The Offshore Tax Planning Review

REFLECTIONS ON *R v IRC ex parte COMMERZBANK AG*[1]

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Introduction

The *Commerzbank* case has rightly attracted very considerable attention from commentators.[3] Clearly, the ability and willingness of the European Court of Justice to apply the law prohibiting discrimination on grounds of nationality to the direct tax laws of member states is of vital importance in fiscal and political terms. Yet the decision of the court ought not to have been too surprising having regard to the previous law on discrimination which had been developed. The decision may be regarded as significant rather more for the fact that it demonstrates a willingness to apply existing principles than for any great extension of them.[4] In this note some of the contentions advanced in *Commerzbank* are looked at in the context of one or two previous cases, then other more general considerations are examined.

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1 Case 330/91, [1994] 2 WLR 128 (ECJ).

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3 See for example: 'Nondiscrimination protection broadened for non-residents' *The Journal of International Taxation*, Dec 1993, p549 (DL Hinds); 'Discrimination within the EC: Is this the end?' 33 *European Taxation* [1993] 345 (L Secular) 'Differential treatment or discrimination?' [1993] BTR 435 (JDB Oliver) '*Commerzbank* - Fast track to harmonisation?' [1993] BTR 517 (D Sandler).

4 In fact the ECJ has recently emphasised the boundaries of the concept of discrimination in *Hans Werner v Finanzamt Aachen-Innenstadt* Case 112/91, judgment delivered 26th January 1993 and noted at STI [1993] 376. It has also demonstrated that it is willing to add the cohesion of a tax system to the list of reasons why discrimination may be permitted: see *Commission v Kingdom of Belgium* Case C-300/90; *Bachmann v Belgian Tax Authorities* Case C-204/90 [1992] ECR 249, [1992] ECR 305, [1993] I CMLR 785.

As is well-known, the UK government wrongly demanded from Commerzbank tax on interest which was exempt from tax under the UK/US double tax treaty. The tax was repaid but the Inland Revenue refused to pay repayment supplement since the bank was a branch of a German company and not a company resident in the UK. The matter came before the ECJ by virtue of a reference under Article 177 of the EEC Treaty ("EECT") by the Divisional Court before which the bank had brought judicial review proceedings.

Commerzbank did not ask the court to extend the law of discrimination to cover its situation. Rather, it argued that the facts of *Commission v France*[5] were "in all material respects identical"[6] to its own and that the court's ruling in that case was "equally applicable"[7] to its case. The ECJ gave a short judgment and did apply the reasoning in *Commission v France*. In that case the ECJ said that it was discriminatory that French legislation permitted the shareholders of French resident insurance companies to obtain the tax credit known as the *avoir fiscal* whilst it denied it to branches and agencies of foreign insurance companies. The parallel with the position of Commerzbank is clear.

Naturally, prior to determining whether or not discrimination exists it is necessary to be clear which Articles of the EECT are in point. This is something which was considered at the conclusion of the ECJ's judgment in *Commerzbank* but which we shall consider first.

Which Articles of the Treaty Apply?

As amended by the Maastricht Treaty the general non-discrimination provisions of the EECT, formerly contained in Article 7, are contained in Article 6. This prohibits discrimination on grounds of nationality generally but in fact applies only to those situations in which the EECT lays down no specific prohibition of discrimination. Other provisions of the EECT prohibit discrimination in specific circumstances. In *Commerzbank* it was Articles 52 and 58, which give the right of establishment, which were relevant. In its judgment the court made clear, agreeing with Commerzbank's submissions, that it did not need to consider the general prohibition since Article 52, as extended to enterprises by Article 58, had

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5 Case C270/83, [1986] ECR 273.

6 Supra, p132.

7 Supra, p132.

been infringed. If Article 48[8], 52, or 58 is infringed so is the general provision.[9] On the other hand, if the specific Article is not infringed neither is the general one. This was demonstrated in *Hans Werner.*[10] In that case the ECJ followed the approach laid down in *Van Ameyde v UCI,*[11] namely that Article 52 of the Treaty guaranteed, in relation to the right of establishment, the specific application of the general principle of non-discrimination. In *Werner* since the provisions in question were compatible with Article 52 they were of necessity compatible with Article 7.

