a collision of 'principles'. Instead of giving priority to one norm over the other, it tries to optimize the competing principles, that is, realize them to the greatest extent possible under the concrete circumstances of the case.

The second qualification to the statement that EU law is a hierarchical normative order refers to the relationship between primary and secondary law. Undoubtedly, the founding Treaties, the general principles of EU law and fundamental rights are the highest ranking norms in the Union's legal order having a constitutional status with which secondary law must comply. However, the examination of the case law of the Court on the substantive scrutiny of Union legislation shows that the Court uses a very low standard when it reviews the compatibility of secondary law with primary law. This weakens the hierarchy between primary law and secondary law.

More specifically, the analysis of the case law carried out in this thesis reveals that, first, the intensity of scrutiny of secondary law differs depending on whether the act of secondary law is reviewed for its compliance with procedural rules, primarily the legal basis provisions set out in the founding Treaties, or norms of a substantive nature. The Court is much more reluctant to engage in a substantive review of secondary Union law than in a procedural one. Second, a difference can be observed between the Court's approach to the scrutiny of secondary law under the general principles of EU law, including the fundamental rights, and its review under the Treaty's free

movement provisions, i.e. the fundamental freedoms. In particular, the Court has recently intensified the review of Union legislation in the light of fundamental rights. However, the enforcement of stricter fundamental rights standards towards the Union legislature seems to be limited to non-economic fundamental rights. Thus, the Court continues to allow a broad scope of discretion to the Union legislature in situations where what is at stake is essentially an economic interest. Thus, the standard of scrutiny of Union acts in the light of the fundamental freedoms – given their inherently economic nature – is still very low.

Although Union acts apply, in principle, uniformly to the whole of the Union, they very often contain authorizations for one or more or all of the Member States to deviate from the common regime or a harmonized rule. Such authorization measures endanger the unity of the internal market just as much as Member State measures given that they lead to differentiations between comparable situations in different Member States. Moreover, while it is true that the Union itself has no incentive to enact discriminatory acts, the Council – the Union institution which has a predominant role in the legislative process – consists of the Member States. The Member States certainly do have an interest in obtaining special favourable treatment in deviation from the common rules and – under the circumstances of supranational lawmaking – they are in a position to extract such. Compromises may be unavoidable and, thus, discriminatory measures can pass through the channels of Union legislation. This is even more so where the legislative procedure prescribes unanimity voting, as is the case with all the Union acts concerning taxation. Hence, Union measures may well contain distinctly applicable or outright discriminatory provisions. Therefore, the Court's low standard of scrutiny of Union legislation in the light of the fundamental freedoms cannot be excused by the reason that there is no need for a more effective scrutiny.

As regards the question how the Court avoids the need to scrutinize the legality of secondary law in the light of primary law, three techniques can be distinguished. The first is applied when at issue is the relationship of national law – secondary law – primary law. As regards the fundamental freedoms, the Court established the rule that in exhaustively harmonized areas, national law is to be tested only against secondary law and not against the fundamental freedom under the scope of which the situation may otherwise fall. By means of this rule, the Court can avoid addressing the question whether the national measure at issue complies with the requirements of the freedoms and thus, also the ensuing question of the compatibility of secondary law with the freedoms. This rule combined with the presumption of legality of Union acts, i.e. lack of *ex officio* examination of the validity of Union acts, helps the Court stay away from examining the compatibility of secondary law with the fundamental freedoms.

With regard to the relationship of national law – secondary law – primary law an important question is to whom the infringement of primary law – either that of the fundamental freedoms or the State aid rules – is to be attributed when the infringement follows from the exercise by a Member State of an option or authorization granted by secondary law. Where secondary law grants an authorization which leaves no discretion to the Member States as regards the way in which it can be exercised, the ensuing infringement must be imputed to the Union. On the other hand, where a tax directive grants an option which leaves sufficient margin of discretion to the Member States and a Member State exercises it in a way which breaches primary law, the infringement is imputable to the Member State.

There is an important difference between the fundamental freedoms and the State aid rules in this respect. While the prohibitions set out under the free movement provisions are addressed not only to the Member States but also the Union legislature, the same is not true in the case of the State aid rules. The definition of State aid requires that aid must be granted by a Member State; therefore, Union aid is excluded from the scope of Article 107(1) TFEU. Thus, while a Union act may very well infringe the fundamental freedoms, the State aid rules exclude *a priori* the possibility that aid granted by a Union act could be in breach of Articles 107-108 TFEU. However, Union measures which distort competition by selectively favouring certain undertakings ought to be reviewed in the light of the principle of equality as a general principle of EU law.

