HB CASE: DISPARITY NOT DISCRIMINATION

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In the *HB case,*[2] the Court determined that pensions paid to retired Italian public service workers, who had moved to Portugal, could be taxed in Italy under the "paying-State principle", unless these pensioners were Portuguese nationals. The Court held that the difference in tax treatment under the Italian-Portuguese double tax convention ("the DTC") between pensions paid to private sector workers and public sector workers did not constitute discrimination under Article 18 and 21 of the Treaty on the Functioning of the European Union ("TFEU").

Part I

Background

HB and IC are Italian nationals who worked in the public sector. They received retirement pensions from the INPS and transferred their residences to Portugal. Under the DTC, their pensions were taxed in Italy pursuant to Article 19(2) of the DTC. If they had worked in the private sector, their pensions would have been taxed under Article 18 of the DTC by their State of residence, Portugal.

Since the taxation on their pensions was higher in Italy than in Portugal, HB and IC argued that this tax treatment amounted to discrimination under the TFEU contrary to Articles 18 and 21.

The Italian referring court (the Corte dei conti – Sezione Giurisdizionale per la Regione Puglia), the Court of Auditors – Judicial Chamber for the Region of Puglia, Italy, considered that the DTC clearly introduced inequality of treatment between Italian public and private sector workers who had moved to live in Portugal. It

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2 *HB and IC v Instituto nazionale della previdenza sociale (INPS), ("HB"),* C-168/19, ECLI:EU:C:2020:338.

considered that such a difference in tax treatment constituted discrimination on grounds of nationality contrary to Article 18 TFEU and Article 21 TFEU. Accordingly, it referred the matter to the CJEU for a preliminary ruling.

Free Movement of Citizens

The Court of Justice of the European Union ("CJEU" or "the Court") noted that Article 21 TFEU and Article 18 TFEU could apply in the circumstances of this case. Article 21 TFEU concerns the free movement of EU citizens from one Member State to another and Article 18 TFEU contains the principle of non-discrimination on grounds of nationality.

The Court pointed out, in paragraph 13, that –

> "any citizen of the Union may rely on the prohibition of discrimination on grounds of nationality laid down in Article 18 TFEU in a situation where he or she has exercised the fundamental freedom of movement and residence within the territory of the Member States conferred by Article 21 TFEU".

The Court also pointed out that Articles 18 and 19 of the DTC were based on the OECD Model Tax Convention ("MTC") and were intended to allocate powers of taxation between Italy and Portugal. These provisions contained different connecting factors depending on whether a person worked in the private or public sector. The Court accepted that Article 19 reflected the "paying-State principle", whereby, under the DTC, a pension paid to a public sector worker was taxed by that paying-State unless the payee was a national of the other State. Thus, an Italian national who received a public service pension, though residing in Portugal, was taxed in Italy.

Connecting Factors

The Court accepted, in paragraphs 16 and 17, that –

> "hearing requests for a preliminary ruling on the question of whether the conventions on double taxation concluded between the EU Member States must be compatible with the principle of equal treatment and, in general, with the freedoms of movement guaranteed by primary EU law, the Court has already held that the Member States are free to determine the connecting factors for the allocation of fiscal sovereignty in bilateral conventions for the avoidance of double taxation …
>
> the objective of a bilateral convention for the avoidance of double taxation, such as the Italian-Portuguese Agreement, is to prevent the same income from being taxed in each of the two parties to that convention; it is not to ensure that the tax to which the taxpayer is subject in one State is no higher than that to which he or she would be subject in the other contracting State".

The Court pointed out that it was not unreasonable in these cases for Member States to follow international tax practice, in particular, by following Article 18 and Article 19 of the OECD MTC, which Italy and Portugal did in the *HB case*, for the purpose of allocating powers of taxation.

The Court also indicated, in paragraph 19, that –

> "where, in a convention on double taxation concluded between the Member States, the criterion of nationality appears in a provision which is intended to allocate fiscal sovereignty, there is no justification for considering such differentiation on the basis of nationality as constituting prohibited discrimination".

