

Department of Business Law

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**The Relationship Between the General  
Legal Principle of Equality and the Equal  
Treatment Principle in the Direct tax  
Judgements of the Court of Justice of the  
European Union; the Consequences for  
National Sovereignty.**



**LUND UNIVERSITY**  
School of Economics and Management

Eleanor Campbell

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Supervisor: Cécile Brokelind

## List of Abbreviations

AG	Advocate General
EU	European Union
PE	Permanent Establishment
TEU	The Treaty On European Union
TFEU	The Treaty On The Functioning of the European Union
'The Court'	the Court of Justice of the European Union
UK	United Kingdom of Great Britain and Northern Ireland

## Foreword

During this Master's degree course I found that the lectures and seminars which interested me most were those relating to the jurisprudence of the Court of Justice of the European Union; its application of the general principles of European Law and its interpretative style. I was intrigued by its teleological and purposive interpretation which to me seemed far reaching, sometimes inconsistent and generally difficult to reconcile with my previously held view as to the appropriate exercise of judicial control.

In relation to direct taxes and the treaty free movement provisions, our class read and discussed many of the 'landmark' judgements dealing firstly with cases relating to natural persons and thereafter those relating to legal persons. I wanted to look more deeply into this jurisprudence as my impression was that the Court had not necessarily been consistent in the way it dealt with legal as opposed to natural persons. I decided to re-examine these cases in depth as a preliminary to my thesis. Whilst I identified that the Court's method of analysis did arguably lead to a different outcome for legal as opposed to natural persons in certain situations, what was more striking to me was the potential inequality which some of the judgements created at national level. This was not necessarily an inequality between natural and legal persons rather a general inequality between tax subjects arising from the Court's focus on nationality and inconsistencies in its choice of comparators. This discovery led me back to the general legal principles of taxation which we had studied at the very beginning of the master's course and I began to see that the root of my unease with the Court's jurisprudence arose from a clash of principles. What I wanted to find out was whether legal equality was present in the Court's judgements, was equality at EU level something different from the concept of legal equality at national level and was the latter being compromised in pursuit of the treaty objectives?

## Summary

The Legal Principle of Equality underpins most national tax systems and encompasses both substantive and procedural equality. In its substantive form, the principle requires that equal treatment of equal situations. This does not mean however that unequal situations always merit unequal treatment. Political will may determine that particular distinguishing criteria should be discounted. Gender and race for example are usually excluded. Economic theory plays a big part in how the Member States of the European Union assess equality. Most systems contain some element of progressivity linked to the ability to pay so that equality is achieved with reference to an equal deprivation of resources. Systems often also aspire to neutrality so that neither taxpayer behaviour nor the source of any resources should affect his ability to pay. Since practical and political considerations sometimes lead to a departure from neutrality most systems include a scheme of deductions and allowances in an attempt to address imbalances. The national rules are concerned with maintenance of equality over a life time however and not just at one particular point in time or in relation to one particular aspect of a person's activities. National rules strive for equality between tax residents.

In the European Union, the principle of equality is expressed in the Treaties in terms of a general prohibition on discrimination. The treaty freedom of movement rights provide protection from discrimination on grounds of nationality not residence. Against this background, the Court of Justice had already developed the principle of equal treatment between nationals and non-nationals when it was faced with its earliest case on direct taxes in the mid 1980's. The cross-border nature of cases before the Court mean that the objectives of two or more national systems are always at play alongside the Treaty aims. The fact that the national rule or rules in question may have been designed to ensure equality with reference to the function of a tax system as a whole has not been something to which the Court has necessarily had regard. As a result, the judgements indicate a clash of principles and an emerging hierarchy with national principles deferring to the European ones.

The EU equal treatment principle has been applied to direct tax cases by finding that different national treatment based on tax residence, can amount at EU level, to indirect discrimination on grounds of nationality. Particular cases highlight the difficulties which the Court has encountered in finding an appropriate comparator for its discrimination approach, the criticism it received when it adopted a more wide reaching restrictions approach and the trend in its more recent decisions away from a series of separate steps of analysis and indications of a renewed discrimination approach with greater emphasis on establishing the aim of the national legislation in question and a perceived increasing receptiveness to justifications advanced by the Member States. There has also been recognition by the Court that some disadvantages do not amount to a breach of the treaty provisions but rather exist as a result of disparities between national systems.

From a procedural point of view, the general principle of equality requires that all should be equal before the law and have the same right of challenge. At EU level this would require that all who are subject to the treaties should be treated in the same way. This is not always the case however. In terms of access to treaty rights, it is observed that differing national

legislation on the formation of companies can exclude certain nationalities of company from treaty protection. Similarly access to particular freedoms is controlled by the Court with its jurisprudence supporting the concept of a hierarchy of freedoms such that corporate shareholders in cross border dividend cases cannot rely on the free movement of capital provisions and in turn the extended protection which this offers in relation to third countries. A difference of treatment is also observed in relation to legal form with inconsistency in treatment of different forms of legal entity and legal and natural persons not always receiving like treatment in the areas of cross border losses and cross border dividends.

In the light of the jurisprudence examined, it is questionable whether it could ever be possible, with the current level of harmonisation, for the Court to adjudicate in the area of direct taxation without undermining the general legal principle of equality upon which national systems are based. Whilst some of the more recent decisions have been welcomed as evidence of a greater regard by the Court to national principles as justifying inequality at EU level, other commentators argue that some of these cases should not in any event have been considered as breaches requiring justification. The Court has also been criticised for inconsistency. For example, some of the recent cross border worker decisions have been interpreted as requiring the host state to encroach upon home state tax sovereignty whereas in other cases the Court has acknowledged that a disparity exists as a result of retention of national sovereignty with which it cannot interfere. There is evidence that Member States have required to take steps to try and restore imbalance in their internal systems as a result of such decisions. In the present political climate, perhaps the only solution is a fairly large scale change in national tax system design in an attempt to retain equality and hold on to national sovereignty.

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# 1. Introduction

There is an inherent conflict between the EU direct tax jurisprudence and the accepted principles which underpin the effective working of most of the Member States' national tax systems. Direct taxes are not specifically referred to in the Treaty provisions and although there now exists a handful of secondary EU legislative measures in this area, it remains a largely non-harmonised and politically sensitive one. In the absence of any integrated provisions, the Court of Justice has nonetheless received a significant number of preliminary ruling requests in the last twenty years, in cases where national tax legislation has been challenged as contrary to one or more of the fundamental freedoms laid down in the Treaty of Rome (now in the TFEU).<sup>1</sup> These freedoms are underpinned by the non-discrimination principle enshrined in European Law which seeks to achieve equality between nationals and non-nationals. Equality is also a feature of the tax systems of the Member States. At national level, it is often treated synonymously with the ability to pay. This principle of economic theory, immortalized in one of Adam Smith's canons of taxation, suggests that equality between tax subjects is to be achieved by contributions which are proportionately equal, with reference to their "respective abilities"<sup>2</sup> How to measure the 'ability' of an individual continues to vex and challenge those responsible for tax system design.<sup>3</sup> As a result, different states have adopted different approaches. Economic theory also argues that this ability should not be measured with reference to the types of activity which an individual engages in. The choices an individual makes in arriving in his personal situation should not therefore be influenced by the prospect of a greater or lesser tax contribution. This related theory, which many tax systems also embrace, is referred to as the principle of neutrality. As political and practical reasons may be held to justify a departure from neutrality, the systems which have emerged in the EU Member States generally include not only progressive rates but a system of deductions, credits and allowances designed to equalise tax contributions.

Where the activities of individual tax payers transcend the boundaries of one or more nations, it may be difficult to apply the system in a way which ensures this equality. The treaties establishing the European Union were entered into with the purpose of facilitating trade between nations. They exist to support the free flow of goods, persons, services and capital across borders.<sup>4</sup> In areas where the treaties have provided the legal basis to do so, Union wide unified systems of rules have been established. In other areas, states have been obliged to harmonise their own rules towards a common purpose. For the most part, direct taxes fall into neither of these categories. Yet this desired free flow of goods, persons, services and capital inevitably has involved the application of the rules of national tax systems in cross-border situations. As a result, national rules have been subject to extensive challenge before the

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<sup>1</sup> Consolidated version of the Treaty on the Functioning of the European Union [2010] OJ C83/47

<sup>2</sup> Smith A, *An inquiry into the Nature and Causes of the Wealth of Nations* (first published 1776, 5<sup>th</sup> edition 1904 published online at Library of Economics and Liberty, [www.econlib.org/library/Smith/smWN.html](http://www.econlib.org/library/Smith/smWN.html))

<sup>3</sup> Holmes K, *The Concept of Income A multi-disciplinary analysis* (IBFD Publications BV 2001) ch1 Tax Fairness

<sup>4</sup> Consolidated version of the Treaty on the Functioning of the European Union [2009] OJ Titles II, III and IV

Court of Justice of the European Union as representing a barrier to the exercise of these treaty rights. To date, the Court has considered over two hundred challenges and in the vast majority of cases the national rules have been disallowed.<sup>5</sup> In arriving at its decisions, the Court has sought to apply the European Union Law general principle of equality but there is an uneasy relationship between this principle and the general legal principle of equality upon which most of the Member States' tax systems are based. In particular, assessing equality requires a comparison to be made. National Tax systems treat as like, persons deemed to have the same ability to pay but at EU level, the Court has not generally involved itself in such economic and political considerations.<sup>6</sup> This paper examines this uneasy relationship, looks at whether there has in fact been an insidious creation by the Court of a hierarchy of principles in an area of retained national sovereignty and questions whether the strive for equality at EU level comes at the expense of inequality at national level.

## 2. Method, Material and Outline

The starting point for this paper was an exploration of what the legal principle of equality means in terms of tax system design. The research identified that the principle encompasses both substantive and procedural equality.<sup>7</sup> Following this division, the first stage was to question whether and to what extent the body of direct tax case law from the Court of Justice seeks to uphold each of these aspects of the principle. In this connection, a detailed analysis of the EU law principle of equal treatment was undertaken in the context of its application to direct tax cases. The origins of this principle in the Treaties and the stages of development of its application in the case law was examined with a view to identifying parallels with the general legal principle of equality, pinpointing differences and highlighting the consequences for national tax systems where these differences have led to the Court of Justice failing to recognise the political, legal and economic considerations which are bound up in the concept of substantive equality at national level. The next step was to scrutinise the case law in order to establish whether the legal principle of equality in the procedural sense is present in the direct tax decisions and to identify the areas where lack of procedural equality may be of concern.

