C. Principles of EU Tax Law – Direct Taxation

1. Principles of Primary Community Law

1.1. Establishing an Internal Market

In accordance with Art. 3 (1)(c) EC, Art. 14 (2) EC provides that the internal market shall compromise 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 Treaty (see also Ospelt, 29).

1.2. Prohibition of Discrimination

Art. 12 EC provides that within the scope of the application of the Treaty and without any prejudice to any special provisions contained therein, any discrimination on the grounds of nationality shall be prohibited.

1.3. Freedom to Move and Reside

Since the Treaty of Maastricht (enacted in November 1993), the Treaty contains a chapter regarding the citizenship of the Union (Art. 17 – 22 EC). Under **Art. 18 (1) EC, every citizen** of the Union shall have the **right to move and reside freely** within the territory of the Member States, subject to the limitations laid down by the Treaty and by the measures adopted to give it effect.

It has been argued that Art. 18 of the Treaty is a general principle of EC law that should not be interpreted as being limited to individuals but rather should be interpreted as also applying companies and other legal entities[1].

1.4. No Primary Community Law regarding Direct Taxation

"**The power to tax is the power to govern**". The competence to impose direct taxes rests with the sovereign Member States, and the EU has no authority to enact a tax system of its

[1] Pasquale Pistone, The Impact of Community Law on Tax Treaties, Kluwer 2002, 24.

own. Consistent with this principle, the Treaty does not contain any provisions that would give to the EU a mandate to harmonize the various national tax systems.

This means that there is no single market for matters regarding direct taxation (=> “es gibt keinen Binnenmarkt für direkte Steuern”).

2. Procedural Issues

Requests for a **preliminary ruling** are made by Member State courts pursuant to Art. 234 EC. A Member State court generally has the right, but not the obligation, to file a request for a preliminary ruling (=> “Vorlageberechtigung”).

An obligation (=> “Vorlageverpflichtung”) to file a request for a preliminary ruling only exists with respect to Member State courts that render a final judgment against which no appeal is admissible (Art. 234 (2) EC).

The ECJ is the only judicial authority authorized to interpret the Treaty (=> “Auslegungsmonopol des EuGH”).

3. Free Movement of Goods

Under Art. 7 OECD MC, business profits are taxable only in the country of residence of the recipient.

The fact that there is no withholding tax on business profits, and such profits are taxable only in the source country if attributable to a permanent establishment in the other Member State, causes Art. 7 of the OECD MC to be **a pillar of any free market system**.

In the EU, **PE issues** are not dealt with in connection with business profits but rather in connection with the freedom of establishment (Art. 43 EC in combination with Art. 48 EC).

4. Freedom of Movement and Freedom of Establishment

4.1. Statutory Framework

4.1.1. Individuals in General

Individuals who are neither employed nor self-employed persons will **directly** rely on Art. 18 EC, in combination with Art. 12 EC, in order to challenge discriminatory practices applied with respect to foreigners (i.e., non-nationals).

In a recent (non-tax) ECJ decision, the court decided that it was discriminatory not to grant loans to foreign students solely on the basis that such foreign students were "not settled in the United Kingdom". For the ECJ, this position violated Art. 12 EC (Dany Bidar, 22).

4.1.2. Employed Individuals (Workers)

Art. 18 EC grants to individuals the right to move and reside freely within the territory of the Member States, subject to limitations set forth by the Treaty and by measures adopted to give it effect.

Art. 39 (1) of the treaty reads: "***Freedom of movement for workers*** *shall be secured within the Community*".

With regard to the free movement of persons within the Community, Article 39(2) EC requires the **abolition of any discrimination** based on nationality between workers of the Member States as regards, inter alia, remuneration (Schumacker, 22).

4.1.3. Companies

Although the **freedom of establishment** was originally based on the free movement of persons, it can also be directly derived from Art. 18 EC.

Art. 43 (1) EC provides as follows: "*Restrictions on the* ***freedom of establishment*** *of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of a Member State established in the territory of any Member State*".

Art. 43 EC distinguishes between the freedom to establish one's **primary** (or main) **residence** (=> "die primäre NLF") and the freedom to set up a **secondary residence** (=> "die sekundäre NLF"), such as a branch in another Member State.

