Chartered Institute of Taxation

Edinburgh lunchtime seminar

The effect of European law on direct taxation

by

Philip Simpson

Advocate ~ Barrister
Chartered Tax Adviser

I. Introduction

In his valedictory article in the British Tax Review, Sir Andrew Park (formerly Mr Justice Park) stated, 'All of the questions which arise about the impact of Community law on UK corporation tax are not remotely resolved yet... In my opinion the subject has been by some distance the most important and stimulating aspect of tax law which I have encountered over the period of more than 40 years in which I have been involved in the field, either as a practitioner or as a judge.'[1] Of course, European law affects more direct taxation than merely corporation tax, so while considering the effect to date of Community rules on corporation tax this paper will take a broader look at the United Kingdom tax system and suggest other possible weaknesses in it.

However, the scope of this paper has some limits. European law has both 'hard' and 'soft' effects on direct taxation. 'Hard', deriving from the application of existing European law to the exercise of Member States' retained powers within the field of direct taxation; 'soft', in connection with initiatives within the European Union, such as the proposals for a common consolidated basis of assessment for corporation tax, that seek to persuade Member States to reach further, supranational agreements in the area. This paper is confined to the former; the latter are for another day.

II. Treaty provisions

The starting point for considering European law is that the institutions of the European Union have no power beyond that conferred upon them by the various Treaties and other instruments. In particular, they have no specific powers in relation to direct taxes. These remain vested with the Member States.

[1] Sir Andrew Park, *A Judge's Tale: Corporation Tax and Community Law*, [2006] B.T.R. 322, at 344.

However, that is not the end of the story. The EC Treaty also guarantees certain freedoms to individuals and other persons who are citizens of the European Union. It is axiomatic in European law that the powers retained by the Member States, even in the context of direct taxation, must be exercised consistently with Community law.[2] So it becomes necessary to identify the relevant provisions of Community law and their content, in order to ascertain the scope of Member States' powers.

First in terms of importance in the area of taxation is freedom of establishment. Article 43 EC provides:

> 'Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.
>
> Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital.'

Article 48 extends this in relation to companies:

> 'Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States.'

---

[2] *Finanzamt Köln-Stadt* v. *Schumacker* [1995] ECR I-225, paragraph 21; *Wielockx* v. *Inspecteur der Directe Belastingen* [1995] ECR I-2493, paragraph 16; *Asscher* v. *Staatssecretaris van Financiën* [1996] ECR I-3089, paragraph 36; *Futura Participations S.A. and Singer* v. *Administration des contributions* [1997] ECR I-2471, paragraph 19; *ICI* v. *Colmer* [1998] ECR I-4695, paragraph 19; *Metallgesellschaft Limited* v. *Commissioners of Inland Revenue* [2001] ECR I-1727, paragraph 37; *Lankhorst-Hohorst GmbH* v. *Finanzamt Steinfurt* [2002] ECR I-11779, paragraph 26; *de Lasteyrie du Saillant* v. *Ministère de l'Économie, des Finances et de l'Industrie* [2004] ECR I-2409, paragraph 44; *Marks & Spencer plc* v. *Halsey* [2005] ECR I-10837, paragraph 29; *N.* v. *Inspecteur van de Belastingdienst Oost / kantor Almelo*, not yet reported, paragraph 33; *Cadbury Schweppes plc* v. *Commissioners of Inland Revenue*, not yet reported, paragraph 40.

This affects principally corporation tax, profits of self-employed individuals and capital gains tax.

Second is free movement of capital, in terms of Article 56 EC:

> '1. Within the framework of the provisions set out in this Chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.
>
> 2. Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited.'

A specific exception is allowed from this in relation to distinctions between taxpayers not in the same position in terms of residence or where their capital is invested.[3]

Next is freedom of movement for workers. Article 39 EC provides:

> '1. Freedom of movement for workers shall be secured within the Community.
>
> 2. Such freedom of movement shall entail the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment.'

This affects questions of income tax and capital gains tax.

Article 18 EC provides a general right for citizens of the Union to move freely between the Member States.

Finally, there is a residual anti-discrimination provision, namely Article 12 EC, which prohibits any discrimination on the ground of nationality between citizens of the Union. But this is available only where the circumstances do not fall within the scope of application of one of the fundamental freedoms: it is very much a last resort.[4]

---

[3] Article 58(1) EC.

[4] Case C-1/93 *Halliburton Services B.V.* v. *Staatssecretaris van Financiën* [1994] ECR I-1137, at paragraph 12; *Metallgesellschaft*, paragraph 38.

A few points may be noted at this stage.

