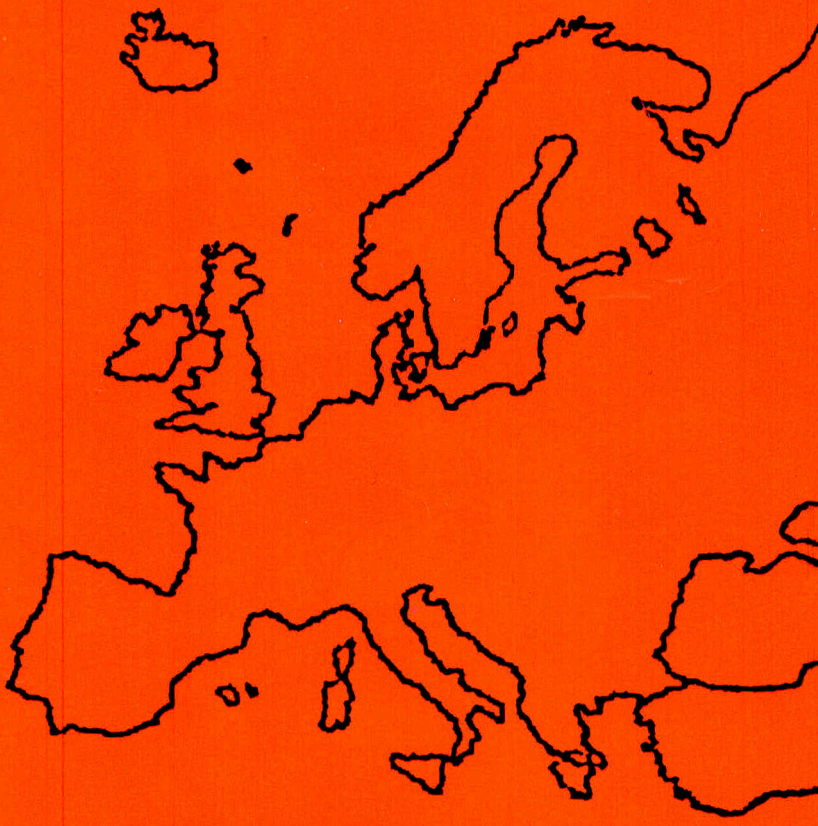
Maria Hilling

Free Movement and Tax Treaties in the Internal Market



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Jönköping, April 2005

Maria Hilling

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Abbreviations

BTR	British Tax Review (periodical)
Bulletin	Bulletin for International Fiscal Documentation (periodical)
CLJ	Cambridge Law Journal (periodical)
COM	Communication
CYELS	Cambridge Yearbook of European Legal Studies
CMLRev	Common Market Law Review (periodical)
EATLP	European Association of Tax Law Professors
EBLR	European Business Law Review (periodical)
EC	European Communities or Treaty Establishing the European Communities (in reference to Articles)
ECJ	Court of Justice of the European Communities
ECR	European Court Reports
ECTJ	EC Tax Journal (periodical)
ECTRev	EC Tax Review (periodical)
ed.	Editor or Edition
eds.	Editors
EEC	European Economic Community
ELRev	European Law Review (periodical)
ERT	*Europarättslig tidskrift* (periodical)
ET	European Taxation (periodical)
EU	European Union or Treaty on European Union (in reference to Articles)
EWS	*Europäisches Wirtschafts- und Steuerrecht* (periodical)
HST	Home State Taxation
IBFD	International Bureau of Fiscal Documentation
Ibid.	*Ibidem*

ICCLJ	International and Comparative Corporate Law Journal (periodical)
i.e.	*Id est*
IFA	International Fiscal Association
Intertax	International Tax Review
KStG	*Körperschaftsteuergesetz*
MFN	Most-Favoured-Nation
MTC	Model Tax Convention
no.	Number/Issue
OECD	Organization for Economic Co-operation and Development
OJ	Official Journal
p.	page
para.	paragraph
paras.	paragraphs
PE	Permanent establishment
pp.	pages
RTD eur	*Revue trimestrielle de droit européen* (periodical)
SITA	Swedish Income Tax Act [*Inkomstskattelag (1999:1229)*]
SN	*Skattenytt* (periodical)
SOU	Swedish Government Official Reports [*Statens Offentliga Utredningar*]
SvSkT	*Svensk Skattetidning* (periodical)
TNI	Tax Notes International (periodical)
Vol.	Volume
v	versus
WFR	*Weekblad for Fiscaal Recht* (periodical)
WRP	*Wettbewerb in Recht und Praxis* (periodical)
YEL	Yearbook of European Law

1 Introduction

1.1 The Subject

1.1.1 Impact of the Free Movement Rules on National Tax Law

The importance of the impact of free movement provisions[1] of the EC Treaty on EU Member States'[2] income tax legislation has grown steadily in the past years. The Court of Justice of the European Communities (hereinafter referred to as the ECJ or the Court) is continuously finding tax measures, which from a national and an international tax law perspective have been considered as perfectly acceptable, to be in conflict with the free movement provisions.

The reason for this development is the ambition to establish an internal market.[3] By interpreting the free movement provisions in relation to tax measures, the ECJ has found that Member States' tax provisions which have a restrictive effect on the free movement in principle are prohibited unless they can be legally justified.[4]

The EC Treaty contains no provisions for income taxes comparable to the provisions on consumption taxes.[5] Consequently, the Member States retain their competence in income tax matters. However, their competence is subject to the requirement that it is exercised "consistently with

[1] Primarily Articles 39, 43, 49 and 56 EC. When an article is followed by *EC*, it is an indication that the numbering of the EC Treaty, which took effect May 1, 1999, is used. When the previous numbering is used, the wording *of the EC Treaty* follows the number of the article. When referring to the EC Treaty as such in the text, the term EC Treaty is used.

[2] The Member States of the EU are as follows: Austria, Belgium, Denmark, France, Germany, Greece, Spain, Ireland, Italy, Luxembourg, The Netherlands, Portugal, Finland, Sweden, United Kingdom, Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia.

[3] See Articles 3 (1) (c) and 14 (1) EC.

[4] See chapter 5.

[5] For instance, see Articles 90–93 EC.

Community law".[6] To comply with this requirement, the Member States have to "avoid any overt or covert discrimination by reason of nationality".[7] To predict a tax measure's compatibility with free movement law, the essential question is under what circumstances a tax provision may conflict with the free movement provisions in the EC Treaty. This study aims at answering this question in relation to provisions in tax treaties concluded between EU Member States.

1.1.2 Avoidance of Juridical Double Taxation

EU Member States legislate unilaterally on national tax law. In order to solve situations where a taxpayer is subject to international juridical double taxation, countries conclude bilateral or multilateral tax treaties. Juridical double taxation is the imposition of comparable taxes in two or more states on the same taxpayer in respect of the same subject matter and for identical periods.[8] It arises because of the overlapping of tax claims between different states. For example, foreign income of a resident juridical person is often subject to taxation based on the principle of residence. However, it is most likely that also the state of source taxes the income as it has its source within its territory.

Due to the fact that juridical double taxation has a restraining impact on the development of economic relations between countries, most states regard it as desirable to remove, or at least reduce, international juridical double taxation.[9] Through a tax treaty, the contracting states undertake a joint effort to limit their respective national taxing jurisdictions with regard to cross-border transactions and investments. Tax treaties are normally concluded bilaterally. However, a multilateral treaty is concluded between the Nordic countries.[10]

Another purpose of concluding tax treaties is to fight tax evasion through providing a basis for cooperation between the tax administrations and to hinder certain types of discrimination between the contracting states.[11]

[6] Case C-80/94 *Wielockx* v *Inspecteur der directe belastingen* [1995] ECR I-2493, para. 16. For a study of Community competence in the area of social security and direct taxation, see Erhag, *Fri rörlighet och finansiering av social trygghet,* (2002).

[7] Case C-80/94 *Wielockx* v *Inspecteur der directe belastingen* [1995] ECR I-2493, para. 16.

[8] OECD MTC, Introduction OECD Commentaries, para. 1.

[9] *Ibid.*

[10] The recent Nordic convention was signed 23 September, 1996. The countries, which are parties to the convention, are Denmark, Sweden, Finland, Norway, Iceland and the Faeroes Islands.

[11] OECD MTC, Introduction OECD Commentaries, para. 16.

The special provisions in tax conventions normally deal with those issues.

The Organization for Economic Co-operation and Development (hereinafter referred to as the OECD) recommends its member countries to conclude tax treaties based on its Model Tax Convention (hereinafter referred to as OECD MTC, OECD Model or the Model).[12] Today, all EU Member States conclude bilateral tax treaties more or less based on the OECD Model.[13]

The basic aim of tax conventions is to reduce international juridical double taxation. Moreover, the ECJ has stated in the case *Gilly*[14] that the abolition of double taxation within the European Community (hereinafter referred to as the Community) is to be recognized as included among the objectives of the EC Treaty.[15] However, the main difference in this respect between the OECD and the Community is that the OECD is not taking the realization of the internal market into consideration when designing the Model. From a Community perspective, the realization of the internal market is one of the main means through which the objectives of the EC Treaty are to be fulfilled.[16] The objectives of the two organizations are comparable in respect of avoiding double taxation. Nevertheless, tax treaties between EU Member States based on the OECD Model could raise problems from an internal market perspective in general and with respect to free movement law in particular.[17] An illustration of consequences following the preclusion of a tax treaty provision under a free movement provision is provided in section 1.1.4 below.

[12] *Ibid.*, para. 13. The Community has a special status at the OECD as a full member, but without voting rights, and in that capacity the Commission represents the Community's interests as a whole, see *Tax Policy in the European Union – Priorities for the years ahead,* COM (2001) 260 final, p. 15.

[13] The following EU Member States are also members of the OECD: Austria, Belgium, Czech Republic, Denmark, Germany, Greece, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Finland, Sweden, Slovakia, Hungary, Poland and the United Kingdom. Latvia, Lithuania, and Estonia are countries which express their position with regard to the OECD MTC and its Commentaries even though they are not OECD member countries (see section 1.3). As it appears, countries which conclude tax treaties least influenced by the OECD Model are Cyprus, Malta and Slovenia. The reason is that those countries are neither OECD members, nor part of the group of non-member countries stating their position in regard to the Model and its Commentaries.

[14] Case C-336/96 *Mr and Mrs Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793.

[15] *Ibid.* para. 16.

[16] See Articles 2, 3 (1) (c) and 14 (1) EC. See also section 3.2 of this study.

[17] See Kemmeren, *Principle of origin in tax conventions – a rethinking of models,* (2001), pp. 120–121.

Article 293 EC obligates the Member States, in so far it is necessary, to enter into negotiations with each other with the view to securing for the benefits of their nationals the abolition of double taxation within the Community.[18] The ECJ has held that this provision does not have direct effect.[19] In the literature, it has been emphasized that the ECJ in the *Gilly* case underlined that the link between Community rules on the free movement and Article 293 EC only concerns the allocation of powers between the Community and the Member States.[20]

To facilitate the abolition of double taxation within the Community, the European Economic Community presented a preliminary draft on a multilateral convention in 1968.[21] However, this convention has not reached general acceptance. In fact, it never seems to have been the starting point for treaty negotiations.[22] Recently, the Commission has put forward possible approaches on how to solve the problems of EC incompatible tax treaty provisions. It has mentioned, for instance, the development of an EU Model tax treaty or the conclusion of a multilateral tax treaty between all EU Member States.[23]

[18] In the literature, Article 293 EC has been interpreted in different ways. One way of interpreting it is as an obligation for the Member States to enter into negotiations with the aim of concluding bilateral tax treaties (see, for instance, Kemmeren, *EC Law: Specific Observations* in Essers, de Bont & Kemmeren (eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law,* (1998), p. 19.) An alternative interpretation is that Article 293 EC refers both to bilateral and multilateral treaties but that the latter is more effective in order to abolish double taxation (see, for instance, Urtz, *The Elimination of Double Taxation within the European Union and Between Member States and Non-Member States – Multilateral Treaty or Directive?* in Lang *et al.* (eds.), *Multilateral Tax Treaties,* (1998), pp. 108–109, compare van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles,* (2002), p. 497).

[19] Case C-336/96 *Mr and Mrs Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 17, see also Case 137/84 *Criminal Proceedings against Mutsch* [1985] ECR 2681 para. 11.

[20] Pistone, *The Impact of Community Law on Tax Treaties*, (2002), p. 70.

[21] 1968 preliminary draft of a European double taxation convention (multilateral agreement of the Member States of the European Communities for the avoidance of double taxation on income and on capital and on multilateral assistance in the field of direct taxes) Text and final protocol and notes, EC Doc 11.414/XIV/618-D of 1 July 1968. See Maisto, *Shaping EU Company Tax Policy: The EU Model Tax Treaty,* ET 2002, p. 304 and Lang & Schuch, *Europe on its way to a Multilateral Tax Treaty,* ECTRev 2000, p. 40.

[22] See Lang, *The Concept of a Multilateral Tax Treaty* in Lang *et al.* (eds.), *Multilateral Tax Treaties*, (1998), p. 189 and Kemmeren, *Principle of Origin in Tax Conventions – A Rethinking of Models,* (2001), p. 6.

[23] See *An Internal Market without company tax obstacles – achievements, ongoing initiatives and remaining challenges,* COM (2003) 726 final, pp. 10–11. See also *Towards an Internal Market without tax obstacles,* COM (2001) 582 final.

1.1.3 Differences Between National Tax Law and Tax Treaties

Tax treaty provisions differ in four main respects from national tax provisions. First, tax treaties are international agreements between states. Second, a tax treaty restricts the contracting states' right to impose taxation on the basis of national law. Third, the vast majority of tax treaties in the internal market are based on the OECD Model. In this respect, the OECD Model has contributed to a harmonization which does not exist to the same extent in respect of internal tax legislation. Fourth, tax treaties concluded between EU Member States, also referred to as the tax treaty network between Member States, give rise to different treatment according to the place of residence of a person or company in the internal market.

It is interesting to notice that a bilateral tax treaty might be regarded as a legislative act that is applicable only in relation to persons who are residents in one specific state.[24] For instance, the tax treaty between Member State A and Member State B is only applicable to residents of the contracting states. Therefore, only persons resident in those two Member States can make use of the tax treaty benefits. Only Member State B's residents can benefit from the tax treaty reductions of Member State A's tax claims in respect of non-residents. It is possible that another tax treaty concluded by Member State A and another EU Member States involves less favourable reductions of its source tax. Accordingly, the place of residence determines the tax treatment in Member State A. Internal tax legislation does not differentiate in this way between non-residents from different countries. It generally differentiates between residents and non-residents only.

1.1.4 Impact of the Free Movement Rules on Tax Treaties

This thesis concentrates on the circumstances where tax treaty provisions may be considered as contrary to free movement law. Two questions may be asked in this context. *First*, tax treaties are generally in favour of taxpayers as they reduce the risks of double taxation. How is it then possible that a tax treaty provision could be contrary to the free movement provisions? *Second*, why is such a research topic relevant for further study?

To answer *the first question*, from the Court's case law on free movement, it is clear that the Court precludes tax rules that have a dissuasive effect with regard to the taxpayers' willingness to exercise their right to free movement.[25] If a person is liable to pay more tax when having foreign

[24] See Lang, *The Binding Effect of the EC Fundamental Freedoms on Tax Treaties*, in Gassner, Lang & Lechner (eds.), *Tax Treaties and EC Law*, (1997), p. 31.

[25] For instance, see Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819, paras. 78, 83–84 and Case C-18/95 *F.C. Terhoeve* v *Inspectuer van de Belastingdienst Particulieren/Ondernemingen Buitenland* [1999] ECR I-345, para. 40.

income than the corresponding domestic income, such an effect is evident.[26] Tax treaties are concluded with another basic aim.[27] They are concluded to prevent juridical double taxation. The question could, then, be whether an application of a tax treaty gives rise to a situation that is sufficient when evaluated under free movement law. Accordingly, there exist situations that raise doubts whether tax treaty provisions are in line with free movement law or not.[28]

To answer *the second question*, the following illustration is provided. If a tax treaty provision is found to be in conflict with a free movement article, and it could not be legally justified, it is rendered inapplicable.[29] Moreover, if such a tax provision is part of other tax treaties concluded between EU Member States, they are also inapplicable. If the tax treaty provision, which is precluded by a free movement provision, has been drafted closely to the OECD Model, it is most likely part of a vast number of tax treaties concluded between EU Member States. From this, it is clear that if the ECJ precludes a tax treaty provision under one treaty, it is possible that it has consequences for a vast number of tax treaties in the internal market.

Furthermore, the specific consequences following the inapplicability depend on the tax treaty provision at issue. For instance, the outcome of the *Saint-Gobain*[30] case is that residents of neither of the contracting states are, in certain situations, granted tax treaty benefits. It is possible that the inapplicability of a tax treaty provision gives rise to a situation

[26] See Lang, *The Binding Effect of the EC Fundamental Freedoms on Tax Treaties*, in Gassner, Lang & Lechner (eds.), *Tax Treaties and EC Law*, (1997), pp. 17–18.

[27] See section 2.2.

[28] For analysis of such situations, see sections 6.4–6.6 and chapter 7.

[29] That a national measure conflicting with directly applicable Community legislation is inapplicable was first established in Case 106/77 *Amministrazione delle Finanze dello Stato* v *Simmenthal SpA* [1978] ECR 629 paras. 17–18, 21–22. A tax treaty provision in conflict with free movement law is described by de Bond, Essers and Kemmeren as being "not binding and can therefore not be enforced on a tax payer", see Essers, de Bont, & Kemmeren (eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law*, (1998), p. 213. The ECJ may determine that a free movement provision conflicts with the application of a provision of a tax treaty. See Case C-336/96 *Mr and Mrs Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161 and Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819. See also Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law. The Rules*, ECTRev 1994, p. 162, Farmer, *EC Law and Double Taxation Agreements*, ECTJ, vol. 3, 1999, issue 3, p. 140 and Lehner, *Limitation of the national power of taxation by the fundamental freedoms and non-discrimination clauses of the EC Treaty*, ECTRev 2000, p. 6.

[30] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161.

that deviates considerably from what the contracting states bilaterally agreed on when concluding the tax treaty. A possible consequence of such a judgment by the ECJ would be that EU Member States consider a renegotiation of the treaties at issue. A more drastic measure would be for the Member States to terminate the tax treaties affected and rely on their unilateral rules for avoidance of double taxation. This implies a less favourable situation in the internal market as regards the avoidance of juridical double taxation.

The potential far-reaching consequences following the preclusion of tax treaty provisions in conventions concluded between EU Member States justifies an analysis of this topic. It is of importance, primarily, for taxpayers and governments of the Member States to predict when a provision in a tax treaty may be in conflict with free movement law. This study aims at providing guidelines for such an analysis.

1.2 Aim of the Study and Delimitation

The aim of this study is to establish the impact of the free movement articles on tax treaties concluded between EU Member States in the light of the Court's case law. The main question of this analysis, being of an intra-European character, is under which circumstances provisions, contained in tax treaties concluded between EU Member States, might be in conflict with the free movement provisions in the EC Treaty. This does not signify that all different types of tax treaty provisions found in the OECD Model are dealt with. The Court's statements in its case law are analysed and conclusions are made based on these statements. The result is that conclusions on the compatibility with free movement rules of, for instance, Article 25 on mutual agreements, Article 26 on exchange of information and Article 27 on assistance in the collection of taxes are omitted. Instead, this study mainly provides guidelines for the assessment of distributive rules and method provisions found in tax treaties concluded between EU Member States. The reason for this focus is due to the Court's own statements in its case law.

In order to fulfil the aim of this study, the focus is placed on the following seven questions. The first three questions are of a general character, *i.e.*, they are relevant for the application of free movement law regardless of which area of national law that is at issue. However, finding answers to these questions are of vital importance to be able to fulfil the principal aim of this study. The following four questions are of direct importance for establishing the impact of free movement law on tax treaties.

Questions of fundamental importance under free movement law:

- Which are the Court's main lines of reasoning when interpreting free movement articles?
- Under which circumstances does the Court apply a certain line of reasoning?
- Which grounds of justification may a Member State invoke to justify a restrictive national measure?

Questions of direct relevance to establishing the impact of free movement law on tax treaties:

- Are there reasons why the ECJ would interpret free movement provisions in relation to tax treaty provisions differently in comparison with its interpretation of the same articles in relation to Member States' internal tax legislation?
- How has the ECJ dealt with tax treaty provisions in its current case law?
- Which are the circumstances of importance for the Court's assessment of the compatibility of tax treaty provisions with free movement law?
- Do the free movement provisions prescribe most-favoured-nation treatment?[31] This involves, for instance, whether a resident of one EU Member State who receives income from a particular source Member State has the right to claim, from that source state, the most beneficial tax treaty benefits granted to a resident of a third Member State who earns the same kind of income in the source state. If this question is answered in the affirmative, it would most likely have a considerable impact on tax treaties concluded between EU Member States.

The expectation is that the answers to these questions will provide guidelines for predicting tax provisions' compatibility with free movement law.

The principal focus of this study is on income taxation. Accordingly, consumption taxes and import duties are not considered. The tax treaties

[31] See chapter 8. The Commission has observed that it is legitimate to raise the question whether any difference in treatment of EU residents under tax treaties automatically violates basic treaty rights, see *Company Taxation in the Internal Market*, COM (2001) 582 final, p. 287.

dealt with are the treaties on income and capital taxes, and, consequently, treaties on gift and inheritance tax are not considered. Moreover, the OECD MTC referred to in this study is the *OECD Model Tax Convention on Income and Capital.* The other two OECD Model conventions in existence, the *OECD Model Tax Convention for Mutual Administrative Assistance in the Recovery of Tax Claims* and the *OECD Model Tax Convention on Estates and Inheritances and on Gift* are not within the scope of this research project.

Outside the scope of this study is the impact of Community law on tax treaties concluded with third states. This is a complicated issue which is of great interest. However, due to the limited size of this study, it is not dealt with here. Nevertheless, this study includes some ECJ judgments where the provision at issue is part of a bilateral treaty with a third state. The reason for including such cases is the limited number of cases dealing with bilateral treaty provisions in general and tax treaty provisions in particular.

A different issue from the one of analysing the impact of free movement provisions on tax treaties is to determine whether, and in what form, involvement of the Community institutions is appropriate and warranted under the EC Treaty to prevent and cure possible incompatibilities.[32] This relates to whether the EC Treaty requires Member States to transfer their power to conclude tax treaties to the institutions of the Community[33] and whether a multilateral tax treaty concluded by all EU Member States would solve existing problems. The latter question has been thoroughly analysed.[34] Also, the development of an EU Model Tax Convention has been discussed in the literature.[35] This study, however, does not deal with these issues. Instead, it focuses on ECJ case law when

[32] Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law. The Rules,* ECTRev 1994, p. 163.

[33] When no internal transfer of powers has taken place, and no implied external powers have been used, each EU Member State is competent to enter into international agreements. However, when exercising its powers, the Member States must comply with Community law. According to the Case 22/70 *Commission* v *Council* [1971] ECR 263, the Community has implied external powers if entering into an external agreement which is necessary to attain a harmonization goal. For instance, see de Graaf, *Avoidance of international double taxation, Community or joint policy,* ECTRev 1998, pp. 258–276, Farmer, *EC Law and Double Taxation Agreements,* ECTJ, vol. 3, 1999, no. 3, pp. 137–156.

[34] See Lang, *et al.* (eds.), *Multilateral Tax Treaties,* (1998). See also Pires, *A multilateral tax convention for the European Union?,* ECTRev 2003, pp. 43–44.

[35] See Malherbe & Berlin, *Conventions Fiscals et Droit Communautaire,* RTD eur 1995, pp. 245–272, Kemmeren, *The termination of the most favoured nation clause dispute in tax treaty law and the necessity of a Euro Model Tax Convention,* ECTRev 1997, pp. 146–152 and Pistone, *The Impact of Community Law on Tax Treaties,* (2002).

interpreting free movement provisions in the light of Member States internal tax legislation in general and tax treaty provisions in particular. Accordingly, the study aims at identifying circumstances of importance when the ECJ is interpreting free movement provisions in relation to tax treaties. This is an area that has not been studied to a great extent in relation to tax treaty provisions and which is of essential importance. Considering the difficulties connected with passing legislation in the Council due to the unanimity requirement, it is possible that negative integration based on the free movement provisions will remain the main tool for abolishing restrictions constituted by tax provisions in the internal market in the foreseeable future.[36]

As this study focuses on establishing the impact of free movement provisions on tax treaties concluded between EU Member States, the possible impact on tax treaties of Articles 17 and 18 EC, dealing with the citizenship of the Union, is not considered.[37] The same applies to the Treaty provisions on state aid.[38] The impact of Article 10 EC, the principle of loyalty, is also not dealt with in this thesis.[39] Moreover, this study does not deal with possible Community law remedies that follow tax treaty provision being held inapplicable, such as state liability in line with the *Francovich*[40] case.[41] Also Article 307 EC, dealing with rights and obligations stemming from international agreements concluded by a Member State prior to its accession, is not dealt with in this study.[42]

[36] See Lodin, *EU:s beslutsordning ett hinder för välfärdsutvecklingen,* in Gustavsson, Oxelheim & Wahl (eds.), *EU, skatterna och välfärden,* (2004), p. 137. However, if EU Member States adopt home state taxation (hereinafter referred to as HST), the issue of the impact of free movement rules on tax treaties between Member States appears less significant. But, as such a system would be elective both for Member States and enterprises, it remains relevant. See Lodin & Gammie, *Home State Taxation,* (2001), pp. 23, 53.

[37] For a study of the citizenship of the Union, see Lokrantz Bernitz, *Medborgarskapet i Sverige och Europa,* (2004).

[38] For instance, see Luja, *Tax Treaties and State Aid: Some Thoughts,* ET 2004, pp. 234–238.

[39] For the impact of Article 10 EC on the Member States' income tax legislation, see Bergström, *EG-rättens lojalitetsprincip och rätten till fri etablering i artikel 43 EG – några inkomstskatterättsliga synpunkter,* in Krüger-Andersen, Neville & Winther-Sørensen (eds.), *Festskrift til Aage Michelsen,* (2000), pp. 355–363.

[40] Case C-6 & 9/90 *Francovich and Bonifaci and Others* v *Italian Republic* [1991] ECR I-5357.

[41] For instance, see van den Hurk, *Is the ability of the Member States to conclude tax treaties chained up?* ECTRev 2004, pp. 28–30.

[42] See Lang, *The Binding Effect of the EC Fundamental Freedoms on Tax Treaties,* in Gassner, Lang & Lechner (eds.), *Tax Treaties and EC Law,* (1997), pp. 20–22 and Pistone, *The Impact of Community Law on Tax Treaties,* (2002), pp. 85–99.

Article 24 of the OECD Model provides for elimination of tax discrimination in various circumstances. Even though an analysis of the differences between the prohibitions of discrimination under Community law and Article 24 is of interest, no such analysis is carried out in this study. This issue is elaborated on in other studies.[43]

1.3 Method and Material

The principal objective of this study is to establish the impact of the free movement provisions in the EC Treaty on tax conventions concluded between EU Member States. This is done by applying a traditional legal method, *i.e.* clarifying the existing legal situation by means of legal materials such as the EC Treaty and case law of the ECJ.[44] In addition, judicial research involves studying legal material in the light of a legal area as a whole.[45] Such a research method provides a comprehensive picture of the legal system. It facilitates finding consistencies and inconsistencies in the system, which can be the attention of further analysis.

This study is focused on the judicial review of tax treaty provisions from the perspective of free movement law. Hence, the analysis of the existing legal situation is based on case law studies. It is of importance to notice that the number of cases where the ECJ has dealt with the compatibility of tax treaty provisions with free movement provisions is limited. There are only three cases where the ECJ has had to make such an assessment. Therefore, to fulfil the aim of this study, it has been considered necessary to analyse the Court's case law on income taxation. However, to rely on the Court's case law on unilateral income tax rules, when searching for guidelines as to the Court's assessment of bilateral tax treaty provisions, is not completely unproblematic. There are important differences between those two categories of tax provisions.[46] Hence, I

[43] For instance, see Farmer, *EC Law and Direct Taxation – Some Thoughts on Recent Issues*, ECTJ, Vol. 1, 1995/96, issue 2, pp. 91–94, van Raad, *The Impact of the EC Treaty's Fundamental Freedoms Provisions on EU Member States' Taxation in Border-crossing Situations – Current State of Affairs*, ECTRev 1995, pp. 192–200, Jiménez, *Towards Corporate Tax Harmonization in the European Community: an Institutional and Procedural Analysis*, (1999), pp. 182–196 and Mattsson, *Är diskrimineringsreglerna i OECD:s modellavtal i överensstämmelse med EG-rätten? Några jämförelser mellan två regelsystem*, in *de lege*, (2002), pp. 246–303.

[44] For an explanation of the content of traditional legal science, see Hellner, *Trends in Legal Science Relating to Contracts and Torts*, in Peczenik, Lindahl & van Roermund (eds.), *Theory of Legal Science*, (1984), pp. 456–458 and Myrsky, *Basic Research in Tax Law*, in Scandinavian Studies in Law, (2003), pp. 277–279.

[45] Peczenik, *Vad är rätt?*, (1995), pp. 313–314.

[46] See section 1.1.3 and chapter 2.

use the Court's interpretation of the free movement rules in relation to national income tax provisions as guiding principles, and consequences for tax treaties are analysed having in mind their different characteristics.[47]

The extensive case law studies have been considered necessary in order to identify the rights and obligations deriving from the free movement provisions. In the literature, these rules have been described as "ill-defined, if not equivocal" as well as "Chameleon-like", which can be interpreted as a need for systematized case law studies.[48] This part of the thesis aims at contributing to the systematization of the Court's case law on free movement law.[49]

In this study a vast number of cases are analysed where the ECJ has applied the free movement provisions to Member States' legislation in general and tax legislation in particular. In order to establish whether a measure is permissible according to free movement law, the Court's main lines of reasoning are identified.[50] Next, those findings are compared with the Court's interpretation when dealing with tax treaty provisions.[51] Finally, the outcome of this analysis has been applied to different tax treaty provisions that have not, so far, been assessed by the ECJ.[52] In addition, the Court's case law is commented on from the perspective of consistency and clarity.[53] Such issues are of significance as they concern the predictability,[54] which is essential when trying to establish the impact of free movement law on tax treaty provisions.

The method involves the presentation and use of relevant legal material such as legislation, case law and legal doctrine.[55] The EC Treaty is the primary source of EC law. However, without considering the case law of the ECJ, together with the EC Treaty, one is far from understanding

[47] See Jann, *How Does EC Law Affect Benefits Available to Non-Resident Taxpayers under Tax Treaties,* in Gassner, Lang & Lechner (eds.), *Tax Treaties and EC Law,* (1997), p. 45.

[48] Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law. The Rules,* ECTRev 1994, p. 159 and Hinnekens, *Non-Discrimination in EC Income Tax Law: Painting in the Colours of a Chameleon-Like Principle,* ET 1996, pp. 286–303.

[49] See Myrsky, *Basic Research in Tax Law,* in Scandinavian Studies in Law, (2003), p. 278.

[50] For further elaboration on the systematization employed in this study, see section 3.4.2.

[51] See chapter 6.

[52] See chapter 7.

[53] The ECJ judge von Bahr has called attention to the need of doctrinal analysis which points out when the Court's case law lacks clarity and logic. See von Bahr, *Något om EG-domstolens praxis på skatteområdet,* in Arvidsson, Melz & Silfverberg (eds.), *Festskrift till Gustaf Lindencrona,* (2003), p. 71.

[54] See section 1.5.3.5.

[55] Where not otherwise stated, this thesis considers legal material up to 1 November 2004.

Community law. Given the great amount of legal material, it has not been possible to take all cases and literature into account in a study of this scope. Accordingly, I have been forced to make selections. These selections are particularly evident in Chapters 4–6 and further commented on below.

The case law study in Chapter 4 consists of cases dealing with national measures, falling within the scope of the free movement provisions, within any field of Member States' legislation. This case law study serves the purpose of reaching indications on the Court's reasoning when interpreting free movement provisions. The Court's reasoning is systematized in two different categories: either if it is focused on whether the national rule is particularly to the disadvantage of non-nationals or non-residents, or if it is focused on the more general question whether the national provision hinders the free movement. The former line of reasoning is in this study referred to as a *nationality-based approach* and the latter as a *free movement-based approach.*[56] To be able to draw conclusions regarding under which circumstances these different lines of reasoning are applied by the ECJ, it is in this study analysed from which perspective the Court has assessed a national rule, either from a host or a home state perspective.[57]

The cases presented in Chapter 4 are to be considered as exemplifications of case law under the different free movement provisions and, therefore, the presentation is in no way exhaustive.[58] Due to the limited selection of cases analysed in this chapter, one has to be careful when drawing general conclusions. Instead, the outcome of this chapter can be seen as preliminary results that are further tested in the subsequent chapters.

In Chapter 5, the ECJ's reasoning is studied in an income tax context exclusively. The same systematization of the Court's reasoning is applied as the one in Chapter 4. However, the selection of cases in Chapter 5 is more representative in comparison with the cases covered in Chapter 4, as the aim is to cover all income tax cases dealt with by the ECJ regarding the interpretation of free movement provisions until 1 August 2004.

The systematization and the terminology used in Chapters 4 and 5 is not found in previous studies. However, that does not mean that such an analysis is new in its entirety. Fragments are found in other doctrinal analyses.[59] The case law study in Chapter 5 is unusual considering the

[56] See section 3.4.

[57] See section 3.4.1.

[58] For further comments on the selection of cases in chapter 4, see section 4.1.

[59] For instance, see Farmer, *The Court's case law on taxation: a castle built on shifting sands?*, ECTRev 2003, pp. 75–81 and Lyal, *Non-discrimination and direct tax in Community law*, ECTRev 2003, pp. 68–74.

number of cases included in the systematization. The choice to include all income tax cases in the case law survey makes it different from most other studies. It is more common that a limited number of cases are analysed and other cases are excluded.

Most of the cases included in the case law studies in Chapters 4 and 5 are analysed in the literature. The reason for the limited references to literature found in these chapters is that other studies do not generally comment on these cases from the perspective of the connection between the Court's reasoning and whether the national measure is analysed from a host state or a home state perspective, something that is the aim of Chapters 4 and 5.

It may be considered that Chapter 5 is too extensive considering a study of this size, but including all cases on income taxation in the study makes the conclusions as regards the Court's reasoning in a particular situation more reliable than if the study had been limited to only cover parts of the case law. As is clear from the conclusions of this study, the results of Chapter 5 are of importance for the validity of the guidelines given as regards an assessment of the compatibility of tax treaty provisions.[60] However, for the reader who already has intimate knowledge of the case law, the reading of Chapters 4 and 5 are unnecessary.

In Chapter 6 the focus is on the three cases where the ECJ has interpreted free movement provisions in relation to tax treaty provisions.[61] The Court's analysis of tax treaty situations is dealt with having regard to the findings of the case law studies carried out in Chapters 4 and 5. Deviations from those findings are analysed in Chapter 6. Due to its significance for this study, the use of case law from the ECJ is further elaborated on in isolation in section 1.5.

Due to the vast doctrine available in the area of the impact of free movement law on Member States' tax legislation, this study is limited to literature primarily written in English. Nevertheless, the aim is to cover doctrinal writing by authors from different countries. This has been facilitated by the fact that much of the discussions in this field are carried out in English. However, to a limited extent also literature written in other languages is considered.

The OECD MTC is not in itself an international treaty. The reason for emphasizing the OECD MTC is that 19 out of 25 Member States of the

[60] See chapters 6, 7 and 9.

[61] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161 and Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819.

EU also are members of the OECD and, as a consequence, the vast majority of tax treaties concluded between EU Member States are based on the OECD MTC.[62] The Commentaries to the provisions of the OECD MTC constitute a widely accepted guide to the interpretation and application of concluded tax treaties.[63] In this thesis, the Commentaries have been employed for guidance on the proper application of tax treaty provisions.

1.4 Previous Research

In general, this study concerns the impact of Community law on Member States' tax legislation. Even though this is a fairly young subject, there are many valuable research contributions in this area. I will not mention any particular contributions as the risk of leaving important work outside is probable.

Considering research contributions that specifically have dealt with the issue of the impact of free movement law on tax treaty provisions, the number is more limited. When considering contributions in English, in 1997 Gassner, Lang and Lechner published *Tax Treaties and EC Law* and in 1998 Lang *et al.* presented *Multilateral Tax Treaties.* These publications provide valuable and in-depth analysis of the issue at a stage when the ECJ's case law on tax treaty provisions was even more limited than today.[64] In 1998, Essers, de Bont and Kemmeren published a study named *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law.* This study provides valuable guidelines when it comes to assessing the compatibility of special tax treaty provisions, anti-abuse provisions, with Community law. In 2002, Pistone presented his work

[62] The six EU Member States that are not OECD members are as follows: Estonia, Latvia, Lithuania, Cyprus, Malta and Slovenia. Three of the non-member countries of the OECD are part of the group of non-member countries who give their positions with regard to the OECD Model and its Commentary. The reason for including the positions also of non-OECD countries in the Commentaries to the OECD Model is that the OECD has recognized that the influence of the Model has extended far beyond the OECD Member countries. Therefore, recognizing that non-member countries could only be expected to associate themselves to the development of the OECD Model if they could retain their freedom to disagree with its content, it has been decided that these countries should, like OECD Member countries, have the right to identify and express areas where they are unable to agree with the text of an article or with an interpretation given in the Commentary. For these three countries, Estonia, Latvia and Lithuania, the relevance of the OECD Model when concluding their tax treaties is evident.

[63] OECD MTC, Introduction OECD Commentaries, para. 15.

[64] For an account of how this study deviates from previous studies, see section 1.2.

The Impact of Community Law on Tax Treaties. This book ends with a proposal of an EC Model Tax Convention on direct taxes.

Other studies that also cover the impact of Community law on tax treaties are *EC Tax Law*, written by Farmer and Lyal and published in 1994, and Kemmeren's study *Principle of Origin in Tax Conventions – A Rethinking of Models.* The latter was published in 2001. Also van Thiel's 2002 book *Free Movement of Persons and Income Tax Law: the European Court in Search of Principles,* covers this subject.

For studies in other languages than English, the following books need to be mentioned. Already in 1985, Scherer presented *Doppelbesteuerung und Europäisches Gemeinschaftsrecht.* More recent studies are Burgers' 2001 book *Een eigen koers – Gedachenten over de verhouding tussen Europees en international belastingrecht* and Cordewener's study, *Europäische Grundfreiheiten und Nationales Steuerrecht,* which was published in 2002.

There are a vast number of articles written in this area. Many of them are used in this study and can, therefore, be found in the list of references. In this context, I will only mention articles that early pointed out the impact of Community law on tax treaties. In 1990, Hamaekers published an article with the title "Corporate Tax Policy and Competence of the European Community: An EC Tax Convention with Non-Member States?". In 1994 and 1995, a thorough analysis of the impact of Community law on tax treaties was presented by Hinnekens in the form of two articles: "Compatibility of Bilateral Tax Treaties with European Community Law – The Rules" and "Compatibility of Bilateral Tax Treaties with European Community Law – Application of the Rules".

When considering research contributions in the area of free movement law, Barnard's book *The Substantive Law of the EU – The Four Freedoms* from 2004 is worth a special mention. This study provides a comprehensive view of the interpretation and application of the free movement articles. Also the different topics elaborated on in the book *The Law of the Single European Market* present in-depth analysis on free movement law. Editors of the latter are Barnard and Scott, and it was published in 2002. Other contributions are *EU Law*, written by Craig and de Búrca from 2002 and Arnull's study from 1999, *The European Union and its Court of Justice.*

1.5 The ECJ and the Free Movement Provisions

1.5.1 The Importance of the ECJ Case Law

The ECJ is the final interpreter of EC law, and it has an important role in interpreting the free movement provisions. In the absence of comprehensive legislation, the case law of the ECJ regarding free movement has contributed substantially to ensure the free movement in the internal market.[65] Consequently, it is crucial to be aware of some of the fundamental features of the ECJ.

According to Article 220 EC, the role of the ECJ is to ensure that the law is observed in the interpretation and application of the EC Treaty. The ECJ takes an active role in the creation of the internal market in cases that come before it by requiring the removal of national barriers to the free movement in the internal market. The Commission has the right to bring proceedings before the Court against any Member State that allegedly has failed to fulfil its obligations under the EC Treaty.[66] Also a Member State that considers that another Member State has failed to fulfil its obligations under the EC treaty may bring the matter before the ECJ.[67] However, this right has been used very rarely. Under Article 228 EC, the ECJ can impose a pecuniary penalty on a Member State that has failed to comply with a previous judgment against it.

The ECJ case law dealt with in this thesis is mainly the product of the Court's jurisdiction through the preliminary ruling procedure under Article 234 EC.[68] The objective of this article is to ensure uniform application of Community law. It provides that the ECJ has jurisdiction to respond to questions raised by national courts concerning the application of EC law to cases pending before them. The preliminary ruling procedure has as a result that the ECJ is asked to resolve questions of fundamental relevance that might not otherwise have been brought before it.[69] The ruling given by the Court is an interlocutory one, *i.e.*, it constitutes a step in the proceedings before the continued treatment by the national court. The national court is bound by the preliminary ruling and must proceed to apply the ruling to the facts of the case.[70]

[65] For example, see sections 5.2–5.4.

[66] Article 226 EC.

[67] Article 227 EC.

[68] See Wathelet, *Direct taxation and EU law: integration or disintegration?* ECTRev 2004, p. 3.

[69] Arnull, *The European Union and its Court of Justice,* (1999), p. 50.

[70] See Article 234 EC and *ibid.*, p. 49.

Formally, the ECJ does not have jurisdiction to rule on the compatibility of a national measure with Community law in a preliminary ruling procedure.[71] What the Court has competence to do is to provide the national court with all criteria for the interpretation of Community law which may enable it to determine the issue of compatibility for the purposes of the decision in the case before it.[72] Craig and de Búrca hold that the distinction between interpretation and application is meant to be one of the characteristic features of the division of authority between the ECJ and national courts, as the former interprets the Treaty and the latter apply that interpretation to the facts of a particular case.[73] However, the more detailed the interpretation provided by the ECJ, the closer does it approximate to application. A reason why the Court in many preliminary ruling procedures delivers very detailed interpretations is that many of the questions submitted to the ECJ are very detailed and require a specific response.[74] In fact, the answers given by the ECJ when interpreting the free movement provisions often leave the national court in little doubt about how the case before it is to be resolved.[75] For instance, it is common that the ECJ expresses itself as "Article 43 EC is to be interpreted as precluding a measure such as that contained in Paragraph 8a (1), Head 2, of the KStG."[76] Therefore, this study employs expressions such as the Court's ability to *strike down* a national measure and *assess the compatibility* of a national measure. Considering that the ECJ does not formally have the right to rule on the compatibility of a national measure with Community law under Article 234 EC, such expressions may, in a strict sense, be considered inappropriate.

The principle that courts in general should try to be consistent and, therefore, put great emphasis on earlier judgments when deciding a case is based on the principle that like cases should receive like treatment and that each concrete decision should be based on a general rule.[77] The desire to secure certainty in the judicial process inspires an effort towards consistency in the application and interpretation by courts.

[71] For example, see Case C-15/96 *Kalliope Schöning-Kougebetopoulou* v *Freie und Hansestadt Hamburg* [1998] ECR I-47, para. 9.

[72] For example, see Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'Ordine degli Avvocati e Procuratori de Milano* [1995] ECR I-04165, para. 19.

[73] Craig & de Búrca, *EU Law*, (2002), p. 472. See also Ståhl & Persson Österman, *EG-skatterätt*, (2000), pp. 29–30.

[74] Craig & de Búrca, *EU Law*, (2002), p. 472.

[75] Arnull, *The European Union and its Court of Justice*, (1999), p. 51.

[76] Case C-324/00 *Lankhorst-Hohorst GmbH* v *Finanzamt Steinfurt* [2002] ECR I-11779, para. 45.

[77] Ross, *On law and justice*, (1958), p. 84.

The ECJ is not bound by its previous decisions but in practise it does not often depart from them.[78] In situations where the Court has clearly deviated from earlier case law regarding either the reasoning or the result, occasionally the ECJ has indicated a change of direction and explained the reasons for its change.[79] Arnull observes that since the beginning of the 1990s there have been signs of a growing willingness on the part of the Court to confront the implications of earlier case law.[80]

The deliberations of the Court remain secret, and no dissenting judgments are permitted.[81] Therefore, a judgment of the Court may be the result of a compromise between opposed ideas and lack a single line of thought.[82]

1.5.2 The Use of Opinions by Advocates General

When analysing case law on the free movement provisions, references are occasionally made to the opinions given by Advocates General. An opinion is an independent and impartial investigation including relevant facts, legislation and relevant case law of the ECJ as well as an analysis of the issues raised in the proceedings. It is concluded with a recommendation to the Court on how the case should be decided.[83] As these opinions in no way are binding upon the ECJ, I will below give the reasons why they to some extent are used in this study.

The ECJ consists of judges and Advocates General.[84] The main rule is that an Advocate General is assigned to each case before the Court, and the task of the Advocate General is to present an opinion after the parties have concluded their submission and before the judges begin their deliberations.[85]

Generally, the style and content of the opinions make them more readable than the Court's judgments.[86] As the opinion is the product of one

[78] Arnull, *The European Union and its Court of Justice*, (1999), p. 528, Craig & de Búrca, *EU Law*, (2002), p. 95.

[79] See Cases C-267 & 268/91 *Criminal Proceedings against Bernard Keck and Daniel Mithouard* [1993] ECR I-6097 para. 14, Case C-10/89 *SA CNL-Sucal NV* v *HAG GF AG* [1990] ECR I-3711, para. 10, Case C-308/93 *Bestuur van de Sociale Verzekeringsbank* v *J.M.Cabanis-Issarte* [1996] ECR I-2097, para. 34, Craig & de Búrca, *EU Law*, (2002), p. 95.

[80] Arnull, *The European Union and its Court of Justice*, (1999), p. 531.

[81] Article 35 Statute of the Court of Justice.

[82] Arnull, *The European Union and its Court of Justice*, (1999), p. 9.

[83] *Ibid.*, p. 7.

[84] Article 222 EC.

[85] *Ibid.*, and Arnull, *The European Union and its Court of Justice*, (1999), pp. 7–9.

[86] See also Craig & de Búrca, *EU Law*, (2002), p. 94.

person only, it often has clarity and directness, something which judgments of the Court may lack.[87] The point of view expressed by Advocates General in their opinions is frequently cited in the legal doctrine.

It is hard to measure empirically the influence of the opinions of the Advocates General on the development of case law. This is due to, as is stated earlier, that deliberations of the Court remain secret and no dissenting judgments are permitted.[88] The modern practise of the Court is to refer expressly to the opinion where it agrees with the position taken by the Advocate General.[89] It happens that the Advocate General and the Court are in agreement regarding the result but their reasoning can differ. The opinions can also be useful as the Advocates General commonly stress obscurities in the case law of the ECJ relevant in the case in question.[90]

Hence, to study opinions by Advocates General may provide alternative views on the interpretation of EC law in a specific situation. Such alternatives are not generally acknowledged by the Court in its reasoning.

1.5.3 Interpretation of the Free Movement Provisions

1.5.3.1 An Extensive Scope of Application

Besides the EC Treaty, case law from the ECJ is the most vital legal source used in this thesis. The reason is that the ECJ interprets the free movement provisions in the EC Treaty. In analysing the impact of Community law on tax treaties concluded between EU Member States, the interpretation given by the ECJ to the free movement provisions is crucial. It is, therefore, necessary to discuss the ECJ process of interpretation, or in other words, how the ECJ determines the meaning of the applied treaty provisions.

The wording in the free movement provisions of the EC Treaty gives rise to a vast range of applicability. A distinguishing feature of the free movement provisions, compared with legislation of a more specific kind, is that the former are applicable to a vast number of situations. From the wordings of the free movement provisions, it appears that they prohibit any restriction on the free movement or, in the case of free movement of workers, any national measure which discriminates in terms of nationality

[87] Arnull, *The European Union and its Court of Justice,* (1999), p. 9 and Craig & de Búrca, *EU Law,* (2002), p. 95.

[88] See section 1.4.1 and Article 35 Statute of the Court of Justice.

[89] Arnull, *The European Union and its Court of Justice,* (1999), p. 9.

[90] For instance, see Advocate General Jacobs' opinion in Case C-136/00 *Rolf Dieter Danner* [2002] ECR I-8147, paras. 37–39.

between workers. The scope of the free movement provisions could potentially concern almost any part of the legal systems of the Member States.

Moreover, the EC Treaty does not include any detailed rules on how to apply the provisions to specific situations. Consequently, the ECJ has considerable freedom in applying the free movement provisions.

1.5.3.2 The Teleological Method of Interpretation

The basic task of every court is the determination of issues by interpreting the law.[91] This involves determining the meaning and effect of the written provisions which the Court is called upon to apply. In contrast to the method of interpretation used by many national courts in the Member States, the ECJ has a preference for a purposive or teleological approach to questions of interpretation.[92] This method is based on the objective of the legislation. In other words, this method of interpretation construes ambiguity in the light of the objective of the provision concerned.[93] Objectives of the EC Treaty are found in the preamble to the EC Treaty as well as in Article 2 EC. They are further specified in Articles 3 and 4 EC.

The approach chosen by the ECJ when applying a teleological method of interpretation to the openly formulated EC Treaty is controversial.[94] Arnull concludes that the reason for the criticism of the use of this method of interpretation is that it may lead the Court to interpret a provision in a way which might seem surprising to those who are accustomed to seeing judges accord greater weight to the terms the legislature has chosen to express itself.[95]

[91] Kutscher, *Methods of interpretation as seen by a judge at the Court of Justice,* in *Reports of a Judicial and Academic Conference held in Luxembourg on 27–28 September 1976,* p. I-5. For an analysis of the ECJ's reasoning, see Bengoetxea, *The Legal Reasoning of the European Court of Justice,* (1993).

[92] See Bengoetxea, *The Legal Reasoning of the European Court of Justice,* (1993), pp. 250–251. For a presentation of other methods of interpretation applied by the ECJ, see, for instance, Bengoetxea, MacCormick & Soriano, *Integration and Integrity in the Legal Reasoning of the European Court of Justice,* in de Búrca & Weiler (eds.), *The European Court of Justice,* (2001), p. 46 and Bernitz & Kjellgren, *Europarättens grunder,* (2002), pp. 44–48.

[93] Arnull, *The European Union and its Court of Justice,* (1999), p. 515.

[94] See Bengoetxea, MacCormick & Soriano, *Integration and Integrity in the Legal Reasoning of the European Court of Justice,* in de Búrca & Weiler (eds.), *The European Court of Justice,* (2001), pp. 44–45.

[95] Arnull, *The European Union and its Court of Justice,* (1999), p. 515. Compare Hartley, *The Foundations of European Community Law,* (2003), pp. 79–80.

1.5.3.3 Characteristic Features of Community Law of Importance for the Interpretation

When comparing the differences between the ECJ and national courts of the Member States in terms of adjudication, one must, according to the Court itself, take into account the "characteristic features of Community law and the particular difficulties to which its interpretation gives rise".[96] The Court has stressed different features which need to be borne in mind when interpreting Community law.[97] In the *CILFIT*[98] case, the ECJ emphasized the following features. Community law is drafted in several languages and as those different language versions are all equally authentic they may have to be compared. Moreover, Community law uses a terminology that is peculiar to it, and the legal concepts used do not necessarily have the same meaning in Community law as they have in the legislation of the Member States. Every provision of Community law must be placed in its context and interpreted in the light of the provisions of Community law and with regard to the present state of Community law.

1.5.3.4 The Distinction between Interpretation and Legal Policy

As indicated above, one of the most important tasks of the ECJ is to interpret the EC Treaty, a treaty that has the character of a framework treaty. The free movement provisions are written in a general way without much specification.[99] Restrictions on the free movement are prohibited according to Article 49 EC, for instance. But what kind of tax provisions constitutes restrictions?

As regards the ECJ's process of interpretation when dealing with the openly formulated free movement provisions, the legal theorists Hart and Kelsen provide interesting thoughts. They explain a court's process of interpretation when dealing with openly formulated provisions.[100]

Hart explains that when the text of a provision of a statute or an article in a Treaty is formulated in a very general way, there will be plain indisputable examples of what does, or does not, fall under the statute.[101]

[96] Case 283/81 *Srl CILFIT and Lanificiodi di Gavardo SpA* v *Ministry of Health* [1982] ECR 3415, para. 17.

[97] *Ibid.*, paras. 18–20.

[98] Case 283/81 *Srl CILFIT and Lanificiodi di Gavardo SpA* v *Ministry of Health* [1982] ECR 3415.

[99] See Vanistendael, *The role of the European Court of Justice as the supreme judge in tax cases* ECTRev 1996, p. 115.

[100] For an analysis of the distinction between interpretation and legal policy, see Gunnarsson, *Skatteförmåga och skatteneutralitet – juridiska normer eller skattepolitik?*, SN 1998, pp. 454–463 and Israelsson, *Aktivism och hermeneutik*, ERT 2001, pp. 153–178.

[101] Hart, *The Concept of Law*, (1993), p. 128.

Some extreme cases may always be identifiable. When moving away from those clear cases and considering the difficult cases, the wording of the statute may not give sufficient guidance. Hart argues that this is the result of the open texture of the language.[102] This is evident in all fields of experience, not only in that of rules. There is a limit, inherent in the nature of language, to the guidance which general language can provide.[103]

Hart claims that in the difficult cases "...it is clear that the rule-making authority must exercise discretion, and there is no possibility of treating the question raised by the various cases as if there were one uniquely correct answer to be found, as distinct from an answer which is a reasonable compromise between many conflicting interests."[104] From this, one may conclude that Hart identifies the room for, and necessity of, considerations of a merely legal policy character when the courts are interpreting and deciding these difficult cases. Moreover, Hart acknowledges that courts often disclaim that they have a creative function and insist that the proper task of interpretation is to search for the intention of the legislature and the law that already exist.[105]

Kelsen argues that a legal rule cannot be binding with respect to every detail of the act putting it into practice. Therefore, there is always a range of discretion, sometimes narrower, sometimes wider, so that the statute has simply the character of a frame to be filled by the act of applying it.[106]

As a result, the act of applying a statute is determined only in part by this statute and remains indeterminate for the rest. The statute only provides for a frame within which various possibilities for application are given, and every possibility that stays within this frame, in some possible sense filling it in, is in conformity with the statute.[107] Kelsen convincingly argues that the interpretation of a statute does not necessarily lead to one single decision which is the only correct decision but to a number of decisions, all of them of equal standing if measured solely against the statute which was to be applied.[108] However, only a single one of them becomes, in the act of the judicial decision, positive law. The fact that a judicial decision is based on a statute means simply that the decision

[102] *Ibid.*, p. 132. See also Strömholm, *Rätt, rättskällor och rättstillämpning*, (1996), pp. 429–430.
[103] Hart, *The Concept of Law*, (1993), p. 123.
[104] *Ibid.*, p. 128.
[105] *Ibid.*, p. 132.
[106] Kelsen, *Introduction to the Problems of Legal Theory*, (1992), p. 78.
[107] *Ibid.*, p. 80.
[108] *Ibid.*

stays within the frame of the statute, not that it is the only possible outcome of the application of the statute to the situation at hand.

Kelsen distances himself from the theory of interpretation which involves finding the one correct judicial decision, when the statute gives rise to several possible outcomes, through some sort of cognition of existing law.[109] Instead, Kelsen advocates that finding the correct choice among the possibilities given within the frame of the statute is hardly a question of cognition directed to the existing law, rather, it is a problem not of legal theory but of legal policy.[110]

To sum up, both Hart and Kelsen hold that when interpreting provisions which are formulated in a very general way, there will be plain indisputable examples of what does, or does not, satisfy them. When you move away from those clear cases, the interpretation becomes a lot more difficult. As the text of the provision does not provide the judge with unambiguous answers, he will be forced to find the correct choice among the possibilities given within the frame of the statute.[111] When deciding which interpretation that is the correct one among the rival interpretations, it is a question of legal policy.

Hart and Kelsen seem to agree that interpretation of difficult cases involves an element of legal policy.[112] They describe it in different ways but they identify the use of judicial discretion. Kelsen, and similarly Hart, argue that the interpretation of a statute does not necessarily lead to one single decision but to a number of possible decisions, all of them of equal standing if measured solely against the statute which is applied. Kelsen claims that when the judge gives priority to one of the possible interpretations, it is not a question of cognition of the existing law but a decision based on legal policy.

The open texture of the language is certainly evident in the articles on the free movement in the EC Treaty.[113] Considering Hart's and Kelsen's theories, the fact that the free movement provisions are formulated without giving many details gives the ECJ a frame of considerable width to

[109] *Ibid.*, p. 82.

[110] *Ibid.*

[111] See Simmonds, *Protestant Jurisprudence and Modern Doctrinal Scholarship,* CLJ, 60 (2), 2001, p. 272.

[112] Similarly see Hägerström, *Inquiries into the nature of law and morals,* (1953), p. 85, Ross, *On law and justice,* (1958), pp. 151–152, Strömholm, *Rätt, rättskällor och rättstillämpning,* (1996), pp. 192–193, 402 and Wiklund, *Taking the World View of the European Judge Seriously – Some reflections on the role of ideology in adjudication,* in Wiklund (ed.), *Judicial Discretion,* (2003), p. 35. Peczenik describes interpretation in difficult cases as *creative* [translation from Swedish: kreativ], Peczenik, *Vad är rätt?,* (1995), p. 329.

[113] See Hinnekens, *Non-Discrimination in EC Income Tax Law: Painting in the Colours of a Chameleon-Like Principle,* ET 1996, p. 287.

be filled when applying these provisions. The ECJ's range of discretion is, consequently, also wide.[114] What emerges from this is that the act of applying the free movement provisions is determined only in part by the provisions themselves and remains indeterminate for the rest. As a result, the Treaty provisions only provide for a frame within which various possibilities for application are given, and every possibility that stays within this frame, in some possible sense filling it in, is in conformity with the Treaty provision applied. From this, one realizes that the interpretation of a free movement provision does not necessarily lead to one single decision, which is the only correct one, but to a number of decisions. However, only a single one of them becomes positive law in the act of the judicial decision given by the ECJ. From Hart's and Kelsen's theories on interpretation, one may conclude that the ECJ, when interpreting the free movement provisions, in many situations has to use its judicial discretion to give judgments on cases before it. This view on interpretation is reflected in the analysis of the ECJ's case law carried out in this study.[115]

Interpreting the free movement provisions, the ECJ has to rank different interests considering whether the outcome of striking down a national measure is more beneficial than harmful in the light of the underlying societal concern.[116] On the one hand, there is the objective of creating a well-functioning internal market, in other words economic integration, and, on the other hand, it is in the interest of Member States to hinder the free movement to safeguard, for example, the protection of the health of its citizens or the effectiveness of fiscal supervision. It is for the ECJ to decide which of the interests involved that are of greater value in the particular situation.

From this, one may conclude that interpretation of the free movement provisions, which are formulated in a way that gives the ECJ substantial room for considerations of a legal policy character, may be one of the reasons why the ECJ has been criticized for being involved in legal

[114] For a study of the ECJ's judicial discretion, see Wiklund, *EG-domstolens tolkningsutrymme,* (1997). Wiklund defines the expression judicial discretion as "the authority vested in a person who applies law to make a choice between two or more conceivable alternatives. The legal element in the concept appears in the form of the requirement that the choice must be found within the realm of law, that is, based on a valid legal norm. Thus legitimate judicial discretion is constituted by the authority (jurisdiction) which the law vests in the judge to choose between alternatives found within the boundaries of the law." (p. 477).

[115] For instance, see sections 5.9, 6.4.3.2 and 8.3.4.

[116] See Wils, *The Search for the Rule in Article 30 EEC: Much Ado About Nothing?,* 18 ELRev 1993, p. 478 and Quitzow, *Fria varurörelser i den Europeiska gemenskapen,* (1995), pp. 410–414.

activism.[117] Hartley has argued that one of the distinctive characteristics of the ECJ is the extent to which its adjudication is based on legal policy.[118] By legal policy he means the values and attitudes of the judges and the objectives they wish to promote. Another reason is probably the extensive use of the interpretation principle referred to as the teleological method.[119] The result is that it is difficult to predict whether a tax treaty provision may be found to constitute a restriction under free movement law or not.

1.5.3.5 Predictability

The element of legal policy in the adjudication carried out by the ECJ when interpreting the free movement provisions may be in conflict with the general aim of having a high degree of predictability. The non-retroactivity of certain judicial decisions made by the Court seems to indicate that the Court is aware of this problem.[120] When the ECJ interprets a provision of Community law, the interpretation, in principle, takes effect as from the moment the provision in question entered into force, whenever that may be.[121] It is interesting to notice that in certain circumstances the ECJ has limited the timing effect of its rulings in recognition of the inconvenience that may be caused where a provision of EC law is given an unexpected interpretation.[122] In other words, the reason for the Court to limit the timing effects of a judgment is to satisfy the requirements of legal certainty in general and predictability in particular.

Persons who have not accepted that the decision-making taking place within the ECJ includes elements of legal policy have criticised the non-retroactivity of certain ECJ judgments as a clear indication of the legislative function of the ECJ.[123] This is due to the fact that when the effect of a judgment is limited, the judgment concerns only the legal situation in the future and leaves the past untouched. Consequently, this is hard to

[117] For example, see Rasmussen, *On Law and Policy in the European Court of Justice,* (1986).

[118] Hartley, *The Foundations of European Community Law,* (2003), p. 80.

[119] See section 1.5.3.2.

[120] For instance, see Case 43/75 *Defrenne* v *Sabena* [1976] ECR 455 and Case C-415/93 *Union Royal Belge des Sociétés de Football Association ASBL* v *Jean-Marc Bosman* [1995] ECR I-4921.

[121] Arnull, *The European Union and its Court of Justice,* (1999), p. 198.

[122] See Case 43/75 *Defrenne* v *Sabena* [1976] ECR 455, Case C-415/93 *Union Royal Belge des Sociétés de Football Association ASBL* v *Jean-Marc Bosman* [1995] ECR I-4921, Arnull, *The European Union and its Court of Justice,* (1999), p. 198.

[123] See Hamson, *Methods of interpretation – A critical assessment of the results,* in *Reports of a Judicial and Academic Conference held in Luxembourg on 27–28 September 1976,* p. II-15.

reconcile with the basic understanding that the ECJ is only clarifying how a provision should have been interpreted all along, *i.e.* since it entered into force.

The structure of the EC Treaty, being a framework treaty, together with the teleological method of interpretation, is a legal context which may work to the detriment of predictability and puts a burden on the Court to be as clear and detailed as possible in its reasoning to achieve a necessary level of predictability.[124] In this context, it is interesting to notice that the ECJ has identified legal certainty as a general principle of Community law.[125]

1.6 Terminology

The terminology used within both Community law and international tax law may be difficult to apprehend. Certain concepts that are frequently employed, and of special importance in this study, are defined in this section, whereas others are explained in their context.

First of all, the expressions *he*, *him* and *his* found in this study are used referring to both genders. The term *internal tax law* is used to refer to the unilateral law of the state concerned. Consequently, the term does not cover tax treaties even though tax treaties are recognized as part of the domestic legislation of one state. The terms *tax treaty*, *tax convention* and *double tax convention* are used interchangeably.

In reference to Articles 6–22 in the OECD MTC, the term *distributive rules* is used. These articles classify income and their assignment to the contracting states.[126] *Residence state* is the state where the taxpayer is resident for tax purposes. The *source state* is the state where the income has its source.

The ECJ tends to use the expression *mandatory requirements* within the framework of free movement of goods, in reference to the broader grounds of justifications first introduced by the ECJ in the *Cassis de Dijon* case.[127] Instead of using the expression mandatory requirements, the Court sometimes uses *overriding requirements of general public*

[124] For the importance of a court's reasoning on predictability, see Kellgren, *Mål och metoder vid tolkning av skattelag*, (1997), pp. 60–65.

[125] For example, see Case C-415/93 *Union Royal Belge des Sociétés de Football Association ASBL* v *Jean-Marc Bosman* [1995] ECR I-4921, para. 142.

[126] In the doctrine, these articles are sometimes referred to as *classification and assignment rules* or *substantive provisions*.

[127] Case 120/78 *Rewe-Zentral AG* v *Bundesmonopolverwaltung für Branntwein* [1979) ECR 649.

importance[128] or *imperative requirements in the general interest*[129]. In this study, the term mandatory requirements is used alternating with the expression *imperative interests* in relation to all free movement provisions. When referring to these justifications not explicitly stated in the EC Treaty, the expression *non-Treaty grounds for justification* is sometimes used.

The test involved when considering whether imperative interest may justify a restriction on the free movement is often referred to as the *rule of reason.*[130] The so-called rule of reason test involves investigating whether a restrictive measure serves a legitimate purpose of public interest that is a mandatory requirement and, given a legitimate objective, whether it is proportionate in its restrictive effect.[131]

From studying the reasoning of the ECJ in free movement cases, it is evident that the Court argues in terms of *discrimination* and *restrictions.* In this study, the term *restriction* is used as an umbrella concept including any type of prohibited measure under the free movement provisions. Accordingly, it includes measures which are discriminatory on grounds of nationality.

It is found from the case law that the ECJ generally applies two main lines of reasoning in its assessment in free movement cases, a *nationality-based approach* and a *free movement-based approach.*[132] Under the former approach, the ECJ focuses on different treatment due to nationality or residence. The main characteristic of the latter approach is that the ECJ focuses on whether the national measure is liable to dissuade persons from exercising their right to free movement. These terms, a *nationality-based approach* and a *free movement-based approach,* both not found in the literature, are used in order to recognize and thereby systematize the Court's lines of reasoning.[133]

In the literature, a different terminology is employed when it comes to describing the Court's interpretation of free movement provisions. For instance, the expressions *non-discrimination doctrine* and *non-restriction*

[128] See Case C-34/95 *Konsumentombudsmannen* v *De Agostini* [1997] ECR I-3843, para. 46.

[129] Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'ordine delgi Avvocati e Procuratori di Milano* [1996] ECR I-4165, para. 37. See section 3.5.

[130] See Craig & de Búrca, *EU Law,* (2002), p. 638.

[131] See Barnard, *The Substantive law of the EU – The Four Freedoms,* (2004), pp. 241–242.

[132] See section 3. 4.

[133] However, Hinnekens uses the term *nationality-based interpretation,* see Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law. The Rules,* ECTRev 1994, p. 149.

doctrine are commonly used.[134] Also terms such as a *restriction-based approach*[135] and *discrimination-based approach* are employed.[136] The reasons for not using these terms when analysing ECJ case law are two-fold. First, those terms may, in the context of this study, be considered misleading. This is due to that the term restriction is used, as stated earlier, as an umbrella concept in this study. Using the term restriction-based approach may then mistakenly be considered as also including a discrimination-based approach, which is not the way this term is generally used. Second, different authors appear to be giving different meanings to the same concept, for instance a restriction-based approach, which does not facilitate the understanding.

As the Court's assessment is focused on different aspects under a *nationality-based approach* and under a *free movement-based approach*, the case law surveys aim at establishing under what circumstances the Court uses either approach. In this context, the expressions *home state perspective* and *host state perspective* are used. When the ECJ analyses national legislation from a host state perspective, it focuses on the impact of a Member State's legislation on non-nationals or non-residents. In other words, the Court envisages the national measure's impact on persons who have exercised their free movement rights to come under the jurisdiction of the host state. When the Court analyses national legislation from a home state perspective, it focuses on the effect of Member States' legislation on its own nationals or residents.

1.7 Outline

This study consists of 9 chapters. In this introductory chapter, a general presentation has been given of the subject area and the purpose of the study. Also the method is described and the relevant materials are presented and commented on. The importance of the ECJ case law for this study is emphasized, and the Court's process of interpretation of the free movement provisions are penetrated.

[134] For instance, see Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax system of the Member States*, ECTRev 2003, p. 136.

[135] For instance, van Thiel employs the term *restriction-based reading*, see van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, (2002), p. 78.

[136] For instance, see Farmer, *EC Law and Double Taxation Agreements*, ECTJ, vol. 3, 1999, issue 3, p. 143 and Cordewener, Dahlberg, Pistone, Reimer & Romano, *The Tax Treatment of Foreign Losses: Ritter, M & S, and the Way Ahead (Part Two)*, ET 2004, p. 218.

In Chapter 2, the nature and operation of tax treaties are outlined. The focus is on tax treaties based on the OECD Model, as most tax treaties in the internal market are based on this Model. This chapter is aimed at providing the reader with the necessary information about tax treaties in order to understand the subsequent analysis.

Core issues of free movement law are presented and analysed in Chapter 3. In this chapter, the theoretical basis for the systematization of the case law in subsequent chapters is provided.

The objective of Chapter 4 is to establish indications of in which situations the Court applies a *nationality-based approach* and when it applies a *free movement-based approach*. The case law survey contains national measures in relation to any field of Member State legislation tested under free movement provisions.

In Chapter 5, a survey of ECJ case law in relation to free movement law and income taxation is presented. The preliminary results from Chapter 4 are tested in relation to ECJ case law on Member States' income tax legislation. However, this case law study does not contain the cases where the ECJ has interpreted free movement articles in relation to tax treaty provisions. Such cases are dealt with in Chapter 6. For the reader who already has intimate knowledge of the case law, the reading of Chapters 4 and 5 are not necessary.

The three main cases dealing with the impact of free movement provisions on tax treaties are analysed in Chapter 6. After the analysis of these cases, also other statements by the ECJ of importance to the impact of free movement provisions on tax treaties are presented.

In Chapter 7, the findings of the study are applied on two tax treaty provisions not yet dealt with by the ECJ. The first one illustrates an application of a *free movement-based approach* and the second one an application of a *nationality-based approach*.

The question whether the free movement provisions prescribe most-favoured-nation treatment is handled in Chapter 8. If the ECJ would conclude that the free movement provisions prescribe such treatment, the tax treaty network in the internal market would be affected.

Finally, the findings of the study are presented in Chapter 9. These conclusions are found throughout the study but they are in this chapter presented in one context to provide the reader with a coherent presentation.

2 The Functioning of Tax Treaties

2.1 Focus on Tax Treaties Based on the OECD Model

The main objective of this chapter is to briefly describe and explain how tax treaties based on the OECD Model operate. For the analysis carried out in the subsequent chapters it is of importance to understand the specific characteristics of tax treaties in comparison with internal tax legislation. Moreover, different tax treaty provisions serve different purposes and are accordingly of more or less importance to the aim of avoiding double taxation.

As is stated in the previous chapter, the OECD Model is not in itself an international treaty.[1] It is a model convention which the Council of the OECD has recommended its Member States to follow when concluding tax treaties.[2] The development of tax treaties based on the OECD Model has influenced the legislation worldwide.[3] The OECD Model has contributed to a common understanding of basic concepts such as permanent establishment *etc.*[4] The majority of tax treaties concluded between EU Member States are based on this model.[5] It is common, however, that countries deviate from the OECD Model in certain respects and include in their tax treaties provisions specifically designed to function in correlation with their own tax systems. For instance, a tax treaty may include certain substantial rules for the avoidance of double taxation in a contracting state.[6]

[1] For example, see Baker, *Double taxation conventions: a manual on the OECD model tax convention on income and on capital,* (2003) marginal number A.07 and Winther-Sørensen, *Beskatning af International Erhvervsindkomst,* (2000), pp. 74–79.

[2] OECD Model, volume II, appendix II, Recommendation of the OECD Council Concerning the Model Tax Convention on Income and on Capital.

[3] See Westberg, *Cross-Border Taxation of E-Commerce,* (2002), p. 12.

[4] *Ibid.*, pp. 12, 57.

[5] See section 1.3.

[6] For example, see the Dutch provision under review in the Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819. The case is analysed in section 6.6.

2.2 Characteristics of Tax Treaties

Tax treaties can be described as having a dual nature; they are part of international treaty law and simultaneously constitute national internal tax law. As tax treaties are concluded between states, they are international agreements governed by international public law.[7] The procedure set up in each contracting state is decisive for how a tax treaty becomes part of the national internal legal system.[8]

The main purpose of tax treaties is to facilitate cross-border investment and trade by restricting domestic tax law and thereby avoid juridical double taxation.[9] Hence, a tax treaty can be regarded as a mechanism for providing treaty benefits to the residents of the two contracting states, such as reduced levels of cross-border withholding taxes.[10]

For certain types of income, the tax treaty reduces the right to tax for the source state.[11] This is done either by giving the residence state the exclusive right to tax or by limiting the tax rates available for the source state. In order to achieve more effective double taxation relief, tax treaties provide for definitions of terms used in the treaty.

Furthermore, tax treaties include provisions for mutual agreements and non-discrimination.[12] Article 24 OECD Model provides for elimination of tax discrimination in various circumstances.[13] This prohibition of discrimination is not as far-reaching as the prohibitions found in the context of EC law.[14]

Besides facilitating cross-border investment and trade, tax treaties are also concluded in order to counteract international tax avoidance and

[7] See Qureshi, *The Public International Law of Taxation*, (1994), chapter 1.

[8] For instance, see Baker, *Double taxation conventions: a manual on the OECD model tax convention on income and on capital*, (2003) marginal numbers B.01 and F.01.

[9] OECD Model, Introduction OECD Commentaries, paras. 1–3, 16. See also para. 7 of the OECD Commentaries on Article 1.

[10] For example, see para. 8 of the OECD Commentaries on Article 1 and 1996 U.S. Model, Technical Explanation on Article 22 (limitation on benefits).

[11] It may be argued that the expression *right to tax* is not entirely correct to use for tax treaties as the tax treaty generally only *restricts* the internal tax law claims. In this study the expression *right to tax* is nevertheless used as it appears to be an accepted expression in international tax law literature.

[12] See Articles 24 and 25 OECD Model.

[13] For further reading, see van Raad, *Nondiscrimination in International Tax Law*, (1986).

[14] For example, see Farmer, *EC Law and Direct Taxation – Some Thoughts on Recent Issues*, ECTJ, Vol. 1, 1995/96, issue 2, pp. 91–94, van Raad, *The Impact of the EC Treaty's Fundamental Freedoms Provisions on EU Member States' Taxation in Border-crossing Situations – Current State of Affairs*, ECTRev 1995, pp. 192–200 and Mattsson, *Är diskrimineringsreglerna i OECD:s modellavtal i överensstämmelse med EG-rätten? Några jämförelser mellan två regelsystem*, in *de lege* (2002), pp. 246–303.

evasion.[15] This is mainly done through the exchange of information on a reciprocal basis and the opening of a channel for this cooperation.[16]

Tax treaties are the outcome of bargaining and individual compromises reached in the particular circumstances of the contracting states and based on the specific characteristics, not just of their tax systems, but also of the interactions between the two countries' tax systems.[17] Accordingly, what a state may be prepared to give up in domestic taxation in one bilateral relationship may be different from another in which the circumstances are different.[18] The outcome is that tax treaties between different states vary when it comes to giving benefits to the residents of the contracting states.

It is important to keep in mind that a tax treaty only describes the ultimate limits to which the tax systems involved may extend. It is not necessary for a state to make use of the taxing rights that it is granted according to a treaty. A treaty may permit a maximum withholding tax of 15 per cent, but according to domestic tax law the withholding tax is 5 per cent. Where one contracting state does not take up its full right to tax under a treaty, the treaty can be seen as a guarantee to foreign investors that future taxation will not go beyond the limits set out in the tax treaty unless the treaty is amended or terminated.

The mechanisms of treaty application work briefly as follows. The countries involved in a cross-border transaction want to impose taxation on the basis of their national law. The applicable tax treaty restricts their right to do so. Tax treaties can allocate taxing rights in three different ways:[19]

1. The tax treaty may provide for taxation in the source country according to its domestic tax law but obligates the residence state to provide for double taxation relief in accordance with the tax treaty.

2. The tax treaty may give the exclusive right to tax to one of the contracting states and thereby completely take away the other contracting state's right to tax.

[15] OECD Model, Introduction OECD Commentaries, para. 16. In the Partnership report it is stated that the basic purposes of a tax treaty is "to eliminate double taxation and to prevent double non-taxation." See OECD, *The Application of the OECD Model Tax Convention to Partnerships,* (1999), para. 52.

[16] See Baker, *Double taxation conventions: a manual on the OECD model tax convention on income and on capital,* (2003), marginal number B.09.

[17] See Owens, *Taxation within a Context of Economic Globalization,* Bulletin 1998, p. 292.

[18] Avery Jones, *Flows of capital between the EU and third countries and the consequences of disharmony in European international tax law,* ECTRev 1998, p. 97.

[19] See OECD Model, Introduction OECD Commentaries, paras. 20–25.

3. The tax treaty may limit the source country's right to tax to a certain tax rate and at the same time require the residence state to provide for double taxation relief.

Finally, it is worth noticing that it is international juridical double taxation, and consequently not economic double taxation, that the tax treaties generally aim at reducing. Juridical double taxation is defined by the OECD as "...the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same matter and for identical periods."[20] Economic double taxation is used to describe the situation where two different persons are taxable in respect of the same income or capital.[21] The term *economic double taxation* is also used in reference to the taxation of a corporation's income that is taxed initially at the corporate level and subsequently at the shareholder level.[22]

2.3 Tax Treaties and Domestic Tax Law

The relationship between tax treaties and domestic tax law varies in different countries.[23] This relationship may depend on the constitutional law of the countries. When it comes to incorporating tax treaties into domestic law, states require different procedures.[24] Some states require parliamentary approval before a tax treaty becomes part of domestic law, while others require legislation implementing the tax treaty in order for it to take effect in the domestic context. In other states a tax treaty automatically becomes part of domestic law as soon as it comes into effect. One reason for these differences is that states have different views regarding the relationship between national and international law.[25]

Following the incorporation into domestic law, tax treaties acquire the nature of internal tax law but retain their nature as international agreements binding on both contracting states.[26] Concerning the relationship

[20] OECD Model, Introduction OECD Commentaries, para. 1. See also para. 1 of the OECD Commentaries on Articles 23 A and 23 B.

[21] Para. 2 of the OECD Commentaries on Articles 23 A and 23 B.

[22] Vogel, *Klaus Vogel on Double Taxation Conventions*, (1997), *Introduction* (marginal number 3).

[23] See Baker, *Double taxation conventions: a manual on the OECD model tax convention on income and on capital*, (2003), marginal number F.01.

[24] See Vogel & Prokisch, general report in IFA cahiers de droit fiscal international, *Interpretation of double taxation conventions*, (1993), p. 59.

[25] See Vogel, *Klaus Vogel on Double Taxation Conventions*, (1997), *Introduction* (marginal numbers 39–42).

[26] See Becker & Würm, *Double-taxation conventions and the conflict between subsequent domestic laws*, Intertax 1988, p. 258.

between international and internal law, there are two basic theories presented in the literature, however with a number of varieties.[27] The first doctrine is called the *dualistic* view and assumes that international law and internal law are two separate legal systems that exist independently from each other.[28] The second doctrine, called the *monistic* view, understands both international and internal law as forming part of one and the same legal order.[29] A state's standpoint in relation to the question of monistic versus dualistic view could have an impact on how to rank provisions in a double tax convention in relation to internal tax law.

The question of where to position tax treaties in the legal hierarchy in relation to internal tax law usually has to do with the process of making an international treaty domestically applicable. Generally, a state harmonizing with the monistic view does not require parliamentary consent in order to become domestically applicable.[30] For example, under Dutch constitutional law, a tax treaty becomes applicable domestically at the time it enters into force.[31] In Sweden both an acceptance by the parliament and enactment of internal legislation in the form of an act of incorporation, which states that the authentic text of the tax treaty is domestically applicable, are necessary in order to make the treaty applicable in the domestic context.[32] This procedure reflects the dualistic approach.

In Sweden, where parliamentary consent is needed, tax treaty provisions have the same rank as internal tax law.[33] Moreover, in the act of incorporation, it is usually explicitly stated that the treaty is applicable only to the extent it limits the liability to pay Swedish tax.[34] Consequently, a tax treaty can only reduce Swedish tax claims under internal tax law but it can never create tax liability on the mere basis of a tax

[27] See Brownlie, *Principles of Public International Law,* (2003), pp. 31–32, Aldén, *Om regelkonkurrens inom inkomstskatterätten,* (1998), pp. 225–229, Dahlberg, *Svensk skatteavtalspolitik och utländska basbolag,* (2000), pp. 61–62, Aust, *Modern Treaty Law and Practice,* (2000), pp. 146–155.

[28] Malanczuk, *Akehurst's Modern Introduction to International Law,* (1997), p. 63.

[29] *Ibid.*

[30] See Vogel, *Klaus Vogel on Double Taxation Conventions,* (1997), *Introduction* (marginal number 41) and Aust, *Modern Treaty Law and Practice,* (2000), p. 146. For an opposite opinion regarding the connection between a state's method of implementing its double tax conventions and the state's connection to either the monistic or dualistic approach, see Dahlberg, *Svensk skatteavtalspolitik och utländska basbolag,* (2000), p. 62.

[31] Vogel, *Klaus Vogel on Double Taxation Conventions,* (1997), *Introduction* (marginal number 41), see also Vogel & Prokisch, General Report, *Interpretation of double taxation conventions,* (1993), p. 59.

[32] See the Swedish Constitution (*Regeringsformen*), chapter 10, sections 1 and 2.

[33] See Aldén, *Om regelkonkurrens inom inkomstskatterätten,* (1998), p. 229.

[34] For example, see Article 2 in the 1991 tax treaty between Sweden and the Netherlands.

treaty.[35] Lindencrona has expressed the relationship between tax treaties and Swedish internal tax law[36] with these words: "...the law of double taxation conventions constitutes a special system, separate from the internal tax legislation, which is to be applied simultaneously to the same."[37]

In some states tax treaties are considered to have priority over internal tax law. Vogel points out that in both Belgium and France effectively concluded treaties have primacy over internal tax law from the moment of their publication.[38] In many states the international character of tax treaties is respected by treating them according to the principle of *lex specialis legi generali derogat* on the basis either of express provisions or of case law, so that the treaty provisions have priority in the case of a conflict.[39] As tax treaties specifically address cross-border situations, they could be considered to be of a more specific nature than general tax laws.

Before further elaborating on tax treaties, an introduction is given to the OECD Model. This Model has provided a pattern for the vast majority of tax treaties in force in the world today.[40] One reason for this widespread use is the OECD's recommendation to its Member States to comply with the Model when concluding tax treaties.[41]

2.4 OECD Model

The main purpose of the OECD Model is "to clarify, standardize, and confirm the fiscal situation of taxpayers" who have cross-border activities through the application by all countries of common solutions to identical cases of double taxation.[42] Due to its work in drafting the Model and through its research and reports on various international tax issues, the OECD significantly influences the development of international taxation.[43]

[35] Boström & Tyllström, Swedish branch report, *Interpretation of double taxation conventions*, (1993), p. 559.

[36] Lindencrona, *Skatter och kapitalflykt*, (1972), p. 156.

[37] The original text in Swedish: "*...dubbelbeskattningsavtalsrätten utgör ett från den interna rätten särskilt rättssystem som skall tillämpas samtidigt som detta.*" in Lindencrona, *Skatter och kapitalflykt*, (1972), p. 156.

[38] Vogel, *Klaus Vogel on Double Taxation Conventions*, (1997), *Introduction* (marginal number 134), regarding France see also Lindencrona, *Dubbelbeskattningsavtalsrätt*, (1994), p. 26.

[39] Vogel & Prokisch, General Report, *Interpretation of double taxation conventions*, (1993), p. 59.

[40] OECD Model, Introduction OECD Commentaries, paras. 13–15.

[41] OECD Model, volume II, appendix II, Recommendation of the OECD Council Concerning the Model Tax Convention on Income and on Capital.

[42] OECD Model, Introduction OECD Commentaries, paras. 2–3.

[43] Responsibility for the OECD Model lies within the OECD Committee on Fiscal Affairs.

Since 1963, the OECD Model has had a considerable consequence on the negotiations, application and interpretation of tax treaties.[44] OECD Member States have largely conformed to the Model when concluding tax treaties. In general, concluded tax treaties follow the pattern and the main provisions in the Model. In this way the Model has contributed to a harmonization of tax treaties between OECD Member countries.[45] In addition, the OECD Model has been used as the basis for the *United Nations Model Double Taxation Convention between Developed and Developing Countries*.[46]

However, it should be underlined that even though the OECD Model has contributed to a harmonization of tax treaties, the OECD Model still leaves the decision in many questions to the contracting states.[47] Consequently, the outcome of applying different tax treaties, which look similar to one another, could have a very different result. This is mainly due to the domestic law that the tax treaty is set up to restrict.[48]

The Commentaries on the provisions of the OECD Model are a widely accepted guide to the interpretation and application of tax treaties.[49] However, the importance given to the Commentaries vary within the OECD Member countries.

