JUSTIFICATIONS FOR RESTRICTING FUNDAMENTAL FREEDOMS ACCEPTED BY THE EUROPEAN COURT OF JUSTICE

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Intrinsic in the main purpose of the functioning of the EU as outlined in Article 26 of the Treaty of Functioning of the European Union (hereinafter referred to as "TFEU") is the elimination of any internal frontiers so that fundamental freedoms can be enjoyed. Fundamental freedoms, and accordingly the obligations to respect same, are adopted in the Member States legal system with the entrance of each Member State into the EU. The European Community Act 1972 is an example regarding the UK giving its acceptance to respect and take into account the fundamental freedoms as described in Articles 28 to 66 of the TFEU. Supporting this, O' Shea[2] has argued that the two cardinal rules of European Union law are non-discrimination on grounds of nationality and/or non-restriction of the fundamental freedoms, unless justified. Exceptions from the Treaty obligations and defences for infringing fundamental freedoms in cases of discrimination on grounds of nationality are provided for in Article 52 TFEU as derogations on grounds of public policy, public health and public security. In circumstances, though, of restricting the fundamental freedoms by imposing obstacles in enjoying the freedoms or access to the freedoms, the European Court of Justice (hereinafter referred to as "CJ") has acknowledged certain justifications as being accepted grounds of general interest for such restrictions.

This essay will give a critical analysis of the justifications that have been accepted by the Court with emphasis being given on the evolution of each justification and will assess how far these are consistently applied as principles of CJ jurisprudence. The aforementioned justifications include the effectiveness of fiscal supervision, the cohesion of the tax system, the prevention of tax avoidance and the balancing of allocation of taxing rights. Governments and taxpayers have tried to put forward and

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2 *EU Tax Law and Double Tax Conventions*, (Avoir Fiscal Limited, London, 2008), p. 72

claim other justifications which have failed[3], however it is beyond the scope of this paper to discuss them.

Restriction – why should there be a justification?

The concept of non-restriction of the fundamental freedoms unless justified, as mentioned above, is one the cardinal rules of the European Internal Market so Member States have to design their national rules and tax systems in accordance with that. In the case that the CJ concludes that there is a restriction, after they had conducted their comparability analysis, this implies there is a breach of Community law. The CJ in paragraph 94 in *De Groot* says that "Member States must ... 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". This means that any less favourable treatment of a non-national or non-resident as well as any impediment of either exercising the freedoms or enjoyment of the freedoms might amount to a restriction. The CJ has accepted though, the possibility these restrictions to be justified. In this respect the CJ's approach was illustrated in *Gebhard*[4], after being firstly established in *Kraus*[5] by adopting the rule-of-reason test which provides that for a restriction to be justified the following four requirements should be met:

(i) *the rule must be applied in non-discriminatory manner*; in case there is any discrimination found then the rule-of-reason will not apply and the only ways to "save" discriminatory rules is either to establish that they are in an objectively different situation so different treatment will not be contrary to EU law or justify the discrimination under any of the Treaty derogations.

(ii) *it must be justified by imperative general interest requirements*; i.e. any justification accepted by the CJ.

(iii) *it must be suitable for securing the attainment of the objective which it pursues*; this is thought to be the first requirement of the principle of proportionality.

(iv) *it must not go beyond what is necessary to attain it*; the basic requirement of the principle of proportionality.

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3 Namely and often the loss of tax revenue

4 ECJ, 30 Nov. 1995, Case C- 55/94, Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano, ("Gebhard"), [1995] ECR I-4165, paragraph 37.

5 ECJ, 31 March 1993, Case 19/92, Dieter Kraus v Land Baden- Württemberg, ("Kraus"), [1993] ECR I-1663, paragraph 32

However this concept in the CJ's jurisprudence dates as back as 1974 from the *Dassonville*[6] case where it is explicitly stated that *"...if a member state takes measures to prevent unfair practices in this connexion, it is however subject to the condition that these measures should be reasonable and that the means of proof required should not act as a hindrance to trade between member states and should, in consequence, be accessible to all community nationals*". *Dassonville* had sowed the seeds that bore fruit in *Cassis de Dijon*[7] case. In this case the applicant intended to import the 'Cassis de Dijion' liquor from France into Germany. German authorities refused to allow the import because the French drink was not sufficient of alcoholic strength to be marketed in Germany. The applicant argued that the German rules were restrictive, however the Court held that in the absence of common rules relating to the production and marketing of alcohol it is for the MS to regulate on such. Explicitly in paragraph 8 though the CJ says that: "obstacles to movement within the community resulting from disparities between the national laws relating to the marketing of the products in question must be accepted in so far as those provisions may be recognized *as being necessary in order to satisfy mandatory requirements*" recognising as such the existence and need of justifications in the general public interest. Thus, the reason to justify a restriction was clearly the disparities in the national system and the lack of harmonisation of the direct tax area. In addition, the "magic word" for the acceptance of any justification is proportionality which apart from being in CJ's case-law it is also provided in Article 5 of the Treaty on European Union where it is stated in the last sentence that "under the principle of *proportionality* the content and form of Union action shall not exceed what is necessary to achieve the objections of the Treaties".

