



Lund University

School of Economics and Management
Department of Business Law

**Neutralisation of discrimination in direct taxation:
the problem of applicability from the perspective of
tax treaties and ‘opt in’ domestic clauses.**

by

Anna Katarzyna Baranowska

HARN60 Master Thesis
Master’s Programme in European and International Tax Law
2013/2014

Spring semester, 2nd June 2014

Supervisor: Maria Hilling

Examiner: Cécile Brokelind

Author’s contact information:

E-mail address: anna.k.baranowska@gmail.com

Telephone number: 0700661125

Acknowledgements

I would like to extend sincere thanks to my supervisor, Professor Maria Hilling, whose guidance and expertise has been instrumental in the successful completion of this work.

For providing inspiration and equipping me with a critical legal mind, I would like to thank to all my lecturers and tutors at the Lund University Department of Business Law.

List of Contents

Summary.....	II
Abbreviation list.....	III
1. Introduction.....	1
1.1. Background.....	1
1.2. Subject and purpose.....	2
1.3. Method and materials.....	2
1.4. Delimitation.....	3
1.5. Outline.....	3
2. The concept of neutralisation.....	4
2.1. The meaning of neutralisation.....	4
2.2. Neutralisation and non-discrimination.....	5
2.3. Interaction between sources of law.....	7
3. Neutralisation in a domestic situation.....	9
3.1. General overview.....	9
3.2. Gielen.....	10
3.3. Beker & Beker.....	11
3.4. Hirvonen.....	13
3.5. Conclusions for neutralisation by means of parallel taxation system.....	14
4. Neutralisation and tax treaties.....	14
4.1. General overview.....	14
4.2. Avoir Fiscal.....	17
4.3. Bouanich.....	18
4.4. Denkavit.....	19
4.5. Amurta.....	20
4.6. Commission v Spain.....	21
4.7. Emerging Markets.....	22
5. The question of consistency.....	23
6. Potential consequences.....	24
7. Overall difficulties.....	25
8. Final remarks.....	28
9. Conclusion.....	29
Bibliography.....	IV

Summary

The field of direct taxation is not fully harmonised on the European Union level and falls mainly within the competence of the Member States.¹ Nevertheless it still becomes a subject of limitation and scrutiny of fundamental freedoms and principles established by the treaties and the CJEU case law. Non-discrimination became undoubtedly a cornerstone for further integration and legal development. Although originally it has been intended as an absolute principle, with time the CJEU demonstrated that under specific conditions discriminatory and restrictive treatment might be allowed when justified. However in recent years a new factor appeared to gain more in depth consideration and importance, namely the neutralisation of discrimination. Neutralisation, despite continuous appearance in the case law has not yet been clearly defined or evaluated in terms of its legal status.

Firstly, this work presents one of the possible perspectives of understanding the concept, what meaning it has in relation to the non-discrimination principle and how it might be placed within the EU legal order.

Secondly, it evaluates circumstances under which neutralisation might occur: at the current stage of the case law two prime type situations have been examined: the purely domestic context when a discriminatory treatment is intended to be neutralised by another tax regulation (mostly by so called ‘opt in’ provisions) on a national level, while the second type involves a cross-border context and the application of a double tax conventions between Member States.

Thirdly, this work points out the differences in the analysis and reasoning provided by the CJEU, suggesting that the more liberal approach (in comparison to the ‘opt in’ provisions) is given in situations involving tax treaties, where at least two Member States are involved and it is the action of another contracting Member State that neutralises the discriminatory treatment. This aspect will be seen from the perspective and the role of tax treaties and will aim at reconciling them with EU law.

Finally, it also suggests the need of more coherent consideration towards the neutralising provision for securing the legal certainty and legitimate expectations of taxpayers. It will also investigate potential future consequences that might need further evaluation as expanding the application of neutralising provisions may bring more possible risks that are not in accordance with EU objectives.

¹ Judgement in *Royal Bank of Scotland*, C-311/97, ECLI:EU:C:1999:216, para 19.

Abbreviation list

AG	Advocate General
Art.	Article
CJEU	The Court of Justice of the European Union (referred as the Court)
DTC	Double Tax Convention
Ed.	Editor
EEA	European Economic Area
EFTA States	The Court of Justice of the European Free Trade Association
EU	European Union
OECD	The Organisation for Economic Co-operation and Development
p	Page
Para	Paragraph
TEU	Treaty on European Union
TFE	Treaty on the Functioning of the European Union
UK	the United Kingdom
Vol.	Volume

1. Introduction

1.1. Background

The concept of neutralisation is inherently linked to the principle of non-discrimination. Within the EU framework the analysis requires the existence of two situations that are treated differently, even though they are comparable and they result in a less favourable treatment for one of the subjects of the evaluation.² The field of “direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law”.³ In the present scenario we will consider the domestic legislation and tax treaties concluded between Member States and whether discrimination arising from the application of tax legislation can be neutralised by any alternative provisions.

The discussion over neutralisation is a complex task, not only it involves the examination of the non-discriminatory principle which is also incorporated into fundamental freedoms, but also the understanding of the role and functions of bilateral tax treaties and their interaction with the EU legal order and other domestic sources of law. Through years the CJEU slowly yet significantly modified its approach towards legislation that might discriminate: from the absolute prohibition towards the allowance of various justifications and subject to proportionality.

Soon however, the possibility of justification of a discriminatory treatment was also recognised and introduced - for the purpose of the analysis of neutralisation the relevant justification is the cohesion of the tax system.⁴ As the idea of maintaining the existing tax regime might take the priority over the discriminatory provisions does not leave a straightforward guidance as to in which situations it is applicable and potentially upheld, on many occasions it has confirmed the complexity of a multilevel relation between EU law and domestic rules. Involvement of tax treaties only added to such ramification.

As the *Wielockx* case⁵ illustrated, the cohesion principle once secured by bilateral conventions cannot be later invoked by a Member State to justify the discriminatory treatment.⁶ However it was not until the decision in *Bouanich*⁷ when the relationship between income tax treaties and domestic rules was in depth explained, and suggested how, potentially, the former could deliver a better result than purely national legislation. By evaluation of the interplay between various sources of law it broached the subject that in fact tax treaties might heal or balance out potential restrictions over fundamental

² Niels Bammens, *The principle of Non-Discrimination in international and European tax law* (IBFD 2012) p 9.

³ Judgement in *Schumacker*, C-279/93, ECLI:EU:C:1995:31, para 21.

⁴ The cohesion of tax system was firstly introduced in the judgment in *Bachman*, C-204/90, ECLI:EU:C:1992:35, however it was consequently narrowed down in subsequent cases, see further explanation in Pasquale Pistone, *The Impact of Community Law on Tax Treaties: Issues and Solutions*, (Eurotax, Kluwer Law International 2002) p 44.

⁵ Judgement in *Wielockx*, C-80/94, ECLI:EU:C:1995:271.

⁶ *Ibidem*, para 24-25.

⁷ Judgement in *Bouanich*, C-265/04, ECLI:EU:C:2006:51.

freedoms and therefore could offer a form of a compensatory treatment for discrimination.⁸ In other words, it created the base for the concept of neutralisation.

1.2. Subject and purpose

As the discussed subject interacts closely with other fundamental concepts of EU law and therefore cannot be examined in an isolated manner. Although it is not as often examined, it consistently creates difficulties for the CJEU to balance various interests of the EU obligations and Member States' power to regulate the field of direct taxation. Therefore the subject is aimed to show the consistency (if any) in its applicability, synergy of domestic law and tax treaties towards EU law and the obligation of non-discriminatory treatment. In other words the intention is to present a study that would be more than merely an overview, as it seeks to answer questions as to the existence, understanding and purpose of the concept of neutralisation, its interaction with domestic laws and tax treaties, relevance for the non-discrimination principle and application within EU legal framework.

If all of the above can be successfully established and evaluated then they would essentially lead to the answer whether the concept of neutralisation is compatible with EU law and if so, how such compatibility is achieved. Concluding remarks additionally present potential difficulties and questions that might need to be answered in the future, as the concept of neutralisation is still a developing idea without clearly defined application.

1.3. Method and materials

In order to answer the legal questions presented in this work the traditional legal method will be used as the ultimate purpose relates to the law as it stands today and according to the existing case law.⁹ Sources of law such as treaties, CJEU case law, where relevant the national legislation and tax treaties will be mentioned, however always within the context of the EU case law. Additionally for further clarification also the Advocates' General opinions might be brought for the purpose of the analysis, despite the fact that those do not form a part of law in itself. Nevertheless, they are a useful and valuable insight into the mechanism of Union's law as in certain cases they evaluated the issue of neutralisation in more depth than the CJEU was willing to do. Many times in fact it is Advocates' General opinions that provide more detailed analysis and evaluate the problem of neutralisation in a broader perspective, for instance in connection to discrimination or impossibility of justification.¹⁰

To some extent articles and research of scholars and academics might be also validated to provide a valuable theoretical background and commentary in relation to the outcome and consequences of the selected case law. It is also relevant to see whether already decided cases nevertheless lead to uncertainty and how future difficulties are being predicted by academics and practitioners.

⁸ Tom O'Shea, "Spain's Dividend Taxation Rules Breach EU Law", *Tax Notes International* (2010, vol.59, no. 3) p 188.

⁹ Mike McConville and Wing Hong Chui, *Research Methods for Law* (Edinburgh University Press 2007) p 8.

¹⁰ See for instance Advocate General opinion in *Gielen*, C-440/08, ECLI:EU:C:2009:661 or Advocate General opinion in *Amurta*, C-379/05, ECLI:EU:C:2007:323.

Where necessary certain comparative elements might be also introduced in order to emphasise similarities and differences in the application of neutralisation within the context of domestic ‘opt in’ clauses and tax treaties. Such comparison might also help in answering the question as to whether neutralisation is compatible with EU law.

1.4. Delimitation

Albeit the given subject touches upon very broad and comprehensive factors of EU law such as non-discrimination principle, fundamental freedoms, the role of tax treaties (among others) those will be only discussed in a direct connection to the concept of neutralisation.

Firstly, the work will be limited to the field of EU law only and doctrines relevant for the CJEU case analysis, therefore the OECD non-discriminatory guidance will not be analysed, nor will be the role of tax treaties in the international tax law. As the primary aim is to place the concept of neutralisation within the EU law composition and to examine its compatibility the author sees more need for the consistency of the sources and area of research. For the same reason also the *Fokus Bank* case¹¹ will be discussed very briefly, only to present the contrast between the CJEU and the EFTA Court. As the topic only recently received more detailed attention and coherent understanding the author prefers to avoid the risk of too broad and extensive scope of analysis. It has to be however acknowledged that in the future it might be of a great value to compare the EU and international approaches.

Secondly, only several selected cases will be given a more in-depth review. The reason for such selectivity is to provide clear examples that will illustrate relevant similarities and differences that are important for determining the CJEU reasoning. The cases that have been selected for this work represent only a part of all available resources in relation to neutralisation. However in the author’s opinion they illustrate the evolution in the approach, provide clear understanding of the Court’s reasoning and demonstrate key aspects for the approval (or rejection) of neutralisation. The author is aware of the existence of other cases, especially in relation to tax treaties, but it is believed that the selected choice represents the fundamental knowledge and is used by the CJEU in subsequent cases to reaffirm its position. Equally, it would be possible to present the issue of neutralisation in more detail only regarding tax treaty application, but the work would suffer on the part involving domestic situation, which clearly present an interesting and valuable contrast.

