Chapter 8

Optimization by the ECJ in Direct Tax Cases: Assessment of Current Practice and Future Developments

8.1. Introduction

Part II has been devoted to the clash between national tax sovereignty and the requirements of the provisions of free movement in the TFEU. A theoretical optimization model has been submitted which should serve to optimize the principle of direct tax sovereignty and the principle of free movement. Part III of this study analyses the ECJ's case law in the light of this model. It will examine three things. First, it will be discussed how the ECJ decides tax cases at present. Second, it will be reviewed how this practice fits into the theoretical optimization model. To the extent that this practice does not fit into the model, an attempt will be made to provide an explanation for that. Third, to the extent that ECJ case law is insufficient to draw conclusions regarding the ECJ's stance on the model in direct taxation cases in certain situations, a proposal will be made on how the ECJ should decide these situations. Since there are already over 150 ECJ judgments in the area of direct taxation, not all of the case law can be discussed; not all 150 judgments can be confronted with the theoretical optimization model in extenso. I have, therefore, selected the judgments with the highest profile in tax literature, either because they reflect a particularly doctrinal stance of the ECJ or because they are regarded as controversial. The selection discussed hereafter provides, in my view, a good illustration of how the ECJ operates in direct taxation cases in the respective phases of the theoretical optimization model. The selection will discuss (i) case law which is in line with the theoretical optimization model, (ii) controversial case law which is nevertheless in line with the model and (iii) case law which is not in line with the model. It will not be discussed whether the cases in question are "right" or "wrong" if they are compared to each other, because that is not the purpose of the present part of this study: the purpose is to examine to what extent current ECJ case law fits into the theoretical optimization model and what future developments should be expected on a more general level.[430] I have decided to discuss the selected ECJ judgments in the phase of the model where they are the most relevant or interesting. In my view, this approach is the most reader-friendly way of presenting the findings of the present

430. As explained in 7.1., the present study does not claim that the theoretical optimization model necessitates only one solution in an individual case.

study; it would be a rather dull exercise to take 150 ECJ judgments all the way through the model. One may object that this approach does not show to what extent the selected judgments indeed essentially follow the approach presented in the model or can be structured by the model. I would not agree to such an objection because the elements of the ECJ judgments discussed in the various phases of the model reflect the most controversial parts of the judgment; elements which are far more easy to place in the model need not be discussed separately. The table in the appendix to this study shows which direct taxation cases would have been decided differently under the approach followed in the model.

8.2. Disadvantage identification or the scope of the principle of free movement in direct taxation cases

8.2.1. Current ECJ case law on direct taxation

8.2.1.1. Introductory remarks

In *Säger*, the ECJ held that the free movement provisions require not only the elimination of all discrimination on grounds of nationality but also the abolition of any restriction when it is liable to prohibit or otherwise impede economic activities.[431] Thus, a national measure that is liable to prohibit or otherwise impede economic activities restricts free movement *even in cases where there is no allegation of discrimination on grounds of nationality*.[432] Following this definition, the ECJ has, in its general non-tax case law, acknowledged three types of restrictions of free movement. First, there are national rules of a Member State regulating the pursuit of (economic) activities which are such as to place cross-border activity in conditions of *law* or of *fact* that are worse than those of domestic activity. Second, there are national rules of a Member State which directly affect *access* to the market by reason of their objective or effects.[433] This approach focuses on the more general question of whether a national measure is liable to prohibit or otherwise impede access to the market or exercise of free movement. Third, Arts. 49 and 54 TFEU guarantee that a company has the right to choose freely the legal form of a secondary establishment in another Member State:

431. Case C-76/90 *Säger*, Para. 12. See also Case C-19/92 *Kraus*; Case C-55/94 *Gebhard*, Para. 37, Case C-298/05 *Columbus Container Services*, Para. 34, and the case law cited there.
432. Case C-169/07 *Hartlauer Handelsgesellschaft*, Para. 33, and the Opinion of AG Sharpston in Case C-96/08 *CIBA*, Para. 39.
433. Opinion AG Tizzano in Case C-442/02 *CaixaBank France*, Para. 76.

a subsidiary or a permanent establishment. A differential treatment of those legal forms may constitute a restriction of the freedom of establishment.