JUSTIFICATIONS

Effectiveness of fiscal supervision

A Member State may apply measures which enable it to ascertain clearly and precisely the amount of both the income taxable in the state and the losses which can be carried forward there. This has been recognised and accepted for the first time in the well-know *Cassis de Dijion*[8] case, a non-tax case regarding free movement of goods as discussed above. The Court has particularly mentioned and accepted in paragraph 8 in its judgment that the effectiveness of fiscal supervision is a justification to restrict the import of the French liquor into Germany.

6 ECJ, 11 July 1974, Case 8/74, *Procureur du Roi v Dassonville*, ("*Dassonville*"), [1974] ECR 837, paragraph 6

7 ECJ, 20 Feb 1979, Case 120/78, *Rewe Zentrale AG v Bundesmonopolverwaltung fur Branntwein*, ("*Cassis de Dijion*"), [1979] ECR 649, paragraph 8

8 ibid

The Court has applied this justification in the direct tax area in *Futura*[9]. In this case Futura SA was the parent company with a seat in France whilst Singer was its branch in Luxembourg. Singer was seeking a tax relief for the losses it incurred which were calculated as an apportionment of Futura's total income. Luxembourg national rules allowed for carrying forward of losses subject to the condition that the losses should be related to income received locally and that accounts should be duly kept and held within the country. Therefore, the questions referred to the CJ in the preliminary ruling were two: the need for the existence of the economic link between losses carried forward and income earned in the Member State in which tax is charged and the keeping of accounts in Luxembourg. The CJ carried out a discrimination analysis and found that there is no discrimination since the economic link requirement applies both to residents and non-residents in the host state (Luxembourg). However, as far as the second issue is concerned of the keeping of the second set of accounts (since Futura had to keep a set of accounts in France as well) the CJ concluded that this amounted to a disproportionate restriction to the freedom of establishment. The justification of the effectiveness of fiscal supervision has been put forward by the Luxembourg government and the Court accepted in paragraph 31 that it is an overriding requirement of general interest and that the MS may apply measures which enable the amount of both income taxable in that state and the losses which can be carried forward there to be ascertained clearly and precisely.

However, this could be done by the use of the Mutual Assistance Directive 77/799/EEC or by asking the taxpayer to provide such relevant information. Thus, even though the justification was accepted, Luxembourg authorities lost on the proportionality issue since there were less restrictive measures that could be applied in order to attain the objective of the rule.

It has been argued by Pato[10], that the effectiveness of fiscal supervision justification will be mostly relevant in cases where the Mutual Assistance Directive would not apply or the taxpayer does not give the necessary proof demanded by the tax authorities. This was shown in *Scorpio*[11] where the Directive was not in force yet. The issue was that an exemption certificate has to be acquired by non-residents in order to be able to refrain from the withholding tax. The Court held, in paragraph 36, that "The procedure of retention at source and the liability rules supporting it constitute a legitimate and appropriate means of ensuring the tax treatment of the income of a person established outside the State of taxation and ensuring that the

9 ECJ, 15 May 1997, Case-250/95, *Futura Participations SA and Singer v Administration des contributions* ("*Futura*")[1997] ECR-I2471 para 31

10 *Antonio Calisto Pato, Cross-border direct tax issues of investment funds from the perspective of European law*, (EC Tax review, 2008-5), p. 204-205

11 ECJ, 3 Oct. 2006, Case C-290/04, *FKP Scorpio Konzertproductionen GmbH v Finanzamt Hamburg-Eimsbüttel ("Scorpio") [2006]*

income concerned does not escape taxation in the State of residence and the State where the services are provided...". Conversely, if the Mutual Assistance Directive applies, it means that "*...Directive 77/799 enables a Member State to obtain from the competent authorities of another Member State all the information enabling it to determine the correct amount of income tax...*" which applies respectively in free movement of workers, freedom of establishment and freedom to provide services. Therefore, since the Directive is harmonised EU law, the need of monitoring through fiscal rules at an individual Member State level is not needed. This is shown by the Court in the *Rewe Zentralfinanz*[12] case where the court explicitly provided that the Mutual Assistance Directive may be invoked by a Member State in order to obtain from the competent authorities of another Member State all the information which is necessary to allow it to effect a correct assessment of corporation tax and pointed out that German tax authorities should demand the evidence from the parent company itself to determine whether or not to grant the deduction.

In cases involving third countries, i.e. nations outside the European Union, though, especially in the free movement of capital sphere, the Court has applied and accepted the justification in the same way since the Mutual Assistance Directive does not apply to them. For instance in the *A*[13] case with respect to third countries, the Court specifically mentioned that: "*...thus recognised that the need to guarantee the effectiveness of fiscal supervision constitutes an overriding requirement of general interest capable of justifying a restriction on the exercise of freedom of movement guaranteed by the Treaty*"[14].