First, the freedoms laid down by these provisions have both relative and absolute effect. On the one hand they entail that a Member State must mete out the same treatment to nationals of other Member States as it metes out to its own nationals. This is simply a prohibition against discrimination, and therefore a relative freedom. It must however always be borne in mind that this includes a prohibition on indirect discrimination, in other words on rules that, on their face, do not distinguish between persons or companies resident in the relevant Member State and persons and companies resident elsewhere, but that in practice create disadvantages for the latter by comparison with the former.[5] This is relevant in particular in the context of taxation because the usual structure of fiscal rules is to categorise persons by residence, and not by nationality. So strictly speaking, rules rarely discriminate by reference to nationality. But there is a large overlap of these two categories, and so a rule that confers a benefit only on residents is likely *de facto* to confer that benefit mainly on nationals, and to exclude nationals of other Member States from entitlement to that benefit.[6] Moreover, in any case involving a foreign element, the Court of Justice is likely to start from the assumption that more non-nationals than nationals will be affected by the rule in question, even where this is not really clear.[7] So it

---

[5] *R.* v. *Inland Revenue Commissioners*, ex parte *Commerzbank* [1993] ECR I-4017, paragraph 14; *Halliburton Services*, paragraph 15; *Schumacker*, paragraph 26; *Biehl* v. *Administration des contributions du grand-duché de Luxembourg* [1990] ECR I-1779, paragraph 13.

[6] *Schumacker*, paragraph 28.

[7] See, for example, *Biehl*, paragraph 14. In that case it was said that a person who was resident in Luxembourg for tax purposes but ceased to be so resident was likely to be a national of somewhere else, but this seems a fairly bold assumption to make. See also *Asscher*, paragraph 38, where the Court of Justice simply stated that non-residents are most frequently non-nationals. But this arose in circumstances where the taxpayer was a non-resident who worked in the Member State, and it is not clear that such a person is more likely than not to be a non-national. In particular, the taxpayer in question was in fact a national of the Member State in which he worked, and not of the Member State in which he resided.

would be for the Government being challenged to provide evidence to overcome that starting point: the taxpayer need do nothing.

On the other hand, a Member State must not do anything that would prevent or hinder nationals of other Member States from exercising the freedoms within its territory. This is absolute, and its practical effects do not (at least in the first instance) depend on the content of the rules a Member States applies to its own nationals. Given that in most of the cases, the fundamental freedom in issue has in fact been exercised, the Court of Justice has held that the restriction need not actually prevent its exercise: it is sufficient if it has a deterrent effect.[8]

Second, in the context of companies, the concept of 'nationality' is translated into the place where a company has its registered office, central administration or principal place of business.[9]

Third, it is necessary also to refer to secondary law, in other words regulations and directives enacted pursuant to powers conferred by the EC Treaty. For example, workers who are nationals of a Member State are to enjoy, in the territory of the other Member States, the same tax advantages as nationals of those Member States.[10] Equally, none of the cases relies principally on rights under such legislation. But it is important in advising clients to be aware of the relevant rule: the Court of Justice frequently uses them to supporting its reasoning in this area.

Finally in this context, it may be observed that the Treaty provisions are expressed in very general, abstract terms. They suffer gaping omissions. Although the Court of Justice

---

[8] See, for example, *N*, paragraph 34.

[9] *Commission* v. *France* [1986] E.C.R. 273.

[10] Article 7 of Regulation (EEC) No 1612/68 of the Council of 15 October 1968 on freedom of movement for workers within the Community, OJ English Special Edition Series I, 1968(II), p.475.

is often criticised for inventing European law as it goes along, it has been forced to do so by the combination of the facts that it is charged with ensuring that Community law is effective, and that Community law cannot be effective without such things as the doctrines of supremacy and direct effect, damages against Member States for failure to implement, and the principles of equivalence and effectiveness of national remedies, all of which the Court of Justice has been required to invent. Given this tradition, the Court of Justice does not shrink from making up further rules as it goes along. There is thus less reason than in normal, domestic cases for thinking that a taxpayer's position is definitively determined by past decisions of the Court. The case-law is developing all the time.

III. Direct applicability

The question next arises as to the effect of these provisions of the Treaty. There are a number of possibilities in terms of by whom and how they might be enforceable. For example, the Commission can bring actions against Member States for failure to fulfil Treaty obligations.[11] But the provisions are also directly applicable:[12] that is, they can be relied on by nationals of Member States before national courts in cases against the Member State in question. So, for example, if a taxpayer considers that legislation that affects his tax position is incompatible with European law, he can complain of this directly in the national courts, including the General and Special Commissioners.[13] In practice, this means one can appeal against a tax assessment on the ground that although the assessment is perfectly in accordance with UK law as it stands, UK law is not in

---

[11] Article 226.

