

# THE INFLUENCE OF THE EUROPEAN COURT - RECENT AND FORTHCOMING TAX CASES<sup>1</sup>

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## Introduction

The European Court of Justice (“the Court” or “ECJ”) has long been known for its instrumental role in the development of Community law. It is only however in relatively recent times that it has really had the opportunity of flexing its muscles in the fiscal arena. If the Court can be seen as arm-wrestling the governments of the Member States, then it is currently winning hands down. I mention below a number of recent and forthcoming ECJ cases in relation to companies and individuals. To me the cases demonstrate an ever-increasing boldness on the part of the taxpayer in attacking a broad range of fiscal measures and the continuing failure of national governments in defending them. In these circumstances, the reader is of course always at the mercy of the selection of the author, as in when one receives a box of chocolates chosen by a friend. But I hope that in the selection I have made there will be something of interest to everyone.

## Recent ECJ Tax Cases

*Case C-136/00 Danner*<sup>2</sup>

This case sounded the final death knell for the famous, or infamous, *Bachmann* ‘fiscal cohesion’ defence<sup>3</sup>. It will be recalled that Mr Bachmann was a

German national, resident and employed in Belgium. The provisions of Belgian income tax law made the deductibility of Mr Bachmann's pension and life assurance contributions conditional upon them being paid "in Belgium"- *i.e.* to a Belgian resident undertaking. The ECJ ruled that such provisions amounted to discrimination on the grounds of nationality – on the basis of the residence of the undertaking - and contravened Articles 39 and 49 EC (free movement of workers and freedom to provide services). However, the Court held that such provisions could be justified by the need to safeguard the 'cohesion' of the Belgian tax system. The ECJ reached this conclusion on the basis that there was a connection between the deductibility of the contributions and the liability to tax of the sums eventually paid out under the pension insurance contracts. The loss of revenue from the deduction was thus offset by taxation at a later stage.

The decision was widely criticised – not least because the Court failed to take the Belgium-Germany double taxation convention into account, and the ambit of the defence was reduced in later cases. In Case C-80/94 *Wielockx* the Court ruled that cohesion was in any event secured at the level of the relevant double tax treaty (and was not something to be assessed purely by reference to the national tax system), and in Case C-35/98 *Verkooijen* the Court added the requirement that there be a 'direct link', a 'symmetry', between the granting of the tax advantage and the offsetting of that advantage by a fiscal levy. As a consequence, and despite being consistently invoked by Member States to

justify a myriad of measures, the ‘cohesion’ defence has not met with success in any subsequent case.

*Danner*, however, removes any practical possibility of relying on the defence. The facts of the case were on all fours with *Bachmann*: Finnish tax law provisions precluded or restricted the deductibility for income tax purposes of pension insurance contributions paid to institutions established in other Member States (here, Germany). The Court ruled that the legislation restricted the freedom to provide services, contrary to Article 49 EC. It refused however to apply the ‘cohesion’ defence. It did so on the basis that there was no “direct link” between deductibility and taxation and that fiscal coherence was secured by Finland’s bilateral convention with Germany. It also rejected arguments that the provisions could be justified by the need to ensure the effectiveness of fiscal controls, since this could be secured by less restrictive means or, by the need to protect the integrity of the tax base.

Two observations can be made. First, a trawl through the relevant provisions governing the deductibility of pension, life assurance or other contributions paid to institutions established in other Member States, to ascertain those which fall foul of *Danner* (or of other Treaty provisions), may pay dividends. If the deductibility of the contributions is conditional upon the institution being established in a certain Member State, this will almost certainly be prohibited<sup>4</sup>. I very much expect this to be the result of the forthcoming case of C-288/01 *Thomsen*. Second, the

debate may in future shift to a consideration not simply of whether there is a prohibition on the deductibility of contributions paid to foreign schemes, but whether the resident and non-resident schemes are sufficiently similar that the differential treatment amounts to unlawful discrimination. We can already see this happening in Case C-422/01 *Skandia*, where the Swedish court referred the question of whether UK, German or Danish insurance undertakings, which, though not established in Sweden, meet all Swedish requirements, can be treated less favourably than otherwise identical Swedish undertakings. The ECJ is yet to rule on the case. Therefore, instead of Member States seeking to invoke 'legal' justifications such as 'cohesion', we may see a shift to a more practical approach, with Member States seeking to justify discriminatory treatment by drawing out as many factual differences as possible between national schemes and the foreign scheme in question.