Thus, the concept of nationality in such instances, is used in an objective way to allocate a person to one state or the other for taxation purposes. All persons of that nationality who are public service workers are allocated to the State of residence for taxation purposes, instead of the paying-State.

Finally, in relation to the "paying-State principle", the Court highlighted, in paragraph 20, that –

> "the designation of the State responsible for payment of the retirement pension ('the paying State') as being competent to tax pensions received from the public sector cannot, in itself, have negative repercussions for the taxpayers concerned, in so far as the favourable or unfavourable nature of the tax treatment of those taxpayers does not derive strictly speaking from the choice of connecting factor, but from the level of taxation of the competent State, in the absence of harmonisation, at EU level, of the scales of direct taxes".

The Court stressed, in paragraph 21, that the difference in treatment in this case arose from –

> "the allocation of the power to impose taxes between the parties to the Italian-Portuguese Convention and from the disparities existing between the respective tax systems of those contracting parties. The choice of various connecting factors, made by those parties for the purpose of allocating powers of taxation between them, such as, in the present case, the State responsible for paying the retirement pension and nationality, must not be regarded, as such, as constituting discrimination prohibited by Articles 18 TFEU and 21 TFEU".

The Court's Conclusion

The Court concluded that the Italian rules at issue were not incompatible with Article 18 TFEU and Article 21 TFEU.

Part II

Analysis

The Court's judgment in the *HB case* is a very short one and was delivered without a formal Advocate General's opinion because the issues in the case had been mainly decided by the Court in its earlier jurisprudence, namely, in the *Gilly* [3] and *Bukovansky* [4] cases.

The Court made it clear in those cases that there was a difference between allocation of taxing rights on an objective basis and the subsequent exercise of those taxing rights. The Court pointed out that it was the exercise of those taxing rights which had to comply with the principle of equal treatment, in particular, the principle of non-discrimination on grounds of nationality. In the *HB case*, the Court simply echoed its prior case law.

The *HB case* is also an important example in the Court's jurisprudence of a disparity situation rather than a restriction. In other words, it provides an example of a "two-State" problem rather than a problem caused by the rules of a single Member State. Finally, the *HB case* demonstrates the need to ensure the correct comparator is applied for the purposes of the application of the equal treatment principle.

Allocation of Taxing Rights vs Exercise of Taxing Rights

In *Gilly*, the Court explained that there was a difference between the allocation of taxing powers between Member States under double tax conventions and the subsequent exercise of those taxing powers. It will be recalled that Mrs Gilly was a cross-border worker, a teacher, residing in France but working in Germany, in the public sector. She held French and German nationality.

The French-German double tax convention provided for a number of "allocation factors" which depended on whether a person was resident in France, resident in Germany, a teacher working in the private sector or public sector and a national of the employment State or residence State.

The Court accepted that Mrs Gilly was a French national (via marriage) who worked in Germany but resided in France. Therefore, she was a French frontier worker exercising her freedom of movement rights in Germany. The Court explained that in the absence of EU law rules (Community law at the time of this case) governing the elimination of double taxation, competence in relation to such matters remained with

3 *Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin ("Gilly"),* C-336/96, ECLI:EU:C:1998:221.

4 *Roman Bukovansky v Finanzamt Lörrach ("Bukovansky"),* C-241/14, ECLI:EU:C:2015:766.

the Member States, subject to compliance with EU law. Consequently, the Court highlighted, in paragraph 24, that the –

> "Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation".

The Court noted that the French-German double tax convention contained a number of connecting factors for the purposes of allocating persons to either France or Germany for taxation purposes in relation to employment income. Under that convention, frontier workers were generally taxed in their residence State, not the employment State. However, under the "paying-State principle" (also seen in the *HB Case*), taxpayers receiving public service remuneration (such as Mrs Gilly, who worked as a teacher in the public sector in Germany) were taxed by the State of employment ("the paying-State"). The convention contained an exception to the paying-State principle for workers who were nationals of the residence State. However, Mrs Gilly was a national of France and Germany so she failed to qualify for this exception. Accordingly, she was taxed by Germany and not France and, thus, required to pay the higher German taxes on her employment income.

