

On Justification in EC Tax Law

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Despite the fact that the EC Treaty includes hardly any orders specifically dealing with direct taxation issues, the European Court of Justice (ECJ) has been applying the regulations of the agreement and principles of EC Law also in cases concerning income taxation. The ECJ has worked on the assumption that the realisation of the aims of the EC Treaty might be endangered if the basic freedoms included in this agreement could not be applied in these kind of questions, too. When interpreting the provisions of the EC Treaty more comprehensively, the ECJ has in its legal practice created specific justifications by which it is possible to get rid of the obligations of the agreement in exceptional cases. This article deals with the ways in which the ECJ has been applying these justifications in issues related to income taxation.

1 On Justifications in Accordance with the EC Treaty

Direct discrimination cannot be successfully justified in the EC Law by using other justifications than the ones listed in article 30 (former article 36) of the EC treaty. The ECJ has also noted this fact in its legal practice concerning direct taxation.¹ Consequently, as for direct taxation issues, we cannot speak for direct discrimination by referring to other facts than the ones listed in the abovementioned article. It is due to the nature of these facts that they cannot generally be applicable in questions related to taxation. The ECJ has not applied them yet so far in cases concerning direct taxation.

As for the issue on direct discrimination *Avoir fiscal*, concerning the right of a foreign company's permanent establishment in France to receive imputation credit on the same conditions as French companies, the ECJ stated that France could not successfully explain its negative attitude towards granting an imputation credit by referring to a risk of tax avoidance, as the Court considered

¹ ECJ 29 Apr 1999, Case C-311/97, (*Royal Bank of Scotland*), par. 32, dealt with direct discrimination of a foreign company, the Court considered such discrimination to be acceptable only on grounds mentioned in the EC Treaty.

that no exception to the fundamental order in article 52 (present article 43) could be made on such grounds.² In this connection the ECJ has interpreted the exceptions strictly, as well as not accepting reasons of economic kind as justifications.³

As for article 58 of the EC Treaty concerning the freedom of movement of capital, however, the text of the agreement provides an opportunity to apply a certain kind of justification. In accordance with the text, the orders concerning the freedom of capital movement do not affect the Member States' right to take the necessary actions, particularly in the field of taxation, to prevent evasion of the national laws. Nevertheless, this addition made by the Union Agreement on 1 January 1994 contains a statement that it shall only be applied in terms of such jurisdiction of the Member States that was valid at the end of the year 1993. Furthermore, the application of the abovementioned article must not lead to arbitrary discrimination or disguised restriction of free movement of capital. So far the dimensions of the article have not been specifically tested in the legal practice of the ECJ.⁴ It has been considered possible that article 58 could also work in its area of application as a justification for direct discrimination in cases where the regulations aim at preventing tax avoidance.⁵

2 On the Justifications of Indirect Discrimination

To make an exception from direct discrimination, those procedures that only deal with indirect discrimination may be successfully supported by proposing arguments that support their application, if certain prerequisites can be considered to exist. In carrying on its legal practice, the ECJ has developed a rule of reason stating that indirect discrimination, which according to the legal practice is as such against the rules of the EC Treaty, can in certain cases be regarded as justified. The following three prerequisites must, however, be fulfilled; namely, the purpose of the rule must be to aim at the realisation of an important public interest, the rule must be necessary for reaching this objective, as well as being proportionate to the objective it is aiming at.⁶

2.1 Tax Treaty

In accordance with article 307 (former 234) of the EC Treaty, the rules do not affect such rights or obligations that result from an agreement made by one or more Member States with one or more third countries before 1 January 1958 or,

² ECJ 28 Jan 1986, Case C-270/83, (*Avoir fiscal*), par. 25.

³ See Terra, B. and Wattel, P., *European Tax Law*, 3rd ed., The Hague 2001, at 23 and Ståhl, K. and Persson Österman, R., *EG-Skatterätt*, Uppsala 2000, at 122.

⁴ Cf., however, case ECJ 6 Jun 2000, Case C-35/98, (*Verkooijen*).

⁵ By Ståhl, K. and Persson Österman, R., *op.cit.* note 3, at 123; the authors point out that the mention of prohibition of arbitrary discrimination in the article could, however, lead to it not being approved as a justification.

⁶ Cf. Terra, B. and Wattel, P., *op.cit.* note 3, at 33.

in the case of a country that has become a member, from an agreement made before the date of accession. Furthermore, it is stated in the article that in so far as such agreements are not in harmony with the EC Treaty, the Member States concerned will take all justified measures to eliminate conflicts. The ECJ considered that this article concerns all agreements independent of their special field; consequently, tax treaties are also regulated by them.⁷ As a result of this, it is clear that the state cannot successfully refer to a justification stating that the claimed indirect discrimination is based on a tax treaty and not on the internal, purely national legislation.

However, the tax treaties involve a built-in principle of reciprocity, which means that the contracting states have on both sides partly or totally given up their taxing power as prescribed by their internal legislation. Consequently, one could think that the tax treaty is a bilateral commitment with contractual balance based on the principle of reciprocity, a balance that cannot be shaken by taxpayers resident in third countries. At least in so far as taxation is based on the part of the tax treaty in which the reciprocity between the contracting states plays an essential part, one could consider this to function as a justification, as well as making indirect discrimination of taxpayers resident in third countries possible.

In the legal practice of the ECJ, this question came up in the case *Avoir fiscal* concerning direct discrimination, in which France did not agree to imputation credit to a permanent establishment of a foreign company in France, although it granted such a benefit connected to dividend to corresponding French companies. The French Government explained the procedure by arguing that granting imputation credit to foreign companies – which was exceptional as such – was covered by the tax treaties between France and foreign countries and that granting it to a permanent establishment of a foreign company would disturb the balance formed by tax treaties with other contracting states.

