The Rule of Reason Doctrine in European Court of Justice Jurisprudence on Direct Taxation

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PRÉCIS

Dans cet article, l’auteur fait un examen critique de la doctrine de la justification élaborée par la Cour européenne de justice dans sa jurisprudence sur l’imposition directe. Cette doctrine permet de déterminer si, et dans quelles circonstances, une mesure interne dont on juge qu’elle limite l’exercice d’une ou de plusieurs libertés fondamentales garantes par le traité sur l’UE, ou dont l’effet ou l’application est discriminatoire, peut être justifiée par des motifs d’intérêt public. L’auteur donne d’abord un aperçu de la doctrine de la justification, ou « règle de raison », élaborée par la Cour et met l’accent sur son application dans les causes portant sur l’imposition directe. La Cour a toujours interprété de façon très étroite les restrictions à l’exercice des libertés fondamentales contenues dans le traité sur l’UE et l’argument de l’intérêt public pour justifier une mesure fiscale interne restrictive ou discriminatoire. L’auteur laisse entendre que le principe de la non-discrimination élaboré par la Cour dans sa jurisprudence sur l’imposition directe favorise une interprétation plus large des motifs de justification potentiels dont elle a tenu compte à ce jour dans sa doctrine de la règle de raison, et il fait valoir que certains de ses récents jugements pourraient former un cadre en vue d’une interprétation plus pondérée de la règle de raison où la doctrine de la justification est élargie de façon à inclure une analyse des principes de politiques fiscales internationales pertinentes. Cette question est également pertinente dans le contexte de l’application des dispositions sur les mouvements des capitaux de l’article 56 du traité sur l’UE aux investissements par des pays tiers en Europe, alors que la Cour continue de définir les circonstances dans lesquelles les divers motifs de justification qu’elle a pris en considération à ce jour peuvent être appliqués aux ressortissants d’États qui ne sont pas membres de l’UE.

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ABSTRACT
This article critically reviews the doctrine of justification developed by the European Court of Justice in its jurisprudence on direct taxation concerning whether, and the circumstances under which, a national measure that is found to restrict the exercise of one or more of the fundamental freedoms guaranteed by the EC treaty, or that is discriminatory in its application or effect, may be justified as representing an imperative requirement in the public interest. The article begins with an overview of the court’s development of the doctrine of justification, or “rule of reason,” with emphasis on its application in cases involving direct taxation. The limitations on the exercise of the fundamental freedoms contained in the EC treaty and the grounds on which a restrictive or discriminatory national tax measure may be justified as being in the public interest have traditionally been interpreted very narrowly by the court. The article suggests that the non-discrimination principle developed by the court in its jurisprudence on direct taxation supports a more expansive interpretation of the potential grounds of justification that the court has considered to date in its rule of reason doctrine, and argues that some of the court’s recent judgments may form the framework for a more balanced interpretation of the rule of reason in which the justification doctrine is broadened to include an analysis of relevant international tax policy principles. This issue will be of relevance as well in the context of the application of the free movement of capital provisions in article 56 of the EC treaty to third-country investment in Europe, as the court continues to define the circumstances under which the various grounds of justification it has considered to date may be applied to nationals of non-EC member states.

KEYWORDS: EUROPEAN UNION ■ INTERNATIONAL TAXATION ■ EUROPEAN COMMUNITY ■ TREATY OF ROME

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INTRODUCTION

In recent years, there have been unprecedented developments in the harmonization of the national laws of member states of the European Union, as these states continue to work toward the “strengthening and the convergence of their economies and to establish an economic and monetary union,” as resolved in the Treaty on European Union, and the “creation of an area without internal frontiers, through the strengthening of economic and social cohesion” in accordance with the stated objectives of the EC treaty. The primary goals of the European Community are stated in article 2 of the treaty, to be promoted by the community through the establishment of a common market and the implementation of an internal market characterized by the removal, as between member states, of restrictions on the free movement of goods, persons, services, and capital. In some areas of law a significant degree of integration has already been achieved, while in many others harmonization has been slower, and this process continues to evolve. However, unlike in the case of indirect taxation, the EC treaty does not contain specific provisions relating to the harmonization of direct taxation, or otherwise provide the European Union with specific authority to intervene in national corporate tax systems, and member states have been particularly protective of national sovereignty in the areas of direct taxation and fiscal legislative competence. The European Council of Ministers is restricted to acting in this area pursuant to general provisions of the EC treaty, to the extent that such measures affect the “functioning of the common market,” and then only by unanimous decision.

The requirement of unanimity in the European Council of Ministers on matters concerning direct taxation has, to date, effectively precluded legislative harmonization, or positive integration, in this area of community law. However, in its recent jurisprudence, the European Court of Justice has adopted a considerably more activist approach to the interpretation of the fundamental freedoms contained in the EC treaty—namely, the free movement of goods, the freedom of movement of persons, the freedom of establishment, the freedom to provide services, and the free movement of capital—as well as article 18 of the EC treaty, which guarantees citizens of the European Union the right to move and reside freely within the territory of the member states, in matters of direct taxation, in many cases finding national tax legislation to be discriminatory or otherwise unduly restrictive of the exercise of these rights. The court’s authority in this regard, and the fundamental basis underlying its reasoning and analysis, is the EC treaty itself, which states that the activities of the community shall include “an internal market characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital” (article 3(1)(c)), 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] Treaty” (article 14(2)), and that within the “scope of application of [the] Treaty . . . any discrimination on grounds of nationality shall be prohibited” (article 12).

Recent decisions of the European Court of Justice have considered the interaction of EC treaty provisions with domestic tax provisions concerning thin capitalization,
group loss utilization, controlled foreign company rules, withholding tax, departure and exit taxes, shareholder imputation regimes, and the participation exemption. These judgments have tended to uphold the principles of European Community law prohibiting member states from discriminating against nationals of other EU member states, or from creating statutory or administrative restrictions on the exercise of the fundamental freedoms guaranteed by the EC treaty, often at the expense of some considerable degree of the fiscal sovereignty or autonomy of the particular member state whose laws were the subject of challenge. In many cases, these decisions have resulted in the application of judicial principles that have the potential to erode the taxing jurisdiction, and thereby the domestic or national tax base, of member states, and in others they have significantly increased the potential for double taxation within the community.

This article considers the doctrine of justification developed by the European Court of Justice in its jurisprudence on direct taxation concerning whether, and the circumstances under which, a national measure that is found to restrict the exercise of one or more of the fundamental freedoms guaranteed by the EC treaty, or that is discriminatory in its application or effect, may be justified as representing an imperative requirement in the public interest. The article begins with an overview of the court’s development of the doctrine of justification, or “rule of reason,” with particular emphasis on its application in cases involving direct taxation. The doctrine has its origins in the jurisprudence of the court concerning the free movement of goods. The court’s reasoning in these cases—and, in particular, its conclusion that, in the absence of community harmonization, member states would take reasonable measures to prevent unfair trade practices, even if the measures otherwise restricted the free movement of goods guaranteed by (what is now) article 28 of the EC treaty—resulted in the development of a non-exhaustive list of circumstances that may justify an otherwise restrictive or discriminatory national measure. The article then reviews the limitations on the exercise of the fundamental freedoms contained in the treaty. The court’s jurisprudence interpreting these limitations and, in particular, the restrictions contained in article 58 of the treaty in respect of the free movement of capital suggests that the court has given these exceptions an extremely narrow scope, preferring instead to rely on its rule of reason doctrine in addressing issues of justification in direct taxation matters, even where these questions directly relate to the limitations on the application of the fundamental freedoms set out in the EC treaty itself.

The European Court of Justice has traditionally adopted a similarly narrow approach in its consideration of the grounds upon which a restrictive or discriminatory national tax measure may be justified. The next section of the article reviews the grounds of justification that the court has accepted in principle: preservation of fiscal coherence, effectiveness of fiscal supervision, the prevention of tax avoidance and fiscal abuse, and, more recently, the balanced allocation of taxing power between member states. Although the court has accepted that the preservation of the fiscal coherence of a member state’s tax legislation may, in some circumstances, justify an infringement of the fundamental freedoms contained in the EC treaty, it has substantially limited the scope of application of this ground in its jurisprudence. It requires
member states to demonstrate the existence of a direct link between the relevant tax disadvantage and the compensatory advantage at issue, and has further narrowed the scope of application of the test so that both the disadvantage and the corresponding tax advantage must relate to the same taxpayer and apply in respect of the same taxes. Moreover, the court has required the compensatory advantage at issue to arise solely by virtue of the domestic tax laws of the member states, not from the application of the provisions of an income tax treaty—a further precondition that has rendered reliance on fiscal coherence as a basis for justifying an EC treaty restriction increasingly difficult.

The court has held that the effectiveness of fiscal supervision may also justify the restriction of EC treaty fundamental freedoms in the area of direct taxation in some circumstances. However, it has significantly narrowed the scope for reliance on this ground by requiring member states to obtain all tax information otherwise accessible through domestic sources before they may rely on the court’s rule of reason doctrine in justifying restrictive or discriminatory national tax provisions. Finally, the court has accepted, in a number of recent judgments, that the prevention of tax avoidance may, in theory, constitute a valid justification for restriction of EC treaty freedoms. It has, however, introduced an exceptionally high standard for justification of national tax provisions on these grounds. Under this standard, member states must demonstrate the existence of a particularized finding of fraud or abuse involving “wholly artificial arrangements” before they may justify restrictive or discriminatory national tax measures whose objective is the prevention of tax avoidance. Finally, the court has employed a broad interpretation of the proportionality limitation in recent case law, which may negate reliance on more expansive grounds of justification that take into account the need for a balanced allocation of taxing power between member states.

The final section of the article briefly considers the impact of the court’s recent jurisprudence in the area of direct taxation. Critics have argued that the court’s non-discrimination principle is so broad that it erodes the tax sovereignty of EC member states, restricting member states’ ability to structure their national tax systems and fully exercise their taxing jurisdiction. It is frequently suggested that the ability of member states to enact international anti-avoidance rules, and thus to protect their domestic tax base, has been significantly curtailed, as has their ability to rely on tax policy as an economic measure in pursuing national savings, spending, or investment incentives. Despite the court’s broad interpretation of the EC treaty fundamental freedoms, it has, to date, failed to apply the non-discrimination principle to prohibit international double taxation, which is arguably one of the most significant impediments to cross-border employment, establishment, and capital investment. The court’s recent jurisprudence in this area has the potential to impede, rather than accelerate, the harmonization of direct taxation within the European Community, by virtue of the disparate response of EC member states to the court’s decisions. These developments weigh in favour of a more expansive interpretation to the potential grounds of justification than the court has considered to date in its rule of reason doctrine, and the introduction of a more flexible test that better takes into account the various factual considerations that should, in principle, inform the court’s analysis
in its determination as to whether a restrictive or discriminatory national tax measure may be justified in accordance with its rule of reason. The court’s judgment in *Marks & Spencer v. David Halsey (Her Majesty’s Inspector of Taxes)*, and in other decisions that have followed it, may form the framework for the application of a more balanced interpretation of the rule of reason by the court in its subsequent jurisprudence in the area of direct taxation, a framework in which the justification doctrine is broadened to include an analysis of relevant international tax policy principles to which the court has, to date, arguably accorded only limited consideration.

**THE APPLICATION OF THE RULE OF REASON DOCTRINE**

There are a number of exceptions to and limitations on the application of the fundamental freedoms contained in the EC treaty. These limitations, set out in the treaty itself, are considered in greater detail in the next section of this article. However, the European Court of Justice has, in its jurisprudence, also developed specific “public interest” grounds on which national measures may be justified, even though the measures may restrict the protection accorded by the fundamental freedoms in the EC treaty, or otherwise render the exercise of those freedoms less attractive. The test applied by the court in its analysis of whether a national measure may be justified pursuant to this doctrine has been referred to as the rule of reason.

The rule of reason doctrine has been expressed in various forms, depending on the specific EC treaty freedom considered. The court generally begins the justification analysis by considering whether the tax measure at issue falls within the scope of community law and the fundamental freedoms contained in the treaty. If it does, the court must then consider whether protection of the particular public interest at issue has been harmonized at the EC level. If it has been, member states would not, in principle, generally be permitted to legislate independently in the specific field. This consideration has, to date, generally been inapplicable in the area of direct taxation; jurisdiction over direct taxation remains within the competence of member states because, with the exception of a limited number of specific European Council directives, there has been no community harmonization of, or EC-level legislation with respect to, direct taxation matters.

The taxation powers of member states must, however, be exercised in accordance with EC law, and thus the court must determine whether the domestic tax measure at issue is compatible with the fundamental freedoms set out in the EC treaty and, in particular, with the non-discrimination principles contained therein. If the court finds that the measure is discriminatory or restrictive, it generally considers whether the measure falls within one of the express exceptions to or limitations on the application of the freedoms contained in the treaty, such as public policy, public security, or public health. If the measure cannot be justified under one of the treaty’s “objective” exceptions, the court has considered whether the public interest served by the national tax measure can justify the restriction of the EC treaty freedom at issue under its so-called rule of reason doctrine. While the court has accepted a number
of grounds of justification as being in the public interest, including consumer protection, protection of the environment, and prevention of unfair competition, the justifications accepted by the court in its jurisprudence in the field of direct taxation have been extremely narrow in both scope and effect. Even if a national tax measure may be justified as representing an imperative public interest purpose, however, the court has held that the measure must be both necessary and proportionate in order to satisfy the rule of reason. A measure will be considered necessary if it is both appropriate and effective for the purpose of protecting the public interest concerned, such that a sufficient causal link may be established between the measure and the objective it is intended to achieve. For a measure to satisfy the proportionality test, it must be possible to conclude that the objective of the measure cannot be achieved through less restrictive means.\(^\text{16}\)

The European Court of Justice summarized the rule of reason doctrine in its decision in the Gebhard case in the following terms: “national measures liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfill 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 in order to attain it.”\(^\text{17}\) The court has been relatively consistent in applying the Gebhard formulation of the doctrine in respect of each of the fundamental freedoms and in tax as well as non-tax jurisprudence. It has required national measures to be applied in a non-discriminatory manner, to represent imperative public interest requirements, and to satisfy both the tests of necessity and proportionality before concluding that the measure may be justified as being in the public interest.\(^\text{18}\)

An examination of the initial precondition to the application of the rule of reason doctrine by the European Court of Justice in Gebhard suggests that a national measure that is discriminatory can never be justified in accordance with the doctrine. On this interpretation, while restrictive national measures—namely, measures that are liable to hinder or render less attractive the exercise of one of the freedoms, even if they apply without distinction to both nationals and foreigners of a member state\(^\text{19}\)—could be “saved” pursuant to the justification principle, measures that are discriminatory, insofar as they effectively apply different rules to comparable situations or the same rule to different situations, could not be saved, because the first condition referred to by the court could never be met in these circumstances.\(^\text{20}\)

Notwithstanding the court’s expression of the test in Gebhard, however, it has in practice distinguished between cases of direct discrimination, in which the unequal treatment at issue arises directly based on nationality, and indirect discrimination, in which the unequal treatment has the same effect as a discriminatory provision based on nationality.\(^\text{21}\) In the area of direct taxation, the most common example of this distinction arises with domestic tax provisions that distinguish between taxpayers that are residents of a particular member state and those that are taxed on a source or territorial basis. While the tax measure at issue may not distinguish between taxpayers based purely on their nationality, such as on the basis of the criteria of citizenship in
the case of individual taxpayers and place of incorporation or situs of corporate seat in the case of corporations, and thus may not constitute direct discrimination, a distinction between taxpayers based on residence would, in many circumstances, tend to affect nationals differently from non-nationals. This is because nationals of a member state tend to be residents of that state for income tax purposes disproportionately to non-nationals, and the domestic measure at issue may, in this respect, constitute indirect discrimination.

To the extent that a national tax measure constitutes direct discrimination, the rule of reason will not, in accordance with the court’s formulation of the doctrine in Gebhard, apply to justify the discriminatory domestic legislation. This was the case, for example, in Royal Bank of Scotland plc. The Royal Bank of Scotland had its seat in the United Kingdom and carried on business through a branch in Greece. The Greek taxing statute applied a higher tax rate to foreign corporations engaged in banking and insurance activities in Greece than the rate applied to domestic companies engaged in equivalent businesses. Not surprisingly, the European Court of Justice found that, since a Greek branch of a foreign corporation engaged in banking activities should be regarded as being in a comparable situation to a domestic corporation engaged in the same activities, the national legislation in these circumstances was discriminatory. Because the Greek legislation constituted direct discrimination, since the application of the differential tax rate depended entirely on the situs of the corporate seat of the taxpayer, the court concluded that the rule of reason could not apply to justify the discriminatory provisions, noting that “[a]ccording to settled case-law, only an express derogating provision . . . could render such discrimination compatible with Community law.” Although commentators have debated whether the rule of reason doctrine should even apply in respect of national measures that give rise to indirect discrimination, it is relatively clear that the court has in practice applied the doctrine in such cases. The more relevant question at this stage in the development of the court’s jurisprudence in the direct taxation field thus seems to be whether there is any policy basis for drawing a distinction between discriminatory and non-discriminatory provisions at all, such that even measures that may result in direct discrimination should be subject to the application of the rule of reason. This argument was forcefully presented by Advocate General Jacobs in his preliminary opinion in the Danner case. This analysis must be informed, to some extent, by the court’s jurisprudence in this area. A review of the court’s decisions in the field of direct taxation suggests that the court has had at least some difficulty determining whether particular measures constitute a form of direct or indirect discrimination, and in many of its tax decisions the court considered and addressed the justification arguments advanced by member states notwithstanding the fact that the impugned legislation clearly constituted direct discrimination (although it is significant in this respect that the court has not, to date, found a discriminatory tax measure to be justified under the rule of reason doctrine in even one case involving direct discrimination). In particular, it has been suggested that the court has effectively circumvented the analysis in its reasoning as to whether a particular tax measure should be regarded as a form of
direct or indirect discrimination, or even whether it is discriminatory or merely restrictive of the exercise of an EC treaty freedom, for the express purpose of enabling the court to consider the grounds of justification advanced. It has been argued, for example, that the court has, in its recent jurisprudence, generally refrained from declaring a particular national tax measure to be discriminatory, and has instead simply found the domestic provision to constitute a barrier, or vaguely described impediment, to the fundamental EC treaty freedom at issue. This trend in the court’s reasoning has been attributed to the precondition to the application of the rule of reason doctrine that the national measure, in order to be justified, must be “non-discriminatory,” which, as noted above, would (if strictly applied) severely limit the doctrine’s scope of application. Because the court believes itself to be bound by this condition as part of the doctrine of justification, it circumvents this analysis by refraining from making any finding concerning discrimination, even where it is relatively clear that this conclusion would follow from the court’s holding. Some commentators have, on this basis, advocated in favour of extending the rule of reason doctrine to include measures that constitute direct discrimination; they justify this proposal largely on the basis that there would be no danger that “floodgates” would be opened in terms of permitting grounds of justification to succeed, because even “if there are some grounds of justification which the Court accepts in principle, . . . the Court very rarely finds them applicable” in practice.

**EC TREATY LIMITATIONS ON THE EXERCISE OF FUNDAMENTAL FREEDOMS**

As noted above, the EC treaty limits the exercise of the fundamental freedoms in a number of respects. For example, the freedom of movement provisions are expressly made subject to “limitations justified on grounds of public policy, public security or public health.” Article 45 of the treaty provides that the freedom of establishment does not apply to activities that are connected with the exercise of official authority. Moreover, the Council of the European Community may, acting by qualified majority on a proposal from the commission, rule that the provisions on freedom of establishment do not apply in respect of certain activities. Article 46 of the EC treaty further provides that these provisions and “measures taken in pursuance thereof shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for special treatment of foreign nationals on grounds of public policy, public security or public health.” The freedom to provide services is subject to the same limitations.

Articles 57 through 60 of the EC treaty contain a series of exceptions to the provisions on the free movement of capital. The restrictions on capital movements to or from non-member states are grandfathered to the extent that they were in force in December 1993 and involve direct investment establishment, including in real estate, the provision of financial services, or the admission of securities to capital markets. The Council of the European Community may, acting by qualified majority and on a proposal from the commission, adopt measures that restrict the free movement of
capital, although unanimity is required if the measure constitutes a “step back in Community law” as regards the liberalization of the movement of capital to or from third countries.\(^3^4\) Perhaps most significantly in the field of taxation, article 58 of the treaty states that article 56, which provides for the free movement of capital, shall be without prejudice to the rights of member states:

(a) to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested; [and]
(b) to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.

However, the treaty provides that these measures and procedures are not to “constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments” as defined in article 56.\(^3^5\)

The limitations contained in article 58 of the EC treaty, which directly address taxation matters, were introduced as specific restrictions on the exercise of the free movement of capital for three reasons: (1) to alleviate concerns of member states which apply an imputation system of taxation in respect of distributed corporate profits that the European Court of Justice could find the discriminatory effects of these provisions, and, in particular, the fact that imputation credits are not generally extended to foreign dividends in respect of foreign corporate tax paid, incompatible with the free movement of capital; (2) to alleviate concerns of member states that they might, by virtue of the free movement of capital, be restricted in their efforts to combat tax fraud, evasion, and avoidance; and (3) to give member states some scope to distinguish, for taxation purposes, between resident taxpayers subject to tax on the basis of worldwide income and non-resident taxpayers subject to tax on a source basis, and between domestic- and foreign-source investment income.\(^3^6\) The court has, however, effectively negated the protection that may be afforded to member states by the limitations contained in article 58 of the EC treaty in its subsequent jurisprudence. In the Verkooijen case,\(^3^7\) for example, the court specifically considered the compatibility of a provision of Dutch law—which provided that dividends distributed by corporations established in the Netherlands were subject to a withholding tax at source that was creditable in computing the shareholder’s income for tax purposes and for a limited exemption in respect of dividends received on which the Dutch withholding tax had been levied—with a council directive (similar in effect to article 56 of the treaty) that prohibited restrictions on capital movements and nationality discrimination with respect to capital investment.\(^3^8\) The taxpayer was a national and resident of the Netherlands employed by a Dutch company, which was a subsidiary of a Belgian public company. He acquired shares of the public company in his employee savings plan, and subsequently received a dividend on which he was subject to Belgian withholding tax at source. The Dutch tax authorities took the
position that the taxpayer was ineligible for the dividend exemption on the basis that the parent company, as a foreign corporation, was not subject to Dutch corporate tax in respect of the underlying profits from which the dividends were paid.

The European Court of Justice concluded that the Dutch provisions did constitute a restriction on capital movement prohibited by the directive. It noted that the Dutch law both dissuaded residents of the Netherlands from investing in corporations that had their corporate seat in other EU member states and restricted the ability of such companies to raise capital in the Netherlands, because dividends paid to Dutch residents by a foreign corporation would receive less favourable tax treatment than those paid by domestic corporations. The court went on to consider the application of the limitations on the free movement of capital contained in article 58 of the EC treaty, noting as follows:

[T]he possibility granted to the Member States by [article 58(1)(a)] of the Treaty of applying the relevant provisions of their tax legislation which distinguish between taxpayers according to their place of residence or the place where their capital is invested has already been upheld by the Court. According to that case-law, before the entry into force of [article 58(1)(a)] of the Treaty, national tax provisions of the kind to which that article refers, in so far as they establish certain distinctions based, in particular, on the residence of taxpayers, could be compatible with Community law provided that they applied to situations which were not objectively comparable . . . or could be justified by overriding reasons in the general interest, in particular in relation to the cohesion of the tax system. . . . In any event, [article 58(3)] of the Treaty states specifically that the national provisions referred to . . . are not to constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments, as defined in [article 56].

