

# KLUWER LAW INTERNATIONAL

## COMMON MARKET LAW REVIEW

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## **Aims**

The Common Market Law Review is designed to function as a medium for the understanding and implementation of Community Law within the Member States and elsewhere, and for the dissemination of legal thinking on Community Law matters. It thus aims to meet the needs of both the academic and the practitioner. For practical reasons, English is used as the language of communication.

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## COMMON MARKET LAW REVIEW

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## THE CLASH BETWEEN EUROPEAN FREEDOMS AND NATIONAL DIRECT TAX LAW: PUBLIC INTEREST DEFENCES AVAILABLE TO THE MEMBER STATES

AXEL CORDEWENER, GEORG KOFLER AND SERVAAS VAN THIEL

### 1. Introduction: The prohibition of direct tax discrimination and the “rule of reason”

Apart from providing the private sector with directly applicable rights to free movement and non-discrimination, Community law also provides the Member States with the possibility to exceptionally maintain (discriminatory) exit or access restrictions if these are justified by a legitimate public interest reason and proportional. Hence, once the applicability of Community law and the existence of a restriction on a fundamental Treaty freedom have been established, the decisive question is whether the continued application of the restrictive measure can nevertheless be justified by the Member State concerned.

According to traditional case law on the interpretation of the fundamental freedoms, a discriminatory restriction on free movement could, in principle, be justified only on the basis of derogating provisions expressly provided for in the Treaty,<sup>1</sup> which must be strictly construed,<sup>2</sup> whereas only a non-discriminatory restriction can be justified, under the so-called “rule of reason”, on the

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1. Case 15/69, *Ugliola*, [1969] ECR 363, para 3; Case 44/72, *Marsman*, [1972] ECR 1243, para 4; Case 352/85, *Bond van Adverteerders*, [1988] ECR 2085; Case C-288/89, *Stichting Collectieve Antennevoorziening Gouda*, [1991] ECR I-4007, para 11; Case C-484/93, *Svensson and Gustavsson*, [1995] ECR I-3955, para 15; Case 270/83, *Commission v. France* (“*Avoir Fiscale*”), [1986] ECR 273, para 25; Case C-311/97, *Royal Bank of Scotland*, [1999] ECR I-2651, para 32. For a recent discussion see Opinion of A.G. Poiares Maduro of 7 April 2005, Case C-446/03, *Marks & Spencer*, [2005] ECR I-10837, para 33.

2. Settled case law since Case 2/74, *Reyners*, [1974] ECR 631, paras. 6 and 7, and Case 41/74, *van Duyn*, [1974] ECR 1337, para 18.

basis of broader overriding public interest grounds<sup>3</sup> (strict approach).<sup>4</sup> Though repeating that basic rule in some direct tax cases,<sup>5</sup> the Court has, in a rather confusing way,<sup>6</sup> nevertheless accepted that discriminatory national direct tax rules may be justified for “imperative” or overriding public interest requirements other than those set out in the Treaty (flexible approach).<sup>7</sup> By

3. Case 120/78, *Rewe-Zentral AG* (“*Cassis de Dijon*”), [1979] ECR 649.

4. In the initial set-up of the Treaty, discriminatory restrictions were prohibited by directly applicable provisions upheld by the Court, whereas non-discriminatory restrictions (partly resulting from disparities) had to be removed by the legislature. From its earliest case law, the ECJ has indicated that the prohibition of discrimination must be interpreted widely as prohibiting overt (direct, open, nationality based) discrimination and covert (indirect, hidden, other criteria based) discrimination; later on, it clarified that the Treaty prohibited discrimination both by the Member State of access or destination and by the Member State of exit or origin. The ECJ also ruled that exceptions/justifications to the prohibition of overt (or nationality based) and covert (or other criteria based) discrimination should be interpreted strictly in two senses. First, only those exceptions explicitly mentioned in the Treaty could be relied on. This was very clear in *Ugliola*, cited *supra* note 1, concerning covert discrimination (the criteria of distinction being the place where military service is carried out), where the Court noted in para 3 that the prohibition of discrimination is subject to no reservations other than the restriction concerning public policy, public security and public health. Second, those exceptions had to be interpreted restrictively (see already Case 152/73, *Sotgiu*, [1974] ECR 153, paras. 4–6). Subsequently, the Court held in *Cassis de Dijon* (cited *supra* note 3) that non-discriminatory import restrictions resulting from disparities could also be contrary to directly applicable Treaty Articles, but that in those cases broader public interest justifications could apply.

5. E.g. in *Royal Bank of Scotland*, cited *supra* note 1, the Court notes in para 32: “According to settled case law, only an express derogating provision, such as Article 56 of the EC Treaty, could render such discrimination compatible with Community law [citing *Bond van Adverteerders*, cited *supra* note 1, paras. 32 and 33, and *Collectieve Antennevoorziening*, cited *supra* note 1, para 11]”. Interestingly, in his Opinion in that case A.G. Alber adds to the confusion by noting that the measures in question constituted indirect discrimination and that, as a matter of principle, direct discrimination cannot be justified on overriding public-interest grounds (para 39). Fact, however, is that the cases cited by the Court itself did not concern direct discrimination.

6. In its income tax case law the Court has focused almost exclusively on the prohibition of discrimination (thus avoiding the transposition of *Cassis de Dijon* to tax law). But it has nevertheless allowed public interest justifications not mentioned in the Treaty, even though in some tax cases it has repeated the old rule that those public interest justifications only apply to non-discriminatory restrictions. As A.G. Maduro noted in para 33 of his Opinion in *Marks and Spencer*: “Secondly, that approach gives rise to a certain amount of confusion in regard to the grounds justifying the rules likely to impede freedom of movement. Advocate General Léger has already had occasion to recall that, in the area of tax, the Court accepts that ‘discriminatory national rules may be justified for imperative public-interest requirements other than those set out in the Treaty and in particular in the name of the cohesion of the tax system.’ However, those judgments contradict a more general approach taken by the Court which applies also in tax matters whereby it affirms that a discriminatory measure can be justified only on the basis of derogating provisions expressly provided for in the Treaty. It would be useful for the Court to put an end to these uncertainties.”

7. Beginning with Case C-204/90, *Bachmann*, [1992] ECR I-249, paras. 14 et seq. See also Opinion of A.G. Léger Case C-80/94, *Wielockx*, [1995] ECR I-2493, para 31, and Opinion of A.G. Tesauro, Case C-120/95, *Decker*, [1998] ECR I-1831, para 49.

adopting such a broad “rule of reason” approach, the Court thus considerably extended the grounds on which Member States may seek to defend any tax measures that might result in a different and disadvantageous tax treatment of cross-border economic activities (whether inbound or outbound) as compared to similar domestic economic activities.

This flexibility is understandable, as the justifications explicitly provided for by the EC Treaty (Arts. 39(3), 45, 46(1), 55) are of little use in the sensitive area of income taxation. First, they traditionally allowed market access restrictions but not post market-access discrimination.<sup>8</sup> Second, they have a very limited scope not normally covering tax measures.<sup>9</sup> The justified refusal to allow access to public sector jobs, for instance, only covers very few sensitive positions that involve the exercise of public power.<sup>10</sup> Likewise, public security only covers defence-related issues, and public health only covers situations that involve persons carrying highly contagious diseases.<sup>11</sup> Also, the public policy justification, even though it was suggested in tax literature that it could cover tax avoidance and evasion,<sup>12</sup> only applies if someone’s personal conduct constitutes “a perturbation of the social order”, as well as a “genuine and sufficiently serious threat to public policy affecting one of the fundamental interests of the society”.<sup>13</sup>

Understandably, therefore, in its income tax case law, the Court has abandoned its strict traditional approach and frequently investigated overriding public interest justifications other than those set out in the Treaty. Under this flexible approach, the Court investigates whether a tax measure constituting a discriminatory restriction on free movement can be justified because it pursues a legitimate aim compatible with the EC Treaty, and because the continued application of that restriction would be justified by pressing reasons of public interest, such as the effectiveness of fiscal supervision and control,<sup>14</sup>

8. See e.g. *Sotgiu*, cited *supra* note 4, para 4; and Joined Cases 389/87 & 390/87, *G.B.C. Echternach and A. Moritz*, [1989] ECR 723, para 14.

9. Surprising perhaps, but even the explicit tax justifications included in the Maastricht Treaty articles on the free movement of capital (Art. 58 EC) were interpreted restrictively by the Court as only allowing different treatment of different situations, or different treatment of similar situations if justified by an overriding public interest. Case C-35/98, *Verkooijen*, [2000] ECR I-4071, paras. 43 et seq. and Case C-478/98, *Commission v. Belgium*, [2000] ECR I-7587, paras. 37 et seq.

10. See e.g. Case 149/79, *Commission v. Belgium*, [1980] ECR 3881, paras. 10 and 12, and Case 307/84, *Commission v. France*, [1986] ECR 1725.

11. Art. 4.1 of Directive 64/221 EEC, O.J. 1963-1964, 117 (English spec. ed.).

12. Betten, *Income tax aspects of emigration and immigration of individuals* (IBFD, 1998), p. 174.

13. See e.g. Case 36/75, *Rutili*, [1975] ECR 1219, para 28; Case 30/77, *Régina v. Pierre Bouchereau*, [1977] ECR 1999; and Joined Cases 115 & 116/81, *Rezguia Adoui and Dominique Cormuaille*, [1982] ECR 1665, para 8.

14. *Cassis de Dijon*, cited *supra* note 3.

the coherence of the tax system,<sup>15</sup> the prevention of tax avoidance or evasion,<sup>16</sup> the prevention of unjust enrichment (“double dip”)<sup>17</sup> or the balanced allocation of tax jurisdiction.<sup>18</sup>

Although the ECJ has not offered a dogmatic foundation for this flexible approach in the income tax area, some authors have suggested that, since the economic freedoms enshrined in the EC Treaty are not the only goal and activity of the Community – as Article 2 EC also lays out the task to promote a high level of social protection, the protection of the environment and social cohesion – the economic freedoms may, in certain cases, have to be balanced with the non-economic aims of the Treaty.<sup>19</sup> Others have suggested that both approaches could be reconciled by distinguishing between *overt* discrimination (strict approach) and other forms of (discriminatory) “restrictions” (flexible approach).<sup>20</sup> The possible grounds of justification as regards *overt* discrimination would basically be limited to the very narrow circumstances explicitly described in the EC Treaty (i.e. public policy, public security or public health).<sup>21</sup> All other forms of discrimination, as well as “non-discriminatory restrictions”, would be justifiable on the basis of a much broader, open-ended

15. First accepted by the ECJ in *Bachmann*, cited *supra* note 7. See also Opinion of A.G. Léger in *Wielockx*, cited *supra* note 7, para 31; and Opinion of A.G. Tesauro in *Decker*, cited *supra* note 7, para 49.

16. See for an early mention Case C-264/96, *ICI*, [1998] ECR I-4695.

17. See clearly *Marks & Spencer*, cited *supra* note 1, in which the Court explicitly considered that the possibility for the complainant of deducting losses twice could, in combination with other reasons, constitute an overriding reason of public interest that could justify restrictive measures.

18. *Ibid.*

19. See Lang and Englisch, “A European legal tax order based on ability to pay” in Amatucci (Ed.), *International Tax Law* (Kluwer, 2006), p. 251, at pp. 288–289.

20. Opinion of A.G. Alber, Case C-168/01, *Bosal*, [2003] ECR I-9409, para 41; see also Opinion of A.G. Poiares Maduro in *Marks & Spencer*, cited *supra* note 1, para 33 with note 36. See also Kingston, “A light in the darkness: Recent developments in the ECJ’s direct tax jurisprudence”, 44 CML Rev. (2007), 1321, at 1328–1329, and Van Crombrugge, “The concept, history and significance of European tax law (Private)” in Hinnekens and Hinnekens (Eds.), *A Vision of Taxes within and outside European Borders – Festschrift in honour of Frans Vanistendael* (Kluwer, 2008), p. 239, at p. 251.

21. See Arts. 39(3), 46(1) and 55 EC. However, the ECJ’s case law is not entirely clear on this point: While the majority of decisions support this view, some decisions seem to open the “rule of reason” even for “overt” discriminations (cf. e.g. *Royal Bank of Scotland*, cited *supra* note 1, paras. 32 et seq., with *Svensson and Gustavsson*, cited *supra* note 1, para 15). For a discussion of these issues see Opinion of A.G. Jacobs in Case C-136/00, *Danner*, [2002] ECR I-8147, paras. 36–41; Opinion of A.G. Stix-Hackl in Case C-42/02, *Lindman*, [2003] ECR I-13519, paras. 63–83; Opinion of A.G. Stix-Hackl in Case C-150/04, *Commission v. Denmark*, [2007] ECR I-1163, paras. 42–47; and Opinion of A.G. Poiares Maduro in *Marks & Spencer*, cited *supra* note 1, para 33; see also Cordewener, *Europäische Grundfreiheiten und nationales Steuerrecht* (O. Schmidt, 2002), pp. 150 et seq.

“rule of reason,”<sup>22</sup> which was developed by the ECJ in the non-fiscal *Cassis de Dijon* case<sup>23</sup> and famously summarized in *Gebhard*:

“[N]ational measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it.”<sup>24</sup>

Though the ECJ has accepted the need carefully to consider broader arguments of justification than those provided by the Treaty, and to weigh them against directly applicable taxpayer rights to free movement and non-discrimination, it has, in practice, been very cautious towards the avalanche of public interest justifications argued by Member States. It has, for instance, routinely refused to justify restrictive national measures for “economic” reasons<sup>25</sup> or because the disadvantage for the cross-border situation was negligible (“*de minimis*”),<sup>26</sup>

22. See e.g. Case C-237/94, *O'Flynn*, [1996] ECR I-2617, paras. 17 et seq.; Case C-107/94, *Asscher*, [1996] ECR I-3089, paras. 49 et seq.; explicitly Case C-388/01, *Commission v. Italy*, [2003] ECR I-721, paras. 21 et seq.; further Case 175/88, *Biehl*, [1990] ECR I-1779, paras. 14 et seq.; *Svensson and Gustavsson*, cited *supra* note 1, paras. 15 et seq.; but see also Case C-224/97, *Ciola*, [1999] ECR I-2517, para 16. See for these questions the extensive discussion by Corde-wener, op. cit. *supra* note 21, pp. 143 et seq.; see also Roth, “Die Niederlassungsfreiheit zwischen Beschränkungs- und Diskriminierungsverbot” in Schön (Ed.), *Gedächtnisschrift für Knobbe-Keuk* (O. Schmidt, 1997), p. 729, at pp. 730 et seq.; Lyal, “Non-discrimination and direct tax in Community law”, 12 EC Tax Rev. (2003), 68, at 74.

23. *Cassis de Dijon*, cited *supra* note 3; see also Hinnekens, “The search for the framework conditions of the fundamental EC Treaty principles as applied by the European Court to Member States’ direct taxation”, 11 EC Tax Rev. (2002), 112, at 114.

24. See Case C-55/94, *Gebhard*, [1995] ECR I-4165, para 37, and also e.g. Case C-3/95, *Reisebüro Broede*, [1996] ECR I-6511, para 28; Case C-19/92, *Kraus*, [1993] ECR I-1663, para 32; Case C-108/96, *MacQuen*, [2001] ECR I-837, para 26. It should be added that the first prong of this test is rather vague, but might also imply that a national measure which is neutral (or “even handed”) on its face must not be applied in a discriminatory way by national authorities in daily practice. For an example of such a situation see Case C-185/96, *Commission v. Greece*, [1998] ECR I-6601, paras. 22 et seq.

25. In *Verkooijen*, cited *supra* note 9, para 48 the ECJ rejected the UK argument that the contested measures were justified by the intention to promote the economy by encouraging individuals to invest in local companies, on the basis of settled case law that aims of a purely economic nature cannot constitute an overriding public interest reason justifying a restriction (paras. 47 and 48). This is in line with settled internal market case law such as *Collectieve Antennevoorziening*, cited *supra* note 1, para 11; *Svensson and Gustavsson*, cited *supra* note 1, para 15; *Decker*, cited *supra* note 7, para 39; Case C-158/96, *Kohll*, [1998] ECR I-1931, para 41.

26. Case 127/75, *Bobie*, [1976] ECR 1079; Case 20/76, *Schöttle*, [1977] ECR 247; Case 171/78, *Commission v. Denmark*, [1980] ECR 447; Case 103/84, *Commission v. Italy*, [1986] ECR 1759, para 18; *Kraus*, cited *supra* note 24, para 32; Case 18/93, *Corsica Ferries*, [1994] ECR I-1783, para 25.

compensated,<sup>27</sup> or avoidable had the taxpayer made alternative choices (such as setting up a subsidiary rather than a branch).<sup>28</sup> Likewise, the Court has in its direct tax case law also rejected a number of “non-economic” justifications advanced by Member States such as the lack of harmonization of direct taxation;<sup>29</sup> the absence of reciprocity,<sup>30</sup> the existence of discretionary or equitable procedures to ensure appropriate fiscal treatment,<sup>31</sup> or the lower taxation, for example, of a service provider in its country of residence as a justification for higher, compensatory taxation of the recipient of the services.<sup>32</sup> Even though several of those arguments were repeatedly submitted by the Member States, the Court has been critical. It has in particular been very reluctant to accept arguments related to the loss of revenue or to administrative difficulties, and it has even been cautious in applying the justifications explicitly mentioned in the Treaty articles on free movement of capital.

On the other hand, however, the ECJ has opened the door to a small number of “overriding public interest” justifications, some of which it had even rejected on earlier occasions. Related to the administration of taxes and the resulting flow of Member State revenue, for instance, are the need to safeguard the systemic coherence of a tax system,<sup>33</sup> the need to prevent tax evasion

27. Joined Cases 2 & 3/62, *Commission v. Belgium and Luxembourg*, [1962] ECR 425 and 445; Case 28/69, *Commission v. Italy*, [1970] ECR 187; Case 45/75, *Rewe*, [1976] ECR 181.