The second technique used by the Court for the purpose of avoiding direct conflicts between primary and secondary law is consistent interpretation whereby the Court construes secondary law in a way which renders it compatible with primary law. Apart from enabling the Court to circumvent the question of validity of secondary law, consistent interpretation can also be used for construing an undefined term or imprecise norm included in secondary law with the help of primary law.

Consistent interpretation becomes highly relevant in connection with the concept of abuse and its various manifestations in the different areas of taxation. In particular, the question is to what extent the specific anti-abuse provisions of the direct tax directives are – and should be – interpreted consistently with the general (case law-based) doctrine of prohibition of abuse. The answer to this question depends on the status of the latter doctrine. The Court's position, i.e. the prohibition of abuse of rights is a general principle of EU law, implies that it has the ranking of primary law of a constitutional nature meaning that secondary law must comply with it. Under this view, the specific anti-abuse provisions of the direct tax directives must be in line, as a matter of normative hierarchy, with the general principle of prohibition of abuse. Accordingly, the Court has strived to interpret consistently the directives' anti-abuse rules with the concept of abuse which it developed in the context of its case law on the fundamental freedoms and VAT thereby, trying to formulate a uniform concept of abuse. In contrast to the Court's perception, in this thesis it is suggested that the prohibition of abuse should be considered a principle of interpretation rather than a formal general principle. This, however, does not affect the conclusion that the anti-abuse rules of the direct tax directives need to be construed consistently with the general doctrine of prohibition of abuse which applies to the abuse of the fundamental freedoms. This follows from the objective of the direct tax directives and the fact that they are aimed at giving effect to the fundamental freedoms in their respective areas of application. In the light of this, it is reasonable that the concept of abuse within the scope of the direct tax directives should be interpreted in the same way as under the fundamental freedoms. The anti-abuse rule of the Parent-Subsidiary Directive, which is a mere authorization for the Member States to apply the anti-avoidance rules under their domestic laws or tax treaties, can be interpreted consistently with the general doctrine of prohibition of abuse. In contrast, the wording of the Merger Directive's anti-abuse clause does not leave scope for consistent interpretation, as it deviates considerably from the content of the general doctrine of prohibition of abuse insofar as it does not refer to the objective element of abuse (i.e. artificiality of the transaction) only to the subjective one (i.e. tax avoidance purpose). Having regard to this the Court should have declared invalid the provision instead of interpreting it *contra legem* to the effect of bringing it into accord with the general abuse doctrine. A solution may be brought about by the

pending proposal of amending uniformly the anti-abuse provisions of all the direct tax directives along the line of the general abuse doctrine.

Finally, the third technique through which the Court avoids the need to formally invalidate secondary legislation which is in breach of primary law is the relaxation of the proportionality standard towards Union acts. The Court, when analysing the proportionality of Union measures *prima facie* infringing the freedoms, had normally used the 'manifestly inappropriate' test which leaves a wide margin of discretion to the Union legislature in striking a balance between two conflicting interests, i.e. the internal market and the public policy objective pursued by the Union measure at issue. Under this test, the various elements of proportionality are not examined to the same extent as they would be in the case of Member State measures. More recently, the Court seems to have abandoned the 'manifestly inappropriate' test and has started to carry out a detailed analysis of the suitability and, especially, the necessity of Union measures. The tendency can be observed both in cases where Union acts are scrutinized in the light of fundamental rights and where they are reviewed under the fundamental freedoms. However, the enhanced proportionality analysis has so far resulted in the invalidation of the Union measure only in fundamental rights cases. This signals, on the one hand, that in the fundamental freedom analysis, the standard of proportionality is still not the same for Union measures and Member State measures and, on the other hand, that a lower standard of proportionality applies to Union measures in cases where the interests and rights at issue are of an economic nature.