The court’s interpretation of the limitations on the free movement of capital set out in article 58 significantly restricts the scope of these saving provisions to the rule of reason doctrine already developed by the Court in its analysis of direct taxation matters (considered in greater detail below). In effect, the court has limited the justification of differences in treatment between resident and non-resident taxpayers in objectively comparable circumstances to grounds of public interest, rather than accorded greater or independent scope for the establishment of grounds for limiting the freedom of movement of capital based specifically on the provisions agreed to by the member states as reflected in article 58 of the EC treaty.

The court’s comments in the Verkooijen case concerning the application of the restrictions on the free movement of capital in article 58 of the EC treaty were subsequently confirmed in the Manninen case, which considered the compatibility of the Finnish imputation system with community law. The Finnish provisions restricted the ability to claim an imputation tax credit on dividends, which effectively eliminated shareholder-level tax, to dividends paid by domestic companies. The taxpayer, who was resident in Finland, received dividends from a Swedish public company, and the Finnish tax authorities accordingly denied his claim for the imputation tax credit. The member state governments argued, in support of the restriction of the credit to
dividends received from domestic corporations, that dividends are fundamentally different in character depending on whether they are paid by Finnish or non-Finnish corporations, because “[u]nlike profits distributed by non-Finnish companies, those paid in the form of dividends by companies established in Finland are subject to corporation tax in that Member State, conferring entitlement on the part of a shareholder who is fully taxable in Finland to the tax credit.” A distinction in national tax law between domestic- and foreign-source dividends should, accordingly, be justified within the limitations of article 58(1)(a) of the EC treaty, in its specific provision that the freedom of movement of capital is without prejudice to the rights of member states to apply the relevant provisions of their tax laws that 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.”

The court disagreed. It concluded that restricting the Finnish credit to dividends received from domestic corporations violated the free movement of capital provisions in article 56 of the EC treaty, deterring taxpayers resident in Finland from investing in shares of corporations established in other EU member states, and correspondingly restricted the ability of such corporations to raise capital in Finland as a result of the less favourable tax treatment accorded to dividends received by taxpayers resident in Finland from their investment in foreign corporations. With respect to the limitations in article 58(1)(a) of the EC treaty, the court acknowledged that, in some circumstances, shareholders resident in Finland may not be in a comparable situation regardless of whether they receive dividends from domestic or foreign-based corporations. For example, there may be circumstances in which the tax laws of the member state in which the investment is made effectively eliminates the risk of double taxation of corporate profits by exempting earnings distributed in the form of dividends from corporate taxation. In that event, it may be appropriate to deny imputation tax credits to the shareholder on the basis that a Finnish shareholder investing in a domestic corporation and a Finnish shareholder investing in the foreign corporation could not be regarded as similarly situated. On the facts at issue, however, both dividends distributed by a Finnish corporation and those distributed by a Swedish corporation were subject to corporate-level tax, giving rise to the potential for double taxation on distributed corporate profits, such that a shareholder resident in Finland that received dividends from a domestic corporation should, in the court’s view, be regarded as being in a comparable situation to a Finnish-resident shareholder that receives dividends paid by a Swedish corporation.

As in the Verkooijen decision, the court’s formulation of the scope of application of the limitations in article 58 of the EC treaty in Manninen appears to be restricted to its own rule of reason doctrine. It is clear, on the basis of a review of the Verkooijen and Manninen decisions, that article 58, as interpreted by the European Court of Justice, has not adequately addressed the three concerns of member states outlined above that prompted the article’s enactment by the Maastricht treaty in 1992. In these decisions, the court clearly found that tax credit imputation systems that distinguish between inbound dividends received from resident and non-resident corporations are incompatible with the free movement of capital in article 56 of the EC treaty. In relying on its own rule of reason doctrine, which has been developed and applied in
the context of the other EC treaty freedoms as well, the court has similarly effectively restricted the ability of member states to rely on the limitations set out in article 58, and has thereby significantly narrowed the scope for member states to distinguish between resident and non-resident persons in applying their national tax provisions in a manner that would be regarded as compatible with community law.

**ACCEPTED GROUNDS OF JUSTIFICATION**

This section of the article considers three specific grounds of justification that have been accepted in principle by the European Court of Justice under the rule of reason doctrine—namely, preservation of fiscal coherence, effectiveness of fiscal supervision, and the prevention of tax avoidance and fiscal abuse (the balanced allocation of taxing power between member states—a further ground of justification accepted more recently by the court, albeit only when taken together with one or more other accepted grounds—is considered separately below). This jurisprudence indicates that these grounds for justification have been defined extremely narrowly and, in practice, accepted only rarely. The grounds of justification that have been expressly rejected by the court, including the lack of harmonization of direct taxation matters within the European Community, the potential for loss of tax revenue by a member state or erosion of the domestic tax base, and the existence of counterbalancing advantages, are considered in detail.

**Preservation of Fiscal Coherence**

The European Court of Justice concluded in two early cases, *Bachmann v. Belgium* and *Commission v. Belgium*, that the preservation of the fiscal coherence of a member state’s tax system may in some circumstances justify restriction of the fundamental freedoms contained in the EC treaty. In *Bachmann*, the court considered the compatibility of a provision of Belgian tax law that permitted Belgian residents to deduct insurance premiums paid to domestic insurance companies with the provisions in article 39 of the treaty regarding the freedom of movement of persons. Under the Belgian law, premiums paid under a foreign insurance contract were non-deductible, but claims paid under the policy were exempt from taxation in Belgium, while those paid under insurance contracts with domestic insurers were fully taxable. The taxpayer, a German national who was employed in Belgium, sought to deduct insurance contributions he made in respect of policies taken out with a German insurer prior to his move to Belgium. His claim for deductibility was denied by the Belgian tax authorities on the basis that the insurance policies were concluded with a foreign-based insurance company. The court held that the non-deductibility provision could operate to the particular detriment of workers who had been employed in one member state and subsequently sought employment in Belgium, because these workers would in most circumstances have concluded their pension and insurance arrangements with the former member state. Such employees are, in general, more likely to be nationals of a member state other than Belgium, and the provision thus constitutes indirect discrimination in contravention of the free movement of persons provisions. The court refused to accept the Belgian government’s argument that,
while these employees may indeed be subject to potential double taxation in the event that they subsequently return to their state of nationality to retire and may, in these circumstances, become subject to taxation on amounts paid out under the insurance contracts even though they were precluded from deducting premiums paid, this detriment arises not as a result of any restriction on freedom of movement imposed under Belgian law, but rather is due to the absence of harmonization of the fiscal laws of the member states.\(^{47}\)

Notwithstanding its finding that the provision at issue constituted indirect discrimination, the European Court of Justice accepted the arguments of the Belgian government that the non-deductibility restriction was justified as being in the public interest, on the basis that it was necessary in order to preserve the fiscal coherence of the Belgian tax system. The court referred to its decision in *Commission v. Belgium*, which concerned an action by the European Commission seeking a declaration that the same national tax measure constituted a violation by Belgium of its obligations under the freedom of movement of persons provisions and the freedom to provide services under the EC treaty:

As regards the need to preserve the cohesion of the tax system, the Court held, in its judgment delivered today in Case C-300/90 *Commission v. Belgium*, that there exists under the Belgian rules a connection between the deductibility of contributions and the liability to tax of sums payable by the insurers under pension and life assurance contracts.

It follows that in such a tax system the loss of revenue resulting from the deduction of life assurance contributions from total taxable income—which includes pensions and insurance payable in the event of death—is offset by the taxation of pensions, annuities or capital sums payable by the insurers. Where such contributions have not been deducted, those sums are exempt from tax.

The cohesion of such a tax system, the formulation of which is a matter for each Member State, therefore presupposes that, in the event of a State being obliged to allow the deduction of life assurance contributions paid in another Member State, it should be able to tax sums payable by insurers.\(^{48}\)

The court noted that Belgium could, in theory, impose tax on amounts paid out under the insurance contracts for purposes of maintaining fiscal coherence. As a practical matter, however, it would be extremely difficult for Belgium to obtain the requisite information concerning the payments so made from foreign-based insurers, and a requirement that the insurer provide an undertaking to pay the tax, accompanied by the deposit of a guarantee, would entail considerable additional expense. This expense would inevitably be reflected in the increased cost of insurance premiums and could result in double taxation of the payments made to the insured (because the payments received would then presumably be taxable both in Belgium and in the policyholder’s state of residence).\(^{49}\)

The court’s decisions in the *Bachmann* and *Belgium* cases have been criticized on the basis that the fiscal coherence justification articulated by the court is vague, unclear, and inconsistent in its application. It has been argued, in particular, that the
assumption of coherence in the Belgian tax system was generally negated by Belgium in its negotiation of tax treaties, in which Belgium typically waived the right to tax private pensions, including payments made under insurance contracts, where the insured was resident in the other member state at the time the payment was received. Even where the premiums are paid to a domestic insurance company, there is thus no guarantee that payments subsequently made will effectively be taxed in Belgium. Moreover, the Belgian tax authorities specifically permitted the deductibility of insurance premiums paid by French, Dutch, and Luxembourg employees of Belgian branches or subsidiaries of corporations resident in those member states in practice, apparently on the basis of an undertaking that required the insurance companies in those states to notify Belgium of any payments made. This suggested that the concern of the Belgian authorities was in fact to ensure payment of tax due in respect of such payments in circumstances where the employees remained resident in Belgium at the time of payment, rather than to preserve collection of tax from the foreign insurance companies, the basis it advanced in support of its argument that the preservation of the fiscal coherence of its tax system justified the restriction of EC treaty freedoms.\textsuperscript{50}

The European Court of Justice appears to have been influenced, at least in part, by the academic criticism of its judgments in the \textit{Bachmann} and \textit{Belgium} cases, and the success of the fiscal cohesion justification advanced by member states in direct taxation cases has been limited considerably in its subsequent jurisprudence. The \textit{Svensson} decision,\textsuperscript{51} heard shortly after \textit{Bachmann}, concerned a provision of Luxembourg law that restricted the grant of certain subsidies on construction loans to those advanced by domestic banks. The government of Luxembourg argued that the provision was justified on the basis that the subsidized interest payments were effectively recovered by way of corporate income tax levied on the Luxembourg banks that advanced the loan, and that in the absence of the imposition of tax on the lenders the social policy underlying the housing subsidy program could not be publicly financed. After finding that the provision constituted a restriction on the free movement of capital, in that it discouraged homeowners from borrowing on an unsubsidized basis from non-resident banks, as well as a restriction on the free movement of services, in that it discriminated against financial institutions established in other member states lending in Luxembourg, the court distinguished \textit{Bachmann} and \textit{Belgium}, concluding that the provision could not be justified by the need to maintain the coherence of the tax system. The court noted that while, in \textit{Bachmann} and \textit{Belgium}, there was a “direct link between the deductibility of the contributions and the tax on the sums payable by the insurers under death and old-age insurance policies,” a link that had to be preserved in order to maintain the integrity of the fiscal regime, there could not be said to be any link between the grant of the interest rate subsidy to borrowers and the financing of the subsidy by means of the tax levied on financial institutions.\textsuperscript{52} The decision in \textit{Svensson} suggested that, in addition to the relevant link between the subsidy and the profits tax imposed to finance it being too remote, the direct link required in order to justify a restriction based on fiscal coherence may not be found in circumstances that involve two separate taxpayers. This is in contrast to the decisions
in *Bachmann* and *Belgium*, in which the court accepted the justification where the provisions in question were designed to ensure that the deduction in respect of insurance premiums would be available only if the same taxpayer would subsequently be subject to tax on payments made by the insurer under the policy.53

The requirement that there be a direct link between the tax disadvantage and the corresponding tax advantage involving the same taxpayer in order to justify an EC treaty restriction, on the basis that the restriction is necessary to preserve the fiscal cohesion of the member state’s tax system, was clarified in the court’s subsequent decision in *Baars*.54 In that case, the court considered the application of the “undertakings exemption” to the Dutch wealth tax, which was levied annually based on a percentage of the value of a Dutch resident’s worldwide assets. The undertakings exemption applied to businesses operated by or on behalf of a taxpayer if either the value of the assets of the undertaking did not exceed a specified threshold or if the taxpayer had a substantial holding in a corporation established in the Netherlands. The taxpayer in *Baars* owned all of the shares of an Irish company, and argued that restricting the exemption to substantial holdings in corporations formed under Dutch law constituted a violation of the EC treaty freedoms of establishment and capital movement. The court agreed, finding that the provisions discriminated against shareholders based purely on the member state in which the seat of the corporation was established, and thereby violated the freedom of establishment, which prohibits a member state from hindering the establishment in another member state of one of its own nationals. The Dutch government argued that the restriction of the undertaking exemption to shares held in companies having their corporate seat in the Netherlands was justified by the need to maintain cohesion in the Dutch tax system, because the exemption was designed to mitigate the effects, in economic terms, of double taxation arising from the profits of a corporation being subject to corporate income tax and the assets of the shareholder invested in that same company becoming subject to the wealth tax. Shares of a corporation that has its seat in another member state should not be entitled to qualify for the exemption from wealth tax, because the profits of the foreign corporation are not subject to corporate tax in the Netherlands and, as a result, there is no need to reduce the potential for double taxation. The court specifically rejected this argument, again distinguishing its holdings in *Bachmann* and *Belgium* based on the absence of a direct link between the implicated provision and the relevant tax advantage.55

The facts of the *Wielockx* case56 were similar to those considered by the court in *Bachmann*. The taxpayer, a Belgian resident and national, worked in the Netherlands as a self-employed physiotherapist, and sought to deduct pension reserve contributions. The Dutch tax authorities denied the deduction because the taxpayer was not resident in the Netherlands for tax purposes. The court noted, citing its decision in *Schumacker*,57 that while resident and non-resident taxpayers may not be similarly situated in every circumstance, where a non-resident taxpayer derives all or substantially all of his income from the member state in which he is employed, he should be regarded as being objectively in the same situation as a resident of that member state. Consequently, if he is not allowed the same deductions from taxable
income, his overall tax burden will be greater than that of a resident of the host member state, because his “personal situation will be taken into account neither by the tax authorities of the State where he works—because he is not resident there—nor by the State of residence—because he receives no income there.” The Dutch provision that denied the deductibility of pension reserves where a substantial part of the non-resident taxpayer’s income is derived from the Netherlands was thus found to be discriminatory, and in violation of the EC treaty freedom of establishment. The Netherlands sought to rely on Bachmann in order to justify the discriminatory effects of the provision, arguing that the pension payments could not subsequently be taxed by virtue of the Belgium-Netherlands income tax convention, which sourced the right to tax pension and annuity payments to the state of residence. The Netherlands argued that, as in the Bachmann and Belgium decisions, these payments would ultimately be exempt from Dutch tax, so that denying the deduction in respect of contributions to the reserve account preserved the fiscal coherence of the tax system, because there was a clear correlation between the amounts deducted from taxable income and those subsequently subject to tax. The court rejected this argument, and distinguished its prior case law as follows:

[T]he effect of double-taxation conventions which, like the one referred to above, follow the OECD model is that the State taxes all pensions received by residents in its territory, whatever the State in which the contributions were paid, but, conversely, waives the right to tax pensions received abroad even if they derive from contributions paid in its territory which it treated as deductible. Fiscal cohesion has not therefore been established in relation to one and the same person by a strict correlation between the deductibility of contributions and the taxation of pensions but is shifted to another level, that of the reciprocity of the rules applicable in the Contracting State.

Since fiscal cohesion is secured by a bilateral convention concluded with another Member State, that principle may not be invoked to justify the refusal of a deduction such as that in issue. The court in Wielockx thus held that the doctrine of fiscal cohesion cannot be relied upon as a justification for discrimination where the inconsistency in taxation arises by virtue of a tax treaty provision negotiated by the member state seeking to uphold the alleged discriminatory or restrictive legislation. In particular, the requisite degree of correlation between the discriminatory rule and the compensatory tax treatment cannot be satisfied in this circumstance, because the member state has, by concluding the treaty, effectively shifted the issue concerning cohesion of the tax system from the domestic to the bilateral treaty level. The exemption applied, by virtue of the relevant treaty, regardless of whether the contributions were deductible, and thus the direct link required between the disadvantage and the compensatory tax advantage could not be established. The conclusion of a tax treaty is, in other words, a form of fiscal coherence which, in and of itself, affects the balance between the particular discriminatory tax provision and the counterbalancing favourable tax treatment, and reflects the negotiations (and thus the preferences) of the member states that are parties to the convention in this regard.
Accordingly, while the European Court of Justice has accepted that preservation of the fiscal coherence of a member state’s tax legislation may, in some circumstances, justify an infringement of the fundamental freedoms, it has in its subsequent jurisprudence considerably limited the scope of this potential ground for justification. The court has required member states to demonstrate the existence of a direct link between the relevant tax disadvantage and the compensatory tax advantage, and has further narrowed the scope of this test so that both the disadvantage and the corresponding tax advantage must relate to the same taxpayer and in respect of the same taxes. Moreover, the compensatory advantage must arise solely by virtue of the domestic tax laws of the member state, not from the provisions of an applicable income tax treaty, which cannot justify the application of restrictive or discriminatory domestic tax legislation. As a result of these successive limitations of the scope of the test, it has become increasingly difficult for member states to satisfy the conditions for justifying an EC treaty restriction on the basis of fiscal coherence. Although a number of commentators have recently tended to favour a slightly more expansive approach to this ground of justification, the basis of fiscal cohesion has, in fact, been consistently rejected by the court in its decisions rendered since the Bachmann and Belgium cases, over 15 years ago, and it is unlikely that those cases would be decided in the same manner today.

Effectiveness of Fiscal Supervision

The European Court of Justice has held in Futura Participations S.A and Singer v. Administration des contributions that the effectiveness of fiscal supervision, or the need for a member state to maintain oversight over fiscal matters including tax administration and collection activities, may also, in some circumstances, justify a restriction of EC treaty fundamental freedoms. Futura Participations was a French corporation that carried on business through a Luxembourg branch. The branch determined its taxable income in the relevant taxation year in accordance with apportionment of income principles, allocating a share of Futura’s loss carryforwards to the Luxembourg branch. The government of Luxembourg denied the claim for deductibility of the apportioned losses carried forward on the basis that they failed to meet two conditions to the carryforward of a loss in the branch context under Luxembourg law: the losses were required to be economically related to income earned in Luxembourg, and accounts relating to the branch operations in Luxembourg were required to be maintained in Luxembourg and in accordance with applicable domestic rules. At issue before the court was whether the application of these two conditions to a foreign branch’s use of loss carryforwards constituted an infringement of the freedom of establishment provisions in article 43 of the EC treaty.

With respect to the first condition to the carryforward of losses, that they be economically linked to the income earned by the branch in Luxembourg, the court noted that, in contrast to resident taxpayers, who were subject to tax on a worldwide income basis, for the purpose of calculating the basis of assessment for non-resident taxpayers, only profits and losses arising from domestic sources were taken into account in computing their tax payable in Luxembourg, and concluded 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.”

The court did not elaborate on the meaning of the “territoriality” principle. It may be concluded, however, on the basis of the court’s decision in *Futura Participations*, that this principle may be viewed as a separate ground for justification of a tax provision that might otherwise constitute an infringement of the EC treaty fundamental freedoms and, in particular, the freedom of establishment.

However, with respect to the second condition to the carryforward of losses, that separate accounts be kept in respect of a non-resident corporation’s foreign branch activities in accordance with domestic rules, the court found that the condition, did, in principle, constitute an infringement of the freedom of establishment. The requirement specifically affected companies that had their corporate seat in another member state, which were thereby obligated to maintain two sets of records in accordance with different accounting standards. The member state governments argued that this condition was necessary in that it enabled taxable income in a particular member state to be ascertained by the tax authorities. The Luxembourg law that required a non-resident taxpayer to keep proper accounts relating to its activities in Luxembourg during financial years in which losses carried forward were incurred was justified by the need to ensure that the losses were in fact economically linked to the activities of the branch in Luxembourg and that the amount of the losses was properly computed in accordance with the principles of domestic tax law. The requirement that the accounts be retained in Luxembourg in the relevant taxation years was, it was argued, necessary in order to enable the Luxembourg tax authorities to audit or inspect the accounts at any time. The European Commission took a contrary view, arguing that while the effectiveness of fiscal supervision may constitute a valid ground for justification in some circumstances, because it constitutes a “pressing reason of public interest,” the condition regarding accounts was not essential for the attainment of this objective. In particular, the commission took the position that the Luxembourg tax authorities could ascertain the amount of losses at issue by simply referring to the accounts maintained by the non-resident taxpayer in its home jurisdiction. The commission argued further that, pursuant to the EC directive on mutual assistance, which contains exchange-of-information provisions similar to those contained in article 26 of the OECD model treaty, the Luxembourg authorities could in any event obtain tax information required for the purposes of determining the tax liability of the branch by way of a request made to the competent authorities of the taxpayer’s state of residence (in this case, France).

The court recognized that the “effectiveness of fiscal supervision constitutes an overriding requirement of general interest capable of justifying a restriction on the exercise of fundamental freedoms guaranteed by the Treaty,” such that a member state may apply measures intended to enable both the amount of income taxable in that state and the amount of any available loss carryforwards to be clearly and precisely ascertained. Noting that no provision had been made for the purposes of harmonizing domestic rules relating to the determination of the tax base under EC law in respect of direct taxation, the court concluded that as “Community law
stands at present and contrary to the Commission’s submission, the aims pursued by the second condition would not be attained if, in order to ascertain the constituent amounts of the basis of assessment, the Luxembourg authorities had to refer to accounts kept by the non-resident taxpayer pursuant to another Member State’s rules.”

However, the court went on to find that the second condition to the carry-forward of branch losses could not satisfy the proportionality test, and the provision thus could not be justified as a valid restriction of the freedom of establishment. The court held that the requirement that the branch accounts be maintained in Luxembourg was overly restrictive, and concluded as follows:

[O]nce such a request is made [for carryforward and application of branch losses], the sole concern of the Luxembourg authorities is to ascertain clearly and precisely that the amount of losses to be carried forward corresponds, under the Luxembourg rules governing the calculation of income and losses applicable in the financial year in which the losses were incurred, to the amount of losses actually incurred in Luxembourg by the taxpayer. Consequently, provided that the taxpayer demonstrates, clearly and precisely, the amount of the losses concerned, the Luxembourg authorities cannot refuse to allow him to carry them forward on the ground that in the year concerned he had not kept and not held in Luxembourg proper accounts relating to his activities in that State.

The *Futura Participations* decision is significant in that it contains a clear expression by the European Court of Justice that the legitimate interests of a member state in determining with precision the amount of a taxpayer’s income subject to tax and losses relevant to the computation of income may, in limited circumstances, justify a restriction of a fundamental EC treaty freedom under national law. The court in *Futura Participations* did indicate that while accounts maintained in the taxpayer’s state of residence were accessible to the Luxembourg tax authorities through the exchange-of-information provisions in the mutual assistance directive, this fact could not negate the need for effective fiscal supervision, because such accounts would not generally be prepared in accordance with the tax accounting rules applicable in Luxembourg and, thus, any information obtained pursuant to the directive could well be insufficient for the purposes of enabling the taxable income and losses of the Luxembourg branch to be determined.