There is more than one version of the Model and its Commentaries. Concluded tax treaties still in force could be based on different models, such as the OECD draft Model of 1963 or the OECD Model of 1977.[50] Since 1992 the OECD has released changes in the Model and to a greater extent in the Commentaries, at much shorter intervals than in the past.[51] Moreover, OECD Member countries have the right to make reservations

[44] OECD Model, Introduction OECD Commentaries, para. 12. For a presentation of the developments before 1963, see Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights between Countries*, (1996), pp. 286–312.

[45] OECD Model, Introduction OECD Commentaries, para. 13.

[46] *Ibid.*, para. 14.

[47] *Ibid.*, para. 27.

[48] See van Raad, *Comment: The Meaning of Nondiscrimination* in Vogel, *Taxation of cross-border income, harmonization, and tax neutrality under European Community law*, (1994), p. 46.

[49] OECD Model, Introduction OECD Commentaries, para. 29.

[50] *Ibid.*, paras. 8–9, 33, and Lang, *The Binding Effect of the EC Fundamental Freedoms on Tax Treaties*, in Gassner, Lang & Lechner (eds.), *Tax Treaties and EC Law*, (1997), p. 25.

[51] For example, amendments were made in 1992, 1994, 1995, 1997, 2000, 2001, 2002 and 2003. The Models and Commentaries of 1963 and 1977 were published as paperbacks. However, since 1992 the OECD has published both the Model and Commentaries primarily as a loose-leaf collection. Paperback versions are only published at irregular intervals and have not been issued every time that amendment has been released. See Vogel, *The Influence of the OECD Commentaries on Treaty Interpretation*, Bulletin 2000, p. 615.

with respect to the articles of the OECD Model.[52] The reservations are published in the Commentaries of the article concerned. The significance of a reservation is that insofar as an OECD Member State has entered reservations, the other OECD Member States, in negotiating bilateral conventions with the former, will retain their freedom of action according to the principle of reciprocity.[53] OECD Member States that cannot agree with the interpretation of a certain article given in the Commentary can request the insertion of an observation.[54] The observation indicates in which way the Member country will apply the provision of the specific article.

2.5 Fundamentals of Tax Treaty Application

2.5.1 Tax Treaty Residence in the OECD Model

The concept of tax residence can be said to be the cornerstone of international taxation. Residence determines, in the domestic context, the rights and obligations to which the taxable person is subject. In an international setting, persons who are residents of one or both of the contracting states fall within the scope of the convention.[55] To be able to apply the distributive rules of a tax treaty, it is necessary to establish only one state of residence.

Article 4 of the OECD Model states that a person is resident of a country if he "...under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature". Article 4 (1) recognizes virtually all jurisdictional connections giving rise to full tax liability as residence for tax treaty purposes.[56] Consequently, due to the reference to the domestic law of the contracting states, it is possible that a person is considered to be resident in both contracting states. To solve this problem, Articles 4 (2) and 4 (3) contain rules on how to decide which state is the residence state under the treaty. These rules are commonly referred to as tie-breaker provisions. If it is an individual who has dual residence according to the domestic law of both contracting states, Article 4 (2) contains a series of subsequently decisive circumstances.

[52] OECD Model, Introduction OECD Commentaries, para. 31.
[53] *Ibid.*
[54] *Ibid.*, para. 30.
[55] Article 1 OECD Model.
[56] van Raad, *Dual Residence*, ET 1988, p. 241.

The tie-breaker clause for companies and persons other than individuals is found in Article 4 (3). According to this rule, the person is deemed to be a resident only of the state in which its place of effective management[57] is situated.

2.5.2 Connecting Factors

Articles 6 to 22 of the OECD Model are generally referred to as distributive rules. These provisions lay down rules attributing the right to tax in respect of various types of income. However, in principle they do not deal with the determination of taxable income, deductions or rate of tax. In the absence of specific provisions in the OECD Model, the domestic tax laws of each contracting state are applicable.[58]

The distributive rules employ different factors for deciding in which of the contracting states an income is to be taxed. Examples of connecting factors are where the property[59] or effective management[60] is located, where the receiver of the income is resident,[61] where the employment is exercised[62] and the nationality of the individual receiving remuneration[63].

2.5.3 Mechanisms of Treaty Application in the OECD Model

The OECD Model establishes different techniques when designing rules to prevent double taxation. Either the Model confers a primary or exclusive right to tax to one of the contracting states (normally the state of residence), or the right to tax is divided between the contracting states. The right to tax dividends and interest is given to both contracting states; however, the amount of tax that may be imposed in the state of source is

[57] Paragraph 24 of the OECD Commentaries on Article 4 describes the place of effective management as follows: "...The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of effective management, but it can have only one place of effective management at any one time."

[58] Para. 38 of the OECD Commentaries on Article 23 A and 23 B.

[59] See Article 6 OECD Model.

[60] See Articles 8 and 13 OECD Model.

[61] For instance, see Article 10 OECD Model.

[62] For instance, see Article 15 OECD Model.

[63] See Article 19 OECD Model.

limited. When the Model states a limited or full right to tax for the source state, the residence state is obliged to allow a relief in order to avoid double taxation. Articles 23 A and 23 B give the rules for such relief.

A primary right to tax is expressed as *may be taxed* by that state.[64] This is the usual expression when the source state is given a primary right to tax the income. For instance, this is the case for the distributive rule given in Article 6 (1) dealing with income from immovable property. This implies a duty under Article 23 for the residence state to avoid double taxation of the income that is allowed to be taxed in the source state. However, this wording gives the state of residence the right to include the income in the tax base when calculating the worldwide income of its resident taxpayers.

When the allocation of taxing right is an exclusive right to tax, the expression *shall be taxable only* in one of the contracting states is used. The general rule is that this expression is used only when the residence state is given the right to tax.[65] This is the case in the main rule given in Articles 7 (1), Article 12 (1), the main rule of Article 13, stated in 13 (5), Article 18 and Article 21.

An exception to this general rule is found in Article 19 dealing with remuneration from government services. In this article the source state is given the exclusive right to tax. The use of the expression *shall be taxable only* in the source state results in that the residence state is not allowed to include the income when calculating the worldwide income of its residents, *i.e.*, the article forces the residence state to apply full exemption for this type of income.[66] Another article that is an exception to the above-mentioned rule is Article 8, which deals with income from shipping, inland waterways transport and air transport. Under this article the exclusive right to tax is given, according to the wording *shall be taxable only*, to the state where the place of effective management of the enterprise is situated. This is not what is normally referred to as the source state, but it is, nevertheless, not a reference to the state of residence of the enterprise. Also in Articles 13 (3) and 22 (3), for instance, an exclusive right to tax is allocated not to the residence state but to the state in which the place of effective management of the enterprise is situated.[67]

Articles 10 and 11, dealing with the taxation of dividends and interest, provide for tax sharing between the source state and the residence state.[68]

[64] OECD Model, Introduction OECD Commentaries, para. 21.

[65] Para. 6 of the OECD Commentaries on Articles 23 A and 23 B.

[66] For an explanation of the term *full exemption*, see section 2.6.2.

[67] Para. 6 of the OECD Commentaries on Articles 23 A and 23 B.

[68] OECD Model, Introduction OECD Commentaries, para. 22.

The taxation in the source state is restricted, and the residence state is obliged to give a credit for the tax levied in the source state. This is the case even if the treaty otherwise applies the exemption method.[69]

The tax sharing provided in those articles is unusual considering the OECD Model as a whole. All other types of income are allocated to one of the contracting states for either primary or exclusive right to tax. According to the OECD Model, the tax sharing between the source state and the residence state is only provided for in the case of dividends and interest. However, contrary to the Model, many states in their tax treaties provide for a tax sharing also in respect to royalties. The OECD Model deals with royalties in Article 12. According to this article, the residence state is given the exclusive right to tax.

The domestic laws usually provide for withholding tax rates considerably higher than the ones in the OECD Model. The maximum amount of tax imposed by the state of source according to the Model is restricted to 15 per cent. Article 10 distinguishes between inter-company dividends and other dividends. Technically, this is achieved by the special provision on inter-company dividends, found in Article 10 (2) (a). If the holding requirement of at least 25 per cent of the capital is fulfilled,[70] the maximum taxation in the state of source is 5 per cent. The reason for providing more favourable treatment of income from direct investments than to portfolio investment is to facilitate direct investments abroad as well as reduce economic multiple taxation of dividend payments among groups of companies.[71]

In the case of interest, the taxation in the source state is restricted to 10 per cent of the gross amount of the interest.[72] The state of source is free to impose the tax according to its own domestic law, without being restricted in any way except as to the amount of tax.[73] Tax treaties between industrialized states commonly deviate from the OECD Model in that they provide for exclusive taxation of interest by the recipient's state of residence.[74]

[69] Article 23 A (2) OECD Model.

[70] According to para. 15 of the OECD Commentaries on Article 10 contracting states may depart from the criterion of capital used in sub-paragraph a) of paragraph 2 and use instead the criterion of voting power.

[71] Para. 10 of the OECD Commentaries to Article 10 and Vogel, *Klaus Vogel on Double Taxation Conventions,* (1997), *Article 10. Dividends* (marginal number 8).

[72] Article 11 (2) OECD Model.

[73] Vogel, *Klaus Vogel on Double Taxation Conventions*, (1997), *Article 11. Interest* (marginal number 36).

[74] *Ibid.*, (marginal number 6).

As the focus of this study is on the impact of free movement law on tax treaties concluded between EU Member States, it is relevant to briefly present the effect for EU Member States of the Parent-Subsidiary Directive[75] and the Interest and Royalty Directive[76].[77] According to the Parent-Subsidiary Directive, cross-border profit distributions paid out of after-tax profits by an EU subsidiary to its EU parent company must, if certain conditions are fulfilled, be free of dividends withholding tax in the Member State of source and free of double corporate taxation in the Member State of the parent company.[78] This entails that such dividends must be exempted from withholding tax by the Member State of the subsidiary and that the Member State of the recipient company has two different alternatives.[79] Either it may apply the exemption method, and thereby refrain from taxing the dividends, or tax it but then grant a credit against the underlying corporation tax already paid by the subsidiary in its state of residence.

The Interest and Royalty Directive prescribes that the debtor's state, generally referred to as the source state, shall exempt from any tax interest and royalty payments paid by a company of that Member State to an associated enterprise in another Member State.[80] As no withholding tax is allowed, interest and royalty payments are supposed to be taxed only once in a Member State.[81] As the EU Member States are obliged under Community law to implement directives, the above-mentioned directives imply that Member States are not able to make use of some of the taxing rights that they are allowed to exercise under their tax treaties.[82]

[75] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and and subsidiaries of different Member States.

[76] Council Directive 2003/49/EC on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

[77] See also section 5.3.

[78] For an in-depth analysis of the Parent-Subsidiary Directive, see Brokelind, *Une interprétation de la directive sociétés mères et filiales du 23 juillet 1990*, (2000).

[79] See Articles 4 and 5 of the Parent-Subsidiary Directive.

[80] See Article 1 of the Interest and Royalty Directive. See also Terra & Wattel, *European Tax Law*, (2001), pp. 433–440.

[81] See para. 3 of the preamble to the Interest and Royalty Directive.

[82] See Article 249 EC.

2.6 Provisions for the Elimination of Double Taxation

2.6.1 The Importance of Article 23 OECD Model

Article 23 of the OECD Model describes two methods for the residence state to avoid double taxation. Article 23 A provides for the exemption method and Article 23 B for the credit method.[83]

In the Commentaries it is pointed out that from a theoretical perspective it would have been preferable if the OECD Model had provided for only one method.[84] However, due to the different preferences among the OECD Member countries, this has not been possible. The current provisions are drafted in a way that Member countries are free to choose between the two methods.

Having regard to the treaty mechanism giving a primary right to tax to the source state and obliging the residence state to avoid double taxation by applying either Article 23 A or B, one realizes the importance of this article to the functioning of tax treaties. If an enterprise of a contracting state has a PE in the other contracting state, then it is taxable only on the income attributable to it in the state where the PE is located.[85] However, the enterprise is taxable on its worldwide income in its state of residence, which includes the income of the PE located in the other contracting state. Accordingly, relief from the juridical double taxation is necessary. Here Article 23 comes into effect.

2.6.2 The Exemption Method

According to Article 23 A, the exemption method provides for the avoidance of double taxation by restricting the residence state's right to tax certain items of income. The items of income that are to be exempted from tax in the residence state are those which under the tax treaty *may be taxed* or *shall be taxable only* in the other contracting state.[86] As a rule, exemption is generally granted irrespective of whether the income

[83] For an illustration of the effects of the different methods for avoidance of double taxation, see paras. 18–27 of the OECD Commentaries on Article 23 A and 23 B, Pires, *International Juridical Double Taxation of Income*, (1989) and Mattsson, *Svensk internationell beskattningsrätt*, (2004), pp. 194–199.

[84] Para. 28 of the OECD Commentaries on Article 23 A and 23 B. See section 2.6.4.

[85] See Article 7 OECD Model.

[86] Para. 13 of the OECD Commentaries on Articles 23 A and 23 B.

concerned is subject to any tax liability in the other contracting state.[87] This is so unless a subject-to-tax clause has been agreed on.[88]

An important aspect of the exemption method is that the exclusion of foreign income from the tax base generally results in non-consideration of such income in the calculation of any carry back or carry forward of losses incurred at home.[89] In other words, profits derived abroad cannot generally be set off against domestic losses.

In Article 23 A two main varieties of the exemption method are presented.[90] The first one is the so-called *full exemption*, which sometimes also is referred to as *income exemption*. According to this method, income that may be taxed in the other contracting state is not taken into account at all by the state of residence for the purpose of its tax. The second method is similar to the first one but it allows the residence state to take the exempted income into consideration when determining the tax to be imposed on the rest of the income. This type of exemption method is called *exemption with progression*. When exemption with progression is applied, a fictitious computation of the total income, including the foreign income, is done in order to establish the correct progressive tax rate.[91] The Commentaries to the OECD Model refers to other varieties of the two main methods of exemption, namely *modified exemption* and *participation exemption.*

An effect of the exemption method is that the taxable income or capital in the state of residence is reduced by the amount exempted in that state. If, in a particular state, the amount of income as determined for income tax purposes is used as a measure for other purposes, such as social benefits, the application of full exemption may have the effect that such benefits may be given to persons who ought not to receive them. To avoid such consequences, a variation of the exemption method is sometimes used, the so-called modified exemption.[92] This is described in the Commentaries to Article 23 A.[93]

[87] However, see Article 23 A (4).

[88] For instance, see para. 35 of the OECD Commentaries on Articles 23 A and 23 B.

[89] Vogel, *Klaus Vogel on Double Taxation Conventions*, (1997), *Methods for Elimination of Double Taxation* (marginal number 68 a).

[90] See also para. 14 of the OECD Commentaries on Articles 23 A and 23 B.

[91] For instance, see Skatteverket, *Handledning för internationell beskattning*, (2004), p. 351.

[92] See Vogel, *Klaus Vogel on Double Taxation Conventions*, (1997), *Methods for Elimination of Double Taxation* (marginal number 69 b).

[93] Para. 37 of the OECD Commentaries on Article 23 A. It appears as if the term *alternative exemption* is used interchangeably with the term *modified exemption.* See Mattsson, *Does the European Court of Justice Understand the Policy behind Tax Benefits Based on Personal and Family Circumstances?* ET 2003, p. 186.

Modified exemption signifies that the foreign income is included in the taxable income. Then, a deduction is made from the income tax, corresponding to that part of the income tax which is applicable to the income derived from the other state.[94]

Participation exemption implies that there are special prerequisites in order to receive the income tax exempt. Like in the case of full exemption, the income is not included in the taxable income. For dividends, the conditions usually include some kind of holding requirement and that the income has been subject to a substantial taxation on the profits out of which the dividends are paid.[95] When participation exemption is applied, the level of withholding tax in the state of source has a direct impact on the taxpayer. In contrast, if the credit method is used for dividends, the withholding tax rate does not, in principle, have an impact on the taxpayer.[96] Sometimes the term *partial exemption* is used instead of participation exemption in order to describe systems where a state exempts income derived from countries that are committed to imposing taxes at rates and under conditions that are roughly comparable to its own rates and conditions.[97]

2.6.3 The Credit Method

According to the credit method in Article 23 B OECD Model, the residence state calculates its tax on the basis of the taxpayer's total income.[98] In the total income, income that, according to the Convention, *may be taxed* in the other contracting state is included. However, it does not include income that shall be taxable only in the source state. In order to avoid double taxation the residence state then allows a deduction from its own tax for the tax paid in the other state.[99] Compared with the exemption method, the credit method is to a greater extent complemented by domestic law.[100]

The OECD Model provides for two main credit methods.[101] Either the residence state allows a deduction of the total amount of tax paid in the other state on income that may be taxed in that state. This is normally

[94] Para. 37 of the OECD Commentaries on Article 23 A.

[95] Paras. 53–54 of the OECD Commentaries on Article 23 A.

[96] See section 2.6.3.

[97] Arnold & McIntyre, *International Tax Primer*, (2002), p. 35.

[98] Para. 15 of the OECD Commentaries on Articles 23 A and 23 B.

[99] For further reading, see, for instance, Harris, *Corporate/Shareholder Income Taxation and Allocating Taxing Rights between Countries*, (1996), p. 283.

[100] Para. 60 of the OECD Commentaries on Articles 23 A and 23 B.

[101] See Article 23 B and para. 16 of the OECD Commentaries on Articles 23 A and 23 B.

referred to as *full credit*. Or the deduction given by the residence state is limited to that part of its own tax which applies to the income that *may be taxed* in the other state. The latter method is referred to as the *ordinary credit* method.

Tax treaties occasionally include different varieties of the principal credit method which are not set out in the OECD Model. For instance, a *reversed credit* implies that the source state gives credit for taxes that have been paid in the residence state.[102]

2.6.4 Theoretical Differences between the Exemption and the Credit Methods

The exemption method gives that the tax on foreign items of income is allowed to stand at the level imposed by the source state.[103] The exemption method obliges the residence state to exempt certain items of income regardless of the actual taxation of the income by the residence state. This follows from that the exemption method focuses on the income itself, rather than the tax burden on the income.[104]

In contrast, under the principle of credit, the tax burden borne by foreign items of income is adjusted to the level prevailing in the residence state if the tax rate in the latter is higher than the one in the source state. Moreover, according to the ordinary credit method, if the tax rate in the state of source is higher than the one in the residence state, the heavier taxation in the state of source is allowed to remain.

According to Vogel, the philosophies underlying the two methods can be described as follows.[105] The exemption method is based on the concept that the source state has a better right to tax the income, and, consequently, the residence state has to give up its taxing rights according to domestic law, while the credit method is designed only to mitigate an excessive burden by reducing the overall taxation to the level of taxation of the residence state or the source state, if that is higher.

The choice of method is closely connected to the question of neutrality and in which market the neutrality is to be achieved.[106] The exemption

[102] For instance, see Skatteverket, *Handledning för internationell beskattning*, (2004), p. 353.

[103] Vogel, *Klaus Vogel on Double Taxation Conventions*, (1997), *Methods for Elimination of Double Taxation* (marginal number 39a).

[104] Para. 17 of the OECD Commentaries on Articles 23 A and 23 B.

[105] Vogel, *Klaus Vogel on Double Taxation Conventions*, (1997) *Methods for Elimination of Double Taxation* (marginal number 39).

[106] For further reading, see Ståhl, *Aktiebeskattning och fria kapitalrörelser*, (1996), pp. 89–114, Mutén, *Credit-metod eller exempt-metod i dubbelbeskattningsavtal – en principfråga?* SvSkT 1993, pp. 307–310 and Kemmeren, *Principle of Origin in Tax Conventions*, (2001), pp. 71–72.

method makes for equally competitive conditions in the state of source among investors from different countries.[107] This is referred to as *capital import neutrality.* In contrast, the credit method makes for equal treatment in the state of residence of capital investments made both at home and abroad.[108] This is called *capital export neutrality.* Accordingly, a state that follows this principle adheres to the opinion that the taxation of foreign-source income of its residents is to be carried out in a way that neither encourages them, nor discourages them to invest abroad.[109] However, due to the general use of the ordinary credit method, neutrality in the residence state is not achieved when the foreign-source income is taxed at a higher level than the corresponding treatment in the residence state.

2.7 Conclusions

The main objective of this chapter has been to describe and explain how tax treaties operate. The starting point is that a tax treaty provides tax treaty benefits to the residents of the contracting states in order to facilitate cross-border investment and trade by avoiding juridical double taxation. Examples of such benefits are reduced levels of withholding taxes and double taxation relief.

The OECD Model has contributed to a harmonization of tax treaty design. The vast majority of tax treaties in force between EU Member States are based on the OECD Model. It is common, however, that states deviate on some matters from the OECD Model and include in their tax treaties provisions specifically designed to function in correlation with their own tax systems.

The concept of tax residence is described as the cornerstone of international taxation. In the domestic context residence determines the rights and obligations to which the taxable person is subject. In terms of tax treaties, persons who are residents of one or both of the contracting states fall within the scope of the convention. Accordingly, it is a person's residence that determines if he is able to benefit from a tax treaty.

In order to prevent double taxation, the OECD Model provides for different techniques. Either a primary or an exclusive right to tax is given to one of the contracting states, in the vast majority of situations to the residence state, or the right to tax is divided between both the contracting

[107] Vogel, *Klaus Vogel on Double Taxation Conventions*, (1997), *Methods for Elimination of Double Taxation* (marginal number 40).
[108] *Ibid.*
[109] See Terra & Wattel, *European Tax Law*, (2001), p. 154.

states. When a limited or full right to tax is given to the source state, the residence state is obliged to allow relief to avoid double taxation.

The distributive rules employ different connecting factors for deciding in which of the contracting states an income is to be taxed. Examples of these factors are where the property or effective management is located, where the receiver of the income is resident, where the employment is exercised and the nationality of the individual receiving remuneration.

The methods for avoiding double taxation where both contracting states have the right to tax an item of income are found in Article 23 of the OECD Model. A tax treaty's method article is one of its core provisions in terms of its importance for the operation of tax treaties, namely avoiding juridical double taxation. Article 23 A provides for the exemption method and Article 23 B for the credit method. The principle of exemption implies that the tax on foreign income is allowed to stand at the level imposed by the source state. In contrast, under the principle of ordinary credit, which is the variation of the credit method commonly used in tax treaties, the tax borne by foreign items of income is adjusted to the level prevailing in the residence state, if the tax rate in the latter state is higher than the one in the source state. If the tax rate in the state of source is higher than in the state of residence, the ordinary credit method implies that the heavier taxation in the state of source remains, as the maximum deduction is the level of residence state taxation on the foreign income.

3 The Framework of Free Movement Law

3.1 Different Lines of Reasoning and Grounds for Justification

The aim of this chapter is to identify the main lines of reasoning used by the ECJ when interpreting free movement provisions. This is of importance as there are great differences in the ECJ's reasoning in different situations. A fundamental question for the predictability of the application of the free movement provisions is whether the different lines of reasoning are applied under specific circumstances.[1] The purpose of Chapters 4 and 5 is to answering under which circumstances each line is commonly used. Moreover, this chapter presents the relevant legal concepts for the case law analysis carried out in primarily Chapters 4, 5 and 6.

The current uncertainty as to when imperative interests may be successfully invoked by the Member States requires an analysis. The grounds for justification are, in principle, dependent on whether or not the national measure found to be in breach of Community law is considered by the Court to be directly discriminatory. According to the traditional understanding, which is based on explicit statements made by the ECJ, all measures but those classified as directly discriminatory may be justified by the explicitly stated justifications in the EC Treaty and by additional grounds for justification, that is the imperative interests. This is an open-ended category developed through case law. However, uncertainty has arisen as it appears that the ECJ has referred to grounds other than the Treaty justifications when assessing whether directly discriminatory national measures could be justified.

To analyse the main question dealt with in this thesis, *i.e.* what is the impact of free movement law on provisions of tax treaties concluded between EU Member States, it is necessary to deal with these issues. It is

[1] See Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax system of the Member States*, ECTRev 2003, p. 140.

vital to predict which line of reasoning the Court is most likely to apply when assessing a certain tax treaty provision and which grounds for justification the Member States may invoke in order to try to justify a tax treaty provision found to be in conflict with a free movement provision of the EC Treaty.

During the past decades, the ECJ has been confronted with a diversity of legal issues relevant to the free movement of goods, workers, services and capital and the freedom of establishment. This case law has filled gaps in the openly formulated provisions which address matters of free movement in the EC Treaty.[2] Interpretation by the ECJ of the free movement provisions has been in a process of ongoing articulation and development.[3]

All the free movement provisions are directly effective.[4] This means that individuals may rely on them before national courts, and the courts are under an obligation to ensure full effect of those provisions.

All freedoms except the free movement of goods are of direct importance when considering the free movement provisions that could be applicable to tax treaty provisions. This is because tax treaties deal with taxes on income and capital, and the free movement of goods is mainly affected by consumption taxes and custom duties. However, the development of the free movement of goods principle is of interest for the development of the other free movement articles, and that is why case law on the free movement of goods is, to a limited extent, included in this study.

Due to the central importance of the free movement provisions in realizing a well-functioning internal market, I find it valuable to briefly go into the significance of the internal market before moving on to the main questions dealt with in this chapter.

3.2 The Internal Market

3.2.1 One of the Main Means for the Realization of the Community

The European Community consists of 25 Member States. The creation of an internal market is one of the main means to achieve the aims of the

[2] See Articles 25, 28– 31, 39, 43, 49 and 56 EC.

[3] See de Búrca, *Unpacking the Concept of Discrimination in EC and International Trade law* in Barnard & Scott, *The Law of the Single European Market*, (2002), p. 182.

[4] For instance, see Case 2/74 *Jean Reyners* v *Belgian State* [1974] ECR 631, Case 33/74 *Johannes Henricus Maria van Binsbergen* v *Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid* [1974] ECR 1299 and Cases C-163, 165 & 250/94 *Criminal proceedings against Lucas Emilio Sanz de Lera* [1995] ECR I-4821.

Community.[5] The idea is that overcoming the inefficiencies of nationally segmented economies enhances the prosperity of the Member States. The creation of an internal market means a merger of different national markets into one single market similar to a domestic market.[6]

The primary objective of the Community is economic welfare but also to promote harmonious, balanced and sustainable development of economic activities throughout the Community.[7] According to Article 3 EC, the Community shall also achieve a system ensuring that competition in the internal market is not distorted and to approximate the laws of the Member States to the extent required for the functioning of the common market.

In the EC Treaty, it is stated that the internal market is an area characterised by the abolition of obstacles to the free movement of goods, persons, services and capital.[8] These statements have been relied on by the Court as important guidelines for its interpretation of the free movement provisions, namely Articles 23, 25, 28–29, 39, 43, 49 and 56 EC, which are to ensure that obstacles to the free movement are removed. The free movement provisions have priority over the non-discrimination provision in Article 12 EC.[9] From this brief presentation, one realizes the central importance of the free movement provisions for the functioning of the internal market.

3.2.2 Stages of Economic Integration

The internal market can be defined in both economic and legal terms. In economic terms, an internal market can be seen as one stage of economic integration.[10]

Economic integration in general refers to the gradual elimination of economic frontiers between independent states, with the desired outcome of changing the separated national economies from being independent to functioning as one entity or, in other words, as an internal market.[11] The main objectives of economic integration are of an economic nature, for

[5] Articles 2 EC and 14 EC.

[6] See Article 2 EC and Case 15/81 *Gaston Schul Douane Expediteur BV* v *Inspecteur der Invoerrechten en Accijnzen* [1982] ECR 1409, para. 33.

[7] Article 2 EC.

[8] See Articles 3 and 14 EC.

[9] For example, see Case 2/74 *Jean Reyners* v *Belgian State* [1974] ECR 631, paras. 15–16. Article 12 EC is of autonomous application only in situations not covered by the free movement provisions or any other Treaty prohibition of discrimination.

[10] Balassa, *The Theory of Economic Integration,* (1962), p. 2.

[11] Molle, *The Economics of European Integration*, (2001), p. 10.

instance higher growth, resulting in more prosperity.[12] Other objectives are of a political nature, for example the reduction of the risks of armed conflicts among partners.[13]

Balassa has described the different stages of economic integration as a free-trade area, a customs union, a common market, an economic union and finally a complete economic integration.[14] A common market can be described as an area characterised by the free movement of both goods as well as other production factors, the elements that are used to make a product. The basic aim is to ensure the optimal allocation of resources within the internal market.

3.2.2.1 Positive and Negative Integration

In an EU context, negative integration is the part of economic integration that consists of the removal of barriers between the economic agents in the different Member States, for example, the removal of barriers to trade in terms of quotas and tariffs.[15] Positive integration refers to the policy co-ordination in order to fulfil economic and welfare objectives.[16]

The original Rome Treaty laid down the foundations for economic integration in general, and an internal market in particular, but it mainly took the form of negative integration in that it prohibited discrimination of foreign goods, workers *etc.*[17] However, the Rome Treaty also included measures of positive integration, for example Article 100, which is now Article 94 EC.

3.2.2.2 A Common, Internal and Single Market

The term *common market* was used in the Rome Treaty without being explicitly defined. The term *internal market* was introduced in the Treaty by Article 8 EEC [now Article 14 EC]. The situation now is that Article 2 EC refers to *common market*, while Article 3 EC refers to both *internal*

[12] *Ibid.*

[13] *Ibid.*

[14] Balassa, *The Theory of Economic Integration,* (1962), p. 2. See also *ibid.*, pp. 16–18.

[15] See Pelkmans, *The Federal Economy: Law and Economic Integration and the Positive State – The U.S.A. and Europe Compared in an Economic Perspective* in Cappelletti, Seccombe & Weiler (eds.), *Integration Through Law,* (1986), p. 327, Jiménez, *Towards Corporate Tax Harmonization in the European Community,* (1999), p. 3. This is sometimes referred to as negative harmonization. See Craig & de Búrca, *EU Law,* (2002), p. 614.

[16] *Ibid.*

[17] Craig, *The Evolution of the Single Market* in Barnard & Scott, *The Law of the Single European Market,* (2002), p. 3.

and *common market* and Article 14 EC refers exclusively to *internal market*. In the words of the ECJ, the establishment of an internal market entails:

> "the elimination of all obstacles to intra-Community trade in order to merge the national market into a single market bringing about conditions as close as possible to those of a genuine internal market."[18]

Kapteyn and VerLoren van Themaat have defined a common market as:

> "a market in which every participant within the Community in question is free to invest, produce, work, buy and sell, to supply or obtain services under conditions of competition which have not been artificially distorted wherever economic conditions are most favourable".[19]

Kapteyn and VerLoren van Themaat draw the conclusion that the concept of a common market is broader than the concept of an internal market, because the latter, as is set out in Article 14 (2) EC, merely consists of "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of this Treaty".[20]

In this thesis, I will not analyse possible differences between *internal market* and *common market* as they are not relevant for the purpose of this study.[21] The same applies to the term *single market*, which is sometimes also used.[22] In this study, the term single market is used interchangeably with internal market and common market.

3.2.3 The Borderline Between Legitimate and Illegitimate National Measures

The free movement provisions concern the integration of national markets for goods, services, workers and capital. The Community's efforts to integrate national markets to establish one, well-functioning, internal market can be seen as attempts to limit the influence of national

[18] Case 15/81 *Gaston Schul Douane Expediteur BV* v *Inspecteur der Invoerrechten en Accijnzen* [1982] ECR 1409, para. 33.

[19] Kapteyn & VerLoren van Themaat, (edited by Gormley), *Introduction to the Law of the European Community*, (1998), p. 123.

[20] *Ibid.*

[21] It seems as if the legal literature is divided when it comes to the interpretation of the concept of the *common market* and the *internal market*. For example, see Jiménez, *Towards Corporate Tax Harmonization in the European Community*, (1999), p. 6.

[22] See Mortelmans, *The Common Market, The Internal Market and the Single Market, What's in a Market?* CMLRev 35, 1998, p. 107.

governments.[23] The reason for doing so is to take away restrictions on the free movement and to encourage people to take advantage of the internal market as a whole. This is, according to economic integration theory, which is briefly presented above,[24] to increase the common welfare of everyone involved as it ensures the optimal allocation of resources in the internal market. Moreover, regulations created by national governments occasionally contain some protectionist bias.[25]

Even though economic integration is of utmost importance for the Community, it is only one among many objectives with which it has to be reconciled.[26] Given these various objectives, it is recognized that while the free play of market forces may be the default position in the internal market, there will be certain areas in which state regulation will persist.[27] The pragmatic solution reconciling the desire for integration with the desire for government integration is partial integration.[28] In a partially integrated market, national governments can influence people's activities, but only to a certain extent. However, the difficult assessment that needs to be done is to identify the border between legitimate and illegitimate national measures. This assessment is to take place within the framework of the free movement provisions as they are the main tools for prohibiting obstacles, raised by the governments, to the free movement.[29]

3.3 The Significance of Free Movement

The EC Treaty itself provides that the internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the EC Treaty.[30] The free movement provisions imply that it is a question of inter-state movement of goods, services, persons and capital that is protected. Moreover, these articles on free movement are interpreted and applied in a way that is focused on state regulations, also referred to as

[23] Wils, *The Search for the Rule in Article 30 EEC: Much Ado About Nothing?*, 18 ELRev 1993, p. 476.
[24] See section 3.2.2.
[25] Wils, *The Search for the Rule in Article 30 EEC: Much Ado About Nothing?*, 18 ELRev 1993, p. 476.
[26] *Ibid.*, p. 477.
[27] Craig, *The Evolution of the Single Market* in Barnard & Scott, *The Law of the Single European Market*, (2002), p. 2.
[28] Wils, *The search for the Rule in Article 30 EEC: Much Ado About Nothing?*, 18 ELRev 1993, p. 477.
[29] *Ibid.*, p. 478.
[30] Article 14 (2) EC.

national measures, which could hinder the free movement and which are prohibited unless they can be legally justified.[31] It is of great relevance for the content of such freedom what is considered as hindering the free movement. When one knows what is considered as an obstacle to the free movement, one knows more exactly the scope of the obligation the Member States have to comply with.

The free movement articles on establishment, services and capital state that all *restrictions* on the free movement are prohibited. Article 39 EC on the free movement of workers prohibits all *discrimination* on grounds of nationality. In some cases, the Court classifies a national measure as being contrary to free movement law as, for instance, indirectly discriminatory, while the Court, in other cases, has confined itself to identify a restriction or simply a breach of free movement law.

In the following sections, where the Court's interpretation and reasoning as well as possible grounds for justification are studied, a cross freedom analogy is used. This is not done in order to advocate convergence for the various free movement provisions but in terms of definitional convergence and clarity for the underlying concepts.[32] Accordingly, case law on the free movement of goods is included in this study to analyse the underlying concept of prohibited national measures. The existence of definitional convergence is indicated by both the similar structure of the free movement provisions and by the various statements given by the ECJ and its Advocates General. In the *Bosman* case[33], Advocate General Lenz expressed it the following way:

> "[t]he fundamental freedoms of the common market are not only based on a common foundation. They also in my opinion form a unity, and the same criteria should be applied as far as possible in dealing with them."

In the *Gebhard* case[34] the ECJ stated:

> "[i]t follows, however, from the Court's case-law that national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions..."

[31] See Kapteyn & VerLoren van Themaat, (edited by Gormley), *Introduction to the Law of the European Community*, (1998), p. 584.

[32] See Shuibhne, *The free movement of goods and Article 28 EC: an evolving framework*, 27 ELRev 2002, p. 410. See also van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, (2002), pp. 77–79.

[33] Case C-415/93 *Union Royal Belge des Sociétés de Football Association ASBL* v *Jean-Marc Bosman* [1995] ECR I-4921. Para. 200 of the opinion.

[34] Case C-55/94 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori de Milano* [1995] ECR I-04165, para. 37.

Hence, in *Gebhard*, the ECJ referred without distinction to all the fundamental freedoms and, thereby, highlighted their unitary nature. Craig and de Búrca conclude that this case shows that the provisions on goods, services, workers and establishment should be similarly construed.[35] Also Wahl is of the opinion that cross freedom analogy is relevant, especially in the sense that the principles developed within the framework of Article 28 EC and 30 EC are of fundamental value for the interpretation of the other free movement provisions.[36]

As was presented in the beginning of this chapter, it is possible to identify two main lines of reasoning from the Court's case law regarding the application of free movement provisions. These lines are presented and analysed below.

3.4 The Court's Reasoning

3.4.1 Two Main Lines of Reasoning

From reading cases where the ECJ has interpreted and applied free movement provisions, it is evident that the Court does not reason in a unitary way. Below, the *Biehl* case and the *Terhoeve* case are presented to illustrate this. In both cases the ECJ has interpreted Article 39 EC in relation to national rules.

In the *Biehl*[37] case, the question was whether a Luxembourg tax provision denying the refund of income tax withheld was contrary to Article 39 (2) EC. The question arose in proceedings between a German national, Mr Biehl, and the Luxembourg tax administration concerning the repayment of a withholding of tax. Mr Biehl was a resident of Luxembourg from November 1973 to October 1983. On 1 November 1983, he moved back to Germany. The tax deducted by Mr Biehl's employer in Luxembourg in 1983 exceeded the total amount of his liability to tax. His request for a repayment of the withholding was denied as Mr Biehl had left Luxembourg during the course of the year.

In the *Biehl* case, the ECJ initially stated that "the rules regarding equality of treatment forbid not only overt discrimination by reason of

[35] Craig & de Búrca, *EU Law*, (2002), p. 784. See also Cordewener, *The prohibitions of discrimination and restrictions have both been intended to achieve a fully integrated internal market in the European Union,* Report at the 2004 Paris meeting of the EATLP, p. 17.

[36] Wahl, *Recent Developments Regarding Barriers to Trade: A General Shift of Emphasis?* in Cameron & Simoni (eds.), *Dealing with Integration,* (1996), p. 123.

[37] Case C-175/88 *Klaus Biehl* v *Administration des contributions du grand-duché de Luxembourg* [1990] ECR I-1779.

nationality but also all covert forms of discrimination which, by the application of other criteria of differentiation, lead to the same result."[38] Moreover, the ECJ held that even though the criterion of permanent residence in Luxembourg applied irrespective of the nationality of the taxpayer concerned, there is a risk that it "will work in particular against taxpayers who are nationals of other Member States. It is often such persons who will in the course of the year leave the country or take up residence there."[39] The Court's reasoning is focused on that non-nationals were more negatively affected by the tax provision than nationals and that is why it held it to be contrary to the free movement of workers. The ECJ did not explicitly classify the restrictive measure but reasoned in a way typical for indirect discrimination on grounds of nationality as it held that the tax measure "will work in particular against taxpayers who are nationals of other Member States".[40] Consequently, the Court's reasoning in *Biehl* was aimed at establishing whether non-nationals in Luxembourg were treated in a less favourable way than nationals, that is an application of the traditional and uncontroversial prohibition of discrimination based on nationality.

In *Terhoeve*[41], the Court applied a different line of reasoning than in *Biehl*. It argued that provisions which preclude or deter a national of a Member State from leaving his country of origin exercising his right to freedom of movement constitute an obstacle to Article 39 EC, even if the provisions apply without regard to the nationality of the workers.

Mr Terhoeve, a Netherlands resident, lived and worked in the UK for part of the year of 1990. Under Netherlands law, he was during this period regarded as non-resident for income tax purposes.[42] After having returned to the Netherlands, he was supposed to pay social security contributions at a level exceeding the amount that he would have been liable to had he remained a resident of the Netherlands for the entire year of 1990.[43]

The Court explained in *Terhoeve* that a person could be deterred from leaving his home state in order to work in another Member State if he

[38] *Ibid.*, para. 13. The terms overt and covert discrimination are handled in sections 3.4.3.1–3.4.3.3.

[39] Case C-175/88 *Klaus Biehl* v *Administration des contributions du grand-duché de Luxembourg* [1990] ECR I-1779, para. 14.

[40] For a presentation of the concept of indirect discrimination on grounds of nationality, see section 3.4.3.3.

[41] Case C-18/95 *F.C. Terhoeve* v *Inspecteur van de Belastingdienst Particulieren/ Ondernemingen Buitenland* [1999] ECR I-345.

[42] *Ibid.*, para. 12.

[43] *Ibid.*, para. 17.

were required to pay greater social contributions than if he continued to reside in the same Member State.[44] The situations compared by the Court were, consequently, a situation where a person exercised his free movement rights and a situation where a person stayed in his home state for the entire year. The Court concluded that the national legislation under review constituted an obstacle to freedom of movement for workers and was, therefore, in breach of Article 39 EC. The Court found it unnecessary to consider "whether there is indirect discrimination on grounds of nationality...".[45]

From this brief presentation of the *Terhoeve* case, it is clear that the ECJ did not focus on whether the Netherlands legislation differentiated on grounds of nationality or its effect on non-nationals. Instead, the Court focused on the effect of the national legislation on persons exercising free movement rights. As the Court found that the legislation had a deterring effect on the free movement, it was in breach of Article 39 EC.

The line of reasoning applied by the ECJ in *Biehl* is, in this thesis, referred to as a *nationality-based approach.* Under this approach, the ECJ is focusing on different treatment due to nationality or residence. The approach applied by the ECJ in *Terhoeve* is referred to as a *free-movement-based approach.* A main characteristic for the latter approach is that the ECJ is focusing on whether a national measure is liable to dissuade or deter a person from exercising his right to free movement. Hence, the Court's reasoning is focused on the general question of a hindrance to the free movement without considering whether the national rule is discriminatory on grounds of nationality. Under this approach, the Court normally makes a comparison which focuses on different treatment due to the exercise of free movement.

In *Biehl,* the Court analysed the national rule from a home state perspective, *i.e.*, it focused on its effect on non-nationals or non-residents. In contrast, in *Terhoeve* the Court assessed the provision based on its effect on nationals or residents. In both these cases, the perspective chosen by the Court coincides with the relationship Mr Biehl and Mr Terhove, respectively, had with the state imposing the legislation. From the content of a *nationality-based approach* and also a *free-movement-based approach,* the perspectives chosen by the ECJ appear logical. In the case law studies carried out in Chapters 4 and 5, it is analysed whether the ECJ generally applies a *nationality-based approach* when assessing rules in the affected person's host state as well as a *free-movement-based approach* when analysing rules in the affected person's home state.

[44] *Ibid.*, para. 40.
[45] *Ibid.*, para. 41.

3.4.2 Comments on Terminology and Systematization

In the literature, one finds disparities as regards the terminology used to describe national measures being in breach of free movement law.[46] A reason for these divergences is possibly that the terminology employed by the ECJ does not always appear clear and consistent.[47] For instance, the term *discrimination* is generally used by the Court in reference to the prohibition of discrimination on grounds of nationality.[48] However, the case law demonstrates that the term *discrimination* is also used by the Court where there is a difference in treatment based on factors other than nationality and residence. Where the national measure differentiates on grounds of whether a person has exercised his right to free movement, the Court also employs the term discrimination.[49] As a result, it is not always clear whether the ECJ regards the discrimination as involving the prohibition of discrimination on grounds of nationality or a prohibition of measures hindering the free movement.[50] In terms of conceptual clarity, I, therefore, find it necessary to keep the two different concepts separated and try to identify when the Court applies either prohibition. This is the main reason for classifying the Court's reasoning as either applying a *nationality-based approach* or a *free movement-based approach,* a systematization which is not found in previous studies. To explain further the rationale behind this classification, additional information is given on the Court's reasoning when applying the free movement provisions.

The reasoning used by the Court can generally be classified as either focusing on whether the national measure entails a difference in treatment

[46] For instance, see Prechal, *EC Law: The Framework,* in Essers, de Bont & Kemmeren (eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law,* (1998), Kapteyn & VerLoren van Themaat, (edited by Gormley), *Introduction to the Law of the European Community,* (1998), Craig & de Búrca, *EU Law,* (2002) and Barnard, *The Substantive law of the EU – The Four Freedoms,* (2004).

[47] See Gammie, *The compatibility of "national tax principles of the Member States" with a fully integrated market,* Report at the 2004 Paris meeting of the EATLP, p. 3 and Cordewener, *The prohibitions of discrimination and restrictions have both been intended to achieve a fully integrated internal market in the European Union,* Report at the 2004 Paris meeting of the EATLP, p. 1.

[48] It is common that the Court in its judgments refer to the prohibition of discrimination on grounds of nationality. In *Biehl,* for instance, the Court 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 to the same result", Case C-175/88 *Klaus Biehl* v *Administration des contributions du grand-duché de Luxembourg* [1990] ECR I-1779, para. 13.

[49] For instance, see Case C-439/97 *Sandoz GmbH* v *Finanzlandesdirektion für Wien, Niederösterreich und Burgenland* [1999] ECR I-7041, para. 31.

[50] See Gammie, *The compatibility of "national tax principles of the Member States" with a fully integrated market,* Report at the 2004 Paris meeting of the EATLP, p. 3.

due to nationality or residence, or whether it is liable to dissuade or discourage a person from exercising his right to free movement. It is argued in this study that these different lines of reasoning demonstrate two different prohibitions. First, it is a prohibition of discrimination on grounds of nationality, which includes differentiation based on residence where the effect of this differentiation is to the particular detriment of non-nationals. Second, it is a prohibition of national measures which hinders the free movement without being discriminatory on grounds of nationality. The fact that the Court applies two different prohibitions is made all the more clear when one considers the Court's choice of comparator.[51] Under a *nationality-based approach*, the Court commonly compares a national with a non-national or a resident with a non-resident. Under a *free movement-based approach*, however, it is common that the Court compares a resident who has not exercised his right to free movement with a resident who has exercised that right. Therefore, it is clear that under the latter approach the nationality or residence is not of importance as the Court compares two residents. In dividing the Court's reasoning in these two categories, and analysing under which circumstances the Court applies either approach, one may be assisted in predicting which approach and, accordingly, what kind of circumstances that will be decisive for the Court when analysing whether a national measure is in line with free movement law or not.

That the terminology employed by commentators is not entirely coherent may give rise to misunderstandings when employing this terminology. The different meaning given to a term can be illustrated by the following example. Barnard appears to define the term *non-discriminatory restriction* as including any type of national measure that does not distinguish on grounds of nationality or residence, while Cordewener gives this term a more narrow meaning. According to Cordewener, a non-discriminatory restriction is a national measure which does not entail any difference in treatment in any sense.[52] The latter signification results in a tax provision that differentiates on grounds of whether a person has exercised his right to free movement generally being classified as a discriminatory rule and not as non-discriminatory rule. In contrast, it appears as if Barnard would classify such provisions as non-discriminatory restrictions as they do not distinguish on grounds of nationality or residence of the person affected.[53] The reason for these different opinions is probably that

[51] See section 3.4.5.

[52] Cordewener, *The prohibitions of discrimination and restrictions have both been intended to achieve a fully integrated internal market in the European Union*, Report at the 2004 Paris meeting of the EATLP, p. 2.

Barnard focuses on discrimination *on grounds of nationality*, implying that it is not discrimination in general that is prohibited but differentiation based on nationality. Cordewener appears to focus on the term *discrimination* as such. Accordingly, any type of difference in treatment falls within this term, even though this difference in treatment has nothing to do with nationality or residence.

Due to the diverging significance given to common terms in the literature, I have considered it an advantage to introduce these two new terms, *nationality-based approach* and *free movement-based approach*. However, to a certain extent, it has been necessary and practical to use traditional terminology. For instance, due to the Court's own statements that certain discriminatory measure cannot be justified having regard to imperative interests, it has been suitable to use the term *direct discrimination on grounds of nationality*.

Moreover, the systematization of the Court's reasoning in these two categories can be considered as an alternative to the systematization presented in earlier studies. Consequently, it is not considered to replace existing classification of national measures but offer an alternative classification where focus is on the Court's reasoning instead of the characteristics of the national measure. The overall purpose of the case law studies carried out within the framework of this thesis is to analyse the impact of free movement law on tax treaties concluded between EU Member State. This classification is used as a tool in that process.

3.4.3 A Nationality-Based Approach

When the Court is applying the free movement provisions and is focusing on whether the national rule distinguishes on grounds of nationality or whether a national measure has a negative impact on non-residents, as non-residents are generally non-nationals, the Court's reasoning is in this study classified as a *nationality-based approach*. What now follows is an analysis of the prohibition of discrimination on grounds of nationality and its different expressions.

3.4.3.1 Prohibition of Discrimination on Grounds of Nationality

Article 12 EC prohibits any discrimination on grounds of nationality within the scope of the EC Treaty. In many cases, the ECJ has stated that the free movement provisions are a specific manifestation of the non-discrimination prohibition found in Article 12 EC.[54] Consequently, the starting

[53] Barnard, *The Substantive law of the EU – The Four Freedoms*, (2004), pp. 295–296.

[54] For example, see Case 2/74 *Jean Reyners* v *Belgian State* [1974] ECR 631, paras. 15–16.

point for the interpretation and application of the free movement provisions has been the prohibition of discrimination on grounds of nationality. Discrimination is traditionally defined as different treatment of comparable situations or equal treatment of non-comparable situations.[55] To establish whether there is discrimination on grounds of nationality at hand, an assessment of the comparability of situations is commonly performed. To achieve a well-functioning common market, the removal of discriminatory or protectionistic rules is at the top of the list of measures that need to be taken because these rules are directly opposed to the common market ideal.[56]

According to the ECJ case law, the type of breach of the free movement provisions, which is found to exist in any given situation, determines the justification hierarchy. The free movement provisions do not explicitly distinguish between direct and indirect discrimination on grounds of nationality and they do not give any indication that the type of breach should have an impact in terms of justification. From the *Cassis de Dijon* judgment[57], one finds that the ECJ distinguishes between different types of discrimination, and the Court confirms that some forms of discriminatory treatment are worse and are, consequently, more difficult to justify than others. This is a value-judgment given in the form of a judicial statement.[58]

When studying the case law of the ECJ concerning discrimination in the context of free movement, one comes across terms other than direct and indirect discrimination. For example, the ECJ has described discrimination as being formal, covert or overt and national measures as being indistinctly applicable or distinctly applicable, without ever having really clarified the difference. It would seem possible to divide the measures, as well as the terms, into the categories of direct and indirect discrimination. The measures which discriminate between different persons and goods on the ground of their nationality or origin fall within the category

[55] Case C-279/93 *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225, para. 30, where the ECJ defines the concept in the following terms: "...discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations". See Spaventa, *On Discrimination and the Theory of Mandatory Requirements*, CYELS, Vol. 3, 2000, p. 467.

[56] For instance, see paras. 10–11 of Advocate General Jacob's opinion in Cases C-92/92 and C-326/92 *Phil Collins* v *Imtrat Handelsgesellschaft mbH and Patricia Imund Export Verwaltungsgesellschaft mgH and Leif Emanuel Kraul* v *EMI Electrola GmbH* [1993] ECR I-5145.

[57] Case 120/78 *Rewe-Zentral AG* v *Bundesmonopolverwaltung für Branntwein* [1979] ECR 649.

[58] See Shuibhne, *The free movement of goods and Article 28 EC: an evolving framework*, 27 ELRev 2002, p. 422.

of directly discriminatory measures (formal, overt). In other words, if national rules expressly use the criterion of nationality, the measure will amount to direct discrimination on grounds of nationality. The measures that simply have the effect of leading to discrimination on grounds of nationality (indirect, covert) fall within the category of indirectly discriminatory measures. If the national rule uses other distinguishing criteria than nationality, which, at first sight, appear to be neutral but in fact lead to a likewise discriminatory effect, it may amount to indirect discrimination. It is enough that there is a risk that the rule may operate to the particular disadvantage of nationals of the discriminated category.[59]

The expressions *distinctly* and *indistinctly applicable measures* are preferably used by the ECJ in the context of Article 28 EC. National rules applicable to both national and imported goods are usually referred to as indistinctly applicable rules or equally applicable rules. Barnard describes distinctly applicable measures as "loosely equivalent to directly discriminatory measures" and indistinctly applicable measures as "loosely equivalent to indirect discriminatory measures".[60]

Throughout this thesis, I am using the terms *direct* and *indirect discrimination* referring to the definitions given in this section. However, other terms employed to describe discrimination occur in this thesis when the Court or Advocates General have used other expressions to describe discrimination.

3.4.3.2 Direct Discrimination on Grounds of Nationality

A typical situation involving direct discrimination were the provisions in French legislation requiring a certain proportion of the crew of ships to be of French nationality.[61] Also in the *Bosman* case[62] one of the two types of provisions under examination was the nationality clause implying that football clubs may field only a limited number of professional players who are nationals of other Member States and third states.[63] Such rules explicitly distinguish based on nationality of the persons affected, and that is why they are directly discriminatory.

[59] See Case C-204/90 *Bachmann* v *Belgian State* [1992] ECR I-249, para. 13, Wouters, *The principle of non-discrimination in European Community Law*, ECTRev 1999, p. 103.
[60] Barnard, *Fitting the remaining pieces into the goods and persons jigsaw?* 26 ELRev 2001, p. 36, see also Shuibhne, *The free movement of goods and Article 28 EC: an evolving framework*, 27 ELRev 2002, p. 409.
[61] Case 167/73 *Commission* v *French Republic* [1974] ECR 359.
[62] Case C-415/93 *Union Royal Belge des Sociétés de Football Association ASBL* v *Jean-Marc Bosman* [1995] ECR I-4921.
[63] *Ibid.*, para. 115.

Two other situations where the rule at issue is to be described as directly discriminatory on grounds of nationality are described below. The first situation involved Spanish legislation that provided for a system under which Spanish citizens, foreigners resident in Spain and nationals of other Member States under the age of 21 years benefited from free admission to national museums while nationals of other Member States, who were older than 21, were required to pay an entrance fee. The ECJ found the Spanish legislation discriminatory.[64] In the second situation, Germany required the collateral for costs to be given by a member of a profession established in another Member State who brings an action before a German court, on the sole ground that he is a national of another Member State. The ECJ found also this practise to be discriminatory.[65]

From these cases, one might conclude that direct discrimination on grounds of nationality implies national measures that expressly use the nationality criterion to differentiate between different treatments. Another way to put it is to describe direct discrimination as when the nationality of the person is the criterion used to place that person in an unfavourable position.[66]

As may have been indicated from the cases mentioned here, the ECJ rarely uses the term direct discrimination but merely the term discrimination. In contrast, as can be noticed in the next section, the term indirect discrimination is commonly used by the Court.[67]

3.4.3.3 Indirect Discrimination on Grounds of Nationality

Indirect discrimination occurs when national measures, although neutral in their wording, are likely to bear more heavily on a protected group. In relation to free movement provisions, the protected group has traditionally been persons having the nationality of other Member States. In other words, a Member State is not allowed to treat individuals and companies having the nationality of another Member State less favourably than its own nationals.

In the case of directly discriminatory national measures, the form alone is relevant and sufficient and a discriminatory intent is not

[64] Case C-45/93 *Commission* v *Spain* [1994] ECR I-911, para. 10.

[65] Case C-20/92 *Anthony Hubbard* v *Peter Hamburger* [1993] ECR I-3777, paras. 14–15.

[66] Oliveira, *Workers and other Persons: Step-by Step from movement to Citizenship – Case Law 1995–2001*, CMLRev 39, 2002, p. 85.

[67] The issue of direct and indirect discrimination in relation to legal entities is discussed in section 3.4.3.3. below.

required, while in the case of indirect discrimination neither the form nor the intention matters, but rather the effect of the rules.[68]

In the *Sotgiu* case[69], the ECJ stated that rules regarding the equality of treatment in the Treaty 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 to the same result. The Court argued that this interpretation was necessary to ensure the effective working of the fundamental principles of the Community.[70] From this, one may conclude that overt discrimination tends to be used for the same situations as direct discrimination and covert discrimination seems to be used interchangeably with indirect discrimination.[71]

In the cases in which the ECJ has found indirect discrimination under Article 39 EC, it is often the criterion of residence that has given rise to discrimination due to that it is a requirement which nationals generally fulfil more easily than non-nationals. An example of this is the *Biehl* case.[72] In this case, the Court held that a national provision which applies the criterion of permanent residence within the country as a condition for the refund of tax, and consequently not referring to the nationality of the taxpayer, potentially works particularly against taxpayers who are nationals of other Member States. It is often such persons who, in the course of the year, will leave the country or take up residence there.[73]

In the *O'Flynn* case[74], the ECJ described the concept of indirect discrimination as follows:

> "...conditions imposed by national law must be regarded as indirectly discriminatory where, although applicable irrespective of nationality, they affect essentially migrant workers [...] or the great majority of those affected are migrant workers [...] where they are indistinctly applicable but can more easily be satisfied by national workers than by migrant workers [...] or where there is a risk that they may operate to the particular detriment of migrant workers [...]".[75]

[68] Spaventa, *On Discrimination and the Theory of Mandatory Requirements*, CYELS, Vol. 3, 2000, p. 467.

[69] Case 152/73 *Giovanni Maria Sotgiu* v *Deutche Bundespost* [1974] ECR 153.

[70] *Ibid.*, para. 11.

[71] See Farmer, *The Court's case law on taxation: a castle built on shifting sands?* ECTRev 2003, p. 76.

[72] Case C-175/88 *Klaus Biehl* v *Administration des contributions du grand-duché de Luxembourg* [1990] ECR I-1779. See section 3.4.1.

[73] Case C-175/88 *Klaus Biehl* v *Administration des contributions du grand-duché de Luxembourg* [1990] ECR I-1779, paras. 13–14.

[74] Case C-237/94 *O'Flynn* v *Adjudication Officer* [1996] ECR I-2617.

[75] *Ibid.*, para. 18.

Hence, a provision of national law must be regarded as indirectly discriminatory on grounds of nationality and contrary to Community law if it is intrinsically liable to affect migrant workers more than national workers and if there is a risk that it will place migrant workers at a particular disadvantage, unless justified and proportionate to its aim.[76] Moreover, the Court also held in *O'Flynn* that it was not necessary to show that the measure did, in practice, affect a substantially higher proportion of migrant workers; it was sufficient that it was liable to have such an effect.[77] This broad definition of indirect discrimination on grounds of nationality was given by the ECJ in *O'Flynn* as it was focusing on the potential effect on persons exercising their right to free movement.[78]

When the concepts of direct and indirect discrimination on grounds of nationality are applied to legal entities and income tax matters, a rather unexpected outcome is sometimes evident. The reason for this is the characteristics of individuals and legal entities.[79] For individuals, the national tax systems generally do not refer to their nationality but to their residence. Consequently, the most common type of discrimination is indirect discrimination on grounds of nationality.

Under internal legislation, the residence of corporations seems to be determined either by reference to its place of incorporation or its place of management.[80] Under the former approach, seat is frequently applied as a criterion for residence.[81] It has been stressed by the ECJ that, regarding legal entities, it is their seat that serves as the connecting factor with the

[76] *Ibid.*, para. 20. This was confirmed in Case C-187/96 *Commission* v *Hellenic Republic* [1998] ECR I-1095, para. 19.

[77] Case C-237/94 *O'Flynn* v *Adjudication Officer* [1996] ECR I-2617, para. 21.

[78] See Barnard, *The Substantive law of the EU – The Four Freedoms*, (2004), p. 237.

[79] Wathelet, *The Influence of Free Movement of Persons, Services and Capital on National Direct Taxation: Trends in the Case Law of the Court of Justice*, YEL 20, 2001, p. 6, Ståhl, *Taxing Companies by Reason of Nationality and/or Place of Management: What Says the ECJ?* in Andersson, Melz & Silfverberg, (eds.), *Liber Amicorum Sven-Olof Lodin*, (2001), p. 254.

[80] See Bisacre, *The Migration of Companies Within the European Union and the Proposed Fourteenth Company Law Directive*, ICCLJ 2001, Vol. 3, Issue 2, pp. 253–254, Arnold & McIntyre, *International Tax Primer*, (2002), p. 18. For the determination of residence of companies under tax treaties, see Article 4 (1) and (3) OECD Model.

[81] For instance, Sweden has chosen to tax companies according to their nationality. Swedish companies are subject to unlimited tax liability whereas foreign companies are subject to limited tax liability. The definition of a Swedish company is a company registered in accordance with Swedish legislation or, if not so registered, a legal person having its seat in Sweden. For further reading, see chapter 6, sections 3 and 7 SITA and Ståhl, *Taxing Companies by Reason of Nationality and/or Place of Management: What Says the ECJ?* in Andersson, Melz & Silfverberg (eds.), *Liber Amicorum Sven-Olof Lodin*, (2001), pp. 252–258.

legal system of a particular state, like nationality in the case of natural persons.[82] Consequently, a tax provision distinguishing on the basis of seat between domestic and foreign legal entities and this classification being to the detriment of foreign legal entities, the discrimination that could occur is to be classified as direct.[83] Therefore, only the express treaty derogations are, in principle, available grounds for justification.[84] Under the EC Treaty, a company's seat is in the state in which the company, formed in accordance with the law of that Member State, has its registered office, central administration or principal place of business.[85]

A clear example of such a classification is the *Royal Bank of Scotland* case[86]. Greek legislation applied different tax rates based on the fact whether or not a company has its seat in Greece. The Royal Bank of Scotland had its seat in the United Kingdom and carried on business in Greece through a branch established there. The Court found that the branch was in an objectively comparable situation to branches of companies which had their seat in Greece, and the discrimination was of a direct character, which could only be justified according to the express derogations found in the Treaty.[87]

3.4.4 A Free Movement-Based Approach

It has previously been mentioned that the ECJ's reasoning when focusing on whether a national measure disadvantages non-nationals in comparison to nationals is in this study classified as a *nationality-based approach*.[88] However, from the Court's case law, one can find various examples of cases where the ECJ applies a reasoning which is focused on

[82] Case 270/83 *Commission* v *France* [1986] ECR 273, para. 18, Case C-264/96 *Imperial Chemical Industries plc (ICI)* v *Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-4695, para. 23.

[83] The case law is not entirely coherent on this point. For instance, in Case C-330/91 *The Queen* v *Inland Revenue Commissioners, ex parte Commerzbank AG* [1993] ECR I-4017, para. 15 the Court ruled that the use of the criterion of fiscal residence was liable to work more to the disadvantage of those companies that had their seat in other Member States and that was why the national measure was held to constitute indirect discrimination. For an in-depth analysis, see Edwards, *Secondary Establishment of Companies – The Case Law of the Court of Justice*, YEL 18, 1998 and Barnard, *The Substantive Law of the EU – The Four Freedoms*, (2004), p. 327.

[84] See section 3.5.

[85] See Article 48 EC and Barnard, *The Substantive Law of the EU – The Four Freedoms*, (2004), p. 324.

[86] Case 311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651.

[87] *Ibid.*, paras. 31–32.

[88] See section 3.4.3.

establishing whether the national measure is liable to dissuade or deter a person from exercising his right to free movement without emphasizing the nationality or residence of the person more directly affected. This kind of reasoning is in this study referred to as a *free movement-based approach.*

3.4.4.1 Beyond Distinctions Based on Nationality or Residence

A convincing argument why the free movement provisions are to be considered as including a prohibition of national rules that do not distinguish based on nationality or residence is that also these rules could constitute obstacles to free movement. For example, hindrance may be caused by legislation which is not based on nationality or residence, but which gives rise to disadvantages for persons using their right to free movement.[89] One might argue that a prohibition of such measures is necessary to comply with the general objective of building an internal market. This is because the central concern of the Treaty provisions on free movement is to prevent unjustified obstacles to free movement between Member States. It would be odd to accept an obstacle to free movement just because the obstacle affects nationals and non-nationals genuinely equally.[90] A prohibition of discrimination on grounds of nationality may be considered as a rather limited instrument in the over-all objective of abolishing all obstacles to the free movement between Member States.[91]

In the literature, a prohibition of discrimination on grounds of nationality has been described as equality-based while a prohibition of measures which hinders the free movement without constituting direct or indirect discrimination on grounds of nationality is designed as liberty rights.[92] However, under a *free movement-based approach*, it is common that the ECJ makes a comparison between a domestic situation where

[89] See Jarass, *A Unified Approach to the Fundamental Freedoms* in Andenas & Roth (eds.), *Services and Free Movement in EU Law*, (2002), p. 146.

[90] See opinion of Advocate General Jacobs in Case C-412/93 *Société d'Importation Edouard Leclerc-Siplec* v *TF1 Publicité SA and M6 Publicité SA* [1995] ECR I-179, para. 39.

[91] Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax system of the Member States*, ECTRev 2003, p. 143. See also para. 10 of Advocate General Jacob's opinion in Cases C-92/92 and C-326/92 *Phil Collins* v *Imtrat Handelsgesellschaft mbH and Patricia Imund Export Verwaltungsgesellschaft mgH and Leif Emanuel Kraul* v *EMI Electrola GmbH* [1993] ECR I-5145 where the Advocate General held that "[a]lthough the abolition of discriminatory rules and practices may not be sufficient in itself to achieve the high level of economic integration envisaged by the Treaty, it is clearly an essential prerequisite."

[92] See Lehner, *Limitation of the national power of taxation by the fundamental freedoms and non-discrimination clauses of the EC Treaty*, ECTRev 2000, p. 7.

free movement is not involved and a situation where the free movement has been exercised. The latter comparison has, nevertheless, nothing to do with a prohibition of discrimination on grounds of nationality as the distinguishing factor is neither nationality nor residence of the person directly affected.

3.4.4.2 Potentially Severe Effects on National Legal Systems

From the case law, it is clear that the ECJ has prohibited national measures that did not distinguish on grounds of nationality or residence and did not mainly disadvantage non-nationals. The emphasis of the discussion about nationality non-discriminatory measures is no longer whether such measures could be prohibited under free movement law but under what circumstances.[93] Accordingly, the case law analysis in Chapters 4 and 5 aims at establishing under which circumstances the Court applies a *free movement-based approach* and when it applies a *nationality-based approach*. The relevance of studying the circumstances where the ECJ applies a *free movement-based approach* is elaborated on below.

One of the most important cases in the area of free movement of goods is the *Dassonville*[94] case. In this case, the ECJ provided an interpretation of *measures having an equivalent effect to quantitative restrictions* under Article 28 EC. The ECJ held that:

> "[a]ll trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are to be considered as measures having an effect equivalent to quantitative restrictions."[95]

In *Dassonville*, the question was whether a host state requirement fell within the concept of measures having an effect equivalent to quantitative restrictions. Due to the Court's very wide definition of this expression, this was found to be the case.

[93] See Cordewener, *The prohibitions of discrimination and restrictions have both been intended to achieve a fully integrated internal market in the European Union*, Report at the 2004 Paris meeting of the EATLP, p. 3. For an illustration of the case law development over time, see, for instance, Cordewener, *Europäische Grundfreiheiten und Nationales Steuerrecht*, (2002), Peters, *Non-discrimination: The Freedom of Establishment in European Tax Law* in Gribnau (ed.), *Legal Protection against Discriminatory Tax Legislation*, (2003), pp. 103–105 and Hinnekens, *The Search for the framework conditions of the fundamental EC Treaty principles as applied by the European Court to Member States' direct taxation*, ECTRev. 2002, pp. 113–118.

[94] Case 8/74 *Procureur du Roi* v *Benoit and Gustave Dassonville* |1974| ECR 837.

[95] *Ibid.*, para. 5.

The *Keck*[96] case indicates that even within the context of free movement of goods, not every restrictive national measure is likely to constitute a sufficient hindrance.[97] In this case, the Court re-examined its case law on Article 28 EC. The Court held that:

> "contrary to what has previously been decided, the application to products from other Member States of national provisions restricting or prohibiting certain selling arrangements is not such as to hinder directly or indirectly, actually or potentially, trade between Member States within the meaning of the Dassonville judgment [...] provided that those provisions apply to all affected traders operating within the national territory and provided that they affect in the same manner, in law and in fact, the marketing of domestic products and to those from other Member States."[98]

In consequence, *certain selling arrangements* are not within the scope of Article 28 EC provided that they apply in a non-discriminatory way both in law and in fact. It is to be noticed that the *Keck* doctrine has not, so far, been transposed to other areas of free movement law.[99] It also appears to be problematic to apply the *Keck* distinction outside the sphere of free movement of goods.[100]

Even though the *Keck* ruling limits the scope of the *Dassonville* formula in the area of free movement of goods, the scope of what is prohibited under free movement law extends considerably if a *free movement-based approach* is applied by the ECJ to host state legislation in general. It is, therefore, of interest to analyse whether a *free movement-based approach* is applied by the ECJ in general to host state legislation under the free movement provisions other than the free movement of goods. Such an application results in a comparison focused on establishing whether national treatment is granted by the host state, *i.e.* the treatment provided by the host state for its own nationals or residents, not being necessary. Under a *free movement-based approach*, the ECJ focuses its assessment on whether the national measure is liable to impede the free

[96] Cases C-267/91 and C-268/91 *Criminal Proceedings against Bernard Keck and Daniel Mithouard* [1993] ECR I-6097.

[97] Craig & de Búrca, *EU Law*, (2002), p. 786.

[98] Cases C-267/91 and C-268/91 *Criminal Proceedings against Bernard Keck and Daniel Mithouard* [1993] ECR I-6097, para. 16.

[99] For example, see Case C-384/93 *Alpine Investments* v *Minister van Financiën* [1995] ECR I-1141 and Case C-415/93 *Union Royal Belge des Sociétés de Football Association ASBL* v *Jean-Marc Bosman* [1995] ECR I-4921.

[100] See Peers, *Free Movement of Capital: Learning Lessons or Slipping on Spilt Milk?* in Barnard & Scott, *The Law of the Single European Market*, (2002), p. 344.

movement, *i.e.* if the national measure is liable to dissuade or discourage a person from exercising his right to free movement. National measures prohibited under a *free movement-based approach* can lead to difficulties concerning the outer boundaries of the free movement provisions.[101]

That the ECJ applies a reasoning focused on whether a measure is liable to impede the free movement in general both to host state legislation and home state legislation is a conclusion that sometimes is drawn from the *Gebhard*[102] case. In this case, the ECJ stated that "[i]t follows, however, from the Court's case-law that national measures liable to hinder or make less attractive the exercise of fundamental freedoms" must fulfil certain conditions in order not to be contrary to free movement law.[103] It needs to be emphasized that such an interpretation has severe effects on the legal systems of the Member States, as any type of national rules hindering the free movement without having a particular negative effect on non-nationals or non-residents, in principle, would be held to be prohibited unless justified.[104]

In the Court's case law, there are cases where the ECJ has concluded that the effect of the national measure is "too uncertain and indirect" and, therefore, not being regarded as liable to hinder the free movement.[105] It is submitted in legal writing that a reasoning by the Court considering whether the effect of the national measure is "too uncertain and indirect" to be regarded as capable of hindering the free movement can be seen as an attempt to define the outer boundaries of the scope of the free movement provisions.[106] This scope needs to be defined considering its potential width under the Court's *free movement-based approach.*

[101] For instance, see Case C-190/98 *Volker Graf* v *Filmoser Maschinenbau GmbH* [2000] ECR I-493 (see section 4.2.3.3 of this study).

[102] Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'Ordine degli Avvocati e Procuratori de Milano* [1995] ECR I-04165.

[103] *Ibid.*, para. 37.

[104] See Cordewener, *The prohibitions of discrimination and restrictions have both been intended to achieve a fully integrated internal market in the European Union,* Report at the 2004 Paris meeting of the EATLP, p. 18, Barnard, *The Substantive law of the EU – The Four Freedoms,* (2004), p. 19 and Persson Österman, *Icke diskrimineringsprincipen i skatterätten enligt Europafördraget – i ljuset av senare praxis,* ERT 2001, pp. 197–203.

[105] For instance, see Case C-190/98 *Volker Graf* v *Filmoser Maschinenbau GmbH* [2000] ECR I-493, para. 25 and Case C-412/97 *ED Srl* v *Italo Fenocchio* [1999] ECR I-3845, para. 11.

[106] See Oliver, *Some further reflections on the scope of Articles 28–30 (ex 30–36) EC,* CMLRev 36, 1999, pp. 788–793 and Cordewener, *The prohibitions of discrimination and restrictions have both been intended to achieve a fully integrated internal market in the European Union,* Report at the 2004 Paris meeting of the EATLP, pp. 14–15.

To sum up, in the case law studies in Chapters 4 and 5, it is analysed under which circumstances the Court applies a *nationality-based approach* and a *free movement-based approach*. Due to the potentially severe effects on national tax systems, it is of particular relevance to study the situations where the Court has applied the latter approach.

3.4.5 The Court's Examination Pattern

When the ECJ is assessing whether a national measure is in breach of the free movement provisions, the following pattern of examination may be distinguished. Generally, the Court starts by assessing whether or not the situation at hand falls within the scope of at least one of the free movement provisions. If it does, the next step of the examination consists of ascertaining whether the national measure is prohibited. If the national measure is found to be in breach of Community law, the last part of the Court's pattern of examination consists of applying possible justifications to the actual situation.[107]

The initial onus of demonstrating a breach of the free movement provisions lies on the complainant to show that the national measure involves discrimination when applying a *nationality-based approach*, or a sufficient hindrance to the free movement when applying a *free movement-based approach*. Once this has been shown, the burden shifts to the defendant to show that there was an adequate justification for the national rule and that it is proportionate and necessary.

When applying a nationality-based approach, the ECJ frequently compares the situation of a national with the situation of a non-national or a resident with a non-resident.[108] The comparison is sometimes referred to as the Court's similarity test. If the non-national or the non-resident is treated in a less favourable way, one may assume that discrimination on grounds of nationality is at hand.

When the Court applies a *free movement-based approach*, there are mainly two questions to be answered.[109] First, does the national provision operate as an obstacle to cross-border operations? Second, is there any valid justification for the restrictive measure? When answering the first question, the ECJ frequently makes a comparison between a domestic situation where the exercise of free movement is not involved and a

[107] See Lenz, *The jurisprudence of the European Court of Justice in tax matters*, ECT Rev 1997, p. 80.

[108] For instance, see sections 4.2.2, 4.3.2, 4.4.2, 5.5.1 and 5.6.1.

[109] Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax system of the Member States*, ECTRev 2003, p. 137.

situation where free movement is involved.[110] When this similarity test shows that the situation where a person has exercised his free movement rights is treated less favourably, a restriction is evident.

A fundamental question for the predictability of the application of the free movement provisions is whether the different lines of reasoning applied under specific circumstances?[111] From the case law studies in Chapters 4 and 5, it is evident that the Court generally applies one of these approaches but in a limited number of cases it combines them. When a combination of the two approaches is applied, the ECJ usually starts with a *nationality-based approach,* but if a restriction is not evident under that approach, the Court shifts to assess the national measure by applying a *free movement-based approach.*[112]

However, in a number of cases, the Court applies what in this study is referred to as a *dual perspective.*[113] This has generally appeared when the Court has applied a *free movement-based approach* under Articles 43 EC, 49 EC and 56 EC. First, the Court has assessed the situations from a home state perspective and found that the rule at issue had a restrictive effect. Second, the Court has added that assessing the rule from a host state perspective a restriction is evident.

3.5 Justifications to Restrictions on the Free Movement

3.5.1 Justifications Explicitly Stated in the EC Treaty

The general understanding is that the expressly stated derogations found in the EC Treaty are available to justify national measures which are considered as restrictions on the free movement.[114] Consequently, the classi-

[110] For instance, see Case C-422/01 *Försäkringsaktiebolaget Skandia (publ.) and Ola Ramstedt* v *Riksskatteverket* [2003] ECR I-6817, para. 35, Case C-141/99 *Algemene Maatschappij voor Investering en Dienstverlening NV (AMID)* v *Belgische Staat* [2000] ECR I-11619, p. 22 and Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax system of the Member States,* ECTRev 2003, p. 139.

[111] See Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax system of the Member States,* ECTRev 2003, p. 140.

[112] For instance, see Case C-190/98 *Volker Graf* v *Filmoser Maschinenbau GmbH* [2000] ECR I-493.

[113] For instance, see Case C-136/00 *Rolf Dieter Danner* [2002] ECR I-8147, paras. 30–31 (see section 5.7.2.2. of this study) and Case C-35/98 *Staatssecretaris van Financiën* v *B.G.M. Verkooijen* [2000] ECR I-4071, paras. 34–35 (see section 5.8.2.1 of this study).

[114] Article 30 EC contains justifications for restrictions to the free movement of goods. As this study deals with the free movement of goods only exceptionally, this article is not included in the presentation.

fication of the measures (as directly or indirectly discriminatory) is not of importance for invoking the Treaty derogations.[115]

The derogations set out in the Treaty in relation to the free movement of workers are found in Article 39 (3) EC, which states that the free movement is subject to limitations justified on the grounds of public policy, public security and public health. In Article 39 (4) EC, a further exception is stated, namely that the provisions of Article 39 EC are not applicable to employment in the public service.

The Court has held that to justify a measure on grounds of public policy, it is necessary to show:

> "the existence, in addition to the perturbation of the social order which any infringement of the law involves, of a genuine and sufficiently serious threat affecting one of the fundamental interests of society."[116]

This statement indicates that it is extremely difficult to justify a national measure on grounds of public policy.

Article 45 EC states that the provisions of the chapter relating to the freedom of establishment shall not apply, so far as any particular Member State is concerned, to activities which are connected with the exercise of official authority. It is rather similar to the exception found in Article 39 (4) EC. The ECJ has given article 45 EC a narrow interpretation.[117] Regarding this article, the Court pointed out, in *Commission* v *Spain*[118], that a derogation from the freedom of establishment:

> "must be interpreted in a manner which limits its scope to what is strictly necessary for safeguarding the interests which that provision allows the Member States to protect...".[119]

Article 46 (1) EC stipulates that the provisions of the chapter on establishment and measures taken in pursuance thereof shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for the special treatment of foreign nationals on grounds of public policy, public service or public health. Article 55 EC gives that Article 46 EC is applicable also in relation to the provisions on services.

[115] Articles 39 (3), 39 (4), 45, 46 (1), 55, 58 (1) EC.

[116] Case C-350/96 *Clean Car Autoservice* [1998] ECR I-2521, para. 40.

[117] See Case 2/74 *Reyners* v *Belgium* [1974] ECR 631 and Case C-42/92 *Adrianus Thijssen* v *Controledienst voor de verzekeringen* [1993] ECR I-4047.

[118] Case C-114/97 *Commission* v *Spain* [1998] ECR I-6717.

[119] *Ibid.*, para. 34.

In the *Kohll*[120] case, the Luxembourg legislation was found to be in breach of Article 49 EC. The ECJ stated that the measure could be justified under Article 46 EC presupposed that the Luxembourg legislation was "essential for the public health and even the survival of the population".[121] In this case, however, the Court found that none of those who submitted observations had argued that the Luxembourg legislation was indispensable to achieve that purpose and, consequently, the measure was not justified.[122]

The derogations available in the EC Treaty for the free movement of capital differ from the Treaty justifications in relation to the free movement of workers, establishment and services due to that the Treaty provides for a wider range of justifications.

Article 58 EC gives the Member States the right to:

> "apply the relevant provisions of their tax law which distinguish between tax payers 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"[123]

and

> "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."[124]

Moreover, if a restriction on the freedom of establishment is justified according to the Treaty, it is not to be prohibited by the provisions on the free movement of capital.[125] Article 58 EC states that a measure that falls within the scope of the derogations shall not constitute a means of arbitrary discrimination or a disguised restriction.

Regarding the public policy and public security exception found in Article 58 (1) (b) EC, the Court held, in the case *Association Eglise de Scientologie*[126], that "those derogations must not be misapplied so as, in fact, to serve purely economic ends".[127]

[120] Case C-158/96 *Raymond Kohll* v *Union des caisses de maladie* [1998] ECR I-1931.
[121] *Ibid.*, para. 51.
[122] *Ibid.*, para. 52.
[123] Article 58 (1) (a) EC.
[124] Article 58 (1) (b) EC.
[125] Article 58 (2) EC.
[126] Case C-54/99 *Association Eglise de Scientologie de Paris and Scientology International Reserves Trust* v *The Prime Minister* [2000] ECR I-1335.
[127] *Ibid.*, para. 17.

In order for a measure to be justified, it must pass a test of proportionality.[128] The ECJ demands that a restrictive measure be the least possible restriction to attain the end in view. As can be concluded from the foregoing, the Treaty derogations have been given a fairly narrow scope when interpreted by the ECJ.[129] As the Treaty justifications represent derogations from the fundamental principles of free movement, the Court's strictness is not surprising.

3.5.2 Imperative Interests

All measures but those classified as directly discriminatory on grounds of nationality benefit also from other and broader grounds of justification, namely the imperative interests, which is an open-ended category first conceived by the ECJ in the *Cassis de Dijon* case[130].[131] The introduction of new grounds for justification, imperative interests, was established in this case and has been reinforced consistently since.[132]

[128] For instance, see Barnard, *The Substantive law of the EU – The Four Freedoms*, (2004), pp. 79, 112–117 and 243–244. For a study of the principle of proportionality in the area of taxation, see Moëll, *Proportionalitetsprincipen i skatterätten* (2003).

[129] The scope of the Treaty derogations has been further defined in secondary legislation, see, for example, Directive 64/221/EEC.

[130] Case 120/78 *Rewe-Zentral AG* v *Bundesmonopolverwaltung für Branntwein* [1979] ECR 649.

[131] See Joined Cases C-321/94 and C-324/94 *Criminal proceedings against Jacques Pistre* [1997] ECR I-2343, para. 52, Case 352/85 *Bond van Adverteerders* [1988] ECR 2085, para. 32, Case C-311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651, para. 32. In terms of literature, see Weiss & Wooldridge, *Free Movement of Persons within the European Community*, (2002), p. 126, Ståhl, *Möjligheter att rättfärdiga inskränkningar i den fri rörligheten – några aktuella frågor*, SvSkT 2001, p. 741, Jarass, *A Unified Approach to the Fundamental Freedoms* in Andenas & Roth, (eds.), *Services and Free Movement in EU Law*, (2002), p. 156, van der Mei, *Free Movement of Persons Within the European Community*, (2003), p. 76, Hatzopoulos, Case C-250/95, *Futura Participations SA & Singer* v *Administration des Contributions (Luxembourg)*, Judgment of 15 May 1997, [1997] ECR I-2471, CMLRev 35, 1998, p. 506, Persson Österman, *Icke diskrimineringsprincipen i skatterätten enligt Europafördraget – i ljuset av senare praxis*, ERT 2001, p. 203, Gammie, *The Role of the European Court of Justice in the Development of Direct Taxation in the European Union*, Bulletin 2003, p. 92, Farmer, *The Court's case law on taxation: a castle built on shifting sands?* ECTRev 2003, p. 76, Vapaavaori, *On Justification in EC Tax Law*, in *Tax Law – Scandinavian studies in law*, (2003), p. 376, Cordewener, *The prohibitions of discrimination and restrictions have both been intended to achieve a fully integrated internal market in the European Union*, Report at the 2004 Paris meeting of the EATLP, p. 2. A dissenting opinion in the literature is presented by Kemmeren, *Principle of origin in tax conventions – a rethinking of models*, (2001), p. 142.

[132] For example, in the Case 302/86 *Commission* v *Denmark* [1988] ECR 4607 the Court accepted the protection of the environment as an imperative interest. In Case 155/80 *Summary proceedings agains Sergius Oebel* [1981] ECR 1993 the ECJ accepted the improvement of working conditions as an imperative interest.

Shuibhne calls attention to that there is no legal obstacle preventing the submission of alternative arguments to be examined as possible imperative interests, implying a policy choice to be made by the Court.[133] According to Advocate General van Gerven, the determination of imperative interests rests mainly on whether or not the interest being considered is "consistent with specific objectives or interests of the Community Treaties."[134] In order for a national measure to be justified according to either the express treaty derogations or the imperative interest doctrine, they must pass the proportionality test.[135]

The ECJ has stipulated that an economic aim cannot constitute an imperative interest[136], but the approach to economic objectives in the case law appears to be somewhat inconsistent. For example, the Court has held that the risk of seriously undermining the financial balance of the social security system might constitute an imperative interest.[137] In *Bachmann*, the coherence of the tax system was held as justifying a barrier to the free movement of workers.[138] These objectives appear to be of a fundamental economic nature.[139] In the *Tourist Guide* case[140], the question was raised whether maintaining industrial peace may constitute an imperative interest.[141] The ECJ found that maintaining industrial peace was a means of preventing adverse effects on an economic sector

[133] See Shuibhne, *The free movement of goods and Article 28 EC: an evolving framework*, 27 ELRev 2002, p. 418.

