Reporter
Richard Lyal*

Summary and conclusions

There is no provision of EC law on direct taxation which corresponds to article 24 of the OECD model convention (MC). The principle of non-discrimination (ND) is instead a central element of the Treaty freedoms: the free movement of persons and companies, the freedom to provide services and the free movement of capital. Those freedoms create obligations for all the Member States and direct effective rights for their citizens and companies.

That principle goes well beyond a simple prohibition of discrimination on grounds of nationality. The function of the Treaty freedoms is to contribute to the realisation of an integrated economy in which factors of production, as well as the fruits of production, may move freely and without distortion. That requires the elimination of rules which close off national markets from each other and exclude foreign competition. The Treaty freedoms thus entail a prohibition not only of overt or covert discrimination on the basis of nationality but more generally of national provisions which treat cross-border situations less favourably than domestic ones. Notably, this implies that Member States must not only ensure national treatment for persons coming from other Member States but also give their own residents freedom to do business in other Member States.

The basic principle is that a person or company who makes use of the Treaty freedoms in order to work, to do business or to invest in another Member State should not be made worse off thereby. Neither the home state nor the destination state may place such a person at a disadvantage by reason of their exercise of the Treaty freedoms. Where a taxpayer is treated differently in such circumstances, it is necessary first to determine whether he is in a comparable situation to the normal domestic taxpayer. If there is no objective difference in situation which is relevant for tax purposes, then the difference in treatment is contrary to Community law. If there is such a difference it is necessary to ensure that the difference in treatment is no greater than that which is justified by the difference in situation.

1. Introduction

There is no provision of EC law in relation to direct taxation which corresponds specifically to article 24 of the OECD MC with respect to taxes on income and

* Legal Adviser, European Commission

on capital. Yet the obligations laid on Member States by Community law comprise and go well beyond those set out in article 24.

There is little legislation in the European Community concerning direct taxes, and what there is principally governs certain aspects of relations between related companies.[1] In addition there are provisions establishing a form of roll-over relief in the event of cross-border restructuring[2] and rules on the taxation of savings,[3] aimed essentially at preventing tax avoidance.

Instead, the increasingly rich body of law on direct tax has been developed by the Court of Justice in its interpretation of the (directly applicable) fundamental economic freedoms laid down in the EC Treaty. Those freedoms incorporate and implement the underlying principle of ND set out in article 12 EC.[4] Article 12 itself is residual in character, applying only where the Treaty does not contain a specific rule.

Essentially the same freedoms apply in the European Economic Area by virtue of articles 28, 31, 36 and 40 of the EEA Agreement. They are interpreted in the same way as the EC Treaty freedoms by the Court of Justice and by the EFTA Court.

2. ND and the Treaty freedoms

According to article 12, first paragraph, "Within the scope of application of this Treaty, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited." The individual freedoms giving effect to the principle which are relevant to the present discussion are those on the free movement of persons and companies, the freedom to provide services and the free movement of capital.

2.1. The individual freedoms

The right of free movement enjoyed by workers, self-employed persons, companies and more generally, now, all citizens is contained in a series of provisions.

1 Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, Official Journal 1990 L 225, p. 6, as amended by Council Directive 2003/123/EC of 22 December 2003, Official Journal 2004 L 7, p. 41; Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, Official Journal 2003 L 157, p. 49. See also the Convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises (1990/436/EEC), Official Journal 1990 L 225, p. 10.

2 Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, Official Journal 1990 L 225, p. 1, as amended by Council Directive 2005/19/EC of 17 February 2005, Official Journal 2005 L 58, p. 19.,

3 Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, Official Journal 2003 L 157, p. 38.

4 In relation to art. 43 see Case 2/74 *Reyners* v. *Belgian State* [1974] ECR 631; arts. 39 and 49, see Case 13/76 *Donà* v. *Mantero* [1976] ECR 1333; arts. 43 and 49, see also Case 90/76 *Van Ameyde* v. *UCI* [1977] 1091; art. 56, see Case C-222/04 *Cassa di Risparmio di Firenze* [2006] ECR I-289.

The general right of free movement for individuals is laid down in article 18(1) EC: "Every citizen of the Union shall have the right to move and reside freely within the territory of the Member States, subject to the limitations and conditions laid down in this Treaty and by the measures adopted to give it effect."

That right, introduced by the Treaty of Maastricht in 1992, had been thought likely by some commentators to become the generally applicable rule for movement of persons, replacing, in practice, the rights previously confined to workers and other economically active persons. Recent case law, however, suggests that article 18(1) is, like article 12, to be regarded as a residual norm applicable only where the more specific rights do not apply.[5]

Those previously existing rights have given rise to significant bodies of case law. Article 39 sets out the rights of workers:

> "1. Freedom of movement for workers shall be secured within the Community.
> 2. Such freedom of movement shall entail the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment.
> 3. It shall entail the right, subject to limitations justified on grounds of public policy, public security or public health:
> (a) to accept offers of employment actually made;
> (b) to move freely within the territory of Member States for this purpose;
> (c) to stay in a Member State for the purpose of employment in accordance with the provisions governing the employment of nationals of that State laid down by law, regulation or administrative action;
> (d) to remain in the territory of a Member State after having been employed in that State, subject to conditions which shall be embodied in implementing regulations to be drawn up by the Commission.
> 4. The provisions of this article shall not apply to employment in the public service."