[12] For an early reference to this by the ECJ in a tax context, see *Commission* v. *France*. See also *Halliburton Services*, paragraph 16, and *Daily Mail*, paragraph 15.

[13] For example, *Cadbury Schweppes* was referred to Luxembourg by the Special Commissioners: see [2004] STC (SCD) 342.

accordance with European law and must therefore be disapplied. Of course, the meaning of European law is not always clear, and so it is possible for national courts to refer questions of European law to the European Court of Justice for preliminary ruling under Article 234 EC; indeed, if such a question arises in a court of last instance (in other words the House of Lords or the Privy Council) that court is obliged to make a reference.[14]

The further consequence of direct applicability is that one can obtain not only release from a (national law) obligation to pay money, but also repayment of money previously paid in consequence of provisions found to be contrary to Community law,[15] provided the breach is sufficiently serious[16] and there is a direct causal link between the infringement and the loss.[17] Where the breach of Community law has consisted in the early payment of sums that would in due course have become payable, the remedy is restitution or compensation in respect of the loss of use of that money.[18]

But a limitation is imposed on reliance on the fundamental freedoms, namely that a national of a Member State is not entitled to rely on them if he is seeking to circumvent his own national legislation improperly or fraudulently.[19] In such cases, even if the Member State is in flagrant breach of European law the taxpayer cannot avail himself of

---

[14] Article 234(3) EC.

[15] *Metallgesellschaft*, paragraph 84.

[16] It almost always is held to be so by the Court of Justice.

[17] See *N*, paragraph 63.

[18] *Metallgesellschaft*, paragraphs 87 f. The particular label is unimportant so far as Community law is concerned; the key point is that the national rules under which the remedy is afforded do not make it practically impossible or excessively difficult to obtain the remedy, nor more difficult than it would be for a national to obtain an equivalent remedy (principles of effectiveness and equivalence, as to which, see also *N*, paragraphs 59 ff.). The English courts are presently working out the exact nature and scope of the remedy: see *Deutsche Morgan Grenfell Group plc* v. *Inland Revenue Commissioners* [2005] STC 329.

[19] *Cadbury Schweppes*, paragraph 35.

it. But it is clear that mere tax avoidance is neither improper nor fraudulent in the relevant sense,[20] and taxpayers seeking to avoid tax will not thereby put themselves out of court.

IV. Freedom of establishment

It is apparent that the actual Treaty provisions conferring various freedoms on citizens of the Union, or prohibiting State aids, do not say anything at all about taxation. But for over 20 years now[21] it has been clear that they none the less have effects in this area.

As mentioned above, a number of different freedoms arise for consideration. But in the field of direct taxation by far the most important has been the freedom of establishment. The Court of Justice tends to regard the issues arising as more closely connected with that than with, for example, the general free movement of persons, free movement of capital[22] or freedom to provide services. So far as the general freedom of movement is concerned, freedom of establishment takes precedence as a *lex specialis*.[23] In relation to the other specific freedoms, priority is given to freedom of establishment because the various cases have concerned shareholdings giving a definite influence over the company's decisions.[24] In any event, it is clear that the same principles apply in working out the case regardless of which freedom is involved,[25] particularly once it is established that one of the freedoms has been infringed and the Court of Justice turns to justification and proportionality. Separate consideration in the present context would result in duplication (apart from the fact that there is a paucity of authority in relation to the other freedoms).

---

[20] *Cadbury Schweppes*, paragraph 36.

[21] In other words, from the time of the judgment in *Commission* v. *France*, the '*Avoir Fiscal*' case.

[22] *Bachmann* v. *Belgium* [1992] ECR I-249, paragraph 34. The reason given is that any restrictions on free movement of capital arise only indirectly, consequent upon the direct restriction of freedom of establishment. See also *Metallgesellschaft*, paragraph 76;

[23] *N*, paragraphs 22 f.

[24] In the context of direct taxation, first referred to in *Lankhorst-Hohorst*, paragraph 20. See also *N*, paragraph 27; *Cadbury Schweppes*, paragraph 31.

[25] *Asscher*, paragraph 29.

As mentioned above, freedom of establishment is the right to take up self-employed activity, and the right to establish branches, agencies or subsidiaries, in other Member States. A Member State must allow these things on the same conditions as it applies to its own nationals, and must not do anything likely to prevent, hinder or obstruct the exercise of the freedom. Freedom of establishment entitles non-nationals not only to equal substantive treatment but also to equal procedural treatment.[26] So if a national taxpayer is permitted to establish the truth of circumstances by a particular means of evidence, a non-national must be allowed the same possibility.