[134] In his joint opinions in Cases C-306/88 *Rochdale Borough Council* v *Stewart John Anders*, 304/90 *Reading Borough Council* v *Payless DIY Ltd and others* and 169/91 *Council of the City of Stroke-on Tent and Norwich City Council V B &Q PLC* [1992] ECR I-6457, para. 23.

[135] For instance, see Barnard, *The Substantive law of the EU – The Four Freedoms*, (2004), pp. 79, 112–117 and 243–244.

[136] See Case C-120/95 *Nicolas Decker* v *Caisse de Maladie des employés privés* [1998] ECR I-1831, para. 39, Case C-264/96 *Imperial Chemical Industries plc (ICI)* v *Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-4695 para. 28, Case C-35/98 *Staatssecretaris van Financiën* v *B.G.M. Verkooijen* [2000] ECR I-4071, para. 48.

[137] Case C-120/95 *Nicolas Decker* v *Caisse de Maladie des employés privés* [1998] ECR I-1831, para. 39.

[138] Case C-204/90 *Hanns-Martin Bachmann* v *Belgian State* [1992] ECR I-249. For an analysis of the significance of "coherence of the tax system" see Reimer, *Die Auswirkungen der Grundfreiheiten auf das Ertragsteuerrecht der Bundesrepublik Deutschland – Eine Bestandsaufnahme*, in Lehner (ed.), *Grundfreiheiten im Steuerrecht der EU-Staaten*, (2000), pp. 60–62.

[139] See Weiss & Wooldridge, *Free Movement of Persons within the European Community*, (2002), p. 138.

[140] Case C-398/95 *Syndesmos ton en Elladi Touristikon kai Taxidiotikon Grafeion* v *Ypourgos Ergasias* [1997] ECR I-3091.

[141] *Ibid.*, para. 22.

and, consequently, on the economy of the state. Hence, it must be regarded as an economic aim that could not constitute an imperative interest.[142]

One may conclude that the traditional understanding is that the grounds available within the framework of the justification test are, in the case of direct discrimination, the derogations listed in the EC Treaty, or, in the case of all other types of national measures constituting a prohibited restriction, the treaty derogations as well as imperative interests. The ECJ has stated, on numerous occasions, that Member States may not rely upon imperative interests to justify directly discriminatory measures.[143]

3.5.3 The Gebhard Test

In the *Gebhard*[144] case, the Court elaborated on the requirements necessary for the national rule to satisfy to be tested under imperative interests. In this case, the ECJ held that it:

> "follows [...] from the Court's case-law that national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary to attain it (see C-19/92 Kraus v. Land Baden-Wuerttemburg [1993] ECR I-1663, paragraph 32)."[145]

These four conditions mentioned by the Court are commonly referred to as the Gebhard test. From this statement, it seems to be clear that national measures sufficiently obstructive to constitute a hindrance to the free movement are prohibited unless they are justified.[146]

The first condition excludes a national measure which is discriminatory from justification by imperative interests according to the second condition. One question is whether the term discriminatory, as used in the Gebhard test, includes both directly and indirectly discriminatory measures. It has been held that in its case law the Court has often used

[142] *Ibid.*, para. 23.

[143] Joined Cases C-321/94 and C-324/94 *Criminal proceedings against Jacques Pistre* [1997] ECR I-2343, para. 52, Case 352/85 *Bond van Adverteerders* [1988] ECR 2085, para. 32, Case C-311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651, para. 32.

[144] Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'ordine degli Avvocati e Procuratori di Milano* [1996] ECR I-4165.

[145] *Ibid.*, para. 37.

[146] Craig & de Búrca, *EU Law*, (2002), p. 786.

the term *discrimination* in reference to direct discrimination.[147] From the quotation of the *Gebhard* case, one can see that the Court is making a reference to the *Kraus*[148] case. To get further guidance on this matter, I will now move on to the *Kraus* case and the *Gebhard* case.

3.5.3.1 The Kraus Case

In *Kraus*[149], the national legislation in question required that persons who had obtained an academic title outside Germany had to apply for authorization to be able to use it in Germany. The German legislation applied equally to nationals and non-nationals.[150]

When the Court assessed the German authorization requirement's compatibility with Article 39 EC, it held that provisions of national law must not constitute an obstacle to the effective exercise of the fundamental freedoms.[151] The Court found that Article 39 EC precluded any national measure governing the conditions under which an academic title obtained in another Member State may be used, where that measure:

> "even though it is applicable without discrimination on grounds of nationality, is liable to hamper or to render less attractive the exercise by Community nationals, including those of the Member State which enacted the measure, of fundamental freedoms guaranteed by the Treaty."[152]

The Court held, further, that such a national measure might not be contrary to Community law if it pursued a legitimate objective compatible with the Treaty and was justified by pressing reasons of public interest. Moreover, it would also be necessary that the national rule be appropriate for ensuring attainment of the objective it pursued and not go beyond what is necessary for that purpose.[153]

The Court held that the Member States were allowed to design national measures to prevent the opportunities created under the Treaty from being abused in a manner contrary to the legitimate interest of the state.[154] Accordingly, the Court found that the German legislation could be justified if it fulfilled certain requirements, such as that the authorization

[147] See section 3.4.3.2.

[148] Case C-19/92 *Dieter Kraus* v *Land Baden-Württemberg* [1993] ECR I-1663, this case is further analysed in section 4.2.3.1.

[149] Case C-19/92 *Dieter Kraus* v *Land Baden-Württemberg* [1993] ECR I-1663.

[150] *Ibid.*, paras. 3–4.

[151] *Ibid.*, para. 28.

[152] *Ibid.*, para. 32.

[153] *Ibid.*

[154] *Ibid.*, para. 34.

procedure was solely intended to verify whether the academic title was properly awarded and that the process was easily accessible.[155]

In order to obtain guidance in interpreting the Court's first condition in the *Gebhard* case, applied in a non-discriminatory manner, it appears as if that is a rewording of the Court's statement presented above in the *Kraus* case, namely *applicable without discrimination on grounds of nationality.* Considering that the ECJ seems to use the term *discrimination on grounds of nationality* in reference to direct discrimination, it may be concluded that the *Kraus* case indicates that it is only direct discrimination that is excluded from justification on grounds of imperative interests.

3.5.3.2 The Gebhard Case

In *Gebhard*[156], the ECJ took a somewhat different position on host state requirements than in previous cases.[157] Mr Gebhard was a German national who was a member of the Stuttgart Bar. Disciplinary proceedings were brought against him by the Milan Bar Council due to his activities as a lawyer in Italy. He had set up chambers and used the title *avvocato* even though he had not been admitted as a member of the Milan Bar.

The ECJ held that the exercise of the right of establishment and the conditions for its exercise depend on what activities the migrant intended to pursue in the territory of the host state.[158] If the specific activities are not subject to any rules in the host state, and accordingly a national of that Member State does not have to have any specific qualifications in order to pursue them, a national of any other Member State is entitled to establish himself in the host state and pursue those activities there.

However, the Court explained that if the pursuit of a specific activity is subject to certain conditions in the host state, "a national of another Member State intending to pursue that activity must in principle comply with them".[159] It, then, proceeded by stating that any national measure "liable to hinder or make less attractive the exercise of fundamental freedoms" must fulfil the four conditions mentioned above in order to be in line with EC law.[160]

[155] *Ibid.*, para. 42.
[156] Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165.
[157] For instance, see section 4.3.2.2.
[158] Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'ordine degli Avvocati e Procuratori di Milano* [1996] ECR I-4165, paras. 34–35.
[159] *Ibid.*, para. 36.
[160] *Ibid.*, para. 37.

The *Gebhard* case concerned a Member State's requirements applied to non-nationals who were exercising their right to free movement. The fact that the Italian legislation applied equally to both nationals and non-nationals makes it interesting when it comes to deciding whether the measure is to be considered as indirectly discriminatory or clearly non-discriminatory on grounds of nationality. One may argue that the legislation is indirectly discriminatory as the requirement for registration with the Italian Bar before using the title *avvocato* might have a disparate effect on migrants.[161] This is an approach adopted by the Court in, for instance, *Angonese*.[162] Another possible line of reasoning is to consider the Italian measure as clearly non-discriminatory on grounds of nationality but liable to prevent or hinder the exercise of free movement rights. Both these conclusions are represented in the literature. Barnard concludes that even though it is possible to consider the Italian legislation as indirectly discriminatory, it is evident that the ECJ focused on the more general question whether the measure was liable to prevent or hinder access to the market or exercise of the freedom.[163] Weiss and Wooldridge are of the opinion that the Italian requirements in *Gebhard* were most likely to be classified as indirectly discriminatory because it was mainly foreign lawyers who were disadvantaged by them, as they had complied with requirements in another Member State. Accordingly, the provisions were more likely to hinder non-nationals than Italians.[164]

3.5.3.3 Conclusion on the significance of "applied in a non-discriminatory manner"

The analysis presented above leads me to conclude that the first condition in the Gebhard test appears to exclude only directly discriminatory measures.[165] In the *Kraus* case, the Court held that national measures *applicable without discrimination on grounds of nationality* could be justified having regard to an imperative interest. Considering that the ECJ seems to use the term *discrimination on grounds of nationality* in reference to direct discrimination, it may be concluded that the *Kraus* case

[161] This line of reasoning is supported by the Court's very wide definition of indirect discrimination presented in, for instance, Case C-237/94 *O'Flynn* v *Adjudication Officer* [1996] ECR I-2617.

[162] See Case C-281/98 *Roman Angonese* v *Cassa di Risparmio di Bolano SpA* [2000] ECR I-4139, paras. 40–46.

[163] Barnard, *The Substantive Law of the EU – The Four Freedoms*, (2004), p. 258.

[164] Weiss & Wooldridge, *Free Movement of Persons Within the European Community*, (2002), p. 104.

[165] Similarly, see Craig & de Búrca, *EU Law*, (2002), p. 786.

indicates that it is only direct discrimination that is excluded from justification on grounds of imperative interests.

The Italian legislation in *Gebhard* can be considered either indirectly discriminatory on grounds of nationality or non-discriminatory on grounds of nationality. However, I find it reasonable to consider this double burden situation as mainly hindering migrants as they commonly have complied with requirements in their home state. Consequently, the arguments pointing in the direction that the first condition in the Gebhard test "must be applied in a non-discriminatory manner" imply that national measures are allowed to be indirectly discriminatory and still be able to be justified based on imperative interests. Therefore, only directly discriminatory measures are excluded from justification by imperative interests according to the Gebhard test. This is a conclusion which is supported by the traditional understanding of when it is possible to invoke imperative interests.[166]

3.5.4 Controversial Cases

3.5.4.1 To Invoke Imperative Interests

In section 3.5.2, the traditional view was presented on when Member States may justify a national measure on ground of imperative interests. It was stated that it was possible to successfully invoke imperative interests in the case of provisions not being directly discriminatory on grounds of nationality. However, what is controversial is that it appears that the ECJ has referred to grounds other than the express derogations found in the Treaty even when examining directly discriminatory provisions.[167] Consequently, the traditional view has been questioned as it appears that the ECJ has applied the imperative interests to directly discriminatory national measures, something that is contrary to the Court's own statements.[168] Some cases illustrating this will now be dealt with.

[166] See section 3.5.2.

[167] For example, see Case C-415/93 *Union Royal Belge des Sociétés de Football Association ASBL* v *Jean-Marc Bosman* [1995] ECR I-4921, paras. 115, 116, 121–137, where the Court considered arguments based on cultural and national identity (imperative interests) not only in respect of the non-discriminatory transfer fee system, but also when examining the directly discriminatory nationality clauses. Also in Case C-67/97 *Criminal Proceedings against Ditlev Bluhme* [1998] ECR I-8033 the Court used the language of mandatory requirements in respect of what appears to be distinctly applicable measures.

[168] See the statement given by Advocate General Jacobs in his opinion in Case C-379/98 *PreussenElektra AG* v *Schleswag AG* [2001] ECR I-02099, para. 220 and Advocate General Jacobs in his opinion in Case C-136/00 *Rolf Dieter Danner* [2002] ECR I-8147, paras. 34–37 and Roth, *Diskriminierende Regelungen des Warenverkehrs und Rechtfertigung durch die "zwingenden Erfordernisse" des Allgemeininteresses*, WRP 9/2000, pp. 979–984.

This involves analysing whether the national measure in question is directly discriminatory or not, because that is the decisive factor.[169] If one may draw the conclusion that the Court has justified directly discriminatory measures by applying imperative interests, or in its assessment considered such grounds for justification, it poses problems mainly because inconsistency in the case law of the ECJ results in less predictability. Moreover, it results in the Court allowing discrimination in the face of express Treaty provisions to the contrary.[170]

3.5.4.2 The Wallonia Waste Case

In the *Wallonia Waste*[171] case, the national measure in question can best be described as directly discriminatory.[172] It prohibited the dumping in Wallonia (Belgium) of waste from other Member States while accepted the dumping when the waste was from Wallonia.[173] Belgium argued that the Belgian legislation was justified by imperative interests relating to environmental protection.[174] The Court replied "...the argument that the contested measure were justified by imperative requirements of environmental protection must be considered as well-founded."[175]

The Commission argued that the imperative interests could not be relied upon because the Belgian legislation was of a discriminatory character.[176] The national measure in question clearly made a distinction based on the origin of the waste. The Court agreed with the Commission regarding that the imperative requirements only could be taken into account when the contested measure applied without distinction to both domestic and imported goods. The Court continued in a way that is most startling "...in assessing whether or not the barrier in question is discriminatory, account must be taken of the particular nature of waste."[177] The Court concluded by stating "...having regard to the differences between

[169] The analysis carried out below is based on the assumption that environmental protection is an imperative interest and not that environmental protection can be read into the Article 30 EC public health justification. See Case 302/86 *Commission* v *Denmark* [1988] ECR 4607 and Barnard, *The Substantive Law of the EU – The Four Freedoms*, (2004), p. 109.

[170] Hatzopoulos, Case C-250/95, *Futura Participations SA & Singer* v *Administration des Contributions (Luxembourg)*, Judgment of 15 May 1997, [1997] ECR I-2471, CMLRev 35, 1998, p. 506.

[171] Case C-2/90 *Commission* v *Belgium* [1992] ECR I-4431.

[172] See Barnard, *The Substantive Law of the EU – The Four Freedoms*, (2004), p. 118.

[173] Case C-2/90 *Commission* v *Belgium* [1992] ECR I-4431, paras. 4–8.

[174] *Ibid.*, para. 29.

[175] *Ibid.*, para. 32.

[176] *Ibid.*, para. 33.

[177] *Ibid.*, para. 34.

waste produced in different places and to the connection of the waste with its place of production, the contested measure cannot be regarded as discriminatory".[178] This way of classifying a measure seems far from an objective and neutral examination based on the factual situation, which ought to be the way of deciding whether a measure is discriminatory or not.

In the later case *PreussenElektra*[179] the Advocate General Jacobs described the Court's reasoning in the *Wallonia Waste* case as "flawed", because the question whether or not a measure applies without distinction to domestic and imported products is a preliminary and neutral one and its only function is to determine which grounds of justification that are available.[180]

It seems as if the Court in *Wallonia Waste* had great difficulties in reaching its desired result, namely to justify the national measure on grounds of environmental protection. As the protection of the environment is not one of the listed derogation grounds found in Article 30 EC, the Court had no other option than to classify the measure as indistinctly applicable, to comply with the established rules on invoking imperative interests.[181] However, in terms of predictability, this practice is highly unsatisfactory as it is contrary to the established way of classification.

3.5.4.3 The Svensson and Gustavsson Case

In *Svensson and Gustavsson*[182], the question was whether it was compatible with the free movement of services and capital for Luxembourg to make the grant of an interest rate subsidy subject to the requirement that the loans which were to benefit from the subsidy had been obtained from a credit institution approved by Luxembourg. This requirement implies that the credit institution must be established in Luxembourg.

This question arose in proceedings between Mr and Mrs Svensson-Gustavsson, residents of Luxembourg, and the Ministre du Logement et de l'Urbanisme, which refused to grant them an interest rate subsidy on a loan for the construction of a house. The reason was that the loan was taken out with a Belgian credit institution.[183]

The ECJ held in relation to the free movement of services that the establishment requirement was discriminatory on the ground of the place

[178] *Ibid.*, para. 36.

[179] C-379/98 *PreussenElektra AG* v *Schleswag AG* [2001] ECR I-2099.

[180] Advocate Jacobs in his opinion in Case C-379/98 *PreussenElektra AG* v *Schleswag AG* [2001] ECR I-2099, para. 225.

[181] See Shuibhne, *The free movement of goods and Article 28 EC: an evolving framework*, 27 ELRev 2002, p. 420.

[182] Case C-484/93 *Peter Svensson and Lena Gustavsson* v *Ministre du logement et de l'urbanisme* [1995] ECR I-3955.

[183] *Ibid.*, para. 2.

of establishment and, thus, justifiable only on the basis of the derogations expressly provided for in the EC Treaty.[184] The Court held "...the rule in question entails discrimination based on the place of establishment" and, accordingly, it "can only be justified on the general interest grounds referred to in Article 56 (1) of the Treaty [now Article 46 EC] ...and which do not include economic aims".[185]

Later in the same judgment, the ECJ considered it necessary to examine the proposition that the measure in question was necessary in order to preserve the cohesion of the tax system, as well as other arguments that did not fall within the explicitly stated justifications in the EC Treaty.[186] Having in mind that the Court first held that only explicit Treaty justifications could be invoked, it appears inconsistent that the Court later in the same judgment assessed whether imperative interests could justify the national measure. Accordingly, it is difficult to draw any conclusions regarding in what situations imperative requirement may be successfully invoked considering the Court's reasoning in this case. One may agree with Barnard, who refers to the *Svensson and Gustavsson* case as "an illustration of complete conceptual and legal confusion".[187]

3.5.4.4 The Aher Waggon Case

In the *Aher Waggon*[188] case, a German provision distinguished according to the place of registration of aircraft. Aircraft previously registered in another Member State could not be registered in Germany, even though aircraft of the same construction, which had already obtained German registration before the German measure was adopted, could retain that registration. Thereby, the German rule subjecting aircraft which had been registered in another Member State to stricter noise standards than those for equivalent domestic aircraft.

Without assessing whether the national measure was directly discriminatory or not, the ECJ found that a barrier such as the German legislation could be justified by considerations of public health and environmental protection.[189] Once again it is not clear whether the ECJ found the German measure to be directly discriminatory and, nevertheless, justified on imperative interest grounds or found the measure to be indirectly discriminatory and, therefore, accepted imperative interests.

[184] *Ibid.*, paras. 12, 15.
[185] *Ibid.*, para. 15.
[186] *Ibid.*, paras. 16–18.
[187] Barnard, *The Substantive Law of the EU – The Four Freedoms*, (2004), p. 348.
[188] Case C-389/96 *Aher-Waggon GmbH* v *Germany* [1998] ECR I-4473.
[189] *Ibid.*, para. 19.

3.5.4.5 The PreussenElektra Case

In the *PreussenElektra*[190] case, the German legislation that was under review treated electricity of domestic origin differently, both in law and in fact, from imported electricity.

The Advocate General Jacobs found the measure to be classified as directly discriminatory.[191] The ECJ did neither assess whether the German legislation was to be classified as directly discriminatory, nor discuss thoroughly possible justifications. The Court only stated that "account must be taken, first, of the aim of the provision in question, and, second, of the particular features of the electricity market."[192]

Without explaining whether the judgment was based on Article 30 EC or on imperative interests, the Court concluded that in "the current state of Community law" the national law was "not incompatible with Article 30 of the EC Treaty" [now Article 28 EC].[193] As the national legislation distinguished based on the origin of the electricity, and treated electricity of foreign origin less favourably, one may reach the conclusion that it is a directly discriminatory measure.

3.5.4.6 Analysis

The inconsistencies discussed above have led some commentators to argue that these cases show a trend of convergence toward accepting both the Treaty justifications and the broader range of justifications in all cases, regardless of the nature of the restrictive measure.[194]

In the literature, the following advantages of applying the Treaty derogations as well as the imperative interests to national measures, regardless of the nature of the restriction, have been presented.[195] While the classification is complicated, this solution is attractive because of its sim-

[190] C-379/*98 PreussenElektra AG* v *Schleswag AG* [2001] ECR I-2099.

[191] In his opinion in Case C-379/98 *PreussenElektra AG* v *Schleswag AG* [2001] ECR I-2099, para. 221.

[192] C-379/98 *PreussenElektra AG* v *Schleswag AG* [2001] ECR I-2099, para. 72.

[193] *Ibid.*, para. 81. See also Barnard, *The Substantive Law of the EU – The Four Freedoms*, (2004), p. 77.

[194] AG Jacobs' opinion in Case C-379/98 *Preussen Electra AG* v Schleswag AG [2001] ECR I-2099, para. 226, Oliver, *Some Further Reflections on the Scope of Articles 28–30 (ex 30–36) EC*, CMLRev 36, 1999, p. 805, Barnard, *Fitting the remaining pieces into the goods and persons jigsaw*, 26 ELRev 2001, pp. 52–55, Roth, *Diskriminierende Regelungen des Warenverkehrs und Rechtfertigung durch die "zwingenden Erfordernisse" des Allgemeinintresses*, WRP 9/2000, pp. 979–984.

[195] Barnard, *Fitting the remaining pieces into the goods and persons jigsaw?* 26 ELRev 2001, pp. 53–55, Spaventa, *On Discrimination and the Theory of Mandatory Requirements*, CYELS, Vol. 3, 2000, p. 466, Barnard, *Fitting the remaining pieces into the goods and persons jigsaw?* 26 ELRev 2001, pp. 55–59.

plicity. Moreover, it removes the need for a two-stage test where the ECJ first classifies the measure and then applies the available justifications. As the classification is controversial, and it is difficult to predict how the Court will describe the situation at hand, this would be a desired outcome. The third advantage is based on the fact that the Court already has ignored the two-stage test in certain cases, for example in *Aher-Waggon* and *PreussenElektra*, and that is why it would be more logical and simpler to abolish the distinction between treaty derogations and imperative interests.

Advocate General Jacobs has argued that it is inappropriate to have different grounds of justification depending upon whether the measure is discriminatory or not.[196] He bases his argumentation on that the Treaty does not make any such distinction and that it is difficult to apply rigorously the distinction between different kinds of restrictive measures. Instead, he recommends that the analysis be based on whether the ground invoked is a legitimate aim of general interest and, if so, whether the restriction can be properly justified under the principle of proportionality.

However, the proposal that any type of restrictive measure is to be justified having regard to imperative interests has also been criticized.[197] The main objection is that the ECJ has made numerous statements where it has held that Treaty derogations have to be interpreted strictly and are exhaustively listed. For instance, in *Gebhard*, the ECJ stated that only national measures applied in a non-discriminatory manner could be justified having regard to the imperative interests. The reason is that they are derogations from fundamental freedoms granted to European citizens. If the Court would provide for further grounds of justification, it would entail a Treaty amendment through judicial action.

Moreover, as the ECJ has not formally abandoned the general rule that imperative requirements cannot be invoked in connection with directly discriminatory measures, let us presume that the Court intends to stick to its traditional apprehension. The controversial cases dealt with have been within the areas of environmental policy as well as tax and social security policy. These interests have far better chances of being justified if they are assessed having regard to the imperative interests. Environmental protection is not found among the derogations provided for in the Treaty but has been accepted as an imperative interest. The Court has made several statements that economic considerations cannot be relied upon under

[196] In his opinion in Case C-136/00 *Rolf Dieter Danner* [2002] ECR I-8147, para. 40.

[197] See Spaventa, *On Discrimination and the Theory of Mandatory Requirements*, CYELS, Vol. 3, 2000, p. 466 and Barnard, *Fitting the remaining pieces into the goods and persons jigsaw?* 26 ELRev 2001, pp. 55–59.

the Treaty derogations. However, justifying a hindering national measure according to the protection of fiscal cohesion is influenced by economic considerations and has been accepted in the *Bachmann* case.[198] However, the Court has been very strict in the admission of the protection of fiscal cohesion justification. Even though Member States frequently have referred to the protection of fiscal cohesion when arguing in favour of its income tax legislation, no tax rule has been justified on this ground since the justification of the Belgian legislation at issue in the *Bachmann* case.[199]

Finally, both Advocate General Jacobs[200] and Advocate General Tesauro[201] have called for clarification from the ECJ regarding the question whether directly discriminatory measures can be justified by imperative requirements and the actual classification of national measures. Advocate General Jacobs explicitly stated that such clarification was required "in order to provide the necessary legal certainty".[202] In *Danner*[203], Advocate General Jacobs stressed that the Court should clarify its position because "clarity and legal certainty are essential for national courts, litigants, the governments of the Member States, the institutions and citizens in general".[204] Moreover, Advocate General Jacobs went as far as stating that "the current state of uncertainty on this core issue of Community law is unsatisfactory".[205] However, the ECJ has not, so far, complied with the Advocates General's requests, and the uncertainty unfortunately remains.

3.6 Conclusions

In this chapter, the importance of a well-functioning internal market for the achievement of the aims of the Community has been emphasized. The internal market is one of the main means to achieve these aims. The

[198] Case C-204/90 *Bachmann* v *Belgium* [1992] ECR I-249.

[199] For example, see Case C-319/02 *Petri Manninen* [2004], not yet reported in ECR, para. 40 and Quitzow, *Exit Bachmann, bienvenue Danner? – Eller när en dom har blivit så urholkad att den nästan får anses vara "overruled"*, SN 2003, pp. 89–92.

[200] In his opinion in Case C-379/98 *Preussen AG* v *Schleswag AG* [2001] ECR I-2099, para. 229.

[201] In his opinion in Case C-118/96 *Jessica Safir* v *Skattemyndigheten i Dalarnas Län* [1998] ECR I-1897, para. 34.

[202] In his opinion in Case C-379/98 *PreussenElektra AG* v *Schleswag AG* [2001] ECR I-2099, para. 229.

[203] Case C-136/00 *Rolf Dieter Danner* [2002] ECR I-8147.

[204] In his opinion in Case C-136/00 *Rolf Dieter Danner* [2002] ECR I-8147, para. 37.

[205] *Ibid.*, para. 39.

free movement provisions, which prohibit restrictive national measures on the free movement of goods, persons, services and capital, have been interpreted by the ECJ having regard to their central importance for the realization of the internal market.

When interpreting the free movement provisions, the case law shows that the Court normally follows two main lines of reasoning. Either the Court's reasoning is focused on establishing whether the national measure has a negative effect on non-nationals or non-residents, as non-residents are generally non-nationals, compared with nationals or residents, or the Court's reasoning is focused on establishing whether the national measure is liable to dissuade or deter persons from exercising their rights to free movement. The former line of reasoning is referred to in this study as a *nationality-based approach* as the Court focuses on different treatment due to nationality. Under this approach, a national rule may be classified as directly discriminatory or indirectly discriminatory on grounds of nationality. The content of the terms direct discrimination and indirect discrimination has been analysed based on case law and literature. The latter line of reasoning is referred to as a *free movement-based approach*, where the Court focuses on whether a national rule is liable to dissuade or deter persons from exercising their right to free movement. Consequently, the Court's reasoning is focused on whether the national rule has a hindering effect on the free movement.

When the ECJ is applying a *nationality-based approach*, the situations compared are generally the situation of a national and the situation of a non-national or that of a resident with that of a non-resident. Under the *free movement-based approach*, the Court does not focus on different treatment due to nationality or residence but on whether the national measure is liable to dissuade or deter a person from exercising his right to free movement. Under this approach the ECJ frequently compares the treatment of a domestic situation where the free movement has not been exercised and the treatment of a situation where the free movement is exercised.

To deal with the main question of this study, namely to establish the impact of free movement law on tax treaties concluded between EU Member States, it is of importance to have some guidelines, telling under which circumstances the Court analyses a tax treaty provision under a *nationality-based approach* or a *free movement-based approach*. It is argued in this study that these different lines of reasoning demonstrate two different prohibitions, a prohibition of discrimination on grounds of nationality, which includes differentiation based on residence, where the

effect of this differentiation is to the particular detriment of non-nationals, and a prohibition of national measures which hinders the free movement without being discriminatory on grounds of nationality.

The fact that the Court applies two different prohibitions is made all the more clear when one considers the Court's choice of comparator for the similarity test. Under a *nationality-based approach*, the Court commonly compares a national and a non-national or a resident and a non-resident. Under a *free movement-based approach*, if making a comparison, the Court compares a resident who has not exercised his right to free movement and a resident who has exercised that right. Therefore, it is clear that under the latter approach the nationality or residence is not of importance as the Court compares two residents. Dividing the Court's reasoning in these two categories and analysing under which circumstances the Court applies either approach, one may be assisted in predicting which approach and, accordingly, what kind of circumstances that will be decisive for the Court when finding out whether a national rule is in line with free movement law or not.

The main question regarding under which circumstances the Court applies either approach is whether the ECJ in general applies a *free movement-based approach* to host state legislation.[206] This question is of importance since an affirmative answer would imply that the scope of what is prohibited under the free movement provisions then is extremely far-reaching. Accordingly, if the case law studies carried out in Chapters 4 and 5 show that the Court applies a *free movement-based approach* to host state legislation in general, then one may expect severe effects on the legal systems of the Member States.

Expressions such as direct discrimination and indirect discrimination are not found in the EC Treaty. However, according to statements by the ECJ, the type of breach of free movement law determines the justification hierarchy. According to the traditional understanding, all national measures but those classified as directly discriminatory[207] on grounds of nationality can benefit from justifications explicitly stated in the EC Treaty, as well as from imperative interests. The latter category is not explicitly stated in the EC Treaty but has been recognized by the ECJ and accepted as overriding requirements in the general interest. These non-Treaty grounds are also referred to as imperative interests or mandatory requirements. However, it appears as if this is an area of free movement

[206] See section 3.4.4.2.

[207] If the national rule expressly uses the criterion of nationality or origin in order to establish a less favourable treatment of non-nationals than of nationals, then the measure is classified as directly discriminatory on grounds of nationality.

law that is not entirely coherent, as the ECJ has referred to grounds other than the express treaty derogations when examining directly discriminatory national measures.

4 Case Law Survey on the Interpretation of Free Movement Provisions

4.1 The Court's Reasoning

The purpose of this chapter is to look into the Court's reasoning when interpreting the free movement provisions that could have an impact on tax treaties in the internal market. This includes studying in which situations the ECJ focuses on different treatment due to nationality and when it focuses on the more general question whether a national rule hinders the exercise of free movement. The former approach is referred to as a *nationality-based approach* and the latter a *free movement-based approach*.[1]

As these different approaches imply different lines of reasoning, it is important to be able to predict in which situations the Court applies a *nationality-based approach* and when it applies a *free movement-based approach*. In this chapter, this is studied in relation to whether the national rule is assessed by the ECJ from a host state or home state perspective. When the Court has analysed a measure from a host state perspective, it focuses on the effect of the legislation on non-nationals or non-residents. Similarly, when assessing national legislation from a home state perspective, the Court emphasizes its effect on nationals and residents of that state.[2]

It is especially pertinent to analyse whether a *free movement-based approach* is applied in general by the ECJ to host state legislation.[3] It has been presented in Chapter 3 that the ECJ applies a *free movement-based approach* to host state legislation under the free movement of goods provisions. The question is whether this is the case also for the other free movement provisions. This is of central importance as the scope of what

[1] These approaches are explained in section 3.4.
[2] See section 3.4.1.
[3] See section 3.4.4.

is prohibited under free movement law extends considerably if a *free movement-based approach* is applied by the ECJ to host state legislation in general.

Considering the uncertainties connected to in which situations a Member State may successfully invoke imperative interests, also the Court's reasoning in relation to justifications of directly discriminatory national measures is studied in the cases analysed in both this chapter and in Chapter 5.

If it is possible to derive a pattern from the case law studies carried out in this chapter as well as in Chapter 5, predictability is increased as to which approach the ECJ will apply in a given situation involving either an internal tax provision or a tax treaty provision. For instance, if the question is whether a tax treaty provision implemented in the host state is in conflict with a free movement provision, guidance is provided as to which approach the ECJ will apply. As the tax treaty provision decides the tax treatment in the host state, it is assumed that the ECJ assesses it from a host state perspective. If the case law analysis can provide an answer as to which of the two approaches, a *nationality-based approach* or a *free movement-based approach*, the ECJ most likely will apply, the predictability of the outcome of the Court's assessment increases.

This chapter will look into cases that deal with national measures and fall within the scope of the free movement provisions. They may fall within any field of Member States' legislation. The case law in this area is extensive. The cases presented in this chapter represent only a limited selection. They are to be considered as examples of case law under the different free movement provisions and, therefore, the presentation is in no way exhaustive. I have not studied the entire case law on free movement law but considerably more cases than those presented in this chapter. The aim has been to present some cases on each freedom, illustrating both a *nationality-based approach* and a *free movement-based approach.*

As a selection has been made, it is of interest to know the criteria for this selection. I have strived towards covering many of the cases usually commented on in textbooks, such as *EU law* by Craig and de Búrca and *The Substantive Law of the EU – The Four Freedoms* by Barnard. This is to systematize cases generally known and discussed, applying a classification based on the Court's reasoning, either as a *nationality-based approach* or a *free movement-based approach*. This is the only criterion I use for the selection. Whereas this may be considered a weakness in terms of the reliability of the conclusions from this case law study, I want to emphasize that the results are considered as preliminary and are further tested in the subsequent chapters. In Chapter 5, the ECJ's reasoning is studied but then in an income tax context exclusively. The selection of

cases in that chapter is more representative as I have endeavoured to deal with all income tax cases the ECJ has adjudicated with regard to the interpretation of free movement provisions until 1 August 2004. Therefore, the conclusions reached in Chapter 5 are more reliable considering the material used than the conclusions from this chapter.

It is not always clear under which free movement provision a situation is to be assessed. The movement of funds across borders between subsidiaries and parent companies could potentially be described as an aspect of free movement of capital as well as freedom of establishment.[4] In respect of the freedoms where this problem is most evident, case law is penetrated to illustrate how the ECJ has argued when deciding which free movement provision is applicable.[5] In section 4.6, also income tax cases are considered.

The exposition starts with the free movement of workers. Next, follows the right to freedom of establishment, free movement of services and finally the free movement of capital.[6] All these free movement provisions have been held to have vertical direct effect by the ECJ.[7] The exposition only includes information of a more direct relevance to the questions of the impact of free movement law on tax treaties in the internal market. For example, the issue of horizontal direct effect is, therefore, not analysed.[8]

The following presentation is systematized based on the Court's reasoning. If the ECJ's reasoning is focused on establishing whether the national rule is particularly to the disadvantage of non-nationals or non-residents, the case is presented under the heading *nationality-based approach*. Similarly, if the Court's reasoning is focused on whether the national provision is liable to dissuade or deter a person from exercising his right to free movement, the case is presented under the heading *free movement-based approach*. In order to be able to draw conclusions regarding under which circumstances these different lines of reasoning are applied, it is analysed from which perspective the Court has assessed

[4] Peers, *Free movement of Capital: Learning Lessons or Slipping on Spilt Milk?* In Barnard & Scott (eds.), *The Law of the Single European Market*, (2002), p. 337.

[5] See section 4.6.

[6] The free movement of goods is not included, as it does not have a direct impact on the overall question of the influence of free movement law on tax treaties.

[7] Case 41/74 *Van Duyn* v *Home Office* [1974] ECR 1337, Case 13/76 *Gaetano Dona* v *Mario Mantero* [1976] ECR 1333, Case 2/74 *Jean Reyners* v *Belgian State* [1974] ECR 631, Case 33/74 *Johannes Hervicus Maria van Binsbergen* v *Bestuur van de Bedrijfsvereniging voor de Metaalnijverheid* [1974] ECR 1299, Cases C-163, 165 and 250/94 *Criminal Proceedings against Lucas Emilio Sanz de Lera* [1995] ECR I-4821.

[8] Cases as, for instance, C-415/93 *Union Royal Belge des Sociétés de Football Association ASBL v Jean-Marc Bosman* [1995] ECR I-4921 are therefore not considered.

the national rule, either from a host or a home state perspective. Under the above-mentioned headings, the cases are presented in a chronological order.

4.2 The Free Movement of Workers

4.2.1 Introduction

Article 39 EC is set up to ensure the free movement of workers. It prescribes 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.[9] Article 39 EC differs from the other free movement provisions as it prohibits *any discrimination based on nationality* while the other articles refer to a prohibition of restrictions.

4.2.2 A Nationality-Based Approach

4.2.2.1 The Sotgiu Case

In *Sotgiu*[10], the ECJ interpreted Article 39 EC and Articles 7 (1) and 7 (4) of Regulation No 1612/68. An Italian worker, Mr Sotgiu, at the German federal post office was denied a supplementary remuneration. The reason for the denial was that Mr Sotgiu did not fulfill the criterion for the grant of the allowance, namely residence in Germany.

The Court held that both Article 39 EC and Article 7 of the Regulation forbid not only overt discrimination on grounds of nationality but also all covert forms of discrimination which, by the application of other criteria of differentiation, *de facto* lead to the same result.[11] Next, the Court explained that criteria such as the place of origin or the residence of a worker may be tantamount to discrimination on grounds of nationality, which is prohibited by both Article 39 EC and the Regulation.[12]

The ECJ assessed the situation from a host state perspective, arguing solely in terms of differentiation on grounds of nationality or residence

[9] See Article 39 (2) EC and Case 15/69 *Württembergische Milchverwertung-Südmilch AG* v *Salvatore Ugliola* [1969] ECR 363, para. 3. Article 39 EC has been supplemented by means of secondary legislation, see for instance Regulation (EEC) No 1612/68 of the Council of 15 October 1968 on freedom of movement for workers within the Community.

[10] Case 152/73 *Giovanni Maria Sotgiu* v *Deutsche Bundespost* [1974] ECR 153.

[11] *Ibid.*, para. 11.

[12] *Ibid.*

and consequences for migrant workers. The Court held that when a Member State grants benefits to its own nationals, it is obliged to extend the advantage to workers who are nationals of other Member States.[13] The Court's reasoning in *Sotgiu* is a clear example of a *nationality-based approach.*

4.2.2.2 The Scholz Case

In *Scholz*[14], an Italian national was negatively affected by a rule in the Italian legislation.[15] The provision in question concerned the recruitment of staff by an Italian public body for posts that did not fall within the scope of the public service exception found in Article 39 (4) EC. It provided for account to be taken of candidates' previous employment in the public service, but did not take account of the same type of employment if it was carried out in another Member State. Mrs Scholz was of German origin and had acquired Italian nationality by marriage. She argued that the refusal to consider her previous employment in the German post office was contrary to Community law.

The Court stated initially that Article 39 EC prohibits not only overt discrimination by reason of nationality but also all covert forms of discrimination which lead, in fact, to the same result.[16] It also explained that the fact that Mrs Scholz had acquired Italian nationality had not any bearing on the application of the non-discrimination principle.[17] In this context, the Court held that any national who, irrespective of his place of residence and nationality, has exercised the right to freedom of movement for workers and who has been employed in another Member State falls within the scope of Article 39 EC.[18]

The Court held in *Scholz* that the refusal to take into consideration the plaintiff's employment in another Member State constituted unjustified indirect discrimination.[19] Hence, Member States are not allowed to make a distinction according to whether the employment was in the public service of that particular state or in the public service of another Member State.[20]

[13] *Ibid.*, para. 8.

[14] Case C-419/92 *Ingetraut Scholz* v *Opera Universitaria di Cagliari and Cinzia porcedda* [1994] ECR I-505.

[15] See Stanley, *Case C-107/94, Asscher v Staatssecretaris van Financiën. Judgment of 27 June 1996. Fifth Chamber. [1996] ECR I-3089.* CMLRev 34, 1997, p. 719.

[16] Case C-419/92 *Ingetraut Scholz* v *Opera Universitaria di Cagliari and Cinzia porcedda* [1994] ECR I-505, para. 7.

[17] *Ibid.*, para. 8.

[18] *Ibid.*, para. 9.

[19] *Ibid.*, para. 11.

[20] *Ibid.*, para. 12.

It is notable that the Court in *Scholz* used the term *indirect discrimination* as that implies discrimination on grounds of nationality.[21] Nationality was not the decisive criterion; the plaintiff was an Italian national disadvantaged by Italian legislation. Instead, it was the fact that she had used her right to free movement that put her in a less favourable situation. However, it seems as if the Court wanted to disregard this fact as it stated that the circumstance that Mrs Scholz had acquired Italian nationality had not any bearing on the application of the non-discrimination principle. There is one possible explanation to the Court's use of the term indirect discrimination in this case.[22] The effect of the Italian legislation was typically to the disadvantage of non-residents even though Mrs Scholtz had dual nationality.

The Court's reasoning lacks considerations such as whether the Italian legislation mainly disadvantaged workers from other Member States or whether the legislation was liable to dissuade a person from exercising his free movement rights. However, as the Court explicitly used the term indirect discrimination, one may assume, albeit not without caution, that the Court applied a *nationality-based approach.* Also the question whether the ECJ analysed the Italian legislation from a host state or a home state perspective poses a problem. The Court stated that Article 39 EC covers workers who have exercised their freedom of movement and who have been employed in another Member State. This wording appears to indicate that the Court's reasoning is valid both in relation to a person's home state and his host state.

4.2.2.3 The Clean Car Case

In *Clean Car*[23], the question was whether a residence requirement was in line with Article 39 EC. Clean Car, an Austrian company established in Vienna, was denied registration for trade on the ground that it had appointed as manager a person who did not reside in Austria.[24] The Court found that a requirement that nationals of other Member States must reside in the state concerned to be appointed managers of undertakings exercising trade was such as to constitute indirect discrimination based on nationality, contrary to the freedom of movement of workers.[25]

[21] *Ibid.*, para. 11.
[22] See Ståhl & Persson Österman, *EG-skatterätt*, (2000), p. 112. See also section 3.4.3.3.
[23] Case C-350/96 *Clean Car Autoservice* v *Landeshauptmann von Wien* [1998] ECR I-2521.
[24] *Ibid.*, para. 2.
[25] *Ibid.*, para. 30.

Regarding residence requirements, the Court held that they are liable to operate mainly to the detriment of nationals of other Member States, as non-residents in the majority of cases are foreigners.[26] Hence, this is a case where the ECJ applied a *nationality-based approach.* The Court assessed the Austrian legislation from a host state perspective, focusing on the effect of the legislation on non-nationals.

4.2.2.4 The Commission v Spain Case

A situation where the legislation in a Member State explicitly differentiated on grounds of nationality was analysed in *Commission* v *Spain.*[27] The Court considered whether Spanish legislation, which, by laying down a nationality requirement in respect of security personnel, excluded nationals of other Member States from entering that occupation, was in breach of the free movement of workers, services and right to establishment. The Court found the legislation, among other things, to preclude nationals of other Member States from carrying on permanently private security activities in Spain as employed persons or self-employed persons, as well as preventing nationals of other Member States from providing private security services in Spain.[28] The Court held that neither Treaty derogations, nor imperative interests justified the restrictions imposed by legislation such as the Spanish one.[29]

The Court analysed the Spanish legislation from a host state perspective and found that it excluded nationals of other Member States from entering the Spanish market. Accordingly, the Court's reasoning was focused on differentiation on grounds of nationality, and it is clear that the Court applied a *nationality-based approach.* Unfortunately, the case provides no guidance on the question of whether it is possible to invoke imperative interests in cases of direct discrimination as the Court was vague on this point in its reasoning. It merely stated that neither Treaty justifications, nor imperative interests have as their aim to justify legislation such as the Spanish one.[30]

4.2.2.5 The Commission v Belgium Case

In *Commission* v *Belgium*[31], the Court simply stated that a residence obligation imposed on both managers and staff of security firms constituted a

[26] *Ibid.*, paras. 29, 42–43.
[27] Case C-114/97 *Commission* v *Spain* [1998] ECR I-6717.
[28] *Ibid.*, para. 31.
[29] *Ibid.*, paras. 32–43.
[30] *Ibid.*, paras. 41–43.
[31] Case C-355/98 *Commission v Belgium* [2000] ECR I-1221.

restriction on both the free movement of workers and the freedom of establishment.[32] This situation was similar to the one in *Clean Car*, where there also was a residence requirement imposed on managers. The Court classified the breach as indirectly discriminatory in *Clean Car* but found it to constitute a mere restriction in *Commission* v *Belgium*. That means that the Court in *Commission* v *Belgium* refused to classify the restriction in terms of discrimination on grounds of nationality.

The Belgian government argued that the legislation was justified by the need to check the background and conduct of the persons in question. The ECJ responded that such information needs can be satisfied by less restrictive means.[33]

The Belgian legislation was analysed from the perspective of its effect on non-nationals as non-residents are generally non-nationals, and the Court's reasoning is to be classified as a *nationality-based approach*. Moreover, the Court analysed the legislation from a host state perspective.

4.2.3 A Free Movement-Based Approach

4.2.3.1 The Kraus Case

In *Kraus*[34], the national legislation in question required that persons who had obtained an academic title outside Germany had to apply for authorization to be able to use it in Germany. This legislation applied to nationals as well as non-nationals.[35] Mr Kraus was a German national who had obtained a post-graduate academic title in the UK. He argued that the authorization requirement was in breach of Article 39 EC.

When the Court assessed whether the German authorization requirement was precluded by Article 39 EC, it held that provisions of national law must not constitute an obstacle to the effective exercise of the fundamental freedoms.[36] Further, it held that the Court has confirmed that Articles 39 EC and 43 EC implement the fundamental principle contained in Article 3 (c) EC, in which it is stated that, for the purposes set out in Article 2 EC, the activities of the Community are to include the abolition, as between Member States, of obstacles to freedom of movement of persons.[37]

[32] *Ibid.*, para. 31.
[33] *Ibid.*, para. 33.
[34] Case C- 19/92 *Dieter Kraus* v *Land Baden-Württemberg* [1993] ECR I-1663.
[35] *Ibid.*, paras. 3–4.
[36] *Ibid.*, para. 28.
[37] *Ibid.*, para. 29.

The Court found that Article 39 EC precluded any national measure governing the conditions under which an academic title obtained in another Member State may be used where that measure:

> "even though it is applicable without discrimination on grounds of nationality, is liable to hamper or to render less attractive the exercise by Community nationals, including those of the Member State which enacted the measure, of fundamental freedoms guaranteed by the Treaty."[38]

The Court held, further, that such a national measure might not be contrary to Community law if it pursued a legitimate objective compatible with the Treaty and was justified by pressing reasons of public interest. Moreover, it would also be necessary that the national rule be appropriate for ensuring attainment of the objective pursued and not go beyond what is necessary for that purpose.[39]

The Court explained that the Member States were allowed to design national measures to prevent the opportunities created under the Treaty from being abused in a manner contrary to the legitimate interest of the state.[40] Accordingly, the Court found that the German legislation was compatible with the free movement of workers only if it fulfilled certain requirements, such as that the authorization procedure was solely intended to verify whether the academic title was properly awarded and that the process was easily accessible.[41] The Court's pronouncement in *Kraus*, that legislation which was "liable to hamper or to render less attractive the exercise by Community nationals" of free movement rights was prohibited, was similarly repeated in the *Gebhard*[42] case.

In *Kraus,* the Court argued in terms of whether the national measure was *liable to hamper or to render less attractive* the exercise of free movement rights. The Court's reasoning was not focused on whether the national measure was to the specific detriment of workers from other Member States. One may argue that that is understandable as Mr Kraus was a German national disadvantaged by German legislation. However, the ECJ found it necessary to disregard Mr Kraus' nationality as it held that he was in a situation which may be assimilated to that of any other person enjoying the rights and liberties guaranteed by the Treaty.[43] It is

[38] *Ibid.*, para. 32.
[39] *Ibid.*
[40] *Ibid.*, para. 34.
[41] *Ibid.*, para. 42.
[42] Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165, para. 37.
[43] For similar argumentation, see Case C-107/94 *P. H. Asscher* v *Staatssecretaris van Financiën* [1996] ECR I-3089, para. 15.

concluded, however, not without hesitation, that the Court in *Kraus* applied a *free movement-based approach*. This conclusion is based on that the decisive criterion was whether the academic title was awarded in Germany or in another Member State. Mr Kraus exercised his right to free movement and acquired his academic title abroad. This was the reason why he was treated differently. The Court argued that even though the national rule did not discriminate on grounds of nationality, it was liable to hamper or render less attractive the exercise of fundamental freedoms. The significance of the ECJ's statement that Mr Kraus was to be assimilated to that of any other person enjoying the rights and liberties guaranteed by the Treaty is in this context unclear. It may be interpreted as indicating a *nationality-based approach* similarly to the Court's reasoning in *Scholz*.[44] Because the reasons presented here, the conclusion is, nevertheless, that the ECJ applied a *free movement-based approach*.

When it comes to deciding from which perspective the ECJ assessed the German legislation, it appears as if the Court considered both a host and a home state perspective. The reason for this conclusion is that the ECJ held that national rules which are "liable to hamper or to render less attractive the exercise by Community nationals, including those of the Member State which enacted the measure" are contrary to Community law unless justified. This quotation indicates that both non-nationals and nationals are protected by Article 39 EC, which appears to indicate that a Community national can rely on this article in relation to any host state, being an EU member State, as well as to his home state.

4.2.3.2 The Terhoeve Case

Also provisions on social security have been contested under Article 39 EC. In *Terhoeve*[45], the Court stated that provisions 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" constitute an obstacle to Article 39 EC, even if the provisions apply without regard to the nationality of the workers.[46]

Mr Terhoeve, a Netherlands resident, lived and worked in the UK for part of the year of 1990. Under Netherlands law, he was regarded during this period as non-resident for income tax purposes.[47] After having

[44] Case C-419/92 *Ingetraut Scholz* v *Opera Universitaria di Cagliari and Cinzia porcedda* [1994] ECR I-505 (see section 4.2.2.2 of this study).

[45] Case C-18/95 *F.C. Terhoeve* v *Inspectuer van de Belastingdienst Particulieren/ Ondernemingen Buitenland* [1999] ECR I-345.

[46] *Ibid.*, para. 39.

[47] *Ibid.*, para. 12.

returned to the Netherlands, he was supposed to pay social security contributions at a level exceeding the amount that he would have been liable to had he remained a resident of the Netherlands for the entire year of 1990.[48]

The Court explained that a person could be deterred from leaving his home state in order to work in another Member State were he required to pay greater social contributions than if he continued to reside in the same Member State.[49] The Court concluded that the national legislation under review constituted an obstacle to freedom of movement for workers and was, consequently, in breach of Article 39 EC. Therefore, the Court found it unnecessary to consider "whether there is indirect discrimination on grounds of nationality..."[50]. The Court considered the non-Treaty grounds put forward as justifications in the *Terhoeve* case but did not uphold any of them.[51]

In *Terhoeve,* the ECJ applied a *free movement-based approach* and assessed the Netherlands legislation considering its effects on persons residing in the Netherlands, a home state perspective. The Court compared the situation of persons residing in the Netherlands who had exercised their free movement rights with persons who had not done so but remained residents of the Netherlands for the entire year. The Netherlands legislation differentiated not on grounds of nationality but on grounds of the exercise of free movement rights.

4.2.3.3 The Graf Case

In *Graf*[52], the question was whether an Austrian provision, which denied entitlement to compensation on termination of employment when the worker himself terminated the contract but granted it when the worker's contract ended without the termination being at his own initiative or attributable to him, was in breach of the free movement of workers. In its assessment, the ECJ first stated that the legislation at issue applied irrespective of the nationality of the worker concerned.[53] Then, it stated that it could not be maintained that the legislation affected migrant workers to a greater extent than national workers.[54] So far, the analysis was focused on considering the Austrian legislation as host state legislation.

[48] *Ibid.*, para. 17.
[49] *Ibid.*, para. 40.
[50] *Ibid.*, para. 41.
[51] *Ibid.*, paras. 43–46.
[52] Case C-190/98 *Volker Graf* v *Filmoser Maschinenbau GmbH* [2000] ECR I-493.
[53] *Ibid.*, para. 15.
[54] *Ibid.*, para. 16.

Next, the Court stressed that nothing indicated that the Austrian provision operated to the disadvantage of a particular group of workers wishing to take up new employment in another Member State.[55] In this context, the Court held that it was clear from its case law that Article 39 EC prohibits not only all discrimination, direct or indirect, based on nationality but also such national rules which are applicable irrespective of the nationality of the workers but impeded their freedom of movement.[56]

The Court held in *Graf* that "provisions which, even if they are applicable without distinction, 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 therefore constitute an obstacle to that freedom".[57] Similar statements can be read in earlier judgments, but the Court made an additional comment. It stated "in order to be capable of constituting such an obstacle, they must affect the access of workers to the labour market".[58] The Court concluded that the legislation in question was not such as to preclude or deter a national from ending his contract of employment to take up a job with another employer. The effect of the legislation was "too uncertain and indirect" to be regarded a breach of Article 39 EC.[59]

In *Graf,* the Court first assessed the Austrian law from a host state perspective, concluding that it could not be maintained that the legislation affected migrant workers to a greater extent than national workers. When doing that, the Court's assessment was focused on differentiation based on nationality.

Next, in *Graf* the Court stressed that there was nothing that indicated that the Austrian provision operated to the disadvantage of a particular group of workers wishing to take up new employment in another Member State. Here, the ECJ shifted its approach and now considered the effect of the Austrian legislation on persons who wished to exercise their free movement rights to take up employment in another Member State. Accordingly, the Court considered the effect of the Austrian legislation on persons residing in Austria, consequently a home state perspective. In conclusion, the Court first applied a *nationality-based approach* and then shifted to a *free movement-based approach.*

[55] *Ibid.*, para. 17.
[56] *Ibid.*, para. 18.
[57] *Ibid.*, para. 23.
[58] *Ibid.*
[59] *Ibid.*, para. 25.

4.2.3.4 The Sehrer Case

The question in *Sehrer*[60] was whether Article 39 EC precluded Germany from calculating sickness insurance contributions based on the pensions of retired workers without taking account of the fact that a part of the gross amount of that pension already had been deducted by way of sickness insurance contributions in another Member State.

Mr Sehrer, a German national resident in Germany, received a statutory retirement pension from the German federal insurance fund for miners. Due to his previous work in France, he also received a French supplementary retirement pension. The gross amount of that retirement pension was subject to a deduction of 2.4 per cent as a contribution to the French sickness insurance scheme. When the German federal insurance fund learned about Mr Sehrer's French supplementary pension, it demanded from him the payment of arrears of sickness insurance contributions calculated on the basis of the gross amount of that pension.[61] This resulted in Mr Sehrer paying contributions on contributions and thus being required to pay twice.[62]

The ECJ held in *Sehrer,* by reference to *Terhoeve*, that the fact that Mr Sehrer had German nationality did not prevent him from relying on the rules relating to freedom of movement for workers against Germany, as he had exercised his right to freedom of movement and worked in another Member State.[63] Furthermore, the ECJ held that provisions 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" constitute an obstacle to that freedom even if they apply without regard to the nationality of the workers concerned.[64] As a result, the Court found that the effect of the German legislation was to the specific detriment of workers who had used their right to free movement, as it was unlikely that sickness insurance contributions were levied twice in one Member State on the gross amount of the supplementary retirement pension of a worker who has been employed in one Member State only.[65]

The Court's reasoning in *Sehrer* follows its reasoning in *Terhoeve*. The German law in *Sehrer* is analysed from a home state perspective, and the Court found that the factor of differentiation was the exercise of free

[60] Case C-302/98 *Manfred Sehrer* v *Bundesknappschaft* [2000] ECR I-4585.
[61] *Ibid.*, para. 5.
[62] *Ibid.*, para. 6.
[63] *Ibid.*, para. 29.
[64] *Ibid.*, para. 33.
[65] *Ibid.*, para. 34.

movement rights. This is a clear example of a case where the ECJ applied a *free movement-based approach* as the focus was on the exercise of free movement and not nationality.

4.2.4 Summary and Analysis

The cases on the free movement of workers analysed in this section show that a *nationality-based approach* is applied by the Court when national legislation is analysed from a host state perspective. When analysing national legislation from a home state perspective, the Court applies a *free movement-based approach.* From this clear pattern, two special situations must be distinguished.[66] When a Member State's own national who is or has been abroad seeks to exercise his right of movement or investment into its territory, it occurs that the ECJ brings such persons within the scope of Article 39 EC by equating them with nationals of other Member States. The *Scholz* case represents this line of reasoning. In this case, one may have expected the Court to assess the Italian law from a home state perspective as Mrs Scholz was an Italian negatively affected by that law. Instead, the Court considered it possible to use the concept of indirect discrimination in a situation where it was a national who was negatively affected by her own country's legislation, even though it does not fit very well with the purport of indirect discrimination.[67] The Court, however, found this line of reasoning possible. In *Scholz,* the Court applied a *nationality-based approach,* but as it disregarded Mrs Scholz nationality, one may conclude that the Court's reasoning is applicable both in relation to a person's host state and her home state. The second special situation is where the Court's reasoning is broad so it can be interpreted as applicable in relation both to a person's home and host state. This is the case in *Kraus,* where the Court applied a *free movement-based approach.* The Court's reasoning in *Kraus* can be interpreted as taking both a home state and host state perspective. Accordingly, these cases show that the Court, by its reasoning, is not ruling out the possibility of applying a *free movement-based approach* when analysing national legislation from a host state perspective as well as a

[66] See Farmer, *The Court's case law on taxation: a castle built on shifting sands?* ECTRev 2003, p. 77.

[67] See also Stanley, Case C-107/94, *Asscher* v *Staatssecretaris van Financiën.* Judgment of 27 June 1996. Fifth Chamber. [1996] ECR I-3089, CMLRev 34, 1997, p. 718 and Case C-107/94 *P. H. Asscher* v *Staatssecretaris van Financiën* [1996] ECR I-3089 concerning the freedom of establishment.

nationality-based approach when analysing the same law from a home state perspective.

In *Graf,* the Court first applied a *nationality-based approach* and after having found no restriction under this approach, it shifted to a *free movement-based approach.* Under the latter approach, the Court focused on whether the legislation was liable to preclude or deter a person from leaving his country of origin in order to exercise his right to free movement. The Court found that the effect of the national legislation was *too uncertain and indirect* to be regarded as a breach of Article 39 EC. This latter reasoning seems to indicate that there is a threshold for finding that a measure is liable to constitute a restriction under a *free movement-based approach.* Unfortunately, it is still unclear what is considered as constituting that threshold.

Even though Article 39 EC refers to the abolition of discrimination on the ground of nationality, the case law studied in this section illustrates that the Court, nevertheless, argues in terms of restrictions. It is worth noticing that in both *Clean Car* and *Commission* v *Belgium* the Court applied a *nationality-based approach.* The national provisions were similar in structure and effect, but the Court referred to them using different terminology. In *Clean Car,* the Court referred to the national measure as indirectly discriminatory but in *Commission v Belgium* as a restriction. Furthermore, from the case law it is clear that the Court uses the term restriction under both a *nationality-based approach* and a *free movement-based approach.*

4.3 The Freedom of Establishment

4.3.1 Introduction

The right of establishment, provided for in Articles 43 to 48 EC, is granted both to legal persons within the meaning of Article 48 EC and to individuals who are nationals of a Member State. The exceptions to the right of establishment are found in Articles 45 and 46 EC.

Article 43 (1) EC states that "restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited". This implies an obligation for the Member States to grant national treatment when they are in the position of host states. Also the wording of Article 43 (2) EC is focused on national treatment, stipulating that nationals of a Member State have the right to establish themselves in another Member State under the conditions laid down for its own nationals. The case law shows that the ECJ has interpreted

Article 43 EC so that it covers not only restrictions set up by the host state but also those set up by the home state.[68]

Regarding the concept of freedom of establishment of companies, Article 43 EC must be read in conjunction with Article 48 EC. This article, in addition to defining *companies or firms*, provides that 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 are, for the purposes of Article 43 EC, to be treated in the same way as individuals who are nationals of Member States.

The concept of establishment is broad. It allows a national of a Member State to participate, on a stable and continuous basis, in the economic life of a Member State other than his state of origin.[69] It also covers business establishments which are not in the form of a branch or agency but consist only of an office managed by the business' own staff or by a person who is independent but is authorized to act on a permanent basis for the company.[70]

4.3.2 A Nationality-Based Approach

4.3.2.1 The Steinhauser Case

An example of a case concerning a national rule including a nationality requirement is *Steinhauser*.[71] The French town Biarritz pleaded that a professional artist's lack of French nationality prohibited him from making a bid to lease a rented lock-up belonging to the municipality and used for art exhibitions and sale. The Court expressed that the right of establishment includes, besides the right to take up activities as a self-employed person, also the right to pursue them in the broad sense of term.[72] Accordingly, the renting of premises for business purposes furthers the pursuit of an occupation and, consequently, falls within the scope of the right to establishment.

The Court applied a *nationality-based approach* as it held that the French legislation discriminated against nationals of other Member States.[73] Accordingly, the French legislation was analysed from a host

[68] For instance, see Case 81/87 *The Queen* v *H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc* [1988] ECR 5483, para. 16.

[69] See Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165, para. 25.

[70] See Case 205/84 *Commission* v *Germany* [1986] ECR 3755, para. 21.

[71] Case 197/84 *P. Steinhauser* v *City of Biarritz* [1985] ECR 1819.

[72] *Ibid.*, para. 16.

[73] *Ibid.*

state perspective. The ECJ did not mention the term direct discrimination, but an explicit nationality requirement is usually considered as the clearest example of direct discrimination. No analysis of possible justifications is presented in the case.

4.3.2.2 The Gullung Case

The question in *Gullung*[74] was whether a Member State, whose legislation required that any person who whished to establish himself in that state as a lawyer must register at a bar, had the right to prescribe the same requirement for lawyers who came from other Member States and who exercised their right to freedom of establishment. In other words, it is a question of host state requirements.

Mr Gullung was a lawyer of French and German nationality who was registered as a *Rechtsanwalt* in Germany.[75] Although he was refused admission to a bar in France on grounds connected with his character, he argued that he should be able to rely on the liberties guaranteed by the EC Treaty in order to practise his profession in France. One of the questions referred by the national court was whether a lawyer who is a national of one Member State enjoys the right of establishment in another Member State only if he is a member of a bar in the host country, where such membership is required by the legislation of that country.[76]

The Court focused on equal treatment between nationals and non-nationals, accordingly applying a *nationality-based approach*, and found that France had the right to prescribe those requirements also for lawyers exercising their right to freedom of establishment.[77] The French legislation was analysed from a host state perspective.

4.3.2.3 The Centros Case

In *Centros*[78], the host state, Denmark, refused to register a branch of a company formed in accordance with UK legislation. The Danish authorities' reason for not registering the branch was that as no business was conducted in the UK, where the primary establishment was located, the sole purpose of establishing a branch instead of a subsidiary in Denmark

[74] Case 292/86 *Claude Gullung* v *Conseil de l'ordre des avocats du barreau de Colmar et de Saverne* [1988] ECR 111.

[75] *Ibid.*, para. 2.

[76] *Ibid.*, para. 7.

[77] *Ibid.*, para. 31. In the later Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165 the ECJ appears to have taken a stricter position on host state requirements. See section 3.5.3.

[78] Case C-212/97 *Centros Ltd* v *Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459.

was to circumvent the application of Danish company legislation.[79] The Danish rules were more restrictive as regards the paying up of a minimum share capital than the one applicable in the UK.

When interpreting Article 43 EC in relation to the Danish practise, the Court emphasized the wording of Articles 43 and 48 EC and described the national treatment obligation.[80] Further, it held that the location of a company's registered office serves as the connecting factor with the legal system of a particular state in the same way as nationality in the case of individuals.[81]

The Court found that the refusal to register the branch constituted an obstacle to the freedom of establishment.[82] The Court expressed that:

> "[t]he right to form a company in accordance with the law of a Member State and to set up branches in other Member States is inherent in the exercise, in a single market, of the freedom of establishment guaranteed by the Treaty".[83]

When the ECJ in the *Centros* case assessed whether the Danish practise could be justified, it applied the requirements set out in the *Gebhard*[84] case and found that Denmark could adopt measures which were less restrictive or which interfered less with the fundamental freedoms.[85] Consequently, the Danish practise was not justified.

It is clear that in *Centros* the Court assessed the Danish legislation from a host state perspective. The ECJ held that practises as the Danish one, where, in certain circumstances, a branch having its registered office in another Member State is refused registration, resulted in companies formed in accordance with the law of other Member States being prevented from exercising their right to freedom of establishment.[86] From this, it seems as if the ECJ focused on the negative effect on foreign companies of the Danish practise. As this situation did not occur in relation to Danish companies setting up branches in Denmark, the effect of the legislation was to the disadvantage of foreign companies only. Therefore, one may conclude that the Court applied a *nationality-based approach.*

[79] *Ibid.*, paras. 7, 12.
[80] *Ibid.*, para. 19.
[81] *Ibid.*, para. 20.
[82] *Ibid.*, para. 22.
[83] *Ibid.*, para. 27.
[84] Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165, para. 37.
[85] Case C-212/97 *Centros Ltd* v *Erhvervs- og Selskabsstyrelsen* [1999] ECR I-1459, para. 37.
[86] *Ibid.*, para. 21.

4.3.2.4 The Open Skies Cases

One of the questions in the so-called *Open Skies* cases concerned the compatibility with Article 43 EC of provisions in bilateral air service agreements. The Commission brought the cases to the ECJ, challenging eight bilateral treaties concluded by EU Member States with the US.[87] These agreements contained nationality clauses that enabled the contracting states to exclude certain airlines from the benefit of the agreements if they were owned or controlled by nationals of another state.[88]

The ECJ found that airlines established in the UK of which a substantial part of the ownership and effective control was vested either in a Member State other than the UK or in nationals of other Member States, referred to as Community airlines, were capable of being affected by the nationality clause.[89] Moreover, under the agreement, the US was, in principle, under an obligation to grant the treaty benefits to airlines of which a substantial part of the ownership and effective control was vested in the UK or its nationals.[90] The latter are referred to as UK airlines. The ECJ found that the result was that Community airlines might be excluded from treaty benefits while they were assured to UK airlines. The result was, according to the Court, that Community airlines suffered discrimination which prevented them from benefiting from the treatment which the UK, as host state, accorded its own nationals.[91] The Court held that the direct source of that discrimination was the nationality clause of the bilateral agreement and not the possible conduct of the US.[92]

The UK submitted that the discrimination was justified on grounds of public policy under Article 46 EC.[93] The Court held that to justify a discriminatory measure on grounds of public policy, there must be a direct link between the genuine and sufficiently serious threat affecting one of the fundamental interests of society and the discriminatory measure

[87] The judgments delivered on 5 November 2002 included the following cases: C-266/98 *Commission* v *United Kingdom of Great Britain and Northern Ireland*, C-467/98 *Commission* v *Denmark*, C-468/98 *Commission* v *Sweden*, C-469/98 *Commission* v *Finland*, C-471/98 *Commission* v *Belgium*, C-475/98 *Commission* v *Austria* and C-476/98 *Commission* v *Germany*. The decisions of the ECJ in these cases are equivalent. I will refer to the facts and paragraph numbers in Case C-466/98 *Commission* v *United Kingdom of Great Britain and Northern Ireland* [2002] ECR I-9427.

[88] Case C-466/98 *Commission* v *United Kingdom of Great Britain and Northern Ireland* [2002] ECR I-9427, para. 5.

[89] *Ibid.*, para. 48.

[90] *Ibid.*, para. 49.

[91] *Ibid.*, para. 50.

[92] *Ibid.*, para. 51.

[93] *Ibid.*, para. 55.

adopted to deal with it.[94] The Court did not find that this was established in this case.

The Court applied a *nationality-based approach* as it emphasized the effect of the legislation on Community airlines and went as far as stating that the nationality clause discriminated non-UK airlines. The treatment following the bilateral agreement was analysed from a host state perspective, where the UK was considered the host state.

4.3.3 A Free Movement-Based Approach

4.3.3.1 The Daily Mail Case

In *Daily Mail*[95], the question was whether Article 43 EC and 48 EC precluded UK legislation which required a company that wanted to cease to be resident in the UK to apply for the consent of the Treasury. Daily Mail and General Trust plc, an investment holding company, applied for consent in order to transfer its central management and control to the Netherlands.[96] The main reason for the proposed transfer was to avoid paying a substantial capital gain in the UK. If the assets were sold after a transfer of residence to the Netherlands, the transfer envisaged would be taxed only on the basis of any capital gains accrued after the transfer.[97] The negotiations with the Treasury resulted in a proposal to Daily Mail and General Trust plc to alienate at least part of the assets before transferring the residence to the Netherlands.[98]

The ECJ first pointed out that the provisions on the freedom of establishment secure the right of establishment in another Member State not only for Community nationals but for companies referred to in Article 48 EC.[99] Then, it stated that:

> "[e]ven though those provisions are directed mainly to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in the other Member State of one of its nationals or of a company incorporated under its legislation which comes within the definition contained in Article 58 [now Article 48 EC]."[100]

[94] *Ibid.*, para. 57. See section 3.5.1 of this study.
[95] Case 81/87 *The Queen* v *H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc* [1988] ECR 5483.
[96] *Ibid.*, para. 6.
[97] *Ibid.*, para. 7.
[98] *Ibid.*, para. 8.
[99] *Ibid.*, para. 15.
[100] *Ibid.*, para. 16.

The Court noted that the freedom of establishment would be rendered meaningless if the Member State of origin could prohibit undertakings from leaving in order to establish themselves elsewhere in the Community.[101] This reasoning certainly pointed in favour of Daily Mail and General Trust plc.

Nevertheless, the Court found in *Daily Mail* that the UK legislation imposed no restriction on the freedom of establishment.[102] The Court argued that the national legislation did not stand in the way of a partial or total transfer of the activities of a company incorporated in the UK to a company newly incorporated in another Member State.[103] It also stressed that "unlike natural persons, companies are creatures of the law and, in the present state of Community law, creatures of national law".[104] The Court, therefore, held that differences in national legislation concerning whether the registered office or the real office of a company may be transferred from one Member State to another are not resolved by the freedom of establishment but must be dealt with in future legislation or conventions.[105]

The *Daily Mail* case is important as it was the first case where the Court introduced an extension of the freedom of establishment rights also to include restrictions set up by the home state. The Court in its reasoning focused on the right for companies to exercise their right to free movement to move to other Member States. It, therefore, appears as if the Court applied a *free movement-based approach*. The UK legislation was assessed from a home state perspective.

4.3.3.2 The Kemmler Case

A case where the classification of the Court's reasoning in terms of a *nationality-based approach* or a *free movement-based approach* has met with some difficulties is the *Kemmler*[106] case. This case concerns contributions to the Belgian social security system for self-employed persons.

Mr Kemmler, a German national, worked as a self-employed lawyer in Germany and in Belgium. He had always had his habitual residence in Germany but for part of the period to which the proceedings relate he was also a resident of Belgium.[107] Mr Kemmler was covered by the Ger-

[101] *Ibid.*
[102] *Ibid.*, para. 18.
[103] *Ibid.*
[104] *Ibid.*, para. 19.
[105] *Ibid.*, para. 24.
[106] Case C-53/95 *Inasti* v *Hans Kemmler* [1996] ECR I-703.
[107] *Ibid.*, para. 3.

man social security scheme for self-employed persons. According to Belgian legislation, Mr Kemmler was under an obligation to pay contributions in respect of his professional activities in Belgium.[108] Mr Kemmler refused to pay any contributions to the Belgian social security system as he was already covered by the German social security scheme for self-employed persons, and his affiliation to the Belgian social security scheme would not have afforded him any additional social security cover.[109]

The ECJ argued that the Treaty provisions on the free movement of persons are intended to facilitate the pursuit of occupational activities throughout the Community and preclude legislation which inhibits the extension of such activities beyond the territory of a single Member State.[110] The Belgian legislation was found to inhibit the pursuit of occupational activities outside a person's home state and as it did not afford any additional social protection it could not be justified on that basis.[111]

The Belgian law was analysed from a host state perspective.[112] The Court held that for a self-employed person residing in one Member State and is there covered by its social security scheme, the Belgian provision requiring affiliation to the Belgian social security scheme inhibits his right to pursue his occupational activities outside the first-mentioned Member State.[113] The wording used by the Court, "inhibit the pursuit of occupational activities outside the territory of that Member State", resembles the Court's hindrance formula applied, for instance, in *Kraus*. As the Belgian provision was applicable to both nationals and non-nationals, as well as to both residents and non-residents, it is indistinctly applicable. The Court's reasoning was not focused on whether non-nationals or non-residents were particularly negatively affected by the Belgian legislation. The Court did not make a comparison between the situation of residents and non-residents. Accordingly, one may conclude that the Court applied a *free movement-based approach*.

4.3.4 Summary and Analysis

The case law analysed in this section implies partly the same pattern as the case law on Article 39 EC, namely that the Court generally applies a

[108] *Ibid.*, para. 4.
[109] *Ibid.*, para. 5.
[110] *Ibid.*, para. 11.
[111] *Ibid.*, para. 13.
[112] See Barnard, *The Substantive Law of the EU – The Four Freedoms*, (2004), p. 309.
[113] Case C-53/95 *Inasti* v *Hans Kemmler* [1996] ECR I-703, para. 12.

nationality-based approach when national legislation is analysed from a host state perspective.

The Court's reasoning in both *Daily Mail* and *Kemmler* has been classified as a *free movement-based approach*. In the former case, the Court assessed the national legislation from a home state perspective, hence confirming the pattern found in the previous section. However, in *Kemmler,* where the Court's reasoning has proved difficult to classify in terms of applying a *nationality-based approach* or a *free movement-based approach,* it appears as if the Court applied a *free movement-based approach* when analysing equally applicable rules in the host state from a host state perspective. Therefore, this case represents a deviation from the general pattern found in this chapter. It is worth noticing, however, that a very similar situation was analysed by the Court in *Guiot* in relation to Article 49 EC. In the latter case, the Court appears to have applied a *nationality-based approach* instead of a *free movement-based approach* as it did in *Kemmler.*

4.4 The Free Movement of Services

4.4.1 Introduction

The provisions on the free movement of services are found in Articles 49 EC to 55 EC. Article 49 EC states that "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 service is intended." This wording is not specifically directed towards the host state as is the case in, for instance, Article 43 EC. However, Article 50 EC defines services and applies the principle of national treatment to the service provider in the state where the service is provided. [114]

The freedom set out in Articles 49 and 50 EC is expressed in terms of the freedom to provide services. However, it has been interpreted by the ECJ to embrace the freedom to receive services.[115]Article 55 EC, referring to Articles 45 EC and 46 EC, permits exceptions to the free movement of services on grounds of that the activity is related to the exercise of official authority, or public policy, public security and public health.

From the case law, it is evident that the free movement of services covers a wide range of circumstances. The closest connection between the

[114] See Barnard, *The Substantive Law of the EU – The Four Freedoms,* (2004), p. 330.

[115] See Case 118/75 *Lynne Watson and Alessandro Belmann* [1976] ECR 1185 and Case 286/82 *Luisi* v *Ministero del Tesoro* [1984] ECR 377.

free movement of services and the other free movement provisions is the one with the right of establishment.[116]

4.4.2 A Nationality-Based Approach

4.4.2.1 The Bond Case

The *Bond*[117] case concerned the distribution, by operators of cable networks established in a Member State, of television programmes supplied by broadcasters established in another Member State. The television programmes contained advertisements especially intended for the public in the recipient Member State.

The Netherlands prohibited advertising and subtitling for programmes supplied from abroad. When assessing these prohibitions, the ECJ identified two separate services within the meaning of Articles 49 and 50 EC. The first was provided by cable network operators to broadcasters, the second by broadcasters to advertisers.[118] The Court focused on comparing the situation of the Netherlands television stations as a whole with that of the foreign broadcasters.[119] It found that there was discrimination as the prohibition of advertising deprived broadcasters established in other Member States of any possibility of broadcasting on their stations advertisements intended especially for the public in the Netherlands, whereas Netherlands' legislation permitted the broadcasting of advertisements from broadcasters in the Netherlands.[120] Also the prohibition of subtitling was found to be in breach of Article 49 EC.[121]

In relation to possible justifications of the Dutch legislation, the ECJ held that "national rules which are not applicable to services without distinction as regards their origin and which are therefore discriminatory are compatible with Community law only if they can be brought within the scope of an express derogation."[122] Moreover, the Court stated that the only derogation which may be contemplated in this case is that provided for in Article 46 EC.[123]

[116] See section 4.6.
[117] Case 352/85 *Bond van Adverteerders and others* v *The Netherlands State* [1988] ECR I-2085.
[118] *Ibid.*, para. 22.
[119] *Ibid.*, para. 24.
[120] *Ibid.*, para. 26.
[121] *Ibid.*, para. 30.
[122] *Ibid.*, para. 32.
[123] *Ibid.*, para. 33.

In *Bond,* the ECJ was clear as regards the possible grounds for justification as it held that the only grounds were those found in the Treaty.[124] That the Court applied a *nationality-based approach* is evident from its statement that it was discrimination since the prohibition of advertising deprived broadcasters established outside the Netherlands of any possibility of broadcasting on their stations advertisements intended especially for the public in the Netherlands, whereas the Dutch legislation permitted the broadcasting of advertisements from broadcasters in the Netherlands. The Court assessed the Dutch legislation from a host state perspective; accordingly, it focused on the effect of the national measure on foreign broadcasters.

4.4.2.2 The Säger Case

The *Säger*[125] case concerned the question whether equally applicable measures in the host state were prohibited by Article 49 EC. Dennemeyer & Co. Ltd, a company incorporated under English law having its registered office in the UK, was a specialist in patent renewal services. That activity was carried on from the UK for holders of industrial property rights established in other Member States. Mr Säger, a *Patent-anwalt* (patent agent), complained that Dennemeyer was guilty of unfair competition and acted in breach of the German law as it acted without the licence required by that law.[126]

The Court held in *Säger* that:

> "Article 59 of the Treaty [now Article 49 EC] requires not only the elimination of all discrimination against a person providing services on the ground of his nationality but also the abolition of any restriction, even if it applies without distinction to national providers of services and to those of other Member States, when it is liable to prohibit or otherwise impede the activities of a provider of services established in another Member State where he lawfully provides similar services".[127]

This statement has been reiterated by the ECJ in many subsequent judgments.[128] Next, the Court in *Säger* held that a Member State may not

[124] *Ibid.*, paras. 32–33.

[125] Case C-76/90 *Manfred Säger* v *Dennemeyer & Co. Ltd* [1991] ECR I-4221.

[126] *Ibid.*, para. 5.

[127] *Ibid.*, para. 12.

[128] For example, see Case C-43/93 *Raymond Vander Elst* v *Office des Migrations Internationales* [1994] ECR I-3803, para. 14, Case C-222/95 *Société civile immobilière Parodi* v *Banque H. Albert de Bary et Cie* [1997] ECR I-3921, para. 18, Case C-272/94 *Criminal proceedings against Michel Guiot and Climatec SA* [1996] ECR I-1905, para. 10, Case C-3/95 *Reisebüro Broede* v *Gerd Sandker* [1996] ECR I-6511, para. 25.

make the provision of services in its territory subject to compliance with all the conditions required for establishment and, thereby, deprive Article 49 EC of all practical effectiveness.[129] The Court found that the German legislation prevented undertakings established outside Germany from providing services to the holders of patents in Germany and it also prevented those holders from freely choosing the manner in which their patents were to be monitored.[130] Moreover, the ECJ pointed out that it was a fundamental principle of the Treaty that the freedom to provide services may be limited only by rules which are justified by imperative reasons relating to the public interest and which apply to all persons pursuing an activity in the host state, to the extent that that interest is not protected by rules which the service provider is subject to in his home state.[131] The Court concluded that the German legislation was not justified having regard to imperative interests.

The Court's reasoning in *Säger* proves difficult to classify in terms of a *nationality-based approach* or a *free movement-based approach.* One may argue that the Court's above-mentioned statement that "the abolition of any restriction, even if it applies without distinction to national providers of services and to those of other Member States, when it is liable to prohibit or otherwise impede the activities of a provider of services established in another Member State where he lawfully provides similar services" is nothing else than a description of indirect discrimination on grounds of nationality in the context of services. The wording *when it is liable to prohibit or otherwise impede foreign service providers* resembles the Court's definition of indirect discrimination given in the *O'Flynn* case.[132] The conclusion that the Court is applying a *nationality-based approach* is supported by the fact that the Court emphasized the national measure's negative effect on service providers established in other Member States. However, the wording used by the Court, the *measure is liable to prohibit or otherwise impede,* may be considered as pointing in the opposite direction, namely that the Court is applying a *free movement-based approach.* Nevertheless, in this study the Court's reasoning in *Säger* is classified as a *nationality-based approach* mainly because of the Court's focus on a national measure's effect on foreign service providers. The Court assessed the legislation from a host state perspective.

[129] Case C-76/90 *Manfred Säger* v *Dennemeyer & Co. Ltd* [1991] ECR I-4221, para. 13.
[130] *Ibid.*, para. 14.
[131] *Ibid.*, para. 15.
[132] See Case C-237/94 *O'Flynn* v *Adjudication Officer* [1996] ECR I-2617, para. 18 and section 3.4.3.3 of this study.

4.4.2.3 The Hubbard Case

In *Hubbard*[133], the Court found German legislation requiring foreign nationals who acted as plaintiffs in proceedings brought before German courts, upon application by the defendant, to give security for costs and lawyers' fees. German nationals were not subject to any such requirement. The ECJ held, paraphrasing its own statements in previous cases,[134] that the free movement of services "must apply in all cases where a person providing services offers those services in a Member State other than that in which he is established, wherever the recipients of those services may be established".[135] The ECJ found that the German requirement that a national of another Member State who brought proceedings before German courts in the capacity of an executor give security for costs solely on the ground that he was a foreigner constituted discrimination on grounds of nationality contrary to Articles 49 and 50 EC.[136]

The German national court asked whether the fact that the substantive proceedings came under the law of succession could justify the exclusion of the application of the EC Treaty.[137] The Court answered that "the effectiveness of Community law cannot vary according to the various branches of national law which it may affect."[138] The *Hubbard* case does not include any analysis of whether imperative interests could be invoked to justify the German legislation.

This is a case where the ECJ applied a *nationality-based approach.* The ECJ concluded that the less favourable treatment was because Mr Hubbard was a national of another Member State, something that is generally referred to as direct discrimination on grounds of nationality. The Court did not assess whether the German legislation could be justified having regard to either Treaty justifications or imperative interests. The German legislation was analysed from a host state perspective.

[133] Case C-20/92 *Anthony Hubbard (Testamentvollstrecker)* v *Peter Hamburger* [1993] ECR I-3777.

[134] Case C-154/89 *Commission* v *France* [1991] ECR I-659, para. 10, Case C-180/89 *Commission* v *Italy* [1991] ECR I-709, para. 9 and Case C-198/89 *Commission* v *Greece* [1991] ECR I-727, para. 19.

[135] Case C-20/92 *Anthony Hubbard (Testamentvollstrecker)* v *Peter Hamburger* [1993] ECR I-3777, para. 12.

[136] *Ibid.*, para. 14.

[137] *Ibid.*, para. 18.

[138] *Ibid.*, para. 19.

4.4.2.4 The Guiot Case

The *Guiot*[139] case concerned national legislation which required an employer who was providing services to pay employer's contributions to the social security fund of the host Member State in addition to the contributions already paid by him with respect to the same employees and for the same period of work to the state where he was established. The Court found the requirement to constitute a restriction as it resulted in an additional financial burden to the employer in comparison with employers established in the host state.[140]

The Court explained that the public interest relating to social protection of workers may constitute an imperative interest.[141] However, that was not the case in *Guiot* as the workers in question enjoyed the same protection, or essentially similar protection, by virtue of employers' contributions paid in the home state of the service provider.[142]

The ECJ found that the Belgian legislation constituted a restriction. It emphasized that the national measure resulted in an additional financial burden to the employer in comparison with employers established in the host state. This indicates that the Court applied a *nationality-based approach* and analysed the Belgian legislation from a host state perspective as it compared an employer established in the host state with an employer established in another Member State. This is definitely a rule which is equally applicable, albeit its effect ought to be more negative on non-nationals than nationals as it is more likely that non-nationals have paid employer's contributions in their state of establishment. Therefore, one may conclude that the Court applied a *nationality-based approach* when establishing a breach of Article 49 EC.

