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DISCRIMINATION AGAINST INDIVIDUALS AND ENTERPRISES ON GROUNDS OF NATIONALITY: DIRECT TAXATION AND THE EUROPEAN COURT OF JUSTICE

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Introduction

Readers of this journal will need no reminding of the importance of the concept of discrimination in the jurisprudence of the EC. As is well-known, the European Court of Justice has recently had to consider this area of law in relation to direct taxation in *Finanzamt Köln-Alstadt v Roland Schumacker*[2]. Further cases on discrimination will be heard by the Court before too long.[3] With each case that is heard questions are raised for clarification in the future. For example, whilst *Bachmann*[4] may have permitted the cohesion of a tax system as a justification for discrimination, the circumstances in which the ECJ will permit a Member State to rely upon it is by no means clear.

The cases concerning direct taxation are not simply of significance because they require compliance with the EEC Treaty in relation to the particular provisions of

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2 Case C-279/93 judgment given 14th February 1994.

3 See *GHEJ Wielockx v Inspecteur der Directe Belastingen* Case C-80/94 and *Commission v Luxembourg* Case C-154/94.

4 Case C-204/90 *Bachmann v Belgian State* [1992] ECR 249; Case C-300/90 *Commission of the EEC v Kingdom of Belgium* [1992] ECR 305. It should be noted that the French judgment uses the word "cohérence" not "cohésion" and the official German translation uses "Kohärenz" and not "Kohäsion".

a tax system in question and have encouraged lawyers in the Member States to judge their tax legislation by reference to it. Just as important is the fact that legislators are increasingly bearing the EEC Treaty in mind in formulating legislation. An example of this is provided by the Irish government's willingness to make available personal reliefs to members of the European Union (as pointed out by Mr Hickson in his article elsewhere in this issue)[5].

In addition to new cases there are new provisions of the EEC Treaty to be considered. For example, Article 73d, referred to by Advocate-General M Léger in *Schumacker*,[6] inserted by the Maastricht Treaty, permits Member States to apply provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or the place where their capital is invested, in derogation of the prohibition on restrictions of movement of capital.

Against such a background, this article offers some observations, which are by no means comprehensive, on this important and developing area of law.

Preserving Fiscal Sovereignty

The cases which the ECJ has so far heard in this area demonstrate the continued determination of the national governments of Member States to retain as much control of their fiscal system as possible. They object not just to the specific application of the principles of the EEC Treaty to the case before the Court, but also to the application of those principles to direct taxation in general.

In *Commission v France*[7], the French government emphasised that:

> "...as the law now stands, direct taxation is within the jurisdiction of the Member States which may, subject to the provisions of the Treaty, organize their tax systems as they see fit..."[8]

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5 See page 79. The UK government has acknowledged that it too must bear in mind the impact of the EEC Treaty on its legislative proposals in its Press Release of November 1994 regarding the thin capitalisation rules which it is introducing in clause 79 of the current Finance Bill. These are themselves open to the charge of being discriminatory despite being introduced in order to avoid discrimination.

6 Paragraph 32 of his opinion. Articles 73b and d are referred to as demonstrating clearly that the tax legislation of Member States must comply with the fundamental freedoms contained in the EEC Treaty.

7 Case C270/83 [1986] ECR 273.

8 Supra at p 291.

The same approach was apparent in *Klaus Biehl v Administration des contributions du grand-duché de Luxembourg*.[9] The tax authorities in Luxembourg contended that the non-discrimination rules contained in what was then Article 7 of the EEC Treaty were inapplicable:

> "...because the rules governing the collection of income tax do not fall within the scope of the Treaty."[10]

Unsurprisingly, the ECJ did not accept this contention[11].

The member-states' protection of their powers was again apparent in *Bachmann* in which the Belgian government preserved its requirement for insurance premiums to be paid in Belgium if they were to be deductible for tax purposes. The Court acknowledged the discriminatory effects of the requirement but said they were justified on the grounds of the cohesion of the tax system, thereby giving to the member states a new weapon with which to defend their fiscal regimes.

In *Werner,* German income tax provisions were in question. If the case could be characterised as one concerning internal German matters, as it ultimately was, the EEC Treaty would be inapplicable. Consequently, not only the German government but also the governments of Belgium, France, Italy, Portugal, and the United Kingdom appeared before the Court to argue that Mr Werner should be refused a remedy. More recently, in *Halliburton*, the Netherlands' government attempted to treat direct tax provisions as an internal matter outside the remit of the ECJ.[12] The court held, though, that the payment of tax by a Dutch subsidiary of a US group, on the transfer to it by a fellow German subsidiary of land within the permanent establishment of that German subsidiary, was subject to EC law. Had the transferor subsidiary been a Dutch company it would have been exempted from tax and it was held to be discrimination to charge tax in respect of the transfer by the German company.

Clearly, national governments will continue to resist the application of the EEC Treaty to their direct tax regimes. It is not without significance that the first question which was put to the ECJ in *Finanzamt Köln-Altstadt v Roland Schumacker* asked:

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9 Case C-175/88 [1990] ECR I 1779.

10 Supra p 1781.

11 Supra at p 1792.

12 Supra para 18 p 666.

> "Does Article 48 of the EEC Treaty restrict the right of the Federal Republic of Germany to levy income tax on a national of another Community Member State?"[13]

This would seem to be another way of asking if income tax really can be within the scope of Article 48. Indeed, the judge who referred the case to the ECJ commented that the EEC Treaty did not in any way give grounds for the harmonisation of direct tax.[14] However, *Biehl*, amongst other cases, has already clearly decided that the direct tax regimes of member states must conform to the demands of the EEC Treaty. It is, perhaps, not surprising that the ECJ specifically referred to the decision in *Biehl* in its judgment in *Schumacker*[15] - which was another case in which the member-states turned out in force to defend their powers.

