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WITHHOLDING TAXES AND THE FUNDAMENTAL FREEDOMS

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I. INTRODUCTION

1. Aim of the thesis

The TFEU grants four fundamental freedoms: the free movement of goods, the freedom to provide services, the free movement of workers together with the freedom of establishment, and the free movement of capital. Moreover, the TFEU provides for free movement irrespective of an economic activity and non-discrimination. Although direct taxation is still a competence of the Member States themselves, all of these protection provisions have a high influence on the national tax laws of the Member States. The case law of the ECJ in the field of direct taxation has rapidly increased during the last 25 years. And even though the wording of the freedom and non-discrimination articles is rather vague, the ECJ has extensively made use of its monopoly on interpretation of European Union legislation and has demonstrated the limits for national legislators.

Tax laws might be in conflict with the fundamental freedoms whenever they lead to a discriminatory treatment of cross-border situations within the EU or – under application of the free movement of capital – with third countries. Whether a treatment is discriminatory can only be determined by comparing the taxation in the cross-border situation with the taxation in a purely internal situation, i.e., a situation confined to one Member State. Thus, tax laws governing international transactions are never per se in conflict with the fundamental freedoms, but only if the taxation in the internal situations is more favorable.

Thus, withholding tax regimes can potentially conflict with the fundamental freedoms if they are applied in a discriminatory manner. Withholding taxes are part of the national tax systems of many Member States. In cross-border situations, in particular, withholding taxes are often levied to ensure the collection of taxes. Also, withholding taxes are a simple way of administering taxes. This is due to the fact that non-residents are usually less available to the tax authorities than residents. Typically, withholding taxes are levied on passive income, i.e., dividends, interest, royalties, and capital gains, and income received by highly mobile persons, e.g., artistes and sportsmen.

If non-residents are taxed by way of a withholding, while residents are taxed by way of a tax assessment, cash-flow disadvantages may arise. In addition, withholding taxes are frequently levied at a flat rate and on a gross basis. Withholding taxes are also typically withheld by the payment debtor, who is also liable for the tax payment in the event of non-compliance. If these characteristics of withholding taxes lead to an unfavorable treatment or a higher tax burden for non-residents than for residents, discrimination, which is prohibited by the fundamental freedoms, might arise. Due to the discriminatory effects of withholding taxes, the ECJ has tested the compatibility of withholding taxes with EC law in various cases in recent years.

In several cases the ECJ held that EU law prohibits the levying of withholding taxes. These cases dealt with the taxation of dividends. According to the national provisions in question, domestic dividends were exempt from tax in order to avoid economic double taxation. Economic double taxation means taxation of the same income in the hands of two different taxpayers. In the case of dividends, economic double taxation arises when the profits are taxed in the hands of the subsidiary and the profit distribution is taxed in the hands of the parent company. In the above mentioned cases, outbound dividends were not exempt from tax, but were taxed at withholding. Consequently, while outbound dividends were taxed by way of a withholding, no taxes were due on domestic dividends. As the two flows of dividends lead to comparable situations, the difference in treatment led to discrimination. It was caused, however, not so much by taxation at withholding, but by taxation in itself. Accordingly, the ECJ did not accept any justification for the discrimination in these cases.

However, the ECJ held in several judgments concerning dividend withholding taxes that the discrimination caused by the source state could be neutralized by the residence State of the recipient company if the latter gives a "full credit" under a tax treaty. It is not clear what exactly is meant by "full credit" and how such a credit has to be applied in order to fulfill the requirements set by Union law and ECJ case law. Moreover, the practical relevance of a full credit based on an international treaty is questionable. The current tax treaty network does not seem to provide for a full credit that reaches as far as reimbursement of excess taxes by the residence State.

In contrast to the cases on dividend withholding taxes, the ECJ has reached a different conclusion in cases where both residents and non-residents were taxed, but a withholding tax was only levied on cross-border payments. In *Scorpio* and *Truck Center* the ECJ had to elaborate on the comparability between residents and non-residents and the justification for discrimination with regard to withholding taxes. In both cases, the ECJ found that the withholding tax did not infringe EC law because of the need to ensure the effective collection of taxes. Whenever there is discrimination because comparable situations are treated differently or different situations are treated in the same way, it may be justified by reasons in the public interest. When the measure that is taken to achieve the public interest is also proportional, no infringement of Union law occurs.