Art 43 of the Treaty embodies one of the fundamental principles of the EC and has been directly applicable in the Member States since the end of the transitional period, i.e., December 31, 1992.

The abolition of restrictions on the freedom of establishment also applies to restrictions on the setting up of agencies, branches or subsidiaries by nationals of a Member State established in the territory of another Member State (Avoir Fiscal, 13).

4.2. The Consistency Principle

The primacy of Community Law requires that fundamental freedoms be fully respected.

Domestic legislation must therefore be interpreted in the light of Community Law.

Is there a bridge between the national tax systems on the one hand and the free market principles as set forth in the Treaty on the other hand? Is there a bridge between the "**power to tax**" conferred to the member state and "**freedom**" to establish oneself within the Community (Marks & Spencer, Opinion of the Advocate General ,6)

The "Schumacker" case, decided 7 years after "Avoir Fiscal", opened the door for the ECJ to formulate its most important fiscal standard with respect to direct taxation:

"**Although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community Law"** (Schumacker, 21 but also Lasteyrie du Saillant, 40).

The consistency principle amounts to a **fictitious assumption**: Member States will be treated as if there is a single market for direct taxes. As national tax systems are inherently discriminatory, the consistency principle imposes a far-reaching limitation on how sovereign Member States may apply their own tax systems.

4.3. Non-Discrimination Principle

4.3.1. Companies

The registered office of a company determines its nationality (similar to the rule applying to natural persons – Avoir Fiscal 18; Jean Mischo pleading Saint Gobain 31; Überseering BV, 57).

"*Art. 43 is thus intended to insure that all nationals of a Member States who establish themselves in another Member State, even if that establishment is only secondary, for the purpose of pursuing activities there as a self-employed person* ***receive the same treatment as nationals of that state*** *and it* ***prohibits****, as a restriction on freedom of establishment,* ***any discrimination*** *on the grounds of nationality resulting from the legislation of Member States*" (Avoir Fiscal, 14).

In "Avoir Fiscal", the discrimination was determined by considering the facts and circumstances of the case at hand (i.e., shareholders' tax credit), but was not yet part of a more general framework.

4.3.2. Employed Individuals

This second step was accomplished in Schumacker (C-279/93):

"*Accordingly, Art. 48 of the Treaty must be interpreted as being capable of limiting the right of a Member State to lay down conditions concerning the liability to taxation of a national of another Member State, as regards the collection of direct taxes,* ***to treat a na-***

tional of another Member State *employed in the territory of the First State in the exercise of his right of freedom of movement* ***less favorably*** *than one of its own nationals in the same situation*" (Schumacker 24, see also Lasteyrie du Saillant, 42).

The prohibition of discrimination has thus been enlarged to become a national treatment principle (=> „ **Inländergleichbehandlungsgebot“**, vgl. Daily Mail, 16, Saint Gobain, 58).

The Court has consistently held that the rules regarding equal treatment forbid not only **overt discrimination** by reason of nationality but also all **covert forms of discrimination** which, by the application of other criteria of differentiation, lead in fact to the same result (Schumacker, 29).

It is also settled law that discrimination can arise only through the application of different rules to comparable situations or the application of the same rule to different situations (Schumacker; 30, Gschwid, 21).

In relation to direct taxes, the situations of residents and of non-residents are not, as a general rule, comparable (Schumacker 31, Gerritse, 43).

4.4. Allowing for Exceptions

"*It should be noted, secondly, that a measure which is liable to hinder the freedom of establishment laid down by Article 43 of the Treaty can be allowed only if it pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest. It is further necessary, in such a case, that its application must be appropriate to ensuring the attainment of the objective thus pursued and must not go beyond what is necessary to attain it*"(Lasteyrie du Saillant, 49).