The relevant Articles of the Treaty having been established we can now look briefly at the nature of discrimination and particularly of that which existed in *Commerzbank.*

Discrimination: Overt and Covert

The scope of the prohibition of discrimination has been defined as follows:

> All general or particular measures or acts of Community Institutions, Member States, or enterprises which treat a person or enterprise differently on the ground of certain personal or business relations with another Member State will...fall under the prohibition. A Member State will not be able to evade prohibition by means of discriminatory acts on the ground of the place of establishment of the enterprise ... unless such treatment is objectively justified.[12]

The prohibition covers both overt and covert discrimination. In *Commerzbank* the discrimination which the court found to exist contrary to Article 52 of the EECT was covert or indirect. The residence requirement attached to the right to repayment supplement was considered more likely to disadvantage companies with their seat in member states outside the UK. The judgment of the court stated that:

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8 This Article concerns freedom of movement.

9 See *Commission of the European Communities v Hellenic Republic* Case 305/87 [1989] ECR 1461 at pp1476-7.

10 Supra, note 4.

11 C90/76 ECR [1977] 1091; see p1126, para 27.

12 *Introduction to the Law of the European Communities*, PJG Kapteyn and P Verloren van Themaat, 2nd Ed by Laurence W Gormley) (1990 Kluwer) at p96.

> "...it follows from...*Sotgiu*[13]...that the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality or, in the case of a company, its seat, but all covert forms of discrimination which, by application of other criteria of differentiation lead to the same result.
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> Although it applies independently of a company's seat, the use of the criterion of fiscal residence within national territory for the purpose of granting repayment supplement on overpaid tax is liable to work more particularly to the disadvantage of companies having their seat in other member states. Indeed, it is most often those companies which are resident for tax purposes outside the territory of the member state in question."[14]

This was not, of course the first time that *Sotgiu* had been applied in a case concerning direct tax. It had been significant in *Klaus Biehl v Administration des contributions du grand duche de Luxembourg*.[15] In that case a residence requirement linked to the right of repayment under the law of Luxembourg was held covertly to discriminate against nationals of other member states, contrary to Article 48 EECT, since it was they who would be most likely to be affected by it.

Sotgiu was also relied on by the European Commission in *Bachmann v Belgium*[16] in which covert discrimination was established, again in relation to Article 48 of the Treaty.[17] Mr Bachmann, a German national working and resident in Belgium, had entered into a variety of insurance policies with German insurance companies prior to going to Belgium. Under Belgian law, premiums paid in Belgium were deductible but payments by the insurer were taxed, whilst premiums paid outside Belgium were not deductible and the payments by the insurer were not taxed. The effect of these rules in relation to certain insurance policies was held indirectly to discriminate against non-Belgian nationals. They could be in the position of working in Belgium, paying premiums outside Belgium on policies taken out in their state of origin prior to coming to Belgium, and not obtaining the tax deduction. On their return to their state of origin instead of taking the payments

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13 *Sotgiu v Deutsche Bundespost* Case 152/73 [1974] ECR 153.

14 Supra, paras 14 and 15 of the judgment. See also the comments of the Advocate General at p143, para 50 supra.

15 Case 175/88 [1990] ECR 1779 at p1792 para 13.

16 See note 4 supra.

17 The ECJ concluded, though, that the discrimination was justified in order to protect the cohesion of the Belgian tax system. For the position regarding Article 59 of the EEC Treaty see [1993] 1 CMLR 785, paras 31-33.

by the insurer tax free they would be subject to tax in their home state. In such a situation the provisions regarding deductibility would have a covertly discriminatory effect.[18]

Although indirect discrimination was found to exist in *Commerzbank*, the UK government had contended that no discrimination at all had occurred. In doing so it compared the position of Commerzbank to a UK resident company. As we will see, this comparison was considered inappropriate by the ECJ.

Detecting Discrimination: Making Comparisons

In the view of the UK government there could be no discrimination against Commerzbank because its income was exempt from tax under the UK/US double tax treaty. Instead of suffering discrimination it had an advantage over a UK resident company which would not have been exempt from UK tax. Discrimination it was said:

> "...presupposes different treatment of persons who are in an identical situation. In view of the exemption enjoyed by Commerzbank, it must be concluded that the latter is not in a comparable situation to that of its United Kingdom competitors; consequently it is impossible to conclude that there is discrimination."[19]

At root this submission raises the issue of what comparison should be made in order to determine whether or not there has been discrimination.[20] The ECJ was quite clear that:

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18 Supra, page 806-7, paras 9-11. The comments of the court related to pensions and life insurance. So far as sickness and invalidity insurance was concerned the Belgian government contended that an individual could take out a new policy on moving to Belgium. The need to do this, said the court, was an obstacle to freedom of movement: *supra* paras 12-13.

