

## Interaction of EU law and direct tax

Produced in partnership with Étienne Wong of Tax Chambers, 15 Old Square

The EU imposes its own legal order under which the Member States agree to limit their sovereign rights in certain areas, having transferred the relevant powers to EU institutions.

*References:*

*Van Gend en Loos, Case C-26/62*

Direct taxation is not one of these areas. However, the Member States are bound by the treaties that form the constitutional basis of the EU, to which they are all signatories. The treaties set out certain principles (such as the principle of non-discrimination on grounds of nationality) and provide for a number of fundamental freedoms.

Notwithstanding that Member States retain their sovereign rights in relation to direct taxation, they are obliged to exercise these rights in a way that is compatible with applicable EU law, including the principles and freedoms set out in treaties.

*References:*

*Manninen, Case C-319/02*

Possible incompatibility between a national tax provision and these principles or freedoms may be raised by a national of a Member State or the European Commission (Commission).

Where the Commission considers there is possible incompatibility:

*References:*

*TFEU, art 258*

- it would send the Member State in question a letter of formal notice to that effect
- the Member State would be given the opportunity to submit its observations
- the Commission would then deliver a reasoned opinion on the issue, and
- either:
  - the Member State would relent (and amend the relevant national tax provision), or
  - where the Member State does not amend the relevant national tax provision or does not do so within the relevant time frame, the Commission would refer the matter to the CJEU (eg, see *Commission v UK*)

*References:*

*Commission v UK, Case C-112/14*

This Practice Note looks at issues that commonly arise where a referral is made to the CJEU (whether by a court of a Member State or by the Commission) on the basis that there is possible incompatibility between a national direct tax provision and a fundamental freedom.

It does not discuss state aid or related issues (for which, see Practice Note: State aid—a subscription to Lexis<sup>®</sup>PSL Commercial is required).

### Sources of EU law

The treaties are not the only source of EU law. Directives and Regulations derive from the principles and objectives set out in the treaties and form a layer of secondary EU legislation.

Directives that impact on direct taxation include:

- the Parent-Subsidiary Directive

*References:*

*Directive 2011/96/EU*

- the Interest and Royalty Directive, and

*References:*

*Directive 2003/49/EC*

- the Merger Directive

*References:*

*Directive 2009/133/EU*

The objectives and effect of these Directives are to harmonise (to an extent) the direct tax rules in the areas specified.

For example, the objective of the Parent-Subsidiary Directive is to exempt dividends and other profit distributions paid by a subsidiary in one Member State to its parent in another Member State from withholding taxes and to eliminate double taxation of such income at the level of the parent.

*References:*

*Directive 2011/96/EU, recital (3)*

For more information on the sources of EU law, see: [EU law and its interpretation in the UK](#).

## Interaction of EU law and national law

Referral to the CJEU is not the only way in which EU law is enforced.

EU law has supremacy over national law, and certain provisions of EU law have direct effect.

*References:*

*Van Gend en Loos, Case C-26/62*

*Costa v ENEL, Case C-6/64*

A Member State's obligation in relation to EU law extends to its courts (for matters within their jurisdiction), and it is their responsibility to provide the legal protection nationals derive from the relevant rules and to ensure that those rules are fully effective.

*References:*

*Pfeiffer, Case C-397/01*

When applying national law, therefore, the national courts must interpret the (national) provision in question in conformity with EU law.

*References:*

*Marleasing, Case C-106/89*

In some cases, applying a conforming interpretation to national law may avoid inconsistency with EU law. However, where this is not possible, a national court must set aside the (national) provision in question.

*References:*

*Simmenthal, Case C-106/77*

Where a national of a Member State has paid an amount by way of tax that the relevant tax authorities are not entitled under applicable EU law to collect, the national is entitled to recover the wrongly paid/collected amounts.

*References:*

*San Giorgio, Case C-199/82*

They also have a right to reparation where they have suffered loss and damage as a result of a breach of EU law for which the Member State can be held responsible. This is subject to conditions that set a high bar, as well as the principles of equivalence and effectiveness.

*References:*

*Francovich, Joined Cases C-6/90 and C-9/90*

*Factortame, Joined Cases C-46/93 and C-48/93*

For more information on the supremacy of EU law and direct effect, see: [EU law and its interpretation in the UK](#).

For more information on remedies for a breach of EU law, see: [EU law—restitution and damages](#).

## The fundamental freedoms

The fundamental freedoms are cornerstones of the single market (the Internal Market).

The Internal Market exists not only within the EU but extends to Iceland, Liechtenstein and Norway. The EU and these three countries together comprise the European Economic Area (EEA).