Some Provisions of the EEC Treaty

Whilst it is true that there is no specific requirement in the EEC Treaty that direct taxation be harmonised,[16] nevertheless, as has already been noted, the income tax regimes of member states must respect the laws of the Community.[17] Of great importance in this regard is the prohibition of discrimination on grounds of nationality.

A fundamental provision is contained in what is now Article 6[18] of the EEC Treaty. Its first sentence states that:

> "Within the scope of application of this Treaty, and without prejudice to any special provisions contained therein, any discrimination on grounds of nationality shall be prohibited."

In addition to this general provision there are a number of specific ones both in the Treaty and in Community legislation. Article 6 does have a role independent of them. However, it applies only to those situations in which no specific prohibition of discrimination is applicable. Fundamental specific prohibitions are

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13 Supra.

14 See paragraph 16 of the Advocate General's opinion.

15 See paragraph 23 of the judgment.

16 See paragraphs 16 and 17 of the Advocate General's opinion in *Schumacker*.

17 See paragraph 21 of the judgment of the ECJ in *Schumacker*.

18 Prior to the amendments necessitated by the Maastricht Treaty it was Article 7.

established by reference to the basic freedoms enshrined in the EEC Treaty. Article 48 provides for freedom of movement of workers and prohibits discrimination based on nationality between workers of the member-states as regards employment, remuneration and other conditions of work and employment. Article 52 provides a right of establishment which includes the right to take up and pursue activities as self-employed persons and to set up and manage undertakings under the conditions laid down for nationals in which the establishment is effected. It should be noted that both these Articles, Article 59 concerning freedom to provide services and, most probably, Article 73b concerning free movement of capital, can be relied on by persons in their national courts. Indeed, *Halliburton* re-affirmed this in relation to Article 52.[19]

Article 58 provides that so far as the right of establishment for companies or firms is concerned, those who have their registered office, or central administration, or principal place of business within the Community, are to be treated in the same way as natural persons who are nationals of member-states.

It has already been observed that the Maastricht Treaty has had an effect of some significance in relation to tax and discrimination. Article 73d, which it introduced, provides that the prohibition of restrictions on free movement of capital in Article 73b shall be without prejudice to the right 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;
>
> (b) to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation..."

The measures which are taken pursuant to (b) are not, however, to constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments.[20] The exact meaning of the Article is by no means clear, as is widely acknowledged.[21] What the ECJ will make of it remains to be

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19 Supra para 16 p 666.

20 See Article 73d(2).

21 See, for example, the comments of Professor Servas van Thiel reported at 34 *European Taxation* [1994] p 152.

seen.[22] It may well be that there will be a parallel development of case law on Articles 52 and 73b which Farmer and Lyal have suggested is essential if arbitrary distinctions between different categories of cross-border investment are to be avoided.[23]

In addition to being somewhat opaque, the provisions of Article 73d, are unusual in referring specifically to taxation in the context of discrimination.[24] Mostly, the provisions in the EEC Treaty which prohibit discrimination and which apply to direct taxation are of a general nature. The validity of member-states' tax systems in this area is consequently clarified mostly by reference to the fundamental freedoms which the EEC Treaty contains and not by specific fiscal provisions.

The Relationship between General and Specific Provisions of the Treaty

In view of the existence of these differing provisions the relationship between them has had to be considered by the Court. In *Werner* it made clear that the approach laid down in *Van Ameyde* v *UCI* [25] applied, namely that the general provisions of Article 7 (as it then was) are to be regarded as specifically expressed elsewhere in the EEC Treaty. Consequently, in *Werner* Article 52 of the Treaty guaranteed, in relation to the right of establishment, the specific application of the general principle of non-discrimination. As the provisions in question regarding residence were compatible with Article 52 they were compatible with, what was then, Article 7. It should be added that the converse is also true. If Article 48, 52, or 58 is infringed so is the general provision.[26]

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22 Frans Vanistendael has suggested that in permitting non-discriminatory distinctions to be made the Article allows member states "...to make distinctions between residents and non-residents...for tax purposes in the movement of capital, when such distinction is based on legitimate considerations of general interest, such as the preservation of the coherence of a tax system, provided that the distinction is non-discriminatory: ie the distinction must be based on objective criteria that are directly necessary and relevant to reach the policy goals." See 'The Limits To The New Community Tax Order' 31 CML Rev [1994] 293-214. See also 'Direct Taxes part 2' *The Tax Journal*, 28th July 1994 No 270 p 14: J Flynn and G Brannan.

23 See *EC Tax Law* P Farmer and R Lyal, Clarendon Press, Oxford 1995 at pp 334-335. The book will be reviewed in the second issue of this *Journal*.

24 Their introduction may well indicate a sensitivity on the part of certain member-states to the vulnerability of their tax systems.

25 C90/76 ECR [1977] 1091.

26 See *Commission of the European Communities v Hellenic Republic* Case 305/87 [1989] ECR 1461 at pp 1476-7.

The relationship between different Articles of the EEC Treaty was considered also in *Commerzbank*, and *Commerzbank* itself drew attention to the relevant aspects of *Werner*. The Court observed that as the legislation in question was incompatible with Articles 52 and 58 of the Treaty it was unnecessary to consider its compatibility with the general non-discrimination provisions in Article 7 and the general obligation to comply with the Treaty contained in Article 5. In *Halliburton* the ECJ adopted a similar approach.[27]

Individuals and Enterprises

In the cases before the ECJ the position of both individuals and commercial enterprises has been in issue. Their positions are not, though, identical. In prohibiting discrimination on grounds of nationality it may at first sight be thought that only natural persons are referred to in Article 6, especially as it is considered necessary in Article 52 to enlarge the provisions regarding freedom of establishment to include companies and firms. Article 6 is, however, to be interpreted widely both in relation to the persons covered and the nature of the discrimination. It has been said that:

> "All general or particular measures or acts of Community Institutions, Member States, or enterprises which treat a person or enterprise differently on the ground of certain personal or business relations with another Member State will...fall under the prohibition. A Member State will not be able to evade prohibition by means of discriminatory acts on the ground of the place of establishment of the enterprise ... unless such treatment is objectively justified."[28]

In 1986 Professor van Raad suggested that enterprises are in a more favourable position than individuals. This was because, by reason of Article 58, enterprises which are resident in a member-state by reason of the location of their place of business, for example, are treated in the same way as natural persons who are nationals of a member state. There is, however, no express extension of the non-discrimination Article to cover the residence of individuals.[29] Since that time it has been emphasised that discrimination on grounds of an individual's residence can still amount to discrimination on grounds of nationality.[30] Nevertheless, if

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27 Supra para 12 p 665.

