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Single Market for Occupational Pensions - Are we there yet?

Master thesis
20 points

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Field of study: EC Law

Autumn semester 2007

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Summary

For decades the largest part of European citizens has been dependant on State provided pensions. However, this safety net will not hold in the long run. Europe is going through a dramatic demographic change where the elderly group in the society is growing rapidly in size at the same time as the young generation is constantly decreasing. This change has a restraining effect on the public pension schemes as these plans are financed by the taxes of the young people working today. Alternative pension schemes such as occupational pensions provide the solution of compensating the losses in benefits from public pension schemes. However, for the occupational pension schemes to become a reliable and efficient pension complement, the Member States need to create a well functioning and competitive single market for the pension funds on EU level. This has turned out to be easier said than done as tax claims of the Member States have so far constituted a substantial obstacle in the process. Since the legislation concerning occupational pensions does not provide any solutions for dealing with direct tax issues as they fall outside the scope of the competences of the Commission, the disputes were to be settled before the Court. At this stage the road of creating of the single market experienced yet another bump – the *Bachmann* case where the Court accepted justifications provided by the Member State in question for not approving tax reliefs regarding contributions to foreign pension plans. Although only a one time phenomenon, this case opened up for a row of cases where the Member States attempted to justify, and thus to avoid reforming their systems, discriminatory tax treatment of activities related to pension plans situated abroad. It has taken more than a decade for the Member States to realise that the arguments accepted in *Bachmann* were not going to be accepted universally by the Court. Instead the Court has consistently directed the Member States to seek taxation solutions by the means of the Mutual assistance Directive, demands on the tax payer and other intra-State cooperation measures, thus emphasising the importance of proactive national administrative initiatives. Hence, the findings in this thesis lead to the conclusion that the process of building the single market for occupational pensions has nevertheless come far but the responsibility for a fast completion of the internal market now rests on whether the national authorities will carry through the necessary adjustments.

Sammanfattning

Under senaste årtionden har den största delen av Europas medborgade varit beroende av statlig pension. Det är dock klart att detta säkerhetsnät inte kommer att hålla i längden. I dag genomgår Europa en betydande demografisk förändring som innebär att den äldre gruppen i samhället växer samtidigt som den unga generationen krymper konstant. De statliga pensionssystemen stramas åt till följd av denna utveckling eftersom dagens pensioner finansieras genom skattemedel insamlade från de arbetande unga. Pensionsalternativ som tjänstepensioner tillhandahåller en lösning för pensionsproblemet genom att kompensera de väntade minskningarna av statliga utbetalningar. Emellertid, för att tjänstepensioner ska kunna bli ett pålitligt och effektivt komplement till den statliga pensionen, måste medlemsstaterna samarbeta för att skapa en välfungerande gemensam marknad för pensionsfonder på EU-nivå. Detta har dock visat sig vara lättare sagt än gjort då skattefrågor har utgjort det största hindret i processen. Eftersom lagstiftningen på området inte behandlar skatteproblematiken då detta område faller utanför kommissionens kompetens, eventuella konflikter kom att lösas inför EG-domstolen. Även vid denna etapp uppkom det ett gupp i vägen mot en gemensam marknad för tjänstepensioner, närmare bestämt *Bachmann* fallet där domstolen godtog medlemstatens i fråga rättfärdigande av skatteregler enligt vilka skattelättnader inte medgavs för inbetalningar till pensionsplaner belägna utomlands. Trots att fallet visade sig vara ett engångsfenomen resulterade denna dom i en rad fall där medlemsstaterna försökte rättfärdiga, och på så sätt undgå reformer av, diskriminerande skatteregler vad beträffar aktiviteter kopplade till pensionsplaner placerade utomlands. Det gick mer än ett decennium förrän medlemsstaterna insåg att argumentationen som godtogs i fallet *Bachmann* inte skulle accepteras av domstolen som allmängiltig. EG-domstolen har tvärtom konsekvent hänvisat medlemsstaterna till att lösa uppkomna problem med hjälp av direktivet om ömsesidigt bistånd av medlemsstaternas behöriga myndigheter, genom att ställa krav på skattebetalaren eller andra mellanstatliga samarbetsåtgärder. På så sätt har domstolen framhållit vikten av aktiva samarbetsinitiativ från de nationella myndigheternas sida. Därmed har rönen framlagda i denna uppsats lett till slutsatsen att man trots allt har kommit långt på vägen till en gemensam marknad för tjänstepensioner. Samtidigt bär numera de nationella myndigheterna huvudansvaret för att genomföra de sista anpassningarna nödvändiga för att denna process skall kunna fullbordas inom en snar framtid.

Abbreviations

AG	Advocate General
Art	Article
CEA	The European Insurance and Reinsurance Federation
CEIOPS	Committee of European Insurance and Occupational Pensions Supervisors
DC	Defined contribution
DTC	Double tax convention
EC Treaty	Treaty establishing the European Community
ECJ	The European Court of Justice in Luxembourg
EEA	The European Economic Area
EFRP	The European Federation for Retirement Provision
E.g.	*Exempli gratia* (Latin for “for example”)
EU	The European Union
I.e.	*Id est* (latin for “that is”)
Ibid	*Ibidem* (latin for “the same place”)
IORP	Institutions for Occupational Retirement Provision
MS	Member State
OECD	Organisation for Economic Cooperation and Development
ORP	Occupational Retirement Provision
P	Page
Para	Paragraph
Paras	Paragraphs
SMEs	Small and Medium-sized Enterprises
€	Euro

1 Introduction

1.1 Purpose

Occupational pensions constitute a vital part of the future economic and social picture of the EU, if it is meant to be a positive one. However, this topic has not received the attention it should considering the scope and the magnitude of the pension problem in the EU. Today it is no longer disputable that Europe is experiencing a severe pension problem, what is lacking is the actual debate on what is the solution and how far or close are we to witness any results of this solution. When talking about occupational pensions we are literally already talking about the well being of the young generation of today, not only the generations yet to come, which, in turn makes occupational pensions a matter for each and everyone of us. Nonetheless, the debate although existent to some extent in the academic circles, has not reached the standing of a public debate. This paper is thus a quest to find out what is being done about the weakening public provision, are strengthened occupational pensions the solution and, finally, if empowering the occupational pensions' providers is the right path to take, how far has the Community come to solve this rather acute issue also generally referred to as the demographic time bomb, the ticking of which is already echoing. In conclusion, this thesis that you hold in front of you now represents an attempt to answer the impatient question – have we reached the stage of development of the market for occupational pensions that can in the true sense of its meaning be referred to as the single market for occupational pensions?

1.2 Delimitation

Although the subject of this thesis is revolving only around the occupational pensions it is recognised in the text that there are many similarities between the occupational pension schemes and life assurances. The similarities will be discussed briefly below, however the discussion about life assurances is kept on a sustained level and is dealt with only where the context requires so.

Furthermore, it is clearly accepted in the doctrine that taxation issues constitute the main obstacle in the path of creating the single market for occupational pensions. Therefore tax obstacles also constitute the core of this paper. Nonetheless, it should be noted that there are other considerations that belong to the context such the effect of the Member States' labour and social laws on the cross border provision of occupational pensions. These aspects will not be dealt with here. This would be relevant when discussing the real possibilities for operation of pan-European pension funds in the EU which is one of the goals with the integration of occupational pensions. However, in the analysis presented below the main focus lies not on the pan-European pension funds but on the very process of the creation of the single market for occupational pensions. Moreover, when dealing with tax issues, tax treaties constitute a natural part of the mechanism. The implications of tax treaties will be discussed in connection to certain situations considered in the torrent of the text, nonetheless, it should be recognised already at this stage that the role and consequences of tax treaties in this context is a wide and deep subject on its own and therefore will not be dealt with thoroughly below.

Lastly, one of the purposes in this paper has been to provide the reader with a qualitative overview of the pension fund market in the EU. Due to the size restrictions of the paper, specific laws of the Member States will not be analysed closely. Naturally, relevant examples will be taken account of when available, that are attributable to specific Member States, but as expressed the intention in this paper has not been to present a comparative study of certain Member State's systems but to create a bird's view of the problem.

1.3 Method and disposition

This thesis is structured into two main parts. The first part sheds the light on the causes of the discussion of the single market of occupational pensions. Why are we talking about pension funds today and how has the legislation and the situation that we are in today come about? When putting together this initial part of the essay the law and politics method was applied analysing the circumstances in the background of the problem dealt with in the second block of the thesis.

The second block of the paper follows the traditional legal method where legislation, case law, preparatory work of the Commission and the doctrine surrounding these sources will be examined in such a way so as to bring clarity to the given problem and reach conclusions in connection to the main question formulated in the heading of the thesis. Three criteria will be used to analyse whether we have reached the single market for occupational pensions which have also determined the disposition of the second part of the thesis. The criteria mentioned are the legislative, the judicial and the administrative initiatives the combination of which has been proved necessary to create a single market at any level. The intention with following these criteria is to create a reference frame in order to assess what steps have been taken and what steps still await, thus allowing us to locate where the Community is in the process of creating the single market for occupational pensions.

1.4 Evaluation of sources

In the course of writing the first part, which possesses a more narrative character than the rest of the work, both primary and secondary sources were used. Preparatory work from the Commission and other Commission documents has been useful especially when presenting the legislation and the thinking behind the law. Secondary sources however composed of publications of well renowned special interest organisations such as the EFRP, CIEOPS and the OECD have been used in collecting the historical and economical facts. Furthermore, quotes from the doctrine are used occasionally. However it should be noted that the doctrine has been carefully chosen from reliable and traditional periodicals such as the EC Tax Review and European Business Law Review.

In the second part, primary sources such legislation acts, preparatory work from the Commission and case law have been used extensively as well as some doctrine already used or taken from similar periodicals as in the first part has been quoted.

The sources have been objective in their nature, but it should be kept in mind that the primary sources of the Commission have naturally a positive attitude towards the creation of the single market for occupational pensions. This is also true for the organisations of special interest performing a smoothing function in the process of creating the single market. However, these organisations involve representatives of all the parties concerned such as the pension plan providers and representatives of the supervisory authorities, therefore the materials and reports published by the means of the organisations should not be viewed as produced in favour of the Commission, but rather as objective documents presenting varied views on the subject. Furthermore, the doctrine provides more subjective views, but using classic periodicals in the field of EC tax law, *e.g.* “EC Tax Review”, provides certain assurance that the opinions, facts and statements presented in the articles satisfy the academic requirements and are well researched.

In summary, the sources that have been applied in the writing process of this thesis, both primary and secondary, have been carefully chosen from well renown websites, periodicals and journals, with the awareness of neutrality and the need to ensure the correctness of the facts.

2 Pensions on the European Agenda of Today and Tomorrow

2.1 The European pension problem

The past century has witnessed the worst and the best. From the horrendous consequences of two World Wars the development has taken us to a general increase in living standards in Europe. However, the increase in wealth has not been a solution to everything, but has rather triggered another problem. Extensive demographic changes are taking place in Europe. Just to mention some of the subsequent outcomes, people are living longer due to better standards, lifestyle consciousness and continuously advancing health care, at the same time as population growth in Europe is barely keeping up the natural replacement rate. An unchanged retirement age provided in the national laws in combination with people living longer, has created a considerable group of people in the Member States that are not working and living on benefits given out of the States' budgets. These factors taken together, although positive when discussing the quality of life of European citizens, have accumulated to a darker outlook for the budgets of the European States as from 2010 onwards. The future of Europe appears to be dominated by the presentiment of "ever fewer young people and young adults, ever more older workers, pensioners and very elderly people"[1]. More pensioners with increased life expectancy inevitably lead to more pension payouts over longer spans of time. This notion, combined with the prospect of shrinking working population, constitutes the essence of the European pension problem.

