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SOME OBSERVATIONS ON *FINANZAMT KÖLN-ALTSTADT v ROLAND SCHUMACKER*

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The importance of the EC Treaty in the context of direct taxes cannot be overstated. Assertions by the Court of Justice in the recent case of *Finanzamt Köln-Altstadt v Roland Schumacker*[2] that, "as Community law stands at present, direct taxation does not as such fall within the purview of the Community",[3] no doubt have a hollow ring with tax authorities who have lost direct tax cases before the Court.[4] As the Court has repeatedly made clear, the powers retained by Member States must be exercised consistently with Community law and if a provision is inconsistent with Community law it cannot be enforced. It was pointed out in an earlier issue of this *Journal* that:

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Editors' Note: This article was written and accepted for publication prior to the decision of the European Court of Justice in Case C-80/94 *G.H.E.J Wielockx v Inspecteur der directe belastingen* of 11th August 1995 discussed by Marc Quaghebeur *supra*.

2 Case C-279/93 [1995] STC 306.

3 Ibid at paragraph 21. Advocate General Léger remarked in *Schumacker* itself (ibid at p 311) "unlike VAT, direct taxation is at a purely embryonic stage of harmonisation", and legislative progress towards harmonisation has indeed been slow. The constraints affecting the development of European law in the context of direct taxation were discussed by Frans Vanistendael in (1994) 31 CML Review 293.

4 *EC Commission v France* Case 270/83 [1986] ECR 273, [1987] 1 CMLR 401; *R v Inland Revenue Commissioners ex parte Commerzbank AG* Case C-330/91 [1993] ECR I-4017, [1993] 3 CMLR 457; and *Halliburton Services BV v Staatssecretaris van Financiën* Case 1/93 [1994] STC 655, to name but three.

> "... the influence of the ECJ over Member States direct tax regimes is likely to be very strong. That influence inevitably extends beyond the boundaries of the cases that come before it. So far as national legislators are concerned, the decisions of the Court may lead them to try harder to avoid discrimination arising in the first place."[5]

Indeed, the UK has recently amended some of its domestic legislation on the thin capitalisation of companies declaring that it was taking the opportunity y to "remove any uncertainty for taxpayers about the application of the existing rules following a European Court of Justice decision".[6]

The purpose of this piece is to set out some observations on the Court of Justice's recent decision in *Finanzamt Köln-Altstadt v Roland Schumacker*. The point at issue can be shortly stated. Mr Schumacker was a Belgian national and resident who derived the greater part of his income (90%) from his employment in Germany. The Belgium/Germany double tax treaty allocated the taxing rights in such circumstances to Germany. As a non-German resident Mr Schumacker was within the German "limited taxation" regime whereby he was subject to tax on his German income deduced at source with no adjustment for his personal circumstances. Had Mr Schumacker been a German resident he would have been subject to "unlimited taxation" on his world-wide income but, as a married man, he would also have been entitled to the beneficial treatment of income "splitting" under which his income would have been divided equally with his wife and taxed accordingly. As his wife had no income of her own, Mr Schumacker's overall tax bill would have been reduced. Another advantage available to German residents, but unavailable to Mr Schumacker, was that income tax was assessed according to the taxpayer's overall ability to pay.

Mr Schumacker's appeal against the refusal of the German authorities to allow him the benefit of unlimited taxation treatment was referred to the Court of Justice on the grounds that Article 48 might be applicable. As readers of this *Journal* will be familiar, Article 48(2) requires the abolition of any discrimination based on nationality between workers of Member States as regards, *inter alia*, remuneration. Four questions were asked. These can be summarised as follows:

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5 Timothy Lyons, *ECTJ* Volume 1 Issue 1 1995/96 at pp 50-51.

6 The changes to the UK's thin capitalisation rules, announced in the Chancellor's 1994 Budget Speech and implemented by section 87 Finance Act 1995, were a direct response to the Court of Justice's decision in *Halliburton Services BV v Staatssecretaris van Financiën* Case 1/93 [1994] STC 655, see the Budget Press Release IR 46 paragraph 5 and note 5. Ironically, the new legislation has itself been criticised as being in breach of the non-discrimination provisions of the EC Treaty.

(1) Does Article 48 restrict the right of Germany to levy income tax on a national of another Member State?

(2) Does Article 48 allow the German tax authorities to impose a higher income tax burden on a Belgian resident working in Germany?