28 *Introduction to the Law of the European Communities*, PJG Kapteyn and P Verloren van Themaat, 2nd Ed by Laurence W Gormley, 1990 Kluwer at p 96.

29 See *Non-discrimination in International Tax Law*, K van Raad, Kluwer: Law and Taxation Publishers 1986, at p 39.

30 See, for example, the judgment of the ECJ in *Biehl*, supra at para 14.

it does not amount to covert discrimination on such grounds it is acceptable, as Mr Werner discovered.

Determining the Existence of Discrimination

Having briefly examined some of the basic provisions of the EEC Treaty it is proposed to look at the comparisons which need to be made in order to determine whether or not discrimination exists and the breadth of the concept of discrimination.

In assessing whether or not discrimination exists it is not enough merely to establish the existence of discrepancies between situations. As the Advocate General said in *Biehl* "...a difference does not necessarily amount to a discrimination..."[31] Instead, the provision in question must provide for "...unequal treatment in situations which are identical or comparable..."[32] This raises the interesting question of what situations are to be compared.

Making the Correct Comparison

The problem of what comparison to make is, of course, a familiar one in relation to the OECD Model Convention on Income and on Capital.[33] The problem exists too in the quite different context of establishing discrimination prohibited by the EEC Treaty. *Schumacker* tends to support the view that compliance with the OECD Model Convention need not protect a state from attack before the ECJ. As the Advocate General pointed out in his opinion and the ECJ noted in its judgment, the German system of taxing residents and non-residents was coherent. The fact that there were different regimes was not inconsistent with the OECD Model Convention since the two categories of individuals were not generally in comparable situations.[34] Nevertheless, the German approach was not consistent

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31 Supra at p 1785 para 8.

32 *Judicial Protection in the European Communities*, Schermers and Waelbroeck, 5th Ed (Deventner, Kluwer 1992) at p 69 para 116.

33 See, for example, Article 24(5) which provides, in short, that enterprises in one contracting state subject to total or partial ownership or control from the other contracting state are not to be subjected to any requirement which is other or more burdensome than that to which "other similar enterprises" of the first state are or may be subjected. The existence of discrimination depends upon whether the "similar enterprises" are those under third country control or not. See for a discussion: 'The Non-discrimination Article in Tax Treaties' John F Avery Jones et al 31 *European Taxation* [1991] 309 at p 338ff.

34 See paragraphs 58 to 65 of the opinion and paragraphs 32-34 of the judgment.

with the EEC Treaty in relation to individuals who earned the whole or almost the whole of their income in a state in which they were not resident. Such non-residents were in comparable situations to residents and, therefore, ought to be treated similarly.

Of course, in *Schumacker* the ECJ was comparing the way in which one state treated two classes of individuals. It is fundamental that it is not possible for an individual to compare the way in which he is taxed in one country with the way in which another individual is taxed in a different country and allege discrimination. Differences of treatment by different member states are simply the result of a lack of harmonisation. In order to be able to complain about discrimination the discrimination itself must be imputed to a single legal subject.[35] It is worth noting here that the Commission also takes the view that one cannot compare tax treaties and allege that the differences between them amount to discrimination.[36] That is not to deny, of course, that individual tax treaties can in the appropriate circumstances be discriminatory.[37]

It is also essential that a comparison be made between the treatment, whether covert or overt, by one state of the nationals of its own and another state. Consequently, a comparison cannot be made between the differing treatment of the nationals of one member state. The result is that in certain situations a member state may "discriminate" against a class of its own nationals if it wishes.

An example of this happening arose in *Werner*. Mr Werner was a German dentist who lived in Belgium but practised in Germany. Prior to October 1981 he was employed, thereafter he was self-employed. This change resulted in an alteration in the way in which he was assessed to German tax. Whilst employed he was entitled to an allowance given to married couples and certain deductions from his taxable income. On becoming self-employed he lost these advantages because those who do not reside or have their habitual residence in Germany are taxed differently on non-salaried income.

Mr Werner, in effect, contended that he had been the subject of unlawful discrimination when compared with residents of Germany. The ECJ held that he

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35 *Introduction to the Law of the European Communities*, supra, p 95.

36 See Written Answer of the Commission 9th November 1992, Question No. 647/92 OJ C40/13 (15.2.93). Whilst the Commission apparently considers that no discrimination arises, the view is not universally considered beyond challenge. Compare the doctrine of the relative effect of double tax treaties. See paras 54 and 55 of the Commentary on the OECD Model Treaty (1977). These paragraphs are omitted in the 1992 revision.