As the expression has it, the figures speak for themselves. For the European population to at least remain its size there should be about 2.1 children per woman. Today everywhere in Europe the fertility rate is below that goal, falling even under 1.5 child per woman in many Member States.[2] Eurostat's population projections indicate that "total deaths in the EU25 will outnumber total births from 2010"[3]. However population growth will be kept up by immigration but it is expected that by 2025 even immigration will not be enough to stop the gradual decline.[4] Furthermore, Eurostat anticipates the share of population that is in working age (i.e. between 15 and 64) to drop from 67.2% in 2004 to 56.7% in 2050 which would constitute a decrease in 52 million people of working age.[5] Parallel to that we are expected to see an increase of about 37,4 % by 2003 in the group

[1] EC, COM(2005) 94 final, p. 6.

[2] EC, COM(2005) 94 final, p. 2.

[3] Eurostat News Release, 48/2005, 8 April 2005, p.1.

[4] *Ibid.*

[5] *Ibid.*

aged between 65 and 79 and an astounding increase in 57.1 % between 2010 and 2030 in the group of very elderly people, that is people aged over 80. Even though the aging pattern differs somewhat when looking from country to country, the projections show that all the Member States of the EU will see a decline in total population and working population sooner or later – it is just a matter of time.[6]

As already established above, these demographic changes are leading to Europe-wide pension concerns. Today, the majority of pension payouts in the EU are financed from the budgets of the Member States through public pension schemes. "A public pension scheme almost always relies on the pay-as-you-go system"[7] which means that "current workers' contributions are used to fund the pension payments of retired people"[8]. To pay out a regular pension to one retired person the States need contributions of about four working people. Having in mind the prospect of increasing number of pensioners and decreasing number of workers, "the dependency ratio (population between 15 and 64 / population of 65 years and more) is expected to decrease from four people of working age per elderly person in 2004 to only two workers per retiree in 2050."[9]

This prognosis is already having affects on the pension systems in Europe. The pension benefits are normally calculated using a fixed formula. While earlier the pension benefits were usually dependant on the number of years that the individual had worked, the demographic changes have brought about a trend among the Member States to reform the pension systems resulting in a system where the future benefits received are linked to the amount of contributions paid in during the working life. This change, of course, encourages the future pensioners to take own responsibility for their future benefits as they, in a way, have to save up for their pension. Besides the objective of maintaining the financial stability of the States, the reforms are also meant to encourage people to work longer. Earlier, when one could retire after a number of years served and the extra years would not lead to a considerable difference in benefits, people tended to retire earlier.[10] It was also introduced with the aim of sustaining the financial stability of the Member States' budgets.

However, the pay-as-you-go systems are still sensitive to demographic changes. In Sweden, for example, the calculations of rate of returns include also per capita real wage growth in order to ensure, that "workers' relative income had the same effect on their pension income irrespective of when they earned it during their lifetimes"[11]. This could lead to a demographic shock in case of an extensive lack of workforce and, thus, an increase in

[6] See Graph 7 in COM(2005) 94 final, p. 22.
[7] CEA Statistics No. 28, "The role of insurance in the provision of pension revenue", September 2007, p. 11.
[8] EC, COM(97) 283 final, p.2.
[9] CEA Statistics No. 28, "The role of insurance in the provision of pension revenue", September 2007, p. 11.
[10] Sundén, A., Oxford Review of Economic Policy, 2006, p. 135.
[11] Sundén, A., Oxford Review of Economic Policy, 2006, p. 138.

wages which would in turn unbalance the financial stability as the benefits would grow faster than the contributions.[12] Furthermore, once an individual that has paid in contributions retires, a calculation has to be made in regard to the amount comprised to determine what the beneficiary should receive yearly. The total amount attributed to the beneficiary is then spread over the number of years that the pensioner is expected to live in accordance with the contemporary expected lifetime of the cohort. In case of a misjudgement, that is if the benefit receiver lives longer than expected, results to the State paying out more benefits than the actual contributions made. [13] Therefore, in order to secure the financial stability, Sweden's, and calculations take into account an automatic balancing index - a balancing ratio. Continuing with the example of Sweden, the sum of capitalised pension contributions and the total assets of the buffer funds are divided by the State's total pension liability to get the balance ratio that, obviously, should be one when the system is financially stable.[14] As soon as the ratio falls bellow one, it will have a diminishing effect in the final calculations of an individual's annual benefit, thus the financial stability will be maintained. The Nordic countries and also other Member States at least in the short run have secured the financial stability of their budgets, while other States have reforms in progress. The protective perspective when forming the pension systems is motivated by the argument that "the current pension level financed by the public sector should not be so generous that unborn generations must cope with a large Government."[15]

Even though all Member States have a kind of minimum or guaranteed pension, it can be concluded that the individual can no longer rely on the State to provide the pension to the extent as it has been done before. Even if one has paid in ones contributions the pay outs may be less than expected. Thus, "if people want to have a very high living standard in their old age, they must contribute by voluntary saving during their working life to provide the extra"[16].

This paper deals with occupational pensions, which are regarded as one of the likely solutions to the pension problem brought about by the demographic changes. Occupational pensions are highly resistant to the demographic changes and are already a real alternative to public schemes in countries such as the Netherlands, the UK and Finland while in many other Member States they constitute an important supplement to the State provided pension. However, as pension questions are strongly related to taxation questions, harmonisation is not a realistic objective to strive for on the EU level, rather co-operation. Thus, the role of the occupational pension

[12] Sundén, A., , Oxford Review of Economic Policy, 2006, pp. 139.

[13] *Ibid.*.

[14] Sundén, A., , Oxford Review of Economic Policy, 2006, pp. 140.

[15] Påhlsson, R., and Henriksson, A. S., 2007, Report by Balling, M., and Winther-Sørensen, N., "Legal and economic general report", MBNWS, 18 October 2006, p. 36.

[16] Påhlsson, R., and Henriksson, A. S., 2007, Report by Balling, M., and Winther-Sørensen, N., "Legal and economic general report", MBNWS, 18 October 2006, p. 36.

funds in the near future is determined by the efforts of each and every Member State.

2.2 The three pillars

2.2.1 State provided pensions

In Europe and generally even worldwide it is common to visualise the pension system as a three-pillar composition. In this classification, "the first pillar is based on a tax-financed public pension"[17]. The issues dealt with in this paper concern the second pillar which holds the so called occupational pensions, *i.e.* pension schemes created in connection to a person's employment. Individually acquired life assurance schemes provided by insurance companies constitute the third pillar.

The pillar one pensions, the basic State schemes to which contributions are generally compulsory[18], have been regulated on the Community level several decades ago in the Council Regulation (EEC) No. 1408/71 on the application of social security schemes to employed persons, to self-employed persons and to members of their families moving within the Community. This particular regulation ensures the portability of State provided pension rights according to the equal treatment principle as laid down in Art 3 of the regulation:

> 'Persons resident in the territory of one of the Member States to whom this regulation applies shall be subject to the same obligations and enjoy the same benefits under the legislation of any Member State as the nationals of that State.'

Such smooth and early co-ordination of State pensions has been possible due to the fact that at the time of the legislation and prior to the reforms mentioned in the previous chapter, the State pension was "paid out at a rate set with reference to the *time* a worker has been within the system"[19]. Thus, the calculations were rather uncomplicated as the only numbers needed to decide whether an individual has acquired certain pension rights were amount of years. The circumstance that the person in question moving from one Member State to another does not require special treatment but is handled as any other national of the latter State in accordance with its pension rules is also a facilitating factor in the co-operation process. In addition, the circumstance that the whole administration and data accumulation is handled entirely by the authorities of the Member States explains why the information and compensation exchange has been functioning quite smoothly. The State pension reforms have not lead to any remarkable problems as the co-operation between the authorities was well

[17] Påhlsson, R., and Henriksson, A. S., 2007, Report by Balling, M., and Winther-Sørensen, N., "Legal and economic general report", MBNWS, 18 October 2006, p. 36.
[18] EC, COM(97)283, p.2.
[19] Marshall, J. and Butterworth, S., CML Rev. 2000, p. 742.

established prior to the changes. With supplementary pensions, on the other hand, the road to functional co-operation has been more complicated as "supplementary pensions depend on the *level of contributions* paid in and there is no baseline figure that can be relied on for each Member State – each individual will have a different entitlement"[20]. The contributions and the benefits are handled by private actors, which, in turn, complicates the process of information accumulation and following up of every individual. Hence the Member States tax authorities have been more sceptical to dealing with immense information tracking. Moreover, there is a wide variety of forms and types of pension plan providers around the EU which has raised the problem of recognition, a problem that normally does not occur when dealing with State provided entitlements.

"The 1st pillar is predominant in most countries"[21] and constitutes, according to recent measurements, approximately 69% of total premium income in Europe[22]. Eurostat statistics from 1994 indicated that the 1st pillar pension schemes constituted about 88.8 % of all EU-wide (excluding Austria, Sweden and Finland which joined the EU a year later, in 1995) pension pay outs.[23] These figures indicate a slowly diminishing trend in dependence on the State for pension provision. However it should be kept in mind that in the new Member States, dependency on State provision is in general higher than in the old EU. In conclusion, when speaking generally of the EU, the 1st pillar would reach a higher figure than when looking at the EU prior to enlargements. Citizens of the new Member States have been dependent on the State for pension provision and private savings. However, with the encouragement of the EU, especially having in mind that the population of many of the new-comers is prematurely declining due to emigration, reforms with the objective to create new diversified pension systems are being carried out starting prior to the millennium. Nonetheless, even though "a public-private mix in pensions provision is emerging in almost all of the countries"[24] in the new EU block, these reforms are mostly for the younger share of the population and the benefits will not be paid out from the new systems until decades later[25]. In the mean time, the larger part of pension benefits paid out in the Eastern side of the EU will be restraining the budgets of the States until the reforms will start delivering results.

[20] Marshall, J. and Butterworth, S., CML Rev. 2000, p. 742.
[21] CEA Statistics No. 28, "The role of insurance in the provision of pension revenue", September 2007, p. 22.
[22] *Ibid.*.
[23] EC, COM(97)283, p.2.
[24] EC, "Study on the Social Protection Systems in the 13 Applicant Countries Synthesis Report", November 2002, pp. 32-33.
[25] EC, "Study on the Social Protection Systems in the 13 Applicant Countries Synthesis Report", November 2002, p.31.

2.2.2 Life assurances

As already mentioned above, individual life assurance plans constitute the third pillar of the pension system. This area has also been subject to co-operation on the Community level for many years, starting with the Directive of 1979[26] which, however, is no longer in force. Several Directives followed and are now comprised into one recast Directive 2002/83/EC of the European Parliament and of the Council of 5 November 2002 concerning life assurance.

Having in mind that the IORP Directive is a rather recent occurrence and that due to the form of pension provision the similarities between the IORPs and life assurances. It is remarkable that the latter form of pensions has been regulated many years ago. When looking deeper into the question the only possible answer appears to be that the life assurances must have naturally hung along when the co-operation in the Community was being established in the field of insurance in general. For example, motor and non-life insurance issues take up a considerably larger part of the Community legislation with the first Directive dating all the way back to 1972[27]. This particular Directive was important for vehicles moving within the Community especially having in mind insurances for transport of *e.g.* goods, essential for creating a well functioning internal market. Thus the legislating process on life assurances has come about naturally and merely to cover a at the moment relatively small part of insurance businesses' activities. Life assurance provision across the EU, although a part of the pension system, did not raise any dust during the legislation process but has gone by rather unnoticed. The earlier Directives, commonly referred to as Life Assurance Directives[28], which have been comprised in a recast Directive 2002/83/EC as mentioned above, were, subsequently, "not widely used in the Member States"[29]. Prior to the millennium the statistics show that life assurances constituted only 0.9% of total EU pension provision[30]. However, a trend upwards has been noted by life assurance providers during the later years. According to the latest report of the CEA, representing the European insurers, the third pillar receives 13 % of all premium payments in Europe. This leads to the conclusion that although there has been an increase in life assurances provided, the third pillar remains the smallest player of the three "pension schemes in most countries except in Spain where it reaches almost

[26] Directive 79/267/EEC of 5 March 1979 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct life assurance.

[27] Council Directive 72/166/EEC of 24 April 1972 on the approximation of the laws of Member States relating to insurance against civil liability in respect of the use of motor vehicles, and to the enforcement of the obligation to insure against such liability.

