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Georg Kofler, Alfredo Garcia Prats, Werner Haslehner, Volker Heydt, Eric Kemmeren, Michael Lang, João Nogueira, Christiana HJI Panayi, Stella Raventós-Calvo, Isabelle Richelle, Alexander Rust and Rupert Shiers*

# Opinion Statement ECJ-TF 3/2021 on the ECJ Decision of 19 March 2021 in *MK v. Autoridade Tributária e Aduaneira* (Case C-388/19) on the Option of Taxpayers to Avoid Discriminatory Taxation of Capital Gains

**In this CFE opinion statement, the CFE ECJ Task Force comments on the ECJ decision in *MK v. Autoridade Tributária e Aduaneira* (Case C-388/19) of 18 March 2021. The Court confirmed its previous case law and held that the Portuguese (optional) regime for taxation of capital gains from immovable property of non-residents was contrary to the free movement of capital under article 63 of the TFEU since non-residents were taxed less favourably than residents.**

## 1. Introduction

In this CFE opinion statement, submitted to the EU Institutions in November 2021, the CFE ECJ Task Force comments on the ECJ decision in *MK v. Autoridade Tributária e Aduaneira* (Case C-388/19), in which the First Chamber of the ECJ delivered its decision on 18 March 2021.[1] The decision deviated from the Opinion delivered by Advocate General Hogan, on 19 November 2021.[2] In *MK*, the Court confirmed its previous case law and held that the Portuguese (optional) regime for taxation of capital gains from immovable property of non-residents was contrary to the free movement of capital under article 63 of the TFEU since non-residents were taxed less favourably than residents. The fact that the domestic system provided for an election for non-residents to be treated as residents was not sufficient to consider the rule as compatible with EU Law.

## 2. Background and Issues

Optional tax regimes are not a common feature of domestic tax regimes. In this case, it was introduced as a sort of patch to circumvent the hurdles created by a previous court decision[3] that held that a Portuguese tax provision applicable solely to non-residents was incompatible with EU law. Instead of repealing or amending that provision, the Member State in question chose to offer non-residents the possibility of opting for the regime applicable to residents.

Traditionally, residents are taxed on a worldwide basis, whereas non-residents are taxed on the income sourced in that jurisdiction. Accordingly, residents are taxed on their global income, subject to progressive rates and their personal circumstances are taken into account, according to the ability-to-pay principle. In turn, non-residents are taxed on income that has an objective nexus to the jurisdiction, being taxed without regard to their personal circumstances.

This difference is justified by the understanding that it is up to the residence state to consider the individual's ability to pay, as only that state typically has a complete picture of the taxpayers' economic and personal circumstances (which still vary from country to country) and thus has to take them into account.

* Georg Kofler is Chair of this Task Force and Professor at the Institute for Austrian and International Tax Law of WU Wien; Alfredo Garcia Prats is Professor at the University of Valencia; Werner Haslehner is Professor at the University of Luxembourg; Volker Heydt is a Former official of the European Commission; Eric Kemmeren is Professor of International Taxation and International Tax Law at the Fiscal Institute Tilburg at Tilburg University; Michael Lang is Professor at the Institute for Austrian and International Tax Law of WU Wien; João Nogueira is Deputy Academic Chairman at IBFD and Professor at the Portuguese Catholic University; Christiana HJI Panayi is Professor at Queen Mary University of London; Emmanuel Raingeard de la Blétière is Associate Professor at the University of Rennes, Partner PwC France; Stella Raventós-Calvo is President of AEDAF and Vice-President of CFE; Isabelle Richelle is Co-Chair of the Tax Institute – HEC – University of Liège, Brussels Bar Elegis; and Rupert Shiers is Partner at Hogan Lovells. The authors are members of the CFE ECJ Task Force, formed by CFE Tax Advisers Europe. Although the Opinion Statement was drafted by the ECJ Task Force, its content does not necessarily reflect the position of all members of the group. The CFE ECJ Task Force was founded in 1997 and its founding members were Philip Baker, Paul Farmer, Bruno Gangemi, Luc Hinnekens, Albert Raedler† and Stella Raventós-Calvo. For further information regarding this opinion statement of the CFE ECJ Task Force please contact Prof. Dr Georg Kofler, Chair of the CFE ECJ Task Force or Aleksandar Ivanovski, Tax Policy Manager at info@taxadviserseurope.org.