28. *Commission v. France* (“*Avoir Fiscal*”), cited *supra* note 1, para 22; Case C-307/97, *Saint-Gobain*, [1999] ECR I-6161, para 42.

29. See e.g. *Commission v. France* (“*Avoir Fiscal*”), cited *supra* note 1, para 24; *Bachmann*, cited *supra* note 7, paras. 10 et seq. Cf. Knobbe-Keuk, “Restrictions on the Fundamental Freedoms Enshrined in the EC Treaty by Discriminatory Tax Provisions – Ban and Justification”, 3 EC Tax Rev. (1994), 74, at 78 et seq.; Thömmes, “Tatbestandsmäßigkeit und Rechtfertigung steuerlicher Diskriminierungen nach EG-Recht” in Schön, op. cit. *supra* note 22, p. 795, at p. 821; Randelzhofer and Forsthoff in Grabitz and Hilf (Eds.), *Das Recht der Europäischen Union* (Beck, 2003), Art. 39–55, para 249.

30. *Commission v. France* (“*Avoir Fiscal*”), cited *supra* note 1, para 26. Cf., Thömmes, op. cit. *supra* note 29, p. 795, at pp. 821 et seq.

31. See Case 168/85, *Commission v. Italy*, [1986] ECR 2945, para 11; Case C-307/89, *Commission v. France*, [1991] ECR I-2903, para 13; Case C-58/90, *Commission v. Italy*, [1991] ECR I-4193, paras. 12 et seq.; Case C-236/91, *Commission v. Ireland*, [1992] ECR I-5933, para 6; Case C-381/92, *Commission v. Ireland*, [1994] ECR I-215, para 7; Case C-80/92, *Commission v. Belgium*, [1994] ECR I-1019, para 20; Case C-151/94, *Commission v. Luxembourg* (“*Biehl II*”), [1995] ECR I-3685, para 18; *Commission v. Greece*, cited *supra* note 24, para 32; Case C-162/99, *Commission v. Italy*, [2001] ECR I-541, para 33; Case C-160/99, *Commission v. France*, [2000] ECR I-6137, para 23. Cf. Case C-279/93, *Schumacker*, [1995] ECR I-225, paras. 53 et seq.

32. See e.g. Case C-294/97, *Eurowings*, [1999] ECR I-7447, paras. 43 et seq.; *Danner*, cited *supra* note 21, para 56.

33. *Bachmann*, cited *supra* note 7, paras. 21 et seq.; and C-300/90, *Commission v. Belgium*, [1992] ECR 305, paras. 14 et seq.; Case C-418/07, *Société Papillon v. Ministère du Budget*, judgment of 27 Nov. 2008, ny. See also Case C-157/07, *Krankenheim Ruhesitz am Wannsee*

or tax avoidance,<sup>34</sup> and the need to preserve inter-jurisdictional equity or “the balanced allocation of tax jurisdiction”.

But even if a restrictive measure can be justified on the basis of a legitimate public interest, it must, in a *final* step, still be in line with the general Community law principle of proportionality: Firstly, the relevant measure chosen by the Member State concerned must be suitable to realize the aim pursued, i.e. be of such a nature as to ensure the achievement of the legitimate public interest in question. Secondly, and more importantly, the national measure must not go beyond what is necessary for that purpose, in the sense that no other alternative measure must be available which would be equally suitable to protect the public interest in question but impose a less restrictive burden on the individual or enterprise concerned.<sup>35</sup>

However, the details of the proportionality test, including the question of whether there should be a third prong to this test (concerning the proportionality *stricto sensu*, i.e. whether a national measure, even though there are no other equally effective and less restrictive means, may nevertheless have an excessive impact on the addressee’s own interests and therefore be unacceptable from an EC law perspective), will not be discussed in the present contribution.<sup>36</sup>

## 2. Unacceptable grounds of justification

### 2.1. Loss of revenue or erosion of the tax base

Perhaps the most consistent part of the case law of the Court on justifications is the rejection of defences of Member States related to the fact that compliance with Community law would cost money. In its general internal market case law the Court has never been too impressed by the potential budgetary impact of its decisions. Known from the VAT area, for instance, is the Court’s

*Seniorenheimstatt*, [2008] ECR I-8061. However, in many other decisions the ECJ has denied a justification on the ground of the cohesion of the tax system.

34. *ICI*, cited *supra* note 16, para 26; Joined Cases C-397 & 410/98, *Metallgesellschaft and Hoechst*, [2001] I-1727, para 57; Case C-436/00, *X and Y*, [2002] ECR I-10829, para 61; Case C-324/00, *Lankhorst-Hohorst*, [2002] ECR I-11779, para 37.

35. For examples from the ECJ’s case law on direct taxation, see Case C-250/95, *Futura*, [1997] ECR I-2471, para 26; *Verkooijen*, cited *supra* note 9, para 43; *X and Y*, cited *supra* note 34, para 49; *Lankhorst-Hohorst*, cited *supra* note 34, para 33.

36. For an extensive discussion see: Cordewener, op. cit. *supra* note 21, pp. 70 et seq., at pp. 926 et seq.; See also O’Leary and Fernández-Martin, “Judicially-created exceptions to the free provision of services”, 11 EBLR (2000), 347 et seq., and Cordewener, Dahlberg, Pistone, Reimer and Romano, “The tax treatment of foreign losses: Ritter, M & S, and the Way Ahead”, 44 Eur. Tax. (2004), 218, at 223.

decision on the Danish labour market levy, which obliged Denmark to refund billions of Krone in unduly paid taxes, which allegedly amounted to 4 percent of the Danish revenue during the period in question.<sup>37</sup> Also interesting is the case in which Luxembourg provided interest rate subsidies on housing loans (linked to the number of dependent children) on condition that the loan was taken out with a Luxembourg credit institution. Even though Luxembourg had argued that the condition constituted part of a social policy which had considerable financial and economic repercussions, estimated at around 1½ billion BFR or nearly 1 percent of the total budget, the Court rejected the defence with the orthodox argument that the discriminatory measure could only be justified on the general interest grounds referred to in the Treaty, and that these did not include economic aims.<sup>38</sup>

This rather uncompromising attitude of the Court towards the budgetary concerns of the Member States is understandable because all newly adopted Community law measures are likely to have budgetary implications, be it only the administrative costs caused by the process of adapting the domestic legislation. Allowing those costs as a justification for not complying with Community law would risk undermining the latter. Nevertheless, in many income tax cases Member States argued that they should be allowed to apply a restrictive tax measure, because the normal application of Community law would result in a loss of tax revenue or an erosion of the tax base. Unsurprisingly in the light of its settled case law, the Court has consistently rejected such arguments,<sup>39</sup> often with the standard phrase that the reduction in tax revenue is not one of the grounds listed in the Treaty and can not be regarded as a matter of

37. In Case C-200/90, *Dansk Denkavit*, [1992] ECR I-2250, and Case C-234/91, *Commission v. Denmark*, [1993] ECR I-6273, the ECJ considered a Danish labour market contribution contrary to Art. 33 of the Sixth VAT Directive because it was a levy of a fiscal nature generally charged on the same basis of assessment as value added tax, but without complying with the Community rules applying to value added tax. Denmark unsuccessfully asked the Court to limit the effects of its judgment *ratione temporis* as “the amount yielded by the contested levy was approximately 7 000 million ECU, or 4% of Denmark’s revenue during the period in question” and because “having to consider applications for repayment of the levy, which had moreover been passed on to consumers, from only some of the 150 000 to 200 000 taxable persons would lead to the collapse of the Danish judicial system” (see *Dansk Denkavit*, *ibid.*, para 20).

38. *Svensson and Gustavsson*, cited *supra* note 1, paras. 13 et seq., with reference to *Collectieve Antennevoorziening*, cited *supra* note 1, para 11.

39. See e.g. *ICI*, cited *supra* note 16; *Saint-Gobain*, cited *supra* note 28; *Verkooijen*, cited *supra* note 9; Joined Cases *Metallgesellschaft and Hoechst*, cited *supra* note 34; *Danner*, cited *supra* note 21; Case C-422/01, *Skandia and Ramstedt*, [2003] ECR I-6817; *X and Y*, cited *supra* note 34; Case C-385/00, *De Groot*, [2002] ECR I-11819; Case C-9/02, *de Lasteyrie du Saillant*, [2004] ECR I-2409; Case C-315/02, *Lenz*, [2004] ECR I-7063; Case C-319/02, *Manninen*, [2004] ECR I-7477; Case C-196/04, *Cadbury Schweppes*, [2006] ECR I-7995. Cf. *Randlzhofner* and *Forsthoff* in *Grabitz and Hilf*, op. cit. *supra* 29, Art. 39–55, para 247.

overriding general interest which can be relied upon in order to justify discrimination.<sup>40</sup>

Interestingly, the ECJ confirmed this settled line of (internal market and income tax) case law not only in situations where the Member States based their defence arguments on a potential loss of revenue or tax base erosion in a straightforward way, but also where mere revenue aspects were presented more covertly. One example is the argument that the taxpayer concerned would obtain an undue advantage because he did not pay a certain tax or social security contribution in the Member State concerned. The Court normally identifies this “undue advantage for the taxpayer” argument as a disguised “reduction in tax revenue” argument, by noting that the taxpayer concerned in any case pays tax or social security contributions in the other Member State involved in a cross-border activity. In *Biehl*, for instance, Luxembourg had argued that the plaintiff would escape the progression of the domestic income tax rate and thus unduly benefit from moving across the border. The Court replied in a rather abstract way by noting that the contested denial of a refund of overpaid wages tax would in any case work to the disadvantage of an emigrating taxpayer who did not take up a new employment abroad.<sup>41</sup> In *Asscher*, however, the Court more explicitly rejected the Dutch argument that the taxpayer should pay more income tax in the Netherlands because he did not contribute to the Dutch social security system, by noting that *Asscher* was compulsorily insured in Belgium under Regulation 1408/71 and that the question of whether he was insured with one or the other national social security scheme could not justify the different tax treatment.<sup>42</sup> On the other hand, undue advantages for the taxpayer or unjust enrichment may justify restrictive measures that seek to prevent a taxpayer from claiming a tax advantage twice, in one Member State on the basis of Community law, and in another Member State on the basis of domestic law.<sup>43</sup>

40. *ICI*, cited *supra* note 16, para 28; *Saint-Gobain*, cited *supra* note 28, para 53; *Verkooijen*, cited *supra* note 9, para 59; *Metallgesellschaft* and *Hoechst*, cited *supra* note 34, para 59; *X and Y*, cited *supra* note 34, para 50.

41. *Biehl*, cited *supra* note 22, paras. 15 and 16.

42. *Asscher*, cited *supra* note 22, paras. 53 and 54. It may be added that in Case C-18/95, *Terhoeve*, [1999] ECR I-345 the Dutch Government then argued just the other way around and, although again without success, tried to justify a higher social security burden on a national who had been detached to another Member State by the fact that he did not have to pay taxes on the relevant income in the Netherlands.

43. The result of the complicated similarity test for frontier workers, developed by the Court in *Schumacker*, cited *supra* note 31, was that a non-resident frontier worker could, in the work State, only claim the same tax advantages as a resident taxpayer if he earned all his income in the work State, while not earning income in his home State that would allow him to claim those advantages there. Community law was thus interpreted in such a way that an unjust “double dip”

Another example of a revenue-related argument submitted by Member States is that a higher tax burden on a cross-border taxpayer is justified because that taxpayer enjoys other tax advantages, either in the Member State concerned or in another Member State (compensation). In *Commission v. France*, for instance, the argument that the foreign owned branch should pay more tax on profits (i.e. be refused the imputation credit) because it enjoyed other advantages in France (which were not available to domestic companies), was rejected by the ECJ as a matter of principle, because it held that such a compensation, even if it existed, could not justify a breach of the national treatment obligation.<sup>44</sup> In similar cases the Court reiterated that the host State can not justify a different tax treatment on the basis that the non-resident taxpayer or its subsidiary receives more favourable treatment under other rules of the host State's tax system.<sup>45</sup> The logic of these decisions was subsequently extended to the situation in which a Member State imposes a higher tax burden on a cross-border situation as compared to a similar domestic situation, because the cross-border taxpayer enjoys a lower tax burden on its cross-border activities in another Member State. In *Cadbury Schweppes*, for instance, the Court referred to its case law on loss of tax revenue and held that a higher (and discriminatory) home State tax on companies with foreign subsidiaries, cannot be justified by the fact that the foreign subsidiary is subject to a lower tax.<sup>46</sup>

The conclusion is that, as a matter of principle, the Court has not been very receptive to the economic and budgetary arguments submitted by the Member States to justify tax discrimination against cross-border economic activities. One of the few nuances to this consistent attitude is that the Court is sometimes willing to accommodate those budgetary implications of its decisions that are of such a magnitude that they would cause serious economic disruption in the Member States. In fact, the Court exceptionally derogates from the general understanding that the interpretation which it gives to a rule of Community law clarifies and defines the meaning and scope of that rule as it ought to have been understood and applied from the time of its entry into force

could be avoided even though that "double dip" resulted from disparities between the tax systems of the Member States. For further comments see section 3.3.3.

44. *Commission v. France* ("Avoir Fiscal"), cited *supra* note 1, para 21.

45. See, e.g. Case C-330/91, *Commerzbank*, [1993] ECR I-4017, paras. 16 et seq.; *Saint-Gobain*, cited *supra* note 28, paras. 51 et seq.; Case C-141/99, *AMID*, [2000] ECR I-11619, para 27.

46. In *Cadbury Schweppes*, cited *supra* note 39, para 49 the ECJ notes that "it is settled case law that any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company .... The need to prevent the reduction of tax revenue is not one of the grounds listed in Article 46(1) EC or a matter of overriding general interest which would justify a restriction on a freedom introduced by the Treaty ...."

(*ex tunc*). It is on the basis of this understanding that an ECJ decision must be retroactively applied by the national courts, thus even to legal relationships arising and established before the respective ECJ's judgment.<sup>47</sup> Only in exceptional cases does the Court decide to limit the temporal scope of its decision to the future (*ex nunc*), barring retroactive or *ex tunc* effects.<sup>48</sup> Since a 1996 proposal by the United Kingdom to regard protection of national budgets as an exceptional reason to restrict "retroactive" effects of Court decisions was not successful,<sup>49</sup> this aspect is becoming increasingly important in the case law in the direct tax area.<sup>50</sup>

In general terms we tend to agree with the Court's extreme caution on allowing revenue-related exceptions to the fundamental private sector rights to free movement and non-discrimination. We believe that the criticism that the ECJ's decisions are very expensive is exaggerated, and that it is useful to de-mystify certain arguments. First, an initial reality is that nobody, including the tax administration concerned, can indicate with any degree of reliability what the exact revenue consequences of a decision of the ECJ will be,<sup>51</sup> and there is a

47. See e.g. Case C-209/03, *Bidar*, [2005] ECR I-2119, paras. 66 et seq.

48. See e.g. Case 24/86, *Blaizot*, [1988] ECR 379, paras. 28 and 30; *Bidar*, cited *supra* note 47, paras. 66 et seq.

49. See the Memorandum of the UK of July 1996 concerning "The European Court of Justice". The UK proposed three amendments to the Treaty in order to limit the financial consequences of certain judgments interpreting Community provisions in an unexpected way, one of which proposed to introduce an article explicitly conferring on the Court power to exclude retroactive effect of a judgment interpreting a Community provision, thereby adding to the Court's case law the taking into account of serious consequences for the public finances of any Member State and the possible reliance of a Member State on the conduct of a Community institution or, in the case of persons, reliance on the conduct of a Member State.

50. See especially the Opinion of A.G. Stix-Hackl in Case C-292/04, *Meilicke*, [2007] ECR I-1835; for recent surveys on this issue see Kokott and Henze, "Die Beschränkung der zeitlichen Wirkung von EuGH-Urteilen in Steuersachen", 59 NJW (2006), 177 et seq.; Seer, "The jurisprudence of the European Court of Justice: Limitation of the legal consequences?", 46 Eur. Tax. (2006), 470; Schnitger, *Die Grenzen der Einwirkungen der Grundfreiheiten des EG-Vertrages auf das Ertragsteuerrecht* (IDW, 2006), pp. 139 et seq.; Lang, "Limitation of the temporal effects of judgments of the ECJ" in Weber (Ed.), *The Influence of European Law on Direct Taxation – Recent and Future Developments* (Kluwer, 2007), p. 157; Lüdicke, "European tax law, quo vadis?", 62 *Bulletin For International Fiscal Documentation* (2008), 8, at 12.

51. The Opinion of A.G. Tizzano in *Meilicke*, cited *supra* note 50, shows that even the German Government recognized that it had exaggerated its initial estimate of the costs. Para 35 of that Opinion reads: "In the present case, the first condition could be said to have been met if the official figures supplied by the German Government are correct. It has estimated – and the estimate has not been challenged – that the refunds to be granted in the event of failure to limit the effect of a ruling of incompatibility would amount to EUR 9 to 13 billion (or 0.41% to 0.59% of the national GDP in 2004). It is true that that figure was reduced at the hearing to EUR 5 billion (or 0.25% of the GDP in 2004) in view of the fact that, as a result of changes in national tax procedures, unpaid tax credits can be claimed only in respect of dividends paid after 1998. Even so,

tendency on the side of the tax administrations to overstate the cost.<sup>52</sup> Also, rather than preventing the Member States from imposing income taxes or adopting their income tax legislation in accordance with domestic policy and revenue requirements, the ECJ merely tests the margins of the way in which taxes are imposed (on cross-border income flows), very much as any domestic constitutional court would test the constitutionality of any government action at the domestic level (without preventing the government from collecting the necessary revenue). The ECJ does not interfere with the level of taxation (or expenditure) in each Member State. Second, the cost of complying with a specific decision of the ECJ, even if it may sometimes run to more than EUR 100 million in a particular case, is small compared to the amounts of State aid that Member States choose to hand out annually – on average around EUR 70 billion a year of which approximately EUR 15 to 20 billion is in tax advantages.<sup>53</sup> Accordingly, on balance, the strict compliance of a domestic income tax system with EC law (constitutional principles of free movement and rules on State aid) is likely to increase rather than decrease the funds available for government expenditure.