In its case law on direct taxation, the ECJ has in practice applied the first type of restriction on free movement, although there are possibly a few exceptions.[434] The third type of restriction has also been recognized,[435] even in cases where a different treatment on the basis of the legal form of an establishment did not coincide with a disadvantageous treatment of cross-border activity.[436] Apart from this case law, according to the majority of scholars, a direct tax measure only constitutes a restriction on free movement if it treats a cross-border activity worse than a domestic activity: a discrimination approach.[437] A direct tax measure which does not lead to a disadvantage, either in law or in fact, for cross-border investment would in this view not constitute a restriction on free movement (see 2.2.4. of the present study). In his opinion in *Test Claimants in Class IV of the ACT Group Litigation,* AG Geelhoed noted that the ECJ frequently uses the language of "discrimination" instead of non-discriminatory "restrictions" in the context of the free movement provisions applied to direct taxation measures. The ECJ has consistently held these provisions to prohibit discrimination, both direct discrimination (i.e. measures differentiating overtly on nationality grounds) and indirect or "covert" discrimination (i.e. measures equally applicable in law but with a discriminatory effect in fact). In this regard, the ECJ has defined the concept of discrimination as the "application of different rules to comparable situations" or "the application of the same rule to different situations". The question of whether two cases are in an objectively comparable situation must be answered in the light of the object and purpose of the measure under consideration.[438] It is AG Geelhoed's view "that, in the direct taxation sphere, there is no practical difference between these two manners of formulation, i.e. 'restriction' and 'discrimination'."[439] AG Geelhoed stated his view even more clearly in his opinion in *Test Claimants in the Thin Cap Group Litigation*:

> [T]he concept of indistinctly applicable "restrictions" of freedom of movement used in the Court's general free movement case-law cannot meaningfully be

434. Possible exceptions include Case C-433/04 *Commission v. Belgium* and Case C-293/06 *Deutsche Shell*.
435. Case C-307/97, *Compagnie de Saint-Gobain*; Case 270/83, *Commission v. France (Avoir fiscal)*; Joined Cases C-439/07 and C-499/07 *KBC Bank*, Paras. 76-80.
436. Case C-253/03, *CLT-UFA SA*, echoed in Case C-231/05 *Oy AA*, Para. 40.
437. Kingston 2007b, p. 309, and Snell 2007, p. 349 et seq.
438. Case C-418/07 *Société Papillon*, Para. 27. This approach is also apparent in Case C-231/05 *Oy AA*, Para. 38.
439. Opinion AG Geelhoed in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation*, Paras. 35-36.

> transposed *per se* to the direct tax sphere. Rather, due to the fact that criteria for asserting tax jurisdiction are generally nationality- or residence-based, the question is whether the national direct tax measure is indirectly or directly discriminatory.[440]

Also, according to Wattel, the application of the approach of "non-discriminatory restrictions" does not seem to make much sense in direct tax cases.[441] *The question of whether this view is actually correct will be discussed below in 8.2.1.5. First, we will review the easier cases of disparity, double taxation and discrimination.*

8.2.1.2. *Disparities*

General remarks

As stated in 2.2.4., a consequence of the coexistence of discrete national tax systems is that disparities, or variations, exist between these jurisdictions.[442] For example, a Member State may choose to impose a relatively high tax rate within its jurisdiction. The existence of these disparities has inevitable distorting effects on investment, employment and, for companies and self-employed persons, establishment decisions. Possible distortions resulting from mere disparities between tax systems do not, however, fall within the scope of the EU free movement provisions in the TFEU.[443] The ECJ has consistently held:

> [t]hat, in prohibiting every Member State from applying its law differently on the ground of nationality, within the field of application of the Treaty, Articles [18, 49 and 56 of TFEU] are not concerned with any disparities in treatment which may result, between Member States, from differences existing between the laws of the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality.[444]

Accordingly, it is clear that the obstacles resulting from disparities may be contrasted with obstacles resulting from discrimination that occurs as a result of the rules of just one tax jurisdiction.[445] Discrimination and disparity are two concepts which are mutually exclusive. In a discrimination

440. Opinion AG Geelhoed in Case C-524/04 *Thin Cap Group Litigation*, Para. 48.
441. Terra and Wattel 2008, p. 344.
442. Opinion AG Geelhoed in Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation,* Para. 43.
443. Id., Para. 46. See also Case C-403/03 *Schempp,* Para. 45.
444. Case 1/78 *Kenny*, Para. 18; Case C-177/94 *Perfili*.
445. See Douma 2006, pp. 524-526.