The low intensity of judicial review over secondary Union law can be explained by the Court's intent not to interfere with the institutional balance in the Union as well as, by the circumstances of constitutional pluralism under which the primary focus of the Court is and has been to ensure the status of EU law *vis-à-vis* national law rather than enforcing substantive standards towards the Union legislature. In addition, the Court's deferential attitude recognizes the difficulties inherent to a supranational legislative process, which requires – in the field of taxation – the consensus of 28 Member States. While these factors may justify the Court's rejection of judicial activism in the substantive scrutiny of Union legislation, they cannot justify weakening the hierarchy of norms under EU law and rendering the constitutional review of secondary legislation a mere formality. The hierarchy of norms is one of the fundamentals of the Union's legal system and its constitutional construct. Ensuring that Union legislation complies with primary law – whether the fundamental rights, general principles or the fundamental freedoms – is essential, on the one hand, as a constitutional guarantee in the absence of which the authority of EU law may be challenged, and, on the other hand, as a guarantee that the internal market – the economic constitution of the Union – remains free of restrictions and distortions even from Union legislation.

In this thesis, the relationship of various sources of EU law is examined by focusing on the field of taxation. It is a policy field with some specific characteristics which make it especially a suitable context to demonstrate the various aspects of the interactions of primary and secondary Union law. As far as direct taxation is concerned, harmonization is marginal and fragmented in this area. As a consequence of lacking harmonization and the uncoordinated exercise of national tax policies, there are still significant obstacles to the internal market created by national direct tax measures. Negative integration based on the primary law freedoms can offer only a partial solution insofar as it tackles only discriminatory national tax measures leaving obstacles stemming from disparities between the

national tax systems and juridical double taxation unresolved. Therefore, negative integration cannot and should not take over the role and function of harmonizing secondary law.

As regards potential conflicts between primary law and secondary law in the field of direct taxation, the limited or imperfectly defined scope of the direct tax directives cannot, of itself, lead to an infringement of the fundamental freedoms. However, the fact that the narrowly drafted direct tax directives leave certain potential subjects outside the scope of a beneficial regime, where they are in a comparable situation to those falling within the scope of the regime, may contravene the principle of equality. Some of the direct tax directives, in certain respects, have become obsolete or even conflicting with the fundamental freedoms due to the lack of their adaptation to the evolving process of integration which is a consequence of the blocking effect of the unanimity requirement prevailing in the legislative procedure in the field of taxation.

As far as indirect taxation is concerned, the exhaustive harmonization which exists in this area displays a different aspect of the relationship of primary and secondary law from those examined in the case of direct taxation. Due to the substantial presence of secondary law, there is greater potential for conflicts with primary law. However, the Court, also in this area of taxation, refrains from exercising an effective judicial review over Union legislation.

The tax directives contain a host of derogations, special arrangements and transitional rules addressed to certain Member States. It is argued in this thesis that discrimination for the Union legislature should be prohibited not only in the sense that a Union act cannot treat domestic and cross-border situations differently from the perspective of the individual Member States but also to the effect that it cannot regulate similar situations in the various Member States differently unless such is justified by the objective differences between the Member States. In view of this, some of the derogations, special and transitional arrangements under the tax directives could well be challenged on the basis that they lead to unequal treatment and introduce new disparities to the already diverging tax legislation of the Member States.

The conclusion that the Court ought to enhance the intensity of substantive review of secondary law applies equally to the field of taxation even if – or precisely because – the adoption of secondary law in this domain is especially hard and therefore, often loaded with compromises which are far from being immaculate from the point of view of compliance with primary law.

This thesis also includes an analysis of the relationship between two norms of primary EU law, the fundamental freedoms and the State aid rules, which are at the same level of the normative hierarchy. In this horizontal relationship, the focus is on methodology. In particular, a comparison is provided of the methods of analysis applied by the Union Courts when they test the compatibility of national tax measures with the fundamental freedoms, on the one hand, and the State aid rules, on the other. The analysis shows a gradual but clear convergence of these two methods. As a result of the convergence both the fundamental freedom analysis and the State aid analysis of national tax measures boil down to the question (i) whether the national measure under review treats objectively comparable situations differently and if so, (ii) whether such differential treatment can be justified. This is the basic pattern of analysis under any rule which prescribes an obligation of equal treatment. This indicates that both the fundamental freedoms and the State aid rules are the expression of the principle of equality in their specific field of application.