Article 43 sets out the rights of other economically active persons as well as companies:

> "Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.
>
> Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of

[5] See most recently the judgment of 11 September 2007 in Case C-318/05 *Commission* v. *Germany* (school fees), not yet reported, points 32–34.

the country where such establishment is effected, subject to the provisions of the chapter relating to capital."

Article 48 makes particular provision, in this respect, for companies and other legal persons:

"Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.

'Companies or firms' means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making."

Services are governed by article 49 EC, according to which:

"Within the framework of the provisions set out below, restrictions on freedom to provide services within the Community shall be prohibited in respect of nationals of Member States who are established in a State of the Community other than that of the person for whom the services are intended.

The Council may, acting by a qualified majority on a proposal from the Commission, extend the provisions of the Chapter to nationals of a third country who provide services and who are established within the Community."

Finally, article 56 provides for free movement of capital:

"1. Within the framework of the provisions set out in this chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.
2. Within the framework of the provisions set out in this chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited."

Some qualifications of that broad freedom are introduced by articles 57 and 58:

"Article 57
1. The provisions of Article 56 shall be without prejudice to the application to third countries of any restrictions which exist on 31 December 1993 under national or Community law adopted in respect of the movement of capital to or from third countries involving direct investment – including in real estate – establishment, the provision of financial services or the admission of securities to capital markets.
2. Whilst endeavouring to achieve the objective of free movement of capital between Member States and third countries to the greatest extent possible and without prejudice to the other chapters of this Treaty, the Council may, acting by a qualified majority on a proposal from the Commission, adopt measures on the movement of capital to or from

third countries involving direct investment – including investment in real estate – establishment, the provision of financial services or the admission of securities to capital markets. Unanimity shall be required for measures under this paragraph which constitute a step back in Community law as regards the liberalisation of the movement of capital to or from third countries.

Article 58

1. The provisions of Article 56 shall be without prejudice to the right of Member States:
   (a) 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;
   (b) to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.
2. The provisions of this chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.
3. The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56."

2.2. Evolution of the freedoms case law

While the underlying logic of the freedoms can be reduced to the concept of discrimination on grounds of nationality (its core principle according to article 12 EC), the Court's interpretation of the Treaty provisions is considerably wider in its scope. Indeed, a narrow interpretation of the freedoms confined to the simple application of that concept would fail to grasp the requirements of the internal market. As Advocate General Jacobs pointed out in *Phil Collins*,[6]

> "The fundamental purpose of the Treaty is to achieve an integrated economy in which factors of production, as well as the fruits of production, may move freely and without distortion, thus bringing about a more efficient allocation of resources and a more perfect division of labour."

That requires the elimination of discriminatory rules which, intentionally or not, close off national markets from each other and exclude foreign competition. In the view of some people, it requires the elimination even of ND rules where they create an unjustifiable barrier to market penetration.

[6] Joined Cases C-92/92 and C-326/92 [1993] ECR I-5145, point 10.

Thus from an early stage the Court held that the rules on equal treatment prohibited not only discrimination on the basis of nationality but also other forms of discrimination which have the same result, in particular that based on place of origin or residence. In *Sotgiu*,[7] it held that

> "The rules regarding equality of treatment … forbid not only overt discrimination by reason of nationality but also all covert forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result.
>
> … criteria such as place of origin or residence of a worker may, according to circumstances, be tantamount, as regards their practical effect, to discrimination on grounds of nationality …"

In the general case law on the freedoms, rules regarded as covert discrimination may include residence requirements, language requirements, requirements relating to qualifications and experience.

It has also been clear from an early stage in the development of the case law that in order to ensure the proper functioning of the internal market, the rules on equal treatment cannot be confined to preventing discrimination against economic operators coming from other Member States. A Member State may not apply measures which have the effect of preventing its own nationals from leaving to take up opportunities elsewhere.[8]

The general case law on the Treaty freedoms has even gone beyond the concept of discrimination to encompass measures regarded as ND restrictions on free movement. The *locus classicus* of this approach is the *Cassis de Dijon* case,[9] concerning German rules on minimum alcohol content of liqueurs (which applied without distinction to domestic and imported goods). While those rules could be thought to entail a form of discrimination (exclusion of foreign products manufactured according to different technical requirements), the Court treated the case as one of an obstacle resulting from disparities between the product regulations of different Member States. Such an obstacle, it held, was contrary to the relevant Treaty freedom (here, article 28 EC on the free movement of goods) unless the rule could be justified by overriding reasons based on the general interest. In examining the existence of a justification, the Court applies the principle of proportionality: the measures 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 that objective.[10]

The practical effect of the *Cassis de Dijon* ruling and its subsequent extension to trade in services[11] is to establish a form of mutual recognition of technical and other requirements.