1. PT: ECJ, 18 Mar. 2021, Case C-388/19, *MK v. Autoridade Tributária e Aduaneira*, Case Law IBFD.
2. PT: Opinion of Advocate General Hogan, 19 Nov. 2020, Case C-388/19, *MK v. Autoridade Tributária e Aduaneira*, Case Law IBFD.
3. PT: ECJ, 11 Oct. 2007, Case C-443/06, *Erika Waltraud Ilse Hollmann v. Fazenda Pública*, Case Law IBFD.

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In general, this distinction is not problematic and is commonly accepted by the Court. The Court, however, also notes that insofar as residents and non-residents are considered objectively comparable in respect of a specific item of income, non-residents cannot be treated less favourably unless a (domestic) justification is pursued in a proportionate fashion.

One simple solution to such a disadvantage would appear to be to offer non-residents the possibility of opting for the same (worldwide-basis) regime applied to residents. As, however, this would require both an extension of the tax base and the burdensome task of providing the source state with additional information normally only available to the state of residence, it is not clear that it is an appropriate way to effectively remove the discrimination introduced by the default different treatment.

In *MK*, the Court took the opportunity to revisit its case law on this question and to clarify the criteria for the admissibility of optional regimes with EU law.

The facts of the *MK* case are simple. MK is a French national and resident who acquired real estate in Portugal. A couple of years later, and still as a French resident, he sold that real estate resulting in a considerable capital gain.

The Portuguese law applicable to the facts is also relatively straightforward. Residents were taxed only on 50% of the gain, with progressive rates ranging from 14.5% to 48% (subject to an eventual additional 2.5% or 5% "solidarity rate"). Non-residents were taxed on the full amount of the gain, but at a fixed rate of 28%. The latter, solely applicable to non-residents, was the provision at issue in *MK*.

The Court had already held this regime to be inadmissible in *Hollman* (Case C-443/06)[4] and *Teixeira* (Case C-184/18).[5] Instead, however, of repealing the regime (which continued to apply to non-residents by default), the Portuguese government merely added an option for non-residents to be treated as residents.[6] The latter would require them to disclose their worldwide income in order to allow for the determination of the correct bracket rate applicable to a domestically-sourced real estate gain.

In the corresponding annual tax return, MK declared the real estate gain as a non-resident but decided not to opt to submit the capital gain to the progressive rates applicable to residents.

Accordingly, the Portuguese tax authorities assessed him by applying the (fixed) tax rate of 28% to the full capital gain. MK appealed the assessment before the national (arbitration) tribunal, arguing that the assessment was based on rules that had already been considered incompatible with EU law in *Hollmann*.[7] The tax authorities argued that the regime was not entirely the same given the inclusion of an option – not used by the taxpayer – of being treated as a resident taxpayer. MK counterargued, claiming that introducing an optional regime does not remove the compatibility issues underlying the rules that were ultimately applied in his assessment.

The domestic Court had doubts on whether the inclusion of the optional regime was enough to overcome the previously flagged compatibility issues. Thus, it decided to stay the proceedings and refer the following question to the ECJ for a preliminary ruling:

> Should Articles [18, 63, and 65 TFEU] taken together, be interpreted as precluding national legislation, such as that in dispute in the present case [Article 43(2), of the CIRS], which was amended [by the insertion of paragraphs 9 and 10 into Article 72 of that code] to enable the capital gains realised from the transfer of immovable property situated in a Member State (Portugal) by a resident of another Member State of the European Union (France) not to be subject, by virtue of a choice made by the taxable person, to a tax burden greater than the one which would apply for the same type of transaction to capital gains realised by a resident of the State in which that immovable property is situated?