analysis, both the situations to be compared should be wholly or partially located within the same jurisdiction. In cases of disparity, one of the comparable situations is wholly outside the jurisdiction of the state which is being accused of discrimination. It is important to note that the ECJ has accepted that Member States enter into tax treaties to allocate between themselves direct tax jurisdiction to avoid double taxation. If an allocation of jurisdiction to one of the Member States results in, for instance, a higher tax rate than that which would have applied in respect of an allocation of jurisdiction to the other Member State, the resulting disadvantage is the outcome of a disparity and is not a discrimination.[446] Similarly, a disadvantage not resulting from a change of jurisdiction by a certain tax treaty *rule* but by a change of *facts* – for example, emigration to another Member State – does not constitute a discrimination but is the consequence of a disparity. As the ECJ has held in *Lindfors*:

> [EU law] offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation. Given the disparities in the tax legislation of the Member States, such a transfer may be to the citizen's advantage in terms of indirect taxation or not, according to circumstance. It follows that, in principle, any disadvantage, by comparison with the situation in which that citizen carried on activities prior to that transfer, is not contrary to [Art. 21 TFEU], provided that the legislation concerned does not place that citizen at a disadvantage as compared with those already subject to such a tax ….[447]

In *Lütticke*, the ECJ held that Art. 110 TFEU regards "the legal relationships between the Member States and *persons within their jurisdiction*" (emphasis added).[448] This is also true in the area of State aid:

> 30. Under [Art. 107(1) TFEU] "any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in as far as it affects trade between Member States, be incompatible with the common market".
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> 31. This provision thus refers to the Decisions of Member States by which the latter, in pursuit of their own economic and social objectives, give, by *unilateral and autonomous* Decisions, undertakings or other persons resources or procure for them advantages intended to encourage the attainment of the economic or social objectives sought.[449] (emphasis added)

446. Case C-336/96 *Gilly*.
447. Case C-365/02 *Lindfors*, Para. 34. See also Case C-387/01 (*Weigel*), Para. 55. See, in relation to social security, Joined Cases C-393/99 and C-394/99 *Hervein and Others,* Para. 51.
448. Case 57/65 *Lütticke*.
449. Case 61/79 *Denkavit italiana*.

This is logical, because an advantage or a disadvantage for a taxpayer should be attributable to a Member State under the EU free movement provisions, State aid rules or the general EU principle of equality. Otherwise, it would be blamed for something out of its competence. *Porto Antico di Genova* concerned the Italian tax on the income of legal persons (IRPEG) and the Italian regional tax on production (IRAP). These taxes included grants paid by the Community Structural Funds in the assessment of taxable income. The taxpayer argued, inter alia, that the differences which existed between the beneficiaries of the Structural Funds, by reason of the different rates of taxation imposed in the Member States on amounts received by way of Community assistance, should be considered as being liable to breach the principle of equal treatment, which precludes comparable situations from being treated in a different manner unless the difference in treatment is objectively justified. The ECJ rejected this argument:

> For that to be the position, it would be necessary for the situations of the beneficiaries of Community aid to be comparable. That cannot be the case since those beneficiaries receive that aid in a socio-economic context specific to each Member State and, in the absence of Community harmonisation on the assessment of taxable income, objective disparities between the rules in Member States still exist in that field, thereby inevitably creating such differences between those beneficiaries.[450]

Again, disadvantages as a result of the fact that other rules apply in other tax jurisdictions are outside the scope of the principle of equality. In the same vein, Barnard has argued that, "once an individual has been admitted to the *territory* of a Member State he or she cannot be discriminated against on the grounds of nationality in respect of access to, or exercise of, a particular trade or profession."[451]

The reason why obstacles resulting from disparities are not a discrimination or discriminatory restriction is probably that the TFEU cannot compel a Member State to tax persons within its jurisdiction under the rules of another Member State. For example, a Netherlands resident company cannot argue that it should be taxed at a lower corporate income tax rate on the ground that a company resident in Estonia is subject to this low rate. After all, the Netherlands does not have the legislative jurisdiction to amend the Estonian tax rate to the Netherlands level. In other words, a taxpayer's claim for the extension of a rule to its own situation is outside the scope of the EU free movement provisions if the claim relates to the extension of a rule that was

450. Case C-427/05 *Porto Antico di Genova*, Para. 20.
451. Barnard 2010, p. 237.

not adopted by the legislator of the Member State involved. In respect of disparity in direct tax systems, the free movement provisions cannot be applied.

