EUROPEAN TAX CONTROVERSIES - QUIS CUSTODIET IPSOS CUSTODES?*

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Introduction

In his thought provoking article, published in EC Tax Review in 2009,[2] Professor Michael Lang forcefully argued that judgments of the ECJ contradicted each other. After an in-depth analysis of selected EU tax issues, he suggested that the Court should overturn some of its case law and that it should be more consistent. He argued that the Court should refrain from introducing new grounds of justification which lead to uncertainty and that the Court should make it explicit whenever it changes its case law.

More recently, Professor Pasquale Pistone examined the impact of the ECJ's jurisprudence on national tax systems and was highly critical of some of the Court's judgments in the direct tax field.[3] Professor Adolfo Martín Jiménez of the University of Cadiz has also expressed serious concerns about the Court's case law relating to

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2 Michael Lang, "*Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions",* EC Tax Rev. 2009, 3, 98-113.

3 Pasquale Pistone, *"The Impact of ECJ Case Law on National Taxation",* (2010) Bull. I.T., 8/9, 1.

transfer pricing and thin capitalisation.[4] In a July 2010 article concerning the Court's decision in *X Holding BV*,[5] Professor Servaas Van Thiel and Marius Vascega stated that "the authors remain perplexed as to how it is possible that, in a single decision, so many lines of settled case law were ignored, and ask whether or not, in this Court, with all its different judges and Advocates General, there is anybody left that is capable of steering this institution back to its core business of ensuring that, in the interpretation and application of the treaties, the law is observed." [6]

This essay critically analyses the key arguments in Lang's paper and endeavours to provide some alternative views and generate some new discussions of these EU tax issues. Lang suggests that the ECJ needs to receive criticism and that "it is the responsibility of academics not so much to praise the Court where its case law is convincing but to point at possible tensions or contradictions". The thesis advanced in this essay is that the Court's direct tax jurisprudence fits together in a coherent and sensible way even though it is constantly evolving, that much of the criticism in the tax scholarship is often wrong, ill-considered and inappropriate and that many of the "tensions and contradictions" exist purely in the academic scholarship.

This essay is divided into three parts. Part I examines some of Lang's main arguments on comparability, discrimination and restriction. Part II focuses on justification and proportionality issues. Part III sums up the debate, draws some conclusions and opens the door for some fresh discussions.

Part I

Comparability

Lang opens the debate with an analysis of "comparability" which, in an EU tax context, comes into play whenever a Member State's tax system treats a person exercising one of the fundamental freedoms or EU citizenship rights less favourably than a comparable person conducting a similar activity in the same Member State.[7]

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4 Adolfo Martín Jiménez, *"Transfer Pricing and EU Law Following the ECJ Judgement in SGI: Some Thoughts on Controversial Issues",* (2010) Bull. I.T., 5, 1.

5 ECJ, 25 Feb. 2010, Case C-337/08, *X Holding B.V. v Staatssecretaris van Financiën,* [2010] ECR I-0000 (not yet reported). For analysis, see Tom O'Shea, "*Dutch Fiscal Unity Rules Receive Thumbs up from the ECJ*", Tax Notes International, Mar. 8, 2010, 835-838. For some very critical comments on the Court's judgment, see Servaas Van Thiel and Marius Vascega, *"X Holding: Why Ulysses Should Stop Listening to the Siren",* E.T. 2010, 8, 334-349.

6 See previous footnote.

7 Professor Lang sees comparability a bit differently to this author, favouring also a "horizontal discrimination" approach, involving the different treatment of two non-residents by a Member State's tax rules. This is analysed further below.

In other words, a comparability analysis is required in order to determine whether the national exercising the free movement right is disadvantaged compared to a another national who is conducting a similar activity in either the host or origin state depending on the circumstances of each individual case.

This "national treatment test" was clearly set out in paragraph 94 of *De Groot*, where the Court stated that "as far as the exercise of the power of taxation so allocated is concerned, the Member States must comply with the Community rules… and, more particularly, respect the principle of national treatment of nationals of other Member States and of their own nationals who exercise the freedoms guaranteed by the Treaty".[8] Thus, the national treatment principle applies from both an origin Member State and a host Member State perspective. What does this mean in practice?

Example

A Member State (say, France) is under an obligation to respect the national treatment of "nationals of other Member States" who exercise one of the fundamental freedoms or EU citizenship rights in France. In such circumstances France acts as a "host" Member State and the persons concerned are affected by a French tax rule and not by a tax rule in their origin Member State. An example of this type of situation from the Court's jurisprudence is seen in *Avoir Fiscal*,[9] where foreign insurance companies resident in Member States other than France, that had established branches in France, were treated less favourably than French resident companies even though they were in a comparable situation because they were taxed in a similar way to French resident companies.[10]

The second aspect of the principle provides that a Member State is under an obligation to respect the national treatment "of their own nationals who exercise the freedoms" in which case France is the origin Member State and it is a French tax rule which impedes, hinders, discourages, or makes less attractive the exercise of one of the fundamental freedoms or EU citizenship rights by a French national. It is not a tax rule in the host Member State that

8 ECJ, 12 Dec. 2002, Case C- 385/00, *F.W.L. de Groot v Staatssecretaris van Financiën*, ("*De Groot*"), [2002] ECR I-11819.

9 ECJ, 28 Jan. 1986, Case 270/83, *Commission v France ("Avoir Fiscal"),* [1986] ECR 273. For analysis, see Tom O'Shea, "*Freedom of Establishment Tax Jurisprudence: Avoir Fiscal Re-visited"*, EC Tax Review *2008, 6, 259-275* and Tom O'Shea (ed.), "*From Avoir Fiscal to Marks & Spencer*", [2006] 41 Tax Notes International, 587-612.

10 See *Avoir Fiscal* paragraph 19.

is causing the problem. An example from the Court's jurisprudence is seen in *De Lasteyrie*,[11] a case involving French exit tax rules.

De Lasteyrie left France to settle in Belgium. Upon emigration, he was taxed on the latent gains in the values of some shares. He argued that these tax rules hindered his freedom of establishment in another Member State. In this situation, France was an origin Member State and it was its exit-tax rules that caused the restriction on the exercise of the right of establishment of one of its own nationals. The tax rule causing the problem was not that of the "host" State, Belgium.[12]

Less Favourable Tax Treatment

The disadvantageous tax treatment mentioned above can take a number of forms. It can involve discrimination on grounds of nationality (direct discrimination) or on grounds of residence (indirect discrimination). Alternatively, it can involve a restriction of one or more of the fundamental freedoms. A disadvantage can also occur in relation to an "even-handed" tax rule where there is no less favourable tax treatment of the cross-border situation compared to the domestic but the tax rule at issue may still amount to indirect discrimination or an obstacle to the exercise of one or more of the fundamental freedoms.[13]

Discrimination and Restriction

Advocate General Geelhoed in *ACT IV GLO*[14] stated that there was "no practical difference" between "discrimination" and "restriction".[15] Whilst both involve a

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11 ECJ, 11 Mar. 2004, Case C-9/02, *Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie, ("De Lasteyrie"),* [2004] ECR I-2409.

12 This national treatment principle appears in the Court's jurisprudence across the fundamental freedoms and also in its EU citizenship case law. This is discussed in more detail below. See also, Tom O'Shea, "*National Treatment",* The Tax Journal, 26 January 2009, 22-23.

13 For an example, see *Bosman*. ECJ, 15 Dec. 1995, Case C-415/93, *Union royale belge des sociétés de football association ASBL v Jean-Marc Bosman, ("Bosman"),* [1995] ECR I-4921.

14 ECJ, 12 Dec. 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue, ("ACT IV GLO"),* [2006] ECR I-11673. For a more detailed analysis of the *ACT IV GLO* judgment see Tom O'Shea, *"Dividend Taxation Post-*Manninen: *Shifting Sands or Solid Foundations?"* Tax Notes International, 5 March 2007, 887-918.

15 See Opinion of Advocate General Geelhoed in *ACT IV GLO,* point 36.

comparability analysis, it seems clear that there are some practical differences between the two. First, a tax rule which does not discriminate (whether on grounds of nationality or indirectly on grounds of residence) may still constitute a restriction or an obstacle to the exercise of the fundamental freedoms. This is clear from cases like *Futura*[16] and *Truck Center*[17] where the ECJ conducted a discrimination analysis and found that the national tax rules at issue were not discriminatory but still went on to check whether the rules amounted to a restriction on the fundamental freedoms. In *Futura*, the Court concluded that, in one respect, the Luxembourg loss-relief rules amounted to a restriction on the freedom of establishment, whereas in *Truck Center*, the Court found that there was no restriction on the freedom of establishment or on the free movement of capital. Second, from the perspective of an origin Member State, there can be no discrimination on grounds of nationality but only a restriction on the exercise of a fundamental freedom. This is because from an origin Member State perspective[18] the comparator involves a comparison between two origin Member State nationals. By contrast, from a host Member State perspective, the comparator can involve a comparison between nationals from different Member States. Thus, discrimination on grounds of nationality can occur only in a host Member State environment.[19]

Deutsche Shell – discrimination or restriction?

In relation to determining the correct comparator, Lang analysed the *Deutsche Shell* judgment[20] and stated that it is "sometimes quite burdensome to determine the correct comparator" and went on to suggest that "the Court in substance had activated its often repeated but rarely used phrase according to which 'discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations'. In his analysis, Lang stated that "[d]iscrimination arises since the currency loss cannot

16 ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v Administration des contributions ("Futura"),* [1997] ECR I-2471.

17 ECJ, 22 Dec. 2008, Case C-282/07, *Belgian State - SPF Finances v Truck Center SA ("Truck Center"),* [2008] ECR I-

18 In relation to free movement of capital, it should be noted that there may be discrimination from an origin State perspective based on the place of investment. The comparator in such circumstances will involve the different treatment of an investment made in another Member State compared with a similar investment made in the origin Member State.

19 This is explained in more detail in the next section.

20 ECJ, 28 Feb. 2008, Case C-293/06, *Deutsche Shell GmbH v Finanzamt für Großunternehmen in Hamburg ("Deutsche Shell"),* [2008] ECR I-1129. For analysis, see Tom O'Shea, "*German Currency Loss Rules Incompatible With EU Law*, ECJ Says", Worldwide Tax Daily, 2008 WTD 44-2.

be deducted in either situation, despite the additional risk existing in cross-border situations".

From this analysis one might surmise that the ECJ decided the case on the basis of a discrimination analysis. However, a perusal of the judgment shows that this was not the case.[21] The judgment of the Court was clearly based on a restriction analysis. In paragraph 27, the Court investigated immediately whether the German tax rules at issue constituted "an obstacle to the exercise of the freedom of establishment". A few paragraphs later the Court determined that the tax system at issue amounted to an obstacle to the freedom of establishment[22] and the Court went on to reject the justifications argued by the German Government. There was no discrimination analysis conducted by the Court.

The question arising from this analysis is why discrimination was not considered by the Court in the way that Lang suggested. The answer appears to lie in the fact that *Deutsche Shell* is an origin state case - the tax rules at issue were German and it was a German company that had exercised its freedom of establishment in Italy. Since this represented an origin state situation, the correct comparator was between Deutsche Shell, a German company exercising its establishment rights in Italy, and another German company opening a similar establishment in Germany.[23] From an origin Member State perspective, this comparison is always between two nationals of that Member State and, as such, discrimination on grounds of nationality does not enter the picture.

Origin Member States and Discrimination

From an origin Member State standpoint, the national treatment principle is concerned with a restriction of (or an obstacle to) the fundamental freedoms or EU citizenship rights of nationals of the origin Member State. The Court has pointed this

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21 Indeed, there is no reference in the judgment to discrimination.

22 *Deutsche Shell* paragraph 32.

23 Grahame Turner points out that the origin State company incurred a disadvantage because of what it did. The Head Office bought Lira and suffered a loss when it eventually sold the currency. That loss was disallowed for tax purposes because the currency was loaned to a foreign permanent establishment and the German authorities considered that the loss should be accounted for by the permanent establishment. If the Head Office had loaned Deutschmarks to the permanent establishment that is where the loss would have been borne and booked. Peter Cussons makes the point that the Court's analysis was incomplete because German companies were prohibited from having anything other than Deutschmarks as their accounting (i.e. functional) currency. Therefore, it was not possible to compare a German company with a foreign exchange loss with another Germany company. For this author's analysis, see footnote 20 above.

out consistently in its jurisprudence since *Daily Mail*. [24] Thus, in *Keller Holding*,[25] the Court, repeating its *Dail Mail* mantra, highlighted that "even though, according to their wording, the provisions concerning freedom of establishment are directed to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, *they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation*".

This rather different understanding of the Court's case law from that promoted by Lang explains why the Court never discusses discrimination in its origin state direct tax cases and why the Court in *Marks and Spencer,*[26] avoided any discrimination analysis in its judgment despite the considerable emphasis placed on this by Advocate General Maduro in his Opinion[27] and the discrimination arguments put forward by the parties before the Special Commissioners.[28]

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24 See ECJ, 27 Sep. 1988, Case 81/87, *The Queen v H. M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc. ("Daily Mail"),* [1988] ECR 5483, paragraph 16.

25 ECJ, 23 Feb. 2006, Case C-471/04, *Finanzamt Offenbach am Main-Land v Keller Holding GmbH ("Keller Holding"),* [2006] ECR I-2107, paragraph 30 (emphasis added).

26 ECJ, 13 Dec.2005, Case C- 446/03, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes) ("Marks and Spencer"),* [2005] ECR I-10837. For a detailed analysis of the case see Tom O'Shea, *"Marks and Spencer v Halsey (HM Inspector of Taxes): Restriction, Justification and Proportionality",* (2006) EC Tax Rev. 2, 66-82.

27 See Opinion of Advocate General Poiares Maduro in *Marks and Spencer*.

28 See the Special Commissioners Decision in *Marks and Spencer,* 17 December 2002, [2003] STC (SCD) 70.

Host Member States and Discrimination

Discrimination on grounds of nationality only occurs in relation to a host state situation because the correct comparator, generally speaking,[29] is between a national of the host Member State and a national of another Member State exercising a fundamental freedom (or EU citizenship rights). Different tax treatment of the person exercising the fundamental freedom in such circumstances can be on the basis of discrimination or restriction. There can be direct discrimination on the grounds of nationality, indirect discrimination on the grounds of residence or simply a restriction or obstacle to the exercise of a fundamental freedom or EU citizenship right. In other words, in a host state situation there can be different tax treatment of a foreign national compared to a host state national whereas in an origin state setting, the comparator always involves two origin state nationals. Whenever you have the possibility of different treatment of foreign nationals, any differentiation on grounds of nationality or residence may trigger a discrimination situation.[30]

Comparison of two cross-border situations

Lang places great emphasis on the Court's jurisprudence relating to the comparison of two cross-border situations (so-called "horizontal discrimination"), indicating that for a long time the Court has accepted that "[d]ifferent cross-border situations have in many cases been found comparable". In support of this view he cites cases like

29 "Generally speaking" because the situation could involve two host Member State nationals, where one of them is exercising a fundamental freedom right vis-à-vis their origin Member State. For an example, see ECJ, 7 Jul. 1992, Case C-370/90, *The Queen v Immigration Appeal Tribunal and Surinder Singh, ex parte Secretary of State for Home Department* ("*Singh*") [1992] ECR I-4265. Also, the situation could involve a third country national exercising a fundamental freedom right in the host Member State such as the free movement of capital which has been extended to third country nationals. For examples, see *Sanz de Lera*, *FII GLO* and *Thin Cap GLO*. ECJ, 14 Dec. 1995, Joined Cases C-163/94, C-165/94 and C-250/94, Criminal proceedings against *Lucas Emilio Sanz de Lera, Raimundo Díaz Jiménez and Figen Kapanoglu ("Sanz de Lera"),* [1995] ECR I-4821; ECJ, 12 Dec. 2006, Case C-446/04, *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue ("FII GLO"),* [2006] ECR I-11753; ECJ, 13 Mar. 2007, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue ("Thin Cap GLO"),* [2007] ECR I-2107. It should be noted that, from a free movement of capital and origin State perspective, there can be discrimination based on the place where the investment is made.