In addition, the category of persons who can rely on the provisions has been extended beyond their wording. It may also be relied upon a national against his own Member State, when resident in another Member State.[27] Furthermore, it may be relied upon by a national against his own Member State to stop it from hindering him in exercising his freedom of establishment in another Member State.[28]

One point to note is that the fiscal principle of territoriality is recognised by the Court of Justice.[29] So no discrimination exists, and one need not enter the territory of justification, where differences in treatment between residents and non-residents follow from that principle.[30]

A further point of interest is the relevance of double taxation conventions. In many of the cases, the actual tax position of the parties involved has depended on a double taxation

[26] *Schumacker*, paragraph 58.

[27] *Asscher*, paragraphs 31 to 34. Of course, this is subject to the condition that the first hurdle for the application of European law, namely that the case is not a purely internal matter, must be crossed. Hence the need for the national to have emigrated so as to reside in a different Member State.

[28] *Daily Mail*, paragraphs 16 ff.; *ICI*, paragraph 21; *Marks & Spencer*, paragraph 31.

[29] *Futura Participations and Singer*, paragraph 22.

[30] *Futura Participations and Singer*, paragraphs 18 ff.

convention.[31] But the Court of Justice tends to express its judgments more generally, and without regard to whether its reasoning depends to any extent on the existence and effect of such a convention.[32]

V. Justification

Once it has been established that national legislation discriminates against nationals of other Member States, or hinders or prevents a national from exercising one of his freedoms, the question turns into whether the objectionable measure is justified. Justification must be by reference to a legitimate aim compatible with the Treaty,[33] and on the basis of objective grounds in the public interest.[34] The principle of proportionality must also be observed.[35]

Of course, the fact that the person is resident in another Member State cannot of itself be such a ground: otherwise, the Treaty provisions would have no meaning at all.[36]

In the tax context, it seems clear that although the prevention of tax evasion is sufficient to justify a discriminatory measure,[37] a Member State may seek to prevent tax avoidance only by measures that target wholly artificial arrangements in a focused way.[38] In this connection, the Court of Justice's approach is that even if some specific instances of a general class of circumstances involve tax avoidance, it is not legitimate to impose fiscal

---

[31] For example, *Metallgesellschaft*.
[32] See, for example, *Metallgesellschaft*, paragraphs 71 ff.
[33] *Futura Participations and Singer*, paragraph 26.
[34] *Bachmann*, paragraph 14; *Lankhorst-Hohorst*, paragraph 33; *de Lasteyrie du Saillant*, paragraph 49; *Marks & Spencer*, paragraph 35.
[35] *Futura Participations and Singer*, paragraph 26; *Lankhorst-Hohorst*, paragraph 33; *N*, paragraph 40; *de Lasteyrie du Saillant*, paragraph 49.
[36] *Commission* v. *France*, paragraph 18; *Commerzbank*, paragraph 13. What is surprising in this regard is that the argument is sometimes still made by Member States, albeit dressed up as something else. See, for example, *Marks & Spencer*, paragraphs 36 f.
[37] See *Cadbury Schweppes*, paragraph 50. In any event, a person seeking to evade tax would generally not be entitled to rely on a fundamental freedom to achieve his object: see above.
[38] *Commission* v. *France*, paragraph 25, for the first hint at this; expanded, for example, in *Metallgesellschaft*, paragraph 57; *Lankhorst-Hohorst*, paragraph 37; *ICI*, paragraph 26; *Marks & Spencer*, paragraph 57; *de Lasteyrie du Saillant*, paragraph 50; *Cadbury Schweppes*, paragraph 51.

disadvantages on the class generally. So even though sometimes people emigrate in order to avoid tax, this is generally not the reason for moving home, and therefore the purpose of preventing tax avoidance does not permit tax disadvantages to be imposed on emigration *simpliciter*.[39]

Connected with this is the rule that the fact that the taxpayer might simply obtain a tax benefit on account of what he does for *bona fide* purposes does not justify a disadvantage.[40] The same is true in respect of any obligations under double taxation treaties.[41] Alleged difficulties in obtaining information concerning the tax or general legal situation in the other Member State do not count either,[42] at least in so far as they are overcome a European Directive specifically provides for co-operation and information exchange between the tax authorities of the various Member States.[43] But if this procedure is somehow inadequate in the particular situation, then, for example, additional evidential burdens may be imposed on the non-resident taxpayer.[44] Likewise insufficient is the fact that, for example, a company incorporated in another Member State could have obtained the desired tax treatment by establishing a subsidiary instead of a permanent

---

[39] See, for example, *de Lasteyrie du Saillant*, in particular at paragraphs 50 ff.

