Recent EU Direct Tax Initiatives: The End of Tax Sovereignty?

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João Carmona Lobita | **International Tax Manager at KPMG Portugal**
Francisco Loureiro Ferreira | **International Tax Consultant at KPMG Portugal**

The authors can be contacted at jdlobita@kpmg.com and franciscolferreira@kpmg.com

The term “tax sovereignty” commonly refers to a state’s authority to independently design and enforce its tax laws. This includes the authority to determine all aspects of the national tax system, among them which taxes to levy, which entities, activities and events to tax, and the applicable tax rates and exemptions.

Due to its importance as a revenue source and tool of economic policy and competition, taxation is considered a core element of a state’s sovereignty. Unsurprisingly, it is a prerogative states typically resist external interference with, whether from foreign governments or supranational organizations like the European Union.

Discussion regarding tax sovereignty often revolves around states’ decision-making capabilities and the extent of their authority in tax matters. In the field of direct taxation, the recent Pillar Two Directive and the BEFIT proposal raise important questions in both respects. However, before examining these initiatives, let us briefly recall the general framework for tax within the European Union.

1. Tax and the European Union

a. Legal framework: Competence and legislative procedure

In *van Gend & Loos (26-22)*, the European Court of Justice observed that “the Community constitutes a new legal order of international law for the benefit of which the states have limited their sovereign rights, albeit within limited fields”.

The definition of these fields follows the principle of conferral (article 5(2) of the Treaty on European Union (TEU)), under which the European Union shall act only within the competences conferred upon it in the relevant treaties, while competences not conferred in such treaties remain within the Member States’ autonomy.

Referring to the Treaty on the Functioning of the European Union (TFEU), one could conclude that Member States have granted the European Union exclusive competence over customs (article 3(1)(a) of the TFEU) but retain full sovereignty over other fields of taxation, as they are not explicitly addressed. This conclusion, however, is not entirely correct – under article 4(2)(a) of the TFEU, the European Union shares competence with the Member States over the internal market. Considering that tax measures affect the internal market, the European Union has legitimate grounds to intervene in taxation matters to ensure the internal market’s proper functioning. This reasoning has justified extensive harmonization of Member States’ legislation on indirect taxation (e.g. the VAT Directive) and, to a lesser extent, direct taxation.

In terms of legislative procedure, harmonization in the field of direct taxation follows a special legislative procedure under article 115 of the TFEU. This procedure requires new legislation to be proposed by the Commission and unanimously approved by the Member States.

b. The ambitions of the Commission

The legal framework described above is highly protective of Member States' sovereignty, as it ensures that no tax measures are introduced at the EU level without each Member State's consent. Notwithstanding, the Commission considers the unanimity requirement unsuitable for the European Union's present stage of development.

In its 2019 communication Towards a More Efficient and Democratic Decision-Making in EU Tax Policy, the Commission argued as follows:

> In today's larger, modern, and more integrated EU, a purely national approach to taxation no longer works, and unanimity is neither a practical nor an effective way of decision-making. National and common interests are intertwined. The increased mobility of businesses and citizens means that one Member State's tax decisions can significantly affect the revenues of others and limit their scope to make policy choices. Globalisation and digitalisation have created common challenges that require common solutions.

In the Commission's view, Member States would benefit from abandoning the unanimity requirement. The proposed way forward, which would not require changes to the EU treaties, is to move to qualified majority voting in tax matters through the use of the *"passerelle"* clauses (article 48(7) of the TEU and article 192(2) of the TFEU). These clauses authorize the EU Council to change the decision-making process for future tax proposals from unanimity to qualified majority voting.

The Commission's approach with respect to relying on qualified majority voting (rather than unanimity) has faced criticism, particularly from representatives of smaller Member States. Six years have passed since the 2019 communication, and the Commission's efforts in this respect do not seem to have borne fruit. In any case, it is worth pointing out that the current unanimity requirement did not stop the Commission from pushing forward a minimum effective corporate tax rate of 15% for in-scope groups in the European Union. Additionally, building on the efforts to harmonize the EU tax system, in 2023 the Commission (re)launched a proposal to establish a common tax base for corporate taxation.

What could this mean for Member States' tax sovereignty?

2. Tax Sovereignty and recent EU initiatives

a. Pillar Two

In December 2022 – only about 1 year after the publication of the Global Anti-Base Erosion (GloBE) Model Rules – Directive 2022/2523 introduced a minimum tax rate of 15% for multinational enterprises (MNEs) in the European Union. Several aspects of this Directive, as well as the process leading to its enactment, raise questions from a tax sovereignty perspective:

- **Need for a Directive to implement Pillar Two:** According to its recitals, the Directive is justified by the need to "prevent a fragmentation of the internal market" and ensuring compatibility "with the fundamental freedoms guaranteed by the [TFEU]". Some authors argue that these justifications are misleading, as issues regarding the compatibility of Pillar Two with EU primary law remain unresolved (i.e. the compatibility between an "extraterritorial" top-up tax and the fundamental freedom of establishment). If these objections hold true, the Commission's claim for the need of a Directive, approved through special legislative procedure, is largely undermined. Considering that Pillar Two introduces a new form of tax, it is also worth questioning if national parliaments should not have played a greater role in its implementation at EU level from the start (i.e. in the elaboration of the proposal), rather than merely discussing the Directive's transposition after its approval by finance ministers in the EU Council. This approach would better reflect tax sovereignty and democratic principles, while the GloBE Model Rules could safeguard against excessive

divergence in Member States' approaches to Pillar Two.