The European Court of Justice gave the following statement in its judgment⁸:

”Finally, the French Government is wrong to contend that the difference of treatment in question is due to the double-taxation agreement. Those agreements do not deal with the cases here at issue as defined above. Moreover, the rights conferred by Article 52 of the Treaty are unconditional and a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State. In particular, that article does not permit those rights to be made subject to a condition of reciprocity imposed for the purpose of obtaining corresponding advantages in other Member States”.

In this part of the judgment, two significant issues are stated. Firstly, the ECJ considered this not to be a situation that had been regulated by the tax treaty. But, what is more important, the Court, however, continued by saying that the orders of article 52 (presently 43) of the EC Treaty were unconditional and could not therefore be subordinated to the condition of reciprocity, according to which

⁷ See Lang, M., *The Binding Effect of the EC Fundamental Freedoms on Tax Treaties*, in Gassner, W., Lang, M., Lechner, E. (eds.), *Tax Treaties and EC Tax Law*, the Hague 1997, at 21.

⁸ Case C-270/83, (*Avoir fiscal*), par. 26.

benefits could only be protected by requiring the other Member States to grant the same benefits for their part.⁹

Although one may not present any strong reasons for the fact that the case should have been resolved in a different way, we can still question one item included in the reasoning of the ECJ. If the Court's opinion was that this was not such a tax treaty case that the French Government referred to, would it have been possible to omit the statement on the meaning of the condition of reciprocity in this connection. The part of the judgment that the Court had, however, observed in this connection is unambiguous text that will probably not make it possible to come to a different conclusion in other questions related to reciprocity without resulting in a totally new interpretation of the case.¹⁰ The tax treaty law is at least in principal based on the principle of reciprocity, and in the case *Avoir fiscal* the statement given on this will have extensive repercussions on many questions related to the relationship between the EC law and the basic principles of international tax law.

The basic principles of international tax treaties have primarily been formulated in the Model Tax Convention of the OECD, and consequently, tax treaties between the Member States have normally been drawn up according to these guidelines. In practice, the model tax treaty has become a harmonising instrument, and the commentary on the model tax treaty has been of great help in the process. Even though the commentary is not an obliging source of tax treaty interpretation, there is no reason to underestimate its significance in the interpretation of tax treaties between the OECD countries.¹¹ An interesting feature in this connection is that in its legal practice the ECJ has often referred to the existing model tax treaty, although it may be otherwise considered to have taken the basic principles of international taxation into account to a limited extent, particularly as far as its older legal practice is concerned.

As for the case *Schumacker*, the ECJ stated that residents and non-residents are not principally in a similar position in terms of direct taxation.¹² The Court continued by stating that the income received by a non-resident in a Member State comprises in most cases only part of a taxpayer's total income, which the taxpayer earns in his country of residence. Furthermore, the Court considered that it is easier to define a non-resident taxpayer's level of the ability to pay, taking into account all his income as well as personal and family-related deductions, in a country in which his personal and financial ties were concentrated. Furthermore, the Court continued that consequently, international taxation and the OECD Model Convention in particular, recognise the principle according to which taking into account the taxpayer's overall situation, including

⁹ See also Lehner, M. and Scherer, T., *Die Besteuerung der Doppelbesteuerung innerhalb der Gemeinschaft*, in Birk, D. (Hrsg.), *Handbuch des Europäischen Steuer- und Abgabenrechts*, Herne/Berlin 1995, at 958.

¹⁰ Cf. Lang, M., op.cit. note 6, at 23, in which he considers the balance of interests in a tax treaty to concern all stipulations, and if the Court has come to a different conclusion, this could have been interpreted so that the existence of a tax treaty as such could act as a justification.

¹¹ Cf. Vogel, K. et al., *Klaus Vogel on Double Taxation Conventions*, 3rd ed., London 1997, at 43 and onwards.

¹² ECJ 14 Feb 1995, Case C-279/93, (*Schumacker*), par. 31.

personal and family conditions, is the obligation of the taxpayer's country of residence.¹³

As for the case *Wielockx*, the ECJ also referred to the OECD Model Convention stating that in that particular case concerning the question whether the legislation, according to which only a resident taxpayer had the right to make a pension reserve in taxation, was consistent with the stipulations of the EC Treaty, the tax treaty to be applied was in harmony with the OECD Model Convention. Thus the state levied taxes on all the pensions generally received by the taxpayer in the area, independent of the country in which the insurance premiums had been paid; however, the state did not levy taxes on pensions received from abroad, even if their insurance premiums had been deducted in that country.¹⁴

As for the case *Gilly*, the ECJ also referred to the OECD Model Convention. The case dealt with the tax levied on earned income received from the public sector and the effects of the method of relieving international double taxation. As for the principle that the country paying the salary has the power to tax, the Court referred to the international practice and the OECD Model Convention. The possibility to rely on this principle had been confirmed in article 19 of this treaty. The Court observed that according to the reasoning of the article the principle was based on international rules of politeness and mutual respect between sovereign states, as well as on the fact that the principle had been adopted in so many tax treaties between the OECD Member States that it could be considered to be internationally recognised.¹⁵

The case *Gschwind* dealt with the question whether it was against the stipulations of the EC Treaty that a Member State's tax scale based on so-called splitting was not applied to those nationals of the Union who were married and who were working in that Member State and residents of another Member State. The item of the reasoning of the ECJ that dealt with the state's power to levy tax on earned income received within its territory, the Court made an introductory statement and said that as far as international tax law and e.g. the OECD Model Convention are concerned, residence is at present basically considered a fiscal tie in the distribution of the power to tax between different countries in situation of international nature.¹⁶

When considering the legal practice of the ECJ in issues related to direct taxation up to now, one can ask how strong an argument for taxation causing indirect discrimination can be formed by the fact that the procedure is based on the OECD Model Convention and the taxation concerned is following the lines of the Model Convention. On the basis of cases *Schumacker* and *Wielockx* it has been considered that even if the issue referred to by the Court concerning the resident state's obligation to take the taxpayer's personal and family conditions into account is not based on the OECD Model Convention, it is still worth noticing that the Court obviously considers the OECD Model Convention to be

¹³ Case C-279/93, (*Schumacker*), par. 32.