[40] *Biehl*, paragraphs 15 f. In that case, the benefit was that by changing his State of residence in the course of a tax year, the taxpayer spread his employment income between two different States that year, and so obtained two personal allowances, and two basic rate bands, and so on, instead of only one. See also *Asscher*, paragraphs 46 ff. There the taxpayer earned employment income in Belgium and the Netherlands; and was a Dutch national but resident in Belgium. The fact that he might escape progressive rates of tax did not suffice to justify the Netherlands in imposing a higher rate of tax on him than on other, resident taxpayers, particularly given that Belgium could take his Dutch income into account for the purposes of its own progressive tax rates pursuant to a double taxation treaty between the two countries.

[41] *Commission* v. *France*, paragraph 26.

[42] *Halliburton Services*, paragraph 22; *Bachmann*, paragraph 18; *Wielockx*, paragraph 26.

[43] Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, as amended from time to time.

[44] *Bachmann*, paragraph 20. See also *Futura Participations and Singer*, in particular at paragraphs 32 ff., where the point was that different Member States have different rules for drawing up tax accounts, and so the availability of accounts drawn up under the rules of another Member State would not necessarily allow the relevant Member State to obtain the information it wanted.

establishment[45] (or *vice versa*). Because freedom of establishment confers equal rights in relation to setting up a branch or agency and in relation to setting up a subsidiary, a Member State cannot 'encourage' foreign nationals or companies to elect one of those means by making the other unattractive. Nor is the availability of non-binding, administrative arrangements sufficient to prevent a binding rule from breaching European law.[46] It may be noted that this prevents the UK Government from relying on Extra-Statutory Concessions to cure what is otherwise an infringement. Finally, reduction of tax revenue is not sufficient justification.[47]

However, it is accepted that residents and non-residents are not necessarily in comparable situations, mainly because the sources of one's income are normally concentrated wherever one is resident, and the information gathering-exercise necessary to work out a person's tax affairs is easier to conduct there.[48] As one might expect, the Court of Justice having given reasons for accepting that in certain circumstances residents and non-residents are in different situations, it has held that where those reasons do not obtain they must be treated in the same way.[49] So where a person resident in one Member State works full-time in another, and therefore earns his income 'entirely or almost exclusively' there, he must be given the same tax benefits and reliefs as a resident if his income in his State of residence is insufficient to enable him to get the benefit of

---

[45] *Commission* v. *France*, paragraph 22.

[46] *Biehl*, paragraphs 17 f.; *Schumacker*, paragraphs 53 ff.

[47] *ICI*, paragraph 28; *Metallgesellschaft*, paragraph 59; *Lankhorst-Hohorst*, paragraph 36; *Marks & Spencer*, paragraph 44; *de Lasteyrie du Saillant*, paragraph 60.

[48] *Schumacker*, paragraphs 31 ff.; *Wielockx*, paragraph 18. See also *Asscher*, paragraph 41.

[49] *Schumacker*, paragraphs 40 ff.

equivalent reliefs offered by that State.[50] This is in particular because, objectively, such persons are in essentially the same position.[51]

That residents and non-residents may be in different situations has led to the possibility of justification by reference to the allocation of powers of taxation between the Member States: in other words, the need to ensure that each Member State has the opportunity to tax profits arising within its territory, and that no other Member State gets to do so.[52]

The next possible justification, emerging really in *Futura Participations and Singer*,[53] is the need for effective fiscal supervision. This means, for example, that Member States may maintain rules designed to ensure that they can properly ascertain the amount of tax due from a taxpayer[54] and can enforce the payment of that tax.

Perhaps the most difficult justification is cohesion of the tax system. Sought to be relied upon by Governments in possibly every case since the first in which it was identified,[55] it has succeeded only once, and indeed in that first case: *Bachmann* v. *Belgium*.[56] In that case, Belgium would not allow a taxpayer to deduct insurance contributions he paid to German insurers, pursuant to insurance contracts he had taken out while working in Germany before emigrating to Belgium. Had the contracts been with Belgian insurers, the payments would have been deductible. Of course, a person who had an insurance contract

---

[50] *Schumacker*.

[51] *Wielockx*, paragraph 20. Indeed, at this passage the Court of Justice abandoned any need for the person to be unable in practice to obtain reliefs or benefits in his State of residence, although referred to this in the abstract as a justification for its conclusion that there was no relevant difference between the two situations.