- **Excessive reliance on the OECD:** At the time the Directive was proposed (and approved), the work on the qualified domestic minimum top-up tax (QDMTT) at the level of the OECD had not yet been finished. To avoid having to anticipate the work of the OECD on the QDMTT safe harbour rules, the Directive referred in article 32 to a future "qualifying international agreement on safe harbours", which ended up arriving in the form of the OECD administrative guidance of July 2023. Some authors doubt the legitimacy of the Directive's article 32, as it effectively declares that Member States will abide by a decision to be taken at an external forum, in which non-EU states participate and one EU Member State (Cyprus) is not represented. Despite such doubts, the Member States issued a statement endorsing the OECD's safe harbour guidelines, which, from a practical point of view, means that the Member States' sovereignty has not been breached. However, from a theoretical standpoint, the European Union's reliance on the OECD will still raise some eyebrows.

- **Impact on tax attributes:** The speed with which the Directive was approved contrasts sharply with the significant long-term implications Pillar Two will potentially have on Member States' abilities to design their tax systems. Tax attributes represent one of the areas where the impact will be greater, as tax breaks and allowances introduced by Member States may be recaptured through a potential payment of top-up tax (if not seen as *qualified refundable tax credits*). While it could be argued that putting a floor on tax competition was always the aim of Pillar Two, it is surprising how readily Member States accepted these changes.

b. BEFIT

The Business in Europe: Framework for Income Taxation (BEFIT) proposal was first announced in 2021 in the Commission's Communication titled Business Taxation for the 21st Century. It is presented as a "single corporate tax rulebook for the EU" and replaces the Common Consolidated Corporate Tax Base proposal, which failed to gain the agreement of the EU Member States. Like its predecessor, BEFIT aims to establish a common set of rules for determining the corporate tax base of MNE member companies. Their tax base would then be aggregated and allocated to Member States using a specific allocation formula.

The timing of BEFIT's announcement and the ensuing 2023 Proposal is explained by the political momentum generated by BEPS 2.0. It is evident that the Commission hopes to leverage the current reforming impetus to advance its decades-old ambition of establishing a common corporate tax framework in the European Union. In the Commission's view, this would provide a definitive solution to address distortions in the internal market caused by the coexistence of 27 national corporate tax systems. It would, however, come at the expense of a significant portion of Member States' power to design their corporate tax systems.

Whether BEFIT will succeed remains uncertain. A reform as profound as BEFIT requires considerable political momentum. The question, however, is whether BEPS 2.0 will overshadow BEFIT, as Member States may perceive the changes introduced by BEPS 2.0 as substantial enough to delay further tax reforms for several years.

3. Looking ahead

Considering the path that EU tax law is currently traversing, some queries stand out:

- Will Member States find that the current tax reforms sufficiently compensate their loss of tax sovereignty, or has the Commission bitten off more than it can chew?
- If BEPS 2.0 and BEFIT are effectively implemented, will there be any tax sovereignty left to uphold, or will we be on the verge of EU tax federalism?E
- Even if the unanimity requirement remains, is the decision-making process in EU tax matters becoming excessively influenced by the OECD?

The answers to these questions will likely only become evident years from now. However, if we attribute any value to the concept of tax sovereignty as it has been commonly understood in the past, there seems to be legitimate concern that the Commission's efforts to champion international tax reform based on OECD initiatives and to rapidly advance European integration may later lead Member States to regret the loss of tax sovereignty caused by decisions made in a heated tax context. Although the loss of political momentum may prove fatal to any attempts at broad tax reform, perhaps allowing more time for the ideas surrounding BEPS 2.0 to consolidate and for Member States to mature the vision of the tax system they envisage for the European Union (e.g. the desired level of competitiveness of the EU market) is necessary for an impactful reform.

IBFD references

- EU tax law developments are reported in the daily IBFD Tax News Service.
- For an overview of legislative initiatives at the EU level on direct tax matters, *see* the EU Direct Tax Law Initiatives Dossier.
- For details on the Harmonization of Corporate Taxation in the European Union, see C. Valério & D. Arsenovic, *Direct Taxation* sec. 3, Global Topics IBFD.
- D. Hohenwarter & G. Mayr, *Pillar Two and BEFIT: Shocks and Opportunities for the EU Internal Market*, 64 Eur. Taxn. 10 (2024), Journal Articles & Opinion Pieces IBFD, available at https://doi.org/10.59403/3h9cbv4.
- M. Isenbaert, *EC Law and the Sovereignty of the Member States in Direct Taxation*, Books IBFD (Open Archive).
- T. Dagan, *Tax Sovereignty in an Era of Tax Multilateralism*, *Tax Sovereignty in an Era of Tax Multilateralism*, in *EU Law and the Building of Global Supranational Tax Law: EU BEPS and State Aid* (D. (Dennis) Weber ed., IBFD 2017), Books IBFD.

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