Mendzhul Maria,
PhD, Associate Professor of Private International Law Justice and Advocacy of Uzhgorod State National University

Volodymyr Navrotskyy,
LL.M (Essex), practicing lawyer

УДК 347.73

The concept of equality and the elaboration of justifications in direct tax cases in EC tax law

On the of the core pillars of the European Union is the freedom of establishment aiming at providing companies in free and not restricted establishment in all members states of the EU. Even more, this freedom embraces the right for unrestricted establishment of subsidiaries and/or permanent establishment in the EU member states and securing their equal treatment. Any unjustified restrictions in treatment of secondary establishment are prohibited. However, would it be the same in taxation of secondary establishments? Or in other words, is state obliged to treat equally in tax affairs resident and non-resident companies or individuals. And even more, should the EU members

states provide equal treatment to companies generating income and losses within the same tax jurisdiction and companies which have subsidiaries and/or permanent establishments in other members states. Therefore, it is necessary to study the principle of the equality of treatment of domestic and cross-border situations under EC tax law, whether equality could be justified and, if it does, on what grounds. The equality of treatment has been studies by well-known researches Dahlberg M., Farmer P., Lang M., Webber D., Thiel S. V., Rodrigues T. P., Seer R.

It would probably be incorrect to assert that the home Member State has to treat both national and cross-border situations equally in all circumstances without any limitations, i.e. to provide national treatment to non-resident companies or individuals in all cases. Although this might constitute a substantial step towards the establishment of a truly internal common market not divided along the member states' borderlines, such an extreme approach may not fully reflect the principle of territoriality in international tax law. The ECJ is still in the process of finding of a proper balance between the principles of international tax law, which grant to sovereign states a broader scope of rights to shape their tax systems within their territorial jurisdiction, and EC internal market freedoms, which might limit such rights [1]. Its range of freedoms makes the EC market distinctive from other markets, in particular the freedom of establishment and freedom of capital. One of the most important functions of such freedoms is to guarantee non-discrimination and equality of treatment [2].

The equality of treatment, being a foundation of the legal order of the EC, is considered as a general prohibition on discrimination (i.e. difference in treatment), either on the ground of nationality (article 12 and 39(2) of EC Treaty) or, more specifically, prohibition on discrimination and restrictions on the free movement of goods, persons, services and capital [3]. Taking into account ECJ case law it would be possible to define discrimination as different treatment by a single Member State of comparable situation (or similar treatment of different situation) on the basis of the criterion the application of which works to the disadvantage of one as compared to the similar situation [4]. Similarities and consequently ability of being comparable has not been established by the Court in any strict algorithm and is analyzed on a case-by-case basis[5]. It is worth noting that the Court may find as prohibited situations when a cross-border position is treated worse than a strictly national one, constituting a restriction to the exercising of freedoms guaranteed by the EC treaty, even if no discrimination test was applied [6]. Therefore, the principle of equality of treatment requires that comparable situations should not be treated less favourably purely on the grounds of a cross-border element [7].

There are two possible positions for a single Member State: first, where there is a home Member State parent company with secondary establishments resident and deriving income in that state (domestic position); and, second – with a secondary establishment resident or deriving income in another Member state (cross-border position), have often been the subject of the Court's scrutiny as to whether they should be treated equally and if not – could it be justified without infringement of EC treaty freedoms. The finding that national legislation of a Member State differentiates between two positions to the detriment of a cross-border position, thus being restrictive, does not mean that the equality of treatment of such positions was in violation of EC tax law. The difference in treatment capable of being objectively justified by the rule of reason is in line with principle of equality of treatment. Therefore, if the Court considering the case justifies the difference in two situations, one purely domestic and the other cross-border,

in such a case the principle of equality, as a rule, is not infringed.

The analysis of the ECJ line of reasoning allows the identification of two approaches: the 'discriminatory approach' in which comparability of situations is assessed; and the 'restriction approach' in which justifications, within the rule of reason doctrine, are used to find whether difference in treatment is in compliance with EC freedoms. The difference in application of these approaches is substantial as the application of a 'restriction approach' to non-comparable situations in conjunction with restrictive application of justification grounds might lead to inconsistent decisions.