However, the court has consistently required member states to obtain tax information through procedures such as the EC mutual assistance directive before seeking to rely on the court’s rule of reason doctrine in order to justify restrictive national tax provisions. This principle is well illustrated by the decision in the *Vestergaard* case, in which the court considered a provision of Danish law that restricted the deductibility of expenses incurred by a taxpayer in participating in professional courses held at tourist resorts outside Denmark. Although the costs relating to professional education courses held in tourist resorts situated in Denmark were deductible, the provision in issue effectively created a presumption that participation in a conference held at a foreign tourist resort was a non-deductible personal expenditure because it was considered to involve a significant tourism component. The taxpayer was an accountant resident in Denmark who sought to deduct the costs of a tax training
course he attended in Crete, which was organized by a Danish firm. The court held that the presumption constituted a restriction of the EC treaty freedom to provide services, contrary to article 49 of the treaty, because it subjected the professional courses offered by conference organizers to less favourable tax treatment when offered outside Denmark. In reaching its conclusion, the court rejected the argument that the provision could be justified as required in the interests of fiscal supervision, on the basis that the presumption enabled the amount of deductible expenses to be ascertained clearly and precisely for Danish tax purposes. The court noted that the mutual assistance directive enabled the Danish tax authorities to obtain from the competent authorities of other member states any information they required for the purposes of verifying the other states’ legislative conditions concerning the deductibility of professional education expenses. If such information was insufficient, the Danish tax authorities could in any event require the taxpayer himself to produce the proof they needed in order to assess whether or not the deduction of such expenses should be allowed.\(^74\)

Accordingly, although a member state’s need to maintain effective fiscal supervision, including the ability to access the tax information required in order to treat resident and non-resident taxpayers in an equivalent manner, may constitute a justification for restrictive national tax legislation, the court has tended to interpret it narrowly. Under this approach, the court has required member states to obtain tax information through means otherwise available to them, such as directly from the taxpayer as part of the audit function or through the competent authority of the home state or state of residence pursuant to the mutual assistance directive, before accepting that a national tax measure enacted with this express purpose may be justified as a valid restriction of a fundamental EC treaty freedom.

**Prevention of Tax Avoidance and Fiscal Abuse**

The European Court of Justice has also, in a number of recent judgments, affirmed that the prevention of tax avoidance may, in principle, constitute a valid justification for restriction of EC treaty freedoms. The rationale for this ground of justification has been expressed by Weber as follows:

> The prevention of avoidance of direct taxation is, in light of Community law, a legitimate objective. The authority to levy direct taxes lies with the Member States. This means that the Member States must be able to exercise this authority properly and be allowed to counteract avoidance of the national legal system. The prevention of tax avoidance thus becomes an objective that has to be respected by Community law.\(^75\)

Although early non-tax case law of the European Court of Justice established an avoidance doctrine pursuant to which the benefits of EC law could be denied in circumstances of fraud, avoidance, and abuse, and under which member states could restrict EC treaty freedoms by adopting measures intended to prevent such abuse,\(^76\) the court initially appeared to reject tax avoidance as a valid basis for justification in its jurisprudence concerning direct taxation. An early example is the *Avoir Fiscal*
case,\textsuperscript{77} in which the European Commission challenged French legislation that denied the dividend imputation credit to non-resident insurance companies with branch operations in France (among other non-resident shareholders). Noting that the freedom of establishment contained in the EC treaty by its nature entails the right to carry on business in a member state either in corporate form or through a branch, the court found that the French provision unfairly disadvantaged non-resident corporations that carried on business in France through a permanent establishment and thereby contravened the freedom of establishment provisions in article 43 of the treaty, concluding that there could not be said to be an objective distinction between a subsidiary and a branch for this purpose.\textsuperscript{78} The French government had argued that restricting the credit to shareholders resident in France was necessary in order to prevent avoidance of tax. In particular, it was concerned that if French branches of corporations resident in other member states were entitled to the avoir fiscal credit, they could proceed to transfer all of the shares in French corporations otherwise held by them to the branch, even if those holdings were not otherwise connected with the branch operations, in order to benefit from the credit. The court rejected this argument, stating as follows:

[T]he risk of tax avoidance cannot be relied upon in this context. Article [43] of the [EC] Treaty does not permit any derogation from the fundamental principle of freedom of establishment on such a ground. Moreover, the Court is not convinced by the calculations submitted by the French government for the purpose of showing that if the benefit of shareholders’ tax credits was granted to branches and agencies of companies whose registered offices are in other Member States, those companies would be prompted to include the shares they hold in French companies among the assets of their branches and agencies in France. Those calculations are based on the hypothesis, which finds no support in [the relevant French legislation], that the transfer to the place at which the company has its registered office of profits made by branches or agencies would in its turn benefit from the shareholders’ tax credit; nor has the Commission sought in these proceedings to have the benefit of the tax credit extended to such cases.\textsuperscript{79}

Notwithstanding its comments in the 	extit{Avoir Fiscal} case, the court has subsequently recognized the prevention of abuse as a valid ground of justification in direct taxation cases.\textsuperscript{80} In 	extit{Imperial Chemical Industries},\textsuperscript{81} the court considered a restriction under UK law that denied group tax relief to the applicant, a corporation resident in the United Kingdom, because the majority of its subsidiaries were resident outside the United Kingdom. ICI, together with another UK corporation, beneficially owned all of the shares of a UK holding company (Coopers). Coopers held shares in a number of subsidiaries, the majority of which were resident in non-EU member states. One of Coopers’s UK subsidiaries suffered a loss in the relevant taxation year, which ICI sought to deduct against its income in accordance with the UK group relief rules. The court concluded that the UK measure violated the freedom of establishment provisions contained in article 43 of the EC treaty.\textsuperscript{82} Because the legislation at issue used the residence of the taxpayer corporation’s subsidiaries as the criterion for
granting or denying group relief to UK taxpayers, the court found that the provisions contravened community law. The UK government sought to justify the denial of group relief where the majority of the parent holding company’s subsidiaries were established outside the United Kingdom on the basis that the restriction was necessary in order to prevent tax avoidance. In particular, it argued that the situations of resident and non-resident companies could not, for the purposes of direct taxation, generally be regarded as comparable. The limitation was necessary in order to reduce the ability of members of a corporate group to shift expenses of non-resident subsidiaries to subsidiaries resident in the United Kingdom, and to shift profits of resident subsidiaries to non-resident subsidiaries, thereby reducing UK tax, and thus to “prevent the creation of foreign subsidiaries from being used as a means of depriving the United Kingdom Treasury of taxable revenues.”

A further objective of the legislation, argued the UK government, was to prevent a reduction in revenues caused by allowing losses of resident subsidiaries to offset group profits while the income of non-resident subsidiaries was not subject to tax in the United Kingdom. The court expressly rejected these grounds of justification. While the court in ICI appeared to recognize that the reduction of tax avoidance may indeed constitute a valid justification for the restriction of fundamental EC treaty freedoms, it indicated that a high threshold must be satisfied by a member state seeking to rely on this ground. On the facts of ICI, the UK restriction was not, in the court’s view, specific enough to address the objective advanced in its support; it applied in all circumstances as a “bright-line” test even in the absence of specific indicia of tax avoidance, and without regard to whether the non-UK subsidiaries were even subject to tax in their respective states of residence. This test was viewed as entirely unrelated to the risk of tax avoidance advanced in support of the legislation’s justification, which the court indicated would presumably have existed to the same potential degree even if there were only a single foreign subsidiary within the group.

The court applied equivalent principles in Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt. This decision considered the German thin capitalization provisions, which deemed interest payments on non-arm’s-length intercompany debt to be recharacterized as dividends to the extent that a specified debt-to-equity ratio was exceeded. The restrictions applied only to taxpayers that received the advance from a shareholder that was not entitled to claim the German corporation tax credit and to the extent that the particular loan could not otherwise have been obtained on arm’s-length terms from a third-party lender. As a result of these conditions, the thin capitalization provisions effectively applied only to taxpayers that borrowed from either related non-resident or German tax-exempt shareholders. The court found the German thin capitalization provisions to be overly broad in achieving the objective of preventing tax avoidance, apparently on the basis that the restrictions applied simply by virtue of the fact that a non-resident parent company financed its subsidiary with debt, regardless of whether indicia of avoidance were present on the facts. The court appeared to accord substantial weight to the fact that the interest expense deducted by the taxpayer exceeded its taxable income in the relevant taxation years, giving rise to losses, as well as to subjective factors underlying the particular business
reasons for which the advance was made (for the specific purpose of reducing the taxpayer’s arm’s-length borrowings). The court’s conclusions in *Lankhorst-Hohorst* thus confirm that a significant threshold must be satisfied before a provision may be justified on the grounds of prevention of tax avoidance and fiscal abuse. The potential loss of tax revenue may not, in and of itself, justify restrictive or discriminatory tax legislation. In addition, and perhaps most significantly, the court appears to require that a particularized finding of fraud exist on a subjective or case-by-case basis under the national tax measure. It was insufficient, for this purpose, that in *Lankhorst-Hohorst* the relevant provision under German national law required (1) that the loan advanced exceed the statutory debt-to-equity ratio, (2) that the German subsidiary could not have obtained the loan capital from a third party under otherwise similar circumstances, and (3) that the loan failed to constitute a borrowing to finance normal banking transactions. Although these conditions could arguably be viewed as indicia of excess leverage compared with capitalization of an enterprise on arm’s-length terms, and thus may cumulatively signify an avoidance transaction, the court still required that the domestic law account for these subjective factors, having regard to the facts related to the particular borrowing at issue, including consideration of the benefits to the taxpayer of the deduction of interest expense in respect of the intercompany debt. This would include a determination as to whether the shareholder was itself subject to tax in the foreign member state; on the facts before the court, the lender, which was the indirect Dutch parent company of the German taxpayer, was, for example, subject to tax under Dutch domestic law.

The court has upheld this high standard in its subsequent tax jurisprudence, and has continued to require that member states demonstrate that a particularized finding of fraud or abuse exists in order to justify restrictive or discriminatory national tax measures that seek the prevention of either tax avoidance or evasion. A more recent example of the application of this standard is reflected in the court’s reasoning in *de Lasteyrie du Saillant*, which was the first decision in which the European Court of Justice directly addressed whether domestic exit or departure tax provisions imposed by a member state could be regarded as consistent with the EC treaty fundamental freedoms. The French measure at issue applied to individuals who emigrated from France after having resided there for tax purposes in at least 6 of the 10 years immediately prior to emigration. The departure tax was imposed on appreciated gains in securities in which the taxpayer, together with related parties, held a substantial interest (defined to mean an entitlement representing at least 25 percent of the profits of the underlying company). The tax could be deferred until the stock was actually disposed of upon the provision of adequate security by the emigrant. If the taxpayer continued to hold the securities 5 years following the date of emigration, or re-established tax residence in France within that time and continued to own the securities, the liability for exit tax would effectively be reversed. The taxpayer ceased to be resident in France and settled in Belgium, where he intended to carry on his business, and he argued that the imposition of the French departure tax precluded him from effectively exercising his freedom of establishment. The European Court of Justice agreed, adding that the fact that a taxpayer...
seeking a transfer of residence to a foreign member state would, simply by virtue of the exercise of his freedom of establishment in that regard, become liable to tax on unrealized accrued gains constitutes a restriction on the exercise of the freedom of establishment, because he would thereby be subjected to disadvantageous treatment in comparison to a taxpayer who continued to maintain his residence in France. Moreover, the security provisions, which essentially operated as a form of guarantee, were considered in and of themselves to have a restrictive effect and, because the benefit of the deferral was conditional upon the satisfaction of the security requirements, could not therefore preclude the departure tax provisions from contravening the freedom of establishment. The court further rejected the arguments advanced by the French government in support of the provision on the basis that the departure tax was designed to prevent taxpayers from temporarily relinquishing French residence for tax purposes immediately prior to a disposition of securities with the intention of avoiding the French capital gains tax imposed on accrued gains. The French government had maintained that the provisions in question should be regarded as proportionate to their underlying objective in light of the 5-year “look-forward” period within which the disposition was required to occur as a precondition to the application of the exit tax legislation, which operated to ensure the effectiveness of the system and prevent avoidance or abuse by means of an establishment of short duration abroad. The court again emphasized that a specific finding of avoidance or abuse was required in order to justify a restrictive or discriminatory tax measure on grounds of tax avoidance. It noted that the indicia of avoidance referred to by the French government could not be considered to detract from the fact that the impugned provisions applied generally to all individual taxpayers who ceased to be resident in France, and were thus overly broad and, as a result, incapable of being justified under the court’s rule of reason doctrine.

In the still more recent case of Cadbury Schweppes plc and Cadbury Schweppes Overseas Ltd., the court held that the requisite specific finding of avoidance or abuse must be determined having regard to economic realities. The court commenced its analysis in the case by noting that the mere fact that Cadbury Schweppes plc determined to establish its Irish subsidiaries pursuant to the international financial services centre (IFSC) regime for the express purpose of benefiting from the favourable tax rate could not in itself constitute abuse that would preclude reliance by the taxpayer on the provisions of the EC treaty. Although the court did recognize that, pursuant to its prior jurisprudence, nationals of a member state may not attempt, under cover of the rights created by the treaty, to improperly circumvent national legislation by fraudulently relying on provisions of community law, the mere fact that a taxpayer seeks to profit from tax advantages in force in a member state other than its state of residence cannot, in and of itself, deny the taxpayer the right to rely on the guarantees in the EC treaty. The court reiterated that the mere fact that a corporation is established in a member state for the purpose of benefiting from more favourable legislation, including applicable corporate tax provisions, does not in itself suffice to constitute abuse of that freedom. The UK government, supported in its arguments by the governments of the intervening member states, argued that the controlled
foreign company (CFC) legislation was intended to counter a specific type of tax avoidance, which involves the artificial transfer by a resident corporation of profits from the member state in which they were earned to a low-tax member state by means of the establishment of a subsidiary in that state, and the implementation of subsequent transactions intended principally to effect the transfer of profits to that subsidiary. The court noted, however, that it is settled law that any advantage resulting from the low rate of taxation applicable to a subsidiary established in a member state other than that in which the parent company was formed cannot by itself authorize that member state to offset the advantage by less favourable tax treatment of the parent corporation, because prevention of the reduction of tax revenues is not one of the grounds of public interest specifically listed in article 46(1) of the EC treaty or a matter of overriding general interest that would justify a restriction of the treaty’s fundamental freedoms. Similarly, the mere fact that a resident corporation establishes a secondary establishment, such as a subsidiary corporation, in a foreign member state cannot itself give rise to a general presumption of tax evasion sufficient to justify a measure that compromises the exercise of a fundamental freedom guaranteed by the EC treaty. Pursuant to the court’s decisions in ICI, Lankhorst-Hoborst, de Lasteyrie du Saillant, and Marks & Spencer, a national measure restricting freedom of establishment may be justified only where it specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the member state concerned. The court noted that it is necessary, in assessing the conduct of the taxpayer in this regard, to take particular account of the objectives underlying the freedom of establishment, which are intended to enable a national of one member state to set up a secondary establishment in another member state for the purpose of carrying on its activities there. This provision is designed to assist in economic and social integration within the European Community so that community nationals may participate, on a stable and continuing basis, in the economic life of a member state other than their own state of origin, and to profit therefrom.96

The court recognized, in its reasoning, that the CFC provisions may have been intended to prevent resident corporations from engaging in transactions whose sole purpose is to reduce taxation in respect of profits generated by activities carried on in the high-tax jurisdiction; this intention was evident, for example, by the pre-condition in the provisions that the subsidiary be subject to a “lower level of taxation” in its state of residence. Similarly, the UK CFC legislation provided for a number of exceptions that exempted resident corporations from the application of these rules in circumstances where the existence of wholly artificial arrangements entered into purely for tax purposes would be disregarded. For example, the CFC provisions were inapplicable where (1) the CFC adopted an “acceptable distribution policy,” pursuant to which a specified percentage of its profits were distributed within 18 months of being earned and taxed in the hands of a resident corporation; (2) the CFC was engaged in “exempt activities,” including certain trading and other active business activities; (3) at least 35 percent of the voting rights of the subsidiary were publicly held and its shares were listed and traded on a recognized stock exchange; (4) the CFC was resident in a territory listed in the “excluded countries” regulations and
satisfied specified requirements in respect of its income or gains; or (5) the chargeable profits of the CFC did not exceed £50,000, so that the de minimis exception applied. Furthermore, the legislation expressly provided for a “motive test,” under which the CFC rules would not apply if two conditions were satisfied: first, the resident corporation could demonstrate that any reduction in UK tax arising by virtue of the transactions at issue was not the main purpose, or one of the main purposes, of those transactions; and, second, that the resident corporation could demonstrate that the main reason, or one of the main reasons, for the CFC’s existence in the accounting period concerned was not to achieve a reduction in UK tax by means of the diversion of profits that would otherwise have been received by, and taxable in the hands of, a resident of the United Kingdom.97 Notwithstanding these specific provisions, however, the court held that the “fact that none of the exceptions provided for by the legislation on CFCs applies and that the intention to obtain tax relief prompted the incorporation of the CFC and the conclusion of the transactions between the latter and the resident company does not suffice to conclude that there is a wholly artificial arrangement intended solely to escape that tax.”98 In making this determination, the court held, an extremely high threshold must be satisfied:

In order to find that there is such an arrangement there must be, in addition to a subjective element consisting in the intention to obtain a tax advantage, objective circumstances showing that, despite formal observance of the conditions laid down by Community law, the objective pursued by the freedom of establishment . . . has not been achieved . . .

In those circumstances, in order for the legislation on CFCs to comply with Community law, the taxation provided for by that legislation must be excluded where, despite the existence of tax motives, the incorporation of a CFC reflects economic reality.

That incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host Member State. . . .

As suggested by the United Kingdom government and the Commission at the hearing, that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment.

If checking those factors leads to the finding that the CFC is a fictitious establishment not carrying out any genuine economic activity in the territory of the host Member State, the creation of that CFC must be regarded as having the characteristics of a wholly artificial arrangement. That could be so in particular in the case of a “letter box” or “front” subsidiary. . . .

On the other hand . . . the fact that the activities which correspond to the profits of the CFC could just as well have been carried out by a company established in the territory of the Member State in which the resident company is established does not warrant the conclusion that there is a wholly artificial arrangement.

The resident company, which is best placed for that purpose, must be given an opportunity to produce evidence that the CFC is actually established and that its activities are genuine.99

In its judgment in Cadbury Schweppes, the court thus held that, in order to justify a restrictive or discriminatory anti-abuse measure on grounds of tax avoidance, it is
necessary to demonstrate that the restriction relates specifically to wholly artificial arrangements aimed solely at avoiding national tax normally due, where the measure is proportional to the purpose sought to be achieved and does not go beyond what is necessary to achieve that object.\textsuperscript{100} In order to conclude that there is a wholly artificial arrangement justifying the restriction of the particular EC treaty freedom at issue, the court will require, in addition to the requisite subjective element emphasized in the court’s prior jurisprudence described above, that the resident corporation be given an opportunity to produce evidence of the objective and ascertainable factors relating to the arrangement, including, in the case of CFC legislation, the extent to which the subsidiary has economic substance, in terms of its premises, staff, and equipment.\textsuperscript{101} In effect, an analysis of the proportionality of restrictive or discriminatory anti-abuse provisions must involve a review of both objective and subjective factors in considering whether the specific finding of avoidance or abuse required in order to justify the tax measure may be satisfied. In this regard, the court refused to render a decision on the basis of the facts at hand, noting that it was for the national court to determine whether, as maintained by the UK government, the motive test under the CFC rules could be considered to lend itself to an interpretation that takes account of both subjective and objective criteria such as those referred to above. As a matter of community law, a national anti-abuse provision may not be justified under the court’s rule of reason on grounds of tax avoidance unless the transactions at issue relate only to wholly artificial arrangements intended to avoid domestic taxation. In the context of CFC legislation, such a tax measure must not, therefore, be applied where it is proven, on the basis of objective factors that are ascertainable by third parties, that despite the existence of tax motives the controlled foreign corporation is in fact duly established in the host member state and carries on genuine economic activities there.\textsuperscript{102}

REJECTED GROUNDS OF JUSTIFICATION

This section of the article reviews a number of the grounds of justification that have been advanced by member states in seeking to have the European Court of Justice uphold discriminatory or restrictive national tax measures under the rule of reason doctrine, but that have been expressly rejected by the court. These include the lack of EC harmonization concerning the impugned national tax measure, the potential loss of tax revenue and erosion of the domestic tax base, the existence of counterbalancing tax advantages, and the availability of an alternative legal or business form. Each of these grounds is considered in turn.

Lack of EC Harmonization

The European Court of Justice has consistently rejected arguments advanced by member states seeking to justify discriminatory or restrictive national tax legislation on the basis of a lack of harmonization within the European Community concerning the particular measure at issue. In a number of cases concerning direct taxation, member states have argued that the measure under consideration was required as a
direct result of the fact that the tax legislation enacted by the various member states had not yet been harmonized at the national level, so that it became imperative for each state to introduce independent measures in order to take into account existing differences, or disparities, between the national tax systems. A direct corollary implied by this line of argument is that, in the absence of the contested measure, taxpayers resident in a particular member state could take advantage of the differences in the tax laws of other member states and, in this manner, engage in avoidance transactions that one or both states should be entitled to counter unilaterally through the enactment of domestic legislation. An argument of this nature was advanced by the French government in the early *Avoir Fiscal* case. The French government argued that the denial of avoir fiscal credits to branches of foreign corporations could be justified on the grounds that the measure was discriminatory only because the other member states had not harmonized their legislation to accord with the rules applicable in France. It further noted that France did grant the benefits of the imputation credit to branches of foreign EU member states with which France had concluded an income tax convention and that, to the extent that the measure was discriminatory in its effect, this was a direct result of a lack of harmonization with respect to tax treaties concluded between EU member states. The court concluded, however, that the lack of harmonization of direct taxation within the European Community could not justify a discriminatory or restrictive national measure.

The court’s approach to reliance on lack of community harmonization as a basis for justification in direct taxation cases appears to differ from the reasoning adopted by the court in its non-tax jurisprudence, in which this ground appears to have been recognized in limited circumstances. In the *Daily Mail* case, for example, the taxpayer, an investment holding company, applied for the consent of the UK Treasury to transfer its central management and control from the United Kingdom to the Netherlands, while still retaining its corporate status under UK law. The principal reason for the proposed transfer of central management and control was to enable the taxpayer, after establishing its residence in the Netherlands for tax purposes, to sell a significant portion of its capital assets, which had appreciated significantly, and to use the proceeds to redeem its shares, without attracting UK capital gains tax on the accrued gains. The UK Treasury took the position that, as a precondition to the grant of the government consent that the taxpayer needed in order to transfer corporate residence from the United Kingdom while retaining its corporate existence there, Daily Mail should trigger part of the accrued gain while still resident in the United Kingdom for tax purposes, a position that the taxpayer argued was contrary to its freedom of establishment under article 43 of the EC treaty. The court noted that, unlike natural persons, corporations are “creatures of national law,” and exist only by virtue of the various national statutory provisions that determine the conditions for their incorporation and function. It cited article 48 of the treaty, which 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 shall . . . be treated in the same way as natural persons who are nationals of Member States” as support for the proposition that the EC
treaty has specifically recognized the significant variance among the domestic laws of member states in this area, placing on equal footing, as connecting factors, the registered office, central administration, and principal place of business of a company.\textsuperscript{106} The court concluded, on this basis, that the freedom of establishment in article 43 of the treaty could not, in the present state of community law, be interpreted as conferring a right on a company incorporated under the legislation of a member state and having its registered office there to transfer its central management and control to another member state while still retaining its status in the former member state.\textsuperscript{107}

The distinction drawn between the court’s position in tax cases such as \textit{Avoir Fiscal}, in which the lack of EC harmonization was held not to constitute a valid ground of justification under the rule of reason doctrine, and non-tax jurisprudence such as \textit{Daily Mail}, in which the fundamental freedoms in the EC treaty were held not to apply due to a lack of conformity in the national corporate laws enacted by member states governing a transfer of central management and control, may be attributable to the provisions in the treaty. Article 48 does, indeed, expressly recognize this variance in domestic law, though the treaty is silent as to the scope for distinction between the laws of member states governing direct taxation. Although this basis for distinction appears to have been accepted by some commentators,\textsuperscript{108} it seems to rely on an extremely broad, and arguably unintended, scope of interpretation of article 48. In any event, the court has clearly held, in contrast to its jurisprudence in the corporate law field, that the lack of harmonization of EC law may not be relied upon by member states to justify discriminatory or restrictive national tax measures under the rule of reason.