37 See the Commission's Answer to Written Question 2047/90: OJ C195/19 (1.7.93).

had not been. It noted that he was a German national who wished to practise in Germany with professional qualifications and experience in Germany.[38] Mr. Werner's reliance on *Biehl* was considered inappropriate since Mr Biehl, a German national, complained of legislation in Luxembourg which linked repayment of tax to residence in Luxembourg and therefore weighed particularly heavily against nationals of other member states.[39] *Commission v France* was also considered a quite different case, since by treating enterprises differently for the purposes of the *avoir fiscal*, depending upon the Member State in which their management and control was located, the government's conduct was comparable to discrimination on grounds of nationality for natural persons.[40]

Instead of discriminating on grounds of nationality, the legislation discriminated, said the Court, on grounds of residence. There being no question of covert discrimination against nationals of other Member States as in *Biehl,* there was no discrimination on grounds of nationality against Mr Werner. It could be that the court paid too little attention to the fact that Mr Werner was resident outside Germany in concluding that it was an internal German matter.[41] However, a finding in favour of Mr Werner would inevitably have involved a development of the law and it is understandable that the court declined to make one.[42]

Werner can be seen as a case, therefore, in which the taxpayer made an inappropriate comparison. Usually in the reported cases it is the tax authorities which do this. For example, in *Commission v France*[43] the French government justified its restrictions on the availability of the *avoir fiscal* because the difference of treatment:

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38 This distinguished him from Mr Knoors (see *Knoors v Secretary of State for Economic Affairs* Case 115/78 [1979] ECR 399) who was a Netherlands' national who wished to practise there with qualifications obtained in Belgium.

39 Supra para 14 of the judgment.

40 Supra para 15 of the judgment.

41 See D Berlin [1993] *Jurisprudence Fiscal Européene* Rev Trim Dr Eur p 331 para 21 onwards.

42 For discussions of the *Werner* case, see, *Hans Werner v Finanzamt Aachen-Innenstadt*, CML Rev [1993] 1229, B Knobbe-Kenk, and 'A Further Limitation in the Application of the EEC Treaty Non-Discrimination Rules' 33 *European Taxation* [1993] 220, Paul J te Boekhorst.

43 Case 270-83 [1986] ECR 285.

> "...corresponds to objective differences of situation. The difference is based on a criterion of residence, not of nationality."[44]

The Court was unimpressed, as it was in *Biehl*, in which the Luxembourg government vainly attempted to justify its legislation by saying that:

> "Article 48(2) of the Treaty [concerning freedom of movement of workers] does not rule out different treatment for two distinct categories of taxpayers, namely, resident taxpayers and taxpayers who have exercised their right to freedom of movement."[45]

The United Kingdom government also relied on objectionable comparisons in *Commerzbank*. It will be recalled that the government had wrongly demanded tax on interest received from a US company, which was exempt from tax under the UK/US double tax treaty. The tax was repaid but the Inland Revenue refused to pay an equivalent of interest ("repayment supplement") to Commerzbank since it was a branch of a German company and not resident in the UK. It was contended on behalf of the UK that the fact that Commerzbank was exempt from tax under the UK/US double tax treaty meant that there was no discrimination. Discrimination, it was said:

> "...presupposes different treatment of persons who are in an identical situation. In view of the exemption enjoyed by Commerzbank, it must be concluded that the latter is not in a comparable situation to that of its United Kingdom competitors; consequently it is impossible to conclude that there is discrimination."[46]

That the court was unpersuaded by this contention is not surprising, especially when its previously expressed attitude to the provisions of the EEC Treaty and double tax conventions is borne in mind.[47]

Once the correct comparison is made it is necessary not only to have regard to direct or overt discrimination but also indirect or covert discrimination, and it is to the distinction between these two concepts that we now turn.

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44 Supra p 291.

45 Supra at p 1780.

46 Supra at p 135.

47 See further E.1.*iii)*.

Overt and Covert Discrimination

It has been seen that Mr Werner failed because his discrimination was made on grounds of residence, but that Mr Biehl succeeded because, although he too objected to a law relating to residence, the law resulted in covert discrimination contrary to Article 48 of the EEC Treaty against nationals of other member states. In *Biehl* the Court summarised its reasoning as follows:

> "According to the case-law of the Court, the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality but also covert forms of discrimination which, by the application of other criteria of differentiation, lead to the same result (judgment of 12th February 1974 in Case 152/73 *Sotgiu v Deutsche Bundespost* [1974] ECR 153, paragraph 11).
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> Even though the criterion of permanent residence in the national territory...applies irrespective of the nationality of the taxpayer concerned, there is a risk that it will work in particular against taxpayers who are nationals of other Member States. It is often such persons who will in the course of the year leave the country or take up residence there."[48]

The principle established in *Sotgiu* was relied on by the European Commission in *Bachmann v Belgium*[49]. It will be recalled that Mr Bachmann, a German national working and resident in Belgium, had entered into certain insurance policies with German insurance companies prior to going to Belgium. The premiums were not deductible for tax purposes since they were not payable in Belgium. It was alleged that this was a prohibited discriminatory provision.

So far as pension and life assurance contracts were concerned the provisions were considered discriminatory because it would normally be nationals of other member states who, after working in Belgium return to their country of origin, who would be adversely affected. The Belgian rules had the effect of ensuring that where premiums were paid outside Belgium the premiums were non-deductible but the payments by the insurer would be free of Belgian tax. For non-Belgians returning to their state of origin, having paid premiums without deduction of tax, the payments by the insurer would be likely to be subject to tax in their home state. Consequently there was an indirect discrimination contrary to Article 48 of the EEC Treaty providing for freedom of movement.[50] So far as invalidity and sickness insurance was concerned, there was a restriction on freedom of movement

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48 Supra paras 13 and 14.

49 Supra note 6.

50 Case C-204/90 supra para 11.

contrary to Article 48 since the individual concerned would have to cancel existing contracts and take out new policies so as to be eligible for tax deductions.[51]

In *Commerzbank* covert discrimination and the decision of *Sotgiu* was again of significance since the residence requirement attached to the right to repayment supplement was more likely to disadvantage companies with their seat in member-states outside the UK. The judgment of the court stated that:

> "...it follows from...*Sotgiu*...that the rules regarding equality of treatment forbid not only overt discrimination by reason of nationality or, in the case of a company, its seat, but all covert forms of discrimination which, by application of other criteria of differentiation, lead to the same result.
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> Although it applies independently of a company's seat, the use of the criterion of fiscal residence within national territory for the purpose of granting repayment supplement on overpaid tax is liable to work more particularly to the disadvantage of companies having their seat in other member states. Indeed, it is most often those companies which are resident for tax purposes outside the territory of the member state in question."[52]

Covert discrimination was therefore found to exist, contrary this time to Article 52 of the EEC Treaty.