This reasoning based on the existence of an unjustified obstacle has subsequently been extended to the free movement of persons and in some cases to wholly general rules which do not distinguish between domestic and cross-

7 Case 152/73 *Sotgiu* v. *Deutsche Bundespost* [1974] ECR 153, point 11.
8 See Case 81/87 *Daily Mail* [1988] ECR 5483, point 16.
9 Case 120/78 *Rewe* v. *Bundesmonopolverwaltung* [1979] ECR 649.
10 See Case C-19/92 *Kraus* [1993] ECR I-1663, point 32.
11 See Case C-76/90 *Saeger* v. *Dennemeyer* [1991] ECR I-4221.

border situations. At least in rhetorical terms, the obstacle-based reasoning has supplanted the Court's previous discussion of discrimination.

3. Early cases on direct tax

The application of those freedoms in the area of direct taxation was not explored until relatively late in the development of the European Community. Indeed, for a long time the view was widely held that since there was no provision in the Treaty aimed expressly at harmonisation of national provision on direct taxation, and since article 293 EC merely envisaged negotiations between the Member States with a view to eliminating double taxation, the freedoms did not apply in that area. It was not until 1987, in the *Avoir Fiscal* case,[12] that the Court of Justice was called on to decide that issue. The first cases decided by the Court under each of the freedoms give a flavour of its approach.

3.1. Freedom of establishment

The *Avoir Fiscal* case concerned the imputation system formerly applied in France in relation to the taxation of dividends. Insurance companies whose registered office was in France were entitled to a credit for the tax paid by French companies in which they held shares; the French branches of insurance companies based elsewhere were not entitled to any such credit. In arriving at the conclusion that this difference in treatment was contrary to the freedom of establishment enjoyed by insurance companies from other Member States, the Court held (point 14 of the judgment) that

> "Article 52 [now article 43 EC] is thus intended to ensure that all nationals of Member States who establish themselves in another Member State, even if that establishment is only secondary, for the purpose of pursuing activities there as self-employed persons receive the same treatment as nationals of that state and it prohibits, as a restriction on freedom of establishment, any discrimination on grounds of nationality resulting from the legislation of the Member State."

It thus treated article 43 as a rule of national treatment: persons from other Member States are in principle to be treated in the same way as nationals of the host state. In the case of companies, the registered office is to be treated as the analogue of nationality.

The Court's judgment in *Avoir Fiscal* laid down a series of principles which have continued to characterise the case law. First, the Court rejected the general proposition that residents and non-residents were *ipso facto* in a different position and could thus be treated differently. As the Court pointed out, to accept such a proposition as a general rule would deprive the freedom of establishment of all meaning. While the distinction between residents and non-residents could justify

[12] Case 270/83 *Commission* v. *France* [1986] ECR 273.

different treatment in some circumstances, particularly in tax matters, the fact that the Member State placed them on the same footing for the purpose of taxing their profits implied that it should do the same when granting advantages related to that taxation.

The fact that foreign companies could procure equal treatment for themselves by establishing French subsidiaries rather than branches was not an excuse. Article 43 implies that the choice of form of establishment should not be restricted.

Nor is the absence of harmonisation any barrier to the application of the Treaty freedoms. While the tax position of a company naturally depends on the national law applicable to it, and that law will differ from one Member State to another in the absence of harmonisation, that does not justify differing treatment of companies by a single Member State.

Finally, the rights granted by article 43 EC are unconditional. A Member State may not make equal treatment subject to the provisions of a double taxation agreement (DTC) concluded with another Member State. In particular, rights under article 43 may not be made subject to a condition of reciprocity.

3.2. Free movement of workers

The Court applied the same reasoning a few years later in *Biehl*,[13] the first tax case on the free movement of workers. A provision which refused repayment of over-deducted tax where a worker left the country was held to place non-resident workers at a disadvantage, since a resident who ceased work would be able to spread tax liability over the whole year. In its judgment, the Court reiterated the *Sotgiu* case law,[14] noting that measures which give preference to residents are likely to discriminate against foreign nationals.

The concern for covert discrimination and the practical effect of national measures displayed by the Court in *Biehl* was extended in *Bachmann*[15] to cover national provisions which, without explicitly creating different treatment for workers of foreign origin, nevertheless had the effect of placing them at a disadvantage. It held that a Belgian rule which allowed tax deduction for sickness and invalidity insurance contributions and for pension and life assurance contributions only where the contributions were paid to insurers established in that state was likely to operate to the particular detriment of foreign nationals. However, the Court considered that the difference in treatment was justified by the need to ensure cohesion in the tax treatment of contributions and subsequent benefit payments (see below, section 4.4, for a discussion of the possible justifications recognised by the Court).