1.5. Outline

This work has been divided into sections that approach different aspects of neutralisation, chapter 2 will serve the purpose of introducing the concept and how it is connected to other principles of EU law and how it is relevant for this study. Chapter 3 mainly analyses the case law concerned with the “opt in” clauses in the domestic legal systems that are intended to neutralise discrimination. Further in chapter 4 this position will be contrasted with the evolution and application of the concept in tax treaties. Chapter 5 brings out the questions as to the consistency of in the application of neutralisation and subsequently in chapter 6 the potential consequences for such

¹¹ Judgement in *Fokus Bank*, E-1/04.

situation are highlighted. Chapter 7 presents general difficulties that arise with various aspects of the concept in order to fulfil the aim of the analysis. Finally, chapter 8 provides final conclusions and remarks, which summarise the efforts undertaken in this paper.

2. The concept of neutralisation

2.1. The meaning of neutralisation

Neutralisation of discrimination in the EU tax has been mentioned both in the ECJ case law, and to certain extent, in academics' writings. Nevertheless it has yet not received a more detailed analysis and therefore the primary aim is to explain the concept and evaluate potential difficulties related to the topic.

The very basic problem lies in the lack of a legal definition of the concept of neutralisation. Additionally, there is no agreement between scholars as to the function of neutralisation: some see it as a new ground for justification; others prefer to discuss it as a form of compensation. Moreover, as this work will further present and explain, the same concept is used in various situations and the reasoning behind such different application also varies significantly. As indicated before, part of the academic environment see neutralisation as a form of compensation (and this position will be also adapted in this work for reasons explained below), others propose neutralisation to become a new justification ground.¹² Due to those differences, it is appropriate to establish a basic line for further understanding. As the Court never went into many details to explain what exactly should be understood as neutralisation, the concept naturally raises questions and different opinions. However, as stated in the case of *Commission v Italy*¹³ and later also repeated in *Commission v Spain*,¹⁴ neutralisation may arise when the difference in treatment resulting from the application of national legislation can be compensated for, by applying provision of the double taxation convention. It seems there is a substantial difference between the meaning of compensation and justification. While justification reaffirms reasonableness behind action taken or explains reasons why certain treatment might exist, neutralisation compensates for unequal treatment.

According to the Oxford Dictionary “to neutralise” means “to counterbalance or counteract the effect, to render ineffective or to make something ineffective” by applying an opposite force or effect.¹⁵ If we attempt to transfer this common meaning into the legal field we would reach to the understanding that neutralising provisions aim at making discriminatory legislation ineffective. However it is key to notice that it does not remove the discriminatory regime.¹⁶ The neutralisation can appear in two contexts:

¹² Edited by Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer, *Introduction to European Tax Law: Direct Taxation*, (Spiramus 2012, 3rd ed) p 77.

¹³ Judgement in *Commission v Italy*, C-540/07, ECLI:EU:C:2009:717, para 38.

¹⁴ Judgement in *Commission v Spain*, C- 487/08, ECLI:EU:C:2010:310, para 62.

¹⁵ Oxford Dictionary, available online: <http://www.oxforddictionaries.com/definition/english/neutralize> , last accessed on 15th April 2014.

¹⁶ Bammens, *supra note 2*, p 907.

first, in purely domestic situation, mostly under so called ‘opt in’ clauses when the taxpayer could voluntarily to opt for a parallel method of taxation (usually the situation refers to non-residents who wish to be taxed as residents in order to receive allowances, the right of deduction, etc.) and secondly, when tax treaties concluded between Member States can provide a compensatory treatment by the home state over potentially discriminatory withholding tax charged by the source state. In other words, the general purpose of neutralisation is to provide a form of remedy or compensation that aims to remove the disadvantage caused by the discriminatory treatment either by means of national clauses or by the use of tax treaties.

At first it might seem that since both methods target the same situation or are planned to achieve the same result, therefore the approach of the CJEU towards those two practices should be similar. The practice however shows that it is not the case as the reasoning differs to a significant extent and has been continuously adjusted in recent case law. While the domestic situation seeks for a relief from discrimination under the neutralisation offered by a parallel tax regime, the treaty-based neutralisation is concerned with the question whether or not treaty relief in the residence state under a tax treaty might relieve the source state from discrimination.¹⁷

It has to be emphasised that neutralisation is an intangible and abstract concept; it does not have a fixed or universal formula that could be written down in a form a legal provision. It only carries out the idea that some discriminatory situations can be compensated for. Therefore under different circumstances outcome as to its application will vary. The CJEU approves the potential to its existence and effects it might secure, but in a very practical meaning it often has been left to the national courts to decide whether requirements are fulfilled.

Some academics see it as a new form of justification.¹⁸ Perhaps one of the reasons for it comes from the fact that neutralisation in the discussed cases is usually explained at the end of the ruling, mostly in conjunction with the coherence of the taxation system and the language is most of the times not very clear. However, as stated earlier, the author of this work does not agree with such position - neutralisation often is discussed as a separate problem of possible compensation. Additionally, the field of its applicability is too narrow and limited in order to stand as a general defence to discrimination.

The importance of this question is especially relevant for the proper understanding how the CJEU attempts to strike a balance between tax sovereignty of Member States and the EU fundamental freedoms rights,¹⁹ when the justification test is being assessed, and with the capability of safeguarding harmony suitable for the further development of the internal market.

As mentioned earlier, the concept of neutralisation can be applicable in two types of situation: within the domestic setting or a cross-border situation involving tax treaties. As for the latter, some academics see the rationale for allowing neutralisation as it

¹⁷ Georg Kofler, “Tax Treaty Neutralization of Source State Discrimination under the EU Fundamental Freedoms”, *Bulletin for International Taxation* (2011, vol.65, no.12) p 685.

¹⁸ Vanessa Englmaier, “The Relevance of the Fundamental Freedoms for Direct Taxation” in Michael Lang, *Introduction to European Tax Law: Direct Taxation*, supra note 12, pp. 78-78.

¹⁹ Ben J.M.Terra and Peter J. Wattel, *European Tax Law*, (Kluwer Law International 2008, 5th ed) p 733.

would not be reasonable to interfere (in the light of the Treaty provisions) in the division of tax revenues agreed between the source and the home state under double tax convention. If Member States voluntarily take upon themselves an obligation to allow certain methods of relieving double taxation the Court should not set aside legally valid agreements that, if read together, do not violate fundamental freedoms.

2.2. Neutralisation and non-discrimination

Non-discrimination principle within the context of European is most probably one of the most well-described and analysed topic. The Treaty explicitly prohibits discrimination under Art. 18 TFEU and by means of fundamental freedoms. The requirement of comparable situations for the purpose of taxation often touches upon the distinction between residents and non-residents (enough to say that the topic of comparability most probably occurs in literature as often as the topic on non-discrimination itself). Although in many areas the differentiation on the basis of residence would automatically trigger the situation of being contrary to Article 18 as being equal to discrimination based on nationality. However the situation in direct taxation puts the problem in a distinct perspective: the residence status is a factor that defines taxing competence of Member States.²⁰ As earlier explained - direct taxation remains the exclusive competence of EU Member countries and consequently the different treatment based on the residence status becomes a norm rather than an uncommon or rare exception. Additionally, discrimination, which is understood as the difference in treatment, needs to result in less favourable service. Such situation can be addressed either if a different treatment is applied to similar circumstances or when similar treatment is applied to different circumstances.²¹

Keeping that in mind, it will be logical to ask how relevant is the residence status to determine the 'different circumstances' used in the comparative analysis step. The general rule allows treating residents and non-residents differently as their situations can be fundamentally distinguished. However through the case law, the CJEU paved the possibility for taxpayers to claim the same treatment and certain tax allowances and benefits if their factual situation is the same,²² therefore not only purely legal stand is taken into consideration. For the purpose of analysing the application of neutralisation it is relevant as similar mechanism is used by the CJEU: although the legal situation is relevant, the actual circumstances and the final outcome are taken into account when assessing the effect of compensatory measures.

When conducting the analysis whether the discrimination takes place, the CJEU focuses on so called the disadvantage test, and what receives the most attention is the relevance of offsetting the advantages.²³ In theory, whenever a person (either natural or legal) suffers a disadvantage it should be possible to counterbalance the discrimination once another type of advantage is granted. Such reasoning naturally falls within the

²⁰ Richard Lyal, "Non-discrimination and direct tax in Community Law", *EC Tax Review* (2003 vol.12 no.2) p 68.

²¹ A consequence of application of Art. 18 TFEU, developed in more detail through case law, for instance judgement in *Schumacker*, *supra note 3*.

²² Judgement in *Schumacker*, *supra note 3*.

²³ Bammens, *supra note 2*, p 894.

discussion about efficiency of compensatory measures.²⁴ However how this particular issue is addressed is not very systematic, as the case law suggests. We still lack a systematised definition of neutralisation and in general the Court is rather hesitant in approving the offset the less advantageous treatment with advantages granted either in the country where the discriminatory treatment occurs or elsewhere. Neutralisation therefore is not widely accepted by the Court, nevertheless in certain scenarios it is allowed more often than in others.

One should ask what is the aimed position that claimant should be put after granting him a compensatory treatment; or in other words how neutralisation can cure the discriminatory treatment. More importantly, what is the benchmark for assessing whether a taxpayer has been compensated enough? Two notions become meaningful when considering the problem of restrictions of fundamental freedoms: the one of non-discrimination and of equal treatment.²⁵ Even though at first the two could be a substitute to one another, for the purpose of neutralisation the difference is crucial. It is the former approach that is prioritised and protected by the Court: not only the comparable situation has to be found, but it also has to lead to a disadvantageous treatment. If the priority was given towards the equal treatment it would be sufficient enough to only provide a difference in treatment, but the bar for discriminatory actions is placed higher than that. Therefore in terms of securing the neutralisation of difference in treatment the burden would also be different.

Already in *Avoir Fiscal*²⁶ case the Court was willing to conclude that regardless of the extent of the less favourable treatment or whether such disadvantage can be avoided by the use of other legal means the discrimination is still present.²⁷ At the current stage the perspective whether additional advantages can offset the discrimination (so whether neutralisation can be allowed) is not harmonised and depends often which tax system intends to balance out the less favourable treatment (whether it is the state in which the scrutiny occurs or another Member State under the provisions of a tax treaty). As for the neutralisation within the domestic context the CJEU seems to be constantly confirming that additional tax rules available to non-residents do not remove discrimination, all they do is simply a coexistence parallel to the discriminatory provisions as chapter 3 of this work shows. Although several arguments have been presented why possible compensation or procedural remedy could be possible in all instances it has been rejected to allow such neutralisation. Tax treaty application on the other hand appears to receive a systematic relaxation in this strict approach and allows the transfer of obligation between Member States.

2.3. Interaction between sources of law

The analysis as to how neutralisation can be applied requires an overview of the relationship of legal orders and different sources of law: how they interact, what

²⁴ Adequacy of compensatory measures has in itself a wide range of literature and is subject to many academic discussion especially within the field of contract law and what type of damages might provide a sufficient level of compensation.