4.4.2.5 The Commission v Italy Case

In the *Commission v Italy*[143] case, one of the questions was whether Italian law applicable to undertakings engaged in temporary work established in other Member States was in line with Article 49 EC. The provision required such undertakings to maintain their registered office or a branch office in Italy and to lodge a guarantee with a credit institution having its registered office or a branch office in Italy.

[139] Case C-272/94 *Criminal proceedings against Michel Guiot and Climatec SA* [1996] ECR I-1905.
[140] *Ibid.*, paras. 14–15.
[141] *Ibid.*, para. 16.
[142] *Ibid.*, para. 17.
[143] Case C-279/00 *Commission* v *Italy* [2002] ECR I-1425.

In regard to the establishment requirement, the ECJ held that it was "directly contrary to the freedom to provide services, in so far as it renders impossible, in that Member State, the supply of services by undertakings established in other Member States".[144] The Court analysed whether imperative interests could justify the legislation. It did not uphold any such justification.

Regarding the obligation to establish a guarantee with a credit institution having its registered office or branch in Italy, the Court held that it was liable to hinder the business of a provider established outside Italy and, therefore, constituted a restriction on Article 49 EC.[145] The Court stated that imperative interests could potentially justify the legislation at issue but did not accept any such justification.[146]

The Court analysed the Italian legislation from a host state perspective and found that it hindered foreign service providers from offering their services in Italy. Even though the ECJ did not explicitly reason in terms of nationality, one may conclude that the Court applied a *nationality-based approach* as it found that the Italian legislation hindered foreign service providers. The Italian legislation rendered it impossible for non-Italian service providers to supply services unless the conditions were fulfilled. Even though the Italian rules were equally applicable, they worked to the specific disadvantage of non-Italian service providers.

4.4.3 A Free Movement-Based Approach

4.4.3.1 The Alpine Investments Case

In *Alpine Investments*[147], one of the questions was whether it was in breach of Article 49 EC for a Member State to prohibit offers of services which providers made by telephone to potential recipients in the Netherlands as well as in other Member States.

Alpine Investments BV, a company incorporated under Netherlands law and established in the Netherlands, challenged a prohibition of contacting individuals by telephone without their prior consent in order to offer them various financial services. The prohibition was imposed by the Netherlands Ministry of Finance due to numerous complaints from investors who had made unfortunate investments. The prohibition covered both offers of services inside and outside the Netherlands.

[144] *Ibid.*, para. 17.
[145] *Ibid.*, para. 32.
[146] *Ibid.*, paras. 33–34.
[147] Case C-384/93 *Alpine Investments BV* v *Minister van Financiën* [1995] ECR I-1141.

The ECJ held that the Dutch prohibition deprived the operators of a rapid and direct technique for marketing and for contacting potential clients in other Member States.[148] The fact that it was the home state of the service provider which imposed the prohibition did not affect the conclusion that it was contrary to Article 49 EC.[149]

The Court held that the prohibition was "general and non-discriminatory and [that] neither its object nor its effect is to put the national market at an advantage over providers of services from other Member States".[150] Nevertheless, it constituted a restriction as it hindered the freedom to provide services. The ECJ concluded, however, that the Dutch provision was justified on grounds of imperative interests, namely maintaining the good reputation of the national financial sector.[151]

The Court identified the prohibition as non-discriminatory as it applied both to services offered inside and outside the Netherlands but nevertheless held it to constitute a restriction as it impeded the free movement of services.

The Dutch legislation was analysed from a home state perspective as the Court assessed the effects of the Dutch law on service providers established in the Netherlands. In its assessment, the Court did not focus on difference in treatment based on nationality or residence of the service receivers. Such an analysis would only have proved that the Dutch legislation applied equally to providers of services that approached Dutch clients and those who approached clients in other Member States. The Court found that the Dutch legislation hindered the exercise of the free movement rights and constituted a restriction to the freedom to provide services. Hence, the Court applied a *free movement-based approach*. If the prohibition of difference in treatment based on nationality or residence were applied here, the Dutch legislation would not have been held to constitute a restriction. The assessment of whether the Netherlands' legislation could be justified resulted in a justification on the ground of an imperative interest.

4.4.3.2 The Kohll Case

A Luxembourg provision that differentiated on grounds of where the service was provided was under review in the *Kohll*[152] case. Under this

[148] *Ibid.*, para. 28.
[149] *Ibid.*, paras. 30–31.
[150] *Ibid.*, para. 35.
[151] *Ibid.*, para. 49.
[152] Case C-158/96 *Raymond Kohll* v *Union des caisses de maladie* [1998] ECR I-1931, para. 33.

law, reimbursement of the cost of medical treatment provided in another Member State was subject to authorization by the insured person's social security institution. The question was whether those rules set up by the state of insurance, the home state of the service receiver, was in breach of the free movement of services.

Mr Kohll, a Luxembourg national, requested authorization for his daughter to receive treatment from an orthodontist established in Germany. His request was rejected.

The Court emphasized that the Luxembourg provision did not deprive insured persons of the possibility of approaching providers of services established in other Member States. However, it made the reimbursement of the costs incurred in other Member States subject to prior authorization and denied such reimbursement to insured persons who had not obtained that authorization. Costs incurred in Luxembourg were not subject to authorization.[153] The Court concluded that the Luxembourg legislation was able "to deter insured persons from approaching providers of medical services established in another Member State and to constitute, for them and their patients, a barrier to the freedom to provide services".[154]

In *Kohll* the Court also held that:

> "Article 59 of the Treaty [now Article 49 EC] precludes the application of any national rules which have the effect of making the provision of services between Member States more difficult than the provision of services purely within one Member State".[155]

This description of what measures are in breach of the free movement of services has a considerable width due to its use of the expression "more difficult" than only providing the service within one Member State.[156]

It was argued that the Luxembourg legislation was justified in order to avoid the risk of upsetting the financial balance of the social security scheme.[157] The Court did not accept such non-Treaty justification in the present case.

The Court applied a *free movement-based approach* as it argued that the Luxembourg legislation deterred insured persons from approaching

[153] *Ibid.*, para. 34.
[154] *Ibid.*, para. 35.
[155] *Ibid.*, para. 33.
[156] The same extensive formula is found in Case C-118/96 *Jessica Safir* v *Skattemyndigheten i Dalarnas Län* [1998] ECR I-1897, para. 23.
[157] Case C-158/96 *Raymond Kohll* v *Union des caisses de maladie* [1998] ECR I-1931, para. 37.

service providers in other Member States while constituting an obstacle for foreign service providers. Consequently, the impact of the Luxembourg legislation was assessed both from the perspective of service receivers and service providers. In the *Kohll* case, it was the service receiver who practised his right to free movement going to another Member State to receive the service. From his perspective, it was home state legislation which hindered him when exercising free movement rights.

4.4.4 Summary and Analysis

The cases analysed in this section on the free movement of services show a pattern similar to that found under Article 39 EC and, to some extent, under Article 43 EC. Cases where the ECJ has applied a *nationality-based approach* have dealt with provisions analysed from a host state perspective, for instance, requirements that a service provider established in another Member State has to comply with when providing services there. In *Säger,* the ECJ stated that restrictions are prohibited which, even if they are equally applicable, are liable to prohibit or otherwise impede the activities of foreign service providers. One may conclude that this is a description of indirect discrimination on grounds of nationality in the context of services. The *Guiot* case concerned requirements in the host state which were equally applicable. However, it is argued that they were to the particular detriment of nationals of other Member States as they required an employer to pay employer's contributions to the social security fund of the host state in addition to the contributions already paid by him in his state of establishment. It is more likely that nationals of other Member States have paid such contributions in their states of establishment than nationals of the host state and, thereby, are required to pay the contributions twice. The *Guiot* case shows similarities to the *Kemmler* case. However, the Court's reasoning in these cases differs in important aspects. In the former case, the Court's reasoning is classified as a *nationality-based approach* while in the latter as a *free movement-based approach.*

The cases analysed where the ECJ has applied a *free movement-based approach* have dealt with home state legislation of a person exercising his free movement rights. In *Alpine Investments,* it was the home state of the service provider that hindered the free movement and in *Kohll* it was the home state of the service receiver that hindered the free movement. It is important to notice that in the former case it was the service provider who contacted potential clients in their home states and in the latter case it was the service receiver who intended to exercise his free movement rights and approach service providers outside his home state. In *Kohll,*

the Court carried out a comparison between services received in the national territory and services received in other Member States. This comparison exposed a difference in treatment. In *Alpine Investments,* the Court did not make a comparison between services provided in the Netherlands and services provided in other Member States. This is understandable as such a comparison would not expose a difference in treatment since the Dutch legislation applied equally to services provided in the national territory and abroad. The ECJ described the Dutch legislation as being *general and non-discriminatory.*

In the *Bond* case, where the ECJ applied a *nationality-based approach,* it held that national rules which are not equally applicable as regards the origin of the service could only be justified under explicit treaty derogations. In this case, the ECJ refused, in principle, to entertain any imperative interest grounds because of the nature of the restriction.

4.5 The Free Movement of Capital

4.5.1 Introduction

The free movement of capital is one of the four freedoms enshrined in the original Rome Treaty. At that time, the Treaty provisions on the free movement of capital were drafted differently compared with how the provisions stand today.[158] According to Article 67 (1) of the Rome Treaty, the states were under the obligation to abolish progressively the restrictions on capital movements but only to the extent necessary to ensure the proper functioning of the internal market. The importance of capital movements to the macro-economic stability of the Member States economies lay behind this softer approach.[159]

The Maastricht Treaty involved a new set of rules for the free movement of capital. Articles 56 to 60 EC govern the free movement of capital, and the basic principle is found in Article 56 EC. This article declares that all restrictions on the movement of capital, and on payments, between Member States and between Member States and third countries are prohibited. This freedom is the only one which applies to movements both inside and outside the Community. Article 57 (1) EC qualifies the application of Article 56 EC to third countries in that it allows lawful restrictions on capital movements that existed on 31 December 1993 to

[158] Those rules were originally found in Articles 67–73 of the Rome Treaty.

[159] Craig, *The Evolution of the Single Market* in Barnard & Scott, *The Law of the Single European Market,* (2002), p. 3.

remain. Article 57 (2) EC provides a legal basis for the Council to adopt measures on the movement of capital between Member States and third countries.

In *Sanz de Lera*[160], Article 73b (1)[161] of the EC Treaty was held to have direct effect. Before it was stipulated that this article was directly effective, it was up to the Council to adopt secondary legislation in order to make the free movement of capital effective. In 1988, a Directive[162] (hereinafter the 1988 Directive) was adopted that required full liberalization of capital movements, but this free movement was subject to certain exceptions.

No definition of *capital* or *payment* is given in the articles on free movement of capital. However, the ECJ has stated that reference can be made to the list found in the 1988 Directive.[163] In the Court's judgments, examples of the meaning of *capital* and *payments* are found. The free movement of capital covers, according to the *Bordessa* case, the physical transfer of assets such as coins, banknotes and bearer cheques[164]. Also direct foreign investment is an example of free movement of capital according to the case *Association Eglise de Scientologie*[165].

When comparing the articles on free movement of capital with the structure of the other free movement provisions, one finds that the exceptions to the free movement of capital are drafted in a different way.[166] Article 58 (1) (a) concerns taxation and is one of the main exceptions to Article 56 EC. It gives the Member States the right to apply the relevant provisions of their tax law that distinguish between taxpayers based on their place of residence or with regard to the place where their capital is invested.

According to Article 58 (1) (b) EC, which partly resembles the derogations found in relation to the other free movement provisions, the Member States have the right to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of

[160] Cases C-163, 165 and 250/94 *Criminal Proceedings against Lucas Emilio Sanz de Lera* [1995] ECR I-4821, paras. 41–47.

[161] Now Article 56 EC.

[162] Council Directive 88/361/EEC of 24 June 1988 for the implementation of Art. 67 of the Treaty, OJ 1988 L 178/5. It took effect from 1 July 1990 for most Member States.

[163] Case C-222/97 *Manfred Trummer and Peter Mayer* [1999] ECR I-1661, para. 21, Case C-279/00 *Commission* v *Italian Republic* [2002] ECR I-1425, para. 36, see also Craig, & de Búrca, *EU Law*, (2002), p. 681.

[164] Joined Cases C-358/93 and C-416/93 *Criminal proceedings against Aldo Bordessa and Vicente Marí Mellado and Concepción Barbero Maestre* [1995] ECR I-361, para. 13.

[165] Case C-54/99 *Association Eglise de Scientologie de Paris and Scientology International Reserves Trust* v *The Prime Minister* [2000] ECR I-1335, para. 14.

[166] See section 3.5.1.

taxation and the prudential supervision of financial institutions, to require declaration of capital movements for administrative or statistical purposes, and to take measures which are justified on grounds of public policy and public security. Moreover, Article 58 (2) EC states that the provisions on the free movement of capital are without prejudice to restrictions that can be justified pursuant to the chapter on establishment. In addition, both Articles 58 (1) (a) and 58 (1) (b) are subject to Article 58 (3), which stipulates that such measures shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments.

4.5.2 A Nationality-Based Approach

4.5.2.1 The Association Eglise de Scientologie Case

The question in the *Association Eglise de Scientologie* [167] case was whether a national provision that made a direct foreign investment into France subject to prior authorization was contrary to the free movement of capital. The French legislation provided a system of prior authorization for investments that might represent a threat to public policy, public health or public security.

The ECJ simply held that such authorization was contrary to Article 56 (1) EC.[168] Next, the Court analysed Article 58 (1) (b) EC to find out whether the French legislation was justified under that provision. It explained that Member States are, in principle, free to determine the requirements of public policy and public security in the light of their national needs. However, those grounds must, in the Community context and, in particular, as derogations from the fundamental principle of free movement of capital, be interpreted strictly.[169] Moreover, the ECJ pointed out that public security and public policy may only be relied on if there is a genuine and sufficiently serious threat to a fundamental interest of society. It found that the essence of the French system was that prior authorization was required for every direct foreign investment which was "such as to represent a threat to public policy [and] public security, without any more detailed definition."[170] The investors concerned were not given any indication whatsoever as to the specific circumstances in

[167] Case C-54/99 *Association Eglise de Scientologie de Paris and Scientology International Reserves Trust* v *The Prime Minister* [2000] ECR I-1335.
[168] *Ibid.*, para. 14.
[169] *Ibid.*, para. 17.
[170] *Ibid.*, para. 21.

which prior authorization was required. Such lack of precision did not, according to the ECJ, enable individuals to be appraised of the extent of their rights and obligations deriving from Article 56 EC. Therefore, the French legislation was held to be contrary to the principle of legal certainty and constituted a restriction on the free movement of capital.[171]

The Court analysed the French legislation from a host state perspective and found that it constituted a restriction to investments in France. The requirements in the French law applied only to foreign direct investments, while national investments were not subject to the same requirements. Therefore, it seemed to discriminate on grounds of nationality, even though the ECJ itself did not go any further than classifying it as a restriction. One may conclude, albeit not without hesitation, that the Court applied a *nationality-based approach.*

4.5.2.2 The Albore Case

In *Albore*[172], the question was whether Italian legislation exempting only Italians from the requirement of obtaining authorization before buying property in areas designated as being of military importance was precluded by Article 56 EC. The Court found the Italian law to be a discriminatory restriction on capital movements between EU Member States.[173]

When analysing whether the Italian legislation could be justified, the Court complied with the traditional understanding that directly discriminatory measures could be saved only by reference to Treaty derogations.[174] The Court found that the Italian legislation could be justified only if it were demonstrated, for each area to which the restriction applied, that non-discriminatory treatment of nationals of all the Member States would expose the military interests of the Member State concerned to real, specific and serious risks which could not be countered by less restrictive procedures.[175]

When assessing the national measure, the Court applied a *nationality-based approach* as the national measure in itself explicitly distinguished on grounds of nationality. The Italian legislation was analysed from a host state perspective.

[171] *Ibid.*, paras. 22–23.
[172] Case C-423/98 *Alfredo Albore* [2000] ECR I-5965.
[173] *Ibid.*, para. 16.
[174] *Ibid.*, para. 17. See Barnard, *The Substantive Law of the EU – The Four Freedoms,* (2004), p. 467.
[175] Case C-423/98 *Alfredo Albore* [2000] ECR I-5965, para. 22.

4.5.3 A Free Movement-Based Approach

4.5.3.1 The Trummer and Mayer Case

In *Trummer and Mayer*[176], the question was whether Austrian legislation prohibiting registration of a mortgage in the currency of another Member State was contrary to Article 56 EC. This question was raised in proceedings brought by Mr Trummer and Mr Mayer against a refusal to enter in the land register a mortgage denominated in German marks.

The ECJ found that the Austrian legislation was:

> "liable to dissuade the parties concerned from denominating the debt in the currency of another Member State, and thus deprive them of a right which constitutes a component element of the free movement of capital and payments".[177]

Consequently, the Austrian legislation constituted a restriction on the free movement of capital. The ECJ analysed whether imperative interests could justify the Austrian legislation. The outcome was that no justification was accepted.

Under Austrian legislation, a registration of a mortgage in the national currency was allowed. Such registration was refused in all other currencies. This legislation was held by the Court to constitute a restriction as it was liable to dissuade the parties concerned from denominating the debt in the currency of another Member State than Austria. In *Trummer and Mayer,* the Court's reasoning was focused on the effect of the Austrian provision on the free movement of capital and the Court did not analyse its effect on inward investments, such as, for instance, in *Association Eglise de Scientologie.*

Mr Trummer and Mr Mayer were hindered by the Austrian legislation, legislation in their home state, to use foreign currency. The Court used a language of dissuasion and held that the legislation deprived Mr Trummer and Mr Mayer of a right which constitutes a component element of the free movement of capital and payments. Therefore, it appears as if the Court applied a *free movement-based approach* and analysed the Austrian legislation from a home state perspective.

4.5.3.2 Commission v Belgium

In the case *Commission* v *Belgium*[178], the question was whether Belgian legislation was contrary to Article 56 EC. Belgium prohibited the acqui-

[176] Case C-222/97 *Manfred Trummer and Peter Mayer* [1999] ECR I-1661.
[177] *Ibid.*, para. 26.
[178] Case C-478/98 *Commission* v *Belgium* [2000] ECR I-7587.

sition by persons residing in Belgium of debt securities issued abroad. The Commission brought the case to the ECJ as it was of the opinion that Belgium was in breach of Article 56 EC.

The Court expressed that those national measures which are "liable to dissuade its residents from obtaining loans or making investments in other Member States constitute restrictions on movements of capital within the meaning of that provision".[179] The Court found that the Belgian prohibition went well beyond a measure intended to dissuade residents of a Member State from subscribing to loans issued abroad or imposing a requirement of prior authorization, and, consequently, it constituted a restriction on the free movement of capital within the meaning of Article 56 EC.[180]

The Belgian government argued that the contested measure was justified by the need to preserve the fiscal coherence, the need to prevent tax evasion and ensure the effectiveness of fiscal supervision.[181] The ECJ found that as there were no direct links between any fiscal advantage and a corresponding disadvantage which needed to be preserved, the Belgian legislation could not be justified on grounds of fiscal coherence.[182] Moreover, the ECJ stated that "in the present case the fight against tax evasion and the effectiveness of fiscal supervision may be relied on under Article 73 (1) (b) of the Treaty [now Article 58 (1) (b) EC] to justify restrictions of the free movement of capital between Member States".[183] It found that the Belgian legislation did not comply with the principle of proportionality and, therefore, was not covered by Article 58 (1) (b) EC.[184]

As Belgian legislation prohibited the state's own residents from subscribing to a loan issued abroad, the ECJ assessed the legislation from a home state perspective. It concluded that the Belgian prohibition went further than merely dissuading residents from exercising their free movement rights. Consequently, the ECJ applied a *free movement-based approach.*

4.5.4 Summary and Analysis

The free movement of capital cases analysed in this section confirm the general pattern of the case law studied under Articles 39, 43 and 49 EC.

[179] *Ibid.*, para. 18.
[180] *Ibid.*, para. 19.
[181] Case C-54/99 *Association Eglise de Scientologie de Paris and Scientology International Reserves Trust* v *The Prime Minister* [2000] ECR I-1335, paras. 29–32.
[182] *Ibid.*, paras. 35–36.
[183] *Ibid.*, para. 39.
[184] *Ibid.*, para. 47.

A *nationality-based approach* has been applied by the ECJ when analysing national legislation from a host state perspective and a *free movement-based approach* has been applied when analysing legislation from a home state perspective.

A *nationality-based approach* was, for instance, applied in *Association Eglise de Scientologie* when foreign investments in France were subject to prior authorization according to French law. This requirement was not imposed on investments by French nationals. Also in *Albore* the Court applied a *nationality-based approach* when assessing national legislation explicitly discriminated on grounds of nationality. In both these cases, the Court assessed the national measure from a host state perspective.

The legislation under review in *Commission v Belgium* was analysed by the ECJ using a *free movement-based approach*. The Belgian legislation, which prohibited Belgian residents from subscribing to a loan abroad, was held to constitute a restriction. The ECJ concluded that the Belgian legislation went further than merely dissuading its own residents from exercising free movement rights. In the same case, it is interesting to notice that the ECJ stated that the imperative interests of preventing tax evasion and the effectiveness of fiscal supervision may be relied upon under Article 58 (1) (b) EC. Generally, the imperative interests are considered as an independent category of justification grounds separated from the explicit treaty justifications.[185]

In *Albore,* the ECJ complied with the traditional understanding that directly discriminatory measures do not benefit from justification on grounds of imperative interest.

4.6 Relationship between Different Free Movement Provisions

4.6.1 Application of the Provisions on Free Movement of Services

Article 50 EC provides that the Treaty provisions on services are subordinate to the provisions on goods, capital and persons. This seems to indicate that prior to their application, the other free movement provisions are found not to apply.[186] However, in *Veronica*[187], the Court found

[185] See section 5.8.3.

[186] See Hatzopoulos, *Recent Developments of the Case Law of the ECJ in the Field of Services,* CMLRev 37, 2000, p. 45.

[187] Case C-148/91 *Vereniging Veronica Omroep Organisatie* v *Commissariaat voor de Media* [1993] ECR I-487.

that the national legislation on broadcasting was compatible with the free movement of services and from that it concluded that there was no breach of the free movement of capital.[188]

In *Ambry*[189], the ECJ found the national rules to be contrary to the free movement of services. Hence, it did not find it necessary to examine whether there was also a breach of the free movement of capital.[190] In the case *Commission* v *Italy*[191], the Court found that the same national rule was in breach of both the free movement of capital and the free movement of services. According to the Court the rule constituted a restriction on the free movement of capital from the employment agency's perspective and a discriminatory measure within the meaning of Article 49 EC from the perspective of banks established in other Member States.[192]

From these judgments, one may conclude that even though Article 50 EC states that the provisions on services are residual, the ECJ has given primacy to an assessment under the free movement of services provisions in cases where one may have expected the Court first to assess the situation under one of the other free movement provisions. As a result, the ECJ has extended the scope of application of the service provisions.[193]

4.6.2 Do the Provisions on Establishment or Services Apply?

The distinction between freedom of establishment and free movement of services was discussed extensively by the ECJ in the *Gebhard*[194] case. The question was to classify the activities of a German lawyer who lived and exercised his profession in Italy as either within the concept of free movement of services or within the freedom of establishment. The Court held that the free movement of services envisages that the service provider is to pursue his activities in the host state on a temporary basis.[195] The Court continued that "the temporary nature of the activities in question has to be determined in the light, not only of the duration of the provision of services, but also of its regularity, periodicity or continuity".[196]

[188] *Ibid.*, para. 14.
[189] Case C-410/96 *Criminal Proceedings against André Ambry* [1998] ECR I-7875.
[190] *Ibid.*, para. 40.
[191] Case C-279/00 *Commission* v *Italian Republic* [2002] ECR I-1425.
[192] *Ibid.*, paras. 37–39.
[193] See Hatzopoulos, *Recent Developments of the Case Law of the ECJ in the Field of Services*, CMLRev 37, 2000, p. 44.
[194] Case C-55/94 Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165 [1995] ECR I-4165.
[195] *Ibid.*, para. 26.
[196] *Ibid.*, para. 27.

However, the Court pointed out that a service provider may to the extent necessary set up some form of infrastructure in the host Member State.[197] This was confirmed in *Reisebüro Broede*.[198] The conclusion is that the distinguishing criterion is the temporary versus permanent nature of the activities, which is a matter of degree.[199]

4.6.3 Distinction between the Free Movement of Capital and the Freedom of Establishment

The close connection between the freedom of establishment and the free movement of capital is evident in the EC Treaty itself. In Article 58 (2) EC, it is stated that the provisions on the free movement of capital are without prejudice to restrictions that can be justified pursuant to the chapter on establishment. Article 43 (2) EC states that setting up undertakings or pursuing activity as a self-employed person is subject to the chapter on free movement of capital.

From the EC Treaty, it is hard to get clear guidance regarding the dividing line between free movement of capital and the other free movement provisions. Moreover, on several occasions the Court has been asked to rule on the provisions regarding free movement of capital but has, instead, chosen to refer to the other free movement provisions.[200] Many of those situations have concerned both the free movement of capital and the freedom of establishment and it has occurred in relation to the tax legislation of the Member States.[201] This is the reason why some tax cases are presented in this section although this chapter does not otherwise contain income tax cases.

A case concerning a Member State's tax legislation where the ECJ examined the impact of the rules on freedom of capital movements on the

[197] *Ibid.*

[198] Case C-3/95 *Reisebüro Broede* v *Gerd Sandker* [1996] ECR I-6511, para. 21.

[199] Snell & Andenas, *Exploring the Outer Limits: restrictions on the Free Movement of Goods and Services* in Andenas & Roth (eds.), *Services and Free Movement in EU Law*, (2002), pp. 79–80.

[200] See Case C-118/96 *Jessica Safir* v *Skattemyndigheten i Dalarnas Län* [1998] ECR I-1897, Case C-410/96 *Criminal proceedings against André Ambry* [1998] ECR I-7875, Case C-200/98 *X AB and Y AB* v *Riksskatteverket* [1999] ECR I-8261, Case C-251/98 *C. Baars* v *Inspecteur der Belastingen* [2000] ECR I-2787, Joined Cases C-397/98 and C-410/98 *Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd* v *Commissioners of Inland Revenue and HM Attorney General* [2001] ECR I-1727.

[201] See Case C-200/98 *X AB and Y AB* v *Riksskatteverket* [1999] ECR I-8261, Case C-251/98 *C. Baars* v *Inspecteur der Belastingen* [2000] ECR I-2787, Joined Cases C-397/98 and C-410/98 *Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd* v *Commissioners of Inland Revenue and HM Attorney General* [2001] ECR I-1727.

situation is the *Verkooijen* case.[202] Mr Verkooijen resided in the Netherlands and held shares in a company established in Belgium. When he received dividends from the company, he was not allowed a favourable tax treatment in the form of dividend exemption as the dividends received had not been subject to the Netherlands dividend tax.[203] Thus, the Court found this situation to fall within the scope of the free movement of capital provisions.

The *Baars* case[204] concerned a similar situation to the one under review in the *Verkooijen* case. However, in *Baars* a Netherlands resident was the sole shareholder and director of a limited company established in Ireland.[205] Since the company was established outside the Netherlands, he was not granted a tax exemption in relation to wealth tax. Mr Baars argued that this treatment was in conflict with the freedom of establishment and the free movement of capital.[206] Correspondingly, the national court asked the ECJ whether the Dutch legislation was contrary to those provisions.

In *Baars,* the Court started by examining the compatibility of Dutch legislation from the perspective of freedom of establishment. The Court stated that "a 100 percent holding in the capital of a company having its seat in another Member State undoubtedly brings such a taxpayer within the scope of application of the Treaty provisions on the right of establishment."[207] Moreover, the Court expressed that control or management of a company are factors connected with the exercise of the right of establishment.[208] As the ECJ found the Dutch legislation to be in breach of the right to establishment, it found it unnecessary to assess the situation in relation to the free movement of capital.

Comparing the *Verkooijen* case to the *Baars* case, it seems as if portfolio investments, without implying any control of the company in terms of decision-making, fall within the scope of the free movement of capital. In contrast, if the shareholding entails control or management, the situation is more likely to fall within the scope of the freedom of establishment. This conclusion is confirmed by the case *X and Y* v *Riksskatteverket.*[209]

[202] Case C-35/98 *Staatssecretaris van Financiën* v *B.G.M. Verkooijen* [2000] ECR I-4071. This case is further analysed in section 5.8.2.1.

[203] *Ibid.*, para. 14.

[204] Case C-251/98 *C. Baars* v *Inspecteur der Belastingen* [2000] ECR I-2787.

[205] *Ibid.*, para. 9.

[206] *Ibid.*, para. 15.

[207] *Ibid.*, para. 21.

[208] *Ibid.*, para. 20.

[209] Case C-436/00 *X and Y* v *Riksskatteverket* [2002] ECR I-10829. See also Case C-208/00 *Überseering BV* v *Nordic Construction Company Baumanagement GmbH (NCC)* [2002] ECR I-9919, para. 77.

In this case, the ECJ assessed the situation in relation to the freedom of establishment when the Swedish national legislation under review affected transfers of shares to a foreign legal entity in which the transferor directly or indirectly had a holding, provided that that holding gave him definite influence over the decisions of that foreign legal person and allowed him to determine its activities.[210] In contrast, when the legislation affected transfers of shares to foreign legal persons in which the transferor directly or indirectly had a holding which was not such as to give him definite influence over the decisions of that foreign legal person or allowed him to determine its activities, the Court applied the provisions on freedom of movement of capital.[211]

Also in the case *X AB and Y AB*[212] the ECJ assessed Swedish tax legislation in relation to the freedom of establishment. The national Court asked for the compatibility of the national legislation both with the freedom of establishment and the free movement of capital. The legislation in question entailed a difference of treatment on the basis of the criterion of the seat of the subsidiary. If a Swedish company had formed subsidiaries in other Member States, it was not entitled to receiving certain tax concessions on intra-group transfers. As the ECJ found the Swedish legislation to be in breach of the freedom of establishment, it did not find it necessary to examine its compatibility with the free movement of capital.[213]

In *Hoechst*[214], the Court simply started by assessing the situation from the perspective of the freedom of establishment and did not give any reason why it did not examine the situation in relation to the free movement of capital.

To sum up, it seems as if the Court frequently begins by assessing the situation at hand from the perspective of one of the free movement provisions, and if it finds that there is a breach against that freedom, it does not move on to assess whether there is a breach of any of the other free movement provisions.[215] This way of dealing with the free movement

[210] Case C-436/00 *X and Y* v *Riksskatteverket* [2002] ECR I-10829, paras. 65, 67.

[211] *Ibid.*, paras. 68, 74.

[212] Case C-200/98 *X AB and Y AB* v *Riksskatteverket* [1999] ECR I-8261.

[213] *Ibid.*, para. 30.

[214] Joined Cases C-397/98 and C-410/98 *Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd* v *Commissioners of Inland Revenue and HM Attorney General* [2001] ECR I-1727.

[215] For example, see Case C-200/98 *X AB and Y AB* v *Riksskatteverket* [1999] ECR I-8261, Joined Cases C-397/98 and C-410/98 *Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd* v *Commissioners of Inland Revenue and HM Attorney General* [2001] ECR I-1727 and Case C-410/96 *Criminal Proceedings against André Ambry* [1998] ECR I-7875.

provisions, as if they were mutually exclusive, is supported by the Court's explicit statement in the *Gebhard*[216] case. The Court stated that "the situation of a Community national who moves to another Member State of the Community in order there to pursue an economic activity is governed by the chapter of the Treaty on the free movement of workers, or the chapter on the right of establishment or the chapter on services, these being mutually exclusive". In *Safir*[217], the Court stated, after having found a breach against Article 49 EC, that "it is not necessary to determine whether such legislation is also incompatible with Articles 6, 73 b and 73 d of the Treaty".[218] Consequently, the Court treated the different free movement provisions as mutually exclusive.

However, it has occurred that a situation has been assessed from the perspective of more than one free movement provision even though the Court has identified a breach of the provision it first applied. In the *Svensson and Gustavsson*[219] case, the Court, after having established a violation of the free movement of capital, went on to state that the contested measure also infringed Article 49 EC. Further examples of this are the cases *Commission* v *Italy*[220] and *Bachmann*[221].

4.7 Conclusions

The main purpose of this chapter has been to inquire into the Court's reasoning when applying the free movement provisions that could have an impact on tax treaties in the internal market, namely the free movement of workers, the freedom of establishment, the free movement of services and the free movement of capital. The reasoning employed by the ECJ under the *nationality-based approach* and the *free movement-based approach* are generally different in important respects. The aim of this chapter has been to establish preliminary results regarding in which situations the Court applies these different approaches.

The case law study implies that a *nationality-based approach* is applied when the ECJ assesses national legislation from a host state perspective. Under this approach, the focus is on nationality as the decisive

[216] Case C-55/94 Case C-55/94 *Reinhard Gebhard* v *Consiglio dell'Ordine degli Avvocati e Procuratori di Milano* [1995] ECR I-4165 [1995] ECR I-4165, para. 20.
[217] Case C-118/96 *Jessica Safir* v *Skattemyndigheten i Dalarnas Län* [1998] ECR I-1897.
[218] *Ibid.*, para. 35.
[219] Case C-484/93 *Peter Svensson and Lena Gustavsson* v *Ministre du logement et de l'urbanisme* [1995] ECR I-3955 (see section 3.5.4.3 of this study).
[220] Case C-279/00 *Commission* v *Italian Republic* [2002] ECR I-1425.
[221] Case C-204/90 *Hanns-Martin Bachmann* v *Belgium* [1992] ECR I-249.

factor for the difference in treatment. This includes indirect discrimination, where the effect of the national measure is to the particular detriment of non-nationals, even though it formally might be equally applicable to nationals and non-nationals.

The cases analysed in this chapter indicate that the ECJ generally applies a *free movement-based approach* when analysing national legislation from a home state perspective. This approach signifies that the nationality is of no importance for the difference in treatment but rather the exercise of free movement rights. However, the *Alpine Investment* case shows that also national measures that do not entail a difference in treatment between a national context and a cross-border context have been assessed by the ECJ applying a *free movement-based approach.*

From the above-mentioned pattern, certain deviations have been observed. When a Member State's own national, who is or has been abroad, seeks to exercise his right of movement or investment into its territory, it occurs that the ECJ brings such a person within the scope of Article 39 EC by equating him with nationals of other Member States. The *Scholz* case represents this line of reasoning. In this case, the Court ignored Mrs Scholz's Italian nationality and found that the Italian legislation was indirectly discriminatory, even though it was a national that was negatively affected by her own country's legislation. In *Scholz,* the Court applied a *nationality-based approach* but as it disregarded Mrs Scholz nationality and assessed the Italian legislation from a host state perspective, one may conclude that the Court's reasoning is applicable both in relation to a person's host state and home state.

Another deviation from this pattern is where the Court's reasoning is broad so it can be interpreted as applicable both in relation to a person's home state and host state. This is the case in *Kraus,* where the Court applied a *free movement-based approach.* The Court's reasoning in *Kraus* can be interpreted as taking both a home state and host state perspective. In *Kemmler,* the Court went further and applied a *free movement-based approach* to host state legislation, an obvious deviation from the above-mentioned pattern. Accordingly, these cases show that the Court, by its reasoning, does not rule out the possibility of applying a *free movement-based approach* when assessing national legislation from a host state perspective. Even though the Court in *Kemmler* applied a *free movement-based approach* to host state legislation, implying an extensive width of what is prohibited,[222] the case law study indicates that this practise represents a derogation from the main rule derived from this study.

[222] See section 3.4.4.2.

The fact that Article 39 EC refers to *discrimination,* while the other free movement articles refer to *restrictions*, does not seem to have had any influence on the ECJ's terminology when interpreting the said article, since the Court has classified national measures as restrictions when they have been precluded by Article 39 EC.

It has been showed that the Court, when applying a *free movement-based approach*, has found that the effect of the national rule is "too uncertain and indirect" for the rule to be regarded as liable to hinder the free movement. Unfortunately, the Court has not provided much guidance when it comes to assessing what is considered as the threshold for finding that a measure is liable to constitute a restriction under a *free movement-based approach.*

Regarding the question in which situations a Member State may invoke imperative interests, the following is to be noticed. In most cases the ECJ has pragmatically noted all the justifying grounds put forward by Member States and examined them on their merits.[223] In only a few cases, the Court has refused, on principle, to take note of a defence because of the nature of the restriction. This was the case in *Bond* and *Albore,* where the Court applied a *nationality-based approach.* The national measure in both these cases appears to be of a directly discriminatory character. Accordingly, these cases indicate that the Court has not completely abandoned its traditional standpoint on this issue. [224]

As is apparent from the Court's reasoning in the cases presented in this chapter, the Court does not apply a consistent terminology.[225] It occurs that it switches from language based on restrictions and obstacles to one based on discrimination in one and the same judgment in relation to one and the same national measure. National rules being similar in structure and effect have in one case been referred to by the ECJ as indirectly discriminatory and in another case as restrictive. This practise does not facilitate the understanding of the Court's reasoning. Moreover, it emphasizes that caution is needed when interpreting the Court's case law on free movement rules and that it is not advisable to base conclusions on the mere fact that the Court employs the term restriction or the term discrimination. Instead, there is a need to go beyond the Court's use of these terms and consider what type of prohibition the Court actually applies: a

[223] See Farmer, *The Court's case law on taxation: a castle built on shifting sands?* ECTRev 2003, p. 81.

[224] See section 3.5.

[225] This conclusion is also reached by Barnard, see Barnard, *The Substantive Law of the EU – The Four Freedoms,* (2004), p. 471.

prohibition of difference in treatment due to nationality or the prohibition of measures hindering the free movement.

In this chapter, both consistencies and inconsistencies have been observed as regards the Court's reasoning when applying the free movement provisions. In the next chapter, it is tested whether the Court's adjudication in the area of income taxation confirms the conclusions drawn from the case law study carried out in this chapter.

5 Case Law Survey on the Interpretation of Free Movement Provision in Relation to Member States' Income Tax Legislation

5.1 Tax Provisions Constituting Restrictions

This chapter concentrates on the Court's reasoning when interpreting the free movement provisions of the EC Treaty in relation to Member States' income tax legislation.[1] The aim is to answer the question when the ECJ applies a *nationality-based approach* and when it applies a *free movement-based approach* when analysing whether income tax provisions in Member States' tax legislation constitute restrictions on the free movement.[2] In Chapter 4, a similar analysis was presented in relation to case law, primarily not including cases relating to income taxation. The aim of that chapter was to reach preliminary conclusions on the Court's reasoning and assessment when interpreting free movement articles in relation to any type of national legislation.

However, this chapter aims at reaching conclusions regarding the Court's reasoning and assessment when interpreting free movement articles in an income tax context. Similar to Chapter 4, the case law analysis carried out in this chapter includes studying the Court's position on grounds for justification of directly discriminatory measures. Cases where the ECJ explicitly has considered the impact of the free movement

[1] Accordingly, cases that do not concern income tax provisions are not included in this case law study. Hence, the following cases are not part of this case law survey: C-1/93 *Halliburton Services BV* v *Staatssecretaris* [1994] ECR I-1137, C-17/00 *Francois de Coster* v *Collège juridictionnel de la Région de Bruxelles-Capitale* [2001] ECR I-9445, C-439/97 *Sandoz GmbH* v *Finanzlandesdirektion für Wien, Niederösterreich und Burgenland* [1999] ECR I-7041 and C-251/98 *C. Baars* v *Inspecteur der Belastingen* [2000] ECR I-2787.

[2] These approaches are explained in section 3.4.1.

articles on tax treaty provisions are specifically analysed in the subsequent Chapter 6. Therefore, these cases are not handled in this chapter.

Tax legislation may be described as having a distinctive character in comparison with other legal areas affected by the free movement provisions. Tax policy is a central feature of state sovereignty.[3] Taxes are not only a means of generating tax revenue needed by Member States to fulfil the tasks incumbent on the state; they are also an important political tool used by governments to influence the behaviour of their citizens. Taxation has a direct effect on economic operators.[4] Therefore, Member States' tax laws reflect a number of non-fiscal objectives being instruments of social policy.[5] These characteristics may explain why the Member States from the outset have been unwilling to transfer sovereign rights concerning income taxation to the Community.

One may ask whether these characteristics of tax law have required the ECJ to interpret free movement rules differently in relation to income tax legislation than it does in relation to other fields of law.[6] The Court's own statements in the *Hubbard*[7] case indicate that the answer to that question is not affirmative. The Court held that "the effectiveness of Community law cannot vary according to the various branches of national law which it may affect."[8] Also the Court's references to non-tax cases in its reasoning in income tax cases points in the same direction. If there are specific characteristics in the Court's reasoning when dealing with income tax cases, this will most likely be revealed in the case law survey in this chapter. To put the cases dealt with in this section in their proper legal context, the relationship between legislative and juridical application in the income tax area is briefly described.

5.2 Legislative Application and Judicial Application

The area of tax law exemplifies the interconnection between legislative and judicial initiatives for attaining a well-functioning internal market.

[3] See Lehner, *Limitation of the national power of taxation by the fundamental freedoms and non-discrimination clauses of the EC Treaty,* ECTRev 2000, p. 5.

[4] Wathelet, *The Influence of Free Movement of Persons, Services and Capital on National Direct Taxation: Trends in the Case Law of the Court of Justice,* YEL 20, 2001, p. 1.

[5] Regarding principles underlying the design of Swedish tax legislation, see Gunnarsson, *Skatterättvisa,* (1995).

[6] See Lyal, *Non-discrimination and direct taxation in Community law,* ECTRev 2003, p. 68.

[7] Case C-20/92 *Anthony Hubbard (Testamentvollstrecker)* v *Peter Hamburger* [1993] ECR I-3777.

[8] *Ibid.*, para. 19.

One way of dealing with tax legislation – which either by itself or in interaction with tax legislation in other Member States hinders the free movement – is through legislative harmonization. However, many of the legislative proposals from the Commission have not been adopted by the Council. One reason for this is the requirement of unanimity in the Council.[9] Therefore, in the absence of extensive legislation, it is largely the case law of the ECJ that has been instrumental in ensuring free movement in the internal market.

As has been mentioned earlier, the ECJ has, primarily under Articles 226 EC and 234 EC, the right to interpret free movement law in relation to Member States' tax provisions.[10] The result of this negative integration is that a national measure in conflict with Community law is rendered inapplicable. This type of integration is deregulatory as it results in certain national provisions not being applicable. The unenforceable national rule is not automatically substituted with new rules. The opposite type of integration follows from Community legislative measures. It is commonly referred to as positive integration and it stipulates the rules applicable in a given situation.[11]

Without common legislation, the ECJ case law will continue to be limited to forcing the Member States to introduce measures which replace the particular national measures that are found to be in breach of Community law.[12] In general, it does not force the Member States to make any structural changes in coordination with the other Member States. One may be of the opinion that this way of dealing with the issue of structural problems of the tax legislation in the Member States in relation to the achievement of a well-functioning internal market is not satisfactory as it does not represent a systematic approach to the problems at hand.

5.3 Legislative Initiatives

The only possibility of positive integration by the Community in the area of direct taxation is the adoption of measures for the approximation of laws that have a direct impact on the establishment, or functioning, of the

[9] See Article 94 EC and Vanistendael, *A window of opportunity for the making of Europe: Member States cannot have their national cake and eat the European one*, ECTRev 2003, pp. 2–3, and Vanistendael, *Memorandum on the taxing powers of the European Union*, ECTRev 2002, pp. 120–129.

[10] See section 1.5.

[11] See section 3.2.2.1 and Craig & de Búrca, *EU Law*, (2002), p. 614.

[12] Ståhl & Persson Österman, *EG-rätten och skyddet för den svenska skattebasen*, SvSkT 2002, p. 41.

internal market.[13] The legal basis is found in Article 94 EC. The following five directives are all that have been enacted by the Community in the area of direct taxation.

- Directive 77/799/EEC of 19 December 1977, concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation.

- 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 (hereinafter referred to as the Merger Directive).

- 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 (hereinafter referred to as the Parent-Subsidiary Directive).

- Directive 2003/48/EC of 3 June 2003, to ensure effective taxation of savings income in the form of interest payments within the Community (hereinafter referred to as the Savings Directive).

- 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 (hereinafter referred to as the Interest and Royalty Directive).

Besides these adopted directives, the Commission has proposed other direct tax directives, for instance on the cross-border offsetting of losses within groups of companies.[14]

In 1990, the EC Member States signed a multilateral convention on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.[15] This convention provides for arbitration in cases of unresolved transfer pricing disputes. In contrast to the directives, the convention is based on Article 293 EC.

The Commission has issued several non-binding recommendations dealing with direct tax issues. The two most important ones concern the

[13] For an overview of the historic developments in the area of secondary legislation for direct taxation see, for instance, Thömmes, *The European dimension in international tax law*, Intertax 1990, pp. 464–476.

[14] Proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their PEs and subsidiaries situated in other Member States, COM (90) 595 final.

[15] Convention 90/463/EEC of 23 July 1990.

tax treatment of non-resident individuals[16] and the taxation of small and medium-sized enterprises[17].

5.4 Judicial Application by the ECJ

Even though the Member States retain their competence in the field of direct taxation, the national legislation must be in line with Community law. An ECJ statement stressing this is found in almost all cases concerning direct taxation. For example, in the *ICI* case[18] the following statement is found:

> "[a]lthough direct taxation is a matter for the Member States, they must nevertheless exercise their direct taxation powers consistently with Community law."

From this statement follows that when the Member States exercise their retained powers, they must not contravene the rights provided by the free movement provisions. However, this statement does not tell us in what circumstances internal tax legislation or tax treaty provisions conflict with the free movement articles of the EC Treaty. Therefore, the Court's interpretation and reasoning is crucial for establishing the legal boundaries with which the tax legislation of the Member States has to comply.

Below follows an analysis of the Court's reasoning when interpreting Articles 39 EC, 43 EC, 49 EC and 56 EC in relation to Member States internal income tax legislation. To put the statements of the ECJ in a correct context, facts and legal framework are presented to the extent necessary.

The following presentation is systematized following the same principles as the systematization in Chapter 4. Thus it is based on the Court's reasoning. If the ECJ's reasoning in a case is focused on establishing whether the national measure is particularly to the disadvantage of non-nationals or non-residents, the case is presented under the heading

[16] Recommendation 94/79/EC of 21 December 1993 on the taxation of certain items of income received by non-residents in a Member State other than that in which they are residents.

[17] Recommendation 94/390/EC of 25 May 1994 on the tax treatment of small and medium-sized enterprises.

[18] Case C-264/96 *ICI* v *Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-4695, para. 19. Other cases where a similar declaration is found are, for instance, Case C-279/93 *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225 para. 21, Case C-107/94 *P. H. Asscher* v *Staatssecretaris van Financiën* [1996] ECR I-3089, para. 36, Case C-250/95 *Futura Participations and Singer* [1997] ECR I-2471, para. 19.

nationality-based approach. Similarly, if the Court's reasoning is focused on the more general question whether the national measure is liable to dissuade or deter a person from exercising his right to free movement, the case is presented under the heading *free movement-based approach*. To be able to draw conclusions concerning the circumstances under which these different lines of reasoning are applied, it is analysed from which perspective the Court has assessed a national measure, either from a host or a home state perspective.[19] Under the above-mentioned headings the cases are presented in a chronological order.

5.5 Free Movement of Workers in Relation to Income Tax Cases

5.5.1 A Nationality-Based Approach under Article 39 EC

5.5.1.1 The Biehl Case

A Luxembourg tax provision denying the refund of income tax withheld has been held by the ECJ to be in breach of Article 39 (2) EC. The question arose in proceedings between a German national, Mr Biehl, and the Luxembourg tax administration concerning the repayment of an overdeduction of tax.[20] Mr Biehl was a resident of Luxembourg from November 1973 to October 1983. On 1 November 1983, he moved back to Germany. The tax deducted by Mr Biehl's employer in 1983 exceeded the total amount of his liability to tax. His request for a repayment of the overdeduction was denied as Mr Biehl had left Luxembourg during the course of the year.

In the *Biehl* case the ECJ initially stated 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 to the same result."[21]

Moreover, the ECJ held that even though the criterion of permanent residence in Luxembourg applied irrespective of the nationality of the taxpayer concerned, there is a risk that it "will work in particular against

[19] See section 3.4.1.

[20] This question was at issue also in Case C-151/94 *Commission* v *Luxembourg* [1995] ECR I-3685.

[21] Case C-175/88 *Klaus Biehl* v *Administration des contributions du grand-duché de Luxembourg* [1990] ECR I-1779, para. 13.

taxpayers who are nationals of other Member States. It is often such persons who will in the course of the year leave the country or take up residence there."[22] The Court's reasoning focused on that non-nationals were more negatively affected by the tax provision than nationals and that is why it held it to be contrary to the free movement of workers. The ECJ did not explicitly classify the restrictive measure but used arguments common to indirect discrimination as it held that the tax measure "will work in particular against taxpayers who are nationals of other Member States". Consequently, the Court's reasoning in *Biehl* was aimed at establishing whether non-nationals in Luxembourg were treated in a less favourable way than nationals, *i.e.* an application of the traditional and uncontroversial prohibition of discrimination based on nationality. Accordingly, the Court's reasoning is classified as a *nationality-based approach*. The Court considered the effect of the Luxembourg legislation on non-nationals and assessed the Luxembourg legislation from a host state perspective.

In its defence, Luxembourg argued that its legislation was set up to ensure the system of progressive taxation and that Luxembourg law contained a non-contentious procedure allowing temporarily resident taxpayers to obtain refund of income tax withheld.[23] The Court did not accept any of these non-Treaty grounds to justify the legislation.

5.5.1.2 The Bachmann Case – Assessments under Articles 39 and 49 EC

In *Bachmann*[24], the ECJ found that Belgian legislation that made the deductibility of sickness and invalidity insurance contributions as well as pension and life assurance contributions conditional on those contributions being paid in Belgium was contrary to Articles 39 EC and 49 EC.[25] Mr Bachmann was a German national who worked and lived in Belgium. Before moving to Belgium, he concluded sickness and insurance contracts and a life assurance contract with a German insurance company.[26] He was not allowed to deduct the contributions paid to the German insurance company from his occupational income as only contributions paid in Belgium were allowed to be deducted.[27]

[22] *Ibid.*, para. 14.

[23] *Ibid.*, paras. 15, 17.

[24] Case C-204/90 *Hanns-Martin Bachmann* v *Belgian State* [1992] ECR I-249.

[25] For comments in the literature, see, for instance, Knobbe-Keuk, *Restrictions on the Fundamental Freedoms Enshrined in the EC Treaty by Discriminatory Tax Provisions – Ban and Justification*, ECTRev 1994, pp. 74–85.

[26] Case C-204/90 *Hanns-Martin Bachmann* v *Belgian State* [1992] ECR I-249, para. 2.

[27] *Ibid.*, para. 3.

The Court argued that:

> "workers who have carried on an occupation in one Member State and who are subsequently employed, or seek employment, in another Member State will normally have concluded their pension and life assurance contracts or invalidity and sickness insurance contracts with insurers established in the first State."[28]

The Court identified a risk that the Belgian provision might operate to the particular detriment of those workers who were, as a general rule, nationals of other Member States. After having found the national provision to be in breach of Article 39 EC, the Court analysed the proposed justifications.

The Court found in *Bachmann* that the connection between the deductibility of contributions and the liability to tax of sums payable by the insurers under pension and life assurance contracts set up to ensure the cohesion of the tax system justified the Belgian legislation.[29] The cohesion was expressed in that the tax disadvantage resulting for a tax payer of a Member State was compensated for by a corresponding tax advantage for the same person. Where a contribution was not deducted, the sums paid out were exempt from tax.[30]

The cohesion of the tax system is an imperative interest justification accepted by the ECJ for the first, and so far, only time, in relation to this Belgian legislation.[31] The same justification has been put forward in almost all subsequent cases by the governments involved but has been denied repeatedly by the ECJ.

In *Bachmann,* the ECJ applied a *nationality-based approach* when interpreting Article 39 EC in relation the Belgian legislation. The Court focused on the effect of the Belgian requirement on migrant workers such as Mr Bachmann. From this, it is evident that the ECJ analysed the situation from a host state perspective.

When analysing the national legislation in relation to Article 49 EC, the ECJ focused on its effect on insurers established in other Member States and found that the legislation constituted a restriction on their freedom to provide services.[32] When reaching that conclusion, the Court used the language of dissuasion:

> "[p]rovisions requiring an insurer to be established in a Member State as a condition for the eligibility of insured persons to benefit from certain tax

[28] *Ibid.*, para. 9.

[29] *Ibid.*, para. 28. See also Case C-300/90 *Commission* v *Belgium* [1992] ECR I-305.

[30] Case C-204/90 *Hanns-Martin Bachmann* v *Belgian State* [1992] ECR I-249, para. 22.

[31] See also Case C-300/90 *Commission* v *Belgium* [1992] ECR I-305.

[32] Case C-204/90 *Hanns-Martin Bachmann* v *Belgian State* [1992] ECR I-249, para. 31.

deductions in that State operate to deter those seeking insurance from approaching insurers established in another Member State, and thus constitute a restriction on the latter's freedom to provide services."[33]

Hence, the ECJ switched perspective and focused on the effect of the Belgian legislation on foreign service providers and their right to *provide* services. In doing so, the Court did no longer focus on Mr Bachmann, the person more directly affected, but on foreign service providers in general. Considering that the Court focused on foreign insurers' right to provide services, the Belgian legislation was considered as host state legislation. The Court also found that this restriction on the free movement of services was justified having regard to the cohesion of the Belgian tax system.[34]

Belgium, Mr Bachmann's new residence state, treated him less favourably because he paid his insurance contributions to an insurance company outside this country. This situation is similar to the ones generally assessed by the ECJ using a *free movement-based approach*. In this case, the ECJ used a *nationality-based approach* when interpreting Article 39 EC in relation to the national rule. The Court focused on that the Belgian legislation might operate to the particular detriment of non-nationals. This was probably due to the fact that Belgium was not Mr Bachmann's original home state, and therefore it was possible to apply a *nationality-based approach*. Mr Bachmann himself had used the free movement to put himself under the jurisdiction of another Member State, namely Belgium. When the Court applies a *free movement-based approach,* the situation is generally that the person is still within the jurisdiction of his original home state, and it is this state that treats him less favourably due to his use of the free movement while still being in his original position, namely a resident and national of his home state.

If Mr Bachmann would have been of Belgian nationality and had always lived in Belgium but had an insurance policy taken out with a non-Belgian insurance company, the *nationality-based approach* would not have been possible to apply in terms of conceptual clarity. Moreover, that situation would most likely not have been assessed under Article 39 EC but under Article 49 EC.

In conclusion, the ECJ applied a *nationality-based approach* when analysing Article 39 EC in relation to the Belgian legislation. When doing that, the Court focused on Mr Bachmann's situation and assessed the legislation from a host state perspective. However, when the Court

[33] *Ibid.*

[34] *Ibid.*, paras. 32–33.

assessed the situation under Article 49 EC, the Court switched perspective and now mainly considered the legislation's effect on non-resident companies. When doing that, the Court applied a *nationality-based approach*. From their perspective, the Belgian legislation constituted host state legislation. Hence, the Court reached its conclusion in relation to non-Belgian insurance companies' right to provide services.

5.5.1.3 The Schumacker Case

In *Schumacker*[35], the ECJ made several important statements in regard to the types of national tax provisions that may constitute restrictions under free movement law.[36] The case concerned German legislation according to which taxpayers were treated differently depending on whether or not they resided within the national territory. This distinction between resident and non-resident taxpayers is a fundamental characteristic of the tax systems of most countries.

Mr Schumacker, a Belgian national, lived in Belgium but worked in Germany. He was married and had his family in Belgium. As his wife was unemployed, Mr Schumacker's wages were more or less the household's sole income.[37] Under German tax legislation, Mr Schumacker was taxed as a non-resident which resulted in that regard was not taken of his family circumstances. A German resident in Mr Schumacker's position would have been granted several tax allowances.

A simplified tax procedure was applied to non-resident taxpayers.[38] Their liability to income tax was deemed to be definitively discharged by the monthly deduction at source made by the employer. Therefore, they were excluded both from the annual wage tax adjustment made by the employer and from the annual income tax assessment by the tax administration. The effect of this exclusion was that non-resident taxpayers could not qualify for reimbursement of any overpaid tax at the end of the year.

When arguing the *Schumacker* case, the ECJ first stated that Article 39 EC:

> "does not allow a Member State, as regards the collection of direct taxes, to treat a national of another Member State employed in the territory of the first State in

[35] Case C-279/93 *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225.

[36] For comments in the literature, see, for instance, Wattel, *The Schumacker Legacy*, ET 1995, pp. 347–353, Vanistendael, *The consequences of Schumacker and Wielockx: Two steps forward in the tax procession of Echternach*, CMLRev 33, 1996, pp. 255–269 and Avery Jones, *Carry on Discriminating*, ET 1996, pp. 46–49.

[37] Case C-279/93 *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225, para. 17.

[38] *Ibid.*, para. 13.

> the exercise of his right of freedom of movement less favourably than one of its own nationals in the same situation".[39]

The Court then reiterated that the rules on equal treatment forbid not only overt discrimination by reason of nationality but also all forms of covert discrimination which, by the application of other criteria of differentiation, in fact lead to the same result.[40] Then, the Court stressed the fact that the German legislation applied irrespective of the nationality of the taxpayer concerned.[41] It hereby ruled out the possibility of classifying the legislation as directly discriminatory on grounds of nationality.

The next step in the Court's assessment in the *Schumacker* case consisted of analysing whether indirect discrimination on grounds of nationality was at hand. The Court held that national rules, under which a distinction is drawn on the basis of residence so that non-residents were denied certain benefits which were, conversely, granted to persons residing within national territory, "are liable to operate mainly to the detriment of nationals of other Member States. Non-residents are in the majority of cases foreigners."[42] The Court concluded that legislation granting tax benefits only to residents of a Member State may constitute indirect discrimination by reason of nationality.[43] However, the Court stated that it is also settled case law that:

> "discrimination can arise only through the application of different rules to comparable situations and of the application of the same rule to different situations".[44]

The Court then proceeded by declaring that, as a rule, the situations of residents and of non-residents are not comparable.[45] The reason is that income received in one Member State by a non-resident is normally only a part of his total income, which is concentrated at his place of residence. Therefore, the taxpayer's residence state is best suited to assess his personal ability to pay tax since his personal and family circumstances are generally considered by this state. The Court also stated, referring to the OECD Model, that this was an accepted principle in international taxation.[46] Consequently, the situation of a resident is different in so far as the

[39] *Ibid.*, para. 24.
[40] *Ibid.*, para. 26.
[41] *Ibid.*, para. 27.
[42] *Ibid.*, para. 28.
[43] *Ibid.*, para. 29.
[44] *Ibid.*, para. 30.
[45] *Ibid.*, para. 31.
[46] *Ibid.*, para. 32.

major part of his income is normally concentrated to his residence state. As a result, the fact that a Member State does not grant a non-resident certain tax advantages that it grants a resident is not, as a rule, discriminatory, as those two categories of taxpayer are not in comparable situations.[47]

From this general rule, the Court distinguished Mr Schumacker's situation, where a non-resident receives no significant income in his residence state and obtains the major part of his taxable income from an activity performed abroad, with the result that his residence state is not able to grant him the tax benefits normally provided a taxpayer in his personal and family circumstances.[48] The ECJ stated that in those circumstances there is no objective difference between the situations of a non-resident and a resident engaged in comparable employment. For that reason, the ECJ reached the conclusion that discrimination resulted from the fact that Schumacker's personal and family circumstances were neither taken into account in the residence state, Belgium, nor in the source state, Germany.[49] Regarding the difference in treatment at the procedural level, the ECJ found that non-residents were placed in a less advantageous position than residents.[50] The refusal to grant non-resident Community nationals the benefit of annual adjustment procedures which are available to residents constituted unjustified discrimination.[51]

Justifications put forward to justify the German legislation were the cohesion of the tax system and administrative difficulties.[52] None of these grounds were accepted by the ECJ as justification.

From the *Schumacker* case we may conclude that the ECJ considers that residents and non-residents are not, as a general rule, in comparable situations. This is certainly in line with international tax practise and in particular the OECD Model.[53]

However, the Court identified an exception to this rule. When a non-resident obtains "the major part of his taxable income" from another state, resulting in a situation where his state of residence is not able to grant him the benefits connected with the taking into account of his

[47] *Ibid.*, para. 34.
[48] *Ibid.*, para. 36.
[49] *Ibid.*, para. 38.
[50] *Ibid.*, para. 52.
[51] *Ibid.*, para. 58.
[52] *Ibid.*, paras. 40, 43.
[53] See Article 24 (3) OECD Model which states that "[t]his provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents."

personal and family circumstances, "discrimination" arises.[54] The ECJ applied a *nationality-based approach* when analysing whether the national tax legislation was in breach of Article 39 EC as it focused on difference in treatment due to residence. Therefore, the discrimination seems to be of an indirect character since it implies different treatment based on residence having a negative effect mainly on non-nationals. From Mr Schumacker's perspective, the German legislation constituted host state legislation as he neither resided in, nor had the nationality of this state. It is clear that the Court also analysed the German legislation from a host state perspective. Mr Schumacker came within German jurisdiction due to his use of his free movement rights when working in Germany and remaining a resident of Belgium.

It is worth noticing that the Court initially in its reasoning in *Schumacker* referred to *overt* and *covert* discrimination but later on refused to classify the legislation using these terms. Instead, it merely stated that "discrimination arises".[55] In the course of its reasoning, the Court also held that legislation that grants tax benefits only to residents of the Member State may constitute *indirect discrimination* by reason of nationality. One may question the use by the ECJ of the terms *covert*, *overt* and *indirect discrimination* when in the actual case it merely states that *discrimination* is at hand. The Court's use of this terminology in the *Schumacker* case does not clarify the situation.

5.5.1.4 The Gschwind Case

The *Gschwind*[56] case concerned German tax provisions for non-resident taxpayers.[57] The tax provisions at issue had been adopted to conform the German tax system to the *Schumacker* judgment.[58] According to this legislation, a married taxable person who did not reside in Germany but in another EU Member State had the right to apply for a joint assessment under the splitting procedure, if that person's spouse resided in an EU Member State and certain other requirements were fulfilled. The first requirement was that at least 90 per cent of the total income of the spouses was subject to German income tax. If this requirement was not

[54] Case C-279/93 *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225, para. 36.

[55] *Ibid.*, paras. 38, 58.

[56] Case C-391/97 *Frans Gschwind* v *Finanzamt Aachen-Aussenstadt* [1999] ECR I-5451.

[57] For comments in the literature, see, for instance, Newey, *Gschwind Decision – German Tax Law not Discriminatory of Non-Resident Married Couples*, ET 2000, pp. 114–118.

[58] Case C-391/97 *Frans Gschwind* v *Finanzamt Aachen-Aussenstadt* [1999] ECR I-5451, para. 6.

fulfilled, the splitting procedure was available if their income from foreign sources (non-German sources) did not exceed DEM 24000 in the calendar year.[59] The reason for accepting also non-residents to benefit from the splitting rate regime was to establish equal treatment between residents and non-residents when relief based on personal and family circumstances could not be granted in the state of residence of the spouses.

Mr Gschwind, a Netherlands national, lived with his wife in the Netherlands. He was employed in Germany for two years whilst his wife was employed in the Netherlands.[60] During each of these years, Mr Gschwind had taxable earnings of DEM 74000, representing almost 58 per cent of the household's aggregated income. The tax treaty between Germany and the Netherlands allocated the right to tax to Germany, whereas Mrs Gschwind's income was taxable in the Netherlands. The same tax treaty avoided double taxation on behalf of the Netherlands by providing for the Netherlands tax authorities to include in the tax base income taxable in Germany whilst deducting from the tax so calculated the part of it corresponding to the taxable income in Germany.[61]

In the tax assessment in Germany of Mr Gschwind's income, he and his wife did not fulfil the requirements to benefit from the splitting rate regime. This was due to Mrs Gschwind's income that exceeded both the absolute threshold of DEM 24000 a year and the relative threshold of 10 per cent of the household's total income.

The Court was asked to interpret Article 39 (2) EC in relation to the requirements set up by the German legislation. The Court found that by laying down a percentage threshold and an absolute threshold for income respectively taxable in Germany and not subject to German tax, the German legislation took account specifically of the possibility of taking into consideration personal and family circumstances of the taxpayers in their state of residence.[62] Accordingly, the German legislation was in accordance with Article 39 (2) EC.

Similar to *Schumacker*, the *Gschwind* case concerned German legislation which was analysed by the ECJ from the perspective of persons who had exercised their free movement rights and working in Germany. Therefore, the German legislation was analysed from a host state perspective in relation to Mr Gschwind. The *Gschwind* case can be seen as a

[59] *Ibid.*, paras. 6, 14.

[60] *Ibid.*, para. 9.

[61] *Ibid.*, para. 10. Mattsson refers to this relief method as alternative exemption (so-called credit), see Mattsson, *Does the European Court of Justice Understand the Policy behind Tax Benefits Based on Personal and Family Circumstances?*, ET 2003, p. 189.

[62] Case C-391/97 *Frans Gschwind* v *Finanzamt Aachen-Aussenstadt* [1999] ECR I-5451, para. 28. For criticism, see Terra & Wattel, *European Tax Law*, (2001), p. 57.

continuation to the Court's reasoning in *Schumacker,* as it concerned the adjustment of the German legislation in line with the *Schumacker* case. The focus of the Court's reasoning was placed on whether non-residents were treated less favourably than residents, and that is why the Court's reasoning is to be classified as a *nationality-based approach.*

5.5.1.5 The Zurstrassen Case

The *Zurstrassen*[63] case is similar to both the *Schumacker* case and the *Gschwind* case. Luxembourg legislation provided for joint assessment of spouses. Under certain circumstances, this assessment resulted in a less onerous tax burden than if the spouses where taxed separately. This option was also available to non-resident spouses if they did not live apart and provided that they were taxable in Luxembourg in respect of more than 50 per cent of the earned income of their household.[64] Mr and Mrs Zurstrassen did not fulfil these requirements. Both were Belgian nationals. Mr Zurstrassen was resident in Luxembourg because of his employment while his wife, who did not work, lived together with their children in Belgium.[65] The couple spent their weekends together in Belgium. 98 per cent of the household's income derived from Mr Zurstrassen's employment income in Luxembourg. As Mr and Mrs Zurstrassen did not have their respective tax residences in the same state, they were not allowed a joint assessment.

The Court's reasoning in the *Zurstrassen* case focused on that the residence requirement for both spouses was easier to satisfy for Luxembourg nationals than nationals of other Member States who settled in Luxembourg to work there. The Court held that it was more frequent that members of the latter's families lived outside Luxembourg.[66] It also reiterated that the rules on equal treatment prohibited both overt and covert discrimination based on nationality.[67] The Court concluded, therefore, that the condition was not in line with the equal treatment required by Article 39 (2) EC and Article 7 (2) of Regulation No 1612/68.[68]

The Court also explained that the situations of residents and non-residents were comparable as Luxembourg is the only state which can take account of Mr Zurstrassen's personal and family circumstances because

[63] Case C-87/99 *Patrick Zurstrassen* v *Administration des contributions directes* [2000] ECR I-3337.
[64] *Ibid.*, para. 7.
[65] *Ibid.*, para. 8.
[66] *Ibid.*, para. 19.
[67] *Ibid.*, para. 18.
[68] *Ibid.*, para. 20.

he is resident there and earned almost the entire income of the household there.[69] Similar reasoning, focused on the possibility of the residence state to take the taxpayer's personal and family situation into account, is found in both *Schumacker*[70] and *Gschwind*[71].

Luxembourg's attempt to justify its legislation, by arguing that its legislation simplified tax collection, was not accepted by the ECJ.[72]

The ECJ analysed the legislation at hand in the *Zurstrassen* case using a *nationality-based approach*. The Court argued that the residence requirement imposed by Luxembourg legislation for both spouses was easier to satisfy for Luxembourg nationals than nationals of other Member States who settled in Luxembourg in order to work there. Accordingly, the assessment was aimed at establishing whether the Luxembourg legislation treated non-nationals less favourable than nationals. From the perspective of Mr and Mrs Zurstrassen, the Luxembourg legislation was host state legislation, and the ECJ assessed the legislation from this perspective.

5.5.1.6 The Wallentin Case

The question in the *Wallentin*[73] case concerned the compatibility of Swedish legislation on non-resident taxpayers with Article 39 EC.[74] Mr Wallentin, a German national resident in Germany, worked in Sweden for less than a month during the summer of 1996.[75] The rest of the year he studied in Germany and he received money from his parents and a grant from the German state. This income was not taxable under German law.

Mr Wallentin applied for exemption from income tax in regard to his employment income derived in Sweden (SEK 8 724). The application was rejected due to the application of the tax regime on special income tax for non-residents, the SINK legislation, applicable to persons subject

[69] *Ibid.*, paras. 21, 23.

[70] Case C-279/93 *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225, paras. 31–32.

[71] Case C-391/97 *Frans Gschwind* v *Finanzamt Aachen-Aussenstadt* [1999] ECR I-5451, para. 22.

[72] Case C-87/99 *Patrick Zurstrassen* v *Administration des contributions directes* [2000] ECR I-3337, paras. 24–25.

[73] Case C-169/03 *Florian W. Wallentin* v *Riksskatteverket* [2004], not yet reported in ECR.

[74] For comments in the literature, see, for instance, Mutén, *Den europeiska gemenskapens diskrimineringsförbud och dess skattekonsekvenser: den svenska erfarenheten,* SvSkT 2002, pp. 561–573.

[75] Case C-169/03 *Florian W. Wallentin* v *Riksskatteverket* [2004], not yet reported in ECR, para. 4.

to limited tax liability in Sweden. This legislation applied to persons resident abroad who received income in Sweden during short stays not exceeding six months in a year. The tax is levied at source, and there is no right to deduction or allowance based on the taxpayer's personal situation. However, the rate of the special income tax is lower than that applicable to standard income tax which, while, progressive, is approximately 30 per cent for most taxpayers.[76]

Persons resident in Sweden and subject to unlimited tax liability received basic allowance, at that time SEK 8 600. That allowance was granted in full only to persons resident in Sweden the entire year. For periods of residence less than a year but more than six months, the allowance was granted in proportion to the number of months of residence.

The Court reiterated its statement laid down in previous judgments such as the *Schumacker* case and the *Gerritse* case: in relation to direct taxes, the situations of residents and of non-residents are generally not comparable.[77] Therefore, the fact that a Member State does not grant a non-resident certain tax benefits which it grants a resident is not principally discriminatory bearing in mind the objective differences between the situations of residents and non-residents.[78]

Then, the Court emphasized that the position is different in situations where the non-residents receive no significant income in the state of residence but obtain a major part of their taxable income from activities performed in the state of employment. This implies that the residence state is not in a position to grant the benefits resulting from taking into account of personal and family circumstances. The Court explained that discrimination arose from the fact that Mr Wallentin's personal and family circumstances neither were taken into account in the state of residence, nor in the state of employment, irrespective of the different rates applicable under the special income tax and the ordinary income tax.[79] The Court found that the Swedish tax regime for non-residents was discriminatory as it did not grant the allowance to persons subject to limited tax liability when a such person received no taxable income in his state of residence.[80]

The argument that the Swedish legislation was justified having regard to the principle of cohesion of the tax system was rejected by the Court.[81]

[76] *Ibid.*, para. 6.
[77] *Ibid.*, para. 15.
[78] *Ibid.*, para. 16.
[79] *Ibid.*, para. 17.
[80] *Ibid.*, para. 20.
[81] *Ibid.*, paras. 21–22.

According to the ECJ, the reason was that the Community principle of equal treatment requires taking into account of personal and family circumstances by the state of employment in certain situations. Furthermore, the argument that Mr Wallentin would benefit from an unjustified fiscal benefit if personal and family circumstances was considered was rejected by the Court, saying that he could not benefit from a similar allowance in his residence state.[82]

In the *Wallentin* case, the Court analysed the Swedish legislation focusing on its effect on non-residents, *i.e.* a host state perspective. It may be concluded that the Court applied a *nationality-based approach,* even though the Court did not explicitly refer to the fact that non-residents are generally non-nationals. This is a statement regularly found when the Court applies a *nationality-based approach* under Article 39 EC.

5.5.2 A Free Movement-Based Approach under Article 39 EC

A case where the ECJ applied a *free movement-based approach* under Article 39 EC is the *de Groot*[83] case. This case is not dealt with in this section but in Chapter 6, as it deals directly with tax treaty provisions and their compatibility with Article 39 EC.[84]

5.5.2.1 The Mertens Case

In the *Mertens*[85] case Mr Mertens, a Belgian resident, had suffered a loss from a self-employed activity in Belgium.[86] At the same time he received employment income from Germany. The tax treaty in force between Belgium and Germany was based on the OECD Model and applied exemption with progression as relief method.[87] Under Article 15 (1) of that tax treaty, Germany had the right to tax such income, and consequently, Belgium was obliged to apply exemption with progression. Under Belgian internal legislation, the loss from the self-employed activity could only be carried forward after having been set off against the positive income deriving from Germany even though this income was tax exempt in

[82] *Ibid.*, para. 23.

[83] Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819.

[84] See section 6.5.

[85] Case C-431/01 *Philippe Mertens* v *Belgian State* [2002] ECR I-7073 (Order of the Court (First Chamber) of 12 September 2002). The *Mertens* case was decided by order, using the short procedure provided for by Article 104 (3) of the Court's Rules of Procedure.

[86] Case C-431/01 *Philippe Mertens* v *Belgian State* [2002] ECR I-7073, paras. 10–11.

[87] *Ibid.*, para. 9.

Belgium.[88] Mr Mertens argued that the Belgian legislation was contrary to Articles 39 and 43 EC.

The ECJ first emphasized that according to the Court's case law, even though the rules on free movement of persons were according to their wording directed towards establishing national treatment in the host state, they also precluded the state of origin from imposing restrictive measures.[89] The Court found that persons who had exercised their right of free movement were treated less favourably than persons who had not done so.[90] According to the Court, such legislation is liable to deter a taxpayer from taking up employment in other Member States and is, therefore, regarded as a restriction under Article 39 EC.[91] The Court did not accept any justification for the restrictive measure.

The Court clearly applied a *free movement-based approach* as its reasoning focused on the effect of the legislation on persons who wanted to exercise their right to free movement and take up employment in another Member State. The Belgian legislation was assessed from a home state perspective as the Court analysed its effect on persons resident in Belgium. It is also worth noticing that the Court repeated its well-known definition of discrimination from the *Schumacker* case in the *Mertens* case: discrimination requires that either different rules are applied to two groups of persons who are, from a legal and factual perspective, in comparable situations, or that the same rule is applied to different situations.[92] This is somewhat unexpected as it is the first case where the ECJ refers to this definition in a situation which is assessed by the Court using a *free movement-based approach*. The other cases where the Court has referred to this definition have all been cases where the Court has applied a *nationality-based approach*, for instance *Wielockx*, *Gschwind* and *Zurstrassen*.

5.5.2.2 The Schilling Case

The *Schilling*[93] case concerned the interpretation of Article 39 EC and Article 14 of the Protocol on the Privileges and Immunities of the European Communities in relation to German tax legislation. The dispute

[88] *Ibid.*, paras. 5–6.
[89] *Ibid.*, para. 27.
[90] *Ibid.*, paras. 28–31.
[91] *Ibid.*, para. 33.
[92] See Cordewener, *Foreign Losses, Tax Treaties and EC Fundamental Freedoms: A New German Case before the ECJ*, ET 2003, p. 299.
[93] Case C-209/01 *Theodor Schilling and Angelika Fleck-Schilling* v *Finanzamt Nürnberg-Süd* [2003], not yet reported in ECR.

regarded tax deductibility in Germany of expenditure incurred in respect of a household assistant employed and working in Luxembourg.

Mr and Mrs Schilling, both German nationals, moved to Luxembourg to work as officials of the European Communities.[94] During their time in Luxembourg, where they were resident and had their centre of interest, Mr Schilling received income from Germany from letting property and self-employed work. In Luxembourg, the couple employed a household help for whom they paid contributions to the Luxembourg statutory pension insurance scheme.[95] A deduction of the expenditure incurred in respect of the household assistant was refused on grounds that no contribution had been paid to the German statutory pension insurance scheme.[96]

The Court referred to the *de Groot*[97] case and held that:

> "[a]ny Community national who, irrespective of his place of residence and his nationality, has exercised the right to freedom of movement for workers and who has been employed in a Member State other than that of residence falls within the scope of Article 48 of the Treaty [now Article 39 EC]."[98]

Moreover, the Court pointed out that provisions that "prevent or deter" a national of a Member State from leaving his state of origin to exercise his right to freedom of movement constitute an obstacle to that freedom even if they apply without regard to the nationality of the worker concerned.[99] The Court found that if an official of the European Communities who is of German origin and who, while working in another Member State, maintains his habitual residence in his state of origin and employs a household assistant in that state, for whom he pays contributions to that state's statutory pension scheme, is in a position to benefit from the tax deduction in issue.[100] However, if the same circumstances apply but, like in the case of Mr and Mrs Schilling, the persons do not maintain their residence in Germany, they are not granted the tax deduction in Germany. The Court concluded that this shows that persons in the situation of Mr and Mrs Schilling are treated less favourably than persons who are in an identical situation but have retained their residence in the state or

[94] *Ibid.*, para. 9.
[95] *Ibid.*, para. 10.
[96] *Ibid.*
[97] Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819. See section 6.6.
[98] Case C-209/01 *Theodor Schilling and Angelika Fleck-Schilling* v *Finanzamt Nürnberg-Süd* [2003], not yet reported in ECR, para. 23.
[99] *Ibid.*, para. 25.
[100] *Ibid.*, para. 33.

origin.[101] Accordingly, the German legislation was held to be liable to deter nationals of one Member State from leaving that state in order to work, as officials of the European Communities, within the territory of another Member State and, therefore, constituted a barrier to the free movement of workers.[102] The Court found that the German legislation could not be justified.[103]

The German legislation was analysed from a home state perspective. The Court focused on its effect on German residents who wanted to work outside Germany. It is a clear example of a *free movement-based approach* since the ECJ compared a German resident who had exercised his right to free movement with a German resident not having exercised that right. Moreover, the Court held that the German legislation was liable to deter persons from leaving Germany in order to work in another Member State.

5.5.3 Summary and Analysis

The cases studied in this section confirm the results achieved in Chapter 4 concerning the circumstances under which a *nationality-based approach* and a *free movement-based approach* are applied by the ECJ. The former approach is applied when the ECJ analyses tax legislation from a host state perspective. The latter approach is applied when the ECJ assesses tax legislation from a home state perspective, *i.e.* when focusing on its effect on residents in that Member State.

Under the *nationality-based approach,* the main line of reasoning has been that even though the tax rule applied irrespective of nationality, there is a risk that it will work to the particular detriment of nationals of other Member States. This reasoning is found in *Biehl*, *Bachmann* and *Schumacker.* In *Zurstrassen,* the Court argued that the residence requirement was easier to satisfy by Luxembourg nationals than by nationals of other Member States. Therefore, the Court concluded that the national legislation was contrary to the free movement of workers.

The *Mertens* and *Schilling* cases have both been assessed by the Court applying a *free movement-based approach.* In *Mertens,* the Court found that persons who had used their right to free movement were treated less favorably than persons who had not done so, and that is why the national legislation was liable to deter a taxpayer from exercising his right to free movement. Also in the *Schilling* case, the Court held that legislation that

[101] *Ibid.*, para. 35.
[102] *Ibid.*, para. 37.
[103] *Ibid.*, paras. 40–43.

is liable to deter nationals of one Member State from leaving that state and work in another Member State is prohibited by Article 39 EC.

In *Bachmann*, where the national tax legislation was assessed both in relation to Article 39 EC and 49 EC, the ECJ applied a *nationality-based approach* in both assessments. When analysing the national legislation in relation to Article 49 EC, the Court emphasized its effect on foreign service providers and reached its conclusion in regard to their right to provide services. Under the Court's assessment under Article 39 EC, Mr Bachmann's new residence state Belgium was considered as his host state. When analysing the Belgian legislation under Article 49 EC, the Court assessed it from a host state perspective in relation to foreign service providers.

In many of these cases, for instance in *Biehl, Schumacker* and *Zurstrassen,* the Court has stated that covert and overt discrimination is forbidden. Also the term indirect discrimination has been used. However, the Court has consistently refrained from classifying the actual national tax provision by using these terms. Instead, the Court has held that discrimination has arisen or that an obstacle is evident. When applying a *nationality-based approach,* establishing discrimination on grounds of nationality, it would have been helpful if the ECJ had classified the discrimination using the terms which are mentioned in its judgments, for example indirect discrimination. This would have increased the legal certainty as the Court itself has stated that the distinction between different types of discrimination is of importance when considering possible justifications.[104]

In terms of terminology, the Court's statements in the *Mertens* case are also worth noticing. In this case, the Court repeated its well-known definition of discrimination from the *Schumacker* case: discrimination requires that either different rules are applied to two groups of persons who are, from a legal and factual perspective, in comparable situations, or the same rule is applied to different situations. This is unexpected as it is the first case where the ECJ refers to this definition in a situation which is assessed by the Court using a *free movement-based approach.* The other cases where the Court has referred to this definition have all been cases where the Court has applied a *nationality-based approach*, for instance *Wielockx*, *Gschwind* and *Zurstrassen*. This shows that the Court uses the term discrimination not only when there is discrimination on grounds of nationality or residence but also when there is a difference in treatment based on other distinguishing factors, such as whether or not a person has used his right to free movement. This use of the term discrim-

[104] See section 3.5.

ination does not facilitate the understanding of the Court's case law. On the contrary, to keep the different prohibitions separated makes it easier to understand and, hence, predict the Court's assessment of a given national measure. Presumably, the reason is that it is an application of two fundamentally different prohibitions, either a prohibition of discrimination on grounds of nationality or a prohibition of measures hindering the free movement.

In all cases dealt with in this section, the Court has considered non-Treaty grounds as possible justifications. However, it was only in *Bachmann* that the Court accepted a non-Treaty ground as justification in relation to the Belgian law, namely the cohesion of the tax system.

5.6 Freedom of Establishment in Relation to Income Tax Cases

5.6.1 A Nationality-Based Approach under Article 43 EC

In the following cases, the Court's reasoning is classified as a *nationality-based approach.* In order to facilitate the reading, the cases are presented in a chronological order under three sub-headings: Individuals, Permanent Establishments and Subsidiaries.

5.6.2 Individuals

5.6.2.1 The Wielockx Case

In relation to Article 39 EC, the ECJ in the *Schumacker* case held that non-residents and residents were, as a general rule, not in comparable situations. An exception to this rule was evident when a non-resident received no significant income in his state of residence and obtained the major part of his taxable income from an activity performed abroad with the result that his state of residence was not able to grant him the tax benefits following the taking into account of his personal and family circumstances.[105] In the *Wielockx*[106] case, the ECJ reaffirmed this position in relation to self-employed persons.

[105] Case C-279/93 *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225, para. 36.

[106] Case C-80/94 *G.H.E.J. Wielockx* v *Inspecteur der Directe Belastingen* [1995] ECR I-2493.

Mr Wielockx was a Belgian national. He was a partner in a physiotherapy practise in the Netherlands and received his entire income there. Under Dutch rules, he was denied a deduction from his taxable income of contributions to a pension reserve. The reason was that he did not reside in the Netherlands.