In order to develop an understanding of the way in which the legal principle of equality influences tax design, the early economic theory of Adam Smith was consulted. More recent academic writing on the concept of income as a measure of the ability to pay helped to inform the analysis as did the recent publication of the Mirrlees Review; an extensive study into the characteristics of a good tax system which was carried out as part of an inquiry into reform of

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<sup>5</sup> Michael J Graetz and Alvin C Warren Jr 'Dividend taxation in Europe: When the ECJ makes tax policy' (2007) 44 CML Rev 1577, 1597

<sup>6</sup> Frans Vanistendael 'Cohesion: the phoenix rises from his ashes' (2005) 4 EC Tax Review 208, 216

<sup>7</sup> Frans Vanistendael, "Legal Framework for Taxation" in Victor Thuronyi, ed. *Tax Law Design and Drafting* vol 1 & vol 2 ( International Monetary Fund )1998



the UK system.<sup>8</sup> The Court's decisions are the main source of material for the research into equality at EU level together with the respective Advocate Generals' opinions. Academic articles and books in which the cases were discussed and commented on were also consulted.

The order of the paper corresponds to the stages in the research. In the first section, the principle of equality is explained with reference to tax system design. The associated economic principles of ability to pay and neutrality are also explored. Thereafter, the paper provides a description of the EU principle of equal treatment, details its development in the general free movement jurisprudence and explains in detail how it has been applied to direct tax cases. This is followed by an analysis of the substantive equality of the equal treatment principle and the tension with substantive equality at Member State level. The second section of the paper then goes on to examine whether procedural equality is ensured through the Court's judgements. Access to the freedoms, the Court's choice of freedom, difference in treatment based on legal form and equality in application of the equal treatment principle are all examined in turn. This is followed by a short analysis of the procedural equality at EU level. Finally, the paper concludes with a general discussion focussing on the areas where equality at EU level cannot be achieved without a departure from the general principle of equality in national systems and the emerging supremacy of the EU principle in this area.

### **3. Delimitations**

Since this paper is concerned with the fundamental legal principle of equality, it concentrates on the Court of Justice's application of the fundamental treaty provisions, namely the freedoms contained in the TFEU. The specific secondary instruments in the area of direct taxation are therefore not discussed. Similarly, the paper deliberately omits from its research, the possible consequence of bilateral treaties in relation to European Law since these are non-obligatory arrangements between states and not part of the law of the EU. Not all of the cases which were examined during the research stage have been included in the written analysis. The particular cases referred to were chosen for their illustration of the principles which have been derived from them, because they form part of a series of cases which display a continued line of reasoning by the Court, or because they highlight the areas where the differences between the Court's approach to equality and the substantive and legal equality at national level have created a hierarchy of principles which threatens national tax systems. The research was finalised as at 11 May 2012 and therefore considered only material published up to that date.

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<sup>8</sup> *Dimensions of Tax Design: the Mirrlees review* (OUP 2010) and *Tax By Design: The Mirrlees Review* (OUP 2011)

## 4. The Legal Principle of Equality

Tax systems are based, not on a single rule or requirement but on a set of rules, often highly complex and interlinked which together regulate the collection of contributions necessary to finance public expenditure. Who and what should be taxed and the amount of revenue to be raised are decisions for the legislature and are driven by economic and political motivators.<sup>9</sup> Since the resultant public spending is intended for the benefit of those contributing, there is, at least on a collective level, a perceived correlation between contributing and receiving. The nature of the system is such that a change in one aspect will have a knock-on effect elsewhere. In democracies, the economic and political motivators underlying a tax system will differ from one State to another as an expression of the collective will of the electorate. Since all have the intention of raising revenue to finance public expenditure, however, there are common themes. Adam Smith's four canons of taxation are the maxims he considered to have commanded the attention of most systems.<sup>10</sup> The first canon, namely that everyone contributes in proportion to their ability to pay, is often referred to from an economic viewpoint, as the principle of equality. From a legal perspective however, equality in relation to a system of taxation is something more than this. Writing about the General Principles and Limitations on Power to Make Tax Laws, Professor Frans Vanistendael suggests that equality has both a procedural and a substantive meaning. The former relates to equal application of the law to all who are subject to it with the same right of challenge for everyone while the latter involves treating equally, persons who are in equal circumstances. It is here that the ability to pay principle has its place. Equal treatment in the substantive sense does not allow for the unequal treatment of persons in unequal circumstances since, the rule applied in practice involves legal systems to set out criteria on which persons cannot be distinguished from one another such as sex or race. Economic theory such as Smith's are relevant in establishing which criteria should be applied. In Vanistendael's view, both the purpose and the means to effect the unequal treatment must have a rational basis. He thinks that applying progressive rates of taxation can be shown to have such a basis and to fall within the substantive meaning of the legal principle of equal treatment.<sup>11</sup> Arguably therefore, the ability to pay concept is, although based on economic theory, also an aspect of the equality which applies to tax systems. But how does a national system of taxation measure ability to pay in terms of achieving equality? Optimal Tax Theory seeks to achieve equality by measuring ability to pay in terms of well being. This theory acknowledges that a person's income is not necessarily an accurate measure of the extent to which they should contribute. Rather, a combination of several factors is considered. Equality is achieved through the deprivation of resources to the extent that can be tolerated by the individual without negative effect on his wellbeing. Since the factors which contribute to a person's wellbeing are many, include subjective elements and can vary from person to person, there are practical difficulties

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<sup>9</sup> James Banks and Peter Diamond, 'The Base for Direct Taxation' in *Dimensions of Tax Design*, (OUP 2010) [www.ifs.org.uk/mirrleesreview/dimensions/ch6.pdf](http://www.ifs.org.uk/mirrleesreview/dimensions/ch6.pdf)

<sup>10</sup> Adam Smith, *An inquiry into the Nature and Causes of the Wealth of Nations*, (5<sup>th</sup> edition 1904 published online at Library of Economics and Liberty, [www.econlib.org/library/Smith/smWN.html](http://www.econlib.org/library/Smith/smWN.html))

<sup>11</sup> Frans Vanistendael, "Legal Framework for Taxation" in Victor Thuronyi, ed. *Tax Law Design and Drafting* vol 1 & vol 2 (International Monetary Fund) 1998

in assessing equality in this way. As a result, income, although, not without its own difficulties as a concept, has become the default measure of wellbeing in many systems and in turn the ability to pay.<sup>12</sup> It is important to note that optimal tax theory is concerned with ability over a lifetime and not simply at a given point of time. The redistributive effects of a system at a later date may be factored in to the consideration of wellbeing at an earlier point in time. Indeed it has even been suggested that the ability to pay principle would support a tax system which takes into account the age of the tax subject.<sup>13</sup> This presents a significant conflict with EU law where the Court of Justice tends to focus on the interpretation of specific rules to specific sets of circumstances at a specific point in time.

Neutrality is also a feature of many tax systems. This is also more a principle of economic theory than a legal principle. In his doctoral thesis in 1959, Professor Leif Mutén defined this as “*a taxation which does not influence a decision maker’s choice between economic alternatives which are equivalent, if taxes are not taken into account.*”<sup>14</sup> In its purest form, therefore, income from one type of activity should not be taxed more heavily than any other. Choice of investment vehicles or business structure should be driven by economic factors and not motivated by advantages or disadvantages arising from the tax system.<sup>15</sup> It is linked to the ability to pay in so far as there should be no difference in ability as a result of deriving income from a different source. Some systems do not strive for neutrality at all and consider on the contrary, that it is appropriate that the rules on taxes should be used to manipulate the economy. In practice, many systems recognise the need to depart from the principle of neutrality in certain situations but will seek to uphold it as far as possible. In defining neutrality, Mutén counsels that “*If the legislator deviates from the path of neutrality, he should be conscious of and have good reason for a deviation.*”<sup>16</sup> Reasons which are advanced are for example, public health, where many states deliberately seek to influence behaviour through the tax system. Further, as regards procedural equality, Most of the EU Member States operate systems which treat corporate and unincorporated legal persons differently for tax purposes.<sup>17</sup> Although the extent to which the principle of neutrality has influenced each system varies, procedural equality would also preclude a significant difference in treatment as between taxpayers deemed to be in equal positions so that by default, neutrality is often present in the context of a certain group of taxpayers within a system rather than to the system

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<sup>12</sup> Kevin Holmes, *The Concept of Income A multi-disciplinary analysis*, (IBFD Publications BV, 2001)

<sup>13</sup> James Banks and Peter Diamond, ‘The Base for Direct Taxation’ in *Dimensions of Tax Design*, (OUP 2010) [www.ifs.org.uk/mirrleesreview/dimensions/ch6.pdf](http://www.ifs.org.uk/mirrleesreview/dimensions/ch6.pdf)

<sup>14</sup> see Sven - Erik Johansson “The Eutopia of Neutral Taxation” in *International Studies in Taxation: Law and Economics Liber Amicorum* p169 when he refers to the definition of neutral taxation given by Professor Leif Muten in his doctoral thesis *Inkomst eller Kapitalvinst* 1959

<sup>15</sup> Sven - Erik Johansson “The Eutopia of Neutral Taxation” in *International Studies in Taxation: Law and Economics Liber Amicorum* p169 when he refers to the definition of neutral taxation given by Professor Leif Muten in his doctoral thesis *Inkomst eller Kapitalvinst* 1959

<sup>16</sup> Sven - Erik Johansson “The Eutopia of Neutral Taxation” in *International Studies in Taxation: Law and Economics Liber Amicorum* p169 when he refers to the definition of neutral taxation given by Professor Leif Muten in his doctoral thesis *Inkomst eller Kapitalvinst* 1959