3.3. Freedom to provide services

Bachmann also concerned freedom to provide services. The Court went on to say that the legislation in issue restricted the freedom to provide services. The fact

13 Case C-175/88 *Biehl* v. *Administration des contributions du Grand-Duché de Luxembourg* [1990] ECR I-1779.

14 *Op. cit.*

15 Case C-204/90 *Bachmann* v. *Belgian State* [1992] ECR I-249; see also Case C-300/90 *Commission* v. *Belgium* [1992] ECR I-305.

that a tax deduction was granted only in respect of premiums paid to an insurer established in the Member State would tend to dissuade potential customers from approaching insurers established in another Member State, and thus restrict the freedom of those insurers to provide services. It will be observed that the language used here is that of restriction rather than discrimination; see below, section 4.2, for further discussion of the Court's obstacle-based reasoning.

3.4. Free movement of capital

The provision now contained in article 56 EC came into force on 1 January 1994. Prior to that date, the free movement of capital was directly effective from 1 July 1990 under secondary legislation.[16] The first tax case on the free movement of capital was *Sandoz*,[17] which concerned a stamp duty charged on loan transactions recorded in a formal document. It appeared that within the Member State concerned, loans were frequently made with less formal documentation, so that it was possible to avoid payment of the duty. In relation to loans made by persons established outside national territory, however, less formal measures such as entry in the books of the lender were treated as equivalent to a formal document and thus triggered liability for the duty. Such a provision was held to discriminate against foreign lenders.

3.5. Free movement of citizens

Article 18 was inserted in the EC Treaty by the Treaty of Maastricht in 1992. It is of interest above all for persons who are economically inactive (including retired persons and students). The first tax case concerning the general freedom of movement for all citizens, examined in conjunction with article 12 on prohibition of discrimination, was *Schempp*,[18] on the possibility of a deduction from taxable income in respect of maintenance payments made to an ex-spouse who was resident in another Member State. Such payments were deductible in Germany, Mr. Schempp's country of residence, and as a corollary were taxable in the hands of the former spouse, though in view of the amount in issue no tax would actually have been charged. Mr. Schempp's former wife had moved to Austria, where no deduction was available for maintenance payments (but the payments were not taxable in the hands of the recipient). The Court considered that since the tax treatment of the payments received was different, the failure to grant Mr. Schempp the treatment he would have received had the payments been made to a person resident in Germany (or in another Member State in which such payments were taxable in the hands of the recipient) did not amount to discrimination contrary to article 12 EC. The financial disadvantage for Mr. Schempp resulted not from the unilateral act of Germany but from a disparity between the tax legislation of the Member States concerned.

16 Council Directive 88/361/EEC of 24 June 1988 for the implementation of art. 67 of the Treaty, OJ 1988 L 178, p. 5; for its direct effect, see Joined Cases C-358/93 and C-416/93 *Bordessa* [1995] ECR I-361.

17 Case C-439/97 *Sandoz* [1999] ECR I-7043.

18 Case C-403/03 *Schempp* [2005] ECR I-6421.

3.6. Uniform rule for all freedoms

While it has in the past been surmised that the content of the Treaty freedoms could differ, and cases such as *Bachmann* can give that impression (in so far as it contains separate analysis of free movement of workers and freedom to provide services), it now seems clear that there is a single, uniform rule governing the various forms of free movement. That rule is in substance, if not always in the language used, one of national treatment of ND.

4. Content of the ND rule

As the Court consistently points out in its judgments, direct taxation is a matter which lies within the competence of the Member States. However, they must exercise that competence consistently with Community law. The Court thus demonstrates its awareness of the need to have regard to the independence of the Member States in determining their tax policy while at the same time reconciling that independence with the needs of the single market. The instrument of an ND rule strikes the requisite balance between these interests.

4.1. Inbound and outbound movement

It is important to emphasise once again that the Community freedoms have two aspects. Member States are in principle obliged to accord national treatment to persons, services and capital coming from other Member States (and capital from non-member countries); equally, they must not create disadvantages for persons who wish to move, to provide or to receive services or to invest their capital in other Member States. As the Court put it in the *German School Fees* case,[19]

> "The provisions of the Treaty on freedom of movement for persons are intended to facilitate the pursuit by Community nationals of occupational activities of all kinds throughout the Community, and preclude measures which might place Community nationals at a disadvantage when they wish to pursue an economic activity in the territory of another Member State."

That passage now seems to be used as a general statement of the law in respect of both inbound and outbound movements.[20]

A useful illustration of the parallel application of free movement rules to inbound and outbound situations is the taxation of dividends. Member States may not tax dividends received by their residents from companies based in other Member States more heavily than those received from domestic companies.[21]

[19] Case C-318/05, *op. cit.*, point 114.

[20] See, for example, Case C182/06 *Lakebrink*, judgment of 18 July 2007, not yet reported, a case on taxation of non-residents decided from the perspective of art. 39.