The ECJ repeated some of its statements from the *Schumacker* case. It held, for instance, that discrimination arises through the application of different rules to comparable situations or the application of the same rule to different situations.[107] It also held that the situations of residents and non-residents in a given state are not generally comparable, as there are objective differences between them from the point of view of the source of the income and the possibility of taking into account their ability to pay.[108] In reference to the exception to this main rule the ECJ stated that:

> "a non-resident taxpayer, whether employed or self-employed, who receives all or almost all of his income in the State where he works is objectively in the same situation in so far as concerns income tax as a resident of that State who does the same work there. Both are taxed in that State alone and their taxable income is the same."[109]

If a non-resident taxpayer is not granted the same tax treatment in terms of deductions as residents, his personal situation will neither be taken into account in the state where he works, since he is not a resident there, nor in his country of residence, because he receives no income there. The result is that his overall tax burden will be greater and he will be at a disadvantage compared to residents.[110] The Court concluded that a non-resident in Mr Wielockx position was discriminated.[111]

The Dutch government argued that its legislation was justified based on the principle of fiscal cohesion laid down in the *Bachmann* case since if a non-resident were allowed to set up a pension reserve in the Netherlands, that pension would not be taxable in the Netherlands.[112] According to the tax treaty between Belgium and the Netherlands, based on the OECD Model, such income was taxed in the residence state.[113] In its response, the Court limited the scope of the cohesion defence.[114] It held

[107] *Ibid.*, para. 17.
[108] *Ibid.*, para. 18.
[109] *Ibid.*, para. 20.
[110] *Ibid.*, para. 21.
[111] *Ibid.*, para. 22.
[112] *Ibid.*, para. 23.
[113] *Ibid.*
[114] *Ibid.*, para. 24.

that the effect of tax treaties following the OECD Model is that contracting states tax all pensions received by residents in their territory, regardless in which state the contributions were paid, but waives the right to tax pensions received abroad even if they derive from contributions paid and deducted in its territory. Therefore, the Court concluded that fiscal cohesion was not established in relation to one and the same person by strict correlation between the deductibility of contributions and the taxation of pensions. Instead, the correlation was shifted to another level, namely that of the reciprocity of the rules applicable in the contracting states.[115]

When analysing the Dutch legislation the ECJ compared the tax treatment of Mr Wielockx and that of Dutch residents. It found that residence was the determining factor putting the taxpayer at a disadvantage. Hence, the Court applied a *nationality-based approach.* The Dutch legislation was analysed from a host state perspective.

5.6.2.2 The Asscher Case and the Werner Case

The background to the *Asscher*[116] case was Dutch tax law distinguishing between two classes of taxpayers and taxing them at different rates. Those who were residents in the Netherlands, or who earned at least 90 per cent of their worldwide income in the Netherlands, paid 13 per cent income tax in the first band.[117] They also paid national insurance contributions, which were collected simultaneously, so that a total of 35.1 per cent of the income was deducted at source.[118] Those who resided outside the Netherlands and who earned more than 10 per cent of their worldwide income elsewhere paid income tax at a higher rate, 25 per cent in the first band.[119] However, they did not pay national insurance contributions.

Mr Asscher was a Netherlands national resident in Belgium. He earned income as a director of two companies, one in the Netherlands and one in Belgium. With regard to the Dutch company, Mr Asscher was the sole shareholder. Before 1986, Mr Asscher lived in the Netherlands. The move to Belgium did not involve any change in the activities he was engaged in neither in the Netherlands nor in Belgium.[120] After the move, he was taxed according to domestic law and the application of the Dutch-Belgian tax treaty in the following way. The remuneration he received

[115] *Ibid.* See section 6.7.3.
[116] Case C-107/94 *P. H. Asscher* v *Staatssecretaris van Financiën* [1996] ECR I-3089.
[117] *Ibid.*, para. 6.
[118] *Ibid.*, para. 7.
[119] *Ibid.*, para. 8.
[120] *Ibid.*, para. 12.

from his company in the Netherlands was taxed exclusively in that country.[121] In his state of residence, Belgium, he was taxed on the remainder of his income. However, according to Article 24 of the applicable tax treaty, which prescribed exemption with progression, Belgium was entitled to take the exempt income into account when determining the rate of tax and thereby apply progressive taxation.[122] After Mr Asscher's move, he paid national insurance contributions in Belgium alone.[123] He objected to the levy of the Dutch income tax at the rate of 25 per cent. He contended that the application of this higher rate constituted indirect discrimination on grounds of nationality.[124]

The Court considered whether Mr Asscher, as a national of the Netherlands, was entitled to take the benefit from Article 43 EC in relation to his state of origin, the Netherlands. It held that the provisions relating to freedom of establishment:

> "cannot be interpreted in such a way as to exclude a given Member State's own nationals from the benefit of Community law where by reason of their conduct they are, with regard to their Member State of origin, in a situation which may be regarded as equivalent to that of any other person enjoying the rights and liberties guaranteed by the Treaty".[125]

Mr Asscher was considered to have exercised the rights and liberties recognized by the Treaty and was, therefore, entitled to rely on the relevant provisions thereof.[126]

The Court repeated its caution that, although direct taxation falls within the competence of the Member States, they must nevertheless exercise that competence consistently with Community law and therefore avoid any overt or covert discrimination by reason of nationality.[127] The Court found that the legislation at hand applied irrespectively of the nationality of the taxpayer concerned.[128] As a result, the question of direct discrimination was ruled out. The Court proceeded by stating that legislation which laid down a distinction founded on residence, and applied a higher tax rate to non-residents, was "liable to act mainly to the

[121] *Ibid.*, para. 14.
[122] *Ibid.*, para. 15.
[123] *Ibid.*, para. 17.
[124] *Ibid.*, para. 18.
[125] *Ibid.*, para. 32. See also Case C-19/92 *Dieter Kraus* v *Land Baden-Württemberg* [1993] ECR I-1663, para. 15 (see section 4.2.3.1 of this study).
[126] Case C-107/94 *P. H. Asscher* v *Staatssecretaris van Financiën* [1996] ECR I-3089, para. 33.
[127] *Ibid.*, para. 36.
[128] *Ibid.*, para. 37.

detriment of nationals of other Member States, since non-residents are most frequently non-nationals".[129] The Court explicitly classified the Dutch legislation as constituting indirect discrimination on grounds of nationality.[130] This is one of the few cases concerning income taxation where the ECJ is actually explicitly categorising the restrictive measure. This categorisation has been commented on in the literature, something that is presented below. The ECJ held that the difference in treatment in the *Asscher* case was constituted by the fact that non-residents were generally taxed at 25 per cent while residents were taxed at 13 per cent.[131]

It was argued that the Dutch legislation was crucial to prevent non-residents from escaping from progressive taxation.[132] This argument was not accepted by the ECJ as it ignored that under the tax treaty in force, following the OECD Model, Belgium applied exemption with progression.[133] Therefore, Mr Asscher did not escape the application of progressive taxation. Two other justifications for the legislation were also put forward. It was argued that the legislation was necessary to ensure fairness between residents and non-residents and that the cohesion of the tax system justified the legislation.[134] The contentions were of a non-Treaty character, something that is perfectly correct considering the Court's classification and its own statements. However, none of these were accepted as justifications for the Dutch legislation.

In *Asscher,* it was a Dutch national living in Belgium who was negatively affected by Dutch legislation. The rules in question were held to be indirectly discriminatory by the ECJ. Bearing in mind the concept of indirect discrimination, a distinction based on residence can hardly be said to operate as indirect discrimination on grounds of nationality where the non-resident is also a national of the same Member State.[135] A prohibition of discrimination on grounds of nationality ought not to be applied where discrimination is between different nationals of the same Member State.[136] However, that is exactly what the Court did in *Asscher.* Farmer

[129] *Ibid.*, para. 38.
[130] *Ibid.*, para. 39.
[131] *Ibid.*, para. 45.
[132] *Ibid.*, para. 46.
[133] *Ibid.*, para. 47.
[134] *Ibid.*, paras. 51–59.
[135] See Stanley, *Case C-107/94, Asscher v Staatssecretaris van Financiën. Judgment of 27 June 1996. Fifth Chamber. [1996] ECR I-3089,* CMLRev 34, 1997, p. 718. The Court applied a similar reasoning in Case C-419/92 *Ingetraut Scholz* v *Opera Universitaria di Cagliari and Cinzia porcedda* [1994] ECR I-505.
[136] See Stanley, *Case C-107/94, Asscher v Staatssecretaris van Financiën. Judgment of 27 June 1996. Fifth Chamber. [1996] ECR I-3089,* CMLRev 34, 1997, p. 718.

has described the Court's classification in *Asscher* as "rather artificial – the discrimination is not against a national of another Member State but against the exercise by one of its own nationals of a Treaty freedom."[137]

By disregarding Mr Asscher's nationality and equating him with any person enjoying the rights and liberties of the EC Treaty, the Court was able to apply a traditional *nationality-based approach*. This case deals with the special situation where a Netherlands national leaves his home state and becomes a resident of another Member State but still receives income from the Netherlands. The Dutch rules were less favourable to him when he was a non-resident compared with when he was a resident. The Court is clearly taking into account that Belgium was Mr Asscher's new home state and the Dutch legislation was to be considered as host state legislation since the Court held that Mr Asscher was in a situation which was to be regarded as equivalent to that of any other person enjoying free movement rights. Hence, the Court emphasized Mr Asscher's connection with Belgium and neglected his Dutch nationality. This is probably the reason why the ECJ chose to describe the Asscher situation as indirect discrimination based on nationality. From the perspective of conceptual clarity this is not satisfying.

The *Asscher* case can most probably be considered as overruling the earlier *Werner*[138] judgment.[139] The situation in *Werner* was almost identical to the one in *Asscher.* In the former case, German legislation differentiated on grounds of taxpayer's residence. The question was whether the right to freedom of establishment precluded a Member State from making its own nationals, who worked in its territory and received all or almost all their income there, bear a heavier tax burden if they did not reside in that state than if they did.

Mr Werner, a German national, lived in the Netherlands together with his wife but worked at his own dental practice established in Germany. As Mr Werner did not reside in Germany, he was subject to limited tax liability. Accordingly, he was denied certain personal and family allowances.[140]

In the *Werner* case, the ECJ stressed that Mr Werner was a German national setting up practice in his state of origin and that he was subject

[137] Farmer, *The Court's case law on taxation: a castle built on shifting sands?* ECTRev 2003, p. 77.

[138] Case C-112/91 *Hans Werner* v *Finanzamt Aachen-Innenstadt* [1993] ECR I-7.

[139] Farmer has argued that the *Werner* case almost certainly has been overtaken by the directives conferring a right of residence and by the provisions on citizenship. See Farmer, *The Court's case law on taxation: a castle built on shifting sands?* ECTRev 2003, p. 77.

[140] Case C-112/91 *Hans Werner* v *Finanzamt Aachen-Innenstadt* [1993] ECR I-7, paras. 4–5.

to legislation of the state in which he was a national.[141] The Court also noted that the legislation in question applied by reference to a taxpayer's place of residence, and not to his nationality.[142] Accordingly, the only factor which took Mr Werner's situation out of a purely national context was that he lived in a Member State other than in which he practised his profession.[143] These circumstances led the Court to conclude that it was in accordance with the provisions on the right to freedom of establishment to subject taxpayers not residing in Germany to a heavier tax burden than taxpayers residing in Germany.[144]

Comparing the *Werner* case and the *Asscher* case, it can be concluded that the Court in the latter case took a totally different approach from the one in *Werner*. In *Werner*, the Court stressed that Mr Werner was subject to legislation of the state of which he was a national. The Court did not pay attention to this circumstance in the later *Asscher* case. The *Werner* approach is more correct in terms of conceptual clarity. However, it is not satisfying considering that a person living in the Netherlands, who is of Dutch nationality or a national of any other EU Member State but Germany, most likely would be able to argue the case of indirect discrimination towards Germany if being subject to the German legislation at issue in the *Werner* case.

5.6.3 Permanent Establishments

A case where the ECJ applied a *nationality-based approach* and which involved PEs is the *Saint-Gobain*[145] case. This case is not handled in this section, but in Chapter 6, as it deals directly with the compatibility of tax treaty provisions with Article 43 EC.

5.6.3.1 The Avoir Fiscal Case

The *Avoir Fiscal*[146] case is usually referred to as the first case where the ECJ interpreted a free movement provision in relation to a Member State's income tax legislation. The Commission brought this case to the ECJ arguing that the French legislation did not grant the tax benefit of shareholders' tax credit (*avoir fiscal*) to branches in France of insurance companies established in other Member States on the same terms as

[141] *Ibid.*, paras. 13–14.
[142] *Ibid.*, para. 15.
[143] *Ibid.*, para. 16.
[144] *Ibid.*, para. 17.
[145] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161.
[146] Case 270/83 *Commission* v *France* [1986] ECR 273.

those enjoyed by French companies. Therefore, the French legislation was in breach of Article 43 EC. The French legislation granted the tax credit to persons residing in France or having their registered office there.[147] It was also granted by means of tax treaties to persons residing in these states.[148]

In *Avoir Fiscal* the Court initially held that:

> "freedom of establishment for nationals of one Member State on the territory of another includes the right to take up and pursue activities as self-employed persons and to set up and manage undertakings under the conditions laid down for its own nationals by the law of the country where such establishment is effected. The abolition of restrictions on freedom of establishment also applies 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."[149]

The Court also held that the right to freedom of establishment is intended to guarantee that all nationals of Member States who have established themselves in another Member State, even if that establishment is of a secondary nature, for the purpose of pursuing activities there as self-employed persons have the right to receive the same treatment as nationals of that state. Therefore, the freedom of establishment prohibits, as a restriction on the freedom of establishment, any discrimination on grounds of nationality "resulting from the legislation of the Member State"[150]. The Court described the content of the freedom of establishment in terms of national treatment in the host state, which is the same as applying a *nationality-based approach* to host state legislation.

The Court stated that the difference in treatment was based on whether a company's registered office was located in France or not.[151] In this context, the Court held that the registered office constituted the same factor for a company as nationality does for natural persons.

In the *Avoir Fiscal* case, the ECJ did not rule out that a distinction based on residence of an individual, or the location of the registered office of a company, may, under certain conditions, be justified in an area such as tax law.[152] However, in this case the Court gave prominence to that the French legislation did not distinguish between companies having their registered office in France and branches situated in France with

[147] *Ibid.*, para. 4.
[148] *Ibid.*, paras. 4–5.
[149] *Ibid.*, para. 13.
[150] *Ibid.*, para. 14.
[151] *Ibid.*, para. 18.
[152] *Ibid.*, para. 19.

their registered office abroad when it came to taxing their income. In doing that, the French legislature had admitted that there was no objective difference between their situations which could justify different treatment.[153] The difference in treatment could not be justified by an advantage which branches might enjoy in comparison to those benefiting from the shareholder's tax credit.[154] Moreover, the fact that companies whose registered office was situated in another Member State were at liberty to establish themselves by setting up a subsidiary and thereby receive the tax credit could not justify the difference in treatment. The Court stated that the freedom of establishment leaves traders free to choose the appropriate legal form to pursue their activities in another Member State and that freedom of choice must not be limited by discriminatory tax provisions.[155]

The French government argued that the difference in treatment was due to the particular characteristics and of the differences between the tax systems applying in the various Member States and to the tax treaties.[156] As the legislation was not harmonized, different measures were necessary in each case to take account of the differences between tax systems, and that was why the French legislation ought to be justified. Moreover, the French government pointed out that the legislation was necessary in order to prevent tax evasion.[157] Finally, it was argued that the French legislation was in line with the freedom of establishment as the application of tax legislation to persons pursuing their activities in different Member States was governed by tax treaties, the existence of which was expressly recognized by the EC Treaty.

In regard to the arguments put forward as justifications of the French legislation, the ECJ held that the fact that the laws of the Member States on corporation tax had not been harmonized could not justify the difference in treatment in this case.[158] The ECJ also turned down the tax evasion argument.[159] In response to the tax treaty argument, the Court called attention to that the right conferred by Article 43 EC was unconditional and, accordingly, a Member State could not make its respect for them subject to the contents of an agreement concluded with another Member State. Those rights could not be made subject to a condition of reciprocity

[153] *Ibid.*, para. 20.
[154] *Ibid.*, para. 21.
[155] *Ibid.*, para. 22.
[156] *Ibid.*, para. 23.
[157] *Ibid.*
[158] *Ibid.*, para. 24.
[159] *Ibid.*, para. 25.

imposed for the purpose of obtaining corresponding benefits in other Member States.[160] Consequently, the French legislation was in breach of the freedom of establishment.

The contested legislation in the *Avoir Fiscal* case was legislation analysed by the ECJ from a host state perspective and it applied a *nationality-based approach*.[161] The French legislation differentiated based on the place of registered office of the company, which the Court placed on an equal footing with the nationality for individuals. Accordingly, it was a situation of discrimination based on nationality, which is commonly referred to as direct discrimination.[162] The justifications put forward were of a non-Treaty character, and the Court considered them but did not accept any of them as valid justifications. When considering the non-Treaty grounds for justification, the ECJ acted contrary to its own statements as the national measure most likely is to be classified as directly discriminatory on grounds of nationality.[163]

5.6.3.2 The Commerzbank Case

In *Commerzbank*[164], it was argued that tax legislation in the UK which granted a repayment supplement connected to a tax refund only to companies resident for tax purposes in the UK was contrary to the right to freedom of establishment.

Commerzbank was a company incorporated and with its registered office in Germany. Commerzbank had, through its branch in the UK, granted loans to US companies. The company paid tax on the interest in the UK.[165] According to the tax treaty between the UK and the US, the interest was tax exempt in the UK as the branch of Commerzbank was not resident for tax purposes in that country.[166] Accordingly, Commerz-

[160] *Ibid.*, para. 26.

[161] See Lehner, *Limitation of the national power of taxation by the fundamental freedoms and non-discrimination clauses of the EC Treaty,* ECTRev 2000, p. 8.

[162] Similarly Bergström, *Restrictions on Free Movement and the Principle of Non-Discrimination in EC Law and their Implications for Income Taxation,* in Lindencrona, Lodin & Wiman (eds.), *International Studies in Taxation: Law and Economics: Liber Amicorum Leif Mutén,* (1999), p. 49.

[163] In Case C-311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651, para. 33 the Court refused to assess non-Treaty grounds of justification in regard to a national measure employing the same kind of distinction as the French legislation in *Avoir Fiscal*. For further comments, see Barnard, *The Substantive law of the EU – The Four Freedoms,* (2004), p. 327. See section 3.5 of this study.

[164] Case C-330/91 *The Queen* v *Inland Revenue Commissioners, ex parte Commerzbank AG* [1993] ECR I-4017.

[165] *Ibid.*, para. 4.

[166] *Ibid.*, para. 5.

bank received a refund of the overpaid tax but it was denied the repayment supplement, a statutory compensation in the nature of interest.[167] The supplement was only available to companies having their fiscal residence in the UK.

In *Commerzbank,* the ECJ reiterated its statements in *Avoir Fiscal* regarding the content of the freedom of establishment. The Court stressed that for companies it is their seat that serves as the connecting factor within the legal system of a particular country, like nationality in the case of individuals.[168] The Court added, citing its judgment in *Sotgiu*[169], that the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality or, in the case of a company, its seat, but all covert forms of discrimination which, by the application of other criteria of differentiation, would lead to the same result.[170] The conclusion was that the UK legislation applied independently of a company's seat, as the distinguishing factor was fiscal residence, the legislation was liable to work more particularly to the disadvantage of companies having their seat in other Member States.[171]

In order to justify its legislation, the UK government argued that non-resident companies which were in Commerzbank's situation suffered no discrimination under UK tax legislation, but rather enjoyed privileged treatment. They were exempt from tax which was payable by resident companies. Accordingly, they were in different situations.[172] The ECJ responded that the fact that the exemption from tax, which gave rise to the refund, was available only to non-resident companies, could not justify a general rule withholding the benefit.[173]

It seems as if the ECJ considered non-resident companies to be in a comparable situation to resident companies even though non-resident companies were tax exempt. It is apparent that the ECJ in *Avoir Fiscal* assimilated corporate seat to nationality. It has been argued that the Court then had in mind the broad concept of seat in any of the three specific senses described in Article 48 EC.[174] In *Commerzbank,* the Court did not explicitly classify the restrictive measure but reasoned in a way typical

[167] *Ibid.*, paras. 5–6.

[168] *Ibid.*, para. 13.

[169] Case 152/73 *Sotgiu* v *Deutsche Bundespost* [1974] ECR 153, para. 11 (see section 4.2.2.1 of this study).

[170] Case C-330/91 *The Queen* v *Inland Revenue Commissioners, ex parte Commerzbank AG* [1993] ECR I-4017, para. 14.

[171] *Ibid.*, para. 15.

[172] *Ibid.*, para 16.

[173] *Ibid.*, para. 19.

[174] Roussos, *Realising the Free Movement of Companies*, EBLR 2001, p. 10.

for indirect discrimination. It argued that the legislation was liable to work more to the disadvantage of companies having their seat in other Member States. Accordingly, legislation distinguishing on grounds of fiscal residence is potentially considered as indirect discrimination. The UK government argued that discrimination was not at hand as the situations were not comparable. The Court did not accept this line of reasoning.

The UK legislation was, from the perspective of Commerzbank, host state legislation, and the Court also assessed it from this perspective. The branch of Commerzbank was denied the interest because it was not resident for tax purposes in the host state. The Court applied a *nationality-based approach* stating that the UK legislation was liable to work more particularly to the disadvantage of companies having their seat in other Member States.[175]

5.6.3.3 The Futura Case

Two legal issues were analysed in the *Futura*[176] case.[177] The first question concerned whether the freedom of establishment precluded a Member State from making the carrying forward of losses subject to the condition that the losses must be economically related to the income earned by the taxpayer.

The second question was whether it was contrary to Article 43 EC to require that the taxpayer, during the financial year in which the losses were incurred, had to keep and hold in the state where the branch (constituting a PE) was located accounts complying with the relevant national rules of that country. The accounts in question were the ones concerning activities carried out in the state where the branch was located. These questions arose out of a dispute between Singer, the Luxembourg branch of the French company Futura and the Luxembourg tax authorities.

The Court initially considered the condition that the losses carried forward had to be economically linked to the income earned in the Member State in which the tax was charged. This condition resulted in a situation where only losses arising from the non-resident taxpayer's activities in

[175] For further analysis, see Barnard, *The Substantive law of the EU – The Four Freedoms*, (2004), p. 328.

[176] Case C-250/95 *Futura Participations SA and Singer* v *Administration des contributions* [1997] ECR I-2471.

[177] For comments in the literature, see, for instance, Farmer, *EC Law and national rules on direct taxation: a phoney war?* ECTRev 1998, pp. 13–29. One may argue that the *Futura* case is not an income tax case as the question was the compatibility of two bookkeeping obligations with Article 43 EC. However, in this study the case is dealt with in relation to income tax cases because of its relevance and close connection to income taxation.

that state could be carried forward.[178] The Court held that such a condition was in conformity with the fiscal principle of territoriality and could, therefore, not be regarded as "entailing any discrimination, overt or covert, prohibited by the Treaty" as long as resident taxpayers did not receive more favourable treatment.[179]

When analysing the second question, the condition of separate accounts kept in Luxembourg in accordance with national rules, the ECJ held that "the imposition of such a condition, which specifically affects companies or firms having their seat in another Member State, is in principle prohibited".[180] The Court went on to examine whether the condition could be justified by reasons related to the effectiveness of fiscal supervision, a justification which the Court referred to as an overriding requirement of general interest capable of justifying a restriction on the exercise of fundamental freedoms.[181] It stated that "a Member State may therefore apply measures which enable the amount of both the income taxable in that State and of the losses which can be carried forward there to be ascertained clearly and precisely".[182] The Court found that provided that the taxpayer demonstrates, clearly and precisely, the amount of the losses concerned, the Luxembourg authorities were not allowed to refuse him to carry them forward even though he had neither kept nor held in Luxembourg proper accounts.[183] The second condition was, therefore, in breach of Article 43 EC.

When assessing the requirement that losses had to be economically linked to domestically earned income, the ECJ started by reiterating that the Member States must comply with Community law and, therefore, avoid tax legislation giving rise to overt or covert discrimination. It concluded that such a system, which was in conformity with the fiscal principle of territoriality, could not be regarded as entailing any discrimination, overt or covert, which was prohibited by the EC Treaty. Hatzopoulous has argued that in order to arrive at that conclusion, the ECJ ignored both the wording and the material effects of the Luxembourg legislation;

[178] Case C-250/95 *Futura Participations SA and Singer* v *Administration des contributions* [1997] ECR I-2471, para. 18.
[179] *Ibid.*, para. 22.
[180] *Ibid.*, para. 26.
[181] *Ibid.*, para. 31.
[182] *Ibid.*
[183] *Ibid.*, para. 39.

neither did it try to establish whether the taxpayers concerned were in objectively different situations.[184]

The Court's reasoning may be interpreted as suggesting that there are national measures which, even though they are discriminatory with reference to nationality, are in line with the free movement rules because they are in conformity with essential principles of another field of law.[185] Hatzopoulous takes this position and concludes that the fact that essential rules of another field of law may serve as a shield from qualifying a distinctly applicable national measure from being discriminatory is perfectly sensible.[186] From the perspective of conceptual clarity, however, the Court's reasoning on this point seems insufficient. Instead, the principle of territoriality should be applied as a justification.[187] Therefore, it can be argued that the discrimination test is to be carried out objectively, and possible justifications are to be applied separately after the discrimination issue is established. Hence, while the material outcome of the case cannot be criticized, the Court's reasoning seems unsatisfactory.

Considering the classification of the Luxembourg legislation, it is worth noticing that when the Court analysed the economic link requirement, it argued in terms of discrimination. However, when assessing the requirement of the keeping of accounts, the Court did not use the term discrimination but the term restriction.[188] The Court did not explicitly classify the latter requirement but held that it specifically affected companies or firms having their seat in another Member State and was therefore, in principle, prohibited by Article 43 EC. The Court explained that it could be otherwise if the Luxembourg legislation pursued a legitimate aim compatible with the EC Treaty and were justified by pressing reasons of public interests.[189] This is a description that is similar to the *Gebhard* test.[190]

[184] Hatzopoulos, *Case C-250/95, Futura Participations SA & Singer v Administration des Contributions (Luxembourg), Judgment of 15 May 1997, [1997] ECR I-2471*, CMLRev 35, 1998, pp. 501–502.

[185] See section 6.4.

[186] Hatzopoulos, *Case C-250/95, Futura Participations SA & Singer v Administration des Contributions (Luxembourg), Judgment of 15 May 1997, [1997] ECR I-2471*, CMLRev 35, 1998, p. 502.

[187] For instance, in Case C-168/01 *Bosal Holding BV* v *Staatssecretaris van Financiën* [2003] ECR I-9409, paras. 37–39, the Court in its reasoning considered the territoriality principle as a justification.

[188] Case C-250/95 *Futura Participations SA and Singer* v *Administration des contributions* [1997] ECR I-2471, para. 24.

[189] *Ibid.*, para. 26.

[190] See section 3.5.3.

In the *Futura* case, the legislation at issue was host state legislation. The economic link requirements were analysed using a *nationality-based approach*. When analysing the bookkeeping obligations, which applied both to residents and non-residents,[191] the Court held that they specifically affected companies or firms having their seat in another Member State. Such a company had to keep two sets of accounts: one set complying with the accounting rules applicable in the state where it had its seat, another complying with the rules in Luxembourg, where its branch was located. The Court focused on whether the effect of the legislation had a more negative effect on companies having their seat in other Member States. Therefore, one may reach the conclusion that also the requirement of keeping accounts was analysed by using a *nationality-based approach*. However, the bookkeeping obligation has been described in the literature as a non-discriminatory restriction caused by equal treatment in the state of source, since Futura was treated in the same way as resident taxpayer, accordingly an expression of a "restriction-based" reading of the Treaty.[192]

5.6.3.4 The Royal Bank of Scotland Case

Greece applied two different corporate tax rates with respect to banks which had their taxable seat in Greece and banks which had their fiscal seat outside Greece and were represented in Greece only by way of a PE. The latter were taxed at a higher rate than the former.[193] The *Royal Bank of Scotland*[194] case concerned the question whether this Greek legislation was in line with the freedom of establishment. The question was raised in proceedings between the Royal Bank of Scotland, which had its seat in the UK and carried on business in Greece through a branch (constituting a PE), and the Greek tax authorities.[195]

The ECJ held that in the field of self-employment the essential aim of Article 43 EC is to implement the principle of equal treatment.[196] Then, it

[191] See Cordewener, *The prohibitions of discrimination and restrictions have both been intended to achieve a fully integrated internal market in the European Union,* Report at the 2004 Paris meeting of the EATLP, p. 12.

[192] See Lehner, *Fundamental freedoms and national sovereignty in the EU,* Report at the 2004 Paris meeting of the EATLP, p. 6 and Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles,* (2002), p. 358.

[193] Case C-311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651, para. 2.

[194] Case C-311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651.

[195] *Ibid.*, paras. 2–3.

[196] *Ibid.*, para. 21.

described the contents of Article 43 EC in words similar to those used in *ICI*.[197] As a company's seat serves as the connecting factor with the legal system of a particular state, similar to nationality in the case of individuals, the Court held that "[a]cceptance of the proposition that the Member State in which a company seeks to establish itself may freely apply to it different treatment solely by reason of the fact that its seat is situated in another Member State would thus deprive the provision of all its meaning".[198]

Next, the Court analysed whether a company having its seat in Greece and a company having a branch (PE) established in Greece but with its seat in another Member State were in comparable situations. Citing *Schumacker* and *Asscher*, the Court stated that although residents and non-residents generally were not in comparable situations, a denial of a tax advantage to non-residents might constitute discrimination where there was no objective difference such as to justify the difference in treatment.[199] In terms of the method of determining taxable base, the Greek legislation did not establish any distinction which could justify a difference in treatment between the two categories of companies.[200] The fact that companies having their seat in Greece were taxed on their worldwide income and the branches of foreign companies were taxed in Greece only on the basis of the profits of the branch were not considered to prevent the two categories of companies from being considered as being in a comparable situation.[201] The Greek legislation was found to be contrary to the freedom of establishment.

Considering income tax cases, the ECJ made a rather unprecedented statement when dealing with the issue of justification of the discrimination evident in the Greek legislation. The Court held that:

> "[a]ccording to settled case-law, only express derogating provisions, such as Article 56 of the Treaty [now Article 46 EC], could render such discrimination compatible with Community law".[202]

The Court simply acknowledged that the Greek government had not relied on any such grounds and the legislation was not found to be justified.[203] What the Court did was to simply follow explicit statements

[197] Case C-264/96 *Imperial Chemical Industries plc (ICI)* v *Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-4695 (see section 5.6.5.1 of this study).
[198] Case C-311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651, para. 23.
[199] *Ibid.*, para. 27.
[200] *Ibid.*, para. 28.
[201] *Ibid.*, para. 29.
[202] *Ibid.*, para. 32.
[203] *Ibid.*, para. 33.

made by the Court in earlier cases in relation to other fields of law, namely that direct discrimination can only be justified having regard to treaty justifications. However, the Court did not refer to direct discrimination, only "such discrimination". Bearing in mind that the legislation differentiated based on the location of a company's seat, which the Court has at various occasions equated with nationality for individuals, it is most likely classified by the ECJ as being directly discriminatory. Moreover, this approach to imperative interests is different from the one presented by the Court in, for instance, *Avoir Fiscal*.

The *Royal Bank of Scotland* case is a case of host state legislation implying a higher tax rate for branches of foreign companies in comparison to branches to domestic companies. The Court analysed the legislation from a host state perspective. Furthermore, the Court used a *nationality-based approach* arguing that the proposal that the Member State in which a company seeks to establish itself may freely apply different treatment to it solely by reason that its seat is situated in another Member State would deprive Article 43 EC of all meaning. The Court once again equated a company's seat to nationality of individuals. It accepted justification on grounds of explicit treaty justifications only.

5.6.4 Subsidiaries

5.6.4.1 The Baxter Case

The question in *Baxter*[204] was whether it was contrary to Articles 43 EC and 48 EC for a Member State to deny a tax deduction for research expenditures when the research was carried out outside the state but allow the deduction when the research was carried out within the state in question. France charged a special levy on undertakings established in France that exploited proprietary medical products there. The special levy was charged on pre-tax turnover, and deductions were allowed for expenditure on research carried out in France but denied when the research was carried out elsewhere.[205]

The *Baxter* case concerned a subsidiary established in France of a parent company established in another Member State. The company argued that the French legislation caused discrimination between French labora-

[204] Case C-254/97 *Société Baxter, B. Braun Médical SA, Société Fresenius France and Laboratoires Bristol-Myers-Squibb SA* v *Premier Ministre, Ministère du Travail et des Affaires sociales, Ministère de l'Economie et des Finances and Ministère de l'Agriculture, de la Pêche et de l'Alimentation* [1999] ECR I-4809.

[205] *Ibid.*, para. 6.

tories carrying out research mainly in France and foreign laboratories having their principal research units outside France.[206]

When analysing the situation, the Court first observed that Article 48 EC gives companies constituted in accordance with the law of a Member State and having its registered office, central administration or principal place of business within the Community the right to carry on business in other Member States though a branch, agency or subsidiary.[207] The Court also referred to *Commerzbank* and held that "the rules regarding equality of treatment prohibit not only overt discrimination by reason of nationality or, in the case of a company, its seat, but all covert forms of discrimination which, by the application of other criteria of differentiation, lead in fact to the same result".[208] Next, the ECJ held that the tax allowance in question was likely to work more particularly to the detriment of undertakings having their principal place of business in other Member States and operating in France through a secondary establishment. The Court concluded that it was typically those undertakings which, in most cases, had developed their research activity outside the territory of France.[209] The Court found the French legislation to result in unequal treatment contrary to the right to freedom of establishment.

In its defence, the French government argued that the restriction on the deductibility of research costs was necessary for the French tax authorities to be able to ascertain the nature and genuineness of the research expenditure incurred. The Court rejected this argument, saying that as the national legislation absolutely prevented the taxpayer from submitting evidence, that expenditure had actually been incurred, and there was no assessment taking place under the French legislation.[210]

In *Baxter,* the ECJ argued in a way typical for indirect discrimination. It stated that the legislation in question was likely to work more particularly to the detriment of undertakings having their principal place of business in other Member States and operating in France through a secondary establishment, since it was typically those undertakings which, in most cases, had developed their research activity outside the territory of France. Consequently, it was not controversial that the Court considered the non-Treaty justification "effectiveness of fiscal supervision" put forward by the French government. In relation to the secondary establishment the French legislation was considered as host state legislation. As

[206] *Ibid.*, para. 4.
[207] *Ibid.*, para. 9.
[208] *Ibid.*, para. 10.
[209] *Ibid.*, para. 13.
[210] *Ibid.*, para. 19.

the Court focused on the negative effect of the French legislation on such establishments, one may conclude that the ECJ applied a *nationality-based approach.*

5.6.4.2 The Metallgesellschaft Case

In the *Metallgesellschaft*[211] case, the question was whether it was contrary to Article 43 EC for a Member State to have legislation under which companies resident in that Member State were allowed to benefit from a favourable tax regime where their parent company was also resident in that Member State, but were denied this benefit where their parent company had its seat in another Member State.[212]

The facts of the *Metallgesellschaft* case were, in brief, that a UK subsidiary with a parent company in another Member State was not able to join a group income election for dividends, whereas a UK subsidiary with a UK parent company was able to make such an election. The ECJ viewed the right to make the election as a favourable tax regime as it resulted in cash flow advantages.[213]

The Court argued that the UK legislation created a difference in treatment between subsidiaries resident in the UK depending on whether or not their parent company had its seat in the UK.[214] Accordingly, the UK legislation was found to be contrary to the freedom of establishment unless a valid justification was presented.[215] The ECJ rejected defences based on the risk of tax avoidance,[216] the loss of tax revenue[217] and the cohesion of the tax system[218].

In the *Metallgesellschaft* case, it was argued on behalf of the plaintiff that EC law required Member States to grant taxpayers from other Member States the same benefits that would arise under more favourable tax

[211] Cases C-397/98 and C-410/98 *Metallgesellschaft Ltd and others, Hoechst AG and Hoechst (UK) Ltd* v *Commissioners of Inland Revenue and HM Attorney General* [2001] ECR I-1727.

[212] For comments in the literature, see, for instance, Gammie and Brannan, *EC Law Strikes at the UK Corporation Tax – The Death Knell of UK Imputation?* Intertax 1995, pp. 389–405 and Richardson, *The Hoechst and Pirelli cases: the Adventure of an Innocent Abroad or the Curious Case of the Foreign Parents and the Missing Credit,* BTR 1998, pp. 283–316.

[213] Cases C-397/98 and C-410/98 *Metallgesellschaft Ltd and others, Hoechst AG and Hoechst (UK) Ltd* v *Commissioners of Inland Revenue and HM Attorney General* [2001] ECR I-1727, para. 44.

[214] *Ibid.*, para. 43.

[215] *Ibid.*, para. 76.

[216] *Ibid.*, paras. 57–58.

[217] *Ibid.*, para. 59.

[218] *Ibid.*, paras. 67–73.

treaties.[219] Both the Advocate General Fennelly and the ECJ avoided going into these questions. This is further discussed in Chapter 8.

When the ECJ assessed the situation, it focused on considering the UK as the host state.[220] In other words, the state of the subsidiary was considered the host state. Although it was the subsidiary that primarily suffered from the less favourable treatment, the perspective chosen by the Court appears to be that of the parent company exercising its right to free movement to set up a subsidiary in the host state. Such a perspective may not be considered the most logical one. An alternative would be to consider the legislation in the state where the subsidiary is established as home state legislation. However, it appears as if the ECJ considers the state of the subsidiary to be the host state where the legislation at issue differentiates on grounds of where the parent company is located.[221]

The Court repeated that as regards companies, it is their corporate seat that serves as the connecting factor with the legal system of a particular state, like nationality in the case of natural persons.[222] This statement, together with that the state of the subsidiary was considered as the host state, indicates that the Court applied a *nationality-based approach.* The UK legislation was assessed from a host state perspective.

5.6.4.3 The Lankhorst-Hohorst Case

The compatibility of the German thin capitalisation rules with the freedom of establishment was analysed in the *Lankhorst-Hohorst*[223] case.[224] Lankhorst-Hohorst was a German corporation fully owned by a Dutch corporation, Lankhorst-Hohorst BV.[225] The sole shareholder of

[219] *Ibid.*, para. 33.

[220] *Ibid.*, paras. 42–43.

[221] For a similar reasoning see Case C-254/97 *Société Baxter, B. Braun Médical SA, Société Fresenius France and Laboratoires Bristol-Myers-Squibb SA* v *Premier Ministre, Ministère du Travail et des Affaires sociales, Ministère de l'Economie et des Finances and Ministère de l'Agriculture, de la Pêche et de l'Alimentation* [1999] ECR I-4809.

[222] Cases C-397/98 and C-410/98 *Metallgesellschaft Ltd and others, Hoechst AG and Hoechst (UK) Ltd* v *Commissioners of Inland Revenue and HM Attorney General* [2001] ECR I-1727, para. 42. The same statement is found in other cases, see, for instance, Case C-311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651, para. 23.

[223] Case C-324/00 *Lankhorst-Hohorst GmbH* v *Finanzamt Steinfurt* [2002] ECR I-11779.

[224] For comments in the literature, see, for instance, Cordewener, *Company Taxation, Cross-Border Financing and Thin Capitalisation in the EU Internal Market: Some Comments on Lankhorst-Hohorst GmbH,* ET 2003, pp. 102–113 and Gutman & Hinnekens, *The Lankhorst-Hohorst case. The ECJ finds German thin capitalization rules incompatible with freedom of establishment,* ECTRev 2003, pp. 90–97.

[225] Case C-324/00 *Lankhorst-Hohorst GmbH* v *Finanzamt Steinfurt* [2002] ECR I-11779, para. 6.

Lankhorst-Hohorst BV was another Dutch corporation, Lankhorst-Taselaar BV. The latter company had granted a loan to the German company Lankhorst-Hohorst, which was repayable over ten years in annual instalments, with a variable interest rate which was 4.5 per cent until the end of 1997.[226] The loan, which was intended as a substitute for capital, was accompanied by a letter of support under which Lankhorst-Taselaar BV waived repayment if third party creditors made claims against Lankhorst-Hohorst.[227]

The dispute concerned the tax treatment of the interest paid in respect of the loan. The German tax authorities considered the interest to be classified as a covert distribution of profits in accordance with German domestic legislation and taxed Lankhorst-Hohorst on them as such at the rate of 30 per cent.[228]

The Court found that the German legislation established a difference in treatment between resident subsidiary companies according to whether or not their parent company had its seat in Germany.[229] It compared the situation where interest paid by a resident subsidiary on loan capital provided by a non-resident company was taxed as a concealed dividend at the rate of 30 per cent, and a situation where a resident subsidiary whose parent company was also resident in Germany, in which case interest paid was treated as expenditure and not as a concealed dividend.[230] The ECJ concluded that this "difference in treatment between resident subsidiary companies according to the seat of their parent company constitutes an obstacle to the freedom of establishment which is, in principle, prohibited by Article 43 EC."[231] The Court added that the German legislation made it less attractive for companies established in other Member States to exercise the freedom of establishment and it was possible that they refrained from acquiring, creating or maintaining a subsidiary in Germany.[232] Such an additional perspective is in this study referred to as a dual perspective.[233]

It is unclear how to classify the Court's reasoning in the *Lankhorst-Hohorst* case in terms of whether the Court applied a *nationality-based approach* or a *free movement-based approach.* The German company

[226] *Ibid.*, para. 7.
[227] *Ibid.*, para. 8.
[228] *Ibid.*, para. 11.
[229] *Ibid.*, para. 27.
[230] *Ibid.*, para. 29.
[231] *Ibid.*, para. 32.
[232] *Ibid.*
[233] See section 3.4.5.

was treated less favourably by the German tax legislation that differentiated based on the seat of the parent company. The Court commonly equates the seat of a company with nationality for individuals.[234] This indicates that the Court applied a *nationality-based approach.*

The question whether the Court assessed the German legislation from a host state or home state perspective is also difficult to answer. However, when the Court held that the German legislation made it less attractive for non-German companies to exercise their freedom of establishment, the Court took a host state perspective.

In *Lankhorst-Hohorst,* the Court rejected the defence arguments risk of tax avoidance,[235] reductions of tax revenue[236] and the cohesion of the German tax system[237] as well as the effectiveness of fiscal supervision[238]. It is worth noticing that when the German government argued that the German legislation was justified in having regard to the cohesion of the tax system, it held that the German provision was in accordance with the arm's length principle found in Article 9 of the OECD Model.[239] In response, Advocate General Mischo held that assuming that the German provision did comply with Article 9 OECD Model it was still precluded by Article 43 EC.[240]

The compatibility of the German provision with Article 9 OECD Model is not entirely clear.[241] This is something that the Advocate General also indicated by stating that "assuming that a provision such as Head 2 of Paragraph 8 a (1) of the KStG does comply with Article 9".

It has been argued by Cordewener that the German provision may exceed the limits of Article 9 OECD Model. The reasons are that under the German law the focus was on the debt-equity ratio of each individual shareholder and not on the German corporation as a whole, and that the arm's length principle did not apply directly.[242] In its judgment, the Court

[234] See section 3.4.3.3.

[235] Case C-324/00 *Lankhorst-Hohorst GmbH* v *Finanzamt Steinfurt* [2002] ECR I-11779, paras. 34, 37.

[236] *Ibid.*, para. 36.

[237] *Ibid.*, paras. 39–42.

[238] *Ibid.*, para. 43.

[239] For an analysis of the ECJ's position to international tax principles found in the OECD Model, see chapter 6.

[240] See para. 81 of the opinion by Advocate General Mischo in Case C-324/00 *Lankhorst-Hohorst GmbH* v *Finanzamt Steinfurt* [2002] ECR I-11779.

[241] See Cordewener, *Company Taxation, Cross-Border Financing and Thin Capitalisation in the EU Internal Market: Some Comments on Lankhorst-Hohorst GmbH,* ET 2003, p. 110.

[242] *Ibid,* p. 111.

did not go into detail in respect of the German argument that its legislation was in accordance with Article 9 of the OECD Model. This may give rise to a conclusion that the Court did not find this fact of importance when assessing the German legislation in *Lankhorst-Hohorst* as the German legislation was not an arm's length provision in a strict sense.[243]

5.6.5 A Free Movement-Based Approach under Article 43 EC

5.6.5.1 The ICI Case

In *ICI*[244], the question was whether UK legislation regarding tax relief on trading losses was compatible with the right to freedom of establishment.[245] This question was raised in proceedings between ICI and UK tax authorities. ICI and Wellcome Foundations were companies which had been incorporated in the UK. They formed a consortium in which ICI participated as to 49 per cent and Wellcome Foundations to 51 per cent.[246] The consortium owned all the share capital in Coopers Annual Health, which was a holding company incorporated in the UK. The sole business of the holding company was to hold shares in 23 trading companies. Of the 23 subsidiaries, 10 were resident within the EU, including 4 subsidiaries resident within the UK.

One of the UK resident subsidiaries sought to surrender the benefit of trading losses to ICI so that ICI could claim group relief due to its 49 per cent share in the consortium.[247] ICI's claim was refused because its business did not consist wholly or mainly in the holding of shares of trading companies which were resident in the UK. Accordingly, the UK legislation differentiated on grounds of the residence of the subsidiaries. The granting of the tax relief was subject to the requirement that the holding company's business consisted wholly or mainly of the holding of shares in subsidiaries established in the UK.

[243] See Persson Österman, *Strider fusionsdirektivets krav på fast driftställe mot EG-fördragets krav på frihet?*, SN 2004, p. 266 and Cordewener, *Company Taxation, Cross-Border Financing and Thin Capitalisation in the EU Internal Market: Some Comments on Lankhorst-Hohorst GmbH*, ET 2003, p. 110.

[244] Case C-264/96 *Imperial Chemical Industries plc (ICI)* v *Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-4695.

[245] For comments in the literature, see, for instance, Daniels, *The freedom of establishment: some comments on the ICI decision*, ECTRev 1999, pp. 39–42.

[246] Case C-264/96 *Imperial Chemical Industries plc (ICI)* v *Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-4695, para. 3.

[247] *Ibid.*, para. 5.

When analysing the *ICI* case, the ECJ initially repeated that even though direct taxation is a matter for the Member States, they must exercise their taxation powers consistently with Community law.[248] Then, the ECJ expressed that the freedom of establishment includes the right of companies and 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, to pursue their activities in the Member State concerned through a branch or agency.[249] Moreover, the Court stressed that with regard to companies, it is their corporate seat that serves as the connecting factor with the legal system of a particular state, like nationality in the case of natural persons.[250]

Furthermore, the Court cited *Daily Mail* and held that even though the provisions on the right to freedom of establishment are directed mainly to ensuring that foreign nationals and companies are treated in the host state in the same way as nationals of that state:

> "they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation which comes within the definition contained in Article 58" [now Article 48 EC].[251]

The Court found that the UK legislation denied companies tax relief on losses when they had exercised their freedom of establishment.[252] The legislation "applied the test of the subsidiaries' seat to establish differential tax treatment of consortium companies in the United Kingdom".[253] The Court found this to be contrary to Article 43 EC as it held that it was necessary to determine whether there was any justification for such inequality of treatment.[254]

The justifications put forward were the risk of tax avoidance,[255] diminution of tax revenue[256] and the cohesion of the tax system[257]. Apparently, all justification arguments were of a non-Treaty character. The Court considered them but did not uphold any of them.

[248] *Ibid.*, para. 19.
[249] *Ibid.*, para. 20.
[250] *Ibid.*
[251] *Ibid.*, para. 21.
[252] *Ibid.*, para. 22.
[253] *Ibid.*, para. 23.
[254] *Ibid.*, para. 24.
[255] *Ibid.*, paras. 25–27.
[256] *Ibid.*, para. 28.
[257] *Ibid.*, para. 29.

In the *ICI* case, the Court assessed home state obstacles under Article 43 EC applying a *free movement-based approach.* From ICI's perspective, the UK legislation constituted home state legislation. Also the Court analysed the UK legislation from this perspective.

5.6.5.2 The X AB and Y AB Case

In the case *X AB and Y AB*[258], the Swedish tax legislation under review entailed a difference in treatment on the basis of the criterion of the subsidiary's seat.[259] The question was whether this was in breach of the freedom of establishment. The question was raised in proceedings brought by two Swedish companies, X AB and Y AB, against a decision delivered by the Swedish Revenue Law Commission. The decision was appealed to the Swedish Supreme Administrative Court that stayed proceedings and asked the ECJ for a preliminary ruling under Article 234 EC.

X AB was the parent company of Y AB. Under Swedish law, transfers between companies belonging to the same group were, under certain conditions, entitled to tax relief. If a Swedish company owned more than nine tenths of the shares in another Swedish company, intra-group transfers between the first company and the second company were treated as a deductible expense for the transferring company and as taxable income for the transferee.[260] In a situation where Y AB would be owned exclusively by X AB and its Swedish subsidiary, which it controlled entirely, the tax advantage was granted. If the situation were different in so far as a Netherlands subsidiary, Z BV, which was owned by X AB in its entirety, would own 15 per cent of the shares in Y AB, the tax advantage would be denied based on internal legislation. However, the prohibition of discrimination on grounds of ownership found in the tax treaty between the Netherlands and Sweden would make sure that the tax advantage was granted. In contrast, in a situation where a Dutch subsidiary, Z BV, and a German subsidiary, Y GmbH, both of them wholly owned by X AB, would each acquire 15 per cent of the shares in Y AB, the tax advantage would be denied both having regard to internal legislation and tax treaties. This conclusion was based on that the case law of the Swedish Supreme Administrative Court prohibited a cumulative application of two tax treaties.[261]

[258] Case C-200/98 *X AB and Y AB* v *Riksskatteverket* [1999] ECR I-8261.

[259] For comments in the literature, see, for instance, Mutén, *Den europeiska gemenskapens diskrimineringsförbud och dess skattekonsekvenser: den svenska erfarenheten,* SvSkT 2002, pp. 561–573.

[260] Case C-200/98 *X AB and Y AB* v *Riksskatteverket* [1999] ECR I-8261, para. 4.

[261] *Ibid.*, para. 10.

The ECJ observed, citing *Daily Mail* and *ICI,* that the freedom of establishment prohibits the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation which comes within the definition contained in Article 48 EC.[262] Moreover, the Court found that the Swedish legislation did not allow Swedish companies, which had used their freedom of establishment to form subsidiaries in other Member States, to receive the tax advantage when more than one foreign subsidiary held shares in the Swedish company.[263] This was a differentiation based on the subsidiaries' seat, which was held to be contrary to the freedom of establishment unless a valid justification was found.[264] The Swedish government did not present any possible justification of its legislation.

The Swedish legislation that withheld a tax advantage under certain circumstances where Swedish companies have set up foreign subsidiaries is a typical example of home state legislation hindering the free movement. It is clear that the ECJ assessed the Swedish legislation from a home state perspective. The ECJ applied a *free movement-based approach* when analysing the Swedish legislation. Evidently, it was the exercise of free movement rights that was the differentiation criterion, not the nationality or residence of the company primarily affected.[265]

5.6.5.3 The AMID Case

Belgian legislation on loss deduction was under review in the *AMID*[266] case.[267] The legislation established a differentiated tax treatment as between companies incorporated under Belgian law having establishments only on national territory and those having establishments in another Member State.

AMID was a Belgian limited liability company that had its seat in Belgium. The company had a PE in Luxembourg. Under the tax treaty between Belgium and Luxembourg, AMID's income from its PE was exempt from tax in Belgium.[268] In 1981, AMID made a loss in Belgium,

[262] *Ibid.*, para. 26.

[263] *Ibid.*, para. 27.

[264] *Ibid.*, para. 28.

[265] For similar reasoning by the ECJ in relation to a wealth tax provision, see Case C-251/98 *C. Baars* v *Inspecteur der Belastingen* [2000] ECR I-2787, in particular para. 30.

[266] Case C-141/99 *Algemene Maatsschappij voor Investering en Dienstverlening NV (AMID)* v *Belgische Staat* [2000] ECR I-11619.

[267] See Hinnekens, *AMID: The Wrong Bridge or a Bridge Too Far? An Analysis of a Recent Decision of the European Court of Justice,* ET 2001, pp. 206–210.

[268] Case C-141/99 *Algemene Maatsschappij voor Investering en Dienstverlening NV (AMID)* v *Belgische Staat* [2000] ECR I-11619, para. 9.

but the PE in Luxembourg made a profit. Under Luxembourg's corporate tax system, it was not possible to set off the Belgian loss against the Luxembourg profits and that was why AMID, in its Belgian tax return of 1982, deducted its Belgian loss of 1981 from its Belgian profits of 1982.[269] The Belgian tax administration rejected the loss deduction arguing that the loss should have been set off, according to Belgian domestic legislation, against the profits made the same year in Luxembourg.[270]

Initially, the ECJ described the content of Articles 43 EC and 48 EC.[271] It held that the provisions on the freedom of establishment were mainly aimed at ensuring that foreign nationals and companies were treated in the host Member State in the same way as nationals of that state. In addition, these articles also included a prohibition for the state of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation.[272] The Court found that the Belgian legislation limited the right of carry forward of losses incurred in Belgium where those companies made profits in another Member State through a PE. This situation was to be compared with a situation where a Belgian company had a PE in Belgium.[273] In the latter situation, the losses would be allowed to be set off. Accordingly, the Belgian legislation established a differentiated tax treatment between companies incorporated under national law having establishments only in Belgium and those having establishments in other Member States.[274]

In response to the Belgian government's defense that its legislation in many situations were more favourable to companies with establishments abroad, the Court held that as long as the legislation proved disadvantageous to these companies under certain circumstances, this was contrary to the freedom of establishment.[275] As the Court found no objective difference in the respective positions of the companies, the difference in treatment regarding the deduction of losses when calculating the companies' taxable income could not be accepted.[276]

In *AMID*, the Court assessed the Belgian legislation from a home state perspective and compared a situation where a Belgian company had not exercised its freedom of establishment with a situation where a Belgian

[269] *Ibid.*, para. 11.
[270] *Ibid.*, para. 12.
[271] *Ibid.*, paras. 20–21.
[272] *Ibid.*, para. 21.
[273] *Ibid.*, paras. 22, 29.
[274] *Ibid.*, para. 23.
[275] *Ibid.*, para. 27.
[276] *Ibid.*, para. 30.

company had exercised that freedom. This is a clear example of an application by the ECJ of a *free movement-based approach*. The comparable situations were not focused on nationality but on the exercise of free movement rights.

5.6.5.4 The Bosal Case

In *Bosal*[277], the question was whether Dutch legislation providing only partially for the deductibility of costs in relation to holdings in foreign subsidiaries was contrary to Article 43 EC. This question was raised in proceedings between Bosal Holding BV, a limited liability company established in the Netherlands, and the Dutch tax authorities. The tax authorities refused to allow a deduction representing costs in relation to Bosal's holdings in its subsidiaries in other Member States.[278] The Netherlands legislation accepted a deduction of such costs if it was evident that the costs were indirectly instrumental in making a profit that was taxable in the Netherlands.[279]

The Court observed that the Dutch legislation could dissuade parent companies established in the Netherlands from carrying on activities through subsidiaries in other Member States as such subsidiaries generally did not generate profits taxable in the Netherlands.[280] The ECJ compared the treatment of a parent company established in the Netherlands having domestic subsidiaries with the treatment of a parent company established in the Netherlands with foreign subsidiaries.[281] The Court found this difference in treatment to be contrary to Article 43 EC.

It was argued that the Dutch legislation was justified on grounds of the cohesion of the tax system,[282] the principle of territoriality[283] and the avoidance of the erosion of the tax base[284]. None of these grounds were accepted as justifications in the present case.

The Dutch legislation at issue in *Bosal* were rules that had a negative effect on Dutch companies when they had exercised their free movement rights and set up subsidiaries in other Member States. It is clear that the

[277] Case C-168/01 *Bosal Holding BV* v *Staatssecretaris van Financiën* [2003] ECR I-9409.
[278] *Ibid.*, para. 2.
[279] *Ibid.*, para. 8.
[280] *Ibid.*, para. 27.
[281] *Ibid.*, para. 36.
[282] *Ibid.*, paras. 29–36.
[283] *Ibid.*, paras. 37–38.
[284] *Ibid.*, para. 42.

Court assessed the Dutch legislation from a home state perspective, and the Court reasoning is to be classified as a *free movement-based approach.*

5.6.5.5 The Lasteyrie Case

French exit legislation was under review in the *Lasteyrie*[285] case. Exit taxes aim at recapturing tax deferrals and taxing unrealized gains, which the state of departure would otherwise not be able to tax after a person's emigration.[286] The French legislation established the principle that, on the date on which a taxpayer transferred his tax residence outside France, tax was to be charged on the accrued increase of value of company securities representing major shareholdings.[287] The Court found that this tax treatment was disadvantageous in comparison with a person remaining a resident of France. That taxpayer was liable, simply by reason of his transfer of residence, to tax on income which was not yet realized, whereas, if he remained a French resident, the increase in value would become taxable only when and to the extent that it was actually realized.[288] The Court found that such tax treatment "is likely to discourage a taxpayer from carrying out such transfer" and was, therefore, liable to hinder the freedom of establishment.[289]

The Court assessed the non-Treaty justifications put forward in defence of the French legislation, namely the prevention of tax avoidance,[290] the diminution of tax receipts[291] and the cohesion of the tax system[292]. None of these grounds were accepted as justifications for the French legislation.

The Court analysed the French legislation from the perspective of its effect on French residents, that is a home state perspective. The Court emphasized that the distinction was based on the exercise of free movement rights and not nationality or residence; hence, the Court applied a *free movement-based approach.*

[285] Case C-9/02 *Hughes de Lasteyrie du Saillant* v *Ministère de l'Économie, des Finances et de l'Industrie,* [2004], not yet reported in ECR.
[286] See section 6.7.2.1.
[287] Case C-9/02 *Hughes de Lasteyrie du Saillant* v *Ministère de l'Économie, des Finances et de l'Industrie,* [2004], not yet reported in ECR, para. 38.
[288] *Ibid.*, para. 46.
[289] *Ibid.*, paras. 46, 48.
[290] *Ibid.*, paras. 50–57.
[291] *Ibid.*, paras. 59–60.
[292] *Ibid.*, paras. 61–67.

5.6.5.6 The De Baeck Case

In the *De Baeck*[293] case, the question was whether Belgian legislation providing for different treatment of gains in value of shares or stock depending on the place of establishment of the assigning company was contrary to Articles 43 or 56 EC.

The Court found that the reply to the question referred may be clearly deduced from its case law.[294] Therefore, the Court decided to give its decision by reasoned order in accordance with Article 104 (3) of its Rules of Procedure.

The Court held that the effect of the Belgian legislation was that a transferor who assigns his shares in a company established in another Member State suffers a charge to tax on the gains made which is not the case where the transferor assigns his shares to a Belgian company.[295] In line with on the Court's judgment in *X and Y* v *Riksskatteverket*[296], it explained that such difference in treatment was to the detriment of the taxpayer who assigns his shares or stock to companies established in other Member States. Consequently, the Court found the Belgian legislation to constitute a restriction on freedom of establishment.[297] The Court added that by making the assignment of the shares or stock at issue to assignees established in other Member States less attractive, the Belgian legislation was liable to restrict foreign companies' right to establishment. This reasoning provided that the shareholding transferred provided its holder definite influence over the company's decisions and allowed him to determine its activities.[298] If the shareholding transferred did not provide its holder definite influence over the company's decisions or allowed him to determine its activities, the national legislation was precluded by Article 56 EC instead of Article 43 EC.[299]

The referring court did not mention matter capable of justifying the national legislation, and the Court did not find any need to examine whether it could be justified.[300]

[293] Case C-268/03 *Jean-Claude De Baeck* v *Belgian State* [2004], not yet reported in ECR.
[294] *Ibid.*, para. 17.
[295] *Ibid.*, para. 24.
[296] Case C-436/00 *X and Y* v *Riksskatteverket* [2002] ECR I-10829.
[297] Case C-268/03 *Jean-Claude De Baeck* v *Belgian State* [2004], not yet reported in ECR, para. 25.
[298] *Ibid.*
[299] *Ibid.*, para. 26.
[300] *Ibid.*, para. 27.

In its reasoning, the Court focused on the effect of the legislation, explaining that it was to the detriment of taxpayers exercising their right to free movement. It also considered the Belgian legislation's restrictive effect on foreign companies. When the Court assessed the difference in treatment for Belgian residents its reasoning is to be classified as a *free movement-based approach.* The foreign element, transferring the shares to a non-resident company instead of a resident company, gave rise to less favourably treatment. Therefore, it is apparent that the national measure did not differentiate based on the nationality or residence of the taxpayer but whether he exercised his right to free movement.

From the perspective of Mr De Baeck the Belgian legislation constituted home state legislation. The Court also assessed the legislation from this perspective. In addition, it considered an additional perspective, namely the effect of the legislation on companies established outside Belgium. Such dual perspective is occasionally considered by the Court in cases dealt with under Article 43, 49 and 56 EC. This dual perspective gives that the Court assessed the Belgian legislation primarily from a home state perspective but also considered a host state perspective.

5.6.6 Summary and Analysis

The case law survey shows that the freedom of establishment has been interpreted by the ECJ as including different rights. The most obvious one is the right to establish oneself outside one's home Member State on equal terms with nationals of the host Member State. This equal treatment in the host state is explicitly provided for in Article 43 EC. When assessing whether a tax provision is contrary to this right, a *nationality-based approach* is commonly used by the ECJ. This approach is well suited to make this analysis as it is focused on prohibiting different treatment based on nationality, and, more common when dealing with national tax legislation, different treatment based on residence.

Another right embodied in Article 43 EC is the right to exercise free movement rights without being hampered by one's home state. The Court first introduced this interpretation of Article 43 EC in the *Daily Mail* case. Hereafter it has confirmed this position in numerous income tax cases. That gives that national legislation that prescribes a less favorable treatment for residents who have exercised their free movement rights are in principle precluded by Article 43 EC. Generally this exercise has given rise to a foreign element. For instance, in *ICI, X AB and Y AB* and *Bosal*, it was the establishment of subsidiaries outside the

home state, and in AMID it was the establishment of a PE outside the home state, which gave rise to the less favorable tax treatment. In all these cases the home state legislation granted a more favorable treatment when free movement rights were not exercised, and consequently no foreign element was present, for example when the shares were held in a company established in the home state, or where the subsidiaries were set up within the national territory.

When does the Court apply a *nationality-based approach* or a *free movement-based approach* under Article 43 EC? The case law analysed in this section shows a surprisingly consistent answer, namely that a *nationality-based approach* is applied when assessing national legislation from a host state perspective. The *free movement-based approach* has been applied by the Court when assessing home state legislation. The survey shows that the Court applies a *nationality-based approach* when it judges tax legislation in the host state to have an effect on branches. When a company is treated in a less favorable way by its home state due to the establishment of branches abroad, the Court has applied a *free movement-based approach.*

In addition to this rather clear pattern that can be derived from the case law study, the signification of host state perspective and home state perspective needs to be further commented on. In most cases where the host state perspective is chosen by the Court for its assessment, it coincides with the relationship the person who is directly affected by the legislation has with the state imposing the legislation at issue. For instance, in *Royal Bank of Scotland* the Court analysed the Greek legislation from a host state perspective. Also for the company Royal Bank of Scotland Greece represented the host state. However, in some cases dealt with in this case study, the perspective chosen by the Court is not the same as for the person directly affected by the burdening legislation. This is evident in, for instance, the *Metallgesellschaft* case. The legislation at issue differentiated on grounds of where the parent company was established. A subsidiary was granted a more favourable tax treatment when the parent company was established within the national territory in comparison with the tax treatment of a subsidiary with its parent company established in another EU Member State. When the ECJ assessed the national legislation, it considered the state of the subsidiary to be the host state. Although it was the subsidiary that primarily suffered from the less favourable treatment, the perspective chosen by the Court appears to be that of the parent company exercising its right to free movement to set up

a subsidiary in the host state. However, the state imposing the burdening legislation may for the subsidiary be considered as the home state. It appears as if the ECJ considers the state of the subsidiary to be the host state where the legislation at issue differentiates on grounds of where the parent company is located.[301]

In some of its judgments, the ECJ has considered a dual perspective. Besides considering the national legislation's effect on taxpayers exercising their free movement rights, the Court also recognized its effect on foreign companies. These cases could be considered as a deviation from the pattern presented above. However, it is also possible to reach the conclusion that when the Court recognizes the legislation's effect on foreign companies this is to be considered as an additional line of reasoning and not the Court's main reason why the legislation in issue is contrary to Article 43 EC. An example of such a dual perspective is found in the *De Baeck* case.

In terms of grounds for justification, the *Royal Bank of Scotland* case is of particular interest. The Court used a *nationality-based approach* when assessing the Greek legislation from a host state perspective. When dealing with the issue of justification, the Court accepted justification on grounds of explicit treaty justifications only. This is the only tax case where the Court is clearly stating that only express treaty justifications could render the discrimination at issue compatible with Community law. Hereby, the Court excluded imperative interests as possible grounds for justification. Hence, in the *Royal Bank of Scotland* case the Court followed its own statements when applying free movement provisions to other areas of national legislation than tax law, that directly discriminatory national measures cannot be justified having regard to imperative interests. In all other cases, the ECJ has considered all grounds for justification put forward by the Member States. However, the Court has been very restrictive in accepting any grounds as justification for restrictive national legislation.

[301] For a similar reasoning see Case C-254/97 *Société Baxter, B. Braun Médical SA, Société Fresenius France and Laboratoires Bristol-Myers-Squibb SA* v *Premier Ministre, Ministère du Travail et des Affaires sociales, Ministère de l'Economie et des Finances and Ministère de l'Agriculture, de la Pêche et de l'Alimentation* [1999] ECR I-4809.

5.7 Free Movement of Services in Relation to Income Tax Cases

5.7.1 A Nationality-Based Approach under Article 49 EC

The *Gerritse*[302] case concerned German legislation for non-resident taxpayers.[303] Mr Gerritse was a Dutch national resident in the Netherlands who had income from performing as a drummer at a radio station in Germany. In the same year, Mr Gerritse also received income in the Netherlands and from Belgium.[304]

The question was whether the free movement of services precluded the application of German legislation, which took gross income into account when taxing non-residents, without the deduction of business expenses, where residents were taxed on their net income after deduction of business expenses. Moreover, the German legislation made the income of non-residents liable to a definite tax at the rate of 25 per cent, which was withheld at source, whereas the income of residents were taxed in accordance with a progressive rate schedule which included a tax-free allowance.

With regard to the deductibility of business expenses, the Court held that the business expenses in question were directly linked to the activity which generated the taxable income in Germany and that is why residents and non-residents were, in that respect, placed in a comparable situation.[305] In conclusion, the Court stated that the German legislation which refused non-residents deductions for business expenses whereas residents were allowed them, constituted indirect discrimination contrary to the free movement of services.[306] The German legislation, the Court said, "risks operating mainly to the detriment of nationals of other Member States".[307] No arguments were presented to justify the refusal to deduct business expenses for non-nationals.

In regard to the final tax at the rate of 25 per cent which was withheld at source, the Court stated, similar to its previous statements in *Schu-*

[302] Case C-234/01 *Arnoud Gerritse* v *Finanzamt Neukölln-Nord* [2003] ECR I-5933.

[303] For comments in the literature, see, for instance, Molenaar & Grams, *The Arnoud Gerritse Case of the European Court of Justice*, Intertax 2003, pp. 198–204 and Hinnekens, *European Court challenges flat rate withholding taxation of non-resident artist: comment on the Gerritse decision*, ECTRev 2003, pp. 207–213.

[304] Case C-234/01 *Arnoud Gerritse* v *Finanzamt Neukölln-Nord* [2003] ECR I-5933, para. 10.

[305] *Ibid.*, para. 27.

[306] *Ibid.*, para. 28.

[307] *Ibid.*

macker[308] and *Gschwind*[309], that residents and non-residents were generally not in comparable situations.[310] The Court also held that international tax law uses residence as a connecting factor for the purpose of allocating powers of taxation between states. When doing that, it referred to the OECD Model.[311] In terms of the denial of the tax-free allowance, the Court concluded that "it is legitimate to reserve the grant of that advantage to persons who have received the greater part of their taxable income in the State of taxation, that is to say, as a general rule, residents".[312] The Court pointed out that when an advantage comparable to the tax-free allowance is granted in the residence state, one must, in principle, take into account the personal and family circumstances of the person concerned.[313]

Regarding the difference in treatment between residents and non-residents in terms of flat rate of tax and progressive taxation, the Court found that residents and non-residents were in comparable situations.[314] The reason was that Mr Gerritse's residence state, the Netherlands, applied exemption with progression in accordance with the tax treaty between Germany and the Netherlands.[315] As a result, the German income was integrated into the basis of assessment. A fraction of the tax levied in Germany was deducted from the Dutch tax. The fraction corresponded to the relation between the income taxed in Germany and the worldwide income. The ECJ concluded that since residents and non-residents were in a comparable situation with regard to the progressivity rule, if non-residents were taxed more heavily than residents, this would constitute indirect discrimination.[316] It was up to the national court to consider whether the 25 per cent tax rate that applied to Mr Gerritse's income was higher than what would have followed from application of the progressive rate schedule.[317]

From the perspective of the classification of the restrictive measure, this judgment is exemplary clear. The Court identified comparable situations between a resident and a non-resident and classified the different

[308] Case C-279/93 *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225.
[309] Case C-391/97 *Frans Gschwind* v *Finanzamt Aachen-Aussenstadt* [1999] ECR I-5451.
[310] Case C-234/01 *Arnoud Gerritse* v *Finanzamt Neukölln-Nord* [2003] ECR I-5933, para. 43.
[311] *Ibid.*, para. 45.
[312] *Ibid.*, para. 48.
[313] *Ibid.*, para. 51.
[314] *Ibid.*, para. 53.
[315] *Ibid.*, para. 52.
[316] *Ibid.*, para. 53.
[317] *Ibid.*, para. 54.

elements of the German legislation as indirectly discriminatory. It is a clear example of an argumentation following a *nationality-based approach*. To Mr Gerritse, the German legislation constituted host state legislation, and the Court assessed the legislation from this perspective.

5.7.2 A Free Movement-Based Approach under Article 49 EC

5.7.2.1 The Safir Case

Swedish tax legislation that differentiated on the ground of where the service providers were established was under review in the *Safir*[318] case. The ECJ found it necessary to determine whether the legislation created an obstacle to the freedom to provide services. A different tax treatment applied to premiums under life assurance policies contracted with insurance companies not established in Sweden.

Initially, the Court stated that national legislation which "impedes a provider of services from actually exercising the freedom to provide them" is precluded by Article 49 EC.[319] The Court also held that:

> "[i]n the perspective of a single market and in order to enable its objectives to be attained, Article 59 of the Treaty [now Article 49 EC] 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".[320]

This description of measures being in breach of the provisions on free movement of services has a considerable width due to its use of the expression "more difficult" than only providing the service within one Member State.[321]

The ECJ found several elements in the Swedish legislation at issue in the *Safir* case which were liable to dissuade individuals from taking out capital life assurance with companies not established in Sweden as well as liable to dissuade insurance companies from offering their services on the Swedish market.[322] Such elements were, for instance, that it was more costly to surrender a life assurance policy taken out with a foreign

[318] Case C-118/96 *Jessica Safir* v *Skattemyndigheten i Dalarnas Län* [1998] ECR I-1897.
[319] *Ibid.*, para. 22.
[320] *Ibid.*, para. 23.
[321] The same extensive formula is found in, for instance, Case C-158/96 *Raymond Kohll* v *Union des caisses de maladie* [1998] ECR I-1931, para. 33 (see section 4.4.3.2 of this study).
[322] Case C-118/96 *Jessica Safir* v *Skattemyndigheten i Dalarnas Län* [1998] ECR I-1897, para. 30.

insurance company than to surrender a life assurance policy with a Swedish company.[323] Also a requirement to provide the tax authority with additional information concerning the income tax, to which the non-Swedish insurance company is subject, was considered as a "particular burdensome" requirement for the policyholder.[324] The Court applied a dual perspective considering both the legislation's effect on Swedish taxpayers and foreign service providers.[325]

The Swedish government argued that fiscal cohesion and effective fiscal supervision justified its legislation.[326] The Court did not accept these justifications in the present case.

The difference in tax treatment in *Safir* was based on whether the establishment of the provider of the service was within the country in question or in another Member State. From the perspective of Ms Safir, the service receiver, the legislation is to be considered as home state legislation. The ECJ applied a *free movement-based approach* arguing that the legislation made the free movement of services between Member States more difficult than purely within one Member State. In addition to the perspective of service receivers, the Court also stressed that the national legislation had a restrictive effect on service providers. From the perspective of the service provider, the Swedish legislation was host state legislation.

5.7.2.2 The Danner Case

The *Danner*[327] case concerned the question of the compatibility of a Finnish tax regime with Article 49 EC.[328] The Finnish legislation prescribed, similar to the Swedish legislation at issue in *Safir* and the subsequent case *Skandia*[329], that contributions to voluntary pension insurance schemes were subject to different rules depending on whether the insurance was taken out with a Finnish insurance institution or with a foreign insurance institution. Contributions paid to voluntary pension schemes run by Finnish insurance institutions were under certain conditions either

[323] *Ibid.*, para. 27.

[324] *Ibid.*, para. 28.

[325] See section 3.4.5.

[326] Opinion of Advocate General Tesauro in Case C-118/96 *Jessica Safir* v *Skattemyndigheten i Dalarnas Län* [1998] ECR I-1897, para. 35.

[327] Case C-136/00 *Rolf Dieter Danner* [2002] ECR I-8147.

[328] For comments in the literature, see, for instance, de Brabanter, *The Danner case: elimination of Finnish tax obstacles to the cross-border contributions to voluntary pension schemes*, ECTRev 2003, pp. 167–172.

[329] Case C-422/01 *Försäkringsaktiebolaget Skandia (publ.) and Ola Ramstedt* v *Riksskatteverket* [2003] ECR I-6817.

fully or partially deductible.[330] Deduction of contributions for voluntary pension insurance taken out with a foreign institution was generally not allowed. By way of exception, these contributions were deductible in the following two situations.[331] One such case was where the pension was granted by a PE in Finland of a foreign insurance institution and the other where the person had moved to Finland from abroad. In the latter situation contributions were deductible in the year of the move and the following three years.

In *Danner,* the Court first observed that Article 49 EC precluded national legislation resulting in making the provision of services between Member States more difficult than the provision of services purely within one Member State.[332] Therefore, it was not disputed before the Court that the Finnish legislation restricted the freedom to provide services.[333] The legislation was found to be liable to dissuade individuals from taking out voluntary pension insurance with institutions established in a Member State other than Finland and to dissuade those institutions from offering their services on the Finnish market.[334] Hence, the Court applied a dual perspective.

The non-Treaty grounds fiscal cohesion[335] and the effectiveness of fiscal controls[336] were proposed as justifications of the Finnish legislation in the *Danner* case. Neither of them was accepted by the ECJ.

In this case the Court argued very similarly to its reasoning in *Safir.* It applied a *free movement-based approach* and held that the legislation constituted a restriction on the freedom to receive services as well as a restriction on foreign service providers offering their services on the Finnish market. Therefore, the Court analysed the Finnish legislation both from a home and a host state perspective.

5.7.2.3 The Skandia Case

The *Skandia*[337] case concerned the tax treatment in Sweden applying to an occupational pension insurance policy taken out for the benefit of a

[330] Case C-136/00 *Rolf Dieter Danner* [2002] ECR I-8147, para. 5.

[331] *Ibid.*, para. 8.

[332] *Ibid.*, para. 29.

[333] *Ibid.*, para. 30.

[334] *Ibid.*, para. 31.

[335] *Ibid.*, paras. 33–43. See also Quitzow, *Exit Bachmann, bienvenue Danner? – Eller när en dom har blivit så urholkad att den nästan får anses vara "overruled"*, SN 2003, pp. 89–92.

[336] Case C-136700 *Rolf Dieter Danner* [2002] ECR I-8147, paras. 44–56.

[337] Case C-422/01 *Försäkringsaktiebolaget Skandia (publ.) and Ola Ramstedt* v *Riksskatteverket* [2003] ECR I-6817.

Swedish employee with insurance companies established in a Member State other than Sweden.[338] The tax regime for pension insurances taken out with companies established in Sweden was different, especially with respect to the right to deduct the premium payments. Skandia's right to deduct premium payments arose at a later date than when the premiums were paid, namely when the insurance policy was taken out with an insurance company not resident in Sweden. In that case, the deduction was allowed at the time when the employee received the pension benefits. The deduction did not relate to the premiums actually paid but to the sums paid out as pension benefits. In terms of insurance policies taken out with insurance companies operating in Sweden, the employer had the right to deduct the premiums immediately when calculating his taxable income.[339]

The Court started by reiterating its statement in *Safir* and *Danner*:

> "Article 49 EC 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 purely within one Member State".[340]

The Court explained that considering this interpretation of Article 49 EC, it was not disputed before the Court that the Swedish legislation restricted the free movement of services.[341] The postponement of the right to deduct constituted a disadvantage liable both to dissuade Swedish employers from taking out occupational pension insurance with institutions established in Member States other than Sweden and to dissuade those institutions from offering their services on the Swedish market.[342] Therefore, also in this case the Court applied a dual perspective.

The Swedish government argued that fiscal cohesion,[343] the effectiveness of fiscal control,[344] the need to preserve the tax base[345] and competitive neutrality[346] justified the legislation. The Court did not accept any of these imperative interest grounds to justify the legislation.

[338] For comments in the literature, see, for instance, Wiman, *Pending Cases Filed by Swedish Courts: the X and Y Case and the Skandia and Ola Ramstedt Case* in Lang (ed.), *Direct Taxation: Recent ECJ Developments*, (2003), pp. 201–206.
[339] Case C-422/01 *Försäkringsaktiebolaget Skandia (publ.) and Ola Ramstedt* v *Riksskatteverket* [2003] ECR I-6817, para. 9.
[340] *Ibid.*, para. 26.
[341] *Ibid.*, para. 27.
[342] *Ibid.*, para. 28.
[343] *Ibid.*, paras. 30–37.
[344] *Ibid.*, paras. 38–45.
[345] *Ibid.*, paras. 46–53.
[346] *Ibid.*, paras. 54–59.

The ECJ approached the *Skandia* situation in the same way as it did in *Safir* and *Danner*. It applied a *free movement-based approach* and considered the national measure's effect on both service receivers and service providers, analysing the legislation both from a home state and a host state perspective.

5.7.2.4 The Eurowings Case

In *Eurowings*[347], the question was whether a tax regime in Germany was contrary to Article 49 EC. The German tax regime granted lessees more favourable treatment for tax purposes if they leased goods from a lessor established in Germany than if they leased from a lessor established in another Member State. The favourable treatment was only available to lessors who were liable to trade tax, which lessors established in other Member States never were.[348]

The Court described the significance of Article 49 EC as a requirement not only to abolish any discrimination on account of nationality against a person providing services but also the abolition of any restriction on the freedom to provide services imposed on the ground that the person providing services is established in a Member State other than the one in which the service was provided.[349] The ECJ concluded that the legislation dissuaded German companies from having recourse to lessors established outside Germany.[350] Moreover, any legislation which "reserves a fiscal advantage to the majority of undertakings which lease goods from lessors established in that State whilst depriving those leasing from lessors established in another Member State of such an advantage gives rise to a difference of treatment based on the place of establishment of the service provider", which is prohibited by Article 49 EC.[351] Therefore, the German legislation was contrary to the free movement of services.

It was argued that the difference in treatment was necessary because the lessor established in another Member State may be subject to a lower taxation there. In this case, the lessor was established in Ireland and benefited from "the Shannon privileges" in the form of a ten per cent corporation tax.[352] The Court responded that any tax advantage which a

[347] Case C-294/97 *Eurowings Luftverkehrs AG* v *Finanzamt Dortmund-Unna* [1999] ECR I-7447.
[348] *Ibid.*, para. 25.
[349] *Ibid.*, para. 60.
[350] *Ibid.*, para. 37.
[351] *Ibid.*, para. 40.
[352] *Ibid.*, paras. 21, 43.

provider of services may benefit from in another Member State cannot be used by a Member State to justify less favourable treatment in tax matters given to recipient of services in the latter state. Such "compensatory tax arrangements prejudice the very foundations of the single market".[353]

The German legislation at issue in *Eurowings* shows similarities to the legislation under review in *Safir*, *Danner* and *Skandia*. Similar to these cases, the tax legislation in *Eurowings* was home state legislation for the person directly affected by the legislation which established different treatment depending on the place of establishment of the service provider. The legislation did not formally use the place of establishment of the service provider as a distinguishing criterion. However, the favourable tax treatment was only available to lessors liable to trade tax, something which lessors established in Member States other than Germany never were. Formally, this is differentiation based on whether a company is liable to trade tax that is the decisive factor, and not the place of establishment of the service provider. However, as non-German companies never were liable to trade tax, these factors coincided. The Court used a language of dissuasion and held that the legislation dissuaded German companies from having recourse to lessors established outside Germany, an example of a *free movement-based approach.*

5.7.2.5 The Vestergaard Case

In the case *Vestergaard*[354], the ECJ was asked to interpret Article 49 EC in relation to the Danish rules for the deduction of expenses for professional training courses. These rules were based on the presumption that professional training courses held in ordinary tourist resorts located in other Member States involved a significant tourism element, therefore, the cost of taking part in such a course was not treated as a deductible cost. However, no such presumption existed when professional training courses were held in ordinary tourist resorts located within Denmark.[355]

The ECJ explained that services such as the organisation of professional training courses fall within the scope of Article 49 EC when provided to nationals of a Member State on the territory of another Member State.[356] This applies irrespective of the place of establishment of the provider or receiver of services.[357] The Court found that the Danish legislation prescribed different tax treatment based on the place where the

[353] *Ibid.*, para. 45.
[354] Case C-55/98 *Skatteministeriet* v *Bent Vestergaard* [1999] ECR I-7641.
[355] *Ibid.*, para. 7.
[356] *Ibid.*, para. 18.
[357] *Ibid.*

service was provided.[358] Such a regime made it more difficult to deduct costs relating to services provided outside the Member State and involved a difference in treatment based on the place where the service was provided. The Court concluded that this was contrary to the free movement of services.[359]

The Court analysed whether imperative interests put forward could justify the restriction. It found that neither the cohesion of the tax system, nor the effectiveness of fiscal supervision could justify the Danish legislation.[360]

From the perspective of the receiver of the service, Mr Vestergaard, it was his home state legislation that treated him less favourably because he had used his right to freedom of movement. A home state perspective was also chosen by the Court when assessing the Danish legislation. The ECJ used a *free movement-based approach* when arguing the case as it compared situations where the services were provided outside Denmark and within Denmark. The reasoning was not focused on establishing the influence of nationality or residence of the person negatively affected by the legislation.

5.7.2.6 The Commission v France Case

The *Commission v France*[361] case concerned French legislation which provided that individuals who receive interest on Government securities, bonds, equities and other debt instruments, where the debtor is resident or established in France, may elect for them to be subject to a levy in discharge of income tax on the income concerned.[362] This right to elect the fixed levy, which in many situations involved a tax advantage, was only available where the party paying the income was resident or established in France.[363] The Commission argued that this legislation was contrary to the free movement of services and the free movement of capital.

The Court found that the French legislation had the:

> "effect of discouraging taxpayers who are resident in France from entering into contracts of this type with companies which are established in another Member State".[364]

[358] *Ibid.*, para. 21.
[359] *Ibid.*, para. 22.
[360] *Ibid.*, para. 23.
[361] Case C-334/02 *Commission* v *France* [2004], not yet reported in ECR.
[362] *Ibid.*, para. 2.
[363] *Ibid.*, para. 22.
[364] *Ibid.*, para. 23.

The Court also held that the French legislation had a restrictive effect as regards companies established in other Member States since it prevented them from raising capital in France, given that the proceeds of contracts taken out with those companies were treated less favourably from a tax point of view than proceeds payable by a company established in France.[365] The result is that their contracts are less attractive to investors residing in France than those of companies which are established in France. Therefore, the French legislation was found to constitute a restriction both on the freedom to provide services under Article 49 EC and on the free movement of capital under Article 56 EC.[366]

The Court assessed whether the French legislation was justified having regard to imperative interests such as the need to ensure payment of taxes and effective fiscal supervision.[367] The outcome of the assessment was that the legislation was not justified.

The Court assessed the French legislation using a dual perspective. When the Court pointed out the effect of the legislation on French residents, it assessed the legislation from a home state perspective and applied a *free movement-based approach*. When considering its effect on foreign service providers, the ECJ applied a host state perspective.