²⁵ Bammens, *supra* note 2, p 895.

²⁶ Judgement in *Commission v France*, case 270/83, ECLI:EU:C:1986:37.

²⁷ *Ibidem*, paras 21-22.

dependence relation they have and what compliance requirements need to be fulfilled. As the supremacy of EU law obliges Member States to recognise that the European legal order always takes precedence over domestic legislation in a situation of conflict.²⁸ However in certain areas Member States are the bodies having the competence to legislate with direct taxation being one of them. Each country therefore, except having individual domestic tax regime, is also capable of concluding tax treaties in order to provide a relief from double taxation. However despite the limited control mechanism on the European level over direct taxation, nevertheless those sources of law have to comply with fundamental principles of the EU.²⁹ Interestingly, even though tax treaties are international agreements and constitute a part of a domestic legal order it was only recently decided that they in fact should also comply with EU standards, but on the other hand they also became capable of neutralising restriction on fundamental freedoms.³⁰ One of the fundamental reasons why Member States conclude tax treaties (both within the EU scope and on the international stage) is to regulate taxing powers and to provide a relief from double taxation. However the Art. 293 from the former EC Treaty is no longer a part of the TEU or TFEU, therefore there is no clear recognition for the obligation for the avoidance of double taxation as a objective on the Union. The above-mentioned provision used to serve as a legal basis for taxpayers who were claiming the breach of EU law in situations when they faced double taxation. Although the double taxation in itself cannot be claimed as a breach of EU law, if it falls under discriminatory treatment it can still be a subject to CJEU investigation.³¹ As Member States are free to apportion tax jurisdiction between themselves (while the principle of territoriality also allows in theory an establishment of any preferable taxation methods) it is their choice as to how a relief from double taxation should be granted. Tax treaties function under public international law and become equally relevant for two domestic legal orders of contracting states and links the two systems.³²

If the same tax treaty binds two contracting Member States, then those state become linked with the effect that is binding and might have impact on the analysis of the restriction in the source state. In turn, this can have a deciding effect whether neutralisation can be valid in a particular case. The transfer of obligations and application of compensation can only receive recognition in the EU light only when the home state (state of residence) accepts its obligations to grant a tax credit for the tax previously paid by means of withholding tax on dividends.

²⁸ Judgement in *Costa v ENEL*, case 6/64, ECLI:EU:C:1964:66.

²⁹ Judgement in *Test Claimants in Act GLO IV*, C-374/04, ECLI:EU:C:2006:773, para 36.

³⁰ Tom O'Shea, "Double Tax Conventions and Compliance with EU Law", *The EC Tax Journal*, (2010, vol.11) p 99.

³¹ European Commission Initiative, *Tackling discrimination and double taxation of dividends paid across borders*, available online: http://ec.europa.eu/smart-regulation/impact/planned_ia/docs/2012_taxud_001_cross_border_dividends_en.pdf accessed 10th May 2014.

³² Kofler, *supra note 17*, p 686.

3. Neutralisation in domestic situation

3.1. General overview

As mentioned earlier, Member States are free to decide upon their direct taxation rules within their territory. Nevertheless, as practice shows, the jurisdiction to tax in order to exist has to establish an effective link between the country willing to tax and the taxpayer or his income. Therefore due to the type of those connecting factors we can distinguish the residence and source based taxation.³³ The former occurs when a person is taxed based on the income received within the country's territory, regardless of the status of resident and/or non-resident. The latter on the other hand taxes only residents, regardless of the source of income. In it not usual that both situations often clash with one another, which in turn might lead to juridical double taxation.

Domestic application of neutralisation differs from conditions set out by the tax treaty application (which will be discussed in detail later). Such concept is not based on granting additional advantages, but it compensates in the form of a procedural remedy³⁴ when a Member States recognises difference in treatment between categories of taxpayers and attempts to create optional provisions within the domestic tax legislation that would counterbalance any disadvantages suffered by means of another legal procedure. The advantages received would be of the same nature as those available to the other category of taxpayers.

Although some would see the procedural domestic remedy requirements as easier to fulfil than those established in cases involving tax treaties, nevertheless it should be noticed that in none of the cases presented in this work the remedy offered by Member States was held to be not satisfactory and in consequence the discrimination was found. Moreover the CJEU and Advocates General consistently reaffirm that 'opt-in' clauses do not remove discrimination. Therefore despite rejecting reasoning presented by Member States it does not interchangeably state it would accept such neutralisation if amended in a certain way. In fact, the *Gielen*³⁵ case suggests that the idea of the optional tax regime for non-residents should not be allowed as a matter of principle, but on the other hand the facts of the case were quite specific and therefore it cannot be taken for granted that the stand taken by the Court will not be alternated or modified in the future (which should not surprise based on the evolution of the approach towards the tax treaties as explained later). The core problem in understanding cases concerning neutralisation applicable in the domestic situations is to understand that the fact that a taxpayer might be subject to two different types of regimes (and which one he chooses is optional) does not automatically have to result in discrimination when Treaty freedoms are exercised. It is different however when a Member State claims, such as in the discussed case, that making one of the discriminatory regimes only optional does not make it any less discriminatory.³⁶ Yet it provides one more argument as to why neutralisation should be seen as a compensatory measure and not a ground for justification.

³³ Christiana H.J.I Panayi, *European Union Corporate Tax* (Cambridge University Press 2013) p 157.

³⁴ Bammens, *supra note 2*, p 941.

³⁵ Judgement in *Gielen*, C-440/08, ECLI:EU:C:2010:148.

³⁶ Bammens, *supra note 2*, pp. 986-987.

3.2. Gielen³⁷

The case of Mr Gielen provides one of the most clear examples when a Member State pursues to neutralise domestic discriminatory treatment. In the discussed scenario the dispute arose under the difference in treatment between residents and non-residents in relation to calculation of hours worked abroad for the purpose of tax deductions. According to the facts, in the Netherlands it was possible to receive a deduction from taxable income by those who were self-employed, however the requirement was to work 1225 hours or more in their business in the country. Residents were allowed to combine the hours test when working in their business both in the Netherlands and another Member States. Such rules were not applicable to non-residents unless they satisfied the hours test only on the Dutch territory or opt in to be taxed as a resident. The non-resident option did not allow to include hours worked in another Member State.

The Dutch government put the argument that relevant domestic mechanism in fact allowed non-residents to be treated as residents for tax purposes and for that reasons any discrimination should be neutralised. The assumption was therefore that neutralisation occurs when there is an option (therefore a voluntary choice for a taxpayer) to be taxed as resident.

Such line of reasoning was rejected by both AG and the CJEU, by stating that such system creates a division in a national tax system into a discriminatory regime and regime which is deemed not to be discriminatory.³⁸ Although the conclusion reached by the Court and Advocate General was the same, the CJEU followed the approach that alternative as to the choice of methods of taxation cannot remove discrimination or neutralise its effects. However such stand was concluded rather briefly in paragraph 52 of the judgement by referring to the evaluation provided by the Advocate General. It is therefore important to adduce the analysis in more depth.

Part of the judgement focused on evaluation that merely providing an option for a different method of taxation cannot in principle neutralise discriminatory treatment. The issue has been presented as “a problem relating to the principle of equal treatment and whether unlawful discrimination could become lawful if it is freely chosen by the victim”.³⁹ Advocate General pointed out that indeed, it is a common situation in direct taxation when taxpayers are given a choice or an option of alternative arrangements, which not necessarily are advantageous. Further, he disagreed that the right of option has the effect of neutralising the discrimination,⁴⁰ as the effect of such reasoning would lead to a situation when a person (natural or legal) would have a choice between a lawful and an unlawful option,⁴¹ but agreeing on a specific type of treatment would mean that that person would lose the right to complain, and as in the case at issue, Mr Gielen after choosing to be taxed as resident could not argue that the set of rules

³⁷ Judgement in *Gielen*, *supra* note 35.

³⁸ See judgement in *Gielen*, *supra* note 35. Such conclusion could be drawn from the Courts conclusion in para 52: “if such a choice were to be recognised as having the effect described, the consequence would be to validate a tax regime which, in itself, remains contrary to Article 49 TFEU by reason of its discriminatory nature”.

³⁹ Advocate General opinion in *Gielen*, C-440/08, ECLI:EU:C:2009:661, para 46.

⁴⁰ *Ibidem*, para 49.

⁴¹ *Ibidem*, para 50.

applicable to non-residents is discriminatory. The optionality of the method of taxation (out of which one is discriminatory) does not amount to equal treatment simply because the option is available.⁴² On the other hand however, one may wonder what is the position if the option for specifically opted for by a taxpayer and was not only a hypothetical alternative. In the author's opinion, it does not seem that the position of the CJEU would change as the discriminatory order still remain. Additionally, due to the necessity of administrative compliance with two different tax authorities that non-residence experience when if are deemed to be taxed as residents. Therefore even based on the administrative situation, there is no equal treatment and parallel domestic provisions cannot secure the neutralisation of discrimination. Allowing neutralisation in any of the above situations would simply validate the system that is discriminatory in nature.⁴³

The opinion presented by the Advocate General and followed by the CJEU made it clear that the optimality of an alternative tax regime does not remove the discriminatory treatment nor makes it any less discriminatory. Yet it still remains an open issue, whether the same conclusions would be reached if the treatment of non-residents would be operated as an automatic procedural treatment. Such mechanism would be applicable on a similar basis and comparable to the automatic accessibility of double tax conventions. However the downside of this method could turn to be the lack of option. As if such system was automatic, taxpayers would have been left with only one method of taxation, therefore their position could remain disadvantageous because of it, especially in the context of non-residents. Offsetting disadvantages provided by domestic legislation and those secured by tax treaties⁴⁴ even if in theory aims at the same result receives very different approach from CJEU.

3.3. Beker & Beker⁴⁵

The case interpreted the compatibility of German rules in relation to the computation of the maximum tax credit granted to its residents who receive their income from another Member State. Specifically, it was important to decide whether the home state needs to take into account the "personal circumstances" (e.g. personal and/or family circumstances) for the purpose of determining the tax paid in the source state, which should be credited against the tax due to in the resident state.

Mr and Mrs Beker were subject to unlimited tax liability in Germany and the main part of their income originated from Germany. However, certain investments were located in another Member State as well as in third States. When dividends from such investment were distributed the withholding tax at the source State applied, but the couple argued that German tax credit rules were in conflict with Art. 63 TFEU as the calculation of the credit is more beneficial to residents who receive foreign income only in proportion to the domestic income and the proportion of allowances is not taken into account by the tax authorities in Germany when calculating the income tax.

⁴² *Ibidem*, para 52.

⁴³ See judgement in *Gielen*, *supra* note 35, para 52.

⁴⁴ Bammens, *supra* note 2, p 946.

⁴⁵ Judgement in *Beker & Beker*, C-168/11, ECLI:EU:C:2013:117.