[28] Directives 79/267/EEC (OJ 1979 L 63, pp. 1–18), 90/619/EEC (OJ 1990 L 330, pp. 50–61), 92/96/EEC (OJ1992 L 360, pp. 1–27), 2000/64/EC (OJ 2000 L 290, pp. 27–28) and 2002/12/EC (OJ 2002 L 77, pp. 11–16).

[29] Marshall, J. and Butterworth, S., CML Rev. 2000, p. 744.

[30] EC, COM(97)283, p.2.

30% of the 2005 premiums"[31]. Nevertheless, as the importance of life assurances through pension plans is slightly increasing, it is important to note that insurers will without a doubt play a bigger role in the future, thus, the release of the Recast Directive has come in time. It should also be kept in mind that insurers are keen to penetrate and be active throughout all the three pillars, as insurance companies may manage the pension revenue collected by the States under the first pillar as, for example, it is done in Finland, or provide pension funds connected to people's employment.[32]

2.2.3 Pension funds – the last puzzle piece

2.2.3.1 Brief history

The international financial market as we know it started to develop not earlier than during the 1980's. The oil producing States needed an outlet for their surplus while the Western countries were experiencing severe budget deficits.[33] Simultaneously, the Bretton Woods system, within the frame of which the exchange rates of the members of the IMF were tied to the dollar with margin for deviation of ± 1%, collapsed as the dollar was rapidly devalued in the USA due to excessive costs of the Vietnam war and other economic troubles.[34] In the beginning the main investors were banks. The rapid development has however opened the market up to new players such as pensions funds as "households are increasingly opting to have their savings managed more actively than simple deposit accounts"[35] also leading to rasing interest in dealing with securities rather than just the traditional borrowing and investment mechanisms.[36] In conclusion, as the State pensions and insurance businesses had formed important parts of the economies before the 1980's, the importance and need of pension funds became apparent together with the later developments witnessed in the international financial market.

[31] CEA Statistics No. 28, "The role of insurance in the provision of pension revenue", September 2007, p. 22.

[32] CEA Statistics No. 28, "The role of insurance in the provision of pension revenue", September 2007, p. 29.

[33] Sweden's central bank The Riksbank, Speech by First Deputy Governor Lars Heikensten held at Institute of International Affairs, 3 May 1999, "Global capital: advantages, problems and remedies".

[34] Economist.com, Economics A-Z, searching term: Bretton Woods, http://www.economist.com/research/Economics/searchActionTerms.cfm?query=Bretton+Woods (2008-01-15).

[35] *Ibid.*

[36] *Ibid.*

2.2.3.2 Types of pension funds

As explained earlier, the second pillar holds the supplementary occupational pensions which, in turn, are managed mostly by pension funds as the schemes “are backed by assets which are invested to provide future pension payouts”[37]. Nonetheless there exist many variations in the forms of pension funds. Occupational schemes can be organised in collective pension funds *i.e.* “occupational pension funds that cover the employees of more than one employer (enterprise)”[38]. Collective pension funds can be closed or open. Membership in closed funds is “restricted to a particular industry or group of industries”[39]. The common types of closed funds are company pension plans financed through stand-alone pension funds, normally set up by large enterprises such as Philips,[40] and funds limited to a certain employment sector, both of which are popular in the UK.[41] Open funds, on the other hand, manage contributions of various professional sectors and professions. “Over 80% of the work-force who participate in occupational pensions in the Netherlands is covered by the industry-wide pension funds”[42] that are not limited to a certain profession, but are extend to include a whole sector.

Both open and closed funds are governed by either defined benefit or defined contribution principles. In the Netherlands *e.g.* “90% of occupational pension members still participate in defined-benefit schemes”[43]. In a defined benefit pension schemes the participants are guaranteed a certain monthly benefit at the time of retirement, calculation of which is “based on a formula linked to members' wages or salaries and length of employment”[44]. Defined contribution schemes, on the other hand, “provide benefits dependent solely on the return on assets invested”[45] and the rate of return is never guaranteed[46]. It should be noted here that “the link between contributions and benefits is closest in defined contribution schemes”[47]. Defined benefit pension plans, however, the participants are protected against fall in assets values as well as the funds are obliged to follow legal requirements for pension assets to meet liabilities at a certain level.[48]

There is a common understanding in the latter years that defined contribution schemes constitute the better option for Europe. In the recent years the trend has been to “shift from defined benefit towards defined

[37] Marshall, J. and Butterworth, S., CML Rev. 2000, p. 743.
[38] OECD Working Paper on Insurance and Private Pensions No. 9, August 2007, p. 2.
[39] *Ibid.*
[40] OECD Working Paper on Insurance and Private Pensions No. 9, August 2007, p. 38.
[41] Marshall, J. and Butterworth, S., CML Rev. 2000, p. 743.
[42] OECD Working Paper on Insurance and Private Pensions No. 9, August 2007, p. 38.
[43] *Ibid.*
[44] OECD, “Revised taxonomy for pension plans, pension funds and pension entities”, October 2002, p. 4.
[45] EC, COM(97)283, p.3.
[46] OECD, “Revised taxonomy for pension plans, pension funds and pension entities”, October 2002, p. 3.
[47] *Ibid.*
[48] OECD Working Paper on Insurance and Private Pensions No. 9, August 2007, p. 38.

contribution schemes, especially in the UK"[49]. Furthermore, defined contribution pensions have been made mandatory in the new EU Member States.[50] Among the advantages with defined contribution plans one can list the fact that these schemes are "largely resistant to demographic change"[51]. This can be compared to the Swedish system under the 1st pillar as described above, where benefits are linked to the contributions. Furthermore, it encourages the employees to also participate and contribute to the schemes as the more contributions - the larger possibility of great returns. The EC seems to have been encouraging defined contribution schemes because they catalyse investments since the benefits depend on the performance of the investment funds.[52]

As it has been mentioned briefly above, the pension schemes under the second pillar are either voluntary or mandatory for the employer. Participation in a pension plan can be made mandatory for the employer by law, nation-wide or industry-wide bargaining agreements (*e.g.* collective agreements with trade/ labour unions).[53] When there are no such obligations, the employers may establish occupational pension plans for their employees by choice. The fact that employees are often enrolled in these schemes automatically through their employment contract, does not obstruct the voluntary nature of the scheme. It is interesting to note, that in the recent years the employers have started to elicit their occupational pension plans (not rarely even in job advertisings) when competing for the best workforce, further proving the contemporary increased interest in supplementary pensions among workers in Europe.

The different forms of occupational pension schemes are legally separated from the plan sponsor as pension assets are placed and managed either in a legal entity with the special purpose of providing pension plans or in a secluded account managed by a financial institution.[54] Besides the above described scheme types, a small share of all occupational pension schemes includes other types of, non-funded, occupational pension schemes. Pension assets may be placed in so called book reserves, *i.e.* reserves noted in the employers' balance sheet as part of the firms' assets, which occurs in Germany and Austria[55]. Furthermore, employers may place pension assets in so called financial reserves where the reserves are organised under separate legal entities but owned by the employers themselves. In such cases "pension plan members have no legal claim on the pension fund assets"[56]. There may also exit group insurance contracts which fall under the life

[49] EFRP Annual Report 2006, p. 9.
[50] *Ibid.*
[51] EC, COM(97)283, p.3.
[52] *Ibid.*
[53] OECD, "Revised taxonomy for pension plans, pension funds and pension entities", October 2002, p. 3.
[54] OECD, "Revised taxonomy for pension plans, pension funds and pension entities", October 2002, p. 6.
[55] Marshall, J. and Butterworth, S., CML Rev. 2000, p. 743.
[56] OECD, "Revised taxonomy for pension plans, pension funds and pension entities", October 2002, p. 6.

assurance legislation on the EU level as they are to be considered as insurance products and should not be confused with the situation where insurance providers merely manage autonomous pension funds.[57] Despite the wide range of forms when providing occupational pensions it should be stressed once again that "most pillar two schemes are funded"[58].

2.2.3.3 Pension funds in focus

2.2.3.3.1 The key to competitive financial market

In the EU, pensions funds were brought to the spotlight by Sir Leon Brittan, Commissioner responsible for the internal market and financial services between 1989 and 1993, who ,in his speech on 5 July 1990, stressed that "the treatment of retirement financing within separate national frameworks is an anachronism within the Single Market"[59]. Since co-operation on the EU level was already established regarding the first and the third pillars, the Commissioner implied that pension funds are the last puzzle piece needed to complete the single financial market in the Community. The insight of the importance of the pension funds has proved to be true. As discussed above, the financial markets have taken quite a leap from the traditional banking systems and developments in the area of pension funds are regarded as necessary in order to maintain and increase the long-term economic prosperity of the EU. The OECD in its recent economic survey on European Union came to the conclusion that:

> 'In financial services, wholesale markets are fairly well integrated, but market segmentation in retail banking and the investment fund industry needs to be reduced.'[60]

While the Commission is concentrating its efforts to increase the mobility and the conditions in the investment market as a whole pension funds are recognised as an important part of it. Although "official statistics on autonomous pension funds are scarce"[61], the estimates for investments carried out by the European pension funds amount to a total of approximately € 2,235 billion[62]. In the UK alone pension funds stand for a total € 1,095,123 million of yearly investments, a vast figure that illustrates the positive effects of having a well functioning market for pension funds. On the other hand it is not the amount of money that is the most important here, but the way that the investments are allocated.

The EU's future role as a competitive and major market force in the world depends on SMEs which the Commission regards as "essential sources of innovation and job creation, the engines of European growth, whose

[57] *Ibid.*
[58] Marshall, J. and Butterworth, S., CML Rev. 2000, p. 743.
[59] SPEECH/90/57, p. 1.
[60] OECD Economic Surveys: European Union, 2007, p. 10.
[61] Eurostat, European Business: Facts and figures, 2007 edition, p. 412.
[62] Eurostat, European Business: Facts and figures, 2007 edition, p. 412, Table 24.10.

activities promote structural change and improved welfare for the whole of Europe"[63]. It is actually the SMEs, and not the larger companies, "that are best placed to create the new employment opportunities Europe needs"[64]. But once their own funds are used up, during the initial stage of building the business, the SMEs need "seed investors able to provide investments ranging from €25,000 to €2-3 million"[65]. The regular financial institutes, such as banks, are reluctant to grant such loans or micro credits due to relatively high risks involved in combination with high transaction costs but low returns[66], at least in the short run. Pension funds, on the other hand, "have a much longer investment horizon, which can be up to 20-30 years"[67] and thus, can take more equity risks and wait for the investment object to grow, develop and reach its potential at which point also the returns are much higher than in the initial stages. In other words, pension funds have the time to wait and are, therefore, "the ideal institutions to invest in long term risk capital and venture capital markets"[68], if compared to life insurers and other institutional investors. In conclusion, there lies a great potential in creating a single market for pension funds in the EU.

2.2.3.3.2 Free movement of workers

"Approximately 1.5% of EU-25 citizens live and work in a different Member State from their country of origin – a proportion that has hardly changed for the last 30 years."[69] It has become apparent that there despite all the progress and development in the EU, there are still factors dissuading workers from moving across the borders of the Member States. Occupational pensions can be included in the list of these factors. At the moment, the importance of the accumulated assets in occupational schemes for the individual varies depending on the status of second pillar schemes in the Member States that the workers are moving between depending on whether an individual's pension in the future will be largely dependant on benefits from the occupational schemes or not. This dependency is however expected to grow with the weakening of public schemes and increased interest for supplementary pensions. The enlargement that has resulted in high numbers of workers moving from the East side to the West part of the EU, where many of the workers are being enrolled in occupational pension schemes as a part of the employers' general policy, will also lead to a greater need among the workers moving forth and back for a well functioning single market for occupational pensions. Thus, already at this stage, it can be concluded that launching co-operation regarding

[63] EC, COM(2006) 349 final, p. 4.

[64] Vanhanen, V., Enterprise Europe Online, 14 July 2006.

[65] *Ibid.*

[66] *Ibid.*

[67] SPEECH/05/539, McGrievy, C., Dublin, 22 September 2005, p. 4.

