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Editorial

EC law protection against 'horizontal' tax discrimination on the rise – or how to play snooker in an Internal Market

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After round about two decades of ECJ jurisprudence on the impact of the EC Treaty freedoms on national direct tax system, one should assume that at least the basic structural principles of those freedoms and their relevance for taxation have been properly defined. Yet there are still some rather grey areas into which the Court will definitely have to shed some more light in the near future. One of these areas concerns potential 'horizontal' discrimination of cross-border transactions, in particular with regard to tax provisions maintained by a taxpayer's home state that distort the free choice of outbound investment within the EU. This assertion will hopefully become a bit clearer after a rough description of the status quo of the ECJ's case law.

To start with, it may reasonably be stated that the first principle spelled out by the ECJ is the one explicitly laid down in most of the fundamental freedoms, and that is the guarantee of 'national treatment' in the host state. At least since *Commerzbank AG* (C-331/91) and *Schumacker* (C-279/93) we know that this is a rather broad concept, covering also tax rules that do not use nationality as the relevant criterion for distinctions. Translated into international tax lingo this means that, in 'inbound' situations, the source state is basically not allowed to treat non-residents, within the framework of their limited tax liability, less favourably than residents. Some years later a second principle emerged, and that is the prohibition addressed to the home state not to cause any 'restrictions' to cross-border activities of its own companies and citizens (or, rather, residents) in other Member States. From tax cases like *ICI plc* (C-264/96) and *Baars* (C-251/98), however, it can also be derived that what is at stake is not any mere burden or obstacle to free movement, but a distortion of the free choice of a resident taxpayer to engage in economic activities 'outbound' in another Member State rather than in his own state of residence.

In a nutshell, these principles can be traced back to one and the same basic idea, and this is the concept of 'vertical' non-discrimination: Both the host state and the home state are not allowed to treat cross-border transactions worse than equivalent (hypothetical) *purely domestic* transactions within their respective territory.[1] Recent case law now shows that the ECJ is currently trying to explore, and partly even to re-define, the limits of this non-discrimination concept. But while judgments like, for example, *Schempp* (C-403/03), *Marks & Spencer* (C-446/03) and *Kerckhaert-Morres* (C-513/04), seem to imply that the overall tendency is to reduce the scope of the fundamental freedoms, one should not ignore some recent developments in an area that could be called the prohibition of 'horizontal' discrimination. In contrast to the 'vertical' approach, this concept does not take a purely domestic situation as the relevant *tertium comparationis*, but relies on the comparison of a given cross-border situation with *another (hypothetical) cross-border situation*.

A first example concerns secondary establishments: already in *avoir fiscal* (270/83) the ECJ indicated that the second sentence of Art. 43(1) of the EC Treaty guarantees freedom of choice as regards the appropriate legal form for cross-border activities, and in *Compagnie de Saint-Gobain* (C-307/97) the Court indeed held that the host State's tax rules made it less attractive to establish branches as compared to subsidiaries, so that the freedom to choose the most appropriate legal form was restricted. Yet, in that case there was also ('vertical') discrimination of non-residents at stake which altogether led to 'a single composite infringement' of Arts. 43 and 48 of the EC Treaty, so that the independent character of a 'horizontal' non-discrimination principle was left somewhat obscure. In *Marks & Spencer* such a principle was rejected by AG Maduro, and the ECJ did not even bother to analyse whether the unfavourable treatment of foreign subsidiaries as compared to foreign branches by the home state was discriminatory. Against this background it is difficult to evaluate whether *CLT-UFA* (C-253/03) has established a principle of *neutrality of legal form*: it is true that the

[1] Compare in this respect the author's contribution to Vanistendael (ed.), *EU Freedoms and Taxation* (IBFD, Amsterdam 2006), pp. 1 *et seq.*

Court concentrated on the 'horizontal' approach and concluded that the freedom of choice was restricted. But as the overall constellation of the case was similar to *Saint-Gobain*, involving unfavourable treatment of branches in the host state, still some doubts remain as to whether an independent principle has already managed to emancipate itself (see also C-231/05, *Oy AA*, were subsidiaries were worse off than PEs in the host state).

However, while these cases concerned the 'horizontal' comparison of different types of activities pursued in relation to a certain other Member State, another line of cases has recently come up, based on a comparison of otherwise identical cross-border activities in different foreign Member States: the first step was made by AG Léger in *Cadbury Schweppes plc* (C-196/04) who pointed out that the UK CFC rules did not only discriminate ('vertically') against cross-border investments as compared to purely domestic ones, but also ('horizontally') against investments in a low tax Member State as compared to those made in Member States with a higher tax burden – a situation which, according to the AG, was 'contrary to the very notion of the "single market" '. Admittedly, the ECJ itself brought the 'horizontal' concept closer to the 'vertical' approach, when it ruled that the relevant tax disadvantage did not arise in relation to 'a subsidiary taxed in the United Kingdom or a subsidiary established outside that Member State which is not subject to a lower level of taxation'. However, other Advocate Generals have now taken the ball up again 'horizontally', and their arguments have played a forward pass so close to the goal that it will take the Court quite an effort not to score.