<sup>17</sup> In schedular systems like the UK for example, see Income and Corporation taxes Act (ICTA) 1988 as amended

as a whole. This is often the case in the references to neutrality found in the jurisprudence of the Court of Justice of the European Union.<sup>18</sup>

## 5. Equality in the EU case law on direct taxation

### 5.1 Equal Treatment and Substantive Equality

Since the treaties themselves make no specific reference to direct taxes, questions relating to the compatibility of the national rules have come to the Court of Justice in the context of alleged breaches of the general treaty right to free movement of, workers, services and capital and the freedom of establishment.<sup>19</sup> In principle, Member States retain their sovereign powers as long as they exercise these in a way which is consistent with European Law.<sup>20</sup> This view was first applied by the Court of Justice to a direct tax provision in the mid 1980s. Subsequent decisions have reaffirmed that the Court is concerned with the way in which national rules are applied in an EU context rather than the formulation of the rules themselves.<sup>21</sup> In assessing whether particular national provisions are prohibited by the treaty freedoms, the Court has built upon its previous jurisprudence applying the principle of equal treatment to general free movement cases.<sup>22</sup>

This principle of equal treatment, now firmly rooted in EU law, requires that Member States will not treat nationals of another Member State, who are exercising their EU legal rights, less favourably than their own nationals.<sup>23</sup> It emanates from the underlying principle of non-discrimination which runs through the treaties. Article 18 of the TEFU expressly prohibits discrimination of citizens of the Union on grounds of nationality.<sup>24</sup> The right to free movement for workers within the EU is also expressed in terms of the abolition of discrimination on grounds of nationality.<sup>25</sup> In relation to the right of establishment and the free movement of capital, the treaty does not use the word ‘discrimination’ but prohibits ‘restrictions’.<sup>26</sup> In practice, this is also interpreted as precluding any discrimination based on nationality since the overarching equal treatment principle applies to all of the treaty freedoms. The equal treatment principle is in effect an application of the article 18 non - discrimination principle.<sup>27</sup> In a sense, equal treatment is therefore an expression of the

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<sup>18</sup> See for example *Mischo AG in Case C-294/97 Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna* [1999] ECR I-7447

<sup>19</sup> Consolidated version of the Treaty on the Functioning of the European Union [2010] OJ C83/47 articles 28,45,49,56 and 63

<sup>20</sup> Case C-6/64 *Flaminio Costa v E.N.E.L.* [1964] ECR 1194

<sup>21</sup> Case C-270/83 *Commission v France* [1986] ECR 273 (Avoir Fiscal)

<sup>22</sup> See for example Case C-152/73 *Sotgiu v Deutsche Bundespost* [1974] ECR 153

<sup>23</sup> Case C- 48/75 *Procureur du Roi v Royer* [1976] ECR 497, para 23.

<sup>24</sup> Consolidated version of the Treaty on the Functioning of the European Union [2010] OJ C83/47 Article 18

<sup>25</sup> Consolidated version of the Treaty on the Functioning of the European Union [2010] OJ C83/47

Article 45 para 2

<sup>26</sup> Consolidated version of the Treaty on the Functioning of the European Union [2010] OJ C83/47

Articles 49 and 63

<sup>27</sup> Gianluigi Bizioli ‘Balancing the fundamental freedoms and Tax Sovereignty: some thoughts on recent ECJ Case Law on Direct Taxation’ [2008] 3 European Taxation, 133

substantive legal principle of equality along the lines described by Vanistandael.<sup>28</sup> The Treaties have provided that the criterion of nationality, does not justify unequal treatment. There are however, two major challenges in applying this criterion in the area of direct tax cases. Firstly; nothing in the treaty freedoms removes tax sovereignty from the Member States and secondly; tax treatment at national level is based, not on nationality but residence.<sup>29</sup>

Faced with this challenge, the Court of Justice's starting point has been an application of the equal treatment principle so that distinctions drawn on the basis of residence can have the result of indirectly discriminating on grounds of nationality.<sup>30</sup>

The equal treatment principle prohibits both direct and indirect discrimination. On a strict analysis, nearly all of the direct tax jurisprudence concerns measures which are potentially indirectly discriminatory since the difference in treatment relates to residence and not nationality. Questions of direct discrimination have nonetheless arisen. In *The Royal Bank of Scotland v Greece*, a rule applying a uniform rate of tax to all companies but affording a lower rate to companies quoted on the Athens stock exchange or issuing shares registered nationally, was found to discriminate against companies operating in Greece but whose registered offices were in other Member States. In that case, the Advocate General, Alber considered that the Greek rule was directly discriminatory since the location of the company's seat, which was at its registered office, was equivalent to the Company's nationality. Referring to the freedom of establishment provisions as then in force, he explained that, "*That freedom is enjoyed by companies formed in accordance with the laws of a Member State and having their registered offices, central administration or principal place of business within the Community. The seat of a company, thus defined, is decisive in determining whether it may be ascribed to a particular legal system in the same way that nationality is in respect of physical persons*"<sup>31</sup> The distinction is an important one since the EU case law has developed the equal treatment principle so that Member States can only ever apply directly discriminatory national provisions to the treaty freedoms where one of the express derogations in the treaties is shown to apply. On the other hand, indirectly discriminatory provisions can be justified by overriding requirements of general interest.<sup>32</sup> Since residence and not nationality is the determining factor for the basis of taxation most of the cases where national tax legislation has been challenged as prohibiting a treaty freedom, have sought to invoke the equal treatment principle on the basis of indirect discrimination.<sup>33</sup>

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<sup>28</sup> Frans Vanistandael, "Legal Framework for Taxation" in Victor Thuronyi, ed. *Tax Law Design and Drafting* vol 1 & vol 2 (International Monetary Fund) 1998

<sup>29</sup> C-330/91 *Commerzbank* [1993] I-4017, Darmon AG para 37

<sup>30</sup> Case C-18/95 *Terhoeve v Inspecteur van de Belastingdienst Particulieren* [1999] ECR I-345 and Case C-279/93 *Finanzamt Köln-Altstadt v Roland Schumacker* [1995] ECR I-225, paras 28 and 29

<sup>31</sup> Case C-311/97 *Royal Bank of Scotland v Elliniko Dimosio* [1999] ECR I-2651, para 33 of AG Alber's opinion

<sup>32</sup> Case C-120/78 *Rewe Zentrale* [1979] ECR 649 (Cassis de Dijon)

<sup>33</sup> Case C-175/88 *Beihl v Administration des contributions du grand-duché de Luxembourg* [1990] ECR I-1779 and Case C-270/83 *Commission v France* [1986] ECR 273

## 5.2 Objectively Comparable – the Discrimination Approach

In The Royal Bank of Scotland case mentioned above, the Court restated in its judgement, the established principle relating to equal treatment, that “*discrimination consists in the application of different rules to comparable situations or in the application of the same rule to different situations*”<sup>34</sup>. In view of this, it is always necessary in cases where discrimination is established, to identify a comparator. The direct tax case-law suggests that the Court of Justice has found this particularly challenging. A series of decisions in the 1990’s relating to cross-border workers, established clearly that national tax rules which draw a distinction between resident and non-resident tax payers are not automatically discriminatory. In the case of Schumacker, AG Leger acknowledged that in tax law, resident and non-resident taxpayers are “*not, objectively in the same situation.*”<sup>35</sup> Writing in 1994, he cautioned therefore that the, “*(a)pplication of the principle of non-discrimination to the sphere of taxation calls for great circumspection.*” In Schumacker however, the applicant was resident in Belgium but most of his income came from salaried employment in Germany. The German tax system treated him as a non-resident tax payer with a limited liability to taxation and as a result, did not apply to his employment income, an allowance available to resident tax payers which was designed to take into account their personal circumstances. Despite the Advocate General’s cautionary words, he concluded in his opinion that the system of distinguishing between resident and non-resident taxpayers was discriminatory where the non-resident received nearly all of his income in the host state and the effect was to preclude him from having his personal circumstances taken into account either in his state of employment or his state of residence (his income was too low in Belgium to access any allowance). In its judgement, the Court agreed with this analysis, stating 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.*” This judgement was referred to in several subsequent judgements, notably Wielockx and Asscher which confirmed that in direct tax cases situations which national legislation treated as unequal might nonetheless be objectively comparable and thus discriminatory. In the Asscher judgement, this objective comparability was developed still further to include as comparable, an “*objectively and factually relevant different situation*”. Asscher concerned a self-employed cross border commuter who received less than 90% of his income in the host state, having income from self-employed activity in his state of residence too. He was still found to be in an objectively comparable situation to resident tax payers in the host state as regards the rate of tax applied to his income there. The Court seemed to go even further with its objective comparability concept in the later case of De Groot. If one considers that the unequal treatment principle is an EU expression of the general legal principle of equality, this judgement seems to go extraordinarily far. Equal situations must be treated equally. Applying unequal treatment where situations differ because of nationality is prohibited by the

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<sup>34</sup> Case C-311/97 *Royal Bank of Scotland v Elliniko Dimosio* [1999] ECR I-265, para 26

<sup>35</sup> Case C-279/93 *Finanzamt Köln-Altstadt v Roland Schumacker* [1995] ECR I-225, AG Léger, para 38

treaties. Applying unequal treatment on grounds of residence is not per se prohibited but is if the tax subject concerned is objectively in the same situation as a resident. In *De Groot*, the tax payer was resident in the Netherlands but received the greater share of his income from activities in three different Member States. Nonetheless, for free movement purposes, he was deemed to be in a comparable situation to a resident with an income wholly attributable to activities in the Netherlands. In the national system, this was not an equal situation. A rule existed therefore which allowed *De Groot* only a proportion of the allowance relating to his personal circumstances relative to that proportion of his income which was earned in that state. It was also argued (by the Dutch Government) that the taxpayer's personal circumstances could be taken into consideration proportionately in the other states of employment but the Court of Justice, citing the *Schumacker* and *Asscher* cases, did not accept this either. In terms of those cases, the application of any allowances to *De Groot*'s income in the states of employment would have required placing him in an objectively comparable situation to resident taxpayers in those states, but his income from each was not such that the *Schumacker* reasoning could apply. The Court also referred to *Schumacker* as authority for the principle that the State of Residence is generally best placed to take into consideration since that is where his "*personal and financial interests are centred*"<sup>36</sup> In *De Groot*, it is interesting to note that the other states concerned did not apply a similar kind of allowance to resident income. Presumably therefore, if *De Groot*, in the same employment circumstances, had chosen to take up residence in one of those countries, he would have been treated as objectively comparable to his fellow residents who were not receiving any allowance. Perhaps in such circumstances it would still be open to the tax payer to argue that denying him the full allowance in the state of his departure was a restriction on his freedom of establishment and in that way align himself with Netherlands resident taxpayers once again. There have been many observations on this line of cases, suggesting that the Court does not understand how personal allowances function at national level. Nonetheless it has persisted with its reasoning.<sup>37</sup> This application of the equal treatment principle assimilating the source state for the individual's state of residence has been developed still further in more recent cases including cases concerning negative property income in the state of residence which source states have been obliged to relieve.<sup>38</sup>

