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Editorial

Fiscal Federalism, Fiscal Surrealism or Fiscal Realism? Regionalization of Taxing Powers in Belgium

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Fiscal federalism refers to a normative framework whereby various public functions and appropriate fiscal instruments for carrying out of these functions are allocated to different levels of government.

In Belgium, the three regions (the Flemish, Walloon, and Brussels regions) have progressively been entrusted with autonomous taxing powers. Among others, the regions are empowered to regulate and impose twelve sorts of taxes, which were formerly levied by the Federal government (hereinafter 'regional taxes'). The most important regional taxes are the annual tax on the imputed value of real property, the inheritance tax, the gift tax and the tax on the transfer of real property. The regions also have the power to provide tax surcharges or reductions on the federal personal income tax within a range of 6.75% of the revenues, which they derive from the allocated federal personal income tax. The negotiations to form a new Belgian government that are dragging on for months now are, to a large extent, concerned with the further increasing of the fiscal responsibility of the regions so that their taxing powers are more appropriately adjusted to their (increasing) competences, spending needs and preferences. Such could possibly lead to the regions becoming entitled to levy personal income tax and/or corporate income tax together with the Federal government and to an adjustment of the current allocation mechanisms of the federally levied personal income tax and value added tax (VAT) to the regions.

As a matter of principle, the Union does not interfere with the internal devolution of powers within Member States.[1] Also, the question on how (taxing) powers are entrusted to decentralized authorities is a matter for the constitutional system of each Member State.[2] However, each Member State must see to it that the law of the Union is correctly implemented within the whole of its territory independently of how powers are devolved internally. One of the consequences thereof is that, in the exercise of their taxing powers, regional authorities must respect primary Union law. This basically means that regional tax laws must comply with the requirements on non-discrimination and non-restriction imposed by the Treaty on the Functioning of the European Union (TFEU) rules on the fundamental freedoms and with the TFEU rules on state aid. In a previous editorial, the relevance of the ECJ's judgments on state aid for regional tax lawmakers have already been highlighted.[3] This editorial deals with the relevance of fundamental freedoms. Recent experiences have shown that the regional lawmakers in Belgium encounter serious difficulties in complying with the obligations imposed by the TFEU fundamental freedoms.

Where regions in a federalized Member State are entrusted with taxing powers very often different tax regimes will apply within the same Member State. There are many examples of these in Belgium. In *Horvath*, an English farmer considered that he was discriminated since the rules implementing a European Union (EU) regulation in the field of agriculture were stricter in England than in Scotland, Wales and Northern Ireland. The ECJ held that the measure adopted by the decentralized authorities in the United Kingdom must be compatible with the obligations of the Member States stemming from the EU regulation. However, differences between measures provided by the various decentralized authorities cannot as such constitute a discrimination prohibited by the TFEU.[4] It follows from *Horvath* that the differences between the tax laws within a federalized Member State stemming from the exercise by different regions of their constitutional taxing powers cannot in itself lead to a discrimination that is forbidden by the TFEU. However, recent ECJ judgments have made it clear that matters are significantly different where a region treats residents of its own territory more favourably than residents of other Member State that have exercised their TFEU freedoms.

The Flemish rules on inheritance taxes provided that shares in family enterprises were to enjoy a tax exemption on the condition that the enterprise employed at least five FTEs in the Flemish region in the three years preceding the death of the deceased. As such a condition can more easily be complied with by enterprises that are already established in the Flemish region, the ECJ decided that it amounts to indirect discrimination between taxpayers depending on the place of employment. According to the Belgian government, the exemption was justified to ensure the

[1] Article 4(2) Treaty on European Union (TEU).
[2] European Court of Justice (ECJ), 15 Dec. 1971, *International Fruit Company*, C-51/71.
[3] B. Peeters, 'European Guidelines for Federal Member States Granting Fiscal Competences c.q. Tax Autonomy to Sub-National Authorities', *EC Tax Review* (2009): 50.
[4] ECJ, 16 Jul. 2009, *Horvath*, C-428/07.

survival of small- and medium-sized enterprises and the maintenance of employment in them in case of succession, which is otherwise subject to high taxes. The ECJ agreed that this is a sound justification but added that there is no need to limit the exemption to enterprises that maintain employment in Flanders. The Court said:

> In relation to the objective of preventing inheritance tax from jeopardizing the continuation of family undertakings and therefore the jobs which they bring, undertakings having their seat in another Member State are in a situation comparable to that of undertaking established in the first Member State.[5]

Next in *Eckelkamp,* the ECJ decided that the rule of the Flemish Inheritance Tax Code, according to which the heirs of non-residents of Flanders are taxed on the gross value of the real property situated in Flanders (that is, with no deduction for the related mortgage debt) while the heirs of residents of Flanders are taxed on the net value of their worldwide estate, infringes the TFEU rules on the free movement of capital. The Court said:

> Where national legislation places the heirs of a person who, at the time of death, had the status of resident and those of a person who, at the time of death, had the status of non-resident on the same footing for the purposes of taxing an inherited immovable property which is situated in the Member State concerned, that legislation cannot, without giving rise to discrimination, treat those heirs differently in the taxation of that property so far as concerns the deductibility of charges secured on it. By treating the inheritances of those two categories of persons in the same way (except in relation to the deduction of debts) for the purposes of taxing their inheritance, the national legislature has in fact admitted that there is no objective difference between them.

The Belgian government justified the taxation on the gross value with the argument that there is a risk of double deduction if the State of non-residence is to grant the deduction of the debt. The ECJ rejected this justification in the following terms: 'A Member State cannot rely on the existence of a tax advantage granted unilaterally by another Member State (…) in order to escape its obligations under the Treaty.'[6]

Missionswerk Heukelbach concerns a rule of the Walloon inheritance tax legislation according to which legacies to Belgium- and Union-based charitable bodies are taxed at 7%. However, in case of legacies to bodies in other Member States, the 7% only applies if, at the time of death, the deceased actually resided or had his place of work in the Member State where the body is established or if he/she had previously actually resided or worked in that State. If those conditions are not fulfilled, the rate is increased to 80% (!) but only with respect to legacies to bodies based in other Member States. The ECJ, relying on its earlier judgment in *Persche*, decided that an entity established in another Member State that satisfies the conditions laid down in the Walloon statute as to the charitable nature of its activities for the grant of the tax benefit is as regards such a grant by Wallonia in a comparable situation to the Belgian entities carrying on charitable activities. Thus, providing for a different treatment according to the seat of operations of the body leads to indirect discrimination and a restriction of the free movement of capital. The ECJ held that the justification put forward by Belgium is odd. If the goal of the rule is to grant a tax benefit to bodies that have a sufficiently close link with the Belgian territory, as the government argued, why then give the same advantage to foreign entities without requiring that their activities are connected to Belgian territory? According to the ECJ, the rule treats favourably all Belgium-based charitable bodies without requiring that their activities have a close link with Belgian territory and excludes from that treatment bodies established in other Member States – even if their activities meet the close link test – on the ground of an inappropriate criterion, that is, that the legatee upon death lived or worked in the Member State where the body is established or had lived or worked in that State before.[7]

Several other cases concerning Belgian regional taxes are pending before the ECJ or are investigated by the Commission. In 2008, the Commission started an infringement procedure regarding the Flemish rule on portability of the transfer tax. In Flanders, a buyer of Flemish situs real property pays 10% transfer tax. However, the tax paid upon purchase of a former property situated in Flanders is creditable against the tax due on the new property provided that the buyer establishes his residence in the new property and sells the former property within a fixed time period. The exemption is justified by the need to acquire a property close to the work place or to acquire a property that is adjusted to the family needs. According to the Commission, the rule infringes Articles 21, 49 and 63 TFEU, because they deny the tax credit to persons who have exercised their treaty freedoms and acquire real property in Flanders with a view to establish themselves there and sell their properties in another Member State. Very likely, Flanders will justify the measure on ground that it is only empowered to levy transfer tax on a property situated on its territory and hence that it should not give credit for transfer taxes paid elsewhere. It is surprising that this case is already pending three years before the Court.[8] It will be interesting to see whether it will extend its *Manninen* – case law on foreign tax credits to this case, which concerns an indirect tax. In the *Halley* case (C-132/10), the Court will have to deal with the different assessment terms that are applied in all three Belgian regions in the field of inheritance tax to foreign assets that form part of the estate of a Belgian resident. Where the heirs report foreign assets below their fair market value, the tax authorities have ten years to estimate the property and tax any unreported value, while the assessment term in case of assets that are situated in Belgium is limited to two years. The Commission has also announced that the rule of the Brussels region providing for a reduced 6.6% tax