19 Supra, at p135.

20 The problem of what comparison to make arises in the quite different context of the OECD Model Treaty. For example, Article 24(6) provides, in short, that enterprises in one contracting state which are subject to total or partial ownership or control from the other contracting state are not to have imposed on them requirements which are other or more burdensome than that to which "other similar enterprises" of the first state are or may be subjected. Is the comparison to be "similar enterprises" under third country control or not? See for a discussion:'The Non-discrimination Article in Tax Treaties' John F. Avery Jones *et al* 31 *European Taxation* [1991] 309 at 338ff.

> "The fact that the exemption from tax which gave rise to the refund was available only to non-resident companies cannot justify a rule of a general nature withholding the benefit. The rule is therefore discriminatory."[21]

What had to be established was the effects of the provision of domestic law comparing the position of resident and non-resident enterprises.[22] The fact that Commerzbank had certain advantages by reason of the UK/US double tax treaty over resident companies was immaterial. The response of the ECJ in this regard is not particularly surprising. As the Advocate General said, the advantages obtained flowed from a double tax treaty and were unconnected with the national legislation which offended against Article 52.[23] In the words of the ECJ:

> "...observance of Community law cannot depend on the application of a double tax convention concluded with a non-member country."

In *Commission v France* the Court said that the rights conferred by Article 52 were:

> "... unconditional and a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State. In particular, that article does not permit those rights to be made subject to a condition of reciprocity imposed for the purpose of obtaining corresponding advantages in other Member States."[24]

There was, therefore, nothing particularly new in the attitude which the ECJ took in *Commerzbank* to the relationship between Article 52 and a double tax treaty. In any event advantages arising from or negatived by discrimination are most unlikely to justify a breach of Article 52 whether flowing from a double tax treaty or otherwise. Once more it is the ECJ's judgment in *Commission v France* which makes this clear. The Court said in that case in relation to differences of treatment between French subsidiaries and other branches or agencies:

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21 Supra, para 19.

22 Supra, p148 para 18. It is worth noting that Mr Werner also failed to make an appropriate comparison. He tried to compare the way Germany treated its own resident and non-resident nationals in a situation in which, unlike some other cases on discrimination in the EC, there was no real link with another member state. Perhaps, though, the court gave too little weight to the fact that Mr Werner was resident outside Germany and to some earlier pronouncements: see *Jurisprudence Fiscal Européene* Rev. Trim. Dr. Eur. 1993 p331 at p338ff.

23 Supra, p139.

24 Supra, p307 para 25. Part of this quotation was cited by the Advocate General, see supra, p139 para 20.

> "...the difference in treatment...cannot be justified by any advantages which branches and agencies may enjoy *vis-a-vis* companies...Even if such advantages actually exist, they cannot justify a breach of the obligation laid down in Article 52 to accord foreign companies the same treatment in regard to shareholders' tax credits as is accorded French companies."[25]

The point arose again in *Biehl* in a slightly different form. It was said that a taxpayer who was not resident in Luxembourg for a year and therefore exercised the right of free movement obtained an advantage in that the Luxembourg tax authorities did not take into account income arising outside Luxembourg when taxing them. The corollary of that, it was argued, was that such persons did not obtain repayment of tax. This contention was not accepted and the court noted that a non-Luxembourg national could indeed suffer covert discrimination.[26]

Commission v France also provided the answer to another point which arose in *Commerzbank* regarding the avoidability of discrimination.

The Possibility Of Avoiding Discrimination

If Commerzbank had set up a subsidiary resident in the UK repayment supplement would have been available. However, the UK government could not rely on this fact in support of its contention that there was no discrimination. It would have been possible for discriminatory effects of the French legislation governing shareholder credits to be overcome if the insurance business under consideration in *Commission v France* was conducted through a French subsidiary rather than a branch. The court said in that case:

> "...the fact that insurance companies whose registered office is situated in another Member State are at liberty to establish themselves by setting up a subsidiary in order to have the benefit of the tax credit cannot justify different treatment....Article 52 expressly leaves traders free to choose the appropriate legal form in which to pursue their activities in another Member State and that freedom of choice must not be limited by discriminatory tax provisions."[27]

The Advocate General cited a part of the above quotation to demonstrate that this could not be relied upon by the UK government.[28] He also, rather politely one

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25 Supra, p305 para 20.