### 5.3 Restrictive Approach

If the development of the discrimination approach in its application to direct tax cases can be interpreted as lacking consistency and structure in terms of what and who may be held to be in an objectively similar situation, it is perhaps unsurprising that a move away from the pure discrimination approach towards a restrictions approach was observed during the 1990's. Such an approach to the interpretation of the treaty freedoms was already being applied in the Court's general case law having evolved in cases where no discrimination had been identified

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<sup>36</sup> Case C-279/93 *Finanzamt Köln-Altstadt v Roland Schumacker* [1995] ECR I-225, paras 89 and 90

<sup>37</sup> Case C-39/10 *Commission v Estonia* [2012] ECRO

<sup>38</sup> Case C-152/03 *Ritter-Coulais v Finanzamt Gernersheim* [2006] ECR I-1711 and Case C572/06 *RHH Renneberg v Staatssecretaris van Financiën* [2008] ECR I-7735

in terms of unequal treatment either directly or indirectly, but where the application of national provisions nonetheless had the effect of restricting free movement.<sup>39</sup> The basis of this approach is one of mutual recognition, that is, it involves a degree of acceptance of the rules of another Member State as being equally valid.<sup>40</sup> In the case of Futura participations for example, when considering whether conditions attached to the carrying forward of the loss of a non-resident branch, the Court did not look for a comparable situation but rather considered that the conditions, which would require separate accounts to be kept for the branch, was prohibited in principle by virtue of the freedom of establishment provisions.<sup>41</sup> The language of these decisions moves away from talking in terms of persons in similar situations to references to obstacles and hindrances. In Lankhorst, the Court expressed this succinctly when it stated that, “*Such a difference in treatment between resident subsidiary companies according to the seat of their parent company constitutes an obstacle to the freedom of establishment.*”<sup>42</sup> This difference in treatment leading to a restriction rather than unequal treatment resulting in discrimination was interpreted by many commentators as a sufficiently broad interpretation of the treaty freedoms as to potentially capture nearly all differences arising from the existence of separate tax systems within the EU. The application of a higher rate of tax, for example; something which is clearly within the sovereign powers of each Member State, could, theoretically be an obstacle. Indeed, it has been suggested that such an approach would make it almost impossible for a national system not to present a restriction.<sup>43</sup> This kind of all encompassing interpretation would appear to apply to the treaty freedoms a concept of discrimination which goes much further than the application of the legal principle of equality would require. By way of a limitation on this interpretation however, two possibilities exist. Firstly, the Court has acknowledged that these differences in treatment, where found to be obstructive, may nonetheless be justified; and secondly, the Court has accepted, albeit in a limited number of cases, that some differences in treatment arise not from a prohibited exercise of sovereign authority but rather from a disparity caused by the lack of harmonisation of direct tax law.

## 5.4 Justifications

All of the Treaty rights to free movement are accompanied by corresponding articles allowing derogations from the general provisions in particular circumstances. The Court of Justice has developed, through its rule of reason approach, a wider interpretation of allowable justifications based on the “overriding public interest” in cases where it has identified indirect discrimination.<sup>44</sup> This rule, established in the famous ‘*Cassis de Dijon*’ case was succinctly

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<sup>39</sup> Case C-415/93 *Bosman* [1995] ECR I-4921 and Case C-55/94 *Gebhard (Reinhard) v Consiglio dell’Ordinedegli Avvocati e Procuratori di Milano* [1995] ECR I-4165

<sup>40</sup> Case C-120/78 *Rewe Centrale* [1979] ECR 649 (*Cassis de Dijon*)

<sup>41</sup> Case C- 250/95 *Futura Participations SA and Singer v Administration des Contributions* [1997] ECR I-667, para 26

<sup>42</sup> Case C324/00 *Lankhorst- Hohorst GmbH v Fianzamt Steinfurt* [2002] ECR I-11779, para 32 See also, Suzanne Kingston, “A light in the darkness: Recent Developments in the ECJ’s Direct Tax Jurisprudence” [2007] Common Market Law Review 44 at pages 1329 and 1330

<sup>43</sup> *Ibid* [43] page 1331

<sup>44</sup> Case C-120/78 *Rewe Centrale* [1979] ECR 649 *Cassis de Dijon* and see Case C-55/94 *Gebhard (Reinhard) v Consiglio dell’Ordinedegli Avvocati e Procuratori di Milano* [1995] ECR I-4165, para 37



expressed in the case of *Gebhard*<sup>45</sup> “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.” In this way, the Court of Justice is not saying that there is an unequal situation which can be treated unequally (no discrimination) rather where the situation is one which should receive equal treatment but is precluded by a national rule; it has interpreted the treaties as allowing, in limited circumstances, the national rule to be applied.

In its case law on direct taxation, it has taken into consideration nearly all kinds of justifications put forward, although it has accepted relatively few of these.<sup>46</sup> Some commentators have suggested that as the Court moved towards its broader obstacle or hindrance approach to free movement, it correspondingly was prepared to give a wider berth to the justifications advanced by Member States.<sup>47</sup> Coherence of the National Tax System,<sup>48</sup> effectiveness of fiscal supervision and control,<sup>49</sup> prevention of avoidance and evasion,<sup>50</sup> the necessity of avoiding double non-taxation and the balanced allocation of taxing powers have all been accepted as justifications although in some cases the Court has still considered that the justified national provision has gone beyond what is proportionate. Relatively early on in the Court’s direct tax case law, the coherence of fiscal supervision argument was successfully invoked by the Belgian government to justify the refusal of a tax deduction in respect of insurance premium payments to a non-resident insurance company where a deduction was available for payments to Belgian insurers.<sup>51</sup> In that case; *Bachmann*, the Court held that there was a connection between the deduction in respect of the premiums and the tax payable by the insurance company at the time of paying out the sums due under the contracts. In particular, it stated that, “*The cohesion of such a tax system, the formulation of which is a matter for each Member State, therefore presupposes that, in the event of a State being obliged to allow the deduction of life assurance contributions paid in another Member State, it should be able to tax sums payable by insurers.*”<sup>52</sup> It should be noted that the Advocate General, Mischo, delivering his joint opinion in relation to both this case and the separate case of *Commission v Belgium* considered that this justification was not proportionate since, in his view, other possibilities were available for ensuring that tax would ultimately be collected

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<sup>45</sup> Case C-55/94 *Gebhard (Reinhard) v Consiglio dell’Ordinedegli Avvocati e Procuratori di Milano* [1995] ECR I-4165

<sup>46</sup> Van Thiel, Servaas, 2008 ‘Justifications in Community Law for Income Tax Restrictions on Free Movement: Acte Clair Rules That Can Be Readily Applied by National Courts – Part’ [2008] vol 48, 6 *European Taxation*, 279

<sup>47</sup> Cordewener, Kofler and van Thiel ‘The Clash between European Freedoms and National Direct Tax Law: Public Interest Defences Available to the Member States’ ,2009 *Common Market Law Review* 46: 1951-2000, 1952

<sup>48</sup> Case C-204/90 *Bachmann v Belgium* [1992] ECR I-249 and Case C-80/94 *Weilockx (G.E.H.J.) v Inspecteur der Directe Belastingen* [1995] ECR I-2493

<sup>49</sup> Case C -250/95 *Futura Participations SA and Singer v Administration des Contributions* [1997] ECR I-667

<sup>50</sup> Case C-196/04 *Cadbury Schweppes v Commissioners of the Inland Revenue* [2006] ECR I-7995

<sup>51</sup> Case C-204/90 *Bachmann v Belgium* [1992] ECR I-249, Case C-300/90 *Commission v Belgium* [1992] ECR I-305

<sup>52</sup> Case C-204/90 *Bachmann v Belgium* [1992] ECR I-249, para 23

from the non-resident insurance company.<sup>53</sup> (A system was in operation in the Netherlands whereby undertakings were provided by foreign insurers) The Court did not consider that an undertaking was sufficient to ensure payment and discounted the suggestion that the insurance company could be asked to provide a deposit on the basis that the expense of this would ultimately be passed on to the insured. It therefore arrived at the conclusion that the cohesion of the tax system could not be ensured by “*measures less restrictive than those at issue in the main proceedings*”.<sup>54</sup> Following the upholding of this justification in *Bachmann*, subsequent attempts to argue that a national rule is justified to maintain cohesion of the tax system have largely failed. Although it has never expressly contradicted its earlier ruling, *Bachmann* has been distinguished on several subsequent occasions on the basis that there must be a direct link between the tax subject’s payments in to the insurance policy and income later received.<sup>55</sup> The argument has been explored again more recently in a series of complex cases concerning the taxation of cross border dividends where Member States have sought to justify imputation systems in terms of coherence. The Court has consistently held in these cases that no direct link exists between income tax on dividends at shareholder level and any corporation tax payable by the company.<sup>56</sup> It views such cases as involving two separate taxpayers and two separate taxes. It has however been interpreted as accepting such a link in relation to incoming dividends where it has required the state of residence to provide a credit for withholding tax with reference to the amount actually paid in the source state.<sup>57</sup> In *Futura*,<sup>58</sup> the Court accepted that requiring preparation of separate accounts for the Luxembourg branch of a French company was justified in order to ensure effective fiscal supervision.<sup>59</sup> In several cases, the Court of Justice has accepted that a restrictive/discriminatory national rule has been justified on the basis of prevention of tax abuse or evasion.<sup>60</sup> This justification arguably amounts to balancing the allocation of taxing powers which has also been accepted by the Court. Again, the Court has been cautious in upholding these arguments. In all cases, justifications must be proportionate, that is, they must not go beyond what is necessary to protect the public interest. In the case of abuse, the case-law makes it clear that national rules restricting treaty freedoms for this reason must not presume abuse; such provisions being disproportionate.<sup>61</sup> In the *Futura* case, effective fiscal supervision was justified but not to the extent of requiring that accounts be prepared in accordance with Luxembourg legislative requirements and kept in Luxembourg. It was only necessary to be able to ascertain with accuracy what the losses of the branch had been for a given period in order to maintain