[52] *Marks & Spencer*, paragraphs 43 ff.; *N*, paragraphs 41 ff.

[53] [1997] ECR I-2471, in particular at paragraphs 31 ff.

[54] *Futura Participations and Singer*, paragraph 31.

[55] *Wielockx*, paragraphs 23 ff.; *Asscher*, paragraphs 55 ff.; *Metallgesellschaft*, paragraphs 61 ff.; *Lankhorst-Hohorst*, paragraphs 19 and 39 ff.; *de Lasteyrie du Saillant*, paragraphs 61 ff.; and so on.

[56] [1992] ECR I-249. For further background to this case, see *Commission* v. *Belgium* [1992] ECR I-305, in which the Commission brought enforcement proceedings against Belgium seeking to have the Belgian rule declared incompatible with European law.

with a foreign insurer was more likely to be a foreign national than a Belgian. So the measure constituted indirect discrimination, and the issue became justification.

One of the various reasons advanced by Belgium by way of justification was that policy proceeds paid by Belgian insurers were taxed, and this offset the loss of revenue caused by allowing deductions for payments to those insurers. On the other hand, so far as contributions to those insurers had not been deducted, the corresponding policy proceeds were tax exempt. So the deduction was allowed because the proceeds would be taxed. There being no guarantee that policy proceeds paid by foreign insurers would ultimately be subject to Belgian tax, Belgium was entitled, for the sake of cohesion, to disallow deductions for contributions paid to them.

But what the Court of Justice failed to do was to give any reason as to why cohesion of the tax system should be important in this case. It said little more than that because in practice insurance proceeds would be taxed only if from Belgian insurers, only payments to Belgian insurers should be exempted. In subsequent cases it has indicated limits on the principle, for example that the cohesion must relate to one and the same taxpayer;[57] that the cohesion must depend purely on the internal law of the Member State in question, and not be secured by means of bilateral convention;[58] and that, depending on the case, there must be a direct link between the tax receipt and the tax relief,[59] or that the fiscal disadvantage suffered by the person seeking to rely on the fundamental freedom is

---

[57] *Wielockx*, paragraph 24.

[58] *Wielockx*, paragraph 25. Presumably, the reason for this is so as to prevent States circumventing the requirements of European law by concluding side-treaties with one another.

[59] *ICI*, paragraph 29, by way of explaining the rationale in *Bachmann*. The Court of Justice is flexible as to whether the direct link is required to exist between the tax charge and the tax relief suffered by residents, or the absence of a tax charge and the refusal of the tax relief applicable to non-residents: see in particular, *Metallgesellschaft*, paragraph 69.

balanced out by some directly related tax benefit.[60] But none of this gives a satisfactory explanation as to what fiscal cohesion really is, and why it justifies what would otherwise be a breach of the fundamental freedoms. It is now suspected that the Court of Justice made a mistake in *Bachmann*, and is simply not going to recognise fiscal cohesion in any future case.

Finally, the issue of proportionality arises. If it is to be regarded as justified, in addition to being for a legitimate aim, a measure must be apt to achieve that aim and must not go beyond what is reasonably necessary to do so. For example, even where tax avoidance is legitimate justification, a provision will not be justified on that ground unless it applies only to wholly artificial arrangements set up to circumvent the relevant taxing provision, and not generally to a category of situations that do not necessarily involve avoidance, such as establishing a foreign subsidiary.[61] It seems to be at this stage that national legislation now fails the test.

VI. Examples of unlawful rules

One difficulty in general with European law is that it is framed in very general terms, as a read through any of the provisions quoted above makes clear. It is therefore particularly helpful to consider what rules have been struck down and what rules have been upheld by the Court of Justice when trying to work out what other challenges might be made to the UK tax system.

Rules that have been held unlawful include:

- the attachment of a tax credit to dividends paid to persons resident, or companies incorporated, in the Member State, but not to dividends paid to permanent

[60] *Lankhorst-Hohorst*, paragraph 42.
[61] *Daily Mail*, paragraph 26; see also *Metallgesellschaft*, paragraph 57.

establishments in the Member State of companies incorporated in other Member States (*Avoir Fiscal*);