30 See, for instance, ECJ, 26 Apr. 1999, Case C-311/97, *Royal Bank of Scotland plc v Elliniko Dimosio (Greek State),* [1999] ECR I-2651.

the *D case*,[31] *Cadbury Schweppes* [32] and *Denkavit Internationaal*.[33] It is submitted that the Court has never compared two non-residents in its case law and has had no reason to do so. This is easiest to explain using the *Cadbury Schweppes* case.[34]

> *Example: Cadbury Schweppes*
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> In *Cadbury Schweppes*, the UK's controlled foreign companies (CFC) rules were challenged by a UK parent company which had set up a subsidiary and a sub-subsidiary in Ireland, to carry on treasury management operations on behalf of the group and to take advantage of a 10% tax regime. The UK tax authorities took the view that the UK's CFC rules applied and, accordingly, assessed the UK parent company to an additional sum equivalent to corporation tax related to the profits of the CFCs located in Ireland. The UK parent company argued that the UK's CFC rules were incompatible with its right of establishment.
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> The ECJ noted that "[w]here the resident company has incorporated a CFC in a Member State in which it is subject to a lower level of taxation within the meaning of the legislation on CFCs, the profits made by such a controlled company are, pursuant to that legislation, attributed to the resident company, which is taxed on those profits. Where, on the other hand, the controlled company has been incorporated and taxed in the United Kingdom ***or in a State in which it is not subject to a lower level of taxation within the meaning of that legislation***, the latter is not applicable and, under the United Kingdom legislation on corporation tax, the resident company is not, in such circumstances, taxed on the profits of the controlled company".[35] The Court went on to explain that "the separate tax treatment

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31 ECJ, 5 Jul. 2005, Case C-376/03, *D. v Inspecteur van de Belastingdienst/ Particulieren/Ondernemingen buitenland te Heerlen ("D case")*, [2005] ECR I-5821.

32 ECJ, 12 Sep. 2006, Case C-196/04, *Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue ("Cadbury Schweppes"),* [2006] ECR I-7995.

33 ECJ, 14 Dec. 2006, Case C-170/05, *Denkavit Internationaal BV and Denkavit France SARL v Ministre de l'Économie, des Finances et de l'Industrie ("Denkavit Internationaal"),* [2006] ECR I-11949. For analysis, see Tom O'Shea, *"Dividend Taxation Post-*Manninen: *Shifting Sands or Solid Foundations?"* Tax Notes International, 5 March 2007, 887-918 at 911.

34 For an in-depth analysis of *Cadbury Schweppes*, including a discussion of the "horizontal discrimination" point, see Tom O'Shea, "The UK's CFC rules and the freedom of establishment: *"Cadbury Schweppes plc and its IFSC subsidiaries – tax avoidance or tax mitigation?"* (2007) EC Tax Rev. 1, 13-33.

35 See paragraph 44 of the judgment (emphasis is added).

under the legislation on CFCs and the resulting disadvantage for resident companies which have a subsidiary subject, in another Member State, to a lower level of taxation are such as to hinder the exercise of freedom of establishment by such companies, dissuading them from establishing, acquiring or maintaining a subsidiary in a Member State in which the latter is subject to such a level of taxation. They therefore constitute a restriction on freedom of establishment within the meaning of Articles 43 EC and 48 EC".[36]

Lang argues that "a UK corporation with a subsidiary in a low tax jurisdiction was not only held comparable with a UK corporation with a domestic subsidiary but also with UK corporations with subsidiaries in other Member States where no beneficial tax regime is applicable". This thinking is based on paragraph 44 of the Court's judgment, highlighted above. However, it is submitted that this thinking is unsound.

Cadbury Schweppes is an origin state case and, therefore, the correct comparator involves two UK parent companies – one, where a UK parent company is exercising its freedom of establishment by setting up a subsidiary in Ireland (another Member State), the other is a UK parent company which has set up a subsidiary in the UK (or in another Member State where the CFC rules do not apply because that state applies a sufficient level of taxation to avoid triggering the UK's CFC rules). In other words, the tax treatment of a company exercising the freedom (which is affected by the CFC rules) is compared with the tax treatment of a similar company operating a subsidiary domestically or in another Member State (not affected by the CFC rules). There is no suggestion in the Court's judgment that two non-UK situations were comparable. In fact, the Court equated the UK domestic situation with a situation in another Member State since in both instances the UK CFC rules did not apply.[37] However, for the purposes of a restriction on the freedom of establishment it is clear that one leg of the comparison must involve an exercise of the freedom by an origin state company where that freedom is potentially restricted by the UK's CFC legislation and the second leg of the comparator must involve a UK parent company opening an establishment in either the UK or in another Member State where the UK's CFC rules are not triggered. This is a comparison between two UK companies.

The Court applied similar reasoning in *Denkavit Internationaal,* which involved withholding taxes imposed by France on a dividend paid by a French resident company to its Dutch parent company. If a similar dividend

36 See *Cadbury Schweppes* paragraph 46.

37 This was pointed out in the literature in 2007. See footnote 34 above, at page 29.

were paid to a French parent company, the dividend payment would be almost entirely exempt from taxation. Lang's argument is based on paragraph 36 of the judgment where the Court specified that "parent companies receiving dividends paid by resident subsidiaries, are, as regards the taxation in France of those dividends, in a comparable situation, whether they receive those dividends as resident parent companies or as non-resident parent companies which have a fixed place of business in France, or as non-resident parent companies which do not have a fixed place of business in France. ***In each of those cases, the French Republic imposes a liability to tax on dividends received from a resident company*****"**. Again, it is submitted that the Court is not comparing two cross-border situations; rather the Court is indicating a number of cross-border situations which would equally trigger a withholding tax in France. (See the highlighted sentence above). The comparator in *Denkavit Internationaal* still involved the less favourable tax treatment of a Dutch parent company receiving a dividend from a French subsidiary (because of the withholding tax) compared with the tax treatment of a similar dividend paid to a French resident company (which does not suffer withholding tax). The Court noted that "[w]hile resident parent companies may be entitled to almost full exemption from tax on dividends received, non-resident parent companies are, by contrast, subject to tax in the form of a withholding tax of 25% of the amount of dividends paid". [38] There is no comparison of two cross-border situations in this case either.

Accordingly, it is submitted that the Court's jurisprudence [39] does not support the argument that the Court compares two cross-border situations and, therefore, the "horizontal discrimination" argument must also be very suspect. Strong support for this submission is found in the Court's case law. Two examples are sufficient – *Matteucci*[40] and the *D case.*[41] *Matteucci*, which involved the free movement of workers, was the forerunner of the *D*

38 See *Denkavit Internationaal* paragraph 27.

39 See also *Amurta*. ECJ, 8 Nov. 2007, Case C-379/05, *Amurta SGPS v Inspecteur van de Belastingdienst/Amsterdam ("Amurta"),* [2007] ECR I-9569 paragraph 25 et seq. For an analysis, see Tom O'Shea, "*ECJ Strikes Down Dutch Taxation of Dividends*, Tax Notes Int'l, 14 Jan 2008, pp. 103-106.

40 ECJ, 27 Sep. 1988, Case 235/87, *Annunziata Matteucci v Communauté française of Belgium and Commissariat général aux relations internationales of the Communauté française of Belgium ("Matteucci"),* [1988] ECR I-5589.

41 ECJ, 5 Jul. 2005, Case C-376/03, *D. v Inspecteur van de Belastingdienst/Particulieren/ Ondernemingen buitenland te Heerlen ("D case")*, [2005] ECR I-5821.

case, which concerned the free movement of capital. Arguably *Matteucci* more or less provided the answer to the most-favoured nation (MFN) issue[42] in the *D case* some 20 years before the Court delivered its judgment in that case.

Matteucci and MFN Treatment

In 1988, the ECJ decided a case involving a 1956 Cultural Agreement between Belgium and Germany. Under that agreement, the contracting states agreed to provide a certain number of educational scholarships to each other's nationals. Matteucci, an Italian national working and living in Belgium, was denied a scholarship for training in Germany. She argued that this denial of a "social advantage" breached her free movement of worker rights. The ECJ held that "where a Member State gives its national workers the opportunity of pursuing training provided in another Member State, that opportunity must be extended to Community workers established in its territory".[43] The Court went on to uphold the argument of the Italian Government that "another Member State may not prevent the host Member State from fulfilling the obligations imposed on it by Community law".[44] In other words, if Belgium had to grant national treatment to an Italian national, Germany could not impede that obligation by limiting the scholarships to Belgian nationals. The Court highlighted that under Article 5 of the Treaty "every Member State is under a duty to facilitate the application of the provision and, to that end, to assist every other Member State which is under an obligation under Community law".[45]

Matteucci is a very important judgment but its significance often gets overlooked. In *Matteucci*, the Court confirmed that Belgium and Germany can in principle have an international agreement which restricts educational scholarships to the nationals of parties to that agreement. However, the scholarships have to be extended to nationals of other Member States, say Italians, who have exercised free movement of worker rights in Belgium (or Germany) and are thus entitled to be treated no less favourably than Belgian (or German) nationals. However, in relation to the MFN

42 See Tom O'Shea, *"The European Court of Justice, its D. Decision, Most-Favoured Nation Treatment and Double Tax Conventions: Comparability and Reciprocity",* in S. van Thiel (Editor), *The European Union's Prohibition of Discrimination, Most-Favoured-Nation Treatment and Tax Treaties: Opinions and Materials,* Berlin: Confederation Fiscale Europeenne, 2006, 57-76.

43 See *Matteucci* paragraph 16.

44 See *Matteucci* paragraph 18.

45 See *Matteucci* paragraph 19. This was Article 5 of the Treaty at the time of the case (Article 10 EC and now Article 4(3) TEU).

issue, it is important to note that Germany and Belgium were not obliged to grant such scholarships to all Italian nationals – only to those Italian nationals who were in a comparable situation to Belgian (or German) nationals from the point of view of the free movement of workers. Therefore, the Court, in *Matteucci*, more or less provided the solution for the *D case* because it confirmed that the Member States can conclude an international agreement (which includes a tax treaty) which treats nationals of other Member States differently from nationals of the contracting states, except in those situations where the foreign nationals are in a comparable situation to a resident of a contracting state from the perspective of an applicable fundamental freedom or EU citizenship rights. Thus, *Matteucci* may be considered to be the free movement of workers' "*D case*".

D case

Almost twenty years after *Matteucci*, in a case involving the free movement of capital, the MFN question before the ECJ was whether two Member States (Belgium and the Netherlands) could conclude a double tax convention (DTC) which treated a German national, resident in Germany, less favourably in relation to an investment made by him in the Netherlands than a resident of Belgium or the Netherlands. The Court answered in the affirmative, pointing out that the fact "that those reciprocal rights and obligations apply only to persons resident in one of the two Contracting Member States is an inherent consequence of bilateral double taxation conventions. It follows that a taxable person resident in Belgium is not in the same situation as a taxable person resident outside Belgium so far as concerns wealth tax on real property situated in the Netherlands".[46]

Lang argues that the judgment of the Court in the *D case* "indirectly confirmed that different non-residents may be in a comparable situation. The only reason why the Court did not hold that German and Belgian residents were in a comparable situation was that their different treatment was due to a tax treaty. Thus, one may assume that in other situations where the different treatment is the result of the application of domestic law, the Court is willing to compare different cross-border situations". This reasoning is, of course, somewhat flawed because Mr. D was resident in Germany. If he had been resident in Belgium or in the Netherlands he would have qualified for the disputed tax allowance in the same way as any other resident of those States. If no DTC were in place between the Netherlands and Belgium, Mr. D would still have been a resident of Germany and he would still have been a non-resident of the Netherlands or Belgium, and therefore, he would not have been in the same situation as a resident of the Netherlands or Belgium. Accordingly, both Belgium and the Netherlands could treat him differently under their tax system because he would be a non-resident of those states.

46 *D case* paragraph 61.

Thus, the *D case* does not support the argument that the Court compares two non-residents.

CLT-UFA

Finally, Lang relies on paragraph 30 of the *CLT-UFA,*[47] to support his argument that the Court compares two cross-border situations, stating that in "*CLT-UFA*, the situation of a subsidiary with a parent in another Member State was comparable to the situation of a permanent establishment with a head office in the other Member State." Again, a perusal of the case shows that in paragraph 30 the Court states that "German subsidiaries and branches of companies having their seat in Luxembourg are in a situation in which they can be compared objectively". But, this is no more than a description of the national treatment test from a host Member State perspective where the Court is comparing the tax treatment of a German resident company and the less favourable tax treatment of a (non-resident) Luxembourg company with a German branch. Indeed, it might be argued that the case added nothing new to what the Court had decided in *Avoir Fiscal*. It certainly does not support the argument that the Court compares two cross-border situations.

Schumacker should be overturned!

The *Schumacker* judgment [48] is a landmark case in the direct tax jurisprudence of the ECJ. It contains a clear statement of the Court's discrimination concept: "discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations"[49] applied in relation to direct taxes. Moreover, it is a host state case involving the free movement of workers. As such, it forms part of the bigger internal market jurisprudence of the Court and stands as a primary example of how a host Member State's direct tax rules can treat a non-resident worker less favourably than a resident worker through the denial of certain tax advantages granted to that resident worker even though the non-resident worker is in a comparable situation to that resident worker. Sound familiar? The *Schumacker* judgment is no more than an application of the Court's *Avoir Fiscal* judgment except that, in *Schumacker*, the free movement of workers is the applicable freedom, whereas in *Avoir Fiscal* the fundamental freedom at stake was the freedom of establishment. Overturning *Schumacker* would mean that the Court has to overturn its entire scheme for determining comparability

47 ECJ, 23 Feb. 2006, Case C-253/03, *CLT-UFA SA v Finanzamt Köln-West ("CLT-UFA"),* [2006] ECR I-1831.

48 ECJ, 14 Feb. 1995, Case C-279/93, *Finanzamt Köln-Altstadt v Roland Schumacker ("Schumacker")*, [1995] ECR I-225.

49 See *Schumacker* paragraph 30.

in relation to host state situations because the Court applies the same reasoning across the freedoms.[50]

Lang argues that in the *Schumacker* line of cases "the Court never required legal comparability but focused on factual comparability instead". He went on to highlight that the Court "held the situation of a resident taxpayer and a non-resident taxpayer to be comparable if: the non-resident receives no significant income in the State of his residence and obtains the major part of his taxable income from an activity performed in the State of employment, with the result that the State of his residence is not in a position to grant him the benefits resulting from the taking into account of his personal and family circumstances". This rather overlooks the way the Court analyses host Member State situations involving the exercise of a fundamental freedom or EU citizenship rights.[51]

Mr. Schumacker was subject to the German legal (tax) system and was taxed like any other German resident worker as regards his employment income except he was not granted personal allowances since under the German legal (tax) system, these tax advantages were restricted to German resident workers. Germany argued that since he was non-resident his personal allowances should be granted by his residence Member State (Belgium). Under international tax law, this state of affairs is perfectly normal and acceptable. However, in an EU setting, the Court had to take into account that Schumacker had exercised his free movement of worker rights in Germany and that "tax benefits granted only to residents of a Member State may constitute indirect discrimination by reason of nationality".[52] Accordingly, although the Court accepted that in relation to direct taxes, residents and non-residents were generally not comparable, it still had to investigate whether Schumacker's situation was comparable to that of a resident taxpayer in a similar employment. The Court held that the free movement of workers "does not in principle preclude the application of rules of a Member State under which a non-resident working as an employed person in that Member State is taxed more heavily on his income than a resident in the same employment".[53] However, the Court explained that this was not the case in a situation where "the non-resident receives no significant income in the

50 In relation to the other fundamental freedoms, see, for example, *Gerritse* (services), *Bouanich* (capital) and *Martinez-Sala* (EU citizenship). ECJ, 12 June 2003, *Arnoud Gerritse v Finanzamt Neukölln-Nord ("Gerritse"),* [2003] ECR I-5933; ECJ, 19 Jan. 2006, Case C-265/04, *Margaretha Bouanich v Skatteverket ("Bouanich"),* [2006] ECR I-923 and ECJ, 12 May 1998, Case C-85/96, *María Martínez Sala v Freistaat Bayern ("Martinez-Sala"),* [1998] ECR I-2691.

51 See Part III for a more detailed discussion.

52 *Schumacker* paragraph 29.

53 *Schumacker* paragraph 35.

State of his residence and obtains the major part of his taxable income from an activity performed in the State of employment, with the result that the State of his residence is not in a position to grant him the benefits resulting from the taking into account of his personal and family circumstances". The Court concluded that there was "no objective difference between the situations of such a non-resident and a resident engaged in comparable employment, such as to justify different treatment as regards the taking into account for taxation purposes of the taxpayer's personal and family circumstances".[54] The Court commented that "discrimination arises from the fact that his personal and family circumstances are taken into account neither in the State of residence nor in the State of employment".[55]

What is the difference between the approach of the Court in *Schumacker* to that adopted in *Avoir Fiscal, Gerritse* or *Bouanich*? Each was a host state case involving the exercise of different fundamental freedom. In each of these cases, the non-resident was found to be in an objectively comparable situation to that of a resident from the point of view of the host Member State's direct tax system. In each of these cases a legal and factual assessment was conducted to determine comparability.