Moreover, an *ex ante* exercise by the Member States to ensure that their tax laws are Community compatible can be undertaken in a revenue-neutral way, and adjustments only result in costs if, in the absence of proactive domestic legislators, cases are lost in court. Such a systematic exercise seems long overdue.

Finally, in legal terms, the suggestion that the ECJ, when adjudicating income tax cases, should balance the interests of the Internal Market against the revenue interests of the Member States,<sup>54</sup> is not defendable. As noted above,

it seems to me that the sums involved are considerable and are in any case such as to entail a ‘risk of serious economic repercussions’.”

52. Vording and Lubbers, “How to limit the budgetary impact of the European Court’s tax decisions” (available at [www.law.leidenuniv.nl](http://www.law.leidenuniv.nl)); see also the report by Tumbel, “Taking the tax man to court” (available at [www.time.com](http://www.time.com)) that the Dutch Government estimated the potential cost of the *Bosal* Decision at 2 Billion Euro, and that the estimated cost for Germany of the *Marks & Spencer* decision would be 30 billion Euro (or around 1.5 % of GDP). The International Herald Tribune of 13 Dec. 2005 cited former German Finance Minister Hans Eichel as claiming in February that his government could eventually have to repay up to 50 billion (US\$ 60 billion) to German companies if the court ruled in favour of Marks and Spencer. This was clearly exaggerated because the German legislation on loss relief was not at all comparable with the UK legislation (see also previous footnote).

53. Statistics on amounts of State aid and relative share of State aid instruments (grants, tax exemptions, soft loans, tax deferrals etc) are available at [ec.europa.eu/competition/state\\_aid/studies\\_reports/expenditure.html](http://ec.europa.eu/competition/state_aid/studies_reports/expenditure.html). The total amount of aid varies from year to year and on a 10 year average hovers around 70 billion a year. In 2005–2007, around 19.5 billion Euro of total State aid was disbursed in the form of tax exemptions and tax deferrals.

54. See e.g. Seer, “The ECJ on the verge of a Member State friendly judicature?”, 3 *European Company and Financial Law Review* (2006), 237, at 247.

unconstitutional behaviour can never be justified by the argument that complying with the law would be too expensive. This is all the more so, as the Member States have all the domestic and Community regulatory powers at their disposal to ensure that income tax legislation and tax treaties do comply with EC law.

## 2.2. *Administrative difficulties and the effectiveness of fiscal supervision*

Traditionally, the Court has been very reluctant to accept attempts of Member States to justify their non-compliance with Community law on the basis of the administrative difficulties involved in applying the rules. A classic argument has been the administrative impossibility for a Member State to ensure compliance with Community law (such as the transposition of a Directive into national law), because under domestic constitutional law the decision-making powers to do so were in the hands of a national institution (such as a parliament or a government), which however did not or could not take up its responsibility to act (because of ongoing elections and negotiations on the formation of a government). The Court was never impressed, and it is settled case law that a Member State can not escape its responsibility to comply on such administrative grounds.<sup>55</sup>

However, when the Court started to interpret the Treaty prohibition of restrictions on free movement widely as prohibiting also non-discriminatory restrictions, it also broadened the possibility of justifying such restrictions on non-economic overriding public interest grounds. It thus opened a non-exhaustive range of legitimate objectives that could possibly justify restrictive measures, including objectives related to consumer protection,<sup>56</sup> protection of cultural heritage or historic and archaeological treasures,<sup>57</sup> the maintenance of order in society,<sup>58</sup> the protection of the environment,<sup>59</sup> the fairness of commercial

55. Case 7/69, *Commission v. Italy*, [1970] ECR 111; Case 48/71, *Commission v. Italy*, [1972] ECR 529.

56. Case C-17/93, *van der Veldt*, [1994] ECR I-3537; Case C-353/89, *Commission v. Netherlands*, [1991] ECR I-4069; *Collectieve Antennevoorziening*, cited *supra* note 1; Case C-76/90, *Säger*, [1991] ECR I-4221; Case 76/86, *Commission v. Germany*, [1989] ECR 1021; Case 205/84, *Commission v. Germany*, [1986] ECR 3755; Case 220/83, *Commission v. France*, [1986] ECR 3663, Case 15/83, *Denkavit*, [1984] ECR 2171; Case 193/80, *Commission v. Italy*, [1981] ECR 3019; Case 113/80, *Commission v. Ireland*, [1981] ECR 1625, Case 788/79, *Gilli*, [1980] ECR 2071.

57. Case 95/84, *Darras and Dostain*, [1986] ECR 2253.

58. Case C-275/92, *Schindler*, [1994] ECR I-1039, para 58.

59. Joined Cases 3, 4 & 6/76, *Kramer*, [1976] ECR 1279; Case 240/83, *ADBHU*, [1985] ECR 531; Case 302/86, *Commission v. Denmark*, [1988] ECR 4607.

transactions (fair trading and the prevention of unfair competition),<sup>60</sup> the protection of the interests of workers or of their working conditions<sup>61</sup> and protection of public health.<sup>62</sup>

Slightly surprisingly, in view of the strong and consistent rejection by the Court of the “administrative difficulties” defence, the *Cassis de Dijon* list of overriding public interests also mentioned the effectiveness of fiscal supervision and controls.<sup>63</sup> This inspired Member States to reintroduce the argument of administrative difficulties in the income tax case law under the broader name of effectiveness of fiscal supervision.<sup>64</sup> In *Schumacker*, for instance, the Germany authorities argued that administrative difficulties prevented the State of employment from ascertaining the income which non-residents working in its territory receive in their State of residence.<sup>65</sup> In *Safir*, the Swedish Government argued the administrative impossibility of applying the same tax regime to capital life assurance policies taken out with foreign companies as compared to Swedish companies, but the Court, without further explanation, held that these grounds were not such as to justify the different treatment and other restrictive elements in the national legislation.<sup>66</sup> A slight variation of the argument appeared in *Zurstrassen*, in which the Luxembourg Government argued that tax collection was facilitated by reserving joint assessment of spouses to resident couples, thus excluding couples with one non-resident spouse. It thus turned from administrative difficulties in granting joint assessment to couples with one non-resident spouse, to administrative convenience of reserving joint assessment to couples with two resident spouses.<sup>67</sup>

In view of the ECJ’s settled case law on administrative difficulties, however, it should not have come as a surprise to Member States that the Court consistently rejected that justification also in its income tax decisions.<sup>68</sup> In fact,

60. Case 6/81, *IDG v. Beele*, [1982] ECR 707; Case 58/80, *Dansk Supermarket v. Imerco*, [1981] ECR 181.

61. Case 170/84, *Bilka*, [1986] ECR 1607 (exclusion of part-time workers from an occupational pension scheme may be justified if the employer, in the interest of workers, hires as few part-time workers as possible); Case 155/80, *Oebel*, [1981] ECR 1993.

62. *Gilli*, cited *supra* note 56.

63. *Cassis de Dijon*, cited *supra* note 3, para 8.

64. *Futura Participations*, cited *supra* note 34, para 31; Case C-254/97, *Baxter*, [1999] ECR I-4809, paras. 18 et seq.; Case C-55/98, *Vestergaard*, [1999] ECR I-7641, paras. 25 et seq.; *Danner*, cited *supra* note 21, paras. 51 et seq.

65. *Schumacker*, cited *supra* note 31, para 43.

66. Case C-118/96, *Jessica Safir*, [1998] ECR I-1897. The ECJ also rejected the hidden revenue argument, that Sweden needed to fill the fiscal vacuum arising from the non-taxation of savings in the form of capital life assurance policies taken out with companies not established in Sweden (para 34).

67. Case C-87/99, *Zurstrassen*, [2000] ECR I-3337 paras. 24 and 25.

68. *Schumacker*, cited *supra* note 31, paras. 43 et seq.; *Zurstrassen*, cited *supra* note 67, paras. 24 et seq.; *Safir*, cited *supra* note 66, paras. 32 et seq.; *Terhoeve*, cited *supra* note 42,

the argument is even less convincing in the tax area than in other areas, because the tax authorities of the Member States have broad powers to oblige the taxpayer to provide the necessary evidence and may, where necessary, obtain the necessary information from their colleagues in other Member States. If insufficient information is forthcoming to ensure a correct application of domestic tax law, tax authorities can simply refuse access to tax benefits such as exemptions for specific types of income or deductions of certain expenses. No surprise therefore, that the ECJ has taken the view that Member States should, if need be, provide each other with mutual assistance to overcome such difficulties,<sup>69</sup> an approach that has recently been extended to the recovery of tax claims<sup>70</sup> when the recovery directive was extended to cover also direct taxes.<sup>71</sup>

This strict approach of the Court is readily understandable. From the point of view of a national tax administration, there may be good reasons not to grant the same tax treatment automatically to cross-border situations and to domestic situations, because tax collection and enforcement mechanisms, in principle, stop at the border, and information cannot be as easily obtained in cross-border situations. In international tax law, therefore, the argument that administrative difficulties necessitate a different substantive treatment of domestic and cross-border situations, is perfectly understandable. In the framework of a deep multilateral economic integration process based largely on private sector rights to free movement across the border, however, this is an unconvincing reasoning, because, if adopted, it would allow Member States to rely on internal administrative problems to unilaterally escape their Treaty obligations and thus endanger the uniform application of Community law.

That leaves us with the question how to reconcile the consistent rejection of the “administrative difficulties” justification and the recognition by the Court of “effectiveness of fiscal controls” as an overriding public interest. We believe that it is clear from the case law that the need to maintain the effectiveness of fiscal controls allows Member States to obtain, from the taxpayer

para 45. Cf. for the area of indirect taxes also Case 15/81, *Schul*, [1982] ECR 1409, para 39, and Case C-213/96, *Outokumpu Oy*, [1998] ECR I-1777, para 38.

69. See the Council Directive 77/799/EEC of 19 Dec. 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, O.J. 1977, L 336/15. For the respective line of case law see e.g. *Schumacker*, cited *supra* note 31, para 45; *Vestergaard*, cited *supra* note 64, para 26; *Danner*, cited *supra* note 21, paras. 44 et seq.; Case C-334/02, *Commission v. France*, [2004] ECR I-2229, paras. 31 et seq.

70. See Case C-470/04, *N*, [2006] ECR I-7409, para 53; Case C-520/04, *Turpeinen*, [2006] ECR I-10685, para 37.

71. See Council Directive 76/308/EEC of 15 March 1976 on mutual assistance for the recovery of claims relating to certain levies, duties and other measures, O.J. 1976, L 73/18, amended, *inter alia*, by Council Directive 2001/44/EC of 15 June 2001, O.J. 2001, L 175/17.

or from each other, any information that will enable the correct application of their tax laws.<sup>72</sup> But it is also clear that the Court has stopped short of accepting discriminatory tax measures on the ground that information on the cross-border situation was hard to get.<sup>73</sup> Quite on the contrary, the Court has taken the view that Member States should overcome such difficulties by asking the taxpayer or each other, e.g., under the 1977 Mutual Assistance Directive.<sup>74</sup> Only in the exceptional situation that the tax administration of a Member State has no indication whatsoever of taxable income or assets, so that it can not ask either the taxpayer or the tax administration of another Member State for the necessary information to ensure a correct assessment of tax, may a different procedural treatment of domestic and cross-border situations be justified by the need to ensure the effectiveness of fiscal controls and to combat tax evasion.<sup>75</sup> It seems to us that this constitutes a reasonable balance between the need to ensure an open market and the need for Member States to have an adequate flow of information allowing for a correct application of national tax laws.

A final remark on this issue of administrative constraints concerns a nuance in the income tax case law concerning third country situations. The starting point of this nuance is that the Treaty prohibits all restrictions on capital movements, whether intra-Community or with third countries, but that in the case of third country situations, the Treaty provides for extra safeguards.<sup>76</sup> On that basis, the Court noted that the extent to which the Member States are authorized to apply certain restrictive measures on capital movements with third countries cannot be determined without taking account of the fact that those capital movements take place in a different legal context and that a Member State may thus be able to demonstrate that a restriction is justified for a particular reason in circumstances where that reason would not constitute a valid justification for a restriction on intra-Community capital movements.<sup>77</sup>

The Court's next step was in *A*,<sup>78</sup> in which Sweden argued that, in the absence of a tax treaty with the source country providing for exchange of

72. See e.g. *Futura*, cited *supra* note 35; *Vestergaard*, cited *supra* note 64; Case C-347/04, *Rewe Zentralfinanz*, [2007] ECR I-2647.

73. See e.g. *Société Baxter*, cited *supra* note 64, paras. 18 et seq.; *Vestergaard*, cited *supra* note 64, paras. 25 et seq.; *X and Y*, cited *supra* note 34; *Manninen*, cited *supra* note 39; Case C-39/04, *Laboratoires Fournier*, [2005] ECR I-2057.

74. See the references *supra* note 71.

75. Joined Cases C-155/08, *X*, & C-157/08, *E.H.A. Passenheim-van Schoot*, judgment of 11 June 2009, *nyr*.

76. Cordewener, Kofler and Schindler, "Free movement of capital, third country relationships and national tax law: An emerging issue before the ECJ", 47 Eur. Tax. (2007), 107, at 114–117.

77. Case C-446/04, *FII Group Litigation*, [2006] ECR I-11753, paras. 170–171.

78. Case C-101/05, *A*, [2007] ECR I-11531.

information, its refusal to grant a tax exemption for inbound stock dividend from third countries was justified by the need to guarantee the effectiveness of fiscal supervision<sup>79</sup> and the right of Member States to prevent infringements of national law including tax law (Art. 58(1)(b) EC). The complainant and the Commission, on the other hand, considered the contested legislation disproportionate because the Swedish tax authorities could ask the taxpayer to furnish the necessary proof. The Court first recognized that, according to settled case law, a Member State can either obtain information from another Member State, or, if that is difficult, request the necessary evidence from the taxpayer,<sup>80</sup> and that the taxpayer should not be precluded a priori from providing relevant documentary evidence.<sup>81</sup> Subsequently, however, it held that the case law relating to intra-Community situations cannot be transposed in its entirety to capital movements with third countries. These take place in a different legal context because there is no common legal background (such as a mutual assistance Directive) establishing a framework for cooperation between the respective competent authorities,<sup>82</sup> and because the documentary evidence provided by the taxpayer may not produce reliable and verifiable evidence on the structure or activities of a company established in another Member State, which is not required to apply harmonized Community measures, such as those on company accounts.<sup>83</sup> The Court concluded that a Member State may refuse a tax advantage in a third country situation if compliance with the conditions can be verified only by obtaining information from the competent authorities of a third country, and that third country is not under any contractual obligation to provide information and it proves impossible to obtain that information from that country.<sup>84</sup> It is for national courts to determine whether national tax authorities cannot verify compliance with conditions without information exchange with the third country,<sup>85</sup> and whether such information would be available under the tax treaty.<sup>86</sup>

79. *Ibid.*, paras. 54–55. The ECJ refers to *Futura Participations and Singer*, cited *supra* note 35, para 31; *Lenz*, cited *supra* note 39, paras. 27 and 45; and Case C-386/04, *Centro di Musico-logic Walter Stauffer*, [2006] ECR I-8203, para 47.

80. *A*, cited *supra* note 78, para 58, with reference to *Bachmann*, cited *supra* note 7, para 20; Case C-150/04, *Commission v. Denmark*, [2007] ECR I-1163, para 54, and Case C-451/05, *ELISA*, [2007] ECR I-8251, paras. 94 and 95.

81. *A*, cited *supra* note 78, para 59, with reference to *Baxter*, cited *supra* note 64, paras. 19 and 20; *Laboratoires Fournier*, cited *supra* note 73, para 25; and *ELISA*, cited *supra* note 80, para 96.

82. *A*, cited *supra* note 78, paras. 60–61.

83. *Ibid.*, para 62.

84. *Ibid.*, para 63. See now also Case C-521/07, *Commission v. Netherlands*, judgment of 11 June 2009, *nyr*, para 47.

85. *Ibid.*, paras. 64–65.

86. *Ibid.*, para 66.

### 2.3. *Arbitrary discrimination of capital movements*

In respect of possible justifications for EC incompatible restrictions, a particularly delicate exercise for the Court has been the interpretation of the Treaty articles on free movement of capital and payments, because Article 58 EC makes an express reference to permissible non-discriminatory restrictions, whilst at the same time prohibiting arbitrary discrimination and disguised restrictions. In fact, under Article 58(1)(a) EC, the Member States keep the right "to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested." Moreover, Article 58(1)(b) EC allows the Member States to "take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation". Article 58(3) EC, on the other hand, provides specifically that the national provisions referred to by Article 58(1) EC are not to constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments, as defined in Article 56 EC.<sup>87</sup>

For a number of years the interpretation of these clauses was unclear.<sup>88</sup> However, the prevailing opinion in legal writing had already suggested that their character is merely clarifying,<sup>89</sup> and the ECJ basically confirmed this view. In *Verkooijen*<sup>90</sup> and subsequent case law,<sup>91</sup> Article 58(1)(a) EC was qualified as a codification of the Court's prior case law: the ECJ stated that according to that case law national tax provisions of the kind to which Article 58(1)(a) EC refers, insofar as they establish certain distinctions based, in particular, on the residence of taxpayers, could be compatible with EC Law provided that they applied to situations which were not objectively comparable or could be

87. Art. 73d(1) (a)(b) and Art. 73d(3) of the Treaty (Maastricht version – before the Treaty of Amsterdam).

88. See for an overview, e.g., Sedlaczek, "Der Begriff der Diskriminierung und der Beschränkung – die Kapitalverkehrsfreiheit als konvergente Grundfreiheit des EG-Vertrages" in Lechner, Staringer, and Tumpel (Eds.), *Kapitalverkehrsfreiheit und Steuerrecht* (Linde, 2000), p. 27, at pp. 51 et seq.