5 ECJ, 25 Oct. 2007, Geurts-Vogten, C-464/05.
6 ECJ, 11 Sep. 2008, *Eckelkamp,* C-11/07.
7 ECJ, 10 Feb. 2011, *Missionswerk Werner Heukelbach eV*, C-25/10.
8 *Commission v. Belgium,* C-250/08.

on legacies to municipalities and public institutions based in the Brussels region is a non-justifiable exclusion of comparable institutions within the EU and the European Economic Area (EEA) that infringes the free movement of capital.[9] It also requested the Brussels region to change its rules on the taxation of gifts of Brussels real estate. The rate is reduced to 5% but only if the recipient remains a resident of the Brussels region for at least five years. The Commission considers this condition to restrict the freedoms guaranteed by Articles 21, 45 and 49 TFEU, because they dissuade persons from moving from the Brussels region or investing elsewhere in the Union.[10]

Only Flanders has effectively taken a few measures in the field of personal income tax. Several of these measures are scrutinized by the Commission. In 2006, Flanders introduced a lump sum tax reduction for earners of professional income who work and live in Flanders. According to the Commission, applying a *Schumacker* analogy, the exclusion of residents of other Member States who work in Flanders and earn (almost) all of their professional income there infringes Articles 45 and 49 TFEU.[11] Presumably, the Flemish government will argue that under Article 7 of the Special Financing Law of 16 January 1989, it is only allowed to take income tax measures that concern individuals who reside on the territory of Flanders. It will be interesting to see whether this argument will impress the ECJ. The challenge by the Commission offered a welcomed excuse for the Flemish government to abolish the very expensive measure as of 1 January 2011. Flanders also offers a tax reduction to residents of Flanders who live in Flanders and lend to small- and medium-sized enterprises that have their seat of operations in Flanders. According to the Commission, the exclusion of medium-sized enterprises established in other Member States that have a centre of operations in Flanders is in breach of Article 49 TFEU.

Tax measures enacted by regions may discriminate against residents of other regions of the same Member State even if they are nationals of that Member State. The above Belgian rules offer various examples. For example, the Flemish measure allowing the portability of the transfer tax on the acquisition of new real property in Flanders does not apply to residents of the Brussels or the Walloon region who buy real property in Flanders even if they establish their residence there because Flanders only gives credit for its own taxes. And the Flemish lump sum tax reduction on professional income is denied to a resident of the Walloon or Brussels region even if he earns (almost) all his professional income in Flanders. If the ECJ finds both measures to be in breach of the TFEU freedoms, such decisions will only protect residents of other Member States who acquire Flanders situs real property or who work in Flanders but not the vast majority of residents of the Brussels or Walloon regions in the same circumstances. The ECJ case law thus leads to reverse discrimination. Residents of the Brussels and Walloon regions may find this outcome somewhat surrealistic or at least unfair. This is because the residents of the Walloon or Brussels regions are examples of a *purely internal situation*. Such situations are not protected by Union law, as it is settled in ECJ case law that the law of the Union is not concerned with 'activities that have no factor linking them with any of the situations governed by Community law and which are all confined within a single Member State'.[12]

However, over the years, the ECJ has refined its case law on purely internal situations. As often, this evolution became clear first with respect to the free movement of goods. In *Carbonati Apuani*, the ECJ held that a municipal tax, which is levied on marble that is exported from the territory of the municipality regardless whether it leaves the territory of the Member State, is a measure that has equivalent effects to a custom duty and therefore forbidden by Article 30 TFEU. It held that the *internal market* – defined by Article 14 section 2 TFEU as 'an area without frontiers in which the free movement of goods, persons, services and capital is ensured' – makes no difference between the outer and inner border of the Member States.[13] In *Jersey Produce*, the ECJ pushed this reasoning even further and applied it to a duty that hit the movement of goods between two parts of the same Member State (potatoes shipped from Jersey to the British mainland).[14] More recently, in a matter concerning the free movement of persons, the ECJ carried out an in-depth analysis of the facts to limit the *purely internal situations* to those persons who never exercised their TFEU freedoms. The Flemish decree on the care insurance excluded one category of persons from the benefit of the scheme, that is, persons residing in the Walloon region even if they were employed in Flanders. On the argument put forward by the Flemish government that the matter concerned a purely internal situation not falling within the ECJ's competence, the ECJ replied that no such situation is present if the worker is (1) a national of another Member State who works in Flanders but lives in the Walloon region and (2) a Belgian national who has exercised his TFEU freedoms (for example, to establish himself in another Member State to work there as an employee or an independent) and subsequently establish himself in the Walloon region and works in Flanders (hereinafter 'remigrants').[15] As the ECJ puts no time limit on when and how long such remigrants must have exercised their freedom, the potential scope of exclusion of Belgian nationals from the internal situation case law as well as the potential for abuse are wide. If this case law was to be applied to the above cases concerning the portability of the Flemish transfer tax and the lump sum tax reduction, the picture becomes even more surrealistic. Residents of the Wallloon or Brussels regions will see their fellow countrymen and women and residents getting the Flemish tax benefits because the latter happened to