The outcome, however, in *Gschwind* [56] differed from that in *Schumacker* because the Court found that the non-resident was not in a comparable situation to a German worker. The Court pointed out that the non-resident was not in a comparable situation to a German resident worker because nearly 42% of the family income was earned in the residence Member State and that this was sufficient taxable income in that State for the personal allowances to be granted. The Court noted that it was "not established that, ***for the application of tax provisions such as those in question***... a non-resident married couple of whom one spouse works in the State of taxation in question and who may, owing to the existence of a sufficient tax base in the State of residence, have his personal and family circumstances taken into account by the tax authorities of that latter State is in a situation comparable to that of a resident married couple, even if one of the spouses works in another Member State". The key point to note is that the comparability analysis was conducted in relation to the tax provisions of the employment Member State. In other words, the legal system of that State was taken into account in the comparability analysis.

Similar reasoning was applied by the Court in *Avoir Fiscal*, in relation to the freedom of establishment, where the Court held that "French tax law does not distinguish, for the purpose of determining the income liable to corporation tax, between companies having their registered office in France and branches and

54 *Schumacker* paragraph 37.

55 *Schumacker* paragraph 38.

56 ECJ, 14 Sep. 1999, Case C-391/97, *Frans Gschwind v Finanzamt Aachen-Außenstadt ("Gschwind"),* [1999] ECR I-5451.

agencies situated in France of companies whose registered office is abroad".[57] The Court went on to establish comparability between the non-resident companies with branches in France and French resident companies, stating that "by treating those two forms of establishment in the same way for the purposes of taxing their profits, the French Legislature has in fact admitted that there is no objective difference between their positions in regard to the detailed rules and conditions relating to that taxation which could justify different treatment".[58] In other words, the Court conducted a factual and legal assessment as part of the comparability analysis.

Further support is found in *Bouanich,* a host state case involving the free movement of capital. In that case, Ms Bouanich, a French resident had made an investment in a Swedish company. The Swedish company repurchased her shares and Ms Bouanich was denied the right to deduct the acquisition cost of her shares in the tax assessment. Under the Swedish-French DTC Ms Bouanich was treated as having received a deemed dividend, allowed to deduct only the nominal value of the shares and taxed at the rate of 15%. A Swedish resident making a similar investment was taxed on a capital gains tax basis, allowed to deduct the acquisition cost of the shares and taxed at the rate of 30%. The question was whether Ms Bouanich was in a comparable situation to a Swedish resident making a similar investment. Sweden accepted that it treated resident and non-resident investors differently.

In relation to the acquisition cost of the shares, the ECJ noted that the "right to a deduction thus constitutes a tax advantage reserved solely to resident shareholders".[59] The Court found that this different tax treatment amounted to a restriction on the free movement of capital. Next, the Court investigated whether there was an objective difference in situation that might justify the Swedish tax rules. The Court noted that "the cost of acquisition is directly linked to the payment made on the occasion of a share repurchase so that, in this regard, residents and non-residents are in a comparable situation. There is no objective difference between the two situations such as to justify different treatment on this point as between the two categories of taxpayers".[60] The Court concluded that "national legislation such as the 1970 Law constitutes arbitrary discrimination against non-resident shareholders in so far as it taxes them more onerously than resident shareholders in an objectively comparable situation". In other words, contrary to the view expressed by Lang, the Court applied both a legal and factual analysis to the situation at hand.

57 *Avoir Fiscal* paragraph 19.

58 *Avoir Fiscal* paragraph 20.

59 *Bouanich* paragraph 32.

60 *Bouanich* paragraph 40.

EU Citizenship

Interestingly, the Court's more recent case law on EU citizenship rights echoes a similar approach. In *Martinez-Sala*,[61] which concerned a child-raising allowance (a "social advantage"),[62] German rules required claimants, besides meeting the other material conditions for its grant, to be permanently or ordinarily resident in German territory. The Court held that a "national of another Member State who is authorised to reside in German territory and who does reside there meets this condition. In that regard, such a person is in the same position as a German national residing in German territory".[63] The Court went on to conclude that "for a Member State to require a national of another Member State who wishes to receive a benefit such as the allowance in question to produce a document which is constitutive of the right to the benefit and which is issued by its own authorities, when its own nationals are not required to produce any document of that kind, amounts to unequal treatment".[64] This was discrimination in the eyes of the Court and the Court applied both a legal and factual analysis in coming to its conclusion.

Gerritse

Finally, the *Gerritse* decision also appears troublesome even though it is merely an example of a host state situation involving the freedom to provide services. Lang says that in *Gerritse*, the Court "even felt obliged to distinguish between different types of allowances".

In *Gerritse*, the Court, in conducting its comparability analysis, observed that "as regards the application to non-residents of a flat rate of tax of 25% while residents are subject to a progressive table… the Netherlands as State of residence, pursuant

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61 ECJ, 12 May 1998, Case C-85/96, *María Martínez Sala v Freistaat Bayern ("Martinez-Sala"),* [1998] ECR I-2691.

62 The concept of "social advantage" covers all the advantages which, whether or not linked to a contract of employment, are generally granted to national workers primarily because of their objective status as workers or by virtue of the mere fact of their residence on the national territory and whose extension to workers who are nationals of other Member States therefore seems likely to facilitate the mobility of such workers within the Community. Article 7(2) of Regulation 1612/68 provides that an EU worker "shall enjoy the same social and tax advantages as national workers" in the territory of another Member State. Regulation (EEC) No 1612/68 of the Council of 15 October 1968 on freedom of movement for workers within the Community (OJ, English Special Edition 1968 (II), p. 475). The Court's case law on "social advantages" is directly relevant for its future jurisprudence relating to "same tax advantages".

63 *Martinez-Sala* paragraph 49.

64 *Martinez-Sala* paragraph 54.

to the bilateral convention, integrates the income in respect of which the right to tax belongs to Germany into the basis of assessment, in accordance with the progressivity rule".[65] The Court explained that "with regard to the progressivity rule, non-residents and residents are in a comparable situation, so that application to the former of a higher rate of income tax than that applicable to the latter and to taxpayers who are assimilated to them would constitute indirect discrimination prohibited by Community law, in particular by Article 60 of the Treaty".[66] Thus, in relation to the Dutch tax system, progressivity was taken into account and, therefore, Germany was not able to use the lack of progressivity as an argument to justify its different treatment of resident and non-resident service providers because from the perspective of progressivity both were in a comparable situation. Once again, it is clear that the Court adopted a legal and factual analysis in determining comparability between a non-resident and a resident service-provider.

As can be seen from the representative sample of host state cases discussed above,[67] the Court applies its comparability analysis across all its fundamental freedom and EU citizenship jurisprudence from both a factual and a legal context since the tax rules of the host Member State always form the legal background of the case.

The Court also applies a similar comparability analysis from the perspective of the origin Member State, again, across all its fundamental freedom[68] and EU

65 *Gerritse* paragraph 52.

66 *Gerritse* paragraph 53.

67 *Avoir Fiscal*, *Gerritse*, *Bouanich*, *Schumacker* and *Martinez-Sala*.

68 For examples of origin State cases, see, for establishment, *Marks and Spencer*; for services, *Eurowings*; for workers, *De Groot* and for capital, *Manninen*. ECJ, 13 Dec. 2005, Case C-446/03, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes) ("Marks and Spencer"),* [2005] ECR I-10837; ECJ, 26 Oct. 1999, Case C-294/97, *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna ("Eurowings"),* [1999] ECR I-7447; ECJ, 12 Dec. 2002, Case C-385/00, *F.W.L. de Groot v Staatssecretaris van Financiën ("De Groot"),* [2002] ECR I-11819 and ECJ, 7 Sep. 2004, Case C-319/02, *Petri Manninen ("Manninen"),* [2004] ECR I-7477.

citizenship[69] cases but, as noted above, from an origin state perspective, the comparability analysis will always involve two nationals of the origin Member State and a restriction approach will be the approach adopted by the Court. The comparability analysis will also involve both a legal (the tax rules of the origin Member State at issue) and a factual assessment of the situation at issue.

"Almost all of *his* income"

Returning to the Court's *Schumacker* judgment, Lang notes that the Court "had to determine what 'almost all of his income' means and it accepted a 90% threshold, which has been correctly criticized as arbitrary". He contended that even if it were possible "to apply the threshold uniformly, it is not satisfactory that non-resident taxpayers whose income is above that threshold are entitled to all benefits that resident taxpayers get, while those non-resident taxpayers whose income is below the threshold would not get any of these benefits". This analysis of the Court's judgment generates a number of questions.

First, the Court, in *Schumacker*, made no specific reference to the 90% threshold identified briefly in Question 3 of the referring court's questions to the ECJ. Indeed, the Court's focus was not on the 90% (or more) income earned in the Member State of employment, rather the Court's main focus was on the amount of taxable income Schumacker had in his residence Member State. The Court simply referred to "the major part of his income and almost all his family income in a Member State other than that of his residence" without specifying any particular percentage because this

69 Thus, in *Turpeinen*, a retired Finnish national moved to Spain. Her only income was her Finnish retirement pension. Finland taxed resident retirees at the rate of 28.5% but taxed Turpeinen, when she became a non-resident, at the rate of 35%. Turpeinen argued that she should be taxed at the same rate as a Finnish resident and the matter came before the ECJ for a preliminary ruling. The ECJ determined that "[n]ational legislation which places some of its nationals at a disadvantage simply because they have exercised their freedom to move and to reside in another Member State would give rise to inequality of treatment, contrary to the principles which underpin the status of citizen of the Union, that is, the guarantee of the same treatment in law in the exercise of the citizen's freedom to move". The Court went on to apply its previous case law, in relation to free movement of workers and freedom of establishment, which specified that "a non-resident taxpayer, whether employed or self-employed, who receives all or almost all of his income in the State where he works is objectively in the same situation so far as concerns income tax as a resident of that State who does the same work there. Both are taxed in that State alone and their taxable income is the same". The Court indicated that this reasoning also applied in relation to Turpeinen's retirement-pension income, pointing out that "in so far as the retirement pension paid in Finland constitutes all or almost all of their income, non-resident retired persons such as Ms Turpeinen are, objectively speaking, in the same situation as regards income tax as retired persons resident in Finland who receive the same retirement pension". Thus, the Court applies both a legal and factual analysis to the situation at hand. ECJ, 9 Nov. 2006, Case C-520/04 *Pirkko Marjatta Turpeinen ("Turpeinen"),* [2006] ECR I-10685.

is an important criterion in determining whether the non-resident worker is in a comparable situation to a resident. The Court went on to explain that in "a situation such as that in the main proceedings, the State of residence cannot take account of the taxpayer' s personal and family circumstances ***because the tax payable there is insufficient to enable it to do so***. Where that is the case, the Community principle of equal treatment requires that, in the State of employment, the personal and family circumstances of a foreign non-resident be taken into account in the same way as those of resident nationals and that the same tax benefits should be granted to him".[70] Again, there is no reference to a 90% threshold. The Court simply examines whether there is sufficient taxable income in the residence Member State to enable Schumacker's personal and family circumstances to be taken into account. The Court's determination of the questions asked by the referring Court also makes no mention of the 90% threshold.[71] This approach of the Court in *Schumacker* is applied consistently in its subsequent cases.

The national treatment principle does not oblige an employment Member State to grant a personal allowance to a non-resident because such allowances are generally granted by Member States only to their residents. However, in a European Internal Market setting, such personal allowances may have to be granted to a non-resident, who has exercised his free movement of workers' rights, and who earns the greater part of his income in the employment Member State and has insufficient taxable income in his residence Member State to obtain his personal allowances there. In such a case, the non-resident may be in a comparable situation to a resident of that employment state. In order to determine whether comparability exists, a factual determination has to be made on whether the non-resident worker concerned has earned the major part of his income in the employment state and has sufficient taxable income in his residence state to obtain his personal allowances there. In such circumstances, if the worker is entitled to obtain his personal allowances from his residence Member State, the employment Member State is justified in not granting similar allowances because there is an objective difference in that worker's situation to that of a resident. Therefore, in such circumstances the comparability analysis involves both a legal and a factual analysis. The legal analysis involves the application tax system of the employment state to the income of the non-resident. Thus, contrary to Lang's assessment, the comparability assessment in *Schumacker*

70 *Schumacker* paragraph 41 (emphasis added).

71 *Schumacker* paragraph 47 – "Article 48 of the Treaty must be interpreted as precluding the application of rules of a Member State under which a worker who is a national of, and resides in, another Member State and is employed in the first State is taxed more heavily than a worker who resides in the first State and performs the same work there when, as in the main action, the national of the second State obtains his income entirely or almost exclusively from the work performed in the first State and does not receive in the second State sufficient income to be subject to taxation there in a manner enabling his personal and family circumstances to be taken into account".

and similar such cases involves both a legal and a factual analysis. This approach is applied consistently in subsequent cases.

The judgment in *Schumacker* can be compared and contrasted with the Court's judgment in *Gschwind* where comparability was not established between Mr Gschwind and a resident worker; because the Gschwind's taxable income was sufficient in their residence Member State for Mr Gschwind's personal and family circumstances to be taken into consideration. The Court noted that there could be discrimination "between residents and non-residents only if, notwithstanding their residence in different Member States, it was established that, having regard to the purpose and content of the national provisions in question, the two categories of taxpayers are in a comparable situation". [72] Citing *Schumacker*, the Court explained that "this is the case where the non-resident has no significant income in the State of his residence and gains the main part of his taxable income from an activity in the State of employment".[73] The Court pointed out that a "situation such as that in question… is, however, clearly different from that with which the judgment in *Schumacker* was concerned".[74] It explained that, since "nearly 42% of the total income of the Gschwinds is received in their State of residence, that State is in a position to take into account Mr Gschwind's personal and family circumstances according to the rules laid down by the legislation of that State, since the tax base is sufficient there to enable them to be taken into account".[75] In such circumstances, the non-resident was not in a comparable situation to that of a resident worker, and, accordingly, the Court concluded that "Article 48(2) of the Treaty is to be interpreted as not precluding the application of a Member State's legislation under which resident married couples are granted favourable tax treatment such as that under the splitting procedure whilst the same treatment of non-resident married couples is made subject to the condition that at least 90% of their total income must be subject to tax in that Member State or, if that percentage is not reached, that their income from foreign sources not subject to tax in that State must not be above a certain ceiling, thus maintaining the possibility for account to be taken of their personal and family circumstances in the State of residence".[76] Here, it should be noted that the 90% threshold is a national rule. It is not a specific limit imposed by the ECJ in order to determine comparability between non-resident and resident workers. The Court still investigated whether the non-resident had sufficient taxable income in his residence Member State to obtain his personal and family allowances. Earning the "major part of his income" in the employment Member State is simply

72 *Gschwind* paragraph 26.

73 *Gschwind* paragraph 27.

74 *Gschwind* paragraph 28.

75 *Gschwind* paragraph 29.

76 *Gschwind* paragraph 32.

one of the necessary factors to be taken into consideration for the non-resident worker to be in a comparable situation to a resident worker in that Member State.

Ritter- Coulais / Renneberg – a different approach?

In discussing the *Ritter-Coulais*[77] and *Renneberg*[78] judgments Lang comments that the approach taken by the Court in *Ritter-Coulais* was "slightly different" to that taken in *Schumacker* and that the position taken in *Renneberg* "seems to differ from the approach that the Court followed in the *Ritter-Coulais* case". He concludes that if the ECJ had applied the same reasoning in *Renneberg* as it did in *Ritter-Coulais* "Mr Renneberg would have been able to deduct his losses on his Belgian home even if he had received only part of his income from Netherlands sources." Lang goes on to argue that "the comparator should not have been different in *Ritter-Coulais* and in *Renneberg*" and his overall conclusion is that the Court should overturn its *Schumacker* decision. These judgments, therefore, need further consideration.

Reconciling *Ritter-Coulais and Renneberg*

An examination of the *Ritter-Coulais* and *Renneberg* judgments shows important differences which help to explain why the Court's approach differed. *Ritter-Coulais* involved an even-handed rule in the host Member State which mainly affected non-residents, along the lines of the tax rules seen in *Biehl* and *Commerzbank*; whereas *Renneberg* involved the different treatment of comparable situations from a host Member State perspective. Thus, in *Renneberg*, there was less favourable treatment of the non-resident in a comparable situation to a resident, whereas in *Ritter-Coulais*, the national tax rule was applied on an even-handed basis but still amounted to discrimination contrary to the free movement of workers because the rule mainly impacted on foreign nationals. These differences demonstrate why the Court's approach was not the same in both cases. This distinction is explained in more detail in the next sections.

Ritter-Coulais

Ritter-Coulais concerned German tax rules which prevented the recognition of rental income losses from immovable property situated in another Member State in the absence of positive income. The rules at issue were used for the purposes of determining the tax rate in the host Member State. These tax rules treated negative income differently depending on whether the immovable property was situated in

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77 ECJ, 21 Feb. 2006, Case C-152/03, *Hans-Jürgen Ritter-Coulais and Monique Ritter-Coulais v Finanzamt Germersheim ("Ritter-Coulais"),* [2006] ECR I-1711.