The Court pointed out, in paragraphs 30 and 31, that –

> "Although the criterion of nationality appears as such in the second sentence of Article 14(1) for the purpose of allocation of fiscal jurisdiction, such differentiation cannot be regarded as constituting discrimination prohibited under Article 48 of the Treaty. It flows, in the absence of any unifying or harmonising measures adopted in the Community context … from the contracting parties' competence to define the criteria for allocating their powers of taxation as between themselves, with a view to eliminating double taxation …
>
> Nor, in the allocation of fiscal jurisdiction, is it unreasonable for the Member States to base their agreements on international practice and the model convention drawn up by the OECD, Article 19(1)(a) of the 1994 version of which in particular provides for recourse to the paying State principle".

In other words, in the absence of EU law rules to the contrary, Member States are entitled to act in accordance with international tax practice in relation to these matters involving allocation of taxing rights between States using double tax conventions, in particular, those based on the OECD MTC.

The Court also highlighted, in paragraph 34, that –

> "Nor is it established in the present case that the choice of the paying State as the State competent to tax income earned in the public sector can of itself be to the disadvantage of the taxpayers concerned … whether the tax treatment of the taxpayers concerned is favourable or unfavourable is determined not, strictly speaking, by the choice of the connecting factor but by the level of

> taxation in the competent State, in the absence of any Community harmonisation of scales of direct taxation".

This echoes what the Court stated in the *HB case*, paragraph 20.

In *de Groot*, [5] the Court explained that there was a difference between the allocation of taxing rights and the subsequent exercise of such rights by a Member State. The Court indicated, in paragraph 94 of *de Groot*, that –

> "as far as the exercise of the power of taxation so allocated is concerned, the Member States must comply with the Community rules … and, more particularly, respect the principle of national treatment of nationals of other Member States and of their own nationals who exercise the freedoms guaranteed by the Treaty".

This is the equal treatment principle which the Court explained operated from the perspective of both host ("nationals of other Member States") Member States and origin ("their own nationals") Member States. Thus, a discrimination or restriction analysis usually come into play after the connecting factors have allocated a taxpayer on an objective basis, when the allocated taxing rights are being exercised.

Disparity vs Restriction

The *HB case*, like *Gilly*, provides another example of a disparity situation in the Court's jurisprudence.[6]

The problem in both the *HB case,* and *Gilly,* was not caused by the "allocation" factor as such under the DTC (or under the French-German double tax convention). Instead, the problem or difference in tax treatment was caused by the higher tax rates in one of the States involved. Thus, if tax rates were the same or lower, the taxpayer would not complain that there was discrimination. The taxpayer complained because he or she suffered a higher tax burden. This situation is not rectified by EU law at the present time because competence in direct tax matters remains with the Member States and there are currently few rules dealing with the elimination of double taxation at the EU level.

This problem does not arise from the allocation mechanism, which is purely objective in its operation. This problem arises because tax rates can differ in each Member State. Consequently, this is an example of a "two State" problem. The difference in

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5 *F.W.L. de Groot v Staatssecretaris van Financiën ("de Groot"),* C-385/00, ECLI:EU:C:2002:750.

6 For a detailed discussion of the difference between disparity situations and restrictions by this author, see Tom O'Shea, *Understanding EU Tax 2020,* (Avoir Fiscal Publications, London, 2020).

treatment is not caused by the rules of a single member State, rather it is caused by a disparity between the rules of the two States involved in the double tax convention. Moreover, the use of "nationality" as an allocation factor does not constitute discrimination on grounds of nationality since all such "nationals" are allocated in the same way as seen in *Gilly*.

Unless these "two-State" problems (or disparities) are resolved by a double tax convention or unilaterally by a Member State, EU law is unable to resolve them. A classic example is seen in *Kerckhaert-Morres,*[7] which involved dividends from France that were received by Belgian residents, being taxed by both France and Belgium. The Belgian-French double tax convention did not resolve the juridical double taxation problem.