(3) Is the answer to question (2) above affected by the fact that the Belgian resident derived almost all his income from Germany and had insufficient income in Belgium to allow his personal and family circumstances to be taken into account?

(4) Is it contrary to Article 48 for the German tax authorities to exclude non-residents from the benefit of their administrative procedures to assess residents, *inter alia*, in accordance with their overall ability to pay?

According to the Court of Justice, the answer to all these questions was "yes". As to the first question, the Court of Justice held that EC legislation made it clear that the principle of free movement of workers required that nationals of a Member State working in another Member State enjoyed the same taxation treatment as nationals of that other Member State working there.[7] The Court said that it had been established in *Biehl v Administration des Contributions*[8] that the principle of equal treatment with regard to remuneration would be rendered ineffective if it could be undermined by discriminatory national provisions on income tax.

The Court then considered the second and third questions together. The essential issue for the Court was whether the German legislation involved discrimination on the grounds of nationality. Like most tax systems, the German tax legislation was not based on the taxpayer's nationality but on his or her residence. It has been held in other cases, most notably in *R v Inland Revenue Commissioners ex parte Commerzbank*[9] in the context of Article 52,[10] that the use of a criterion of fiscal residence is liable to work more particularly to the disadvantage of nationals of

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7 Article 7 of Council Regulation EEC No. 1612/68 15 October 1968 on freedom of movement of workers within the Community, OJ English Special Edition 1968, (II) p 475.

8 Case C-175/88 [1990] ECR I-1779, [1990] 3 CMLR 143, paragraph 12.

9 Case C-330/91 [1993] ECR I-4017, [1993] 3 CMLR 457.

10 Which, read in conjunction with Article 58, applies the principle of freedom of establishment in Member States to enterprises.

other Member States and therefore can be discriminatory.[11] Thus the proposition that tax benefits granted only to residents of a Member State could constitute indirect discrimination by reason of nationality to nationals of other Member States was accepted as settled law in *Schumacker*.[12]

However, there had been indications in earlier cases that some form of discrimination based on residence could be justified. In *EC Commission v France*,[13] for instance, the Court of Justice said:

> "... distinctions based on the location of the registered office of a company or the place of residence of a natural person might, under certain conditions, be justified in an area such as tax law ...."[14]

It was generally thought that the different treatment of nationals of other Member States was only discriminatory if those nationals were, in all material respects, in the same position as a Member State's own nationals. Discrimination would be justified if the non resident and the resident were in objectively different situations. This is now confirmed by *Schumacker*:

> "It is also settled law that discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations."[15]

Since in many of the cases which have come before the Court of Justice, the taxing authorities have lost because they have made an incorrect comparison of the tax

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11 For authority on Article 48 itself see *Biehl v Administration des Contributions* supra, paragraph 14: "Even though the criterion of permanent residence in the national territory ... applies irrespective of the nationality of the taxpayer concerned, there is a risk that it will work in particular against taxpayers who are nationals of other Member States."

12 See paragraphs 28 and 29 of the judgment.

13 Case 270/83 [1986] ECR 273, [1987] 1 CMLR 401.

14 Ibid., paragraph 22.

15 See paragraph 30 of the judgment. Cf Article 73d of the EC Treaty which specifically provides that Member States are free to apply national tax provisions distinguishing between taxpayers who are not in the same position with regard to residence so long as the measures are not a means of arbitrary discrimination or covert restriction on the basic freedom.

treatment of residents and non-residents[16] they were no doubt relieved to hear the Court confirm in *Schumacker* that:

> "In relation to direct taxes, the situations of residents and non-residents are not, as a rule, comparable .... Consequently, the fact that a Member State does not grant to a non-resident certain tax benefits which it grants to a resident is not, as a rule, discriminatory since those two categories of taxpayer are not in a comparable situation."[17]

However, as readers will be well aware, Mr Schumacker won his case. How did he manage to do this in the light of the above statement? The reason, according to the Court of Justice, was that Mr Schumacker received "no significant income" in Belgium and he obtained the "major part of his taxable income" in Germany. This meant that he had insufficient taxable income in Belgium to allow account to be taken of his family and personal circumstances there. In such circumstances, the Court held, there was no objective difference between the situations of a resident taxpayer and a non-resident taxpayer engaged in comparable employments. Accordingly, Mr Schumacker had earned the right to have his family circumstances taken into account in computing his tax liability in Germany.