78 ECJ, 16 Oct. 2008, Case C-527/06, *R. H. H. Renneberg v Staatssecretaris van Financiën ("Renneberg"),* [2008] ECR I-7735. For analysis, see Tom O'Shea, "*Dutch Rental Income Loss Rules Illegal, ECJ Says*, Tax Notes International, 5 January 2009, 36-39.

Germany or in another Member State. Thus, even though the tax rules at issue did not set out to discriminate on grounds of residence since they affected both German residents and non-residents, the Court determined that they mainly affected residents of Member States other than Germany since such persons were more likely to reside in properties located outside Germany. Put another way, from a “migrant/non-migrant” point of view in the host state, the German rules provided for less favourable treatment of the migrant worker compared to the non-migrant who was allowed to deduct negative income losses related to his dwelling in Germany when determining the applicable tax rate. This indirect discrimination was contrary to Article 39 EC.[79]

The Court has reminded the Member States on numerous occasions that the Treaty provisions relating to free movement of persons “preclude measures which might place Community nationals at a disadvantage when they wish to pursue an economic activity in the territory of another Member State”.[80] In *Ritter-Coulais*, the Court went on to highlight that “[e]ven though the national legislation is not specifically directed at non-residents, the latter are more likely to own a home outside Germany than resident citizens”.[81] The Court concluded that “the treatment of non-resident workers under the national legislation is less favourable than that afforded to workers who reside in Germany in their own homes”.[82]

It seems clear from this brief review of *Ritter-Coulais* that the Court conducted a discrimination analysis similar to that conducted in *Biehl* [83] and *Commerzbank.*[84] Although, the national rule at issue in each of these cases was not specifically aimed at non-residents (in other words, the national rules were even-handed), the rules at stake were indirectly discriminatory rules because they mainly affected non-residents. Such rules (from a host Member State perspective) may be seen as being

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79 Now Article 45 TFEU. On the indirect discrimination issue, see, for instance, ECJ, 23 May 1996, Case C-237/94, *John O’Flynn v Adjudication Officer*, [1996] ERC I-2617 paragraph 18 and the case law cited therein.

80 See *Ritter-Coulais* paragraph 33 and the case law referred to in that paragraph.

81 *Ritter-Coulais* paragraph 36.

82 *Ritter-Coulais* paragraph 37.

83 ECJ, 8 May 1990, Case C-175/88, *Klaus Biehl v Administration des contributions du grand-duché de Luxembourg (“Biehl”),* [1988] ECR I-1779.

84 ECJ, 13 Jul. 1993, Case C-330/91, *The Queen v Inland Revenue Commissioners, ex parte Commerzbank AG. (“Commerzbank”),* [1993] ECR I-4017.

akin to the *Bosman*-type rules[85] (seen from an origin Member State perspective) which involve "even-handed rules" that still amount to a restriction on the exercise of a fundamental freedom. Thus, from an origin Member State perspective, such rules mainly affect nationals of the origin Member State exercising a fundamental freedom, even though the cross-border and domestic situations are treated in a similar way. Such rules still constitute an obstacle to the exercise of the fundamental freedom. From a host Member State perspective, it is clear from the Court's case law that such even-handed rules may amount to indirect discrimination where they mainly affect foreigners or may amount to an obstacle[86] on the freedoms.

Bosman

In *Bosman*, the Court held that although the football transfer rules at issue applied equally to transfers between clubs within the same Member State, they "still directly affect players' access to the employment market in other Member States and are thus capable of impeding freedom of movement for workers".[87] Accordingly, the Court concluded that "the transfer rules constitute an obstacle to freedom of movement for workers prohibited in principle by Article 48 of the Treaty".[88] Thus, even though there was no discrimination in the case, the Court still investigated whether the Belgian rules amounted to a restriction on the free movement of workers.

Biehl

In *Biehl*, the Court was faced with a host state situation concerning a German national who resided and was employed in Luxembourg. In 1983, before the end of the tax year, he moved to Germany, Having ascertained that the amount of tax deducted at source exceeded his Luxembourg tax liability for the year, Biehl asked for a tax refund. This was denied because he was no longer a permanent resident of Luxembourg. The ECJ noted that even though the Luxembourg rules relating to tax refunds applied 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. It is often such persons who will in the course of the year leave the country or take up residence there".[89] Thus, even though the national rule was not

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85 ECJ, 15 Dec. 1995, Case C-415/93, *Union royale belge des sociétés de football association ASBL v Jean-Marc Bosman, Royal club liégeois SA v Jean-Marc Bosman and others and Union des associations européennes de football (UEFA) v Jean-Marc Bosman ("Bosman"),* [1995] ECR I-4921.

86 For an example, see *Futura*, footnote 112 below.

87 *Bosman* paragraph 103.

88 *Bosman* paragraph 104. Article 48 of the Treaty is now Article 45 TFEU.

89 *Biehl* paragraph 14.

designed to discriminate on grounds of nationality, it still amounted to discrimination contrary to the free movement of workers.

Renneberg

The Court's decision in *Renneberg* is a simple application of the *Schumacker* judgment and the national treatment principle from a host state point of view. The Court even refers to, and applies, paragraph 94 of *De Groot*.[90] Renneberg moved from the Netherlands to live in Belgium but continued to work in the Netherlands where he received his entire work related income. The Netherlands refused to grant Renneberg a deduction for his negative income relating to his Belgian dwelling even though it did allow its own residents such a deduction for dwellings in the Netherlands and for dwellings located in Belgium. The Dutch tax rules, therefore, established a difference in treatment between resident and non-resident taxpayers by denying the tax advantage to a non-resident. The Court noted that this might constitute "discrimination within the meaning of the Treaty where there is no objective difference between the situations of the two which would justify different treatment in that regard".[91] The Court went on to apply its *Schumacker* reasoning, highlighting that discrimination arises from the fact that the personal and family circumstances of the non-resident (in the circumstances of this case) were taken into account neither in his residence Member State nor in his employment Member State. The Court also pointed out that in its *Lakebrink* judgment,[92] it had determined that the scope of the case law arising from *Schumacker* extended to all the tax advantages connected with the ability of the non-resident to pay tax which are granted neither in the residence Member State nor in the Member State of his employment. The Court emphasised that this reasoning also applied to the case at hand. Thus, the non-resident taxpayer was disadvantaged by the Dutch tax rules when compared to the tax treatment of a resident taxpayer (who could deduct the rental income losses relating to properties occupied by himself in the Netherlands or immovable property located in Belgium which he did not occupy on a permanent basis) when determining his income tax liability in the Netherlands. Accordingly, where the non-resident taxpayer has no significant income in his Member State of residence, "he is for the purposes of taking into account his ability to pay tax, in a situation objectively comparable, with regard to his Member State of employment, to that of a resident of that Member State who is also in salaried employment there".[93] Such a non-resident taxpayer can have his rental income losses taken into

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90 *Renneberg* paragraph 51.

91 *Renneberg* paragraph 60.

92 *Lakebrink* paragraph 34. ECJ, 18 July 2007, Case C-182/06, *État du Grand Duchy of Luxemburg v Hans Ulrich Lakebrink and Katrin Peters-Lakebrink ("Lakebrink"),* [2007] ECR I-6705.

93 *Renneberg* paragraph 66.

account in neither his residence Member State nor in his employment Member State. This was contrary to Article 39 EC in the absence of some justification. Accordingly, the Member State of employment was obliged to grant the tax advantage in question to a non-resident like Renneberg because he was in a comparable situation to that of a Dutch resident and unable to obtain his rental income losses as a tax deduction in his residence Member State (because he had no taxable income there). This was merely an application of *Schumacker*.

From the above analysis, it is clear that the Court's decisions in *Renneberg* and *Ritter-Coulais* are perfectly reconcilable with the *Schumacker* and *Lakebrink* line of cases and with *Biehl* and *Bosman,* so-called "even-handed rule" cases. The Court's jurisprudence is consistent and the different approach adopted by the Court in *Ritter-Coulais* from its approach in *Renneberg* is explainable on the basis of the Court's previous case law. Recognising the difference between the two types of case is the key to understanding the different approaches taken by the Court.

Truck Center: the solution of the Court is not convincing?

Lang suggests that the solution of the Court in *Truck Center* [94] is not convincing and he is highly critical of the Court's judgment. It is perhaps important to highlight that the *Truck Center* judgment represented some of the trickiest direct tax issues to come before the Court since *ACT IV GLO*. Interestingly, both judgments involved Member States acting in a source Member State capacity, but in *ACT IV GLO* the income streams at issue involved outbound dividend payments whereas in *Truck Center*, the income stream arising in the source State was an interest payment. The difference between these two types of payment is that in an outbound dividend payment situation, the company paying the dividend may have already suffered a corporate income tax whereas in an outbound interest payment situation, that interest payment will be taxed normally only once in the source Member State (when, or if, a withholding tax is imposed). This means that the two types of payment may be treated differently since normally only an outbound dividend payment can give rise to economic double taxation or a "series of charges to tax" under the rules of one Member State.

ACT IV GLO

In *ACT IV GLO*,[95] the source Member State (the UK) imposed corporation tax on the UK company paying the dividend and imposed a further tax on the non-resident recipient company when the dividend was paid with a tax credit in certain DTC

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94 ECJ, 22 Dec. 2008, Case C-282/07, *Belgian State - SPF Finances v Truck Center SA ("Truck Center"),* [2008] ECR I-10767.

95 ECJ, 12 Dec. 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue ("ACT IV GLO"),* [2006] ECR I-11673.

situations. This triggered economic double taxation of such income streams. The Court pointed out that "[w]here the company making the distribution and the shareholder to whom it is paid are not resident in the same Member State, the Member State in which the company making the distribution is resident, that is to say the Member State in which the profits are derived, is not in the same position, as regards the prevention or mitigation of a series of charges to tax and of economic double taxation, as the Member State in which the shareholder receiving the distribution is resident".[96] Thus, where the UK exempted the outbound dividend, which it usually did in the absence of a double tax convention providing for the payment of a tax credit, there was no need for it to provide a tax credit in such circumstances to the cross-border recipient company because that recipient did not suffer economic double taxation.[97] However, the Court stressed that "once a Member State, unilaterally or by a convention, imposes a charge to income tax not only on resident shareholders but also on non-resident shareholders in respect of dividends which they receive from a resident company, the position of those non-resident shareholders becomes comparable to that of resident shareholders".[98] Thus, by taxing the non-resident recipient company, the UK triggered economic double taxation. The Court explained that "it is solely because of the exercise by that State of its taxing powers that, irrespective of any taxation in another Member State, a risk of a series of charges to tax may arise. In such a case, in order for non-resident companies receiving dividends not to be subject to a restriction on freedom of establishment prohibited, in principle, by Article 43 EC, the State in which the company making the distribution is resident is obliged to ensure that, under the procedures laid down by its national law in order to prevent or mitigate a series of liabilities to tax, non-resident shareholder companies are subject to the same treatment as resident shareholder companies"[99].

Perhaps, the most significant point arising from the *ACT IV GLO* judgment was the Court's acceptance of Advocate General Geelhoed's suggestion that a Member State had a different capacity and obligations under EU law depending on whether the Member State in question was acting in a residence or source Member State capacity. Advocate General Geelhoed pointed out that "[a]s source States have tax

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96 *ACT IV GLO* paragraph 58.

97 This is clear from the limitation on benefit (LoB) issue in the *ACT IV GLO* case, where the Court accepted that dividends paid to two Dutch resident companies could be treated differently depending on whether or not their ownership was mainly Dutch residents. See *ACT IV GLO* paragraph 91. For a detailed analysis on LoB clauses in an EU context, see Tom O'Shea, *"Limitation on Benefit (LoB) Clauses and the EU – Part I",* International Tax Report, October, 2008 and Tom O'Shea, "*"Limitation on Benefit (LoB) Clauses and the EU – Part II",* International Tax Report, November, 2008.

98 *ACT IV GLO* paragraph 68.

99 *ACT IV GLO* paragraph 70.

jurisdiction only over the income that is earned by the non-resident within the source State's jurisdiction, they are subject to a more limited obligation under Article 43 EC. In essence, this can be expressed as an obligation to treat all non-residents in a comparable way to residents (non-discrimination), insofar as these non-residents fall within their tax jurisdiction – i.e., subject to the difference in the extent of their tax jurisdiction over residents and non-residents".[100] Generally, this finding does not appear to have been appreciated in the literature.[101]

Truck Center

In *Truck Center*, the Court had to deal with a similar source Member State issue, but this time concerning an outbound interest payment instead of an outbound dividend payment. As briefly noted above, the important distinction between these two types of payment is that an interest payment is taxed normally only once in the source Member State (if it is subject to a withholding tax) whereas a dividend may be taxed twice so that, as a result of the source Member State's actions alone, an outbound dividend payment can suffer economic double taxation whereas normally an outbound interest payment cannot. As discussed above, this means a source Member State has different obligations depending on whether an outbound interest payment or an outbound dividend payment is at stake. This is a very significant point in terms of understanding the obligations of a source Member State under EU law because in *ACT IV GLO*, the Court makes it clear that "[a]s regards the application of procedures intended to prevent or mitigate the imposition of a series of charges to tax or economic double taxation, the position of a Member State in which both the

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100 See points 66-73 of Advocate General Geelhoed's Opinion in *ACT IV GLO* where this distinction is explained. The Court followed this reasoning in its *ACT IV GLO* judgment in paragraph 68, which is discussed above in the text. Advocate General Geelhoed provides a number of very helpful examples drawn from the Court's direct tax jurisprudence to illustrate his thesis.

101 For instance, the CFE Opinion Statement on *Truck Center* highlighted in relation to the source State's obligations that "this is simply recognizing that residents are taxed on a residence basis, while non-residents are taxed on a source basis (i.e. only on income having its source in Belgium). It amounts to saying that residents and non-residents are different because residents and non-residents are different". See *"CFE - Comment by the CFE Task Force on ECJ Cases on the Judgment in Belgium SPF Finance v. Truck Center SA, Case C-282/07, Judgment of 22 December 2008*", E.T. 2009, 10, 491-496 at 493 (paragraph 16). Other than making the simple observation that "Belgium acts in its capacity as the source state of the interest", Luc de Broe and Niels Bammens' article on *Truck Center* makes no reference to the source/residence distinction and no reference to the *ACT IV GLO* judgment. See Luc de Broe and Niels Bammens, "*Belgian Withholding Tax on Interest Payments to Non-resident Companies Does Not Violate EC Law: A Critical Look at the ECJ's Judgment in Truck Center",* EC Tax Rev. 2009, 3, 131-137. The issue was identified in the literature in March 2007 by this author. See Tom O'Shea, *"Dividend Taxation Post-*Manninen: *Shifting Sands or Solid Foundations?"* Tax Notes International, 5 March 2007, 887-918, at 904.

companies making the distribution and the ultimate shareholders are resident is thus not comparable to that of a Member State in which a company is resident which pays dividends to a non-resident company, which pays them, in turn, to its ultimate shareholders, in that the second State acts, in principle, only as the State in which the distributed profits are derived”.[102]

Lang suggests that “the Court obviously took the position that once the legal situations are different, even if only to a small extent, the legislator is permitted to treat these situations completely differently”. However, he makes no reference to the different obligations of source Member States to those of residence Member States under EU law and he concludes that this approach of the Court “is not convincing at all”. This seems to miss the point.

It has been clear since *Schumacker*, that in relation to direct taxes, “the situations of residents and of non-residents are not, as a rule, comparable”. [103] The Court explained that “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”.[104]

In *Wielockx*,[105] the Court clarified this reasoning further, stating that “[i]n relation to direct taxes, the situations of residents and of non-residents in a given State are not generally comparable, since there are objective differences between them *from the point of view of the source of the income* and the possibility of taking account of their ability to pay tax or their personal and family circumstances”.[106]

In *ACT IV GLO*, the Court, following this line of reasoning , pointed out that “[i]n order to determine whether a difference in tax treatment is discriminatory, it is, however, necessary to consider whether, having regard to the national measure at issue, the companies concerned are in an objectively comparable situation”.[107]

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102 *ACT IV GLO* paragraph 65.

103 *Schumacker* paragraph 31. There is a full explanation of this distinction in the Opinion of Advocate General Léger in *Schumacker*.

104 *Schumacker* paragraph 34.

105 ECJ, 11 Aug. 1995, Case C-80/94, *G. H. E. J. Wielockx v Inspecteur der Directe Belastingen (“Wielockx”),* [1995] ECR I-2493.

106 *Wielockx* paragraph 18 (emphasis added).

107 *ACT IV GLO* paragraph 46.