However, whether the effective collection of taxes is a valid justification for withholding taxes seems to be a completely open issue. Since *Scorpio*, there has been speculation regarding whether or not withholding taxes are still admissible following the implementation of the EU Assistance Recovery Directive. Most scholars tend to answer the question in the negative. The German Federal Tax Court, however, gives an affirmative answer. Accordingly, the ECJ yet has to be given the opportunity to finally resolve this question.

Also, is still has to be clarified what „effective collection of taxes" exactly means. Could it imply that the levy of taxes with the use of mutual administrative assistance is less effective than taxation at withholding? In particular, it is questionable what importance is given to the term "effective". The Advocate General Kokott's Opinion in the *Truck Center* case implies that she considers the collection of taxes through administrative assistance ineffective and, therefore, favors withholding tax. If this is also the position of the ECJ (which can be assumed from the judgment following Advocate General Kokott's Opinion) the usefulness of the Directives regarding mutual assistance may be questioned.

Taking the different judgments of the ECJ into account, it yet has to be clarified under what circumstances withholding taxes infringe the fundamental freedoms and which reasons can lead to withholding taxes not being in conflict with the fundamental freedoms. While the freedom of establishment was infringed in the *Denkavit* case by a withholding tax levied on a cross-border dividend payment, the freedom of establishment did not preclude the taxation at withholding of a cross-border interest payment in the *Truck Center* case. Even more open questions arise when taking into account third countries. These include on the one hand all third countries protected under the free movement of capital and on the other hand the EEA States protected by the EEA Agreement, Switzerland, and associated countries.

In the cases *Commission vs. Netherlands* and *Commission vs. Italy* the ECJ had to examine the admissibility of withholding taxes in third-country situations. In *Commission vs. Netherlands* the ECJ held that dividend payments to the EEA countries Iceland and Norway must not be treated less favorably than dividend payments within the Netherlands or to EU Member States. However, the ECJ implicitly confirmed that the differences in the framework for mutual administrative assistance within the European Union and vis-à-vis third countries could justify a difference in treatment. In *Commission vs. Italy* the ECJ argued the opposite way. The framework for mutual assistance is just different, if mutual assistance with the third country is not available under a tax treaty or a similar convention. However, although mutual assistance was available between Italy and Iceland, as well as between Italy and Norway, a justification based on the need to avoid abuse was accepted by the ECJ.

Following these two judgments it is questionable what importance the administrative assistance in tax matters has for the admissibility of withholding taxes. Also, taking the *Truck Center* judgment into account, another open issue is the relevance of international law provisions on mutual assistance, for example, the exchange of information and mutual assistance in the recovery of taxes under tax treaties. By not taking into consideration the multilateral treaty in *Truck Center*, the ECJ appears to attach no importance to international law provisions. Accordingly, such provisions may

not prevent the application of withholding taxes. This is especially true for the third-country scenario, where the Mutual Assistance Directives do not apply.

In general, withholding taxes in third-country situations have not been dealt with to a significant extent by the ECJ. Most ECJ case law on the legality of withholding taxes addresses intra-Union situations. In relation to third countries, other standards of comparability and justifications might apply. It is, therefore, not clear whether or not and under what circumstances the ECJ will find withholding taxes compatible with the free movement of capital with regard to third countries and with the EEA freedoms.

The ECJ case law on withholding taxes seems to be constantly evolving. The issue of withholding taxes has been dealt with by the ECJ for the first time in 2003. Since then, the ECJ has been making clear that withholding taxes levied on non-resident taxpayers may to some extent infringe the fundamental freedoms. However, as the ECJ only gives answers to certain questions raised in a preliminary ruling referred by a court of a Member State or decides infringement procedures against a Member State initiated by the Commission or another Member State, it has only answered certain questions concerning withholding taxes in its case law so far and left many more open. The aim of this thesis is to bring the various ECJ judgments in line with each other to determine the interference of the fundamental freedoms with national tax laws' withholding tax regimes and to give possible answers to open questions not yet clarified by the ECJ.

In literature only certain aspects of withholding taxes were tested against Union law so far. Either, the examination was based on the national law of a certain Member State, or it was limited to certain types of income, e.g. dividends, or it only described the impact of one of the ECJ's decisions. In contrast, the thesis at hand will give a comprehensive picture of the compatibility of withholding taxes with the fundamental freedoms.