89. See e.g. Dautzenberg, "Die Kapitalverkehrsfreiheit des EG-Vertrages, der Steuervorbehalt des Art 73d EGV und die Folgen für die Besteuerung", 44 RIW (1998), 537, at 541; Ruppe, "Die Bedeutung der Kapitalverkehrsfreiheit für das Steuerrecht" in Lechner, Staringer, and Tumpel, op. cit. *supra* note 88, p. 9, at 21 et seq.; Staringer, "Dividendenbesteuerung und Kapitalverkehrsfreiheit" in Lechner, Staringer, and Tumpel, *ibid.*, p. 93, at pp. 106 et seq.; Saß, "Zum Schutz von Kapitalbewegungen in der EU gegen steuerliche Diskriminierung", 82 *Finanz-Rundschau* (2000), 1270, at 1272; Staringer, "Auslandsdividenden und Kapitalverkehrsfreiheit", (2000) *Österreichische Steuer-Zeitung*, 26, at 28 et seq.

90. *Verkooijen*, cited *supra* note 9, paras. 42 et seq. Cf. Opinion of A.G. Kokott in Case C-242/03, *Weidert and Paulus*, [2004] ECR I-7379, paras. 27 et seq.

91. For example, *Lenz*, cited *supra* note 39, paras. 26 et seq.; *Manninen*, cited *supra* note 39, paras. 28 et seq.

justified by overriding reasons in the general interest, in particular in relation to the cohesion of the tax system.<sup>92</sup> And only a few months later, the Court decided in a similar way with respect to Article 58(1)(b) EC, which was considered to allow “measures intended to ensure effective fiscal supervision and to combat illegal activities such as tax evasion”, as long as any relevant measure complies “with the principle of proportionality.”<sup>93</sup>

### 3. Acceptable grounds of justification (overriding public interest)

#### 3.1. *The coherence of the tax system*

In the 1992 decisions in *Bachmann*<sup>94</sup> and *Commission v. Belgium*,<sup>95</sup> the Court accepted that a tax measure infringing EC law provisions was justified by the need to maintain the coherence of the Belgian tax system.<sup>96</sup> In fact the Court assumed that, under Belgian law, there was a link between deductibility of premiums and taxability of subsequent income, in the sense that Belgium had made the consistent choice that either it did not allow the deduction of premiums (because it did not tax the subsequent income resulting from the insurance contracts and pension arrangements), or it did tax that resulting income in which case it also allowed the deduction of the premiums. In more practical terms, such a genuine “systemic” coherence also meant that the revenue loss due to the deduction was offset by the taxation of subsequent income. The idea behind the coherence justification was that, within the tax system of a particular Member State, there may be a close relationship between, on the one hand, a tax advantage granted to a particular taxpayer in the framework of a particular tax and at a certain point in time, and, on the other hand, a tax burden imposed on the same taxpayer and in the framework of the same tax at a later point in time. From a systemic point of view, therefore, a particular Member State initially foregoes (the collection of) a revenue claim, but only on the clear understanding that the claim can be realized at a later stage.

In an Internal Market, however, such a coherent system encounters the problem that a taxpayer may enjoy a certain advantage in one Member State and subsequently use his right to free movement to move to another Member

92. Cf. Cordewener, op. cit. *supra* note 21, pp. 747 et seq.; Flynn, “Coming of age: The free movement of capital case law 1993–2002”, 39 CML Rev. (2002), 773, at 793 et seq.

93. *Commission v. Belgium*, cited *supra* note 9, paras. 37 et seq.

94. *Bachmann*, cited *supra* note 7, paras. 21 et seq.

95. *Commission v. Belgium*, cited *supra* note 33, paras. 14 et seq.

96. The Court uses both the terms “cohesion” and “coherence”. Coherence is perhaps the better term, because cohesion has another specific meaning in Community law (regional policy).

State, thus making it more difficult for the first Member State to realize the revenue claim it had temporarily forgone by granting the advantage. In these circumstances, that first Member State typically seeks to deny the tax advantage to the cross-border situation, as in *Bachmann*, or to link the realization of the revenue claim to the point of exit of the taxpayer, as in *Daily Mail*.<sup>97</sup> In both cases, the resulting discrimination could, in international tax law, be justified by the need for the Member State concerned to prevent revenue leaks from affecting its budgetary position.

But this kind of revenue related coherence argument necessarily has a very limited scope in Community law, because it cannot serve as an alternative for the “loss of revenue” justifications, which the Court has consistently rejected. Hence, *Bachmann* and *Commission v. Belgium* have been widely criticized, not least because they were decided upon a wrong factual and legal determination.<sup>98</sup> Also the refusal of the deduction in *Bachmann* was disproportional because less restrictive arrangements were in place in case of premium payments to insurers in the Netherlands and France by means of additional reporting obligations for those foreign insurance companies.<sup>99</sup> Unsurprisingly the ECJ has subsequently shown great reluctance to accept the fiscal coherence type of justification and it in fact often denied a justification on that ground.<sup>100</sup>

In Community law, therefore, the need to maintain coherence may exceptionally justify a restrictive measure that seeks to ensure system coherence, but not a measure that merely seeks to protect the revenue interests of the State, as was at issue in *Bachmann*. Hence, a justification of a discriminatory mea-

97. Case 81/87, *Daily Mail*, [1988] ECR 5483.

98. See for this e.g. Knobbe-Keuk, *op. cit. supra* note 29, 74, at 79 et seq.; Thömmes, *op. cit. supra* note 29, p. 795, at pp. 826 et seq.; Kofler, “Ramstedt: Benachteiligung von Beitragszahlungen an ausländische Rentenversicherer ist nicht mit der Dienstleistungsfreiheit vereinbar!”, (2003) *Österreichische Steuer-Zeitung*, 404, at 406 et seq.

99. Even A.G. Léger, in his Opinion in *Wielockx*, cited *supra* note 7, para 37, agreed with the literature that the same result could have been reached with less restrictive rules (proportionality test). See e.g. Hinnekens and Schelpe, “*Bachmann v. Belgium* (C-204/90) and *Commission v. Belgium*, 28 January 1992 (C-300/90)”, 1 EC Tax Rev. (1992), 58 et seq.; Farmer and Lyal, *EC Tax Law* (Clarendon Press, 1994), p. 333; see also Wattel, “The EC Court’s attempts to reconcile the Treaty freedoms with international tax law”, 33 CML Rev. (1996), 223, at 239–243. For a critical discussion of *Bachmann*, including a summary of the literature, see Van Thiel, *EU case law on income tax, Part I* (IBFD, 2001), Ch. 5, at pp. 225–254.

100. See e.g. Schumacker, cited *supra* note 31, paras. 40 et seq.; *Wielockx*, cited *supra* note 7, paras. 13 et seq.; Svensson and Gustavsson, cited *supra* note 1, paras. 15 et seq.; Vestergaard, cited *supra* note 64, para 24; *ICI*, cited *supra* note 16, para 29; *Eurowings*, cited *supra* note 32, paras. 41 et seq.; Case C-251/98, *Baars*, [2000] ECR I-2787, paras. 37 et seq.; *Verkooijen*, cited *supra* note 9, paras. 49 et seq.; *Metallgesellschaft and Hoechst*, cited *supra* note 34, paras. 67 et seq.; *Danner*, cited *supra* note 21, paras. 33 et seq.; *Lankhorst-Hohorst*, cited *supra* note 34, paras. 40 et seq.; *Ramstedt*, cited *supra* note 39, paras. 30 et seq. Cf. e.g. Thömmes, *op. cit. supra* note 29, p. 795, at pp. 826 et seq.

sure on the grounds of “fiscal coherence” requires the existence of a direct link between deduction and taxation within the same tax system,<sup>101</sup> whereas the existence of a merely indirect link between the tax advantage and another charge (not the same tax) or a tax advantage accorded to one taxable person and the unfavourable tax treatment of another (not the same taxpayer) cannot justify discrimination.<sup>102</sup> As the case law of the ECJ indicates, in national rules there is rarely a strict correlation between deductions and benefits.

Nor is there a need to maintain such a strict coherence at the micro level of the taxpayer, if one takes account of bilateral tax treaties,<sup>103</sup> which ensure systemic coherence at a macro level so that it need not to be ensured on a case by case basis.<sup>104</sup> In *Bachmann*, for example, a tax treaty was in place between Belgium and Germany that allocated tax jurisdiction on the basis of residence, irrespective of where the premiums had been deducted and irrespective of where the insurance company was resident, so that coherence between tax advantages and tax charges was realized at the overall tax treaty level, even if not in every individual case. Acknowledging this, and implicitly overruling *Bachmann*, the Court in *Wielockx* noted that “the effect of double-taxation conventions which follow the OECD model is that the State taxes all pensions received by residents in its territory, whatever the State in which the contributions were paid, but, conversely, waives the right to tax pensions received abroad even if they derive from contributions paid in its territory which it treated as deductible.”<sup>105</sup> Thus, fiscal cohesion may be secured by a bilateral convention concluded with another Member State, and may therefore not be invoked on the level of domestic tax law. Hence, the existence of a bilateral tax treaty shifts the question to another level, “that of the reciprocity of the rules applicable in the Contracting States.”<sup>106</sup> While this case law opens a variety of new questions, especially with regard to the relationship between a “micro coherence” on the domestic level and a “macro coherence” on the treaty level,<sup>107</sup> it can nevertheless be inferred that a coherence justification will only

101. See e.g. *Svensson and Gustavsson*, cited *supra* note 1, paras. 13 et seq.; *Eurowings*, cited *supra* note 32, paras. 20; *Ramstedt*, cited *supra* note 39, paras. 30 et seq.

102. See e.g. *Eurowings*, cited *supra* note 32, para 20.

103. For an initial discussion of this point, see Hinnekkens and Schelpe, *op. cit. supra* note 99, 58, at 61, and for a recent analysis see Kofler, *Doppelbesteuerungsabkommen und Europäisches Gemeinschaftsrecht* (Linde, 2007), pp. 712–758, and the references therein.

104. *Wielockx*, cited *supra* note 7, para 24.

105. *Ibid.*, para 24.

106. *Ibid.*

107. See e.g. Cordewener, “Company taxation, cross-border financing and thin capitalization in the EU Internal Market: Some comments on *Lankhorst-Hohorst GmbH*”, 43 *Eur. Tax.* (2003), 102, at 110 et seq.

be available in situations where a Member State has not given up a taxing right in *any*<sup>108</sup> treaty with another country.

In view of the above it is no surprise that in practically all cases subsequent to *Bachmann*, the Court rejected the coherence defence, in particular if system coherence was secured at macro level,<sup>109</sup> or if there was no direct link between the tax advantage given and the subsequent tax burden,<sup>110</sup> i.e. whenever the advantage and disadvantage were provided in the framework of two different taxes or affected two different taxpayers.<sup>111</sup>

That means that the coherence justification is, in practical terms, of limited use in cases that concern discriminatory income tax measures.<sup>112</sup> But it is not completely dead, as some have suggested in the past. A first example of a case in which coherence could justify taxation on exit for instance would be the case of a taxpayer who leaves his tax jurisdiction in the middle of the fiscal year. The Member State of exit will routinely require the person concerned to fill out an “emigration” tax return and to pay all his tax debts before actually moving abroad. In principle the taxpayer could argue discrimination contrary to Community law because he must, by virtue of exercising his right of free movement, pay his taxes in the middle of the year, i.e. much earlier than taxpayers who stay at home and normally pay their tax only at the end of the fiscal year. The different tax treatment causes a cash flow disadvantage that in particular affects non-residents or persons who exercise their right to free movement. Though the measure could, in principle, be considered discriminatory, the Member State of exit could nevertheless rely on the coherence justification. In fact, a taxpayer’s obligation to pay tax arises continuously, as he earns income. A Member State could thus require the payment of tax on a monthly or even weekly basis because the tax debt arises as income is earned. By not collecting the tax due, a tax deferral advantage is granted to the taxpayer, but on the understanding that subsequently the tax can be collected at the end of the fiscal year or when the taxpayer leaves the tax jurisdiction.

A second example is the recent decision of the ECJ in *Papillon*,<sup>113</sup> concerning a French tax measure that allowed loss compensation between a domestic

108. See in this direction Opinion of A.G. Jacobs in *Danner*, cited *supra* note 21, para 56.

109. See the explicit reversal of *Bachmann* in *Wielockx*, cited *supra* note 7, paras. 24–26; see also *Danner*, cited *supra* note 21, para 41; *X and Y*, cited *supra* note 34, paras. 53–55; *Weidert and Paulus*, cited *supra* note 90, paras. 25–26.

110. In *Svensson and Gustavsson*, cited *supra* note 1, para 18, the Court clarified the requirement for a direct link between tax advantage and disadvantage.

111. See e.g. *Asscher*, cited *supra* note 22; *ICI*, cited *supra* note 16; *Eurowings*, cited *supra* note 32; *Vestergaard*, cited *supra* note 64; *Baars*, cited *supra* note 100; *Verkooijen*, cited *supra* note 9; *Manninen*, cited *supra* note 39.

112. For an interesting recent analysis see, however, Opinion of A.G. Poiates Maduro in *Marks & Spencer*, cited *supra* note 1, paras. 65 et seq.

113. *Société Papillon*, cited *supra* note 33.

parent and a domestic subsidiary, thus considering both as one legal person from a tax point of view (consolidation between group members). The loss compensation was refused, however, if the domestic (sub)subsidiary was indirectly owned by another subsidiary of the parent established in another Member State. This was considered justified by the Court, because there was a systemic link in the French tax system between allowing the French subsidiary to shift its losses to the parent, and simultaneously disallowing the parent to reduce the book value of its participation in the (loss making) subsidiary. That systemic link, which avoided the dual use of losses, would be broken if the French (sub-)subsidiary were held by another subsidiary in another Member State. The ECJ thus accepted the coherence justification, but nevertheless considered the French rule disproportional because the taxpayer was not allowed to provide evidence that he did not benefit from a double deduction of losses.<sup>114</sup>

A third example is the recent decision of the Court in *Krankenheim Ruhesitz am Wannsee* which concerned the German clawback of the amounts of cross-border loss compensation which, in previous years, had been granted to a German head office in respect of the losses incurred by its Austrian permanent establishment.<sup>115</sup> As a general rule, Germany neither taxed the domestic head office on foreign branch profits, nor did it allow that head office to deduct foreign branch losses. Exceptionally, however, it did allow the deduction of foreign branch losses on the understanding that the amounts so offset would be clawed back in the future once the foreign branch realized profits. The Court noted that the clawback of the foreign branch losses previously offset constituted a discriminatory exit restriction because in a domestic situation a head office could always offset the losses of its domestic branch.<sup>116</sup> Subsequently, however, the Court considered the restriction justified by the need to guarantee the coherence of the German tax system. In this respect it stressed that, under the German Austrian tax treaty, the profits of the Austrian branch are taxed only in Austria (exclusive allocation of tax jurisdiction), and that the German tax on the foreign branch losses (their reintegration in the head office profits) was directly linked to the prior exceptional deduction of those losses.<sup>117</sup>

114. Ibid., paras. 41 et seq.

115. *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH*, cited *supra* note 33.

116. Ibid., paras. 35–39.

117. Ibid., para 42, in which the ECJ uses several strong coherence indicators including: “cannot be dissociated”, “logical symmetry”, and “direct personal and material link”. In addition the Court considers the measure proportional, because it is appropriate to achieve the objective and the losses are reintegrated only up to the amount of the profits made (paras. 43 and 44). This conclusion is not affected by the fact that, as a result of the exceptional German loss compensation provision, the taxpayer lost his ability to carry forward losses in Austria, because even if that would cause a restriction, it would be imputable only to the Austrian and not to the German tax system and would arise from the allocation of tax competences under the German Austrian tax

A final remark concerns the argument that the Court has revived coherence in the guise of other grounds for justification such as fiscal territoriality and the need for a balanced allocation of tax jurisdiction.<sup>118</sup> We disagree with this view, since in most cases coherence was presented as a mere revenue concern of Member States, and it was fundamentally flawed as a possible justification because it sought to assess restrictive measures from a public sector revenue perspective (which is irrelevant in the context of the Internal Market) rather than a private sector ability to pay (and “freedom to move around in the Internal Market”) perspective, which is what the European Union is all about. Coherence can only be a justification if there is a systemic direct link within the same tax system between the tax advantage and a subsequent charge. Territoriality and balanced allocation of tax jurisdiction, on the other hand, concern the systemic coherence between the tax systems of two Member States. Both are concepts that suggest a need to respect rules and understandings on the allocation of jurisdiction and the avoidance of double taxation. This is, for instance, why the Court correctly referred to territoriality in *Futura*,<sup>119</sup> because, as Luxembourg only taxed the domestic source income of the permanent establishment on the basis of the tax treaty with France, it should be allowed to limit the deductibility of losses to the losses related to the activities of the permanent establishment. Likewise, in *Lidl Belgium* the Court held that the German refusal to allow the deduction of foreign branch losses was justified by the need to maintain a balanced allocation of tax jurisdiction and a double dip, because the tax treaty allocated tax jurisdiction over the branch profits exclusively to source State Luxembourg.<sup>120</sup>

Again, the Court correctly rejected the territoriality claim in *Bosal*,<sup>121</sup> because, on the basis of domestic law, the Netherlands allowed the deduction in the hands of the parent of financing costs of setting up a domestic (but not a foreign) subsidiary, whereas it did not tax in the hands of the parent, the profits of either the domestic or the foreign subsidiary.<sup>122</sup>

treaty (paras. 46–52). Nor can the conclusion be affected by the fact that the German company sold its Austrian establishment and, overall, incurred a loss, because “the reintegration of the amount of the permanent establishment’s losses in the results of the principal company is the indissociable and logical complement of their having previously been taken into account” (paras. 53–54).