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<sup>53</sup> Case C-204/90 *Bachmann v Belgium* [1992] ECR I-249, Opinion of AG Mischo, para27

<sup>54</sup> Case C-204/90 *Bachmann v Belgium* [1992] ECR I-249, para 27

<sup>55</sup> Case C-80/94 *Weilockx (G.E.H.J.) v Inspecteur der Directe Belastingen* [1995] ECR I-2493 and Case C- 35/98 *Staatssecretaris van Financiën v B.G.M. Verkooijen* [2000] ECR I-4071

<sup>56</sup> Case C- 35/98 *Staatssecretaris van Financiën v B.G.M. Verkooijen* [2000] ECR I-4071 and Case C-446/04 *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue*[2006] ECR I-11753

<sup>57</sup> Case C-319/02 *Manninen* [2004] ECR I-7477 and see Michael J Graetz and Alvin C Warren Jr ‘Dividend taxation in Europe: When the ECJ makes tax policy’ [2007] 44 CML Rev 1577,1597

<sup>58</sup> Case C -250/95 *Futura Participations SA and Singer v Administration des Contributions* [1997] ECR I-667

<sup>59</sup> *Ibid* [59] paras 39 and 40

<sup>60</sup> Case C-196/04 *Cadbury Schweppes v Commissioners of the Inland Revenue* [2006] ECR I-7995, Case- C 28/95 *Leur-Bloem v Inspecteur der Belastingdienst/Ondernemingen* [1997] ECR I -4161

<sup>61</sup> Case C-196/04 *Cadbury Schweppes v Commissioners of the Inland Revenue* [2006] ECR I-7995

adequate supervision. The balanced allocation of taxing powers has been accepted in some of the more recent tax law cases both in relation to the interplay between tax treaties and EU law and also in relation to non tax-treaty so called “double dip” cases where the tax payer would be able to take advantage of a deduction in more than one Member State.<sup>62</sup>

## 5.5 Disparities

Beyond the possible justifications for restrictive or discriminatory national measures, the Court of Justice has also recognised that in some situations, exercise of the right to free movement may result in a less favourable set of circumstances, caused not by the lack of equal treatment but rather as a result of a disparity between the tax systems of different Member States. Unlike a disadvantage, which arises from differing or discriminatory treatment, a disparity does not involve any difference in treatment but because of the autonomous application of the rules of two different systems, the taxpayer is left in a less advantageous position. This was the view taken in the case of *Kerckhaert and Morres*<sup>63</sup> when the Court found that the right to free movement of capital did not preclude a Belgian law which applied the same rate of tax to incoming dividends regardless of the State of residence of the issuing company. The fact that resident taxpayers with shareholdings in non-resident companies might be subject to a withholding tax in those states with no corresponding right of offset in Belgium and therefore taxed in both countries arose from a disparity between the systems. The effect of the application of Inheritance tax rules has also been found on several occasions to be the result of a disparity rather than any infringement of free movement rights. In *Block*,<sup>64</sup> a German resident taxpayer inherited from a deceased German resident, assets situated in Spain. She paid inheritance tax in Spain on these assets but was subsequently also assessed to tax on them in Germany. The referring court asked if the free movement of capital provisions prohibited German inheritance tax rules where they did not provide any credit for the inheritance tax paid in Spain. The difference in treatment was held not to arise from the application of the disputed rule but to the “choice by the Member State.....pursuant to the exercise of its fiscal sovereignty” and the Court clearly stated with reference to previous case law, that, “*the Treaty offers no guarantee to a citizen of the Union that transferring his residence to a Member State other than that in which he previously resided will be neutral as regards taxation.*” Equal treatment does not therefore require the elimination of double juridical taxation.

## 5.6 Analysis

The Court’s earlier case law on direct taxes demonstrates a fairly strong reliance on the principle of equality in so far as the discrimination approach employed by the Court made it easy to see that the objective was to ensure equal treatment on the basis of nationality. The

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<sup>62</sup> Case C-376/03 *D v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heelen* [2005] ECR I-5821, Case C-446/03 *Marks & Spencer v Halsey*[2005] ECR I-10837 , Case C- 337/08 *X - Holding BV v Saatssecretaris van Financiën* [2010] ECR I-0000 and see Axel Cordewener, Georg Kofler and Servaas Van Thiel ‘The Clash between European Freedoms and National Direct Tax Law: Public Interest Defences Available to the Member States’ [2009] 46 CML Rev 1951-2000 , 1988

<sup>63</sup> Case C-513/04 *Kerckhaert-Morres v. Belgium* [2006] ECR I-10967

<sup>64</sup> Case C-67/08 *Margarete Block v FA Kaufbeuren* [2009] ECR I-883

main difficulty with the approach was and still is, however, identifying a suitable comparator. At EU level, the Court is concerned with national treatment, sometimes from the perspective of an internal comparison and at other times a cross border comparison. It has not only compared the legal situation of the taxpayer but also their respective factual situations and in doing so it has not been persuaded by arguments from the member states to the effect that the comparison it seeks to make does not in fact take into account all of the relevant aspects of the national systems.<sup>65</sup>

Nor does the Court concern itself with any resulting disadvantage internally, that is so called reverse discrimination. A highly poignant example of this is the German case of Schwarz. In that case, a German couple were held to be entitled to a deduction for school fees paid to a private school in the UK where they had chosen to send two of their children. This deduction was available to German resident taxpayers in relation to a small number of schools in Germany which were run on a private basis. In holding that this was unequal treatment contrary to the free movement of services, there was no regard to or discussion of the fact that UK residents, sending their children to the same school would have no benefit of deduction and thus would have to pay considerably more to go there.<sup>66</sup> The rationale seems to be that EU citizens have a remedy against reverse discrimination in their home state by virtue of the democratic process. In a situation like this one, the only way to achieve equality would be for the UK government to introduce a tax deduction, something which would not necessarily be politically or economically acceptable. The alternative of charging higher fees to non-residents to compensate the inequity would of course be contrary to the treaty freedoms.

While the discrimination approach to the equal treatment principle employed by the Court of Justice in its earlier cases displays some obvious resemblance to the legal concept of equality associated with the requirements of a good tax system, the progress of the Court's case law towards a more restrictions based interpretation of the freedom of movement provisions has made the link less clear. The restrictions based approach initially held to a clear sequence of analysis in the order of restriction – justification – proportionality but a blurring of this approach has been noted in more recent decisions.<sup>67</sup> In the Marks and Spencer case, Advocate General Maduro indicated that in his view the non-discrimination approach was “not sufficient to safeguard all the objectives comprised in the establishment of an internal market”<sup>68</sup> Maduro noted the difficulty in applying the discrimination approach in terms of requiring a comparison and acknowledged that the restrictions approach was more severe. He suggested however that in tandem with the move towards an obstacles based approach, the concept of discrimination was still present in the Court's judgements but this was not

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<sup>65</sup> See the arguments of the Dutch Government in the cases Case C-251/98 *Baars v Inspecteur der Belastingdienst Particulieren/Ondernemingen Gorinchem* [2000] ECR I-2728, Case C- 35/98 *Staatssecretaris van Financiën v B.G.M. Verkooijen* [2000] ECR I-4071 and Case C-168/01 *Bosal Holding BV* [2003] ECR I-9049

<sup>66</sup> Case -C76/05 *Herbert Schwarz und Marga Gootjes-Schwarz v. Finanzamt Bergisch Gladbach* [2007] ECR I-6849

<sup>67</sup> Suzanne Kingston, ‘A light in the Darkness: Recent Developments in the ECJ's Direct Tax Jurisprudence’ (2007) 44 CMLRev. 1321,1334

<sup>68</sup> Case C-446/03 *Marks & Spencer v Halsey*[2005]ECR I-10837 AG Maduro para34

discrimination on grounds of nationality, more discrimination in respect of a disadvantage arising through the exercise of the right of free movement.<sup>69</sup> Subsequent to the judgement in Marks and Spencer, a blurring of the original approaches has been observed.<sup>70</sup> This has interesting consequences. The discrimination approach left Member States only able to justify an inequality in situations which the court had already identified as discriminatory or restrictive. Now, justifications by the Member States seem to be given consideration before arriving at that conclusion.<sup>71</sup> Following a period when the Court still seemed to be applying a more obstacle based approach with a greater openness to justifications, a return to the discrimination approach has also been identified.<sup>72</sup> This has been welcomed by some commentators as providing greater legal certainty after a period when it was almost a foregone conclusion that the measure would be restrictive and the onus of proof was on Member States to plead justification and proportionality.<sup>73</sup> As far as where this leaves equality, perhaps this return to the discrimination approach provides greater assurance that substantive equality will be maintained. Advocate General Maduro did admit in his Marks and Spencer's opinion, that the discrimination approach "*may have appeared more respectful of national systems.*"<sup>74</sup>

Although referred to on many occasions following the Bachmann judgement, it has been pointed out that the Court did not define cohesion in that decision.<sup>75</sup> Terra and Wattel have described fiscal cohesion or symmetry as "*tax base integrity in terms of ensuring that connected positive and negative elements of the same source of income of the same tax payer within the same taxing jurisdiction stay connected within that same taxing jurisdiction.*"<sup>76</sup> The trend of the decisions post Marks and Spencer's appears to support the view that internal coherence can justify unequal treatment and that a balanced allocation of taxing powers will be respected by the Court of Justice. There is some debate about exactly what is covered by each of these justifications with a suggestion that really all of the justifications which the Court has ever accepted amount to tax base integrity arguments.<sup>77</sup> Others dispute this assertion and maintain that separate concepts exist. In some cases, like in the Marks and Spencer's decision, the Court accepted that the national provisions were justified for several reasons.