5.7.3 The Lindman Case – the Court's Reasoning Proves Difficult to Classify

In the *Lindman*[368] case, the question was whether Finnish tax treatment of lottery winnings was compatible with Article 49 EC.[369] Ms Lindman was of Finnish nationality and a resident of Åland, an autonoumous province of Finland. In 1998, she won (approximately) 113000 in a lottery arranged by a Swedish company in Sweden. She bought her winning ticket during a stay in Sweden. This amount was taken into account in Finland as taxable income of Ms Lindman. If the lottery had been organised by a Finnish company, the winnings would have been tax exempt under Finnish law.[370]

The Court first made it clear that the organisation of lotteries falls within the scope of Article 49 EC, provided that at least one of the

[365] *Ibid.*, para. 24.
[366] *Ibid.*, para. 25.
[367] *Ibid.*, paras. 27–33.
[368] Case C-42/02 *Diana Elisabeth Lindman* [2003], not yet reported in ECR.
[369] For comments in the literature, see, for instance, Helminen, *Pending Cases Filed by Finnish Courts: the Danner Case and the Lindman Case* in Lang (ed.), *Direct Taxation: Recent ECJ Developments*, (2003), pp. 113–117.
[370] Case C-42/02 *Diana Elisabeth Lindman* [2003], not yet reported in ECR, paras. 4–5.

providers is established in a Member State other than that in which the service is offered. Hence the Court concluded that "it is therefore necessary to examine the case from the viewpoint of freedom to provide services".[371]

The Court emphasized that foreign lotteries were treated differently for tax purposes from, and were in a disadvantageous position compared to, Finnish lotteries.[372] This difference in treatment means that Finnish taxpayers prefer to participate in a lottery organised in Finland rather than a lottery taking place in another Member State. In reply to the Finnish Government's submission that gaming providers in Finland are subject to tax as organizers of gambling, the ECJ held that such a fact did not take away the manifestly discriminatory character of the Finnish legislation as that tax is not analogous to the income tax charged on winnings from lotteries held in other Member States.[373]

Next, the Court considered whether the legislation at issue could be justified.[374] The Court turned down arguments such as the prevention of wrongdoing and fraud and the reduction of social damage caused by gambling by stating that no statistical or other evidence had been transmitted to the Court which enabled any conclusions on the existence of a particular causal relationship between such risks and participation by nationals of the Member State concerned in lotteries organised in other Member States.[375] Accordingly, the Court found that the Finnish legislation was precluded by Article 49 EC.

Even though it was Ms Lindman who was treated in a less favourable way, the Court focused on the national measure's effect on foreign service providers and found that they were in a disadvantageous position in comparison to Finnish providers. From the Court's reasoning, it is difficult to find that much attention was paid to the perspective of the service receivers, such as Ms Lindman, who was the person more directly affected by the legislation at issue. The Court's reasoning is different from the one usually applied by the Court in other similar cases analysed in this study under Article 49 EC. Generally, the Court focuses on the perspective of the service receiver when he is negatively affected, and only briefly mentions the negative effect of the legislation on foreign service providers. This was the reasoning employed in, for instance, *Safir*, *Skandia*, *Danner* and *Commission v France*.

[371] *Ibid.*, para. 19.
[372] *Ibid.*, para. 21.
[373] *Ibid.*, para. 22.
[374] *Ibid.*, paras. 23–26.
[375] *Ibid.*, para. 26.

The Court's reasoning in *Lindman* proves difficult to classify because the Court compares Finnish service providers and foreign service providers, but more directly it is not the foreign service providers that are negatively affected but the service receivers resident in Finland to whom the Finnish legislation applies. It would, therefore, not be completely correct to classify the Court's reasoning as a *nationality-based approach* as that would indicate that it is the nationality or residence of the person more directly affected that is decisive. However, from the perspective of the service providers, it is their residence that is decisive and the Court appears to have applied a host state perspective. From the perspective of Ms Lindman, it is not her nationality or residence that is of importance but whether she has exercised her right to free movement and bought a service from a foreign service provider instead of a national service provider.

From the foregoing, one may conclude that the Court in *Lindman* diverted from its established line of reasoning considering mainly the perspective of the person more directly affected, namely Ms Lindman, and instead focused only on the effect of the legislation on foreign service providers. When doing that, the Court compared the situation of a national service provider with that of a foreign service provider. In regard to the perspective of service providers, the Court appears to have assessed the Finnish legislation from a host state perspective.

5.7.4 Summary and Analysis

The income tax cases dealt with under Article 49 EC handled in this section show that the ECJ has used either a *nationality-based approach* or a *free movement-based approach*. The pattern evident in the case law under Article 39 EC and Article 43 EC is confirmed also in the Court's interpretation under Article 49 EC.

In *Gerritse,* where legislation in Mr Gerritse's host state was under review, the Court applied a *nationality-based approach*. In this case, the ECJ explicitly classified the legislation as indirectly discriminatory.

In *Danner, Skandia, Eurowings* and *Vestergaard* the Court applied a *free movement-based approach*. The legislation under review was legislation in Ms Safir's, Mr Danner's, Skandia's, Eurowings' and Mr Vestergaard's home states. Although the ECJ focused on the negative effect of the legislation on the states own residents it, in addition, in *Safir, Danner, Skandia* and *Commission* v *France* considered the negative effect of the legislation on the foreign service provider. Hence, the Court applied a dual perspective.

The Court's focus in the *Lindman* case is different from the above-mentioned line of case law. Instead of focusing on the service receiver, who was treated in a less favourable way by the Finnish legislation because she used a foreign service provider, the Court only considered the Finnish legislation's effect on foreign service provider. One may, therefore, conclude that in the *Lindman* case the Court diverted from its established line of reasoning considering mainly the perspective of the person more directly affected, namely Ms Lindman, and instead focused only on the effect of the legislation on foreign service providers. When doing that, the Court compared the situation of a national service provider and a foreign service provider.

The case law on Article 49 EC analysed in this section shows that the ECJ in general has considered non-Treaty grounds as possible grounds for justification. However, in none of these cases, the ECJ has accepted any such ground as a justification for the restrictive national tax provision.

5.8 Free Movement of Capital in Relation to Income Tax Cases

5.8.1 A Nationality-Based Approach under Article 56 EC

The dispute in the *Barbier*[376] case concerned a tax inspector's refusal, when assessing the immovable property held by Mr Barbier in the Netherlands, to deduct the value of the obligation to transfer the legal title to that property on the ground that Mr Barbier was not a resident in the Netherlands at the time of his death.[377] It was argued that this tax treatment was contrary to the free movement of capital.

In 1970, Mr Barbier moved from the Netherlands to Belgium from where he continued his activities as director of a private company established in the Netherlands. In 1988, Mr Barbier transferred the "economic ownership" of his real estate to his wholly-owned Netherlands-based companies because that would save tax on the income from the real estate. Only the economic ownership and not the legal ownership was

[376] Case C-364/01 *The heirs of H. Barbier* v *Inspecteur van de Belastingdienst Particulieren/ Ondernemingen buitenland te Heerlen*, [2003], not yet reported in ECR.

[377] For comments in the literature, see, for instance, Wattel, *Pending Cases Filed by Dutch Courts: the Bosal Holding Case and the Heirs of H. Barbier Case* in Lang (ed.), *Direct Taxation: Recent ECJ Developments*, (2003), pp. 162–169.

transferred in order to avoid the transfer tax.[378] After Mr Barbier's death, his heirs appealed against the tax assessment because no deduction in respect of the obligation to transfer legal title was allowed.

The Court found that the Dutch provisions:

> "are such as to discourage the purchase of immovable property situated in the Member State concerned and the transfer of financial ownership of such property to another person by a resident of another Member State".[379]

The Court also held that the legislation had the effect of reducing the value of the estate of a resident of a Member State other than that in which the property was situated who was in the same position as Mr Barbier. The Court stated that the Dutch legislation had the effect of restricting the free movement of capital.[380] The ECJ did not accept any justification for the national legislation.[381]

The Court focused on the effect of the Dutch legislation on persons resident outside the Netherlands, thus assessing the legislation from a host state perspective. The Court argued that the Dutch legislation was liable to discourage the purchase of immovable property of non-residents. The legislation employed a distinction based on the residence of owners. It may, therefore, be concluded that the Dutch legislation worked to the particular detriment of non-residents, and the Court's reasoning is classified as a *nationality-based approach*. However, the Court's reasoning involves an expression which is commonly used when applying a *free movement-based approach*, namely "liable to discourage".

5.8.2 A Free Movement-Based Approach under Article 56 EC

5.8.2.1 The Verkooijen Case

In *Verkooijen*[382], the question was whether it was compatible with the free movement of capital to grant exemption from income tax for dividends paid to individuals who are shareholders in domestic companies

[378] Case C-364/01 *The heirs of H. Barbier* v *Inspecteur van de Belastingdienst Particulieren/ Ondernemingen buitenland te Heerlen,* [2003], not yet reported in ECR, para. 22. Wattel, *Pending Cases Filed by Dutch Courts: the Bosal Holding Case and the Heirs of H. Barbier Case* in Lang (ed.), *Direct Taxation: Recent ECJ Developments,* (2003), p. 162.

[379] Case C-364/01 *The heirs of H. Barbier* v *Inspecteur van de Belastingdienst Particulieren/ Ondernemingen buitenland te Heerlen,* [2003], not yet reported in ECR, para. 62.

[380] *Ibid.*, para. 63.

[381] *Ibid.*, paras. 64–74.

[382] Case C-35/98 *Staatssecretaris van Financiën* v *B.G.M. Verkooijen* [2000] ECR I-4071.

but not to individuals who are shareholders in companies in other Member States. Mr Verkooijen resided in the Netherlands and held shares in a company established in Belgium. When he received dividends from the Belgian company, he was not allowed a dividend exemption on the ground that the dividends received had not been subject to dividend tax in the Netherlands.

The national tax legislation in *Verkooijen*[383] differentiated based on whether dividends were paid by a company resident in the Netherlands or elsewhere. The Court found this situation to be covered by the 1988 Directive.[384] Then, the Court turned to the effect of the Dutch legislation. It found that the legislation had:

> "the effect of dissuading nationals of a Member State residing in the Netherlands from investing their capital in companies which have their seat in another Member State."[385]

The Court also pointed out that the legislation had a:

> "restrictive effect as regards companies established in other Member States: it constitutes an obstacle to the raising of capital in the Netherlands as the dividends which such companies pay to Netherlands residents receive less favorable tax treatment than dividends distributed by a company established in the Netherlands, so that their shares are less attractive to investors residing in the Netherlands than shares in companies which have their seat in that Member State."[386]

The Court concluded that the Dutch legislation constituted a restriction on capital movements.

Next, the Court analysed whether the Dutch legislation was justified having regard to Article 58 (1) EC. It explained that the option granted to the Member States by this provision had already been upheld by the Court itself. Therefore, the Court's case law shows that national tax provisions of the kind, which Article 58 (1) EC refers to, could be compatible with Community law provided that they applied to situations which were not objectively comparable or could be justified by imperative interests.[387] This was the reason why the Court next examined whether

[383] *Ibid.*

[384] *Ibid.*, paras. 26, 30. See section 4.5.

[385] Case C-35/98 *Staatssecretaris van Financiën* v *B.G.M. Verkooijen* [2000] ECR I-4071, para. 34.

[386] *Ibid.*, para. 35.

[387] *Ibid.*, para. 43. See also Ståhl, *Free movement of capital between Member States and third countries*, ECTRev 2004, pp. 47–48.

the restriction arising from the Netherlands' tax provision could be justified by any imperative interests.[388] It was argued that the Dutch legislation was necessary to preserve the cohesion of the tax system,[389] promote the Dutch economy[390] and hinder a loss of tax revenue[391]. The Court considered these arguments but found that they could not justify the Dutch legislation.

The *Verkooijen* case shows similarities in different respects to *Safir*, *Danner* and *Skandia*. The national legislation differentiated based on place of establishment, and it was home state legislation which treated the taxpayer less favorable due to his exercise of free movement rights. Another similarity is that the Court in *Verkooijen* applied a dual perspective involving analysing the effect of the Dutch legislation considering the perspective of Dutch nationals as well as of companies in other Member States. First, the national legislation was found to dissuade Dutch nationals from investing their capital in companies which had their seat in another Member State. Second, the national provision also had a restrictive effect on companies established in other Member States as much as it constituted a restriction on these companies in the raising of capital in the Netherlands, dividends from their shares being less favourably treated than dividends on shares in Dutch companies.

The Dutch legislation was analysed by the ECJ from the perspective of home state legislation applying equally to all taxpayers resident in the Netherlands but distinguished on the ground of the exercise of free movement rights. The differentiation was based on whether a person invested in shares in a company established or resident in the Netherlands or in another EU Member State. The ECJ applied a *free movement-based approach* and found that the effect of the Netherlands legislation was twofold. It dissuaded Dutch nationals residing in the Netherlands from investing their capital in companies established outside the Netherlands and it had a restrictive effect with regard to companies established in other Member States as it constituted an obstacle to the raising of capital in the Netherlands. When considering the effect of the rule on companies established outside the Netherlands, the Court considered the Dutch legislation from a host state perspective.

[388] Case C-35/98 *Staatssecretaris van Financiën* v *B.G.M. Verkooijen* [2000] ECR I-4071, para. 46.
[389] *Ibid.*, para. 49.
[390] *Ibid.*, para. 47.
[391] *Ibid.*, para. 52.

5.8.2.2 The X and Y v Riksskatteverket Case

In the case *X and Y* v *Riksskatteverket*[392], the Swedish legislation in question subjected transfers at undervalue of shares in companies to tax treatment that differed according to the nature of the transferee.[393] If the transferee was a foreign legal person or a Swedish limited company in which a foreign legal person had a holding, a tax advantage was denied while if the transferee was a Swedish limited company which was not owned by a foreign legal entity, the tax advantage was granted. The Court found that the Swedish legislation constituted a restriction on the free movement of capital as it was:

> "liable to dissuade those liable to Swedish tax on gains from transferring shares at undervalue to transferee companies established in other Member States in which they directly or indirectly have a holding and, therefore, constitutes, for those taxpayers, a restriction on free movement of capital within the meaning of Article 56 EC".[394]

In the situation where the transferor directly or indirectly had a holding which gave him definite influence over the decisions of the foreign legal person and allowed it to determine its activities, the Court found a breach against Article 43 EC instead of Article 56 EC.[395] The free movement of capital was, therefore, applicable only in respect of situations where Article 43 EC did not apply due to insufficient level of participation of the transferor in the transferee company established outside Sweden.[396]

The ECJ considered, but did not uphold, the non-Treaty grounds put forward as justifications for the Swedish legislation. The Court applied a *free movement-based approach* in analysing the Swedish legislation. It found that the Swedish legislation was liable to dissuade those liable to Swedish tax on gains from transferring shares at undervalue to transferee companies established in other Member States. It was the foreign element that decided whether the tax advantage was granted or not, and it is clear that the Court applied a *free movement-based approach*. The Court did not argue in terms of differentiation due to nationality but rather focused on the effect of the Swedish legislation on persons resident in Sweden. The Swedish legislation was assessed from a home state perspective.

[392] Case C-436/00 *X and Y* v *Riksskatteverket* [2002] ECR I-10829.

[393] For comments in the litterature, see, for instance, Tjernberg, *Rättfärdigande av hindrande skatteregler mot bakgrund av EG-domstolens underkännande av ännu en svensk skatteregel,* SN 2003, pp. 230–246.

[394] Case C-436/00 *X and Y* v *Riksskatteverket* [2002] ECR I-10829, para. 70.

[395] *Ibid.*, para. 65..

[396] *Ibid.*, para. 68.

5.8.2.3 The Lenz Case

In the *Lenz*[397] case, the question was whether Articles 56 EC, 58 (1) and (3) EC precluded Austrian legislation that allowed more favourable tax treatment of revenue from capital of Austrian origin in comparison to revenue from capital from other Member States.

Ms Lenz, a German national fully liable to tax in Austria, received dividends from limited liability companies established in Germany.[398] If the dividends had been received from Austrian companies, she would have had the option of a final tax of 25 per cent or of a tax rate reduced by half.[399] Due to the foreign origin of the dividends, they were taxed at the ordinary income tax, the maximum rate of which is 50 per cent. Ms Lenz argued that this less favourable treatment was contrary to the provisions on free movement of capital.

The ECJ held that the Austrian legislation had a deterring effect on taxpayers living in Austria from investing their capital in companies established in other Member States.[400] In addition, the Court found that the Austrian legislation produced a restrictive effect in relation to companies established in other Member States as it constituted an obstacle to their raising capital in Austria. The reason for this conclusion was that the legislation at issue prescribed a less favourable tax treatment of dividends from shares of these companies. As a result, these shares were less attractive for investors living in Austria.[401] Therefore, the Court held that the Austrian legislation constituted a restriction on the free movement of capital, and the Court's next step was to assess whether the legislation could be justified.[402]

The Court explained that Article 58 (1) EC must be interpreted strictly because it represents a derogation from the fundamental principle of the free movement of capital. According to the Court, this provision cannot be interpreted as meaning that any tax legislation making a distinction between taxpayers by reference to the place where they invest their capital is automatically compatible with the EC Treaty.[403] One has to consider that Article 58 (1) EC is limited by Article 58 (3) EC, which provides that the national provisions referred to in Article 58 (1) EC shall not con-

[397] Case C-315/02 *Anneliese Lenz* v *Finanzlandesdirektion für Tirol* [2004], not yet reported in ECR.
[398] *Ibid.*, para. 13.
[399] *Ibid.*, paras. 10–11.
[400] *Ibid.*, para. 20.
[401] *Ibid.*, para. 21.
[402] *Ibid.*, paras. 22–23.
[403] *Ibid.*, para. 26.

stitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56 EC. Consequently, the Court held that a distinction must be made between unequal treatment which is permitted under Article 58 (1) EC and arbitrary discrimination which is prohibited by Article 58 (3) EC.[404] After having said that, the Court turned to the case law and held that the difference in treatment must concern situations which are not objectively comparable or be justified by imperative interests. Furthermore, to be justified, the difference in treatment must not go beyond what is necessary in order to attain the objective of the legislation.[405]

First, the Court considered whether the difference in treatment under Austrian legislation related to situations which were not objectively comparable. When doing that the Court turned to the aim of the national legislation which was to attenuate the economic effects of double taxation of company profits. The Court reached the conclusion that dividends of Austrian origin as well as dividends from companies in other Member States were capable of being subject of double taxation. Therefore, shareholders who were fully taxable in Austria and received dividends from a company established in another Member State were in a situation comparable to that of shareholders who were likewise fully taxable in Austria but received dividends from a company established in Austria.[406]

Second, the Court assessed whether the Austrian legislation was justified based on imperative interests. It was argued that the national legislation was justified by the need to ensure the coherence of the national tax system[407] and the need to ensure the effectiveness of fiscal supervision[408]. The Court rejected both arguments. The reason for rejecting the defence based on the cohesion of the tax system was twofold.[409] First, the Austrian legislation involved two distinct taxes which affected two different taxpayers. Second, there existed no direct link between the tax advantage and the taxation of company profits by way of corporation tax. Hence, the cohesion of the tax system was not achieved. The Court rejected the effectiveness of fiscal supervision by arguing that it had not been demonstrated that the application of different rates of tax by reference to the origin of the dividends were capable of making financial supervision more effective. Moreover, administrative inconvenience was

[404] *Ibid.*, para. 27.
[405] *Ibid.*
[406] *Ibid.*, para. 32.
[407] *Ibid.*, para. 34.
[408] *Ibid.*, para. 44.
[409] *Ibid.*, paras. 35–39.

not capable of justifying an obstacle to a fundamental freedom of the Treaty.[410]

The outcome of the Court's assessment was that the Austrian rule breached Article 56 EC. That the Court's reasoning is to be classified as a *free movement-based approach* is apparent. It compared two shareholders both being subject to unlimited tax liability in Austria, where one of them received dividends from a company situated in Austria and the other one received dividends from a company located in another Member State. The foreign element, in the form of the origin of the dividends, was decisive for whether the tax treatment was granted or not. Consequently, the national measure did not differentiated based on nationality or residence of Ms Lenz but on grounds of whether she as a shareholder had exercised her right to free movement.

The Austrian legislation was mainly assessed from a home state perspective. It applied irrespectively of nationality to shareholders resident in Austria but established a difference in treatment based on the exercise of free movement rights. Similar to what has been found in cases dealt with under Articles 43 EC and 49 EC, the Court considered a dual perspective. Besides assessing the national legislation's effect on residents, the Court recognized its effect on companies established in other Member States. For these companies, the Austrian legislation represented host state legislation. However, it appears as if this circumstance was not the main reason for turning down the Austrian legislation. The same perspective was considered by the Court in the *Verkooijen* case.[411]

5.8.2.4 The Weidert-Paulus Case

The dispute in *Weidert-Paulus*[412] concerned Luxembourg tax legislation, which denied income tax relief to individuals when acquiring shares representing cash contributions in companies in other Member States. Such an income tax relief was granted when individuals acquired shares in companies in Luxembourg. Mr and Mrs Weidert-Paulus argued that the Luxembourg legislation favoured undertakings having their seat in Luxembourg over those established in other Member States and was, therefore, in breach of the free movement of capital.[413]

[410] *Ibid.*, paras. 46–48.

[411] Case C-35/98 *Staatssecretaris van Financiën* v *B.G.M. Verkooijen* [2000] ECR I-4071, para. 35.

[412] Case C-242/03 *Ministre des Finances* v *Jean-Claude Weidert and Élisabeth Paulus* [2004], not yet reported in ECR.

[413] *Ibid.*, para. 8.

The ECJ assessed whether the Luxembourg legislation was precluded by Article 56 (1) EC and Article 58 (1) (a) EC. It first found that the legislation had the effect of discouraging Luxembourg nationals from investing their capital in companies which have their seat in another Member State.[414] The Court noticed that the provision in question has the direct object of promoting investment in companies having their seat in Luxembourg. The Court identified also a restrictive effect in relation to companies established in other Member States because it constitutes an obstacle to the raising of capital in Luxembourg. The Luxembourg legislation makes the acquisition of shares in those companies less attractive in comparison with acquisition of shares in Luxembourg companies.[415] Accordingly, the Court assessed the national legislation using a dual perspective. These circumstances led the Court to conclude that the Luxembourg legislation was contrary to Article 56 EC.

In its defence, the Luxembourg government argued that Article 58 (1) (a) EC allows tax provisions 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, where those distinctions are objectively justified or may be justified by overriding reasons in the general interest, in particular relating to the cohesion of the tax system.[416] The Luxembourg government stressed that the provision in question aims at guaranteeing that cohesion.[417] The tax advantage represented by the tax relief for the acquisition of shares in companies established in Luxembourg is offset by dividends subsequently paid by those companies. By contrast, where investment is made in a company outside Luxembourg, tax on dividends is generally reduced by 15 per cent by way of a tax treaty. In such a situation, Luxembourg would forgo the right to part of the tax, which would not apply in the case of dividends distributed by Luxembourg companies. The Court replied that the Luxembourg legislation is linked only to the acquisition of shares and is independent of any subsequent distribution by way of dividends.[418] Furthermore, the Court rejected the cohesion of the tax system defence, saying that there existed no direct link between the tax advantage and an offsetting fiscal levy.[419] In this context, the ECJ explained that tax treaties concluded by Luxembourg resulted in shifting fiscal cohesion to the level

[414] *Ibid.*, para. 13.
[415] *Ibid.*, para. 14.
[416] *Ibid.*, para. 16.
[417] *Ibid.*, para. 17.
[418] *Ibid.*, para. 19.
[419] *Ibid.*, para. 22.

of reciprocity of the rules applicable in the contracting states.[420] A tax treaty creates fiscal reciprocity, inasmuch as in foregoing 15 per cent of the net amount of dividends paid by companies established outside Luxembourg to individuals subject to Luxembourg income tax, Luxembourg may in return receive 15 per cent of the dividends paid by companies having their seat in Luxembourg to individuals in other Member States. Finally, the Court held that a tax treaty may not be invoked to justify an inconsistency as regards the taxpayer, which instead must be remedied by an extension of the relief in question.[421]

Based on the fact that the ECJ focused on the discouraging effect of the Luxembourg legislation on Luxembourg nationals to exercise their right to free movement, one may conclude that the ECJ's reasoning is to be classified as a *free movement-based approach*. The decisive factor was the location of the seat of the company in which the investment was made. However, the Court also considered the restrictive effect of the legislation on companies established in other Member States when raising capital in Luxembourg. The Court has taken such a dual perspective in previous cases, for instance *Verkooijen* and *Lenz*. This dual perspective gives that the ECJ assessed the Luxembourg legislation both from a home state perspective and a host state perspective.

In *Weidert-Paulus* the ECJ only very briefly dealt with Article 58 (1) (a) EC. It held that Article 58 (1) EC must be read in conjunction with Article 58 (3) EC, which gives that measures and procedures are not to constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital.[422] The Court found that in the present case there was clear discrimination between taxpayer, depending on the location of the seat of the company in which the investment was made. Thereafter, the Court assessed whether the Luxembourg legislation could be justified by the need to maintain the cohesion of the tax system.

5.8.3 The Relationship between Article 58 (1) (a) EC and the Imperative Interests

The Treaty justifications regarding free movement of capital are somewhat different in comparison with the other free movement provisions.[423] Article 58 (1) (a) EC, which states that the Member States have the right to

[420] *Ibid.*, para. 25.

[421] *Ibid.*, para. 26.

[422] *Ibid.*, para. 18.

[423] See section 4.5.1. For an analysis of the Treaty derogations in relation to the free movement of capital, see Sedlaczek, *Capital and Payments: The Prohibition of Discrimination and Restrictions*, ET 2000, pp. 14–28.

apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation regarding their place of residence or the place where their capital is invested, was to some extent dealt with by the ECJ in *Verkooijen*[424], *Lenz*[425] and *Weidert-Paulus*[426].

From *Verkooijen* and *Lenz,* it appears as if the Court when interpreting Article 58 (1) and (3) EC, the latter limiting the application of the former, focuses on two aspects: whether the difference in treatment under the national tax legislation relates to situations which are not objectively comparable and whether it is justified by imperative interests. In *Weidert-Paulus,* the ECJ simply held that there was clear discrimination between taxpayers, depending on the location of the seat of the company in which the investment was made. Then, the Court assessed whether the Luxembourg legislation could be justified by the need to maintain the cohesion of the tax system.

One way of understanding the Court's way of interpreting the explicit treaty derogation found in Article 58 (1) (a) EC is that the ECJ is more or less disregarding its existence.[427] When the Court applies Articles 39 EC, 43 EC and 49 EC, it more or less focuses on the above-mentioned factor. These provisions do not include any Treaty justification comparable to Article 58 (1) and (3) EC.

The Court's interpretation of Article 58 EC is problematic having in mind the Court's own statements that a distinction is to be upheld between Treaty justifications and imperative interests. If one considers a situation where a national tax provision is held by the ECJ to be directly discriminatory, recourse may only be had to explicitly stated Treaty justifications such as Article 58 (1) and (3) EC. However, when the Court decides whether the unequal treatment is permitted under Article 58 EC or constitutes arbitrary discrimination which is prohibited by Article 58 (3) EC, it applies a two-stage test. First, it considers whether the difference in treatment under the national tax legislation relates to situations which are not objectively comparable. Let us assume that the Court finds that the situations are comparable, similar to its findings in the *Lenz* case. Next, the Court has to consider whether any imperative interest may justify the tax provision. However, as the tax provision at issue is directly discriminatory, such justification is traditionally considered not available.

[424] Case C-35/98 *Staatssecretaris van Financiën* v *B.G.M. Verkooijen* [2000] ECR I-4071, paras. 43–46.

[425] Case C-315/02 *Anneliese Lenz* v *Finanzlandesdirektion für Tirol* [2004], not yet reported in ECR, paras. 26–48.

[426] Case C-242/03 *Ministre des Finances* v *Jean-Claude Weidert and Élisabeth Paulus* [2004], not yet reported in ECR, para. 18.

[427] Similarly, see Terra & Wattel, *European Tax Law,* (2001), p. 41.

It is possible that the Court after having found that the situations are comparable simply states that directly discriminatory tax provisions cannot be justified by imperative interests and concludes that the provision could not be justified having regard to Article 58 EC. However, such an outcome appears unsatisfactory.

In *Verkooijen,* the Court held that the Treaty exception in Article 58 EC and its own case law give rise to the same effect. This could be interpreted as pointing in the direction of accepting imperative interests in all situations regardless of the nature of the national measure. That implies also in situations involving a directly discriminatory national measure.

Further case law is needed to clarify how the ECJ will deal with a directly discriminatory tax measure when a Member State in its defense argues that it is justified under Article 58 (1) and (3) EC.

5.8.4 Summary and Analysis

The five income tax cases dealt with under Article 56 EC analysed in this section confirm the pattern from the other free movement provisions. A *nationality-based approach* was applied by the Court in the *Barbier* case, where the national legislation was analysed from a host state perspective. The Court did not attach relevance to the fact that the Netherlands was Mr Barbier's state of origin, which is in line with the Court's assessment in cases such as *Asscher*[428] and *Scholz*[429].

Cases where the Court applied a *free movement-based approach* have concerned legislation in the taxpayer's home state. It was the foreign element, in the form of holding shares in a foreign company in *Verkooijen* and *Lenz* as well as the foreign involvement in the transferee in *X and Y v Riksskatteverket* that gave rise to the less favourable tax treatment. The ECJ found that the legislation was liable to dissuade the taxpayers from exercising their right to free movement. The nationality or residence of the person directly affected by the tax legislation was not the decisive factor but whether he had used his right to free movement. However, in, for instance, *Verkooijen* and *Lenz* the ECJ considered a dual perspective. Besides focusing on the effect on residents of the national legislation, it also recognized its effect on foreign companies. As the exercise of free movement rights in the form of holding shares in foreign companies entailed less favorable tax treatment, it was less attractive for investors in these countries to own shares in such companies in comparison with

[428] Case C-107/94 *P. H. Asscher* v *Staatssecretaris van Financiën* [1996] ECR I-3089.
[429] Case C-419/92 *Ingetraut Scholz* v *Opera Universitaria di Cagliari and Cinzia porcedda* [1994] ECR I-505.

domestic companies. The Court has considered such a dual perspective in cases under Articles 43 EC, 49 and 56 EC.

In terms of justifications, the Court examined whether non-Treaty grounds could justify the restrictive national measures in all five cases. The outcome was negative in all cases. The Court's interpretation of Article 58 (1) and (3) EC appears to be problematic when applied to directly discriminatory tax provisions. It is unclear whether the Court in such a situation would allow a directly discriminatory measure to be justified having regard to imperative interests. If the Court would allow justification on such basis, it would be contrary to its own statements in other cases.

5.9 Conclusions

From the cases analysed in previous chapters as well as in this chapter, one finds that the reasoning employed by the Court under the *nationality-based approach* and what is used under the *free movement-based approach* are usually very different. Therefore, in terms of predictability, it is of importance to try to answer the following question: Under which circumstances is the ECJ applying a *nationality-based approach* and when is it applying a *free movement-based approach*?

From the case law study carried out in this chapter, a clear pattern can be derived. A *nationality-based approach* is applied by the Court when national legislation is analysed from a host state perspective. A *free movement-based approach* is used by the Court when assessing national legislation from a home state perspective. This confirms the result from the case law study in Chapter 4 on non-tax cases. In general, the Court has not applied a *free movement-based approach* when analysing tax legislation from a host state perspective. The only exceptions are when the Court has considered a dual perspective under Articles 43 EC,[430] 49 EC,[431] and 56 EC[432]. Under Article 49 EC, for instance, the Court's dual perspective has generally consisted of considering both the effects on a service receiver, for whom the legislation usually has been home state legislation, and the effects on foreign service providers, for whom the legislation at issue has been host state legislation.

[430] Case C-264/96 *Imperial Chemical Industries plc (ICI)* v *Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-4695, paras. 21–23.

[431] For instance, see Case C-136/00 *Rolf Dieter Danner* [2002] ECR I-8147, para. 31 and Case C-422/01 *Försäkringsaktiebolaget Skandia (publ.) and Ola Ramstedt* v *Riksskatteverket* [2003] ECR I-6817, para. 28.

[432] See Case C-315/02 *Anneliese Lenz* v *Finanzlandesdirektion für Tirol* [2004], not yet reported in ECR, para. 21 and Case C-35/98 *Staatssecretaris van Financiën* v *B.G.M. Verkooijen* [2000] ECR I-4071, para. 35.

The signification of host state perspective and home state perspective needs to be further elaborated on. In most cases where the host state perspective is chosen by the Court for its assessment, it coincides with the relationship the person who is directly affected by the legislation has with the state imposing the legislation at issue. For instance, in *Royal Bank of Scotland* the Court analysed the Greek legislation from a host state perspective. Also for the company Royal Bank of Scotland Greece represented the host state. However, in some cases dealt with in this case study, the perspective chosen by the Court is not the same as for the person directly affected by the burdening legislation. This is evident in, for instance, the *Metallgesellschaft* case and the *Lindman* case.

In *Metallgesellschaft,* the legislation at issue differentiated on grounds of where the parent company was established. A subsidiary was granted a more favourable tax treatment when the parent company was established within the national territory in comparison with the tax treatment of a subsidiary with its parent company established in another EU Member State. When the ECJ assessed the national legislation, it considered the state of the subsidiary as the host state. Although it was the subsidiary that primarily suffered from the less favourable treatment, the perspective chosen by the Court appears to be that of the parent company exercising its right to free movement to set up a subsidiary in the host state. However, the state imposing the burdening legislation may for the subsidiary be considered as the home state. It appears as if the ECJ considers the state of the subsidiary to be the host state where the legislation at issue differentiates on grounds of where the parent company is located.[433] The Court's choice of perspective makes sense when one considers that it is the parent company which has exercised its right to free movement to set up a subsidiary in another Member State.

In the *Lindman* case, it was the service receiver Ms Lindman who was treated in a less favourably way under Finnish tax legislation. However, the Court focused on the national legislation's effect on foreign service providers and found that they were in a disadvantageous position in comparison to Finnish providers. From the Court's reasoning, it is difficult to find that much attention was paid to the perspective of the service receivers, such as Ms Lindman, who was the person more directly affected by the legislation at issue. The Court's reasoning in *Lindman* proves difficult to classify because the Court compared Finnish service providers and

[433] For a similar reasoning see Case C-254/97 *Société Baxter, B. Braun Médical SA, Société Fresenius France and Laboratoires Bristol-Myers-Squibb SA* v *Premier Ministre, Ministère du Travail et des Affaires sociales, Ministère de l'Economie et des Finances and Ministère de l'Agriculture, de la Pêche et de l'Alimentation* [1999] ECR I-4809.

foreign service providers, but more directly it was not the foreign service providers who were negatively affected but the service receivers resident in Finland to whom the Finnish legislation applied. From the perspective of the service providers it is their residence that was decisive and the Court appears to have applied a host state perspective. From the perspective of Ms Lindman, it is not her nationality or residence that is of importance but whether she has exercised her right to free movement and bought a service from a foreign service provider instead of a national service provider.

The question of home state or host state perspective is also relevant in the *Asscher* case. In this study, the *Asscher* case has been described as a case where the Court applied a *nationality-based approach*. The reason for this conclusion is that the Court held that Mr Asscher was in a situation equivalent to that of any other person enjoying the rights recognized by the EC Treaty. The ECJ considered the Netherlands, Mr Asscher's state of origin, as the host state and did not attach relevance to the fact that Mr Asscher was of Dutch nationality. This made it possible for the ECJ to argue that the Dutch legislation was liable to act mainly to the detriment of nationals of other Member States since non-residents were in most cases non-nationals. A similar reasoning is found in, for instance, *Scholz,* a case which is analysed in Chapter 4.[434]

Inconsistencies such as the one in the *Lindman* case are probably part of the reason why, even though it is possible to derive a clear pattern on the Court's reasoning, it remains difficult to predict the compatibility of national tax provisions with free movement law.[435] These inconsistencies can be identified in terms of from which perspective the Court assesses a situation and the Court's position to when imperative interests may be invoked. The former area appears to give rise to more uncertainty than the latter, since it is clear that Member States have very limited chances of justifying a national tax provision even if they are allowed to invoke imperative interests.

The inconsistencies apparent in the area of justifications concern the situations where a Member State may invoke imperative interests. The traditional understanding, which is based on explicit statements by the ECJ, is that directly discriminatory national measures do not benefit from justifications based on imperative interests.[436] However, neither in cases

[434] Case C-419/92 *Ingetraut Scholz* v *Opera Universitaria di Cagliari and Cinzia porcedda* [1994] ECR I-505.

[435] See Wathelet, *Direct taxation and EU law: integration or disintegration?* ECTRev 2004, p. 3.

[436] See section 3.5.

dealt with in Chapter 4, nor in this chapter, the Court has generally refused, in principle, to entertain a defence because of the nature of the restriction. Regarding income tax cases the Court in only one case, the *Royal Bank of Scotland* case, refused entertaining any justification ground but Treaty justifications due to the nature of the national measure. As the national legislation in question differentiated on grounds of the seat of the company, which the Court has held to be the same as nationality for individuals, it is a directly discriminatory measure, and thereby the Court in *Royal Bank of Scotland* confirmed the traditional understanding of when imperative interests may be invoked. From the case law study in Chapter 4, it is apparent that the Court took the same standpoint in the *Bond*[437] case and in the *Albore*[438] case. In these three cases, where the Court refused to assess the merits of imperative interest justifications due to the nature of the restriction, the Court applied a *nationality-based approach*. Hence, based on the cases studied, the ECJ has not refused, in principle, to consider imperative interests when it has assessed home state legislation and applied a *free movement-based approach*. Based on the Court's reasoning in *Royal Bank of Scotland, Bond* and *Albore,* one may conclude that that the Court has not formally abandoned the traditional understanding of when imperative interests may be invoked. However, the Court's case law is apparently inconsistent on this point.

The Court's interpretation of the explicitly stated Treaty justification in Article 58 (1) and (3) EC appears to be problematic when applied to directly discriminatory tax provisions. It is unclear whether in such a situation the Court would allow a directly discriminatory measure to be justified having regard to imperative interests. Therefore, the conclusion is that the case law survey in Chapter 4 and in this chapter does not diminish the uncertainties in what situations a Member State may successfully invoke imperative interests. However, it is clear that the Court has been very strict in the admission of justifications. With only two exceptions, the cohesion of the tax system in *Bachmann* and the principle of territoriality in *Futura*, the Court has rejected the justifications put forward by the Member States.[439]

[437] Case 352/85 *Bond van Adverteerders and others* v *The Netherlands State* [1988] ECR I-2085.

[438] Case C-423/98 *Alfredo Albore* [2000] ECR I-5965.

[439] It is worth noticing that in *Futura* the ECJ did not apply the principle of territoriality as a justification for an otherwise prohibited restriction. It simply held that "[s]uch a system, which is in conformity with the fiscal principle of territoriality, cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty." See Case C-250/95 *Futura Participations SA and Singer* v *Administration des contributions* [1997] ECR I-2471, para. 22 (see section 5.6.3.3 of this study).

These inconsistencies in the Court's case law can not be said to be examples of where the Court's adjudication is contrary to the Treaty provisions applied. The free movement provisions in the EC Treaty are, as is argued in Chapter 1, formulated in a very general manner and give the Court considerable freedom in its adjudication. The provisions do not, for instance, prescribe from which perspective a national measure is to be assessed, from the perspective of the person more directly affected or from the perspective of a more or less unidentified person. For example, in the *Lindman* case, the service receiver, Ms Lindman, was negatively affected by the Finnish legislation, but the Court assessed the situation from the perspective of foreign service providers, who were not formally party in the proceedings. It is possible to argue that by taking this perspective, the outcome served Ms Lindman, because the rule that was to her disadvantage was found to be a prohibited restriction. However, in terms of predictability it would have been preferable if the Court had followed its established line of reasoning found in, for instance, *Danner* and *Skandia*. If the Court found a need to make a deviation from its established case law, one would have appreciated if the Court had distinguished the case at hand from the previous line of cases. The judicial discretion following the broadly worded free movement provisions reduces legal certainty when the Court uses this discretion differently under, apparently, similar circumstances. That the Court needs to make legal policy considerations when interpreting and applying the free movement provisions is unavoidable due to their character of framework provisions.[440] However, it puts a burden on the Court to decrease legal uncertainty as far as possible. The Court's current practise is unsatisfactory in this respect.

The inconsistencies found in the case law lead to uncertainty for anyone who is to apply free movement law, such as national courts, litigants and national legislators. It is, therefore, of importance to have some clear guidelines. The predictability would be improved if the ECJ was clearer in its reasoning, for example when it comes to the terms used. Furthermore, it would be preferable if the Court would relate its analysis of a particular situation to previous cases both confirming the standpoint at hand and cases pointing in another direction.

In comparison with the results from Chapter 4 on non-tax cases, it is worth noticing that when the Court has applied a *free movement-based approach* in income tax cases, the national tax rule has always included a difference in treatment based on whether free movement rights have been exercised or not. In contrast, in *Alpine Investments*, a non-tax case ana-

[440] For the underlying reasoning see section 1.5.

lysed in Chapter 4, the Court applied a *free movement-based approach* to a home state provision which did not entail such a difference but was equally applicable in a domestic context and a cross-border context.

A final observation is that the development of the Court's interpretation and application of free movement provisions is an extension from a traditional and rather uncontroversial prohibition of discrimination on grounds of nationality to a prohibition of negative treatment due to the exercise of free movement rights. The latter prohibition has nothing to do with nationality but has been argued by the Court to be necessary to remove national measures dissuading persons from exercising their free movement rights, a central concern for a well-functioning internal market. This development is not always evident as the Court, when applying a *free movement-based approach,* is arguing in terms of discrimination, which commonly are connected with a prohibition of discrimination on grounds of nationality.

6 The Impact of Free Movement Provisions on Member States' Tax Treaties

6.1 Free Movement Law and Tax Treaty Articles

The functioning of tax treaties is outlined in Chapter 2. The aim of this chapter is to reach conclusions on the ECJ's interpretation of free movement provisions in relation to provisions which are part of tax treaties concluded by Member States. However, one should be aware that there are only a limited number of cases where the ECJ has dealt with tax treaty provisions. Therefore, the guidance for establishing the impact of free movement rules on tax treaties is limited.

In this chapter the three essential cases for establishing the impact of free movement law on tax treaties are analysed. These cases, *Gilly*[1], *Saint-Gobain*[2] and *de Groot*[3], have not been dealt with in previous chapters. However, to a more limited extent, cases presented in Chapter 5 are also analysed here, in respect of statements by the ECJ of central importance for the question of the impact of free movement provisions on Member States' tax treaties.

In Chapters 4 and 5 conclusions have been reached on in which situations the ECJ applies a *nationality-based approach* and when it applies a *free movement-based approach.* These conclusions are tested in this chapter in reference to the cases *Gilly, Saint-Gobain* and *de Groot.*

It is worth noticing that both *Gilly* and *Saint-Gobain* were decided in full Court (*petit plenum*)[4]. The formation chosen by the Court is generally determined by the difficulty or importance of the proceedings.[5]

[1] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793.

[2] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161.

[3] Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819.

[4] See Arnull, *The European Union and its Court of Justice,* (1999), p. 11.

[5] *Ibid.*

6.2 Tax Treaty References to Community Law

Prior to analysing the case law to establish the impact of free movement law on tax treaties, it is worth noticing that a few tax treaties in the internal market include explicit references to Community law. These references are the result of the attempts of some Member States to adjust their tax treaties to Community law.[6] For instance, the French-Italian treaty of 5 October, 1989 contains a provision providing that if the clauses of the treaty:

> "become incompatible with the provisions decreed by the bodies of the European Communities, both States shall, after consultation between their competent authorities, settle by mutual agreement, through diplomatic channels, the means and conditions under which such clauses shall cease to apply".[7]

Maisto argues that such a provision has little practical relevance as it does not provide for a solution.[8]

Numerous references to Community law are found in the Dutch-Portuguese tax treaty of 20 September 1999.[9] For instance, in Article 11 on interest and Article 12 on royalty, reference is made to directives, pending at the time of the conclusion of the treaty, namely the Interest and Royalty Directive and the Savings Directive.[10] In the treaty it is stated that these directives, when in force, will be applicable instead of the relevant tax treaty provisions.[11]

6.3 Interpretation of Free Movement Provisions in Relation to Provisions in International Treaties

A difference between internal tax legislation and tax treaties is that tax treaties are of a bilateral or multilateral origin.[12] Before going into detail with the three cases where the ECJ has dealt with tax provisions which were part of tax treaties, statements by the Court in relation to other bilateral international conventions are presented. This is relevant since free movement provisions are considered not only in relation to tax treaties

[6] See Maisto, *Shaping EU Company Tax Policy: The EU Model Tax Treaty,* ET 2002, pp. 304–306.

[7] Para. 17 of the protocol (unofficial translation, IBFD tax treaty data base).

[8] Maisto, *Shaping EU Company Tax Policy: The EU Model Tax Treaty,* ET 2002, p. 306.

[9] See van den Ende & Smit, *European Tax Law Influences the New Tax Treaty,* ET 2001, pp. 98–105.

[10] See section 5.3.

[11] See Articles 11 (5) (a) and (b) as well as Article 12 (3) (IBFD tax treaty data base).

[12] See sections 1.1.3 and 2.2.

but also in relation to other international agreements. This presentation is limited to statements regarding the Court's interpretation of free movement provisions in relation to provisions forming part of international treaties not being tax treaties.

In terms of international treaties concluded between EU Member States and non-member countries, Article 307 EC is of importance.[13] The first paragraph of Article 307 EC provides that the rights and obligations arising from agreements concluded before the entry into force of the EC Treaty between one or more Member States, on the one hand, and one or more non-member countries, on the other, are not to be affected by the provisions of the EC Treaty.[14] However, the second paragraph of the same article requires Member States to take all appropriate steps to eliminate any incompatibilities between such agreements and the EC Treaty.

The *Hubbard*[15] case concerns national treatment where international agreements are involved. Mr Hubbard, an English solicitor, acted in the capacity of an executor under English law. In a German court, he sought an order vesting in him property, located in Germany, which formed part of a testator's estate.[16] The defendant demanded security for costs in accordance with German domestic law. According to German legislation, foreign nationals who acted as plaintiffs in proceedings brought before German courts were obliged, upon application by the defendant, to give security for costs and lawyers fees. However, this obligation did not apply where the plaintiff was a national of a state which did not require such security to be given by German nationals.[17] Two international agreements were involved, a German-British convention on the conduct of legal proceedings[18] and the European Convention on Establishment[19]. The former granted treaty benefits to residents while the latter, also including the same residence requirement, did not apply this rule to

[13] For the Court's interpretation of Article 307 EC, see, for instance, Case C-466/98 *Commission* v *United Kingdom of Great Britain and Northern Ireland* [2002] ECR I-9427, paras. 22–30.

[14] It follows from Case 812/79 *Attorney General* v *Burgoa* [1980] ECR 2728, para. 8 that the purpose of the first paragraph of Article 307 EC is to make it clear, in accordance with the principles of international law (see Article 30 (4) (b) of the Convention of the Law of Treaties signed in Vienna on 23 May 1969), that application of the Treaty does not affect the duty of the Member State concerned to respect the rights of non-member countries under a prior agreement and to perform its obligations thereunder.

[15] Case C-20/92 *Anthony Hubbard* v *Peter Hamburger* [1993] ECR I-3777.

[16] *Ibid.*, para. 3.

[17] *Ibid.*, para. 4.

[18] The Convention was concluded on 20 March 1928.

[19] The Convention was concluded on 13 December 1955.

nationals of states which had made reservations under Article 27 of the Convention. The UK had made such reservation, and Mr Hubbard was, therefore, denied treaty benefits under that convention. Moreover, as he did not reside in Germany, he did not fulfil the residence requirement under the German-British convention. As a result, Mr Hubbard could not rely on any of the two international agreements.

The ECJ stated that the fact that Germany required security for costs to be given by a national of another Member State who had brought an action before one of its courts, whilst its own nationals were not subject to such requirement, constituted discrimination on grounds of nationality.[20] Next, the ECJ held that "the right to equal treatment laid down in Community law may not be made dependent on the existence of reciprocal agreements concluded by Member States."[21] Hence, Hubbard was granted the same treatment as residents even though the international agreement did not give him that right.

In the *Gottardo*[22] case the ECJ summarized the impact of free movement law on provisions in international agreements in the following way:[23]

> "[W]hen giving effect to commitments assumed under international agreements, be it an agreement between Member States or an agreement between a Member State and one or more non-member countries, Member States are required, subject to the provisions of Article 307 EC, to comply with the obligations that Community law imposes on them. The fact that non-member countries, for their part, are not obligated to comply with any Community-law obligation is of no relevance in this respect."[24]

In the *Open Skies*[25] cases the ECJ interpreted Article 43 EC in relation to bilateral air service agreements concluded between EU Member States and the US.[26] The Court held that application of Article 43 EC is neither

[20] Case C-20/92 *Anthony Hubbard* v *Peter Hamburger* [1993] ECR I-3777, para. 14.

[21] *Ibid.*, para. 17.

[22] Case C-55/00 *Elide Gottardo* v *Istituto nazionale della previdenza sociale (INPS)* [2002] ECR I-413. See also PR 02/02.

[23] The *Gottardo* case is also commented in section 6.7.1.

[24] Case C-55/00 *Elide Gottardo* v *Istituto nazionale della previdenza sociale (INPS)* [2002] ECR I-413, para. 33.

[25] The judgments delivered on 5 November 2002 included the following cases: C-266/98 *Commission* v *United Kingdom of Great Britain and Northern Ireland*, C-467/98 *Commission* v *Denmark*, C-468/98 *Commission* v *Sweden*, C-469/98 *Commission* v *Finland*, C-471/98 *Commission* v *Belgium*, C-475/98 *Commission* v *Austria* and C-476/98 *Commission* v *Germany*. The decisions of the ECJ in these cases are equivalent. I will refer to the facts and paragraph numbers in Case C-466/98 *Commission* v *United Kingdom of Great Britain and Northern Ireland* [2002] ECR I-9427.

[26] This case is analysed more extensively in section 4.3.2.4.

suspended nor excluded in relation to any sector. As a basic provision of the EC Treaty, it also applies in areas falling within the competence of the Member States.[27] The Court observed that the bilateral provision, employing an ownership and effective control requirement, was capable of having a negative effect on non-UK airlines, *i.e.* airlines established in the UK of which a substantial part of the ownership and effective control is vested either in a Member State other than the UK or in nationals of such a Member State (Community airlines).[28] These airlines may, according to the agreement, always be excluded from the benefits of the international treaty, while the benefits are assured to UK airlines. The ECJ concluded that the UK, therefore, discriminated Community airlines as they were prevented from the more favourable treatment by the US which national airlines were granted.[29] The source of the discrimination was not the possible conduct of the US but the provision in the international agreement which acknowledged the right of the US to act in a discriminatory fashion.[30]

Finally, in *Open Skies* the ECJ further commented its statements in the *Saint-Gobain* case that the extension of tax treaty benefits to PEs of non-resident companies could be decided upon unilaterally by Germany without in any way affecting the rights of the non-member country arising from that tax treaty and without imposing any new obligations on that non-member country.[31] The Court held that this statement:

> "does not mean, however, that, where the infringement of Community law results directly from a provision of a bilateral international agreement concluded by a Member State after its accession to the Community, the Court is prevented from holding that that infringement exists so as not to compromise the rights which non-member countries derive from the very provision which infringes Community law."[32]

The conclusion drawn from these statements is that, in principle, the fact that a provision is a part of an international agreement does not have any impact on the application of free movement provisions. The situation is more complex where the international agreement is concluded between

[27] Case C-466/98 *Commission* v *United Kingdom of Great Britain and Northern Ireland* [2002] ECR I-9427, paras. 41–43.

[28] *Ibid.*, para. 48. For a more comprehensive account of the facts of the case, see section 4.3.2.4.

[29] *Ibid.*, para. 50.

[30] *Ibid.*, para. 51.

[31] See section 6.5 below.

[32] Case C-466/98 *Commission* v *United Kingdom of Great Britain and Northern Ireland* [2002] ECR I-9427, para. 54.

an EU Member State and a non-Member State. In the latter situation Article 307 EC needs to be considered as well as the more significant circumstance that non-EU Member States are not bound by Community law. However, according to the ECJ's statement in *Open Skies*, the non-member country may be negatively affected by the fact that a bilateral provision is inapplicable due to its contravention of Community law.[33]

6.4 The Gilly Case

In the *Gilly*[34] case the ECJ analysed the compatibility of a distributive provision and a method provision of a tax treaty based on the OECD model with Article 39 EC. This was the first time that the ECJ focused on the compatibility of actual tax treaty provisions with free movement law.[35] In previous cases the ECJ had come across situations where tax treaty provisions had had a certain impact on a situation, but in these cases the focus was always on the compatibility of national tax rules with free movement law.

In *Gilly* the ECJ initially held that the second indent of Article 293 EC did not have direct effect as it only defined an objective and was not intended to lay down a directly applicable rule conferring on individuals any right on which they might be able to rely before their national courts.[36]

[33] Kemmeren concludes that it seems to be impossible to declare a tax treaty provision in a tax treaty between a Member State and a non-Member State void. The reason is that Article 46 of the Vienna Convention on the law of treaties states that such a declaration is merely possible if the tax treaty provision is unmistakably in conflict with the EC Treaty. Kemmeren argues that since the state of art of Community law in relation to tax treaty law and the discussion in the literature, such a position cannot be held. See Kemmeren, *The Netherlands*, in Essers, de Bont & Kemmeren (eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law*, (1998), p. 147.

[34] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793.

[35] The case has been extensively analysed in the literature, see, for instance, Vanistendael, *Case C-336/96, Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas Rhin, Judgment of the Court of Justice of 12 May 1998. Full Court. [1998] ECR I-2793*, CMLRev 37, 2000, pp. 167–179, Eicker, *Tax Treaties and EC Law: Comment on the Gilly Case*, ET 1998, pp. 322–327, Gammie, *Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas-Rhin, Case C-336/96*, Bulletin 1998, pp. 336–337, Lehner, *Annotations on the Judgment of the European Court of Justice, Case C-336/96 – The Gilly Case – of 12 May 1998*, Bulletin 1998, pp. 334–335, Hughes, *Gilly and the Big Picture*, Bulletin 1998, pp. 329–333, Vogel, *Some observations regarding 'Gilly'*, ECTRev 1998, p. 150 and van den Hurk, *The European Court of Justice knows its limits (A discussion inspired by the Gilly and ICI cases)*, ECTRev 1999, pp. 211–223.

[36] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, paras. 15–17.

6.4.1 The Facts of the Case

Mr and Mrs Gilly lived in France. Mrs Gilly, a German national who acquired French nationality by marriage, was employed as a teacher in the German state education system.[37] Her husband, of French nationality, worked as a teacher in the French state education system. For tax purposes, they were considered to be residents of France. They brought proceedings in the Tribunal Administratif in Strasbourg against the French tax authorities concerning the computation of their personal income tax liabilities for the tax years of 1989 to 1993. Mr and Mrs Gilly argued that the application of the tax convention between France and Germany had led to unjustified, discriminatory and excessive taxation which was incompatible with Article 12 EC, 39 EC and 293 EC. The French court referred to the ECJ for a preliminary ruling under Article 234 EC.

The applicable tax treaty was the double tax convention between France and Germany concluded on 21 July 1959, as amended by protocols on 9 June 1969 and 28 September 1989. Article 13 (1) of the tax treaty sets out the main principle regarding the taxation of dependent employment:[38]

> *"Subject to the provisions of the following paragraphs, income from dependent work shall be taxable only in the Contracting State in which the personal activity in respect of which it is received is carried out."*

An exception to the principle set out in Article 13 (1) is found in Article 13 (5) (a):[39]

> *"By way of exception to paragraphs 1, 3 and 4, income from dependent work earned by persons who work in the frontier area of one Contracting State and who have their permanent home in the other Contracting State, to which they normally return each day, shall be taxable only in that other State."*

Article 13 does not apply to remuneration and pensions from the public sector, which, instead, are governed by Article 14 (1):[40]

> *"Salaries, wages and similar remuneration, and retirement pensions, paid by one of the Contracting States, by a Land or by a legal person of that State or Land governed by public law to natural persons resident in the other State in consideration for present or past administrative or military services shall be taxable only in the first State. However, that provision shall not be*

[37] *Ibid.*, para. 3.
[38] *Ibid.*, para. 4.
[39] *Ibid.*, para. 5.
[40] *Ibid.*, para. 6.

applicable where the remuneration is paid to persons having the nationality of the other State without being at the same time nationals of the first State; in such case, the remuneration shall be taxable only in the State in which such persons are resident."

According to Article 14 (1), the nationality of the taxpayer is decisive. The taxing power is allocated to the state of residence when the individual receiving the income is not a dual national or a national of the paying state and to the paying state when the individual has a dual nationality.

Article 16 of the tax treaty lays down a special rule applicable to teachers who are temporarily resident, under which taxation remains with the state of the original employment:[41]

"Teachers resident in one of the Contracting States who, in the course of a period of temporary residence not exceeding two years, receive remuneration in respect of teaching in a university, college, school or other teaching establishment in the other State shall be taxable in respect of that remuneration only in the first State."

Article 20 (2) (a) (cc) of the French-German tax treaty provides for relief of double taxation:[42]

"2. Double taxation of persons resident in France shall be avoided in the following manner:

(a) Profits and other positive income arising in the Federal republic and taxable there under the provisions of this Convention shall also be taxable in France where they accrue to a person resident in France. The German tax shall not be deductible for calculation of the taxable income in France. However, the recipient shall be entitled to a tax credit to be set against the

[41] *Ibid.*, para. 7.

[42] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 8. An unofficial translation of this provision is found in the IBFD tax treaty database. This translation reads:

"2. With respect to persons resident in France, double taxation shall be avoided as follows:

(a) profits and other positive income which arise in the Federal Republic and which may be taxed there in accordance with the provisions of this Convention may also be taxed in France if derived by a resident of France. The German tax shall not be deductible in determining the taxable income in France. However, the recipient shall be entitled to a tax credit against the French tax in the base of which such income is included. The amount of the credit shall be equal to: [...]

(cc) with respect to all other income, the amount of French tax attributable to such income. This provision shall apply especially to income referred to in Article 3, paragraphs 1 and 2 of Article 4, paragraph 1 of Article 6, paragraph 1 of Article 12, paragraphs 1 and 2 of Article 13 and Article 14;".

French tax charged on the taxable amount which includes that income. That tax credit shall be equal: [...]

(cc) for all other income, to the amount of the French tax on the relevant income. This provision shall apply in particular to the income referred to in Articles ... 13 (1) and (2) and 14."

Mrs Gilly's wages were taxed in Germany in accordance with Article 14 of the French-German tax treaty.[43] This article follows the general principle of the OECD Model that remuneration paid by a contracting state to officials in government service is taxable in that state. According to the tax treaty, an exception is made when the remuneration is paid to a person having the nationality of the other contracting state, without being at the same time a national of the first state. In such a case, the remuneration shall be taxable in the state of residence. Due to Mrs Gilly's dual nationality, the rule of taxation in the state of residence did not apply.

The applicable tax treaty prescribed full jurisdiction to tax Mrs Gilly's wages to Germany. However, according to Article 20 of the tax convention, her income was also subject to tax in France because of the tax credit mechanism applied by France to avoid double taxation.[44] In the literature there are examples of different classifications of this relief method.[45] Here, the focus is on the effect of the relief method instead of

[43] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 6.

[44] *Ibid.*, para. 8.

[45] The method provision under review in *Gilly* has been classified differently by commentators in the literature. Vanistendael and Kemmeren refer to it as a ordinary credit provision, see Vanistendael, *Case C-336/96, Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas Rhin, Judgment of the Court of Justice of 12 May 1998. Full Court. [1998] ECR I-2793,* CMLRev 37, 2000, p. 168 and Kemmeren, *EC LAW: Specific Observations,* in Essers, de Bont & Kemmeren (eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law,* (1998), p. 21. Vogel refers to it as a tax credit mechanism which is subject to "the usual tax credit limitation", see Vogel, *Some observations regarding 'Gilly',* ECTRev 1998, p. 150. Avery Jones refers to the method provision as "a so-called credit". He explains that the reason for describing it as a so- called credit is that, "while the treaty article was expressed as a credit, the amount credited in France was the French tax, not, as one might have expect, the German tax." Furthermore, Avery Jones held in regard to the method provision that "[i]f this is different from exemption with progression, the difference is not apparent to me". See Avery Jones, *What is the Difference between Schumacker and Gilly?,* ET 1999, p. 2. van den Hurk interprets the method provision as the "credit on Mrs Gilly's German tax liability (credit d'impôt) is calculated by multiplying her basic tax liability in France by the fraction of the German net income and the total net income. This shows that no full credit is available." See van den Hurk, *The European Court of Justice knows its limits (A discussion inspired by the Gilly and ICI cases),* ECTRev 1999, p. 212. Pistone classifies it as a schedule mechanism for credit of foreign taxes, explaining that it is different from both ordinary and full tax credit, in Pistone, *The*

its classification as its effect is likely to be most significant in terms of considering the impact on the Member States' tax treaties of the Court's judgment in this part. The relief method operated in Mrs Gilly's case to limit the credit for German tax paid to the French tax paid on the relevant income.[46]

The national court noticed that the tax credit to be set against the French tax might prove to be less than the tax actually paid in Germany when the applicable tax rate in Germany was higher than the one applicable to the income in France.[47] This was the situation for Mrs Gilly. The German tax due on Mrs Gilly's salary exceeded considerably the French tax due on the same income. Vanistendael has explained that the reason was the German federal income tax law, which applied a 50-50 splitting system for married taxpayers.[48] This system considerably reduced the progressivity of the tax rate scale. Since it was not applicable to non-residents, Mrs Gilly was subject to the full force of the progressivity of the German tax scale. In France, however, her German source income benefited from a certain splitting rate system. The result was that Mrs Gilly's tax liability in France was more than compensated by the amount of tax paid in Germany. Accordingly, she did not pay any tax in France, but she ended up paying more tax in Germany than she would have paid had her income only been subject to tax in France. In the literature it is argued that Mrs Gilly should have appealed against the taxation in Germany and, in particular, the denial of the splitting relief by the German tax authorities.[49]

Impact of Community Law on Tax Treaties, (2002), p. 133. Wattel explains that the method provision under review in *Gilly* case "was the same double taxation relief mechanism as the one used in the Netherlands, although the French relief at first sight would appear to be a credit method, rather than an exemption method. Substantively, the method applied, however, was an exemption with progression with a similar fractional allocation of personal allowances to the foreign-source income as the Dutch one", see Wattel, *Progressive Taxation of Non-Residents and Intra-EC Allocation of Personal Tax Allowances: Why Schumacker, Asscher, Gilly and Gschwind Do Not Suffice*, ET 2000, p. 218. The method provision has also been decribed as an alternative exempt by Mattsson, *Does the European Court of Justice Understand the Policy behind Tax Benefits Based on Personal and Family Circumstances?* ET 2003, pp. 190–191.

[46] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 9. The Court emphasized that the method provision at issue was based on the OECD Model, see para. 41 of the Court's judgment.

[47] *Ibid.*, para. 10.

[48] Vanistendael, *Case C-336/96, Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas Rhin, Judgment of the Court of Justice of 12 May 1998. Full Court. [1998] ECR I-2793*, CMLRev 37, 2000, p. 168. See also Eicker, *Tax Treaties and EC Law: Comment on the Gilly Case*, ET 1998, p. 326.

[49] Eicker, *Tax Treaties and EC Law: Comment on the Gilly Case*, ET 1998, p. 326.

Evidently, Mrs Gilly's tax situation was more burdening due to her German source income in comparison with a situation where she only had had income derived in France.

6.4.2 The Compatibility of the Distribution Provisions with Article 39 EC

6.4.2.1 The Reasoning of the Court

When interpreting Article 39 EC in relation to the distributive rule found in Article 14 (1) of the tax treaty, the ECJ first stated that Mrs Gilly was to be considered a person who had exercised her freedom of movement. Consequently, her situation fell within the scope of Article 39 EC.[50] The French government argued in the opposite direction and held that since she worked in her state of origin, namely Germany, she could not benefit from the rights conferred by Article 39 EC. Considering the ECJ's reasoning in the cases *Kraus*[51] and *Scholz*[52], the fact that the ECJ turned down this line of reasoning is not surprising.[53]

The Court identified the abolition of double taxation within the Community as one of the objectives of the EC Treaty.[54] It also emphasized that no general unifying or harmonizing measures for the elimination of double taxation had been adopted at the Community level.[55] Consequently, the ECJ concluded, the Member States were competent to determine the criteria for taxation on income and wealth with a view to eliminate double taxation by way of, for instance, international agreements based on the OECD model.[56] The Court found that the French-German tax treaty had been concluded in that context.

As has been presented, the provisions in the tax treaty dealing with the taxation from dependent work employed a number of connecting factors

[50] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 22.

[51] Case C-19/92 *Dieter Kraus* v *Land Baden-Württemberg* [1993] ECR I-1663.

[52] Case C-419/92 *Ingetraut Scholz* v *Opera Universitaria di Cagliari and Cinzia porcedda* [1994] ECR I-505.

[53] See sections 4.2.3.1 and 4.2.2.2.

[54] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 23.

[55] The only harmonizing measure for the elimination of double taxation is the convention of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.

[56] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 24.

for the purpose of allocating taxing jurisdiction between France and Germany.[57] The ECJ stated that although:

> "the criterion of nationality appears as such in the second sentence of Article 14 (1) for the purpose of allocation of fiscal jurisdiction, such differentiation cannot be regarded as constituting discrimination prohibited under Article 48 of the Treaty [now Article 39 EC]."[58]

The ECJ presented three reasons for this conclusion. First, it held that in the absence of any unifying or harmonizing measure adopted in the Community, it follows from "the contracting parties' competence to define the criteria for allocating their powers of taxation as between themselves, with a view to eliminating double taxation."[59]

Second, the ECJ stated that "[n]or, in the allocation of fiscal jurisdiction, is it unreasonable for the Member States to base their agreements on international practise and the model convention drawn up by the OECD, Article 19 (1) (a) of the 1994 version of which in particular provides for recourse to the paying State principle."[60] Next, the Court referred to the Commentaries on Article 19 and held that the paying state principle is justified by the rules of international courtesy and mutual respect between sovereign states, and this principle is contained in so many existing tax treaties between OECD member countries that it can be said to be already internationally accepted.[61] The Court noticed that Article 14 of the applicable tax treaty was not identical to Article 19 of the OECD Model but concluded that Article 19 included an exception based on the criterion of nationality similar to the one found in Article 14 of the tax treaty.[62]

The third reason presented by the ECJ to justify its interpretation of Article 39 EC in relation to Article 14 of the tax treaty was that even if the nationality criterion in Article 14 were to be ignored, Mrs Gilly's tax position would remain unchanged.[63] Her income earned in Germany would still be subject to the paying state principle as she was teaching in the state education system.

[57] *Ibid.*, para. 29.
[58] *Ibid.*, para. 30.
[59] *Ibid.*
[60] *Ibid.*, para. 31.
[61] *Ibid.*
[62] *Ibid.*, para. 32. Gammie has argued that it appears that the ECJ misinterpreted the circumstances in which Article 19 applies, see Gammie, *Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas-Rhin, Case C-336/96*, Bulletin 1998, p. 337.
[63] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 33.

6.4.2.2 Analysis of the Court's Reasoning

One may interpret the Court's reasoning as that the Member States are free to choose connecting factors for the allocating of fiscal jurisdiction without running the risk of acting contrary to free movement law.[64] As the Court in its reasoning mentioned the connecting factors in Article 13 (1), 13 (5) (a) and 16, besides the criterion of nationality employed in Article 14, it is reasonable to conclude that the Court's reasoning in the *Gilly* case has an impact on all the different types of connecting factors employed by the distributive rules.

The way the ECJ refers to the OECD model and its Commentaries shows that the Court is cautious in relation to this internationally accepted model. However, as is evident in the subsequent *Saint-Gobain* judgment, this does not validate a conclusion that when Member States follow the OECD Model when concluding tax treaties, they are automatically acting in line with free movement law.[65]

When finding that the tax treaty provision employing the criterion of nationality did not constitute discrimination on grounds of nationality, the ECJ did not follow its common test, for instance, establishing whether the taxpayers were in objectively different situations. This was also noticed in the *Futura* case, where the ECJ simply stated that where a national measure is in conformity with the fiscal principle of territoriality, it could not be regarded as "entailing any discrimination, overt or covert, prohibited by the Treaty".[66] In Chapter 5 it was argued that the Court's reasoning in *Futura* suggested that there was a category of national measures which, even though they were discriminatory with reference to nationality, were in line with free movement law because they were in conformity with essential principles of another field of law. Hatzopoulous concluded in relation to the *Futura* case that this principle

[64] See Vanistendael, *Case C-336/96, Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas Rhin, Judgment of the Court of Justice of 12 May 1998. Full Court. [1998] ECR I-2793*, CMLRev 37, 2000, p. 174. See also Lehner, *The Influence of EU Law on Tax Treaties from a German Perspective*, Bulletin 2000, p. 466, Weber, *Pending Cases Filed by Dutch Courts: the F.W.L. de Groot Case and Related EC Cases before Dutch Courts* in Lang (ed.), *Direct Taxation: Recent ECJ Developments*, (2003), p. 183 and Cordewener, *Foreign Losses, Tax Treaties and EC Fundamental Freedoms: A New German Case before the ECJ*, ET 2003, p. 300.

[65] Similarly, Lehner, *The Influence of EU Law on Tax Treaties from a German Perspective*, Bulletin 2000, p. 463 and Kemmeren, *EC Law: Specific Observations* in Essers, de Bont & Kemmeren (eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law*, (1998), p. 28.

[66] Case C-250/95 *Futura Participations SA and Singer* v *Administration des contributions* [1997] ECR I-2471, para. 22.

is perfectly sensible.[67] The Court's reasoning in *Gilly* may be seen as another example of this.

The ECJ justifies its conclusion in *Gilly* by referring *inter alia* to the lack of harmonization and the internationally accepted practice in the form of the OECD Model and its Commentaries. However, the lack of harmonization was turned down by the Court as a justification of discriminatory tax treatment in *Avoir Fiscal*.[68]

The Court's reference to the OECD Model and international accepted practice is interesting and understandable. In Chapter 5 numerous situations have been presented where the ECJ has found that free movement provisions have precluded national tax measures. In the *Gilly* case the ECJ seems to be taking a more cautious attitude towards tax provisions being part of a tax treaty concluded between two Member States and based on the OECD Model. I believe that one important reason for this attitude is that tax treaties generally are based on the OECD Model, which is quite a different situation than when the ECJ deals with unilateral internal tax legislation. The reason is that the OECD Model has contributed to a harmonization of tax treaty design implying that the consequences of not accepting a tax treaty provision based on the OECD Model, in comparison with a unilateral tax provision, potentially are more far-reaching.[69]

If the ECJ had found the connecting factor used in Article 14 (1) to be discriminatory on grounds of nationality, the result would have been that it were inapplicable under the French-German tax treaty. Even more importantly, though, the same would happen to any other tax treaty between EU Member States based on the OECD Model and that included such a connecting factor.[70] If the ECJ had come to the conclusion that Article 39 EC precluded the application of nationality as a connecting factor under tax treaties, it is not clear what the outcome would have been. One possible interpretation is that, as indicated by the Court in its

[67] Hatzopoulos, Case C-250/95, *Futura Participations SA & Singer* v *Administration des Contributions (Luxembourg)*, Judgment of 15 May 1997, [1997] ECR I-2471, CMLRev 35, 1998, p. 502.

[68] See chapter 5 and Pistone, *The Impact of Community Law on Tax Treaties: Issues and Solutions*, (2002) p. 134.

[69] See chapter 2. In his opinion in the *Gilly* case, Advocate General Ruiz-Jarabo Colomer noticed that some intervening Member States had drawn the Court's attention to the repercussions which would ensue from a judgment interpreting Article 39 EC as precluding the provisions under review in *Gilly*, as all the tax treaty provisions under review conformed with the OECD Model, on which most bilateral tax treaties signed between EU Member States among themselves are based. See para. 10 of the opinion.

[70] The impact on tax treaties concluded between EU Member States and third states is uncertain.

reasoning, the remaining parts of Article 14 (1) would have applied. Hence, Mrs Gilly would still be subject to taxation in Germany. An alternative interpretation is to consider the entire Article 14 (1) inapplicable, possibly leading to a situation as if there was no tax treaty at all. This would mean that the internal legislation applies. I find the latter interpretation less convincing. The reason is that it appears more likely that it is only the nationality criterion as such that is inapplicable and not the entire provision.

In Chapters 4 and 5 it has been shown that when a tax provision is analysed from a host state perspective, *i.e.*, it is applicable to persons leaving their home state to exercise their free movement rights in the host state, the Court is generally applying a *nationality-based approach.* When analysing national legislation from a home state perspective, the ECJ is generally applying a *free movement-based approach.* The distributive rule is not easily classified in terms of home state or host state legislation as it may give rise to taxation in the host state or in the home state. The aim of a distributive rule is to decide whether, and to what extent, income in a cross-border situation may be taxed by the residence state or the source state. Accordingly, the only determination made is which national tax system should be applied.[71] This division of tax jurisdiction aims at avoiding double taxation in favour of the taxpayer. The distributive rules do not generally prescribe how, *i.e.* according to which standards, tax should be levied by the contracting states; it merely sets the limits for such taxation.[72] To the extent that the tax on an income item is allocated to the source state by a distributive rule of a tax treaty, the source state may, within the limits drawn by the distributive rule, apply its national standards of taxation.[73] Therefore, distributive rules may be considered as neutral even though they explicitly apply a criterion of nationality.[74] A pure tax jurisdiction allocation does not have anything to do with the actual tax treatment in the contracting states.

[71] Weber, *Pending Cases Filed by Dutch Courts: the F.W.L. de Groot Case and Related EC Cases before Dutch Courts* in Lang (ed.), *Direct Taxation: Recent ECJ Developments,* (2003), p. 183.

[72] Lehner, *The Influence of EU Law on Tax Treaties from a German Perspective,* Bulletin 2000, p. 466.

[73] *Ibid.*

[74] See para. 45 of Advocate General Ruiz-Jarabo Colmer's opinion in Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793. See also van Thiel, *Removal of income tax barriers to market integration in the European Union: litigation by the Community citizen instead of harmonization by the Community legislature?,* ECTRev 2003, p. 14.

In the *Gilly* case the distributive rule gave rise to taxation in the host state, which resulted in a less favorable situation to Mrs Gilly than if the income had been taxed solely in her state of residence. The Court argued in terms of discrimination only, and one may conclude that it is discrimination on grounds of nationality that is referred to, as the connecting factor explicitly refers to the criterion of nationality. Therefore, there seems to be a situation where the ECJ's reasoning shows signs of a *nationality-based approach*. The Court did not, however, follow its usual line of reasoning under the *nationality-based approach* including establishing whether taxpayers were in objectively comparable situations or not.

That the distributive rule could be considered as neutral as long as it merely allocates powers of taxation appears to be the main reason for the Court's different assessment of the distributive rule in the *Gilly* case when compared to previous as well as subsequent case law.

6.4.3 The Compatibility of the Method Provision with Article 39 EC

6.4.3.1 The Reasoning of the Court

The question was whether Article 39 EC precluded the application of Article 20 (2) (a) (cc) of the French-German tax treaty, which limits the tax credit mechanism described in Article 23 B (1) (a) of the OECD Model, so that no full credit was available.[75]

The Court first gave prominence to the fact that the tax credit mechanism found in the applicable tax treaty was based on the OECD Model.[76] Next, the Court stated that the family circumstances of Mrs Gilly were not taken into account in the host state, Germany, whereas they were indeed taken into consideration in the home state, France.[77] Consequently, the ECJ stated, the differences in progressivity of the tax rate scales resulted in the amount of tax credit allowed in the country with

[75] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 9.

[76] *Ibid.*, para. 41.

[77] *Ibid.*, para. 43. This statement has been criticized in the literature as showing that the Court did not fully understand the question of personal deductions. Vogel argues that even though Mrs Gilly was entitled to personal deductions in France, she did not get the advantage of these deductions due to the tax credit limitation. See Vogel, *Some observations regarding 'Gilly'*, ECTRev 1998, p. 150. See also Eicker, *Tax Treaties and EC Law: Comment on the Gilly Case*, ET 1998, p. 325 and Mattsson, *Does the European Court of Justice Understand the Policy behind Tax Benefits Based on Personal and Family Circumstances?* ET 2003, pp. 190–192.

lower progressivity would expectedly always be lower than the amount of tax due in the state with a more progressive tax scale.[78]

The applicants argued that the relief method penalized those who had exercised their freedom of movement in that it allowed a degree of double taxation to remain.[79] Instead, they submitted, a full credit would fully avoid the double taxation.[80] On this point the governments of France, Belgium, Denmark, Finland, Sweden and the UK argued that if the state of residence (the home state) was required to accord a full tax credit, it would have to reduce its tax in respect of the remaining income, which would entail a loss of tax revenue.[81]

Citing its Advocate General, the ECJ emphasized that the object of a tax treaty is simply to prevent the same income from being taxed in each of the two states. It is not to ensure that the tax burden to which the taxpayer is subject in one state not be higher than to what he or she would be subject to in the other state.[82] The Court, further, held:

> "it is common ground that any unfavourable consequences entailed in the present case by the tax credit mechanism set up by the bilateral convention, as implemented in the context of the tax system of the State of residence, are the result in the first place of the differences between the tax scales of the Member States concerned, and, in the absence of any Community legislation in the field, the determination of those scales is a matter for the Member States."[83]

The Court distinguished the *Gilly* case from the *Schumacker* case by emphasizing that Mrs Gilly was able to benefit from personal and family-related tax advantages in France.[84]

6.4.3.2 Analysis of the Court's Reasoning

When assessing whether Article 39 EC precluded the application of the tax credit mechanism provision in the tax treaty, the ECJ emphasized the aim of tax conventions. The aim of a tax measure is something that the Court generally does not pay the same attention to in its judgments on internal tax provisions.[85] Instead, the ECJ commonly focuses on the

[78] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 44.
[79] *Ibid.*
[80] *Ibid.*, para. 45.
[81] *Ibid.*, para. 48.
[82] *Ibid.*, para. 46.
[83] *Ibid.*, para. 47.
[84] *Ibid.*, para. 50.
[85] See chapter 5.

effect of the legislation on persons exercising their free movement rights. Nowhere in its reasoning does the Court analyse the effect on free movement of the tax credit mechanism in the tax treaty.

The problem involved in classifying the distributive rule in terms of home state or host state legislation is not evident when classifying the method provision. The reason is that the tax credit mechanism always is applicable in the residence state of the taxpayer, *i.e.* generally his home state. Therefore, following the conclusions from Chapters 4 and 5, one can assume that the ECJ would apply a *free movement-based approach* and analysing whether the method provision could have a dissuasive effect on French residents from exercising their free movement rights. The effect of the tax credit mechanism on Mrs Gilly was that she paid more tax in respect of her professional activity in another Member State than she would have paid if she had worked in France. It is obvious that such a system makes the free movement of workers less attractive.[86] Accordingly, if the ECJ would have reasoned in a consistent way in respect to previous as well as subsequent case law, it would have assessed whether the method provision made the exercise of free movement rights less attractive. It appears as if the Advocate General Ruiz-Jarabo Colomer reasoned also in this way as he emphasized that the question was whether, although the tax credit mechanism provision applied:

> "irrespective of nationality, that procedure in fact has adverse effect on persons who have exercised their freedom of movement by treating them less favourably than those who have not done so".[87]

The Court, however, avoided reasoning in terms of the effect of the tax credit mechanism on the free movement and avoided an argumentation based on discrimination. Therefore, the Court's reasoning validates a conclusion that the Court neither applied a *free movement-based approach*, nor a *nationality-based approach*. Instead, the Court simply referred to the objective of tax treaties and the OECD Model.

[86] The ECJ explained in *Terhoeve* that a person could be deterred from leaving his home state to work in another Member State if he were required to pay greater social security contributions than if he continued to reside in the same Member State, see Case C-18/95 *F.C. Terhoeve* v *Inspectuer van de Belastingdienst Particulieren/Ondernemingen Buitenland* [1999] ECR I-345, para. 40. See also Wathelet, *The Influence of Free Movement of Persons, Services and Capital on National Direct Taxation: Trends in the Case Law of the Court of Justice,* YEL 20, 2001, p. 4 and Ståhl & Persson Österman, *EG-rätten och skyddet för den svenska skattebasen,* SvSkT 2002, p. 48.

[87] Opinion in Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 60.

One may conclude that it appears as if the ECJ did not want to deliver the judgment that Article 39 EC precluded the tax credit mechanism. What could be the reason for the Court's unwillingness to follow its established lines of reasoning? If the Court had found the tax credit mechanism to be contrary to Article 39 EC due to its dissuasive effect on the exercise of free movement of French residents, the outcome is not entirely clear. It is clear, however, that Article 20 (2) (a) (cc) of the French-German tax treaty would be inapplicable in its current form. The tax credit mechanism was subject to a limitation, namely the amount of French tax on the relevant income. This limitation, together with the tax rates applicable in Germany and France, gave rise to Mrs Gilly's unfavourable tax situation. If this limitation had been precluded by Article 39 EC, the tax credit mechanism would most likely have turned into a full credit. Such a relief method is found in Article 23 B of the OECD Model but is rarely used in tax treaties.[88] The reason is that it makes a state's tax revenue dependent on the tax rates in other countries.[89] It was argued on behalf of the intervening governments that a full credit would reduce tax revenue. This is an argument that has been turned down as a justification for restrictive tax measures by the ECJ in many previous cases.[90] It is worth emphasizing that Mr and Mrs Gilly argued that a full credit would have taken away the problem that Mrs Gilly faced. However, the Court did not respond to this argument. Instead, it held that the unfavourable consequences were due to the differences between the tax scales in France and Germany.[91]

One may conclude that if the Court had found the method provision in *Gilly* to be incompatible with Article 39 EC, this would have had several implications. Most likely, method provisions that do not grant the taxpayer similar or less burdening taxation in a cross-border situation in comparison with an internal situation would be inapplicable due to their dissuasive character. Such a decision would probably not have gone down well with the governments of the Member States as a large number of Member States apply ordinary credit provisions. To apply, for instance, a full credit would, as some intervening governments emphasized in the *Gilly* proceedings, result in a loss of tax revenue.[92] Moreover,

[88] This was noticed by the Advocate General in his opinion, para. 64.
[89] See section 2.6.3.
[90] See chapter 5.
[91] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 47.
[92] *Ibid.*, para. 48.

it would, in the short term, result in uncertainty.[93] Also, the impact of such a decision on tax treaties with third countries where the EU Member States employ such method provisions would be unclear. This supports a conclusion that the reason for the Court's unusual reasoning in relation to the method provision in the *Gilly* case was because of the negative consequences that potentially would follow, if the Court had found that the tax credit mechanism was in conflict with Article 39 EC.[94]

It appears as if the Court had found that striking down such provisions would result in more negative consequences than benefits, as it could give rise to a situation where Member States held that they could not afford to have tax treaties. Such a situation would not be benefiting for the internal market as regards the avoidance of double taxation.

Therefore, the Court used its judicial discretion and gave a judgment which, from an overall perspective, was in line with the aim of establishing an internal market. However, from the perspective of the Court's assessment in previous and subsequent case law, the Court's reasoning and judgment were not consistent. One may conclude that when dealing with core provisions of tax treaties where the impact of striking down such a provision would have potentially far-reaching negative effects on the tax treaty network, due to the harmonization following the OECD Model, the ECJ deviates from its established practice and uses its judicial discretion in a way that gives rise to an inconsistency considering the Court's case law as a whole.[95]

6.5 The Saint-Gobain Case

A basic principle in tax treaty application is that tax treaty benefits are available only to taxpayers resident in one of the two contracting states.[96] If the taxpayer is resident of neither of the contracting states, he may not invoke the benefits under the tax treaty. This is the situation for permanent establishments (hereinafter PEs) that do not as such qualify as taxpayers in the state of activity (the host state), as a PE is not considered as a resident of a contracting state. Prior to the *Saint-Gobain* case, it was

[93] For an analysis of the consequences of striking down an exemption provision in a German tax treaty, see Cordewener, *Foreign Losses, Tax Treaties and EC Fundamental Freedoms; A New German Case before the ECJ*, ET 2003, p. 301.

[94] It occurs that the Court explicitly reason in terms of possible consequences of a given interpretation. See Bengoetxea, *The Legal Reasoning of the European Court of Justice*, (1993), p. 256.

[95] See section 1.5.