¹⁴ ECJ 11 Aug 1995, Case C-80/94, (*Wielockx*), par. 24.

¹⁵ ECJ 12 May 1998, Case C-336/96, (*Gilly*), par. 31.

¹⁶ ECJ 14 Sep 1999, Case C-391/97, (*Gschwind*), par. 24.

of specific significance.¹⁷ On the other hand, however, it is questionable to what extent this can be relied on as a justification. Actual tax treaties may differ from the Model Convention, which has not aimed to tie the contracting states' hands. The practice in individual contracting states may deviate from the Model Convention so that reservations have been made in it, and the convention is in a continuous process of changing. Uniform principles of international taxation cannot always be indicated, and consequently, the Court's references to the Model Convention should not be overestimated; thus, the tax treaty stipulation being based on the Model Convention may not as such be considered to act as a justification.¹⁸

On the other hand, one can notice that unlike the case of direct discrimination, there is no exhaustive list of the justifications to indirect discrimination anywhere. Although the abovementioned facts objecting to the opinion that the OECD Model Convention should be understood as a uniform and comprehensive codification of the basic principles of international tax law have weight as such, it is hardly necessary to try to form an either-or combination of the position of the Model Convention as a justification. Like the Model Convention, the legal practice of the ECJ is also developing with time. The Court has also referred to the Model Convention in its more recent legal practice. It can be clearly observed to have established a position as one argument among the others. The tax system, including the system concerning international tax relations, should rather be understood as a dynamic system, not as a collection of eternal legal principles. The fact that the Model Convention is in a process of changing does not prevent us from referring to it, and the fact that Member States do not always follow its lines does not mean that, either. The ECJ has basically referred to the Model Convention only in cases where a Member State has formulated its tax regulations in accordance with the principles included in the Model Convention.

2.2 The Tax Treatment in the Other Contracting State

The tax treatment of a taxpayer in another Contracting State could also be assumed to act as a justification. When estimating the justification of indirect discrimination, the overall situation of the taxpayer would be taken into account, not just his position in one Contracting State. The ECJ has been reasoning in the *Schumacker* case in a similar way; in that particular case the tax authorities suggested that the taxpayer's personal and family situation should not be taken into account as deductions in the taxation of the country of employment, because this would happen in the taxpayer's resident state, anyway. If the deductions were also taken into account in the source state, the taxpayer would be able to deduct them twice. The Court, however, did not agree with this opinion; it considered that it was not possible for the taxpayer to make these deductions in

¹⁷ See Wattel, P., *The EC Court's Attempts to Reconcile the Treaty Freedoms with International Tax Law*, *Common Market Law Review* 1996, at 225.

¹⁸ Lang, M., *op.cit.* note 6, at 24-25.

his resident state, because the taxable income there did not make it possible in this case.¹⁹

As for the case *Wielockx*, the Court considered that a non-resident working in the country, who received all or almost all his income from that country, was objectively seen in the same situation as a resident doing the same work in that country. If a non-resident person's deductions were neither taken into account in his country of employment nor in his residence country due to the missing taxable income, he is in a less favourable position, due to the overall tax burden, than a resident of that country of employment. In this case the Court specially mentioned the overall tax burden of the taxpayer, thus taking into account the taxation in the other Contracting State, i.e. the taxpayer's residence country.²⁰

On the basis of the cases *Schumacker* and *Wielockx* it can be observed that although the ECJ has not considered the taxation in the other state to be a justification that could be used as a reason for discriminating taxation in the state imposing the taxes, it has, however, taken the taxation of the taxpayer in the resident state into account when estimating the question whether non-resident and resident persons are in an equal position. It should be particularly noted that in the case *Wielockx* the Court specifically referred to the overall tax burden of the taxpayer.²¹ For the benefit of the taxpayer it had to be noted that the taxpayer could not make deductions in his resident state, and therefore, taking the overall tax burden into account, he had to be allowed to make the deductions in the source state. As for the case *Schumacker*, the Court did not make such a clear statement, and it can be asked whether the result had been different if the taxpayer had had the opportunity to make deductions in his resident state. As far as the last mentioned decision is concerned, one should not perhaps draw too far-reaching conclusions on whether the taxation in another state could act as a justification.²²

The decision in the case *Wielockx* may be considered to be rather problematic, because when making a decision whether or not discrimination in the source state was concerned the Court included application of the tax legislation of the resident state in the case.²³ A remark has been made that in the present situation of non-harmonised legislations of the Member States we should concentrate to study the taxation in one single state. In its subsequent legal practice, the ECJ has not put an emphasis on taking the overall tax burden into account in the same way as in the two abovementioned cases concerning the

¹⁹ Case C-279/93, (*Schumacker*), par. 40-41.

²⁰ Case C-80/94, (*Wielockx*), par. 20-21.

²¹ This is also emphasized by Lang, M., *op.cit.* note 6, at 26.