First of all, the examination will be detached from a certain national law. No particular reference will be made to Austrian tax law. Rather, it will be shown which borders are set by Union law to the implementation of withholding taxes, irrespective of any current provisions on withholding taxes. This feature will also be supported by the language of the thesis, which is English. This should enable a cross-border dissemination of the research results.

Second, the thesis will not deal with certain types of income, but focus on the instrument of withholding tax as such. Withholding taxes are typically levied on dividends, interest, income from independent activities etc. The thesis will not treat these income categories separately. Rather, the common features of withholding taxes on any kind of income will be highlighted.

Third, the research will focus on the characteristics of withholding taxes and an interpretation of the fundamental freedoms. The ECJ case law will be the most important source of

interpretation. However, ECJ case law from other areas than withholding taxes will be considered as well, to ensure a consistent interpretation. The different decisions on withholding taxes will be compared and combined in order to find an answer to the research question.

2. Structure of the thesis

Chapter II of the thesis will elaborate on the possible discriminatory effects of withholding taxes. This should serve as a starting point for the discrimination test. Withholding taxes will usually lead to liquidity disadvantages compared to a tax assessment procedure because they are levied at the time of the income payment. Also, in most cases, the taxable base for the withholding tax will be the gross amount of the payment. Even though gross taxation indeed serves the simplification, the net-taxation principle and the ability-to-pay principle seem to be in conflict with it. Just like the gross taxation, the flat tax rate can lead to discrimination in comparison to a progressive tax rate. Most importantly, tax base and tax rate must be considered in a combined manner to determine the effective tax rate. Withholding taxation of gross income at a flat tax rate has to be compared to net taxation at progressive tax rates. The influence of tax treaties on the tax rate levied on passive income will also be considered in this chapter. Concerning procedural law, a lack of the taxpayer's procedural rights may arise in connection with withholding taxes. Procedural rights include information about the withholding, the possibility of a tax assessment, and the right to appeal. As regards the payment debtor, the administrative burden caused by the withholding obligation, the need to consider directly linked and reported expenses at withholding, and the liability for the withholding tax may constitute discriminatory effects. If the withholding tax is levied on dividend payments between related companies, economic double taxation arises, because the profits from which the dividend was distributed have already been taxed in the hands of the subsidiary. Thus, the withholding tax can lead to discrimination if comparable income is exempt from taxation. In this case, not the withholding is discriminatory, but the taxation itself. This sub-chapter will deal with the common practices to avoid economic double taxation and the harmonized measures within the EU.

Chapter III will describe the protection provisions under the TFEU in detail. After presenting the general principles of primary EU law, the fundamental freedoms will be explained one by one. The third sub-chapter will be devoted to the determination of the applicable freedoms in cases where two or more of the freedoms overlap. The approaches of the ECJ throughout time will be discussed. Following the most recent case law, it will be examined how the ECJ determines the primarily affected freedom. Also, a special emphasis will be put on third-country situations. Here, the free movement of capital may come into play. In these cases, the application of the primarily affected freedom, as currently conducted by the ECJ, may lead to non-protection in third-country situations. This occurs whenever a situation is protected under the free movement of capital and another freedom and the ECJ finds the other freedom to be primarily affected. The historic development of the free movement of capital with third countries will be presented and its peculiarities will be described. To round up chapter III, protections provisions contained in other

treaties except the TFEU will be presented. These include the EEA Agreement, the Agreements with Switzerland, and Association and Partnership Agreements.

Chapters IV, V, and VI will follow the examination scheme of the ECJ for assessing an infringement of the fundamental freedoms. In chapter IV a comparability analysis of with regard to withholding taxes will be conducted. The chapter will treat both the legal comparability analysis usually conducted by the ECJ and the factual comparability analysis, also known as the *Schumacker* doctrine. The comparability between residents and non-residents and between non-residents of different countries will be treated. Then, again, a focus will be put on comparability and third countries.

Chapter V will deal with the possible justifications for a discrimination caused by withholding taxes. The effectiveness of fiscal supervision and the effective tax collection, as well as a treaty based tax credit in the residence State that neutralizes the negative effects of the withholding tax have been accepted as justifications by the ECJ. The requirements for a valid justification will be closely examined. Justifications that were rejected by the ECJ and possible other justifications will also be tested. As in previous chapters, the differences between intra-EU situations and third country cases will be highlighted.