*Case C-324/00 Lankhorst-Hohorst GmbH v Finanzamt Steinfurt*

I think it is not going too far to describe this case as a landmark decision. Tax advisers have long been aware that certain measures are incompatible with Community law but, for one reason or another, they have not been challenged. In *Lankhorst*, however, the taxpayer successfully challenged the German thin capitalisation legislation. The ECJ ruled that such legislation was incompatible with Article 43 EC (freedom of establishment). Under the relevant legislation (the German law on corporation tax), interest payments made

by a German undertaking to a shareholder not entitled to a German corporation tax credit were recharacterised as a non-deductible dividend (a covert distribution of profits), if the loan capital represented more than three times the shareholder's proportional equity capital. The legislation did not however bite if (i) the company could have obtained the loan capital from a third party under similar circumstances, or (ii) the loan constituted borrowing to finance normal banking transactions. The only groups of shareholders *not* entitled to corporation tax credit, and therefore subject to the thin capitalisation rules, were non-resident shareholders and a very limited class of corporations governed by German law and exempt from corporation tax.

In ruling that the legislation was incompatible with Community law, the Court held that it could *not* be justified on the basis that it was aimed at combating tax evasion – i.e. the extraction of profits from high tax jurisdictions. Nor was it necessary to ensure fiscal 'cohesion'. In this regard the German, Danish and UK governments raised not only *Bachmann*, but Article 9 of the OECD Model Convention as support for the existence of thin capitalisation rules. Broadly speaking, the Court (and more particularly the Advocate General) dismissed the relevance of the Model Convention on the basis that the objectives of the OECD differed from those of the EU. Thin capitalisation rules lead to discrimination on the grounds of nationality, constitute a restriction within the single market and are therefore prohibited.

As an aside, it is interesting to note that Advocate General Mischo considered that Article 5 of Directive 90/435/EC (the Parent-Subsidiary Directive) applied to the German rules. The Article provides that profits distributed by a subsidiary to a parent shall be exempt from withholding tax. However the ECJ did not address this point.

The case is interestingly in direct contrast to recent moves by the US administration to tighten up the equivalent US rules on 'earnings stripping'. In the context of the EU, the case will undoubtedly have an impact on similar tax legislation in many Member States and is a serious blow to national tax authorities as the amounts of tax at stake are potentially huge. It will lend encouragement to those planning equally bold challenges, for example to Controlled-Foreign-Company legislation. Anyone considering mounting a CFC challenge needs to be aware that the matter has been considered by the French and Finnish national courts. In *Re Société Schneider Electric*, the Conseil d'Etat, Paris, by judgment of 28 June 2002, held that Article 7(1) of the France-Switzerland double taxation convention prevented the French authorities applying CFC legislation in respect of the Swiss subsidiary of a French company. Obviously, this case did not consider the application of Community law. In contrast, the Finnish Supreme Administrative Court, Helsinki, held in its judgment of 20 March 2002, in the case of *Re A OY AB*, that the Finland-Belgium double taxation convention did not prevent the application of Finnish CFC rules. It also held that the rules did not amount to a restriction on the

freedom of establishment within Article 43 EC or on the free movement of capital within Article 56 EC. The conclusion of the Finnish court on Community law is particularly unconvincing, and it is a pity that the matter was not referred to the ECJ. However, the case may yet end up before the Court: the taxpayer company (Partek Oy) refused to be defeated and has lodged a complaint before the Commission in mid-February, asking the Commission to take Finland to the ECJ under Article 226 EC. I understand that the Commission is interested in pursuing it; perhaps we shall see results later next year.

*Case C-436/00 X and Y v Riksskatteverket*

In this case, Swedish legislation prevented a transferor of shares at undervalue obtaining a deferral of capital gains tax (akin to roll-over relief) on those shares, where the transfer was made to a foreign legal entity in which the transferor had a direct or indirect holding, or to a Swedish company which was a branch or subsidiary of such a foreign entity. On the facts of the case, X and Y were Swedish resident individuals who, together with a Maltese company, held shares in a Swedish company. These shares were to be transferred, as part of a re-organisation, to another Swedish company, a subsidiary of a Belgian company, again owned by X, Y and M. X and Y applied for an advance ruling from the Swedish authorities as to the treatment of the planned re-organisation, and were informed that no roll-over relief or deferral would be available.