Although the *ratio decidendi* of the case focused similarly to the *De Groot*⁴⁶ case considered precisely the obligations of the home state towards its residents when granting tax allowances based on the personal and family circumstances, nevertheless the *obiter dictum* presented by both Advocate General Mengozzi and the CJEU considered the possibility of the need of preserving the coherence of a tax system that could provide grounds for a valid restriction of fundamental freedoms if a compensatory effect could be demonstrated.⁴⁷ This however has been rejected because, although in theory such situation might be possible, it requires a *precise compensatory effect* that needs to be demonstrated between a tax advantage and a specific tax payable for the purpose of preserving an essential element of the tax system.

Additionally, having an option of an alternative scheme (other than tax calculation) and when the taxpayer exercises such option, the set-off mechanism is not applied and the tax paid abroad is deducted from the overall tax base. As Advocate General explained in para 58 as the practical exercise of the option only brings about a ‘classic’ situation of double taxation in which the State of residence considers that all income acquired by the taxpayer both at home and abroad is taxable. In that scenario when the option provides the choice when the double taxation is not reduced, but at the current situation Member States are not obliged to remove or eliminate double taxation under the obligations of the EU law.⁴⁸ Therefore simply having a tax measure that does not eliminate double taxation does not automatically qualify such law as being incompatible with the treaty provisions. But the question “whether the possibility given to the taxpayer to opt for a legal regime which is generally less advantageous, but not incompatible with Union law, renders the tax system under consideration compatible as a whole” still remains valid.⁴⁹

The answer given by the CJEU followed the Advocate’s General opinion that the right of option does not make it possible to render such situation as being compatible with EU law. A tax regime cannot compensate for the unlawfulness of a scheme by an additional option, especially when the unlawful scheme is the one being applied automatically. Moreover, simply having a right of option does not, in itself, correct the illegal nature of the system.⁵⁰ The mechanism used by the German government (the option to choose the deduction of the foreign tax from the tax base as an expense rather than a tax credit) could not rectify the infringement of the Union law. As mentioned earlier, the problem was not evaluated in detail and it appears that the main argument behind the negative conclusion about the right of option was because the discriminatory regime was applicable automatically. One can ask therefore whether the decision could have been different if none of the taxation methods was automatic or if the parallel option was exercised as the primary one. Neither Advocate General, nor the CJEU opened the door for such discussion, as the general question whether the option for a taxpayer for choosing less favourable treatment, but which was compatible with EU law was answered in negative. Therefore even though Member States do not have a formal obligation under the Treaty to remove double taxation, the purely domestic provision cannot compensate or neutralise the discriminatory regime.

⁴⁶ Judgement in *De Groot*, C-385/00, ECLI:EU:C:2002:750.

⁴⁷ Advocate General opinion in *Beker & Beker*, C-168/11, ECLI:EU:C:2012:452, para 56.

⁴⁸ Especially after the removal of Art. 293 from the Treaty.

⁴⁹ Advocate General opinion in *Beker & Beker*, *supra note* 47, para 60.

⁵⁰ Judgement in *Beker & Beker*, *supra note* 45, para 62.

3.4. Hirvonen⁵¹

The case of Ms Hilka Hirvonen yet again rises the question what is the relation between co-existing tax regimes which offer different treatment to residents and non-residents and whether the right of option could neutralise the potentially discriminative legislation. The claimant worked in Sweden and her professional income originated there. After moving to Finland she started receiving her pension from Sweden for which she was still taxed at the source State as non-resident (at the fixed rate of 25%, now 20%). However after the CJEU case law development Swedish government made adjustments in the tax system and allowing non-residents to be taxed as residents, which in turn would allow them to enjoy certain benefits and deductions: in this particular case it was the deduction on the mortgage interest for the house in Finland. Mr Hirvonen consequently applied for the resident taxation in 2006, however claimed that between 2000-2005 she should also receive the deduction of the mortgage interest.

The problem arises from the fact that Swedish tax law offers two methods of taxation, in particular either the unlimited tax liability at a progressive tax rate with the possibility of all deductions or the limited tax liability with the standard tax rate when personal deductions are limited to when the taxable income originates solely from Sweden.⁵² The claimant argues that despite the possibility of option, the taxation as non-resident (for the specified period of time) does not provide a solution for the deduction of an interest on mortgage.

The CJEU will have to determine whether income related deductions should be granted to non-residents who could obtain such right if they decide to opt in for a resident taxation, but who nevertheless prefer to be taxed as non-residents. If the Court follows its previous findings from the *Gielen* case to be applicable, then the right of option that had a potential of removing the disadvantage will be rejected as a possibility of removing discrimination. Nevertheless, one has to remember that *Gielen* was decided based on the specific facts, and the Swedish case already offers some deductions. Nevertheless it can be expected that the argument provided by the Swedish tax authorities that there is no discrimination if the right of option is exercised was the same one provided in *Gielen* and it was clearly held by the CJEU that discrimination is not removed in such circumstances - the situation in only changed in a manner that another system is added, the non-discriminatory one, but the other remaining one does not become any less discriminatory because of that.

Member States are left with the option that they can treat different categories of taxpayers differently (by means of procedural differentiations) but those cannot result in discriminatory or less advantageous treatment between similar categories or taxpayers in the comparable situations. Although neutralisation intends to provide a compensatory optional treatment but insofar as the case law shows, such procedural remedy has not yet been approved by the Court. Therefore from the purely legal perspective the non-discriminatory parallel system does not guarantee neutralisation. However the factual situation of Ms Hirvonen has been calculated during the domestic proceedings, showing

⁵¹ Case C-632/13, not reported yet, neither AG opinion, nor the judgement has been released at the time of writing.

⁵² Cecile Brokelind, "Hirvonen case and commentary", *Highlights and Insights in European Taxation* (2014, no. 4) pp. 28-31.

that in fact even without the allowance for the interest deduction her tax situation was better off as a non-resident.⁵³ Yet again, it is rather unlikely that the CJEU would get involved into the matter of technical calculation - the case law makes it clear, that it is up to the national court to decide upon the factual situation of a taxpayer.

3.5. Conclusions for neutralisation by means of parallel taxation system

As the selection of the case law shows, the Court has been hesitant to approve the use of the right of option to neutralise less favourable treatment. Naturally, some questions related to the topic still remain unanswered and future cases might create variations as to the established principle. The Hirvonen case demonstrates that despite present rules there is still lack of clarity as to how to treat the tax regimes that exists alongside but relate to residents and non-residents. Although it has been long established that the position of residents and non-residents is not comparable from the legal point of view, the CJEU in certain cases blurs the distinction whether the legal or factual situation should be taken into account when assessing the potentially discriminatory treatment.

The problem of neutralisation as a counterbalance within the domestic context does not occur as often as neutralisation involving tax treaties. Despite several indicators as how hypothetically it could be allowed, meaning the fulfilment of securing legal certainty, adequate form of compensation or procedural remedy, the automatic access to the parallel system (although there has not been 100% clarity in that regard, the CJEU only indicated that the non-discriminatory treatment is not automatically given therefore it upholds the more restrictive regime). Nevertheless, after the judgement in *Gielen* case it will be difficult to open the door and to affirm neutralisation, as it appears that the right of option so far has been rejected in general as a principle. However, as the Swedish tax authorities argue in the Hirvonen case, that Member States represents two different taxation systems (progressive for residents and proportional for non-residents) while other cases simply assess the application of different rules within the scope of the same tax regime. That argument however might not be too convincing as simply any rules applicable to non-residents could be claimed as a separate tax system, when in reality they only supplement the entirety of a national tax system.

4. Neutralisation and tax treaties

4.1. General overview

As evaluated earlier, situations when tax jurisdictions clash with one another are quite common and may include interaction between two residence taxation, two source taxation. On the EU ground it is most frequent example however when a residence and source taxation lead to problematic situations. For instance upon payment of dividends they might be subject to withholding tax at the source state and income tax at the resident state. Such juridical double taxation is one of the reasons why Member States decide to conclude double tax conventions - to avoid or to reduce the burden of situations that will be disadvantageous for taxpayers. The EC Treaty used to contain a

⁵³ As the non-resident fixed tax rate (25% now 20%) was more advantageous than the progressive tax rate (30%, 50% up to 55%).

provision that Member States should avoid such situations.⁵⁴ The case law confirms⁵⁵ that Member States retain the power to decide on the content of tax treaties or whether to enter into such agreements, as there are no harmonised measures on the EU level that would require specific composition or criteria of the tax treaties. Both contracting parties need to divide the right of their fiscal competence and the allocation of taxing powers. Such task is not an easy one, and as the growing number of case law confirms that despite Member States' freedom to choose the method applicable in tax treaties and to exercise the powers of taxation vested in them, they nevertheless have to comply with EU law.

There is an ongoing debate as to whether Member States should be obliged to extend or adapt their own tax systems to the system of another Member State (closely linked to the Most Favourable Nation principle) in order to eliminate double taxation. It is however beyond the scope of this work to discuss it in detail; for the purpose of this assessment it is worth noting that the exercise of two equal and parallel taxing powers might lead to the difference in treatment. The question is whether legislation that leads to the restriction of fundamental freedoms or which in any other means violates the non-discriminatory principle could be potentially cured and compensated for under tax treaties. However in order to be able to start such analysis one has to agree that tax treaties could be examined from the perspective of compliance with EU law.

The review of the case law at the current stage points out that tax treaties, as being part of domestic legislation and national tax rules, also need to be evaluated when deciding whether treaty provisions have been violated.⁵⁶ As introduced earlier, the concept of neutralisation serves the purpose of compensating for the difference in treatment. The difficulty arises however with the lack of standard to what extent the compensation should be provided. The rulings of the CJEU only establish certain criteria of a general nature, for instance that tax treaties do not always compensate the discriminatory treatment in full,⁵⁷ that the tax treatment in residence Member State is not taken into evaluation (single country oriented approach), as each Member State should ensure the non-discriminatory treatment,⁵⁸ or that not only the legal intention behind the tax treaties are relevant as the actual / factual results are to be duly taken into account.⁵⁹

The difference between the “overall approach” and “single state” approach is a significant one as it determines what should be taken into account when determining if fundamental freedoms were violated and whether the situation in the other contracting state could compensate for such discrimination.⁶⁰ There has not been much consistency within judgements as to which of the two should prevail, nevertheless it has been suggested in academic writings commenting the recent case law that the overall approach represents majority of cases. Although the early case law seemed to be more

⁵⁴ Article 293 of the former EC Treaty.

⁵⁵ See for example cases: judgements in *Gilly*, C-336/96, ECLI:EU:C:1998:221 and *Gschwind*, C-391/97, ECLI:EU:C:1999:409.

⁵⁶ Judgement in *Bouanich*, *supra* note 7.

⁵⁷ Judgement in *Commission v Italy*, *supra* note 13, para 37.

⁵⁸ Kofler., *supra* note 17, p 684.

⁵⁹ The CJEU introduced the principle in *Schumacker*, *supra* note 3, that not only legal, but also factual situation has to be taken into account.