More recently in *Haribo*[15] the justification was addressed in the light of EEA countries. Austria, the resident country of Haribo, exempted portfolio dividends received from EEA countries only if there were mutual assistance agreements regarding administrative matters and enforcement concluded with the relevant EEA state. The CJ held that the requirement for the enforcement of the mutual assistance agreement went beyond what was necessary to attain the objective of the rule. But the CJ noted that *"...Directive 77/799 provides for the possibility for national tax authorities to request information which they cannot obtain themselves.."*[16], even though such a request does not in any way constitute an obligation. Therefore, it was decided that in the case of an EEA country the justification for the effectiveness of

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12 ECJ, 29 March 2007, Case C-342/04, Rewe Zentralfinanz eG v Finanzamt Köln-Mitte ("Rewe*") [2007]*

13 ECJ, 18 Dec 2007, Case C-101/05, Skatteverket v A ("A*") [2007]*

14 *ibid*para 55

15 ECJ, 10 Feb 2011, Joint Cases C-436/08 and C-437/08, Haribo Lakritzen Hans Riegel BetriebsgmbH (C-436/08), Österreichische Salinen AG (C-437/08) v Finanzamt Linz ("Haribo")[2011]

16 ibidpara 101

fiscal supervision was not accepted for the different treatment of dividends received by EU member states countries and EEA countries.

Thus it can be argued that this shows consistency by the CJ as the justification applies in both an intra-EU and in a third country situation in the same way.

The most interesting point to note is how the positive harmonisation of the EU, i.e. the direct applicability of the Directives passed by all Member States, is on top of the O Shea's triangle and thus superior and paramount to negative harmonisation, i.e. the Court's jurisprudence. It can be deduced as such that the fiscal supervision justification might fade away amongst Member States issues in post-Directive eras since the EU law is supreme and may only remain relevant to third countries.

Cohesion of the tax system

The cohesion of the tax system justification is probably the most controversial of all the justifications or defences for restrictions of the fundamental freedoms. It can be defined as "the timing or amount of a deduction for tax purposes is dependent on when or how much of the payment in question is taxable in the hands of the recipient". Since, firstly accepted in *Bachmann*[17] and *Commission v Belgium*[18], it has been repeatedly invoked by governments as a general interest justification. The CJ's reluctance to accept it though, has given the 'impression' that the rule established in *Bachmann* is blurred and vague and the "direct link" requirement is a confusing one. Nevertheless, the CJ has consistently approved the coherence of the tax system justification in *Krankenheim*[19].

To begin with, in *Bachmann* the Court specified that the justification would be accepted once it is shown that a direct link existed between the tax imposed and the tax advantage enjoyed i.e a direct link between the deductions of life assurance contributions paid in another Member State and the tax on the sums payable by the insurers. This is the crucial point for the justification to succeed. Mr Bachmann was German and he was working in Belgium. He was claiming deductions from his occupational income for insurance payments made in Germany. The tax authorities denied such deductions on the ground that such deductions would have been allowed only if the premiums were paid to a Belgium resident insurance company. This direct link as outlined in paragraph 23 presupposes that for the Member State to be obliged to allow the deduction of life insurance contributions it should be able to tax them as well. On the same day, the Court in *Commission v Belgium* again decided

17 ECJ, 28 Jan 1992, Case C-204/90, Hanns-Martin Bachmann v Belgian State [1992] ("Bachmann") para 23

18 ECJ, 28 Jan 1992, C-300/90, Commission v Belgium [1992]

19 ECJ, 23 Oct 2008, Case C-157/07, Finanzamt fur Korperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenhemstatt GmbH [2008] ("Krankenheim")

that the direct link was a connection between the deductibility of contributions and the subsequent taxation of the sums payable by the insurers under pension and life assurance contracts.

No matter how clear this might have sounded at the time, some years later, in *Wielockx*[20], the CJ adopts a slightly different approach taking into account the impact of the Double Tax Convention (hereinafter referred to as "DTC") between The Netherlands and Belgium. Mr Wielockx was Belgian self-employed in the Netherlands and had a non-resident pension reserve. The denial of deductibility from his taxable profits of the pension reserve caused the problem at issue. Such denial would not have occurred if the pension reserve was in a resident company. The CJ emphasised in this case, rejecting the justification, that "s*ince fiscal cohesion is secured by a bilateral convention concluded with another Member State, that principle may not be invoked to justify the refusal of a deduction such as that in issue"*[21] which has moved cohesion of the tax system from a taxpayer level to a treaty level. Although it may be accepted as a justification for a restriction at an individual taxpayer level where the essential direct link can be proved, in case of DTC existing if this is achieved by the DTC there is no need to restrict the freedom.