The Court ruled on a reference from the Swedish

court that the legislation contravened the freedom of establishment and the free movement of capital – Articles 43 and 56 EC. Again, as in the other cases mentioned above, the ECJ refused to find that the rules could be justified, and rejected arguments based on possible abuse of freedom of establishment, on prevention of a reduction in tax revenue, on the ‘cohesion’ of the tax system, on the risk of tax evasion, on the effectiveness of fiscal supervision and on the provisions of Article 58 EC (which allow distinctions based on residence, but not where they amount to discrimination). What is interesting here is that the ECJ noted that the Swedish tax treatment resulted in a cash-flow disadvantage. This rationale could be applied to challenge other types of fiscal measures, where their application results not simply in the outright unavailability of a relief, but merely its postponement or deferral.

*Case C-385/00 De Groot v Staatssecretaris van Financiën*

I mention this case in passing, because it forms part of the ongoing stream of cases concerning the personal tax advantages or allowances of those whose occupations or professions lead them to work in a number of Member States. Mr De Groot was a Dutch national who had worked in France, the United Kingdom and Germany. As a consequence of this, he forfeited, in the calculation of income tax in the Netherlands, his state of residence, part of his personal tax advantages, on the grounds that he had also received income in other Member States

which had been taxed without taking his personal and family circumstances into account. The ECJ ruled that Article 39 EC (the free movement of workers) precluded such rules, whether in national legislation or as a consequence of double taxation conventions.

*Case C-208/00 Überseering BV v Nordic Construction Company GmbH*

While not a tax case, *Überseering* is interesting because it looks at the link between company residence and national rules on legal capacity. *Überseering* was incorporated in the Netherlands. It was deemed under German law to have moved its actual centre of administration to Germany, because its shareholders were resident there and its activities took place in Germany. Nevertheless, German law required *Überseering* to be reincorporated in Germany before it could have the capacity to bring legal proceedings there. The ECJ ruled that in such circumstances Articles 43 and 48 EC (freedom of establishment) precluded Germany from denying *Überseering* legal capacity and thus the capacity to bring legal proceedings in Germany. This makes sense, because the requirement of reincorporation in Germany in order to bring legal proceedings amounts to the outright negation of the right of a company to establish itself in another Member State.

### **Pending ECJ Tax Cases**

There are a number of pending cases – those in which an Advocate General has given his or her opinion, but the Court has yet to deliver its ruling. In most cases,

the ECJ agrees with the Advocate General (although usually with a more broad brush, or sometimes frankly unintelligible, approach to the case), so the following cases provide a good guide to what is likely to come out of the ECJ next.

*Case C-168/01 Bosal Holding BV v Staatssecretaris van Financiën*

*(Opinion of Advocate General Alber of 24 September 2002)*

This case concerns the deductibility in computing the profits of a parent company of charges relating to the holding of its subsidiaries. Bosal Holding BV, resident in the Netherlands, had subsidiaries in the Netherlands, in other EU Member States and outside the EU. Dutch legislation permitted Bosal to deduct any charges relating to the holding of its subsidiaries, but only if such charges assisted indirectly in generating taxable profits in the Netherlands. In reality, in order to generate such profits, the subsidiary would have to be resident in the Netherlands or have branches there. The Dutch court referred the question of whether such legislation was compatible with Articles 43 and 48 EC (freedom of establishment) and Directive 90/435/EC (the Parent-Subsidiary Directive).

The Advocate General found that the legislation was contrary to the freedom of establishment, because it made it less attractive for Dutch parent companies to have subsidiaries in other Member States. He went on to determine that the legislation could *not* be justified by

Article 4, paragraph 2, of the Directive. While that Article granted Member States the option of refusing to allow parent companies a deduction of charges related to their holdings, if they did so, they had to apply the same régime to all shareholdings. There could therefore be no discrimination between holdings in Netherlands subsidiaries and those in subsidiaries in other Member States. In addition, he found that the legislation could not be justified by (i) the need for ‘cohesion’ of the tax system, (ii) the principle of fiscal territoriality or (iii) the need to prevent the reduction of tax revenues.