Chapter VI will deal with the end of the ECJ's examination scheme, namely the proportionality test. The measure taken to achieve the public interest must be suitable to attain the objective and not go beyond what is necessary. Possible alternatives to withholding taxes will be weighed.

In the concluding chapter VII, the discriminatory effects of withholding taxes will again be scrutinized. As a counterpart to chapter II, each possible discriminatory effect will undergo a final analysis taking into account the findings of chapters III to VI and the ECJ's case law to this date. Finally, the thesis will elaborate on the future of withholding taxes within and outside European borders and highlight open issues that are still to be clarified by the ECJ.

II. DIFFERENT TREATMENT BASED ON WITHHOLDING TAXES

1. Tax collection method

1.1. The taxpayer perspective

1.1.1. Taxpayers subject to withholding taxes

Withholding taxes are above all a method of tax collection[1] that is applied in order to enforce a state's taxing rights. They are levied in situations in which the income would possibly escape taxation otherwise.[2] Through withholding taxes, equal taxation of all taxpayers should be guaranteed.[3] To ensure taxation, withholding taxes are collected at the time of the payment made to the taxpayer.[4] Thus, income is taxed when it is earned.[5] The taxpayer receives only his net income by the payment debtor, i.e., the gross income minus income taxes. The income taxes become an immediate cost factor for the taxpayer.

Due to the fact that withholding taxes serve to ensure the actual taxation of income, they are levied on income that the taxpayer would very likely not declare voluntarily. Thus, withholding taxes are applied to certain categories of taxpayers and/or certain categories of income. In regard to the category of taxpayers, non-residents are most likely to underlie taxation at withholding.[6]

Most countries have two different kinds of personal income tax liability, differentiating between residents and non-residents.[7] Residents are those persons (individuals or legal entities) that

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[1] They are not a separate kind of taxes; see Goez, *Quellenbesteuerung als Erhebungsform*, p. 1.

[2] See, for example, American Bar Association, *Report of the Special Committee on Extension of Withholding Taxes*, pp. 1 et seq.; Motiwalla/Ramaskrishnan, *Tax Deduction*, preface; Bauer-Balmelli, *Sicherungszweck*, pp. 3 and 193; Goez, *Quellenbesteuerung als Erhebungsform*, p. 113; Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalverkehrsfreiheit und Steuerrecht*, pp. 86 and 90.

[3] See Goez, *Quellenbesteuerung als Erhebungsform*, pp. 117 et seq.

[4] See Motiwalla/Ramaskrishnan, *Tax Deduction*, p. 6; Doernberg, *International Taxation*, p. 173; Goez, *Quellenbesteuerung als Erhebungsform*, pp. 55 and 79.

In regard to withholding at payment, the time of the payment needs to be specified. In most cases, no actual transfer of cash or property is necessary for a deemed payment to arise (See Doernberg, *International Taxation*, p. 173; Poissant, *Taxation in Canada*, pp. 66 and 130). For dividend payments, for example, the date of the payment can be deemed as the date which is agreed on as the payment date in the shareholder assembly (See for Austria Sec. 95 (3) (1) ITA; for Germany Goez, *Quellenbesteuerung als Erhebungsform*, p. 55). In many other cases, e.g., service payments, withholding tax may have to be levied at the time of the actual payment or on an accrual basis.

[5] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 120.

[6] See Gopalakrishnan, *Law Regarding Non-Residents*, p. 143; Goez, *Quellenbesteuerung als Erhebungsform*, p. 71. If withholding taxes are levied on residents and non-residents alike, the latter are usually subject to a final withholding tax, whereas the former can credit the withholding tax against their tax liability at assessment; see Goez, *Quellenbesteuerung als Erhebungsform*, pp. 18-19 and 73.

[7] See in detail Moore, *U.S. Tax Aspects*, pp. 44 et seq.; see also Doernberg, *International Taxation*, pp. 7 et seq.; Roin, in Aaron et al. (eds.) *Taxing Capital Income*, p. 212; Plasschaert, *Schedular, Global and Dualistic Patterns*, pp. 91-92.