Thus, the exception must not go beyond what is necessary to attain its purpose (=> "Erforderlichkeit der Einschränkung")

In matters of direct taxation, there is only one recognized standard for allowing exceptions to the freedom of establishment. This is the **principle of cohesion**. This principle was originally determined in the Bachmann (28) case:

"*In the light of the foregoing, it must be recognized that, in the field of pensions and life assurance, provisions as those contained in the Belgian legislation at issue* ***are justified*** *by the need to* ***ensure the cohesion*** *of the tax system of which they are part, and that such provisions are not, therefore, contrary to Art. 39 of the Treaty*".

In Bachmann, the taxpayer asked for the tax effective deduction of sickness and invalidity insurance premiums paid to a non-resident insurer despite the fact that the pensions, annuities, capital sums or surrender values paid to the taxpayer by such non-resident insurer were not subject to tax.

The “**direct link**” test as developed in the Bachmann case is an **extremely narrow standard**, which has remained unchanged ever since. In later cases, the narrow Bachmann cohesion principle has been repeatedly invoked, but it has almost always been rejected by the ECJ (see, e.g., Lankhorst-Hohorst 39).

In Marks & Spencer finally the Advocate General himself argued that the Bachmann standard is far too narrow and he pleaded for a more open cohesion limitation: Cohesion must first and foremost be adjudged in the light of the **aim and logic of the tax regime at issue** (Marks & Spencer, Opinion of the Advocate General, 71).

4.5. Abuse of Fundamental Freedom

Fundamental freedoms may not only be used but can (at least in theory) also be abused.

The ECJ is, however, extremely reluctant to justify a discriminatory practice by allowing parties to invoke tax evasion, or even tax fraud arguments (Lankhorst-Hohorst, 37).

Tax abuse and tax evasion have an entirely different meaning if considered from the point of view of a double taxation treaty or from the point of view of the EC (see the instructive ECJ decision Leur-Bloem).

4.6. Reduction of Tax Revenue

It is well-settled law that a reduction in tax revenue **does not constitute an overriding reason** in the public interest that justifies a measure that is contrary to a fundamental freedom (amongst others, Lankhorst-Hohorst, 36).

5. Moving One’s Primary Residence to Another Member State

5.1. Moving the Primary Residence

While individuals may give up an old residence and easily set up a new residence in another Member State, legal entities find it more difficult to move their registered office to another Member State.

A company’s **registered office** (the seat specified in the articles of incorporation) determines a company’s nationality (Avoir Fiscal 18, Jean Mischo pleading Saint Gobain, 31).

In most countries, it is not possible to change **the registered office** of a company from one Member State to another Member State. Most commercial registries will either refuse such registrations or render them so complicated as to virtually impede any such transfers.

5.2. Keeping the Statutory Residence

Companies may, however, keep their registered office (the primary residence) in one Member State and set up a **secondary residence** in another Member State.

Germany and many other Member States apply the **company seat principle** (=> "Sitz-theorie") according to which a company's head office (the place of effective management and control) must necessarily correspond to the place of its registered office (=> "keine Divergenz zwischen Verwaltungssitz und Satzungssitz").

The ECJ and some other Member States, however, apply the "incorporation theory" according to which a company that has been set up in one Member State may exercise all its activities in another Member State and may thus set up its **head office in another Member State**.

The leading case is "Centros" where a Danish couple wanted to avoid the high cost of incorporating a Danish company and thus went to the UK to incorporate a £100 private company. Because the Danish minimum equity requirements were not fulfilled, the Danish authorities refused to register a Danish branch of such UK company. The ECJ held that the Danish provisions were inapplicable because they violated the freedom of establishment principle.

In "Inspire Art Ltd.", a Dutch antique dealer set up a £ 100 UK private company that was to exercise all its activities in the Netherlands. The Dutch authorities refused to register such "UK letter box" since it did not meet the Dutch letter box avoidance rules, which required minimum equity contributions for all Dutch companies.

In both "Inspire Art" (105) and "Centros", the courts ruled in favor of the registration of a branch, despite the fact that both companies had actually moved their "head office" (=> "die Hauptniederlassung") to another Member State. In the UK there was nothing left of these two companies, except for the registration. All this is obviously favored by **UK tax rules**, which do not impose any corporate tax as long as such £ 100 private company does not exercise any activity in the UK.