The applicability of the rule of reason doctrine to justify the difference between two situations was precisely formulated in the Gebhard case [8]. One of its conditions is that national measure has to be non-discriminatory, or, in other words, that discriminatory (direct or indirect) measures are out of the scope of the rule of reason and therefore cannot be justified. However, moving from the 'discriminatory' to the 'restriction' approach has aimed to enable the Court to apply justification to indirectly discriminatory measures, such as, for example, restriction based on residence (in the Bachman case) [9].

Before the delivery of the Marks&SpenserII (M&SII case) decision the Court accepted the following justifications: the need to preserve the coherence of national tax systems, the fiscal territoriality principle and the prevention of tax avoidance.

The fiscal cohesion principle was introduced in the Bachman case. The Court stated that unequal treatment of domestic and cross-border positions, or, in particular, the freedom of movement, may be justified where within one taxing jurisdiction a direct link existed between tax advantages in the form of the deductibility of insurance premiums and where such an advantage is supplemented by a corresponding disadvantage in the form of a fiscal levy on insurance benefits from the companies as related to the same taxpayer and the same tax – income tax. However, it would be necessary to clarify that this concept is not finally elaborated or structured in EC tax law [10]. On the one hand, we have "one tax – one taxpayer – one taxing jurisdiction" as established in Bachman. However, ignoring the fact of the existence of tax treaty between states, we have, on the other hand, the possibility of waiving cohesion by Member States in the case of tax treaty as elaborated in Wielockx [11]. The extension of the scope of the fiscal cohesion principle was claimed, although applied at the proportionality test, in the Manninen case, in particular to apply it to situations in which taxes were levied in the hands of different taxpayers [12]. Further attempts to extend this principle were undertaken in the M&SII case, in which AG Maduro proposed to apply it in order to prevent unwarranted interference with internal logic of the Member State's tax system, ensuring its integrity and equity[13]. Unfortunately, this argument was not considered by the Court directly. Repeating the Manninen case approach in the Meilicke case, the Court established that the granting of tax credit to a taxpayer fully taxable in Germany on the dividends received from non-subjected to tax companies would be less restrictive than a complete ban on such credit and the cohesion of the tax system would not be infringed [14]. Therefore, at the risk of failing a proportionality test or the requirement of a direct link between tax advantage and disadvantage, Member States remain with quite limited room for manoeuvre justifying the integrity of their tax systems by fiscal cohesion. To sum up, the core while invoking the fiscal coherence principle is the formula "direct link – same tax – same taxpayer – same taxing jurisdiction" ('three same formula') established by national law, not double tax treaty. This can be supported by the recent opinion in the Krankenheim case, in which the Court identified a

direct link between the deduction of foreign PE losses from the income of the principal establishment and later recapturing of these losses and subsequent levying of tax on that amount within one taxing jurisdiction and the issue at stake related to the same – corporate income tax. Therefore, the ECJ confirmed the possibility of applying the fiscal coherence to justify the differences in treatment between principal establishments with domestic and foreign PEs if the Bachman criteria are satisfied [15].

A further argument which might be used as justification was introduced in the Futura case. Originally, the principle of territoriality was not established as a justification, but was later assessed in the number of cases as such. In the Futura case the Court assessed the Luxembourg domestic provisions allowing the carry-forward of losses by a non-resident company on one of the conditions that such losses must be economically linked to profits within that taxing jurisdiction. The two main features of the principle may be identified: an economic link between losses and profits on the one hand, and delineation of a sovereign state's fiscal jurisdiction, on the other. As to the former, although the territoriality principle does not precisely state that both positive and negative incomes must be attributed to the same taxpayer, it might be interpreted from the facts of Futura case, and that losses are attributed to that same taxpayer in the Member State in which tax is charged [16].