Halliburton and *Schumacker* have provided yet further examples of covert discrimination in relation to direct taxation. In *Halliburton* the fact that there was no exemption from Dutch tax payable by a Dutch transferee on the transfer of land to it by a German fellow-subsidiary was considered to make the conditions of sale more onerous for the German transferor subsidiary. Covert discrimination occurred because such tax would not have been payable by a Dutch transferor. The ECJ said:

> "In a case such as this, the vendor is in a distinctly less favourable position than if it had chosen the form of a public or private limited company instead of that of a permanent establishment for its business in the Netherlands."[53]

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51 Supra para 13.

52 Supra paras 14 and 15 of the judgment.

53 Supra para 19 p 666. Note here the importance of the correct comparison, i.e., that between a Dutch company and the permanent establishment of a company formed in another member state.

In *Schumacker* the ECJ noted that fiscal advantages reserved for German residents could constitute indirect discrimination on grounds of nationality.[54]

Having seen examples of covert discrimination established in relation to Articles 48 and 52 of the EEC Treaty it is worth considering the position in relation to Article 59 which governs the provision of services. That there are circumstances in which this can apply in relation to tax matters is not in doubt.[55] It may be thought that covert discrimination would have occurred in *Bachmann* contrary to Article 59 just as it was found to exist in relation to Article 48. This was not the case, although the Belgian laws had the effect of requiring foreign insurers to set up a permanent establishment in Belgium if they wished to offer insurance policies on similar terms to those offered by Belgian insurers.

The Court in *Commission v Germany*,[56] when dealing with the freedom to provide services, said:

> ...the requirement of a permanent establishment is the very negation of that freedom. It has the result of depriving Article 59 of the Treaty of all effectiveness, a provision whose very purpose is to abolish restrictions on the freedom to provide services of persons who are not established in the State in which the service is to be provided...If such a requirement is to be accepted, it must be shown that it constitutes a condition which is indispensable for attaining the [public interest] objective pursued."

In *Bachmann* the ECJ held that the requirement of a permanent establishment was indispensable in relation to pensions and life assurance since it was not possible to ensure payment of tax by insurers on the sums paid out where premiums had been allowed as deductions, i.e., to ensure cohesion of the tax system.[57]

It is hard not to agree with the comments of Professor W-H Roth in a more detailed discussion of this aspect of *Bachmann* when he says:

> "...It is suggested that the idea of a single market demands that undertakings and persons are treated indiscriminately, irrespective of the location of their establishment or residence."

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54 Paragraph 29 of the judgment of the ECJ.

55 By way of example, see *Corsica Ferries France v Direction General des Douanes* [1989] ECR 4441.

56 Case 205/84 [1986] ECR 375 at para 52.

57 So far as sickness and invalidity insurance was concerned the ECJ held it was for the national courts to decide if the provisions in question were necessary for the cohesion of the tax system: see supra para 32.

After having referred to the question of public interest considerations, he concludes in relation to Article 59 that:

> "...it seems easy to explain, but hard to defend, why the Court does not classify an establishment requirement as a discriminatory provision."[58]

It may well be that this is an area which will receive consideration in the future.

Justifications for Discrimination

Having looked at certain aspects of discrimination we can turn to examine some of the justifications for it which the member-states have advanced. It is proposed to look first at some of those which have been rejected by the ECJ.[59]

Unacceptable Justifications

i) Harmonisation of law has not yet been achieved

In *Commission v France* the French government argued that the inability of branches of insurance companies to claim the *avoir fiscal* could only be addressed by approximation of the laws concerned or by bilateral treaties. Any other approach would, it was argued, result in a risk of avoidance. This was clearly rejected by the ECJ in *Commission v France*.[60] Neither the lack of harmonisation nor the risk of avoidance would do as justifications for discrimination.

It is not just a lack of harmonisation of the tax laws on which member states have relied. In *Bachmann* the absence of harmonisation in social security laws was relied upon and said by the Advocate General not to be a justification.[61]

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58 See the article referred to at note 19.

59 It cannot be assumed that every justification listed will always be rejected whatever the circumstances in the future.

60 Supra at p 306 paras 24 and 25.

61 Supra para 11 p 226. The Advocate General relied upon *Stanton v Inasti* Case 143/87 [1988] ECR 3877.

ii) Discrimination is avoidable by the party discriminated against

In *Commission v France* it would have been possible for discriminatory effects of the legislation to be overcome if the business was conducted through a French subsidiary rather than a branch. The court said that:

> "...the fact that insurance companies whose registered office is situated in another Member State are at liberty to establish themselves by setting up a subsidiary in order to have the benefit of the tax credit cannot justify different treatment....Article 52 expressly leaves traders free to choose the appropriate legal form in which to pursue their activities in another Member State and that freedom of choice must not be limited by discriminatory tax provisions."[62]

The issue also arose in *Commerzbank*. If Commerzbank had set up a subsidiary resident in the UK repayment supplement would have been available. The Advocate General cited a part of the above quotation from *Commission v France* to demonstrate that this could not be relied upon by the UK government to justify the provisions complained of.

iii) The discrimination is diminished by the effects of a double tax treaty

This justification was considered by the ECJ in *Commission v France*. However, in relation to Article 52 the Court said that the rights it confers are:

> "... unconditional and a Member State cannot make respect for them subject to the contents of an agreement concluded with another Member State. In particular, that Article does not permit those rights to be made subject to a condition of reciprocity imposed for the purpose of obtaining corresponding advantages in other Member States."[63]

This passage was cited by the Advocate General in *Commerzbank* since whether the double tax treaty referred to is made with a member-state or a non-member state does not matter. It had been argued by the UK government that there was no discrimination against Commerzbank because when the UK/US double tax treaty was taken into account Commerzbank paid no tax on the income which it obtained from the USA and which the authorities had wrongly taxed, whereas a

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62 Supra. p 305 para 21.