The Court's judgment in *Truck Center* merely follows this same pathway. The Court had to decide whether the different treatment of residents and non-residents by the Belgian tax rules was acceptable under EU law. The Court pointed out that this meant that the "host state" could not discriminate on the basis of where the companies making the loan have their seat ("Freedom of establishment thus aims to guarantee the benefit of national treatment in the host Member State, by prohibiting any discrimination based on the place in which companies have their seat").[108] Moreover, the Court highlighted that the Belgian tax rules could not constitute restrictions of the fundamental freedoms ("all measures which prohibit, impede or render less attractive the exercise of freedom of establishment must be regarded as constituting such restrictions").[109] Thus, in *Truck Center*, the Court conducted both a discrimination analysis and a restriction analysis and found that neither discrimination nor a restriction occurred.

***Truck Center*: "The Discrimination Analysis"**

The ECJ commenced its discrimination analysis in *Truck Center* by noting that "the effect of the legislation at issue in the main proceedings is that the procedure for the charging of the tax varies depending on the place where the company receiving the interest has its registered office".[110] The Court went on to state that "[i]n order to determine whether a difference in tax treatment is discriminatory, it is, however, necessary to consider whether, having regard to the national measure at issue, the companies concerned are in an objectively comparable situation".[111] Lang objects to this approach, submitting that these arguments should have been dealt with at the level of proportionality. This is somewhat surprising given that the Court adopted its normal approach and examined whether an objective difference in situation existed before any general interest justifications were considered, because a lack of comparability alone may justify the different treatment of the non-resident to the resident. In other words, if the situations of the non-resident and the resident are objectively different then the national rules at issue can treat the non-resident differently from the resident provided that the rules not constitute a restriction on the fundamental freedoms. Thus, the discrimination analysis, if it takes place, occurs before a restriction analysis.

It is clear from the Court's judgment (see paragraphs 41-48) that there is an objective difference in the situation of resident and non-resident recipients of the interest payments from a Belgian associated company. The Court sets out a number

108 *Truck Center* paragraph 32.

109 *Truck Center* paragraph 33.

110 *Truck Center* paragraph 34.

111 *Truck Center* paragraph 36.

of reasons why this is so, including the fact that where the lender is a non-resident, Belgium is acting purely as a source State whereas if the lender is a resident it is acting as a residence State. This is the same distinction that was first highlighted in *ACT IV GLO*. As such, because there is an objective difference in the situations of non-resident and resident lenders, there can be no discrimination in this case and Belgium is entitled to maintain its different tax rules provided they do not constitute an unjustified restriction on the fundamental freedoms. This explains why the Court went on to investigate whether the Belgian tax rules constituted a restriction on the freedom of establishment and the free movement of capital in paragraphs 49-51 of the judgment.

***Truck Center*: "The Restriction Analysis"**

Even though the Court was satisfied that there was no discrimination in *Truck Center*, the Belgian tax rules could still amount to a restriction on the freedom of establishment and the free movement of capital. Therefore, the Court was obliged to conduct a restriction analysis. In conducting such an analysis, the Court was merely following precedent.[112]

In *Truck Center*, the Court concluded that there was no discrimination (because the situations were not objectively comparable) and it went on to conduct a restriction analysis and to conclude that the Belgian rules did not amount to a restriction on the freedom of establishment or on the free movement of capital.[113] The Court highlighted that "the difference in treatment resulting from the tax legislation at issue in the main proceedings does not necessarily procure an advantage for resident recipient companies because… those companies are obliged to make advance payments of corporation tax and, secondly, the amount of withholding tax deducted from the interest paid to a non-resident company is significantly lower than the corporation tax charged on the income of resident companies which receive interest".[114]

112 In *Futura*, for instance, the Court had carried out a discrimination analysis followed by a restriction analysis in a situation where it had found that no discrimination existed, because the Luxembourg tax rules at issue applied equally to residents and non-residents with branches in Luxembourg. However, the Court held that the Luxembourg tax rules constituted a restriction on the freedom of establishment in certain limited circumstances. *Futura* is therefore an example of a case where the Court found no discrimination but went on to conduct a restriction analysis and found a restriction. ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v Administration des contributions ("Futura"),* [1997] ECR I-2471. See, Tom O'Shea, *"Freedom of Establishment Tax Jurisprudence: Avoir Fiscal Re-visited", (2008)* EC Tax Rev. 2008, 6, 259-275.

113 See paragraphs 49-51 of the judgment. Since there was no restriction on the freedom of establishment, the Court concluded that there was also no restriction on the free movement of capital.

114 *Truck Center* paragraph 49.

As this author has pointed out before,[115] there was no restriction on the freedom of establishment because a company in Truck Center's situation was not treated less favourably when it obtained a loan from an associated company resident in another Member State as compared to receiving a similar loan from a Belgian resident associated company. Both situations required tax to be paid on the interest payment (either by way of a withholding tax or by way of advance corporation tax) and the headline rate of tax paid by a non-resident recipient was lower than the headline rate of corporation tax paid by a resident associated company. Therefore, there was no restriction on the freedom of establishment from the point of view of Truck Center in its origin Member State (Belgium).

Similarly, from the perspective of Wickler Finance, the associated company providing the loan, there was no restriction on its right of establishment in the host Member State because the "headline rate" of tax it paid on its interest income was less than the "headline rate" of corporation tax paid by an associated company resident in the host Member State providing a similar loan and the timing of the taxation of Wickler Finance's interest income in the host Member State was not less favourable than the timing of the advance payments of corporation tax made by the loan provider resident in the host Member State. The Court pointed out that the different tax treatment of resident and non-resident companies did "not necessarily procure an advantage for resident recipient companies".[116]

Source vs. Residence Obligations of the Member States

The Court's *Truck Center* judgment is fully in line with *ACT IV GLO* where the Court recognised for the first time that the capacity in which a Member State imposed taxation, namely, as a source or residence Member State, triggered different obligations under EU law. The Court applied similar reasoning in *Denkavit Internationaal,*[117] a case involving outbound dividends from French companies, where it affirmed that "in the context of measures laid down by a Member State in order to prevent or mitigate the imposition of a series of charges to tax on, or the double taxation of, profits distributed by a resident company, resident shareholders receiving dividends are not necessarily in a situation which is comparable to that of shareholders receiving dividends who are resident in another Member State".[118]

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115 See Tom O'Shea, "*Truck Center: A Lesson in Source vs. Residence Obligations in the EU",* Tax Notes International, Feb. 16, 2009, 593-601 at 601.

116 *Truck Center* paragraph 49.

117 ECJ, 14 Dec. 2006, Case C-170/05, *Denkavit Internationaal BV and Denkavit France SARL v Ministre de l'Économie, des Finances et de l'Industrie ("Denkavit Internationaal"),* [2006] ECR I-11949.

118 *Denkavit Internationaal* paragraph 34.

The Court went on to explain the EU law obligations imposed on France when it imposed a withholding tax on such dividends, indicating that "since the French Republic has chosen to relieve its residents of such a liability to tax, it must extend that relief to non-residents to the extent to which an imposition of that kind on those non-residents results from the exercise of its tax jurisdiction over them".[119] The Court made it clear that "[i]n refusing to extend to non-resident parent companies the more advantageous national tax treatment accorded to resident parent companies, the national legislation at issue … amounts to a discriminatory measure which is incompatible with the Treaty, in that it imposes a heavier tax burden on dividends paid by resident subsidiaries to Netherlands parent companies than that imposed on dividends paid to French parent companies".[120]

The Court has continued to recognise the importance of the distinction between Member States acting in a source or residence State capacity. In *OY AA*,[121] the Court reiterated that "to accept that an intra-group cross-border transfer … may be deducted from the taxable income of the transferor would result in allowing groups of companies to choose freely the Member State in which the profits of the subsidiary are to be taxed … would undermine the system of the allocation of the power to tax between Member States because, according to the choice made by the group of companies, the Member State of the subsidiary would be forced to renounce its right, in *its capacity as the State of residence* of that subsidiary, to tax the profits of that subsidiary in favour, possibly, of the Member State in which the parent company has its establishment".[122] More recently, in *Commission v Spain ("Outbound Dividends"),* the Court affirmed this "distinction between the powers of the State of residence of the recipient company and those of the State of the source of the income".[123] The approach taken by the Court in *ACT IV GLO*, in relation to the distinction between Member States acting in a source or residence Member State capacity, seems to have become settled case law. Therefore, the judgment of the Court in *Truck Center* is merely an application of the Court's reasoning relating to a Member State acting in a source State capacity.

119 *Denkavit Internationaal* paragraph 37.

120 *Denkavit Internationaal* paragraph 3

121 ECJ, 18 July 2007, Case C-231/05, *OY AA* [2007] ECR I-6373.

122 *OY AA* paragraph 56 (emphasis added). For analysis, see Tom O'Shea, *"Finland's Intra-group Financial Transfer Rules Compatible with EU Law",* Tax Notes International, 13 August 2007, 634-638.

123 ECJ, 3 June 2010, *Commission v Spain ("Outbound Dividends"),* [2010] ECR I-0000, paragraph 24 (not yet reported).

Philips Electronics

Finally, it should be noted that a decision of the UK's First Tier Tribunal (Tax), in *Philips Electronics UK Limited v The Commissioners for HMRC* ,[124]demonstrates that the ECJ's jurisprudence, relating to the different EU law obligations of the Member States acting in a source or residence State capacity, has not gone unnoticed. This case concerned the compatibility of the UK's consortium relief rules with EU law and related, in particular, to the losses of a UK branch of a Dutch company. If all companies involved in the consortium had been resident in the UK, the Dutch company would have been entitled to surrender approximately 50% of its losses to Philips Electronics UK Limited ("the taxpayer"). But, under UK law at the time of the case, such losses could not be surrendered because of two provisions of UK law which the taxpayer contended infringed EU law.

The First Tier Tribunal highlighted that the UK was acting as a source Member State, so that the UK was obliged to treat non-residents in a comparable way to residents insofar as the non-residents fell within its tax jurisdiction. This meant that the Dutch company with the UK branch was treated less favourably than a UK subsidiary which would have been granted consortium relief. The Tribunal observed that the Dutch company with the UK branch was taxed in the same way as a UK subsidiary/ company in relation to its business profits, except in relation to the granting of group relief. Consequently, this amounted to a restriction on the freedom of establishment. In terms of justifications, the Tribunal decided that there was no risk that the UK losses would be used more than once in the UK and that, accordingly, the coherence of the UK's tax system was not in jeopardy. The Tribunal also held that a Member State cannot rely solely on the prevention of the double-use of losses as a stand-alone justification. In this situation, the UK acted as a source Member State. Accordingly, where the UK gave relief for losses of its own resident companies it could not deny a similar tax advantage to a Dutch company with a branch in the UK since the balance in the allocation of taxing rights between Member States lies with the source State in such circumstances. The Tribunal commented that the "use of losses of a branch cannot therefore in our view jeopardise the balanced allocation". [125] The restriction on the freedom of establishment, therefore, was not justified. The Tribunal highlighted that it was an

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124 *Philips Electronics UK Limited v. The Commissioners for HMRC,* ("*Philips Electronics"),* [2009] UKFTT 226(TC). For a case comment, see Timothy Lyons, "*Philips Electronics UK Ltd v HMRC: more unjustifiable restrictions on loss relief*", B.T.R. 2010, 1, 46-54. Note that in June 2010, the Upper Tier Tribunal (Tax) referred *Philips Electronics* to the ECJ for a preliminary ruling.

125 It should be noted that the losses in question did not cross the border from a UK perspective. The losses were already linked to the UK. Therefore, from the UK's perspective there would be no impact on the balance in the allocation of taxing rights. This situation differs from that at issue in *Marks and Spencer* where the losses were not UK losses.

accepted principle that "a source state should offer non-residents equivalent tax benefits to those offered to residents to the extent that the source state exercises equal tax jurisdiction over both".[126]

Part II

Justification and Proportionality

Cash-flow Disadvantages – one-State and two-State problems

The debate on cash-flow disadvantages and the Court's jurisprudence has continued to rage since *Marks and Spencer v David Halsey ("Marks and Spencer").* It raised its head again in the Opinion of Advocate General Sharpston in *Lidl Belgium*[127] and in the Opinion of Advocate General Kokott in *Truck Center*. Sharpston in *Lidl Belgium* stated that "[i]t seems anomalous that, having clearly accepted the potential significance of the denial of a cash-flow advantage and categorised it (correctly) as a prima facie infringement of Article 43 EC, the Court did not also examine expressly whether, where the restriction was prima facie justified, the denial of a cash-flow advantage which was an unavoidable consequence was disproportionate".[128] Lang noted that "the Court, without any explanation, did not follow her approach" and in the wake of the *Truck Center* judgment, Lang commented that if the Court had "taken this position in its earlier case law, *Hoechst and Metallgesellschaft*[129] would have been decided in favour of the tax authorities as well". Given that the ECJ did not follow the advice of Advocate General Sharpston in *Lidl Belgium*, this issue needs further clarification.

The author has pointed out before,[130] that there is a difference between a cash-flow disadvantage created by the rules of a single Member State and a cash-flow disadvantage created by the interaction between the rules of two Member States. This explains why the Court determined that the cash-flow disadvantages in *Marks*

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126 See *Phillips Electronics* paragraph 45.

127 For the judgment, see ECJ, 15 May 2008, Case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn ("Lidl Belgium"),* [2008] ECR I-8501.

128 See point 30 of the Opinion of Advocate General Sharpston in *Lidl Belgium*.

129 ECJ, 8 Mar. 2001, Joined Cases C-397/98 and C-410/98, *Metallgesellschaft Ltd and Others (C-397/98), Hoechst AG and Hoechst (UK) Ltd (C-410/98) v Commissioners of Inland Revenue and HM Attorney General ("Metallgesellschaft"),* [2001] ECR I-1727.

130 See Tom O'Shea, *"EU Cross-border Loss Relief: Which View Will Prevail?"* 2008 WTD 66-3 (4 April 2008) and Tom O'Shea, "*ECJ Rejects Advocate General's Advice in Case on German Loss Relief"*, 2008 WTD 123-2 (25 June 2008).

and Spencer and *Lidl Belgium* amounted to a restriction on the freedom of establishment, but were justified by the need to ensure balance in the allocation of taxing rights caused by the interaction between the rules of two Member States. By contrast, the Court found that an unjustified restriction existed in relation to a cash-flow disadvantage in the cases cited by Advocate General Sharpston in her Opinion in *Lidl Belgium: Metallgesellschaft, X and Y, De Baeck, Test Claimants in the FII Group Litigation (FII GLO),* and *Rewe Zentralfinanz*.[131] It did so because in those cases the disadvantage was triggered by the rules of a single Member State. This is discussed below.

In relation to the *Truck Center* (one-state) situation, there has to be comparability between the situations for there to be a cash-flow disadvantage. This explains why the "cash-flow disadvantage" seen in *Truck Center* did not amount to a restriction on the freedom of establishment or on the free movement of capital.

Cash-flow Disadvantages caused by the rules of one Member State: *Metallgesellschaft*

In *Metallgesellschaft*, when a UK resident subsidiary paid a dividend to its German resident parent company it was obliged to account for advance corporation tax (or ACT). If its parent company were resident in the UK, the payment of ACT could be avoided by making a group income election. Consequently, the parent company argued that its subsidiary suffered a cash-flow disadvantage, which a subsidiary with a UK parent company did not incur. "By making a group income election, the latter were able to retain, until the date when the MCT[132] to which they were liable fell due, the sums which they would otherwise have had to pay as ACT on the distribution of dividends to their parent companies".[133] The German parent company argued that that disadvantage amounted to indirect discrimination on grounds of nationality contrary to the EU law and amounted, in particular, to a restriction on the freedom of establishment.

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131 The Advocate General referred to *Metallgesellschaft* paragraphs 44, 54 and 76; ECJ, 21 Nov. 2002,Case C-436/00 *X and Y v Riksskatteverket ("X and Y"),* [2002] ECR I-10829, paragraphs 36 to 38; ECJ, 8 June 2004,Case C-268/03 *Jean-Claude De Baeck v Kingdom of Belgium ("De Baeck"),* [2004] ECR I-5961, paragraph 24; ECJ, 12 Dec. 2006, Case C-446/04 *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue ("FII GLO"),* [2006] ECR I-11753, paragraphs 96, 97, 153 and 154; and ECJ, 29 Mar. 2007, Case C-347/04, *Rewe Zentralfinanz eG v Finanzamt Köln-Mitte ("Rewe Zentralfinanz")* [2007] ECR I-2647, paragraph 29.

132 MCT = Mainstream Corporation Tax.

133 *Metallgesellschaft* paragraph 30.