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<sup>69</sup> Ibid, [69] para28.

<sup>70</sup> Case C-446/04 *Franked Investment Income (FII) Group Litigation* [2006] ECR I-11753

<sup>71</sup> Prof Mr. Lieven, A. Denys, 'The ECJ Case Law on cross-border dividends revisited' (2007) May European Taxation 221, 237

<sup>72</sup> Ben J.M.Terra and Peter J. Wattel, *European Tax Law* (6th ed. Walters Kluwer)

<sup>73</sup> Suzanne Kingston, 'A light in the Darkness: Recent Developments in the ECJ's Direct Tax Jurisprudence' (2007) 44 CML Rev. 1321,1335

<sup>74</sup> Case C-446/03 *Marks & Spencer v Halsey* [2005] ECR I-10837, AG Maduro para 29

<sup>75</sup> Joined Cases C-397 &410/98 *Metallgesellschaft Ltd and Hoechst v Commissioners of Inland Revenue* [2001] ECR I-1727 , AG Fennelly, para 28

<sup>76</sup> Ben J.M.Terra and Peter J. Wattel, *European Tax Law* (6th ed. Walters Kluwer) 895

<sup>77</sup> Ibid

## 6. Equal Treatment and Procedural Equality ( equal application of the law to all who are subject to it with the same right of challenge)

### 6.1 Equal Access to Treaty Freedoms

Before investigating whether the Court of Justice is applying the law equally, it is necessary to consider whether it affords equal access to the law

In relation to the freedom of establishment, article 54 of the TFEU ensures that Companies have the same entitlement to equal treatment on grounds of nationality as natural persons. Broadly speaking, the definition of company covers all forms of legal personality as recognised by the Member States and including cooperative societies.<sup>78</sup> The Court has confirmed that the nationality of a company in this context is defined by reference to the place of its registered office.<sup>79</sup>

In its early case law on direct taxation, the Court, having regard to the fact that national law on the formation of Companies was beyond its competence, created a distinction between legal and natural persons in terms of treaty access. In applying its discrimination approach, the Court has treated as objectively comparable, the situation of another Company or branch or agency but has always maintained a distinction between Companies and natural persons. In *Daily Mail*, it set out that, *“it should be borne in mind that, unlike natural persons, companies are creatures of the law and, in the present state of Community law, creatures of national law. They exist only by virtue of the varying national legislation which determines their incorporation and functioning.”*<sup>80</sup> In this case, the purported application of an exit tax to a UK registered company wishing to transfer its place of central management to the Netherlands forced the Court to look into the complicated issue of the real seat and seat of incorporation differences in approach applied in the company law of different Member States. In terms of UK law, a company is resident in the UK if its seat of incorporation is there. Regardless of where the company is managed from or the location of its operations. In practical terms this means that there is no requirement to dissolve the company where its operations are physically transferred to another location. In other Member States, the transfer of the central management or control of a company triggers an automatic winding up. As Community Law stood in 1988, the Court of Justice did not consider that the then article 52 on the right to freedom of establishment applied to the *Daily Mail* situation. In arriving at this decision, it stated that, *“It must therefore be held that the Treaty regards the differences in national legislation concerning the required connecting factor and the question whether - and if so how - the registered office or real head office of a company incorporated under national law may be transferred from one Member State to another as problems which are not resolved by the rules concerning the right of establishment but must be dealt with by future legislation or conventions .*

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<sup>78</sup> Consolidated version of the Treaty on the Functioning of the European Union [2010 ] OJ C83/47 Article 54

<sup>79</sup> Case C-270/83 *Commission v France* [1986] ECR 273 (Avoir Fiscal)

<sup>80</sup> Case C-81/87 *Daily Mail* [1988] ECR 5005, para 19

*Under those circumstances, Articles 52 and 58 of the Treaty cannot be interpreted as conferring on companies incorporated under the law of a Member State a right to transfer their central management and control and their central administration to another Member State while retaining their status as companies incorporated under the legislation of the first Member State”<sup>81</sup>.*

The distinction in EU direct tax law has therefore been created by judicial interpretation. In terms of procedural equality there is some evidence that the Court’s application of EU law will not always provide a consistent result. For example, the author Catherine Barnard has interpreted the Royal Bank of Scotland judgement as an indication that where a rule discriminates on the basis of the registered office of a company, an organisation incorporated through legislation based on the seat of incorporation theory would be treated as having its nationality based on its registered office and therefore to have been directly discriminated by such a rule. On the other hand, non – resident companies formed in accordance with the real seat theory would still have been discriminated against by the rule but not directly since their nationality is not necessarily consistent with the location of their registered office.<sup>82</sup> Since direct discrimination can only be justified by one of the express derogations provided for in the treaty, the former type of company has potentially a better chance of success.

In December 2008, the Court reaffirmed this view in the case of *Cartesio* where a limited partnership, formed in accordance with the law of Hungary, was unable to rely on the right to freedom of establishment as precluding a national rule which refused to allow transfer of its seat to Italy whilst retaining a legal personality in Hungary.<sup>83</sup> More recently in *National Grid Indus*, the Court restated this approach when applying the free movement of establishment provisions to a Dutch rule which applied an exit tax on the transfer of a company’s place of management to the UK. In that regard, the Court restated that, *“In the absence of a uniform definition in European Union law of the companies which may enjoy the right of establishment on the basis of a single connecting factor determining the national law applicable to a company, the question whether Article 49 TFEU applies to a company which seeks to rely on the fundamental freedom enshrined in that article – like the question whether a natural person is a national of a Member State and hence entitled to enjoy that freedom – is a preliminary matter which, as European Union law now stands, can only be resolved by the applicable national law.”* In this case however, the national rule which was being challenged did not itself affect the status of the company under Netherlands law. The Court was able to proceed to apply the treaty freedom and found that there was an infringement.

From a practical point of view, the *Daily Mail* and *National Grid* cases both concern attempts by the taxpayer to challenge the imposition of exit taxes when moving their place of effective management from one Member State to another. Whilst in the *Daily Mail* case, European Law was not applicable, in the *National Grid* case there was a restriction. Although from a legal point of view one can see the rationale behind the distinction, the

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<sup>81</sup> Case C-81/87 *Daily Mail* [1988] ECR 500, paras 23 and 24

<sup>82</sup> Case C-208/00 *Uberseering BV v Nordic Construction Company Baumanagement GmbH* [2002] ECR I-9919

<sup>83</sup> Case C210/06 *Cartesio* [2008] ECR I-9641

reality of this judgement is that based on the state of national company law, a company from one member state may be denied treaty access while another can obtain treaty protection. Arguably this is itself, discrimination based on nationality; the equal treatment principle clearly only applying once treaty access has been upheld.

## 6.2 Equal Access – application of different freedoms

In terms of equality before the law, the Court is not alone in distinguishing between natural and legal persons regarding its assessment of discrimination. Many national tax law systems also draw a distinction. They do so however by the application of separate rules and rates but that is not the case in the EU direct tax law context where in most cases, the Court has to apply the same treaty rules to all types of taxpayer.<sup>84</sup> Since the Court is concerned with the conformity in law between national tax rules and the provisions of the treaties, it is logical that from a legal point of view, only those persons who are subject to the national rule can be in an objectively similar situation as far as possible discrimination is concerned. This has been the case in several of the cross border dividend cases which have reached the Court of Justice. Here, the Court has interestingly made its own distinction in European Law, not such that it applies the treaty freedoms differently as between different types of shareholder but that it applies a different freedom. It has done so through its so- called definite influence rule which will establish the dominance of the freedom of establishment over the free movement of capital. The origins of this rule lie in the Baars case and subsequent decisions in the<sup>85</sup> In terms of the dominance rule, the case law has now been interpreted as clarifying that where the freedom of establishment articles apply, the right to free movement of capital or services if also applicable, will be viewed as ancillary to the right of establishment. In practice this has meant that if the right of establishment precludes the national measure complained about, the Court will not question whether any of these other free movement rights have also been infringed since the rule will already be in breach of EU law.

In order to establish the dominance of the freedom of establishment, a shareholder will be deemed to have a ‘definite influence’ where the shareholding confers influence over the company’s activities. Although the case law of the Court refers to the definite influence concept on many occasions, it has been noted that the method of assessing definite influence has not been consistent.<sup>86</sup> In the case of X and Y, where the same national rule applied to several types of share, the Court found the free movement of capital provisions to be applicable only where there was an insufficient level of participation for the national measure to be precluded by the right to freedom of establishment provisions. It has also been observed that definite influence is not always the determining factor in deciding which

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<sup>84</sup> For a different set of schedules and rates for different income see for example the UK Income and Corporation Taxes Act 1988 as amended

<sup>85</sup> Case C-251/98 *Baars v Inspecteur der Belastingdienst Particulieren/Ondernemingen Gorinchem* [2000] ECR I-2728, para 21

<sup>86</sup> Sigrid Hemels et al ‘Freedom of establishment or free movement of capital: is there an order of priority? Conflicting visions of national courts and the ECJ’ (2010) 1 EC Tax Review 19, 23



freedom applies, in other cases the court has looked at the national rule and where this has been applied to both types of shareholder; both freedoms have been deemed to apply. There seems to remain a degree of confusion in the area.<sup>87</sup> In terms of the outcome for the taxpayer, there is a significant difference in that the free movement of capital extends to third countries which is not the case with the right of establishment. The possible consequence that national tax legislation could be deliberately discriminatory towards third country direct investment without infringing treaty rights has been received with amazement.<sup>88</sup>