As for the latter, the principle of territoriality was acknowledged to underline the fiscal jurisdiction of the Member State to tax the world-wide profits of resident companies and those profits of non-resident companies which were made from the sources in that State, meaning that a state cannot subject to tax a non-resident company deriving profit from the territory of other state, unless agreed by states. Such delimitation of which economic operators shall be subjected to tax and what shall be taxed is considered by the Court as a sovereign right of each Member State, exercised by them either unilaterally or through bilateral tax treaties in the absence of harmonisation of Community tax law. Consequently, the principle of territoriality may be interpreted as requiring the ECJ not to interfere in the delimitation of the taxing jurisdiction by a Member State, and the respect to such a principle should be in not obliging that state to include or exclude either taxpayer or object of taxation into such a taxing jurisdiction [17]. This might lead to the logical conclusion that forcing a Member State to extend its tax jurisdiction, where it has not exercised before, does not comply with the principle of territoriality. Taking into account the Futura statement about the economic link between both positive and negative income, the principle of territoriality might be expressed as the following: in contrary to the principle of territoriality to force a Member State to include into its tax jurisdiction losses in the case, when that State refused to exercise its sovereign right to delineate its taxing jurisdiction over profits, which are economically related to such losses. In other words, non-taxation of foreign profits requires a symmetrical disregard of foreign losses. This embraces the key idea of symmetry rule – the need to allocate and tax corresponding positive and negative incomes in the correct tax jurisdiction, protect the state's sovereign right to prevent territorial mismatches of profits and corresponding losses, benefits and deductions, incomes and expenses. This rule is applicable both to foreign subsidiaries and foreign permanent establishments. As for the latter, a correct application of art. 5 and 23(A) of the OECD Model Treaty, the losses of a foreign PE must be rejected from being able to be set against the profits of resident company is profits of foreign PE are tax exempt [18].

The third justification elaborated by the Court was the prevention of tax avoidance. The criteria for its applica-

bility were formulated first in the Avoir Fiscal case, in which the Court required the existence of strong evidence of the possibility of tax avoidance; suggestions based purely upon hypotheses were not enough[19]. In the ICI case, where the Court generally recognised that prevention of tax avoidance might constitute the objective of public interest adequate to justify the hindrance of EC freedoms, but which was similar to the previous case, has established a high threshold: the need to prove that national measure is directed specifically to combat artificial arrangements, that the risk of such tax avoidance was not merely hypothetical [20]. The simple fact that a national of a Member State has decided and established itself on the territory of the low-taxing jurisdiction were not recognised by the Court as constituting tax avoidance [21].

To sum up, the elaborated grounds of justification by the Court are quite restrictive in their interpretation: fiscal coherence applies the 'three same formula'; the territoriality principle stipulates the economic link between losses and profits; tax avoidance requires clear and specific proof of the risk of tax avoidance. But, conceptually, they all embrace the same idea – fair allocation and treatment of both economically related positive and negative incomes within corresponding jurisdiction, prevention of their mismatches. This might effectively be used by the Court for the elaboration of a completely new concept of justification; something called 'system consistency' [22] embracing features of both fiscal coherence and territoriality for that purpose.

Before the M&SII case, the ECJ as a rule limited itself in justifying the difference in treatment based on the one ground of the rule of reason doctrine, whereas, not finding the proper justification, declared the national measure to be in contradiction of EC freedom and required equality as happened in the Bosal case.

Bibliography

1. *Farmer P.* Tax Law and Policy in the Adolescent European Union / Farmer P. // ET . – 2007.- № 2. – P. 42-43.
2. *Cordewener A.,* Dahlberg M., Pistone P., Reimer E., Romano K. The Tax Treatment of Foreign Losses: Ritter M&S, and the Way Ahead // ET .- 2004. -№ 5. - P. 218.
3. *Webber D.* Tax Avoidance and the EC Treaty Freedoms / Webber D. // Kluwer Law International – 2005. - P. 84
4. *Thiel S. V.* Why the ECJ Should Interpret Directly Applicable Community Law as the Rights to Most-Favoured Nation Treatment and a Prohibition of Double Taxation', Chapter 5 in The Influence of European Law on Direct Taxation: Recent and Future Developments / Ed. Webber D. // Kluwer Law International. – 2007 . - P. 88-89
5. *Rodrigues T. P.* Cross-border loss relief jurisprudence and its impact in Portuguese domestic rules / Rodrigues T. P. // EC Tax Journal . - Source: www.linexlegal.com/transit.php?content_id=81022
6. *Dahlberg M.* The European Court of Justice and Direct Taxation: A Recent Change of Direction?' in 'National Tax Policy in Europe: To Be or Not to Be?/ Ed. Andersson, K., Eberhartinger, E Oxelheim, L.' // Springer Berlin Heidelberg. – 2007. - P. 172.
7. *O'Shea T.* News Analysis: Further Thoughts on Rewe Zentralfinanz / O'Shea T. // Tax Notes International. - 2007. - № 9. - P. 134.
8. *ECJ*, C-55/94 (Gebhard) [1995] ECR I-4165, §37