What constitutes a "significant income" in the taxpayer's own Member State is, apparently, "sufficient income to be subject to taxation there in a manner enabling his personal and family circumstances to be taken into account". This will vary with Member States' tax systems, but, as far as the UK is concerned, presumably it means that the taxpayer must have sufficient UK income to ensure that the individual's personal income tax allowances can be taken into account.[18] The logical conclusion is that a UK taxpayer who derives all his *income* from (say) an employment in Germany but has UK taxable *capital gains* which, obviously, cannot be used to offset his UK income tax reliefs, can claim German income tax reliefs on the grounds that, for income tax purposes, he or she is in the same position as a German taxpayer working in Germany.[19]

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16 *EC Commission v France* supra; *Biehl v Administration des Contributions* supra; and *R v IRC ex parte Commerzbank* supra cf *Werner v Finanzamt Aachen-Innestadt* Case 112/91 [1993] ECR I-429, discussed in the conclusion to this note.

17 See paragraphs 31 and 34 of the judgment.

18 For example, the personal allowance, the married couples allowance and any age allowance.

19 An interesting question is how far the Court of Justice might be prepared to go in developing an anti-avoidance doctrine if taxpayers (in conjunction with their employers) sought to manipulate the source of their income to take the benefit of Member States' differing tax regimes. In the context of Article 52 the Court has shown itself alive to the possibility of such tax planning by, in effect,

As far as the meaning of a "major" part of the taxpayer's income coming from the Member State in which he or she works is concerned, the Court said that it meant that the taxpayer's income was "derived entirely or almost exclusively from the work performed" there. Mr Schumacker derived over 90% of his income from Germany and so he clearly satisfied the condition. Query whether deriving 85% of his income would have qualified, or a lesser sum (say) 75%. It is interesting to note, that in 1993, the EC Commission recommended that Member States should not tax the employment income of non-residents more heavily than residents if the non-resident's income from the relevant Member State constituted at least 75% of the non-resident's total income.[20] If the vagueness of the test adopted by the Court of Justice in *Schumacker* results in Member States adopting a 75% test, the Commission will have managed to get its proposal adopted by the backdoor. Indeed, some countries have already "complied" with the EC Commission's recommendation. It was, for instance, noted in a previous issue of this *Journal* that full Irish personal tax allowances are made available to residents of other Member States who derive 75% or more of their total income from Ireland.[21]

In any event, a "test" for discrimination which is based on how much income is derived from a particular country will cause problems for tax authorities who have to verify the taxpayer's claims as to quantum and source. In spite of this, the Court of Justice had little time for the German tax authority's argument that a ruling in the taxpayer's favour would impose administrative difficulties in attempting to ascertain the income of non-residents working in Germany. The lack of sympathy shown by the Court is not surprising given that it has been established in other cases that administrative difficulties will not justify Member State's breaching EC Treaty requirements.[22] As it has done before,[23] the Court of Justice pointed out in *Schumacker* that the taxing authorities could rely on the EC

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denying participants the benefit of the EC Treaty *R v HM Treasury and Commissioners of Inland Revenue ex parte Daily Mail and General Trust plc* Case 81/87 [1988] ECR 550, [1988] 3 CMLR 713.

20 Commission Recommendation of 21st December 1993 (94/79). OJ 1994 L39/22.

21 John Hickson, ECTJ Volume 1 Issue 1 1995/96 at p.82.

22 See, for example, the rejection of the Netherlands government's argument in *Halliburton Services BV v Staatssecretaris van Financiën* Case 1/93 [1994] STC 655 that it was unable to check whether legal entities incorporated in other Member States were equivalent to Netherlands incorporated companies.

23 *Halliburton Services BV v Staatssecretaris van Financiën* supra. That case also established that the Member State had to accept any additional costs that this imposed. Only in very exceptional cases, if at all, could Member States rely on the argument that verification was unreasonably costly.