## 3. The ECJ Decision

In *MK*, the Court examined whether a Member State was allowed to retain a (previously held) incompatible tax regime insofar as it introduced, as an option, a tax regime that would – as a generally applicable regime – be compliant with EU law.

The Court started by determining the relevant provision of the Treaty on the Functioning of the European (TFEU) (2007)[8] for its assessment since the domestic Court had submitted its question under articles 18, 63 and 65 of the TFEU "taken together".[9] The Court concluded that the case should be assessed under article 63 of the TFEU regarding the free movement of capital.[10] It dismissed the application of article 18 of the TFEU (general prohibition against discriminatory treatment) since a more specific non-discrimination provision was applicable. It also rejected the application of article 64 of the TFEU, given the absence of any fact capable of triggering its application.

The Court proceeded to examine the breach of that freedom. The analysis was conducted solely considering one of the optional regimes (and not both of them, as proposed by Advocate General Hogan), namely, the default regime applicable to non-residents, which was compared with the regime applicable to residents.[11] In its examination, the Court took into account both the differences in the taxable basis and the applicable rates. It noted that the reduction in the taxable basis, combined with the application of the progressive scale of rates, would allow residents "to benefit systematically from a tax burden which,

4. *Hollman* (C-443/06).
5. PT: ECJ, 6 Sept. 2018, Order in Case C-184/18, *Fazenda Pública v. Carlos Manuel Patrício Teixeira*.
6. Actually, the text of the applicable provision merely provides for the application of the system of rates that would be applicable to residents, leaving open whether the deductions normally made available to residents would also be made available and in which circumstances or proportion.
7. *Hollmann* (C-443/06).
8. Treaty on the Functioning of the European Union of 13 December 2007, OJ C115 (2008), Primary Sources IBFD.
9. *MK* (C-388/19), at para. 18.
10. Recalling *Hollmann* (C-388/19), the Court held that the alienation of real estate had to be considered a movement of capital, falling under the purview of art. 64 TFEU.
11. And that could be applied to non-residents that opted for it.


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for that reason, is lower regardless of the tax rate applicable to the whole of his income".[12]

Therefore, and recalling *Hollmann*,[13] the Court concluded that in respect of "the sale of the same immovable property situated in Portugal, if capital gains are realised, non-residents are subject to a tax burden greater than that applied to residents and are consequently in a less favourable position than the latter".[14]

The Court distinguished the present case from *Hirvonen* (Case C-632/13),[15] wherein it dealt with a tax system in which residents were also taxed at progressive rates (and benefited from a tax-free allowance), whereas non-residents were taxed at a fixed rate. That system was considered as "compatible with EU law" since "the single rate [applicable to non-residents was] not higher than that which would actually be applied to the person concerned [if it were a resident], in accordance with the progressive scale, in respect of net income increased by an amount corresponding to the tax-free allowance".[16] The situation was different in *MK* since the assessed tax regime meant that "non-residents [were] systematically subject to a tax burden greater than that applied to residents".[17]

Accordingly, the Court concluded that the tax regime at stake constituted a restriction on the free movement of capital under article 63 of the TFEU.