[21] See Case C-35/98 *Verkooijen* [2000] ECR I-4073; Case C-446/04 *Test Claimants in the FII Group Litigation* [2006] ECR I-11753.

Equally, they may not tax non-resident shareholders who receive dividends from domestic companies more heavily than resident shareholders.[22]

It may not always be clear just what is inbound and what is outbound. In the case of dividend payments, for example, the direction of the payment is probably the reverse of the protected freedom of movement (whether it is regarded as establishment, in the case of a controlling participation, or movement of capital). Nevertheless, the free movement of capital can be seen from two perspectives: as the Court noted in the *FII* case,[23]

> "Such a difference in treatment has the effect of discouraging United Kingdom-resident companies from investing their capital in companies established in another Member State. In addition, it also has a restrictive effect as regards companies established in other Member States in that it constitutes an obstacle to their raising of capital in the United Kingdom."

That is to say, capital transactions may be seen as an outward movement by investors or as an inward movement by companies seeking investment.

Similarly, in relation to the free movement of services, a Member State is obliged both to allow persons from other Member States to come and provide services and to allow its own residents to go and provide services elsewhere. It must also allow its residents to go to other Member States to receive services there[24] and allow persons from other Member States to come and receive services in its territory.[25] Here too, the notion of inbound and outbound movements is hard to define.

4.2. A rule about discrimination

In respect of inbound movement it is easy to think in terms of national treatment and to describe as discriminatory any failure to provide such treatment. As already noted, the unfavourable treatment of, for example, persons resident in other Member States may be considered equivalent to discrimination on the basis of nationality.

Outbound movement presents a conceptual difficulty in the sense that it is typically a state's own nationals who are moving to work or provide services in another country. Unfavourable treatment of them is hard to describe as discrimination on the basis of nationality. For that reason commentators have analysed the freedoms in terms of two rules: a rule of national treatment for inbound movement and a prohibition of restrictions on outbound movement. This reflects the language used by the Court:

> "Rules which preclude or deter a national of a Member State from leaving his country of origin in order to exercise his right to freedom of movement

22 See Joined Cases C-397/98 *Metallgesellschaft* and C-410/98 *Hoechst* [2001] ECR I-1727; Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I-11673; most recently, Case C-379/05 *Amurta*, judgment of 8 November 2007, not yet reported.

23 Case C-446/04, *op. cit.*, point 64.

24 Joined Cases 286/82 and 26/83 *Luisi and Carbone* [1984] ECR 377.

25 Case 186/87 *Cowan* [1989] ECR 195.

therefore constitute an obstacle to that freedom even if they apply without regard to the nationality of the workers concerned."[26]

Yet in determining whether a measure can be said to deter someone from making use of a Treaty freedom the Court essentially engages in a comparative exercise, assessing whether national legislation makes outbound movement less attractive than simply staying at home. For that reason it seems legitimate to regard the Court's interpretation of the freedoms as tantamount to a rule prohibiting discrimination against cross-border transactions or movement in comparison with purely domestic situations.

It is true that for some years now[27] the Court's case law on direct taxation, following the trend in its general case law on the freedoms, has adopted the language of restriction in describing the criteria which govern their interpretation. As already noted, the Court uses that language for both inbound and outbound situations.

Nevertheless, the Court's logic does not correspond to its language. In determining the existence of an obstacle to free movement, it consistently focuses on the existence of a difference in treatment between domestic and cross-border situations. For example, in *Safir*,[28] one of the first direct tax cases in which the language of restriction is used, the Court begins by saying that "Article 59 of the Treaty precludes the application of any national legislation which, without objective justification, impedes a provider of services from actually exercising the freedom to provide them."

It then says that "In the perspective of a single market and in order to enable its objectives to be attained, Article 59 of the Treaty likewise precludes the application of any national legislation which has the effect of making the provision of services between Member States more difficult than the provision of services exclusively within one Member State", before going on to examine the difference in treatment and its possible justifications.

In its most recent cases the Court continues to use the same approach: "That difference in treatment is likely to make it more difficult for those workers to exercise their rights under Articles 39 EC or 43 EC."[29]

It is clear, therefore, that what is in issue is not some abstract or inherent character of restrictiveness to be found in the legislation but a difference in treatment which is not justified. That is the logic of discrimination.

4.3. A far-reaching and pragmatic rule

As has been seen, the principle which underlies the case law in this field can be stated in simple terms: a person or company who makes use of the Treaty free-

26 Case C-318/05, *op. cit.*, point 115.

27 In his article "The search for the framework conditions of the fundamental EC Treaty principles as applied by the European Court to Member States' direct taxation", *EC Tax Review*, 2002, p. 112, Professor Luc Hinnekens places this change in 1997. It is worth observing that the 1997 *Futura* judgment (Case C-250/95 [1997] ECR I-2471) uses the two different approaches in respect of two aspects of the same case.