have their domicile or seat within the country. They are taxed on their worldwide income by most countries. This is referred to as 'personal jurisdiction'.[8] Due to their physical presence in the country, the tax authorities can easily get hold of them. In contrast, non-residents have no physical presence in the country. They neither have a domicile or seat, nor their usual abode or place of business within the country. Thus, only income that is territorially connected to the country, i.e., income sourced in the country, underlies taxation in that country.[9] This is referred to as 'territorial jurisdiction'.[10] Also, due to the lack of a physical connection, non-residents are not readily available to the tax authorities wishing to enforce the state's taxing rights. Thus, non-residents can easily circumvent their tax liability, by simply not declaring their income. If they do not act voluntarily, their tax liability cannot be enforced. The tax authorities have virtually no chance to get hold of them.[11]

Due to the lack of 'availability' of non-residents for the tax authorities, their income is often subject to withholding taxes.[12] There should be no advantage for non-resident taxpayers, as, for example, being able to circumvent taxation.[13] In contrast, while the taxation of non-residents is often ensured by way of a withholding tax, residents are usually taxed at assessment.[14] With a tax assessment procedure, the tax liability is determined after each period, which is usually one calendar year. Thus, instead of paying tax at the time the income is earned, the tax payment is postponed for approximately a year. Throughout this year the taxpayer can freely dispose of the money that will pay off his future tax liability. He can invest it as he wishes. Effectively, the taxpayer is granted an interest-free loan by the tax authorities.[15]

Usually, tax assessment is connected with regular, e.g. quarterly, advance payments against the expected tax liability. The expected tax liability is an estimate based on previous years' tax liabilities. Tumpel argues that due to the advance payments no different treatment arises for the taxpayer subject to a withholding tax compared to the taxpayer who is subject to tax assessment.[16] It may be true that the advance payments balance out the earlier tax payment through withholding at payment. But, Tumpel even argues that, in general, a tax assessment with advance payments is

[8] See Avi-Yonah, *International Tax*, p. 28; for the rationale behind personal jurisdiction see Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 92.
[9] See Avi-Yonah, *International Tax*, pp. 13 et seq.; Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 91.
[10] See Avi-Yonah, *International Tax*, p. 28; for the rationale behind territorial jurisdiction see Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 92.
[11] See Doernberg, *International Taxation*, p. 167; Lyell, *Income Tax*, p. 130; see also Aaron et al. (eds.) *Taxing Capital Income*, Introduction xvi; Goez, *Quellenbesteuerung als Erhebungsform*, pp. 72, 119 and 124.
[12] See Lyell, *Income Tax*, p. 128 on the 'Indirect assessments upon Persons Abroad'.
[13] See Goez, *Quellenbesteuerung als Erhebungsform*, pp. 119 and 126.
[14] See, for example, Doernberg, *International Taxation*, p. 167 et seq.; Dourado, *EC Tax Review* (1994) p. 184; Goez, *Quellenbesteuerung als Erhebungsform*, pp. 3 and 72-73.
[15] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 130; Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalverkehrsfreiheit und Steuerrecht*, p. 84.
[16] Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalverkehrsfreiheit und Steuerrecht*, p. 84.

unfavorable for the taxpayer as far as the time of the tax levy is concerned.[17] This opinion cannot be supported. In case of equally high withholding taxes and advance payments, it is true that the latter may even be due at an earlier point in time. However, while the taxpayer cannot influence the amount of withholding taxes, he may well influence the amount of advance payments. In an assessment procedure, taxpayers often have the chance to apply for lower advance payments due to an expected income decrease, while they will probably not apply for higher advance payments in case of expected higher income. Also, if the taxpayer experiences losses in a certain tax year, there will be no or very low advance payments for the next tax year.[18] In case of withholding taxes, however, the overall income of the taxpayer is not taken into account. The same holds true for losses from other income categories. Thus, in case of low previous year income or losses, withholding taxes will certainly lead to a different and unfavorable treatment compared to tax assessment with advance payments.

1.1.2. Income subject to withholding taxes

In regard to the category of income subject to withholding, especially passive income[19] and income of highly mobile activities, such as those of artistes and sportspersons, and independent