[68] *Ibid.*

[69] EC, European Year of Workers' Mobility 2006, http://ec.europa.eu/employment_social/workersmobility_2006/index.cfm?id_page_category=FF&language=EN (2007-10-12).

occupational schemes and mobility of the pension funds is expected to have encouraging effect on the workers' movement with the EU.

Mobility is also in high demand as a new demographic trend has emerged over the later year which indicates that people tend to shift jobs much more often then they used to.[70] Life-long tenure and collecting one's occupational pension set up by the single employer is becoming very rare in the modern labour market of today. Under such conditions, "workers should not be penalised on retirement for changing jobs during their professional life."[71] Simultaneously, a large number of multi-national companies, which are also often big employers, are searching for better solutions in handling the pension plans for their employees. Pan-European pension funds managing the occupational pensions of all the employees coming from different Member States is the ultimate goal when opening and mobilising the European pension fund market as such funds are expected to decrease the costs for the employers, increase the returns for the employees as well as increase the activities of pension funds in the financial market. The prospect of this win-win situation will be discussed further on, as the real possibility for pan-European funds to operate without significant obstacles on the market is actually the ultimate measure of whether the Community has a functioning single market for occupational pensions.

2.2.3.3.3 Important supplement to State provision

Developments in the second and third pillar pensions have been in the spotlight in the later years as the sought after solution to the European pension problem. Pension funds and life assurances are resistant to demographic changes as well as they encourage individual arrangements to balance out the inevitably decreasing State benefits.

Pension funds however are advantageous in the sense that the employers make sure that the contributions are regularly paid. Furthermore, third pillar pensions appear to be in general more costly for the individual than second pillar pensions.[72]

Recent studies measuring the pressure on EU pensions[73], have lead to remarkable conclusions that are of utter interest here. Firstly, it has been concluded that the key factors that have been noted as present in the Member States that have been top ranked as having adequate pension conditions and thus low pressure on their pensions systems, are "favourable demographics complemented by a favourable position in terms of private

[70] Palme, Joakim, "EU, skatterna och socialförsäkringarna", *EU, skatterna och välfärden*, Europaperspektiv 2004, Gustavsson, Sverker, Oxelheim, Lars, and Wahl, Nils (red.), p.61, Santérus Förlag, Stockholm 2004.
[71] SPEECH/05/539, McCreevy, C., Dublin, 22 September 2005, SPEECH/05/539, p. 3.
[72] EC, COM(97) 283 final, p.4.
[73] AON Consulting Ltd, European Pensions Barometer, 2006 Report.

pensions"[74]. The case of Denmark, for example, that has topped the chart both year 2006 and 2007[75], constitutes a clear example of what the potential is of a well functioning market for occupational pensions in combination with first pillar pensions. The main reason to why this country's system has become the best example of a pension system in the EU where "coverage of first and second pillar pensions is almost universal"[76] as "95% of Danish workers are accumulating a private pension"[77], lies in the fact "that the majority of the pension structure is fully funded and based on employer or employee contributions"[78]. The most striking finding in these studies has however been that Portugal that held the top ranking of 2005 was rapidly surpassed by 12 countries in only one year which in also indicates a quite increased pressure on the Portuguese pension system. The explanation behind this dramatic change lies in the observation that "while most countries have seen positive changes to company pension schemes, Portugal has failed to encourage private pension savings"[79]. These findings acquaint us, generally taken, with the best case and the worst case scenario and most importantly show that developing the conditions for operating IORPs has a positive effect on the endangered pensions systems as they lift the weight of the strained public schemes thus releasing the tension. In conclusion it can be said that there are indications today showing that developing the pension fund markets in the EU would benefit the pension systems of all the Member States and that the example of Denmark can be spread and applied in all the EU.

2.2.3.3.4 The role of the Commission

The Commission has pointed out that second and third pillar pensions are not intended to become an alternative to first pillar schemes. The role of the supplementary pensions is meant to be, as the title itself indicates, supplementary *i.e.* serve as a buffer to compensate for the decrease in benefits from pay as you go schemes.[80] There are no plans to switch entirely to the second pillar pensions but there is an apparent need to strengthen the sector as a whole in order to turn occupational pensions to a reliable and solid complement to first pillar schemes. Since pension funds with time have blossomed in the financial market, 2nd pillar pensions have become an important player, but without an intra-Community playing field. Thus the task of the Commission became to create firstly a single market for pension funds but at the same time also a level playing field between the pension funds and life assurances increasing competition for the supplementary pension sector as a whole. This initiative, although turned down once upon lack of consensus between the Member States in 1994, was put into practice

[74] AON Consulting Ltd, European Pensions Barometer, 2006 Report, p. 8.
[75] AON Consulting Ltd, European Pensions Barometer, 2007 Report, p. 7.
[76] *Ibid.*
[77] AON Consulting Ltd, European Pensions Barometer, 2006 Report, p. 8.
[78] AON Consulting Ltd, European Pensions Barometer, 2007 Report, p. 7.
[79] AON Consulting Ltd, European Pensions Barometer, 2006 Report, p. 9.
[80] EC, COM(97) 283 final, p.5.

in the Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision (hereafter referred to as the IORP Directive).

3 The creating of a single market for occupational pensions

3.1 The subtle mix

In order to answer the question of whether the EU has now a well functioning single market for occupational pensions it is of importance to establish how a single market is created. Firstly, as the need for a single market for occupational pensions became apparent, the Commission drafted a Directive. That is naturally the initial stage in bringing about a change on political level. However it should be kept in mind that the mere enforcement of the Directive cannot on itself trigger the conclusion that the single market for occupational pensions has been established. The history of the EU shows that the creation of a single market at any level requires “a subtle mix of legislative, administrative and judicial initiatives”[81]. The process of building up the single market for occupational pensions has proved to be no exception to the well tested formula. Hence, the following analysis refers to the three stages, namely, the legislative, the judicial and the administrative stage. If all the three initiatives can be claimed to have been carried out successfully, this taken together would indeed indicate that the process of the single market for occupational pensions has been more or less completed.

3.2 The legislative initiative

3.2.1 The IORP Directive

“In many countries a large part of the pension schemes is offered by life insurance companies”.[82] Moreover, the occupational pension schemes are in many countries being referred to as occupational pension *insurances* and in many cases are treated similarly by the national laws as life assurances.[83] Indeed life assurance schemes are in regard to many aspects similar to the DC schemes provided by pension funds. Despite the similarities between the two pillars, the fundamental differences between the products have, nonetheless, been acknowledged. The pillars were to be legislated separately due to the fact that pension funds, “unlike life assurances, do not guarantee the eventual payment of benefits, the risks being assumed by the sponsoring

[81] Craig, P., and de Búrca, G., 2003, p. 1170.
[82] CEIOPS, CEIOPS-DOC-18/07, December 2007, p. 25.
[83] *E.g.* in Sweden.

company or by the employees themselves"[84] and thus, the involved parties were in agreement that a separate set of, especially, prudential rules was necessary. Hence, the IORP Directive was passed covering the occupational schemes.

The Directive applies to institutions established separately from any sponsoring undertaking and operating on a funded basis in following an agreement entered into either individually or collectively between the employers and the employees or a contract with self-employed persons.[85] The requirement of funded activities excludes the non-funded pension schemes, *e.g.* book reserves, briefly described earlier, from the scope of the Directive. Moreover, as also touched upon above, it may well be the case that in practice IORPs are owned and managed by ordinary insurance companies. In that case the Directive strictly provides that all assets and liabilities attributable to the ORP business "shall be ring-fenced, managed and organised separately from the other activities of the insurance undertakings, without any possibility of transfer"[86]. During a number of meetings between the Member States concerning the transposition of the Directive, it was concluded that the term *ring-fencing* "implies a strict separation"[87] and is an important aspect of the Directive "because different investment rules will apply to the corresponding assets of the ORP business"[88] than those applied to life assurances.

The Directive provides the parties concerned with a set of prudential rules laying down firstly the conditions for operation that IORPs should fulfil in every Member State[89] and, what regards cross-border activities, the procedure for authorisation of a foreign pension fund followed by the competent authorities of the host Member State[90]. Subsequently, the Directive imposes an obligation on the IORPs to provide certain information to the competent authorities and to the members and beneficiaries, as well as account for their own investment policy principles.[91] Moreover, the limits to financial liability of the funds are made unanimous throughout the Community[92] in such way safeguarding the pension rights of the employees in all the Member States. The rules laid down by the Directive may be perceived as rather strict as they have been "designed to ensure that occupational pension transactions attain a high level of security and efficiency"[93], but on the other hand, the IOPR Directive is regarded as a rather modern piece of legislation due to the 'prudent person' rule imposed by Art 18 concerning investment rules. This principle indicates that a more

[84] EC, "Overview of the responses on the Green Paper on Supplementary Pensions in the Single Market", Brussels, 21 April 1998, p. 6.
[85] See the IORP Directive, Art. 6.
[86] The IORP Directive, Art. 4, 1st paragraph.
[87] EC, MARKT/2520/05-EN, p. 4.
[88] *Ibid.*
[89] See the IORP Directive, Art. 9.
[90] See the IORP Directive, Art. 20.
[91] See the IORP Directive, Art. 11-13.
[92] The Directive applies to the EU and EFTA Member States.
[93] Hanlon, J., EBLR, 2003, p. 674.

qualitative than quantitative approach is set out in the Directive, the latter approach being more commonly used in other financial services directives,[94] adopted in line with the expectations that this principle would lead to higher investment returns in practice as it gives the pension funds more acting space in their activities.

Cross-border situations, which are at the heart of this paper, are dealt with in Art 20 of the Directive. Pension funds, once authorised according to the due procedure as laid out in that particular article, are free to provide their services in other Member States as stated in Art 20:

> 'Without prejudice to national social and labour legislation on the organisation of pension systems, including compulsory membership and the outcomes of collective bargaining agreements, Member States shall allow undertakings located within their territories to sponsor institutions for occupational retirement provision authorised in other Member States.'[95]

This particular article expresses the principle of mutual recognition of the IORPs between the Member States. Thus, the philosophy behind the Directive is that if strict prudential rules are followed by each Member State, the States can trust that the pension funds have fulfilled a certain amount of important requirements which, subsequently, facilitates cross-border movements as the risks for fraud and tax evasion are considerably diminished. Art 20 is the prerequisite for the creation of a single market for occupational pensions. But in order to achieve that, one more important aspect needs to be taken into account, namely the freedom of cross-border membership, which is the tricky part as, in fact, the main problems in the way of free cross-border memberships and in creating pan-European pension funds revolve around tax treatment of contributions paid to the IORPs, a crucial aspect which is not even touched upon in the IORP Directive. It has been concluded in the doctrine that if the draft of the Directive would have included any suggestions dealing with taxation, "it is almost certain that agreement between the Member States would have been impossible"[96].

3.2.2 The limitations of the IORP Directive

The view that tax issues were separated in order to pass the Directive at all can be supported by a simple example from the past. The first initiative to legislate in the area of supplementary pensions, including occupational pensions, came in the form of the Council Directive 98/49/EC on safeguarding supplementary pension rights of employed or self-employed persons moving within the Community. The scope of this Directive however included only posted workers, i.e. workers that are positioned in another Member State than the State of their origin for only a limited period of time.

[94] Dejmek, P., EBLR, 2006, p. 1388.
[95] The IORP Directive, Art. 20.1.
[96] Hanlon, J., EBLR, 2003, p. 677.

The aim was to prohibit any sort of compulsion to contribute to a pension scheme in the host Member State during the posting period enabling the posted workers to continue paying in to their regular schemes at home while stationed abroad. The Directive thus deals with the question of removing obstacles in movement for a group of workers in the Community and also in this case the aspect of taxation was highly relevant and, actually, included in the proposal to the Directive. However, the question of tax treatment of the contributions paid to a pension scheme in the resident and not the host MS was left unresolved due to lack of consensus between the Member States. Article 7 of the Directive 98/49/EC was supposed to lead as following:

> 'Where contributions continue to be made in accordance with Article 6 (1) to an approved supplementary pension scheme, a host Member State shall, to the extent that it has taxing rights, treat such contributions in the same way as it would treat contributions paid to a comparable approved supplementary pension scheme established in the host Member State.' [97]

This Article is missing in its entirety in the present form of the Directive which shows that there is a pattern to leave taxation issues unresolved in the Directives concerning the supplementary pensions. On the other hand, this example also illustrates the Commission's intentions to achieve equal tax treatment of contributions at the early stages of creating a single market for supplementary pensions, however unsuccessful.