**Reduction in Tax Revenues**

As described above, the European Court of Justice has, in numerous tax judgments, also definitively rejected arguments advanced by member states to the effect that a particular national tax measure should be justified as necessary in order to prevent the loss of tax revenues or erosion of the member state’s tax base. In the \textit{de Lasteyrie du Saillant} case, for example, in which the court held that the French departure tax provisions violated the freedom of establishment provisions in the EC treaty, the Danish government intervened in order to argue that the purpose of exit tax provisions was to prevent fiscal erosion of the tax base of the member state concerned, by precluding taxpayers from deriving tax advantages from distinctions between the tax systems of the various member states. The court responded to this argument as follows:

\begin{quote}
In that respect, it is sufficient to recall that, in accordance with settled case-law, diminution of tax receipts cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify a measure which is, in principle, contrary to a fundamental freedom.\ldots Therefore, a simple loss of receipts suffered by a Member State because a taxpayer has moved his tax residence to another Member State, where the tax system is different and may be more advantageous for him, cannot in itself justify a restriction on the right of establishment.\textsuperscript{109}
\end{quote}
In its consideration of the compatibility of the German thin capitalization rules with the EC treaty freedoms in *Lankhorst-Hoborst*, the court similarly rejected this basis for justification of the anti-avoidance provisions, concluding that it is “settled law that reduction in tax revenue does not constitute an overriding reason in the public interest which may justify a measure which is in principle contrary to a fundamental freedom.” The court’s rejection of erosion of the domestic tax basis or a potential reduction in tax revenues as a ground for justification of the violation of an EC treaty provision is consistent, in many respects, with its determination as to when an anti-avoidance provision may be justified under the rule of reason. As outlined in detail above, the court has held that overly broad anti-avoidance measures, or avoidance provisions of general application, cannot satisfy the preconditions to the application of the rule of reason and will not, therefore, be justified as supporting an overriding purpose in the public interest.

**Counterbalancing Tax Advantages**

In the *Avoir Fiscal* case, the French government argued that it was justified in failing to extend shareholder-level imputation credits generally available to resident corporations to branches of foreign companies, because any disadvantage attributable to this difference in treatment was amply compensated for by various tax and fiscal advantages enjoyed by branches of foreign corporations in comparison to domestic French corporations, such as the exemption from various charges (capital duties, for example) imposed on incorporated entities. The European Court of Justice did not accept this argument, finding that even if counterbalancing advantages of this nature did exist, they could not justify a breach of fundamental freedoms contained in the EC treaty. The court has ruled consistently on this basis in its subsequent tax jurisprudence.

In *The Queen v. Inland Revenue Commissioners, ex parte Commerzbank AG*, the court held that a provision of UK law that denied refund interest on tax overpayments to non-resident taxpayers was discriminatory, and could not be justified under its rule of reason doctrine. Commerzbank was a financial institution incorporated under German law and resident in Germany for tax purposes. Its UK branch had made a number of loans to US corporations in respect of which it paid tax in the United Kingdom, but was entitled to a refund of that tax under the UK-US income tax treaty. The UK government argued that, far from suffering discrimination under the domestic tax provisions at issue, non-resident corporations such as Commerzbank AG enjoyed preferential treatment: they were specifically exempted (pursuant to the applicable provisions of the treaty) from tax on interest received on loans made to residents of the United States, in contrast to corporations resident in the United Kingdom, which were subject to corporate tax on the interest so received. In these circumstances, the UK government argued, there could not be said to be discrimination by virtue of the denial of the repayment supplement (the refund interest at issue), because non-resident companies were not subject to tax on the income received; resident and non-resident corporations were treated differently precisely because,
for corporate tax purposes, they were in different situations. The court refused to accept this argument, concluding that where “a non-resident company is deprived of the right to repayment supplement on overpaid tax to which resident companies are always entitled, it is placed at a disadvantage” by comparison, and the fact that the “exemption from tax which gave rise to the refund was available only to non-resident companies cannot justify a rule of a general nature withholding the benefit.”

Similarly, in Eurowings the court refused to accept the argument that a counter-balancing tax advantage, in this case low tax rates in the non-resident’s home state (Ireland), could justify a restrictive national tax measure. The German legislation at issue required a portion of rental payments made for fixed business assets leased by a taxpayer to be added back in computing income for tax purposes unless the lessor of those assets was also subject to the German trade tax. A similar provision applied for capital tax purposes, and required that leased assets be included in the lessee’s capital tax base unless the lessor was subject to capital tax in Germany. The German tax authorities assessed trade tax payable on half of the lease payments made by Eurowings, a German airline company, on an aircraft leased by it from an Irish company, as well as capital tax payable on the value of the aircraft. Eurowings argued that the legislation violated the freedom to provide services pursuant to article 49 of the EC treaty. The European Court of Justice agreed, rejecting the German government’s argument that the provisions could not be regarded as discriminatory because their application depended on whether the lessor was subject to the relevant trade and capital taxes, such that even leases originated by German lessors could in some circumstances trigger the application of the tax. The court recognized that, in the vast majority of cases, leases originated by German-resident lessors would be exempt from the tax, whereas the legislative exceptions could never apply in respect of a lease of property by a non-resident, since these taxpayers were not subject to German trade or capital taxes. The court also concluded that both the service provider and the service recipient could rely on the individual rights conferred by the freedom to provide services, contrary to the arguments of the German government that Eurowings should not have standing to challenge a restriction of the freedom of the Irish company to provide services within Germany. With respect to its justification of the national tax provisions, the German government argued that the court should take into account the fact that the lessor, an Irish company, was not subject to a tax comparable to the trade or capital taxes levied by Germany and enjoyed access to a preferential (then 10 percent) corporate tax rate. It claimed that such “tax advantages might be sufficient . . . to outweigh the theoretical restriction of the freedom to provide services and mean that if the lessor enjoys the same exemptions as regards add-back as lessors established in Germany the latter would suffer discrimination.” Not surprisingly, the court rejected this argument, noting that such compensatory tax arrangements “prejudice the very foundations of the single market.” The court went on to hold that any “tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State.”
Change in Form

Although it may appear to be contrary to the principles underlying the fundamental freedoms in the EC treaty, member states have, on occasion, attempted to justify a domestic tax measure on the basis that it would no longer be discriminatory or restrictive in its effect if the taxpayer simply adopted an alternative legal or business form. This argument would, if accepted, negate to a significant extent the protections afforded by the EC treaty, a result that the European Court of Justice has recognized in rejecting this ground as a basis for application of the rule of reason doctrine. The French government also advanced this potential ground in the Avoir Fiscal case. It argued that non-resident insurance companies could obtain the benefits of the avoir fiscal system simply by incorporating and carrying on business through a French subsidiary corporation, which would then be entitled to claim the imputation credits at issue for the purposes of relieving the incidence of economic double taxation. The court disagreed with the notion that the French legislation denying the credit to branches of non-resident corporations could be justified on the basis that these disadvantages could be avoided through incorporation of a subsidiary resident in France. It recognized that the underlying freedom of establishment contained in article 43 of the EC treaty specifically mandated that taxpayers were entitled to carry on business in other member states through the legal form of their choosing. This principle forms the basis of the fundamental rights underlying the EC treaty provision, and does not allow a discriminatory or restrictive measure to be justified on the basis that disadvantageous treatment would not arise if an alternative business form were used.119

De Minimis Threshold

The court has further limited the scope for member states to justify restrictive national tax measures by refusing to adopt a de minimis threshold in applying its rule of reason doctrine. In the Metallgesellschaft and Hoechst decisions,120 the court refused to justify a UK provision that denied availability of a domestic group election that enabled advance corporation tax (ACT) payments to be deferred where the dividend recipient was a non-resident, even though the sole detriment suffered was the corresponding cash flow disadvantage related to the prepayment of tax on account under the (former) ACT regime. A similar result was reached in Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue,121 in which the court concluded that the free movement of capital provisions in article 56 of the EC treaty preclude domestic tax provisions (in this case, the now repealed UK franked investment income rules) that have the effect of taxing foreign dividends in a manner less favourable than the equivalent national taxation of domestic dividends, even if this distinction merely results in a cash flow disadvantage to the taxpayer.122 Similarly, the court has consistently adopted the position that considerations of an administrative nature cannot justify derogation by a member state from the rules of community law.123 We have already seen that the court has refused to justify a national tax measure on the basis of fiscal supervision where the relevant tax information may be
obtained through other means, including pursuant to the EC mutual assistance directive.\textsuperscript{124} This principle is also illustrated by the court’s decision in Biebl,\textsuperscript{125} in which the taxpayer, a German national employed in Luxembourg for part of the 1983 taxation year, argued that a Luxembourg domestic provision precluding the repayment of overwithheld taxes where the taxpayer was employed during only part of the relevant taxation year constituted covert discrimination, because it detrimentally affected non-residents of Luxembourg. The court agreed, refusing to accept, as a ground of justification, the fact that a non-contentious administrative procedure was available pursuant to which temporarily resident taxpayers could obtain repayment of an overdeduction of tax by demonstrating that they were subject to unfair treatment in the particular circumstances by virtue of the application of the provision.\textsuperscript{126}

**MARKS & SPENCER: A CRACK IN THE RULE OF REASON?**

In its decision in *Marks & Spencer plc*, the European Court of Justice considered the application of the rule of reason doctrine in the context of a claim made by the taxpayer under the United Kingdom’s group relief rules, which allowed UK parent companies to offset losses of group companies incurred in the United Kingdom against the profits of other group companies in specified circumstances.\textsuperscript{127} A number of Marks & Spencer’s EU subsidiaries had incurred substantial losses in the member states (Belgium, Germany, and France) in which they carried on business, which the taxpayer claimed in computing its income for UK tax purposes, even though the group relief system restricted the deductibility of losses to those incurred by corporations that carried on business in the United Kingdom. The court agreed with the taxpayer’s argument that the exclusion of the advantages of group relief in respect of the losses incurred by a subsidiary established in a foreign member state that does not conduct any trading activities in the member state of the parent company restricts the parent company’s freedom of establishment by deterring it from establishing subsidiaries in other member states, insofar as the group relief system treats losses incurred by a resident subsidiary differently from those incurred by a non-resident subsidiary. In the words of the court: “[A]cceptance of the proposition that the Member State in which a company seeks to establish itself may freely apply to it a different treatment solely by reason of the fact that its registered office is situated in another Member State would deprive Article 43 of all meaning.”\textsuperscript{128} However, the court went on to hold that the restriction of the freedom of establishment by the group relief rules could be justified under the court’s rule of reason doctrine, for three specific reasons.

First, the court noted, referring to its decision in *Manninen*,\textsuperscript{129} that while reduction in tax revenues could not be regarded as an overriding reason in the public interest that may be relied upon to justify a measure that is in principle contrary to a fundamental freedom, in a situation like the one before the court,

it must be accepted that by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the
parent company’s Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognized by Community law [in such cases as the *Futura Participations* decision].

However, the fact that the member state of the parent company refrained from taxing the profits of the parent’s non-resident subsidiaries was found to be insufficient, in and of itself, to justify restricting group relief to losses incurred by resident subsidiaries. The court then went on to state:

> [As the United Kingdom rightly observes, the preservation of the allocation of the power to impose taxes between Member States might make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses.]

> In effect, to give companies the option to have their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardize allocation of the balance of power to impose taxes between Member States, as the taxable basis would be increased in the first State and reduced in the second to the extent of the losses transferred.

Thus, while the court appeared to reject the territoriality principle as an independent ground of justification, at least in theory, it did accept the principle that a restrictive national tax measure may be justified in its differential treatment of resident and non-resident taxpayers where there is a need to preserve the allocation of taxing rights between EU member states. Profits and losses are, in the court’s view, “two sides of the same coin” and must therefore be “treated symmetrically in the same tax system in order to protect a balanced allocation of the power to impose taxes between the different Member States concerned.”

A company established in the United Kingdom that conducted trading activities in a foreign member state through a subsidiary established in that state was not (at least to the extent that the UK CFC provisions were inapplicable) taxed on the profits derived from those activities on a current basis, but only on the dividends paid by the subsidiary (subject to appropriate credit given for the tax paid in the foreign country and for any withholding taxes levied), and the losses realized by the subsidiary thus could not be applied against the profits of its UK-resident parent.

The second ground of justification accepted in principle by the court was that a member state may impose restrictions to prevent the risk of losses arising in another member state being used twice, a concern that the court acknowledged was a danger “if group relief is extended to the losses of non-resident subsidiaries,” which is “avoided by a rule which precludes relief in respect of those losses.” This justification is closely related to the final ground accepted by the court, that of tax avoidance:

> it must be accepted that the possibility of transferring losses incurred by a non-resident company to a resident company entails the risk that within a group of companies losses will be transferred to companies established in the Member States which apply the highest rates of taxation and in which the tax value of the losses is therefore the highest.
To exclude group relief for losses incurred by non-resident subsidiaries prevents such practices, which may be inspired by the realization that the rates of taxation applied in the various Member States vary significantly.\footnote{134}

The court concluded that, in “the light of those three justifications, taken together,” restrictive provisions such as the limitation of UK group relief to losses incurred by resident subsidiaries “pursue legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest and that they are apt to ensure the attainment of those objectives.”\footnote{135}

However, the court accepted the arguments advanced by the taxpayer and the European Commission that the restrictive measures at issue (namely, the general exclusion from group relief) went beyond, and were not proportional to, the limitations necessary in order to ensure attainment of these objectives. This would be the case, in particular, where the non-resident subsidiary has exhausted the possibilities available in its state of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods, either by way of the transfer of those losses to a third party or by carrying the losses back in order to offset them against profits earned by the subsidiary in previous periods. Similarly, there would be no possibility that the foreign subsidiary’s losses could be taken into account in its state of residence for future periods, either by the subsidiary itself or by a third party, such as in the event of a sale of the shares of the subsidiary. To the extent that these conditions are demonstrated to have been satisfied and the UK group relief rules preclude loss relief, the restriction must, in the view of the European Court of Justice, be regarded as having failed the proportionality test, and so could not be justified under the EC treaty.

The practical effect of the judgment in Marks & Spencer was to allow the taxpayer to claim losses of its foreign subsidiaries under the UK group relief system, because the taxpayer had, on the facts before the court, divested itself of its business activities in the relevant jurisdictions, having sold its French subsidiary to a third-party purchaser and discontinued its Belgian and German operations, and there was no possibility that the losses could otherwise be claimed. As a result, the conditions referred to by the court in its application of the proportionality test could not be satisfied, because local loss relief was unavailable to the taxpayer in any form, whether carryback, current relief, or carryforward of losses, so that an absolute denial of cross-border loss relief would have been disproportionate to the objectives of the UK group relief legislation.

For other taxpayers, however, it may be extremely difficult to satisfy the conditions set out by the court in Marks & Spencer and to demonstrate that there is no possibility that subsidiary corporations or third-party purchasers could use the losses in the future, unless the business activities of the subsidiaries that incurred the losses were discontinued. It appears that the extent to which group loss relief will be available in these circumstances will depend in large part on a detailed examination of the underlying statutory provisions of the domestic laws of the member state in which the losses have been incurred.\footnote{136} A number of EC member states have recently introduced new
legislation, largely out of concern that their existing group relief provisions could be found to be contrary to EC law, that specifically provides for cross-border group loss relief, and in this sense may enable greater relief to be obtained than the court appeared to require member states to provide in its decision in 

Marks & Spencer.

It is, however, difficult to determine, from a review of the court’s reasoning in 

Marks & Spencer, the precise justification for the exclusion of group loss relief accepted by the court, if only because the three specific grounds relied upon were stated to have been considered on an aggregate or cumulative basis. This aspect of the decision has been heavily criticized; Lang has argued, for example, that a “well-reasoned decision should neither be based on a justification like cohesion nor on an unclear combination of three other reasons.”

He states as follows in this regard:

For the ECJ, it is relevant that these three justifications had to be “taken together.” What this means is not completely clear. Obviously, each one of the justifications is not sufficient for accepting different treatment. Having considered more closely each of the justifications, it becomes clear that none of these justifications is as such very convincing. Neither is it, however, very convincing that the three justifications “taken together” may justify different treatment. The impression is that the ECJ did not want to admit formally that it had changed its case law.

The uncertainty has grown. The ECJ has already rejected many different justifications in its previous case law. Each of these justifications could, however, “taken together” with one or two other justifications that had been rejected in the past, come into play again. The ECJ is now in a position that it may change its case law in any way without admitting doing so. Nevertheless, the new approach that more than one reason “taken together” could serve as a justification is a change. It should be noted that the ECJ has quite often rejected several justifications put forward by the Member States in a single case, without examining whether or not these justifications “taken together” could lead to a different result.

The court’s consideration of interjurisdictional allocation of tax revenues as a theoretical basis for justification represented, at least in principle, a substantial expansion of the potential grounds that the court had previously considered under its rule of reason doctrine, if only because it leaves open the possibility for consideration of more traditional tax policy grounds in the formulation of the potential bases for justification in future cases. This may in turn ultimately give rise to a jurisprudential framework that considerably expands the circumstances in which the consistency and internal coherence of the national tax system of a member state, viewed in relation to the domestic tax legislation of other EU member states, may be seen as a ground for justification in and of itself. Furthermore, the court’s acceptance of the potential for tax avoidance as a general basis for justification of the restrictive UK group loss relief provisions at issue in 

Marks & Spencer appears to represent a broader interpretation of this ground, in distinct contrast to the more particularized finding of abuse that the court required in its prior jurisprudence. It is at least arguable, on the basis of a critical analysis of the various grounds of justification accepted by the court in 

Marks & Spencer in light of its previous jurisprudence, that each of the three
grounds specifically considered could be regarded as a justification defence based on potential loss of revenue, which, as outlined above, has been soundly rejected by the court as an acceptable objective under the rule of reason doctrine.\textsuperscript{139} Even the court’s consideration of the proportionality test appeared to signify that it has become willing to accord greater flexibility to this determination. The court did not, for example, require member states to rely upon less restrictive grounds than statutory exclusion from group loss relief. It did not, for example, mandate that the objectives of the legislation be implemented by way of recapture provisions pursuant to which deduction is permitted currently, subject to recapture in the event that taxable income is reported in subsequent taxation years\textsuperscript{140}—similar to the rules often applicable in the context of the taxation of a branch carried on through a permanent establishment in a foreign member state pursuant to the provisions of an income tax treaty. Instead, the court preferred to adopt a “solution that is easier to accept for the Member States.”\textsuperscript{141}

The court’s decision in \textit{Marks \& Spencer} may well have been motivated in large part by budgetary considerations, in that the arguments advanced by the taxpayer were accepted in principle by the court, although it may have been expected that claims for deductibility of group losses incurred by foreign subsidiaries would be limited to those narrow factual circumstances in which subsidiaries are otherwise precluded from claiming the benefits of losses in the foreign member state, either currently or in the future, thus restricting relief to a very limited number of multinational groups.\textsuperscript{142} Nonetheless, the judgment reflects a more nuanced consideration of the potential impact of a finding of discrimination. It appeared to suggest a more principled approach under which the court may ultimately be willing to accept potential grounds of justification that specifically take into account the allocation of tax revenues between member states, and willing to accord greater consideration to the various objectives underlying national tax provisions in its analysis of tax avoidance as grounds for justification without relying, in particular, on one single accepted ground in applying the rule of reason doctrine. In this respect, while the court’s approach in \textit{Marks \& Spencer} may, as Lang argues, represent a clear shift in the court’s analysis of the doctrine of justification in direct taxation cases, it is a welcome change. Reliance on multiple grounds may indeed give rise to a slightly less predictable and more uncertain framework in the application of the rule of reason test, at least in the short term, but only because the court has appeared to recognize that all relevant underlying facts must be considered, on a case-by-case basis, in determining whether a particular national tax measure ought to be justified. The greater flexibility in applying the justification doctrine, which appears in this formulation to no longer require the court to predicate its justification analysis on only one of a limited number of grounds of justification that have been accepted in principle, should in theory enable the court to develop a more pragmatic and reasoned test in applying the doctrine, one that will better take into account the specific objectives of the national tax measure being examined.

By way of example, in the more recent decision in \textit{Oy AA},\textsuperscript{143} the European Court of Justice held that the freedom of establishment in article 43 of the EC treaty does
not preclude domestic legislation pursuant to which a resident subsidiary may deduct from its taxable income an intragroup financial transfer made by it in favour of its parent company only to the extent that the parent is established in the same member state as the subsidiary. In reaching its conclusion, the court noted that, even if the Finnish national tax measure were not specifically designed to exclude purely artificial arrangements that were devoid of economic reality, the legislation could nevertheless be regarded as proportionate to the objectives pursued in accordance with the rule of reason doctrine. An extension of the tax advantage to cross-border situations would allow multinational corporate groups to choose freely the member state in which their profits would be taxed, and would impair the ability of the member state of the subsidiary to tax profits generated by activities carried out within its territory, thereby effectively undermining the system of the allocation of taxing powers between member states.\textsuperscript{144} The court thus relied upon and upheld its earlier decision in \textit{Marks & Spencer}, and specifically considered the combination of the balanced allocation of the power to tax and the validity of the objective of reducing the risk of tax avoidance through purely artificial arrangements as factors in justifying the restrictive national tax measure.\textsuperscript{145}

**The Doctrine of Justification:**

**In Search of Principles**

**Breadth of Non-Discrimination Principle**

As described in the previous sections of this article, the European Court of Justice has, in its development and interpretation of the rule of reason, traditionally adopted a narrow approach in its consideration of the grounds upon which a restrictive or discriminatory national tax measure may be justified. However, the doctrine of justification becomes relevant only to the extent that a national tax measure is found to contravene one or more of the fundamental freedoms in the EC treaty; even then, the member state may still be able to demonstrate that the restrictive or discriminatory measure can be justified as being in the public interest under the court’s rule of reason. Although a detailed review of the jurisprudence in which the court has applied the non-discrimination principle under community law in direct taxation matters is beyond the scope of this article, the discussion below briefly considers the impact of the court’s case law in interpreting the non-discrimination principle, and argues that these developments support a more expansive application of the rule of reason.

In a number of recent cases, the court has sided with member states in upholding national tax measures on the basis that the differential treatment alleged by the taxpayer resulted from disparities between national tax systems, not from discriminatory or restrictive domestic provisions.\textsuperscript{146} However, the court has generally accorded an extremely broad scope of interpretation to the fundamental freedoms in the EC treaty, significantly expanding their scope of application. It has held that although direct taxation falls within the competence of the member states, this competence must be exercised in a manner consistent with community law, which has primacy over domestic legislation enacted by the member states. The fundamental freedoms
contained in the EC treaty, which have direct effect,\textsuperscript{147} have been held to prohibit discriminatory national tax measures, regardless of whether the measures may give rise to direct discrimination, which the court has defined as overt differentiation between taxpayers on grounds of nationality, or indirect or “covert” discrimination, which the court has held includes measures that may apply equally at law to nationals and non-nationals, but that may result in a discriminatory effect in their application. In this regard, the court has characterized the concept of discrimination as the application of different rules to comparable situations, or the application of the same rule to different situations. In its jurisprudence on direct taxation matters, it has refused to limit the application of the fundamental freedoms to national tax measures that apply only in respect of host jurisdiction, or source-basis, taxpayers. Moreover, while each of the fundamental freedoms contained in the EC treaty may apply only to the extent that there is a cross-border element sufficient to trigger protection thereunder, the court has interpreted this potential limitation narrowly, holding that a particular fundamental freedom may be found to have been violated even where a national of a foreign member state does not directly or indirectly bear the economic burden of the direct taxation measure subject to challenge.\textsuperscript{148}

The judicial non-discrimination principle developed by the European Court of Justice in interpreting the fundamental freedoms in the EC treaty is substantially more expansive than the equivalent non-discrimination provisions typically contained in bilateral income tax treaties.\textsuperscript{149} In particular, commentators have noted that the court’s jurisprudence has effectively precluded member states from enacting or enforcing national tax measures that have the effect of favouring domestic over foreign production,\textsuperscript{150} and that the breadth and scope of the court’s jurisprudence may lead to inconsistencies in the application of its judicial non-discrimination rules in cases involving direct taxation. The result, they argue, will be indeterminacies in according preference to traditional international tax policy principles—in particular, the principles of inter-nation equity and tax neutrality—in the resolution of conflictingjurisdictional tax claims, because the court’s non-discrimination principle effectively prohibits discrimination based on both destination and origin or, put another way, principles of capital import and capital export neutrality, which are inherently inconsistent.\textsuperscript{151} The court’s judgments also give rise to the potential for double taxation, due to the application of inconsistent principles to the determination of questions that relate, in essence, to jurisdictional issues concerning the allocation of taxing powers between EC member states.