The Court moved on to the analysis of the justifications. It started by recalling that, under article 65 of the TFEU, a restriction could only be considered admissible if it "either relate[s] to situations which are not objectively comparable" or if they are "justified by an overriding reason relating to the public interest".[18] This was not the case in *MK*. First, this is because residents and non-residents were objectively comparable[19] as: (i) real estate capital gains were designed as a specific category of income; (ii) such a category was assessed for both residents and non-residents; and (iii) the nexus was the same, i.e. the location of the taxable income in Portugal.[20] The Court also noted that the ratio legis for the reduction in half of the taxable basis of residents (namely avoiding "excessive taxation" of "income which is considered abnormal and fortuitous")[21] would equally apply in respect of non-residents. Second, there were no "overriding reasons in the public interest".[22] The Court has specifically dismissed any claim based on the coherence of the tax system since – and recalling its prior conclusion in *Hollmann* – it would not be possible to establish "a direct link between the tax advantage and the offsetting of that advantage by a particular tax levy".[23]

The Court did not forget the existence of an optional regime. Instead, however, of considering it as part of the assessed regime (or as a composite regime, as proposed by Advocate General Hogan),[24] it considered it autonomously. It concluded that the inclusion of a second (optional) regime was not "capable of excluding the discriminatory effects of the first of the two taxation regimes".[25] With reference to *Gielen* (Case C-440/08),[26] it held that "a national scheme which restricts a fundamental freedom (...) remains incompatible with EU law, even if its application is optional".[27] Accordingly, the Court concluded that the Portuguese tax rule on taxation of non-resident capital gains was incompatible with EU law.

## 4. Comments

### 4.1. Introduction

*MK* is the latest in a series of cases wherein the Court dealt with optionality, i.e. with the question of whether a certain tax rule can be considered as compatible with EU law, despite its restrictive features, taking into account that the taxpayer (i) has to opt for it; and (ii) is free to choose an EU-compliant option.

Previous case law has not been able to resolve all doubts regarding the admissibility of optionality. There is nothing better to illustrate this assertion than the difference of outcomes between the Opinion of the Advocate General Hogan and the decision of the Court.

*MK* raises several interesting issues besides its final outcome. In these comments, the authors deal with some of them, namely: (i) the different Court decisions on optionality; (ii) the difference between composite and alternative regimes; (iii) the difference between default and optional regimes; (iv) the elements that are considered in assessing the different treatment; (v) the legitimacy of extending worldwide income systems of taxation to non-residents; (vi) the wide tax policy implications; and, finally, (vii) some remaining open questions.

### 4.2. The decisions of the Court on optionality

Both the Advocate General and the Court acknowledged the existence of prior case law on the *thema decidendum*. Their interpretation of these cases is not, however, fully aligned. In this section, the authors review the relevant excerpts and examine how the Court interprets them.

In *Test Claimants in the FII Group Litigation*, the Court considered that "the fact that a national scheme which restricts the freedoms of movement is optional does not mean that it is not incompatible with Community law"[28] and that "a system which restricts the freedoms of move-

12. *MK* (C-388/19), at para. 29.
13. PT: ECJ, 11 Oct. 2007, Case C-443/06, *Erika Waltraud Ilse Hollmann v. Fazenda Pública*, Case Law IBFD.
14. *MK* (C-388/19), at para. 27.
15. SE: ECJ, 19 Nov. 2015, Case C-632/13, *Skatteverket v. Hilkka Hirvonen*, Case Law IBFD.
16. *MK* (C-388/19), at para. 31.
17. Id., paras. 28 and 31.
18. Id., para. 35.
19. Id., para. 36.
20. Id., para. 37.
21. Id., para. 39.
22. Id., para. 36.
23. Id., para. 41.
24. AG Opinion in *MK* (C-388/19), at para. 30.
25. *MK* (C-388/19), at para. 43.
26. NL: ECJ, 18 Mar. 2010, Case C-440/08, *F. Gielen v. Staatssecretaris van Financiën*, Case Law IBFD.
27. *MK* (C-388/19), para. 45.
28. UK: ECJ, 12 Dec. 2006, Case C-446/04, *Test Claimants in the Franked Investment Income Group Litigation v. Commissioners of Inland Revenue*, para. 162, Case Law IBFD.