118. See e.g. Wattel, “Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; What is the difference?” in Weber, op. cit. *supra* note 50, pp. 139 et seq.

119. *Futura*, cited *supra* note 35.

120. Case C-414/06, *Lidl Belgium*, [2008] ECR I-3601, paras. 27–43.

121. *Bosal*, cited *supra* note 20.

122. In Case C-471/04, *Keller Holding GmbH*, [2006] ECR I-2107, that question was nuanced, because, in accordance with the principle of territoriality, the dividends received from a foreign subsidiary were not taxable in Germany (whereas those of a domestic subsidiary were

In conclusion, the ECJ routinely rejects the need to avoid loss of revenue or to prevent the erosion of the tax base as a justification of a tax measure that restricts free movement.<sup>123</sup> A nuance in this line of case law is the coherence justification which, though also having effect on a Member State's revenue flows (and in particular the timing thereof), allows a Member State to deny a tax advantage to a cross-border situation if it systematically abstains from imposing a subsequent charge that is systemically related to that initial disadvantage (thus neutralizing its restrictive effect). The coherence justification was erroneously allowed by the Court in *Bachmann* because there were significant leaks in the systemic coherence of the Belgian tax system.<sup>124</sup> But *Bachmann* was no authorization by the Court to allow the need to prevent potential revenue leaks as a possible justification for discrimination under the new label "coherence of the tax system". This was made clear in subsequent case law in which the potential scope of this possible justification was significantly reduced on the argument that there must be a direct (systemic) link (same tax and same taxpayer) between the initial measure (resulting in revenue forgone) and a subsequent measure (resulting in a future possible loss of revenue), and the measures taken must be proportional.<sup>125</sup> In addition, the ECJ clarified that coherence can only be successfully relied upon in an individual case if not already guaranteed on a broader, tax treaty level.<sup>126</sup> In reality the Court rejected the coherence justification in practically all subsequent cases in which Member States tried to rely on that argument merely to protect their revenue base. Only exceptionally, and to the extent that the coherence of a tax system is systemic, can it constitute an acceptable justification for a measure that *prima facie* seems to be disadvantageous for a cross-border situation, but upon closer look, is directly linked to another measure that neutralizes this disadvantage. To be distinguished from the coherence justification (concerning the coherence of the tax system of one Member State), is the agreed coherence between the tax systems of two Member States reflected in rules on the allocation of tax jurisdiction, which in itself can be an acceptable

taxable), and the costs of setting up that foreign subsidiary were not deductible in Germany (whereas the costs of financing a domestic subsidiary were deductible). The territoriality argument nevertheless was, correctly, rejected by the Court in that case, because in reality the domestic-source dividends, though taxable, were never actually taxed (because of German measures to avoid economic double taxation of dividends).

123. See e.g. *Cadbury Schweppes*, cited *supra* note 39; *Manninen*, cited *supra* note 39; *Lenz*, cited *supra* note 39; *De Lasteyrie du Saillant*, cited *supra* note 39; *Skandia*, cited *supra* note 39; *De Groot*, cited *supra* note 39; *Danner*, cited *supra* note 21; *ICI*, cited *supra* note 16.

124. For a detailed analysis of the *Bachmann* decision see van Thiel, op. cit. *supra* note 99, Ch. 5 at pp. 225–254.

125. In several cases, the Court saw no direct link. See e.g. *Manninen*, cited *supra* note 39; *Verkooijen*, cited *supra* note 9; *Baars*, cited *supra* note 100; *Vestergaard*, cited *supra* note 64; *Eurowings*, cited *supra* note 32; *ICI*, cited *supra* note 16; *Asscher*, cited *supra* note 22.

126. *Wielockx*, cited *supra* note 7.

justification, because the agreement with another Member State may eliminate the disadvantage for the cross-border situation.<sup>127</sup>

### 3.2. *National anti-avoidance measures*

In their quest to minimize their overall tax burden, economic operators proactively consider the tax aspects of their intended business choices (tax planning). Sometimes they stay within the letter of the law, but stretch the limits by using loopholes or manipulating the law for a purpose for which it was obviously not intended (tax avoidance). Alternatively, they may seek to reduce tax liability by illegal means, such as under-reporting of income items and over-reporting of expenses (tax evasion). Though tax avoidance is not illegal, the tax implications of certain legal constructions may not be recognized under national law, if they are artificial or “void of substance”. There should be no doubt at all that the fight against tax avoidance is a legitimate objective in international tax law, and States are free to apply their national anti-avoidance measures, including general “substance over form” clauses, and more specific anti-avoidance rules dealing with phenomena such as controlled foreign corporations (CFCs) and thin capitalization.<sup>128</sup> In addition, States have designed international instruments to exchange information, and they sometimes engage in more advanced forms of cooperation, such as joint audits.

Tax avoidance is also a major Community law concern, due to its adverse effects on revenue and taxpayer equity, but also because it may cause distortions of competition between players on the Internal Market. This explains why EC tax harmonization and cooperation measures, as well as the EC Treaty articles on the free movement of capital, explicitly allow Member States to apply anti-avoidance rules.<sup>129</sup> Nevertheless, within the Community national anti-avoidance rules must in principle be applied with full respect of the fundamental EC law principles of free movement and non-discrimination. The ECJ clearly rejected arguments of Member States that their national

127. This also explains why we cannot accept the suggestion that coherence and balanced allocation of tax jurisdiction are the same; see Wattel, *op. cit. supra* note 118, pp. 139 et seq. The first is an autonomous revenue protection argument that comes with discrimination, but is acceptable only in the case of a systemic coherence in the tax system of one Member State. The second is an “agreed allocation of tax jurisdiction” argument that involves the tax systems of two Member States and that ensures that the initial discriminatory effect of the tax measure of one Member State is neutralized by the agreed action undertaken by the other Member State.

128. Martha, *The Jurisdiction to Tax in International Law: Theory and Practice of Legislative Fiscal Jurisdiction* (Kluwer, 1989).

129. Art. 58 EC allows Member States to take all requisite measures to prevent infringements of national laws and regulations, in particular, in the field of taxation. See also Art. 8(1) of the Transfer Pricing Arbitration Convention, Art. 4 of the Mutual Assistance Directive, Art. 1(2) of the EC Parent-Subsidiary Directive and Art. 11(1a) of the EC Merger Directive.

anti-avoidance measures are outside the scope of Community law: there is no *a priori* exclusion of national anti-avoidance clauses from the scope of directly applicable Community law, and thus no sovereignty exception.<sup>130</sup> Nor can Member States deny tax avoiders access to the EC fundamental freedoms on the ground that they would be abusing Community law.

Moreover, the Court has taken the clear line that activities seeking a less burdensome regulatory environment should, in principle, not be denied access to Community law.<sup>131</sup> In the same logic, the ECJ confirmed that exercising the right to free movement, with the aim of enjoying a more favourable tax regime applied in another Member State, cannot be considered *a priori* to constitute an abuse of the freedom of establishment.<sup>132</sup> The Court has already identified several factors that do not *of themselves* suffice to find abuse, such as the mere fact that a subsidiary is established in another Member State,<sup>133</sup> the fact that the activities carried out by a secondary establishment in another Member State could just as well be pursued by the taxpayer from within the territory of its home State,<sup>134</sup> or that tax considerations play a role in the decision on where to establish a subsidiary.<sup>135</sup>

In short, the Court confirmed that shopping for the lower regulatory and tax burden – or the principle of regulatory and tax competition between Member States – must be accepted under Community law, which is perfectly understandable in view of the completion of the Internal Market without frontiers in 1993, and the fact that most “tax planning and avoidance” transactions will, in fact, have economic substance.<sup>136</sup> Logically, therefore, Community law cannot allow the use of broad national anti-avoidance clauses that *a priori*

130. In case *Biehl*, cited *supra* note 22, paras. 15 et seq., the Court rejected the Luxembourg “sovereignty exception” argument that the procedural rule to refuse a refund of overpaid tax to non-permanent residents, which (allegedly) served to prevent them from obtaining an unjust progression advantage, should remain outside the scope of Community law. It simply recalled that the EC Treaty, as confirmed by Art. 7 of Regulation (EEC) No. 1612/68 of the Council of 15 Oct. 1968 on freedom of movement for workers within the Community, O.J. 1968, L 257/2, prohibits any discrimination, and that allowing tax discrimination would be tantamount to turning free movement into an illusion.

131. In Case C-212/97, *Centros*, [1999] ECR I-1459, the Court allowed Danish residents to create a company in the UK because it applied less restrictive capital requirements than Denmark, even though the company only deployed activities in Denmark and not in the UK. Such an exercise of the right to secondary establishment does not constitute an abuse of the right of establishment (paras. 27–29). See also Case C-167/01, *Inspire Art*, [2003] ECR I-10155.

132. *Cadbury Schweppes*, cited *supra* note 39.

133. *Ibid.*, para 50.

134. *Ibid.*, para 69.

135. *Ibid.*, para 65.

136. In *Cadbury Schweppes* (ibid.) the UK argued the non-applicability of Community law to a UK parent which had set up an Irish subsidiary so as to benefit from the lower Irish corporate income tax rate. The question of economic substance returned to the Court’s considerations, but not in the framework of the question of the applicability of Community law to the case, but

exclude *all* cross-border activities from a certain tax advantage, simply because *some* of the taxpayers engaging in cross-border activities might seek to avoid tax.<sup>137</sup> Even the broad clauses in the Maastricht Treaty articles on free movement of capital, which explicitly allow Member States to apply restrictive measures to prevent avoidance and evasion, are interpreted restrictively by the Court in this respect. National anti-avoidance provisions are only allowed if they either constitute different treatment of dissimilar domestic and cross-border situations, or if they serve an overriding public interest and satisfy the condition of proportionality.<sup>138</sup>

The application of EC primary law to national anti-avoidance clauses implies that there is a Community law concept of tax avoidance.<sup>139</sup> In that respect, legal scholarship had suggested that the avoidance concept in most Member States and, therefore, also the European concept, concerns the use of a legal construction that lacks economic substance but is undertaken only or mostly to avoid taxes.<sup>140</sup> Thus, it had already been anticipated that a denial of EC Treaty benefits to cross-border tax avoidance schemes that lack economic substance could exceptionally be justified. But it took the ECJ some time to get there. In fact, in *Avoir Fiscal* the Court held that the Treaty did not permit any derogation from the fundamental principle of freedom of establishment because of the need to prevent tax avoidance (as this justification was not explicitly mentioned in the Treaty).<sup>141</sup> This flat rejection of the tax avoidance justification was cleverly used in *Daily Mail* when the company proposed to transfer its residence for the sole purpose of avoiding UK capital gains tax.<sup>142</sup> The Court did not rule on the issue, but rather denied the applicability of the directly applicable Treaty provisions on free movement. In *Biehl*, however, the Court

rather as part of the question of whether or not the restrictive effect of the national anti-avoidance measure could be justified.

137. In *Bachmann*, A.G. Mischo was tempted to allow a tax evasion exception, but he considered the contested measure disproportionate because it was possible to “devise administrative machinery which is able to obviate the risk of tax evasion” and to find a solution in respect of countries that retain the tax at source. See the Opinion of A.G. Mischo in *Bachmann*, cited *supra* note 7, paras. 27 et seq.

138. *Verkooijen*, cited *supra* note 9, paras. 43 et seq.; *Commission v. Belgium*, cited *supra* note 9, paras. 37 et seq.

139. See Weber, “De materiële fusie eis in Europees perspectief”, (1995) *Weekblad voor fiscaal recht*, 1660.

140. Schön, “Gestaltungsmißbrauch im europäischen Steuerrecht”, 5 *Internationales Steuerrecht* (1996), 1, at 11.

141. *Commission v. France* (“*Avoir Fiscal*”), cited *supra* note 1, para 25. The French Government had argued that all non-resident taxpayers who now received their French sourced dividends directly (and subject to withholding tax without benefit of an imputation credit) would, in case of a Court ruling against France, channel those dividends through a French permanent establishment to (avoid the withholding tax but instead) benefit from the imputation credit.

142. See, *Daily Mail*, cited *supra* note 97, para 7.

decided that the risk of avoiding income tax progression could not justify the total refusal of a refund of overpaid wages tax to non-residents, because that would also cover cases in which the non-resident no longer had any income at all.<sup>143</sup> Thus, the ECJ softened the strict *Avoir Fiscal* approach, and ruled that measures that seek to prevent tax avoidance may not be so widely formulated as to cover situations in which there is clearly no tax avoidance at stake. This suggested that Member States could be allowed to maintain well-formulated rules against tax avoidance, to the extent these rules really targeted avoidance situations and not also situations that were perfectly reasonable from an economic point of view. This idea was further nuanced in *ICI*, where the Court noted that the establishment of a company outside the UK does not necessarily entail tax avoidance, and that the contested UK legislation did not have “the specific purpose of preventing wholly artificial arrangements, set up to circumvent UK tax legislation”.<sup>144</sup> Moreover, it was questionable whether a total exclusion from loss compensation of groups that have a majority of foreign subsidiaries, was a measure that satisfied the proportionality test.

These different elements were further developed in cases such as *Lankhorst*,<sup>145</sup> *X and Y*,<sup>146</sup> and *Commission v. France*,<sup>147</sup> and they were drawn together in *Cadbury Schweppes*.<sup>148</sup> In this judgment the Court recalled that a low-tax advantage enjoyed by a foreign subsidiary cannot by itself authorize the Member State of the parent to offset that advantage by treating the parent less favourably under Controlled Foreign Corporation (CFC) rules, and that the mere fact that a resident company establishes a subsidiary in another Member State cannot justify a general presumption of tax evasion and a national measure

143. In *Biehl*, cited *supra* note 22, paras. 15 et seq., the Court rejected the Luxembourg authorities' argument that the rule was justified to protect the system of progressive taxation, because the contested provision would discriminate against taxpayers who would earn no income after leaving Luxembourg.

144. *ICI*, cited *supra* note 16, paras. 26 et seq.

145. *Lankhorst-Hohorst*, cited *supra* note 34, para 37, the Court rejected the justification for the application of thin capitalization rules, because they applied generally to any cross-border situation, thus not having the specific purpose of preventing wholly artificial arrangements designed to circumvent German legislation from attracting a tax benefit.

146. *X and Y*, cited *supra* note 34, the Court held that the national provision excluded categorically any similar share transfer from the tax deferral, not allowing national courts to make a case-by-case analysis taking account of the particular features of each case (para 43) and that the contested provision was not specifically designed to exclude from the tax advantage purely artificial schemes designed to circumvent Swedish tax law, but concerned any transfer of shares to Swedish companies with foreign parents (para 61). The Court further held that tax evasion or tax fraud could not be inferred generally from the fact that the transferee company or its parent company is established in another Member State (para 62).

147. In *Commission v. France*, cited *supra* note 69, para 27, the Court held that a general presumption of tax avoidance or fraud is not sufficient to justify a fiscal measure which compromises the objectives of the Treaty.

148. *Cadbury Schweppes*, cited *supra* note 39.

compromising the exercise of a fundamental freedom guaranteed by the Treaty.<sup>149</sup> At the same time, however, the Court repeated that a national measure restricting freedom of establishment may be justified on the ground of prevention of abusive practices, as long as it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned. In other words, the contested national provision must be applied to prevent conduct involving the creation of wholly artificial arrangements, which do not reflect economic reality and seek to escape the tax normally due on the profits generated by activities carried out on national territory.<sup>150</sup> This includes a “fictitious” CFC that does not carry out any genuine economic activity in the territory of the foreign host Member State (“letterbox” or “front” subsidiary),<sup>151</sup> but it does not include a CFC that reflects “economic reality”, in the sense that it physically exists in that host Member State “in terms of premises, staff and equipment”.<sup>152</sup>

We consider this a sound approach, even though, as the Commission rightly noted in its 2007 Communication on the application of anti-abuse measures in the area of direct taxation,<sup>153</sup> operationalizing the concept “wholly artificial arrangements” may not always be an easy task.<sup>154</sup>

149. *Ibid.*, paras. 49 et seq.

150. *Cadbury Schweppes*, cited *supra* note 39, paras. 51, 55. Interestingly, the Court specified in *Cadbury Schweppes* that it is for the national court to determine whether the contested legislation is restricted to wholly artificial arrangements or whether, on the contrary, the contested national legislation may apply to parent companies, despite the absence of objective evidence of the existence of a wholly artificial arrangement (*Cadbury Schweppes*, cited *supra* note 39, para 72).

151. The Court had already ruled that an arrangement is wholly artificial if it does not involve the pursuit of an actual economic activity: See *Centros Ltd.*, cited *supra* note 131, para 25; *X and Y*, cited *supra* note 34, para 42; *Reyners*, cited *supra* note 2, para 21. See also Case C-221/89, *Factortame*, [1991] ECR I-3905 paras. 20 et seq.; *Gebhard*, cited *supra* note 24, para 25. In *Cadbury Schweppes*, cited *supra* note 39, the Court repeated this (paras. 52, 53 and 54) and added that an arrangement is wholly artificial or does not reflect economic reality, if it is set up with a view to escaping the tax normally due (para 55), such as “letterbox” companies, which are considered to be without economic link with the host country or without economic substance (para 68 with reference to Case C-341/04, *Eurofood*, [2006] ECR I-3813, paras. 34 and 35). On the other hand the Court noted that the fact that the activities which correspond to the profits of the CFC could just as well have been carried out by a company established in the territory of the Member State in which the resident company is established, does not warrant the conclusion that there is a wholly artificial arrangement (para 69).

152. *Cadbury Schweppes*, cited *supra* note 39, paras. 65, 67.