Directive on mutual assistance[24] to obtain the necessary information from the tax authorities of other Member States. The Court also pointed out that Germany and the Netherlands had entered into an agreement providing that if Netherlands resident taxpayers received 90% of their income from Germany, those nationals would be treated in the same way as German nationals for the purpose of taking into account their personal and family circumstances in computing their liability to German tax.[25] Such "praying in aid" of bipartite agreements by the Court of Justice is, in the author's view, somewhat unfair given that in previous cases the Court has held that the existence of discrimination should be determined without reference to the existence of double tax treaties.[26] This has the result that governments cannot plead that any discrimination implicit in their national tax system is mitigated by the existence of double tax treaties. But if governments cannot rely on the existence of double tax treaties to defend discrimination claims they may, with some justification, feel hard done by if those same treaties are cited against them as evidence of the administrative workability of the Court's decision. Further, in *Schumacker* itself, the Court's assertion that the administrative difficulties of determining non-residents' income should be disregarded sits somewhat uneasily with its earlier acknowledgment that:

> "... a non-resident's personal ability to pay tax, determined by reference to his aggregate income and his personal and family circumstances, *is more easy to assess* [emphasis supplied] at the place where his personal and financial interests are centred. In general, that is at the place where he has his usual abode. Accordingly, international tax law, and in particular the Model Double Taxation Treaty of the Organisation for Economic Co-operation and Development (OECD), recognises that in principle the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the State of residence."[27]

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[24] Council Directive 77/799/ECC of 19th December 1977 as amended by Council Directive 79/1070/EEC of 6th December 1979. Under this Directive the tax authorities may exchange any information which may enable them to assess correctly taxes covered by the Directive. However, tax authorities may refuse to supply information if, *inter alia*, they would be prevented by the laws of their jurisdiction or administrative practices from carrying out particular enquiries or from collecting or using the information for their own purposes.

[25] German Law of 21st October 1980 implementing the additional protocol of 13th March 1980 to the Germany/Netherlands double tax treaty.

[26] See, for example, *EC Commission v France* supra, paragraphs 25 and 26; and *Bachmann v Belgium* Case 204/90 [1992] ECR I 249, [1993] 1 CMLR 785.

[27] Paragraph 32 of the judgment. A residence based (as opposed to source based) system for taxing migrant workers has historically been favoured by the EC Commission (see Easson, *Taxation in the European Community* (1993) at p. 232) but cf the latest EC Commission's proposals at footnote 19.

Finally, as regards the fourth question, the Court held that Article 48 required equal treatment at procedural level as well as at the level of the Member State's substantive law. That being the case, it was insufficient that a non-resident could obtain equal treatment by relying on equitable (but non-binding) measures adopted by the tax administration on a case by case basis to treat non-residents in the same way as residents.[28] Thus the German government had to alter its procedural rules as well as its substantive rules in order to comply with Article 48.

Conclusion

Put simply, whether or not a Member State can treat non-resident individuals differently for income tax purposes from resident individuals now turns on how much of the non-resident individual's taxable income is derived from sources within that State. The question is not "are residents taxed differently from non-residents" but the more sophisticated question "are non-residents who derive the major part of their income from the Member State in which they work treated in the same way as residents who derive the major part of their income from the State in which they reside?" Member States who have double tax agreements with other Member States which adopt Article 24(3) of the 1992 OECD Model Tax Convention that a contracting state is not obliged to grant residents of other contracting states the personal deductions, reliefs and rebates which it grants its own residents on account of family responsibilities, will find these articles ineffective if the non-resident taxpayer falls within the "*Schumacker* criteria".

In effect, a new category of employee, the "frontier worker", has been created for the purposes of Article 48 of the EC Treaty. A frontier worker for these purposes is an employee who works in another Member State and earns substantially all his or her income there. Such an employee is to be treated for income tax purposes as though he or she were resident in the Member State in which he or she works. Frontier workers will be treated differently from other non-residents who can generally be taxed in accordance with the Member State's rules applicable to non-residents. Whether this outcome could have been predicted from the wording of Article 48 is debatable. Certainly, as the number of companies employing frontier workers and other cross-border employees grows, the view of one practitioner who commented that "far from making the expatriate's life easier, decisions [such as *Schumacker*] develop the complex nature of expatriate tax planning further"[29] may become commonplace.

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[28] Paragraph 57 of the judgment. See also *Biehl v Administration des Contributions* supra. Interestingly, the Court did not discuss how far the principle of subsidiarity would prevent the Court of Justice from becoming involved in matters of a Member State's procedure and administration.

[29] Rosell, *Taxation* 8th June 1995 pp 260-263.