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ment still remains incompatible with Community law, even though its application may be optional".[29]

In *Gielen*, it considered that the discriminatory nature of a regime "is not called into question by the argument that the option to be treated as a resident taxable person is capable of remedying the discrimination at issue",[30] even if the taxpayer was provided "with a choice between a discriminatory tax regime and one which is ostensibly not discriminatory".[31] In fact, "such a choice is not (...) capable of remedying the discriminatory effects of the first of those two tax regimes",[32] as the consequence "would be to validate a tax regime which, in itself, remains contrary to Article 49 TFEU by reason of its discriminatory nature".[33] Therefore, it held the legislation to be "discriminatory towards nonresident taxable persons, even though those taxable persons may opt for the regime applicable to resident taxable persons in order to benefit from that tax advantage".[34]

*Becker* revisited the issue and, referring to the two above-mentioned cases, concluded that "the fact that a national scheme which restricts the freedoms of movement is optional does not mean that it is not incompatible with Community law".[35] In fact:[36]

> [t]he existence of an option which would possibly render a situation compatible with European Union law does not, in itself, correct the illegal nature of a system, such as the system provided for by the contested rules, which comprises a mechanism of taxation not compatible with that law. It should be added that this is even more so in the situation where, as in the present case, the mechanism incompatible with European Union law is one which is automatically applied where the taxpayer fails to make a choice.

Seemingly in contrast, in *Hirvonen*, the Court accepted an optional rule that deviated from the standard regime offered to residents. Although it acknowledged that the specific optional rule for non-residents was prima facie discriminatory (i.e. it excluded them from the tax-free allowance offered by the standard regime), the option was still admissible since it did not lead to a less-favourable treatment overall. As the Court explained, the taxpayer:[37]

> would have paid higher taxes if she had opted to be treated like a resident taxpayer and thus to be subject to the ordinary taxation regime. That is why she opted for the taxation at source regime, governed by the special income tax law. Since she benefited from more advantageous taxation than that which would have been applied to her had she opted for the ordinary taxation regime, [she] cannot in addition claim a tax advantage which would have been granted to her under the ordinary taxation system.

A careful reading of the above-cited case law shows that the Court's case law on optionality appears to be quite consistent. In all cases: (i) the Court assesses each of the rules autonomously; and (ii) only accepts the optional *prima facie* restrictive regime (i.e. that deviates from the tax treatment granted to residents) if it does not lead to a worse treatment of the non-resident taxpayer.

### 4.3. Composite regime versus alternative regimes

In the Advocate General's view, the tax rules at stake were "part of a set of provisions, which, taken together, form a composite regime of capital taxation applicable to resident taxpayers".[38] Accordingly, assessing the compatibility with EU law required an overall assessment of both rules. Insofar as one of them provided an EU-compatible solution, the regime – as a whole – should not be struck down. In contrast, it would be beneficial to non-resident taxpayers, as they would be provided with the option to choose the regime most beneficial to them and "in a free market economy, it must be assumed that individuals act rationally".[39] This would have been a reasonable approach.

The Court took a different view and decided that each of the alternatives had to be examined separately. Furthermore, it considered that an option should be struck down as incompatible with EU law even though another fully EU-compliant one was offered.

This conclusion should be considered by both the Commission and the Member States when designing tax rules in the future, since it prevents them from adopting any solutions, even if on an alternative basis (and even if considered more favourable to the taxpayer), that are not fully EU-compliant. Taxpayers can never be left with an option that is not entirely EU-compliant even if it is considered to be more beneficial.

### 4.4. Nominal and effective rates, tax burden and compliance costs

In previous cases on optionality, the Court focused on a specific element of the tax regime and decided on the basis of that. For instance, in *Hirvonen*, the focus was placed on the nominal rate and on the tax-free allowance. In *MK*, and despite a reference to specific elements of the regime (namely, the reduction in the taxable basis for residents and the nominal system of rates), the Court did not consider any of those factors individually; instead, it determined the difference in treatment on the basis of the overall "tax burden".[40]

When determining the tax burden, the Court only took into account the financial stream. The assessment set completely aside any consideration of compliance costs (i.e. computing and declaring worldwide tax income in accordance with Portuguese tax rules). One should note that compliance costs are an essential part of the (tax) equation and may even justify an economically reasonable taxpayer to prefer a prima facie less favourable regime insofar as it reduces its compliance costs.