Hence, tax issues have been expected to serve as the biggest stick in the wheels on the road to a well functioning single market for supplementary pensions, something that the Commission has been highly aware of as it attempted to precede the expected tax troubles by publishing a Communication on the elimination of tax obstacles to the cross-border provision of pensions of April 2001[98] which the Commission referred to as a *supplement* to the Directive[99]. In the light of case law at hand at the time, the Commission gave a clear signal that differing tax treatment of the occupational pension schemes depending on whether the IORP is domestic or foreign would not hold any longer as this discrimination clearly infringes the fundamental freedoms. The Communication naturally, did not give the results wanted, because the Member States have remained reluctant to carry out any substantial reforms. Even though the Commission had explained in the Communication that even justifications that were accepted earlier by the ECJ with certain circumstances regarding contributions to pension insurances would not be applicable in most situations today, the Member States chose to cling to these arguments with the attitude that, despite the Commission's analysis, "the judge will decide in the end"[100]. Therefore the Commission had no choice but to involve the ECJ under its competences provided by the enforcement action Art 226 EC. Although it should also be noted that in a number of important cases on the subject, were initiated by concerned parties who fought for their rights granted to them by the EC

[97] OJ 1998 C 5/04, Article 7.
[98] EC, COM (2001) 214 final.
[99] EC, COM (2001) 214 final, p. 4.
[100] Dietvorst, G., ETR, 2001, p.199.

Treaty. Either way it can be concluded that the ECJ had to take over at the edges of the scope of the IORP Directive in order to annihilate the problems stagnating the potential development catalysed by the Directive.

3.3 The judicial initiative

3.3.1 Jurisdiction of the ECJ

Already in 1969, in a case that concerned monetary policy, the European Court of Justice established that although the issues in question fell within the exclusive powers of the Member States, the States were no less obliged to coordinate their policies and treat these policies as a matter of common concern.[101] Following this principle the Court also found that:

> 'Although […] 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.'[102]

The Court has further explained that it does not have jurisdiction, according to Art 224 of the EC Treaty, to declare national rules regarding direct taxation as such incompatible with the Community law, nonetheless, the Court may in an unhindered manner:

> 'Provide the national court with all relevant guidance as to the interpretation of Community law, with a view to enabling that court to assess the compatibility of those rules with the provisions of Community law mentioned.'[103]

This development has over the years resulted in numerous cases concerning direct tax law. The outcome of the cases has many times lead to amendments of the national tax laws and therefore has raised the discussion of how much sovereignty that the Member States actually enjoy in the area of direct taxation. The effect of the reasoning in the passage quoted above appears to be that the ECJ does not tell the Member States to change their national rules, but "informs" of the consequences if the States do not change them. Therefore it must be admitted here that the ECJ does influence the national taxation scene indirectly even though it might even appear that the results are in the end the same as if the Court would have direct competence to judge as the Member States are left with little real choice but to change the protectionist measure in question.

On the other hand, Art 3.1(a) EC explicitly notes that the activities of the Community shall include abolition of obstacles to the free movement of goods, persons, services and capital. Thus the fundamental freedoms are superior to any kind of obstacles that may be encountered in the process of

[101] Joined cases 6 and 11/69, *Commission / France*, para. 14.

[102] C-279/93, *Finanzamt Köln-Altstadt / Schumacker*, para. 21.

[103] C-204/90, *Bachmann / Belgian State*, para. 6.

creating a well functioning internal market. There is also a practical perspective to the ECJ's standing in the issue. If not for the Court's action, legislation such as the IORP Directive that is impossible to separate from the tax context would be a punch in the air. It has to be remembered that the Member States have been aware of the tax dimension to the IORP Directive long before voting on it in the Council as these issues where dealt with in an early Communication from the Commission and the Court had already delivered a number of judgements on tax treatment of supplementary pensions, but, nevertheless, almost all the Member States have been late with implementing the Directive and changes of the tax systems are going on as we speak although this was planned to be finished in fall 2005. Hence, in this particular case, the Court's ability to address direct tax issues has proved to be necessary in order to achieve any progress in creating the single market for occupational pensions.

3.3.2 The fundamental freedoms and the IORPs

3.3.2.1 The issues at stake

By 2001, *i.e.*, prior to the enlargements of the EU, the large majority of the Member States had what is generally referred to as the EET system (Exempt contributions, Exempt investment income, and capital gains of the pension institution, Taxed benefits) and three Member States (such as Sweden and Denmark) apply ETT system were the contributions are exempt but, besides taxing the benefits, the capital gains are also subject to a so called yield tax. Only two Member States (Germany and Luxembourg[104]) tax the contributions right away thus using the TEE system.[105] The new Member States, were supplementary pensions were almost non-existent, have carried out reforms that normally exempt the contributions. In conclusion, at large, the contributions are exempted within the EU, which is also the key problem in creating a single market for occupational pensions. The contributions paid in and deducted are regarded as postponed salary that is yet to be taxed.[106] Therefore, over the years, the exemptions and deductions amount to a vast tax credit that the tax authorities are keen to cash out.

In domestic situations, the tax authorities collect the information from both the taxpayer and the pension funds. In cross border situations, on the other side, the authorities may encounter more difficulties when collecting the sufficient information needed to levy correct tax in situations where, for example, the resident taxpayer is receiving benefits from a foreign pension scheme. In addition, the national tax authorities may encounter problems when the taxpayer that has been granted exemptions for the contributions

[104] EC, COM (2001) 214 final, p. 7.
[105] EC, COM (2001) 214 final, p. 6.
[106] Swedish Government, Financial Department, Lagrådsremiss, p. 40. Concerning the issue of supplementary pensions treatment as postponed salary see Case 262/88 on equal pay for men and women, para. 20.

moves abroad before or at the time of receiving the benefits. Although, as a rule of thumb, the Member States have enshrined in their tax rules that the Member State that grants the exemption is also entitled to levy tax on the benefits irrespective of where the taxpayer is resident at the time of receiving the benefits, this right, however may be hollowed out as a result of double tax agreements. Tax treaties that normally follow the OECD Model Tax Convention grant the State of residence the right to tax the benefits irrespective of the fact that the contributions have been exempt in the previous State of residence. Thirdly, States that apply the ETT system, *i.e.* levy a tax in the middle of the process of the schemes on the capital gains of the IORP, have to deal with the problem of how to obtain the information needed from the foreign pension funds and enforce taxes on foreign entities. Last but not least, looking from the perspective of the IORPs, pension institutions are subject to different rules of dividend distribution and capital placements than regular companies. This has been explained by the need to protect the beneficiaries.

In conclusion, tax issues appear in every aspect of the supplementary pension system. At the same time the Court may only remove tax obstacles in situations where a certain national measure is found to infringe the freedom of movement for workers, the right of establishment, the freedom to provide services and the free movement of capital.

3.3.2.2 The fundamental freedoms and the IORPs

3.3.2.2.1 The Bachmann phenomenon

3.3.2.2.1.1 The facts and the outcome of the Bachmann case

When it comes to tax treatment of contributions to pension plans, the Court has found that denying a deduction or an exemption for contributions paid to a foreign pension institute, may indirectly restrict the freedom to provide services as these institutions will have difficulties gaining clients as joining a foreign pension scheme places them in a less advantageous situation than if a domestic plan was chosen. Simultaneously, the treatment of contributions to foreign pension plans is of great importance to moving workers, who might need to stay in their pension scheme in the State of residence or may wish to do so because it is more beneficial for them.

Here it should be noted that the case law concerning third pillar and second pillar pensions is connected and intertwined. All supplementary pensions follow a very similar activity cycle with contributions, capital gains and distribution of benefits, which in most Member States has resulted in application of similar tax rules to both types of pension insurances. In the case law the fundamental principle of non-discrimination of the contributions applies to both pillar schemes, although the focus in this paper will be directed towards the occupational pensions.

The first and pivotal case concerning tax treatment of contributions to third pillar pensions was the B*achmann* case[107]. The situation at hand involved a German national employed in Belgium who was not permitted to deduct contributions paid in Germany pursuant to sickness and invalidity insurance contracts and a life assurance contract concluded prior to his arrival in Belgium. According to Belgium law such deductions were allowed only for contributions paid to institutions in Belgium.

When it comes to direct taxation, the Court cannot be as strict when judging whether discrimination is at hand in a certain situation inasmuch it is the core of the tax systems to treat for tax purposes the resident and the non-resident taxpayers differently because the residents are taxed on their worldwide income while the non-residents only on the activities within the State's territory. Thus, in tax cases, different treatment of taxpayers relying on their nationality is discriminatory only in situations where "they are, in all material aspects, in the same position as a Member State's own nationals"[108]. Furthermore, the freedoms may also be restricted if the limitations can be justified on the grounds of public policy, public security or public health.[109]

The circumstances and the verdict are worth taking a closer look at as this judgement formed the foundations of future judgements to come. Regarding Art 39 and the free movement of workers, Belgium firstly argued that the legislation in question was applied without distinction to nationality of workers. The Court came, however, to the conclusion that although there was no direct discrimination, the rules would affect mostly the moving workers who will have concluded an insurance contract in the previous State, thus this type of rules lead to indirect discrimination and therefore constitute a restriction on the free movement of workers. Furthermore, the Court found that it was not acceptable that the workers in many cases would have to pay tax on contributions in Belgium and than be taxed on the benefits upon their return to the first Member State. Nor could the Court accept that moving workers would have to terminate their contracts when moving to open new ones in the new Member State against their wishes and interests. Thus, in conclusion, the legislation at issue constituted a restriction on the freedom of movement for workers.

The ECJ also found that the legislation at stake constituted indirect discrimination of foreign pension providers as due to the tax consequences those seeking insurance would be dissuaded to enrol in a foreign pension plan and was therefore contrary to Art 49 ensuring the free movement of services in the Community.

[107] C-204/90, *Bachmann / Belgian State*.
[108] Williams, D. W., p. 313. See also C-279/93, *Finanzamt Köln-Altstadt / Schumacker*, para. 30, and C-422/01, *Skandia and Ramstedt*, AG's Opinion, para. 27.
[109] See regarding the free movement of persons: Art 39.3 EC, right of establishment and the freedom to provide services: Art 46.1 EC, and free movement of capital: Art 58.1(b).

However, these restrictions were justified on the public interest ground - the need to preserve the cohesion of the tax system. It was surprising that the Court accepted this argument, which in fact has to be seen as an incident of the rule of reason as no such ground has been accepted before when discussing the arguments of public interest. The ECJ considered that there was a direct link between the tax exemption and levying as the tax that is not levied on the contributions is to be collected in the hands of the insurer upon the distribution of the benefits and Belgium would not have been able to secure the levying of this tax effectively from a foreign insurer. Even if the Belgian State could have demanded a guarantee from the foreign insurer, at the time, it was understood that this would involve additional costs for the insurer which would be reflected in higher premiums which was also deemed not to be in the interest of the consumers.[110]

In this particular case Belgium also claimed that there was a need to preserve the effectiveness of fiscal control, but the Court pointed to the Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation (hereafter the Mutual Assistance Directive) and therefore dismissed this argument.

3.3.2.2.2 The aftermath of the case

3.3.2.2.2.1 Critique

3.3.2.2.2.1.1 The principle of proportionality

This case became very popular among the authorities of the Member States as the cohesion argument and the reasoning on effective fiscal control became the most common arguments used by the Member States to justify their indirectly discriminating and thus contrary to the fundamental freedoms direct tax provisions not only in the field of pensions and insurances. Nevertheless, since this sensational judgement in *Bachmann*[111], "the Court has no longer permitted justification on grounds of tax cohesion and only in a few cases has it even affirmed the cohesion of the national tax system"[112].