Viewed in these terms, the member states’ jurisdictional basis for taxation within the European Community, which was established in accordance with traditional international tax policy principles, has been effectively eroded. Accepted international anti-avoidance rules, including thin capitalization, controlled foreign company, and departure tax provisions, have been held by the European Court of Justice to contravene the EC treaty freedoms. The court’s judgments have thus been criticized as leaving EC member states exposed from a tax perspective, hampered in their ability to effectively combat or prevent international tax avoidance, and unable to rely on their national tax systems for economic and fiscal policy purposes.\textsuperscript{152} This jurisprudence
has imposed constraints on the ability of EC member states to legislate domestically in a manner that relies on tax policy as an economic measure in pursuing national savings, spending, or investment incentives, in that national tax measures that effectively favour domestic over foreign production may be regarded as discriminatory and thus in contravention of the fundamental freedoms contained in the EC treaty. The trend toward harmonization of direct taxation within the European Community through negative integration has therefore been criticized as having resulted in a net fiscal loss of tax revenues, by restricting the ability of EC member states to protect their domestic tax base or to structure their national tax systems so as to enable them to fully exercise their taxing jurisdiction in accordance with fundamental international tax policy principles. A review of the court’s jurisprudence concerning direct taxation confirms that the effects of negative integration through judicial decision have generally been principally to reduce taxes in member states; this conclusion is inherent in the fact that the majority of cases on direct taxation are referred to the European Court by national courts of member states at the instance of taxpayers seeking to challenge the domestic tax provisions enacted by member states as restrictive or discriminatory of the fundamental freedoms contained in the EC treaty. In this circumstance, the best result that member states can hope for is generally to uphold their existing tax legislation, yet even this outcome has been relatively uncommon: to date, the vast majority of decisions rendered by the European Court of Justice on referral from national courts of EC member states have found that the domestic tax provisions at issue violate or otherwise contravene EC law. The non-discrimination principle may operate, in this sense, to the benefit of the nationals of third-party states, which as a result of this body of jurisprudence have been accorded greater entitlement to rely on the EC treaty provisions in investing in Europe in a tax-effective manner by virtue of the protections accorded by the fundamental freedoms. These developments could ultimately lead to increased harmful tax competition, in which EC member states compete for the same foreign investment to the detriment of the European Union as a whole, in a “race to the bottom” intended to attract mobile foreign capital. The application of the freedom of movement of capital provisions in article 56 of the EC treaty to third-party non-EC member states may well expand the scope for reliance on the treaty provisions in this context.

Negative Integration and the Harmonization of EC Tax Law

It has been argued that these developments are contrary to the core objectives underlying the promotion of the single European market. The European Community, which was premised on an economic basis, was established with the principal objective of maintaining political stability, and thereby to preserve both the independence and the national identity of individual member states. The decisions of the European Court of Justice concerning direct taxation may result in further disparities between the national tax systems of EC member states, through the creation of internally competitive, as opposed to facilitative, statutory and administrative tax regimes. This effect may be regarded as one of the results of harmonization through negative integration, pursuant to which the fundamental freedoms guaranteed by the EC
treaty are enforced through litigation, by way of the development and application of the court’s judicial non-discrimination principle. Each member state government will inevitably interpret, and respond to, judgments of the court concerning direct taxation in a different manner. The United Kingdom, for example, responded to the Lankhorst-Hohorst case, in which the court invalidated the German thin capitalization provisions, by proposing to extend the equivalent UK earnings-stripping rules so that they apply in the domestic context as well, even though the application of these provisions in the domestic context will in no manner further the anti-avoidance objectives underlying their enactment.\(^{162}\) In contrast, other member states have responded to judgments of the court by repealing domestic tax provisions thought to be discriminatory in their entirety. For example, in response to a number of pending cases concerning whether levying withholding tax on outbound dividends is prohibited under the EC treaty,\(^{163}\) the Dutch Ministry of Finance announced that the Netherlands would introduce an exemption from the Dutch dividend withholding tax for certain EU shareholders.\(^{164}\) Similarly, in Scorpio,\(^{165}\) the court held that German tax provisions that required gross-basis withholding at source in respect of performance fees paid to artistes and entertainers contravened the freedom to provide services, because they discriminated against non-residents who, in contrast to German-resident taxpayers, were subject to tax on a gross basis and not on the net performance income after deduction of expenses. Following this decision, the Netherlands decided to exempt from source-basis taxation income derived by non-resident artistes and sportsmen, notwithstanding its entitlement to tax such income under the vast majority of its tax treaties.\(^{166}\) Negative integration can never ultimately fully harmonize direct taxation in the European Community, because it is reactive rather than proactive in nature.\(^{167}\)

There is, in other words, a fundamental tension inherent in negative integration through judicial decision; the development and application of the non-discrimination principle, which is ultimately intended to move the tax systems of EC member states closer to a common European tax base, may in fact create discordant legislative and administrative responses by member states to the judgments of the European Court of Justice. The resultant disparities in the tax regimes of member states may thereby increase the potential for international tax avoidance, although the non-discrimination principles developed by the court have made it significantly more difficult to counter tax avoidance on a legislative basis. At the same time, these judgments may increase the potential for economic double taxation and lead to the development of national tax measures that are less neutral and efficient, in policy terms, than the provisions they were enacted to replace. To the extent that the non-discrimination principle developed by the court, largely by virtue of its breadth, has required EC member states to replace well-developed and accepted elements of their international tax systems with revised legislation intended to comply with the principles of EC law, the court’s jurisprudence in the field of direct taxation may be viewed as having introduced a significant element of discord in the tax systems of EC member states; prior to the development of the non-discrimination principle, these systems were in many ways considerably closer to a fundamental set of shared principles, predicated on accepted international tax policy objectives, than they are today.\(^{168}\)
The harmonization of direct taxation within the European Community will ultimately require a legislative response that is significantly more extensive than the proposals that have been considered to date. At this stage, however, the tax systems of member states appear far too disparate, and the costs of integration too great, to assume that any shift from unanimity to a form of qualified majority voting (or other effective voluntary abdication by member states of their veto rights) concerning matters of direct taxation, as a purely political matter, might occur in the relatively near term. At the same time, negative integration may continue to fail to effectively harmonize the tax systems of member states, if only because judicial decisions are not in practice implemented statutorily by member states in precisely the same manner, and it may therefore be anticipated that the legal uncertainty inherent in the determination as to the compatibility of national tax systems with community law will continue to grow.

A More Expansive Approach to the Rule of Reason Doctrine

The European Court of Justice has long recognized in its jurisprudence that mere disparities between the national tax systems of member states do not constitute discriminatory treatment within the meaning of the EC treaty, even though these variations may result in distortions in activities protected by the fundamental freedoms, including cross-border business, investment, and employment decisions, provided that disparities in treatment affect all taxpayers equally in accordance with objective criteria and without regard to nationality. In the Gilly case, for example, the court concluded that France was not obliged to fully credit German tax on employment income paid by a French national working in Germany even though the aggregate tax burden of a French employee in this circumstance would be higher than it would have been had the taxpayer earned the same income in France. In effect, the distortion in this case was considered to arise by virtue of the higher progressive tax rates applicable in Germany, which represented a disparity caused by the application of the differential tax regimes of the EC member states, but this disparity in treatment could not be considered to constitute discrimination under community law. Had Germany applied the lower French rate of tax, the taxpayer in Gilly would have been entitled to claim a foreign tax credit that would have fully offset the additional tax paid to Germany on her employment income. The court’s conclusions suggest that the basis for this judgment lies, in effect, in the recognition that Germany had primary jurisdiction, as source country, to tax employment income earned there, and that France could not, as a result, be required as state of residence to grant a credit based on the higher German rate of tax. Such a result would have compromised French sovereignty with respect to the taxation of residents within its jurisdiction to tax. France did not, in other words, have the legislative jurisdiction to reduce the German rate of tax in respect of employment income and, as a corollary, could not be required to provide a foreign tax credit on the basis of that grossed-up foreign rate.

Similarly, the court recognized, in its recent decision in Kerckhaert and Morres, that a member state is not required, pursuant to article 56 of the EC treaty, to provide
a foreign tax credit in respect of withholding tax levied at source on outbound dividends, provided that foreign- and domestic-source dividends are otherwise taxed at the same rate and in the same manner. The court recognized that while discrimination may exist not only in the application of different rules to comparable situations, but also in the application of the same rule to different situations, the position of a shareholder receiving dividends is not necessarily altered, from the perspective of the tax legislation of the state of residence, merely by the fact that the dividends are received from a corporation established in a foreign EC member state that taxes those dividends at source. In particular, the court noted that in “circumstances such as those of the present case, the adverse consequences which might arise from the application of an income tax system such as the Belgian system at issue in the main proceedings result from the exercise in parallel by two Member States of their fiscal sovereignty.” The court recognized that community law, in its current state, does not set out general criteria for the attribution of areas of competence between EC member states in relation to the elimination of double taxation within the community, and noted that it is for member states to take the measures necessary to prevent situations giving rise to double taxation, such as the inclusion in income of foreign-source dividends that were previously subject to withholding tax, by “applying, in particular, the apportionment criteria followed in international tax practice.” Accordingly, article 56 of the EC treaty was found not to preclude the Belgian legislation at issue, which imposed the same (25 percent) rate of tax in respect of both domestic- and foreign-source dividends, without providing domestic credit in the state of residence for the withholding tax levied by the source state (in this case, France).

Disparities that may arise as a result of the application of the provisions of the national tax systems of EC member states have therefore not generally been considered to be discriminatory or restrictive of the EC treaty fundamental freedoms. The court has not, however, traditionally gone further in its analysis of direct tax measures so as to apply its non-discrimination principle, in particular in the context of its consideration of the grounds for application of its rule of reason doctrine, by reference to an analysis focused on the particular member state’s jurisdiction to tax under international tax principles. The court recognized in the Manninen case that the ground of fiscal coherence necessarily involves a cross-border analysis in which foreign, or supranational, tax burdens must also be considered, a determination that has been characterized as a “movement of cautious relaxation of the criteria required to meet the conditions” for justification on this ground under the “direct link” test established in Bachmann. However, the court has otherwise interpreted the basis of fiscal cohesion narrowly. This ground should entail a more nuanced consideration of the approximate allocation of taxing jurisdiction between EC member states, in light of the fact that positive harmonization in the area of direct taxation is not likely to occur in the short term, leaving EC member states no choice but to continue to administer and enforce their domestic tax systems in accordance with the principles of community law pursuant to the EC treaty, as interpreted by the European Court of Justice. In fact, the principal difficulty with harmonization through negative integration may well be related to the historical failure to consider
the international tax policy framework underlying national legislation that has been found to be restrictive or discriminatory of EC treaty freedoms, or the interaction of domestic tax legislation with the principles of community law in a manner that enables the court to further develop, enforce, and protect treaty rights while maintaining an appropriate balance between the rights of member states to enact and administer internally consistent tax systems and the promotion of the internal market as it applies in respect of direct taxation matters. These are precisely the considerations that should specifically be taken into account by the court in its application of the doctrine of justification. The rule of reason was developed by the court for the express purpose of justifying national measures that might otherwise restrict or hinder the exercise of the fundamental freedoms where such justification would be in the public interest. It seems anomalous to define so restrictively the narrow grounds on which direct taxation provisions have in fact been justified pursuant to the rule of reason doctrine as it has been developed by the court (including, more recently, by way of an overly broad conception of the principle of proportionality) when there is a clear need to ensure the application of accepted jurisdictional principles in resolving conflicting tax claims in the interaction between community law and the domestic tax systems of EC member states.

In its jurisprudence concerning direct taxation, the court has implicitly respected some of the most fundamental aspects of international tax law. In particular, in the Schumacker case as well as in the numerous decisions that have followed it, the court accepted the international tax law principles regarding the division of tax jurisdiction between states of residence and states of source as reflected in the OECD model tax treaty. It has therefore concluded that there is a fundamental distinction between resident and non-resident taxpayers that may render them incomparable for the purposes of the EC treaty, on the basis that the substantial part of a resident’s income is generally earned in the state of residence, while a non-resident generally earns only part of his or her income in the source state, and because the state of residence generally has access to all of the information that is required in order to assess the taxpayer’s ability to pay, taking into account personal and family circumstances. Wattel notes that the effect of this determination is to pre-empt entirely the issue of tax discrimination, and thereby to deprive the free movement of persons of all meaning (except to the extent that the non-resident taxpayer earns all of his or her income in the source state). As he argues, however, the court has consistently rejected the lack of available information as a basis for justification, requiring member states to rely on the mutual assistance directive for this purpose. And it is difficult to ascertain why the jurisdiction in which the taxpayer earns substantially all of his or her income should have any relevance whatsoever for the purposes of the EC treaty or, for that matter, for any purpose other than income taxation. Perhaps, as Wattel suggests, the court “considered the limits of negative European integration (integration through prohibitions) to be reached . . . [r]econciling international tax law with Community law is a matter for positive European integration (integration through decisions by the Council).” He notes that the court would have done better to refrain from distinguishing between resident and non-resident employees.
and argues that the court should have expressly stated the basis for its distinction, rather than drawn differences in its comparability analysis that are difficult to reconcile with existing jurisprudence and have no apparent relevance to the interpretive questions at issue in applying the fundamental freedoms. Such an approach would then have been explicitly reflected in the court’s application of the rule of reason doctrine, under which the court would consider whether the taxpayer’s unequal treatment could be justified on the basis of fiscal cohesion. Residents are, for tax purposes, subject to tax on their worldwide income, and thus may take account of their personal and family circumstances in that state, in contrast to source-basis taxpayers, who are taxable only on the basis of the territorial source of their income.

This more flexible approach in the court’s justification analysis of accepted international tax policy principles, including the appropriate manner in which to resolve jurisdictional claims to tax, would thus be applied following the court’s comparability analysis pursuant to the non-discrimination principles it has developed in its jurisprudence concerning direct taxation. Although this analysis will, of necessity, vary depending on the particular facts at issue before the court, the reasoning that would be applied is evident in the opinion rendered by Advocate General Geelhoed in the ACT Test Claimants case. This opinion concerned the UK method of providing imputation tax credits to individual shareholders of UK companies that receive domestic-source dividends. The legislative scheme at issue provided for a refund of the ACT payable under UK law to a corporate shareholder of a corporation resident in the United Kingdom upon receipt of dividends from the UK subsidiary, and for the granting of imputation credits at the individual shareholder level. Advocate General Geelhoed opined that this legislation contravened neither article 43 nor article 56 of the EC treaty. The test claimants argued that the fact that non-UK shareholders of a UK-resident parent company did not receive imputation credits (except under the provisions of certain tax treaties entered into by the United Kingdom) placed foreign parent companies with UK subsidiaries at a disadvantage in comparison to domestic parent companies with UK subsidiaries. In particular, while the UK system ensured a lower aggregate tax burden in respect of profits distributed by a UK parent company through the elimination or reduction of economic double taxation, it offered no such advantage for domestic-source profits distributed to a foreign parent company. This, in the view of the test claimants, made investing in a UK corporation through a domestic parent company more attractive than investing through a foreign parent company, which could deter a foreign parent company from establishing a subsidiary in the United Kingdom.

The advocate general rejected this argument, noting that any disadvantage in this case resulted from disparities, and the corresponding allocation of taxing jurisdiction, between national tax systems. The United Kingdom chose to relieve economic double taxation in respect of the distribution of profits of a subsidiary corporation by granting a tax credit to the UK parent company to ensure that the ACT was paid only once on these profits, and by granting an imputation credit to resident shareholders to relieve all or part of their liability to UK income tax. On the other hand, in the case of profits distributed by a domestic subsidiary to a foreign parent company,
the United Kingdom in principle only exercised source-state, or territorial, jurisdiction to tax. In fact, the United Kingdom levied tax only once on the domestic-source profits, in the form of ACT paid by the UK subsidiary on the distribution of its profits. Under the UK tax system, outbound dividends, unless they gave rise to a tax credit in the United Kingdom, were not subject to a second level of taxation in the United Kingdom in the form of an income tax. As a result, insofar as they were within the taxing jurisdiction of the United Kingdom, outbound dividends were treated in precisely the same manner as domestic-source dividends.

Advocate General Geelhoed recognized that, under accepted international tax law principles, the United Kingdom was entitled, as the state of source, to tax domestic-source profits. When viewed from an economic standpoint, dividends paid by a UK company to foreign and domestic shareholders were therefore treated in precisely the same manner: the payment of each gave rise to liability to ACT. In the case of domestic dividends, UK income tax was in principle levied at the shareholder level, and an imputation credit was granted that effectively eliminated all or part of this income tax liability. In the case of dividends paid to foreign shareholders, however, in the absence of a tax treaty providing otherwise, no income tax was levied by the United Kingdom, and there was therefore no UK income tax liability to eliminate by way of an imputation credit. The non-discrimination principle was therefore applied by reference to an analysis focused on the particular state entitled to tax under international tax law principles. As source state, the United Kingdom could not tax domestically owned, as opposed to foreign-owned, subsidiaries on a preferential basis, but the requirement to relieve economic double taxation at the individual shareholder level rested with the home state, or state of residence.\textsuperscript{184}

The European Court of Justice accepted this reasoning, affirming that while member states are free to determine the method by which dividends are taxed, including by way of allocation of taxing powers either unilaterally or by treaty so as to eliminate (or reduce the potential for) double taxation, resident taxpayers who hold shares in EU corporations must be treated comparably, by the state of residence, to resident taxpayers who hold shares in domestic corporations. However, this principle would not entitle a non-resident corporation to claim imputation tax credits granted by the source state, because the source state should not, in these circumstances, be required to cede its taxing jurisdiction in respect of income earned, on a territorial basis, from economic activities carried on within that state, particularly in light of the fact that the state of residence is generally best situated to relieve economic double taxation based on the shareholder’s ability to pay. With respect to the source state, in other words, resident shareholders would not necessarily be in a situation comparable to that of non-resident shareholders.

In determining whether the UK scheme was discriminatory, both the advocate general and, ultimately, the court in the \textit{ACT Test Claimants} case applied this analysis at the level of the non-discrimination determination, rather than as a matter of justification, which arguably would have been more consistent with the principles underlying the EC treaty. In particular, applying a comparability analysis that takes into account the laws of multiple member states in determining whether a particular
tax provision is compatible with EC law may represent an infringement on the exercise of tax sovereignty by the member state. It is inherent in the notion of tax sovereignty that its exercise is not dependent on the national tax laws of another member state; accordingly, prohibited restrictions of the fundamental freedoms can only arise from the legislation of one member state, not from the application of different tax systems. These same considerations do not apply in the context of a justification analysis, because the sole question in such an analysis is whether the national tax measure may be justified under the court’s rule of reason doctrine. This analysis must reflect an “overall” rather than a per-country approach that takes into account international income allocation issues, including the jurisdiction to tax in accordance with accepted international tax policy principles, and to this extent must have regard to the laws in both the source and residence jurisdictions, but should not infringe upon the tax sovereignty of EC member states. In a comparability analysis, these tax policy principles should, arguably, be irrelevant to the determination of the question whether the tax measure at issue is compatible with the fundamental freedoms in the EC treaty and, more generally, with community law.

In the FII Test Claimants case, the court appeared to acknowledge that it may be amenable to adopting such an approach in future decisions. In that case, the court recognized that a member state may be able to demonstrate that a restriction on capital movements to or from non-EC member states is justified for a reason that would not otherwise constitute a valid justification for a restriction on the movement of capital between member states. This recognition suggests that any analysis of the potential grounds for justification of a restrictive national tax measure requires the adoption of a balancing approach, which would entail greater flexibility depending on the circumstances at issue and, by implication, the underlying tax policy considerations.

This more expansive approach to the court’s analysis under the rule of reason doctrine may be contrasted with the reasoning traditionally adopted in the court’s jurisprudence in the field of direct taxation. In the Marks & Spencer decision, for example, a jurisdictional analysis premised on the allocation of tax revenues between jurisdictions in accordance with international tax law principles would arguably have led to the determination that, because the United Kingdom did not tax the profits of the foreign subsidiaries of Marks & Spencer that carried on active businesses in France, Germany, and Belgium, it had not assumed fiscal jurisdiction over the foreign subsidiaries, and thus should not have been required to provide relief for losses against profits subject to UK corporate tax. Even if the positions of a domestic parent company with a subsidiary whose profits are taxable in that member state, on the one hand, and a parent company with a subsidiary whose profits are exempt from taxation in that member state, on the other, could be regarded as comparable in accordance with the broad non-discrimination principle developed by the European Court of Justice, an application of the rule of reason doctrine, reflecting this proposed approach, would at the very least take into consideration the allocation of taxing jurisdiction between the various member states, but without interpreting the
CONCLUSION

Recent decisions of the European Court of Justice in the field of direct taxation, including the court’s judgment in *Marks & Spencer*, reflect a recognition that all of the relevant underlying facts must be considered, on a case-by-case basis, in determining whether a particular national tax measure may be justified under the court’s rule of reason doctrine. This approach suggests that the court will no longer require its justification analysis to be predicated on only one of the limited number of grounds of justification that have been accepted in principle with respect to issues concerning direct taxation. These developments should, in theory, enable the court to develop a more pragmatic and reasoned test to be applied in interpreting the rule of reason doctrine in its subsequent jurisprudence, which would take into account the specific objectives of the particular national tax measure under consideration within the framework of accepted international tax policy principles, including the appropriate allocation of taxing jurisdiction between EC member states, and thereby result in a more effective balancing of the provisions of the domestic tax legislation of EC member states with developing principles of community law.

NOTES

1 The Treaty on European Union, signed at Maastricht on February 2, 1992, 1992 OJ C191/1, which amended the Treaty of Rome of March 25, 1957, 298 UNTS 11, created the European Union. The amended Treaty of Rome, renamed the Treaty Establishing the European Community, declared (in article 17(1)) every person holding the nationality of a member state to be a citizen of the European Union. The Treaty Establishing the European Community, as amended, is herein referred to as “the EC treaty,” and references to treaty articles are to current provisions, as amended to date. The terms European Community and European Union are, for ease of reference, used interchangeably.

2 Although the Treaty of Rome expressly recognized that indirect taxation represented a restriction on cross-border economic activity, and therefore prohibited the imposition of discriminatory and protective indirect taxes, and conferred legislative power on the European Community with respect to harmonization in this area, the member states intentionally reserved to themselves jurisdictional authority with respect to matters of direct taxation in order to preserve this fundamental aspect of their fiscal sovereignty. See Otmar Thömmes, “Commission’s Reluctance and Member States’ Overreactions—A Perfect Recipe for Chaos” (2004) vol. 32, no. 3 Intertax 124-25, at 125.

3 Article 94 of the EC treaty, which provides for the “approximation of such laws, regulations or administrative positions of the Member States as directly affect the establishment or
functioning of the common market,” is the basis for the enactment of council directives in the area of direct taxation, subject to unanimous decision of the Council of the European Union.