26 Supra, see p1793 para 16.

27 Supra, p305 para 21.

28 Supra, p27 para 140.

may think, called one of the submissions made by the UK government "paradoxical".[29]

The "Paradoxical" Submission

The submission was that the affairs of resident companies were normally dealt with quickly so avoiding the need for repayment supplement to be paid. There was, however, delay in relation to the affairs of non-resident companies due to the dilatoriness of the taxpayer and difficulty of liaising with other tax authorities. Taxpayers would therefore be enriched by their own delay. This was, perhaps, another way of saying that the discrimination could be avoided and ought not to have succeeded on that ground. In any event the Advocate General rejected these submissions noting that the difficulty could have been overcome by the imposition of a time limit for claims.[30] The ECJ did not consider it necessary to deal with the submission specifically.

It will be apparent that in deciding *Commerzbank* the ECJ acted on established principles. The Inland Revenue could not have been surprised to lose the case. Their reaction to the judgment is, however, of some interest.

The Response of the UK Inland Revenue to *Commerzbank*

In their response to the judgment of the ECJ the Inland Revenue issued two press releases. The first press release detailed its approach to repayment claims by companies who received a repayment of tax without supplement within the six years before the date of the *Commerzbank* judgment, namely 13th July 1993.[31]The second dealt with the position of individuals.[32] It stated that by an extra-statutory concession repayment supplement would be made available to residents of other EC member states who were individuals as well as partnerships, trustees and personal representatives. There is also a provision allowing for claims for repayment supplement in respect of repayment of tax within the six years before the date of the judgment.

So far as companies with accounting periods ending after 30th September 1993 are concerned, repayment supplement will be added irrespective of a company's

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29 Supra, p144 para 60.

30 Supra, para 60.

31 STI [1993] 1091.

32 STI [1993] 1264.

residence.[33] So far as individuals and others are concerned, a similar result is achieved by this year's Finance Act,[34] which also deals with the position of repayment supplement in relation to Capital Gains Tax.[35] So far as non-corporate recipients of repayment supplement are concerned they were all dependent upon an extra-statutory concession until the Finance Bill became law. Even now, partnerships whose trades, professions or businesses are set up and commenced before 6th April 1994 will continue to depend upon an extra-statutory concession since the relevant provisions of the Finance Act only apply to them from 1997-98.[36]

An extra-statutory concession gives a taxpayer few rights and can be withdrawn, particularly if the Inland Revenue consider that it is being used for the purposes of tax avoidance. It is very strongly arguable that the UK government has not complied with EC law to that the extent that reliance on an extra-statutory concession remains necessary in order to obtain repayment supplement. A taxpayer who is refused the benefit of it should probably demand repayment supplement in reliance on EC law.

It is worth noting that in *Biehl* it was said by the Luxembourg government that there was a non-contentious procedure allowing temporarily resident taxpayers to obtain repayment of tax by adducing the unfair consequences for them of the law in question. The existence of such a procedure did not, however, assist the government. This is because there was no obligation on the administration:

> "...to remedy in every case the discriminatory consequences arising from the application of the national provision in issue."[37]

Similarly, an extra-statutory concession imposes no obligation on the UK government to remedy in every case the discrimination suffered in relation to the repayment supplement.

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33 See ICTA 1988, s.826 brought into effect by Corporation Tax Acts (Provisions for Payment of Tax and Returns) (Appointed Days) Order, SI 1992 No 3066 article 2.