In later cases, such as *Danner*[22] the Court has again rejected the cohesion of the tax system argument and explained that there is no connection between deductibility and taxation of sums payable by the insurers; if Mr Danner, who worked as a doctor in Germany and was then established in Finland, he continued to live in Finland the pensions which he will receive in Finland will be subject to income tax in that Member State despite the fact that he has not been entitled to deduct the contributions paid to compulsory insurance schemes when he was in Germany and continued paying them after he was established in Finland. The Court stressed here the Wielockx argument again[23] on the DTC concluded between Finland and Germany.

What is more, in the area of freedom of establishment, the Court in *Bosal*[24] explained that for the justification to be accepted it must be shown that "*a direct link existed, in the case of one and the same taxpayer, between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy, both of which related*

20 ECJ, 11 Aug 1995, Case C-80/94, G.H.E.J. Wielockx v Inpecteur der Directe Belastingen [1995], ("Wielockx").

21 ibidpara 25

22 ECJ, 3 Oct 2002, Case C-136/00, Rolf Dieter Danner [2002], ("Danner")

23 ibidpara 43

24 ECJ, 18 Sept 2003, Case C-168/01, Bosal Holding BV v Staatssecretaris van Financien [2003], ("Bosal")

to the same tax"[25] and in that case parents and subsidiaries were distinct taxpayers as they are separate legal entities thus the justification was rejected.

Subsequently, the issue in *Krankenheim* was that the permanent establishment of Krankenheim in Austria incurred losses. The parent company, Krankenheim, was not entitled to deduct those losses during the years that the permanent establishment incurred profits in Austria. Eventually the losses were taken into account in the assessment of the parent's tax liability but were subsequently recaptured when the permanent establishment generated profits. The CJ on these rules provided that there was a direct link.

Thus, it can be argued that the justification of cohesion of the tax system is evolving and becoming clearer but still following the principle firstly established in *Bachmann*. In *Krankenheim* the "deduction and recapture rules" were considered to be necessary to ensure the coherence of the German tax system since under the DTC between Germany and Austria the German resident company was not taxed on the profits attributable to the permanent establishment in Austria but Austria taxed those. Since there was no provision for carrying forward the losses the German rules providing that losses could be deducted from the total income in Germany if they would be taken into account at a later stage when the permanent establishment made profits, were accepted by the Court as showing the desirable "direct link".

At this stage, taking into account the line of cases decided by the Court, it can be concluded that coherence of the tax system is accepted by the CJ as a justification in the general interest and that the existence of DTCs supplement and secure such coherence of the tax system. There may be no need for coherence to be protected at the taxpayer level, and in turn to justify a restriction, when there is a DTC in place even though states persist to invoke this justification. Professor Frans Vanistendael[26] argues that the CJ has engaged in a movement of cautious relaxation of the criteria required for the *Bachmann* direct link. Whether this means that the CJ regrets having accepted it at all and wants to get rid of it as argued by other academics it is controversial.

Prevention of tax avoidance

A difference between tax avoidance and tax evasion was discussed in a recent conference by scholars and practitioners[27] with some arguing that the concepts are not used in the same way in the CJ as they are used in the national tax systems of Member States. In the UK a distinction is made between the meanings of tax

25 ibidpara 29

26 *Professor Frans Vanistendael, Cohesion: the phoenix rises from his ashes*, (EC Tax review, 2005-4), p. 208-222

27 6th Annual 'Avoir Fiscal' EU Tax Conference , School of Advanced Study, 28 January 2011

avoidance and tax evasion. The former is an acceptable form of taxpayer behaviour aimed at reducing tax liability whilst the latter is usually by engaging in such activity using elements of artificiality. There is no such distinction made at a European level although certain forms of tax planning and/or tax mitigation have been accepted by the Court[28] as acceptable ways to minimize tax liability.

The justification of preventing tax avoidance as a defence for a restriction of fundamental freedoms was accepted by the CJ for the first time in ICI29 in respect to the restriction of the freedom of establishment. However, in this case it was dismissed by the Court explaining that not every establishment outside the Member State necessarily entails tax avoidance30 and that the purpose of the legislation should be to prevent wholly artificial arrangements whose purpose is to circumvent the national tax system. However, this was the first turning point in the UK consortium relief legislation since the CJ decided that the national legislation was contrary to the freedom of establishment as group relief was denied in the case of the main holding of shares not being in the UK. The justification being refused to be accepted led to the extension of the UK consortium relief cross border.

This was reiterated in *Cadbury Schweppes*[31] as being a justification for a restriction only if the specific objective of the rule was to prevent wholly artificial arrangements which do not reflect any economic reality with a view to escaping tax liability. In *Cadbury*, the issue concerned the UK CFC rules and the facts briefly were that Cadbury Schweppes, a UK resident company indirectly owned two subsidiaries in Ireland which were subject to tax at a rate of 10%. Thus, they were subject to a "lower level of taxation" within the meaning of the UK legislation on CFCs. CFC rules applied so the UK parent company was taxed on the profits of the Irish subsidiaries. The need to prevent tax avoidance was the basis for the CFC rules. The justification was dismissed again and the tax planning scheme of setting up a subsidiary in Ireland which was proved to be carrying out a genuine economic activity, was not restricted.