5 Articles 28 through 30 of the EC treaty.

6 Article 39 of the EC treaty.

7 Articles 43 through 48 of the EC treaty.

8 Article 49 of the EC treaty.

9 Articles 56 through 58 of the EC treaty.

10 See, for example, the court’s decision in Pirkko Marjatta Turpeinen, Case C-520/04, released November 9, 2006, in which the court held that the taxpayer, a national of Finland who had retired and moved to Spain, where she was resident for tax purposes, was entitled to rely on the provisions of the EC treaty in respect of the taxation of her retirement pension, which was subject to tax at a higher rate in Finland as a result of her non-resident status, by virtue of article 18.

11 In addition, pursuant to article 4(1) of the EC treaty, the provisions on economic and monetary union require both the member states and the European Community to adopt an “economic policy which is based on the close coordination of Member States’ economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition.” Article 98 of the EC treaty similarly requires the member states and the community to “act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 4.”

12 Pursuant to article 220 of the EC treaty, the court’s principal responsibility is to ensure that in the “interpretation and application of [the EC treaty] the law is observed.” The court hears infringement cases brought by the European Commission in order to enforce the provisions of the EC treaty. There is also a ruling procedure pursuant to article 234 of the EC treaty under which a national court of any member state may request a legally binding preliminary ruling in a case involving EC law. The court’s judgment in article 234 rulings is limited to the question of community law referred to it, which may include examination of the validity of regulations, directives, or decisions adopted by the council or the commission or the interpretation of particular treaty provisions.


15 See, for example, article 46 of the EC treaty.

16 The court’s expression of the proportionality test in its rule of reason doctrine is consistent in principle with the wording of article 5 of the EC treaty, which provides (in part) that “[a]ny action by the Community shall not go beyond what is necessary to achieve the objectives of this Treaty.”


18 The steps involved in applying the rule of reason test were helpfully summarized by Denys as follows: measures that do not constitute prohibited discrimination per se (as to which see the text following) but that represent covert discriminatory restriction or non-discriminatory restrictions may be justified if the measure (1) is justified by compelling reasons of public interest (in respect of this determination, the tax measure at issue must not be disproportionate to its intended objective, and the aim of the measure and the fundamental freedom at issue must be balanced against each other), (2) is suitable for guaranteeing the realization of the objective, (3) does not go further than necessary in order to achieve the objective, (4) is applied without discrimination to all market participants and transactions, and (5) is not incompatible with specific EC law, such as the council directives that have been adopted in the field of direct taxation. See Lieven A. Denys, “The ECJ Case Law on Cross-Border Dividends Revisited” (2007) vol. 47, no. 5 European Taxation 221-38, at 222.

19 See Dieter Kraus v. Land Baden-Württemberg, Case C-19/92, [1993] ECR I-1663, at paragraph 32.

20 The distinction between discriminatory and restrictive tax measures is inherently uncertain, and the court has blurred the conceptual difference between the two concepts. Vanistendael explains the restriction concept by analogizing the “EU market [to] a huge snooker table, where all the economic balls roll smoothly from one corner to the other. In the non-discrimination approach it is sufficient that each snooker player can play under the same conditions at different snooker tables. In the non-restriction approach all players are playing from different corners at the same snooker table”: Frans Vanistendael, “The Compatibility of the Basic Economic Freedoms with the Sovereign National Tax Systems of the Member States” (2003) vol. 12, no. 3 EC Tax Review 136-43, at 139. Nevertheless, the distinction is crucial, because directly discriminatory measures may only be justified pursuant to an express provision in the EC treaty; restrictive measures may be justified pursuant to the court’s rule of reason doctrine. For a critique of the court’s interpretation of the fundamental freedoms as prohibiting merely restrictive measures, on the basis that the doctrine “leads to results beyond the scope of the Treaty provisions, it is inconsistent, and it cannot reasonably be applied on direct taxation issues,” see Joachim Englisch, “The European Treaties’ Implications for Direct Taxes” (2005) vol. 33, no. 8/9 Intertax 310-35, at 315. Englisch argues that all taxes on cross-border activities would contravene the fundamental freedoms, because they would “certainly tend to render any taxable economic activity less attractive” (ibid., at 316). In the direct taxation area, indirect discrimination generally involves treating non-resident taxpayers in a manner different from residents, whereas a restrictive national tax measure typically prevents both resident and non-resident taxpayers from exercising their community rights. It has therefore been suggested that indirect discrimination will almost always constitute a restriction, though a restriction generally will not give rise to discrimination. See Christiana H.J.I. Panayi, “Treaty Shopping and Other Tax Arbitrage Opportunities in the European Union: A Reassessment—Part 1” (2006) vol. 46, no. 3 European Taxation 104-10, at 106.

21 For a more detailed discussion of this distinction, see C. Peters, “Non-Discrimination: The Freedom of Establishment and European Tax Law,” in Hans Gribnau, ed., Legal Protection Against Discriminatory Tax Legislation: The Struggle for Equality in European Tax Laws (The Hague: Kluwer Law International, 2003), 102-5. Peters notes that while “direct discrimination is based on nationality, indirect discrimination is based on another criterion leading to the same result,” such as residence for tax purposes (ibid., at 104).

The court concluded, ibid., at paragraph 30, as follows: “Consequently, national legislation, such as the Greek tax legislation, which, for the purposes of taxing income, does not establish, as between companies having their seat in Greece and companies which, having their seat in another Member State, have a permanent establishment in Greece, any distinction such as to justify, in relation to the same taxation, a difference in treatment between the two categories of companies and which establishes a difference in treatment as regards the rate of income tax, introduces discrimination against companies having their seat in another Member State insofar as it imposes on them, irrespective of their legal form and the nature of the shares which they issue, a rate of taxation of 40% whereas the rate of 35% applies only to companies whose seat is in Greece.”

Ibid., at paragraph 32.

For discussion, see Dahlberg, supra note 14, at 119-24.

See, for example, the court’s decision in Hanns-Martin Bachmann v. Belgian State, Case C-204/90, [1992] ECR I-249, discussed below, in which the court held that the domestic tax provisions in question were justified on the basis that they preserved the fiscal coherence of the Belgian tax system.

Rolf Dieter Danner, Case C-136/00, [2002] ECR I-8147, opinion of March 21, 2002. Jacobs stated as follows (ibid., at paragraph 40): “As to which grounds of justification may be invoked, I think it is inappropriate to have different grounds depending upon whether the measure is discriminatory (directly or indirectly) or whether it involves a non-discriminatory restriction on the provision of services. Once it is accepted that justifications other than those that are in the Treaty may be invoked, there seems no reason to apply one category of justification to discriminatory measures and another category to non-discriminatory restrictions. Certainly the text of the Treaty provides no reason to do so. . . . In any event, it is difficult to apply rigorously the distinction between (directly or indirectly) discriminatory and non-discriminatory measures. Moreover, there are general interest aims not expressly provided for in the Treaty (e.g. protection of the environment, consumer protection) which may in given circumstances be no less legitimate and no less powerful than those mentioned in the Treaty. The analysis should therefore be based on whether the ground invoked is a legitimate aim of general interest and if so whether the restriction can properly be justified under the principle of proportionality. In any event, the more discriminatory the measure, the more unlikely it is that the measure complies with the principle of proportionality.”

Ibid., at 329.

Article 39(3) of the EC treaty.

Article 45(2) of the EC treaty. Subject to ratification of the Treaty of Lisbon, which was signed on December 13, 2007, this power would be exercisable, with effect as of January 1, 2009, by the European Parliament and the Council of the European Union, acting in accordance with the ordinary legislative procedure.

Article 55 of the EC treaty.

Article 57(1) of the EC treaty.

Article 57(2) of the EC treaty. See the comments at supra note 31.

Article 58(3) of the EC treaty.

Terra and Wattel, supra note 14, at 23.


39 Supra note 37, at paragraphs 43-44.

40 The court in Verkooijen further addressed the submission of the governments of the Netherlands and the United Kingdom that article 58(3) of the EC treaty, which provides that the “measures and procedures referred to in Articles 58(1) and (2) shall not constitute a means of arbitrary discrimination or disguised restriction on the free movement of capital and payments” in article 56, should not operate to restrict the interpretation of the limitation in article 58(1)(a), which refers to the “relevant provisions” of the tax legislation of member states, because such provisions cannot be characterized as “measures and procedures.” The court found that any distinction in wording was “irrelevant,” noting that the terms “measures and procedures” and “provisions” were substantively similar, and that the former term is not, in any event, ever referenced in article 58(2) of the EC treaty, even though article 58(3) is clearly specified to apply in respect of that provision. In this regard, see paragraph 45 of the court’s judgment, ibid.

41 Petri Manninen, Case C-319/02, [2004] ECR I-7477.

42 Ibid., at paragraph 30.

43 With respect to the application of article 58(1)(a), the court stated, ibid., at paragraphs 28-29, as follows:

[I]t should be noted that Article 58(1)(a) of the Treaty, which, as a derogation from the fundamental principle of the free movement of capital, must be interpreted strictly, 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 Treaty. The derogation in Article 58(1)(a) EC is itself limited by Article 58(3) EC, which provides that the national provisions referred to in Article 58(1) “shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56.”

A distinction must therefore be made between unequal treatment which is permitted under Article 58(1)(a) EC and arbitrary discrimination which is prohibited by Article 58(3). In that respect, the case-law shows that, for national tax legislation like that at issue, which, in relation to a fully taxable person in the Member State concerned makes a distinction between revenue from national dividends and that from foreign dividends, to be capable of being regarded as compatible with the Treaty provisions on the free movement of capital, the difference in treatment must concern situations which are not objectively comparable or be justified by overriding reasons in the general interest, such as the need to safeguard the cohesion of the tax system (Verkooijen, paragraph 43). In order to be justified, moreover, the difference in treatment between categories of dividends must not go beyond what is necessary in order to attain the objective of the legislation.

44 This has led commentators to conclude as follows: “Article 58(1)(a), as an exception to the liberalization of capital movement, must be interpreted narrowly, and . . . it cannot save discriminatory imputation systems: imputation systems which treat domestic and foreign-source dividends differently are incompatible with the free movement of capital. Therefore, Article 58(1)(a) is superfluous in that it does not add to the possibilities which Member States have under the Court’s rule of reason to distinguish, for capital movement purposes, between domestic and foreign taxpayers and between domestic and foreign investment. . . . This leads us to believe that the Court interprets Article 58(1)(a) and (3) as no more than a codification of its rule of reason in the field of capital movement, therefore not undoing or restricting any of the limitations its case law on other Treaty Freedoms sets on the sovereignty of the Member States in tax matters.” See Terra and Wattel, supra note 14, at 24. See also Michael Sedlacek, “Capital and Payments: The Prohibition of Discrimination and Restrictions” (2000) vol. 40, no. 1/2 European Taxation 14-31, at 23-24, who considers these provisions to be superfluous in that they merely reflect the rule of reason doctrine otherwise developed by the court in its jurisprudence.
45 Supra note 26.
47 In this regard, the court concluded, supra note 26, at paragraph 11, that it is “normally nationals of other Member States who, after working in Belgium, return to their State of origin, where the sums payable by the insurers are liable to tax, and who are therefore prevented from deducting their contributions for income tax purposes without receiving the corresponding benefit of exemption from tax on the sums payable by the insurers. Whilst this situation results from the absence of harmonization of the fiscal laws of the Member States, such harmonization cannot constitute a condition precedent to the application of Article [39] of the Treaty.” The court further rejected the argument that the provisions at issue could not be regarded as discriminatory on the basis that the taxpayer could simply terminate his old insurance contract and enter into a new arrangement with a Belgian insurer upon taking up employment in Belgium, because to be “obliged to terminate a contract concluded with an insurer based in one Member State, in order to be eligible for a tax deduction provided for in another Member State, in circumstances where the person concerned considers the continuation of such a contract to be in his interests, constitutes, by reason of the arrangements and the expense involved, a restriction on his freedom of movement” (ibid., at paragraph 13).
48 Ibid., at paragraphs 21-23 (citations omitted).
49 The court therefore concluded as follows, ibid., at paragraphs 27-28:

   It follows that, as Community law stands at present, it is not possible to ensure the cohesion of such a tax system by means of measures which are less restrictive than those at issue in the main proceedings, and that the consequences of any other measure ensuring the recovery by the State concerned of the tax due under its legislation on sums payable by insurers pursuant to the contracts concluded with them would ultimately be similar to those resulting from the non-deductibility of contributions.

   In the light of the foregoing, it must be recognized that, in the field of pensions and life assurance, provisions such 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 form part, and that such provisions are not, therefore, contrary to [article 39] of the Treaty.

50 These criticisms were noted by Brigitte Knobbe-Keuk in “Restrictions on the Fundamental Freedoms Enshrined in the EC Treaty by Discriminatory Tax Provisions—Ban and Justification” (1994) vol. 3, no. 3 EC Tax Review 74-85, at 80-81.
52 Ibid., at paragraph 18.
53 For a more recent application of these same principles on substantially equivalent facts, see Commission of the European Communities v. Kingdom of Denmark, Case C-150/04, released January 30, 2007. The court in that case further restricted the doctrine of fiscal cohesion as a ground of justification, noting, ibid., at paragraph 71, that the “factor liable adversely to affect the cohesion of the Danish tax system is to be found in the fact that the transfer of the residence of the person concerned occurs between the time of payment of contributions to a pension scheme and that of payment of the corresponding benefits, and less in the fact that the pension institution is in another Member State.” In other words, Denmark could not rely on this ground of justification where the same potential loss of coherence could in any event arise in the domestic context upon the emigration of the contributor prior to the receipt of benefits. For further discussion, see Tom O’Shea, “Commission v. Denmark: Can Cohesion Work as a Justification?” (2007) vol. 46, no. 1 Tax Notes International 43-46.
The court noted that a direct link could not be said to exist on these facts, which concerned two separate taxes levied on different taxpayers. See ibid., at paragraphs 39-40. A similar conclusion was reached with respect to the justification argument advanced in the Verkooijen case discussed above in the context of the Dutch dividend exemption: see supra note 37, at paragraph 58. A direct link was not considered to exist between the “grant to shareholders residing in the Netherlands of income tax exemption in respect of dividends received and taxation of the profits of companies with their seat in another Member State,” because these were “two separate taxes levied on different taxpayers” (ibid.). In effect, the Dutch corporate tax was levied against the corporation, while tax on the dividend was levied against the shareholder, such that the “single taxpayer” correlative requirement could not be satisfied.  

57 Supra note 56, at paragraph 21.  
58 Ibid., at paragraphs 24-25.  
59 For criticism of the court’s reasoning in Wielockx, see Peter J. Wattel, “The EC Court’s Attempts To Reconcile the Treaty Freedoms with International Tax Law” (1996) vol. 33 Common Market Law Review 223-54.  
60 The court has consistently upheld these limitations on the fiscal coherence justification in its subsequent jurisprudence. See, for example, Ministre des Finances v. Jean-Claude Weidert and Elisabeth Paulus, Case C-242/03, [2004] ECR I-7379, at paragraphs 24-27, in which the court noted that the treaty provision at issue had the effect of shifting the fiscal cohesion analysis to the state as opposed to the individual taxpayer level, thereby negating the ability of the Luxembourg government to rely on the analysis as a legitimate basis for justification of the impugned tax provision.  
61 See the references and advocate general opinions in infra note 177 and accompanying text. Vanistendael notes that the court has limited the fiscal cohesion ground of justification in its jurisprudence precisely because a broad approach to this ground could easily subsume a number of grounds of justification that have been expressly rejected by the court (and discussed further in the text following), including effective fiscal supervision, tax evasion and avoidance, and loss of fiscal revenues. In his words, “if, apart from the wide inventory of public policy reasons which shelter under the umbrella of cohesion, we would also bring the other public policy motives under the concept of cohesion, we would have a concept that becomes so general and so vague that it only could be used in a political debate, but would hardly be of any use as a distinctive criterion in a Court decision”: Frans Vanistendael, “Cohesion: The Phoenix Rises from His Ashes” (2005) vol. 14, no. 4 EC Tax Review 208-22, at 215-16.  
62 See Mason, supra note 14, at 100-1.  
64 Ibid., at paragraph 22.  
65 See, for example, Dahlberg, supra note 14, at 125. In its subsequent jurisprudence, however, the court has consistently rejected the principle of territoriality as a ground of justification when advanced on behalf of member states of residence with jurisdiction to tax on a worldwide basis. In other words, the court has rejected this basis for justification where the state of residence has sought to justify discriminatory or restrictive differential treatment in respect of the taxation of foreign-source income or loss on the basis that the corresponding income is not subject to taxation by, or within the jurisdiction of, the member state of residence. See, in this regard, the court’s judgments in Bosal Holding BV v. Staatssecretaris van Financien, Case C-168/01, [2003] ECR I-9409, and N, infra note 93. This has led commentators to express the view that the “territoriality principle can be invoked as a justification only by a source state, never by a state of residence (or a state that taxes all, or almost all, of the income of a person, as in . . .
Schumacker): see Christian Wimpissinger, “Beyond Marks & Spencer: Cross-Border Losses and EC Law” (2005) vol. 38, no. 10 Tax Notes International 923-28, at 927. Moreover, the court in Bosal Holding appeared to further limit the potential application of the territoriality principle to circumstances involving a single taxpayer (at paragraph 38). It may therefore be argued that the principle of territoriality is, in essence, simply one form of application of the general ground of fiscal cohesion described above, and in this sense the court’s limitation in Bosal Holding is consistent with its interpretation of the scope of the fiscal coherence doctrine.


Supra note 64, at paragraph 31.

Ibid., at paragraph 32.

Ibid., at paragraph 39.

In reaching this result, the court relied principally on precedent relating to intra-community trade law and, most notably, its decision in the Cassis de Dijon case (sub nom. REWE-Zentral AG v. Bundesmonopolverwaltung für Branntwein), Case C-120/78, [1979] ECR I-649. The early expression by the court of a non-exhaustive list of the grounds of justification that may prevent a trade rule that otherwise inhibits the free movement of goods from constituting a violation of article 28 of the EC treaty formed the basis for the court’s recognition in Futura Participations that the effectiveness of fiscal supervision could potentially represent a valid ground for justification of a restriction of the fundamental freedoms contained in the EC treaty in matters of direct taxation. For further discussion, see Hinnekens, supra note 14, at 80-81.


The court’s decision in Halliburton Services BV v. Staatssecretaris van Financiën, Case C-1/93, [1994] ECR I-1137, is of similar effect. The justification claims advanced by the government of the Netherlands in that case were primarily based on the contention that the restriction of a transfer tax exemption to companies formed under domestic law was required in order to enable the Dutch competent authorities to verify that the legal forms of entities constituted in other member states were equivalent to those that qualified under the Dutch exemption provisions. The court did not accept this argument, holding that information pertaining to the forms in which companies may be constituted in other member states could be obtained by the Dutch competent authorities pursuant to the provisions of the EC mutual assistance directive. See Mason, supra note 14, for more detailed consideration of this line of authority.


See, for example, Van Binsbergen, Case C-33/74, [1974] ECR I-1299.


The court stated, ibid., at paragraph 20: “Since the rules at issue place companies whose registered office is in France and branches and agencies situated in France of companies whose registered office is abroad on the same footing for the purposes of taxing their profits, those rules cannot, without giving rise to discrimination, treat them differently in regard to the grant of an advantage related to taxation, such as shareholders’ tax credits. By treating the two forms of establishment in the same way for the purposes of taxing their profits, the French legislature has in fact admitted that there is no objective difference between their positions in
regard to the detailed rules and conditions related to that taxation which would justify different treatment."

79 Ibid., at paragraph 25.

80 For a summary and further discussion of the authority that follows, and the prevention of tax avoidance and fiscal abuse as a ground of justification more generally, see Mason, supra note 14, at 101-5; and Dahlberg, ibid., at 233-42.


82 The court noted that the freedom of establishment includes, by virtue of article 48 of the EC treaty, the right of a company formed in accordance with the laws of a member state and having its registered office, central administration, or principal place of business within the EC to pursue its activities through a branch or agency. The court also noted that, although the provisions of article 48 are intended primarily to ensure that foreign nationals and corporations are treated in the host state in the same manner as nationals of that member state, they also prohibit 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.

83 Supra note 81, at paragraph 25.

84 In response to these arguments, the court noted, ibid., at paragraphs 26-27:

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 United Kingdom 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 United Kingdom. However, the establishment of a company outside the United Kingdom does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the State of establishment.

Furthermore, the risk of charges being transferred, which the legislation at issue is designed to prevent, is entirely independent of whether or not the majority of subsidiaries are resident in the United Kingdom. The existence of only one non-resident subsidiary is enough to create the risk invoked by the United Kingdom Government.

85 The court's approach in ICI is consistent with its approach in analyzing EC treaty restrictions in non-tax cases as well. Perhaps the most frequently cited decision in the corporate law context is Centros Ltd. v. Erhvers, Case C-212/97, [1999] ECR I-1459, in which the court specifically noted that a member state may apply national anti-avoidance provisions to prevent rights available under EC law from being used to circumvent domestic legislation in cases of abuse. However, this determination requires a particularized finding of fraud or abuse, which must be made on a case-by-case basis in view of the objectives underlying the EC treaty provisions at issue. The mere fact that business is not conducted in the state of incorporation was insufficient to prove the existence of fraud or abuse and, as a result, could not justify Denmark's denial of registration of a branch of a UK company on the basis that this structure could be used to circumvent minimum capital requirements under Danish company law.

86 Case C-324/00, [2002] ECR I-11779.

87 See ibid., at paragraphs 36-38.


89 See also the more recent judgment of the European Court of Justice in Test Claimants in the Thin Cap. Group Litigation v. Commissioners of Inland Revenue, Case C-524/04, released March 13,
2007, at paragraph 92, in which the court concluded as follows with respect to the former UK thin capitalization provisions: “Article 43 EC precludes legislation of a Member State which restricts the ability of a resident company to deduct, for tax purposes, interest on loan finance granted by a direct or indirect parent company which is resident in another Member State or by a company which is resident in another Member State and is controlled by such a parent company, without imposing that restriction on a resident company which has been granted loan finance by a company which is also resident, unless, first, that legislation provides for a consideration of objective and verifiable elements which make it possible to identify the existence of a purely artificial arrangement, entered into for tax reasons alone, to be established and allows taxpayers to produce, if appropriate and without being subject to undue administrative constraints, evidence as to the commercial justification for the transaction in question and, secondly, where it is established that such an arrangement exists, such legislation treats that interest as a distribution only in so far as it exceeds what would have been agreed upon at arm’s length.”

90 The court has arguably applied a different, and less restrictive, standard in its VAT decisions. In *Halifax plc, Leeds Permanent Development Services Ltd., County Wide Property Investments Ltd.* v. *Commissioners of Customs & Excise*, Case C-255/02, February 21, 2006, at paragraphs 69 and 74-75, the court defined abuse to include a transaction that is carried out solely for the purpose of wrongfully obtaining the advantages provided for by community law where, on an objective basis, they cannot be justified on commercial grounds but rather only in light of the tax benefits at issue, which are obtained in a manner contrary to the underlying purpose of the relevant provisions.


92 See ibid., at paragraphs 50-54.

93 The European Court of Justice reached a similar result in its more recent decision in *N v. Inspecteur van de Belastingdienst Oost/kantoor Almelo*, Case C-470/04, [2006] ECR I-7409, which concerned the Dutch departure tax provisions. In its justification analysis in that case, the court noted that the obligation to provide a guarantee for the crystallized departures tax liability in order to benefit from the deferral provisions went beyond what was strictly necessary in order to ensure the functioning and effectiveness of a tax system based on the principle of fiscal territoriality, notwithstanding the potential availability of less restrictive methods, including reliance on the mutual assistance directive for recovery of the subsequent tax liability that would, in the absence of the guarantee provisions, subsequently arise on the disposition of the assets subject to accrued gain. Similarly, the court noted that in order to be regarded as proportionate to the objective pursued, the system for collecting the departure tax on the subsequent disposition of the property would have to take full account of the potential for a decline in value of the property deemed to have been disposed of following the taxpayer’s transfer of residence, unless such decline was already taken into account in the host member state.