The ECJ accepted that the cash-flow disadvantage existed and determined that "in so far as ACT is in no sense a tax on dividends but rather an advance payment of corporation tax, it is incorrect to suppose that affording resident subsidiaries of non-resident parent companies the possibility of making a group income election would allow the subsidiary to avoid paying any tax in the United Kingdom on profits distributed by way of dividends".[134] The Court explained that "to afford resident subsidiaries of non-resident companies the possibility of making a group income election would do no more than allow them to retain the sums which would otherwise be payable by way of ACT until such time as MCT falls due. They would thus enjoy the same cash-flow advantage as resident subsidiaries of resident parent companies, there being no other difference - assuming equal bases of assessment - between the amounts of MCT for which the two types of subsidiary are liable in respect of the same accounting period".[135] Accordingly, the Court concluded that "the difference in the tax treatment of parent companies depending on whether or not they are resident cannot justify denial of a tax advantage to subsidiaries, resident in the United Kingdom, of parent companies having their seat in another Member State where that advantage is available to subsidiaries, resident in the United Kingdom, of parent companies also resident in the United Kingdom, since all those subsidiaries are liable to MCT on their profits irrespective of the place of residence of their parent companies".[136] Thus, this case involved the tax rules of the UK only. These rules alone triggered the cash-flow disadvantage for the foreign parent companies receiving dividends from their subsidiaries in the UK. This tax disadvantage amounted to a restriction on the freedom of establishment which was not justified.

X and Y

A similar scenario occurs in *X and Y*.[137] In that case two Swedish nationals, X and Y, applied for a preliminary tax ruling from the Swedish Revenue Law Commission concerning the tax implications of a proposed share transfer at an undervalue[138] by X and Y, of their shares in X AB, a Swedish company, to Z AB, another Swedish company, which was a subsidiary of a Belgian resident company, Y SA. The Swedish tax rules allowed share transfers to take place undervalue in a situation where the owners of the Swedish transferee company had Swedish owners but not where it had foreign owners. X and Y argued that such rules breached the freedom

134 *Metallgesellschaft* paragraph 52.

135 *Metallgesellschaft* Paragraph 54.

136 *Metallgesellschaft* Paragraph 60.

137 ECJ, 21 Nov. 2002, Case C-436/00 *X and Y v Riksskatteverket ("X and Y"),* [2002] ECR I-10829.

138 At their acquisition cost.

of establishment and free movement of capital because a deferral of capital gains tax was denied in situations involving a cross-border element with a consequential cash-flow disadvantage.

The ECJ determined that the "refusal of the tax advantage in question on the ground that the transferee company in which the taxpayer has a holding is established in another Member State, is likely to have a deterrent effect on the exercise by that taxpayer of the right conferred on him by Article 43 EC to pursue his activities in that other Member State through the intermediary of a company".[139] Accordingly, the Court held that such rules amounted to a restriction on the freedom of establishment and "[a]cceptance, in the present case, of the proposition that the Member State concerned may refuse the benefit of deferring capital gains tax, thus depriving the transferor of a cash flow advantage, by reason of the fact that the parent company of the transferee company is situated in another Member State would deprive Article 43 EC of all meaning".[140] The Court found no justification for this restriction. The tax rules at stake were those of a single Member State. The refusal to grant the cash-flow advantage (i.e., the deferral of the payment of capital gains tax on the transfer of shares at an undervalue), in cross-border situations amounted to a restriction on the freedom of establishment and that restriction was caused by the Swedish tax rules at issue which were not justified by a general interest.

De Baeck

In *De Baeck*,[141] the Court, delivering its decision by way of reasoned Order, dealt with Belgian tax rules which provided that gains in value were not chargeable to tax if the shares or stock were assigned to Belgian companies, associations, establishments or bodies, but they were chargeable if the shares or stock were assigned to foreign companies, associations, establishments or bodies. The Court noted that "[t]he effect of the national legislation at issue in the main proceedings is that the transferor who assigns his shares in a company established in another Member State suffers a charge to tax on the gains made which is not the case where the transferor assigns his shares to a Belgian company".[142] This amounted to a restriction on the freedom of establishment or the free movement of capital depending on the circumstances. Thus, the tax rules at stake were those of a single

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139 *X and Y* paragraph 36.

140 *X and Y* paragraph 38.

141 ECJ, 8 June 2004,Case C-268/03 *Jean-Claude De Baeck v Kingdom of Belgium ("De Baeck"),* [2004] ECR I-5961.

142 *De Baeck* paragraph 24.

Member State (Belgium). It was these rules which caused the restriction on the fundamental freedoms.

The other cases cited by Advocate General Sharpston in her Opinion in *Lidl Belgium* were *FII GLO*[143] and *Rewe Zentralfinanz.*[144] These also concerned the rules of a single Member State which caused the unjustified restriction on the fundamental freedoms. However, these one-State situations have to be distinguished from situations involving the rules of two Member States which create situations that are either disparities or which are prima facie restrictions on the fundamental freedoms but are justified by a general interest of the Member States such as by the need to ensure a balance in the allocation of taxing rights.[145]

Cash-flow Disadvantages caused by the rules of two Member States

The Court has made it clear in its direct tax jurisprudence since *Gilly*[146] that there is a difference between the situation where it is the tax rules of a single Member State causing a restriction on the fundamental freedoms and the situation where there is a problem caused by the interaction of the tax rules of two Member States. In the latter situation, which the Court often classifies as a disparity, EU law may not provide a solution. Thus, in *Gilly*, the Court determined that "whether the tax treatment of the taxpayers concerned is favourable or unfavourable is determined not, strictly speaking, by the choice of the connecting factor but by the level of taxation in the competent State, in the absence of any Community harmonisation of scales of direct taxation".[147] The Court went on to say that "the effect on the amount of the tax credit of the fact that the taxpayer's personal and family circumstances are taken into account in the State of residence but not in the State of employment, it must be pointed out that the disparity derives from the fact that, in relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable, since income received in the territory of a State by a non-resident is in most cases only a

143 For analysis of *FII GLO*, see Tom O'Shea, *"Dividend Taxation Post-*Manninen: *Shifting Sands or Solid Foundations?"* Tax Notes International, 5 March 2007, 887-918.

144 For analysis of *Rewe Zentralfinanz*, see Tom O'Shea, *"Further Thoughts on Rewe Zentralfinanz*", Tax Notes International, 9 April 2007, 134-137.

145 Support for this proposition is found in the Opinion of Advocate General Geelhoed in *ACT IV GLO* point 46, where he pointed out that "obstacles to freedom of establishment resulting from disparities or differences between the tax systems of two or more Member States fall outside the scope of Article 43 EC. These may be contrasted with obstacles resulting from discrimination, which occurs as a result of the rules of just one tax jurisdiction".

146 ECJ, 20 Nov. 1997, Case C-336/96, *Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin ("Gilly"),* [1997] ECR I-2793.

147 *Gilly* paragraph 34.

part of his total income, which is concentrated at his place of residence".[148] In relation to the France-Germany double tax convention, the Court explained that "any unfavourable consequences entailed in the present case by the tax credit mechanism set up by the bilateral convention, as implemented in the context of the tax system of the State of residence, are the result in the first place of the differences between the tax scales of the Member States concerned, and, in the absence of any Community legislation in the field, the determination of those scales is a matter for the Member States".[149] The Court concluded that "the fact that in allocating powers of taxation between them the contracting parties have chosen various connecting factors, in particular nationality with regard to public-service remuneration received in the State other than the State of residence, cannot in itself constitute discrimination prohibited by Community law".[150] Thus, the fact that Mrs Gilly had to pay the higher German taxes rather than the lower French taxes was not regarded as discrimination within the meaning of the free movement of workers' provisions of the EC Treaty.

This type of disparity could be solved by harmonised tax rules adopted at the EU level, but to date this has generally not occurred. Therefore, these types of "restrictions" (disparities) involving the tax rules of two Member States remain unresolved at the moment. Consequently, the regulatory framework for tax[151] in the EU contains tax rules at three different levels – at the national level; at the international level (usually double tax conventions and other international agreements entered into by the Member States, like the Arbitration Convention[152]) and at the EU level. Because the rules are not all harmonised and, therefore, operate at three different levels rather than simply at the EU level, situations will occur, such as that seen in *Gilly*, where the exercise of a fundamental freedom right was discouraged. However, under the current state of development of EU law, this type of (disparity) discouragement has to be accepted.

Similarly, as seen below in cases like *Marks and Spencer* and *Lidl Belgium*, the Member States may justify their restrictive tax rules on the ground that such rules are necessary to safeguard the balance in the allocation of taxing rights. These "two-

148 *Gilly* paragraph 49.

149 *Gilly* paragraph 47.

150 *Gilly* paragraph 53.

151 For a detailed discussion of the Regulatory Framework for Tax in the EU, see Tom O'Shea, *"EU Tax Regulatory Framework"*, Tax Journal, Issue 955, 21 (3 Nov.2008).

152 Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of transfers of profits between associated undertakings (O.J. L 225 of 20.08.1990).

State" situations remain unresolved in the current framework for tax in the EU. An example might be helpful.

Example

Suppose X lives in the UK and pays tax at 28% and moves to France and pays tax at 40%. This does not amount to a breach of his free movement rights provided that France taxes him in a similar way to a French national who is resident in France.[153] The mere fact that France charges a higher tax rate than the UK is not a matter that is resolved by EU law as it currently stands. The higher or lower tax rates fall within the competence of the Member States in relation to direct taxes and the problem is caused by the interaction between the tax rules of two Member States. In *Marks and Spencer*, the situation is the same, but this time the issue at stake is not the rate of tax, but rather whether group loss relief has to be extended cross-border.

Marks and Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)

In *Marks and Spencer*, the Court observed that the UK's group relief rules constituted a "tax advantage for the companies concerned. By speeding up the relief of the losses of the loss-making companies by allowing them to be set off immediately against the profits of other group companies, such relief confers a cash advantage on the group". The Court went on to decide that "[t]he exclusion of such an advantage in respect of the losses incurred by a subsidiary established in another Member State which does not conduct any trading activities in the parent company's Member State is of such a kind as to hinder the exercise by that parent company of its freedom of establishment by deterring it from setting up subsidiaries in other Member States".[154] Therefore, the UK's rules amounted, in principle, to a restriction on the freedom of establishment unless they could be justified.

153 See for instance *Lindfors* where the Court specified that "the EC Treaty offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation. Given the disparities in the tax legislation of the Member States, such a transfer may be to the citizen's advantage in terms of indirect taxation or not, according to circumstance. It follows that, in principle, any disadvantage, by comparison with the situation in which that citizen carried on activities prior to that transfer, is not contrary to Article 18 EC, provided that the legislation concerned does not place that citizen at a disadvantage as compared with those already subject to such a tax". ECJ, 15 July 2004, Case C-365/02, *Marie Lindfors ("Lindfors"),* [2004] ECR I-7183, paragraph 34.

154 *Marks and Spencer* paragraph 33.

"Two -sides of the same coin" argument

The Court noted that residence may not always be a proper factor for distinction and that "[i]n each specific situation, it is necessary to consider whether the fact that a tax advantage is available solely to resident taxpayers is based on relevant objective elements apt to justify the difference in treatment".[155] Significantly, the Court went on to point out that "the fact that it does not tax the profits of the non-resident subsidiaries of a parent company established on its territory does not in itself justify restricting group relief to losses incurred by resident companies". This was the Court's rejection, in part, of the UK's "two -sides of the same coin" argument which suggested that since the UK did not tax the profits of the foreign subsidiaries of UK parent companies, it should not have to give relief for the losses of such foreign subsidiaries. That argument alone was not sufficient to justify the UK's group relief rules.[156] Therefore, the Court went on to examine the further justifications offered by the UK and the other intervening Member States.

Preserving the power to allocate taxing rights

In *Marks and Spencer*, the Court accepted that "the preservation of the allocation of the power to impose taxes between Member States might make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses".[157] In other words, in establishment situations where two Member States have agreed to share their overlapping tax jurisdiction in a certain way, only the tax rules of the establishment Member State should apply to the profits and losses. However, the Court went on to conclude that this was not always the case, indicating that the principle of proportionality may require the UK to grant loss relief cross-border, in situations where there are terminal losses in the establishment Member State because where the UK parent company meets the conditions laid down in the "no-possibilities test",[158] it would be a disproportionate restriction on the freedom of establishment

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155 *Marks and Spencer* paragraph 38.

156 The Court confirmed this in *Marks and Spencer* paragraph 40.

157 *Marks and Spencer* paragraph 45.

158 See *Marks and Spencer* paragraph 55: "In that regard, the Court considers that the restrictive measure at issue in the main proceedings goes beyond what is necessary to attain the essential part of the objectives pursued where: – the non-resident subsidiary **has exhausted the possibilities** available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods, if necessary by transferring those losses to a third party or by offsetting the losses against the profits made by the subsidiary in previous periods, and – there is **no possibility** for the foreign subsidiary's losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party" (emphasis added).

for the UK to grant group relief to UK parent companies with subsidiaries in the UK and to refuse to grant similar loss relief to UK parent companies with subsidiaries in other Member States. The Court highlighted that the UK's rules went beyond what was necessary to achieve the essential part of the objectives pursued where there was no possibility of obtaining the loss relief in the establishment Member State.

Reconciling *Marks and Spencer* with *Metallgesellschaft*

The Court's judgment in *Marks and Spencer* triggers the debate regarding cash-flow advantages and disadvantages and it is important to reconcile this case with *Metallgesellschaft* and *X and Y* which also involved cash-flow disadvantages. It is clear that the Court is satisfied that that a cash-flow disadvantage can amount to a restriction on the freedom of establishment. However, as in the case of any non-discriminatory restriction of a fundamental freedom, the possibility exists for the Member States to justify their tax rules. The Court emphasised this in its *Marks and Spencer* judgment when it stated that "[s]uch a restriction is permissible only if it pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest. It is further necessary, in such a case, that its application be appropriate to ensuring the attainment of the objective thus pursued and not go beyond what is necessary to attain it". [159] The important distinction to note is that in *Marks and Spencer*, such a justification existed whereas in *Metallgesellschaft* and *X and Y* it did not.

In *Marks and Spencer*, the justification accepted by the Court involved the need to safeguard the balance in the allocation of taxing rights "taken together"[160] with the need to prevent double use of losses (so-called "double-dipping") and the need to prevent tax avoidance (caused by the transfer of losses within a group to the Member State which applied the highest rate of taxation – so-called "loss trafficking"). This justification was accepted by the Court in relation to all cross-border loss situations not meeting the "no-possibilities test". However, in a situation involving terminal or final losses (where the "no-possibilities test" was satisfied), the Court found that there was no justification for the UK's group relief rules not being extended to cover the final losses of subsidiaries established by UK parent companies in situations where other UK parent companies with subsidiaries in the UK received such loss relief and thereby acquired a tax advantage (cash

159 *Marks and Spencer* paragraph 35. This is merely an application of the *Gebhard* formula. See ECJ, 30 Nov. 1995, Case C-55/94, *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano ("Gebhard*"), [1995] ECR I-4165, paragraph 37: "national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it".

160 *Marks and Spencer* paragraph 51.

advantage[161]). In such circumstances it is clear that there was no opportunity for double dipping; no opportunity for moving the losses to another Member State and no opportunity for the taxable basis to be increased in the origin Member State and reduced in the establishment Member State "to the extent of the losses transferred"[162] because the final losses in the establishment Member State could not be utilised there. In such circumstances, the refusal to grant the loss relief cross-border failed the proportionality test.

The author has pointed out before[163] that the *Marks and Spencer* decision does not mean that a Member State is always obliged to grant loss relief for the terminal losses of subsidiaries established in other Member States. The Member States' obligations are far more limited than this. The UK is only obliged to relieve terminal losses in cross-border establishment situations because it grants this type of relief to UK parent companies with loss-making subsidiaries in the UK. If the UK did not offer such loss relief domestically, then it would not be obliged to relieve terminal losses in cross-border establishment situations because, in such instances, the UK would not be treating the cross-border situation less favourably than a comparable domestic situation.[164] In other words, there would be no restriction on the freedom of establishment: all UK parent companies establishing in the UK or elsewhere in the EU would be treated in a similar way and no group relief would be available in either situation.

The cash-flow disadvantage in the circumstances of *Marks and Spencer* differs from the situation seen in *Metallgesellschaft* and *X and Y* cases. In *Marks and Spencer*, it is not the UK's rules alone that must be taken into account. The situation of the establishment Member State must also be factored into the equation. This can be better seen from the following example.

> *Example*
>
> Consider the situation of the Belgian subsidiary in Marks and Spencer, which incurred terminal losses. Under the arrangements put in place for the taxation of that non-UK resident company, the UK agreed not to tax its profits unless such profits were attributed to a permanent establishment in the UK. Similarly, if a Belgian company established a UK subsidiary,

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161 *Marks and Spencer* paragraph 32.