28 Case C-118/96 *Safir* [1998] ECR I-1897, see points 22 and 23.

29 Case C-318/05, *op. cit.*, point 117.

doms in order to work, to do business or to invest in another Member State should not be made worse off because of that. Neither the home state nor the destination state may place such a person at a disadvantage by reason of their exercise of the Treaty freedoms. Where a taxpayer is treated differently in such circumstances, it is necessary first to determine whether he is in a comparable situation to the normal domestic taxpayer. If there is no objective difference in situation which is relevant for tax purposes, then the difference in treatment is contrary to Community law. If there is such a difference, it is necessary to ensure that the difference in treatment is no greater than that which is justified by the difference in situation.

A striking example of the Court's concern for substantive equality of treatment is the line of case law beginning with *Schumacker*.[30] Mr. Schumacker was a Belgian resident who worked in Germany; virtually all his income was obtained from that employment, and his wife had little or no income. His employment income was taxed in Germany under the rules applicable to non-residents, which meant that he was not entitled to the basic tax-free amount or to the splitting tariff available to residents. In assessing the case, the Court accepted the general rule that personal allowances and the like were normally the responsibility of the state of residence. It noted, however, that to apply that rule in all cases would ignore the situation of persons with little or no income in their state of residence. The Court considered that such persons were in reality in the same position as residents from the point of view of the rationale of the rule, that is to say, the ability of the state to take into account personal circumstances and total income. Consequently, in order to ensure even-handed application of its tax system in accordance with the internal logic of that system, Germany was obliged to grant him the same tax benefits as a resident.

One aspect of *Schumacker* which is striking for a Community lawyer is precisely the way in which the Court accepts that it may be legitimate to treat residents and non-residents differently. In other areas of Community law such an idea would be anathema: normally it would *ipso facto* be contrary to the Treaty freedoms to treat persons differently because they were resident elsewhere or of a different nationality. The recognition by the Court of the role of residence (and in some cases even nationality) as a connecting factor in determining national tax competence demonstrates the way in which it has adapted its approach to the particular logic of tax systems.

The frequent invocation of this distinction by national tax authorities as a reason for different treatment and the attention devoted by the Court to the question whether residents and non-residents should be considered to be in a comparable situation for the purposes of the tax rule in issue emphasises the continued importance of the concept of discrimination, whatever the language deployed in the Court's reasoning.

In a pragmatic and realistic approach to the issue of discrimination the Court does not seek a precise comparison between a cross-border situation and an exactly corresponding domestic situation. The search for a precise analogue could

[30] Case C-279/93 *Schumacker* [1995] ECR I-225; see also Case C-169/03 *Wallentin* [2004] ECR I-6443; conversely, Case C-391/97 *Gschwind* [1999] ECR I-5453.

have anomalous results. For example, in *Commerzbank*[31] the Court held that to refuse to pay interest to non-residents in connection with refunds of overpaid tax when interest was paid on refunds to resident taxpayers was discriminatory. It rejected the argument that if Commerzbank had been a resident company it would not have been entitled to a refund in the first place, so that it was not in fact placed at a disadvantage in relation to residents. The important question was whether interest was payable on refunds, irrespective of the reason for the refund.

An interesting example of this issue may be seen in a pending case, *Deutsche Shell*,[32] which concerns tax relief for currency losses incurred on the sale of a foreign subsidiary. Some commentators have argued that in the absence of a convincing domestic comparator, a failure to grant relief cannot be said to amount to discrimination. However, such losses are a cost of doing business like any other. To give disadvantageous treatment to a cost which necessarily can arise only in a cross-border situation must surely be considered discriminatory.

4.4. Overriding reasons based on the general interest

In its tax case law as in the more general case law on the Treaty freedoms, the Court has (in applying the obstacle-based reasoning described above) accepted that a measure restricting one of the Treaty freedoms may be justified if the restriction is necessary and proportionate in order to protect an important public interest.

Examples of public interests which may override the freedoms, according to the general case law, are the protection of public health and of the environment, the fairness of commercial transactions and the defence of the consumer. In the tax field, the Court has recognised interests such as the effectiveness of fiscal supervision and prevention of tax avoidance. It is worth observing on the other hand that the interest in maintaining tax revenue has not been accepted as a justification.

In relation to the prevention of tax avoidance, the Court has made clear that the principle of proportionality requires careful attention. A restrictive rule is not made acceptable simply because it may assist in combating tax avoidance. In order to be justified from this perspective, the measure must be narrowly focused on situations that clearly do constitute avoidance, that is to say on "wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned".[33]

One concept which has given rise to considerable discussion is that of tax cohesion, which was first accepted as a justification in *Bachmann*.[34] That case concerned a German resident who moved to Belgium to work. He was already a member of an occupational pension scheme in Germany and wished to continue his membership. Belgium granted a tax deduction for such contributions, but only when they were made to Belgian schemes. The result was that Mr. Bach-

31 Case C-330/91 *Commerzbank* [1993] ECR I-4017.

32 Case C-293/06 *Deutsche Shell*; Opinion of Advocate General Sharpston delivered on 8 November 2006.

33 See Case C-196/04 *Cadbury Schweppes* [2006] ECR 7995, points 51ff., on CFC rules; Case C-524/04 *Test Claimants Thin Cap* [2007] ECR I-2107, points 72 ff.