An illustrative example of a disparity under the Dutch principle of equality is provided by a judgment of the Dutch Council of State (acting in its capacity of Supreme Administrative Court). A flower shop in the Amsterdam district of *Bos en Lommer* could not set up a flower stall on the pavement due to a regulation of the district council. A competing flower shop on the other side of the street, however, was allowed to do so because it was located in another district (*De Baarsjes*); the district frontier runs exactly over the middle of the road. The flower shop argued that the advantageous treatment of its direct competitor infringed the principle of equality. The Council of State, however, decided that decisions of *De Baarsjes* cannot constitute obligations vis-à-vis *Bos en Lommer*.[452] The parallel with direct taxation in the European Union is evident.

Now I will give three examples from the ECJ's case law in the field of direct taxation in which discrimination could not be established because the disadvantageous treatment was the result of a disparity in national tax legislation.

Gilly

Mr and Mrs Gilly resided in France, near the German border. Mr Gilly, a French national, taught at a state school in France. Mrs Gilly, who was a German national with also French nationality by marriage, taught at a state primary school in Germany in the frontier area. With regard to the taxation of employment income, Art. 14(1) of the France–Germany tax treaty states that taxpayers receiving remuneration and pensions from the public sector are, in principle, taxable in the paying state if the taxpayer has the nationality of that state (this was the case because Mrs Gilly also had German nationality). In respect of double taxation, the tax treaty effectively provides for an exemption in France of the positive income that is, under the tax treaty, taxable in Germany. This exemption is achieved by granting to a French resident a tax credit that corresponds to the French income tax attributable to the income taxable in Germany. Consequently, the tax credit to be set off against the French tax may be less than the tax paid in Germany, as the tax scale in Germany is more progressive. French frontier workers taxed both in Germany, on income received there, and in France, on their total income after deduction of this tax credit, may therefore be taxed more heavily than persons receiving exactly the same income but only in France. Mr and Mrs

452. ABRvS 26 September 1996, AB 1996/483.

Gilly argued that the application of these provisions of the tax treaty resulted in unjustified, discriminatory and excessive taxation that was incompatible with the free movement of workers (Art. 45 TFEU), because the higher tax burden would not have occurred if Mrs Gilly had not had German nationality. In effect, Mr and Mrs Gilly contended that France should make good the increase of their tax burden, which was caused by the allocation of taxing power to Germany, by paying the difference between the German and French level of taxation. In so doing, Mrs Gilly would effectively be taxed according to the French rules, notwithstanding the fact that Germany had the jurisdiction to tax.

The ECJ stated that, while the abolition of double taxation within the Community is one of the objectives of the EC Treaty,[453] it must, however, be noted that no unifying or harmonizing measure for the elimination of double taxation had been adopted at Community level nor had the Member States concluded any multilateral convention to this effect under Art. 293 EC.[454] Accordingly, the Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation, by way, inter alia, of international agreements, and have concluded many tax treaties based, in particular, on the OECD Model Tax Convention. It is therefore clear that the various provisions of the tax treaty set out different connecting factors to allocate jurisdiction.

The ECJ observed that this differentiation cannot be regarded as discrimination prohibited under the fundamental freedoms, even if the criterion of nationality is used for the purpose of the allocation of fiscal jurisdiction.[455] Whether or not the tax treatment of the taxpayers concerned is favourable or unfavourable is determined not, strictly speaking, by the choice of the connecting factor, but by the level of taxation in the competent Member State, in the absence of any EU harmonization of scales of direct taxation.[456] Double taxation could only be fully avoided by a tax credit equal to the tax charged in Germany. The ECJ also observed that any unfavourable consequences in *Gilly* entailed by the tax credit mechanism were the result of the differences between the tax rates of the Member States concerned and, in the absence of any EU legislation in the relevant area, the Member States determined these rates.[457] In addition, if the Member State of residence had to grant a tax credit greater than the fraction of its national tax corresponding