[17] Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalverkehrsfreiheit und Steuerrecht*, p. 84-85.
[18] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 130.
[19] When the income is effectively transmitted abroad; see Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 92; see also Goez, *Quellenbesteuerung als Erhebungsform*, p. 18.
Canada taxes outbound dividends, interest, rents, and royalties with a 25 percent withholding tax. No deductions are allowed. The withholding tax is final. See Moore, *U.S. Tax Aspects*, p. 50; Poissant, *Taxation in Canada*, pp. 66 and 130.
Finland, Germany, and Sweden tax dividends paid to non-residents. Germany taxes at 25 percent, Sweden at 30 percent. See Helminen, *Dividend Concept*, p. 33.
In **France**, dividends paid to non-resident shareholders are subject to a 25-percent withholding tax; see Moore, *U.S. Tax Aspects*, p. 50.
In **India**, dividends and interest paid to non-residents are taxed at 25 percent. The tax is levied at withholding on a gross basis; see Gopalakrishnan, *Law Regarding Non-Residents*, p. 113; see also Motiwalla/Ramaskrishnan, *Tax Deduction*, p. 1.
Dividends distributed from an **Irish** company to a non-resident shareholder are subject to a 20-percent withholding tax. The same is true for outbound interest. See Moore, *U.S. Tax Aspects*, p. 51.
Japan taxes interest paid by a Japanese source to non-residents at withholding with a 15 percent rate on a gross basis. The withholding tax is final. Dividends distributed by a Japanese company are subject to a 20-percent withholding tax. See Masui, in van Raad (ed.) *International and Comparative Taxation*, p. 128; Moore, *U.S. Tax Aspects*, pp. 51-52.
Switzerland levies a withholding tax on receipts from moveable capital assets; see Bauer-Balmelli, *Sicherungszweck*, pp. 57 et seq.
The **U.S.** taxes non-residents on their passive income by way of withholding. The tax rate is 30 percent and the tax base is the gross income. Passive income compromises capital gains, interest, royalties, dividends, and rents. However, capital gains and interest are tax exempt in most cases. See Avi-Yonah, *International Tax*, pp. 14 et seq. and 64 et seq.; see also Doernberg, *International Taxation*, pp. 10, 15 et seq., and 85 et seq.; Isenbergh, *International Taxation*, p. 15; Moore, *U.S. Tax Aspects*, pp. 741 et seq.; Roin, in Aaron et al. (eds.) *Taxing Capital Income*, p. 212.

service providers are covered.[20] The rationale behind subjecting certain income to withholding taxes is thoroughly explained by Roin:[21]

> *Although countries have the right to levy an income tax on all income generated within their borders, they lack personal jurisdiction over many of the foreign individuals and entities that earn such income. In particular, a country of source is unlikely to be able to collect unpaid taxes or run an effective audit on foreign investors who are "passive" investors–those not engaged in active business activities in the source country but receiving payments such as interest or dividends from source country entities. Many such taxpayers never enter the source country, conducting all of their income-producing activities through agents, or even through the mail. Because countries can exercise only very limited powers of tax enforcement outside their borders, source countries typically do not even try to impose their normal income tax regimes on such taxpayers. Instead, they impose withholding taxes at flat rates on the gross amount of certain types of investment income paid to such foreigners.*

On the contrary, business income with a fixed nature that is earned by non-residents, e.g., in the form of a permanent establishment, is often taxed in the same way as the residents' income. This is due to the fact that a fixed nature makes non-residents similarly available to the tax authorities as residents.[22] Thus, withholding taxes are not considered necessary to secure the tax payment. Doernberg describes this discrepancy between passive and active income as follows:[23]

> *[It] is more a concession to economic reality than it is a policy decision. While a nonresident engaged in a trade or business in the United States often has assets (e.g., factory, office, machinery) that may be seized if the nonresident fails to pay the required tax, the nonresident with FDAP [Fixed or Determinable Annual or Periodical, i.e. passive] income may escape U.S. tax jurisdiction if no withholding tax is collected before payment is received.*

1.1.3. Withholding taxes in the absence of a tax liability

Each country is free to decide whether to tax non-residents and, if yes, on what kinds of income to tax them. Non-residents are usually only subject to limited tax liability, i.e. they are taxed only with the income sourced in their host country. What kind of income is taxed under the limited

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[20] See Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 191.
[21] Roin, in Aaron et al. (eds.) *Taxing Capital Income*, pp. 213-214.
[22] See Doernberg, *International Taxation*, p. 10; Poissant, *Taxation in Canada*, p. 129; Roin, in Aaron et al. (eds.) *Taxing Capital Income*, pp. 212 and 216; see also Avi-Yonah, *International Tax*, p. 64.
Countries may also be bound by the non-discrimination provision incorporated in their bilateral tax treaties (following Art. 24 (3) OECD Model) or the freedom of establishment of Art. 49 TFEU to treat permanent establishments of non-residents equally to resident companies. On the latter see in detail chapter III.2.4.
[23] Doernberg, *International Taxation*, p. 86.

tax liability depends on the national tax law of the host country. The law has to determine what counts as a territorial source of income[24] and which income categories are included under the limited tax liability.[25] National law also determines the mode of tax collection for different categories of income of non-residents. As explained above, in many cases, countries will apply withholding tax regimes to the income of non-residents to secure their tax revenue.