34 See Schedule 19 para 41.

35 Supra, para 46.

36 See sched 19 para 40(4).

37 Supra, p1794 para18.

Other Areas of Discrimination

There are numerous areas in which the non-discrimination laws may be applicable. There is space in this short note to give only a few examples. In the UK the requirement for group relief that both the claimant and the surrendering company are resident in the UK, the denial of group relief because the parent company is resident in an EU state other than the UK, and the denial of unilateral foreign tax credit relief and small companies' relief for branches of EC residents must all be considered suspect.[38] Of course, it is not just the UK government that has reason to be wary of the doctrine of non-discrimination. Other member states' governments are also concerned.[39]

So far as France is concerned doubts have been expressed as to the legitimacy of the recently amended exemption from tax on the disposal of a taxpayer's principal residence. By virtue of the Finance Law for 1992 the exemption will only be available if the vendor has been fiscally resident in France continually for the duration of at least one year at any time prior to sale. It may be that this condition infringes the non-discrimination rules of the EU.[40]

An example of possible discrimination in Belgium is provided by the rules regarding assessment of income in the absence of evidence. A taxpayer's income can, in the absence of other evidence, be determined by reference to the taxable income of at least three other similar taxpayers. However, in relation to the permanent establishment of companies resident outside Belgium no comparison is carried out. Instead different levels of taxation are specified for different types of activity. It may be that the imposition of these fixed rates is contrary to the EECT.[41]

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[38] In relation to group relief attention should now be paid to the recent decision in *Halliburton Services BV v Staatssecretairs van Financien* Case C-1/93, judgment 12th April 1994. The ECJ in this case considered Dutch residence requirements in relation to certain group tax provisions to be indirectly discriminatory it is not possible to consider the decision in this note.

[39] For an example of the governments of the member states uniting against the Commission to defend their influence over direct taxation, see *Werner*.

[40] For a discussion of this matter which concludes that the condition may not be struck down by the ECJ see: 'Non-discrimination: New Conditions for Exemption from Taxation on the Sale of a Residence in France,' 32 *European Taxation* [1992] 257, Henry Lazarski.

[41] For a fuller discussion of this problem in an interesting context see 'A Case of Use or Abuse of the EEC Treaty for Tax Purposes', 33 *European Taxation* [1993] 270, Caroline H. V. Vanderkerken.

So far as Germany is concerned a new case has already been referred to the ECJ, namely *Finanzamt Koln-Alstadt v Roland Schumackers*.[42] This concerns a Belgian resident who worked for a German employer in Germany and as a result was effectively subjected to a rate of tax higher than that imposed on his German colleagues. Of the four questions asked of the ECJ the second is worthy of particular attention. It asks:

> "Does Article 48 of the EEC Treaty allow ... Germany to impose a higher level of income tax on a natural person of Belgian nationality, whose sole permanent residence and usual abode is in Belgium and who has acquired his professional qualifications and experience there, than on an otherwise comparable person resident in ... Germany, if the former commences employment in ... Germany without transferring his permanent residence to ... Germany?"[43]

One commentator has said that "[t]here is little doubt that the ECJ will answer this question in the negative."[44]

Conclusion

Clearly the direct influence of the ECJ over the income and corporation tax regimes of member states is extensive. It may also have significant indirect influence in that its rulings could form an additional discouragement to member states from enacting discriminatory tax laws. In this context it is, perhaps, worth noting that the French government has recently amended the 3% tax on real property so as to avoid allegations of discrimination generally.[45] Furthermore, the rulings of the court may well have the effect of spurring the European Commission into action in certain situations.[46]

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42 OJ No C 177/7 29.6.93. A number of other cases on discrimination in the context of taxation have also been referred to the ECJ.

43 See note 36.

44 'Discrimination against non-resident taxpayers remains on the agenda of the European Court of Justice' *Intertax* [1993] 440, Otmar Thommes.

45 For a more detailed consideration of this problem see: 'The 3% Tax on Real Property', 34 *European Taxation* [1994] 34, Rene Bizac and Christien Gassiat.

46 See the Commission's Recommendation on the taxation of certain items of income received by non-residents in a Member State other than that in which they are resident: OJ No L39/22 (10.2.94) and STI [1994] 201.

Professor Easson has said:

> "...challenges to the validity of direct taxes could become as common as are those to indirect tax provisions..."[47]

If they do, as seems very likely, judicial activity will probably prove at least as important as that of the legislators in moulding the member states' tax systems into compliance with the EECT. Which aspect of the UK tax system will be scrutinised by the ECJ next is hard to tell. The decision in Halliburton Services BV[48] suggests that it could be the group relief provisions.

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47 *Taxation in the European Community* by AJ Easson, (The Athlone Press, 1993) at p181.

48 See note 38 *supra*.