²² See also Jann, M., *How Does EC Law Affect Benefits Available to Non-Resident Taxpayers under Tax Treaties?*, in Gassner, W., Lang, M., Lechner, E. (eds.), *Tax Treaties and EC Law*, The Hague 1997, at 68.

²³ Lang, M., *op.cit.* note 6, at 27, points out that the way of observation developed by the Court based on the comparison of total tax burden does not seem to be in harmony with the sovereignty of the national legislative power of the states that is in force as far as direct taxation is concerned. The resident state cannot be responsible for the compatibility of the source state's legislation with the EC Treaty.

personal and family deductions of a paid employee.²⁴ On the other hand, we can ask whether the Court is acting correctly in formulating a decision that deviates from the general basic principles of international tax law just for a single, special case²⁵ so that no general conclusions to be applied in other cases can be drawn from the decision.

2.3 *Compensation by Using other Tax Benefits*

The ECJ's legal practice concerning income taxation includes many cases in which the taxpayer's right to get other benefits to counterbalance inconvenient taxation has been referred to as a justification. According to this interpretation, the total, final result would be decisive, not an individual act concerning taxation as such.

As far as this item is concerned, the Court gave a clear opinion already in connection with the case *Avoir fiscal* concerning direct discrimination stating that France could not give reasons for the discrimination of permanent establishments of foreign companies in France concerning the imputation credit by stating that these permanent establishments had other benefits compared with local companies. The Court considered that even if such benefits existed they could not entitle France to ignore its obligations as prescribed by article 52 (present 43) of the EC Treaty.²⁶ As far as a permanent establishment is concerned, the Court gave the same statement in the case *Saint-Gobain*.²⁷ As for the case *Commerzbank*, the Court considered that the fact that exemption from taxes payable for the income concerned in the state imposing taxes was only applicable to non-resident persons in that state could not be used as a justification of not granting the non-resident person a similar compensation for excessive tax payments due to the exemption from taxes which resident taxpayers of the state were entitled to.²⁸ As for the case *Asscher*, the Court considered it to be different treatment if persons resident abroad whose income in the source state were less than 90% of their total income had a tax rate of 25% in tax class I, although persons resident in that source state and carrying on the same business had a tax rate of 13% also in cases where their income received in that state remained under 90% of their income received from all countries. The source state explained this by arguing that non-residents were exempted from the payment of social security fees; furthermore, the change according to which the payments made could no longer be deducted in taxation did not increase their tax

²⁴ See Schuch, J., *Will EC Law Transform Tax Treaties into Most-Favoured-Nation Clauses?*, in Gassner, W., Lang, M., Lechner, E. (eds.), *Tax Treaties and EC Law*, The Hague 1997, at 117-118, considering that one should not draw such conclusions from the abovementioned decisions that the taxpayer's taxation in another state could be used as a justification in the discriminating State.

²⁵ As far as the international tax law system is concerned, taking the taxpayer's personal deductions into account is not basically included in the taxation of the source state.

²⁶ Case C-270/83, (*Avoir fiscal*), par. 21.

²⁷ ECJ 21 Sep 1999, Case C-307/97, (*Saint-Gobain*), par. 53.

²⁸ ECJ 13 Jul 1993, Case C-330/91, (*Commerzbank*), par. 16-19.

burden, as was the case with resident taxpayers. Depending on the source state, if the same tax base was applied to these groups in these circumstances, non-residents would be in a better position. The Court, however, considered that such an issue related to compensation could not be referred to, because non-residents would be punished for not being liable to pay the social security fees in the source state.²⁹ Finally, as for the case *Verkooijen*, the Court considered that taxation that was unfavourable and against the fundamental freedoms of the EC Treaty could not be justified by other tax benefits to the taxpayer even if they existed³⁰; refusal of the deduction to be granted to a person earning dividend concerning dividends received from abroad was considered to be discriminating.

In these cases the question was about the benefits given to that particular taxpayer who was included in discriminating taxation treatment and about obtaining benefits in that particular state that imposed the taxes.³¹ The Court has in these cases adopted a line of action according to which the overall position of the taxpayer is not decisive, but the functioning of each stipulation is evaluated separately from other consequences to the taxpayer.³² It can be noted that in the cases where the tax authorities aimed to refer to the overall situation of the taxpayer the Court stated that no other benefits could be taken into account even if they were real. As for the case *Wielockx*, however, the Court specifically referred to the overall tax treatment of the taxpayer³³ to the taxpayer's benefit, which required that the effect of the taxation in the resident state be taken into account. It is, of course, possible that the Court saw the last mentioned case differently, due to the fact that the taxpayer's position is determined in accordance with the joint effect of the taxation in the resident state and the source state, whereas in the abovementioned case reference was clearly made to issues that were separate from the core question.

2.4 Maintaining the Effectiveness of Fiscal Supervision and Need to Prevent Tax Avoidance

A common feature in the cases submitted to the ECJ has been that the Member State argues that application of its own stipulations is necessary to guarantee the effectiveness of fiscal supervision. As for the case *Futura* the Court has even in its legal practice stated that this is in principle a competent justification.³⁴

²⁹ Case 107/94, (*Asscher*), par. 53.

³⁰ Case C-35/98, (*Verkooijen*), par. 61.

³¹ Cf. the case concerning trade tax in Germany (gewerbesteuer) ECJ 26 Oct 1999, C-294/97, (*Eurowings*), par. 36-37 and 43-44, in which the Court considered that the fact that the foreign service provider was submitted to minor tax burden in his resident state could not be a justification to the service receiver in Germany generally being taxed (trade tax) less favourably if he had elected to buy the service from such a foreign service provider. – In this case the person receiving the claimed benefit and the primary object of taxation were two different subjects, and consequently, the final result cannot be considered to be surprising.