*References:*

*Agreement on the European Economic Area (the EEA Agreement)*

Switzerland, while part of the single market, is neither a (EU) Member State nor an EEA State. Its relationship with the EU is governed by a range of agreements (such as the free trade agreement signed in 1972, relating to economic and trade matters). The agreement on freedom of movement signed in 1999 gives nationals of each signatory party the right to enter, and to live and work in, the territory of the other—a right not dissimilar in nature to the free movement of persons within the EEA (for which, see below).

The CJEU adopts a uniform interpretation in relation to those rules set out in the EEA Agreement (such as those relating to the fundamental freedoms) that are identical in substance to those laid down by the EU treaties.

*References:*

*Ospelt and Schlössle Weissenberg, Case C-452/01*

However, it also recognises that EU case law on restrictions on fundamental freedoms cannot always be fully transposed to the freedoms provided for in the EEA Agreement—eg where the latter are exercised in a different legal context.

*References:*

Prohibiting restrictions on fundamental freedoms ensures that:

- a Member State or EEA State (the host state) does not discriminate against nationals from other Member States or EEA States, and
- a Member State or EEA State (the state of origin) does not hinder the exercise by its own nationals of a right or freedom in other Member States or EEA States

The fundamental freedoms are:

- the freedom of establishment

*References:*

*TFEU, art 49*

*EEA Agreement, art 31*

- the free movement of capital

*References:*

*TFEU, art 63*

*EEA Agreement, art 40*

- the free movement of goods

*References:*

*TFEU, art 28*

*EEA Agreement, art 8*

- the freedom to provide services, and

*References:*

*TFEU, art 56*

*EEA Agreement, art 36*

- the free movement of persons

*References:*

*TFEU, arts 20, 21, 45*

*EEA Agreement, art 28*

### **Freedom of establishment**

The freedom of establishment includes the right of a national of a Member State to:

*References:*

*TFEU, arts 49–55*

- take up and pursue activities as a self-employed person, and
- set up and manage undertakings (in particular, companies or firms)

and prohibits restrictions on the freedom of such a national setting up an establishment (eg an agency, branch or subsidiary) in any other Member State.

### **Free movement of capital**

The free movement of capital prohibits restrictions on movements of capital and payments between countries.

*References:*

*TFEU, arts 63–66*

Movements of capital between Member States include transactions by which nationals of a Member State make investments in immovable property in another Member State.

*References:*

*Trummer and Mayer, Case C-222/97*

The prohibition in relation to the free movement of capital is not limited to the movement of capital or payments between Member States, but extends to the movement of capital and payments between a Member State on the one hand, and a third country (ie a country outside the EU) on the other.

*References:*

*TFEU, arts 63–66*

### **Free movement of goods**

The free movement of goods is consequential on the EU being a customs union covering all trade in goods, and prohibits customs duties on imports and exports between Member States.

*References:*

*TFEU, arts 28–37*

## Freedom to provide services

This prohibits restrictions on the freedom of service providers established in one Member State to provide services within the EU where the intended service recipients are in another Member State.

*References:*

*TFEU, arts 56–62*

## Free movement of persons

The free movement of persons guarantees the right of a national of a Member State to move and reside freely within the territory of the EU.

*References:*

*TFEU, arts 20–21*

It also prohibits discrimination between workers in the EU in matters of employment, remuneration and other conditions of work and employment where such discrimination is based on nationality.

*References:*

*TFEU, arts 45–48*

## Compatibility of national provisions with fundamental freedoms

The key questions when considering whether a national tax provision is compatible with the fundamental freedoms are as follows:

- whether the national tax provision in question constitutes a restriction on a fundamental freedom
- if so, whether the restriction is justified, and
- if the restriction is justified, whether it is proportionate

## Whether there is a restriction

Possible incompatibility with a fundamental freedom is normally raised where the national tax provision in question applies a different tax treatment depending on whether the person in question is, or whether the transaction in question is entered into with, a national of the Member State.

Whether the difference in tax treatment is a restriction on a fundamental freedom depends on whether it is discriminatory—ie whether it involves the application of different rules to comparable situations or the application of the same rule to different situations.

*References:*

*Schumacker, Case C-279/93*

In most cases the question is whether, having regard to the tax provision, a national and a non-national are in an objectively comparable situation.

*References:*

*Test Claimants in Class IV of the ACT Group Litigation, Case C-374/04*

In relation to direct taxes, the situations of nationals and non-nationals are, as a rule, not comparable. This is because, generally, the major part of a person's income is concentrated, and their personal and family circumstances are easier to assess, in the State where their personal and financial interests are centred—ie the State where they have their usual abode, or the State of which they are a national (their State of residence).