Kerckhaert-Morres, a Belgian resident, argued that the Belgian tax rules at issue were discriminatory because they failed to grant a credit for the French dividend withholding taxes. However, the Court rejected this submission, pointing out that Belgium taxed dividends received from France in the same way as dividends received from Belgian companies. Consequently, the Belgian rules did not constitute a restriction on the free movement of capital.

The Court explained, in paragraph 23 of *Kerckhaert-Morres,* that –

> "it is for the Member States to take the measures necessary to prevent situations such as that at issue … by applying, in particular, the apportionment criteria followed in international tax practice. The purpose of the France-Belgium Convention is essentially to apportion fiscal sovereignty between the French Republic and the Kingdom of Belgium in those situations. However, that convention is not at issue in the preliminary reference at hand".

In other words, since France imposed a withholding tax on the outbound dividend and Belgium taxed the inbound dividend, this resulted in juridical double taxation that was not relieved or eliminated by the Belgian-French double tax convention in the circumstances of this case. Consequently, this was a two-State problem and, therefore, it did not constitute discrimination or a restriction on the free movement of capital.[8]

In terms of a restriction situation, an example is seen in *de Groot,* discussed above. In that case, de Groot, a resident of the Netherlands, worked partly in the Netherlands and partly in a number of other Member States. As a result, he was denied a full deduction for his maintenance payments by the Netherlands tax authorities because

7 *Mark Kerckhaert and Bernadette Morres v Belgische Staat ("Kerckhaert-Morres"),* C-513/04, ECLI:EU:C:2006:713.

8 For a detailed analysis of the *Kerckhaert-Morres* judgment by this author, see Tom O'Shea, "Dividend Taxation Post-*Manninen:* Shifting Sands or Solid Foundations? Tax Notes International, Mar. 5, 2007, 887-918 at p909.

all of his income was not earned in the Netherlands. de Groot argued that these rules breached his free movement of worker' rights.

The Court agreed, pointing out, in paragraph 78, that –

> "Provisions which preclude or deter a national of a Member State from leaving his country of origin to exercise his right to freedom of movement therefore constitute an obstacle to that freedom even if they apply without regard to the nationality of the workers concerned".

The Court concluded, in paragraphs 83-85, that –

> "due to the application of the proportionality factor, a portion of the personal tax relief to which Mr de Groot was entitled did not give rise to an actual tax reduction in the Netherlands. He therefore suffered a real disadvantage as a result of the application of the proportionality factor since he derived from his maintenance payments and from the tax-free allowance a lesser tax advantage than he would have received had he received his entire income for 1994 in the Netherlands …
>
> That disadvantage caused by the application by the Member State of residence of its rules on the avoidance of double taxation is liable to discourage a national of that State from leaving it in order to take up paid employment, within the meaning of the Treaty, in the territory of another Member State …
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> Contrary to what the Netherlands Government maintains when it relies on *Gilly*, the disadvantage suffered by Mr de Groot is attributable neither to the disparities between the tax systems of the Member States of residence and employment nor to the tax systems of the various States in which Mr de Groot was employed".

Accordingly, the Court distinguished the "restriction" in *de Groot* from the "disparity" situation in *Gilly*.

Correct Comparator

Finally, one major problem arising from the *HB case* is the difficulty incurred by the national court in understanding the correct comparator for the purposes of determining whether the different treatment amounted to a restriction or discrimination.

The national referring court investigated whether public sector workers and private sector workers could be treated differently when they received their pensions. There was no consideration as to whether these pensioners were in a comparable situation.

The Court noted, in paragraph 16 of the *HB case*, that Member States were free to "determine the connecting factors for the allocation of fiscal sovereignty in bilateral conventions" subject to compliance with EU law. Therefore, as in *Gilly*, Italy and Portugal were entitled to agree on certain objective factors for allocating taxing powers under the DTC. Thus, private sector pensions could be allocated differently to public sector pensions for taxation purposes. As long as Portugal and Italy treated all private sector pensioners in a similar was as per the DTC, then there was no breach of EU law.

Consequently, the correct comparator involved the tax treatment of two private sector pensioners or the tax treatment of two public sector pensioners but never the tax treatment of a private pensioner and a public pensioner.