The limited tax liability also implies that only particular kinds of income are taxed by the source country. Thus, it may occur that a non-resident receives income which is not covered by his limited tax liability in the source country. The logical consequence of a non-existing tax liability is non-taxation. However, in case the tax collection method is taxation at withholding, taxation in the absence of a tax liability may occur. This is because withholding taxes are collected by the payment debtor who is subject to a withholding obligation prescribed by law. The payment debtor may only refrain from collecting the withholding tax, if he is entitled by law to do so. If, however, the tax exemption of certain kinds of income of non-residents is not paired with a waiver of the withholding obligation of the payment debtor, the latter is obliged to withhold the tax, even in the absence of a tax liability. In such cases, the non-resident taxpayer would be bound to initiate a refund procedure. The burden caused by the withholding tax is especially high in such cases, because they do not serve to secure the payment of an existing tax liability. The taxpayer pays money to the tax authorities, which they entirely refund at a later point in time. Thus, the taxpayer grants an interest-free loan to the tax authorities.[26] Moreover, he is forced to undergo the administrative process of claiming a refund of taxes that were not covered by a tax liability in the first place. In case the taxpayer was subject to taxation at assessment, no taxes on exempted income would arise.

A similar situation may occur if the tax exemption is not based on the national law of the source state, but a tax treaty entered into by the source state and the taxpayer's residence state. This is because the taxing rights provided by the national law of the source state might be limited by tax treaties entered into bilaterally with other countries.[27] The residence state usually taxes the worldwide income of its residents. Thus, if the host state also taxes the income, double taxation arises. Therefore, countries conclude treaties for the avoidance of double taxation.[28] Tax treaties have the aim to eliminate international juridical double taxation, i.e., taxation of the same income in

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[24] The U.S., for example, does not tax capital gains of non-residents, because the source of the income is considered to be where the seller is resident; see Avi-Yonah, *International Tax*, pp. 68 et seq.

[25] The U.S., for example, does not tax 'portfolio' interest of non-residents. 'Portfolio' means that the interest payment is made to a non-shareholder or a shareholder who owns less than 10 percent of the stock; see Avi-Yonah, *International Tax*, pp. 69 et seq.; Doernberg, *International Taxation*, pp. 87 et seq.

[26] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 130.

[27] See Lang, *Double Taxation Conventions*, p. 31.

[28] See Doernberg, *International Taxation*, p. 3.

the hands of the same taxpayer by two tax jurisdictions.[29] This is achieved by granting the exclusive taxing right to one of the contracting states or binding the residence state to exempt the income that is taxed in the source state or to credit taxes levied by the source state, i.e., the exemption or the credit method.[30]

Most bilateral tax treaties follow the Model Conventions drafted by the OECD and the UN.[31] According to the OECD Model Convention, the taxing right of the source state is eliminated for income from shipping, inland waterways transport and air transport (Art. 8) and connected capital gains (Art. 13 para. 3), royalties (Art. 12), capital gains not covered by Art. 13 paras. 1 to 4 (Art. 13 para. 5), pensions (Art. 18) and other income (Art. 21). Under the UN Model Convention the source state is granted a wider range of taxing rights than under the OECD Model Convention. However, the source state's taxing right is eliminated for income from shipping, inland waterways transport and air transport (Art. 8)[32] and connected capital gains (Art. 13 para. 3), capital gains not covered by Art. 13 paras. 1 to 5 (Art. 13 para. 6), and pensions (Art. 18)[33]. The consequence of these exclusive taxing rights of the residence state is a tax exemption in the source state. Thus, even if the source state's national law stipulates taxation of these kinds of income under the limited tax liability, the tax treaty prohibits such taxation. In this way, a tax treaty acts like a stencil placed over the national tax law.[34] It covers up some areas, which means it limits taxing rights provided by national law. Other areas, however, are left open. These are the taxing rights that remain untouched by the tax treaty. Most important, a tax treaty can never create taxing rights that were not provided for by the national tax law of the contracting state.