*References:*

*Schumacker, Case C-279/93*

For an example of a situation in which a difference in treatment did not constitute a restriction of a fundamental freedom because the difference was between non-comparable situations, see *Truck Center*.

*References:*

*Truck Center, Case C-282/07*

This concerned Belgian tax provisions under which withholding tax was charged on interest paid to a non-Belgian recipient company but not on interest paid to a Belgian recipient company.

The provisions in question being tax provisions, the difference in treatment was not in itself discriminatory. The question was whether it was actually discriminatory (or not) on the facts. The CJEU ruled that it was not, broadly because a Belgian recipient company was both within the Belgian tax net and subject to the supervision of the Belgian tax authorities, whereas a non-Belgian recipient company was not. It also found that, as a matter of fact, the disparity in mechanics and rates of the provisions at issue and the Belgian corporation tax regime meant that the difference in treatment did not necessarily result in an advantage for the Belgian recipient company in any event.

For an example of a situation in which a difference in treatment did constitute a restriction on the fundamental freedoms, see *Commission v Italy* (which concerned Italian tax provisions under which dividends distributed to non-Italian companies were subject to tax at a higher rate than dividends distributed to Italian companies).

*References:*

*Commission v Italy, Case C-540/07*

In that case, the difference in treatment was between national and non-national shareholders, the situations of whom are not (as mentioned above) necessarily comparable. However, as soon as the Member State in question, either unilaterally or by way of a

convention, imposes tax on dividends received from a company in the Member State, not only by national shareholders, but also those received by non-national shareholders, the position changes, and the situation of those non-national shareholders becomes comparable to that of the national shareholders.

*References:*

*Commission v Italy, Case C-540/07*

*Test Claimants in Class IV of the ACT Group Litigation, Case C-374/04*

Similarly, in relation to national tax provisions that prevent or mitigate the double taxation of a company's profits, non-national permanent establishments are, in principle, not in a comparable situation to national permanent establishments. However, by making the profits of permanent establishments outside a Member State subject to tax in that Member State, that Member State places those non-national establishments in a comparable situation to national establishments.

*References:*

*Nordea Bank, Case C-48/13*

## **Whether the restriction is justified**

Where there is a difference in tax treatment, and that difference constitutes a restriction of a fundamental freedom, that difference (and thus restriction) may nevertheless stand where it is justified.

A difference in tax treatment is justified where it concerns situations that are not objectively comparable. It is also justified where there is an overriding reason in the public interest.

*References:*

*Test Claimants in the FII Group Litigation, Case C-446/04*

Examples of overriding reasons in the public interest include:

- maintaining the coherence of the tax system of the Member State in question

*References:*

*Bachmann, Case C-204/90*

- preserving or maintaining the balanced distribution of the power to impose taxes between Member States, and

*References:*

*Marks & Spencer, Case C-446/03*

- combating abusive practices (ie tax avoidance and tax evasion)

*References:*

*Itelcar, Case C-282/12*

*Commission v United Kingdom, Case C-112/14*

For an example of a situation in which a national tax provision imposing a restriction was justified on the ground of combating abusive practices, see *Test Claimants in the Thin Cap Group Litigation* (which concerned the tax treatment of interest paid by UK tax-resident companies on loans granted by a non-UK tax-resident related company).

*References:*

*Test Claimants in the Thin Cap Group Litigation, Case C-524/04*

The fact that a company resident in one Member State has established a secondary establishment (such as a subsidiary) in another Member State does not, by itself, give rise to a general presumption of abusive practice to justify a national tax provision that restricts a fundamental freedom.

*References:*

*Cadbury Schweppes, Case C-196/04*

However, a national tax provision that is specific in targeting wholly artificial arrangements designed to circumvent the legislation of the Member State in question may be justified in its restrictive effect.

*References:*

*Test Claimants in the Thin Cap Group Litigation, Case C-524/04*

## **Whether the restriction is proportionate**

Even where a restriction is justified, it is justified only to the extent that it is appropriate and proportionate to the objective pursued.