In order to facilitate the freedom of establishment, the ECJ argued in favor of allowing the registration of branches in the other Member State, despite the fact that in both cases the "secondary residence", which carried all of the company's activities, was in effect the establishment of a head office in another Member State. As most domestic legislation would not allow for the registration of companies moving their head office

(=>"**Hauptniederlassung**") from one Member State to another, it was easier to treat such transfers as the establishment of "foreign branches".

In Überseering, the ECJ finally ruled against the German company seat principle and recognized that the freedom of establishment cannot be restricted by national laws which impede such company from moving its "**actual center of administration**" to another Member State (Überssering BV, 82).

5.3. Exit Taxes

5.3.1. Companies

Daily Mail was an early case that the ECJ decided in **1988**. In Daily Mail the "applicant" did not want to obtain the consent of H.M. Treasury before ceasing to be a resident of the UK. It wanted to do so by relocating its **central management and control** from the UK to the Netherlands. For UK tax purposes, a company was considered to be a UK resident if its central management and control was located in the UK. Section 482 (1) (a) of the UK Inland and Corporation Taxes Act prohibited companies that were resident for tax purposes in the UK from ceasing to be so resident without the (prior) consent of the Treasury.

It should be noted that, at that time, the Dutch holding company tax regime was more favorable for the taxpayer than the UK holding company regime. The very purpose of the exercise was, as the ECJ accurately pointed out, for the applicant not to pay the UK capital gains tax that would have been due had the participations been sold out of a UK company rather than out of a Netherlands holding company.

Art. 48 of the Treaty secures the right of establishment in another Member State not merely for Community nationals but also for companies (Daily Mail, 15). The ECJ has nevertheless ruled in favor of the UK Inland Revenue seeking to impose tax on all unrealized gains (=> "**stille Reserven**") of the taxpayer who intended to emigrate to the Netherlands. "In that regard, it should be borne in mind that, unlike natural persons, companies are creatures of the law and, in the present state of Community law, **creatures of national law**. They only exist by virtue of varying national legislation which determines their incorporation and functioning (Daily Mail, 19). The ECJ viewed the transfer of the registered office or the real head office of a company as a problem that cannot be resolved by the rules concerning the right of establishment but must be dealt with by future legislation or conventions (Daily Mail, 23).

5.3.2. Individuals

In **Lasteyrie du Saillant**, a case decided by the ECJ in 2004, the ECJ challenged the French exit tax system with respect to a French citizen who wanted to move to Belgium.

Upon leaving France, Mr. Lasteyrie du Saillant was subject to tax with respect to unrealized gains on a more than 25% participation in a French company[2].

The ECJ decided that such French tax had at the very least a **dissuasive effect** on taxpayers wishing to establish themselves in another Member State. The ECJ thus voided the French exist tax system as it applies to individuals wishing to move to other Member States.

This case has opened a new gateway: *Not only does Art. 52 of the Treaty ensure that foreign nationals are treated in the host Member State in the same way as nationals of that state,* ***but it also prohibits the Member State of origin from hindering the establishment in another Member State of one of its nationals*** (Lasteyrie du Saillant, 42).

Comparing "Avoir Fiscal" with Lasteyrie du Saillant shows how far the ECJ has come in less than 20 years. At the beginning, the ECJ was concerned with discrimination imposed on a PE wishing to establish itself in another Member State (an immigrant). Now the same ECJ is concerned with obstacles erected by a Member State with respect to an individual who seeks to leave the territory of that same Member State (an emigrant). The ECJ is thus looking at the same problem but has essentially changed its position.

Lasteyrie du Saillant (43, 45) has further narrowed down the application of national laws that are not consistent with the Treaty.

The freedom of establishment is thus unduly restricted by virtue of national legislation

- treating foreign nationals in the host Member State in a discriminatory manner compared with nationals from that State,
- even if the discrimination is of limited scope or
- minor importance, or
- has, at the very least, a **dissuasive effect** on taxpayers wishing to establish themselves in another Member State (Lasteyrie du Saillant, 45).

6. Free Movement of Services

To date, the free movement of services as set forth in Art. 49 (1) EC has only received little attention by the ECJ.