[96] See Article 1 OECD Model.

analysed in legal doctrine whether this practise was contrary to free movement law.[97] Subsequent to *Saint-Gobain*, the discussion in the literature has concerned how far-reaching its effect is on tax treaty application.[98]

Already in the *Avoir Fiscal* case the ECJ held that Article 43 EC included the freedom for economic operators to choose the most appropriate legal form for the pursuit of activities in another Member State. The difference between the *Avoir Fiscal* case and the *Saint-Gobain* case is that the latter grants PEs access to benefits on the basis of a tax treaty between the PE state and a third state.[99]

6.5.1 The Facts of the Case

Saint-Gobain Zweigniederlassung Deutschland (hereinafter Saint-Gobain Germany), was a branch (PE) of the French company *Compagnie de Saint-Gobain SA* (hereinafter Saint-Gobain SA) located in Germany. The latter was incorporated under French law with its seat and business management in France.[100] In Germany, Saint-Gobain SA was subject to limited tax liability as neither its seat, nor its business management was located in Germany. Due to Saint-Gobain SA's limited tax liability, the German tax authorities refused to grant the company certain tax concessions relating to the taxation of dividends from shares in foreign companies. At the time these concessions were only granted to companies subject to unlimited tax liability in Germany.[101] These tax concessions, which were granted either by means of German internal legislation or tax treaties, concluded by Germany with the non-EU Member States Switzerland and the US, were the following.[102]

[97] For instance, see Jann, *How does Community law affect benefits available to non-resident taxpayers under tax treaties?* ECTRev 1996, pp. 168–171. See also Rädler, *Tax Treaties and the Internal Market*, in *Report of the Committee of Independent Experts on Company Taxation (the Ruding Report)* (1992), p. 373.

[98] For instance, see Kostense, *The Saint-Gobain case and the application of tax treaties. Evolution or revolution?* ECTRev 2000, pp. 220–232, Jiménez, Prats, & Carrero, *Triangular Cases, Tax Treaties and EC Law: The Saint-Gobain Decision of the ECJ*, Bulletin 2001, pp. 241–253 and Offermanns & Romano, *Treaty Benefits for Permanent Establishments: The Saint-Gobain Case*, ET 2000, pp. 180–189.

[99] See Kostense, *The Saint-Gobain case and the application of tax treaties. Evolution or revolution?* ECTRev 2000, p. 222.

[100] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161, paras. 3–5.

[101] *Ibid.*, para. 8.

[102] *Ibid.*, paras. 18–22.

- Exemption from German corporation tax for dividends by means of tax treaties. The tax treaty provisions providing for such exemption restricted it to German companies and companies subject to unlimited tax liability in Germany (a so-called participation exemption[103]).[104]

- Credit against German corporation tax provided by means of German internal tax legislation (a so-called indirect credit[105]). The credit was restricted to companies subject to unlimited tax liability in Germany.

- Exemption from capital tax for shareholdings in companies established in non-Member countries provided for by internal legislation. The exemption was limited to domestic companies limited by shares.

The tax treaty provisions limiting the exemption from German corporate tax for dividends to German companies and companies subject to unlimited tax liability in Germany were designed as follows. In terms of the dividends received from the US subsidiary, the applicable tax treaty was the convention between the Federal Republic of Germany and the United States of America for the avoidance of double taxation with respect to taxes on income of 22 July 1954, as amended by protocol on 17 September 1965. Article XV of this treaty reads as follows:

> *"(1) It is agreed that double taxation shall be avoided in the following manner:*
>
> *(a) ...*
>
> *(b) 1. Federal Republic tax shall be determined in the case of a natural person resident in the Federal Republic or of a German company as follows:*
>
> *(aa) ...there shall be excluded from the basis upon which Federal Republic tax is imposed any item of income from sources within the United States or any item of capital situated within the United States which, according to this Convention, is not exempt from tax by the United States. ...The first sentence shall, in the case of income from dividends, apply only to such dividends subject to tax under United States law as are paid to a German company limited by shares (Kapitalgesellschaft) by a United States corporation, at least 25 percent of the voting shares of which are owned directly by the first-mentioned company..."*[106]

[103] See section 2.6.2.

[104] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161, para. 16.

[105] An indirect credit is a credit granted for the tax levied on the profits of the company out of which the dividends have been paid (IBFD, *International Tax Glossary*, (2001), p. 87).

[106] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161, para. 17.

Article II (1) (f) of the Germany-US treaty explains that the term *German company* covers legal persons as well as entities treated as legal persons for tax purposes under the laws of Germany, if the company has its business management or seat in Germany.

With respect to the dividends received from the company in Switzerland, the applicable tax treaty was the convention between the Federal Republic of Germany and the Swiss Confederation for the avoidance of double taxation with respect to taxes on income and capital of 11 August 1971, as amended by protocol on 30 November 1978. Article 24 of this treaty provides as follows:

> *"(1) As regards a person established in the Federal Republic of Germany, double taxation shall be avoided in the following manner:*
>
> *(1) The following income, originating in Switzerland, which, according to the preceding articles, is taxable in Switzerland, shall be excluded from the basis on which German tax is imposed:*
>
> *(a) ...*
>
> *(b) The dividends, within the meaning of Article 10, which a company limited by shares established in Switzerland distributes to a company limited by shares subject to unlimited tax liability in the Federal Republic of Germany where, according to German tax legislation, a Swiss tax levied on the profits of the distributing company could also be credited against German corporation tax to be levied on the German company."*[107]

In 1988 Saint-Gobain SA held the following shareholding through Saint-Gobain Germany:[108]

- 10.2 per cent of the share capital of a US resident company,
- 98.63 per cent of the share capital of a German resident subsidiary, which held 33.34 per cent of the shares of a Swiss resident company and 46.67 per cent of the shares of an Austrian company, and
- 99 per cent of the share capital of another German resident subsidiary, which had a 24.8 per cent shareholding in an Italian resident company.

[107] *Ibid.*, para. 18. In the literature it has been argued that even though the ECJ referred to Article 24 of the tax convention, the exclusion of PEs follows from Article 1 in conjunction with Articles 3 and 4 of the treaty. See Offermanns & Romano, *Treaty Benefits for Permanent Establishments: The Saint-Gobain Case*, ET 2000, p. 182.

[108] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161, paras. 9, 12–13.

Due to German internal legislation on group treatment, there was a direct distribution of dividends from the US company to Saint-Gobain Germany (the PE).[109] Moreover, as a consequence of the group treatment legislation, the taxable profits of Saint-Gobain Germany included the dividends distributed by the Austrian, Italian and Swiss companies.

The German tax authorities allowed Saint-Gobain SA a direct credit provided for by internal tax legislation. Furthermore, the tax authorities computed against the German corporation tax payable on the income of the PE the foreign tax of which had already been withheld at source in the various countries in which the distributing companies were established.[110] However, the exemption stipulated in tax treaties from German corporation tax on the dividends was denied. Also the indirect credit that was provided in German internal legislation for the corporation tax paid in respect of the dividends by the distributing companies against German corporation tax was refused. This resulted in a situation where resident companies receiving dividends from foreign subsidiaries either carried a credit for underlying taxes or were exempt from German corporate income tax. The situation for non-resident companies was, however, another. For non-resident companies maintaining a PE in Germany, dividends received from foreign subsidiaries were taxed in full in Germany, even though the dividends in most situations had been liable to corporation tax in the state of distribution.

In 1994 Germany introduced new legislation granting the above-mentioned benefits also to PEs. As this legislation came into effect after the 1994 tax period, it did not affect the tax situation of 1988.[111]

Saint-Gobain Germany challenged the refusal by the German tax authorities to grant the various tax concessions.[112] The Finanzgericht Köln stayed proceedings and asked for an interpretation of Articles 43 and 48 EC in relation to the refusal to grant the tax concessions available to resident companies to non-resident companies.[113]

[109] For a presentation of the German internal legislation, see paras. 10–14 of the case. For further information see also Offermanns & Romano, *Treaty Benefits for Permanent Establishments: The Saint-Gobain Case,* ET 2000, pp. 180–181 and Kemmeren, *Principle of Origin in Tax Conventions,* (2001), p. 136.

[110] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161, para. 19.

[111] *Ibid.*, paras. 25–28.

[112] *Ibid.*, para. 15.

[113] *Ibid.*, paras. 31–32.

6.5.2 The Reasoning of the Court

Initially the ECJ emphasized the national treatment principle. It held that Article 43 EC grants nationals of EU Member States the right to access and pursue activities as employed persons and to "the forming of management of undertakings" in another EU Member State on the same conditions as those laid down for the latter's own nationals by its laws.[114] Article 48 EC extends this right to companies or firms formed in accordance with the laws of a Member State and that have their registered office, central administration or principal place of business within the Community. The Court concluded that these two provisions guarantee nationals of EU Member States:

> "who have exercised their freedom of establishment and companies or firms which are assimilated to them the same treatment in the host Member State as that accorded to nationals of that Member State."[115]

Next, the ECJ reaffirmed its notion stated in previous cases that a company's seat serves to determine, like nationality for natural persons, its connection to a Member State's legal order.[116]

The Court found that the refusal to grant the exemption from corporation tax and the indirect credit in principle affected companies not resident in Germany and was based on the criterion of the company's corporate seat in determining the tax treatment in Germany of dividends received from other states.[117] As these tax concessions resulted in a lighter tax burden from which PEs of non-resident companies were not able to benefit, the ECJ concluded that these were in a less favourable situation than resident companies, including German subsidiaries of non-resident companies.[118] Therefore, the refusal to grant the tax concessions to PEs of non-resident companies made it less attractive for those companies to have intercorporate holdings through German branches. Thus, the German tax treaties and internal legislation were found to restrict the freedom to choose the most appropriate legal form for the pursuit of activities in another Member State. The Court pointed out that the second sentence of Article 43 EC expressly conferred this right on economic

[114] *Ibid.*, para. 34.
[115] *Ibid.*
[116] *Ibid.*, para. 35.
[117] *Ibid.*, para. 37. Compare to the Court's reasoning in Case C-311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651, paras. 23, 32.
[118] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161, para. 38.

operators.[119] The difference in treatment, together with the restriction of the freedom to choose the form of secondary establishment, was regarded by the ECJ as constituting a single composite infringement of Articles 43 EC and 48 EC.[120]

In terms of justifications, the German government argued that PEs of non-resident companies were in a situation objectively different from that of companies resident in Germany. In response, the Court held that in terms of taxation of foreign-source dividends in the host state, PEs and subsidiaries were in a comparable situation, as the income would be taxed regardless of whether received by a PE or a subsidiary.[121] The Court held, further, that the situations of resident companies and non-resident companies were even more comparable in the sense that the difference in treatment applied only as regards the grant of the tax concessions.[122]

The German government also put forward that the difference in treatment was justified by the need to prevent a reduction in tax revenue.[123] In response, the ECJ stated, not surprisingly considering previous cases where this argument has been presented by the Member States, that a reduction in tax revenue was not one of the grounds listed in Article 46 EC and could not be regarded as an imperative interest.[124] Moreover, the German government argued that the difference in treatment was justified by other advantages which PEs enjoy in comparison with resident subsidiaries as regards the transfer of profits to the non-resident company.[125] The ECJ responded that even if such advantages existed, they could not justify a breach of the obligations laid down by Article 43 EC.[126]

Finally, the German government argued that the conclusion of bilateral tax treaties with non-Member States did not come within the sphere of Community law, and, for this reason, its refusal to grant the tax concessions was justified.[127] In reply, the ECJ held that:

[119] *Ibid.*, para. 42. On this issue, see Schön, *Freie Wahl zwischen Zweigniederlassung und Tochtergesellschaft – ein Grundsatz des Europäischen Unternehmensrechts*, EWS Heft 7, 2000, pp. 281–291.

[120] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161, para. 43.

[121] *Ibid.*, para. 47.

[122] *Ibid.*, para. 48.

[123] *Ibid.*, para. 49.

[124] *Ibid.*, para. 50.

[125] *Ibid.*, paras. 51–52.

[126] *Ibid.*, para. 53.

[127] *Ibid.*, para. 54.

> "in the absence of unifying or harmonising measures adopted in the Community, in particular under the second indent of Article 220 of the EC Treaty (now the second indent of Article 293 EC), the Member States remain competent to determine the criteria for taxation of income and wealth with a view to eliminate double taxation by means, inter alia, of international agreements."[128]

In this context the ECJ stated that Member States are at liberty, in the framework of tax treaties, "to determine the connecting factors for the purpose of allocating powers of taxation as between themselves."[129] As regards the exercise of the power of taxation so allocated, the Member States may not disregard Community rules. From this, one may conclude that the ECJ distinguishes between allocation and exercise of powers of taxation. In line with the *Gilly* case, the Member States are at liberty when it comes to designing connecting factors used for the allocation of taxing rights between the contracting states. However, when it comes to the exercise of Member States' rights according to a tax treaty, they must comply with Community law.

If one compares the situation in *Saint-Gobain* with the situation in *Royal Bank of Scotland*, one finds similarities. In both cases the ECJ observed that the national legislation employed the criterion of the company's seat in determining the tax treatment.[130] In *Royal Bank of Scotland* the ECJ refused in principle to assess whether any non-Treaty grounds would justify the Greek legislation, while in *Saint-Gobain* the Court carried out such examination. This illustrates the Court's inconsistent reasoning when it comes to imperative interests.

In terms of tax treaties concluded between EU Member States and non-Member States, the ECJ stated that:

> "the national treatment principle requires the Member State which is party to the treaty to grant to PEs of non-resident companies the advantages provided for by that treaty on the same conditions as those which apply to resident companies."[131]

Moreover, it emphasized that the obligations which Community law imposes on Germany "do not affect in any way those resulting from its agreements with the United States of America and the Swiss Confedera-

[128] *Ibid.*, para. 56.

[129] *Ibid.*

[130] Case C-311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651, para. 23 and Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161, para. 37.

[131] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161, para. 58.

tion."[132] The Court explained that a unilateral extension, on behalf of Germany, of the category of recipients in Germany who would be able to benefit from the treaty would not affect the balance and the reciprocity of these treaties. Finally, the ECJ noted that such an extension would not impose new obligations on the US and Switzerland.[133]

The ECJ concluded that the exclusion of PEs in Germany of a non-resident company having its seat in another Member State from benefiting on the same conditions as German companies from tax advantages is precluded by Articles 43 EC and 48 EC.

6.5.3 Analysis of the Court's Reasoning

In contrast to the *Gilly* case, the Court's reasoning in *Saint-Gobain* is clearly recognized from the Court's reasoning in other judgments. In *Saint-Gobain* the ECJ focused on the effect of the legislation at issue and established comparable situations. The situations compared were that of a PE to a non-resident company and that of a resident company. The ECJ stressed that a company's seat serves to determine, like nationality for natural persons, its connection to a Member State's legal order. By so doing, the Court showed that the criterion for differentiation employed by the tax provisions was, in fact, a nationality criterion. Therefore, it is evident that the ECJ applied a *nationality-based approach* when assessing the German legislation. It is also clear that the German legislation was assessed from a host state perspective as the focus of the Court's reasoning was the effect of the provisions on non-residents, namely secondary establishments in the form of PEs.

A debated issue is the implications of the *Saint-Gobain* judgment on tax treaty application in EU Member States.[134] The main question seems to be which status is to be accorded to PEs in EU situations, if taxed by the PE-state in the same way as resident companies.[135] Is the PE entitled to full resident status for tax treaty purposes or does the *Saint-Gobain* judgment merely imply an obligation for the PE-state to grant the PE the same treaty benefits as resident companies, without conferring resident

[132] *Ibid.*, para. 59.

[133] *Ibid.*

[134] For instance, see Kostense, *The Saint-Gobain case and the application of tax treaties. Evolution or revolution?* ECTRev 2000, pp. 220–232, Jiménez, Prats & Carrero, *Triangular Cases, Tax Treaties and EC Law: The Saint-Gobain Decision of the ECJ*, Bulletin 2001, pp. 241–253 and Terra & Wattel, *European Tax Law*, (2001), pp. 90–91.

[135] Kostense, *The Saint-Gobain case and the application of tax treaties. Evolution or revolution?* ECTRev 2000, p. 220.

status upon PEs for tax treaty purposes and without third party states necessarily having to accept such status?[136]

The first alternative interpretation entails an obligation for the state (the source state) from where the dividends are paid, and likely any other passive income derives, to apply the treaty with the PE-state. This is a possible alternative only where the source state is an EU Member State. The traditional opinion in tax treaty application is that the source state does not apply the tax treaty with the PE-state but the treaty with the state where the company, acting through a PE in the PE-state, is resident. In the *Saint-Gobain* case that would be the US-France treaty and the Switzerland-France treaty. The first alternative interpretation signifies a change in this regard.

The second alternative interpretation limits the implications of the *Saint-Gobain* case to the PE-state. This state is obligated to grant PEs and domestic companies the same treaty benefits.

These two alternative interpretations have been thoroughly investigated by Kostense.[137] In particular, his analysis shows that the result of these two alternatives, in terms of total tax burden of the company in question, is very much dependent on the method of avoidance of double taxation applied by the residence state of the company. Generally, the effect stays the same under both alternative interpretations if the residence state applies the credit method with regard to the profits realized by the PE in its state of activity (the host state).[138] This is due to the functioning of the credit method as it gives the residence state the right to levy additional tax up to its own tax level. If the cumulated tax level of the PE-state and the source state decreases, the residence state levies a corresponding additional amount of tax up to its own level of taxation. If the residence state of the company instead applies the exemption method in terms of positive PE profits, the total tax burden of the company decreases. Kostense concludes that the impact of the *Saint-Gobain* case on tax treaty application is the more limited one of the two alternative interpretations, namely an obligation for the PE-state to grant the PE the same treaty benefits as resident companies without conferring resident status upon PEs for tax treaty purposes and without third party states necessarily having to accept such status.[139]

[136] *Ibid.*

[137] *Ibid.*, pp. 220–232.

[138] *Ibid.*, p. 228.

[139] For further reading, see van de Streek, *Verslag EFS-seminar van 23 november 1999*, WFR 2000/6374, pp. 253–260 and Dourado, *From the Saint-Gobain to the Metallgesellschaft case: scope of non-discrimination of permanent establishments in the EC Treaty and the most-favoured-nation clause in EC Member States tax treaties*, ECTRev 2002, p. 148.

Due to the Court's own reasoning in the *Saint-Gobain* case, one must agree with Kostense's conclusion. The ECJ is focusing on the national treatment principle in terms of the tax treatment in Germany. It did not take into consideration the tax treatment in the source state nor in the residence state of the company. One may argue that the ECJ did not have to, as the issue addressed was the tax treatment in the PE-state. However, if the ECJ had intended a full treaty status of PEs, one must assume a clearer indication in that direction in its reasoning. If a full residence status was the Court's objective, reasoning indicating that the aim was to achieve exactly the same treatment for PEs as subsidiaries in all situations would have been necessary. Moreover, in *Saint-Gobain* the Court limited its comparable situations to PEs and subsidiaries receiving dividends from a source state.

From the foregoing, it is evident that in *Gilly* the ECJ employed a reasoning which can be considered as inconsistent in relation to previous and subsequent case law when interpreting Article 39 EC in relation to the tax treaty provisions. However, in *Saint-Gobain* the Court's reasoning is well-recognized from its case law when interpreting Article 43 EC. What may be the reason for this difference? I believe that the reason can be found in the operation and characteristics of the tax treaty provisions under review. In *Saint-Gobain* an extension of tax treaty benefits by the PE-state was possible without severely disturbing the functioning of the tax treaties involved. The Commentaries to the OECD Model even mention this solution.[140] However, if the tax treaty provisions under review in *Gilly* would have been prohibited, and consequently inapplicable, there would have been several implications on the tax treaty network in the internal market. Therefore, one may draw the conclusion that the ECJ strives as far as possible to apply the free movement provisions and remove any restrictive tax measure, either in the form of internal tax legislation or in the form of tax treaty provisions. However, when the consequences for the internal market of such application are undesirable, the Court uses its judicial discretion and comes up with a more practical solution. This shows that the Court clearly considers the limits for its negative integration and takes into account the effects of its judgments on the internal market.

[140] See paras. 29–35 of the OECD Commentaries on Article 24.

6.6 The de Groot Case

From *Schumacker*[141], *Gschwind*[142] and *Zurstrassen*[143], it is clear that the ECJ puts an obligation on the residence state to take into account the individual taxpayer's ability to pay tax.[144] The *de Groot*[145] case concerns the specific technique, a *pro rata parte* method, invoked by the Netherlands, by way of tax treaties or internal legislation, when considering personal and family circumstances of a worker who has worked and received income in other Member States during the year.

6.6.1 The Facts of the Case

Mr de Groot was a Dutch resident who in 1994 was employed in the Netherlands and three other EU Member States: the United Kingdom, France and Germany. The bilateral tax treaties concluded between the Netherlands and these three EU Member States applied to the income derived from these countries, respectively. In each of these three tax treaties the Netherlands, according to the ECJ, avoided double taxation by applying exemption with progression, a method provided for in Article 23 A of the OECD Model.[146]

However, the method provision in the applicable treaties deviated from the Model in one important aspect, namely the application of a *pro rata parte* method. This mechanism of relief of double taxation corresponds with, or explicitly refers to, the provisions laid down in the Dutch domestic tax act *Besluit voorkoming dubbele belasting.*[147] The tax treaty with the UK explicitly referred to the internal legislation of the Netherlands,

[141] Case C-279/93 *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225.

[142] Case C-391/97 *Frans Gschwind* v *Finanzamt Aachen-Aussenstadt* [1999] ECR I-5451.

[143] Case C-87/99 *Patrick Zurstrassen* v *Administration des contributions directes* [2000] ECR I-3337.

[144] See chapter 5.

[145] Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819.

[146] *Ibid.*, para. 12. The method provision applied in *de Groot* is described by Valat as exemption with progression, see Valat, *General Allowances and Home State Obligations under EC Law: Opinion delivered in the de Groot Case,* ET 2002, p. 447. Mattsson describes the method provision as "to have followed the alternative exemption model (or the so-called credit method)", see Mattsson, *Does the European Court of Justice Understand the Policy behind Tax Benefits Based on Personal and Family Circumstances?* ET 2003, pp. 191–193.

[147] Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819, para. 15 and Weber, *Pending Cases Filed by Dutch Courts: the F.W.L. de Groot Case and Related EC Cases before Dutch Courts* in Lang (ed.), *Direct Taxation: Recent ECJ Developments,* (2003), p. 175.

while the treaties with Germany and France directly provided for the *pro rata parte* method.[148]

The Dutch rules regarding the calculation of the exemption with progression distributed the allowances relating to a taxpayer's personal and family circumstances over his total income. The result was that allowances were deducted from the tax payable in the Netherlands only in proportion to the income received by the taxpayer in the Netherlands.[149] The aim of this system was to distribute the allowances relating to the taxpayer's personal and family circumstances over his total income since these deductions were not connected with specific sources.[150] The result was that Mr de Groot received less tax relief on account of the personal liabilities borne by him and was able to take less advantage of tax free allowances than would have been the case had he derived his total income from one or more employments exercised only in the Netherlands.

The Dutch *pro rata parte* method would have work well had the source states involved given Mr de Groot the corresponding personal deductions. However, the case law of the ECJ indicates that the source state has an obligation to consider personal and family circumstances only when the residence state is unable to do so due to the lack of income in this state.

6.6.2 The Reasoning of the Court

Ruling on the *de Groot* case the Court stated that it is:

[148] Under Article 22 (2) (b) of the Convention between the Netherlands and the UK, the former state was required to exempt income which may be taxed in the UK by granting a reduction of the Netherlands tax calculated in accordance with the provisions of internal legislation. Under Article 20 (3) in the tax treaty between the Netherlands and Germany and Article 24 Part A (2) in the tax treaty between the Netherlands and France, the reduction to avoid double taxation in respect of income which a resident of the Netherlands derives from these States was regulated in a way similar, in effect, to that which applied under the tax treaty between the Netherlands and the UK. In contrast to the latter convention, which explicitly referred to the unilateral Netherlands rules on the avoidance of double taxation and the calculation on the tax reduction, the tax treaties with Germany and France contained no such reference. Instead, they directly provided for the application of the *pro rata parte* method (the proportionality factor) in calculating the tax reduction in the Netherlands. The Court held that it was irrelevant that the proportionality factor was applied in accordance with internal legislation, in relation to the income derived and taxed in the UK, or with the provisions of the tax treaties with Germany and France, in relation to the income taxed in those Member States. (see Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819, paras. 10–11, 93).

[149] Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819, para. 26.

[150] *Ibid.*, para. 25.

> "settled case-law that all of the Treaty provisions relating to the freedom of movement of 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."[151]

The wording of this statement is interesting as it says that "measures which might place Community nationals at a *disadvantage* [italics added by the author] when they wish to pursue an economic activity". The use of the word *disadvantage* shows the extensive scope of what is prohibited. Similar statements are found in previous case law.[152]

The Court went on to hold that:

> "provisions which preclude or deter a national of a Member State from leaving his country of origin to exercise his right to freedom of movement therefore constitute an obstacle to that freedom even if they apply without regard to the nationality of the workers concerned."[153]

The Court found that Mr de Groot suffered a real tax disadvantage as a result of the application of the *pro rata parte* method as he received "a lesser tax advantage than he would have received had he received his entire income for 1994 in the Netherlands".[154] This disadvantage was, according to the ECJ, liable to discourage a Dutch national from taking up employment in another Member State.[155] The Court concluded that the Dutch rules constituted an obstacle to the free movement of workers.[156]

Possible justifications for the Dutch rules were presented. For instance, the argument that the disadvantage suffered by Mr de Groot was compensated for by a progressivity advantage was turned down. The ECJ stated that it is settled case-law that detrimental tax treatment contrary to free movement law cannot be justified by the existence of other tax advantages.[157] In response to the argument that the Dutch rules were legitimate as it is for the state of employment to give a proportionate share of the deductions, the ECJ turned to the OECD Model and stated

[151] *Ibid.*, para. 77.

[152] For instance, see Case C-158/96 *Raymond Kohll* v *Union des caisses de maladie* [1998] ECR I-1931, para. 33 (see section 4.4.3.2 of this study).

[153] Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819, para. 78.

[154] *Ibid.*, para. 83.

[155] *Ibid.*, para. 84.

[156] *Ibid.*, para. 95.

[157] *Ibid.*, para. 97.

that taking account of taxpayers' personal and family circumstances is a matter for the residence state.[158] The Court explained that the residence state may be released by way of an international agreement from its obligation to take into account in full the personal and family circumstances of resident taxpayers earning income from abroad.[159] Also the fact that a source state, in fact, grants advantages based on personal and family circumstances may relieve the residence state from granting these advantages.[160]

The ECJ went as far as stating that the mechanisms used to eliminate double taxation or the tax systems which have the effect of eliminating or at least alleviating double taxation must permit the taxpayers to be certain that, as the final result, all their personal and family circumstances are taken into account.[161] The Court noticed that Dutch law and its conventions with Germany, France and the United Kingdom did not ensure this result.[162] The Court did not accept any of the proposed justifications.

In this case the Court puts a clear obligation on residence states. They bear the responsibility for ensuring that their residents do not lose allowances relating to personal and family circumstances when using their right to free movement of workers.

6.6.3 Analysis of the Court's Reasoning

The *de Groot* case concerned tax rules in the Netherlands having a negative impact on a Dutch national residing in this state. The legislation may, therefore, be described as home state legislation. According to the conclusions from Chapters 4 and 5, one may, consequently, expect the ECJ to apply a *free movement-based approach.*

Ruling on the *de Groot* case, the ECJ, initially, reiterated that overt and covert discrimination based on nationality is prohibited.[163] Thereafter, the Court did not mention these terms again and finally simply concluded that the Dutch rules constituted an obstacle to the free movement of workers.[164] It is clear that Mr de Groot was a Dutch national residing in this state. He was placed at a disadvantage by the Dutch tax legislation because of his foreign income. The difference in treatment did not have anything to do with his nationality or where he resided. The legislation

[158] *Ibid.*, para. 98.
[159] *Ibid.*, para. 99.
[160] *Ibid.*, para. 100.
[161] *Ibid.*, para. 101.
[162] *Ibid.*, para. 102.
[163] *Ibid.*, para. 75.
[164] *Ibid.*, para. 95.

had the same effect on everyone residing in the Netherlands having foreign income. Consequently, there is a differentiation based on whether someone has foreign income or not. In other words, there is a difference in treatment depending on whether one has exercised one's right to free movement but remains a resident of the Netherlands. Therefore, one can rule out the possibility of both direct and indirect discrimination based on nationality as of no relevance to the Dutch legislation. If one compares a situation where a Dutch resident has no foreign income and has, therefore, not exercised his freedom of movement with a situation such as de Groot's, where he has foreign income due to his exercise of his free movement rights, one finds that the distinguishing factor is a person's exercise of free movement while remaining a resident of his home state. Therefore, the Court's reasoning can be described as a *free movement-based approach*.

When analysing the Court's reasoning in the *Gilly* case, this thesis argues that if the Court would have applied a *free movement-based approach* when analysing the method provision, the outcome would have been that the rule at issue had been prohibited by Article 39 EC, since it dissuaded persons residing in France from exercising their free movement. Furthermore, it is argued that a reason for the Court not to come to that judgment is the ensuing consequences of such a decision.[165] Then one may ask what the reason is why the Court ruled out the *pro rata parte* method being a part of the tax treaties between the Netherlands and Germany and the Netherlands and France, respectively.

The Netherlands *pro rata parte* method was not designed on the basis of the OECD Model and, therefore, not found in a vast number of tax treaties in the internal market. The Model only provides for the main method, exemption with progression, without giving much guidance on the substantive rules necessary in order to implement such a method. Hence, the consequences of judging that the *pro rata parte* method was precluded by Article 39 EC did not have an impact on the tax treaty network between EU Member States comparable with what had followed had the Court concluded the tax credit mechanism to be contrary to free movement law.

One may argue that the *de Groot* case validates a conclusion that the cautious attitude on behalf of the Court in the *Gilly* case was due to the consequences on the tax treaty network that would follow turning down such a provision, a rule necessary for the functioning of treaties that include such provisions. In contrast, when the Court assesses tax treaty provisions which are not based on the OECD Model and which can be

[165] See section 6.4.3.

held to be contrary to free movement law without giving rise to severe problems for the tax treaty network between EU Member States, the Court will treat them no different from tax provisions of a unilateral origin. In *de Groot* the ECJ went as far as stating that it was:

> "irrelevant that the proportionality factor was applied in accordance with the 1989 Decree, in relation to the income derived and taxed in the United Kingdom, or with the provisions of the Conventions with Germany and France, in relation to the income derived and taxed in those Member States, even if those conventions merely reflect the provisions of Netherlands law on the matter."[166]

It is worth emphasizing that the ECJ in the *de Groot* case attempted to distinguish the situation from the one in the *Gilly* case. The Court explained that the unfavourable consequences that the tax credit mechanism entailed for Mrs Gilly were the result primarily of the differences between the tax scales of the Member States concerned, and that, in the absence of harmonization, the determination of those scales was a matter for those Member States.[167] The Court argued that the unfavourable consequences suffered by Mr de Groot had nothing to do with the tax rates of the Member States involved, and, hence, the cases were not to be compared. This reasoning is not convincing as the decisive factor ought to be the effect of the legislation on the free movement. The Court is not considering this aspect here but rather the source of the unfavourable consequences. The latter is a circumstance which the Court generally does not emphasize. As is argued in section 6.4.3.2, instead of focusing on the different tax scales as the source of the unfavourable consequences for Mrs Gilly, the Court could have argued that it was the limitation employed by the method provision that was the occasion for Mrs Gilly's unfavourable tax situation.

From the foregoing, one may conclude that substantial tax treaty provisions not based on the OECD Model appears to be treated by the ECJ similarly to tax provisions of a unilateral origin, *i.e.*, the Court will follow its established lines of reasoning and adjudicate consistently with free movement case law.

[166] Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819, para. 92.
[167] *Ibid.*, para. 86.

6.7 Other Statements by the ECJ on the Impact of Free Movement Law on Tax Treaties

6.7.1 The Principle of Reciprocity

As early as in the *Avoir Fiscal* case the ECJ held that the rights conferred by Article 43 EC are unconditional, and a Member State, therefore, could not make respect for them subject to the contents of an agreement concluded with another Member State.[168] It held, further, that the rights provided by the freedom of establishment could not be made subject to "a condition of reciprocity imposed for the purpose of obtaining corresponding advantages in other Member States."[169]

In the *Gottardo*[170] case the ECJ indicated that the principle of reciprocity may be relevant as a ground for justification in the context of bilateral agreements. The *Gottardo* case did not concern income taxation but a bilateral agreement between an EU Member State and a third State on social security. The Court held:

> "Disturbing the balance and reciprocity of a bilateral international convention concluded between a Member State and a non-member country may, it is true, constitute an objective justification for the refusal by a Member State party to that convention to extend to nationals of other Member States the advantages which its own nationals derive from that convention (see, to that effect, Saint-Gobain ZN, [...], paragraph 60)."[171]

In the *Gottardo* case the ECJ did not apply this justification. The Court argued that it was not established that the Community obligation of national treatment resulted in a disturbance of the balance and the reciprocity of the treaty.[172] It is worth noticing that the ECJ in the abovementioned statement specifically refers to "an international convention concluded between a Member State and a non-member country." Therefore, it is not clear whether the principle of reciprocity may be considered as a justification for a tax treaty concluded between two EU Member States.

From the Court's statement in *Avoir Fiscal*, together with the Court's judgments in the cases *Gilly*, *Saint-Gobain* and *de Groot*, one may

[168] Case 270/83 *Commission* v *France* [1986] ECR 273, para. 26.
[169] *Ibid.*
[170] Case C-55/00 *Elide Gottardo* v *Istituto nazionale della previdenza sociale (INPS)* [2002] ECR I-413.
[171] *Ibid.*, para. 36.
[172] *Ibid.*, para. 37.

conclude that the mere fact that a provision is a part of a tax treaty cannot formally justify a breach of free movement law.[173] Therefore, it is very unlikely that a Member State could justify a restriction on free movement by arguing that the provision is part of a tax treaty and, therefore, it needs to be accepted. A justification based on the disturbance of the balance and reciprocity has, to my knowledge, not been applied by the ECJ to justify a restrictive measure being part of an international agreement. Moreover, one may interpret the Court's statement in the *Gottardo* case as this justification is only applicable in relation to bilateral agreements between an EU Member State and a third state.

The Court's assessment in the *Gilly* case in regard to the method provision implies that the Court may accept a treaty provision that is based on the OECD Model and is vital for the functioning of tax treaties, even though it has a negative impact on the free movement. In this study it is argued that the reason for such an approach is that the outcome of turning down such a tax treaty provision was considered by the Court to be negative for the internal market. Considering the *Gilly* case, one may conclude that the Court's caution would most probable be visible only through its analysis of whether the tax treaty provision constitutes a restriction or not. Accordingly, it will not be openly stated as an accepted justification.

6.7.2 Connecting Factors

It has been argued that the *Gilly* case indicates that EU Member States are free to choose connecting factors for the allocation of fiscal jurisdiction without running the risk of acting contrary to free movement law.[174] In the *Gilly* case the focus was on the use of nationality as a connecting factor. Residence is a connecting factor more commonly used in tax law in general and tax treaty law in particular.

In *Schumacker* the Court analysed internal tax legislation which employed residence as a distinguishing factor. The Court declared that, as a rule, the situations of residents and non-residents are not comparable.[175] The reason was that income received in one Member State by a non-resident is normally only a part of his total income, which is concentrated at his place of residence. This statement has been confirmed by the

[173] Similarly, see Lang, *The Binding Effect of the EC Fundamental Freedoms on Tax Treaties*, in Gassner, Lang & Lechner (eds.), *Tax Treaties and EC Law*, (1997), p. 22.

[174] See section 6.4.2.

[175] Case C-279/93 *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225, para. 31.

Court in many subsequent judgments.[176] The Court explained, however, that if there are no objective differences between the situations of a resident in comparison to a non-resident, the situations are comparable.

In *Gschwind*[177], where the question was whether internal tax law was precluded by Article 39 EC, the Court referred to the OECD Model:

> "...for tax purposes residence is the connecting factor on which international tax law, in particular the Model Double-Taxation Convention of the Organisation for Economic Cooperation and Development (OECD), is normally founded in order to allocate powers of taxation between States in situations involving extraneous elements."[178]

An almost identical statement is found in *Gerritse* with regard to internal tax legislation using residence as a connecting factor.[179] From these statements, one may conclude that as a general rule the ECJ accepts residence as a connecting factor both in internal tax law and in tax treaties. The differentiation under tax treaties granting tax treaty benefits only to residents of the contracting states is therefore, in principle, in line with free movement law.[180] However, differentiation based on residence is not acceptable when the situations for residents and non-residents are not objectively different. This was the situation in, for instance, *Schumacker* and *Saint-Gobain.*

In *Schumacker* a non-resident who received no significant income in his state of residence but obtained his major part of his taxable income in his state of employment was considered to be in a comparable situation to residents of the latter state. In *Saint-Gobain* the non-resident PE was held to be in a situation comparable to resident subsidiaries in respect of them receiving dividends from a source state. Accordingly, to follow the Court's reasoning in *Gilly* that Member States are at liberty to determine the connecting factors for the purpose of allocating taxing powers as between themselves, one may conclude that the *Saint-Gobain* case, according to the ECJ, did not concern the connecting factor residence but

[176] For instance, see Case C-87/99 *Patrick Zurstrassen* v *Administration des contributions directes* [2000] ECR I-3337 and Case C-234/01 *Arnoud Gerritse* v *Finanzamt Neukölln-Nord* [2003] ECR I-5933.

[177] Case C-391/97 *Frans Gschwind* v *Finanzamt Aachen-Aussenstadt* [1999] ECR I-5451.

[178] *Ibid.*, para. 24.

[179] Case C-234/01 *Arnoud Gerritse* v *Finanzamt Neukölln-Nord* [2003] ECR I-5933, para. 45.

[180] A similar conclusion is reached in, for instance, Essers, de Bont & Kemmeren (eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law,* (1998), p. 209.

"the exercise of the power of taxation so allocated".[181] This emphasizes the difficulties involved in separating between allocation and exercise of powers of taxation.[182]

6.7.3 Justifications

In this study it has been argued that the Court's case law indicates that the fact that a provision is part of a tax treaty cannot formally justify a breach of Community law.[183] One may even take this a step further and note that the existence of a tax treaty has had the effect that a possible justification for a restrictive tax provision was no longer available.[184] This was the situation in, for instance, *Wielockx,*[185] *X and Y* v *Riksskatteverket*[186] and *Asscher*[187].

In *Wielockx* the question was whether the Dutch legislation that only granted residents deduction from taxable income with respect to contributions to pension reserves was contrary to Article 43 EC. The Dutch government argued that its legislation was justified based on the principle of fiscal cohesion laid down in the *Bachmann*[188] case. It argued that if a non-resident was allowed to set up a pension reserve in the Netherlands, that pension would not be taxable in the Netherlands.[189] According to the applicable tax treaty, which was based on the OECD Model, such income was taxed in the state of residence.[190] In its response, the Court held that the effect of tax treaties following the OECD Model is that each contracting state taxes all pensions received by residents in its territory, regardless of in which state the contributions were paid, but waives the right to tax pensions received by non-residents, even if they derive from contributions paid and deducted in its territory.[191]

[181] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161, para. 56.

[182] See also section 6.4.2 and 8.5.1.

[183] See section 6.7.1.

[184] See van Thiel, *Removal of income tax barriers to market integration in the European Union: litigation by the Community citizen instead of harmonization by the Community legislature?* ECTRev 2003, p. 15 and van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles,* (2002), pp. 171, 583.

[185] Case C-80/94 *G.H.E.J. Wielockx* v *Inspecteur der Directe Belastingen* [1995] ECR I-2493.

[186] Case C-436/00 *X and Y* v *Riksskatteverket* [2002] ECR I-10829.

[187] Case C-107/94 *P.H. Asscher* v *Staatssecretaris van Financiën* [1996] ECR I-3089.

[188] Case C-204/90 *Hanns-Martin Bachmann* v *Belgian State* [1992] ECR I-249.

[189] Case C-80/94 *G.H.E.J. Wielockx* v *Inspecteur der Directe Belastingen* [1995] ECR I-2493, para. 23.

[190] *Ibid.*

[191] *Ibid.*, para. 24.

In the *Wielockx* case the Court concluded that fiscal cohesion was not established in relation to one and the same person by strict correlation between the deductibility of contributions and the taxation of pensions. Instead, the correlation was shifted to another level, namely that of the reciprocity of the rules applicable in the contracting states.[192] The *Wielockx* case is an example of a situation where the Court rejected a justification by referring to the applicable tax treaty. As the treaty allocated taxing rights to the state of residence regardless of where the contributions were deducted, the Netherlands had already given up a strict cohesion in its tax system and, therefore, it could not rely on such a defence.[193]

In *X and Y* v *Riksskatteverket* the ECJ turned down the Swedish government's defence, which was based on the cohesion of the tax system. The Court reasoned in a way similar to its reasoning in *Wielockx*. The Swedish legislation in question subjected transfers at undervalue of shares in companies to tax treatment that differed according to the nature of the transferee.[194] If the transferee was a foreign legal person or a Swedish limited company in which a foreign legal person had a holding, a tax advantage was denied, while if the transferee was a Swedish limited company not owned by a foreign legal person, the tax advantage was granted. According to the preparatory works, the objective of this legislation was to prevent the Swedish tax system from being deprived of a source of revenue, especially where, prior to a definitive move abroad, the proprietor of shares in a Swedish limited company transfers them at undervalue to a foreign legal person in which he has a direct or indirect holding.[195]

The Court observed that under the general rule in the applicable tax treaty, Article 13 (4) of the Belgian-Swedish tax treaty, a state taxes all gains on shares received by transferors resident in its territory and does not impose tax on gains made by transferors residing in the territory of the other contracting state. Article 13 (5) of the same treaty provides for a reciprocal system which specifically apportions the right to tax gains on disposal of shares. This provision aims at covering share transfers where the taxpayer has moved definitely to the other contracting state, a situation which was also covered by the internal tax legislation at issue. In short, Article 13 (5) provides that in the event of a transfer of shares in a company resident in its territory by its own nationals, the contracting

[192] *Ibid.*
[193] *Ibid.*, para. 25.
[194] Case C-436/00 *X and Y* v *Riksskatteverket* [2002] ECR I-10829, para. 29.
[195] *Ibid.*, para. 47.

state concerned loses its right to tax share transfers only when they take place more than five years after the definite departure for the other contracting state of the transferor.[196]

The Court held that as Sweden has concluded tax treaties with other Member States, "there is no fiscal coherence in relation to any one taxpayer in establishing a strict correlation between the deferral of capital gains tax and the final taxation of the gain."[197] The Court explained that the coherence was at another level, "namely, the reciprocity of the rules applicable in the Contracting States in terms of the convention on the basis of connecting factors for the purposes of apportioning competence in tax matters."[198] Accordingly, the Court turned down the cohesion of the tax system defense by referring to the existence of the tax treaty.

Also in *Asscher* the ECJ referred to the applicable tax treaty when it turned down the Dutch government's argumentation in favour of its legislation.[199] The Dutch legislation distinguished between two classes of taxpayers and taxed them at different tax rates. The Dutch government argued that the higher tax rate for non-residents was necessary to prevent avoidance of income tax progression.[200] The Court referred to the Belgian-Dutch tax treaty, which provided for an exemption with progression. Accordingly, the Court argued, residents and non-residents were in comparable situations as regards the rule of progression.[201]

As has been set out in Chapter 3 of this study, the doctrine of imperative interests is flexible. Therefore, there is no legal obstacle preventing the submission of alternative arguments to be examined as possible imperative interests. The acceptance of arguments as an imperative interest is a policy choice to be taken by the Court. In theory, it would be possible for the ECJ to accept an argument such as the protection of the well functioning of tax treaties or the protection of the national tax base as imperative interests. However, considering the case law of the ECJ, it has had many opportunities to take such a position; but the Court has not added such an argument to its list of imperative interests.

[196] *Ibid.*, para. 56. See also section 7.3.2.
[197] *Ibid.*, para. 53.
[198] *Ibid.*
[199] See Case C-107/94 *P.H. Asscher* v *Staatssecretaris van Financiën* [1996] ECR I-3089, paras. 46–48 and van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, (2002), p. 172.
[200] Case C-107/94 *P.H. Asscher* v *Staatssecretaris van Financiën* [1996] ECR I-3089, para. 46.
[201] *Ibid.*, para. 48.

6.8 Conclusions

The aim of this chapter is to reach conclusions on the Court's interpretation of free movement articles in relation to tax treaty provisions. One may argue that as there are no explicit statements on behalf of the ECJ stating that free movement provisions are applied in a different manner when applied to tax treaty provisions in comparison with internal tax law, tax treaty provisions are dealt with just as internal tax legislation. Also, the Court's statement in the *Avoir Fiscal* case points in this direction. In this case the ECJ held that Member States could not make respect for free movement rights subject to the contents of an agreement concluded with another Member State. However, from analysing the cases *Gilly*, *Saint-Gobain* and *de Groot*, one may conclude that this issue is more intricate.

In the *Gilly* case the ECJ argued in an unusual way in relation to the two tax treaty provisions, which may be considered as essential components of tax treaties, considering the Court's reasoning in other cases. The Court did not analyse the effect of the tax treaty provisions on free movement and did not establish whether there were objectively different situations. One may conclude that the Court showed a more cautious attitude towards tax provisions being a part of a tax treaty concluded between two Member States and based on the OECD Model in comparison with internal tax legislation.

Especially the fact that the Court in the *Gilly* case found the credit mechanism to be in line with Article 39 EC is surprising considering the Court's reasoning in other cases. The effect of this method for avoidance of double taxation is that Mrs Gilly paid more tax in respect of her professional activity in another Member State than she would have paid had she worked in France. It is evident that such a tax treaty provision makes the free movement of workers less attractive. However, the Court in its reasoning did not analyse possible dissuasive effects of the method provision.

However, as the OECD Model has contributed to a harmonization of tax treaty design, the consequences of not accepting a tax treaty provision based on the OECD Model, and, therefore, probably found in a large number of tax treaties in the internal market, has generally a considerable and far-reaching effect. If the ECJ in the *Gilly* case had found the credit mechanism to be precluded by Article 39 EC, the result would have been that it would be inapplicable under the French-German tax treaty. However, which is more important, the same would potentially happen to any other tax treaty between EU Member States that includes a method provision which has the same effect as the tax credit mechanism at issue,

namely less favorable tax consequences in a cross-border situation in comparison with an internal situation. This would have been a decision by the ECJ that would most likely not be easily accepted by the governments of the Member States, as a large number of Member States apply provisions having this effect in certain situations. To apply, for instance, a full credit would, as some intervening governments emphasized in the *Gilly* proceedings, result in a loss of tax revenue. It appears as if the Court had found that striking down such provisions would have had more negative consequences than benefits, as it could give rise to a situation where Member States held that they could not afford to have tax treaties. Such a situation would not be benefiting for the internal market as regards the avoidance of double taxation. One may conclude that this was the reason why the Court used its judicial discretion and delivered a judgment in *Gilly*, which, from an overall perspective, may be seen to be in line with the aim of establishing an internal market. However, from the perspective of the Court's assessment in previous as well as subsequent case law, the Court's reasoning and judgment were not consistent. Accordingly, one may conclude that when dealing with core provisions of tax treaties where the impact of striking down such a provision would have far-reaching negative effects on the tax treaty network between EU Member States, due to the harmonization following the OECD Model, the ECJ deviates from its established practice and uses its judicial discretion in a way that gives rise to an inconsistency considering the Court's case law as a whole.

In contrast to the *Gilly* case, the Court's reasoning in both *Saint-Gobain* and *de Groot* is in line with its reasoning in other cases. The Court, for instance, focused on the effect of the provisions and established comparable situations. In *Gilly* the Court found that the tax treaty provisions were in line with free movement law, but in *Saint-Gobain* and *de Groot* the outcome was the opposite. The tax treaty provisions under review were precluded by Article 43 EC and 39 EC, respectively. What may be the reason for this different approach by the ECJ? It is suggested here that the reason is to be found in how the different tax treaty provisions under review operate and also what the consequences are of striking down such a provision.

In *Saint-Gobain* an extension of tax treaty benefits by the PE-state was possible without severely disturbing the functioning of the tax treaties involved. The Commentaries to the OECD Model even mention this solution.

In *de Groot* the Dutch *pro rata parte* method was not designed on the basis of the OECD Model and, therefore, not found in a large number of tax treaties in the internal market. The Model only provides for the main

method, exemption with progression, without giving much guidance on the substantive rules necessary to implement such a method. Therefore, the consequences of judging that the *pro rata parte* method was precluded by Article 39 EC did not have an impact on the tax treaty network between EU Member State comparable to what would have followed had the Court concluded that the credit mechanism in *Gilly* were contrary to free movement law.

To sum up, it appears as if the impact of free movement law on tax treaty provisions is, in practice, dependent on the potential consequences following such a judgment. If the tax treaty provision is not based on the OECD Model, and is, therefore, not a provision included in a vast number of tax treaties, one may assume that the ECJ assesses such a provision in a way similar to its assessment of internal tax legislation. Accordingly, the Court interprets the free movement provisions in a way which leads to the preclusion of those tax treaty provisions which are discriminatory on grounds of nationality or have a negative effect on the exercise of free movement.

If the tax treaty provision concerns exclusion of a person from the benefits of a tax treaty, like in the *Saint-Gobain* case, one may assume that in many situations it is possible for the ECJ to argue that an extension of tax treaty benefits are necessary. Such bilateral extension could be possible without seriously disturbing the tax treaty network in the internal market. The cases *Hubbard* and *Open Skies* also point in this direction.

If the question is whether a provision in a tax treaty is contrary to free movement law and the provision is based on the OECD Model and is necessary for the functioning of tax treaties including such provision, one may conclude that the ECJ will be very careful in its assessment. If the consequences of finding that the provision is precluded by free movement law are severe on the tax treaty network between EU Member States, it is probable that the Court will use its judicial discretion and judge as it did in *Gilly*, namely that the tax treaty provision is in line with free movement law even though it has a negative impact on free movement.

From the case law surveys carried out in Chapters 4 and 5, it has been established that the Court applies a *nationality-based approach* when dealing with national measures from a host state perspective. When dealing with national measures in a home state perspective, the ECJ applies a *free movement-based approach*. The *Saint-Gobain* case concerned provisions analysed from a host state perspective and, as predicted from the case law survey, the ECJ applied a *nationality-based approach*. In the *de Groot* case the Dutch internal tax legislation and tax treaty provisions were analysed from a home state perspective and the ECJ applied a *free*

movement-based approach. Accordingly, both these cases confirm the conclusions from the case law survey also when it comes to application of free movement provisions to tax treaties. However, also in this respect the *Gilly* case represents a discrepancy. In the *Gilly* case the Court did not follow its usual line of reasoning. Accordingly, it has not been possible to identify whether the ECJ applied a *nationality-based approach* or a *free movement-based approach* in this case. Moreover, the distributive provision proves difficult to classify in terms of host state legislation or home state legislation. The tax credit mechanism is, however, easily classified as home state legislation.

In conclusion, the cases *Gilly*, *Saint-Gobain* and *de Groot* show that the ECJ clearly considers the limits for its negative integration and takes a broader approach in favour of a well-functioning internal market. The Court deviates from its established case law when the consequences in the form of an increase in double taxation situations otherwise could be the outcome.

7 Tax Treaty Provisions Potentially in Breach of Free Movement Law

7.1 Application of the Findings of this Study on Tax Treaty Provisions in Existing Tax Treaties

On the basis of primarily the conclusions reached in Chapter 6 the aim of this chapter is to illustrate the impact of free movement law on certain categories of tax treaty provisions. This presentation does not aim at being exhaustive in terms of presenting possible tax treaty provisions that potentially could be considered as being in breach of free movement law, but it serves merely as an illustration of the findings of this study on certain tax treaty provisions.

7.2 Division Between Allocation and Exercise of Powers of Taxation

As has been discussed in Chapter 6, the Court held in the *Gilly*[1] case, and subsequently reiterated in the *Saint-Gobain*[2] case, that Member States are at liberty, in the framework of tax treaties, to determine the connecting factors for the purpose of allocating powers of taxation between themselves.[3] Distributive rules prescribing which national tax system that should apply are, therefore, in line with free movement law. Generally, the distributive rules state whether, and to what extent, income in a cross-border situation may be taxed by the residence state or the source state.[4]

[1] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793.

[2] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161.

[3] See Persson Österman, *Strider fusionsdirektivets krav på fast driftställe mot EG-fördragets krav på frihet?* SN 2004, p. 265.

[4] See Lehner, *The Influence of EU Law on Tax Treaties from a German Perspective*, Bulletin 2000, p. 466.

This implies that the ECJ differentiates between allocation and exercise of powers of taxation under a tax treaty.[5] When the taxing rights are allocated under the treaty, the next step consists of exercising the taxing rights. The exercise of the taxing rights can, in principle, be described as applying standards of taxation within the limits drawn by the distributive rules.[6]

Once a Member State has been allocated the right to tax under a tax treaty, it is under an obligation to exercise that right in full respect of free movement law. Accordingly, dealing with the issue of tax treaty provisions being potentially in breach of free movement law, focus should be directed towards provisions that include substantive rules that determine how a contracting state exercises its powers of taxation. Van Thiel concludes that tax treaties contain relatively few substantive rules that determine how one of the contracting states, once it has been allocated a right to tax, should exercise that right.[7] As examples, van Thiel mentions rules prescribing how the source state should determine the profits of a PE, treaty articles prescribing shared rights to tax where the source state is allowed to apply a withholding tax rate that does not exceed a certain ceiling and rules relating to Article 23 of the OECD Model. Since this latter article does not include much specification, additions are common.

In the following sections mainly two different tax treaty provisions are analysed based on the findings from previous chapters. The first one illustrates an application of a *free movement-based approach* and the second one an application of a *nationality-based approach.*

7.3 Provisions Deviating from Article 13 (5) OECD Model

A conclusion from the case law analysis carried out in Chapter 6 is that it appears as if tax treaty provisions not found in a vast number of tax treaties concluded by EU Member States, are assessed by the ECJ similarly to internal tax legislation. This means that the Court interprets the free movement provisions in a way that results in the preclusion of those tax treaty provisions which are discriminatory on grounds of nationality or

[5] See sections 6.4.2. and 8.5.1. and Farmer, *EC Law and Double Taxation Agreements,* ECTJ vol. 3, 1999, issue 3, p. 150.

[6] See Lehner, *The Influence of EU Law on Tax Treaties from a German Perspective,* Bulletin 2000, p. 466 and Farmer, *EC Law and Double Taxation Agreements,* ECTJ vol. 3, 1999, issue 3, p. 151.

[7] See van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles,* (2002), p. 515.

have a negative effect on the exercise of free movement. An example of a tax treaty practice which is not found in a vast number of tax treaties in the internal market, and which potentially is contrary to the free movement provisions, is found where EU Member States deviate from Article 13 in the OECD Model. The general rule under Article 13 OECD Model is found in Article 13 (5). This provision gives that capital gains on shares in a corporation are taxed in the alienator's state of residence.

7.3.1 Emigration of Individuals

A common method of taxation is to tax individual taxpayers on significant items of income on a cash rather than accrual basis.[8] Accordingly, no income or deduction or gain or loss is recognized until cash or the equivalent is received or paid. Likewise, states following this method of taxation do not generally require or allow taxpayers to recognize gain on an increase, or loss on a decrease, in the value of property until that gain or loss is realized.[9] Once an individual departs, prior untaxed income and appreciation may never be taxed by the state of emigration. States which have strived to counteract this result have generally followed one of the following two methods.[10] A state may impose rules treating the act of expatriation as a taxable event, resulting in the deemed disposition of all assets and the realization of all accrued income and gains (generally referred to as an *exit tax*). An alternative method is to determine the assets and income that should be taxed but to defer taxing these gains until the property is sold and the gain actually realized (generally referred to as a *trailing tax*).[11]

7.3.2 The Swedish Trailing Tax

Sweden imposes a trailing tax on certain former residents.[12] This extended tax liability concerns capital gains on participations in Swedish limited liability companies, partnerships and co-operative societies. Moreover, the tax liability also covers convertible bonds and participating debentures issued by Swedish companies, as well as purchase options

[8] Goldberg, *et al.*, *Taxation Caused by or After a Change in Residence (Part I)*, TNI 2000, p. 644.
[9] *Ibid.*
[10] However, a state may have different regimes for different assets. For further reading, see Betten, *Income Tax Aspects of Emigration and Immigration of Individuals*, (1998).
[11] Goldberg, *et al.*, Taxation *Caused by or After a Change in Residence (Part I)*, TNI 2000, p. 645.
[12] See chapter 3, section 19 SITA and Wiman, *Tax Aspects of Migration* in Andersson, Melz & Silfverberg (eds.), *Liber Amicorum Sven-Olof Lodin*, (2001), pp. 306–317.

and subscription options connected with promissory notes issued by Swedish companies. Furthermore, any futures or options that refer to such assets here described are also covered.[13] To be subject to this trailing tax, it is sufficient that the taxpayer has been a resident of Sweden at some time during the ten-year period preceding the alienation of the above-mentioned assets.

According to the preparatory works, the main reason for introducing the trailing tax was to counteract various practices resulting in a loss of revenue for Sweden.[14] For instance, the rule would reduce the risk that owners of smaller companies would accumulate profits in the company and then, after emigration, realize the accrued capital gain by selling the shares.[15]

It is worth noticing that the Swedish trailing tax not only covers gains that have accrued before emigration but gains accrued after emigration.[16] This extends to gains on disposals where the shares were acquired after emigration from Sweden.

As Article 13 (5) OECD Model allocates the exclusive right to tax capital gains on shares to the state of residence, the Swedish internal trailing tax would be without effect if Sweden concluded a treaty in accordance with the OECD Model. Thus, in tax treaty negotiations Sweden has attempted to make the trailing tax effective to the largest extent possible.[17] This has involved including a provision in Swedish tax treaties providing for a right to tax after the departure during a period of, generally, five years after emigration.[18] In addition, Sweden has made a reservation

[13] See chapter 3, section 19 SITA and Wiman, *Tax Aspects of Migration* in Andersson, Melz & Silfverberg (eds.), *Liber Amicorum Sven-Olof Lodin,* (2001), p. 307.

[14] See the Swedish Government Bill [*Proposition*] 1982/83:144 om utvidgning av skattskyldigheten i Sverige för aktievinster m.m. p. 11.

[15] Wiman, *Tax Aspects of Migration* in Andersson, Melz & Silfverberg (eds.), *Liber Amicorum Sven-Olof Lodin,* (2001), p. 307.

[16] See chapter 3, section 19 SITA. See also Skatteverket, *Handledning för internationell beskattning* 2004, p. 320 and Wiman, *Tax Aspects of Migration* in Andersson, Melz & Silfverberg (eds.), *Liber Amicorum Sven-Olof Lodin,* (2001), p. 308.

[17] Even though a vast number of Swedish tax treaties are designed so that the trailing tax is applicable it has been questioned whether the provision is effective. Considering shares kept outside Sweden there is no automatic information in case of alienation of such property. See Mutén, *Skatteprinciper och kollisionsnormer,* in the Swedish Government Official Reports SOU 2002:47 *Skattebasutredningen,* Vol. B., p. 56 and Westberg, *Will Double Taxation Conventions Be More Extensively Used?* in Arvidsson, Melz & Silfverberg (eds.), *Festskrift till Gustaf Lindencrona*, (2003), p. 566.

[18] The time limit varies under different treaties. According to a Swedish IFA branch report written by Holmgren, & Benjaminsson, *The tax treatment of transfer of residence by individuals*, (2002), p. 525, the time limit provided in the Swedish treaties varies between two and ten years. For instance, see Case C-436/00 *X and Y* v *Riksskatteverket* [2002] ECR I-10829, para. 56.

to Article 13 of the OECD Model, stating that "Sweden wants to reserve the right to tax gains from the alienation of shares or other corporate rights in Swedish companies."[19] The tax treaty rule extending Sweden's right to tax applies regardless of whether or not the capital gain is exempt from taxation in the immigration country.[20]

The tax treaty provisions providing for an application of the Swedish trailing tax differ when it comes to whether the provision is reciprocal or not. When the provision is reciprocal, the extended right to tax capital gains is granted to both contracting states under the tax treaty.[21] In contrast, under other Swedish treaties, the extended taxing right is only granted to Sweden.[22]

Wiman has emphasized the risks of double taxation following an application of the Swedish trailing tax.[23] The risk of double taxation concerns both pre-emigration and post-emigration appreciation.[24] Either the state of emigration or the state of immigration may provide a tax credit to avoid the potential double taxation. Unsurprisingly, it seems as if the availability of such credits provided by the new residence state is fairly limited.[25] The EC Treaty fails to provide any substantive criteria that would be applied to allocate the shares of responsibility for double taxation in this situation.[26] Lehner argues that in such a situation one needs to ask which state has the better right to tax. It is not necessarily the state which causes the additional burden that is also responsible for and obligated to remove the obstacle.[27] To Lehner, the OECD Model answers the question whether the state of residence or the state of source has the better right to tax a cross-border activity.

Accordingly, one may argue that the burden to avoid the potential double taxation is on the state imposing the trailing tax, especially when the

[19] Para. 39 of the OECD Commentary on Article 13.

[20] Compare para. 21 of the OECD Commentary on Article 13.

[21] For instance, see Article 13 (5) of the German-Swedish tax treaty, concluded 14 June 1992.

[22] For instance, see Article 13 (7) of the French-Swedish tax treaty, concluded 27 November 1990.

[23] Wiman, *Tax Aspects of Migration* in Andersson, Melz & Silfverberg (eds.), *Liber Amicorum Sven-Olof Lodin*, (2001), p. 312.

[24] See Goldberg, *et al.*, *Taxation Caused by or After a Change in Residence (Part I)*, TNI 2000, p. 652.

[25] *Ibid.*, p. 653.

[26] See Lehner, *The Influence of EU Law on Tax Treaties from a German Perspective*, Bulletin 2000, p. 465.

[27] Lehner, *Fundamental freedoms and national sovereignty in the EU*, Report at the 2004 Paris meeting of the EATLP, p. 9.

treaty provision is not reciprocal.[28] The reason for this standpoint is that it is this state, in this case Sweden, which has deviated from the OECD Model in order to be able to apply its trailing tax. If the Member State in question instead would have followed the OECD Model, no double taxation of the capital gain would generally have occurred. Accordingly, one may argue that when a Member State has deviated from this internationally accepted Model, it has the burden to remove any double taxation following its deviation. The question may, therefore, be to what extent Sweden provides for rules which alleviate the potential double taxation following its trailing tax.

The Swedish internal Foreign Tax Credit Act[29] applies primarily to Swedish residents. When Sweden applies the trailing tax to non-residents, it does so in its capacity as former residence state or source state. Therefore, the Foreign Tax Credit Act does not seem to apply to taxes paid in the state of immigration.[30] In certain tax treaties Sweden has provided for a reversed credit.[31] This means that Sweden as a source state provides for a credit for the tax levied in the state of immigration and the problem of double taxation is generally solved. However, the double taxation following an application of the Swedish trailing tax to non-residents will often have to be removed by the state of immigration if double taxation is to be avoided.[32]

7.3.3 Assessment under Article 43 EC

Let us assume that a Swedish national moves from Sweden to settle in another EU Member State. He intends to carry on his profession there. He owns 60 per cent of the shares in a closely held Swedish corporation. The applicable tax treaty gives Sweden the right to impose the trailing tax within five years from departure from Sweden, a rule which is not reciprocal. After four years the individual disposes of his shares which were acquired five years before departure. Both Sweden and the new residence state tax the capital gains. Sweden taxes the accrued gain from the time of the purchase of the shares until their disposal, and the new

[28] See Goldberg, *et al.*, Taxation *Caused by or After a Change in Residence (Part I)*, TNI 2000, p. 653.

[29] In Swedish: *Lag (1986:468) om avräkning av utländsk skatt.*

[30] See section 1 Foreign Tax Credit Act and Wiman, *Tax Aspects of Migration* in Andersson, Melz & Silfverberg (eds.), *Liber Amicorum Sven-Olof Lodin,* (2001), p. 313.

[31] For instance, see Article 23 (1) (b) of the French-Swedish tax treaty, concluded 27 November 1990 and Article 24 (5) of the Spanish-Swedish tax treaty, concluded 16 June 1976. For a brief explanation of a reversed credit, see section 2.6.3.

[32] Wiman, *Tax Aspects of Migration* in Andersson, Melz & Silfverberg (eds.), *Liber Amicorum Sven-Olof Lodin,* (2001), p. 313.

residence state taxes the gain accrued from the time of the immigration until the time of realization. Furthermore, Sweden does not provide for a reverse credit under the applicable tax treaty, and the internal Foreign Tax Credit Act does not apply. The new residence state does not credit the taxes paid to Sweden.

First of all, one needs to consider whether the Swedish tax treaty provision making the trailing tax effective concerns merely the allocation of taxing rights or whether it is concerned with the exercise of taxing rights. If the tax treaty provisions at issue only concern the allocation of taxing rights, no conflict with free movement law is possible. However, if the latter applies, namely that the tax treaty provisions concern the exercise of taxing rights, a potential conflict with free movement law is possible. Article 13 (5) of the OECD Model is a distributive rule allocating the exclusive right to tax capital gains on shares to the state of residence. One may conclude that, therefore, it is a provision which is neutral in its formulation and only concerns the allocation of taxing rights. However, Sweden has diverted from the pattern of allocation stated in Article 13 (5) OECD Model. One may, therefore, argue that the tax treaty provisions giving effect to the Swedish trailing tax concern the exercise of taxing rights as they are not merely rules stating which country has the right to tax with the objective of avoiding double taxation. Instead, the rules are included in the Swedish tax treaties with the aim to protect the Swedish tax base. In situations where the tax treaty provisions in question give rise to double taxation, one may, therefore, conclude that the tax treaty provisions go beyond a neutral allocation of taxing rights.

The reason for analysing this situation in relation to Article 43 EC is that it concerns the move of an individual who holds shares in a Swedish company that gives him a substantial interest in that company. He intends to carry on his profession in his new residence state. A comparable situation in this respect was under review in the *de Lasteyrie*[33] case, which the Court analysed in relation to Article 43 EC.

Based on primarily the findings of Chapter 6, one may draw the following conclusions. As it is Sweden which deviates from the OECD Model, one may find it reasonable to make this state responsible for any double taxation following an application of its trailing tax.[34] This is not an argument that is based on statements of the Court. However, it is not

[33] Case C-9/02 *Hughes de Lasteyrie du Saillant* v *Ministère de l'Économie, des Finances et de l'Industrie*, [2004], not yet reported in ECR.

[34] See Lehner, *The Influence of EU Law on Tax Treaties from a German Perspective*, Bulletin 2000, p. 465 and *Fundamental freedoms and national sovereignty in the EU*, Report at the 2004 Paris meeting of the EATLP, p. 9.

unreasonable to assume that the ECJ would put the burden on Sweden to make sure that the individual will not suffer double taxation due to the application of the trailing tax. Moreover, following this line of reasoning, one may consider that the double taxation is due to the trailing tax, and that this is classified as home state legislation. The trailing tax is imposed by the state of emigration. The conclusions drawn from this study is that the Court, therefore, would apply a *free movement-based approach.*[35] Accordingly, the Court's reasoning would assumably be focused on whether the legislation is liable to dissuade or deter individuals from leaving Sweden. The legislation most likely deters individuals from leaving Sweden if they own shares in a Swedish company, since it may result in double taxation.[36]

This situation may be compared to the situation in *de Groot*[37] and previous cases such as *Terhoeve*[38]. In the former case the ECJ stated that:

> "provisions which preclude or deter a national of a Member State from leaving his country of origin to exercise his right to freedom of movement therefore constitute an obstacle to that freedom even if they apply without regard to the nationality of the workers concerned."[39]

This is definitely a reasoning which results in a prohibition of the Swedish trailing tax when leading to double taxation for an individual moving from Sweden and to another EU Member State. Similarly to the conclusion drawn by the Court in *de Groot*, one may conclude that the individual in that situation suffers a real tax disadvantage due to the application of the tax treaty provision deviating from the OECD Model. This is based on the assumption that when a Member State deviates from the OECD Model and does not make sure, either treaty-wise or under internal law, that the potential double taxation is avoided, this Member State is most likely acting contrary to free movement law.

An alternative argument would be to argue that it is the new residence state which is responsible to remove the double taxation, as this is an obligation generally burdening the state of residence. This latter line of reasoning is not convincing. The reason is that the OECD Model offers a

[35] See chapter 5.

[36] See Case C-9/02 *Hughes de Lasteyrie du Saillant* v *Ministère de l'Économie, des Finances et de l'Industrie*, [2004], not yet reported in ECR, paras. 45–46.

[37] Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819 (see section 6.6 of this study).

[38] Case C-18/95 *F.C. Terhoeve* v *Inspectuer van de Belastingdienst Particulieren/ Ondernemingen Buitenland* [1999] ECR I-345 (see section 4.2.3.2 of this study).

[39] Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819, para. 78.

solution to avoid double taxation on capital gains. When an EU Member State deviates from the Model with respect to the taxation of capital gains, it is reasonable to put a responsibility on this Member State to avoid double taxation caused by this deviation.

The disadvantage suffered by the individual in the example may, in accordance with the ECJ's statement in *de Groot*, be considered to be liable to discourage a Swedish national from exercising his free movement rights.[40] As a result, one may conclude that the Swedish trailing tax constitutes an obstacle to the freedom of establishment when it leads to double taxation. However, the Court's judgment in the *Gilly* case may be considered as running counter to this conclusion. From the Court's case law on internal tax legislation presented in Chapter 5, it is clear that the Court, under a *free movement-based approach*, precludes tax rules that have a dissuasive effect on the free movement. However, in terms of the method provision in *Gilly*, the Court deviated from this pattern.[41] As has been argued in Chapter 6, it is clear that the *Gilly* case and the *de Groot* case point in different directions when it comes to the preclusion of tax treaty rules having a dissuasive effect on the exercise of free movement rights.

The Swedish tax treaty practise deviates from the OECD Model; in that respect it resembles the legislation at issue in the *de Groot* case. However, it is possible that the ECJ would find that it would be too far-reaching to interpret Article 43 EC in this way. The Court would most likely acknowledge the risk that EU Member States would not easily accept such an interpretation. The reason is that most Member States deviate from the OECD Model in some respects, and would not appreciate being responsible for taking away potential double taxation in those situations.

If following the line of argument that results in declaring the Swedish tax treaty practise as having a dissuasive effect on the free movement, the next question is to consider whether the trailing tax may be justified. The fact that the Swedish trailing tax covers gains after emigration makes it very far-reaching considering its underlying purpose.[42] This may lead the ECJ to conclude that even though in principle it could be justified, it is not proportionate.

Justification under Article 46 EC is very unlikely when it comes to tax provisions. This is due to the Court's very strict interpretation of the jus-

[40] *Ibid.*, para. 84.

[41] See section 6.4.3.

[42] Wiman, *Tax Aspects of Migration* in Andersson, Melz & Silfverberg (eds.), *Liber Amicorum Sven-Olof Lodin,* (2001), p. 308.

tifications found in the EC Treaty. Therefore, the question is whether the trailing tax may be justified having regard to an imperative interest. The cases studied in the previous chapters show that the ECJ has not refused, in principle, to consider imperative interests when it has assessed home state legislation and applied a *free movement-based approach.* Accordingly, one may assume that Sweden may rely on imperative interests when arguing that the trailing tax is justified. In other words, the ECJ would in such a situation most likely assess the merits of Sweden's reasoning in relation to imperative interests.

Considering the purpose of the trailing tax, to counteract practices where individuals emigrated in order to avoid paying Swedish tax on capital gains accrued before emigration, Sweden would probably argue that the trailing tax is necessary in order to prevent tax avoidance. From the Court's case law, it is evident that when arguing that a measure is necessary in order to prevent abuse, the Court demands that the provision is structured so that it merely hinders tax avoidance situations and does not cover *bona fide* situations. In *ICI*, for example, the Court held:[43]

> "As regards the justification based on the risk of tax avoidance, suffice it to note that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent UK legislation, from attracting tax benefits, but applies generally to all situations in which the majority of a group's subsidiaries are established, for whatever reason, outside the United Kingdom."

Considering the Court's reasoning in ICI, it is not very likely that the Swedish trailing tax, if tested, would be found justified by the Court, as it applies generally to all situations where a Swedish resident emigrates and owns shares.

Moreover, the Swedish trailing tax is not limited, as is presented above, to situations where the capital is exempt from taxation in the new state of residence. This is the reason why double taxation occurs in the situation presented above. This design of the Swedish trailing tax implies that its aim is to protect the Swedish tax base rather than a protection against double non-taxation.[44] If Sweden would argue to the ECJ that the trailing tax is necessary in order to protect the Swedish tax base, it would most likely not be upheld by the Court. This conclusion is based on that the ECJ in its case law has stipulated that economic aims cannot consti-

[43] Case C-264/96 *Imperial Chemical Industries plc (ICI)* v *Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-4695, para. 26.

[44] See Holmgren & Benjaminsson, *The tax treatment of transfer of residence by individuals*, (the Swedish IFA branch report), (2002), p. 525.

tute an imperative interest.[45] In, for instance, the *Skandia* case the ECJ held that the need to preserve the tax base did not constitute an imperative interest.[46]

In conclusion, the possibilities of justifying the Swedish trailing tax appear limited. Hence, it is most likely that the tax treaty provision, commonly found in Article 13 (5) of Swedish tax treaties, is contrary to Article 43 EC when leading to double taxation. As the provision deviates from the OECD Model and is not found in a vast majority of tax treaties in the internal market, one may conclude that the Court would deal with it similarly to the tax treaty provision under review in *de Groot*. Accordingly, the Court would deal with it in a way consistent with the Court's case law in relation to unilateral tax provisions.

However, there is an alternative interpretation. It suggests that the ECJ would rule similarly to the judgment delivered in *Gilly*, namely to find that even though the tax treaty provision has a dissuasive effect on the free movement, it is not precluded by free movement law. The reason for doing so could be that the Court would consider it a too far-reaching interpretation that would not be easily accepted by the Member States. There is a risk that the result of such an interpretation is that the Member States would be less eager to conclude tax treaties. This implies a less favourable situation in the internal market as regards the avoidance of double taxation.

7.4 Provisions Excluding Persons from a Tax Treaty's Scope of Application

In certain situations, a person is excluded from benefiting from a tax treaty. The limited personal scope is due to the prevention of tax treaty shopping.[47] Only persons resident in a contracting state may benefit from a tax treaty. A PE is not, according to international tax practise and the general rule in the OECD Model, considered as a tax subject in itself and is, therefore, not a person resident in a contracting state. Accordingly, a PE is not granted tax benefits. The ECJ held in *Saint-Gobain* that a PE of a company established in an EU Member State has the right to national treatment in its state of location (the host state) if the latter state is an EU

[45] See section 3.5.2.

[46] Case C-422/01 *Försäkringsaktiebolaget Skandia (publ.) and Ola Ramstedt* v *Riksskatteverket*, [2003] ECR I-6817, paras. 46–53.

[47] For instance, see para. 20 of the Commentaries to Article 1 OECD Model and van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, (2002), p. 480.

Member State. This presupposes that the PE is in an objectively similar situation to resident companies in the host state.

7.4.1 Limitation on Benefits Clauses

Also anti-abuse provisions included in tax treaties give rise to exclusion of persons from a tax treaty's scope of application. Such exclusion may be considered in conflict with free movement provisions following the Court's verdict in *Saint-Gobain* and, as is shown below, the *Open Skies* cases. A typical example of such a provision is *limitation on benefits clauses*. In the literature, they have been pointed out as EC-incompatible.[48] The aim of limitation on benefits clauses is to restrict the benefits of a tax treaty to prevent loss of revenue through treaty shopping, *i.e.*, the situation where residents of a third country who do not have the benefits of the tax treaty use a company resident of one of the contracting states as a conduit.[49] The US Model Convention contains limitation on benefits clauses, and, therefore, such provisions are generally found in tax treaties between EU Member States and the US. Those are the limitation on benefits clauses that have been most often analysed in the literature.[50] The design of these provisions differs but many of them include five objective tests of which one needs to be satisfied before a taxpayer will be entitled to treaty benefits. The tests are the following:[51]

1. the direct stock exchange test,
2. the indirect stock exchange test,
3. the resident shareholders test,
4. the base erosion test, and
5. the active trade or business test.

[48] For instance, see Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law – Applications of the Rules,* ECTRev 1995, pp. 226–230, van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles,* (2002), p. 481, Essers, de Bont & Kemmeren (eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law,* (1998), p. 210, Malherbe, & Delattre, *Compatibility of Limitation on Benefits Provisions with EC Law,* ET 1996, p. 18, Farmer, *EC Law and direct taxation – some thoughts on recent issues,* ECTJ, Volume 1, 1995/96 Issue 2, pp. 104–106 and Becker & Thömmes, *Treaty Shopping and EC Law – Critical Notes to Article 28 of the New German – US Double Taxation Convention,* ET 1991, pp. 173–176.

[49] Vanistendael, *Impact of European tax law on treaties with third countries,* ECTRev 1999, p. 166.

[50] For instance, see Essers, de Bont & Kemmeren (eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law,* (1998), p. 209.

[51] Clark, *The Limitation on Benefits Clause Under an Open Sky,* ET 2003, p. 25, see also Malherbe & Delattre, *Compatibility of Limitation on Benefits Provisions with EC Law,* ET 1996, p. 17.

If a company does not fulfil any of these requirements, it is excluded from the tax treaty's scope of application even though the company is a resident of a contracting state. Features that have been considered as contrary to the freedom of establishment are the stock exchange test and the resident shareholders test. The former commonly distinguishes between stock exchanges within the EU, allowing only some exchanges to be taken into consideration.[52] The latter implies that only companies controlled by residents of the contracting states can benefit from the tax treaty. Thus, the limitation on benefits clause excludes parent companies from other Member States from benefiting through their subsidiaries from the treaty benefits agreed between the Member State in which their subsidiary is located and the US.[53]

When Member States conclude tax treaties with the US including such limitation on benefits clauses they have arguably negotiated advantages for their own residents and disadvantages for nationals of other Member States carrying out activities in their country as well as for companies having their seat in their territory but owned or controlled by residents of other Member States.[54] Kemmeren explains that under the limitation on benefits clause in Article 26 of the Dutch-US tax treaty the following applies.[55]

> "If a Dutch resident company does not pass any of the tests of Article 26, it will not be entitled to treaty benefits in the state of source (i.e. the USA) nor in the state of residence (i.e. the Netherlands). For example, withholding taxes in the USA will not be reduced because Articles 10–13 will not be applied and those taxes cannot be credited because Article 25 will not be applied either. As a result, double taxation arises, which is only partly mitigated because the US withholding taxes can be taken into account as expenses when determining the taxable base of the company in the Netherlands."

The bilateral treaty provisions under review in the *Open Skies* cases[56] show similarities with the limitation on benefits clauses found in EU

[52] Malherbe & Delattre, *Compatibility of Limitation on Benefits Provisions with EC Law*, ET 1996, p. 17.

[53] Vanistendael, *Impact of European tax law on treaties with third countries*, ECTRev 1999, p. 165.

[54] Clark, *The Limitation on Benefits Clause Under an Open Sky*, ET 2003, p. 25.

[55] Kemmeren, *The Netherlands*, in Essers, de Bont & Kemmeren (eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law*, (1998), p. 136.

[56] See sections 4.3.2.4. and 6.3.

Member States' tax treaties with the US.[57] Both types of clauses restrict the benefits of the international treaties to qualified persons; for companies, residence is not enough.

The outcome of the Court's analysis in the *Open Skies* cases is that EU Member States may not, by means of international agreements, restrict the rights of persons from other Member States even if the treaty is with a third country. This is valid even though the international agreement concerns an area that is primarily the responsibility of the Member States.[58] The *Open Skies* judgments certainly point in the direction that limitation on benefits clauses are contrary to the freedom of establishment. It is worth noticing that, in *Open Skies*, the ECJ held that the direct source of the prohibited discrimination in the bilateral air service agreement was the treaty provision giving the US the right to exclude airline companies of which a substantial part of ownership and effective control was vested either in a Member State other than the UK, or in nationals of other Member States, and not the possible conduct of the US.[59]

However, depending on the design of the limitation on benefits clauses, it is possible to argue, but not very likely to be accepted by the Court, that they are justified on grounds of their aim of preventing treaty abuse and being proportionate.[60] As this study focuses on the impact of free movement law on tax treaties concluded between EU Member States, no analysis of the compatibility with free movement law of limitation on benefits clauses in tax treaties with third countries will be presented. Instead, this thesis focuses on limitation on benefits clauses found in tax treaties between EU Member States.

7.4.2 Assessment under Article 43 EC

Among others, the following limitation on benefits clauses found in tax treaties between EU Member States have been presented in the literature.[61] In the tax treaty between Spain and Ireland, the third provision of the protocol states as follows:

[57] See also De Ceulaer, *Community Most-Favoured-nation Treatment: One Step Closer to the Multilateralization of Income Tax Treaties in the European Union?*, Bulletin 2003, p. 498.

[58] See Craig, *Open Your Eyes: What the "Open Skies" Cases Could Mean for the US Tax Treaties with EU Member States*, Bulletin 2003, p. 64.

[59] Case C-466/98 *Commission* v *United Kingdom of Great Britain and Northern Ireland* [2002] ECR I-9427, para. 51.

[60] See Craig, *Open Your Eyes: What the "Open Skies" Cases Could Mean for the US Tax Treaties with EU Member States*, Bulletin 2003, pp. 72–73.

[61] Raventos, *Spain*, in Essers, de Bont & Kemmeren (eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law*, (1998), pp. 180–181.

"Notwithstanding the provisions of articles 10, 11, 12 and 13, the tax reductions or exemptions which would, under those provisions, otherwise be applicable to dividends, interest, royalties and gains, shall not apply where such income or gains are derived from one Contracting State by a company which is a resident of the other Contracting State and in which persons who are not residents of that other Contracting State hold directly or indirectly a participation of more than 50 % of the share capital:

Provided that the provisions of this paragraph shall apply only to dividends, interest, royalties and gains arising in one of the Contracting States and derived by a company resident in the other Contracting State where that company is engaged merely in the holding of shares or other property."[62]

In the tax treaty between Spain and Portugal, the third provision of the protocol reads:

"With respect to Articles 10, 11, 12 and 13, it is understood that the tax reduction or exemptions provided for in the Convention in connection with dividends, interest, royalties and capital gains, shall not apply where such items of income are derived from a Contracting State by a company which is a resident of the other Contracting State the capital of which is held, directly or indirectly, for more than 50 % by shareholders or members who are non-residents of that other State. The provisions of this paragraph shall not apply if such company carries on in the Contracting State of which it is a resident a substantial business activity other than the mere holding of securities or other assets."[63]

Below, these two limitation on benefits clauses are analysed based on the findings of this study. The analysis is carried out without considering the internal legislation in the Member States involved, which may lead to an incorrect conclusion with regard to the situations in those particular Member States. However, such an analysis, based on the two tax treaty provisions, provides for an illustration of the findings of this study, why it is of interest in principle.

Both these two tax treaty provisions, found in tax treaties between EU Member States, prevent residents from other Member States from enjoying important benefits of the treaties. Accordingly, national treatment between, for instance, a company resident in Spain owned solely by Spanish nationals and a Spanish resident company owned to 60 per cent by Swedish nationals is prevented.[64] The wholly Spanish-owned company is granted

[62] Tax treaty concluded between Spain and Ireland on 10 February 1994.

[63] Tax treaty concluded between Spain and Portugal on 26 October 1993. Unofficial translation (IBFD).

[64] Similarly, the same applies for an Irish or a Portugese company under the same circumstances.

tax treaty benefits which are not available to the other company and, therefore, the latter most probably is in an unfavourable situation.

It is most likely that those two Spanish companies are considered by the ECJ as being in objectively comparable situations in terms of receiving dividends, interest, royalties and capital gains from the other contracting state. This conclusion is based on the ECJ's statement in the *Saint-Gobain* case. The Court held that a domestic resident company and a PE to a company resident in another EU Member State were in comparable situations when receiving dividends from a third state.[65]

As the limitation on benefits clauses concern tax benefits in the source state, which Spain in this case has agreed not to be granted if the Spanish company does not fulfil the ownership requirement, the rules certainly show similarities with the provisions at issue in the *Open Skies* cases. The Court applied a *nationality-based approach* in *Open Skies*[66] and focused on national treatment in the EU Member State in which the disadvantaged airlines were resident.[67] Similarly, the limitation on benefits clauses prevent national treatment in Spain, the state where the companies are residents. Accordingly, one may conclude that discrimination on grounds of nationality is evident, being the result of the fact that Spain has concluded a treaty with such a limitation on benefits clause.