153. See the Commission’s Communication on “The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries,” COM(2007)785 final, and for comments see De Broe, “Some observations on the 2007 communication from the Commission: ‘The application of anti-abuse measures in the area of direct taxation within the EU and in relation to third countries’”, 17 EC Tax Rev. (2008), 142.

154. The Commission notes in its Communication, cited *supra* note 153, 3, that this: “amounts in effect to a substance-over form analysis. Application of the relevant tests in the

### 3.3. *The balanced allocation of tax jurisdiction or inter-jurisdictional equity versus taxpayer equity*

#### 3.3.1. *The ECJ's initial approach to tax treaties*

Realizing “inter-jurisdictional equity”, or obtaining a “fair” or “right” share of the international revenue cake, has typically motivated States to tax residents on their worldwide income and non-residents on their local source income. As this automatically results in double taxation of cross-border income flows, States will usually enter into negotiations on tax treaties that allocate tax jurisdiction and, if tax jurisdiction is shared, the residence State is required to apply the exemption or credit method to avoid double taxation. Tax treaties can, thus, be seen as an agreed “fair” distribution of revenue between the States concerned and, of course, as a reflection of the actual negotiating power of the parties. They establish a perceived balance of mutually agreed concessions under which certain taxing rights with regard to specific kinds of income are wholly or partly waived by one State, in exchange for comparable concessions by the other State.

Against this background, it is understandable that Member States, which are required to extend tax benefits to Community citizens on the basis of directly applicable Community law rather than on the basis of a bilateral tax treaty, argue that such an interpretation of Community law would be incompatible with the objective of inter-jurisdictional equity.<sup>155</sup> And indeed Advocate General *Colomer* fully recognized that the prohibition of horizontal discrimination in a tax treaty context would imply dangers as to “the equilibrium and reciprocity which prevail in the system of double-taxation treaties”,<sup>156</sup> but he also insisted that tax treaties must not become obstacles to the establishment of the single market by noting:

context of EC Treaty freedoms and corporate tax directives necessitates an evaluation of their objectives and purposes against those underlying the arrangements entered into by their prospective beneficiaries (taxpayers). In the context of corporate establishment there are inevitably difficulties in determining the level of economic presence and commerciality of arrangements. Objective factors for determining whether there is adequate substance include such verifiable criteria as the effective place of management and tangible presence of the establishment as well as the real commercial risk assumed by it. However, it is not altogether certain how those criteria may apply in respect of, for example, intra-group financial services and holding companies, whose activities generally do not require significant physical presence.” This is one of the reasons why the Commission, after evaluating the case law, concluded that there remains scope for exploring the practical application of the principles laid down by the ECJ more generally and urged the Member States to work with it to promote a better understanding of the implications for Member States’ tax systems and to explore the scope for specific co-ordinated solutions.

155. See also Opinion of A.G. Van Gerven in Case C-23/92, *Grana Novoa*, [1993] ECR I-4505, para 12.

156. Opinion of A.G. Colomer, 26 Oct. 2004, Case C-376/03, *D*, [2005] ECR I-5821, para 101.

“First, in setting in those agreements the criteria for allocating competence in taxation matters, the Member States must act with the utmost care, avoiding any provisions which might hinder that objective [of the single market]. Second, the right to equal treatment stands alone and is independent from the principle of reciprocity and therefore, in the event of a conflict, it takes precedence over mutual commitments. If the reciprocity of the obligations in such an agreement runs counter to the fundamental ideas driving the construction of a unified Europe, the Member States in question have a duty to seek other formulae which, whilst achieving the objective sought, do not, in breach of Community law, prejudice the citizens of other Member States. The principle of proportionality so demands.”<sup>157</sup>

The Court took a similar approach in its social security and income tax case law: it recognized that treaties applied on the basis of reciprocity, but nevertheless straightforwardly found that (lack of) reciprocity may not be invoked to justify discriminatory treatment contrary to the Treaty freedoms.<sup>158</sup> In fact the reciprocity argument was first presented by France in *Avoir Fiscal*,<sup>159</sup> when it argued that the tax treaties with other States were based on reciprocity, and that their provisions did not extend the imputation credit to non-residents because other Member States had not agreed to provide the required “*quid pro quo*”. The Court rejected this reference to tax treaties as a possible justification for discrimination, however, because the contested French tax measure went beyond the allocation of jurisdiction (inter-jurisdictional equity) and caused different tax burdens for competing taxpayers in the Internal Market (taxpayer equity). The ECJ recalled that the right to equal treatment is unconditional and cannot be made subject to a condition of reciprocity,<sup>160</sup> as Community law provides exactly such reciprocity by giving French taxpayers the right to equal treatment in all other Member States.<sup>161</sup> Consequently, inter-jurisdictional equity negotiated on a reciprocal basis has, in principle, to yield before a taxpayer’s right to equal treatment.<sup>162</sup>

157. *Ibid.*, para 101.

158. See e.g. Case C-55/00, *Gottardo*, [2002] ECR I-413, para 36, with reference to *Saint-Gobain*, cited *supra* note 28, para 60: “Disturbing the balance and reciprocity of a bilateral international convention concluded between a Member State and a non-member country may, it is true, constitute an objective justification for the refusal by a Member State party to that convention to extend to nationals of other Member States the advantages which its own nationals derive from that convention”.

159. *Commission v. France* (“*Avoir Fiscal*”), cited *supra* note 1, para 12.

160. *Ibid.*, para 26; see already Case 1/72, *Frilli*, [1972] ECR 457, para 19, and instructively Case C-20/92, *Hubbard*, [1993] ECR I-3777, para 17.

161. For an in-depth analysis of reciprocity in Community tax law see Kofler, *op. cit. supra* note 103, pp. 697–712, and Lang and Dommes, “Tax Treaty Law and EC Law – Reciprocity and the Balance of a Tax Treaty” in Lang, Schuch and Staringer (Eds.), *Tax Treaty Law and EC Law* (Linde, 2007), pp. 61 et seq.

162. See Opinion of A.G. Colomer in *D*, cited *supra* note 155, para 101.

*Gilly*<sup>163</sup> was the first case in which the Court ruled on the EC compatibility of tax treaty rules on the allocation of tax jurisdiction and the avoidance of double taxation. The Court essentially recognized that Member States are competent to determine the connecting factors for allocating tax jurisdiction between them with a view to eliminating double taxation. Any different tax burden resulting from such allocation rules results from a disparity between the tax laws of the Member States, which remains to be removed by harmonization.<sup>164</sup> The Court also considered that the abolition of double taxation was one of the EC Treaty's objectives and found that the credit method of avoiding double taxation<sup>165</sup> was compatible with EC law.<sup>166</sup> The Court ignored that the Gilly couple could not deduct family expenses in Germany under the *Schumacker* rule, while being able to deduct those expenses in France only *pro rata* to the part of the French-source income in the total income. But that problem was solved in *De Groot*,<sup>167</sup> in which the Court condemned the Netherlands for applying a method for the avoidance of double taxation that limited the deductibility of an alimony payment *pro rata* to the part of the Netherlands-source income in the total income.<sup>168</sup> To summarize: different methods for the avoidance of double taxation – credit or exemption – are in principle acceptable, provided they are not applied in a discriminatory way.<sup>169</sup>

163. Case C-336/96, *Gilly*, [1998] ECR I-2793.

164. See e.g. Case C-513/04, *Kerckhaert and Morres*, [2007] ECR I-10967, paras. 20–21.

165. Under the credit method, the State of residence (R) of a taxpayer taxes that person's global income, including that from a foreign source, but then credits the foreign tax levied by the source State (S) on that income against its own tax claim. Usually the credit given by R is then limited to the amount of tax it levies on that income ("ordinary credit"), so that a higher tax burden in S on that income cannot lead to a refund of tax in R. For details see Art. 23B of the OECD Model Convention.

166. See also e.g. Opinion of A.G. Geelhoed in Case C-374/04, *ACT Group Litigation*, [2006] ECR I-11673, para 51; see also Opinion of A.G. Geelhoed in *Kerckhaert and Morres*, cited *supra* note 163, para 33; Opinion of A.G. Kokott in Case C-231/05, *Oy AA*, [2007] ECR I-6373, para 55 with note 33;

167. *De Groot*, cited *supra* note 39.

168. For a detailed analysis see Kofler, op. cit. *supra* note 103, pp. 651–665.

169. See Lang, "Double taxation and EC law", and van Thiel, "The future of the principle of non-discrimination in the EU: towards a right to most-favoured-nation treatment and a prohibition of double burden" in Avi-Yonah, Hines and Lang (Eds.), *Comparative Fiscal Federalism: Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence* (Kluwer, 2007). See also Pistone, *The Impact of Community law on Tax Treaties: Issues and Solutions* (Kluwer, 2002). For an extensive discussion, also of potentially discriminatory features of the concrete application of both methods under domestic law, see Kofler, op. cit. *supra* note 103, pp. 631–694. For a specific case on discriminatory features of a credit limitation due to cost-allocation see the EFTA Court's decision in Case E-7/07, *Seabrokers AS*, [2008] EFTA Court Report 171.

The *Commission v. France* and *Gilly* line of case law was confirmed in *Saint-Gobain*,<sup>170</sup> in which the Court held, on the one hand, that Member States are free to enter into tax treaties with third countries and to determine connecting factors for the purpose of allocating tax jurisdiction, but, on the other hand, that the tax jurisdiction so allocated must be exercised in a way that is compatible with Community law. Member States must, thus, extend those treaty benefits to non-residents in a non-discriminatory fashion, as such a unilateral extension of tax treaty benefits would in no way disturb the balance and reciprocity of the treaty between the Member State and the third country.<sup>171</sup> Hence, as long as the rights of a third country are not impeded,<sup>172</sup> the Court rightly rejected arguments of reciprocity in its *vertical* discrimination analysis irrespective of whether the disputed benefits were granted under domestic law<sup>173</sup> or tax treaty law.<sup>174</sup> Thus, the Court, on the one hand, accepts the majority of tax treaty clauses, because Member States are free to shape their understanding of inter-jurisdictional equity in concrete rules on the allocation of tax jurisdiction and the avoidance of double taxation, but, on the other hand, it does not accept the reservation of substantive benefits available under national law or tax treaties to certain, but not all, Community citizens, on the basis of reciprocity, as this would affect taxpayer equity.

### 3.3.2. *A questionable change of direction: Interjurisdictional versus taxpayer equity*

This rather clear position of the Court was distorted by the 2005 decision in *D*<sup>175</sup> concerning *horizontal* discrimination, in which the Court accepted that the Belgium-Netherlands tax treaty could lawfully provide for the Netherlands to grant a substantive benefit to a resident of Belgium, whereas that same benefit was not available to a German resident, simply because a different tax treaty applied and these mutual benefits were considered an inherent part of the *quid pro quo* balance in tax treaties.<sup>176</sup> An astonishing decision in an Internal Market without frontiers, because effectively two Member States now can discriminate together against a resident of a third Member State, something which they cannot do separately or by themselves. And astonishing also

170. *Saint-Gobain*, cited *supra* note 28.

171. *Ibid.*, paras. 56 et seq.

172. For this criterion see, instructively, Case C-466/98, *Commission v. United Kingdom*, [2002] ECR I-9427, para 54; and *Gottardo*, cited *supra* note 157, para 37. See also de Graaf and Janssen, “The implications of the judgment in the *D* case: The perspective of two non-believers”, 14 EC Tax Rev. (2005), 173, at 184.

173. *Commission v. France* (“*Avoir Fiscal*”), cited *supra* note 1.

174. *Saint-Gobain*, cited *supra* note 28.

175. *D*, cited *supra* note 155.

176. *Ibid.*, paras. 61–62.

because the Court assumed that the *quid pro quo* balance in tax treaties, which it had to respect, was made up not only of allocation rules (that shape inter-jurisdictional equity), but also of substantive tax treaty rules (that affect private sector tax burden and thus taxpayer equity).<sup>177</sup> An unfortunate mix-up indeed, because, under this new approach, private sector EC Treaty rights no longer have priority over bilateral tax treaty rules, and it is quite amazing that the Court did not provide any convincing motivation for this dramatic departure from the principles of direct effect and primacy.<sup>178</sup> The Court merely noted that

“[t]he fact that those reciprocal rights and obligations apply only to persons resident in one of the two Contracting Member States is an inherent consequence of bilateral double taxation conventions. It follows that a taxable person resident in Belgium is not in the same situation as a taxable person resident outside Belgium so far as concerns wealth tax on real property situated in the Netherlands. ... A rule such as that laid down in ... the Belgium-Netherlands Convention cannot be regarded as a benefit separable from the remainder of the Convention, but is an integral part thereof and contributes to its overall balance.”<sup>179</sup>

Indeed, this new approach is a very slippery slope towards the acceptance of a sovereignty exception, or a “placing above the law”, of tax treaties even if they go far beyond their essential mission of allocating tax jurisdiction and avoiding double taxation. A slippery slope on which a further step was set in *ACT Group Litigation*,<sup>180</sup> in which the Court considered *Limitation-on-Benefits* clauses to contribute to the reciprocal balance of rights and duties of tax

177. For criticism in the light of previous case law see e.g. Lang, “Das EuGH-Urteil in der Rechtssache D. – Gerät der Motor der Steuerharmonisierung ins Stottern?”, 15 *Steuer & Wirtschaft International* (2005), 365, at 372; Weber, “Most-Favoured-Nation Treatment under tax treaties rejected in the European Community: Background and analysis of the D Case – A proposal to include a most-favoured-nation clause in the EC Treaty”, 33 *Intertax* (2005), 429, at 436–437; van Thiel, “A slip of the European Court in the D case (C-376/03): Denial of the Most-Favoured-Nation Treatment because of absence of similarity?”, 33 *Intertax* (2005), 454, at 455–456; Lang, “Eine Wende in der Rechtsprechung des EuGH zu den direkten Steuern?” in Hebig, Kaiser, Koschmieder and Oblau (Eds.), *Aktuelle Entwicklungsaspekte der Unternehmensbesteuerung*, Festschrift Wacker (Erich Schmidt, 2006), p. 365, at pp. 370 et seq.; Cordewener and Reimer, “The future of Most-Favoured-Nation Treatment in EC Tax Law – Did the ECJ pull the emergency brake without real need?”, 46 *Eur. Tax.* (2006), 291, at 296; Lang and Dommes, op. cit. *supra* note 160, p. 61, at pp. 73 et seq. But see also de Graaf and Janssen, op. cit. *supra* note 171, 173, at 184, who distinguish *Saint-Gobain* from *D* according to the impact on third countries.

178. See the very thin and circular reasoning in *D* case, cited *supra* note 155, paras. 61–62; see also *ACT Group Litigation*, cited *supra* note 165, paras. 84–88.

179. *D*, cited *supra* note 155, paras. 61–62; see also *ACT Group Litigation*, cited *supra* note 165, paras. 84–88.

180. *ACT Group Litigation*, cited *supra* note 165.

treaties, even though they clearly carve up the Internal Market, thus closing a 15 year discussion in literature without any further motivation.<sup>181</sup> In fact, the Court allowed a different treatment of European companies on the basis of the place of residence of shareholders (control), which is *contra legem*<sup>182</sup> and at odds with general Internal Market case law.<sup>183</sup> It also causes the amazing discrepancy in its own income tax case law that foreign-owned branches are, under *Saint-Gobain*, entitled to the host State's tax treaty benefits, whereas foreign-owned subsidiaries can be excluded from those benefits. Finally, it is unclear why the Court did not follow its established approach on national anti-abuse measures, thus considering the Limitation-on-Benefits clause justified (only) to the extent it would restrict the use of wholly artificial constructions without economic substance that are set up with the only objective to avoid tax otherwise due.<sup>184</sup>

In conclusion, and with all due respect, it seems that the Court will have to take another thorough look at its case law concerning the relation between EC Treaty freedoms and tax treaties concluded by the Member States, if only to provide a convincing motivation for its rather dramatic departure from fundamental Community law principles, explicit provisions in the Treaty and settled prior case law. For the moment certain basic rules are clear. As explicitly confirmed in Article 293 EC, Member States are competent to conclude tax treaties and are free to select the connecting factors for allocating jurisdiction between them with a view to abolishing double taxation for the benefit of their

181. For further references see Van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in Search of Principles* (IBFD, 2002), 481–482; Kofler, op. cit. *supra* note 103, pp. 500–530.

182. Art. 294 EC explicitly provides that Member States must grant national treatment as regards the participation in the capital of companies and firms established in accordance with the EC Treaty articles on establishment.

183. In the 2002 “*Open skies*” decisions, the Court held that the nationality clauses in the bilateral agreements between the Member States and the United States, which restrict international traffic rights to the national flag carriers of the countries concerned, are contrary to the EC Treaty. See *Commission v. United Kingdom*, cited *supra* note 171; Case C-467/98, *Commission v. Denmark*, [2002] ECR I-9519; Case C-468/98, *Commission v. Sweden*, [2002] ECR I-9575; Case C-469/98, *Commission v. Finland*, [2002] ECR I-9627; Case C-471/98, *Commission v. Belgium*, [2002] ECR I-9681; Case C-472/98, *Commission v. Luxembourg*, [2002] ECR I-9741; Case C-475/98, *Commission v. Austria*, [2002] ECR I-9797; Case C-476/98, *Commission v. Germany*, [2002] ECR I-9855. For an analysis of this case law, also in the light of the “quota hopping” decisions concerning fishing quotas, see Kofler, “European taxation under an ‘open sky’: LoB Clauses in tax treaties between the U.S. and EU Member States”, 35 *Tax Notes Int’l* (2004).