While the Member States were thrilled about the new line of reasoning, the cased was met with vast scepticism from the legal commentators in the doctrine who found many flaws with the judgement. Firstly, most of the scholars of EC tax law have criticised the Court for not applying the regular scheme of dealing with the problem by identifying whether the legislation in

[110] Williams, D. W., p. 328.

[111] The Court came to a similar conclusion in a case that it handled simultaneously, C-300/90, *Commission / Belgium*, but it turned out later on that the Court had misunderstood the Belgium system concerning group insurance premiums and therefore this case is disregarded in the context of this paper.

[112] C-150/04, *Commission/ Denmark*, AG's opinion, para. 75.

question constitutes a restriction on the fundamental freedoms, if so whether this restriction can be justified and, if it can, whether the measure is proportional or can the results sought for be achieved with the means of less restrictive measures. In case *Bachmann*, the ECJ stopped at the justification and did not even consider whether the measure in question was proportional. However, a strong understanding commonly found in the doctrine is that "the national measure at issue in *Bachmann* (refusal of deduction) was disproportionate and should not have been allowed by the Court"[113]. It has been suggested that the Belgian state could have instead applied a form of exit tax and recaptured the tax credit when and if Mr. Bachmann was leaving Belgium.

The proposed solution to apply some sort of exit tax has turned out to be the correct presentiment of the future reforms. Sweden, that is still just about to carry out the complete reform in order to open up for cross border movement of pension insurances, is applying this particular solution. More specifically, in order to ensure that the beneficiary or the provider of the pension insurance does not abuse or in any way take undue advantage of the Swedish pension system that grants the right to deduct contributions to pension insurances, Sweden will apply a sort of exit tax the purpose of which is to safeguard the taxing rights of the Swedish State in a situation where the parties do not cooperate efficiently. If the parties do not submit their statements of income or attempt to deceive the authorities in an unlawful manner, the parties will be subjected to a tax on the total value of the insurance in question amounted up until the day of decision times 1.8 thus increasing the tax payment by 80% in reality compared to what the amount paid would have been if the benefits would have been taxed in the regular manner. This tax is also meant to discourage the beneficiaries with pension schemes enrolled in pension schemes abroad to cash out their benefits in one lump sum (which may lead to avoidance of taxation if the authorities miss this withdrawal). [114]

The Swedish example proves that it is possible to design tax rules in a way that is less infringing than a general prohibition to deduct contributions paid to foreign pension institutes. This rather new reform that is still awaiting the parliamentary procedures to become fully implemented in Sweden mirrors the recent development in the case law that encourages the Member States to apply less restrictive and, thus, more proportional measures.

In case *Wielockx*[115] the applicant was a Belgian citizen working in the Netherlands as self-employed. According to the Dutch legislation that was presented in the case, self-employed residents were entitled to create a pension reserve where they could allocate a proportion of their profits with the advantage that the amounts set aside each year remain in the business

[113] Terra, B. J. M. and Watell, P. J., 2005, p. 111.
[114] The Government of Sweden, Ministry of Finance, Lagrådsremiss, 26 November 2007, p. 2.
[115] C-80/94

which also meant that these amounts would remain untaxed as long as they were in the pension reserve. Mr. Wielockx was denied this opportunity merely due to the fact that he was a resident of Belgium. The Court did not accept the justification grounds presented by the defendant, but merely stated that the tax authorities may always collect all necessary information pursuant to the Mutual Assistance Directive.[116]

In case *Danner*[117] where a German national working in Finland was not granted deductions for his voluntary contributions to two insurance schemes that doctors were enrolled in when working in Germany but could also continue to participate on voluntary basis while working abroad. Under the Finnish law, contributions to voluntary pension insurance taken out with a foreign insurance institution were not deductible. The ECJ found the rules in question as contrary to the freedom to provide services. AG Jacobs in this particular case also marked clearly that "the advantage of deductibility is in all probability so significant that no one will wish to take out insurance with a foreign institution"[118]. Besides the conclusion that the measures in question were restrictive and unjustified, the Court also found that:

> 'The effectiveness of the supervision of the taxation of pensions paid to Finnish residents, it may be ensured by measures which restrict freedom to provide services to a lesser degree than a national measure such as that at issue in the main proceedings.'[119]

Just as in *Wielockx,* the ECJ did not make any suggestions on exit tax but, on the other hand, the Court implied in the subsequent paragraph that the tax authorities should demand for the information from the tax payer and, if not satisfied with it, only then deny the taxpayer the right to deduct. The normal procedure would be in Mr. Danner's case that he would apply to the tax authorities in order to receive the deduction for the contributions. To the understanding of the Court, in time of such application the Finnish tax authorities are able to request documentary evidence that they find necessary in order to grant the deductions and, therefore, the authorities should recognise this documentation process as a valuable source of information about the future pension payments.[120] In conclusion, the Court is suggesting here that if no other legal measures such as exit or withholding taxes are available, the need to secure future tax revenue can be solved by the authorities demanding all the information necessary in order to grant a deduction. Such a demand would be neutral in terms of nationality and would enable deductions for everyone who fulfils the requirements of the tax authorities.

The Court firmly repeated the paragraph quoted previously from case *Danner* also in its judgement *Skandia*[121]. This case was a so called test case

[116] C-80/94, *Wielockx / Inspecteur der directe belastingen*, para. 26.
[117] C-136/00.
[118] C-136/00, *Danner*, AG's Opinion, para. 30.
[119] C-136/00, *Danner*, para. 51.
[120] C-136/00, *Danner*, para. 52.
[121] C-422/01.

insinuated by employer Skandia, that is actually one of biggest independent providers of solutions for long-term savings and investments in Europe that intended to test whether a pan-European pension fund would be able to operate in reality by asking for a preliminary ruling from the Swedish National Tax Board concerning the possibility to deduct eventual contributions on behalf of its employee to pension plans provided by insurers that are part of the Skandia company group, but situated in, among other States, Denmark, the UK and Germany. According to the Swedish law at the time, such contributions could not be deducted by the employer immediately but only later, when the time has come to pay the benefits. The benefits would then be paid by the foreign insurer to the employer, who would pass them on to the beneficiary and only then would be able to deduct the sum spent of contributions during the beneficiaries employment. If the contributions would have been paid to a Swedish insurer, the employer would have been able to deduct the contributions immediately. The Court found that this differential treatment could not be justified by the cohesion of the tax system argument as there was "no compensatory measure to offset the disadvantage he [the employer, author's note] suffers compared with the employer who takes out comparable insurance with a company established in Sweden"[122] Furthermore the ECJ came to the conclusion that the supervisory effectiveness could be achieved with much less restrictive measures.

Finally in the case *Commission / Denmark*[123] which reached the Court after the Commission had "pursued nine infringement cases against Belgium, Spain, France, Ireland, Italy, Portugal, United Kingdom and Sweden"[124] addressing the discriminatory treatment in relation to foreign pension insurances and all the mentioned Member States agreed to comply with the demands of the Commission except for Denmark[125]. Despite all the previous cases Denmark decided to go all the way and claim argue for the cohesion of its tax system. Denmark has in fact been very active in supporting the Member States in their argumentation on cohesion and effective fiscal control contributing with its arguments in cases such as *Bachmann*, *Danner* and *Skandia*. This particular case tested once again the tax scheme were deductions were only granted to providers of occupational pensions or life assurances established in the Kingdom of Denmark In its argumentation Denmark claimed that "the uncertainty surrounding the receipt of tax paid on benefits provided by foreign pension institutions is the determining factor justifying the need to ensure the cohesion of the tax system"[126]. The Court, among other considerations, answered that:

[122] C-422/01, *Skandia and Ramstedt*, para. 35.
[123] C-150/04, *Commission / Denmark*.
[124] Westberg, B., May 2005, p. 16.
[125] *Ibid*.
[126] C-150/04, *Commission / Denmark*, para. 63.

> 'By refusing in general to grant tax advantage in respect of contributions paid to a pension institution established in another Member State, the contested legislation cannot be justified by the need to guarantee the cohesion of the tax system.'[127]

From all the case law presented so far it can be concluded that the argument for tax cohesion would not be accepted in situations where a Member State in a general rule treats differently contributions paid to foreign pension institutes from the ones paid to domestic insurers where the situations are comparable on all the points except for the demand of establishment. The Court is prepared to accept measures such as exit taxes which in away still do refrain the free movement of workers and services, relying on the circumstance that these taxes would only be imposed when the tax authorities have not been able to obtain the necessary information from the parties. It should be noted that in this case there is no need for the authorities to apply the Mutual Assistance Directive as this way is considered to be an alternative to that kind of procedure.

In short, it can be concluded that we will most likely not see any cases like this anymore brought before the ECJ as the fall of Denmark, which is considered to be the most protectionist in its tax system Member State, symbolises that we have reached a point where it is clear that the probability for the Court to support the argument on cohesion of tax system regarding contributions to foreign pension funds is very low by this point.

In addition, the ECJ has also found in the Swedish case *Safir* that also restrictions of general nature regarding tax on the capital gains (*i.e.* the yield) of the insurers are disproportional. In this particular case, an individual that had paid contributions to a foreign life assurance provider was forced to register themselves and declare their premiums to the tax authorities as well as pay the tax themselves and for this purpose give money out of their own pocket. These obligations were also combined with the demand from the tax authorities on the taxpayer to provide them with the precise information concerning the income tax to which the company abroad is subject in order to achieve reduction or exemption of tax on the premiums. Such a far reaching procedure was judged by the Court as dissuading the people from enrolling in foreign pension plans and incompatible with EC law as:

> 'Other systems which are more transparent […] whilst being less restrictive of the freedom to provide services, are conceivable, in particular a system for charging tax on the yield on life assurance capital, calculated according to standard method and applicable in the same way to all insurance policies, whether taken out with companies established in the Member State concerned or with companies established in another Member State.'[128]

And of course, Sweden did find a way to apply less restrictive measures. The issue of yield taxation will, once the latest law proposal will be implemented, be dealt with under the rules of exit taxation. The

[127] C-150/04, *Commission / Denmark*, para. 74.

[128] C-118/ 96, *Safir / Skattemyndigheten i Dalarnas län*, para. 33.

policyholder of a pension insurance provided by a foreign insurer, will have to make sure that the insurer takes upon itself the obligation to supply information relevant for yield taxation to the tax authorities in Sweden on behalf of the beneficiary. Due to this development and the fact that it is only Sweden, Denmark and Italy[129] that have imposed such yield taxes, one can conclude that the question of yield tax and IORPs is solved and will be treated together with the cross-border policies for tax treatment of the contributions.

3.3.2.2.2.1.2 Cohesion of tax system viewed together with double tax conventions

Besides the fact that the Court in case *Bachmann* did not try whether the measure in question was proportional, the case has been also widely criticised for not taking account of double tax conventions based on the model of OECD.[130] Most of the Member States' double tax conventions thus follow Articles 18 and 21 of the Model that "attribute power of taxation to the state in which the beneficiary resides at the time the capital sum or periodic pension payments are made"[131].

Already in judgement *Wielockx* delivered three years after *Bachmann*, the Court established that since there was a double-taxation convention between Belgium and the Netherlands according to which a person resident in the Netherlands and who sets up a pension reserve and receives the favourable tax treatment for the amounts set aside to the pension reserve, but later on decides to move to Belgium, would be taxed on the benefits in Belgium and not in the Netherlands. The thinking behind tax conventions is that the right to tax is allocated to the State of residence and the contracting State although maybe giving up its right to tax a certain former resident but at the same time it gains the right to tax the former residents in Belgium coming to the Netherlands. In this kind of situation one can say that the deductions allowed are financed by taxing the benefits, but one cannot claim that there is a direct link between the contributions that a certain person has deducted and therefore the need to tax his or her benefits. The State in question just taxes any benefits paid in to a resident thus not following up every person's activities. The Court also confirms this in its conclusion:

> 'Fiscal cohesion has not therefore been established in relation to one and the same person by a strict correlation between the deductibility of contributions and the taxation of pensions but is shifted to another level, that of the reciprocity of the rules applicable in the Contracting States.