Again the same reasoning was followed in *X and Y*[32] case where the Court again stated that tax avoidance cannot be inferred generally because the transferee

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28 ECJ, 11 Dec 2003, Case C-364/01, The heirs of H. Barbier v Inspecteur van de Belastingdienst Particulieren/Ondernemingen buitenland te Heerlen [2003], ("Barbier")

29 ECJ, 16 July 1998, Case C-264/96, Imperial Chemical Industries plc v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes) [1998] ("ICI")

30 Ibidpara 26

31 ECJ, 12 Sept 2006, Case C-196/04, Cadbury Schweppes plc, Cadbury Schweppes Overseas Ltd v Commissioners of Inland Revenue [2006] ("Cadbury Schweppes") para 55

32 ECJ, 21 Nov 2002, Case C-436/00, X, Y v Riksskatteverket [2002], ("*X and Y*")

company or its parent company was just set up in another Member State[33]. The CJ also expressly stated in this case that the prevention of tax avoidance is not accepted in cases of discrimination[34], a point that was firstly made in *Avoir Fiscal*[35].

Later on in the high profile and long discussed case of *Marks and Spencer*[36] the Court repeats the principle established in *ICI* that prevention of tax avoidance can be a justification for the national rules restricting fundamental freedoms however points out as well that the risk of tax avoidance entails also the danger that losses could be used twice (double dipping)[37] or losses can be transferred to companies established in Member States with high tax value of losses (loss trafficking) which if combined with balancing the allocation of taxing rights can amount to a separate justification for restriction[38]. In this case, the Marks and Spencer group consisted of subsidiaries established and resident in Germany, France and Belgium. The subsidiaries incurred losses outside the UK, where the parent company was resident. By December 2001 the French subsidiary has been sold to a third party and their trading operations were discontinued whilst the German and Belgian subsidiaries were essentially dormant. Offsetting of losses to the parent company was denied as well as group loss relief. The CJ decision was that the UK group relief rules were compatible with the EU and that the justification for the prevention of tax avoidance was accepted for such restriction of the freedom of establishment. However, the case was lost on the grounds of proportionality on the basis that the losses incurred by the subsidiaries had no other possibility to be taken into account anywhere else than in the parent company[39]. However, this was only a caveat provided by the CJ. The principles followed by earlier cases were still in place.

It seemed up to this point that there were two justifications involving tax avoidance that could have been accepted by the Court, or at least argued by governments, however, this was not clearly set out and explained by the Court until in *SGI* case[40] where it was confirmed that "*a national measure [...] may be justified where is specifically targets wholly artificial arrangements designed to circumvent the*

33 Ibidpara 67

34 Ibidpara 22

35 ECJ, 28 Jan 1986, Case C-270/83, Commission v French Republic [1986], ("Avoir Fiscal") para 25

36 ECJ, 13 Dec 2005, Case C-446/03, Marks and Spencer plc v David Halsey (Her Majesty's Inspector of Taxes) [2003] ("Marks and Spencer")

37 Ibidpara 47

38 Ibidpara 49 and para 57

39 Ibidpara 55

40 ECJ, 21 Jan 2010, Case C-311/08, Societe de Gestion Industrielle SA (SGI) v Etat belge [2010] ("SGI") para 65

legislation of the Member State concerned". In such a way, the need to prevent tax avoidance was established to be a stand-alone justification[41] which means that if rules are proportional, according to the guidance provided by the Court in later paragraphs of the judgment, then Belgium could maintain its transfer pricing rules in the intra – group situations.

Therefore, any national rules or measures combating structures that are less than wholly artificial arrangements may only be justified if they are combined with the need to preserve the balanced allocation of taxing rights. By this clarification it is made clear that there are two separate tax avoidance justifications:

(i) a standalone one targeting wholly artificial arrangements aiming to usurp the tax system; and

(ii) a lesser form of tax avoidance (for example double-dipping and loss trafficking as forms of avoiding tax liability) merged with the need for the balance of allocation of taxing rights.

This seems to be the end of the long line of arguments after the *Marks and Spencer* case around what was the justification of preventing tax avoidance referring to.

Balanced allocation of taxing rights

Due to the lack of harmonisation in the direct tax area Member States have competence to deal with the problem of double taxation however, this should still be in line with EU law as provided in *Gilly*[42] and subsequently repeated in later case law. Following this, it emerges in paragraph 30 of the same judgment that Member States have the competence to define the criteria for allocating their powers of taxation as between themselves. The necessity to have an allocation can be attributed to international law rules such as those relating to source and residence, or the principle of territoriality and allocation of taxing powers is also achieved through the conclusion of international agreements and DTCs for the elimination of double taxation. A distinction should be made though between the allocation of taxing powers and the exercise of taxing powers which is what is protected by EU law. Therefore, any conduct capable of jeopardising the right of the Member State to exercise their taxing powers in relation to activities carried out on their territory can be prevented by national tax systems. This may amount to a restriction of fundamental freedoms but the need to safeguard the balanced allocation of taxing rights between Member States may justify such a tax system.