*References:*

*Commission v Belgium, Case C-250/08*

The question is whether the national tax provision in question goes beyond what is necessary to attain the objective. For example, in relation to determining whether a transaction represents an artificial arrangement entered into for tax reasons, a national tax provision does not go beyond what is necessary to attain the objectives of:

*References:*

*SGI, Case C-311/08*

- maintaining the balanced distribution of the power to impose taxes between Member States, and
- combating abusive practices

where:

- firstly, in each case where there is suspicion that a transaction goes beyond what would have been agreed under fully competitive conditions, the taxpayer in question is given an opportunity, without being subjected to undue administrative constraints, to provide evidence of any commercial justification there may have been for the transaction, and
- secondly, where the conclusion is that the transaction does go beyond what would have been agreed under fully competitive conditions, the corrective tax measure is confined to the part that exceeds what would have been agreed if the persons in question did not have an interdependent relationship

## No common system

Save where harmonised by virtue of a Directive (see Sources of EU law, above), the EU does not have a common system in relation to direct taxes.

This contrasts with an indirect tax like VAT, in relation to which there is a common system in the EU, and Member States are generally obliged to implement substantively identical provisions to ensure that a uniform treatment is applied in relation to the same transactions.

In relation to direct taxes, even where national provisions are subject to applicable EU law, Member States are not obliged to deal with comparable situations in identical, or even substantively similar, ways.

For example, in the area of what could broadly be categorised as fiscal consolidation, the following were all referred to the CJEU:

- the UK group relief rules that permitted a company to surrender its losses to another company in the same corporate group

*References:*

*Marks & Spencer, Case C-446/03*

- the Finnish rules on intra-group financial transfers that permitted a company to transfer its profits to another company in the same corporate group—ie a different way of achieving the same result as the UK group relief rules, and

*References:*

*Oy AA, Case C-231/05*

- the Dutch rules on fiscal unity that permitted the results of companies in the same corporate group to be consolidated

*References:*

*X Holding BV, Cases C-337/08*

Although the national tax provisions at issue in each of the three cases produced substantively the same result (setting the losses of one company against the profits of another in the same corporate group), the differences in their structure and mechanics, and how they operated, meant that the impact of the fundamental freedoms on each set of provisions was subtly different. While they were all subject to the same general principles (eg as to what may justify a restriction on a fundamental freedom), the detail of how the principles applied depended on the precise context, and there was not the same level of conformity as one would find with a common system (such as VAT).

## After a CJEU ruling

Member States do not respond in exactly the same way to adverse rulings from the CJEU. The following is a short summary of how the UK responded to the ruling of the CJEU in *Cadbury Schweppes*.

*References:*

*Cadbury Schweppes, Case C-196/04*

*Cadbury Schweppes* concerned the UK controlled foreign company (CFC) rules. Broadly, the CJEU held that the rules constituted a restriction on the freedom of establishment that would be justified where they related only to wholly artificial arrangements intended to escape UK tax, but not where it was shown, on the basis of objective factors, that despite the existence of tax motives, the CFC was actually established in the other Member State and carried on genuine economic activities there.

*References:*

*Cadbury Schweppes, Case C-196/04*

In response, the UK introduced changes to the UK CFC rules in the Finance Act 2007.

The Commission considered this to be an inadequate response and issued a reasoned opinion to this effect in May 2011.

This led (eventually) to further changes to the rules and the introduction of the new CFC regime in the Finance Act 2012.

The convoluted path to, and complexity of, this new regime illustrates how costly and time-consuming it could be for a Member State to rectify an unjustified restriction on a fundamental freedom, and how, in making an already complicated area even more complicated, the 'cure' may be a double-edged sword.

For a more detailed examination of the *Cadbury Schweppes* case and the resulting changes to UK law, see Practice Note: EU law and CFCs.

Another example of a situation in which a change to UK law following a ruling of the CJEU did not mark the end of the story

concerns the group relief rules first referred to the CJEU in *Marks & Spencer*.

*References:*

*Marks & Spencer, Case C-446/03*

In December 2005, the CJEU ruled that the UK group relief rules at the time constituted restrictions on the freedom of establishment (because they precluded the surrender of losses by a non-UK resident company).

Changes were introduced in the Finance Act 2006 to allow cross-border group relief, subject to certain conditions.

One was that a non-UK resident company must have exhausted all possibility of having the losses taken into account in the accounting period in which the losses were incurred (or in previous accounting periods). Another was that there must be no possibility of the losses being taken into account in future accounting periods.

In July 2007 the Commission sent a letter of formal notice to the UK, to the effect that even the amended rules were incompatible with the freedom of establishment (on account of the particularly restrictive interpretation of the condition relating to the exhaustion of all possibility of the non-UK resident subsidiary's losses being taken into account).

This led eventually to a second referral to the CJEU, and only in February 2015 (almost ten years after the ruling in *Marks & Spencer*) was the matter finally resolved, with the dismissal of the Commission's complaints.

*References:*

*Commission v United Kingdom, Case C-172/13*

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