If the ECJ reaches a similar conclusion – and I would expect a judgment any day now – this case will not only have serious consequences for the Dutch revenue authorities, but is likely to impact on similar regimes in a number of Member States.

*Case C-58/01 Océ van der Grinten NV v Inland Revenue Commissioners*

*(Opinion of Advocate General Tizzano of 23 January 2003)*

In this case, a UK company, Océ, paid dividends to its Dutch parent. On making the distribution it paid advance corporation tax (“ACT”) to the UK Inland Revenue. The dividends carried a tax credit on the basis of the ACT paid. The final value of the tax credit was however reached by deducting from it a ‘charge’ equal to 5% of the aggregate of the dividend and the tax credit. This ‘charge’ was levied under Article 10(3)(a) of the UK-Netherlands double taxation convention. The

national court referred the question of whether this ‘charge’ was compatible with Article 5(1) of Directive 90/435, the Parent-Subsidiary Directive, which prohibits the levying of withholding taxes on the distribution of profits by a subsidiary to its parent.

The Advocate General found that the 5% charge had to be considered separately in relation to its application to the dividend and the tax credit. The 5% levy on the dividend clearly amounted to a “withholding tax” within the meaning of Article 5 of the Directive. However, it fell within the exemption provided by Article 7(2), because its application was designed to lessen the double economic taxation of dividends (the Netherlands parent being given credit for the 5% charge by the Dutch authorities). The 5% levy on the tax credit did not however amount to a withholding tax, because it was in effect just a step in the calculation of the final tax credit (a calculation which was described by the Advocate General as of “baroque complexity”).

This case follows on from Case C-397/98 *Metallgesellschaft Ltd and Others v IRC*, also known as “*Hoechst*”. In that case, the Court ruled that UK legislation which permitted UK subsidiaries to pay ACT-free dividends to UK parents, but not to parent companies resident in other Member States, was contrary to Article 43 EC, the freedom of establishment.

*Case C-364/01 Barbier v Inspecteur van de  
Belastingdienst Particulieren**(Opinion of Advocate General Mischo of 12 December  
2002)*

This case concerned inheritance tax – not something one would ordinarily expect to fall under the scrutiny of Community law. Nevertheless, according to Advocate General Mischo, certain provisions of Dutch inheritance tax legislation need to be amended in the near future. The Dutch legislation provided that, for the purposes of calculating inheritance tax, those administering the estate of a non-resident could only deduct debts such as mortgages from the value of the deceased's real property situated in the Netherlands. The legislation applied in particular where the deceased had transferred the economic ownership of the property to another person. Perhaps not surprisingly, deductions were not so limited in the case of resident deceased persons.

The factual matrix we have here – with Mr Barbier owning the legal title to Dutch property, but the economic or equitable title being held through a Dutch resident company – derives from a stamp duty or transfer tax avoidance scheme. Mr Barbier had agreed in time to transfer the legal title to the resident company, but this obligation was *not* secured by way of mortgage. In these circumstances the effect of the legislation was that the full market value of Mr Barbier's property in the Netherlands was included in his estate. Had Mr Barbier been resident in the Netherlands, the taxable amount

would have been reduced by the unsecured obligation to transfer the legal title.

The Advocate General found that the legislation was discriminatory on grounds of residence and contravened not only the free movement of capital (Mr Barbier having bought the Netherlands properties once he had moved to Belgium) but also Article 39 EC (the free movement of workers). The principle to be drawn from the Advocate General's Opinion is that where a non-resident is taxed in the same way as a resident in respect of particular assets, the non-resident should be entitled to the same deductions and reliefs as the resident (especially where similar reliefs are unavailable to the non-resident in his Member State of residence). The Advocate General's view was that once a Member State treats a resident and non-resident in the same way for the purposes of taxation, it effectively admits that there are no objective differences between them and therefore cannot rely on pretended differences to deny a non-resident relief. This approach could clearly be applied in other fiscal areas.