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41 Tom O' Shea, "ECJ upholds Belgian Transfer Pricing Regime" January 29, 2010, World Tax Daily.

42 ECJ, 12 May 1998, Case C-336/96, Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas-Rhin [1998] ("Gilly") para 24

An example of allocation of taxing powers can be found in *Gilly*. In this case, Mrs. Gilly, a German national who also acquired French nationality by marriage, was a teacher who resided in France and taught in a state school in the frontier area of Germany. Pursuant to the Germany–France tax treaty, the public-service remuneration received by Mrs. Gilly in Germany from 1989 until 1993 was taxed in Germany. It was also taxed in France, but France granted an ordinary tax credit for the tax paid in Germany. In the case of Mrs. Gilly, such tax credit was less than the tax actually paid in Germany on the German-source income. Mr. and Mrs. Gilly brought proceedings against the tax authorities in which they claimed that the taxation of Mrs. Gilly's German-source income according to the relevant tax treaty was contrary to EC law and specifically to their free movement of workers. The Court rejected this by saying in paragraph 47 that any unfavourable consequences by the tax credit system in the DTC were the result of allocation of different taxing powers between Member States and furthermore, the CJ states explicitly in paragraph 30 *"...contracting parties' competence to define the criteria for allocating their powers of taxation as between themselves...*". Nonetheless, this is always subject to the non-discrimination provision on grounds of nationality as provided by the TFEU. If they choose to allocate and divide their powers due to overlapping tax jurisdiction it means that each State should only tax their own nationals.

Even though mentioned in previous cases, the need to preserve the balance in the allocation of taxing rights as a justification was firstly accepted by the Court in *Marks and Spencer* along with the famous statement of the Court that "profits and losses are two sides of the same coin and must be treated symmetrically". AG Maduro in his opinion explained that this is an extension of the Court's jurisprudence in direct tax area from other fields, such as health services and social security[43]. In *Marks and Spencer* the UK group relief legislation prevented the resident parent company (M&S) from deducting from its taxable profits losses that incurred in another Member State by its subsidiaries established in that other Member States although at the same time it allows deduction of losses incurred by a resident subsidiary. However, in the specific circumstances Marks and Spencer non-resident subsidiaries' losses were terminal, and they could not have been relieved in any other way rather than as losses of the parent company, so the Court has decided in favour of the taxpayer and group relief should have been given to Marks and Spencer parent company for such losses. In respect of the need to preserve the balance of allocation of taxing rights the CJ has stated in paragraph 46 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, as the taxable basis will be increased in the first state and reduced in the second to the extent of the losses transferred". Thus, the UK group relief legislation is justified for restricting freedom of establishment however this is only due to the

43 Tom O' Shea, EU Tax Law and Double Tax Conventions, Avoir Fiscal Limited, 2008, p.135

danger of a form of tax avoidance. It may be argued though that need to preserve the balance of the allocation is not a standalone justification yet.

This justification was reiterated in the *Rewe* case[44] where again losses in the Netherlands were not taken into account since Germany argues that it does not tax the profits of the subsidiary in the Netherlands so they should not take any of the foreign subsidiary losses into account. However, in this case the Court rejects this "symmetry" and stated in reply of the German government's argument that "*accordingly, an argument based on the balanced allocation of the power to impose taxes between the Member States cannot in itself justify a Member State systematically refusing to grant a tax advantage to a resident parent company, on the ground that that company has developed a cross-border economic activity which does not have the immediate result of generating tax revenues for that State*" and also rejected the argument that the rules were necessary to avoid losses incurred abroad from being used twice. The Court has distinguished this case with *Marks and Spencer* on the fact that in the latter the balance of the allocation of taxing rights was accepted as a justification only due to the existence of the danger of tax avoidance as well - as put by the Court only because "*it was taken together with two other grounds*" (taking into account tax losses twice)[45] so in the *Rewe* case the justification was rejected and the German rules had as such inflicted a restriction on the free movement of establishment.

The same line of reasoning was followed in *Oy AA*[46] and *Lidl Belgium*[47] where the Court clarified the justification even more. In *Oy AA* intra-group financial transfers were available if the transferor and the transferee were both established in Finland. In this case OyAA was a Finnish resident and was denied the deductibility of the intra-group financial transfer to its UK resident company which was making a loss. The Court explained that, even though the justification is not allowed for systematically refusing to grant tax advantages to resident subsidiaries of parent companies being taxed in another Member State, "*this justification may be allowed where the system in question is designed to prevent conduct capable of jeopardizing the right of the Member States to exercise their taxing powers in relation to activities carried on in their territory*"[48]. Thus, the Finnish legislation intergroup financial transfer rules limiting tax advantages only to transfers between Finnish resident group companies were a justified restriction to the freedom of