29. *Test claimants* (C-446/04), para. 195.
30. *Gielen* (C-440/08), para. 49.
31. Id., para. 50.
32. Id., para. 51.
33. Id., para. 52.
34. Id., para. 55.
35. DE: ECJ, 28 Feb. 2013, Case C-168/11, *Dr Manfred Beker and Christa Beker v. Finanzamt Heilbronn*, para. 62, Case Law IBFD.
36. *Beker* (C-168/11), para. 62.
37. *Hirvonen* (C-632/13), para. 45.
38. AG Opinion in *MK* (C-388/19), para. 30.
39. Id., para. 73.
40. *MK* (C-388/19), paras. 19, 28-31. The Advocate General referred to the notion of "effective tax rate", which, in this context, is the same. *See* AG Opinion in *MK* (C-388/19), para. 74.


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In this respect, the position of the Court differs from the views expressed by the Portuguese government and by Advocate General Hogan. The Court, however, has not even considered the discussion of whether the taxpayer's exercise of the option would lead to higher compliance costs, which might deter taxpayers to so choose. Indeed, those costs are a real problem in non-harmonized areas, such as direct taxation, where taxpayers are exposed to many different legal systems.

Advocate General Hogan's Opinion can be summarized as "choice is always good": insofar as there is an EU-compliant option, Member States should be allowed to adopt any other regimes. One should also take into account that the alternative (and non-discriminatory) option could be preferable to the taxpayer in light of such compliance costs. This, of course, assumes that "in a market economy [...] individuals act rationally".[41]

### 4.5. Neutralization of the differences by extending a worldwide system of taxation to non-residents

Advocate General Hogan considered it legitimate for a Member State to overcome discrimination by simply extending regimes conceived and applied to residents to non-residents. In his words:[42]

> Portugal could have simply decided, in the application of the Court's judgment in Hollmann, to require non-residents to declare, as residents are required to do, all their income in order to determine at which rate the capital gains resulting from the transfer of immovable property should be taxed. This would indeed have meant that the persons concerned would have had to fill in two tax returns, but this would have been the admittedly regrettable, yet nevertheless inevitable consequence in the absence of harmonisation, of the exercise in parallel by two Member States of their powers of taxation. Indeed, any other solution would amount in substance to a challenge to the fiscal autonomy of each Member State.

The proposal put forward by Advocate General Hogan may not have taken due account of the manner in which tax systems are currently designed and administered, namely in relation to data gathering and automatic exchange of information. In light of future technologic developments and EU initiatives, however, it might be easier for source states to gather information and support taxpayers to fulfil their reporting obligations.

### 4.6. Impact on tax policy

The decision in *MK* reduces Member States' scope of action in the design of tax rules for non-residents.

On the one hand, Member States cannot treat non-residents less favourably when they are in an objectively comparable situation. On the other hand, however, the extension of the tax regime designed for residents to non-residents may also not be adequate, as mentioned above.

In the authors' view, the decision in *MK* cannot be interpreted as requiring (or giving permission to) Member States to extend domestic tax regimes to non-residents in all circumstances (and to allow them to gather information on the individual's global income and expenses).[43]

In the current state of affairs, it continues to make sense to treat non-residents differently. Member States simply have to ensure that they are not treated less favourably than comparable residents. Of course, one could claim that this solution would be unfair and infringe the domestically protected equality principle, but this is a matter for equal treatment under domestic constitutional law.