- an exemption from a capital gains tax conferred in the context of group reorganisations, but only where transferor and transferee are incorporated in the relevant Member State (*Halliburton Services*)
- a rule confining entitlement to interest (repayment supplement) on overpaid tax to taxpayers resident in the Member State in question, even where tax was repaid because the taxpayer benefited from an exemption not available to residents (*Commerzbank*);
- the aggregation of spouses' income and equal allocation to each, in order to ameliorate the effects of progressive rates of taxation, and the allowance of deductions for family expenses, but only for residents, at least in cases where non-residents who worked full-time in the Member State and obtained their income wholly or almost exclusively in that Member State and could not get the benefit of equivalent allowances in their Member State of residence, because their income there was too law (*Schumacker*);
- a rule precluding entitlement to repayment of over-deductions of tax on employment income at source where the taxpayer went non-resident in the course of the tax year (*Biehl*);
- a rule precluding deduction of money allocated to a pension reserve by a non-resident working full-time in the Member State in question, where, although the pension payments would not be taxed in that Member State, they would be taxed in his State of residence, pursuant to a double taxation treaty (*Wielockx*);

- a rule requiring the permanent establishment of a non-resident company to keep proper accounts at the permanent establishment, drawn up in accordance with the Member State's laws, if the permanent establishment is to be allowed to carry forward losses, whereas a resident company may simply apportion global losses and profits without keeping separate accounts for each establishment. This failed on account of lack of proportionality, because the purpose of the rule was to enable the tax authorities to determine accurately the amount of losses that could be carried forward, whereas it was not necessary for the taxpayer to keep accounts in accordance with the Member States' law in order to be able to do this, provided it had the raw material available (*Futura Participations and Singer*);
- a rule treating repayments of loan capital as covert profit distributions, and therefore not deductible, in effect when made to a parent either non-resident or resident but in an exceptional category, such as a public law or charitable body, the general rule for resident parents being that such repayments were to be treated at face value (*Lankhorst-Hohorst*);
- a rule crystallising a capital gain when a person emigrates on assets he continues to own after emigration, in circumstances where although the payment of the tax is deferred until the asset is actually disposed of the person is required to give a guarantee or provide security for payment of the tax and decreases in value following emigration will not be taken into account in calculating any tax ultimately due (*N*, on the basis of proportionality);

- a rule allowing a company to transfer profits to a loss-making company within the same group, in order to allow the profits to be offset by the losses (*AA*,[62] in other words the reverse scenario to *Marks & Spencer*).

Rules that have been acceptable to the European Court of Justice include:

- a rule precluding deduction of insurance premiums for income tax where paid to insurers resident in other Member States, in circumstances where those premiums would be deductible for income tax purposes if paid to an insurer in the Member State in question (*Bachmann*, being justified only by the elusive principle of fiscal cohesion);
- a rule limiting non-residents to carry forward losses arising from the activities of permanent establishments in the Member State in question, when such non-residents are taxed in that State only on the income arising out of the permanent establishment, even though residents may carry forward worldwide losses, being liable to unlimited taxation (*Futura Participations and Singer*);

One thing that is instantly apparent is that the list of acceptable rules is much shorter than the list of unacceptable ones.

VII. The attack on the UK tax system

It is worth mentioning briefly the well-known attack that has taken place over the past few years on the UK tax system.

Starting with ex parte *Daily Mail*,[63] and continuing with *ICI*[64] through most recently to *Cadbury Schweppes*,[65] with more cases pending before the Court of Justice, UK

[62] Case C-231/05. The rule is unlawful at least according to the Advocate General; the decision of the Court of Justice is awaited.
[63] [1988] ECR 5483.
[64] [1998] ECR I-4695.

corporate taxpayers have made a sustained onslaught on various rules of the corporation tax system. So, within the Member States of the European Union, there is no longer a need to obtain Treasury consent before a company can change its tax residence;[66] consortium relief no longer requires the consortium company's business, if a holding company, to be holding shares in UK-incorporated subsidiaries;[67] the advance corporation tax regime was held to be unlawful in so far as it did not allow group income elections to be made where the parent company was incorporated in another Member State;[68] the rule that group relief was not available to relieve losses of foreign subsidiaries has been held to be unlawful in circumstances where the foreign subsidiary is not otherwise able to obtain relief for those losses;[69] the controlled foreign companies legislation may be applied only where the foreign subsidiary is a wholly artificial arrangement designed with the sole purpose of avoiding tax;[70] with space to be watched in relation to franked investment income and thin capitalisation issues.

Of course, the taxpayers who have taken cases to Luxembourg have not been acting out of a disinterested public spirit, but for more commercial reasons. For example, in *Daily Mail* the taxpayer wanted to try the individual's trick of going non-resident before realising a capital gain; and in *Metallgesellschaft* the taxpayers sought and obtained an entirely new remedy, at least so far as English law was concerned, in relation to the loss of use of money unnecessarily paid to the Revenue by way of advance corporation tax.