34 *Op. cit.*

mann was denied a tax benefit to which other workers in his state of residence were entitled. The Court recognised the obstacle to free movement, but accepted the justification advanced by Belgium of tax cohesion: that is to say, the idea that the loss of revenue through the tax deduction must be offset by the right to tax the pension.

The concept of tax cohesion is frequently advanced but has not subsequently been successful, perhaps in part because its application in *Bachmann* rested on insufficient assumptions, in particular on the premise that the state granting relief for contributions will normally be the state competent to tax the resulting pension. In *Wielockx*[35] the Court noted that cohesion was assured at the level of the distribution of tax competence under applicable DTCs. In later cases it has often been said that in order for the justification to succeed there must be correspondence between a tax advantage and a later tax charge in the hands of the same taxpayer,[36] though in other cases the Court has arguably accepted the existence of cohesion between, for example, a tax charge on a company and a tax benefit for shareholders.[37]

The shade of *Bachmann* was laid to rest in recent infringement proceedings against Denmark and Belgium,[38] in which the Court recognised that there was no necessary correlation between the place where deductions were granted and the place where the person concerned lived in retirement. Yet the concept of cohesion remains an important one, for it recognises the importance of maintaining the internal logic and integrity of national tax systems. The concept of "balanced allocation of tax competence", accepted by the Court as a possible justification in *Marks & Spencer*,[39] may be regarded as a manifestation of tax cohesion.

For the purposes of the present discussion it is important to emphasise that the inclusion of these justifications in the Court's obstacle-based analysis is not inconsistent with the view that the application of the Treaty freedoms in the area of direct taxation rests on a concept of discrimination. Where tax cohesion does exist (that is to say, where a tax advantage is linked to a subsequent tax charge), it must be clear that someone who will not be subject to the tax charge is not in the same situation as someone who will. Equally, someone who has created an artificial structure in order to seek to avoid taxation is not in the same situation as someone who has not. In such cases there is an objective difference in situation which is relevant to the tax system and different treatment thus does not constitute discrimination.

4.5. The impact of DTCs

It is not always clear just how to treat DTCs from the perspective of Community law. Certainly, one of their objectives is to reduce (mainly juridical) double taxation, an aim which is consistent with economic integration. But their bilat-

35 Case C-80/94 *Wielockx* [1995] ECR I-2508.
36 Case C-422/01 *Skandia* [2003] ECR I-6817.
37 Case C-319/02 *Manninen* [2004] ECR I-7477.
38 Case C-150/04 *Commission* v. *Denmark* [2007] ECR I-1163; Case C-522/04 *Commission* v. *Belgium*, judgment of 5 July 2007, not yet reported.
39 Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, points 44–46.

eral, reciprocal logic and the manner in which they are applied may give rise to difficulties in relation to the freedoms.

The *Gilly* case[40] established the principle that in general, the Member States are free to allocate tax competence between themselves, and this allocation is not normally a matter with which Community law will interfere, even if it is based on criteria which are not usually considered to be acceptable grounds of differentiation (residence, nationality). That does not mean, however, that Member States are free to lay down rules of any kind in DTCs. They remain bound by Community law, which takes precedence over the terms of such conventions. In practical terms, they may allocate tax competence between themselves, but their exercise of their tax competence is constrained in particular by the prohibition of discrimination.

One of the first cases on the relationship between DTCs and Community law was *Saint-Gobain*,[41] which concerned the taxation of dividends from US and Swiss shareholdings received by the German permanent establishment of a French company. The Court held that in so far as non-residents were in a comparable situation to residents, they were entitled to all the tax benefits enjoyed by the latter, including those flowing from the application of DTCs. Accordingly, non-resident companies taxed in Germany were entitled to the double tax relief provided for in its conventions with the USA and Switzerland. The Court did not accept the argument that such a result would upset the balance and the reciprocity between the parties to the conventions; the extension of benefits to non-residents had no effect on the USA or Switzerland.

The Court has not, however, accepted that the logic of equal treatment demands that it take a further step and hold that non-residents are entitled to the benefit of any favourable provisions they may find in a DTC concluded by a Member State, irrespective of whether it relates to their own situation. Thus in the *D* case,[42] concerning wealth tax charged in the Netherlands on a holiday home there owned by a German resident, it did not accept the argument that the tax relief granted to Belgian residents by the DTC between the Netherlands and Belgium should be extended to all Community citizens. The Court considered that such a result (in effect, a sort of most-favoured nation clause) would disregard the particular balance of rights and obligations negotiated by the Member States concerned.