[129] EC, COM (2001) 214 final, p. 7.
[130] De Brabanter, V., ECTR, 2003, p. 169.
[131] *Ibid.*

> Since fiscal cohesion is secured by a bilateral convention concluded with another Member State, that principle may not be invoked to justify the refusal of a deduction such as that in issue.'[132]

It is indeed hard to see how a refusal could be justified when the result, *i.e.* the impediment to tax the benefits, in the end may turn out the same irrespective of in which State the person in question was resident in first.

The reasoning of the Court in this particular case changed the application of the argument of the fiscal cohesion in the case law of the ECJ as it was followed up in all the cases following the *Wielockx* judgment.[133]

What is interesting to note is that AG Stix-Hackl in her opinion for case *Commission / Denmark* chose to look at the argument of the need to preserve the fiscal cohesion of the Danish tax system from the national perspective and from the perspective including double tax conventions. Firstly she recognised that in the situation at hand in the *Bachmann* case there was a compensation mechanism were losses of tax revenue resulted by the deductions of insurance premiums were gained back from the taxation of the benefits. If no deduction was granted the benefits would also be exempt from tax. The AG, when assessing the argument of cohesion in the national context, recognised that "such a direct link between the deductibility of pension contributions and the taxation of benefits paid by pension institutions evidently exists"[134] also in the Danish tax system. However, for the reasons explained previously in the discussion concerning the *Wielockx* judgement, the AG concluded that "the allocation of competence in accordance with a DTC is apt, thus, to sever the link in national law between deductibility of contributions and later taxation of pension benefits"[135].

This development was not recognised by the Member States as this became the States' favourite argument that was used in almost every case concerning supplementary pensions without any real selection. This came out even in case *Skandia*, where the Swedish Council of Advance Rulings had dismissed the claims of the appellant for the right to deduct contributions made to foreign pension insurers without any real analysis, closing the discussion with the reference to the *Bachmann* case.[136] However, the Court showed the national authorities in this particular case as well as it had been doing for almost a decade in all the cases subsequent to *Bachmann*, "that the cohesion principle as an instrument for the defence of a closed national tax system, in the way it has been argued in the past by the national governments of the Member States is dead"[137].

[132] C-80/94, *Wielockx / Inspecteur der directe belastingen*, paras. 24-25.

[133] See for example C-136/00 *Danner* para. 41 and C-150/04 *Commission / Denmark* paras. 71-72.

[134] C-150/04, *Commission / Denmark,* AG's opinion, para. 82.

[135] C-150/04, *Commission / Denmark,* AG's opinion, para. 86.

[136] C-422/01, *Skandia and Ramstedt,* para. 14.

[137] Vanistendael, F., ECTR, 2005, p. 221.

In conclusion, the concept of cohesion of tax system has no been dismissed in its entirety but the development of the case law has refined the applicability of the concept which today must be viewed not only in comparison to the national tax system but also to the tax systems of the EU that the national tax system is a part of. Indeed as the AG Poiares Maduro has expressed it in his opinion in case *Marks & Spencer*:

> 'The concept of fiscal cohesion performs an important corrective function in Community law. […] The function performed by fiscal cohesion is the protection of the integrity of the national tax systems provided that it does not impede the integration of those systems within the context of the internal market.'[138]

3.3.2.2.3 Future prospects

3.3.2.2.3.1 Free movement of capital

From the case law that we have today it is clear that general rules denying deductions or tax exemptions for contributions would most likely not be accepted by the ECJ. Issues related to yield taxation, existent only in a small number of Member States have hanged along the reforms triggered by the developments regarding tax treatment of contributions. The issue of pensioners moving abroad and being taxed in their new State of residence despite that the contributions have been deducted in the former one, will probably not be a subject for the ECJ to try as pensioners so far do not fall within the category of "workers" and therefore cannot enjoy the same protection. However, it is most likely that if there are any problems in this field, it will also tag along the overall reforms concerning portability of occupational pensions.

The Commission and the ECJ have come a long way but there is still a lot left to unravel. Firstly, there have been no clear indications what consequences an individual would have to face upon moving capital accumulated in one Member State to an occupational pension scheme provider in another Member State upon moving there. In other words, the occupational pension has not been viewed in the light of the free movement of capital yet. As in most cases the legislation in question was found to be contrary to the freedom to provide services and the free movement of workers, the Court did not see the necessity to assess whether the free movement of capital was hampered too.[139] In rather recent doctrine one can find conclusions indicating that "most Member States tax transfer of pension capital to a foreign pension fund, which makes such transactions unlikely to be undertaken"[140]. The presentiment that new troubles are on their way is strong especially having in mind the rather recent proposal for a Directive on improving the portability of supplementary pension rights[141].

[138] C-446/03, *Marks & Spencer*, AG's opinion, para. 66.

[139] See for example C-150/04, *Commission / Denmark*, para. 60.

[140] Dejmek, P., EBLR, 2006, p. 1392.

[141] COM(2005) 507 final.

This proposal is the result of the Commission's disappointment over the fact that "15 years of discussions at European level have failed to produce a voluntary initiative of this type"[142]. The purpose of this proposal is to secure that an outgoing worker opting for transfer of his rights would not be penalised by certain measures of the Member States when the value of the rights is transferred between two schemes, one being the foreign one.[143] The term "transfer" is defined in Art 3(j) of the Proposal Directive as the possibility for the moving worker to either cash out the sum representing part or all of the pension rights acquired under the person's pension scheme or to move this sum to a new supplementary pension scheme in another Member State. As the IORP Directive, this Directive does not deal with any tax issues involved. In this case, the Commission has already indicated that 15 years of discussions have not lead any were as far as it regards the cooperation between the Member States. Will the ECJ need to come to the rescue again? Well, the probability is high.

3.3.2.2.3.2 Freedom of establishment

One more freedom has not been dealt with in the cases presented so far, namely, the freedom of establishment. It appears to be the case that "the European pension industry has complained about higher taxation of pension funds if they exercise their rights under the EC Treaty to invest across the border"[144]. This insurgence was insinuated by the Court's judgement in case *Denkavit Internationaal*[145].

In the situation dealt with in case *Denkavit Internationaal* , dividends that a Dutch parent company had received from its daughter company in France were subjected to a withholding tax of 5% while if the distribution would have taken place between two domestic companies, no tax whatsoever would have been imposed. Moreover as the dividends were exempted from tax in the Netherlands, there was nothing that the parent company could credit the withholding tax against; such ending up with no relief and more tax paid than if it would have been a French parent company. The applicant argued before the ECJ that this kind of conduct was contrary to Art 43 EC granting the European companies freedom of establishment.

In its judgement the Court brought forth that "although direct taxation falls within their competence, the Member States must none the less exercise that competence consistently with Community law […] and avoid any discrimination on grounds of nationality"[146]. In connection to that, "freedom of establishment thus seeks to guarantee the benefit of national treatment in the host Member State, by prohibiting any discrimination, even minimal,

[142] COM(2005) 507 final, p. 6.
[143] COM(2005) 507 final, p. 8.
[144] IP/07/616.
[145] C-170/05.
[146] C-170/05, *Denkavit Internationaal and Denkavit France*, para. 19.

based on the place in which companies have their seat".[147] Discrimination in tax cases, as already discussed above, arises only when the Member States cannot show that they distinguish between the residents and non-residents on objective grounds. However in the present case the AG had argued that "the actual effect of a DTC on a taxpayer's situation should be taken into account in assessing whether, in a specific case, that taxpayer is discriminated against in a manner contrary to Article 43 EC"[148]. But the Court concluded that when a Member State imposes a tax on income of non-residents, the non-resident and resident companies are to be considered as being in a comparable position.[149] In that context, the withholding tax in question could not be justified by the need to prevent the non-resident companies from avoiding any liability to tax on those dividends, because the resident companies are free of this type of tax and therefore the ECJ interpreted Articles 43 and 48 EC as precluding national legislation which imposes, only as regards non-resident parent companies, a withholding tax on dividends paid by resident subsidiaries.[150]

By January 2008 the Commission has asked 11 Member States in total in the form of a letter of formal notice, the first step in infringement procedures, to provide Commission with information about their rules on discriminatory taxation of dividends and interest paid to foreign pension funds[151] referring to the *Denkavit Internationaal* that the Commission views as a confirmation that higher taxation of outbound dividends than domestic is not in conformity with EC law. "Pension funds are usually subject to different tax rules than companies"[152] and furthermore are also subjected to discriminatory treatment if dividends are to be distributed to similar foreign institutions. This can be illustrated by an example from Germany where upon receiving dividends a domestic fund is taxed on the sum minus any costs related to investment activities, while dividends paid from German actors to pension institutions abroad are subjected to a withholding tax without the possibility to deduct the investment costs.

Hence, unless the Member States in question are going to comply with the Commission's demands, the discriminatory treatment of outbound dividends to pension funds is yet to be tried before the ECJ.

3.3.2.2.4 Additional remarks and conclusions

The concept of fiscal cohesion has obviously taken time to sink in. Reversing the concept in its entirety could have negative consequences as this would be a kind of a ban for the Member States to design certain tax links within their systems that may well follow the direct link even viewed

[147] C-170/05, *Denkavit Internationaal and Denkavit France*, para. 22.
[148] C-170/05, *Denkavit Internationaal and Denkavit France*, AG's opinion, para. 33.
[149] C-170/05, *Denkavit Internationaal and Denkavit France*, para. 35.
[150] C-170/05, *Denkavit Internationaal and Denkavit France*, para. 56.
[151] See IP/07/616 and IP/08/143.
[152] IP/08/143.

in the context of the whole Community. In addition, there is plenty of direct taxation situations that have not been tried before the Court and thus, it would be adequate to simply disregard the possibility of a direct tax following the direct link proving the cohesion of the tax system in question.

On the other hand, it is also regrettable that the Member States have been so fixated with the one argument supporting their position and have applied it extensively and, actually quite regardless whether the situation at hand was any similar to the one in *Bachmann* as this argumentation soon enough appeared in all possible cases concerning direct taxation. This has without a doubt slowed down the development of the single market for occupational pensions. In addition, once the Court did not accept the argument of fiscal cohesion, several other public interest grounds were "submitted by the Member States without much distinction: fiscal supervision, tax avoidance, tax base and loss of revenue, to the Member States they seem to be all in the same league"[153]. This has led to a situation where legal uncertainty is high and "even in such a clear case law as the current one, it remains difficult to predict the compatibility of national tax systems with the Community law".[154]

On the other hand, the positive outcome of the judicial initiative is that the Court has consistently directed the Member States to turn to less restrictive measures, encouraged the communication between the authorities of the Member State within the frame of the Mutual Assistance Directive and pushed the Member States to rely on the double tax conventions. If taken seriously this development would be very beneficial for the EU as the States would become more pro-active and active in Community matters instead of awaiting orders from the top.

However, the probability that it will take years until the ECJ has dealt with all the taxation angles concerning pension funds is substantial. Furthermore, it is important to note that where "the ECJ can strike down national legislations, it cannot build up a system which would be compatible with the Single Market"[155]. The judicial initiative is helpful and necessary to address certain situations or occasional infringements in the field of direct taxation but it should not become the only solution as it is recommended that this "destructive" process should be exchanged to a course including for example guidelines for the Member States, double tax conventions initiated by the Member States themselves, Commission recommendations, codes of conduct and similar cooperation tools. Accumulating a large number of cases dealing with fact specific situations is not the answer when creating the single market for occupational pensions. The Commission was right in its initial attempts to achieve agreement between the Member States by firstly publishing a Communication on abolishing tax obstacles for occupational pension. Also the analysis of the judicial initiatives shows what the Commission knew from the very beginning, the success of creating

[153] Vanistendael, F., ECTR, 2005, p. 215.
[154] Wathelet, M., ECTR, 2004, p. 3.
[155] *Ibid*.

the single market for supplementary lies in the field of administrative initiative.