95 Citing its decisions in *Centros*, supra note 85, and *Kamer van Koophandel en Fabricken voor Amsterdam v. Inspire Art Ltd.*, Case C-167/01, [2003] ECR I-10155. In *Inspire Art*, the court held that the reasons underlying a corporation’s decision to incorporate under the laws of a particular member state are, with respect to the application of the freedom of establishment, irrelevant except in the case of fraud. Schindler argues that the premise of the court’s decision significantly undermines the holding in these cases, in that the factors relied upon by the court (described in the text following), including the degree of physical presence of the subsidiary in the host state, the genuine nature of the subsidiary's activities, and the economic value thereof within the group, require significantly greater economic substance than the “wholly artificial arrangement” standard applied in prior case law. See Clemens Philipp Schindler, “What
96 On this basis, the court, supra note 94, at paragraphs 54-55, went on to state as follows (citations omitted):

Having regard to that objective of integration in the host Member State, the concept of establishment within the meaning of the Treaty provisions on freedom of establishment involves the actual pursuit of an economic activity through a fixed establishment in that State for an indefinite period. . . Consequently, it presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there.

It follows that, in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory.

The court noted that, as in the case of intragroup loss utilization transfers, pursuant to which group losses are shifted from subsidiaries in low-tax member states to group companies in member states that impose higher rates of taxation, the type of conduct so described would undermine the rights of member states to exercise their tax jurisdiction in relation to activities carried out within their territory, and thus would jeopardize a balanced allocation between member states of the power to impose taxation.

97 The UK CFC rules have recently been amended in response to the decision in *Cadbury Schweppes*.

98 Supra note 94, at paragraph 63.

99 Ibid., at paragraphs 64-70 (citations omitted).


101 This will obviously make the administration of CFC regimes that extend to intra-community subsidiaries by member states highly impractical. For criticism of the result, on the basis that it inappropriately assumes the relevance of comparability of an arm’s-length standard to an internal group financing structure and improperly respects the status as a separate entity of a captive group subsidiary, see Lee A. Sheppard, “Cadbury Schweppes: The ECJ Versus Tax Administration” (2006) vol. 43, no. 6 *Tax Notes International* 452-58.

103 Supra note 77. As outlined above, in that case the European Commission had commenced an action against France for a declaration that, by virtue of the refusal of the French government to grant the benefit of shareholder imputation-based tax credits to branches of foreign insurance companies that carried on business in France through a permanent establishment on the same terms as those that could be claimed by French corporations, France had breached its obligations under the freedom establishment provisions in article 43 of the EC treaty.

104 The court stated, ibid., at paragraph 24: “[T]he fact that the laws of the Member States on corporation tax have not been harmonized cannot justify the difference of treatment in this case. Although it is true that in the absence of such harmonization, a company’s tax position depends on the national law applied to it, Article [43] of the Treaty prohibits the Member States from laying down in their laws conditions for the pursuit of activities by persons exercising their right of establishment which differ from those laid down for its own nationals.”


106 Ibid., at paragraph 21. Furthermore, the court noted, article 293 of the EC treaty specifically provides for the conclusion of agreements between member states for the purpose of securing, inter alia, the retention of legal personality in the event of a transfer by a corporation of its seat from one member state to another, although no convention has yet been concluded between member states on the basis of this provision.

107 See ibid., at paragraphs 20-23.

108 See, for example, the discussion in Dahlberg, supra note 14, at 265-66.

109 Supra note 91, at paragraph 60 (citations omitted).

110 Supra note 86, at paragraph 36.

111 Supra note 77, at paragraph 21: “Notwithstanding the French government’s argument to the contrary, the difference in treatment also cannot be justified by any advantages which branches and agencies may enjoy vis-à-vis companies and which, according to the French government, balance out the disadvantages resulting from the failure to grant the benefit of shareholders’ tax credits. Even if such advantages actually exist, they cannot justify a breach of the obligation laid down in Article [43] to accord foreign companies the same treatment in regard to shareholders’ tax credits as is accorded to French companies. It is also not necessary in this context to assess the extent of the disadvantages which branches and agencies of foreign insurance companies suffer as a result of the failure to grant them the benefit of shareholders’ tax credits and to consider whether those disadvantages could have any effect on their tariffs, since Article [43] prohibits all discrimination, even if only of a limited nature.”

112 For discussion, see Mason, supra note 14, at 111-12; Dahlberg, ibid., at 267-68.


114 The 1946 UK-US income tax convention provided, in general terms, that interest paid by a US corporation was subject to tax in the United Kingdom only when paid to a UK company or a company resident for tax purposes in the United Kingdom. Commerzbank AG, a German-resident corporation, was effectively exempt from tax on loans made through the UK branch.

115 Supra note 113, at paragraphs 18-19.


117 Ibid., at paragraph 21.

118 Ibid., at paragraphs 44-45. In deciding in Eurowings that unfavourable tax treatment cannot be compensated for by other tax advantages in order to justify discrimination, the court cited its judgment in Asscher v. Staatssecretaris van Financiën, Case C-107/94, [1996] ECR 3089. In that case the court concluded that a differential tax rate applied to resident and non-resident taxpayers constituted a violation of article 43 of the EC treaty, which could not be justified
under the rule of reason doctrine, despite the arguments of the Dutch government that the higher rate of tax was intended to compensate for (1) the fact that certain non-resident taxpayers could, by earning income in more than one country, escape the progressive nature of the tax by “splitting” income among those jurisdictions, thus avoiding the highest marginal rates, and (2) the non-deductibility of social security contributions made by resident taxpayers.

119 See supra note 77, at paragraph 22.


121 Case C-446/04, [2006] ECR I-11753.

122 The court rejected the ground for justification advanced by the UK government to the effect that the foreign tax relief granted to UK-resident companies that received foreign-source portfolio dividends under the foreign tax credit system could be limited to foreign withholding taxes levied (and not extend to the underlying corporate tax paid, even though domestic-source dividends were subject to full exemption) because of the administrative difficulties concerned, such as the need to carry out “lengthy and complex checks” (ibid., at paragraph 66).

123 See, for example, Arnaud Gerritse v. Finanzamt Neukölln-Nord, Case C-234/01, [2003] ECR I-5933.

124 This approach has not been without criticism. For example, Hinnekens, supra note 14, at 92-93, asks as follows: “What if the information or documentation is not available in the home state? What with admissible grounds for refusal of cooperation in the Directive? What would be language barriers and human, financial and technical restraints experienced in . . . practice? The Court’s answer (that it is the responsibility and obligation of the Member State and not of the individual to deal with those obstacles) seems too easy. . . . The interpretation flatly dismisses without much discussion the reasonable and imperative need of procedural simplicity and administrative cost saving, both for the taxpayer and the tax inspector.”


126 The court noted that the Luxembourg authorities had not put forward any evidence that there was an obligation to remedy the discriminatory consequences resulting from the application of the national provision by way of this appeal procedure. For discussion of the authority on this point, see Mason, supra note 14, at 108-10.

127 Very generally, group relief was available between members of a UK group (companies with common ownership of at least 75 percent) that either were resident in the United Kingdom or carried on business in the United Kingdom through a permanent establishment situated there. Following the decision in ICI, supra note 81, the UK group relief rules were extended to foreign branches of UK corporations and branches of foreign corporations situated in the United Kingdom. As discussed in greater detail in the text above, the court in ICI held that the group relief provisions violated the EC treaty freedom of establishment to the extent that they differentiated between UK branches and resident subsidiaries. However, the group relief rules were not extended to foreign subsidiaries where the relevant business activities were carried on outside the United Kingdom. For discussion of the background to the case, see Julian Ghosh, “The Marks & Spencer Case: A Prediction of the ECJ’s Holding” (2005) vol. 38, no. 1 Tax Notes International 33-43; Ingmar Doer, “A Step Forward in the Field of European Corporate Taxation and Cross-Border Loss Relief: Some Comments on the Marks and Spencer Case” (2004) vol. 32, no. 4 Intertax 180-86; and L.A. Denys, “Previous EU Proposals for Cross-Border Loss Relief” (2006) vol. 46, no. 9 European Taxation 443-48.

128 Supra note 13, at paragraph 37.

129 Supra note 41.

130 Supra note 13, at paragraph 39.
Whether the particular member state applies a group relief system similar to the UK provisions at issue in Marks & Spencer or a fiscal consolidation or Organschaft regime. See Sjoerd Douma and Caroline Naumburg, “Marks & Spencer: Are National Tax Systems Éclairé?” (2006) vol. 9 European Taxation 431-42; and Marjana Helminen, “The Esah Case (C-231/05) and the Future of Group Taxation Regimes in the EU” (2005) vol. 33, no. 12 Intertax 595-602. Wattel has referred to this element of the court's judgment as the “always somewhere” principle: an exemption must be made to the fiscal coherence or territoriality principle where “jurisdictional coherence . . . would cause loss relief possibilities permanently to be lost (as compared to the internal parent-subsidiary situation),” in which event the parent is required to provide loss relief as if the loss were a domestic subsidiary loss, despite the fiscal cohesion of the member state's tax system (that is, that it has not and will never tax the profits of the foreign subsidiary). He argues that the fiscal cohesion and territoriality justifications have been applied inconsistently by the court, and that exceptions thereto by way of the “always somewhere” principle in such decisions as Marks & Spencer and N reflect an allocation decision for which the EC treaty ultimately fails to contain a legal basis. See Wattel, infra note 144, at 148-51.


138 Ibid., at 59 (citations omitted).


140 For comment, see Adam Craig, Hans van den Hurk, Susan Lyons, Anno Rainer, Jan Roels, Otmar Thömmes, and Eric Tomsett, “Advocate General Backs Marks & Spencer's Claim for Loss Relief” (2005) vol. 38, no. 3 Tax Notes International 195-97, at 197; and Gerard T.K. Meussen, “The Marks & Spencer Case: The Final Countdown Has Begun” (2005) vol. 45, no. 4 European Taxation 159-63. This principle was upheld most recently by the court in Lidl Belgium (Case C-414/06), released on May 15, 2008. The court confirmed that it was not inconsistent with the freedom of establishment provisions in article 43 of the EC treaty for Germany to deny deductibility by the German corporate taxpayer of losses incurred by its permanent establishment in Luxembourg where the bilateral tax treaty between those countries allocated taxing rights in respect of the branch income to Luxembourg (relying on a pure exemption method), because the losses could still be applied at the branch level in a subsequent
taxation year. The court refused to adopt the method proposed by Advocate General Sharpston in her opinion, which would require deductibility of the loss by the head office on a current basis subject to recapture out of future branch profits.

141 Lang, supra note 137, at 61.

142 As Sheppard, supra note 139, at 1120, notes, lawyers “representing other large multinational taxpayers had anticipated massive refund claims in the wake of a Marks & Spencer victory. They were disappointed. The taxpayer won its case and will probably receive a much-needed multimillion-pound refund, but nothing about this case will improve the lot of other large taxpayers. The ECJ placed restrictions on loss claims that will make it very difficult for them to claim refunds, especially in Britain. The British and German governments said that the decision would not cost them much in lost revenue.”

143 Case C-231/05, released July 18, 2007.

144 Ibid., at paragraph 60. There is in fact considerable conceptual convergence between the various grounds of justification accepted in principle by the court. For discussion, see Peter J. Wattel, “Fiscal Cohesion, Fiscal Territoriality, and Preservation of the (Balanced) Allocation of Taxing Power: What Is the Difference?”, in Dennis Weber, ed., The Influence of European Law on Direct Taxation: Recent and Future Developments (The Netherlands: Kluwer Law International, 2007), 139-156. He argues, ibid., at 156, that fiscal cohesion, territoriality, and the need to preserve the balanced allocation of taxing power are “conceptually identical”; they all refer to the “need for jurisdictional consistency between tax base reductions and corresponding tax base increases; the need for territorial matching of ‘two sides of the same coin’, for symmetrical treatment,” and that the prevention of tax avoidance is a “subcategory of the need for fiscal territoriality cohesion, featuring the additional criterion of intent.”

145 The court stopped short of reaching a similar conclusion, however, in Rewe Zentralfinanz eG v. Finanzamt Köln-Mitte, Case C-347/04, released March 29, 2007, which concerned a German provision that enabled writedowns in the book value of shareholdings in domestic subsidiaries to be taken into account for tax purposes without restriction as operating expenses of the German parent company in calculating its taxable profits, but restricted deductibility in respect of shareholdings in subsidiaries established in foreign member states, which could only be written down in limited circumstances. The court made reference to its decision in Marks & Spencer, which was cited by the German government in support of the national tax measure at issue, but concluded, ibid., at paragraphs 42-43, that while there are courses of action that are capable of jeopardizing the right of member states to exercise their taxing powers in relation to activities carried on in their territory, and thus of undermining a balanced allocation of the power to impose taxes between member states that may justify a restriction on freedom of establishment, such an argument could not in itself justify a member state systematically refusing to grant a tax advantage to a resident parent company, on the ground that the company has developed a cross-border economic activity that does not have the immediate result of generating tax revenues for that state. Similarly, in Deutsche Shell GmbH v. Finanzamt für Großunternehmen in Hamburg, Case C-293/06, released on February 28, 2008, the court refused to allow Germany to justify a national tax measure that precluded a corporate taxpayer from deducting foreign exchange losses in respect of an investment in its foreign (in this case, Italian) permanent establishment on the basis of an exemption by treaty in respect of income derived by the German taxpayer through the foreign branch. In particular, the court noted that a member state may not justify its denial of a deduction in respect of losses that would not otherwise be taken into account either in the home or in the host state as a result of its own determination to negotiate a tax treaty provision that precludes it from taxing the foreign permanent establishment.

146 See, for example, the decisions in D v. Inspecteur van de Belastingdienst, Case C-376/03, [2005] ECR I-05821 (rejecting most-favoured-nation treatment in the tax treaty context on the basis of community law); Egon Schempp v. Finanzamt München V, Case C-403/03, [2005] ECR I-06421
(denying deductibility of cross-border alimony payments); Mark Kerckhaert and Bernadette Morres v. Belgische Staat, Case 513/04, [2006] ECR I-10967; and Heirs of M.E.a. van Hilten-van der Jeijden v. Inspecteur van de Belastingdienst, Case C-513/03, [2006] ECR I-1957. The distinction between disparities in domestic tax legislation and restrictive or discriminatory national tax measures is considered in greater detail below.

147 A provision of community law that has direct effect may be invoked and relied upon by an EC member state national in proceedings before a national court. The doctrine was established by the court in Van Gend en Loos v. Nederlandse Administratie der Belastingen, Case C-26/62, [1963] ECR 1.

148 See, for example, the Halliburton Services BV case, supra note 74.

149 For consideration of this issue, see Richard Lewin and J. Scott Wilkie, “Canada,” in Non-Discrimination Rules in International Taxation, Cahiers de droit fiscal international, vol. 78b (Deventer, the Netherlands: Kluwer Law and Taxation, 1993), 357-87. Although article 24(1) of the OECD model convention appears to be exceptionally broad in scope, it has not generally been applied in circumstances that would tend to constitute indirect or covert discrimination, including, in particular, where residence, as opposed to nationality, is the primary criterion for the differential treatment at issue. It is clear, on the basis of the wording of the non-discrimination provisions in the OECD model convention and the commentary, that residents and non-residents are not considered to be similarly situated for income tax purposes. For consideration of the relevant jurisprudence, see Lara Friedlander, “The Role of Non-Discrimination Clauses in Bilateral Income Tax Treaties After GATT 1994” [2002] no. 2 British Tax Review 71-118. Furthermore, unlike the non-discrimination principles established by the European Court of Justice in its interpretation of the EC treaty, the non-discrimination provisions in bilateral income tax treaties generally apply only to limit discrimination by the state of residence against taxpayers resident in the other contracting state that earns source-basis income in that country.


151 See, for example, Graetz and Warren, ibid., at 1219, who conclude as follows: “The problem with the argument that the foreign tax credit (and residence taxation) is discriminatory [is that] there is simply no principled basis to prefer it to the opposite argument that exemption of foreign income (and source taxation) is discriminatory. Putting the point more generally, prohibiting discrimination based on destination is ultimately inconsistent with prohibiting discrimination based on origin. This indeterminacy confirms the limits of non-discrimination as a tool for resolving basic issues of international taxation. The core tax policy issue here is the division of the tax base between source and residence countries, the resolution of which has depended more on compromising practice than on any over-arching principle. Regulating that division by reasoning from a principle of non-discrimination ultimately produces an incoherent result.” This conclusion has been challenged, on the basis that the “question of how to address discrimination (i.e. neutrality within one tax system as regards domestic and cross border activities), should . . . be distinguished from the question [of] how to address disparities between two tax systems, including double taxation, i.e. import and export neutrality”: Servaas van Thiel, “The Future of the Principle of Non-Discrimination in the EU: Towards a Right to Most Favored Nation Treatment and a Prohibition of Double Burdens?” in Comparative Fiscal Federalism, supra note 4, 331-400, at 344.

152 In this regard, see Fred C. de Hosson, “On the Controversial Role of the European Court in Corporate Tax Cases” (2006) vol. 34 no. 6/7 Intertax 294-304, at 300ff. See also the court’s decision in Laboratoires Fournier S.A v. Direction des vérifications nationales et internationales, Case C-39/04, [2005] ECR I-2057, at paragraph 23, in which it found that certain French research and development credits intended to promote regional development violated the free
movement of services provisions in article 49 of the EC treaty in that they were inconsistent with the aim of community policy in the field of research and technological development.

153 For discussion, see Graetz and Warren, supra note 150, at 1223-26.

154 See, for example, Otmar Thömmes, “Effect of ECJ Decisions on Budgets of EC Member States: EC Law Without Mercy?” (2005) vol. 33, no. 12 Inter Tax 560-61; and Graetz and Warren, supra note 150. These budgetary consequences are obviously compounded by the court’s reluctance, in recent direct taxation cases, to grant only prospective effect to its determination that national tax measures contravene EC law. See Pasquale Pistone, “Kirchberg 3 October 2006: Three Decisions that Did . . . Not Change the Future of European Taxes” (2006) vol. 34, no. 12 Inter Tax 582-84; Henck Vording and Allard Lubbers, “The ECJ, Retrospectivity and the Member States’ Tax Revenues” [2006] no. 1 British Tax Review 91-112; and Advocate General Stix-Hackl’s opinion in Wienand Meilicke, Heidi Christa Weyde, Marina Stöffler v. Finanzamt Bonn-Innestadt, Case C-292/04, at paragraphs 38ff., which describes the principles upon which temporal limitations of a judgment will generally be allowed (there must be a risk of serious economic repercussions as a result of the significant number of legal relationships entered into in good faith on the basis of national rules considered to be valid in force, and it must be apparent that the taxpayers and the national authorities have been led into adopting practices that do not comply with community legislation because of objective, significant uncertainty regarding the implications of community provisions to which the conduct of other member states or the commission may even have contributed).

155 The commission itself recognizes this effect of the court’s jurisprudence, which is equally applicable in the context of infringement procedures initiated by the commission. In a recent communication (Commission of the European Communities, Co-ordinating Member States’ Direct Tax Systems in the Internal Market, COM(2006) 823 final (Brussels: Commission of the European Communities, December 19, 2006), 4), the commission stated as follows: “It has become increasingly apparent that the lack of co-ordination between direct tax systems may also lead to unintended non-taxation or abuse and, hence, erosion of tax revenues, interfering with the ability of Member States to operate efficient and balanced tax systems. This may impact on the sustainable financing of Member States’ social models.” The commission contemporaneously released communications concerning exit taxes and cross-border corporate and group loss relief, each responding to the recent European Court of Justice decisions in these specific areas, appealing to member states to take concerted action on coordinating their respective tax systems and to cooperate with respect to enforcement in these areas pending developments in the implementation of a common consolidated tax base within the community. See also Graetz and Warren, supra note 150.

156 In this regard, see Christiana H.J.I. Panayi, “Treaty Shopping and Other Tax Arbitrage Opportunities in the European Union: A Reassessment—Part 2” (2006) vol. 46, no. 4 European Taxation 139-55, at 155, who concludes that “lack of Community policy on tax-location shopping has the effect of making the internal market a fiscal paradise for aggressive tax planning, undertaken both by Member State and third country residents, which not only minimizes but even eliminates taxation,” and that the broad readings of the provisions of the EC treaty by the European Court of Justice “suggest that anti-conduit or anti-treaty shopping measures are, prima facie, inconsistent with the single market, as protected by the fundamental freedoms and the competition provisions.”

157 In part for this reason, the European Union has been particularly active in its attempts to reduce and prevent harmful tax practices. In 1997, the Council of Economic and Finance Ministers (ECOFIN) adopted the Code of Conduct for Business Taxation, a series of measures designed to eliminate harmful tax practices (1998 OJ (C 2) 1). EC member states agreed in the Code of Conduct that they would refrain from introducing new harmful tax measures, to eliminate existing harmful tax practices in their dependencies and controlled or associated territories, and
to exchange information concerning tax measures that may violate the Code of Conduct. The code has political force but is not legally binding, and is therefore an instrument of “soft law.” For discussion, see Maria Flavia Ambrosiano and Maria Serena Caroppo, “Eliminating Harmful Tax Practices in Tax Havens: Defensive Measures by Major EU Countries and Tax Haven Reforms” (2005) vol. 53 no. 3 *Canadian Tax Journal* 685-719, at 710-13. The authors conclude, ibid., at 718, that the “high-tax jurisdictions’ goal of protecting their tax base seems to be partially frustrated, in that harmful international tax competition can still take place through general statutory rates and special regimes.”

158 For discussion, see Ruth Mason, “US Tax Treaty Policy and the European Court of Justice,” in *Comparative Fiscal Federalism*, supra note 4, 405-64, at 436-38. The spectre of harmful tax competition is often raised in support of the further harmonization of European taxation. However, for the reasons set out in the text following, negative harmonization through judicial decision arguably can never sufficiently address these concerns. In fact, many of the existing tax preferences within the community, such as the low Irish tax rate and the Hungarian tax regime applicable to related-party interest and royalties, now apply equally to domestic and foreign investors, and are not considered to constitute harmful tax practices at all. In this regard, positive harmonization would be required to eliminate the variance in domestic rates and related preferences to the extent that these cannot otherwise be addressed through “soft law” instruments such as the Code of Conduct and similar OECD measures.

159 Article 56(1) of the EC treaty expressly provides that, within the framework of the freedom of movement of capital and payments provisions set out therein, “all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.” However, it has been suggested that the lack of reciprocity, the absence of a common objective corresponding to the establishment of the single market, and the inability of EC institutions to act as harmonizing powers outside the EU mitigate in favour of a limited interpretation of these provisions of the EC treaty. For a comprehensive recent review of this issue, see Axel Cordewener, Georg W. Kofler, and Clemens Philipp Schindler, “Free Movement of Capital, Third Country Relationships and National Tax Law: An Emerging Issue Before the ECJ” (2007) vol. 47, no. 3 *European Taxation* 107-19.

In its more recent jurisprudence the court has demonstrated what appears to be an increasing reluctance to extend the scope of application of the EC treaty fundamental freedoms to third countries, principally by limiting the application of the free movement of capital provisions in article 56 where another fundamental freedom may be more directly applicable on the facts. For example, in *Lasertec Gesellschaft für Stanzformen mbH v. Finanzamt Emmendingen*, Case C-492/04, order dated May 10, 2007, the court held that the German thin capitalization rules did not contravene the provisions of the EC treaty in circumstances involving a loan advanced by a parent company resident in Switzerland to its German subsidiary, in which it held a controlling interest. The court noted that the freedom of establishment extends to participations in which the shareholder has a determinative influence over the decisions and activities of the subsidiary. As a result, the freedom of capital movement provisions were considered to be inapplicable, because a restriction of that freedom merely represented an unavoidable consequence of an obstacle to exercise of the freedom of establishment, which was found to be the primary freedom affected, but does not extend to nationals of third-country (non-member) states.