A separate point is that it is regrettable that the decision in *Schumacker* does not shed any further light on the principle developed in *Bachmann v Belgium*[30] that discriminatory tax treatments may be justified by the need to safeguard the coherence[31]of the tax system, "the formulation of which is a matter for each Member State".[32] Governments in other cases which have attempted to defend their discriminatory provisions on the grounds that they are needed to preserve the integrity of their tax systems have been unsuccessful,[33] and it is thought that the explanation of the decision in *Bachmann* is that it is limited to cases where there is a direct link between the tax relief sought and the tax charge imposed. This argument was advanced by various governments in *Schumacker*, i.e., that the different tax treatment of non-residents and residents was justified on the basis that there was a link between taxing the world-wide income of the taxpayer and taking into account the taxpayer's personal and family circumstances. If, it was argued, the Member State where the taxpayer worked took account of the taxpayer's family and personal circumstances as well as the State of residence, the taxpayer would be benefiting twice. This argument was dismissed by the Court of Justice, the Court saying simply that the Community principle of equal treatment required the non-resident State to take into account the taxpayer's family circumstances where this could not be done in the State of residence and the distinction in issue was in no way required to ensure the cohesion of the tax system.[34] It thus seems that the Court is prepared to see the uncertainty as to the ambit of the *Bachmann* principle continue and taxpayers and their advisers must wait for other cases to develop the Court's jurisprudence in this area.[35]

Finally, the authority of the Court of Justice's earlier decision in *Werner v Finanzamt Aachen-Innestadt*[36] is now doubtful. It will be recalled in *Werner* that the taxpayer, a German national, resided in the Netherlands but carried on business

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30 Case 204/90 [1992] ECR I-249, [1993] 1 CMLR 785.

31 Or, possibly, "cohesion" - see the French judgment in *Bachmann*.

32 See paragraph 23 of the judgment.

33 See, for example, *EC Commission v France* [1986] ECR 273.

34 Paragraphs 41 and 42 of the judgment.

35 The explanation offered by Advocate General Léger was that the Court of Justice applies the "rule of reason" to discriminatory tax rules (see paragraph 48 of his opinion). This may represent a move towards the approach recommended by Farmer and Lyal in *EC Tax Law* at p 331 that "it would be preferable for the Court, rather than making rigid and possibly fragile distinctions, to weigh up in each case the severity of the restriction and the importance of the national interest at stake."

36 Case C-112/91 [1993] ECR I-429.

as a dentist in Germany. The taxpayer's only income came from his dental practice. Like Mr Schumacker, Mr Werner was subject to German income tax as a non-resident and therefore could not take the benefit of the income splitting rules. However, unlike Mr Schumacker, Mr Werner failed in his claim that this constituted a breach of the EC Treaty.[37]

In *Schumacker*, Advocate General Léger noted that "the factual and legal aspects" of *Werner* and *Schumacker* were very similar. Nevertheless, he concluded that *Werner* had been correctly decided because, as a German national working in Germany, Mr Werner "never exercised the freedoms conferred by the Treaty, particularly that of establishing himself in another Member State".[38] According to Advocate General Léger, this could be contrasted with *Schumacker* since in that case the taxpayer was a Belgian national who had acquired his qualifications and professional experience elsewhere and had exercised the right of freedom of movement for workers to go to Germany and take up employment there.

It has been noted elsewhere the "the Court's conclusion [in *Werner*] that there was no Community dimension seems curious given that the cross-frontier element, [Mr Werner's] non-residence, was the sole cause of the alleged discriminatory restriction on his self-employment in Germany. ... In holding in effect that no Treaty freedom was in issue the Court adopted a rather narrow approach to the Treaty."[39] The Court's judgment in *Schumacker* does not refer to *Werner* and, notwithstanding the opinion of Advocate General Léger, it may be that this is an implicit acknowledgement that *Werner* is no longer good law.

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37 The taxpayer, as a self-employed businessman, argued that the German rules were in breach of Article 52 of the EC Treaty. It is submitted that nothing turns on the fact that the claim related to Article 52 as opposed to Article 48 in this context.

38 Paragraph 33 of Advocate General Léger's opinion. Cf the position of Mr Werner's wife — who, as a Dutch national working as an employee in her husband's dental practice in Germany, was certainly exercising her rights under Article 48.

39 Farmer and Lyal, *EC Tax Law* (1994) at pp 323-324. See also the comments of Flynn and Brannan *Tax Journal* 21st July 1995 at p 75 that *Werner* "is plainly a narrow decision and might have to be reconsidered with slightly different facts ... Whether the German tax authorities were justified in treating him differently from a resident when in effect he had a permanent establishment in Germany was the real issue in the case, but the Court did not feel able to address it."