Some recent cases have raised the issue of the extent to which tax relief granted under DTCs can eliminate discrimination resulting from national provisions. It is not uncommon for a Member State to charge withholding tax on outbound payments of, for example, dividends in circumstances where it does not impose tax on residents. In *Denkavit*,[43] the Court left open the question whether a Member State could cure that discrimination by arranging for the Member State of residence of the shareholder to give a credit for the tax paid. In *Amurta*,[44] however, it has now recognised that such a solution will ensure compliance with

40 Case C336/96 *Gilly* [1998] ECR I-5453.
41 Case C-307/97 *Saint-Gobain* [1999] ECR I-6163.
42 Case C-376/03 *D* [2005] ECR I-5821.
43 Case C-170/05 *Denkavit International* [2006] ECR I-11949.
44 *Op. cit.*

Community law only if the tax charge in the source state is completely and systematically neutralised.

4.6. The limits of ND

An ND rule cannot solve all the problems faced by persons who engage in cross-border transactions. For example, a migrant worker may find that the tax burden is greater in the state of employment, or that tax advantages such as income splitting are not available there. More generally, persons and companies which work or do business across frontiers are faced with a range of tax problems, from additional administrative burdens to varying tax treatment of items of revenue. Disadvantages which are simply the result of differences between tax systems must be tolerated, and it should not be forgotten that such disparities may also work to the advantage of economic operators.[45]

As already observed, the general principle is that someone who goes to work or to do business in another Member State should not be made worse off because of his exercise of a Treaty freedom. Neither of the Member States involved may treat the person worse by reason solely of that fact. However, there is no obligation to adapt their tax systems in order to ensure that there is a seamless fit between them. That goes beyond what is possible through simple application of the Treaty freedoms and would instead be a matter for possible harmonising legislation.

It is not always easy to draw a clear line between what constitutes a discriminatory rule and what is simply an effect of the disparity between systems. One case which has given rise to a certain amount of adverse comment is *Gilly*.[46] Mrs. Gilly was a teacher with German and French nationality, resident in France, who taught in a state school in Germany. Under the applicable DTC, her income from employment (as a public servant of German nationality) was taxable in Germany. But it was also taxable in France (as the residence state), subject to a credit there for the tax paid in Germany. However, that credit was limited to the amount of tax which would be payable in France on the same income. Since the German tax scale was more steeply progressive and since Mrs. Gilly's personal situation was not taken into account in Germany for tax purposes, the French tax credit was very much less than the tax actually paid. As the Court held, that apparent disadvantage was nothing more than the consequence of the allocation of tax competence under the DTC.

5. Current trends

The great majority of the direct tax cases decided by the Court of Justice have resulted in a finding that the national measure in question was contrary to the Treaty freedoms. That was only to be expected if regard is had to the nature of the

[45] For a discussion of this topic, see the Opinion of Advocate General Geelhoed in Case C-374/04 *Test Claimants ACT*, *op. cit.*, points 37ff.

[46] *Op. cit.*

national rules which have been examined. Most cases have concerned clear discrimination against foreign taxpayers or cross-border transactions. That is not to say that the discrimination was deliberate. On the contrary, the main problem has been the inward-looking nature of tax systems, which are generally constructed with the purely national context in mind.

More recently, however, the Court has been faced with cases in which the way forward was less clear. One group of cases has dealt with complex schemes whose application across borders could disturb the balanced allocation of tax competence between Member States and potentially allow companies to manipulate the location of revenue in order to procure the application of the most favourable tax treatment. Thus in *Marks & Spencer*,[47] a case on group consolidation of income, the Court held that such a scheme should in principle be available to cross-border corporate groups but that a Member State was entitled to restrict its application in so far as was indispensable in order to prevent tax avoidance and protect its tax base. Similarly, in *Oy AA*[48] it held that the failure to extend a group contribution scheme to non-resident affiliates was a restriction of the freedom of establishment but that that restriction could be justified by the need to protect the tax base and to prevent gratuitous transfers of income to low-tax jurisdictions.

Other cases have concerned measures specifically designed to combat cross-border tax avoidance. Thus in *Cadbury*[49] the Court held that controlled foreign company rules under which the income of a (non-resident) subsidiary could in certain circumstances be attributed for tax purposes to a resident parent were compatible with the freedom of establishment in so far as they were confined to wholly artificial arrangements intended to escape the national tax normally payable. Similarly, in the *Thin Cap* case[50] it held that rules under which payments of interest made to a parent or other related company could be recharacterised as dividends were compatible with Community law where they were specifically targeted at abusive practices.

In those cases the difference in treatment accorded to cross-border situations in comparison with purely domestic situations reflects an objective, relevant difference in the circumstances, in that the problem of tax avoidance or of loss of the tax base arises only in the cross-border situation.

47 *Op. cit.*

48 Case C-231/05 *Oy AA*, judgment of 18 July 2007.

49 *Op. cit.*

50 *Op. cit.*; adding a nuance to the previous case law, Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779.