The main driver in the approximation of the State aid analysis to the fundamental freedom analysis is the interpretation given by the Court(s) to the concept of selectivity. In particular, the Court interprets selectivity in a way that it requires a comparative analysis similar to the one used for the establishment of discrimination. Hence, both selectivity and discrimination are concerned with different treatment of comparable situations. With respect to the criterion of comparison, under the fundamental freedoms the Court takes essentially three factors into account for the purpose of establishing comparability between two distinct situations: (i) the tax treatment of the cross-border situation under the law of the Member State concerned, (ii) the factual circumstances of the case, and (iii) the objective of the national measure under review. It is not clear what the actual comparability criterion is, as the Court treats randomly one or the other of the three factors as such. The comparison test which the Court uses under the State aid rules integrates all these factors. Nevertheless, the selectivity analysis under the State aid rules also involves ambiguity, as the Court sometimes uses as a comparability criterion the objective of the measure under review while at other times the objective of the system of which the measure forms part.

As far as the justification phase of the analysis is concerned, a common feature between the fundamental freedoms and the State aid rules is that under both rules the case law-based justification grounds play an important role besides or, instead of, the Treaty-based exceptions. Furthermore, the reasons which are accepted under the State aid rules as justification by the nature and general scheme of the system are similar to the accepted justification grounds under the fundamental freedoms (balanced allocation of taxing rights, cohesion of the tax system, preventing tax avoidance, effectiveness of fiscal supervision) in the sense that they are all reasons internal to the tax system. Finally, another symptom of convergence is that the proportionality test forms part of both the fundamental freedom analysis and the State aid analysis.

This thesis sets out a proposal for a consistent analytical framework according to which national tax measures should be examined under the State aid rules. Under the proposed analytical framework, the analysis of *prima facie* selectivity depends on whether the measure under review is a self-sufficient measure or it forms part of a broader system. In the case of a self-sufficient measure, that is, a measure which constitutes a system itself – either the general tax system or a subsystem – the question to be answered under the State aid review is whether its scope is defined in such a way that it covers all the undertakings which are in a legally and factually comparable situation in the light of the objective of the tax. Thus, the *prima facie* selectivity of such measure is to be established via the pure comparison approach without the need to identify a reference system and a derogation from the latter. By this interpretation, the State aid regime can be used to ensure that taxes are levied in a coherent and neutral way so that all those subjects who should be liable to tax according to the internal logic of the tax are, in fact, covered by the scope of the tax.

In the case of measures which form part of a broader, comprehensive system the derogation approach also plays a role in establishing their *prima facie* selectivity. Under this approach, first, the reference system must be identified and then it has to be examined whether the (dis)advantageous treatment that the tax measure entails constitutes a derogation from such reference system inasmuch as it leads to situations which are legally and factually comparable being treated differently. The rules which make up the reference system are those which implement the fundamental guiding principle of the system, which can be either the principle of ‘ability to pay’ or

another specific principle, for example, environmental protection. Thus, in the case of these measures, the analysis combines the derogation test with the comparison test.

Furthermore, under the proposed analytical framework, any unjustified differentiation within a system which constitutes a derogation to either direction from the benchmark can constitute State aid whether it is an advantage or a disadvantage for certain undertakings.

A comparison is made both at the stage of examining *prima facie* selectivity and that of justification. At the first stage of the analysis, the objective of the system is taken as the criterion of comparison while at the justification stage the objective of the measure.

Under the proposed analytical framework, general policy objectives which are external to the tax system can justify *prima facie* selective measures as long as they are compatible with the internal market and its underlying rules and principles.

Finally, the analysis in this thesis extends to the issue of overlap between the fundamental freedoms and the State aid rules. Due to the similarity of the methods of analysis under the two regimes, one and the same national measure may qualify both as State aid and as a restriction on the fundamental freedoms. Due to the differences in the enforcement mechanisms of the two regimes and the contradictory remedies which follow from their infringement, we maintained that their concurrent application should be avoided. To this effect, the State aid rules should be considered as general rules in relation to the more specific fundamental freedoms. This follows from the fact that the relationship of the core concepts of these two legal regimes, i.e. selectivity and discrimination, is also in the nature of general – specific. In particular, selectivity covers all differential treatment of comparable situations which distort competition while discrimination targets a specific category of such differential treatments namely, that between residents and non-residents or domestic and cross-border situations. Accordingly, national measures which treat non-residents less favourably than residents should be tackled by the more specific norm, that is, the fundamental freedoms. On the basis of the *lex specialis* premise, these measures come within the scope of the freedoms which excludes the application of the more general rule, i.e. the State aid rules. When a national measure entails a differentiation other than cross border – domestic or resident – non-resident it will come within the scope of the general rule, i.e. State aid.