One may argue that the problem occurs in the state which does not grant the Spanish company the tax treaty benefits, *i.e.* the state of source. As this state is an EU Member State, unlike the situation in *Open Skies*, it should, consequently, be responsible for its actions in breach of free movement law. However, the primary problem is the fact that by not protecting the companies resident within its territory, national treatment is not achieved, and the Member State in question has acted contrary to the freedom of establishment when including the limitation on benefits clause in the convention.

When considering whether the limitation on benefits clauses could be justified, different circumstances need to be considered. First, it is highly unlikely that the limitation on benefits clauses could be justified having regard to the treaty justifications found in Article 46 EC. The Court interprets it strictly, and, so far, no tax rule has been justified on grounds of public health, public security or public policy.[68]

[65] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161, para. 38.

[66] See section 4.3.2.4.

[67] The ECJ also applied a *nationality-based approach* when assessing the situation in the *Saint-Gobain* case.

[68] See section 3.5.

Second, to rely on imperative interests, the general rule is that the restrictive measure has to be a measure that is not classified as directly discriminatory on grounds of nationality. This issue is complicated as it seems as if the ECJ is not consistent.[69] For instance, in *Saint-Gobain* the ECJ considered imperative interests but in *Royal Bank of Scotland* it refused to do so in principle.[70] In terms of limitation on benefits clauses, there is a difference in treatment of the company due to the nationality of its owners. To justify the similar treaty provision in *Open Skies*, the UK government referred solely to treaty grounds, namely Article 46 EC.[71] There could be several reasons for not referring to imperative interests. One reason may be that the UK representatives considered the provisions to be directly discriminatory.

If concluding that imperative requirements will be considered by the Court as possible justifications, an argument is that the limitation on benefits clauses are necessary in order to prevent abuse of tax treaties. As is shown in the previous section,[72] in order to justify a discriminatory measure on such a ground, the Court demands that the provision is structured so that it merely hinders situation of abuse and that it does not have a general application.

The fact that the limitation on benefits clause in the tax treaty between Spain and Portugal states that the refusal of granting tax treaty benefits does not apply to companies which carry on a substantial business activity in their states of residence shows an attempt to exclude *bona fide* transactions from the scope of the clause. If this is enough to make it justified is uncertain. There is still a considerable risk that the limitation on benefits clause is applicable to *bona fide* activities and not merely artificial arrangements set up with the mere intent of getting treaty access. Moreover, to justify the limitation on benefits clauses, the Member States must be able to show that the measures are proportionate.

A third circumstance that needs to be considered is the fact that the two limitation on benefits clauses are allegedly based on the *look through* approach as defined in the Commentaries to the 1992 OECD Model.[73] Does this result in a situation similar to the *Gilly* case, where the Court judged that the tax credit mechanism was in line with Article 39 EC even

[69] *Ibid.*, and chapters 4–5.

[70] See chapter 5 and section 6.5.

[71] See Case C-466/98 *Commission* v *United Kingdom of Great Britain and Northern Ireland* [2002] ECR I-9427, para. 55.

[72] See section 7.3.3.

[73] Raventos, *Spain*, in Essers, de Bont & Kemmeren (eds.), *The Compatibility of Anti-Abuse Provisions in Tax Treaties with EC Law*, (1998), p. 180.

though it hindered the free movement? In this study, it is argued that the reason for the Court's position in *Gilly* was that it concerned an essential component of tax treaties based on the OECD Model. The present situation is not comparable to the *Gilly* case because the consequences would not be comparable to those that would have followed from rejecting the tax credit mechanism had the Court rejected the limitation on benefits clauses dealt with here. Limitation on benefits clauses do not play the same vital role for the functioning of tax treaties in terms of avoiding double taxation as a tax credit mechanism. Accordingly, one may conclude that the ECJ would deal with those limitation on benefits clauses in a similar way as with unilateral legislation which does not respect the national treatment principle. Therefore, one may reach the conclusion that the limitation on benefits clauses most likely will be found to be in breach of Article 43 EC when interpreted by the ECJ.

A fourth circumstance that may be of importance in terms of the tax treaties concluded between Spain and Portugal and Spain and Ireland, respectively, is that those states provide for tax incentives consisting of a lower tax burden than the ordinary under certain circumstances.[74] One may question whether this affects the Court's assessment of whether a limitation on benefits clause is contrary to free movement law. The case law surveys carried out in this study do not provide any guidance on this issue.

To sum up, an application of the findings of this study shows that the ECJ most likely would apply a *nationality-based approach* when assessing the limitation on benefits clauses analysed in this section. Thereby, the Court would focus on the lack of national treatment in the state where the company is resident, which in our example is Spain. The only possible way of justification is by invoking imperative interests, namely that the provisions are necessary to prevent abuse of tax treaties and to show that the measures are proportionate. The Court would most likely deal with the limitation on benefits clauses similarly to ordinary unilateral tax legislation. The reason is that the Court would not have to consider severe consequences following a rejection of the limitation on benefits clauses, as those provisions are not that relevant for the functioning of tax treaties having regard to the avoidance of double taxation.

[74] *Ibid.*, p. 181. See the Spanish Royal Decree-Law 2/2000 of 23 June 2000 establishing the Canary Islands Special Zone Regime, the Portuguese Regional Legislative Decree of Madeira or Azores and the Irish Tax Consolidation Act of 1997 (source IBFD, *Taxation of Companies in Europe*, 2004).

7.5 Conclusions

In this chapter, an analysis based on the findings of this study of the impact of a free movement article on tax treaty provisions is presented.

Two types of tax treaty provisions are assessed. First, the Swedish tax treaty practice to deviate from the OECD Model in regard to the taxation of capital gains on shares in a corporation. Second, limitation on benefits clauses found in tax treaties between EU Member States.

The analysis of the compatibility of the Swedish tax treaty practise with Article 43 EC involves essential questions. First, whether the Swedish tax treaty provision making the trailing tax effective concerns merely the allocation of taxing rights or whether it is concerned with the exercise of taxing rights. If the tax treaty provision at issue only concerns the allocation of taxing rights, no conflict with free movement law is probable. However, if the latter applies, namely that the tax treaty provision concerns the exercise of taxing rights, a potential conflict with free movement law is possible. In this chapter, it is argued that the tax treaty provision at issue concern the exercise of taxing rights as it is not merely a rule stating which country has the right to tax with the objective of avoiding double taxation. Instead, the rule is included in the Swedish tax treaties with the aim to protect the Swedish tax base. In situations where the tax treaty provisions in question give rise to double taxation, one may, therefore, conclude that the tax treaty provisions go beyond a neutral allocation of taxing jurisdiction.

Second, which of the two contracting states is responsible for the double taxation that could be the result of the trailing tax? In this chapter, it is argued that because it is Sweden that deviates from the OECD Model, one may find it reasonable to make this state responsible for any double taxation following an application of its trailing tax. This is not an argument that is directly based on statements of the Court. However, it is not unreasonable to assume that the ECJ would put the burden on Sweden to make sure that the individual will not suffer double taxation due to the application of the trailing tax.

Third, if one considers that the double taxation is due to the trailing tax, the tax treaty provision is classified as home state legislation. The reason is that the trailing tax is imposed by the state of emigration. The conclusions drawn from this study is that the Court, therefore, would apply a *free movement-based approach*. Accordingly, the Court's reasoning would most likely be focused on whether the legislation is liable to dissuade or deter individuals from leaving Sweden.

Fourth, does the trailing tax have a dissuasive effect on the free movement? When an application of the trailing tax results in double taxation,

one may assume that it has a deterrent effect on individuals wishing to move to another EU Member State. Such an interpretation is in line with the Court's reasoning in *de Groot*. Considering that the Swedish tax treaty practise deviates from the OECD Model, this appears to be the most probable outcome. However, as has been argued in Chapter 6, it is clear that the *Gilly* case and the *de Groot* case point in different directions when it comes to the preclusion of tax treaty rules having a dissuasive effect on the exercise of free movement rights. Accordingly, it is possible that the ECJ would rule similarly to the judgment delivered in *Gilly*, namely to find that even though the tax treaty provision has a dissuasive effect on the free movement, it is not precluded by free movement law. The reason for such a position could be that the Court considers it to be a too far-reaching interpretation that would not be easily accepted by the Member States. Such an interpretation could result in the Member States becoming less eager to conclude tax treaties. This implies a less favourable situation in the internal market as regards the avoidance of double taxation.

Fifth, could the Swedish tax treaty practise be justified having regard to Article 46 EC or the rule of reason? The case law indicates that the chances of justifying the Swedish trailing tax when giving rise to double taxation is limited.

To sum up, the outcome of the analysis of the compatibility of the Swedish tax treaty practise with Article 43 EC is dependent on the answers to these five questions. Guidance on some of these questions can be found in the case law, while for other the case law provides no help. The question of which state is responsible for the double taxation is an example of the latter.

The analysis of the compatibility of limitation on benefits clauses found in tax treaties concluded between EU Member States with Article 43 EC appears to be less complicated. The *Saint-Gobain* case and the *Open Skies* cases provide possible guidance.

The limitation on benefits clauses analysed in this chapter are found in tax treaties between Spain and Portugal and Spain and Ireland, respectively. For instance, the result of the limitation on benefits clause in the treaty between Spain and Ireland is that it hinders national treatment in Spain for companies owned by nationals of another EU Member State in comparison with companies owned by Spanish nationals when receiving dividends, interest, royalties and capital gain from Ireland.

In such a situation, Spain has agreed that withholding tax reductions in Ireland are not to be granted if the Spanish company does not fulfil the ownership requirement. This situation certainly shows similarities with

the *Open Skies* cases.[75] The Court applied a *nationality-based approach* in *Open Skies* and focused on national treatment in the EU Member State in which the disadvantaged airlines were resident.[76] Similarly, the limitation on benefits clause prevents national treatment in Spain, the state where the companies are residents. Accordingly, one may conclude that discrimination on grounds of nationality is evident, being the result of the fact that Spain has concluded a treaty with such a limitation on benefits clause. The outcome of the analysis is that by not protecting the companies resident within its territory, national treatment is not achieved, and the Member State in question has acted contrary to the freedom of establishment when including the limitation on benefits clauses in its conventions with other Member States.

In conclusion, an application of the findings of this study shows that the ECJ most likely would apply a *nationality-based approach* when assessing the limitation on benefits clauses analysed in this section. Thereby, the Court would focus on the lack of national treatment in the state where the company is resident, which in our example is Spain. The only possible way of justification is by invoking imperative interests, namely that the provisions are necessary to prevent abuse of tax treaties and to show that the measures are proportionate. The Court would most likely deal with the limitation on benefits clauses similarly to ordinary unilateral tax legislation. The reason is that the Court would not have to consider severe implications on the tax treaty network in the internal market following a rejection of the limitation on benefits clauses, as those provisions are not of that importance for the functioning of tax treaties having regard to the avoidance of double taxation.

[75] See section 4.3.2.4.

[76] The ECJ also applied a *nationality-based approach* when assessing the situation in the *Saint-Gobain* case.

8 Do the Free Movement Provisions Prescribe a Most-Favoured-Nation Treatment?

8.1 Possible Effects of a Most-Favoured-Nation Treatment on Tax Treaties in the Internal Market

A much debated issue in the literature is whether it is compatible with Community law for tax treaties concluded between EU Member States to grant more favourable treatment to some residents than to others.[1] This issue is generally referred to as whether Community law prescribes most-favoured-nation treatment.

In this chapter, the question whether the free movement provisions prescribe most-favoured-nation treatment is analysed. This is relevant to this study as an answer in the affirmative could have a considerable impact on tax treaties concluded between EU Member States. Such a result can be illustrated as follows. To obtain tax benefits under a tax treaty in relation to the source state, a non-resident taxpayer, who is a resident of a treaty state, may invoke the tax treaty which the source state has concluded with his residence state. If the free movement provisions would prescribe most-favoured-nation treatment, the taxpayer could, if certain conditions were fulfilled, invoke the provisions of a tax treaty which the source state (an EU Member State) has concluded with another EU Member State and which would grant tax benefits more beneficial to him than the ones under the treaty concluded with his state of residence.[2]

The purpose of this chapter is twofold. First, it will present arguments for and against interpreting the free movement provisions as prescribing *most-favoured-nation treatment.* Second, it will analyse the implications

[1] See section 8.4.

[2] See Schuch, *Bilateral Tax Treaties Multilateralized by the EC Treaty,* in Lang, *et al.* (eds.), *Multilateral Tax Treaties,* (1998), p. 36.

of a most-favoured-nation treatment on tax treaties in the internal market in the light of the Court's case law, primarily the cases *Gilly*[3] and *Saint-Gobain*[4].

As this study deals with the impact of free movement provisions on tax treaties concluded between EU Member States, it does not consider whether Community law prescribes a most-favoured-nation treatment in relation to non-Member States.[5]

8.2 The Concept of a Most-Favoured-Nation Treatment

In Chapter 3 of this study, the concept of discrimination has been described. It was held that the free movement provisions have traditionally been interpreted as prohibitions of discrimination on grounds of nationality.[6] This implies that a national of a Member State A could rely on a free movement provision to receive national treatment in Member State B. The comparison is then made between the treatment of a national of Member State B and the treatment prescribed by Member State B to a national of Member State A. If the free movement provisions prescribe *most-favoured-nation treatment,* the national of Member State A has the right to demand from Member State B to be treated in the same way as a national of a Member State C. The difference from the obligation of national treatment is, therefore, the comparative standard.[7]

As the ECJ has extended the prohibition of discrimination also to cover a situation where the distinguishing factor is residence, the above-mentioned example is also relevant for residents of different Member States.[8] The question is then whether a resident of Member State A may demand the same treatment by Member State B as this Member State

[3] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793.

[4] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161.

[5] See van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles,* (2002), p. 346.

[6] The ECJ has explained that Article 12 EC, which states that "any discrimination on grounds of nationality shall be prohibited", is applicable only in cases where the free movement provisions do not apply. For instance, see Case C-311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651, para. 20.

[7] See van der Linde, *Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the D case,* ECTRev 2004, p. 11.

[8] See Case 152/73 *Giovanni Maria Sotgiu* v *Deutsche Bundespost* [1974] ECR 153 and section 3.4.3.3.

prescribes for a resident of Member State C.[9] Generally, internal tax legislation does only differentiate between residents and non-residents, and not between non-residents from different states, why the question of most-favoured-nation treatment is of little relevance. Even though bilateral tax treaties in the internal market generally are based on the OECD Model, which implies that they are very similar in structure and wording, they represent a trade-off of measures reflecting the specific circumstances of the two countries involved.[10] Therefore, the tax treaties differ with regard to tax benefits granted, and the issue of most-favoured-nation treatment is pivotal.

Whether or not to interpret the free movement provisions as prescribing most-favoured-nation treatment depends on the application of the similarity test[11].[12] The application of this test is not a pure factual issue as it involves a normative choice.[13] In its case law, the ECJ has compared a resident with a non-resident as well as two resident taxpayers, one with a connection with another Member State.[14] The question appears to be whether, in the future, the ECJ will compare two non-residents as well as two residents who have connections with two different Member States.[15] If the Court will apply the similarity test so that also these comparisons are applied, the free movement provisions prescribe a most-favoured-nation treatment.

In this study, a most-favoured-nation treatment implies two different meanings depending on the situations. First, that a resident of one EU Member State, who receives income from a particular source Member

[9] See van der Linde, *Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the D case*, ECTRev 2004, p. 11.

[10] See Hughes, *Withholding Taxes and the Most Favoured Nation Clause*, Bulletin 1997, p. 128 and van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, (2002), p. 497.

[11] The expression *similarity test* is explained in section 3.4.5.

[12] See Schuch, *Bilateral Tax Treaties Multilateralized by the EC Treaty*, in Lang, *et al.* (eds.), *Multilateral Tax Treaties*, (1998), p. 43 and van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, (2002), p. 335.

[13] See van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, (2002), p. 329, van der Linde, *Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the D case*, ECTRev 2004, p. 13 and Spaventa who has stated that it "is not to deny that the assessment of comparability may be very much guided by the aimed result." See Spaventa, *On Discrimination and the Theory of Mandatory Requirements*, CYELS, Vol. 3, 2000, p. 468.

[14] See chapter 5.

[15] See section 8.3 below.

State, has the right to claim, from that source state, the most beneficial tax treaty benefits granted to a resident of a third Member State, who derives the same kind of income from the source state.[16] Second, that a resident can claim, from his state of residence (an EU Member State), the same tax treatment as provided in a tax treaty between his state of residence and another source state (also an EU Member State). In other words, the taxpayer is allowed to rely on the latter tax treaty if that treaty is more beneficial in terms of home state legislation than the treaty which is applicable considering the source of the income.

8.3 Does the EC Treaty Allow for a Most-Favoured-Nation Treatment?

8.3.1 No Explicit Reference in the EC Treaty

The EC Treaty does not refer explicitly to a most-favoured-nation treatment.[17] However, as most-favoured-nation treatment is a classical measure for avoiding discrimination, one may question whether the free movement provisions prescribe such treatment.[18] As has been mentioned earlier in this study,[19] the wording of the free movement provisions implies that discrimination and restrictions are prohibited.[20] In this chapter, arguments are reviewed to analyse whether those terms implicitly prescribe most-favoured-nation treatment.

It is worth emphasizing that, so far as I am aware, the ECJ has not yet ruled explicitly on the issue whether the EC Treaty prescribes most-favoured-nation treatment.[21] Some commentators have, however, found statements in the Court's judgments that they have interpreted as implicit

[16] See van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, (2002), p. 510.

[17] See Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law. The Rules*, ECTRev 1994, p. 152.

[18] See Rädler, *Most-Favoured-Nation Concept in Tax Treaties*, in Lang, *et al.* (eds.), *Multilateral Tax Treaties*, (1998), p. 3.

[19] See section 1.5.

[20] See chapters 3–4.

[21] The same opinion is presented by van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, (2002), p. 492 and van der Linde, *Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the D case*, ECTRev 2004, p. 12. However, see section 8.5.2.

references both in favour and against an interpretation including a most-favoured-nation treatment.[22]

The responsible Commissioner has in the past replied to a Parliamentary Question that current Community law does not oblige a Member State to grant automatically the withholding tax rates of its most favourable bilateral agreements to taxpayers of other Member States not covered by those agreements.[23] Consequently, the Commissioner denied interpreting the free movement provisions as including a most-favoured-nation treatment in this respect. However, it is worth noticing that in the 2001 report *Company Taxation in the Internal Market* the Commission remarked in regard to tax treaties that:

> "it nevertheless remains unclear whether all differences between tax treaties will be incompatible with the equal treatment principle. In particular it is arguable that the equal treatment principle does not allow reciprocal concessions which go beyond mere allocation of taxing rights, such as differences in concessions to avoid economic double taxation (refund of imputation credits)".[24]

In this context, it needs to be observed that it is not the Commission that is responsible in the Community for interpreting Community law, but the ECJ.[25]

Moreover, the OECD Model does not incorporate a most-favoured-nation clause. As a result, the use of most-favoured-nation clauses in tax treaties is limited.[26]

[22] For instance, see Rädler, *Most-Favoured-Nation Concept in Tax Treaties*, in Lang, *et al.* (eds.), *Multilateral Tax Treaties*, (1998), pp. 7–8, who interprets such statements as pointing in the direction that Community law prescribes most-favoured-nation treatment, and Kemmeren, *The termination of the 'most favoured nation' clause dispute in tax treaty law and the necessity of a Euro Model Tax Convention*, ECTRev 1997, p. 148 who interprets the Court's statements as pointing in the opposite direction, namely that Community law does not prescribe most-favoured-nation treatment.

[23] Answer to Parliamentary Question 647/92.

[24] *Company Taxation in the Internal Market*, COM (2001) 582 final, p. 316.

[25] See Article 220 EC. See also van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, (2002), p. 504.

[26] For a presentation of the employment of most-favoured-nation treatment in international tax law, see Rädler, *Most-Favoured-Nation Concept in Tax Treaties*, in Lang, *et al.* (eds.), *Multilateral Tax Treaties*, (1998), pp. 3–14. Owens emphasizes that "applying the MFN obligation in trade and investment treaties to direct taxes would turn the existing individually-negotiated compromise into a universal right to be extended to other countries without cost. Future tax treaty negotiations would have to change altogether and might, on the most pessimistic prognosis, become a multitude of Uruguay round negotiations, instead of a series of flexible and responsive exchanges." See Owens, *Taxation within a Context of Economic Globalization*, Bulletin 1998, p. 292.

8.3.2 The ECJ Compares a Resident with a Non-Resident

The ECJ has held that in the area of direct taxation the main rule is that residents and non-residents are not in comparable situations.[27] The result is that legislation that restricts tax benefits to residents of that Member State is not, as a rule, discriminatory.[28] According to the ECJ, there are several reasons why residents and non-residents are generally not in comparable situations.[29] First, income received in the territory of a Member State by a non-resident is in most cases only part of his total income, which generally is concentrated at his place of residence. Second, a non-resident's personal ability to pay tax, determined by reference to his aggregate income and his personal and family circumstances, is more easy to assess at the place where his personal and financial interests are centred, *i.e.* in his state of residence. Third, the ECJ emphasized that OECD recognizes that, in principle, the overall taxation of taxpayers, having regard to their personal and family circumstances, is a matter for the state of residence.

In the case law, one finds many examples of situations that represent derogations from the main rule that residents and non-residents are not in comparable situations.[30] Those situations have in common that the ECJ has found that there are no objective differences between the situation of the non-resident taxpayer, in comparison to the resident taxpayer, which could justify a difference in treatment.

It is worth emphasizing that when the Court analyses a situation in relation to free movement law, it generally considers whether two taxpayers are in comparable situations only if they have a common connection to the tax legislation of one and the same Member State.[31] One may conclude that this would be the starting point also if the Court would extend the similarity test to include a comparison of two non-residents as well as two residents with comparable connections to different Member States. In the former situation, the common connection would be with the source state and in the latter the common connection would be with the state of residence.

[27] Case C-279/93 *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225, para. 31.

[28] *Ibid.*, para. 34.

[29] *Ibid.*, para. 32.

[30] For instance, see Case C-279/93 *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225, paras. 36–38 and Case C-311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651, paras. 27–28.

[31] See section 3.4 of this study and Schuch, *Bilateral Tax Treaties Multilateralized by the EC Treaty*, in Lang, *et al.* (eds.), *Multilateral Tax Treaties*, (1998), p. 43 and Lehner, *The Influence of EU Law on Tax Treaties from a German Perspective*, Bulletin 2000, p. 464.

8.3.3 The ECJ Compares Two Resident Taxpayers, One of them with a Connection to another State

As explained earlier in this study, the free movement provisions of the EC Treaty have traditionally been seen by the ECJ as giving specific expression to the prohibition of discrimination on grounds of nationality in Article 12 EC.[32] By extending this to cover also distinctions based on residence, the Court compared a resident with a non-resident when assessing a situation in relation to free movement law.[33] This is what in this study has generally been referred to as a *nationality-based approach.*

However, the Court has gone further and applied a so-called *free movement-based approach* when interpreting free movement provisions. In doing that, the Court is not applying a prohibition of discrimination on grounds of nationality but prohibiting Member States from treating their own residents less favourably when they have a connection to another state. This connection (or foreign element) can be in the form of foreign source income or the establishment of a subsidiary abroad.[34] Under a *free movement-based approach,* the Court compares two residents, one of them with a connection to another state. Consequently, this prohibition has little to do with a distinction based on residence or nationality but whether the taxpayer has exercised his right to free movement. One conclusion from the case law study carried out previously in this thesis is that the Court applies a *free movement-based approach* when it assesses the national legislation from a home state perspective.

8.3.4 Will the ECJ Extend its Similarity Test?

If the Court would find that two non-residents, having a common connection to an EU Member State, are in comparable situations, the following would be the result.[35] A resident of one EU Member State, who receives income from a particular source Member State, has the right to claim,

[32] See section 3.4.3.

[33] See section 3.4.3.3.

[34] See Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819 and Case C-200/98 *X AB and Y AB* v *Riksskatteverket* [1999] ECR I-8261 respectively.

[35] Hughes states that "it is currently impossible to envisage a situation where an investor resident in one country is in an identical or at least "comparable" situation to an investor resident in another country." Hughes, *Withholding Taxes and the Most Favoured Nation Clause,* Bulletin 1997, p. 129. van Thiel argues that the fact that two non-residents are subject to two different home Member State tax jurisdictions may bring an end to the similarity, especially when subject to different methods of avoiding double taxation in their home states. See van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles,* (2002), p. 518.

from that source state, the most beneficial tax treaty benefits granted to a resident of a third Member State who earns the same kind of income in the source state.

If the Court would find two residents that have comparable connections to different Member States to be in comparable situations, the result would be that a resident of an EU Member State can claim, in relation to his state of residence, the most favourable tax treatment provided for in a tax treaty between his state of residence and another source state (also an EU Member State).

Extending the similarity test to two non-residents, as well as two residents with comparable connections to different Member States, appears to be within the Court's judicial discretion under the free movement provisions.[36] The reason for this conclusion is two-fold. First, the EC Treaty does not specify what is a correct comparable standard when assessing whether discrimination is at hand. Second, the Court has extended the similarity test in the past. It is evident from the Court's case law that it has extended the test from comparing residents with non-residents to comparing two residents of the same Member State, where one of them has a connection to another EU Member State. This change of the similarity test implied a new prohibition, or at least an extended prohibition, under the free movement provisions. The change indicated that from first prohibiting merely discrimination on grounds of nationality, a concept including differentiation based on residence, the Court went on to prohibit any national measure having a negative impact on free movement. The latter approach indicates that discrimination on grounds of nationality is no longer a necessary precondition. Instead any type of national measures which dissuade or discourage a resident from exercising his free movement rights is, in principle, prohibited under free movement law.[37]

The change of the similarity test, which would give rise to a most-favoured-nation treatment, seems to be less far-reaching in terms of principal considerations than the change observed above. The Court argued that the extension of the similarity test, from comparing residents with non-residents to also comparing two residents, was necessary to make Article 43 EC effective.[38] Accordingly, if the Court had interpreted the free movement provision so that it did not cover obstacles set up by the home state, the Court would have rendered it less effective. This is some-

[36] See section 1.5.3.

[37] See chapters 4–5.

[38] See Case 81/87 *The Queen* v *H.M. Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc* [1988] ECR 5483, para. 16.

thing that would not benefit the internal market. This extension resulted in a prohibition of home state legislation restricting the exercise of free movement. This indicates that these obstacles were as harmful for the internal market as discriminatory host state measures. Accordingly, one may assume that the Court will extend the similarity test if the Court finds that it benefits a well-functioning internal market.

In the literature, it is held that the severe consequences on tax treaties argue against interpreting the free movement provisions as prescribing a most-favoured-nation treatment. However, the tax literature is divided on this issue, and a variety of arguments is presented both for and against interpreting free movement provisions in this way. This is further presented below.

8.4 Divided Opinions in the Literature

Whether the free movement provisions prescribe most-favoured-nation treatment has been extensively argued in the literature. Commentators are divided on this question.[39]

Arguments presented in favour of interpreting the free movement provisions as prescribing most-favoured-nation treatment are, for instance, that such an interpretation could be considered as inherent in the very concept of an internal market.[40] Moreover, it is argued that a most-favoured-nation treatment is the result of the prohibition of discrimination on grounds of nationality; it is merely an appellate form of this kind of discrimination.[41] Schuch argues that it is only a matter of time until the ECJ will hand down a decision on equal treatment of two non-resident

[39] Commentators who are clearly in favour of a most-favoured-nation reading are for instance: van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, (2002), pp. 486–494 and 496–522, Schuch, *EC law requires multilateral tax treaty*, ECTRev 1998, p. 36, and van der Linde, *Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the D case*, ECTRev 2004, p. 17. Commentators who are definitely against a most-favoured-nation reading are for instance: Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law. The Rules*, ECTRev 1994, p. 154, Avery Jones, *Flows of capital between the EU and third countries and the consequences of disharmony in European international tax law*, ECTRev 1998, p. 97, and Lehner, *The Influence of EU Law on Tax Treaties from a German Perspective*, Bulletin 2000, p. 470.

[40] Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law. The Rules*, ECTRev 1994, p. 152 and van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles*, (2002), p. 487.

[41] For instance, see Schuch, *EC law requires multilateral tax treaty*, ECTRev 1998, p. 30 and van der Linde, *Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the D case*, ECTRev 2004, p. 11.

taxpayers in relation to each other.[42] He explains that if two non-resident taxpayers in similar situations are subject to different tax treaty rules, the non-resident taxpayer having been placed at a disadvantage may have suffered discrimination in this respect.[43] In addition, van Thiel argues that Article 54 EC provides most-favoured-nation treatment as between Member States in respect of services. As there is a strong assumption underlying the case law of the Court that all free movement provisions are interpreted in the same way, this is one reason why van Thiel concludes that all free movement provisions prescribe for most-favoured-nation treatment.[44] It is also argued that an application of a most-favoured-nation obligation would create equal competition conditions in the internal market. Rädler describes the question of whether EC law prescribes a most-favoured nation treatment as complex. However, he concludes that an affirmative answer seems to be quite likely.[45] He argues that the principle of the internal market requires the establishment of equal competition conditions. In this respect, he finds that the principle of most-favoured-nation treatment would be an excellent instrument for realizing neutrality of competition.[46]

Arguments against a most-favoured nation obligation are mainly focused on the far-reaching effects following such an interpretation. Hinnekens concludes that it would influence in an uncontrollable manner the Member States' budgetary policies and their internal tax policies.[47] Kemmeren argues that if the ECJ would decide in favour of the application of the most-favoured-nation principle in the field of tax treaties, it would "create enormous chaos in a prominent part of international law", as the reciprocity principle would be demolished.[48] Lehner also focuses on the consequences for the principle of reciprocity. He states that "as long as tax treaties are concluded on a bilateral basis, the application of a most-favoured-nation obligation cannot be based on the fundamental freedoms and non-discrimination clauses. Assuming that the fundamental

[42] Schuch, *EC law requires multilateral tax treaty,* ECTRev 1998, p. 30.

[43] *Ibid.*, p. 36.

[44] van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles,* (2002), p. 487.

[45] Rädler, *Most-Favoured-Nation Concept in Tax Treaties,* in Lang, *et al.* (eds.), *Multilateral Tax Treaties,* (1998), p. 8.

[46] *Ibid.*, p. 14.

[47] Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law. The Rules,* ECTRev 1994, p. 154.

[48] Kemmeren, *The termination of the 'most favoured nation clause'dispute in tax treaty law and the necessity of a Euro Model Tax Convention,* ECTRev 1997, p. 148. See also Winther-Sørensen, *Beskatning af International Erhvervindkomst,* (2000), pp. 694–695.

freedoms granted most-favoured-nation treatment, this would result in the abolition of the principle of reciprocity which, however, forms the backbone of bilateral agreements."[49] Hughes identifies adverse practical implications of a finding in favour of a most-favoured-nation treatment applicable to withholding taxes.[50] He raises doubts as to whether the Member States' tax treaty network would survive the initial aftermath of the introduction of an application of a most-favourable-nation treatment.[51] Pistone describes the effects of a most-favoured-nation interpretation as "producing irrecoverable damage on the coherence of tax treaties and domestic law."[52] He, therefore, questions whether Community law as it stands is ready for an application of a most-favoured-nation treatment.[53] Gammie and Brannan also emphasize the effects of interpreting the free movement provisions as prescribing most-favoured-nation treatment.[54] They argue that such an interpretation would have wide ranging effects on the tax systems of Member States, "opening the door to a variety of actions."[55] For that reason, at least, Gammie and Brannan conclude that the ECJ is likely to be particularly cautious in its approach to an interpretation in favour of a most-favoured-nation principle.[56]

Most commentators, regardless of whether they are in favour of a most-favoured-nation obligation or not, seem to agree that an application of a most-favoured-nation obligation would give rise to a multilateralization of the tax treaty network between EU Member States.[57] However, their opinions differ regarding whether this multilateralization is welcomed or not. Avery Jones argues that a most-favoured-nation obligation would destroy the bargaining underlying tax treaties, perhaps even requiring the lowest withholding tax rate in any treaty to be applied to all, which a state could not afford to allow to happen, thus leading to no tax

[49] Lehner, *The Influence of EU Law on Tax Treaties from a German Perspective*, Bulletin 2000, p. 470.

[50] Hughes, *Withholding Taxes and the Most Favoured Nation Clause*, Bulletin 1997, p. 128.

[51] *Ibid.*, p. 130.

[52] Pistone, *The Impact of Community Law on Tax Treaties*, (2002), p. 210.

[53] Pistone, *An EU Model Tax Convention*, ECTRev 2002, p. 131.

[54] Gammie & Brannan, *EC Law Strikes at the UK Corporation Tax – The Death Knell of UK Imputation?*, Intertax 1995, p. 404.

[55] *Ibid.*

[56] *Ibid.*

[57] For instance, see Schuch, *EC law requires multilateral tax treaty*, ECTRev 1998, p. 30, Hamaekers, *Fiscal Soverignty and Tax Harmonization in the EC*, ET 1993, p. 26, Terra & Wattel, *European Tax Law*, (2001), p. 97 and Farmer, *EC law and national rules on direct taxation: a phoney war?* ECTRev 1998, p. 29.

treaties at all. Therefore, Avery Jones concludes that the result would be the exact opposite of what Article 293 EC requires and, hence, he does not regard a most-favoured-nation obligation as a serious argument between Member States.[58] A similar conclusion is reached by Hinnekens, who argues that it is a matter of Member States' sovereignty.[59] He gives prominence to that the principle of most-favoured-nation treatment cannot function as a surrogate for harmonization, which Member States are not eager to approve in the direct tax field with the required unanimity. Moreover, he concludes that "tax harmonization may be achieved, with a better degree of acceptance and precision, by the alternative method of a multilateral agreement among all Member States, than the blind and automatic application of the principle of MFN."[60] Rädler welcomes the multilateralization as he finds the result favourable, namely equal competition conditions in the internal market.[61] Also Schuch is in favour of such multilateralization as it would be achieved without having to renegotiate all tax treaties in the internal market.[62]

A number of commentators are cautious in their approach to a most-favoured-nation interpretation. Hamaekers, for instance, concludes, on the basis of the supremacy of Community law over international treaties between Member States, that preferential treatment accorded by Member State A to residents of Member State B under its treaty with B can probably no longer be refused to residents of other EU Member States.[63] Farmer argues that where a Member State distinguishes between Member States in the granting of tax privileges, it is at least possible to present a case for a discriminatory restriction of freedom of establishment within the Community.[64] He points out, however, that the likely outcome of such a case, when the issue is eventually tested, is far from clear.[65] He considers it clear that, "as a matter of policy, the Court is likely to approach this issue with considerable caution in view of the potentially far-reaching

[58] Avery Jones, *Flows of capital between the EU and third countries and the consequences of disharmony in European international tax law,* ECTRev 1998, p. 97.

[59] For instance, see Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law. Application of the Rules,* ECTRev 1995, p. 210.

[60] Hinnekens, *Compatibility of Bilateral Tax Treaties with European Community Law. The Rules,* ECTRev 1994, p. 154.

[61] Rädler, *Most-Favoured-Nation Concept in Tax Treaties,* in Lang, *et al.* (eds.), *Multilateral Tax Treaties,* (1998), p. 14.

[62] Schuch, *EC law requires multilateral tax treaty,* ECTRev 1998, p. 36.

[63] Hamaekers, *Fiscal Soverignty and Tax Harmonization in the EC,* ET 1993, p. 26.

[64] Farmer, *EC Law and Direct Taxation – Some Thoughts on Recent Issues,* ECTJ, Vol. 1, 1995, issue 3, p. 102.

[65] *Ibid.*, p. 103.

implications of a finding of illegality."[66] Farmer has pronounced that he is very doubtful about the possibility of multilateralizing bilateral treaties by the stroke of a judicial pen,[67] which is the purport of interpreting the free movement provisions as prescribing most-favoured-nation treatment.

Vogel takes the position that it should be clear that applying a most-favoured-nation standard cannot mean that a taxpayer is entitled to choose the most favourable distributive rule from the tax treaties concluded by the country in question.[68] The Court's statements in *Gilly* and *Saint-Gobain* may be interpreted as giving rise to exactly the situation pronounced by Vogel, namely that a potential most-favoured-nation treatment is not applicable for neutral distributive rules. The reason is the Court's division between allocation and exercise of taxing rights.[69] The Court's statement in *Gilly* has primarily been interpreted in this way by Hughes and van Thiel.[70] Hughes interprets the *Gilly* judgment as a clear indication that the Court does not incorporate a most-favoured nation treatment into Member States tax treaties, as Member States are free to design fiscal connecting factors in their tax treaties without the threat of acting contrary to free movement law.[71] van Thiel argues that the practical problems following a most-favoured-nation interpretation of the free movement provisions would give rise to complicated issues and problems; however, they would not be insurmountable.[72] One reason for this conclusion is the Court's division between allocation and exercise of taxing rights, which he finds excluding most distributive rules from the application of a most-favoured-nation treatment.[73] This issue is further analysed below.

[66] *Ibid.*

[67] Farmer, *EC law and national rules on direct taxation: a phoney war?* ECTRev 1998, p. 29.

[68] Vogel, *Problems of a Most-Favoured-Nation Clause in Intra-EU Treaty Law,* ECTRev 1995, p. 264.

[69] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, paras. 24, 30, Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161 para. 56.

[70] The same conclusion is reached by van der Linde, *Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the D case,* ECTRev 2004, p. 14.

[71] Hughes, *Gilly and the Big Picture*, Bulletin 1998, p. 332.

[72] See also Rädler, *Most-Favoured-Nation Concept in Tax Treaties,* in Lang, *et al.* (eds.), *Multilateral Tax Treaties,* (1998), p. 503.

[73] van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles,* (2002), pp. 515, 518.

8.5 Possible Effects of the Court's Distinction between Allocation and Exercise of Taxing Rights

8.5.1 Which Tax Treaty Provisions Provide Merely for an Allocation of Taxing Rights?

According to the ECJ, there is no discrimination, and therefore no obligation of most-favoured-nation treatment, in a situation regarding tax treaty provisions that merely provide for an allocation of taxation rights.[74] The question is then how one is supposed to know which tax treaty provisions merely provide for an allocation of taxing rights and which provisions that go beyond that and concern the exercise of taxing rights. For instance, are tax treaty provisions that provide for a certain maximum withholding tax percentage on dividends, interest or royalties[75] to be considered to provide only for an allocation of taxing rights or also for an exercise of the same?[76] One may argue that to the extent the withholding tax is entirely absorbed by the foreign tax credit in the country of residence, the combined application of the withholding tax and the credit represents a rule of allocation of taxing rights which is neutral in character.[77] However, as is emphasized by van Thiel, tax treaties rarely prescribe a full credit, which would guarantee neutrality in all situations. Instead, an ordinary credit is generally applied, which may result in situations where the entire withholding tax is not credited in the country of residence.

[74] See Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793 paras. 24, 30 and Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161, para. 56 as well as van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles,* (2002), p. 515 and van der Linde, *Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the D case,* ECTRev 2004, p. 14.

[75] For the impact of the directives concerning taxation of dividends, interest and royalties, see section 2.5.3.

[76] See van der Linde, *Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the D case,* ECTRev 2004, p. 14.

[77] See Vogel, *Problems of a Most-Favoured-Nation Clause in Intra-EU Treaty Law,* ECTRev 1995, p. 264, van Thiel, *Free Movement of Persons and Income Tax Law: the European Court in search of principles,* (2002), p. 518 and van der Linde, *Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the D case,* ECTRev 2004, p. 14.

It is likely that the distributive rules prescribing shared taxing rights in line with the OECD Model generally would be considered by the ECJ as being neutral in their formulation.[78] This cautious conclusion is based on the Court's statements in *Gilly*.[79] However, if one disregards the *Gilly* case, one would argue that it is the method provision that is incompatible with free movement law when giving rise to a situation where the entire withholding tax is not creditable due to the application of a tax credit limitation. However, as this was an argument raised without success by Mr and Mrs Gilly in the *Gilly* case, one may conclude that the Court's case law indicates that the method provision is in line with free movement law even if its application results in a higher tax burden than if the income would have derived from within the country in question.

If the expression *allocation of taxing rights* covers all distributive rules in the OECD Model, I assume that the chances that the ECJ, in a future case, will find that the free movement provisions prescribe most-favoured-nation treatment increase considerably. The reason is that the consequences of such an interpretation would then have less far-reaching effects on the tax treaty network between EU Member States. It would be easier for the ECJ to foresee the consequences following such a most-favoured-nation interpretation. Moreover, similarly to, for instance, Farmer as well as Gammie and Brannan, I assume that the ECJ will approach this issue with considerable caution. In line with the conclusions presented in Chapter 6, I believe that one can expect an interpretation in favour of a most-favoured-nation reading *only* if the ECJ is convinced that this will have an overall favourable impact on the internal market.

If one accepts that the Court's division between allocation and exercise of taxing rights results in an exclusion of a most-favoured-nation treatment in general for the distributive rules, the following question then comes up: In which situations may there be an application of a most-favoured-nation treatment under the free movement provisions to tax treaty provisions?

[78] The OECD Model prescribes shared taxing rights in Article 10 (dividends) and Article 11 (interest). However, in many tax treaties shared taxing rights are also prescribed in regard to, for instance, royalties.

[79] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 24.

8.5.2 Claims for Most-Favoured-Nation Treatment

In two cases pending before the Court, the issue of most-favoured-nation treatment has been raised, in the *D* v *Rijksbelastingdienst*[80] case (hereinafter referred to as the *D* case) and in the *Bujara*[81] case.

8.5.2.1 The D Case

D is a German national and resident of Germany.[82] Ten per cent of D's possessions consist of immovable property in the Netherlands. His remaining possessions are located in Germany. In respect to his Dutch property, D was subject to Dutch wealth tax. Persons resident in the Netherlands were always granted a tax-free allowance. Non-residents were granted the allowance if 90 per cent or more of their possessions were situated in the Netherlands. According to Article 25 (3) of the old (1970) Belgium – Netherlands tax treaty and Article 26 (2) of the new (2001) Belgium – Netherlands tax treaty, Belgian residents are entitled to a tax free amount for Dutch wealth tax purposes.[83] The tax treaty between Germany and the Netherlands did not grant D this tax allowance. The question in the dispute is whether D has the right to a tax-free allowance.

The tax systems in neither Germany, nor in Belgium prescribe a liability to pay wealth tax. Accordingly, from a tax perspective, D's possessions in the Netherlands can be considered as his total taxable wealth.

Primarily, D requested national treatment in the Netherlands. In other words, he claimed to be treated in the same way as a Dutch resident

[80] Case C-376/03 *D* v *Rijksbelastingdienst*. At the time of this writing, the case is pending but an opinion from Advocate General Ruiz-Jarabo Colomer was delivered on 26 October 2004. The preliminary ruling was referred to the ECJ by a decision of 24 July 2003 in case No. 00/00296 by the Gerechtshof Hertogenbosch, the Netherlands.

[81] Case C-8/04 *E. Bujara* v *Inspecteur van de Belastingdienst Limburg/Kantoor Buitenland, Heerlen*. At the time of writing, the case is pending and an opinion from the Advocate General is not yet presented. The preliminary ruling was referred to the ECJ by a decision of 8 January 2004 by judgment of the Gerechtshof Hertogenbosch, the Netherlands.

[82] The presentation of the facts of the case is based on information given in the opinion given by the Advocate General as well as in Official Journal C 289 29.11.2003 p. 12 and mainly three articles: van der Linde, *Some thoughts on most-favoured-nation treatment within the European Community legal order in pursuance of the D case*, ECTRev 2004, p. 11, Weber, *Pending Cases Filed by Dutch Courts: the F.W.L. de Groot Case and Related EC Cases before Dutch Courts* in Lang (ed.), *Direct Taxation: Recent ECJ Developments*, (2003), pp. 180–185 and Weber & Spierts, *The "D Case": Most-Favoured-Nation Treatment and Compensation of Legal Costs before the European Court of Justice*, ET 2004, pp. 65–71.

[83] de Ceulaer, *Community Most-Favoured-Nation Treatment: One Step Closer to the Multilateralization of Income Tax Treaties in the European Union?* Bulletin 2003, p. 497.

taxpayer and, accordingly, to be granted the tax-free allowance. Alternatively, if his first request was not successful, he held that he should have the right to deduct the basic allowance based on the fact that a non-resident taxpayer living in Belgium is always granted the allowance. He based his argument on most-favoured-nation treatment, namely that he, as a non-resident taxpayer living in Germany, and a non-resident taxpayer living in Belgium, were in objectively similar situations. The Dutch national court requested, among other things, an interpretation of Article 56 EC in relation to the situation at hand.

The *D* case is an example of a situation where the tax treaty provision at issue is not a distributive rule of a tax treaty but a tax benefit generally only available to a resident taxpayer. The most-favoured-nation argumentation is based on that under at least one Dutch tax treaty, the non-discrimination article of the tax treaty extends this benefit also to non-residents. Weber and Spierts argue that "the deduction of the basic allowance for residents in Belgium is not an allocation of taxing rights between Member States, but merely an allocation of a benefit."[84] Accordingly, they contend that the most-favoured-nation argumentation in the *D* case does not concern a tax treaty provision dealing with the allocation of taxing rights but a reciprocal concession which goes beyond the mere allocation of taxing rights.

It can be concluded that the situation in the *D* case does not concern a tax treaty provision providing for the allocation of taxing rights. Instead, it concerns one of the special provisions of a tax treaty which has the power of extending a national tax benefit to non-residents. Thus, Article 25 (3) of the tax treaty at issue extends certain benefits to non-residents to achieve national treatment. It is not a core provision for the operation of a tax treaty. If the Court would find that this practise is contrary to free movement law, one would not expect far-reaching effects on the tax treaty network between EU Member States. It appears that the only effect would be that Member States have to include non-discrimination articles in their treaties which are formulated in a similar way so that they extend national treatment under similar circumstances. As is presented below, also the Advocate General in his opinion emphasized that the tax treaty provision was not instrumental in avoiding double taxation.

The Advocate General found that D was to be granted the tax-free allowance in accordance with D's first request. Hence, the Advocate General held that Article 56 EC precluded the Dutch legislation. When reaching this conclusion, he compared D's situation with the situation of

[84] Weber & Spierts, *The "D Case": Most-Favoured-Nation Treatment and Compensation of Legal Costs before the European Court of Justice*, ET 2004, p. 69.

a Dutch resident.[85] Even though it was not necessary for the Advocate General to consider D's second request since he found in favour of the first claim, he assessed D's claim based on the most-favoured-nation argumentation. The Advocate General held that if one finds that D is in a comparable situation to the situation of a Dutch resident having his entire wealth in the Netherlands, then also D's situation is comparable to the situation of a Belgian resident taxable in the Netherlands.[86] In this context, the Advocate General explained that his assessment of the issue was to be considered as hypothetical and subsidiary.[87]

Article 25 (3) of the tax treaty was described by the Advocate General as a benefit for Belgian residents that was granted without reciprocity.[88] This fact, the Advocate General held, implies that its assessment under Community law must be even stricter. In addition, he argued that the tax treaty provision at issue lacked connection with the specific content of the treaty aiming to avoid double taxation.[89] The Advocate General concluded that the difference in treatment prescribed by the Dutch system, which includes the tax treaty at issue, is precluded by Articles 56 and 58 EC.[90]

In conclusion, the Advocate General held that considering that the question of the most-favoured-nation interpretation was asked by the national court as a second question, and considering his recommendation on the first question, he advised the ECJ not to respond on the second question.[91] The reason for this cautious recommendation by the Advocate General is most likely due to the resistance on behalf of the Member States.[92]

8.5.2.2 The Bujara Case

In the *Bujara* case, the question asked by the Dutch court is whether a foreign taxpayer resident in Germany, who is not entitled to the benefits afforded by the Dutch-German convention because he does not satisfy the condition that he receive at least 90 per cent of his income in the Netherlands, has the right according to Community law to receive from the Netherlands the tax free allowance and tax credit for income tax in

[85] Opinion in Case C-376/03 *D* v *Rijksbelastingdienst*, para. 65.
[86] *Ibid.*, para. 75.
[87] Ibid.
[88] *Ibid.*, para. 82.
[89] *Ibid.*
[90] *Ibid.*, para. 83.
[91] *Ibid.*, para. 106.
[92] *Ibid.*, paras. 98–105.

the calculation of his income from savings and investments.[93] A taxpayer who is resident in another Member State, in this case Belgium, has the right to such benefits in his calculation of his income from savings and investments by virtue of the Netherlands-Belgium tax treaty, even though he does not receive at least 90 per cent of his income in the Netherlands.

As is evident from the national court's question in the *Bujara* case, the issue is whether a resident of one EU Member State who receives income from a particular source Member State has the right to claim, from that source state, the most beneficial tax treaty benefits granted to a resident of a third Member State who earns the same kind of income in the source state. Due to the limited information found about the circumstances in this case, further comments are omitted.

8.6 Conclusions

The aim of this chapter has been to present arguments for and against interpreting the free movement provisions as prescribing most-favoured-nation treatment and to analyse the implications of such treatment on tax treaties in the internal market in the light of the Court's case law, especially the cases *Gilly*[94] and *Saint-Gobain*[95].

If the free movement provisions prescribe most-favourable-nation treatment, a national of Member State A has the right to demand from Member State B to be treated equally to a national of Member State C. Therefore, the difference from the obligations of national treatment is the comparative standard. When applying the free movement provisions, the ECJ compares situations where the distinguishing factor is residence, arguing that non-residents generally are non-nationals. Hence, the interesting question in the context of bilateral tax treaties is: Has a resident taxpayer of Member State A the right to demand the same tax treatment by Member State B as this state prescribes for residents of Member State C?

Neither the EC Treaty, nor the current case law of the ECJ gives an explicit answer to whether the free movement provisions prescribe most-favoured-nation treatment. It is argued in this chapter that whether the free movement provisions prescribe most-favoured-nation treatment

[93] This information is based on Official Journal C 59 06.03.2004 p. 17.

[94] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793.

[95] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161.

depends on the application of the similarity test. The EC Treaty does not explicitly tell how this test is to be applied.

Traditionally, the ECJ, when applying the free movement provisions, compares a national with a non-national or a resident with a non-resident. This is what in this study has generally been referred to as a *nationality-based approach.* However, the Court has gone further and applied a so-called *free movement-based approach.* In doing that, the Court is not applying a prohibition of discrimination on grounds of nationality but prohibiting Member States from treating their own residents less favourable when they have a connection to another state. Under a *free movement-based approach,* the Court compares two residents, one of them with a connection to another state. Consequently, this prohibition has little to do with a distinction based on residence or nationality but whether the taxpayer has exercised his right to free movement.

An extension of the similarity test, so that two non-residents are compared as well as two residents with comparable connections to different Member States, appears to be within the Court's judicial discretion under the free movement provisions. The reason for this conclusion is twofold. First, as is noted above, the EC Treaty is silent on what is a correct comparable standard when assessing whether a national measure is incompatible with free movement law. Second, the Court has extended the similarity test in the past. From the Court's case law, it is evident that the ECJ has extended the test from comparing residents with non-residents to comparing two residents of the same Member State, where one of them is having a connection to another EU Member State. This change of the similarity test implied a new prohibition, or at least an extended prohibition, under the free movement provisions. From first merely prohibiting discrimination on grounds of nationality and residence, the Court prohibited any national measure having a negative impact on free movement. The latter approach indicates that discrimination on grounds of nationality is no longer a necessary precondition. Instead, any type of national measures which dissuade or discourage a resident from exercising his free movement rights are, in principle, prohibited under free movement law.

The change of the similarity test, which would give rise to a most-favoured-nation treatment, seems to be less far-reaching in terms of principal considerations than the previous development. It is concluded that one may assume that the Court will extend the similarity test in this way only if the ECJ considers such an interpretation favourable to a well-functioning internal market.

In the literature, one finds dividing opinions in regard to whether the free movement provisions prescribe most-favoured-nation treatment.

Various arguments are presented both for and against a most-favoured-nation interpretation. Arguments in favour of such an interpretation are, for instance, that such an interpretation could be considered as inherent in the very concept of an internal market and that a most-favoured-nation obligation stems from the general prohibition of discrimination on grounds of nationality. In terms of the effects of such an interpretation, it is argued that it would be an excellent instrument for realizing neutrality of competition.

Arguments presented against a most-favoured-nation obligation are mainly focused on the far-reaching effects following such an interpretation; for instance, that it would influence in an uncontrollable manner the Member States' budgetary policies and their internal tax policies as well as cause irrecoverable damage on the tax treaty network in the internal market.

Many of the commentators who identified far-reaching and negative effects of an application of a most-favoured-nation treatment under the free movement provisions did this before the Court's judgments in *Gilly* and *Saint-Gobain*. Accordingly, at the time of their statements, the Court's division between allocation and exercise of taxing rights was not known. It is argued in this chapter that the Court's division implies that there is no breach of free movement law, and therefore no obligation of most-favoured-nation treatment, in a situation regarding treaty provisions that merely provide for an allocation of taxation rights. The question is then how one is supposed to know which tax treaty provisions provide merely for an allocation of taxing rights and which provisions that go beyond that and concern the exercise of taxing rights? For instance, are tax treaty provisions that provide for a certain maximum withholding tax percentage on dividends, interest or royalties to be considered as only providing for an allocation of taxing rights?

It is possible to identify different scenarios involving tax treaty provisions prescribing shared taxing rights. One is where the withholding tax is entirely absorbed by the foreign tax credit in the country of residence. The combined application of the withholding tax and the credit may then be considered as representing a rule of allocation of taxing rights that is neutral in character. Another scenario is where the tax treaty, as is generally the case, only provides for an ordinary credit, resulting in the entire withholding tax not being credited in the country of residence. It is assumed to be likely that the distributive rules prescribing shared taxing rights in line with the OECD Model generally would be considered by the ECJ as neutral in their formulation. This conclusion is based on the Court's statements in *Gilly*. However, if one disregards the *Gilly* case, one would argue that it is the method provision that is incompatible with

free movement law when giving rise to a situation where the entire withholding tax is not creditable due to an application of the credit mechanism where no full credit is available. However, as this was an argument raised without success by Mr and Mrs Gilly in the *Gilly* case, one may conclude that the Court's case law indicates that a method provision is in line with free movement law, even if its application results in a higher tax burden than if the income would have been derived from within the country in question.

If the expression *allocation of taxing rights* covers all distributive rules in the OECD Model, I believe that the chances that in a future case the ECJ will find that the free movement provisions prescribe most-favoured-nation treatment increase considerably. The reason is that the consequences of such an interpretation would then have less far-reaching effects on the tax treaty network between EU Member States. The opinion given by the Advocate General in the *D* case also points in this direction.

Moreover, it is reasonable to conclude that the ECJ will approach this issue with considerable caution. In line with the conclusions presented in Chapter 6, it is believed that one can expect an interpretation in favour of a most-favoured-nation reading *only* if the ECJ is convinced that it will have an overall favourable impact on the avoidance of double taxation in the internal market.

9 Final Conclusions

9.1 Avoidance of Double Taxation in the Internal Market

The aim of this study is to analyse the impact of the free movement provisions found in the EC Treaty on tax treaties concluded between EU Member States. This is a highly relevant issue since a provision in breach of the free movement rules is inapplicable. If such a tax provision is part of other tax treaties concluded between EU Member States, these are also inapplicable. If the tax treaty provision precluded by a free movement provision has been drafted closely to the OECD Model, it is most likely part of a vast number of tax treaties concluded between EU Member States. From this, it is clear that if the ECJ precludes a tax treaty provision under one treaty, it is possible that it has consequences for a vast number of tax treaties in the internal market. Whether or not the tax treaty is able to fulfil its purpose of avoiding juridical double taxation on residents of the contracting states after one of its provisions is held inapplicable depends on the operation of the provision at issue. It is worth emphasizing that in the *Gilly*[1] case the ECJ stated that the abolition of double taxation within the Community has to be recognized as included among the objectives of the EC Treaty.

The ECJ has consistently found that Member States' tax provisions constitute restrictions on the free movement in the internal market. The free movement provisions are the main tool for removing obstacles to the free movement introduced by governments of the EU Member States. The free movement provisions on goods, persons, services, capital and the freedom of establishment are of essential importance for the realization of a well-functioning internal market. The realization of such a market is one of the main means to achieve the objectives of the Community, which primarily concern economic welfare. The idea is that by overcoming the inefficiencies of segmented national economies, the prosperity of

[1] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, para. 16.

the Member States will increase. The creation of an internal market means a merge of different national markets into one single market with the characteristics of a domestic market. This study focuses on the ECJ's interpretation of these free movement provisions in relation to tax treaty provisions found in tax conventions concluded between EU Member States.

9.2 Identifying the Rules

The free movement provisions of the EC Treaty are formulated in a general fashion, which gives rise to an extensive scope of application. The free movement provisions prohibit "discrimination based on nationality"[2] or "restrictions"[3] on the free movement unless justified. The EC Treaty includes very few detailed rules to rely on when applying the free movement provisions to a specific situation. This gives the Court a considerable freedom in its adjudication.[4] This judicial discretion is evident when studying the Court's case law in this area.[5]

9.2.1 The Court's Different Lines of Reasoning

To analyse the impact of free movement law on tax treaty provisions, it is necessary to identify the rights and obligations stemming from the free movement provisions. As these provisions are formulated without much specification, the case law is crucial. When reading cases, one soon realizes that the Court follows different lines of reasoning. In some cases, the Court's reasoning is focused on establishing the national provision's effect on non-residents, explaining that non-residents generally are non-nationals. In other cases, the Court does not mention the national rule's effect on non-residents at all, but its interest is entirely focused on whether the national legislation dissuades a person from exercising free movement rights. The obligation under free movement law has been described in the literature as "ill-defined, if not equivocal" as well as "Chameleon-like".[6] Such descriptions emphasize the need for systematized case law studies.

The case law studies in this thesis have been systematized based on the Court's reasoning. The reasoning used by the Court can generally be

[2] Article 39 (2) EC.
[3] Articles 43, 49 and 56 EC.
[4] See section 1.5.
[5] See chapters 3–6.
[6] See section 1.3.

classified as either focusing on whether the national rule entails a difference in treatment due to nationality or residence, or whether it is liable to dissuade or discourage a person from exercising his right to free movement. The former line of reasoning is referred to in this study as a *nationality-based approach* and the latter as a *free movement-based approach.* In this thesis, it is argued that these different lines of reasoning demonstrate two different prohibitions. First, a prohibition of discrimination on grounds of nationality, which includes differentiation based on residence, where the effect of this differentiation is to the particular detriment of non-nationals. Second, a prohibition of national measures which hinder the free movement without being discriminatory on grounds of nationality.

To come to a conclusion on the issue under which circumstances these different lines of reasoning are applied, it is analysed from which perspective the Court has assessed a national measure when applying the different lines of reasoning, either from a host state perspective or a home state perspective. An important issue, considering its far-reaching implications on Member States' legal systems, is whether the Court applies a *free movement-based approach* when analysing a national measure from a host state perspective.[7] If the case law shows that this is the case, any national measure liable to dissuade or discourage a person from exercising his right to free movement is prohibited unless justified. Hence, a comparison which focuses on establishing whether national treatment is granted by the host state would then be unnecessary.

9.2.2 Conclusions from the Case Law Studies

9.2.2.1 Application of the Different Lines of Reasoning

In Chapter 4, a case law study has been carried out including cases where the Court has interpreted free movement provisions in relation to other national measures than tax rules. Cases where the ECJ has interpreted free movement provisions in relation to income tax legislation of Member States are analysed in Chapter 5. Before presenting the main results of these case law studies, it is to be noticed that when the Court has applied a *free movement-based approach* in income tax cases, presented in Chapter 5, the national tax rule has always included a difference in treatment based on whether free movement rights have been exercised or not. In contrast, in *Alpine Investments*, a non-tax case analysed in Chapter 4, the Court applied a *free movement-based approach* to a home state

[7] See section 3.4.4.2.

provision, which did not entail such a difference but was equally applicable in a domestic context and a cross-border context.

The main purpose of Chapters 4 and 5 is to clarify in which situations the Court applies a *nationality-based approach* and when it applies a *free movement-based approach*. The conclusion from Chapter 4, which was confirmed in Chapter 5, was that the ECJ generally applies a *nationality-based approach* when analysing national legislation from a host state perspective and a *free movement-based approach* when analysing national measures from a home state perspective. The vast majority of cases follow this pattern and, therefore, there is a clear consistency in the Court's adjudication in this respect.

In general, the Court has not applied a *free movement-based approach* when analysing tax legislation from a host state perspective. The main exceptions are when the Court has considered a dual perspective under Articles 43 EC,[8] 49 EC,[9] and 56 EC[10]. Under Article 49 EC, for instance, the Court's dual perspective has generally consisted of considering both the effects on a service receiver, for whom the legislation usually has been home state legislation, and the effects on foreign service providers, for whom the legislation at issue has been host state legislation.

Inconsistencies are present in the Court's case law on free movement law. An inconsistency can be identified in terms of from which perspective the Court assesses a national measure. This is probably part of the reason why, even though it is possible to derive a clear pattern on the Court's reasoning, it remains difficult to predict the compatibility of national tax provisions with free movement law. The *Baxter*[11] case, for instance, illustrates this problem.

In *Baxter,* the Court applied a *nationality-based approach*. The Court considered the state of the subsidiary as the host state, arguing that the host state legislation was likely to work more particularly to the detriment of undertakings that have their principal place of business in other Member States and that operate in France through a secondary establishment.

[8] Case C-264/96 *Imperial Chemical Industries plc (ICI)* v *Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-4695, paras. 21–23.

[9] For instance, see Case C-136700 *Rolf Dieter Danner* [2002] ECR I-8147, para. 31 and Case C-422/01 *Försäkringsaktiebolaget Skandia (publ.) and Ola Ramstedt* v *Riksskatteverket* [2003] ECR I-6817, para. 28.

[10] See Case C-315/02 *Anneliese Lenz* v *Finanzlandesdirektion für Tirol* [2004], not yet reported in ECR, para. 21 and Case C-35/98 *Staatssecretaris van Financiën* v *B.G.M. Verkooijen* [2000] ECR I-4071, para. 35.

[11] Case C-254/97 *Société Baxter, B. Braun Médical SA, Société Fresenius France and Laboratoires Bristol-Myers-Squibb SA* v *Premier Ministre, Ministère du Travail et des Affaires sociales, Ministère de l'Economie et des Finances and Ministère de l'Agriculture, de la Pêche et de l'Alimentation* [1999] ECR I-4809.

It would have been possible, however, to approach the situation from the perspective that *Baxter* was considered a French company suffering from a disadvantage in the French legislation. That approach would have been more correct considering the Court's statement that a company's seat is equivalent to nationality for individuals. However, it appears as if the Court focused on the parent company's right to exercise its free movement rights. From this angle, the state of the subsidiary can be considered as the host state. The Court's reasoning in the *Baxter* case emphasizes the signification of host state perspective and home state perspective.

In most cases, the perspective chosen by the Court for its assessment coincides with the relationship the person who is directly affected by the legislation has with the state imposing the legislation at issue. For instance, in *Royal Bank of Scotland* the Court analysed the Greek legislation from a host state perspective. Also for the company Royal Bank of Scotland Greece represented the host state. However, in some cases, like the *Baxter* case, the perspective chosen by the Court is not the same as for the person directly affected by the burdening legislation. This is also evident in, for instance, the *Metallgesellschaft*[12] case and the *Lindman*[13] case.[14]

Based on the *Metallgesellschaft* case, it appears as if the ECJ considers the state of the subsidiary to be the host state where the legislation at issue differentiates on grounds of where the parent company is located.

In the *Lindman* case, it was the service receiver, Ms Lindman, who was treated in a less favourably way under Finnish tax legislation. However, the Court focused on the national legislation's effect on foreign service providers and found that they were in a disadvantageous position in comparison to Finnish providers. From the Court's reasoning, it is difficult to find that much attention was paid to the perspective of the service receivers, such as Ms Lindman, who was the person more directly affected by the legislation at issue. The Court's reasoning in *Lindman* proves difficult to classify because the Court compared Finnish service providers and foreign service providers, but more directly it was not the foreign service providers that were negatively affected but the service receiver resident in Finland, to whom the Finnish legislation applied. From the perspective of the service providers, it is their residence that was decisive, and the Court appears to have applied a host state perspective.

[12] Cases C-397/98 and C-410/98 *Metallgesellschaft Ltd and others, Hoechst AG and Hoechst (UK) Ltd* v *Commissioners of Inland Revenue and HM Attorney General* [2001] ECR I-1727.

[13] Case C-42/02 *Diana Elisabeth Lindman* [2003], not yet reported in ECR.

[14] See sections 5.6.6 and 5.9.

From the perspective of Ms Lindman, it was not her nationality or residence that was relevant but whether she has exercised her right to free movement and bought a service from a foreign service provider instead of a national service provider.

The question of home state or host state perspective is also relevant in the *Asscher* case. In this study, the *Asscher* case has been described as a case where the Court applied a *nationality-based approach*. The reason for this conclusion is that the Court held that Mr Asscher was in a situation equivalent to that of any other person enjoying the rights recognized by the EC Treaty. The ECJ considered the Netherlands, Mr Asscher's state of origin, as the host state and did not attach relevance to the fact that Mr Asscher was of Dutch nationality. This made it possible for the ECJ to argue that the Dutch legislation was liable to act mainly to the detriment of nationals of other Member States as non-residents were in most cases non-nationals. A similar reasoning is found in, for instance, *Scholz*, a case which is analysed in Chapter 4.[15]

Cases such as *Lindman* show that even though one has guidance in terms of when the Court applies a *nationality-based approach* and when it applies a *free movement-based approach* the question may in certain situations be which perspective the Court will choose when assessing a national rule under free movement law.

Another inconsistency, which also affects the possibility of predicting a national measure's compatibility with free movement law, occurs when a Member State may rely on imperative interests to justify a national measure. This issue is elaborated on below.

9.2.2.2 Inconsistencies in the Area of Justifications

The inconsistencies apparent in the area of justifications concern the situations where Member States may invoke imperative interests. Besides the treaty justifications, which can be invoked independent of the nature of the restrictive measure, imperative interests may be invoked in certain situations.[16] The traditional understanding, which is based on statements by the ECJ, is that directly discriminatory national measures do not benefit from justifications based on imperative interests.[17] However, in the cases dealt with both in Chapter 4 and Chapter 5, the Court has generally not refused, in principle, to entertain a defence because of the nature of the restriction. Regarding income tax cases, in one case only, the *Royal*

[15] Case C-419/92 *Ingetraut Scholz* v *Opera Universitaria di Cagliari and Cinzia porcedda* [1994] ECR I-505.

[16] See section 3.5.1.

[17] See section 3.5.2.

Bank of Scotland[18] case, the Court refused entertaining any other justification ground than Treaty justifications due to the nature of the national measure. As the national legislation at issue differentiated on grounds of the seat of the company, which the Court has held to be the same as nationality for individuals, this is a directly discriminatory measure, and thereby the Court in *Royal Bank of Scotland* confirmed the traditional understanding of when imperative interests may be invoked. From the case law study in Chapter 4, it is clear that the Court took the same position in the *Bond*[19] case and in the *Albore*[20] case. In these three cases, where the Court refused to assess the merits of imperative interest justifications due to the nature of the restriction, the Court applied a *nationality-based approach.* Accordingly, based on the cases covered in this study, the ECJ has not refused, in principle, to consider imperative interests when it has assessed home state legislation and applied a *free movement-based approach.* Based on the Court's reasoning in *Royal Bank of Scotland, Bond* and *Albore,* one may conclude that the Court has not formally abandoned the traditional understanding of when imperative interests may be invoked. However, the Court's case law is apparently inconsistent on this point. Therefore, the conclusion is that the case law surveys in Chapters 4 and 5 do not diminish the uncertainty about in what situations a Member State may successfully invoke imperative interests. However, what is clear is that the Court has been very strict in the admission of justifications. With only two exceptions, the cohesion of the tax system in *Bachmann*[21] and the principle of territoriality in *Futura*[22], the Court has rejected the justifications put forward by the Member States.[23]

[18] Case C-311/97 *Royal Bank of Scotland plc* v *Elliniko Dimosio (Greek State)* [1999] ECR I-2651.

[19] Case 352/85 *Bond van Adverteerders and others* v *The Netherlands State* [1988] ECR I-2085.

[20] Case C-423/98 *Alfredo Albore* [2000] ECR I-5965.

[21] Case C-204/90 *Hanns-Martin Bachmann* v *Belgian State* [1992] ECR I-249. See also Case C-300/90 *Commission* v *Belgium* [1992] ECR I-305.

[22] Case C-250/95 *Futura Participations SA and Singer* v *Administration des contributions* [1997] ECR I-2471.

[23] It is worth noticing that in *Futura* the ECJ did not apply the principle of territoriality as a justification for an otherwise prohibited restriction. It simply held that "[s]uch a system, which is in conformity with the fiscal principle of territoriality, cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty." See Case C-250/95 *Futura Participations SA and Singer* v *Administration des contributions* [1997] ECR I-2471, para. 22.

9.2.2.3 Judicial Discretion and Predictability

The above-mentioned inconsistencies in the Court's case law cannot be said to be examples of where the Court's adjudication is contrary to the Treaty provisions applied. The free movement provisions in the EC Treaty are formulated in a very general manner and give the ECJ considerable freedom in its adjudication.[24] They do not, for instance, prescribe from which perspective a national measure is to be assessed: from the perspective of the person more directly affected or from the perspective of a more or less unidentified person. In, for example, the *Lindman*[25] case, the service receiver, Ms Lindman, was the person more directly affected by the Finnish legislation, but the Court assessed the situation from the perspective of foreign service providers, who were not formally parties in the proceedings. It is possible to argue that by taking this perspective, the outcome served Ms Lindman as the rule which was to her disadvantage was found to be a prohibited restriction. However, in terms of predictability, it would have been preferable if the Court would have followed its established line of reasoning found in, for instance, *Danner*[26] and *Skandia*[27]. If the Court found the need to make a deviation from its established case law, it would have been useful if the Court had distinguished the case at hand from the previous line of cases. The judicial discretion following from the broadly worded free movement provisions reduces legal certainty when the Court uses its discretion differently under, apparently, similar circumstances. That the Court needs to make legal policy considerations when interpreting and applying the free movement provisions is unavoidable due to their character of framework provisions.[28] However, it puts a burden on the Court to remove the legal uncertainty as far as possible. The Court's current practice is unsatisfactory in this respect.

The inconsistencies found in the case law lead to uncertainty for anyone who is to apply free movement law, such as national courts, litigants and national legislators. It is therefore important to have some clear guidelines. The predictability would increase if the ECJ were more clear in its reasoning, for example when it comes to the terms used. Furthermore, it would be better if the Court could relate its analysis of a particular

[24] See section 1.5.

[25] Case C-42/02 *Diana Elisabeth Lindman* [2003], not yet reported in ECR.

[26] Case C-136/00 *Rolf Dieter Danner* [2002] ECR I-8147.

[27] Case C-422/01 *Försäkringsaktiebolaget Skandia (publ.) and Ola Ramstedt* v *Riksskatteverket* [2003] ECR I-6817.

[28] For the underlying reasoning, see section 1.5.

situation to previous cases confirming the standpoint at hand as well as to cases pointing in another direction.

9.2.2.4 Terminology

The case law studies in Chapters 4 and 5 show that the Court in its reasoning is not consistent with regard to terminology. It occurs that it switches from a language based on restrictions and obstacles to a language based on discrimination in one and the same judgment in relation to one and the same national provision. National rules being similar in structure and effect have in one case been referred to by the ECJ as indirectly discriminatory and in another case as a restriction.[29] This practise does not facilitate the understanding of the Court's reasoning. Moreover, it emphasizes that caution is needed when interpreting the Court's case law on free movement rules and that it is not advisable to base conclusions on the mere fact whether the Court employs the term restriction or the term discrimination. Instead, there is a need to go beyond the Court's use of these terms and consider what type of prohibition the Court is actually applying: a prohibition of difference in treatment due to nationality or a prohibition of measures hindering the free movement.

A final observation based on the case law studies is that the development of the Court's interpretation and application of free movement provisions is an extension from a traditional and rather uncontroversial prohibition of discrimination on grounds of nationality to a prohibition of negative treatment due to the exercise of free movement rights. The latter prohibition has nothing to do with nationality but has been argued by the Court to be necessary in order to remove national measures dissuading persons from exercising their free movement rights, a crucial concern for a well-functioning internal market. This development is not always evident as the Court, when applying a *free movement-based approach,* uses the term discrimination, which is commonly connected with a prohibition of discrimination on grounds of nationality.

9.3 Consequences of Striking Down a Tax Treaty Provision

When analysing whether a free movement provision precludes a tax treaty provision, it is argued in this study that the Court takes into account whether the advantages of striking down the tax treaty provision outweighs the disadvantages, in the light of the underlying internal market concerns of avoiding double taxation. In comparison with national tax

[29] For instance, see sections 4.2.4 and 4.7.

provisions, which have been held to constitute prohibited restrictions in the vast majority of cases dealt with by the ECJ, tax treaty provisions have a specific status considering the disadvantages that may follow striking down such provisions.

The vast majority of tax treaties in the internal market are based on the OECD Model. This Model has provided a harmonization of tax treaty design which does not exist to the same extent in internal tax legislation. If a tax treaty provision is held by the ECJ to constitute a prohibited restriction, the tax treaty provision is inapplicable. However, which is more important, the same would happen to any corresponding tax treaty provision found in tax treaties between EU Member States.[30] If the prohibited tax treaty provision is based on the OECD Model, it is most likely that the same or similar provision is found in the vast majority of tax treaties concluded between EU Member States. It is possible that the outcome is that the internal tax legislation of the contracting states, which the tax treaty is set up to restrict, will be applicable when the tax treaty provision is held inapplicable.

If the outcome of the inapplicability of a tax treaty provision is a decrease in tax revenue, a possible consequence could be that EU Member States consider a renegotiation of the treaties affected. A more drastic measure would be for the Member States to terminate the tax treaties affected and rely on their unilateral rules for avoidance of double taxation. This implies a less favourable situation in the internal market as regards the avoidance of juridical double taxation.

States deviate on some matters from the OECD Model and include in their tax treaties provisions specifically designed to function in correlation with their own tax systems. Therefore, all tax treaty provisions found in tax treaties between EU Member States are not based on the OECD Model. Striking down tax treaty provisions not based on the OECD Model does not, in principle, give rise to disadvantages comparable to those following an OECD Model provision. Therefore, it is much more likely that the ECJ will find such a provision to constitute a restriction. These conclusions are based on an analysis of case law, in particular *Gilly*[31], *Saint-Gobain*[32] and *de Groot*[33].[34]

[30] The impact on tax treaties concluded between EU Member States and third states is uncertain and outside the scope of this study.

[31] Case C-336/96 *Mr and Mrs Robert Gilly* v *Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793.

[32] Case C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161.

[33] Case C-385/00 *F.W.L. de Groot* v *Staatssecretaris van Financiën* [2002] ECR I-11819.

[34] See sections 6.1–6.6.

9.4 Guidelines when Assessing a Tax Treaty Provision's Compatibility with Free Movement Rules

Below, circumstances are presented that need to be considered when assessing a tax treaty provision's compatibility with the free movement provisions. This presentation is based primarily on the findings from Chapters 5 and 6. It only includes issues that are specific for the assessment of tax treaty provisions.[35]

9.4.1 Does the Tax Treaty Provision Concern the Allocation of Taxing Rights or the Exercise of Taxing Rights?

The Court held in the *Gilly* case, and subsequently reiterated in the *Saint-Gobain* case, that Member States are at liberty, in the framework of tax treaties, to determine the connecting factors for the purpose of allocating powers of taxation between themselves. Distributive rules merely prescribe which national tax system should apply are, therefore, in line with free movement law. When the taxing rights are allocated under the treaty, the next step consists of exercise the taxing rights. Once a Member State has been allocated tax jurisdiction under a tax treaty, it is under an obligation to exercise that tax jurisdiction in full respect of free movement law. In this study, it is concluded that when establishing the impact of free movement law on tax treaties, one may exclude tax treaty provisions that deal with the allocation of taxing rights. Such provisions are, based on statements by the ECJ, outside the scope of the free movement provisions.

Some tax treaty provisions are difficult to classify as dealing with the allocation or the exercise of taxing rights. For instance, distributive provisions providing for shared taxing rights may raise problems in this respect.[36]

9.4.2 Home State or Host State Legislation?

The main conclusion from the case law studies is that the Court generally applies a *nationality-based approach* when it assesses national provisions from a host state perspective and a *free movement-based approach* when it analyses national rules from a home state perspective. Accordingly, this is the starting-point when assessing a tax provision's compatibility

[35] For general guidance when applying free movement law, see chapters 3–5. On the issue of justifications, see section 6.7.3.

[36] See section 8.5.1.

with free movement law. Tax treaty provisions dealing with, for instance, PEs constitute host state legislation from the perspective of the company at issue.[37] Therefore, it is reasonable to assume that the ECJ would analyse such tax treaty provisions using a *nationality-based approach*. One may, therefore, presume that the Court would analyse such rules focusing on difference in treatment based on residence and their effect on non-residents. This would be an application of the special form of the prohibition of discrimination on grounds of nationality, namely on grounds of residence.[38]

If the tax treaty provision under review is a rule that is implemented in the home state of the taxpayer, for instance, an exit tax provision, the Court would most likely assess such a provision from the perspective of its effect on residents, accordingly, a home state perspective. One can then assume that the Court would apply a *free movement-based approach* and focus on whether the provision is able to dissuade or discourage a person from exercising his right to free movement.

9.4.3 Potential Consequences

The next step is to consider the origin and operation of the tax treaty provision and thereby also the consequences of turning down such a provision for the tax treaty network in the internal market. If the tax treaty provision represents a core provision of a tax treaty, *i.e.* it is necessary for the tax treaty's ability to fulfil its aim of avoiding or reducing double taxation, and it is based on the OECD Model, it appears less likely that the Court would turn it down. The reason is that it is probable that the effect following such an interpretation would be disadvantageous in terms of the abolition of double taxation in the internal market as the OECD Model has resulted in a harmonization of tax treaty design.[39] It is a different situation when a tax treaty provision is based on the OECD Model but the provision is not fundamental for the operation of the tax treaty. This was the situation in the *Saint-Gobain* case, where the OECD Commentaries even mentioned an alternative formulation of the tax treaty provision, more in line with the internal market concerns. The Court found the tax treaty provision precluded by Article 43 EC. This judgment did not jeopardize the operation of the tax treaty at issue, or other tax treaties including similar provisions.

[37] See section 6.5.
[38] See section 3.4.3.
[39] See chapter 2 and sections 6.2–6.8.

One may, therefore, conclude that when tax treaty provisions are not based on the OECD Model, and therefore not found in a vast number of tax treaties concluded by EU Member States, the ECJ assesses them similarly to internal tax legislation.[40] This means that the Court interprets the free movement provisions in a way resulting in the preclusion of such tax treaty provisions that are discriminatory on grounds of nationality, or have a negative effect on the exercise of free movement. Accordingly, one may conclude that substantial tax treaty provisions not based on the OECD Model are treated by the ECJ similarly to tax provisions of a unilateral origin, *i.e.,* the Court will follow its established lines of reasoning and adjudicate consistently with free movement case law.

9.5 The Possibility of a Most-Favoured-Nation Interpretation

Today, there are different opinions on whether the free movement provisions prescribe a most-favoured-nation obligation. Such an obligation results in resident taxpayer of Member State A having the right to demand the same tax treatment by Member State B as this state prescribes for residents of Member State C.

Neither the EC Treaty, nor the case law of the ECJ, gives an explicit answer to whether the free movement provisions prescribe most-favoured-nation treatment. It is argued in Chapter 8 that whether the free movement provisions prescribe most-favoured-nation treatment depends on the application of the similarity test[41]. The EC Treaty does not explicitly state how this test is to be applied.

Currently, the ECJ applies two different lines of reasoning when applying the free movement provisions. Either it compares a national with a non-national, or a resident with a non-resident. This is what in this study has generally been referred to as a *nationality-based approach.* Alternatively, it applies a so-called *free movement-based approach.* In doing that, the Court does not apply a prohibition of discrimination on grounds of nationality but instead prohibits Member States from treating their own residents less favourable when they have a connection to another state. Under a *free movement-based approach,* it is common that the Court makes a comparison. When doing that, it compares two residents, one of them with a connection to another state.

[40] See chapter 5.

[41] The expression *similarity test* is explained in section 3.4.5.

Extending the similarity test to two non-residents, as well as two residents, with comparable connections to different Member States, appears to be within the Court's judicial discretion under the free movement provisions. The reason for this conclusion is twofold. First, as is noted above, the EC Treaty does not specify what is a correct comparable standard when assessing whether a national measure is incompatible with free movement law. Second, the Court's case law shows that it has extended the similarity test in the past. The case law shows that it has extended the test from comparing residents with non-residents to comparing two residents of the same Member State, where one of them is having a connection to another EU Member State. The change of the similarity test that would give rise to a most-favoured-nation treatment seems to be less far-reaching in terms of principal considerations than the change observed above. It is argued in this thesis that the Court will extend the similarity test in this way only if the ECJ considers such an interpretation favourable to a well-functioning internal market.

In the literature, one finds divided opinions in regard to whether the free movement provisions prescribe most-favoured-nation treatment.[42] Various arguments are presented both for and against a most-favoured-nation interpretation. Arguments presented against a most-favoured-nation obligation are mainly focused on the potentially far-reaching effects following such an interpretation. For instance, it would influence in an uncontrollable manner the Member States' budgetary policies and their internal tax policies and cause irrecoverable damage on the tax treaty network in the internal market.

Since the Court introduced the division between allocation and exercise of taxing rights, it is argued in this thesis that the consequences of a most-favoured-nation interpretation of the free movement provisions would have considerably less impact on the tax treaty network between EU Member States than has been predicted in the literature.[43] The Court's division indicates that there is no breach of free movement law, and, therefore, no obligation of most-favoured-nation treatment, in a situation regarding treaty provisions that merely provide for an allocation of taxation rights. The problem is to decide which tax treaty provisions that provide merely for an allocation of taxing rights and which provisions that go beyond that, and concern the exercise of taxing rights.[44]

[42] See section 8.4.
[43] See section 8.5.
[44] See section 8.5.1.

It is reasonable to conclude that the ECJ will approach this issue with considerable caution. In line with the conclusions presented in section 8.3, I conclude that one can expect an interpretation in favour of a most-favoured-nation reading only if the ECJ is convinced that it will have an overall favourable impact on the avoidance of double taxation in the internal market.

9.6 Concluding Remarks

In this study, the case law of the ECJ has been commented on from the perspective of consistency and clarity as these are essential components for achieving predictability. In this context, it is interesting to notice that the ECJ has identified legal certainty as a general principle of Community law.[45] One can assume that the ECJ, like most courts, endeavours to maintain consistency in terms of its decisions as well as its reasoning, as this most certainly works in favour of predictability.[46] However, this is obstructed by the fact that the ECJ has to apply the free movement provisions to various situations. To apply the same provision, which is generally worded and without much specification, to situations dealing with different treatment of foreign and domestic insurance companies in terms of the tax treatment of their policy holders, to the nationality clauses prescribing how many foreign football players a team is allowed to field at the same time, is of course problematic. Consequently, one has to accept a certain degree of inconsistency in the Court's reasoning. However, as has been argued in this study, the ECJ should, to a further extent than today, try to be consistent in its reasoning and clarify issues that give rise to particular problems in terms of predictability.

The conclusions of this research project certainly do not put an end to the issue of the impact of free movement law on tax treaties. It is a dynamic area which is dependent on case law. Like this study, future research would benefit from following up on case law. Furthermore, this study supports the idea that from comparing the Court's reasoning in different cases, it is possible to address problems of inconsistencies. In future research, such a perspective can be further refined.

[45] See section 1.5.
[46] *Ibid.*

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This book deals with the impact of the free movement rules in the EC Treaty on tax treaties in the internal market. This is a highly relevant issue since a provision in breach of the free movement rules is inapplicable. The potential far-reaching consequences following the preclusion of tax treaty provisions makes it important for taxpayers and governments of the Member States of the EU to predict when a provision in a tax treaty may be in conflict with free movement law.

This book identifies the rights and obligations stemming from the free movement rules. As they are not very detailed, the case law is crucial. Hence, this book includes extensive case law studies, focusing primarily on cases where the Court of Justice of the European Communities (ECJ) has interpreted the free movement rules in relation to tax treaty provisions and unilateral income tax legislation. This study provides a systematization of such case law, highlighting consistencies and inconsistencies.

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