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44 ECJ, 29 Mar 2007, Case C-347/04, Rewe Zentralfinanz eG v Finanzamnt Koln-Mitte [2007] ("Rewe") para 43

45 ibidpara 41

46 ECJ, 18 July 2007, Case C-231/05, Oy AA [2007], ("Oy AA")

47 ECJ, 15 May 2008, Case C-414/06, Lidl Belgium GmbH & Co. KG v Finanzamt Heibronn [2008] ("Lidl Belgium")

48 Ibidnote 45, para 54

establishment. The reasoning behind this is the jeopardy to the right of Member States to exercise their taxing powers, since if deductions for the inter group financial transfers were allowed cross-border the companies would be able to determine where their profits will be taxed[49]. Thus, the Court establishes again the link between the need to preserve a balance in the allocation of taxing rights with the need to prevent tax avoidance.

Similarly in *Lidl Belgium* the Court again stressed that giving companies the right to elect where to have their losses taken into account would seriously undermine the balanced allocation of taxing rights within Member States[50]. As a result, the tax regime at issue which denied losses of the PE in Luxembourg to be taken into account against the German parent company income tax was found to be justified as safeguarding the symmetry between the allocation of profits and deduction of losses[51]. This symmetry was safeguarded and achieved by the DTC by establishing that Luxembourg will tax the profits attributed to the PE and Germany will exempt those profits. Therefore only Luxembourg should deal with any losses on the basis that losses and profits are "two sides of the same coin" following the Marks and Spencer line of reasoning.

In *SGI*, a Belgian transfer pricing regime case, the transactions between the SGI and its associated companies were challenged as granting of unusual and gratuitous advantages to the associated companies established in other Member States. The Belgian government argued that the rules were based on article 9 of the OECD Model and that they sought to combat tax avoidance by making it possible to adjust taxation of transaction between associated companies that have not been carried out under fully competitive conditions (the arm's length principle). The Court in this case accepted the Belgian rules are being compatible with EU law and not precluded them. The rules were justified under the need to prevent tax avoidance because the rules are specifically targeted wholly artificial arrangements designed to circumvent the tax system[52]. However, the conduct may not amount to wholly artificial arrangements but be jeopardising the right of the member state to exercise its tax jurisdiction which when combined with the need to prevent tax avoidance amounts to a justification for the restriction of the fundamental freedoms.

The only case that the need to preserve balance in the allocation of taxing rights was accepted as a justification was in the *N*[53] case. A reason for this may have been the

49 "Finland's intergroup financial transfer rules compatible with EU", Tom O Shea, Tax Notes International, 13 Aug 2007

50 Ibidnote 46, para 32

51 Ibidnote 46, para 33

52 Ibidnote 39 para 65

53 ECJ, 7 Sept 2006, N v Inspecteur van de Belastingdienst Oost/kantoor Almelo [2006] ("N")

fact that the purpose of the exit tax rule was to protect the tax base of the Netherlands. In this case Mr N transferred his residence from the Netherlands to the UK. He was requested to provide guarantee for the deferment of payment of the exit tax in respect to the profits made by shares he was holding in the three limited liability Netherlands companies. This was a restriction to the freedom of establishment which was however justified on the balance of the allocation of taxing rights justification[54].

Therefore, it has been proved that this is not a carte blanche justification generally but has been clarified by recent case law establishing that if combined with a lesser form of tax avoidance it may amount to an acceptable justification but it could not be denied that it is still evolving in the Court's jurisprudence.

It should be noted that the conclusion of DTCs plays an important role to the allocation of taxing rights as well as the international tax law principle of territoriality.

Double Tax Conventions

Double Tax Conventions are agreements between two or more states for the avoidance of double taxation. As clearly noted in *Gottardo*[55] Member States need to comply with their EU law obligations when entered into international agreements either between Member States or with third countries , projecting as such the supremacy of EU law.

Governments have attempted to argue that the conclusion of double tax conventions is a justification for restricting fundamental freedoms and needs to be accepted, since it is an agreement between the contracting states for the benefit of their residents. This attempt led to the emergence of the "most-favoured-nation principle" in *D* case[56]. In that particular case, the Netherlands-Belgium tax treaty was more favourable than the Germany-Netherlands tax treaty under which the German resident was denied a tax advantage. The Court held that this was allowed and re-affirmed its previous position in *Gilly* that the purpose of the tax treaties was to ensure elimination of double taxation and that it was for the benefit of the residents of the contracting states.