9 IP/10/1253 of 30 Sep. 2010.
10 IP/11/59 of 16 Feb. 2011.
11 IP/10/1403 of 28 Oct. 2010.
12 ECJ, 8 Dec. 1987, *Gauchard*, C-20/87.
13 ECJ, 9 Sep. 2004, *Carbonati Apuani v. Comune di Carrara*, C-72/03.
14 ECJ, 8 Nov. 2005, *Jersey Produce Marketing Organization*, C-293/02.
15 ECJ, 1 Apr. 2008, *French Community and Walloon Government v. Flemish Government*, C-212/06.

have exercised their Treaty freedoms at some point in the past.

One question remains: Could such persons contest their exclusion from the Flemish tax advantages on the basis of the rules of Belgian constitutional law? According to Article 6 section 1, VI of the Law of 8 August 1980 (as amended from time to time):

> The Belgian Federal State is an economic and monetary union characterized by an internal market and by one single currency. In economic matters, the regions exercise their powers with respect for the free movement of persons, goods, services and capital, for the freedom of trade and commerce as well as for the general normative framework of the economic and monetary union as set forth by statute or by international treaties.

Thus, the Belgian Federal State is a *mini-Europe*, and the regions must exercise their taxing powers with respect for the Belgian internal market and for the constitutional freedoms on which the Belgian Federal State is grounded and which are prima facie the same as the TFEU freedoms. The Belgian Constitutional Court condemned a duty imposed by the Walloon region on water exported from Wallonia to the Brussels and Flemish region as contravening the above free movement principles governing the Federal Belgian State.[16] On the other hand, the same Court did not find the Flemish care insurance scheme excluding residents of Wallonia from the benefits of the scheme to infringe the above-mentioned Article 6 section 1, VI of the Law of 8 August 1980.[17] However, very recently, the Constitutional Court copy–pasted the above-mentioned ECJ decision in *Geurts-Vogten* to a purely internal situation. The case concerns the heirs of a resident of Flanders who were denied the inheritance tax exemption because the companies that were owned by the deceased did not meet the employment test in Flanders, although they did meet them in the other regions of Belgium. The Court decided that the measure infringed Article 6 section 1, VI of the Law of 8 August 1980 as it hinders the freedom of establishment and the free movement of capital of persons living in Flanders and desiring to invest in other regions of Belgium.[18]

If the ECJ would condemn the Flemish tax rules on, for example, the portability of the real property transfer tax or the lump sum tax reduction for workers because they dissuade residents of other Member States to acquire Flemish real property or to work in Flanders and the Constitutional Court would follow the ECJ judgments to protect Belgian nationals residing in the other regions like it did in the recent inheritance tax case, this would be a serious blow for the exercise of regional taxing powers in Belgium. I admit that this is speculative. However, the ECJ and the Belgian Constitutional Court have set out important guidelines (in connection with the TFEU and constitutional freedoms and with state aid). Fiscal lawmakers in Belgium and those wishing to further increase regional tax autonomy should display a sense of fiscal realism and carefully consider those guidelines when shaping further the taxing powers in the Belgian Federal State.

16 Constitutional Court, 25 Feb. 1988, Case 47/88.

17 Constitutional Court, 21 Jan. 2009, Case 11/2009.

18 Constitutional Court, 8 Jul. 2010, Case 83/2010.