162 See *Marks and Spencer* paragraph 46.

163 See Tom O'Shea, *"The Common Consolidated Corporate Tax Base (CCCTB) – Issues for Member States Opting Out and Third Countries: A Critique and Some In-depth Analysis",* ECTJ, 10, 1, 2008, 1-14 at 6.

164 For an example, see ECJ, 6 Dec. 2007, Case C-298/05, *Columbus Container Services BVBA & Co. v Finanzamt Bielefeld-Innenstadt* ("*Columbus Container*"), [2007] ECR I-10451.

Belgium agreed not to tax that non-resident subsidiary on its profits unless it maintained a permanent establishment in Belgium.[165] In a situation where the Belgian subsidiary made losses, such losses would fall to be determined under Belgian loss relief rules. Similarly, if the Belgian parent company's UK's subsidiary made losses, these losses would fall to be determined and relieved under UK rules.[166] In other words, the incorporation of the subsidiary in another Member State, whilst constituting an act of establishment, meant that a new legal entity was created which was subject to the tax rules of the establishment Member State. The establishment Member State, therefore, taxes the profits and relieves the losses according to its rules. Cash-flow advantages /disadvantages in such circumstances will invariably occur according to the circumstances of each case.

This "cash-flow" problem has not been resolved by EU law as it currently stands because the rules relating to direct taxes and the granting of loss relief are a matter for the Member States. Thus, in *Schempp*,[167] the Court held that "the Treaty offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation. Given the disparities in the tax legislation of the Member States, such a transfer may be to the citizen's advantage in terms of indirect taxation or not, according to circumstances".[168] Therefore, the norm in such situations is for the UK to neither tax the profits of the Belgian subsidiary nor provide relief for its losses. Such losses would normally stand to be relieved by Belgium under its tax regime. Any cash-flow disadvantage suffered by the UK parent company would be a natural consequence of the interaction between the tax rules of the UK and Belgium. In other words, such cash-flow disadvantages arise from a disparity rather than a restriction. In a non-EU environment, these cash-flow disadvantages would remain unresolved and indeed, that is the norm whenever cross-border establishments are created involving a subsidiary.

165 Under UK domestic law and Article 7(1) of the Belgium-UK Double Tax Convention, available at the following link - http://www.hmrc.gov.uk/manuals/dtmanual/DT3456.htm (last visited on 17 August 2010).

166 Note, the possibility of an exception such as the one seen in *Krankenheim*. ECJ, 23 Oct. 2008, Case C-157/07, *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH ("Krankenheim"),* [2008] ECR I-8061. For an analysis of the *Krankenheim* judgment, see Tom O'Shea, "*German Loss Deduction and Reintegration Rules and the ECJ",* Worldwide Tax Daily, 20 March 2009, 2009 WTD 52-11.

167 ECJ, 12 July 2005, Case C-403/03, *Egon Schempp v Finanzamt München V, ("Schempp"),* [2005] ECR I-6421.

168 *Schempp* paragraph 45.

However, in a European Internal Market setting, such losses may have to be relieved by the UK in situations where (a) the UK grants loss/group relief domestically and (b) the UK parent company can demonstrate that the Belgian terminal losses meet the "no-possibilities test" set out in paragraphs 55-56 of *Marks and Spencer*. In such cases, the UK's rules are clearly protectionist because there is no general interest justification for limiting the granting of group relief to UK parent companies establishing subsidiaries in the UK. Merely arguing that the balance in the allocation of taxing rights would be disturbed is not enough. The UK has to demonstrate how that balance might be breached in cross-border situations. From the above analysis it is clear that in relation to losses which meet the "no-possibilities test" (and which will therefore never be relieved in the establishment Member State), the balance in the allocation of taxing rights, taken together with the avoidance situations discussed above, is not disturbed. Thus, the UK is required to provide similar relief to UK parent companies who establish subsidiaries in other Member States to that granted to UK parent companies that establish UK subsidiaries.

Lidl Belgium

The "cash-flow disadvantage" debate was re-kindled by Advocate General Sharpston in *Lidl Belgium*, where the Court was again faced with a two-State situation. The Court recognised that "a provision which allows losses incurred by a permanent establishment to be taken into account in calculating the profits and taxable income of the principal company constitutes a tax advantage[169] … However, the provisions of that tax regime do not grant such a tax advantage where the losses are incurred by a permanent establishment situated in a Member State other than that in which the principal company is established[170]…In those circumstances, the tax situation of a company which has its registered office in Germany and has a permanent establishment in another Member State is less favourable than it would be if the latter were to be established in Germany. By reason of that difference in tax treatment, a German company could be discouraged from carrying on its business through a permanent establishment situated in another Member State".[171] Therefore, the Court determined that the German tax rules at issue amounted to a restriction on the freedom of establishment which required justification.

Germany argued that, since, under its double tax convention with Luxembourg, the income of the Luxembourg permanent establishment of the German company was exempt from taxation in Germany, the need to ensure a balance in the allocation of

169 *Lidl Belgium* paragraph 23

170 *Lidl Belgium* paragraph 24.

171 *Lidl Belgium* paragraph 25.

taxing rights and the need to prevent tax avoidance, similar to that seen in *Marks and Spencer,* were a sufficient justification for its tax rules.[172]

The Court accepted that "the objective of preserving the allocation of the power to impose taxes between the two Member States concerned, which is reflected in the provisions of the Convention, is capable of justifying the tax regime at issue in the main proceedings, since it safeguards symmetry between the right to tax profits and the right to deduct losses".[173] The Court pointed out that "to accept that the losses of a non-resident permanent establishment might be deducted from the taxable income of the principal company would result in allowing that company to choose freely the Member State in which those losses could be deducted"[174] and that "there is clearly a danger that the same losses will be used twice".[175] Consequently, the Court held that the tax rules at issue could be justified by "the need to safeguard the allocation of the power to tax between the Member States and the need to prevent the danger that the same losses will be taken into account twice"[176] and that the German tax regime was "appropriate for ensuring the attainment of the objectives pursued by it".[177] The Court concluded that it had recognised (in *OY AA*)[178] "the legitimate interest which the Member States have in preventing conduct which is liable to undermine the right to exercise the powers of taxation which are vested in them. In this connection, where a double taxation convention has given the Member State in which the

172 In this case, Germany and a number of intervening Member States indicated that there was a possibility of "loss- trafficking" and "double-dipping".

173 *Lidl Belgium* paragraph 33.

174 *Lidl Belgium* paragraph 34.

175 *Lidl Belgium* paragraph 36.

176 *Lidl Belgium* paragraph 42.

177 *Lidl Belgium* paragraph 43.

178 *OY AA* paragraph 55. For an analysis of the *OY AA* case, see Tom O'Shea, "Finland's Intra-group Financial Transfer Rules Compatible with EU Law", Tax Notes International, 13 August 2007, 634-638. It should be noted that the *Oy AA* case did not concern "terminal losses". If a terminal loss situation were involved, it now seems clear that the Court would apply its *Marks and Spencer* reasoning and insist that the Member State operating the group contribution scheme would have to relieve the cross-border losses that meet the "no possibilities test". This is because the "conduct capable of jeopardising the right of the Member States to exercise their taxing powers in relation to activities carried on in their territory" no longer exists if the "no-possibilities test" is met. Such losses cannot be used in two States. Such losses cannot amount to tax avoidance involving "double dipping" or "loss trafficking" because they can only be utilised if the Member State operating the group contribution scheme allows the transfer of profits cross-border. In such circumstances, arguably, there is no justification for the national rules which fail to allow the group contribution cross-border for losses that meet the "no-possibilities test". In such circumstances, the restriction on the freedom of establishment (determined by the Court in paragraph 43 of *Oy AA* would not be justified.

permanent establishment is situated the power to tax the profits of that establishment, to give the principal company the right to elect to have the losses of that permanent establishment taken into account in the Member State in which it has its seat or in another Member State would seriously undermine a balanced allocation of the power to impose taxes between the Member States concerned". [179] Accordingly, the Court noted that "[i]n the light of all of the above, the tax regime at issue in the main proceedings must be considered to be proportionate to the objectives pursued by it".[180]

Reconciling *Lidl Belgium* with *Metallgesellschaft*

Can the Court's judgment in *Lidl Belgium* be reconciled with *Metallgesellschaft* in relation to the cash-flow disadvantage argument so forcefully put by Advocate General Sharpston in her Opinion in *Lidl Belgium*? As discussed above, the distinction between the two cases depends on whether it is the rules of one Member State (as in *Metallgesellschaft*) that are in play or whether there is an interaction between the rules of two Member States. In the former situation there is no general interest justification for the national tax rules, whereas in the latter situation the balance in the allocation of taxing rights put in place by the two Member States in their double tax convention must be factored into the equation. The situations at stake in the two cases can clearly be distinguished which explains why the Court came to different conclusions relating to the "cash-flow disadvantages".

New grounds of justification

One final comment is worth making in response to Lang's suggestion that the Court "should avoid combining different grounds of justification" and "refrain from introducing new grounds of justification that lead to uncertainty". This argument fails to take into account that EU law is constantly evolving.

When the Court first introduced justifications into its case law only some were specifically mentioned, and the Court made it very clear that the justifications it outlined were only examples and were not meant to be an exhaustive list. Thus, in *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein,* (otherwise known as *Cassis de Dijon),* the Court highlighted that "obstacles to movement within the Community resulting from disparities between the national laws relating to the marketing of the products… must be accepted in so far as those provisions may be recognized as being necessary in order to satisfy mandatory requirements relating ***in particular*** to the effectiveness of fiscal supervision, the protection of public health,

179 *Lidl Belgium* paragraph 52.

180 *Lidl Belgium* paragraph 53.

the fairness of commercial transactions and the defence of the consumer".[181] In its direct tax jurisprudence, the Court added coherence of the tax system in *Bachmann,* [182] the need to prevent tax avoidance (through wholly artificial arrangements set up to circumvent UK tax legislation)[183] in *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* and the need to safeguard the balance in the allocation of taxing rights in conjunction with tax avoidance (through "loss-trafficking") in *Marks and Spencer*. It is the introduction of this last justification which has caused some concern. Lang suggests that the ECJ should avoid combining different grounds of justification and that the approach that was first adopted in *Marks and Spencer* should be overturned. He goes on to submit that "[c]ohesion and balanced allocation of taxing powers seem to be exchangeable and lead to a large amount of uncertainty". This approach fails to accept that the ECJ treats both justifications separately and carries out separate analyses.

Safeguarding the balance in the allocation of taxing rights

In terms of the Court's direct tax jurisprudence, it is clear that the need to safeguard the balance in the allocation of taxing rights between Member States taken together with a tax avoidance factor was a newly introduced justification in *Marks and Spencer*[184]. It was not however the same justification as the need to preserve the coherence of the tax system. This is clear from cases subsequent to *Marks and Spencer* where both justifications have been put forward independently and analysed

181 ECJ, 20 Feb. 1979, Case 120/78, *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein ("Cassis de Dijon"),* [1979] ECR 649, paragraph 8 (emphasis added).

182 ECJ, 28 Jan. 1992, Case C-204/90, *Hanns-Martin Bachmann v Belgian State ("Bachmann"),* [1992] ECR I-249.

183 ECJ, 16 July 1998, Case C-264/96, *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes) ("ICI v Colmer"),* [1998] ECR I-4695, paragraph 26.

184 Note the justification had been rejected by the ECJ in *De Lasteyrie* paragraph 68. The explanation for this rejection is found in paragraph 3 of the judgment, which highlighted that France exonerated the payment of the "exit tax" after five years from the date of departure. In other words, France did not maintain its taxing right beyond five years from the date of emigration where the taxpayer had not returned to France during this period and had not disposed of the shares in question. The Court provided further clarification in paragraph 59 of its later *Amurta* decision, pointing out that "where a Member State has chosen not to tax recipient companies established in its territory in respect of this type of income, it cannot rely on the argument that there is a need to safeguard the balanced allocation between the Member States of the power to tax in order to justify the taxation of recipient companies established in another Member State". See ECJ, 11 Mar. 2004, Case C-9/02, *Hughes de Lasteyrie du Saillant v Ministère de l'Économie, des Finances et de l'Industrie, ("De Lasteyrie"),* [2004] ECR I-2409 and ECJ, 8 Nov. 2007, Case C-379/05, *Amurta SGPS v Inspecteur van de Belastingdienst/Amsterdam ("Amurta"),* [2007] ECR I-9569.

separately by the Court. Moreover, as this author pointed out before,[185] the need to safeguard the balance in the allocation of taxing rights has a link to the jurisprudence of the Court in the social security and health services areas. Allowing nationals to go abroad to have their hip operations has budgetary implications for a Member State and, therefore, the requirement of a prior authorisation before such treatment can be obtained abroad at the expense of that origin Member State is not an unreasonable requirement. Indeed, the Court emphasised in *Watts*[186] that "the requirements arising from Article 49 EC and Article 22 of Regulation No 1408/71 are not to be interpreted as imposing on the Member States an obligation to reimburse the cost of hospital treatment in other Member States without reference to any budgetary consideration but, on the contrary, are based on the need to balance the objective of the free movement of patients against overriding national objectives relating to management of the available hospital capacity, control of health expenditure and financial balance of social security systems".[187] The Court explained that "the resulting patient migration would be liable to put at risk the competent Member State's planning and rationalisation efforts in the vital healthcare sector so as to avoid the problems of hospital overcapacity, imbalance in the supply of hospital medical care and logistical and financial wastage".[188] Similar planning and budgetary concerns occur in the taxation field, for example, in relation to the relief of cross-border losses. Generally, a Member State will not have budgeted for the relief of cross-border losses of foreign subsidiaries because those subsidiaries are not taxed by that Member State, rather they are taxed by their respective States of establishment and it is their States of establishment that should be responsible for the relief of their losses. That is the "two sides of the same coin" argument discussed above. But that argument alone was rejected by the Court as a stand-alone justification in *Marks and Spencer*.[189] Therefore, something more had to be demonstrated and this explains why the Court examined the situation that would occur where the advantages of the group relief scheme were extended cross-border. In a European Internal Market environment, it might be an unjustified restriction of the fundamental freedoms to deny cross-border relief in situations where such loss relief was granted domestically.

185 See footnote 26 above.

186 ECJ, 16 May 2006, Case C-372/04, *The Queen, on the application of Yvonne Watts v Bedford Primary Care Trust and Secretary of State for Health ("Watts"),* [2006] ECR I-4325.

187 *Watts* paragraph 145.

188 *Watts* paragraph 71.

189 See *Marks and Spencer* paragraph 40, where the Court said that "the fact that it does not tax the profits of the non-resident subsidiaries of a parent company established on its territory does not in itself justify restricting group relief to losses incurred by resident companies".

In situations where group relief was extended cross-border, the Court determined that "to give companies the option to have their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardise a balanced allocation of the power to impose taxes between Member States".[190] In other words, there was a specific threat shown that the balance in the allocation of taxing rights would be jeopardised by the extension of the UK's group relief rules. The question remained whether such rules met the principle of proportionality.

The Court decided that only situations covered by the "no-possibilities test" went too far. In situations where the "no-possibilities test" was met, the UK was obliged to grant the loss relief cross-border because it granted the relief domestically. In those situations, it was clear that a balance in the allocation of taxing rights would not be a sufficient justification for the failure to grant loss relief cross-border in situations where the relief was granted domestically. There would be no risk of double-dipping or loss-trafficking in such circumstances because the terminal losses could not be relieved in the establishment Member State. Therefore, the balance in the allocation of taxing rights was not in jeopardy. The mere fact that the terminal losses would have to be relieved in the origin Member State was merely a consequence of that Member State's protectionist tax rules which restricted group relief to domestic subsidiaries. Support for this reasoning is found in *SGI*.[191]

SGI

In *SGI*, the Court discussed the balance in the allocation of taxing rights' justification in more detail, highlighting, as it did in *Marks and Spencer*, that "such a justification may be accepted, in particular, where the system in question is designed to prevent conduct capable of jeopardising the right of a Member State to exercise its tax jurisdiction in relation to activities carried out in its territory".[192] The Court explained that it would "undermine the very system of the allocation of the power to impose taxes between Member States because, according to the choice made by companies having relationships of interdependence, the Member State of the company granting unusual or gratuitous advantages would be forced to renounce its right, in its capacity as the State of residence of that company, to tax its income in favour, possibly, of the Member State in which the recipient company has its establishment".[193] The Court concluded that by taxing the gratuitous advantages the

190 *Marks and Spencer* paragraph 46.

191 ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle (SGI) v Belgian State ("SGI"),* [2010] ECR I-0000 (not yet reported). For an analysis, see Tom O'Shea, *"ECJ Upholds Belgian Transfer Pricing Regime"*, 2010 WTD 19-1.

192 *SGI* paragraph 60.

193 *SGI* paragraph 63.