*MK* urges Member States to revise their domestic laws to ensure that all of the options provided to non-residents lead them to a tax burden that is the same or more favourable than what would apply if they were residents.[44]

### 4.7. Open questions

Despite their clarifications, *MK* still leaves some open questions the solutions to which may require further consultation.

First, in *MK*, the non-EU compliant option was the default one. Non-resident taxpayers had to elect to avoid being taxed under that regime. This could raise the question of whether it matters whether or not the non-compliant option is offered as the default or the elective tax regime. In fact, if the taxpayer had to explicitly opt for the non-EU compliant regime, one could question if it should even be allowed to raise the issue of compatibility at all since it would be a *venire contra factum proprium*. It remains to be seen if the Court would reach the same decision if the default regime was compliant with EU law and the optional one was the non-compliant one.[45]

Second, it remains to be seen whether or not the Court will ever include in its assessment compliance costs and the impact those might have on taxpayers. And if it will ever consider a regime as incompatible with EU law that, at face value, substantively and procedurally is precisely the same for both residents and non-residents, but that factually exposes non-resident taxpayers to a significatively higher level of compliance/compliance costs in light of having to deal with multiple legal systems. At present, the Court straightforwardly prohibits non-EU compliant regimes, even if they are offered as an option to fully EU-compliant regimes and create a lower compliance burden for taxpayers. Indeed, the Court only interferes with the proce-

41. AG Opinion in *MK* (C-388/19), para. 73.
42. Id., para. 65.
43. Thus, the authors do not agree with the position of the Advocate General, expressed in para. 65 of his Opinion, that the Member State could have simply extended the regime designed for residents to non-residents requiring the latter "to fill in two tax returns" as, even if "admittedly regrettable", it would be the "inevitable consequence in the absence of harmonisation, of the exercise in parallel by two Member States of their powers of taxation. Indeed, any other solution would amount in substance to a challenge to the fiscal autonomy of each Member State" – AG Opinion in *MK* (C-388/19), para. 65.
44. Some countries still provide non-residents with the option of being treated as residents in the event that all or most of their income derives from domestic sources. Following *MK*, a taxpayer that has not opted for being treated as a resident, may claim that he was offered a route that was incompatible.
45. Likely, it would not matter since, as the Court acknowledged, the application of the default regime also required action by the taxpayer. *See* *MK* (C-388/19), para. 11.



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dural aspects (for example, filing requirements, proof, etc) if those are different for resident and non-resident taxpayers.[46]

## 5. The Statement

The CFE welcomes the decision, as it clearly refers to a case of unjustified discrimination. There are, however, some questions that remain open (and that the Court was not required to answer). The Court's decision in *MK* reinforces established case law that EU law prohibits the adoption of non-EU compliant regimes, even if offered as an option to fully EU-compliant regimes. Member States are still free to adopt optional regimes but have to ensure that each one of the routes that the taxpayer may elect does not lead to an unfavourable tax treatment.

The CFE stresses, however, that the creation of EU-compliant options should not necessarily imply that Member States simply extend the rules conceived for residents to non-residents, as such an extension may be both burdensome and disproportionate.

The CFE notes that *MK* may lead Member States to adopt simplified rules that end up treating non-residents more favourably. This should not be regarded as unfair taking into account that they will normally be again subject to taxation in the residence Member State, which is (traditionally) the one in the best position to assess a taxpayer's ability to pay a corresponding final tax burden.

46. *See*, for example, BE: ECJ, 21 Jan. 2010, Case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian State*, para. 71, Case Law IBFD, wherein the Court refers to the taxpayer's ability to provide evidence of any commercial justification in transfer pricing cases without being subject to "undue administrative constraints".

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**IBFD Head Office** Rietlandpark 301 1019 DW Amsterdam
P.O. Box 20237 1000 HE Amsterdam The Netherlands
**Tel.:** +31-20-554 0100 (GMT+1) **Email:** academic@ibfd.org **Sales:** sales@ibfd.org
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