Interestingly, at the same date as the Advocate General's Opinion was delivered, the Dutch court ruled that legislation deeming Dutch nationals who have emigrated to be resident for the purposes of inheritance tax in the ten years following their departure is discrimination based on nationality.

### **Two Forthcoming Tax Cases**

The Advocate General delivered his opinion in the

first of these cases on 13<sup>th</sup> March; the other, while still at the time of writing before the national court, may yet end up in Luxembourg.

*Case C-9/02 De Lasteyrie*

*(Opinion of Advocate General Mischo)*

Under Article 167 *bis* of the French Code Général des Impôts, a capital gains tax exit charge is levied on individuals leaving France and becoming resident in, for our purposes, another Member State. The charge can be avoided, but only after a series of burdensome administrative requirements are met and guarantees given. If the charge is levied, it is only repaid after a period of five years and then only if certain conditions are met.

A challenge was brought to this legislation under Article 43 EC (freedom of establishment). The Advocate General held that the legislation was clearly a restriction on this freedom. The question was whether the restriction could be justified. Four justifications were advanced – the erosion of the tax base, the fight against tax avoidance and the efficiency of fiscal controls, the cohesion of the tax system and the distribution of the power to tax between the Member State of departure and that of destination. None of the justifications was accepted by the Advocate General. In particular, he found that there were less restrictive means of combating tax avoidance. The Opinion, although brief, is well-reasoned, and I shall be surprised if the Court does not adopt a similar approach. If this happens, the case is

likely to have a huge impact on exit taxes levied by Member States on, for example, the emigration of trusts or companies – such as the deemed disposal of trust assets on emigration, which arises under UK capital gains tax legislation. If therefore one is involved in planning in this area prior to the Court's judgment, and wishes at least to have the possibility of relying on this case, it will be wise to ensure that the country to which the individual, trust or company emigrates is within the EU. Jersey, Guernsey and the Isle of Man would therefore be out, but Cyprus and Gibraltar remain a possibility.

*Marks and Spencer v Halsey (Inspector of Taxes)*

This case is currently at national level (coming before the High Court in April), and has not yet been referred to the ECJ. It concerns a challenge to the UK group relief provisions for corporation tax. It raises interesting issues in relation to differences in the treatment of non-resident branches and subsidiaries and is certainly one to watch.

**State Aid Cases**

State aid has recently become a hot topic in the tax world. Following a more aggressive approach by the Commission – hand in hand with the Code of Conduct on Direct Business Taxation - the rules are being applied in a wide range of situations in which certain undertakings are taxed differently from their competitors - whether by means of a difference in tax rates, tax exemptions, concessions, deferrals or reliefs.

For Article 87 EC, to apply, there are five requirements:

- (i) there must be an aid,
- (ii) granted by Member State/through State resources,
- (iii) which distorts competition/threatens to distort competition,
- (iv) by favouring certain undertakings/the production of certain goods,
- (v) and actually/potentially affects trade between Member States.

In the fiscal arena we have recently seen aid measures being struck down in a wide range of cases - such as in respect of the Gibraltar Exempt and Qualifying Company regimes (T-195/01, T-207/01). We can expect to see the State aid rules playing an ever-increasing role in the control of Member States' tax systems. It is therefore more than worth bearing not only the four freedoms in mind when considering challenging national tax legislation, but also the State Aid provisions – Articles 87 and 88 EC.

### **Conclusion**

There is little doubt that the tax systems of the Member States are being attacked, albeit in a rather random, haphazard way, on all sides – and that this

attack is being spearheaded by the taxpayer. There remains however a vast, multi-layered web of rules – at the national, European and international level – within which many difficulties and inconsistencies remain ensnared. To disentangle and simplify this web is a truly Augean task, which falls largely on the shoulders of the Court. It is up to us to ensure that it is properly guided. The future of our tax systems is at stake.

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<sup>1</sup> From a paper contributed by the author to an International Tax Planning Association conference held in Cannes in March 2003.

<sup>2</sup> The Advocate General's Opinion in this case was considered in an earlier edition of the *Review* (May 2002).

<sup>3</sup> Case 204/90 *Bachmann v Belgian State* [1992] ECR I-249.

<sup>4</sup> See also the recent Commission Communication on the elimination of tax obstacles to the cross-border provision of occupational pensions (O.J. 08/06/01 C 165/03).