Belgian tax rules permitted Belgium "to exercise its tax jurisdiction in relation to activities carried out on its territory".[194]

The relationship between two types of "tax avoidance"

In *SGI*, as in *Marks and Spencer,* (but perhaps less clearly in that case),[195] the Court drew a distinction between national rules which are designed to prevent tax avoidance by specifically targeting "wholly artificial arrangements designed to circumvent the legislation of the Member State concerned" [196] and national legislation "which is not specifically designed to exclude from the tax advantage it confers such purely artificial arrangements – devoid of economic reality, created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory – may nevertheless be regarded as justified by the objective of preventing tax avoidance, taken together with that of preserving the balanced allocation of the power to impose taxes between the Member States".[197]

The need to prevent the latter type of tax avoidance is not a standalone justification but rather a factor used in determining whether the balanced allocation in the allocation of taxing rights is jeopardised. In *SGI*, for instance, the Court indicated that "to permit resident companies to grant unusual or gratuitous advantages to companies with which they have a relationship of interdependence that are established in other Member States, without making provision for any corrective tax measures, carries the risk that, by means of artificial arrangements, income transfers may be organised within companies having a relationship of interdependence towards those established in Member States applying the lowest rates of taxation or in Member States in which such income is not taxed".[198] Thus, the Belgian transfer pricing rules at stake are "able to prevent such practices, liable to be encouraged by the finding of significant disparities between the bases of assessment or rates of tax applied in the various Member States and designed only to avoid the tax normally due in the Member State in which the company granting the advantage has its seat".[199]

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194 *SGI* paragraph 64.

195 See *Marks and Spencer* paragraphs 49 and 57.

196 *SGI* paragraph 65.

197 *SGI* paragraph 66.

198 *SGI* paragraph 67.

199 *SGI* paragraph 68.

The Court completed its reasoning, highlighting that " [i]n the light of those two considerations, concerning the need to maintain the balanced allocation of the power to tax between the Member States and to prevent tax avoidance, taken together, it must be held that legislation such as that at issue in the main proceedings pursues legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest and that it is appropriate for ensuring the attainment of those objectives".[200] It is submitted that this approach of the Court does not need to be abolished. The Court is simply defining the scope of the relationship between safeguarding the balance in the allocation of taxing rights between the Member States and the need to ensure that tax avoidance does not place a Member State's taxing rights in jeopardy.

From the *Marks and Spencer* and *SGI* judgments, it is clear that the Court does not see balance in the allocation of taxing rights as a stand-alone justification. Clearly, some jeopardy to, or some potential breach of, that "balance" must be shown. The national rules at issue must endeavour to prevent that jeopardy or breach from occurring, or ensure that the Member State's right to tax activities related to its territory is not undermined.[201] Similarly, in these types of situation, the Court also makes it clear that this type of tax avoidance (not involving wholly artificial arrangements designed to circumvent the national tax system) is not a stand -alone justification either but operates only in tandem with the need to protect the balance in the allocation of taxing rights between the Member States. Therefore, balance in the allocation of taxing rights and the risk of this type of tax avoidance are only justifications when taken together.

The Court's approach, first adopted in *Marks and Spencer* and clarified considerably in *SGI*, is necessary given that it has shown that there are two types of tax avoidance situation. The first category of tax avoidance involves wholly artificial arrangements designed to circumvent the national tax system. Preventing such tax avoidance is a general interest justification for a Member State's national rules subject to meeting the principle of proportionality. This type of tax avoidance may occur in situations where a balance in the allocation of taxing rights is not relevant. However, the Court has identified, in *Marks and Spencer* and *SGI*, a second category of national rules designed to prevent tax avoidance, which does not necessarily involve wholly artificial arrangements designed to circumvent the national tax system. This not a justification in its own right but may be a justification in the context of safeguarding the balance in the allocation of taxing rights. The national rules may be justified as being necessary to protect that Member State's taxing rights and the tax avoidance in question demonstrates the jeopardy to the balance in the allocation of taxing rights and explains the reason for the restrictive national tax rules in question.

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200 *SGI* paragraph 69.

201 The provisions of the DTC in *Lidl Belgium* ensured the balance in the allocation of taxing rights between Germany and Luxembourg.

Based on this reasoning, it seems clear that balance in the allocation of taxing rights taken in conjunction with the need to prevent tax avoidance is a significant general interest justification in the Member States' arsenal against avoidance situations that do not rise to the level of wholly artificial arrangements designed to circumvent their tax systems.

Part III

Concluding remarks

This essay set out to provide an alternative view of the Court's jurisprudence to that offered by Lang in his 2009 article and endeavoured to generate some new discussions on EU tax issues. This Part sums up the debate, highlights the fresh thinking, sets out how tax is actually regulated in the EU, and looks at some of the lessons to be learned from this research.

Understanding the direct tax jurisprudence of the ECJ

From this research it is clear that there are at least three schools of thought operating in the EU tax field. The first comprises those commentators who feel that the Court's case law is inconsistent; is often wrong and contradictory and thus, leads to tensions and uncertainty. In general terms, such commentators believe that the Court's direct tax jurisprudence deserves criticism from the worldwide academic community. Lang stressed that it was "the responsibility of academics not so much to praise the Court where its case law is convincing but to point at possible tensions or contradictions." The second school of thought probably covers the majority of commentators on EU tax matters. Its subscribers accept most ECJ judgments and only query certain controversial issues which fail to easily fall in line with the Court's earlier jurisprudence. The author, along with a small minority of commentators, belongs to a third school of thought; one which recognises that the Court's judgments are extremely consistent across the fundamental freedoms and that EU tax law is evolving. Commentators subscribing to this third school of thought point out that many of the controversial issues highlighted in the tax literature are generated by the academic writers' understanding of the Court's jurisprudence rather than by the Court's jurisprudence itself. This essay has sought to demonstrate how, on closer inspection, many of these issues are not at all controversial.

The Consistency of the Court's direct tax jurisprudence

The ECJ is not a tax court. Rather, it may be seen as an "Internal Market" court that interprets EU law, whenever a Member State's national (or DTC) tax rule interacts with one of the fundamental freedoms / EU citizenship rights. The Court does not "strike-down" national tax rules.[202] Instead, in the direct tax area, the Court simply interprets the EU's freedom/ EU citizenship rights for the benefit of national courts in preliminary ruling situations or for the purposes of declaring whether a Member State has breached its EU law obligations in infringement proceedings brought by the Commission.

For the purposes of assessing the consistency of the Court's direct tax case law in relation to comparability, it is submitted that it is important to divide the Court's case law into host state cases and origin State cases. This aids the identification of the correct comparator as was demonstrated in Part I. Clearly, there is a "national treatment" (or "migrant/non-migrant" test) rule at play and one of the keys to understanding the Court's direct tax jurisprudence is paragraph 94 of *De Groot*.

An analysis of the Court's fundamental freedom and EU citizenship case law demonstrates that this "national treatment" principle is applied across the freedoms.[203] Dividing the jurisprudence into host and origin-State cases also aids a discrimination or restriction analysis given that discrimination on grounds of nationality does not arise in relation to origin State cases because the comparator involves two origin State nationals.

Similarly, the realisation that the Court never compares branches and subsidiaries is important. From a host-State point of view, it has been apparent since *Avoir Fiscal* that the comparator in a corporate establishment setting involves a non-resident company with a branch in the host Member State and a resident company of the host Member State.[204] From an origin-State point of view, the comparator always

202 Lang expresses the opposite view. See Michael Lang, "*ECJ case law on cross-border dividend taxation – recent developments",* EC Tax Rev. 2008, 2, 67-77 at 73. His view is supported by Vanistendael. See Frans Vanistendael, *"Does the ECJ have the power of interpretation to build a tax system compatible with the fundamental freedoms?"* (2008) EC Tax Rev. 2, 52-66 at 55, 60 and 66. For the Court's jurisdiction in relation to preliminary rulings, see Article 267 TFEU. The Court's jurisdiction is limited to giving preliminary rulings to the national court in relation to interpretation of the Treaties and the validity and interpretation of acts of the institutions, bodies, offices or agencies of the Union. Under Article 260 TFEU, if the ECJ finds that a Member State has failed to fulfil an obligation under the Treaties, "the State shall be required to take the necessary measures to comply with the judgment of the Court. Under Article 260(2) TFEU, if the Court finds that the Member State concerned has not complied with its judgment it may impose a lump sum or penalty payment on it. There is no power to "strike-down" national legislation granted to the ECJ under Articles 260 and 267 TFEU.

203 See Tom O'Shea, *EU Tax Law and Double Tax Conventions* (Avoir Fiscal Limited, London. 2008), ISBN: 978-0-955916403.

204 See Tom O'Shea, "*Dutch Fiscal Unity Rules Receive Thumbs up from the ECJ*", Tax Notes International, Mar. 8, 2010, 835-838 at 837.

involves two origin-State companies each of which is establishing a branch or each of which is establishing a subsidiary. One of the two companies in the comparator will be exercising a fundamental freedom right.

Finally, understanding the EU's internal market requires an appreciation of so-called "even-handed" national rules, which can constitute restrictions on the fundamental freedoms or EU citizenship rights even though the "migrant" is not treated less favourably than the "non-migrant". The analysis outlined in Part I makes the link between *Bosman, Biehl* and *Ritter-Coulais* for the first time. In *Bosman,* the Court explained that even an even-handed rule could amount to an obstacle of the free movement of workers from the perspective of an origin Member State. *Biehl* and *Ritter-Coulais* are merely examples of this phenomenon from a host-State perspective. Such rules can amount to indirect discrimination because they "mainly affect" foreign nationals. In *Bosman*, from an origin-State perspective, the Court noted that the national rules "still directly affect players' access to the employment market in other Member States and are thus capable of impeding freedom of movement for workers".[205]

Regulatory Framework for Tax in the EU

It is also pertinent in understanding the Court's direct tax case law to be aware that the regulatory framework for tax in the EU consists of rules at three different levels. Since all the rules concerning direct taxation matters are not harmonised at the EU level, there are going to be times where anomaly situations will occur. Although these "anomaly" situations very often look like "restriction" situations, in a European Internal market where the rules are not all harmonised at the EU level, these anomaly situations have to be accepted given the current state of EU law. This helps to explain why "horizontal discrimination" does not form part of EU law. Equally, it explains why "one-state" situations may differ from "two-state" situations. Thus, a cash-flow disadvantage in *Metallgesellschaft* may constitute a restriction on the freedom of establishment whereas a similar cash-flow disadvantage in *Marks and Spencer* may be justified by the need to safeguard a balance in the allocation of taxing rights between two Member States, in situations where the cross-border losses are not terminal or final in nature. This does not make the Court's jurisprudence inconsistent. It simply requires a better understanding of how the regulatory framework for tax in the EU works given that competence in relation to direct tax matters remains with the EU Member States.[206] Consequently, there are going to be situations where a Member State is allowed to maintain tax rules which would otherwise be restrictive of the fundamental freedoms or EU

205 *Bosman* paragraph 103.

206 For an in-depth analysis of competence issues and the EU, see Tom O'Shea, "*Double Tax Conventions and the European Union*", ECTJ, 10, 3, 71-116.

citizenship rights because the Member State has a general interest justification (such as the need to ensure the effectiveness of fiscal supervision) and it has demonstrated that its tax rules meet the *Gebhard* formula. These anomalies are not solved by the current scheme for regulating tax in the EU. Accordingly, such anomalies have to be accepted as being part of that regulatory framework in the absence of harmonised rules at the EU level.

The *Schumacker* debate

As shown above, *Schumacker* is an example of a host Member State situation involving the exercise of the right of free movement of workers. The Court's judgment applies the national treatment principle from a host-State perspective. It demonstrates that in a European Internal Market setting a non-resident person can be in a situation comparable to a resident.[207] The Court had already demonstrated this in relation to the freedom of establishment in *Avoir Fiscal*, where it held that non-resident companies resident in Member States with branches in France were in a comparable situation to French resident companies because such non-residents were taxed on their branch profits in France in the same way as French resident companies. Thus, France could not treat them less favourably in relation to the granting of tax advantages like tax credits which it only afforded only to French resident companies or under its DTCs. In *Schumacker*, comparability was established on a similar basis in relation to the employment (host) Member State where the non-resident obtained "the major part of his taxable income from an activity performed in the State of employment, with the result that the State of his residence is not in a position to grant him the benefits resulting from the taking into account of his personal and family circumstances".[208] In such circumstances, there was no objective difference in situation between the non-resident and a resident worker in similar employment to justify the different treatment. In both *Schumacker* and *Avoir Fiscal*, the Court clearly adopted a legal and factual analysis in coming to its decision on comparability. In both cases the tax system of the host Member State was the applicable legal framework and set of tax rules under consideration by the Court.

In its subsequent *Gschwind* judgment, the Court found that the non-resident was not in a comparable situation to a resident. This was based on a similar comparability analysis to that conducted in *Schumacker* in relation to an assessment of the legal (tax) situation but the factual situation differed from that at stake in *Schumacker*. In *Gschwind*, the Gschwinds had sufficient taxable income in their residence Member State for Gschwind to obtain his personal allowances. Therefore, Germany could

207 For a more detailed discussion of tax treatment of non-residents in the EU, see Tom O'Shea, *"Taxation of Non-residents"* The Tax Journal, 2 March 2009, 20-22.

208 *Schumacker* paragraph 36.

justify not granting the allowances at issue because there was an objective difference in situation between a German resident and Gschwind.

Should *Schumacker* be overturned? Since the *Schumacker* case forms just another part of the Court's host state jurisprudence relating to the free movement of workers, it is submitted that it is fully in line with other cases involving the other freedoms and EU citizenship. Moreover, the Court cannot overturn its *Schumacker* decision without causing major ripples in its Internal Market jurisprudence. The comparability analysis conducted involved both a legal and factual analysis from the point of view of the German tax system. In such circumstances, *Schumacker* represents a fundamental case on discrimination and comparability from a host Member State perspective. Accordingly, it should not be overturned.

Final thoughts

What are some of the lessons to be learned from this discussion? Clearly, it is very easy to criticise the judgments of the ECJ. However, the above analysis has demonstrated that there is an alternative view of the Court's jurisprudence available; one that shows the Court's judgments are very consistent and not simply in the direct tax area. This is clear when links between cases like *Bosman*, *Biehl* and *Ritter-Coulais*; between *Matteucci* and the *D case*, and between *Watts* and *Marks and Spencer* are examined. Moreover, the analysis of five basic host and origin-State cases discussed above demonstrate the consistent approach taken by the Court across the fundamental freedoms and EU citizenship situations. [209]

The *Ritter-Coulais* and *Renneberg* distinction has been clearly shown to exist and the cases have been reconciled with the Court's national treatment, indirect discrimination and obstacle to the freedoms' jurisprudence. The distinction shown to exist between the two judgments explains why the approach adopted by the Court differed.

The different obligations imposed on the EU Member States depending on whether they are acting in a source or residence-State capacity has been clear since the *ACT IV GLO* judgment. *Truck Center* is fully in line with that line of precedent. Moreover, the approach of the Court in *Truck Center* is fully in keeping with the discrimination and restriction approach adopted by the Court in *Futura*.

The very troublesome cash-flow disadvantages involving the rules of one Member State are distinguished from those involving the rules of two Member States. This explains the different outcomes in cases like *Lidl Belgium* and *Marks and Spencer* from that in *Metallgesellschaft* and *X and Y*. The former are examples of two-State situations involving a justification which was acceptable to the Court, whereas in the latter situation, only the rules of a single Member State were at stake and no

209 See the cases cited in footnotes 67 and 68 above.

justification was accepted by the Court. The two scenarios are clearly distinguishable which explains the different results in the jurisprudence.

In relation to justifications, the need to safeguard a balance in the allocation of taxing rights is an important general interest justification for the Member State to ensure that their legitimate taxing rights related to their territory are protected; to ensure that their budgetary commitments are not jeopardised and to make certain that the sharing of overlapping tax jurisdiction (via DTCs or otherwise) is not threatened. Even though this justification was only introduced by the Court in its *Marks and Spencer* judgment, there is a clear parallel with the Court's health services cases, concerning damage to the budgetary equilibrium of the Member States in situations where health services are acquired in Member States other than the State of residence.

Lastly, the identification by the Court, in *Marks and Spencer* and *SGI,* of the two different forms of tax avoidance and an explanation of how each fits into the Court's scheme for justifications. Whilst the justification concerning balance in the allocation of taxing rights needs some tax avoidance to potentially take place in order to show that the national tax rules are necessary in order to safeguard against a breach of the balance in the allocation of taxing rights (meaning that safeguarding that balance is not a stand-alone justification), the Court makes it very clear that combating the risk of tax avoidance involving wholly artificial arrangements designed to circumvent the national tax system is a stand-alone justification. The clarification of these issues in *SGI* is to be welcomed.