### 6.3 Equal Application - legal form

The Court of Justice has had some difficulty in reconciling the treaty provisions with fiscal neutrality. The prohibition of restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State applies expressly to, “*the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.*”<sup>89</sup> In terms of neutrality of EU direct tax law therefore, there should in theory be no objective difference in treatment between a company setting up a branch in another state and a company establishing itself in another state by the formation of subsidiary company. On the face of it, this treaty provision would appear to require equal treatment regardless of legal form however, as with natural and legal persons, there is a legal difference in form between branches and subsidiaries. Furthermore, the right of establishment applies to “nationals” which covers by implication of the terms of article 54, both natural and legal persons. A branch is neither. The case law on establishment has been criticised as inconsistent and inconclusive as to whether a branch (or P.E) as it is often referred, are entitled to equal treatment.<sup>90</sup> It appears that the Court will treat as comparable a branch with a branch<sup>91</sup> and a subsidiary with a subsidiary<sup>92</sup> but not a branch and a subsidiary. As is seen in *Columbus Container Services* the Court has also compared partnerships with partnerships in comparing the tax treatment of foreign partnership profits with domestic partnership profits. The two main areas of the Court’s jurisprudence where this has been pertinent have arisen in the case of cross border loss relief and the cross border taxation of dividends. In relation to cross border losses, the Court has been criticised for the lack of consistency in its approach, sometimes looking at the cross border PE situation from the perspective of two separate entities and at other times, maintaining the unity in law between a company and its branch.<sup>93</sup> In the case of *Lidl*, the Court established that failure to allow a resident parent company to offset losses of a non –

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<sup>87</sup> Sigrid Hemels et al ‘Freedom of establishment or free movement of capital: is there an order of priority? Conflicting visions of national courts and the ECJ’ [2010] EC Tax Review no.1 p19 article page 7

<sup>88</sup> Cordewener, Kofler and Schindler, ‘Free Movement of Capital and third countries: exploring the outer boundaries with Lasertec, A and B and Holbock’ (2007) vol 47 issue 8,9 European Taxation, 371

<sup>89</sup> Consolidated version of the Treaty on the Functioning of the European Union [2010 ] OJ C83/47 Article 49

<sup>90</sup> Ben J M Terra & Peter J Wattel, *European tax Law* (6<sup>th</sup> edn Wolters Kluwer Law & Business 2012) 1003

<sup>91</sup> Case C250/95 *Futura Participations SA and Singer v Administration des Contributions* [1997] ECR I-2471

<sup>92</sup> Joined Cases C-397 & 410/98 *Metallgesellschaft Ltd and Hoechst v Commissioners of Inland Revenue* [2001] ECR I-1727

<sup>93</sup> Case C-168/01 *Bosal Holding Bvu v Staatssecretaris van Financiën* [2003] ECR I-9409

resident branch was a restriction.<sup>94</sup> In the Marks and Spencer judgement, the Court extended this reasoning to the losses of non-resident subsidiaries by finding that national rules on group relief constituted a restriction on the freedom of movement.<sup>95</sup> In arriving at its decision, the Court seems to have been persuaded by the Advocate General, Maduro's opinion that the question at issue was whether disadvantageous treatment was being applied to the group, that is, the parent and its subsidiaries. Noting that in the UK, foreign branches and subsidiaries were accorded different tax treatment, he stated that, "*However, the provisions on freedom of establishment do not preclude different tax treatment from being accorded to legal or natural persons in different legal situations. It is not the purpose of those provisions to impose uniformity in the regimes applicable to the different types of establishment. They merely seek to ensure tax neutrality in the exercise of the right to freedom of establishment within the Community. Any other solution would have the effect of calling in question the more stringent tax regimes among the Member States even though no transnational situation was specifically contemplated. That cannot be the purpose of the Treaty rules on freedom of movement.*" In subsequent decisions, the Court has reaffirmed this interpretation. Interestingly in these cases there has been no suggestion of discrimination; rather the court has found that an obstacle existed. In the case of X-Holding, Advocate General Kokott emphasised that "*EU law does not require that the state of origin should treat as equal, a subsidiary and a P.E in the State of establishment*"<sup>96</sup> In a very recent opinion, in a case still pending, the same Advocate General distinguished her ruling in X-Holding on the basis that, "there are different duties for the Member State of origin and the host Member State with regard to the allocation of the power to impose taxes," She considers in her latest opinion that the state of origin can treat a PE and a subsidiary differently since it only has taxing rights over the former whereas in the host state taxing rights are enjoyed over both branches and subsidiaries. The Court has yet to issue its judgement in the case.

#### **6.4 Equal Application of the equal treatment principle**

Although in cases concerning legal persons the Court does make reference to general principles derived from its cases involving natural persons, it has maintained a distinction between the two types of taxpayer based on the progressive nature of individual taxation. As noted by Advocate General Alber in the Bank of Scotland case<sup>97</sup> "*a clear distinction must first be made between physical and legal persons as regards possible discrimination in the area of direct taxation. That is because the factors decisive to the taxation of physical persons*'

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<sup>94</sup> Case C-414/06 *Lidl Belgium v GmbH & Co.KG v Finanzamt Heilbronn* [2008] ECR I-0000

<sup>95</sup> Case C-446/03 *Marks & Spencer v Halsey*[2005] ECR I-10837

<sup>96</sup> Pending Case C-18/11 *The Commissioners for Her Majesty's Revenue and Customs v Philips Electronics UK Ltd*, Opinion of Advocate General Kokott 19 April 2012 at para 55

<sup>97</sup> Case C-311/97 *Royal Bank of Scotland v Elliniko Dimosio*[1999] ECR I-2651, AG Alber, para 44

*income, such as personal and family circumstances (21)*<sup>98</sup> do not apply in the same way to legal persons.”

During the period of development of the Court’s jurisprudence in which a departure from the discrimination approach was noted in favour of the obstacles or restrictions approach, references to the earlier Schumacker line of cases on ground allowances in relation to free movement of workers were fewer. In recent years, and particularly following the Marks and Spencer Judgement of December 2005, the Court appears to have returned to a discrimination type of approach to the analysis of cases. In doing so, the Court has continued to distinguish between its treatment of cases concerning individuals and cases concerning legal persons. This difference in application has had noticeable consequences in two main areas:

#### 6.4.1 Cross Border Losses – source state /home state distinctions

In relation to cross border losses, the Court appears to have extended its Schumacker thinking beyond ground allowances for individuals to include source based deductions. For example, in the 2006 case of Ritter-Coulais, a couple living in France and working in Germany were successful in arguing that Germany should take into account losses incurred from the use of their home in France. The issue in this case has been interpreted as whether a Member State should apply the same treatment to foreign and domestic sourced income. Since in this case, Germany had no taxation rights over the foreign income, the requirement that it should consider the foreign losses has been questioned.<sup>99</sup> A similar situation arose in the later case of Rennberg. In that case, the Court, quoting Schumacker stated that the, “*discrimination arises from the fact that the personal and family circumstances of a non-resident who receives the major part of his income and almost all his family income in a Member State other than that of his residence are taken into account neither in the State of residence nor in the State of employment*” This practice of looking at the taxpayer’s situation in both the resident and host state and the expectation that losses should be taken into consideration at least once somewhere has been referred to as the ‘overall approach’.<sup>100</sup> It has been applied in relation to ground allowances as established in the case of Wallentin<sup>101</sup> and in the very recent judgement against Estonia in an action brought by the Commission following a complaint from a non-resident who was unable to obtain the advantage of the Estonian ground allowance in relation to income tax liability there for pension payments.<sup>102</sup> In principle, the overall approach has also been applied to cases on cross border loss relief relating to corporate income tax though the radical move of theoretically appointing the host state as the home state has not been extended where legal persons are concerned. Two judgements in this area, issued around the same time as the

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<sup>98</sup> Case C-279/93 *Finanzamt Köln-Altstadt v Roland Schumacker* [1995] ECR I-225

<sup>99</sup> Dennis Weber, *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC* (2006 Kluwer-Deventer)

<sup>100</sup> *Ibid* and Ben J.M.Terra and Peter J. Wattel, *European Tax Law* (6th ed. Walters Kluwer) 906

<sup>101</sup> Case C-169/03 *Florian W. Wallentin v Riksskatteverket* [2004] ECR I-6443

<sup>102</sup> Case C-39/10 *Commission v Estonia*[2012] ECRO

Rennberg decision, did not ultimately find that the national treatment was precluded. In *Lidl Belgium*, the Court held that the refusal was justified where the losses of a foreign PE could be offset against its future liability to non-resident taxation in the source state. In the EFTA case of *Krankenheim*, the Court found that German legislation for the recapture of foreign losses previously deducted was justified in terms of the coherence of the tax system. Another notable difference is that in the cases concerning individuals, the Court has not concerned itself with the risk that losses might be taken into account twice. In the cases involving legal persons, it seems to have taken on board this aspect. As a result, it has even been suggested that countries offering a fairly restrictive loss carry forward regime could prove an attractive secondary establishment location.<sup>103</sup>

#### 6.4.2 Cross Border Dividend Payments - Economic and Legal Double Taxation

The other area in which the Court has drawn a distinction in its application of the treaty freedoms relates to the taxation of cross border dividends. Several judgements arising from complex cases in this area have been widely understood as indicating that economic double taxation arising as a consequence of the exercise of treaty rights should be precluded however legal double taxation so arising may be the result of the parallel application of more than one system of taxation and is not therefore prohibited.<sup>104</sup> Thus it was held that a Belgian couple, subject to a dividend withholding tax in France and in turn also taxed by the Belgian authorities on the dividends could not obtain protection from the Treaty provisions on the free movement of capital. The distinction seems to arise from the recognition that the home state in these situations cannot extend its sovereignty into the other Member State's jurisdiction. As such, it must apply its own rules equally. This means that where national rules seek to relieve economic double taxation for residents, the same relief must be extended in a home state context to non-residents however EU law does not oblige Member States, in the exercise of their sovereignty either as home or as source state, to take measures to eliminate any disadvantage which may result in a cross border situation as a consequence of the equal application of their rules. The recent case of *Banco Bilbao* is an example of this. A Spanish company was unable to take advantage of a deduction from corporation tax provided for in a bilateral treaty with Belgium, since the latter country exempted the income there.<sup>105</sup> Reason for this seems to lie in the Court's acknowledgement of the territorial limitations of national sovereignty. This is somewhat incongruous with the *Renneberg* type decisions involving individuals where the indirect effect of the decision was to extend the sovereignty of the host state to take account of tax rules in the state of residence.<sup>106</sup>