⁶⁰ Panayi, *supra* note 33, p 165.

strict by stating that benefits from other Member States are “irrelevant and cannot justify less favourable in tax matters”.⁶¹ Nevertheless in subsequent cases Advocate General Geelhoed called for the application of the “overall approach” suggesting that tax obligations and benefits in both source and residence states aim at “achieving an equilibrium”⁶² and that analysis from only one perspective might lead to incomplete reality; such approach was adapted in *ACT GLO IV*⁶³, *Denkavit*⁶⁴ or *Thin Cap GLO*.⁶⁵

Additionally, it was the *Bouanich*⁶⁶ case that clearly confirmed that tax treaties should be added up to the equation when balancing the domestic tax responsibilities and EU obligations. The CJEU ruling clarified that tax treaties should be taken into consideration when determining whether discrimination occurred, however the specific decision is for the national court to determine such situation. It is important to notice then, that the content of the tax treaty is relevant not only from purely legal perspective, but what factual outcome it secures.⁶⁷

The current understanding of the concept of neutralisation and a method of its application went through a multistage development: whether tax treaties form part of domestic law, whether the potential benefits in another contracting state can be taken into account when assessing the potential compensation of the discrimination, the effectiveness of tax treaty provision to provide the neutralising effect on discriminatory legislation. Within the interpretation of tax treaties the strict approach of not allowing any compensatory or neutralising measures has been relaxed, as opposed to the neutralisation occurring on purely domestic ground.

What distinguishes the non-discrimination principle from other situations in law where compensation could be applied is that the disadvantage can be only hypothetical, and no actual damage needs to occur to be capable of classifying a legal principle discriminatory.⁶⁸ Including the effects of the tax treaties in the discriminatory application of fundamental freedoms allows the use of the agreement as a tie-breaker as it accepts the taxing powers between Member States, without the disadvantage for the taxpayer. If a home (resident) state accepted the obligation under the tax treaty in a legally binding and internationally recognised agreement there should be no objections as to why such convention should not be allowed as a part of domestic law. However the position adopted by the CJEU was not always so straightforward.

⁶¹ See for example judgement in *Eurowings*, C-294/97, ECLI:EU:C:1999:524, para 44 or judgement in *Danner*, C-136/00, ECLI:EU:C:2002:558, para 56.

⁶² Advocate General opinion in *Denkavit*, C-170/05, ECLI:EU:C:2006:266, para 37.

⁶³ Judgement in *Test Claimants in Act GLO IV*, *supra* note 29.

⁶⁴ Judgement in *Denkavit*, C-170/05, ECLI:EU:C:2006:783.

⁶⁵ Judgement in *Thin Cap Glo*, C-524/04, ECLI:EU:C:2007:161.

⁶⁶ Judgement in *Bouanich*, *supra* note 7.

⁶⁷ Judgement in *Act GLO IV*, *supra* note 29, para 60.

⁶⁸ See for instance judgement in *Thin Cap GLO*, *supra* note 65, para 62.

4.2. Avoir fiscal⁶⁹

The Court initiated the consideration over the general compatibility of tax treaties with the Community law already in 1960s, however it was not until 1980s that the CJEU started the more complex analysis of the relationship between tax treaties and EU law.⁷⁰

The case concerned tax credit rules “avoir fiscal” which allowed an application towards French resident companies, but refused the similar treatment to non-resident bodies that only had branches in France. As the starting point for the neutralisation analysis would be the comparability criteria and the Court decided that when profits of residents companies and non-resident branches are taxed in the same manner, then they are in comparable situation. One of the arguments put forward by the French government to justify the discriminatory treatment was *inter alia* that companies from other Member States could easily become incorporated (and therefore automatically qualify for the tax credit) or that the problem should be solved on either the EU level (as national laws in the specific area differed a lot) or by DTC because non-residents avoid certain tax burdens and can enjoy other tax benefits, therefore they did not suffer any significant disadvantage.

The case of *Avoir Fiscal* is undoubtedly one of the most important cases for the field of direct taxation in general. In respect of neutralisation it established the early approach towards the concept of compensation for discrimination by offsetting it with other advantages. The Court was hesitant to accept such argumentation provided by the French government and clarified for the first time that “the rights conferred by article [52] of the Treaty are unconditional and a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State”,⁷¹ additionally to emphasise even more the subordinate character of bilateral tax treaties, the court later added in the same judgement that Treaty provisions do not permit fundamental freedoms rights to be made subject to a condition of reciprocity imposed for the purpose of obtaining corresponding advantages in other Member States.

The substance of the case provided that any assessment of discrimination not only has to be concluded in isolation, but it cannot be analysed from the perspective of potential neutralisation provided by other measure, as in the case, the tax treaty. The importance of the analysis in isolation was subsequently used in reasoning for the second argument provided by the French Government, that disadvantage suffered was a corresponding treatment to what French companies may experience in other Member State. Therefore the reciprocity principle was intended to be used for both: advantages and disadvantages, but such proposal was rejected by the AG and later by the Court.

⁶⁹ Judgement in *Commission v France*, *supra* note 26.

⁷⁰ EC Law and Tax Treaties, Workshop of Experts, available online at: http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/double_tax_conventions/eclawtaxtreaties_en.pdf (website accessed on 1st April 2014).

⁷¹ Judgement in *Commission v France*, *supra* note 26, para 26.

4.3. Bouanich⁷²

The dispute investigated the tax treaty application in French-Swedish situation. Margaretha Bouanich was a French resident and hold certain shares in Swedish company which decided to repurchase the shares. The problem arose upon different treatment of residents and non-residents under Swedish tax law upon the possibility of the deduction of the acquisition costs for residents (when the capital gain is taxed at the rate of 30%). Non-residents could not exercise the option of deduction and 15% withholding tax rate was applicable at the source State while any capital gain that resulted from the sale was to be taxed at the resident State.

The case at issue constituted a landmark impact on the understanding of the neutralisation and its applicability in situations where tax treaties are involved and the compensatory measure is to be secured by the other contracting State. The CJEU decided to examine whether the Swedish-French tax treaty is capable of removing the restriction on the free movement of capital and therefore neutralise the discriminatory provision. The Court engaged two-step analysis in order to determine whether the breach of fundamental freedoms could be neutralised under the correct application of the tax treaty, despite the argument from the Commission's side referring back to the approach established in *Avoir Fiscal* or *Saint-Gobain*⁷³.

Firstly, it was examined whether the convention was of any relevance for the compatibility of national provisions in the State introducing treatment infringing fundamental freedoms and to what extent the discrimination occurs under the treaty. Secondly, when the answer to question one is affirmative the Court needs to analyse the mitigating effect⁷⁴ so the next step could focus whether in practical terms the restriction was removed. As the CJEU stated "tax treaties has to be taken into account in determining whether tax legislation is consistent with Community rules on the free movement of capital. If that is the case, it falls then to be established whether that agreement removes the restriction on fundamental freedom that has been found to exist".⁷⁵

The judgement of the case made it clear that potential breaches relating to restrictions over fundamental freedoms can be healed by the income tax treaty provisions. However it has to be kept in mind that although the Court confirmed it is necessary to take tax treaties into consideration as a part of the domestic legal order, nevertheless it is for the national courts to determine whether the treatment in cross-border situations is treated as in the domestic situation and that has to be based on the factual analysis of the case facts.⁷⁶ This allows to conclude that the CJEU in practice opened the possibility for the domestic judges to examine and evaluate whether national legislation combined with effects of tax treaties can neutralise restrictions of EU law. However as noticed before, those are the questions that call for the factual analysis that are not dealt by the CJEU which could also explain why neutralisation as such could not be treated as a general

⁷² Judgement in *Bouanich*, *supra* note 7.

⁷³ Judgement in *Saint Gobain*, C-307/97, ECLI:EU:C:1999:438.

⁷⁴ Isenbaert Mathieu, *EC Law and the Sovereignty of the Member States in Direct Taxation* (IBFD 2010) p 474.

⁷⁵ Judgement in *Bouanich*, *supra* note 7, para 48.

⁷⁶ *Ibidem*, para 51.

ground for justification as some academics would like to present. As Juliane Kokott pointed out, “double tax conventions cannot in itself justify discriminations, but advantages that may result from their application may compensate disadvantages constituted by such discriminations”.⁷⁷ As such tax treaties have the capacity of influencing taxpayer’s decisions and effect his position in front of the tax authorities and for that reason it should be allowed to grant any positive action that might be the result of neutralisation.

4.4. *Denkavit*⁷⁸

French legislation at the time of the case provided an exemption for French companies receiving dividends from their French subsidiaries (not subject to withholding tax) and additionally they were entitled to participation exemption. On the other hand, non French companies were subject to withholding tax at 25% rate. *Denkavit* concerned distribution made by French companies to their Dutch parent company. According to the French-Dutch tax treaty it was allowed to levy 5% withholding tax by France and in the Netherlands to make dividends as a part of the tax base. However, according to the Dutch legislation the foreign source dividends were exempt from tax then it resulted in no credit given for the tax paid in France. Therefore despite the usual method of granting a credit for withholding tax, the practical application of the tax treaty did not result in any relief, which is the main factor when considering neutralisation.

The case provided further needed explanatory comments on the neutralisation and compensatory character of tax treaties. Especially Advocate’s General opinion, and although not legally binding, it nevertheless presented several valid observations in relation to the concept of neutralisation. For instance when justifying the overall approach of taking tax treaties into consideration, namely that ignoring the content of such agreements would effectively result in neglecting the economic reality of the taxable subject, and in practice could lead to a limited cross-border activity which clearly go against the foundations of the Internal Market.⁷⁹ Additionally, the obligations undertaken by the home and source states towards fulfilment of the Internal Market should be seen from the broader perspective, or as AG Geelhoed called it “as achieving a type of equilibrium”.⁸⁰ This perspective allows to place the concept of neutralisation within the broad context of not only the legal order and relationship between Member States but also general concepts behind the creation of the EU, such as the idea of internal market.

As Georg Kofler pointed out, *Denkavit* and *Amurta* gave the foundation of what can be described as “treaty-based overall approach”⁸¹ within the application of neutralisation for withholding tax on dividends. The approach however requires the full neutralisation to be applicable, stating that partial neutralisation is not sufficient enough, which

⁷⁷ Juliane Kokott, “European Court of Justice” in *Courts and Tax Treaty Law* vol. 3, (IBFD Publications 2007, ed. Guglielmo Maisto) pp. 110-111.

⁷⁸ Judgement in *Denkavit*, *supra note 64*.

⁷⁹ Advocate General opinion in *Denkavit*, *supra note 62*, para 36.

⁸⁰ *Ibidem*, para 37.

⁸¹ Kofler, *supra note 17*, p 690.

upholds the source state's obligation to grant the exemption from the supposedly discriminatory withholding tax.

While in *Denkavit* the combined effect of the application of the tax treaty and domestic provisions still did not remove the disadvantage as the application of the tax credit was impossible in practice and the CJEU precluded the nation legislation for that reason, it left the door open that the opposite situation, namely when the combined effect of the tax treaty and the national law allows to apply the compensatory credit then the disadvantage could be removed. It is worth noticing, that even when the disadvantage is of a minor nature, it is still precluded as a restriction of the freedom of establishment.⁸²

4.5. *Amurta*⁸³

The difficulties with application of neutralisation arose once again in the case of *Amurta*, a Portuguese company (with a resident status) which hold shares in a Dutch resident company. Upon payment of dividends by the Dutch company to shareholders 25% of withholding tax was levied. Within the domestic situation (Dutch-to-Dutch company) with a minimum 5% shareholding a waiver was applicable while the cross-border situation did not receive such benefit.