9. *Dahlberg M.* Direct Taxation in Relation to the Freedom of Establishment and the Free Movement of Capital / Dahlberg M. // The Hague, Kluwer Law International. – 2005. - P. 328-329
10. *Lang M.* Direct Taxation: Is the ECJ Heading in a New Direction? / Lang M. // ET. – 2006. - № 11. - P. 424-426.
11. *ECJ*, C-80/94 (G.H.E.J. Wielockx v. Inspecteur) [1995] ECR I-2493
12. *ECJ*, C-319/02 (Manninen) [2004] ECR I-7477
13. *ECJ*, AG Maduro opinion, 7 April 2005, Case C-446/03. §65
14. *ECJ*, C-292/04 (Wienand Meilicke and Others v. Finanzamt Bonn-Innenstadt), Press Release No 19/07
15. *ECJ*, C-157/07 (Krankenheim). Available: http://curia.europa.eu
16. *O'Shea T.* German Loss Deductions and Reintegration Rules and the ECJ / O'Shea T. // Tax Notes International. – 2009. - P. 967-969.
17. *ECJ*, C-336/96 (Gilly) [1998] ECR I-2793
18. *Born A.*, Kunze M., ECJ to Rule on Denial of Deduction for Currency Loss on Start-Up Capital Granted to a Foreign Branch / Born A., Kunze M. // ET – 2007. - P. 39.
19. *ECJ*, C-270/83 (Commission v. France) [1986] ECR I-273, §25
20. *ECJ*, C-264/96 (ICI) [1998] ECR I-4695
21. *ECJ*, C-196/04 (Cadbury Schweppes) [2006] ECR I-7995
22. *Seer R.* The ECJ on the Verge of the Member State Friendly Judicature? / Seer R. // European Company and Financial Law Review. – 2006. - № 2. - P. 247.

Менджул М. В., Навроцький В. В. Концепція рівності та розробка обґрунтувань в податкових справах в сфері податкового права ЄС

Заборона нерівності щодо юридичних осіб та їх вторинних структурних підрозділів, закріплена в праві ЄС, передбачає, що держави-члени ЄС повинні однаково регулювати на своїй території діяльність компаній-резидентів та компаній-нерезидентів. Проте, оподаткування юридичних осіб, які здійснюють діяльність в двох і більше країнах не завжди відповідає оподаткуванню компаній, які працюють виключно в межах однієї країни. В даній статті проаналізовано, які аргументи приймаються Європейським судом справедливості для обґрунтування різного ставлення державами-членами ЄС щодо оподаткування зазначених юридичних осіб.

Ключові слова: принцип рівності, Європейський Суд Справедливості, оподаткування, резидент, нерезидент.

Менджул М.В., Навроцкий В.В. Концепция равенства и разработка обоснований в налоговых делах в области налогового права ЕС

Запрет неравенства в отношении юридических лиц и их вторичных структурных подразделений, закреплённый в праве ЕС, предусматривает, что государства-члены ЕС должны одинаково регулировать на своей территории деятельность компаний-резидентов и компаний-нерезидентов. Однако, налогообложение компании, которая ведёт деятельность в двух и более странах не всегда соответствует налогообложению компании, которая работает исключительно в пределах одной страны. В данной статье описывается, какие аргументы принимаются Европейским судом справедливости для обоснования различного обращения государствами-членами ЕС в сфере налогообложения указанных выше юридических лиц.

Ключевые слова: принцип равенства, Европейский Суд Справедливости, налогообложение, резидент, нерезидент.

Mendzhul M., Navrotskyy V. The concept of equality and the elaboration of justifications in direct tax cases in EC tax law

The prohibition of unequal treatment of legal entities and their subsidiary establishment is established in the EC law. EU Member States shall equally treat on its territories residents and non-residents. However, the taxation of the company working in two or more states not always corresponds to taxation of the company working within one single state. This article explores which arguments are accepted by the European Court of Justice to justify different treatment by the EU Members states of mentioned above types of companies.

Key words: the principle of equality, European Court of Justice, taxation, resident, non-resident.