184. As such, *Limitation-on-Benefits* clauses might be applied to pure tax treaty shopping constructions that use conduit companies without economic substance to ensure access to the tax treaties which would not have applied, had the income not been re-routed. For a detailed analysis of this approach see Kofler, op. cit *supra* note 103, pp. 516–526.

nationals.<sup>185</sup> The Court thus fully respects the way Member States shape their bilaterally agreed understanding of inter-jurisdictional equity. However, as regards the question of how to deal with tax treaty clauses that provide substantive benefits to taxpayers, rather than allocate jurisdiction between Member States, the Court will have to make a choice: it can either continue on its recent track set out in *D*<sup>186</sup> and *ACT Group Litigation*<sup>187</sup> that anything that is agreed in a tax treaty contributes to the bilaterally agreed balance of that treaty, and is, thus, beyond the reach of directly applicable Community law. This choice, however, gives a *carte blanche* to Member States to carve pieces out of the Internal Market; it reverses previous income tax case law and violates Article 294 EC; and it seems to go against fundamental principles of Community law, such as direct effect, primacy and the principle of good faith cooperation, which the ECJ has itself upheld in more than 50 years of case law. It also raises the question whether there are any reasonable grounds to reserve this “above the law status” to bilateral tax treaties, for the simple fact that all bilateral treaties are based on an assumed balance of rights and duties. As illustrated by other decisions, such as *Open skies*, this, for sure, is not “business as usual”.

The other option for the Court would be to reiterate its case law in *Avoir Fiscal*,<sup>188</sup> *Saint-Gobain*<sup>189</sup> and *De Groot*<sup>190</sup> so that Member States may shape inter-jurisdictional equity in tax treaties, but not distort taxpayer equity. This would imply that substantive tax treaty benefits cannot be granted on the basis of reciprocity, and that directly applicable private sector rights of free movement and non-discrimination continue to have priority over the reciprocal balance in rights and obligations of tax treaties. Even under this approach it is quite clear that the bulk of tax treaty clauses remain in the “safe area” to the extent they allocate tax jurisdiction or avoid double taxation.

### 3.3.3. *Non tax-treaty based “allocation of tax jurisdiction” to prevent “double dips” and tax base erosion: Extreme caution required*

This leads us to some further remarks on the question to what extent EC incompatible restrictions could perhaps be justified by the need to preserve the balanced allocation of tax jurisdiction between Member States. The issue has not only arisen in relation to tax treaties, but also in cases in which the unreserved

185. See e.g. *Gilly*, cited *supra* note 162, paras. 24 et seq.; *Saint-Gobain*, cited *supra* note 28, para 56; *De Groot*, cited *supra* note 39, para 93; Case C-513/03, *van Hiltten-van der Heijden*, [2006] ECR I-1957, para 47; *ACT Group Litigation*, cited *supra* note 165, para 52.

186. *D*, cited *supra* note 155.

187. *ACT Group Litigation*, cited *supra* note 165.

188. *Commission v. France* (“*Avoir Fiscal*”), cited *supra* note 1.

189. *Saint-Gobain*, cited *supra* note 28.

190. *De Groot*, cited *supra* note 39.

application of Community law would jeopardize the right of Member States to exercise their tax jurisdiction in respect of domestic source income realized by residents, because taxpayers in cross-border situations would have the (undue) possibility to avoid taxes or to deduct certain costs or losses twice ("double dip").

The question of a possible undue advantage for cross-border taxpayers, as a result of the unreserved application of Community law, in relation to a traditional rule on allocation of tax jurisdiction, had already arisen in *Schumacker*. In a straightforward discrimination analysis there was little doubt that Germany was covertly discriminating against inbound frontier workers because it refused them the personal and family deductions (different treatment) which it granted to residents (on grounds of residence), even though, in economic terms, the inbound frontier worker was competing with his resident colleague and thus for economic purposes substitutable (similar or comparable situations). The ECJ must have realized, however, that an unreserved application of Community law could result in an undue advantage for those frontier workers who could deduct their costs first in Germany (on the basis of Community law) and subsequently in Belgium (on the basis of national law). The ECJ could have chosen to ignore this issue, because Community law prohibits restrictions on cross-border economic activity, and would have the natural tendency to applaud advantages for cross-border situations as compared to domestic situations (reverse discrimination). Strictly speaking, if Member States consider such advantages undue they can take action, unilaterally or bilaterally, to repair their legislation. Nevertheless, the ECJ chose to incorporate the issue of undue advantage in its discrimination analysis by distinguishing inbound frontier workers with income in their home State (and thus the possibility to deduct their costs in the residence State) from inbound frontier workers without income in their home State (who, like resident workers, can only deduct their costs in the work State). It held that inbound frontier workers with income in their home State were not in a comparable (ability to pay tax) situation to German workers, with the effect that they cannot, on the basis of Community law, claim the right to deduct their costs in the work State. Inbound frontier workers without income in their home State, on the other hand, were considered to be in a comparable situation to their German colleagues in that they could only deduct their costs in the work State. Interestingly, therefore, out of respect for the traditional international tax law choice to primarily hold the residence State responsible for the deduction of personal and family expenses, the ECJ elaborated an extended similarity test for frontier workers (objective economic factors and subjective ability to pay situation) compared with other cross-border tax situations (objective economic factors). This *Schumacker* criterion of comparability, i.e. whether the frontier worker earns

all his income in the work State and not enough income in the residence State to deduct costs there, has been applied consistently in subsequent case law.<sup>191</sup>

The question how to deal with a possible or potential undue advantage also arose in *Marks & Spencer*<sup>192</sup> concerning parent subsidiary relationships (in essence repeated in *Oy AA*<sup>193</sup> and *Lidl Belgium*<sup>194</sup> concerning head office branch relationships). In *Marks & Spencer*, the Court was asked to assess the UK's refusal to automatically and immediately extend domestic consolidation provisions to groups with foreign subsidiaries. Though the relevant national legislation was clearly discriminatory, the Court, confronted with several defence arguments, went beyond the usual isolated analysis of individual defences and considered three risks "taken together" when deciding whether the measure could be justified. A first risk of tax avoidance could occur if multinational companies would, by virtue of the unreserved application of the Community law prohibition of discrimination, have the possibility to bring all their European losses to the UK, while realizing their European profits outside the UK in low tax European tax jurisdictions. A second risk would be a distortion of the allocation of tax jurisdiction because the UK would, as a result of that tax planning or avoidance exercise, run the risk of no longer being able to exercise its tax jurisdiction over domestic source profits realized by residents, as these profits would all be compensated away by the losses of the foreign subsidiaries. A third risk would be that the losses would be deductible in the Member State of the parent (the UK), on the basis of Community law, and possibly a second time in the country of the subsidiary, on the basis of national law.

Unsurprisingly, when replying to the question concerning the EC compatibility of the UK refusal to extend group consolidation to foreign subsidiaries, the Court concluded that the UK measure *did* restrict outbound establishment, because it treated domestic parents with domestic subsidiaries better than domestic parents with foreign subsidiaries. Interestingly, the Court subsequently dealt with the above concerns when addressing the question whether the UK measure, even though in principle constituting an EC incompatible restriction, could nevertheless be justified by overriding public interest. In a first step, the ECJ decided that the UK was justified in not unreservedly extending its group consolidation benefits to UK groups with European (instead of UK) subsidiaries, because of the combination of the three different grounds of

191. *Schumacker*, cited *supra* note 31; see also e.g. *Wielockx*, cited *supra* note 7; *Asscher*, cited *supra* note 22; *Gilly*, cited *supra* note 162; Case C-391/97, *Gschwind*, [1999] ECR I-5451; *Zurstrassen*, cited *supra* note 67; *De Groot*, cited *supra* note 39.

192. *Marks & Spencer*, cited *supra* note 1.

193. *Oy AA*, cited *supra* note 165 (concerning group contributions).

194. *Lidl Belgium*, cited *supra* note 120 (concerning losses in treaty-exempt permanent establishments).

justification – the aim of preserving the allocation of the power to impose taxes, the danger that losses might be used twice and the risk of tax avoidance.<sup>195</sup> In a second step, the ECJ nevertheless found that a refusal to extend the benefits to UK groups with European subsidiaries would become disproportional in respect of “final” losses of the foreign subsidiary, which could not be offset anywhere else. Therefore, as the Court subsequently clarified for situations concerning cross-border group contributions and the utilization of treaty-exempt losses of foreign permanent establishments,<sup>196</sup> Member States may justify restrictions if the domestic measure is necessary to ensure, *first*, the balanced allocation of the power to tax and, *second*, the ability to exercise that power in respect of income realized on their own territory, which could be jeopardized by tax avoidance and possibility that the same losses could be deducted in two tax jurisdictions (“double dip”), even if tax avoidance is not an issue.<sup>197</sup> Indeed, from a policy perspective, there is no need for Community tax law to provide undue benefits to the private sector, such as double dips or possibilities of “loss trafficking”.<sup>198</sup>

However, it remains to be seen first, how and to what extent the ECJ will consider these grounds of justifications in their combination, and what weight will be given to each.<sup>199</sup> Second, unclear as of yet is in how far the acceptance of a “balanced allocation” is reasonable or just the “insidious impact of numerous statements made by the Member States’ governments, which complained about the significant budget repercussions of the ECJ’s ruling related to direct taxation”, as former Judge Wathelet has suggested.<sup>200</sup> Finally, even if the

195. *Marks & Spencer*, cited *supra* note 1, para 51; for a detailed analysis see the Opinion of A.G. Poiares Maduro in *Rewe Zentralfinanz*, cited *supra* note 72, paras. 24 et seq.

196. *Oy AA*, cited *supra* note 165, para 60; and *Lidl Belgium*, cited *supra* note 120, paras. 39–42.

197. See also the Opinion of A.G. Sharpston in *Lidl Belgium*, cited *supra* note 120, para 18.

198. Broadly, the Court had already used similar arguments in *Futura*, cited *supra* note 35 (where it accepted the Luxembourg rule that the permanent establishment of a French company could, in Luxembourg, only offset those losses that were related to the economic activity carried out in Luxembourg), *Schumacker*, cited *supra* note 31 (where it accepted, on the level of comparability, that the host State is not obliged to immediately and unreservedly allow frontier workers the deduction of their family related expenses, unless the frontier worker cannot deduct these expenses in the residence State for lack of income there), and again in *ACT Group Litigation*, cited *supra* note 165 (where it held that the UK should, as a general rule, not be obliged to extend its domestic imputation credit to foreign shareholders that are not taxed by the UK on their dividends, because otherwise the UK could effectively no longer tax domestic source profits of domestic companies).

199. For recent analyses of this question see the Opinion of A.G. Poiares Maduro in *Rewe Zentralfinanz*, cited *supra* note 72, paras. 24 et seq., and the Opinion of A.G. Sharpston in *Lidl Belgium*, cited *supra* note 120, paras. 8 et seq.; see also Wathelet, “*Marks & Spencer plc v Halsey: Lessons to be drawn*”, 53 *British Tax Review* (2006), 128, at 131–132; Lang, “*Direct taxation: Is the ECJ heading in a new direction?*”, (2006) *Eur. Tax.*, 421, at 426–427.

200. See Wathelet, op. cit. previous note, at 131.

“balanced allocation of tax jurisdiction” is capable of justifying a restrictive measure, the question is how the condition of proportionality would apply in such cases.

On the first point, it can be derived from subsequent case law that not all the three *Marks and Spencer* elements of justification need to be present simultaneously. The main concern that the Court considers worth protecting under this heading is the fact that a Member State would, without a restrictive measure, risk no longer being able to tax income generated on its territory (balanced allocation of tax jurisdiction), because that income would disappear as a result of private sector (avoidance) activities, irrespective of loss trafficking or claiming losses twice (double dips). In *OyAA*, the Member States argued that their basing themselves on the principle of territoriality and considering themselves entitled to tax income generated on their territory reflected the consensus on international allocation of tax jurisdiction (para 47). The ECJ, however, considered it sufficient that the balanced allocation of tax jurisdiction was jeopardized only by the possibility of loss trafficking.<sup>201</sup> In *Lidl Belgium* the national court asked whether the *Marks & Spencer* justifications should be understood as being cumulative (or whether the existence of only one of those factors would be sufficient), and the Court held, correctly in our view, that it was not necessary for all those justifications to be present simultaneously, and that, in that case, the contested tax regime could be justified in the light of two factors, namely the need to safeguard the allocation of the power to tax between the Member States and the need to prevent the danger that the same losses will be taken into account twice.<sup>202</sup>

On the second point, it seems that the Court’s key concern is that Community law should not interfere with any fundamental right of States to tax income generated on their territory to the extent a real consensus exists on the right to tax that income. We would argue that such a consensus only exists as regards the right of each State to tax domestic source income of residents. Member States should thus indeed be able to continue to tax the domestic source income of residents, and restrictive measures against tax avoidance activities that would undermine that right could be justified if proportional. Interesting for this understanding of the scope of this justification (income generated on its territory meaning domestic source income of residents) is the Court’s *Jobra* decision in late 2008.<sup>203</sup> *Jobra*, an Austrian company, acquired transport trucks and leased them to a German permanent establishment of another Austrian company. *Jobra* claimed an Austrian investment premium for the acquisition of the trucks, but this was refused on the ground that the trucks were not used

201. *Oy AA*, cited *supra* note 165, paras. 44–60.

202. *Lidl Belgium*, cited *supra* note 120, paras. 38–42.

203. Case C-330/07, *Jobra*, judgment of 4 Dec. 2008, nyrr.

by an Austrian establishment. Though this clearly constituted a prohibited discrimination, Austria relied on the “allocation of tax jurisdiction” defence to justify its restrictive condition by arguing that the advantage of the investment premium was given only if the subsequent income resulting from the use of the trucks could be taxed in Austria (hence the need for use by an Austrian establishment). The Court recalled previous case law that, in conjunction with other grounds of justification, the balanced allocation of the power to impose taxes between the Member States could be regarded as a legitimate requirement,<sup>204</sup> but it considered that justification not applicable. In fact Austria could tax the rental income (domestic source income) which *Jobra* (resident) generated by hiring out the transport trucks, and it could thus not claim that, without the contested legislation, its right to exercise its taxing powers in relation to activities carried on in its territory would be jeopardized (even though it could not tax the income generated abroad by the German enterprise that operated the leased trucks).<sup>205</sup>

Thirdly, even if a restrictive measure is justified to prevent the unacceptable possibility that a Member State could no longer tax the domestic source income of its residents, that measure must still pass the proportionality test. In view of subsequent case law, the *Marks and Spencer* position of the Court is in this respect perhaps surprising, as it takes into account the immediate effects of a negative judgment on Member States’ tax systems instead of requiring them to find less restrictive means (e.g. by foreseeing a recapture of losses once they have been utilized in the foreign jurisdiction),<sup>206</sup> while in other lines of case law the ECJ leaves it to the Member States to overcome negative decisions.<sup>207</sup>

204. *Ibid.*, para 32 with reference to *Marks & Spencer*, cited *supra* note 1, paras. 45, 46 and 51; *Rewe Zentralfinanz*, cited *supra* note 72, para 41; *Oy AA*, cited *supra* note 165, para 51; *Lidl Belgium*, cited *supra* note 120, para 42.

205. *Jobra*, cited *supra* note 203, para 33, with reference to *Marks & Spencer*, cited *supra* note 1, para 46, and *Rewe Zentralfinanz*, cited *supra* note 72, para 42.

206. See specifically *Marks & Spencer*, cited *supra* note 1, para 58, where the ECJ noted: “in so far as it may be possible to identify other, less restrictive measures, such measures in any event require harmonization rules adopted by the Community legislature”. See in this respect also the Commission’s Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States, COM(90)595 final, reprinted in O.J. 1991, C 53/30, in (1991) *Bulletin Supplement*, 55, and in 18 *Intertax* (1991), 34. This proposal was withdrawn in 2001 (see O.J. 2004, C 5/20) and the Commission has recently suggested a co-ordination approach in its Communication on “Tax treatment of losses in cross-border situations”, COM(2006)824 final. See, however, also the Opinion of A.G. Sharpston in *Lidl Belgium*, cited *supra* note 120, paras. 22 et seq., who was strongly in favour of a “deduction-and-recapture rule” in the case of treaty-exempt losses of foreign permanent establishments as the least restrictive measure.

207. See e.g. *de Lasteyrie du Saillant*, cited *supra* note 39, where the ECJ struck down a French exit tax provision without taking into account whether France was able to tax, on a

We believe that the outcome of this case law of the Court is rather balanced. While upholding their rights to free movement and non-discrimination, the Court clearly signals to taxpayers that it is reluctant to allow the use of Community law to enable them to obtain an undue advantage, for instance by claiming the same tax advantages in two Member States. As regards the Member States, the Court signals that Community law, though prohibiting the different tax treatment of similar domestic and cross-border situations, is not a threat to the basic understanding of international tax law that States are entitled to tax domestic source income of residents. It may be clear that this double meaning of the concept “balanced allocation of tax jurisdiction” must be applied with a considerable degree of caution in concrete cases.

A final point perhaps that urges caution on the future use of the concept of the balanced allocation of the power to tax as a ground of justification,<sup>208</sup> is the fact that in other cases in which Member States sought to rely on related arguments, such as the “territoriality” of a tax system, the Court was always rather reserved. In *Bosal*<sup>209</sup> and *Keller Holding*,<sup>210</sup> for instance, the Court did not accept arguments of “territoriality” to justify the discriminatory denial of deductions for financing costs for an investment in a foreign subsidiary either based on the taxability of the subsidiary or its profit distributions. Clearly these were unconvincing attempts to invoke the territoriality argument, because both in the domestic and the cross-border situation the profits of the subsidiary were, in effect, not taxed in the hands of the parent, while financing costs were deductible only in the domestic situation. Likewise, in *Rewe Zentralfinanz*,<sup>211</sup> the German tax authorities refused the deductibility of losses related to a write down to the book value of shares in foreign subsidiaries, whereas it accepted the deductibility of such losses on shares in domestic subsidiaries. Germany sought to justify this different treatment on grounds of “symmetry” of its tax system (i.e. no deduction of losses related to a foreign subsidiary, if its profits are not taxed). Unsurprisingly, in the light of *Bosal*, the Court refused to accept this. It noted that the profits of both the domestic and the foreign subsidiary were not taxable in the hands of the parent, but that only losses suffered on the book value of domestic shareholdings were deductible. Furthermore, the ECJ also pointed out that there was no risk of a double dip (losses of the parent could only be deducted in the State of residence of the parent), and that

subsequent sale of the asset, the appreciation in value that occurred while the taxpayer was a resident.