The case yet again brought into attention the problem of neutralisation of potentially discriminatory treatment. The difficulty of granting tax credit in specific situations needed more in-depth explanation after the *Denkavit* case, particularly whether the less advantageous treatment occurring in the Netherlands could be compensated by the full tax credit by the recipient shareholder's state (state of residence). The judgement initially started with the reminder that the violation of fundamental freedoms could not be counterbalanced by any existing tax advantages. However, such position was emphasised to be true in relation to tax benefits or advantages that are granted unilaterally, but the position towards tax treaties was different.

The case therefore clearly opened the door for the neutralisation under the tax treaty (as said in para 79): "it cannot be excluded that Member States may succeed in ensuring compliance with its obligation under the Treaty through the conclusion of a convention for the avoidance of double taxation with another Member State". Similar approach echoed later in both cases in relation to outbound dividends in *Commission v Italy* and *Commission v Spain* (see para 36 and para 39).

The Court provided an explanatory remark on the interaction between double tax convention and domestic legislation and how the latter can ensure Member State's compliance with EU obligations. In terms of explaining the neutralisation under the tax treaty it suggested that bilateral convention should ensure the "national treatment"⁸⁴ in the host Member State. Additionally, it was relevant that not only legal situation was analysed (providing the credit method), however the detailed analysis disclosed that the ordinary credit applicable under the tax convention in the factual application did not apply, therefore the Dutch government could not claim that the restriction of

⁸² Judgement in *Denkavit*, *supra note* 64, paras 49-50.

⁸³ Judgement in *Amurta*, C-379/05, ECLI:EU:C:2007:655.

⁸⁴ Judgement in *Amurta*, *supra note* 83, para 73.

fundamental freedoms was neutralised. Therefore not only legal, but also factual situation is relevant for deciding in each case whether the phenomenon of neutralisation occurs and whether it can be used. It is possible to see that in many aspects the Court echoed the reasoning already given in *Bouanich* as both concerned the situation from the source State perspective: that tax treaties need to be considered as a part of domestic legislation, but that it is for the national court to determine “to what extent such conventions do secure national treatment in cross-border situations”.⁸⁵

4.6. Commission v Spain

*Commission v Spain*⁸⁶ is yet another case (after *Commission v Italy*) that brought more clarification into the issue of the role of tax treaties and their meaning for EU law. It also involved the outbound dividends - non resident companies were required to have 20% shareholding in Spanish companies to be able to benefit from exempt taxation while the threshold for resident companies was only 5%. As the Parent-Subsidiary Directive⁸⁷ allowed Member States to choose adequate methods to avoid economic double taxation, the Court nevertheless noticed that such measures cannot contravene provisions of the Treaty.⁸⁸ The Spanish Government argued that the situation of resident companies in Spain and companies resident and established in another Member State which receive dividends from Spain is not objectively comparable. In consequence, the lack of comparability should shift the burden of relief of double taxation into the residence state, and not the source state (Spain).⁸⁹

Not surprisingly, the stand presented by the Spanish government was rejected by the CJEU, after declaring that although in theory the situation of residents and non-residents are not comparable, the Member State (Spain) by means of introducing a taxing regime applicable to both groups made their situation comparable.

Another argument brought by the Spanish Government was based on the parallel exercise of taxing powers and that any excessive tax obligations were the result of taxation imposed by the Member State of the recipient company. The Court also rejected this claim but explain that in fact tax treaties might be used to ensure the compliance with the Treaty, but in order to satisfy such treatment the convention “must allow the effects of the difference in treatment under national legislation to be compensated for”.⁹⁰ However in the case at issue the Court did not find that more restrictive national measure was neutralised and the less favourable conditions were purely the result of the domestic tax regime.

Interestingly, except the above mentioned argumentation, no formal ground for justification was claimed by the accused Member State. This suggests that earlier judgements rendered by the CJEU in *Denkavit*, *Amurta* and *Commission v Italy* already

⁸⁵ Tom O’Shea, “ECJ Strikes down Dutch Taxation on Dividends”, *Tax Notes International* (2008, no. 1) pp. 105-106.

⁸⁶ Judgement in *Commission v Spain*, *supra note* 14.

⁸⁷ Parent Subsidiary Directive 90/435/EEC.

⁸⁸ Judgement in *Commission v Spain*, *supra note* 14, para 40.

⁸⁹ O’Shea, *supra note* 8, p 186.

⁹⁰ Judgement in *Commission v Spain*, *supra note* 14, para 59.

established a coherent approach, which would not allow any of the commonly claimed justifications in this type of cases.

As for the mechanism of neutralisation it was explained that it could be considered as a valid tool if the terms of the tax treaty would allow setting off the tax withheld at the source state against the tax due in another Member State.⁹¹ In addition, such deduction needs to be “in its entirety”.⁹² Moreover, Member States cannot rely on more favourable treatment present in another Member States in order to relieve the extensive tax burden to escape their own obligations, regardless whether it is an exemption for the dividends received or any other tax benefit.⁹³ However the application of tax treaties does not always compensate the difference in treatment, thus the neutralisation is not always accepted and there is no positive obligation to apply it every time.⁹⁴ The difference is visible, especially when considering application of ordinary tax credit and the full tax credit. The mechanism of ordinary tax credit allows the residence state to grant the credit for the tax already paid in the source state, however that being only limited to the proportion that would be payable in the residence state on the foreign source income. This does not remove disadvantageous treatment in every situation, for instance where the tax rate is proved to be higher at the source state and foreign tax already paid is not compensated entirely. Therefore the condition set out to allow the neutralisation is not met. The question remains however how often in practice will the full tax credit occur in bilateral tax treaties due to its negative impact on revenues of residence states.

4.7. Emerging Markets⁹⁵

One of the latest decided cases that shed some light into the issue of neutralisation and the relationship between the source and resident State in the context of possible deductions or benefits was the Polish case decided on the 10th April 2014 which concerned the difference in treatment between dividends paid to resident and non-resident investment funds, in particular the refusal to recognise and refund an overpayment of flat-rate corporation tax.

In particular, the case involved investments located in Poland by a US investment fund that experienced withholding tax levied over dividends distributed from Poland (as they were not eligible to the income tax exemption which was firstly applicable to only Polish investment funds and later extended towards EU/EEA based funds). The US company applied for the refund claiming discriminatory treatment contrary to Art. 63 TFEU (free movement of capital). Although Polish-American tax treaty was only invoked in the proceedings for the purpose of the exchange of information it is interesting that nevertheless the CJEU still raised the question about the applicability of neutralisation.

One of the arguments provided focused on the possibility of accessing additional tax benefits in the state of residence which companies resident in Poland would not have the access to, however the Court rejected such statement based on the finding that

⁹¹ *Ibidem*, para 59.

⁹² *Ibidem*, para 60.

⁹³ *Ibidem*, para 66.

⁹⁴ Panayi, *supra note* 33, p 168.

⁹⁵ Judgement in *Emerging Markets*, C-190/12, ECLI:EU:C:2014:249.

whenever the sole distinguishing criteria for taxation of distributed profits is the place of residence (which allows investment funds established in Poland to qualify automatically for the exemption) the assessment of whether the situations are comparable must be carried out only at the level of the investment vehicle.⁹⁶ In such circumstances it is an obligation of a Member State to secure the equal treatment when exercising its power to tax and establishing a criteria for tax exemption. Therefore, “the argument put forward by the German Government, that the effects of a restriction may in general be nullified where an investor may, in his State of residence, attribute the tax to which the non-resident investment fund is subject at source to his personal tax liability or deduct that tax when the basis of the tax for which he is liable in his State of residence is determined, cannot be accepted”.⁹⁷

The wording used by the CJEU should perhaps receive additional attention. The usual meaning of ‘neutralisation’ has been replaced with the phrase ‘nullified effect’ which not necessarily represents the same conceptual characteristics. According to the Oxford Dictionary “to nullify” means “to make legally null and void or to invalidate”.⁹⁸ It is rather evident that the meaning behind so far used concept of neutralisation differs significantly from nullification in terms of effect over the non-discriminatory principle. As it was emphasised by various AGs (and which is also argued in this work) one of the reasons for allowing the application of neutralisation was to compensate for the effects that discrimination could have created, but it did not remove the discrimination per se. However it is important to notice that in the Polish version of the case (which is the language the case was presented) the word actually occurring is “neutralizacja” which corresponds to the English word neutralisation and not nullification (similar situation occurs in the Swedish translation when the word “neutraliseras” is used).

The case also reaffirms that the unilateral tax benefits cannot constitute a valid ground for neutralisation, which was earlier stated for instance in *Eurowings* case or *Amurta*. Only the mutual recognition of Member States’ obligations could possibly transfer the undertaken obligations under the Tax Treaty. The latest developments seem to confirm the shift from the struck approach initially started by cases such as *Avior Fiscal* or *Saint Gobain*.

5. The question of consistency

Differences between the approach used for the tax treaty neutralisation and provisions provided in the domestic legislation vary - the former allows neutralisation under specified criteria while the latter still rejects the idea on the principal ground. One could ask whether there is enough argumentation to maintain such opposite stands for the concept that aims at achieving the exact same outcome of compensating for discrimination or perhaps whether it is time to provide a doctrinal distinction between those two as otherwise it might become more difficult to reconcile those two types of application of neutralisation.

⁹⁶ *Ibidem*, paras 61-63.

⁹⁷ *Ibidem*, para 64.

⁹⁸ Oxford Dictionary, online edition: <http://www.oxforddictionaries.com/definition/english/nullify> access on 24th April 2014.

If the emphasis is to be put on what the CJEU has been also focusing on, namely the need to include the factual situation of the taxpayer, then it could be argued that it should not matter at which end he or she receives compensation - whether it is secured “by a tax treaty, national law or on flipping a coin”⁹⁹ - as long as the wrongdoing is undone it should be irrelevant by what means. The source state will remain responsible for discriminatory treatment in all situations as neutralisation can simply only compensate for the less advantageous circumstances. Moreover, if a Member State could ensure neutralisation for the difference of treatment by means of tax treaties it might provide different standard of treatment not only between Member States but even within a single Member State who concludes different treaties with various Member States, as currently EU lacks a multilateral tax treaty. Such position can introduce “equality in the box”¹⁰⁰ - different standards of compliance depending on the circumstances, disintegrates legal certainty and legitimate expectations of the taxpayer with partial application (depending on the location).

Although the case law does not state it clearly, it can be deduced that the domestic “opt in” provisions cannot ease the harm of discriminatory treatment as (following the *Thin Cap GLO*) the less favourable treatment should have been neutralised in every situation. Therefore it can also be assumed that if a tax treaty offers an optional compensatory treatment (i.e. is not granted automatically or is conditional) it would also not result in neutralisation of discrimination¹⁰¹ - it also raises the question what happens if any corresponding advantages are subject to scrutiny of tax authorities

All questions raised call for a more detail clarification from the CJEU, however it can be expected that answers can only arrive when the suitable case will be referred by domestic courts of Member States as it is rather unlikely that the CJEU would evaluate on the issue without being given specific facts.