2 C-9/02 Hughues de Lasteyrie du Saillant vs. Ministère de l 'Economie, des Finances et de l'Industrie, 12.

The leading case is Gerritse (C-234701). The Court's first remark was that the tax situation of residents and non-residents is generally not comparable, because the income received in the territory of a Member State by a non-resident is in most cases only part of his total revenue, which is concentrated at his place of residence (Gerritse, 43).

With respect to a Dutch resident artist (a drummer) performing in Germany, the ECJ upheld the German taxation system under which such artist was subject to a German flat rate tax amounting to 25% rather than the progressive taxation applicable to German residents performing in Germany.

The ECJ ruled, however, that the German system, which imposed a gross taxation (with business expenses not being deductible) rather than a net taxation (business expenses being deductible) on such artist's German source income could not be upheld because it violated Arts. 49 and 50 of the Treaty.

7. Free Movement of Capital

7.1. Statutory Framework

Only the Maastricht Treaty (1992) has fully liberalized the free movement of capital.

Art. 56 of the Treaty forbids all restrictions on the movement of capital between Member States and between Member States and third countries.

The term "movement of capital" remains undefined (Verkooijen, 27).

7.2. Scope

7.2.1. Dividends

Dividends received by a national of a Member State on shares in a company whose seat is in another Member State **are covered by the free movement of capital** (Verkooijen 30).

7.2.2. Investments in Personal Property

Under the rules set forth in Weidert/Paulus (15), it appears that the **acquisition of securities** is subject to the free movement of capital.

7.2.3. Acquisition of Immovable Property

National measures governing the **acquisition of immovable property** should be assessed in the context of those provisions of the Treaty that relate to the movement of capital (Ospelt, 24).

7.3. Admissible Restrictions in General

Measures which entail a restriction on the free movement of capital may nevertheless be permitted, provided that, first, they pursue in a non-discriminatory way an objective in the public interest (=>"Allgemeininteresse") and, secondly, they are appropriate for ensuring that the aim pursued is achieved and do not go beyond what is necessary for that purpose (=> "Grundsatz der Verhältnismässigkeit") (Ospelt, 34, 46).

7.4. Tax Considerations

Art. 58(1)(a) of the EC Treaty: free movement of capital does not preclude Member States from applying the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested.

It must be borne in mind, however, that although direct taxation falls within their competence, the Member States must exercise that competence in a manner consistent with Community law (Verkooijen 32, Weidert/Paulus 12).

In any event, **Art. 58 (3) of the Treaty** states that the national provisions referred to by paragraphs 1 and 2 of Art. 58 of the Treaty cannot constitute a **means of arbitrary discrimination** or a **disguised restriction on the free movement of capital** (Verkooijen, 44, Manninen 28).

A distinction must therefore be made between unequal treatment, which is permitted under Art. 58(1)(a) of the Treaty, and arbitrary discrimination, which is prohibited by Art. 58(3) of the Treaty.

Certain distinctions may be compatible with Community law provided that they apply to **situations that are not objectively comparable** (thus no discrimination) **or could be justified by overriding reasons in the general interest** (=> "zwingende Gründe des Allgemeinteresses"), in particular in relation to **the cohesion of the tax system** (Verkooijen 43). In order to be justified, the difference in treatment between different categories of dividends must not go beyond what is necessary to attain the objective of the legislation (=> "Kriterium der Erforderlichkeit").

7.5. Principle of Cohesion

The need to safeguard the cohesion of the tax system may justify a restriction on the exercise of the fundamental freedoms guaranteed by the Treaty (Bachmann, 28), but such an exception to the principle of the free movement of capital must be construed strictly and subject to the limitations of the doctrine of proportionality (Weiert/Paulus 20).

"*Coherence of the tax system necessarily required that, if the Belgian tax authorities were to allow the deductibility of life assurance contributions from taxable income, they had to be certain that the capital paid by the assurance company at the expiry of the contract would in fact subsequently be taxed*" (Manninen 47).

Thus, there must be a **direct link** between the **grant of a tax advantage** (in Bachmann, it was the tax deductibility of insurance premiums) and the **offsetting of that advantage by a fiscal levy** (in Bachmann, it was the taxation of the payments made by the insurance company), both of which relate to the same tax (Verkooijen 57, Weidert/Paulus 20).