63 Supra p 307 para 25.

UK resident company would have paid tax on it. As in *Commission v France*, so also in *Commerzbank*, the principle to be applied was that:

> "...observance of Community law cannot depend on the application of a double tax convention concluded with a non-member country."[64]

iv) There are advantages enjoyed by the person suffering discrimination

Once more it is to the ECJ's judgment in *Commission v France* that we must turn to begin consideration of this justification. The Court said in relation to differences of treatment between French subsidiaries and other branches or agencies:

> "...the difference in treatment...cannot be justified by any advantages which branches and agencies may enjoy *vis-à-vis* companies...Even if such advantages actually exist, they cannot justify a breach of the obligation laid down in Article 52 to accord foreign companies the same treatment in regard to shareholders' tax credits as is accorded French companies."[65]

The point arose again in *Biehl* in a slightly different form. It was said that taxpayers who were not resident in Luxembourg for an entire year because they had exercised the right of free movement obtained an advantage in that the Luxembourg tax authorities did not take into account income arising outside Luxembourg when taxing them. The corollary of that, it was argued, was that such persons did not obtain repayment of tax. This was not an analysis which proved attractive to the Court since in its view the provision caused discrimination in various situations. One which it mentioned was that a taxpayer may commence residing in Luxembourg part way through a year with no income in the state which he left. Such a taxpayer would not obtain repayment of tax which other residents of Luxembourg would obtain.[66] It appears, therefore, to be the case that the existence of an alleged advantage cannot negate discrimination.

In *Commerzbank* the UK government contended, as we have seen, that Commerzbank was better off than a UK resident company would have been in the same circumstances because of its exemption from tax pursuant to the UK/US

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64 This was stated in *Commission v France* supra at p 307, para 26 and was quoted by the Advocate General in *Commerzbank* supra at p 139, para 20.

65 Supra p 305 para 20.

66 Supra see p 1793 para 16.

double tax treaty. It was not possible, however, to take account of this advantage in determining whether or not discrimination had taken place. The Advocate General noted that any advantage derived from the double tax treaty and had no connection with repayment supplement.[67] The Court also directed its attention to the domestic provisions concerning repayment supplement. In determining the existence of an advantage it was the effect of the national provision on resident and non-resident companies which had to be considered, and that provided for unequal treatment.[68] Of course, even if the advantages provided under the double tax treaty could be considered they would have provided no justification for discrimination which the national provisions could have caused in other circumstances.

v) The discrimination may be reversed by administrative procedure

In *Biehl* it was said by the Luxembourg government that there was a non-contentious procedure allowing temporarily resident taxpayers to obtain repayment of tax by adducing the unfair consequences for them of the law in question. The existence of such a procedure did not assist the government. This is because there was no obligation on the administration:

> "...to remedy in every case the discriminatory consequences arising from the application of the national provision in issue."[69]

This reasoning may have interesting implications in relation to the *Commerzbank* case, following which the UK Inland Revenue issued two Press Releases. The first explained their approach to repayment claims by companies who received a repayment of tax without supplement within the six years before the date of the judgment, i.e., 13th July 1993[70]. The second dealt with the position of individuals[71] and stated that, by an extra-statutory concession, repayment supplement would be made available to residents of other EC member states who were individuals as well as partnerships, trustees and personal representatives. It also permitted claims for repayment supplement in respect of repayments of tax within the six years before the date of the judgment.

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67 Supra p 139.

68 Supra p 148 para 18.

69 Supra p 1794 para 18.

70 STI [1993] 1091.

71 STI [1993] 1264.

There have now, of course, been legislative developments. So far as companies are concerned, in relation to repayments in respect of corporation tax for accounting periods ending after 30th September 1993, interest is to be added irrespective of a company's residence by virtue of a change in the law preceding the *Commerzbank* judgment.[72] So far as individuals and others are concerned, the provisions governing repayment supplement are amended by the Finance Act 1994[73], which also deals with the position in relation to Capital Gains Tax.[74]

Nevertheless, the result of this activity is that some persons remain without a statutory entitlement to repayment supplement. Indeed, in relation to partners of partnerships whose trades, professions or businesses are set up and commenced before 6th April 1994 the relevant provisions of the Finance Act expressly apply from 1997-98.[75]

Plainly, an extra-statutory concession gives a taxpayer few rights and can be withdrawn, particularly if the Inland Revenue consider that it is being used for the purposes of tax avoidance. It is very strongly arguable, therefore, that the UK government has not complied with the EEC Treaty to the extent that reliance on administrative discretion remains necessary in order to obtain repayment supplement.

Acceptable justifications for discrimination

As was noted earlier, there are a number of acceptable justifications for discrimination. It is not proposed to deal with these in these here. Instead it is proposed to look briefly at the concept of the cohesion of a tax system as a justification for discrimination.

The cohesion of a tax system

Following *Bachmann* it is clear that the cohesion of a tax system is a ground of public policy on which discrimination may be made. This justification was foreshadowed in the earlier cases to some extent. In *Commission v France* the ECJ showed that it would have regard to the overall logic of a tax system in reaching

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72 See Income and Corporation Taxes Act 1988 s. 826, brought into effect by Corporation Tax Acts (Provisions for Payment of Tax and Returns) (Appointed Days) Order, SI 1992 No 3066 Article 2.