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<sup>103</sup> Klaus Vogel Lecture by prof Leif Mutén *European Law - Quo Vadis?*, (2008 ) 1 Bulletin for International Taxation , 2

<sup>104</sup> Case C-513/04 *Kerckhaert-Morres v. Belgium* [2006] ECR I-10967

<sup>105</sup> Case C157-10 *Banco Bilbao Vizcaya Argentaria SA v Administración General del Estado* [2011] ECRO

<sup>106</sup> Prof. Dr. Gerard TK Meussen "Renneberg: ECJ Unjustifiably Expands Schumacker Doctrine to Losses from Financing of Personal Dwelling" [2009] vol 49 issue 4 *European Taxation* 185

The Court has also made some distinction between taxpayers when assessing whether a restriction is justified or proportionate. In several cases the Member States have sought to justify the national measure in terms of coherence of the tax system. In particular, in the cross border dividend cases, this argument has focussed on national imputation systems which have been created to relieve internal economic double taxation. The court has not accepted the coherence argument in these situations. It has taken the view that a company is distinct from its members. To that extent, it does not consider that taxation of profits at corporate level amounts to taxation of the shareholders. By way of contrast, withholding tax levied on a dividend distribution is treated by the Court as a tax on the same subject and object as the income tax levied on shareholders in respect of dividends received. This distinction means that while an imputation system created to relieve advance corporation tax must be extended to include profit distributions to companies with non-resident parents, there is no obligation to extend relief from withholding tax to non-resident shareholders.

## 6.5 Analysis

Just as there are difficulties for the Court of Justice in seeking to ensure substantive equality in its direct tax jurisprudence, procedural equality is also a challenge. The Court is forced into differentiating between situations mainly as a result of the lack of harmonisation of national law. In relation to access to the treaty freedoms, it has been forced into an unequal protection for companies from different jurisdictions. In relation to the application of particular freedoms, the Court has found itself in the difficult territory of differentiating between one shareholder who is actually establishing himself in another country and another who is merely investing. Further, in its application of the freedoms, while the perceived return to a more discrimination based approach to the determination of an infringement may arguably ensure greater substantive equality in its judgements, applying the discrimination approach uniformly to all who are subject to the Treaties is problematic. The problem of course, comes back to the difficulty of establishing when the law should be applied equally. Terra and Wattel point to what they term the subject-to-tax comparability. By this, they mean that equal treatment must be afforded to persons in an equal situation based on the fact that the national rule in question applies to both.<sup>107</sup> This would seem to be a sensible starting point given that the Court's role is to interpret and apply the law. From a procedural equality point of view, this should not be problematic so long as the same process for identifying discrimination happens in every case. It is not clear from the recent decisions that this is in fact happening.<sup>108</sup>

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<sup>107</sup> Ben J.M.Terra and Peter J. Wattel, *European Tax Law* (6th ed. Walters Kluwer) 895

<sup>108</sup> See for example discussion on difference in treatment re credits for inbound and outbound dividends in Michael J Graetz and Alvin C Warren Jr 'Dividend taxation in Europe: When the ECJ makes tax policy' (2007) 44 CML Rev 1577, 1608

## 7. Conclusions

Speaking in October 2007 on the theme, European Law – Quo Vadis? Professor Leif Mutén commented in his opening remarks that, “*In a sense, we have no European Tax Law*”.<sup>109</sup> Looked at from this perspective, finding EU principles in the area of direct taxation may seem to be a rather optimistic starting point for research. As the paper shows however, there is now an extensive body of case law from which principles can be extracted in relation to the compatibility of the exercise of Member State fiscal autonomy with EU rights. It seems that despite a period when the Court was focussing on restrictions rather than discrimination, it has, through the equal treatment principle, tried to apply EU law in a manner which is consistent with the treaty principle of equality. The cases reveal a conflict however between the Court of Justice’s objective comparisons and the substantive equality which most national systems attempt to achieve through the ability to pay and neutrality principles.

The Court has been criticised for lack of consistency in its approach and failure to recognise the rationale behind national systems.<sup>110</sup> In its defence however, its role has quite rightly always been limited to the interpretation of EU law.<sup>111</sup> Perhaps it should be of concern therefore, that its demonstration of a greater openness to the justifications put forward from the Member States in recent case law, has been accompanied by a conscious move towards analysing the aim and purpose of national legislation.<sup>112</sup> Looking behind the legislation has inevitably taken the Court into an examination beyond the legal and into the economic aspects of national taxation and its approach has created a hierarchy of principles in an area where national sovereignty has not been relinquished in terms of the treaties.<sup>113</sup> In its questioning for example, of the mechanisms behind the particular imputation systems which exempted Advance Corporation Tax in the UK when a dividend distribution was made to a UK parent company, the Court has tried to dig much more deeply into the design of the national system.<sup>114</sup>

There is significant criticism that in applying the equal treatment principle to direct tax cases, the Court is encroaching on an area of national sovereignty for which it has no legal mandate. Denis Weber, for example, argues that some of the Court’s findings of discrimination, albeit in certain cases justified by Member States should in fact have been treated as disparities. In particular he points to the cross border dividend cases of Lenz, Manninen and Ritter

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<sup>109</sup> Klaus Vogel Lecture by prof Leif Mutén European Law - Quo Vadis? , (2008 ) 1 Bulletin for International Taxation , 2

<sup>110</sup> See Nils Mattsson, ‘Does the European Court of Justice Understand the Policy behind Tax benefits based on Personal and Family Circumstances?’(2003) vol 43 issue 6 European Taxation 186

<sup>111</sup> Professor Dr. Frans Vanistendael “ In Defence of the European Court of Justice” [2008] vol 62 3 Bulletin for International Taxation,90

<sup>112</sup> Ben J.M.Terra and Peter J. Wattel, *European Tax Law* (6th ed. Walters Kluwer) 892

<sup>113</sup> Lars Pelin and Mikael Sundström, ‘A Law Unto Itself?The ECJ and Income Taxation’ (2005) International Studies Association Conference , Hawaii

<sup>114</sup> Case C-374/04 *Test Claimants in Class IV of the ACR Group Litigation v Commissioners of Inland Revenue* [2006] ECRI-11673 and Case C-446/04 *Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue*[2006] ECR I-11753

Coulais.<sup>115</sup> Opponents of the ‘overall approach’ in the Courts reasoning, like Weber argue that looking at the situation in more than one state has resulted in the Court requiring Member States to extend their sovereignty when they do not have the power to do so. He also considers that the Court has effectively been deciding in cross border cases, which Member State should remedy double taxation when it has no legal authority to do so.<sup>116</sup>

Arguably, as soon as the Court involves itself in the area of direct taxation, it is impossible for it to arrive at judgements which do not encroach on national sovereignty. If it disregards the economic principles upon which national systems are based, its decisions are criticised as threatening the substantive equality of national systems and potentially providing more favourable treatment for non-residents. If it takes account of the national principles, it is accused of exercising sovereignty.<sup>117</sup>

Having embarked on the journey, keeping to the middle of the road appears to be difficult. Perhaps this is why procedural equality is not always present in the Court’s judgements. National principles are not fully investigated in the cases concerning personal and family allowances but they are examined in depth when it comes to imputation systems. Distinctions are made regarding portfolio and direct investors in cases when such distinctions do not exist at national level.

On the positive side, where the Court has taken into consideration the aim and purpose of the national provision, it has provided the Member States with an opportunity to highlight the explanations for national rules based on substantive equality and neutrality. There is evidence that where it has done so it has shown greater regard for national sovereignty, particularly in the areas of double taxation and cross border loss relief.

That Member States have taken remedial action at national level however, surely reinforces the conclusion that the Court is encroaching on national sovereignty. Following *Metallgesellschaft*, the UK abolished its advance corporation tax, and many of the Member States have moved to an exemption system for dividends following challenges to the credit method.<sup>118</sup> In the Netherlands, a residence taxation ‘opt in’ has been introduced following the cases on the source state taxation of cross border workers.<sup>119</sup> Sometimes the reaction of the

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<sup>115</sup> Case C-315/02 *Lenz v Finanzlandesdirektion für Tirol* [2004] ECR I-7063, Case C-319/02 *Manninen* [2004] ECR I-7477

Case C-152/03 *Ritter-Coulais v Finanzamt Germersheim* [2006] ECR I-1711

<sup>116</sup> Weber D, In search of a (new) equilibrium between tax sovereignty and the freedom of Movement within the EC” ( Kluwer-Deventer 2006)

<sup>117</sup> Lars Pelin and Mikael Sundström, ‘A Law Unto Itself?The ECJ and Income Taxation’ (2005) International Studies Association Conference , Hawaii

<sup>118</sup> Michael J Graetz and Alvin C Warren Jr ‘Dividend taxation in Europe: When the ECJ makes tax policy’ (2007) 44 CML Rev 1577, 1597

<sup>119</sup> See Nils Mattsson, ‘Does the European Court of Justice Understand the Policy behind Tax benefits based on Personal and Family Circumstances?’(2003) vol 43 issue 6 European Taxation 186

Member States has been a removal of an advantage for all taxpayers rather than an extension of the advantage to non-residents.<sup>120</sup>

Faced with this emerging hierarchy of principles it would appear that the Court has shifted the problem of reconciling equal treatment with equality to the Member States. It is hard to see that the Member States can avoid making adjustments to their own systems as cases arise. Wholesale redesign of a national system with a view to achieving equity both for residents and non-resident EU nationals is an unlikely possibility. Complete harmonisation within the EU would appear to be an equally remote prospect at present. Perhaps a more realistic national approach would aim for greater equality in a way which encompasses non-nationals. Perhaps some of the possibilities explored by the Mirrlees review such as a shift away from income to consumption as the basis for taxation or corporate income taxed at shareholder level might meet this challenge.

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<sup>120</sup> Philip Baker QC, 'Protection of the Taxpayer by the European Court of Justice', CFE Forum 22 April 2004, (2004) vol 44 issue 10 European Taxation 453



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## Pending Cases

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