6. Potential consequences

As suggested, it would be beneficial for the taxpayer (and to tax authorities to certain extent) to receive more clarification on the matter of neutralisation. Since 2004 there has been an increasing number of cases that in some way were discussing the problem of neutralisation. It cannot be excluded that further evolution of this area would start developing relationship with other areas of tax law, for instance it might be required to consider neutralisation in the light of anti-abusive principle to avoid treaty shopping and creation of artificial arrangements purely for the purposes of obtaining tax benefits. It may once again bring the discussion back as to whether there is or whether there should be the MFN principle under EU law and how could that potentially affect treaty shopping when no other means of direct taxation harmonisation are available on the centralised level.

So far Member States are not obliged to adapt their own tax systems to the systems of another EU member countries just to eliminate double taxation. As long as the tax rules are not discriminatory member states do not need to adapt tax benefits available in other

⁹⁹ Terra, Wattel, *supra* note 19, p 744.

¹⁰⁰ Kofler, *supra* note 17, p 684.

¹⁰¹ Bammens, *supra* note 2, p 933.

Member States.¹⁰² Accepting different standards under different tax treaties shifts EU further away from having a unilateral tax treaty (despite the efforts of CJEU to, for instance, encourage the full tax credit as a common measure to relief double taxation and therefore to harmonise the type of remedy available).

After judgements in *Denkavit* and *Amurta* one can conclude that in relation to the taxation of “dividends a foreign tax credit agreed in a tax treaty and actually available in the residence state may neutralise taxes in the source state. However, the source state does not have the right to refrain from eliminating international economic double taxation caused by taxes levied in that country solely because the state of residence of the dividend recipient unilaterally has chosen to apply the credit method for the purposes of eliminating international double taxation”.¹⁰³

An interesting note can be given as to whether other forms of international agreements could possibly allow neutralisation as well if concluded on a similar basis to tax treaties. The *SGI* case¹⁰⁴ in a limited scope discussed the position of arbitration conventions (though not specifically in the context of neutralisation but what type of obligation it creates between countries). Although the CJEU concluded in other cases that tax treaties have the capacity of shifting the obligations under the Treaty it has not been ruled out that other type of international agreements could fulfil the same function as long as they constitute a part of domestic legal order.

7. Overall difficulties

Although the concept of neutralisation still raises questions and the Court's position is not entirely settled, it is possible to conclude on some general remarks. Firstly, any potentially discriminatory measures are analysed in a type of seclusion, meaning that whether national law breaches EU obligations is a matter of the legal provision itself under the comparison mechanism. In that way, once the discrimination is found any additional benefits cannot remove the discrimination, but can be capable under special circumstances to neutralise the less advantageous treatment.¹⁰⁵ With time, the CJEU departed from the strict approach under which none of the hypothetical benefits could counterbalance the breach of fundamental freedoms and triggering the discrimination. Advantages however can have different source: either under national provision or resulting from tax treaties. It has been argued that purely domestic measures cannot offset disadvantages, but measures having bilateral character of a tax treaty on the other hand can be successfully applied, however subject to the examination by the national courts.¹⁰⁶ It cannot be automatically assumed that any provision from the tax treaty can be successfully invoked in such manner: as provided by the case law it can only be possible when the full compensation is granted. A clear example can be seen by the evaluation of cases related to dividend taxation when the issue considers the problem of exemption or ordinary tax credit methods for avoiding double taxation. As seen in

¹⁰² Judgement in *BBVA*, C-157/10, ECLI:EU:C:2011:813, para 39.

¹⁰³ Maria Helminen, *EU Tax Law - Direct Taxation*, para 2.3.8. (2013, available on IBFD web search platform) last access on 24th April 2014.

¹⁰⁴ Judgement in *SGI*, C-311/08, ECLI:EU:C:2010:26.

¹⁰⁵ Bammens, *supra note 2*, p 935.

¹⁰⁶ *Ibidem*, p 936.

*Commission v Italy*¹⁰⁷ or *Commission v Spain*¹⁰⁸, the ordinary tax credit cannot protect Member States from being in breach of non-discriminatory principle (as action for infringement can be initiated even if the danger is only hypothetical) due to the fact that ordinary tax credit agreed upon in bilateral tax agreements does not shift the responsibility in full to eliminate any discriminatory restriction between the source and the residence state, as *such credit only aims to eliminate juridical double taxation rather than economical double taxation*.¹⁰⁹

Neutralisation, which is the final product of the application of tax treaties can save domestic provisions from being incompatible with EU law¹¹⁰ as the domestic provisions which are held discriminatory can only be applied in a limited manner to the extent that tax treaty comes into force. There has not yet been a clear clarification and comparison as to why it is a bilateral character of legal agreements rather than unilateral instrument of granting advantages is the preferable method of allowing neutralisation and setting off the disadvantageous treatment. One of the suggested justifications for such approach is the argument for securing legal certainty for taxpayers which occurs under bilateral agreements.¹¹¹

The difference between unilateral and bilateral character of granting advantages and in turn securing the neutralisation of discrimination also goes in accordance with the overall approach used by CJEU. The position of a taxpayer is then considered in the light of all factors influencing his situation (therefore taking into account both the source and the residence state condition), but then the neutralisation might only be allowed if the less favourable treatment is compensated in full and further, it also cannot be subject to optionality. That scenario is rather difficult to fulfil if the grant of advantages is dependant on the unilateral actions of a Member State (also the question of the reciprocity).¹¹² Having the condition does not guarantee the removal of the disadvantage and therefore opens the risk of discrimination to remain uncompensated. As the number of variables abides considerable, it should not surprise that the CJEU is rather reluctant to adopt only one approach, universal to different scenarios. Thus, the general guidance being available, the factual analysis of individual details of the case will most probably continue to be within the power of domestic courts to decide. Within the tax treaty context there is a trend that the CJEU broaden the scope under which the national provisions are examined for the purpose of compatibility with EU law and non-discriminatory principle.¹¹³

Neutralisation takes mostly affirmative position only when considered by mean of bilateral tax treaties, so far the position for unilateral agreement (and obligations put over the home State versus the source state) are not settled with clarity, but as there are currently no unilateral agreements present, the position is unlikely to become clearer.

¹⁰⁷ Judgement in *Commission v Italy*, *supra note* 13, paras 38-40.

¹⁰⁸ Judgement in *Commission v Spain*, *supra note* 14, para 45.

¹⁰⁹ Joachim Englisch, "Taxation of Cross-Border Dividends and EC Fundamental Freedoms", *Intertax* (2010, vol.38 no.4) p 219.

¹¹⁰ Peter J. Wattel "EC Treaty freedoms, tax treaties and national courts" in *Courts and Tax Treaty Law vol.3*, (EC and International Tax Series 2007) p 136.

¹¹¹ Advocate General opinion in *Amurta*, C-379/05, ECLI:EU:C:2007:323, para 78.

¹¹² Bammens, *supra note* 2, p 940.

¹¹³ Panayi, *supra note* 33, p 169.

A very different decision and approach was provided by the EFTA court in the *Fokus Bank* case¹¹⁴, where the EFTA court decided that (see para 35-38) “as a general rule, unfavourable tax treatment contrary to a fundamental freedom cannot be justified by the existence of any tax advantages” (where the Court referred to cases of *Avoir Fiscal* and *Saint-Gobain*). Additionally, it was of no legal or factual significance whether the credit granted would be a full or an ordinary credit. Such position differs notable from the current approach adopted by the CJEU. The legal assessment, under which there is no relevance whether the home (residence) state grants any benefits¹¹⁵ could interrupt the consistency in interpretation of EU rules, however it has to be borne in mind that EFTA judgements are not binding over EU Member States,¹¹⁶ therefore the potential impact of the *Fokus Bank* case remains rather hypothetical as the CJEU has not directly referred to it either by means of confirmation or rejection. In academics writing nevertheless the case is put in a way of contrast to recent decisions made by the CJEU.¹¹⁷

It appears that a general tendency in neutralisation cases are that yet the concept is not allowed on the national ground only by means of additional (and by a matter of choice only optional) provisions leading to a different method of taxation of non-residents, however in the cross-border context involving double tax convention neutralisation might be allowed under specific circumstances. Based on the existing case law a full tax credit implemented by a bilateral tax treaty might be sufficient to neutralise a restriction present in the tax regime of a source state. Unilateral application would make the neutralisation dependent on the treatment at the home state, which from the dogmatic perspective is not in accordance with the purpose of the EU law in general. For the current stage of development of the direct taxation and lack of greater harmonisation only bilateral full credit could lead to equal treatment in the domestic and foreign EU situation.¹¹⁸ As the CJEU also emphasises the importance of the actual situation of the taxpayer, granting an ordinary tax credit would trigger each and every time the need to investigate the facts and possibility of neutralisation

The rejection of the unilateral relief could be explained in the following manner: it would make source state compatibility dependent with tax system of another Member State and this would restrict the fiscal sovereignty and would require adjustments to fellow Member States.¹¹⁹ The advantage that overall approach used in tax treaties has the advantage as it secures the compensatory effects under voluntarily negotiated binding agreements as “it avoids an overt contradiction with the general prohibition of counterbalancing tax disadvantages with unrelated tax advantages in other jurisdictions”.¹²⁰ It is worth to consider yet again the consistency (or the lack of it) in focusing on the real situation of the taxpayer. If hypothetically it was placed as the final requirement for allowing compensation then what if the unilateral grant of tax benefits compensates for discrimination? Does it really matter by which means neutralisation is secured? Despite those doubts, the CJEU always do need to take also a legal framework

¹¹⁴ E-1/04 Fokus Bank, EFTA Court.

¹¹⁵ Alexander A. Fortuin, “Neutralisation of Restrictions by Means of a Full or Ordinary Credit”, *EU Income Tax Law: Issues for the Years Ahead*, (IBFD 2013 ed. Dennis Weber) p 218.

¹¹⁶ Matthew Parish, “International Courts and the European Legal Order”, *European Journal of International Law* (2012 vol.23 no.1), p 145.

¹¹⁷ O’Shea, *supra note* 8, p 188.

¹¹⁸ Fortuin, *supra note* 106, p 225.

¹¹⁹ Kofler, *supra note* 17, p 687.

¹²⁰ Kofler, *supra note* 17, p 687, Englisch *supra note* 109, p 218.

into consideration: the need of securing legal certainty and legitimate expectations is also of a high importance.

8. Final remarks

Recent cases confirm that the issue of non-discrimination and problems closely linked to it emerge across different Member States, neutralisation being one of them and challenged both by individuals and companies. As there is no fixed definition of discrimination its relativity depends on the model of comparison of treatment.¹²¹ However recently also the provisions in tax treaties has been challenged in the light of compatibility with EU law. Neutralisation became an important concept as it allows to compensate for the less favourable treatment. It has to be remembered that one cannot put an equals sign between compensation and justification.

It has to be noted that, based on the *Amurta* judgement,¹²² the neutralisation at the current stage is only possible under tax treaties as the argument of unilateral application of full tax credit has been rejected, and therefore Member States cannot automatically rely on such assumption to escape from their obligation to prevent double economic taxation. Some could see in this judgement also a negation of the ruling in the *Fokus Bank* case as it explicitly confirmed that in fact, Member State can transfer their obligations under the bilateral agreements.