208. See e.g. *N*, cited *supra* note 70, para 42, and the analysis in the Opinion of A.G. Sharpston in *Lidl Belgium*, cited *supra* note 120, para 18.

209. *Bosal*, cited *supra* note 20.

210. *Keller Holding*, cited *supra* note 122.

211. *Rewe Zentralfinanz*, cited *supra* note 72.

even though fraud might be rampant in a certain sector, this was not enough to allow a Member State to assume the existence of a purely artificial arrangement.<sup>212</sup> Again in *Amurta*, the UK defended the Dutch withholding tax on outbound dividends with the argument that otherwise the Netherlands could not tax those dividends at all, which would be contrary to the balanced allocation of tax jurisdiction, hence presuming that the State of source can impose a withholding tax.<sup>213</sup> It is true that the Court recognized that the need to safeguard the balanced allocation of the power to tax between the Member States may be accepted, in particular where the system in question is designed to prevent conduct capable of jeopardizing the right of Member States to exercise their taxing powers in relation to activities carried on in their territory.<sup>214</sup> However, in that particular case the ECJ denied this justification and held that, once a Member State has chosen not to tax domestic corporate shareholders on the dividends received, it cannot rely on this argument to justify a withholding tax on dividends received by corporate shareholders established in other Member States.<sup>215</sup>

#### 4. Summary and conclusions

The preceding analysis can be summarized by noting that the Court, though readily assessing the broader public interest justifications argued by the Member States in the direct tax area, will be rather cautious in actually allowing discriminatory tax measures on such broad “rule of reason” grounds. It is settled case law, for instance, that these wider overriding public interests cannot be of an economic nature (including loss of revenue, erosion of the tax base, revenue coherence of the tax system). Nor does the Court accept the argument that a restrictive measure is necessary to avoid administrative difficulties. Tax authorities do have the right to ensure effective fiscal supervision and control, but this essentially means that they are fully entitled to seek, from the taxpayer or the other Member States, all information necessary to correctly apply their tax laws. They cannot for that reason exclude cross-border situations from a tax advantage that is available to similar domestic situations. Likewise, Member States cannot rely on (the risk of) tax avoidance to *a priori* exclude a cross-border situation from a tax benefit that would be available to similar domestic situations, because such a general *a priori* exclusion, without

212. *Ibid.*, paras. 34, 43 and 51.

213. Case C-379/05, *Amurta*, [2007] ECR I-9569, para 53.

214. *Ibid.*, para 58, with reference to *Rewe Zentralfinanz*, cited *supra* note 72, para 42; and *Oy AA*, cited *supra* note 165, para 54.

215. *Amurta*, cited *supra* note 213, para 59.

a case-by-case investigation, would constitute an unacceptable restriction on free movement.

On the other hand the Court has accepted certain “overriding public interests” on the basis of which Member States may justify a different tax treatment of domestic and cross-border situations. First of all, Member States may exceptionally rely on the systemic coherence of their national tax system to reserve a certain tax advantage exclusively to domestic situations, but only if the system is fully consistent and if the direct link between the tax advantage initially granted and a tax burden subsequently imposed under domestic tax law cannot be ensured in the cross-border situation.

Secondly, national anti-avoidance measures may exceptionally be allowed if they are specifically targeted at wholly artificial constructions without economic substance that seek to avoid the tax burden that would otherwise apply.<sup>216</sup> This typically concerns “letterbox” companies,<sup>217</sup> but excludes any companies that physically exist in the host State “in terms of premises, staff and equipment”.<sup>218</sup>

Thirdly, the Court accepts the need for a balanced allocation of tax jurisdiction between Member States and, for that reason, has shown great respect for tax treaties and for the basic understanding that a State should not be deprived of its right to tax domestic source income of residents. As regards tax treaties, which constitute an agreed balanced allocation of tax jurisdiction, the Court clearly accepts all conflict rules, i.e. rules that allocate tax jurisdiction, because they merely affect inter-jurisdictional equity, i.e. the division of revenue between Member States, without distorting taxpayer equity. In the same logic, the Court accepts the exemption and credit methods, because they serve to avoid double taxation in all cases in which the source and residence State share tax jurisdiction. The Court in *Denkavit Internationaal*<sup>219</sup> and *Amurta*<sup>220</sup> even recognized that a discriminatory withholding tax in the source State can be neutralized by an agreed credit applied by the residence State. However, the Court also decided that substantive tax benefits that are available on the basis of domestic law to domestic situations can not be granted to similar cross-border situations on the basis of reciprocity, i.e. only if provided for by a tax treaty.<sup>221</sup> Moreover, methods to avoid double taxation cannot be

216. *ICI*, cited *supra* note 16; *Marks & Spencer*, cited *supra* note 1; *Cadbury Schweppes*, cited *supra* note 39; *Oy AA*, cited *supra* note 165.

217. *Eurofood*, cited *supra* note 151, and *Cadbury Schweppes*, cited *supra* note 39.

218. *Cadbury Schweppes*, cited *supra* note 39.

219. Case C-170/05, *Denkavit Internationaal*, [2006] ECR I-11949, paras. 45–55.

220. *Amurta*, cited *supra* note 213, paras. 79–83.

221. *Commission v. France* (“*Avoir Fiscal*”), cited *supra* note 1; *Saint-Gobain*, op. cit. *supra* note 28.

applied in such a way that cross-border situations are worse off than similar domestic situations.<sup>222</sup>

A first general conclusion that can be drawn is that the Court's position on justifications for discriminatory tax measures has evolved in line with the broad cyclical pattern which developed in its income tax case law over the last 20 years. After an initial hesitant phase,<sup>223</sup> the Court arrived at a long intermediate period, lasting from the early 1990s until 2005, in which it has routinely applied Internal Market principles in the income tax area. Since 2005, however, the Court seems to have returned to a more prudent phase,<sup>224</sup> rearranging the relationship between fundamental private sector rights and the ways in which the Member States exercise their taxing powers, and becoming more cautious again in all the main questions that arise in each income tax case: whether Community law is applicable,<sup>225</sup> whether the contested tax measure constitutes discrimination,<sup>226</sup> and whether the continued application of that

222. *De Groot*, cited *supra* note 39.

223. See e.g. *Daily Mail*, cited *supra* note 97; *Bachmann*, cited *supra* note 7; Case C-112/91, *Werner*, [1993] ECR I-429.

224. See e.g. *D*, cited *supra* note 155; *Marks & Spencer*, cited *supra* note 1; *ACT Group Litigation*, cited *supra* note 165; *FII Group Litigation*, cited *supra* note 77; Case C-524/04, *Thin Cap Group Litigation*, [2007] ECR I-2107.

225. This is for instance true for the more dubious line of recent case law on taxpayer access to EC law, which broadened the exclusion of third country operators from the benefits of EC law, not only if they sought to have access directly from the third country to the EC market in the form of, e.g., inbound services or establishment (Case C-492/04, *Lasertec*, [2007] ECR I-3775; see also Case C-290/04, *Scorpio*, [2006] ECR I-9461, paras. 62 et seq.), but also as regards the intra-Community transactions between two group members who themselves were qualifying companies. In fact, the ECJ has gone so far as to qualify an intra-Community cross-border capital movement between two qualifying persons as an inward establishment into the Community by their common third country parent (*Thin Cap Group Litigation*, cited *supra* note 224, paras. 93–102). This new line is unsustainable in that it uses the control criterion, whereby qualifying persons who are engaged in an intra-Community loan and corresponding interest payment, risk being excluded from the scope of EC law if they are both controlled by a third country parent (for the prohibition of discriminatory rules that rely on the residence of the shareholders see, e.g., Case C-299/02, *Commission v. The Netherlands*, [2004] ECR I-9761, paras. 16–21). Moreover, the legal basis and reasoning for re-qualifying an interest payment between two EC companies as an inward establishment into the EU by their common third country parent is at least surprising. One can only hope that the ECJ will return to a more traditional approach towards third country persons (see e.g. Case C-1/93, *Halliburton*, [1994] ECR I-1137). This should, however, not affect the conclusion that neither inward establishment or supply of services from a third country into the EU, nor outbound establishment or supply of services from the EU towards a third country are eligible for EC Treaty benefits (until so provided for in the EU GATS schedule of commitments or bilateral treaties), which the ECJ also confirmed in recent income tax cases (see for a third country service provider, e.g., *Scorpio*, *ibid.*, paras. 62 et seq., and for a third country permanent establishment Case C-415/06, *Stahlwerk Ergste Westig GmbH*, [2007] ECR I-151).

226. This is for instance true for the decision of the Court in *D*, cited *supra* note 155, that horizontal discrimination does not constitute discrimination if it is based on differences in tax treaties. Another low point is the Court's decision in Case C-282/07, *Truck Center*, judgment of

measure can nevertheless be justified by overriding public interest grounds. Though applauded by Member States and part of academia as a correct rebalancing by the Court of “Internal Market interests” against the “tax sovereignty interests” of the Member States, a thorough analysis of the recent case law shows that this new caution has in most cases been unnecessary, while resulting in conceptual confusion and potential distortions of the Internal Market.<sup>227</sup>

Conversely, and that is our second general conclusion, two recent developments in the area of justifications are welcome. In the first place, recent case law on the tax avoidance justification is positive to the extent it permits restrictive national anti-avoidance measures that are specifically aimed at preventing the use of wholly artificial arrangements without economic substance with a view to circumventing national tax law.<sup>228</sup> The Court is developing a useful and balanced approach which will allow Member States to distinguish between genuine cross-border economic activities, including those that seek to benefit from a better tax climate abroad, and artificial tax avoidance and evasion constructions that would not exist if it were not for the objective of escaping home country taxes. Here, on the one hand, the ECJ in *Cadbury Schweppes*,<sup>229</sup> *Thin Cap Group Litigation*<sup>230</sup> and *Oy AA*,<sup>231</sup> and also the Commission in its recent communication on the application of anti-abuse measures in the area of direct taxation,<sup>232</sup> have made it clear that national anti-avoidance rules have to be “targeted at wholly artificial arrangements only,” while above all, it is crucial that taxpayers are given the opportunity to demonstrate, under judicial review, that their transactions served *bona fide* business purposes.<sup>233</sup> On the other hand, the ECJ has identified several factors that do not *of themselves* suffice to constitute abusive arrangements; among those factors are the mere fact that a subsidiary is established in another Member State,<sup>234</sup> the fact that the activities carried out by a secondary establishment in another Member State could just

22 Dec. 2008, *nyr*, that a withholding tax on outbound investment income flows does not constitute discrimination because from the point of view of the taxing State a resident and a non-resident taxpayer are not in a similar situation.

227. See the two previous footnotes.

228. For recent analyses see Lang and Heidenbauer, “Wholly artificial arrangements” in Hinnekens and Hinnekens, *op. cit. supra* note 20, p. 597, and Schön, “Rechtsmissbrauch und Europäisches Steuerrecht” in Kirchhof and Nieskens (Eds.), *Festschrift für Wolfram Reiß* (O. Schmidt, 2008), p. 571. See also the “Opinion Statement of the CFE ECJ Task Force on the Concept of Abuse in European Law”, 48 *Eur. Tax.* (2008), 33.

229. *Cadbury Schweppes*, cited *supra* note 39, paras. 51 et seq.

230. *Thin Cap Group Litigation*, cited *supra* note 224, paras. 72 et seq.

231. *Oy AA*, cited *supra* note 165, para 62.

232. See Commission Communication, cited *supra* note 153, and for comments De Broe, *op. cit. supra* note 153, 142.

233. Commission Communication, cited *supra* note 153, 7.

234. *Cadbury Schweppes*, cited *supra* note 39, para 50.

as well be pursued by the taxpayer from within the territory of its home State,<sup>235</sup> or that tax considerations play a role in the decision on where to establish a subsidiary.<sup>236</sup> Also, no formal guidelines on the concept “genuine substance” were laid down in *Cadbury Schweppes*, but the Court referred to a physical existence in terms of “premises, staff and equipment”<sup>237</sup> and, by way of example, mentioned “letterbox” or “front” subsidiaries.<sup>238</sup> Against this background of putting much emphasis on the freedom of taxpayers and an unhindered competition between the Member States’ tax systems,<sup>239</sup> it remains to be seen how the requirement that national anti-avoidance measures are targeted at wholly artificial arrangements only can be applied in practice, and in how far, if at all, this standard adds to the “normal” principles of attribution of income employed by the Member States.<sup>240</sup> In this respect it is, moreover, unclear why the Court chose not to apply this approach to anti-avoidance clauses in tax treaties, and, in particular, the limitation-of-benefit clauses. These clauses should not be allowed without limit and on the ground that they contribute to the balance of a tax treaty, but rather to the extent they actually affect only wholly artificial constructions, such as empty conduit companies that were set up only to have access to benefits provided in tax treaties that would otherwise not apply to the beneficial owner.

Secondly, the introduction of the concept of “a balanced allocation of tax jurisdiction” as a potential justification for infringements of Treaty freedoms is an interesting development. It has, however, multiple and diverse facets.<sup>241</sup> The ECJ not only employed this approach as regards the utilization of losses<sup>242</sup> or exit taxation,<sup>243</sup> but it also recognized that Member States can lift domestic measures up into the sphere of an agreed coordination of their tax systems, with the result that those tax measures are no longer EC incompatible. For instance, the imposition of withholding taxes is often a potentially discriminatory exercise, but if lifted up into a balanced allocation of tax jurisdiction

235. *Ibid.*, para 69.

236. *Ibid.*, para 65.

237. *Ibid.*, para 67.

238. *Ibid.*, para 58; see also, *Eurofood*, cited *supra* note 151, paras. 34 and 35. For a discussion, see e.g. Meussen, “*Cadbury Schweppes*: The ECJ significantly limits the application of CFC Rules in the Member States”, 47 *Eur. Tax.* (2007), 13, at 16 et seq.

239. *Cadbury Schweppes*, cited *supra* note 39, para 49.

240. See also Whitehead, “Practical implications arising from the European Court’s recent decisions concerning CFC legislation and dividend taxation”, 16 *EC Tax Rev.* (2007), 176, at 180 (“sham”).

241. See also Englisch, “Grundfreiheitsbeschränkungen zwecks Wahrung der Aufteilung der Besteuerungsbefugnis”, 17 *Steuer & Wirtschaft International* (2007), 399 et seq.

242. See e.g. *Marks & Spencer*, cited *supra* note 1, paras. 43–46; *Lidl Belgium*, cited *supra* note 120, paras. 30–33; see also *Oy AA*, cited *supra* note 165, paras. 54 et seq. and 62 et seq.

243. See, *N*, cited *supra* note 70, paras. 41–46.

under a tax treaty and matched with a credit in the State of the recipient of the income, it loses its discriminatory character.<sup>244</sup> If one were to accept an obligation to grant “Most-Favoured-Nation treatment”, the same would hold true for different withholding taxes applied in different bilateral situations: if not matched with credits, these would constitute discriminatory measures that distort free movement on the Internal Market, but if part of a balanced allocation of tax jurisdiction, the discrimination would be neutralized. Again, however, this justification does (and indeed should) have its limits, and the Court goes too far in accepting practically anything that Member States may foresee in a tax treaty.<sup>245</sup>

In this light it is not so clear what to think about the new line of case law developed by the Court since 2005 in cases such as *D* and *ACT Group Litigation*,<sup>246</sup> in which it held that substantive benefits can be granted on the basis of reciprocity because they form part and parcel of the balance of the tax treaty. Perhaps this exception to the rule only applies to allow differentiation between two cross-border situations (*horizontal discrimination*) and not between a cross-border and a domestic situation (*vertical discrimination*). Even so the question remains, however, whether this is a sustainable line in the Court’s case law. We believe it is not because these substantive benefits go beyond shaping inter-jurisdictional equity (which is about the allocation of revenue) and do affect taxpayer equity (which is about the actual tax burden on and thus ability to pay of the taxpayer). Therefore the new line of case law allows a differentiation between Internal Market participants on the basis of tax treaties contrary to the prohibition of discrimination. In view of the poor motivation for this dramatic change in course and the rather substantial inconsistency it creates in the Court’s case law, we believe that the Court should rethink this line in the future.

Nor should the need to preserve a balanced allocation of tax jurisdiction (which affects two tax systems) be mixed up with “coherence” or “territoriality” (which concerns only one tax system).<sup>247</sup> The Court should, therefore, not allow the Member States to fence off their tax systems and return to the idea of unlimited sovereignty, under which States are free to define tax jurisdiction

244. See *Denkavit Internationaal*, cited *supra* note 219, paras. 43–47, as well as *Amurta*, cited *supra* note 213, paras. 79–83; see also *ACT Group Litigation*, cited *supra* note 165, para 71.

245. See e.g. *D*, cited *supra* note 155; and *ACT Group Litigation*, cited *supra* note 165. In this respect the overall balance of the tax treaty depends on the allocation of tax jurisdiction between the contracting parties (the bilateral shaping of inter-jurisdictional equity which is neutral from an Internal Market point of view) but this should not be confused with tax treaty clauses which reserve substantive tax advantages for bilateral relationships and which discriminate against all other potential market participants (distorting tax payer equity).

246. *D*, cited *supra* note 155; and *ACT Group Litigation*, cited *supra* note 165.

247. Cf. in this respect Wattel, op. cit. *supra* note 118, pp. 139 et seq.

in a way that causes double taxation, that distinguishes between different incoming economic activities on the basis of their place or origin, or that treats domestic situations more favourably than similar cross-border situations. The Commentary to the OECD Model Convention is filled with this kind of “only mind your own business” rules, and while this is perfectly understandable in an international context, it is quite incompatible with a deep economic integration process such as that in the European Union.

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