³² See Ståhl, K. and Persson Österman, R., op.cit. note 3, at 125.

³³ Cf. also Case C-279/93, (*Schumacker*).

³⁴ ECJ 15 May 1997, Case C-250/95, (*Futura, Singer*), par. 31.

However, in the judgment concerning the case *Futura, Singer* the Court stated that in this particular case it was not necessary that a non-resident taxpayer could show the amount of losses claimed at the balancing of loss only in the ways prescribed by the laws of that state that, for example, obliged him to keep the accounts in that state. According to the Court, this could be done in another way and the claim went too far considering its purpose.³⁵ In this case like in the case *Bachmann*, the Court referred to a Member State's opportunity to resort to the Mutual Assistance Directive of the EC. As far as the last mentioned case is concerned, the Court considered that the non-deductibility of the insurance premiums paid by the taxpayer could not be justified by the need of maintaining the effectiveness of fiscal supervision. In accordance with the opinion of the tax authorities supervision was not possible if premiums were paid to a foreign insurance company.³⁶ As for the case *Safir*, the Court stated that there were also other possible systems that were more open and that could be used to fill the gap that according to the state collecting the taxes would result from agreeing to the plaintiff's demands, however, restricting the freedom of providing services less at the same time. Interesting enough, the judgment given by the Court also contained a statement of what this different system could be like.³⁷

The need to maintain the effectiveness of fiscal supervision is closely connected to the prevention of tax avoidance. In the case *ICI* the tax authorities explained that the legislation aimed to prevent foreign subsidiaries from being used as a channel for moving taxable income out of the reach of government authorities. The Court considered as follows: "As regards the justification based on risk of tax avoidance, suffice it to note that the legislation at issue in the main proceedings does not have specific purpose of preventing wholly artificial arrangements, set up to circumvent UK tax 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 UK. However, the establishment of a company outside the UK does not, of itself, necessarily entail avoidance (...)".³⁸

As for direct discrimination, the Court in the case *Avoir fiscal* stated that the argument concerning the risk of tax avoidance could not be used as an excuse for deviating from the provisions of article 52 (present 43) of the EC Treaty.³⁹ It is often claimed that the argument concerning tax avoidance could not therefore be successful as a justification. However, one should perhaps not see the present legal situation to be as unambiguous as that. In fact, the Court did not in the case *Avoir fiscal* quite clearly state whether it even considered the risk of tax avoidance to be likely.⁴⁰ Secondly, the issue dealt with direct discrimination, and consequently, justifications can successfully be only referred to in cases

³⁵ Case C-250/95, (*Futura, Singer*), par. 39-41.

³⁶ ECJ 28 Jan 1992, Case C-204/90, (*Bachmann*), par. 18.

³⁷ ECJ 28 Apr 1998, Case C-118/96, (*Safir*), par. 33.

³⁸ ECJ 16 Jul 1998, Case C-264/96, (*ICI*), par. 26.

³⁹ Case C-270/83, (*Avoir fiscal*), par. 25.

⁴⁰ See Terra, B. and Wattel, P., op.cit. note 3, at 80, which suggest that the Court's strict attitude towards all the arguments and justifications presented by France can probably be explained by the fact that it did not see the abovementioned risk in this case.

provided by article 30 of the EC Treaty. This may not yet exclude the possibility that the argument could have significance in a case concerning indirect discrimination. The Court's statement according to which the provisions of article 52 of the EC Treaty cannot be deviated from on grounds of this nature, can also be interpreted as meaning cases in which a regulation conflicts directly with a provision of the EC Treaty. In view of this and if the risk of tax avoidance can be shown to be at least evident, the significance of this argument in cases of indirect discrimination cannot perhaps be wholly ruled out on the basis of current legal practice. Also noteworthy, and perhaps even more so, is the aforementioned Court statement in the case *ICI*, in which the Court can be seen as having left open a possibility like this in refusing the claim of the tax authorities concerning the need to restrict tax avoidance, by stating that the legislation of the Member State was not purely aimed at excluding tax benefits from arrangements aimed at tax avoidance, but that it regulated all situations in which a company was established in another country. If the primary function of the legislation can be shown to be of the nature mentioned (purely aimed at excluding tax benefits), the result could perhaps be different.⁴¹

The Court has shown reservedness towards arguments concerning the effectiveness of fiscal supervision and need to prevent tax avoidance for the obvious reason that, in the cases presented, it has been visible that the legislation of the tax collecting state has either not been aimed at this end at all, or it has been disproportionate to its aim, specifically taking into consideration that other, less restrictive means could have been used to reach this aim. From the line currently followed, it can be seen that successful justification by referring f.ex. to the effectiveness of fiscal supervision requires strong proof that the approvable aims cannot be reached by less restricting means. The ECJ is reluctant to accept all possible problems concerning obtaining of information as a justification, and has in its judgements in many cases referred to the Mutual Assistance Directive (Council Directive 77/799/EEC), even mentioning that it enables similar obtaining of information to that possible at a national level.⁴² However, perhaps this can be seen as a somewhat too optimistic view of the possibilities of obtaining information.⁴³

⁴¹ See also Terra, B. and Wattel, P., op.cit. note 3, at 83-84, which suggest that the Court will only accept restrictive anti-abuse measures if, disregarding the tax effects, the corporate or trade arrangement is "wholly artificial", and continue: "We conclude that the Court does not easily consider abuse present where taxpayers seek to avail themselves of the benefits of differences between tax jurisdictions, even if in the other tax jurisdiction a special favourable (tax competitive) regime exists, deviating from the normal tax system of that state. Abuse is only present where (i) there is intent to obtain, through artificial schemes, benefits not intended for the economic operator involved, and (ii) granting the benefits would be at odds with the object and purpose of the EC law rule invoked".