73 See Schedule 19 para 41.

74 Supra. para 46.

75 Supra para 41(4).

its conclusion. In that case the Court noted that French branches of foreign companies and French resident companies were both subject to tax on their profits made in France by virtue of the same provision of the Code Général des Impôts. However, the shareholder's credit was not available to both. There was what one may call a lack of coherence in the tax system which told against the contentions of the French government.[76]

Furthermore, the Court in that case did leave open the possibility of allowing some discrimination on grounds of nationality in tax law as the Advocate General in *Bachmann* noted.[77] It said:

> "Even if the possibility cannot altogether be excluded that a distinction based on location of the registered office of a company or the place of residence of a natural person may, under certain conditions, be justified in an area such as tax law, it must be observed in this case that French tax law does not distinguish...between companies having their registered office in France and branches and agencies situated in France..."[78]

An attempt was made in *Biehl* to justify the discrimination by reference to the characteristics of the Luxembourg tax system. It was said that the objectionable provision protected the system of "progressive taxation" and, as was mentioned above, prevented certain taxpayers obtaining advantages over others. As we have already noted, this attempt failed. In the light of the above it is not surprising that in the *Bachmann* case the Belgian government argued that discrimination should be permitted in order to maintain the cohesion of the tax system. What is perhaps more surprising is the degree of uncertainty which the Court has allowed to remain over the nature of the concept.[79]

It appears that in allowing this justification for discrimination the Court was not merely preserving the logical features of the tax system, it was acting to counter loss of revenue by reason of tax evasion and consequent loss of tax revenue to the Belgium government.[80] This loss would result because if a taxpayer obtained tax-

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76 Supra p 305 para 20.

77 See supra p 269 para 20.

78 Supra p 504 para 19.

79 For an illuminating discussion see 'Restrictions on the Fundamental Freedoms Enshrined in the EC Treaty by Discriminatory Tax Provisions - Ban and Justification', B Knobbe-Keuk *EC Tax Review* [1994] 74.

80 See further *Jurisprudence Fiscale Européene* Rev. Trim. Dr. Eur. [1992] 289 at p 344 (Prof D Berlin).

deductions for premiums, left Belgium and subsequently obtained payments from the insurer, recovery of tax from *the insurer* would be unlikely.[81] In this respect the taxpayer, unlike the permanent Belgian resident, would probably suffer no Belgian tax at all notwithstanding that he had obtained deductions, at the expense of the Belgian state, in relation to his Belgian income tax.

As Professor Dassesse has indicated,[82] this analysis by the Court proceeds on the mistaken belief that it was the obligation of the insurer to pay the tax, whereas it was in fact the obligation of the insured individual. Given its assumption, however, the Court considered that it was not sufficient safeguard for the insurer to be asked to give an undertaking to pay tax. Furthermore, it considered that if an undertaking accompanied by the deposit of a guarantee were required the insurer would suffer additional expense which would be passed on to the taxpayer who may have no interest in maintaining the insurance contract.[83] It should be noted that even if the insurer were liable it is not beyond dispute that there were no other options available to prevent a loss of tax revenue. This was demonstrated by the Advocate General who noted that the Netherlands had similar legislation to Belgium but would have permitted deduction of premiums and furthermore that Belgium had come to an agreement with France, Luxembourg and the Netherlands in permitting deduction for group insurance. He therefore concluded, unlike the Court, that:

> "...it is possible to devise administrative machinery which is able to obviate the risk of tax evasion."[84]

Further cases will be required before it will be possible to say with certainty what is meant exactly by the cohesion of a tax system and in what circumstances it may be relied upon to justify discrimination. There may well be questions over whether the concept is related to a large loss of tax receipts or is simply designed to prevent evasion of tax whatever the amounts at stake.[85] It may also be necessary to determine whether a tax system includes double tax treaties or not. Given that discrimination is ascertained without reference to double tax treaties,

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81 Prof M Dassesse suggests the government's real concern was over payment of tax by policy-holders resident in Belgium at the time of the payment to them: 'The Bachmann Case: A Major Setback for the Single Market in Financial Services?' *Butterworths Journal of International Banking and Finance Law,* June 1992, p 260.

82 See supra p 257.

83 Supra pp 282-3 paras 23 and 24.

84 Supra at p 273 para 27-2.

85 See also D Berlin supra, note 80.

it may be that the Court will ignore them in this circumstance too. Indeed, on the evidence of *Bachmann* it would appear that this is indeed the approach of the Court. The cohesion of the Belgian tax system was, after all, destroyed by tax treaties Belgium had entered into with other member states under which Belgium surrendered the right to tax insurance payments when the policyholder is resident in the other contracting state.[86]

Unsurprisingly, the member states relied on the preservation of the coherence of the German tax system as a justification for the discrimination which existed. They contended that there was a link between the taxpayer's right to have family and individual circumstances taken into account and the state's right to tax worldwide revenue. The ECJ rejected this defence saying that the principle of equality of treatment required that the personal and family situations of non-resident workers must be taken into account by the state in which the individual worked when they could not be taken into account in the state of residence.[87]

It is worth noting that just as the coherence of the tax system was infringed by tax treaties in *Bachmann* so it was infringed in *Schumacker*. A protocol to the German/Netherlands double tax treaty permitted Dutch frontier workers to be given the benefit of the "splitting tariff" which was denied Belgian frontier workers when 90% of their income was derived from the state in which they were not resident.

In concluding this discussion of the cohesion of a tax system two points should be borne in mind. First, the cohesion of a tax system is not to be confused with administrative difficulty for tax authorities. Administrative problems alone are unlikely to attract the sympathy of the ECJ. In *Bachmann* the Belgian government expressed concern about obtaining information regarding the payment of premiums. The ECJ pointed to the provisions of the EC Council Directive concerning the mutual assistance of competent authorities in the field of direct taxation[88] as a means of obtaining information. To the extent that the directive was inadequate to ensure the provision of the necessary information regarding payment of premiums the ECJ considered that the Belgium government could make requests of the member state concerned. The inadequacy of the directive did not justify the discriminatory effects of the Belgian legislation.[89]

The directive was again relevant in *Halliburton*. The Dutch government in that case contended that in order to extend the exemption from tax to non-Dutch

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86 See Dassesse at p 260, supra note 81.