54 Ibidpara 44

55 ECJ, 15 Jan 2002, Case C-55/00, Elide Gottardo v Istituto nazionale della previdenza sociale (INPS) [2002], ("Gottardo") para 33

56 ECJ, 5 July 2006, Case C-376/03, D v Inspecteur van de Belastingdienst/ particuliern/ Ondernemingen buitenland te Heerlen [2005] ("D")

In this respect, comparing the decision in *Avoir Fiscal* and the decision in *Bouanich*[57] it has been distinguished that DTCs can be used as a "heal" and not as an "excuse" to restrict fundamental freedoms. In the first case the tax credit was not given by France to branches and agencies of insurance companies in other Member States while in the latter case there was different tax treatment between residents and non-residents with regard to the company repurchasing shares which were treated as capital gains in the hands of residents and as dividend distributions in the hands of non-residents. As the Court found in *Bouanich* the DTC could bring a better result for the non-resident who would be taxed at 15% on a deemed distribution whilst the resident will be taxed at the higher rate of 30% on a capital gains basis. This is also in accordance with the national treatment principle of "no less favourable treatment than that of a comparable resident".

Principle of Territoriality

The principle of territoriality was first recognised in *Futura*. It can be defined as the "...the levying of tax only within the territorial jurisdiction of the tax authority or country". In *Futura*, the argument put forward by the Luxembourg authorities, and accepted by the Court, is that if the national tax system is in "*conformity with the fiscal principle of territoriality, cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty"*[58]. Even though the case was eventually decided as having a disproportionate restriction on the keeping of the second accounts, the territoriality issue was an important ground to be used by governments later on.

Such an example is in the *Bosal* case where the Netherlands government relied on this and argued that subsidiaries making profits outside the Netherlands are not objectively comparable to subsidiaries making profits in the Netherlands so any difference in treatment of the two will not constitute discrimination or restriction[59]. However, in *Bosal* the Court did not accept such a justification for the restriction of freedom of establishment explaining that in *Futura* the taxation was of a single company which carried on business in the Member State where it had its principal establishment and in other Member States where it had secondary establishments[60]. In *Futura*, Singer was a branch and not a subsidiary while in *Bosal*, the issue was about subsidiaries outside Netherlands.

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57 ECJ, 19 Jan 2006, Case C-265/04, Margaretha Bouanich v Skatteverket [2006] ("Bouanich")

58 Ibidnote 8, para 22

59 Ibidnote 23, para 37

60 Ibidpara 38

Moreover, the principle of territoriality was again rejected in *N* case[61] by the Court stating that *"...the obligation to provide guarantees, necessary for the granting of a deferment of the tax normally due, whilst doubtless facilitating the collection of that tax from a foreign resident, goes beyond what is strictly necessary in order to ensure the functioning and effectiveness of such a tax system based on the principle of fiscal territoriality. There are methods less restrictive of fundamental freedoms*"[62]. In this case, the exit taxes levied by a Member on capital gains on assets accrued whilst resident in the Member State (Netherlands) were attempted to be justified using the principle of territoriality which has already begun to be combined with or used as part of the justification to achieve a balance allocation of taxing rights. The defence was accepted, however the government lost on the issue of proportionality since the guarantee required to be given by the taxpayer was more than what was necessary to achieve the objective of the tax system.

Even though tried to be invoked by governments as a justification, the principle of territoriality still remains an international tax law principle and is not a recognised and established overriding general interest to be accepted by the Court.

It should also be noted that loss of revenue and erosion of the tax base as well as availability of administrative remedies even though invoked and defended in the Court, they have failed to be accepted as imperative requirements in the general interest.

Concluding remarks

The Court in its latest case *Tankreederei*[63], considers and analyses each one of the above mentioned justifications and if they are accepted in that particular case providing in such a way guidance for the national courts. It can be argued that in this way the Court recognises that these are the accepted grounds of general interest that governments could invoke, as opposed to the reduction or loss of national tax revenues which has been constantly rejected over the last ten years due to being a purely economic justification[64]. It may be concluded as such that these are recognised principles in the Court's jurisprudence.

However, it should be noted that the CJ seems to be willing to further clarify already existing justifications, as seen in *SGI* or even accept new ones as shown in *Centros*[65]

61 Ibidnote 52

62 ibidpara 51

63 ECJ, 22 Dec 2010, Case C-287/10, Tankreederei I SA v Directeur de l'administration des contributions directes [2010] ("Tankreederei")

64 Ibidnote 31 and ibidnote 62, para 27

and *Sevic*[66] where the need to protect creditors and the need to protect minority shareholders and employees were considered. Remarkable is also the interaction between the EU legislation and DTCs with the justifications and the Court's attempts to keep its balancing role of protecting at the same time the interests' of the Member States, the Community and EU citizens.

In line with all the above it should be stressed though, that even if there is a justification of general interest available to the Member State for restricting the freedom, this justification needs to be accepted by the Court as relevant and valid under the present circumstances based on the comparator established and then finally is must be in accordance with the principle of proportionality[67] which implies that their application is appropriate to ensure the attainment of the objective and do not go beyond what is necessary to attain it[68].

65 ECJ, 9 March 1999, Case C-212/97, Centros Ltd v Erhvervs- og Selskabsstyrelsen [1999] ("Centros")

66 ECJ, 13 Dec 2005, Case C-411/03, Sevic Systems AG [2005] ("Sevic")

67 Being also in accordance with Article 5 ECT.

68 As provided for in the Gebhrad formula