⁴² Case C-279/93, (*Schumacker*), par. 45.

⁴³ See also Terra, B. and Wattel, P., op.cit. note 3, at 53.

2.5 *Administrative and Economic Reasons*

The Court has also disqualified justification for general administrative reasons that have been used to defend regulations on the basis of their function in facilitating taxation. The Court has also not accepted superficial statements about the procedures required by the taxpayer leading to loss of revenues for the Member State as justification. In the case *ICI*, this matter may have reached more significant dimensions, as the Court stated that loss of revenues is not mentioned among the reasons in Article 56, and that it could not be viewed as a compelling reason of public interest that could be used to justify unequal treatment against the provisions of Article 56. In this case, the tax authorities referred to the fact that they could not compensate the loss of tax revenues caused by required deduction of losses, by collecting taxes from the profits of the foreign subsidiaries.⁴⁴ Similarly in the case *Verkooijen*, the tax authorities referred to the fact that allowing deductions to shareholders on the basis of received dividends in cases where the dividend is paid by a company in a foreign country would result in loss of tax revenues, since it could not collect taxes from the dividend payer in the same way as it could in domestic cases. The Court stated that as in the case *ICI*, to which it also referred in this context, that the abovementioned issue could not be viewed as a matter of compelling public interest.⁴⁵ In the same case, the Court rejected the claim that the aforementioned taxation of dividends is reasonable, since it is aimed at enhancing the economy of the Member State by encouraging investments in companies having their registered place of business in that country. The Court stated that a purely economic reason could not be considered to be a matter of compelling public interest, and therefore could not be used as justification for restricting the principle of free movement of capital guaranteed by the EC Treaty.⁴⁶

2.6 *Cohesion of the Tax System*

The cohesion of the tax system as a justification was concretely brought up in the case *Bachmann*. This case dealt with the right of a person, citizen of another Member State, to deduct life insurance premiums in the taxation of his resident Member State when the insurance had been taken in another Member State. The tax authorities regarded these premiums as non-deductible, unlike premiums paid to an insurance company of that state. To support this practice, they explained that insurances taken in other countries were not in the same position, since the state could not check the foreign company's reliability and financial standing no more than it could check their accounts in case the company did not have an office in that state. Furthermore, they argued that the state (Belgium)

⁴⁴ Case C-264/96, (*ICI*), par. 28. Article 56 (present 46) states that the provisions of the EC Treaty regarding the right of establishment do not restrict the application of laws, rules and administrative regulations according to which special regulations are applied to foreigners on grounds of public order, safety or national health.

⁴⁵ Case C-35/98, (*Verkooijen*), par. 59.

⁴⁶ Case C-35/98, (*Verkooijen*), par. 48.

could not impose a tax on insurance benefits that were paid for insurances taken in a foreign country, and therefore, the premiums for these kinds of insurances would be non-deductible. Its taxation was based on the principle that deductibility corresponded with taxability. A benefit based on a premium already deducted should also be taxable in this State, which would not be the case if the insurance had been taken from a foreign insurance company.

The ECJ rejected the first two reasons but approved the arguments of the tax authorities concerning the third justification. The Court considered that there was a connection between the deductible insurance premiums and insurance benefits in the Belgian tax system.⁴⁷ The Court considered that the coherent application of the tax system was a matter internal to the Member State, and that it required that insurance benefits should be taxable in the cases where the state granted deductibility to insurance premiums paid to another state.⁴⁸ As regards the tax treaty between these countries wherein it was stated that the beneficiary's resident state should have the right for taxation of the benefits, regardless of where the insurances had been taken, the Court stated that this would only be possible on the basis of a tax treaty or as a result of harmonizing procedures in the EC.⁴⁹ As the cohesion of such a tax system could not be ensured by less restricting means, the Court considered the Member State's actions to be justified.⁵⁰

The reasons presented by the ECJ in the case *Bachmann* have met with a lot of criticism. It has been believed that this decision will lead to the use of cohesion of the tax system as a justification of a variety of discriminating tax regulations, and a statement has been made on the impossibility of the conclusion that an expense can be deductible in income taxation only if a corresponding payment is taxable in the same state. This could even result in interest payments abroad becoming non-deductible, since the right of taxation of interest income belongs to the country of residence of the party receiving the interest income. In addition, it has been reminded that the Court has obviously presumed the taxes on insurance benefits to be paid by the insurance company, even though this is a case concerning the taxation of the beneficiary, which is again affected by the tax treaty between the countries in question. According to the treaty, the state of residence of the beneficiary has the exclusive power to tax, regardless of the fact that deductions for insurance premiums have been granted in the other contracting state. The fact that insurance premiums have been paid to an insurance company in one state does by no means guarantee that benefits from these insurances would be taxable in the same state, since the beneficiary may have moved to another state which now would have the power to tax these benefits according to a tax treaty.⁵¹

⁴⁷ Case 204/90, (*Bachmann*), par. 21.

⁴⁸ Case 204/90, (*Bachmann*), par. 23.

⁴⁹ Case 204/90, (*Bachmann*), par. 26.

⁵⁰ Case 204/90, (*Bachmann*), par. 27-28.