87 See paragraphs 40-42 of the ECJ's judgment.

88 EC Council Directive 77/799 (OJ L36/15, 27.12.77) as amended.

89 See *supra* paras 17-20.

entities it would have to check that such entities were equivalent to those of private and public Dutch companies within the relevant national legislation. This, it said, it could not do. The ECJ disagreed stating that the government could rely on the provisions of the directive. The Advocate General went somewhat further. Having discussed the restriction of the freedom of establishment by reference to administrative checks he concluded:

> "...the host state cannot simply refer to "difficulties" of verification if the exercise of the basic freedoms depends on its own provisions being compared with those of the state of origin. On the contrary, it is possible to propound the rule that it is obliged to undertake such verification and must accordingly accept the additional administrative costs involved.
>
> ...An exception on the ground that such verification could give rise to unreasonable costs should be accepted, if at all, only in rare cases."[90]

Undeterred, the member states again contended that administrative difficulties were a justification for the discriminatory tax treatment which existed in *Schumacker*. In particular it was said that it would be difficult for the state in which the taxpayer worked to ascertain the revenue taxable in the state of residence. Again, the ECJ rejected this defence pointing to the availability of the directive on mutual assistance. Furthermore, the provisions of the protocol to the German/Netherlands double tax treaty referred to above undermined the contentions of the member states.[91]

Second, what is necessary to protect the cohesion of a tax system can change over time. The changes may well occur not by virtue of the harmonisation of direct taxation but by the harmonisation or development of other areas of law. For example, the Third Life Assurance Directive[92] would have been of relevance to certain matters discussed in *Bachmann*.

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90 Supra p 662 paras 45 and 46.

91 See paragraph 46 of the ECJ's judgment.

92 See Council Directive 92/96/EEC of 10th November 1992 on the coordination of laws, regulations and administrative provisions relating to direct life assurance and amending Directives 79/267/EEC and 90/619/EEC (Third Life Assurance Directive). OJ L360/9 (9.12.92). Domestic laws implementing the directive were required to take effect no later than 1st July 1994.

Conclusion

The non-discrimination rules discussed above would appear capable of application in many areas of direct taxation which have yet to be considered by the ECJ. In the UK, as has been seen, it may be asked whether Community law is now complied with in relation to repayment supplement. In fact a question mark may be placed over many areas of UK tax law. Four examples in quite different areas of tax are the residence restrictions regarding loss relief for groups of companies, the unavailability of unilateral foreign tax credit relief, the small companies' rate of corporation tax to branches of other EC residents and the charge to advance corporation tax as between parents and subsidiaries, currently the subject of a challenge.[93] The other member states also face difficulties.[94]

Although the ECJ is going to face an increasing number of cases in this area, it may be that there will be a continuing need for the law to be re-stated as much as developed, especially bearing in mind the apparent determination of member-states to preserve their rights in relation to their direct tax systems. It is noteworthy that in *Commerzbank* the bank did not ask the court to extend the law of discrimination to cover its situation. Rather, it argued that the facts of *Commission v France*[95] were "in all material respects identical"[96] to its own and that the court's ruling in that case was "equally applicable"[97] to its case. The ECJ gave a short judgment and did, of course, apply the reasoning in *Commission v France*. Similarly, in *Halliburton* and *Schumacker* the ECJ did not so much make new law as apply existing law to a new situation.

Whether re-stating the law or developing it, the influence of the ECJ over the member states direct tax régimes is likely to be very strong. That influence inevitably extends beyond the boundaries of the cases that come before it. So far as national legislators are concerned, the decisions of the Court may lead them to

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93 Many articles concerned with this area of law include examples of discriminatory provision in UK tax law: see Flynn and Brannan supra and 'Discrimination Post *Commerzbank*', *The Tax Journal*, 12th May 1994, No 259, p 14 (D Hinds).

94 By way of example, see in relation to Belgium 'A Case of Use or Abuse of the EEC Treaty for Tax Purposes' 33 *European Taxation* [1993] 270, Caroline H V Vanderkerken. In relation to France see 'Non-discrimination: New Conditions for Exemption from Taxation on the Sale of a Residence in France' 32 *European Taxation* [1992] 257, Henry Lazarski.

95 Case C270/83 [1986] ECR 273.

96 Supra p 132.

97 Supra p 132.

try harder to avoid discrimination arising in the first place.[98] So far as the Community legislators are concerned, the Court's decisions will be a spur to their own work in this area. Indeed, it may be thought that in *Schumacker* the ECJ has achieved a great deal of what the Commission has been aiming for in its recommendations.[99]

One commentator has said that:

> "...challenges to the validity of direct taxes could become as common as are those to indirect tax provisions..."[100]

This would seem very likely to be the case, especially when one bears in mind that such challenges will not be based solely on the grounds of discrimination on grounds of nationality. Another ground, potentially as important, as Professor Dassesse has shown in his article elsewhere in this issue, is that of the prohibition on state aids pursuant to Articles 92 and 93 of the EEC Treaty as was shown in *Banco de Credito Industrial SA, now Banco Exterior de Espana SA v Ayuntamiento de Valencia*.[101]

Direct taxation, with its immense domestic political significance for the member states and its links with foreign affairs so far as double taxation is concerned, is not an easy area in which to operate for Community institutions. Consequently, as *Schumacker* shows, the ECJ being less troubled by political considerations, may well play a crucial role in the adaptation of domestic tax systems to the demands of the EEC Treaty.

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98 For an example of an attempt by a legislature to avoid discrimination generally see: 'The 3% Tax On Real Property' 34 *European Taxation* [1994] 34, Réné Bizac and Christien Gassiat.

99 See the Commission's recommendations on the taxation of certain items of income received by non-residents in a Member State other than that in which they are resident [1994] O J L39/22.

100 *Taxation in the European Community*, AJ Easson, The Athlone Press, 1993, at p 181.

101 Case C-387/92 [1994] STC 603. See also the proceedings instituted against Germany in respect of fiscal aid for airlines: C41/93 (E4/93 and N640/93) OJ No C16/3 (19.1.94).