3.4 The Administrative Initiative

3.4.1 The Mutual Assistance Directive

Latest investigations on the implementation of the IORP Directive suggest that "lack of certainty in relation to practical implications of cross-border activities continues to be dissuasive"[156] and is containing the IORP Directive from its full potential. This is no surprise as also in the case law presented above, all the way from *Bachmann* to the most recent cases such as *Commission / Denmark*, the States have been trying to prove that the Mutual Assistance Directive "is not a sufficiently effective tool to overcome the difficulties involved"[157]. In the case of direct taxation of pensions the argument of fiscal supervision coincides with the need to prevent tax evasion which makes the issue of information exchange extra sensitive.

In case *Bachmann*, Belgium explained that the Directive does not work because "certain Member States have no legal basis for requiring insurers to provide the information needed to monitor payments made within their territory"[158] as according to Art 8.1 of the Directive, the authorities of another Member State are not obliged to collaborate more than to the extent that the law and administrative practices of the particular State allow them to[159]. Belgium also noted that the Mutual Assistance Directive did not provide any security for the information provided from being used by the Member States for other purposes than those the information has been requested for. Ever since these arguments have been compressed into one single phrase frequently used by the Member States namely that the Mutual Assistance Directive is inadequate for collecting the necessary information.

On the contrary, the Commission explained in a Communication that in its view Art 8.1 of the Directive "does not allow the Member States to refuse to exchange information on the grounds that the information is not required for domestic tax purposes"[160] as it merely means that the authorities of the Member State in question naturally cannot provide any information that they themselves are not entitled to collect or use. The Commission further established that it had so far not been informed or aware of "any fundamental impediment in national tax laws to collection of such

[156] EFRP, "IORP Directive – a catalyst for change", November 2007, p. 7.
[157] C-446/03, *Marks & Spencer*, AG's opinion, para. 61.
[158] C-204/90, *Bachmann*, para. 19.
[159] C-204/90, *Bachmann*, para. 20.
[160] COM(2001) 214 final, p. 15.

information"[161]. As Art 8.1 appeared for some Member States as open to more than one interpretation[162], the Article was amended in 2004 in accordance with the Commission's explanation in the earlier Communication[163]. While amending Art 8.1, the Commission also replaced old Art 7.1 with a new rule on security when handling the information collected and limits to what the information can be used for. Furthermore Art 8 (a) was added providing the rules for automatic information exchange according to which, on request of the authority of a Member State, the other Member State shall "notify the addressee of all instruments and decisions which emanate from the administrative authorities of the requesting Member State and concern the application in its territory of legislation on taxes"[164] . Also Article 8 (b) was added allowing for simultaneous controls "where the tax situation of one or more taxable persons is of common or complementary interest to two or more Member States"[165]. These amendments have addressed for instance Belgium's doubts presented in the *Bachmann* case, but still the States keep claiming that the Mutual Assistance Directive is inadequate.

Even after the amendments the Danish government in case *Skandia*, stated dramatically that "as long as Community law does not expressly provide for the right of Member States to require foreign insurance companies to provide information on payments made, such controls cannot be effectively implemented"[166]. This statement however needs to be taken with a pinch of salt. The case in question concerned Swedish legislation which is similar to Danish, especially on the point that both countries impose yield taxation on capital gains. Thus, this argument does not fit universally the whole EU. The two States reasoned that they do not have the legal power to force a pension institution abroad to provide their authorities with necessary the information. However, Sweden has recently showed in its reforms that it is possible to solve the information problems by including such obligations in the contracts concluded between the pension institutions and the policy holders with the threat of a much higher tax on the whole value of the insurance if the parties would not comply with the information requests.

In conclusion, especially having in mind the amendments of the Directive, one may question whether the hard criticism of the Directive is well founded.[167] It may well be the case that the Member States are using it as a standard argument as they have not presented any concrete examples in the cases or provided the Court with any good reason to why the Directive is inadequate. Furthermore, both the Commission, the judges of the Court and the AGs have continuously maintained that the Member States are able to gather the information necessary within the framework of the Directive. On

[161] *Ibid.*
[162] COM(2003) 446 final/2, p. 4.
[163] Council Directive 2004/56/EC.

[164] *Ibid.*
[165] *Ibid.*
[166] C-422/01, *Skandia and Ramstedt*, para. 39.
[167] Compare with C-446/03, *Marks & Spencer*, AG's opinion, para. 72.

the other hand, while the Court has been accused for merely pointing to the Directive and not seeing the reality, it is important to remember that the Directive is in fact not the only and exhaustive way to attain the sufficient level of information flow. Already in case *Bachmann*, the Court stated that "the inability to request such collaboration cannot justify the non-deductibility of insurance contributions"[168] suggesting that the Member States in such cases should demand sufficient proof from the policy holder when assessing the deductibility of the contributions. Indeed, the granting of deductions is a powerful weapon in the hands of the tax authorities because the denial to deduct could even put pension funds out of business.

In conclusion, there are indications that the Mutual Assistance Directive does not deliver the results wanted. The Member States may be right, but they are also the ones that hold the key to functioning co-operation, not the Commission. The Commission has also indicated that it is rather a matter of interpretation and application of the Directive, once again redirecting the attention to the Member States. As also the Court has indicated, every Member State has the power to negotiate and work together with their fellow States and should not dismiss the possibilities altogether with a mere reference to the limits of the Mutual Assistance Directive.

3.4.2 Alternative solutions

AG Jacobs identified three potential sources of information in his opinion for case Danner.[169] Firstly, the State may rely on the tax payer. In several cases starting with *Wielockx*, the Court has found that when applying for the deductions, the taxpayer will have to provide sufficient information in order to be able to receive a deduction. In this way the authorities have the opportunity to collect valuable information. In the Swedish reform accounted for earlier in this paper, it is the taxpayer that is utterly responsible for the tax being paid in. As Sweden taxes the yields of the pension funds, the taxpayer has to make sure that his or her insurance company contains an obligation for the pension fund to provide information necessary to assess the yield taxation on the part corresponding to the contributions paid in. However, this may not be the best way of solving the problem as placing the responsibility also for the doings of the pension may result in harsh consequences for the individual as in Sweden were the person would be subjected to a penalising tax on the whole accumulated value of the insurance.

Denmark has further argued in case *Skandia* that "taxpayers do not have the same interest in providing the national tax authorities with full and correct information on payments received, which are subject to tax, as on payments made or payments which can be deducted". This argument cannot be accepted. As mentioned briefly above, it is very much in the taxpayers

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[169] See C-136/00, *Danner*, AG's opinion, para. 70.

interest to obtain the right to deduct and the authorities are free to decide what kind of information that they need, so unless the taxpayer forges or submits faulty information, which is in most countries unlawful and involves personal risks for the individual, the authorities should be content with the documentation presented upon request.

Secondly, instead of making the taxpayer take responsibility for the IORP, the authorities could conclude a standard contract with the institution in question themselves. This seems to be an effective way to receive the information on both contributions and benefits as well as capital gains , if needed, paid to the residents of the requesting Member State. This has actually been put in practice in the Netherlands were the tax authorities conclude civil law contracts with the foreign pension funds and if the pension funds breach the contract, the tax authorities stop the tax deductibility of the contributions to these pension funds which in practice puts these pension funds out of business in the Netherlands.[170] There is even the possibility of immediate suspension of the deductions. Hence there are positive examples coming up around the Community which puts pressure on the Member States showing that the criticised solutions are actually possible.

Last but not the least, the Member States may chose different ways to co-operate with each other. Today we have the example of the "arrangement of 10 July 2002 between the relevant authorities of France and Belgium on the exchange of information and official cooperation in order to combat tax evasion and fraud"[171]. The tax authorities of the Scandinavian members of the EU have also well established mechanisms of cooperation. Although many believe that they work so well due to the rare in other parts of Europe personal number systems and similar features, this type of cooperation proves that the Member States do not necessarily need the Mutual Assistance Directive in order to obtain the information needed. All the measures proposed so far can be widely applied throughout the EU, but are dependant on the initiative of tax authorities.

Another alternative, not mentioned by AG Jacobs, is also for the Member States to collaborate through *e.g.* forums for the authorities to meet on the EU level. CEIOPS that was founded by the Commission and is composed of high level representatives from the supervisory authorities for insurances and occupational pensions in the EU and the EEA has also issued a protocol of February 2006 on the co-operation of relevant supervisory authorities as regards the application of the IORP Directive.[172] These type of tools worked out together by the authorities should be put into use by the members of the Committee and communicated by the representatives in their workplaces back home.

[170] Schonewille, P., ECTR, 2005, p. 81.
[171] de Brabanter, V., ECTR, 2003, p. 170.
[172] CEIOPS-DOC-08/06.

In conclusion, the argument that the Mutual Assistance Directive is inadequate is not worth much anymore. It has been made clear that there is a handful of measures that can be and have been put into practice by the supervisory authorities. To my opinion, were possible, contracts with the pension funds seem to be the most effective way of collecting information because they are the direct source in order to avoid penalising the individual tax payer. The main issue here appears not to be the lack of alternatives for securing information collection but the lack of initiative from the relevant authorities. This, could however be also explained by the lack of sources needed which are needed as more work needs to be done but have not been budgeted in for the authorities as this type of cooperation is still in many countries not being counted in as an important part of the authorities' tasks. As noted in the early stages of this paper, the numbers of moving workers are still relatively very low. This in turn results in lack of experience as well as lack of incentive to implement substantial reforms. But, the authorities should not hide behind excuses and stay content with the present situation, but precede the inevitable development of increased mobility and, actually, encourage it. All parties would win if efficient administrative systems would be put into effect and in time. We know that it is doable as the example of co-operation on collecting VAT proves, it is the incentive, which is present in the VAT example, that has not been awakened yet.

3.5 Final remarks and conclusions

In this paper it has been shown that there are great benefits to reap for the EU as a whole once the single market for occupational pensions is established. However, the process of creating this market has stumbled greatly on the amount of tax issues involved. When it comes to direct taxation, Member States tend to be protectionist and ridged which has also been illustrated in this essay. This became the sensitive part of the single market project.

What has been clarified in this paper is that general prohibitions in this field will most likely not be accepted by the Court anymore. The Court has in every case but one explained to the Member States that the goals can be reached with less restrictive and more proportionate measures. After a number of cases and also legal reforms in the EU, the peer pressure among the Member States is rising. It has become harder and harder for the Member States to claim that a certain reform is not possible when the other Member States with very similar systems have shown that it is doable.

When creating the single market for occupational pensions the Commission had intended from the very beginning that so called "soft law" would be the force behind it. After all the legislation and all the cases one must say that the Commission was right - the fact that it knew from the very beginning just became more apparent – the Member States need to cooperate and show good will in this extensive project for the Community as a whole to succeed. The administrative cooperation is in great need to be refined and smoothed out by the Member States as more legislation, for instance more amendments to the Mutual Assistance Directive, will only make the conclusion reached more obvious, because in this particular situation it is not in legislation that the main problem lies. The same applies for the judicial initiatives, as it is clear that if the Member States continue turning to the ECJ instead of solving the main problem of communication, it would only once again prolong the development of the single market for occupational pensions but in any case direct the Member States to solve the administrative matters.

What is now needed from the Member States is more pragmatism as well as more participation in the Community. The Commission and the ECJ have both pushed the Member States to take part more actively and of own initiative in the process of creating the single market for occupational pensions. One thing is clear, the wide range of excuses has been narrowed down significantly and now it is "the Member States that are sitting in the first row and have the opportunity to agree to common rules on cross-border taxation"[173]. For in the end it this way that the Member States can win the most, not waiting for a most likely negative decision from the ECJ.

So have we reached the single market for occupational pensions? The answer has to be that we haven't quite yet. There are still plenty of aspects that need to be solved as we do not have pan-European pension funds operating in a well established and regular manner. On the other hand, the experiences and the lessons learned by the Member States has triggered reforms even in the most reluctant states which, in turn, has created better conditions for the remaining reforms needed in order to complete the single market for occupational pensions which now can be expected in the near future.

[173] Vanistendael, F., ECTR, 2005, p. 222.

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