⁵¹ See especially Knobbe-Keuk, B., *Restrictions on the Fundamental Freedoms Enshrined in the EC Treaty by Discriminatory Tax Provisions – Ban and Justifications*, EC Tax Review 1994/3, at 80-81. Thömmes, O., *Verbote der Diskriminierung von Steuerausländern und Steuerinländern*, in Lehner, M. (Hrsg.), *Steuerrecht im Europäischen Binnenmarkt*, Köln

It has also been considered that the Court should have interfered more actively in the tax policies that affect the formation of the Member State's tax system, as well as assessing whether the chosen policy was compatible with the provisions of the EC Treaty, and whether the Member State could have reached its objectives by means less restrictive of the basic freedoms granted by the Treaty.⁵²

The criticism aimed at the decision in the case *Bachmann* can, for the most part, be held accurate. Undoubtedly, the Court made a mistake in disregarding the decisive effect of the tax treaty on the material outcome of this matter. However, it is likely that in this part of its decision, the Court tried to clarify the fact that the tax treaties, insofar as they do not function more or less coherently between all Member States, shall not play a significant role in the argumentation concerning coherence, and that in the meantime a harmonization process at the EC level is the only thing that can shift the argumentation concerning this matter from a national to an international level. This might be the reason why the Court did not consider the provisions of the tax treaty as a prohibiting factor for accepting the justification.⁵³

The part of the criticism that compares the outcome to the fact that interest payments abroad would not, according to the decision, be deductible, since the state granting the right for deduction would not have the power to tax the income on interest, may be clearly seen as going too far. The principle presented in the decision could rather be seen as significant in cases where, instead of pure deduction of expenses, the deduction would result in tax credit, which would be justifiable to be entered as income in the state where the deduction has been made.⁵⁴ Given the current, clearly disharmonised state of the Community legislation on direct taxation, the point of view that the Court's decision would also be questionable as regards the part where it refers to the right of the Member States to independently formulate the principles on which its tax system is based, can hardly be agreed with.

In the case *Wielockx*, the ECJ no longer mentioned the fact of the tax treaty legislation not being totally harmonised, but specifically focused on the tax treaty to be applied in resolving the case. The case dealt with the right of a person living abroad to make a deductible pension reserve, and the tax collecting state referred to the need of maintaining the cohesion of its tax system in support of denying the deductibility. When the pension reserve would eventually dissolve, the entered income would, according to the provisions of the tax treaty applicable in the case, be taxed in the taxpayer's resident state. According to tax authorities, denying the deductibility was justified when a tax was imposed on the corresponding income in another state. The Court disagreed with this and

1996, at 100, referring to the first author, states that no "coherence" exists between the Member States who have a tax treaty drawn up on the lines of the OECD model tax treaty.

⁵² See Farmer, P. and Lyal, R., *EC Tax Law*, Oxford 1994, at 332-333, in which they consider among other things that in the case *Bachmann* the Court adopted an astonishingly low standard for accepting justifications, given the strict regulations that this decision caused to cross-border services.

⁵³ Wattel, P., *op.cit.* note 15, at 240.

⁵⁴ By Ståhl, K. and Persson Österman, R., *op.cit.* note 3, at 129.

considered that a cohesion of the tax system in regard to one individual had not been reached in a way that a strict correlation between the deductibility of expenses and the taxability of pension payments would have been established, but that the correlation had been shifted to another level where regulations of Member States based on reciprocity were applied.⁵⁵

It appears from this case that, because of the criticism caused by the decision in the case *Bachmann*, the Court had noticeably clarified its line as regards the significance of tax treaties. This time the Court reasoned its decision with the fact that the state had, by its tax treaty, shifted the perspective in this matter outside the context of its national tax system and, therefore, the cohesion of the tax system could not be used as a justification at this level. However, in applying the tax treaty, the Court did not succeed in the best possible way.⁵⁶

In the case *Svensson/Gustavsson*⁵⁷, the ECJ further specified the conditions of use of the term cohesion of the tax system. In accordance with the legislation of the Member State applicable in this case, the state would not grant an interest subsidy if a loan for buying, building or renovating a dwelling was taken from a credit institution that did not have an office in that Member State. The interest subsidy was only granted in case a loan of this kind had been taken from a credit institution located in that particular country. The Member State considered the legislation justifiable by the cohesion of the national tax system, because it should be able to tax the interest income as compensation for the interest subsidy that it has granted to the owner of the dwelling. This was not possible, if the loan had been taken from abroad. The Court referred to the case *Bachmann* where a direct correlation existed between the deductibility of insurance premiums and the taxability of income from insurance. According to the Court, a corresponding correlation did not exist between the taxpayer's right to interest payment deductions and the fact that this deduction would be funded by taxation of the credit establishments granting the loan.

In this case that was not primarily a tax case, the decision seems quite clear-cut, since a direct correlation between the subsidy and its funding obviously did not exist. The funding was apparently meant to come from public tax revenues. However, it is noteworthy that the Court again referred to the term cohesion of the tax system formulated in the *Bachmann* case. It emphasised the demand for direct correlation, and even though this demand was not met in the case

⁵⁵ Case C-80/90, (*Wielockx*), par. 24. – Prior to this, the Court had already in the case C-279/93, (*Schumacker*), par. 41-42 commented on a claim by the tax collecting state, according to which the cohesion of the tax system could be used as justification. In this case that dealt with personal and family-related deductions, the Court considered these deductions deductible to the taxpayer in the source state, based on the principle of uniform treatment, since his income in the resident state would not enable these deductions, and since denying these deductions could not be justified by the cohesion of the tax system. The Court also commented on the use of cohesion of the tax system as an argument in the cases C-107/94, (*Asscher*), par. 59 and C-264/96, (*ICI*), which are not as interesting regarding the development of the term, since the successfulness of the argumentation could not be seen as likely in these cases.

⁵⁶ Cf. Wattel, P., op.cit. note 15, at 244-247.