Although we are yet to observe the positive application of neutralisation the CJEU gave clear indicators that such situation should not be exploded from happening, however due to the amount of variable factors it is still for the domestic courts to decided whether requirements established on the European level are satisfied as under specific circumstances the application of double tax conventions allow the difference in treatment under national legislation to be compensated for.¹²³ Case law is not consistent in the matter as to how methods of relieving from double taxation, at one point credit and exemption method should be considered equivalent when considering type of cases involving taxation of dividends and discriminatory tax regimes as credit method allows non-resident companies to treat foreign sourced and nationally sourced dividends as bearing the same tax burden¹²⁴. But clearly for the purpose of consideration over neutralisation under tax treaty the full credit method takes the precedence over other forms of treatment.

Christina Panayi suggests that the difference in treatment by the CJEU between tax credit granted unilaterally and that under a tax treaty results from the fact that the credit method under tax treaties forms a part of a national legal order relevant for the proceedings and is relevant for the interpretation given by the Court.¹²⁵ From this it should also follow why neutralisation is not in itself a justification: it is presented under the coherence of the tax system, which needs to be considered as a overall examination

¹²¹ Bruno da Silva, “Non-discrimination in Tax Treaties vs EU Law: Recent Trends and Issues for the Years Ahead”, *EU Income Tax Law: Issues for the Years Ahead* (IBFD 2013, ed. Dennis Weber) p 271.

¹²² Judgement in *Amurta*, *supra* note 83, para 78 and 84.

¹²³ Judgement in *Commission v Spain*, *supra* note 14, para 59.

¹²⁴ Panayi *supra* note 33, pp. 247-248.

¹²⁵ *Ibidem*, p 264.

of rules constituting a tax regime presented in a Member State, including concluded tax treaties. However on the other hand if a tax credit is granted unilaterally it also should be a part of a domestic legislation that should be taken into account. What remains relevant is the relationship between the host and the home state and how they are bound by the existence of a tax treaty. Only to the extent that the tax credit available in the home state forms a part of the legal order in the host state becomes of relevance and *only to the extent that it neutralises the discriminatory effect of the host state rules*.¹²⁶

When considering the compatibility of the neutralisation concept with the EU principles one can conclude that neither alternative domestic provisions, nor double tax conventions can justify the restrictive measures over the Treaty's fundamental freedoms and discriminatory treatment. It is only the established justification grounds such as cohesion of the tax system or the exercise of taxing powers, etc. Yet equally, the principles laid down by the DTC that are not incompatible with the Community rules should not be ignored when answering questions included in the preliminary ruling.¹²⁷ The overall approach, recently gaining more support from the CJEU decisions establish the broader perspective when interpreting how Member States exercise their power of taxation. The possibility of neutralisation of discrimination undoubtedly might encourage Member States to revise their tax treaties to coordinate common efforts on the way to harmonise tax systems while lacking the general harmonisation on the EU level.

It should be noticed that the tax treaty neutralisation applies so far only for the withholding tax treatment, although some cases considered discriminatory disallowance of deduction and the possibility of neutralising with the credit in the home state¹²⁸ but the CJEU did not consider evaluating such action. As for the domestic neutralisation the stand taken by the CJEU is far more restrictive and has not been successfully claimed.

9. Conclusion

This thesis aimed at conducting the analysis of the concept of neutralisation and focused on providing the explanatory theory of what neutralisation is and in what situations it is applicable, in order to answer the question whether neutralisation is compatible with EU law. To fulfil such aim the traditional legal method was used upon the study of the case law. It has been argued that the purpose of the concept is to provide compensation for the discriminatory treatment rather than to introduce the new method of justification and different arguments have been used to support such opinion.

The investigation of case law proves the existence of two different approaches which the CJEU systematically develops and applies depending whether the situation concerns domestic 'opt in' provisions or tax treaties involvement. In relation to the legal question this work states that neutralisation is allowed mostly in circumstances involving less favourable treatment in the area of withholding taxation when tax treaties are taken into account, as according to the current CJEU's approach, there is a direct link between

¹²⁶ *Ibidem*, p 267.

¹²⁷ Jean N.Cougon, "Plea for a Multinational Approach in the Judgements of the European Court of Justice", *EC Tax Review* (2011, vol.20 no.4) p 191.

¹²⁸ Judgement in *Centro Equestre*, C-345/04, ECLI:EU:C:2007:96.

allowing neutralisation and the obligation that Member States take upon themselves when concluding tax treaties. Therefore it appears that at the current stage of development neutralisation is compatible with EU law in the above mentioned circumstances. Naturally, there are specific conditions that have to be met and, as this thesis indicates, the final decision as to the affirmative application of neutralisation depends on the national courts who conduct the factual analysis of the scope of compensation.

A different answer can be however given to the scenario involving “opt in” provisions. This research shows that the CJEU so far has been rejecting the application of neutralisation in the domestic situation. One of the reasons for that is the approach applied by Member States who claimed neutralisation to serve the propose of justification. One cannot exclude a possibility that in the future if presented as a remedial automatic procedure it could be allowed. Nonetheless, these are only hypothesis and it is difficult to predict which direction the Court may apply in the future.

The result therefore has been achieved in accordance to its initial aim, pointing out most relevant conditions and suggesting existing and forthcoming difficulties of the concept of neutralisation.

Bibliography

Articles

Brokelind C. “Hirvonen case and commentary”, *Highlights and Insights in European Taxation* (2014, no. 4) pp. 28-31.

Cougon J.M., “Plea for a Multinational Approach in the Judgements of the European Court of Justice”, *EC Tax Review*, (2011 vol. 20 no.4) pp. 179-191.

da Silva B., “Non-discrimination in Tax Treaties vs EU Law: Recent Trends and Issues for the Years Ahead”, *EU Income Tax Law: Issues for the Years Ahead* (IBFD 2013 ed. Dennis Weber), pp. 271-349.

Englisch J., “Taxation of Cross-Border Dividends and EC Fundamental Freedoms”, *Intertax* (2010 vol.38 no.4) pp.197-221.

Fortuin A.D., “Neutralisation of Restrictions by Means of a Full or Ordinary Credit”, *EU Income Tax Law: Issues for the Years Ahead*, (IBFD 2013 ed. Dennis Weber) pp. 213-226.

Kofler G., “Tax Treaty Neutralization of Source State Discrimination under the EU Fundamental Freedoms”, *Bulletin for International Taxation* (2011 vol.65 no.12)pp. 684-690.

Kokott J., “European Court of Justice” in Courts and Tax Treaty Law” in *Courts and Tax Treaty Law* vol. 3, (IBFD Publications 2007, ed. by Maisto G) pp.101-113.

Lyal R., “Non-discrimination and direct tax in Community Law” , *EC Tax Review* (2003 vol.12 no. 2) pp. 68-74.

O’Shea T., “Double Tax Conventions and Compliance with EU Law”, *The EC Tax Journal*, (2010, vol.11), pp. 93-102.

O’Shea T., “ECJ Strikes down Dutch Taxation on Dividends”, *Tax Notes International* (2008, no.1) pp. 103-106.

O’Shea T., “Spain’s Dividend Taxation Rules Breach EU Law”, *Tax Notes International* (2010 vol.59 no.3) pp.185-189.

Parish M., “International Courts and the European Legal Order”, in *European Journal of International Law* (2012 vol. 23 no.1) pp. 141-153.

Wattel P “EC Treaty freedoms, tax treaties and national courts” in *Courts and Tax Treaty Law*, ed Maisto, G. (EC and International Tax Series, vol 3, 2007) pp. 115-157.

Books

Bammens N., *The principle of Non-Discrimination in international and European tax law* (IBFD 2012)

Helminen M., *EU Tax Law - Direct Taxation*, (2013 available on IBFD web search platform).

Ed. Lang M., Pistone P., Schuch J., *Introduction to European Tax Law: Direct Taxation*, (Spiramus 2012 3rd ed).

Maisto G., *Courts and Tax Treaty Law* (EC International Tax Law Series, vol. 3 2007).

Mathieu I., *EC Law and the Sovereignty of the Member States in Direct Taxation* (IBFD 2010).

McConville M., and Chui W.H., *Research Methods for Law* (Edinburgh University Press 2007).

Panayi Ch.H.J.I., *European Union Corporate Tax* (Cambridge University Press 2013).

Pistone P., *The Impact of Community Law on Tax Treaties: Issues and Solutions*, (Eurotax, Kluwer Law International 2002).

Terra B.J.M. and Wattel P.J., *European Tax Law*, (Kluwer law International, 5th edn.).

Weber D., *EU Income Tax Law: Issues for the years ahead* (IBFD 2013).

Case law

Judgement in *Costa v ENEL*, case 6/64, ECLI:EU:C:1964:66.

Judgement in *Commission v France*, case 270/83, ECLI:EU:C:1986:37.

Judgement in *Schumacker*, C-279/93, ECLI:EU:C:1995:31.

Judgement in *Wielockx*, C-80/94, ECLI:EU:C:1995:271.

Judgement in *Gilly*, C-336/96, ECLI:EU:C:1998:221.

Judgement in *Eurowings*, C-294/97, ECLI:EU:C:1999:524.

Judgement in *Gschwind*, C-391/97, ECLI:EU:C:1999:409.

Judgement in *De Groot*, C-385/00, ECLI:EU:C:2002:750.

Judgement in *Bouanich*, C-265/04, ECLI:EU:C:2006:51.

Judgement in *Centro Equestre*, C-345/04, ECLI:EU:C:2007:96.

Judgement in *Test Claimants in Act GLO IV*, C-374/04, ECLI:EU:C:2006:773.

Judgement in *Thin Cap Glo*, C-524/04, ECLI:EU:C:2007:161.

Judgement in *Denkavit*, C-170/05, ECLI:EU:C:2006:783.

Judgement in *Amurta*, C-379/05, ECLI:EU:C:2007:655.

Judgement in *Commission v Italy*, C-540/07, ECLI:EU:C:2009:717.

Judgement in *Commission v Spain*, C- 487/08, ECLI:EU:C:2010:310.

Judgement in *Gielen*, C-440/08, ECLI:EU:C:2010:148.

Judgement in *BBVA*, C-157/10, ECLI:EU:C:2011:813.

Judgement in *Beker & Beker*, C-168/11, ECLI:EU:C:2013:117.

Judgement in *Emerging Markets*, C-190/12, ECLI:EU:C:2014:249.

C-623/13 Hirvonen.

E-1/04 *Fokus Bank*, EFTA Court.

AGs' Opinions

Advocate General opinion in *Denkavit*, C-170/05, ECLI:EU:C:2006:266.

Advocate General opinion in *Amurta*, C-379/05, ECLI:EU:C:2007:323.

Advocate General opinion in *Gielen*, C-440/08, ECLI:EU:C:2009:661.

Advocate General opinion in *Beker & Beker*, C-168/11, ECLI:EU:C:2012:452.

Online resources

<http://www.oxforddictionaries.com/definition/english/nullify>

http://ec.europa.eu/taxation_customs/resources/documents/taxation/personal_tax/double_tax_conventions/eclawtaxtreaties_en.pdf

KPMG Report “Mixed messages from CJEU on how to neutralise a discrimination”
<http://www.kpmg.com/Global/en/services/Tax/regional-tax-centers/european-union-tax-centre/Documents/mixed-messages-from-CJEU-neutralise-discrimination.pdf> accessed on 13th May 2014.