The initiative was taken by AG Mengozzi when dealing with the German quasi-CFC rules in the pending *Columbus Container Services* case (C-298/05). These rules trigger a switch-over from the treaty exemption to a mere tax credit if a permanent establishment set up in the other Contracting State is subject to a low tax burden there, so that in the end the foreign PE suffers the same tax burden as if it had been set up in Germany. Even though the AG argued that this effect could not be considered discriminatory in the traditional ('vertical') sense, he nevertheless took one decisive step forward. Relying in particular on AG Léger's explanations in *Cadbury*, he emphasized that the ('horizontal') comparison between the cross-border investment at hand (in a tax-privileged Belgian co-ordination centre) and an equivalent investment of the German plaintiff in a third Member State, was necessary to avoid a *fragmentation of the Internal Market* and therefore had to be accepted as an independent element of the prohibition of 'restrictions' under Art. 43 of the EC Treaty. Thus, he considered the German rule in question to be discriminatory.

This view has now received further support by AG Bot in the pending *Orange European Smallcap Fund* case (C-194/06) which, *inter alia*, concerns the issue of whether Dutch investment organisms are entitled to credits of foreign dividend withholding tax. The AG pointed out that, in the relevant tax year, such relief measures were not available in relation to Germany (as there was no credit under the tax treaty as it stood then) and to Portugal (as there was no tax treaty at all yet), but that the Netherlands, on a unilateral basis, had decided to extend the credit mechanism in the tax treaty with Italy also to investment organisms (which as such were not covered by the scope of that treaty). Advocate General Bot, too, took the view that, pursuant to *Cadbury*, the prohibition of discrimination applied to national measures which distinguish within the EU and treat investment in one Member State less favourably than in another. Thus, Art. 56(1) of the EC Treaty was considered to oblige the Netherlands to grant investment organisms the same favourable treatment also with respect to dividends from Germany or Portugal.

These arguments are new to the area of fundamental freedoms protection against national tax measures. However, they are fully in line with the concept of an Internal Market, as a brief look at other areas may demonstrate. According to vested case law, the Treaty rules on competition law forbid measures 'capable of bringing about a partitioning of the market in certain products between Member States and thus rendering more difficult the interpenetration of trade which the Treaty is intended to create' (56/65, *LTM v MBU*). And during the process of re-defining the free movement of goods from *Dassonville* to *Keck*, AG Van Gerven had emphasized that the afore-mentioned *prohibition of market fragmentation* should not only apply to agreements between private parties under (now) Art. 81 of the EC Treaty, but also to measures taken by the Member States (C-145/88, *Torfaen*). All these ideas are also contained in *Frans Vanistendael's* convincing description of how the concept of a prohibition of 'restrictions' on the fundamental freedoms functions from a home state perspective: 'It views the EU market as a whole where all economic actors can move from one end to the other. It views the EU market as a huge snooker table, where all the economic balls roll smoothly from one corner to the other'.[2]

Still, one may ask whether the new 'horizontal' approach does not contradict the ECJ's recent decisions in *D* (C-376/03) and *ACT Group Litigation* (C-374/04), which had rejected the idea that a person resident in state A could claim from source state B the same tax treatment the latter state grants to residents of state C. From a purely formal perspective one could point out that these were 'inbound' cases concerned with host state rules, whereas *Cadbury*, *Columbus* and *Orange* all concern home state rules in 'outbound' situations. From a more substantive perspective one could also argue that already the decision in *D*, which is simply based on the questionable idea that persons covered by a certain tax treaty are per se incomparable with other persons, should be reconsidered by the Court. However, the most striking difference between both groups of cases has already been stressed by AG

[2] F. Vanistendael, 'The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States', *EC Tax Review* 2003, p. 136.

Mengozzi and AG Bot, and this is the fact that the rules under scrutiny in *Columbus* and *Orange* do not represent 'integral parts' of existing tax treaties with other Member States but, quite to the contrary, *unilateral deviations* from such treaties. Therefore it is hard to see how the finding of a violation of EC fundamental freedoms could endanger the 'overall balance' of those treaties. Rather, the ECJ should seize the opportunity and establish clear snooker rules for a level playing field, i.e. define as a legal principle that the EC market freedoms prevents a taxpayer's home state from creating 'horizontal' discrimination between outbound investments in different foreign Member States!