⁵⁷ Case C-484/93, (*Svensson/Gustavsson*).

Svensson/Gustavsson, it can be regarded as an obvious fact that in principle, this term is still usable in legal practise.⁵⁸

The case *Baars* dealt with a person holding shares of a foreign company. According to the law of the person's resident state, he was liable to pay wealth tax for his entire property, regardless of where it was located. The law on property tax also provided exemption from property tax in cases where the person liable to pay taxes owned a considerable share of a company. Although the size of the ownership was not contested in the case, *Baars* was not granted exemption, since, according to the law in question, exemption did not concern foreign companies. The state imposing the tax justified its legislation by the need to maintain cohesion of its tax system. The exemption had been granted to avoid double taxation, which was not the situation in this case, since it could not levy a tax on the profits of a foreign company. The ECJ, however, deemed this to be a case where securing the cohesion of the tax system would not be required. Besides, according to the Court, this was not a case of double taxation, and a direct correlation did not exist between corporate tax and property tax, which it considered to be two different taxes imposed on two separate taxpayers.⁵⁹

The ECJ continued on this line in the case *Verkooijen* that dealt with income taxation. This was also a case in which a person owned shares of a foreign company. Even though according to the law of the taxing state a person receiving dividend was entitled to tax exemption on grounds more specifically stated in the law, the exemption was not granted in this case, because the law did not cover dividends received from foreign companies. The taxing state reasoned this with the need to maintain the cohesion of the tax system. The foreign company did not pay corporate tax to this state, and cases such as this did not include double taxation that would have needed to be alleviated. This alleviation was only granted in cases that dealt with a company located in that state and also paying its corporate tax there, which was the only case that the state saw as including the possibility of double taxation. The Court referred to the case *Bachmann* stating that in that case a direct correlation existed regarding a single individual between the tax benefit and the compensating tax levied within the same tax system. It deemed that such direct correlation did not exist in the case *Verkooijen* between exemption from income tax on dividends and the corporate tax on the profits of a company located in another Member State. It considered this to be a case of two separate taxes imposed on two separate taxpayers.⁶⁰

3 *Final Remarks*

As far as direct discrimination is concerned, the discretionary power of the ECJ concerning justifications is fairly limited due to the provisions of article 30 of the EC Treaty. It seems hardly likely that the Court would consider the justifications listed in the article to be applicable in future cases dealing with direct taxation either. In the case *Avoir fiscal* concerning direct discrimination,

⁵⁸ See also Case C-264/96, (*ICI*), par. 29.

⁵⁹ ECJ 13 Apr 2000, Case C-251/98, (*Baars*), par. 39-40.

⁶⁰ Case C-35/98, (*Verkooijen*), par. 57-58.

the Court stated very clearly that the possibility of tax avoidance could not be used as a justification to deviate from the provisions of the EC Treaty. Thus, it seems likely that justifications for direct discrimination are limited to the rights mentioned in article 56 that allow Member States in specific conditions to apply their national legislation even though the result would be contradictory with the principles of free movement of capital mentioned in the same article. As clarifying Court practice is still lacking, it is hard to predict the significance of the justification clause, formed by the Member States and included in the article, in practical situations.⁶¹

In the area of indirect discrimination, the situation is quite different. From past Court practice it can be seen that the ECJ has clearly accepted two main reasons that can, at least in principal, be used as a justification. These are the need to ensure the efficiency of fiscal supervision and the cohesion of the tax system. Regarding both of these, the Court has kept a cautious line, and emphasised that also in these cases, the measures to be taken will really have to be necessary for reaching the given objectives, and that the measures have to be correctly proportioned. From the Court's practice regarding cases in which these partly overlapping reasons are used, it could be concluded that the Court would in principle be ready to accept the need of a Member State to defend its tax base as a justification in exceptional cases.⁶² This holds true, regardless of the fact that the reasoning used by the Court in trying to define the scope of the concept cohesion of the tax system has occasionally been shaky.

The Court's mistake in the case *Bachmann* in accepting an argument based on the cohesion of the tax system that was not suitable for the case has been frequently referred to. Since the Court has not accepted this as justification since then, a conclusion has sometimes been drawn that the concept would be devoid of meaning. Nevertheless, it would hardly be necessary to go this far, because the Court has referred to this case in its later practice, even though it has deemed that grounds for justification have not existed in these later cases.⁶³

As the ECJ has remarkably widened the EC Treaty's scope of application by creating the term indirect discrimination in its practice, and by further developing the principle of prohibition of restrictive measures, it is only fair that it has, in order to take into account the Member States' views and principles of international taxation, also created some justifications as compensation. The need to ensure the cohesion of the tax system can basically be seen as a viable justification, but in defining the scope of this concept the Court has acted in a manner that can jeopardize this delicate balance. In particular, this concerns the Court's judgement in the case *Verkooijen*, in which it emphasised the meaning of the case concerning only a single individual as a precondition for the use of

⁶¹ The case C-35/98, (*Verkooijen*), dealt with questions parallel to this one, but without forming any new information. This was due to the special features of the case.

⁶² Also Ståhl, K. and Persson Österman, R., op.cit. note 3, at 133.

⁶³ See also Ståhl, K., *EG-domstolen och den internationella skatterätten*, SkatteNytt 1997, at 762 onwards, in which she makes a note of the legislative role of the ECJ and also sees significant areas of application for the term cohesion of the tax system in its legal practice.

this kind of justification, and did it in a way that could reduce the future scope of application for the concept cohesion of the tax system almost to insignificance.⁶⁴

⁶⁴ See also Ståhl, K. and Persson Österman, R., *op.cit.* note 3, at 134.