If no such direct link exists, the principle of cohesion cannot be invoked (Verkooijen 58, Weidert/Paulus, 22).

7.6. Reduction Tax Revenue

"*Aims of a purely economic nature cannot constitute an overriding reason in the general interest justifying a restriction of a fundamental freedom guaranteed by the Treaty*" (Verkooijen, 48).

"*Whilst, for the republic of Finland, granting a tax credit in relation to corporation tax due in another Member State would entail a reduction of its tax receipts in relation to dividends paid by companies in other Member States, it has been consistently held in the case-law that a reduction in tax revenue cannot be regarded as an overriding reason in the public interest which may be relied on to justify a measure which is in principle contrary to a fundamental freedom*" (Manninen 49).

7.7. Relevant Cases

7.7.1. Ospelt **(C-452/01)**

"*Furthermore, one of the principal aims of the EEA Agreement it is to provide for the fullest possible realisation of the free movement of goods, persons, services and capital within the whole European Economic Area, so that the internal market established within the European Union is extended to the EFTA States*" (however, subject to the EEA Agreement, not including Switzerland) (Ospelt, 29).

The “Vorarlberger Grundverkehrsgesetz”, which imposed restrictions on non-residents acquiring Austrian agricultural real estate (abbreviated as “ VGVG”), is not, a priori, discriminatory in nature (Ospelt, 37).

Secondly, there is no doubt that the VGVG pursues public-interest objectives (=> “Allgemeininteresses”) that justify restrictions on the free movement of capital.

VGVG corresponds to the objectives outlined by Art. 33 (1)(b) of the Treaty (Ospelt 40).

With respect to the condition on proportionality, it must be borne in mind that a system of **prior authorization** may, in certain circumstances, be necessary and proportionate to the aims pursued if the same objective cannot be attained by less restrictive measures (Ospelt 41).

The VGVG cannot, however, preclude such authorization in every case in which the acquirer does not farm the land himself, as this would constitute a hindrance on the free movement of capital (Ospelt 54).

7.7.2. Verkooijen **(C-35/98)**

The ECJ ruled on a contested application of the dividend exemption where the dividends paid by a Belgian company (Petrofina NV) were subject to the Netherlands dividend tax (Verkooijen, 14/16).

It is necessary to consider whether the fact that a Member State refuses to exempt its taxpayers who receive dividends on shares in a company whose seat is in another Member State from liability to tax on those dividends constitutes a restriction of capital movements within the meaning Art. 1 of Directive 88/361 (now Art. 56 EC-Treaty) (Verkooijen, 31).

A legislative provision such as the one at issue in the main proceedings has the effect of **dissuading** nationals of a Member State residing in the Netherlands from investing their capital in companies which have their seat (=> Sitz) in another Member State (Verkooijen, 34).

7.7.3. Weidert/Paulus **(C-242/03)**

Taxpayer holding shares of a Belgian company wanted to claim the Luxembourg relief for investment in personal property; taxpayer's request was denied by the Luxembourg authorities.

In Luxembourg, there was income tax relief for investment in personal property (Weidert/Paulus 4) for a maximum amount of LUF 60’000 but only with respect of shares of Luxembourg companies (Weidert/Paulus 3).

7.7.4. Manninen **(C-319/02)**

Taxpayer was a Finnish resident individual holding shares in a Swedish company. The Finnish tax authorities denied credit on these foreign shares and taxed the dividend income received by the Finnish taxpayer on those Swedish shares.

For dividend income on Finnish shares, the taxpayer in question would have been entitled to receive a tax credit for an amount, which corresponded to the tax due on such dividend income.

The ECJ based its decision on the consistency principle (Manninen, 19) and argued that a distinction must be made between unequal treatment, which is permitted under Art. 58 (1) EC, and an arbitrary discrimination, which is prohibited under Art. 58 (3) EC.

The ECJ argued that the Bachmann principle was not applicable in the present case and that the difference in tax treatment between domestic and foreign shares was therefore an arbitrary violation of the free movement of capital (Manninen, 45).