---

[65] Case C-196/04, so far unreported in ECR reports.

[66] Albeit not by virtue of the decision of the European Court of Justice: see *Daily Mail*, paragraph 24. Section 765(1)(a) of the Income and Corporation Taxes Act 1988, which prevented UK-resident companies going non-resident without Treasury consent, was repealed with effect from 15th March 1999: Finance Act 1988, section 105(6).

[67] See former sections 258 and 259 of the Income and Corporation Taxes Act 1970.

[68] *Metallgesellschaft*; by the time of the judgment, the ACT regime had been abolished in any event, subject of course to the shadow ACT rules.

[69] *Marks & Spencer*; see in particular paragraphs 53 ff.

[70] *Cadbury Schweppes*.

One issue that arises in this connection is what good such cases ultimately do. While (potentially) benefiting the claimant taxpayers, their success increases directly the tax burden on other UK taxpayers, and indeed without the tax saving being passed to any other Member State's treasury. Moreover, it is not always the case that there is only one legislative response that will relieve the infringement. For example, in consequence of the Court's decision in *Marks & Spencer*, group relief was extended so as to allow EEA subsidiaries' losses to be transferred to UK companies, if not otherwise relievable.[71] This cured the infringement. But the infringement could equally have been cured simply by abolishing group relief entirely (although in practice this is solution would probably have been politically unacceptable).[72]

One other noticeable point is that by contrast with other Member States, so far all attacks have been mounted on corporation tax. No case has considered the UK tax system as it relates to individuals. Although corporation tax issues remain to be worked out, a number of rules affecting individuals may be liable to challenge. I shall mention three.

First, the rule that one is resident for a whole tax year, even if one emigrates a week after it starts. This is clearly a hindrance to exercise of fundamental freedoms. The question is whether it is justified by a legitimate aim and proportionate. It seems unlikely to pass either of those tests. What the rule's aim is is unclear: possibly simply administrative convenience. But even if to prevent tax avoidance it goes far beyond what is necessary for that purpose. That the rule is not really acceptable is shown by the existence of extra-statutory concessions allowing for split-year treatment in certain circumstances. But those circumstances are defined by general time limits, not specifically related to wholly

[71] See Finance Act 2006, section 27 and Schedule 1.
[72] An indication of what the Government might do is likely to be given in the pre-Budget report.

artificial arrangements, and in any event as mentioned above a mere administrative practice cannot cure what is otherwise a breach of Community law.

Second, the rule that a person who goes non-resident and returns to the UK before 5 complete tax years have expired is taxed on any capital gains realised while he was non-resident by the disposal of assets he owned while first resident in the UK.[73] In *de Lasteyrie du Saillant* the Court of Justice indicated that such a system is acceptable if confined to taxing gains realised during a 'relatively brief stay' in another Member State, but the reason given is that such a system would not affect taxpayers having no other aim that the *bona fide* exercise of their freedom of establishment. Apart from the fact that five complete tax years does not immediately strike one as a 'relatively brief stay', this reasoning is clearly flawed. One could easily legitimately go abroad even for 18 months, simply deciding that foreign climes were not to one's taste, and return. The rest of the Court's case-law would suggest that some condition relating to evidence of a wholly artificial arrangement would be required before such a system would be acceptable under European law. The aim of tax avoidance in addition to a *bona fide* reason for emigration would not, under that case-law, justify an infringement of the fundamental freedoms. There is of course no such condition in the UK regime.

Third, the rule that profits of a foreign close company may be allocated to UK resident participators.[74] Again, the point is that incorporation of a foreign company is a legitimate exercise of one's freedom of establishment, even if the purpose is tax avoidance, provided the arrangement is not a wholly artificial one. So in the absence of a condition

[73] Taxation of Chargeable Gains Act 1992, section 10A.
[74] Taxation of Chargeable Gains Act 1992, section 13.

limiting the scope of the rule to such arrangements designed for the sole purpose of avoiding tax, it is at least arguable that this too infringes European law.

VIII. Conclusion

As mentioned at the start of this paper, the judge really at the centre of the English group litigation orders concerning the interplay of corporation tax and Community law regards the questions arising in that field as 'not remotely resolved yet'. While this is true, the questions arising in the context of personal tax have not even been asked. It may be expected that the emphasis of new litigation as to the effect of European law on United Kingdom direct taxation may shift gradually to personal taxes,[75] and why should not such cases start before the Special Commissioners sitting in Edinburgh?

[75] Indeed, John Cullinane, this year's president of the Chartered Institute of Taxation, has made this prediction in a recent Tax Adviser article.