The court reached a similar decision in the context of an analysis of the UK thin capitalization rules in *Thin Cap. Group Litigation*, supra note 89. It concluded that the UK provisions affected related-party loans, which, by their very nature, arose only where the parent corporation had a definite influence or control over the group subsidiaries, with the result that the legislation primarily affected the freedom of establishment, and not the freedom of movement of capital under article 56 (ibid., at paragraphs 98-99). The still more recent decision in *Winfried L. Holböck v. Finanzamt Salzburg-Land*, Case C-157/05, released May 24, 2007, concerned the differential tax treatment of dividends received by individuals resident in
Austria from foreign, as opposed to domestic, corporations. The court found that the free movement of capital provisions could apply to dividends received by an Austrian controlling shareholder from a Swiss corporation, because their application did not depend on the level of influence or control over management, but found that the application of the provisions was grandfathered in these circumstances pursuant to article 57 of the EC treaty, because the domestic provisions had been in force on December 31, 1993. For further discussion of this trend, see Christiana H.J.I. Panayi, “Thin Capitalization Glo et al: A Thinly Concealed Agenda?” (2007) vol. 35, no. 5 Intertax 298-309, at 302. As discussed below, the court has also suggested that additional (or more flexible) grounds for justification of a national tax measure in this context may well be available.

In Skatteverket v. A, Case C-101/05, released on December 18, 2007, the court held that a provision disentitling a taxpayer from reliance on the Swedish participation exemption in the context of a dividend in kind where the subsidiary is resident in a third country (Switzerland) that does not have a treaty currently in force with Sweden containing an exchange-of-information article could be justified under the rule of reason doctrine based on the need to ensure the effectiveness of fiscal supervision, and that the Swedish provision was regarded as proportional. The court concluded, ibid., at paragraph 63, that, where “the legislation of a Member State makes the grant of a tax advantage dependent on satisfying requirements, compliance with which can be verified only by obtaining information from the competent authorities of a third country, it is, in principle, legitimate for that Member State to refuse to grant that advantage if, in particular, because that third country is not under any contractual obligation to provide information, it proves impossible to obtain such information from that country.” It therefore recognized, in applying its doctrine of justification, that movements of capital to or from third countries take place in a different legal context from that within the community. It further acknowledged that, owing to the degree of legal integration between member states, including bilateral exchange-of-information provisions such as the EC mutual assistance directive, the taxation of economic activities with cross-border aspects that occur within the EC will not always be comparable, in applying the rule of reason doctrine, to that of economic activities involving relations between member states and third countries, and that a member state may well be able to demonstrate that a restriction on the movement of capital in that circumstance may be justified on grounds that would not otherwise be valid in respect of intra-community capital movements. The Treaty of Lisbon amending the EC treaty, which was signed on December 13, 2007 and is proposed (subject to ratification) to enter into force in January 2009, would amend article 58 of the EC treaty by adding a new paragraph (article 58(4)) concerning the free movement of capital in relation to third countries. Under this provision, the Commission of the European Communities or, in the absence of a decision of the commission within three months following a request of a member state, the Council of the European Union, acting unanimously upon application by a member state, may adopt a decision stating that restrictive tax measures concerning one or more third countries are to be considered compatible with the EC treaty if they are justified by one of the objectives of the European Union and are compatible with the proper functioning of the internal market.

Mason argues that encroachment on member state tax sovereignty should be resisted, on the basis that tax policy reflects deep cultural and political values of the citizens of each state: Ruth Mason, “U.S. Tax Treaty Policy and the European Court of Justice” (2005) vol. 59, no. 1 Tax Law Review 65-131, at 99-100, referencing article 151 of the EC treaty, which states that the “Community shall contribute to the flowering of the cultures of the Member States, while respecting their national and regional diversity and at the same time bringing the common cultural heritage to the fore.”

It is recognized that membership in the European Union necessarily entails a compromise of national sovereignty, including tax sovereignty, in order to obtain the perceived benefits of regional integration; but these considerations must be properly balanced with the need of member states to continue to administer and enforce their domestic tax systems.

163 These cases have now been decided by the European Court of Justice on this basis. See Amurta SGPS v. Inspecteur van de Belastingdienst, Case C-379/03, released on November 8, 2007, and Denkavit Internationaal BV and Denkavit France SARL v. Ministre de l’Économie, des Finances et de l’Industrie, Case C-170/05, released on December 14, 2006. In Amurta the court noted, citing its decisions in Denkavit Internationaal and ACT Group Litigation, infra note 183, that to the extent that a member state imposes income tax not only on resident shareholders but also on non-resident shareholders in respect of outbound dividends paid by a resident corporation, both resident and non-resident shareholders would be regarded as being in a comparable position, and thus must be accorded the same treatment for tax purposes under domestic law. The court concluded that the justification of fiscal cohesion could not be relied upon, because the domestic exemption was intended to prevent economic double taxation. Similarly, the imposition of withholding tax on outbound dividends could not be justified as necessary for the purpose of safeguarding the balanced allocation of taxing rights between member states as in Marks & Spencer, supra note 13, and Oy AA, supra note 143, because that justification had, in the words of the court, been “recognized together with other grounds based on the risks of tax avoidance or of double use of losses” (at paragraph 56), neither of which was at issue on the facts at hand. Although the treaty between the Netherlands and Portugal provided for a limited credit in respect of the Dutch withholding tax imposed, the dividends received by the Portuguese shareholder were subject to a Portuguese domestic exemption from tax and thus no relief was available.

164 Although a Dutch corporate shareholder that owns at least 5 percent of the nominal paid-up capital of a Dutch company is already entitled to exemption at source from the Netherlands dividend withholding tax, the exemption did not apply to foreign shareholders and tax-exempt entities such as pension funds. The 2007 Dutch Corporation Tax Reform Bill extended the exemption to all corporate shareholders and tax-exempt entities resident within the European Union. Similarly, following the court’s judgment in Anneliese Lenz v. Finanzlandesdirektion für Tirol, Case C-315/02, [2004] ECR I-7063, which held that article 56 of the EC treaty precluded Austria from levying a higher rate of tax on foreign inbound dividends than on domestic dividends, Austria extended its preferential tax rate in respect of domestic-source dividends to all dividends received from corporations formed under the laws of EC member states. See Dietmar J. Aigner and Georg W. Kofler, “Austria Clarifies Third Country Impact of ECJ’s Lenz Decision” (2004) vol. 36, no. 4 Tax Notes International 477-85.

165 FKP Scorpio Konzertrproduktionen GmbH v. Finanzamt Hamburg-Eimsbüttel, Case C-290/04, [2006] ECR I-9461. The court considered a backup withholding obligation applicable in the context of fees paid by the German-resident taxpayer to a Dutch service provider (Europop). Under German tax law (as under the equivalent Canadian provisions in Income Tax Regulation
105), a 15 percent withholding tax was levied on payments made to non-residents in respect of services performed in Germany. The court acknowledged that the German withholding tax regime constituted an obstacle to the freedom to provide services pursuant to articles 59 and 60 of the EC treaty, but concluded that such legislation was “nevertheless justified by the need to ensure the effective collection of income tax” (ibid., at paragraph 35). It is worth noting, however, that the mutual assistance directive did not apply to the collection of tax debts between Germany and the Netherlands in the relevant taxation years at issue in Scorpio; the scope of the directive has since been extended and would now likely apply.


167 It has thus been noted, for example, that while the European Court of Justice held in Marks & Spencer that the UK group relief provisions contravened EC law to the extent that they did not apply in respect of foreign subsidiaries in specified circumstances, member states that have no domestic group relief provisions were arguably unaffected by the judgment, reinforcing an existing inherent economic inefficiency in both domestic and cross-border situations for taxpayers with business operations in such countries.

In a communication released by the Commission of the European Communities on December 10, 2007, The Application of Anti-Abuse Measures in the Area of Direct Taxation—Within the EU and in Relation to Third Countries, COM(2007) 785 final (Brussels: Commission of the European Communities, December 10, 2007), the commission recognized that it is necessary to strike a proper balance between the public interest of combatting abuse and the avoidance of disproportionate restrictions on cross-border activity within the community, and to better coordinate the application of anti-abuse measures in relation to third countries in order to protect the national tax base of member states. The commission expressly noted that it is not in favour of member states extending the scope of application of anti-avoidance measures to purely domestic transactions where no risk of abuse exists, for the sole purpose of avoiding contravention of the fundamental freedoms, because this approach ultimately undermines the competitiveness of member states and does not further the interests of the internal market. The commission suggested improving administrative cooperation to identify potentially abusive practices, including with respect to third countries through the exchange of information, and recommended that emphasis be placed on the development of common definitions for abuse and wholly artificial arrangements, in order to provide guidance on their application in the area of direct taxation; sharing best practices that are compatible with EC law, in particular with a view to ensuring proportionality of anti-abuse measures; and reducing potential mismatches resulting in inadvertent non-taxation.

168 This is not to say that the continued development by the court of its non-discrimination principle would not ultimately lead to amendments to the domestic tax systems of EC member states reflective of a base or minimum level of rights guaranteed by EC law, which, in and of itself, could potentially further promote the single European market through the removal of restrictions on or barriers to the right of establishment and the provision of goods, services, and capital. Nor is it to suggest that negative integration through judicial decision is necessarily an inappropriate means of enforcing EC treaty protections in the field of direct taxation; its appropriateness remains a matter of considerable debate. However, while the European Court of Justice has accorded a broad scope of application to the provisions of the five council directives in the area of direct taxation (and a correspondingly restrictive scope to certain limiting provisions in the directives themselves: the parent-subsidiary directive, the savings directive, the mutual assistance directive, the interest and royalties directive, and the merger directive)—arguably as broad as the scope of the non-discrimination rule—there has been relatively little progress made by way of positive integration of the national direct taxation legislation of the various EC member states.
For discussion, see Kaye, supra note 4, at 260-61. This is notwithstanding the commission's intention to move forward this year with a proposal to introduce a common consolidated corporate tax base (CCCTB) within the European Community. Under this proposal, which aims to simplify procedures, improve efficiency, and reduce compliance costs, companies would be entitled to follow the same rules for calculating the tax base in respect of all of their EC activities. The consolidated tax base would be allocated among member states in accordance with an agreed sharing mechanism (also specified in the proposal). The commission confirmed that it would not make any proposal with respect to the harmonization of corporate tax rates, which would continue to be set by the EC member states. See Commission of the European Communities, Implementing the Community Programme for Improved Growth and Employment and the Enhanced Competitiveness of EU Business: Further Progress During 2006 and the Next Steps Towards a Proposal on the Common Consolidated Corporate Tax Base (CCCTB), COM(2007) 223 final (Brussels: Commission of the European Communities, May 2, 2007). See also Daniel Durrtschmidt, “Comprehensive Approaches to Company Taxation in the European Union and Cross-Border Corporate Reorganizations” (2007) vol. 35, no. 3 Intertax 152-82, at 170ff. While the commission has embraced the CCCTB as its preferred approach to positive harmonization of direct taxation within the community on an interim basis, a number of member states, including Ireland, the United Kingdom, and many smaller states that have acceded to the EU more recently, have said that they remain opposed in principle to the enactment of a consolidated EC-wide tax base. Thus, any implementation of the commission’s proposal remains uncertain. For further discussion, see John Chown, “Eliminating Tax Obstacles for Cross-Border Operations” (2007) vol. 46, no. 6 Tax Notes International 563-71, at 570-71.

As one commentator has noted, the “sole reliance on the ECJ cannot assure the tax integration required for the realization of the internal market”; the legal “uncertainty of the ECJ case law is high and its effect is destructive (negative integration): it cannot replace by compatible rules the rules that it struck down as incompatible.” Hinnekens, supra note 14, at 100.


A similar basis for conclusion is evident in the court’s decision in the van Hilten case, supra note 146. The court refused to find that the Dutch inheritance tax provisions, which imposed inheritance tax on the estate of a testator who was a Dutch national and had resided in the Netherlands in the 10-year period prior to death, were contrary to article 56 of the EC treaty. It noted that the legislation applied equally to nationals resident in the Netherlands and to those residing abroad; any difference in treatment of Dutch nationals and non-nationals was a restriction attributable solely to the power of member states to define the criteria for allocating their respective tax jurisdictions. See J.J. van den Broek and M.R. Wildeboer, “European Court of Justice Permits Inheritance Tax Based on Nationality in Van Hilten-van der Heijden” (2007) vol. 61, no. 5 Bulletin for International Taxation 214-19; and Sjoerd Douma, “The Three Ds of Direct Tax Jurisdiction: Disparity, Discrimination and Double Taxation” (2006) vol. 46, no. 11 European Taxation 522-33, at 526.

Supra note 146. For a discussion of the background to this case, see Patrick Smet and Hannes Laloo, “ECJ To Rule on Taxation of Inbound Dividends in Belgium” (2005) vol. 45, no. 4 European Taxation 158-59.

Kerkhaut and Morres, supra note 146, at paragraph 20. See also the court’s comments in Columbus Container Services BVBA & Co. v. Finanzamt Bielefeld-Innenstadt, Case C-298/05, December 6, 2007, at paragraphs 39-45.

Kerkhaut and Morres, supra note 146, at paragraph 23.

Interestingly, as commentators have noted, because of the grant of the French avoir fiscal imputation credit to shareholders, the taxpayers in fact paid less net tax on the French-source dividends than they would have paid on a domestic-source dividend from a Belgian company. See Georg W. Kofler and Clemens Philipp Schindler, “Belgium Can Disregard French
Withholding Tax on Dividends, ECJ Advocate General Says” (2006) vol. 43, no. 6 Tax Notes International 459-61. The decision in Kerckhaert and Morres has nonetheless been severely criticized, in that the court’s decision implies that juridical double taxation is not, in and of itself, contrary to the fundamental freedoms, such that its elimination would require positive harmonizing steps to be taken at the level of the European Community. Kofler and Mason argue that, when viewed in relation to its ruling in Marks & Spencer denying the double use of corporate losses, the court’s ruling creates a “striking asymmetry,” in that the court appears to be protecting member states from the double use of losses but not, correspondingly, protecting taxpayers from the double taxation of corporate profits. They note that if the decision represents a political compromise, judicial self-restraint appears to be inappropriate where “the fact that a taxable event might be taxed twice is the most serious obstacle there can be to people and their capital crossing internal borders.” See Georg W. Kofler and Ruth Mason, “Double Taxation: A European ‘Switch in Time?’” (2007) vol. 14, no. 1 Columbia Journal of European Law 63-98, at 80.

177 Supra note 41, at paragraph 48. See Vanistendael, supra note 62, at 221. The opinion of Advocate General Madero in Marks & Spencer, supra note 13, at paragraph 71, reflects a similar approach to a potential broadening of the fiscal cohesion ground of justification: “As Advocate General Kokott pointed out in her opinion in Manninen, . . . that conception of fiscal cohesion rests on over-rigid criteria which are not always germane, regard being had to the objective pursued by the rules at issue. It follows that the margin of manoeuvre granted to the Member States in order to justify their tax regimes is excessively reduced. For that reason, it seems to me necessary, as Advocate General Kokott recommended, to relax those criteria. To that end I propose to revert to the criterion of the aim of the legislation at issue. Cohesion must first and foremost be adjudged in light of the aim and logic of the tax regime at issue.” Because the potential double use of corporate losses would be contrary to the objectives of the UK group relief legislation, the aim of which was to ensure fiscal neutrality of the effects of the creation of a group of companies, justification based on cohesion could thus potentially be accepted, assuming that the foreign losses could be treated equivalently in the member state in which they arose. For discussion, see de Hosson, supra note 152, at 302.

178 Wattel, supra note 60, at 230.

179 Ibid., at 232.

180 Indeed, the holding in Schumacker, supra note 57, has been characterized as “remarkable,” because it “seems as a rule to justify different treatment of resident and non-resident taxpayers, which is precisely forbidden under the doctrine of covert discrimination. The ECJ has made an exception to the acceptance of different treatment in cases where resident and non-resident taxpayers are in similar situations, because the non-resident taxpayer receives a substantial part of his income in the source state, so that he cannot benefit from his personal tax deductions in the state of residence. However this limited exception does not explain why a difference in residence is, as a matter of principle, not relevant for the application of the non-discrimination principle in tax cases.” See Frans Vanistendael, “Fundamental Freedoms and Tax Sovereignty in the European Union—General Report,” in EU Freedoms and Taxation, supra note 14, chapter 5, at 174-75.

181 As Wattel, supra note 60, notes, this ground of justification would not have been available to the German government in Schumacker, because the taxpayer earned substantially all of his income in the source state (Germany) and was thus unable to take his personal and family circumstances into account in the state of residence (Belgium). The same result would have been reached by the court, but its analysis of the fundamental freedoms for the purposes of community law would have accorded with the non-discrimination principles developed by it, and the international tax policy considerations underlying its judgment would have been expressly reflected in its justification analysis, resulting in a more certain and internally consistent body of jurisprudential principles.
This will preserve the court’s application of the non-discrimination principle pending harmonization by way of positive integration without pure fiscal and budgetary considerations affecting the comparability analysis with respect to the fundamental freedoms contained in the EC treaty, and at the same time will ensure that the national tax systems of EC member states remain internally consistent and effective in their respective administration and enforcement functions. The court’s inconsistency in determining cases involving direct taxation either on the basis of its comparability analysis (that is, on the grounds that the national tax measure was not discriminatory), or on the basis of the finding that a particular measure may be justified under the court’s rule of reason doctrine, has been criticized. See Kees van Raad, “Revisiting a 1981 Perspective on EC Non-Discrimination Rules in Income Tax Matters” [2006] no. 3 British Tax Review 318-21.

The court subsequently adopted the reasoning of Advocate General Geelhoed in Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue, Case C-374/04, Advocate General Geelhoed’s opinion, February 23, 2006. The court held in Test Claimants in the FII Group Litigation v. Commissioners of Inland Revenue, Case C-446/04, [2006] ECR I-11753, in the context of the (now repealed) UK franked investment income rules, that in the context of foreign-source dividends received by UK-resident companies, dividends paid by non-resident corporations must be treated in the same manner as domestic-source dividends with respect to relief provided, in this case by the member state acting in its capacity as state of residence, for the purpose of reducing or eliminating economic double taxation. The fact that domestic-source dividends were subject to an exemption system in the United Kingdom and foreign-source dividends were subject to a credit system would not, in itself, be considered to contravene the fundamental freedoms contained in articles 43 and 56 of the EC treaty. However, this is only the case if the tax rate applied in respect of foreign-source dividends does not exceed the rate applicable to dividends received from domestic corporations and the tax credit applied in respect of foreign-source dividends is at least equal to the amount of tax paid in the member state of residence of the corporation making the distribution, to the extent of the tax payable in respect thereof in the member state of the dividend recipient. However, the court held that the exclusion of portfolio dividends (received by a resident corporation from a foreign company in which it held less than 10 percent of the voting rights) from this credit system did contravene the freedom of capital movement provisions in article 56 of the EC treaty. For comment, see Hans van den Hurk, Stefan Meuller, Anno Rainer, Jan Roels, Otmar Thömmes, Eric Tomsett, and Gerben Weening, “U.K. Taxation of Foreign Dividends Violates EU Law, AG Says” (2006) vol. 42, no. 3 Tax Notes International 211-13.

Weber argues, for example, that only disadvantages that arise in the exercise of the fundamental freedoms and that result from the legislation of one EC member state should be considered to represent a restriction of the fundamental freedoms. This is because if disparities in direct tax law are considered to represent a restriction of the fundamental freedoms, the sovereignty of the member states to levy direct taxes will be implicated. The member states will no longer be
entirely free to decide under which conditions tax will or will not be levied, which in turn would compel the European Court of Justice to make choices that properly belong within the political sovereignty of the member states themselves, in the form of a decision as to which member state has caused the particular restriction, and a determination as to which of the competing taxation rights at issue should be accorded priority in the circumstances. He concludes that, in the event that the disadvantages arising from disparities are thus considered to be restrictions, the member states will inevitably lose their sovereignty in respect of direct taxation matters, since their own taxation rights would be linked to how another member state taxes, which in turn would violate the basic assumption reflected in the court's jurisprudence concerning how the freedom of movement affects direct taxation and, in particular, the fact that member states are free to unilaterally or by means of tax treaties determine the connecting factors to allocate taxation rights. See Dennis Weber, “In Search of a (New) Equilibrium Between Tax Sovereignty and the Freedom of Movement Within the EC” (2006) vol. 34, no. 12 *Intertax* 585-616, at 593-94.

186 *FII Test Claimants*, supra note 184, at paragraph 171. See also *Skatteverket v. A*, supra note 159, at paragraph 37, and *Staatssecretaris van Financiën v. Orange European Smalcap NV*, Case C-194/06, released on May 20, 2008, at paragraphs 90 through 95.

187 For further discussion of this principle in the context of the *Marks & Spencer* decision, see Ghosh, supra note 127, at 36-42. He notes (ibid., at 36): “The freedoms, as tools of negative integration, have no application to the absence of cross-border group relief when the losses arise in activities outside the scope of a taxing state's jurisdiction. The United Kingdom did not exercise jurisdiction to deny group relief for non-U.K. resident subsidiaries’ losses because the U.K. resident parent had established subsidiaries rather than branches in other member states. The absence of group relief for those non-resident companies’ losses arises because the United Kingdom has not exercised its jurisdiction over those subsidiaries. The non-resident subsidiaries are outside the notion of a U.K. resident person and their profits and losses are left out of account altogether, so far as the United Kingdom is concerned.” He concludes (ibid., at 41-42): “To require the United Kingdom to compute the losses of a person (the subsidiaries established in other member states) entirely outside its jurisdiction is not only to modify an illegitimate exercise of jurisdiction but also to impugn the very existence of the location of fiscal jurisdiction within the United Kingdom. Once the United Kingdom has asserted jurisdiction over a particular person by taxing its profits or asserting compliance requirements, the question may be posed whether the manner of that assertion is consistent with the internal market. But in identifying the subject that the United Kingdom wishes to tax, the definition of those tax units necessarily excludes some persons. A forced extension of the United Kingdom’s fiscal jurisdiction to those excluded persons . . . is to attack fiscal jurisdiction at a conceptual level that is distinct from, and anterior to, its exercise (namely its very existence). . . . That forced extension of jurisdiction is contrary to both principle and the consistent observation of the court that legislative fiscal jurisdiction remains within the competence of the member state (albeit that its exercise is subject to the provisions of the treaty).”

188 Similarly, in the *Bosal Holding* decision, supra note 66, the European Court of Justice held a restriction under Netherlands tax law limiting the deductibility of costs by a Dutch-resident parent company concerning its foreign subsidiaries to income of the subsidiaries taxable in the Netherlands, unless those costs were indirectly linked to the earning of profits subject to tax in the Netherlands, to be contrary to the freedom of establishment in article 43 of the EC treaty. On the basis of a more flexible analysis taking into account the division of taxing jurisdiction between the state of source and the state of residence (in this case, the Netherlands), the court would have expressly considered in its justification analysis the fact that the Netherlands exempted from taxation dividends received from foreign subsidiaries, such that the jurisdiction to tax the profits earned by the subsidiaries of Bosal Holding resident in other EC member states belonged exclusively to those states of source. Accordingly, while the application of
preferential provisions to Dutch parent companies with domestic subsidiaries would be contrary to the fundamental freedoms pursuant to the court’s non-discrimination principles, because such provisions inappropriately distinguished between the holding of domestic and intra-community participations in a manner that is clearly inconsistent with the principles of the single market, a more flexible and nuanced application of the court’s rule of reason doctrine would lead to the conclusion that it may well be consistent with the allocation of the jurisdiction to tax between the Netherlands and the state of residence of the subsidiaries of the Dutch parent company to require expenses incurred by the parent attributable to exempt profits of its foreign subsidiaries to be borne by the state of residence of those subsidiaries.