453. Note that Art. 293 EC has been repealed in the TFEU.
454. Case C-336/96 *Gilly*, Para. 23.
455. Id., Para. 30.
456. Id., Para. 34.
457. Id., Para. 47.

to the income from abroad, it would have to reduce its tax in respect of the remaining income. This would entail a loss of tax revenue for the Member State and would encroach on its sovereignty in matters of direct taxation.[458]

As stated previously, Mrs Gilly's claim would effectively have resulted in taxation according to the French rules, notwithstanding the fact that Germany had jurisdiction to tax. The reason why the ECJ decided that Mrs Gilly was not discriminated against with regard to a person taxable in France was that France did not have the legislative jurisdiction to adjust the German tax rate to the French level. If Germany had applied a tax rate that was similar to the French tax rate, the differential treatment between French frontier workers taxable in Germany and persons receiving exactly the same income but only in France would disappear. Accordingly, the difference was the result of a disparity.

Schempp

Mr Schempp, a resident of Germany, paid maintenance to his former spouse resident in Austria. The deductibility in Germany of maintenance payments by a resident taxpayer to a recipient resident in another Member State was conditional on their being taxed in that other Member State. Because Mr Schempp's former spouse was not taxed in Austria on the maintenance payments, Mr Schempp could not apply for a deduction in Germany. Had she been resident in Germany or another Member State which does tax maintenance payments, the deduction would have been granted. Mr Schempp argued that this differential treatment infringes Art. 21 TFEU (freedom to travel and reside freely in the European Union).

The ECJ held first that the situation at issue falls within the scope of EU law. This decision was important because Mr Schempp had not exercised his right to freedom of movement. His former spouse, however, had exercised the right granted by Art. 21 TFEU to every citizen of the Union to move and reside freely in the territory of another Member State. Since the exercise by Mr Schempp's former spouse of a right conferred by the EU legal order had an effect on his right to deduct in his Member State of residence, such a situation cannot be regarded as an internal situation with no connection with EU law. The ECJ therefore went on to examine whether Arts. 18 and 21 TFEU preclude the German tax authorities from refusing deduction of the maintenance paid by Mr Schempp to his former spouse resident in Austria.[459]

458. Id., Para. 48.
459. Case C-403/03 *Schempp*, Paras. 22-26.

In that regard, the ECJ found it apparent that the unfavourable treatment of which Mr Schempp complains in fact derives from the circumstance that the tax system applicable to maintenance payments in his former spouse's Member State of residence differs from that applied in his own Member State of residence. The ECJ then reiterated that it is settled case law that Art. 21 TFEU is not concerned with any disparities in treatment, for persons and undertakings subject to the jurisdiction of the Union, which may result from divergences existing between the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality. It followed that the payment of maintenance to a recipient resident in Germany cannot be compared to the payment of maintenance to a recipient resident in Austria. The recipient is subject in each of those two cases, as regards taxation of the maintenance payments, to a different tax system. Consequently, the fact that a taxpayer resident in Germany is not able to deduct maintenance paid to his former spouse resident in Austria does not constitute discrimination within the meaning of Art. 18 TFEU.[460]

The differential treatment according to the place of residence of the recipient was therefore the result of a disparity in tax legislation. As a consequence, the principle of equality could not be applied. The German rule was, in itself, completely neutral. At the same time, EU law does not guarantee that the transfer of residence of Mr Schempp's former spouse will be neutral as regards taxation. Given the disparities in the tax legislation of the Member States, such a transfer may, or may not, be to Mr Schempp's advantage in terms of taxation, according to circumstance.[461]

Cassis de Dijon

As stated in the introduction to this section, all national rules of a Member State regulating the pursuit of (economic) activities which are such as to place cross-border activity in conditions of *law* or of *fact* that are worse than those of domestic activity constitute a restriction on free movement. Such discrimination can arise through the application of different rules to comparable situations or the application of the same rule to different situations.[462] The category of application of the same rule to different situations is often applied by the ECJ in situations where a state takes insufficient account of the fact that a good of person coming from another Member State has also

460. Id., Paras. 32-36.
461. Cf. Case C-365/02 *Lindfors*, Para. 34.
462. Case C-279/93 (*Schumacker*), Para. 30; Case 13/63 *Commission v. Italy (Italian refrigerators)*, Para. 4(a).