In addition to a full elimination of source state taxing rights on the above mentioned income, according to the OECD Model Convention, the source state's taxing right is limited by ways of the tax rate for dividends (Art. 10) and interest (Art. 11) arising within its territory.[35] This means that the source state – if its national tax law provides for the taxation of dividends and interest paid to non-residents – has to reduce the applicable tax rate, if the tax rate provided by national law is higher than the maximum tax rate under the tax treaty.[36]

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[29] See Lang, *Double Taxation Conventions*, pp. 25-26.
[30] See Lang, *Double Taxation Conventions*, p. 31.
[31] See Lang, *Double Taxation Conventions*, pp. 27-28.
[32] However, under Art. 8 (alternative B) the source state may tax profits from such activities if *"the shipping activities arising from such operation in the other Contracting State are more than casual"*.
[33] Except *"pensions paid and other payments made under a public scheme which is part of the social security system"* of the source state. Moreover, Art. 18 (alternative B) also provides for a taxing right of the source state *"if the payment is made by a resident of that other State or a permanent establishment situated therein"*.
[34] See Vogel, in Vogel (ed.) *Double Taxation Conventions*[3], Introduction, MN 56.
[35] See in detail chapter 2.3.
[36] The maximum tax rate under the OECD Model Convention is 5 percent for inter-company (25 percent holding) dividends, 15 percent for all other dividends, and 10 percent for interest payments. The UN Model

If the source state's taxing right is limited by the tax rate, it is up to the national law of the source state to ensure that the maximum source tax rate provided by the tax treaty is not exceeded. The same is true if the source state's taxing right is eliminated completely. This is because tax treaties do not regulate how the reduction of the tax rate or the exemption of income should be achieved.[37] Especially, they do not include rules on the timing of the tax rate reduction or tax exemption. For the case of withholding taxes this means that the tax treaty itself does not waive a withholding obligation of the payment debtor if the income is exempted. Also the tax treaty does not waive the withholding obligation for the tax that is calculated based on the excessive tax rate. In regard to the procedural aspects of limitations of source taxation the OECD Model Commentary[38] states that[39]

> *[...] the Convention does not settle procedural questions and each State is free to use the procedure provided in its domestic law in order to apply the limits provided by the Convention. A State can therefore automatically limit the tax that it levies in accordance with the relevant provisions of the Convention, [...] or it can impose the tax provided for under its domestic law and subsequently refund the part of that tax that exceeds the amount that it can levy under the provisions of the Convention. As a general rule, in order to ensure expeditious implementation of taxpayers' benefits under a treaty, the first approach is the highly preferable method.*

Thus, when the tax of non-residents is levied at withholding, the source state has basically two options how to achieve a reduction of the tax liability. The national law of the source state may leave it to the payment debtor to choose between the two methods or prescribe one of the methods in general of for certain cases. The two methods of tax reduction, though, take effect at two different points in time: Either, the tax treaty is applied at the moment of withholding and the tax is reduced or waived immediately.[40] Thus, the lack of the tax liability leads to cancelation of the withholding tax. Or, the full tax is initially withheld by the payment debtor according to the national law and the taxpayer eventually gets a refund of the excessive tax levied by the source state.[41] In this case, the withholding tax is levied on income that is not covered by a tax liability. The taxpayer again has the material disadvantage of a receivable without the compensation by interest and the procedural

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Convention also provides for a maximum tax rate to be levied on dividends, interest, and royalties by the source state but leaves the determination of the tax rate to the bilateral negotiations. The UN Model Convention foresees the application of the tax rate for inter-company dividends for holdings of 10 percent or more.

[37] See Titz, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 159.

[38] The OECD Model Commentary...

[39] OECD Model Commentary on Articel 1, para. 26.2.

[40] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 84; Bauer-Balmelli, *Sicherungszweck*, p. 171; Titz, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 157.

[41] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 84; Bauer-Balmelli, *Sicherungszweck*, p. 171; Titz, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 157.

disadvantage of having to file a refund claim.[42] In case of tax collection at assessment, the tax exemption under a tax treaty or a maximum tax rate would lead to a lower tax amount.

As has just been explained, a tax liability may be fully cancelled by national law or by a tax treaty, or only partly by reducing the applicable tax rate. If the withholding tax is initially levied despite such exemptions, the tax is not only levied at an earlier point in time, but also on a higher amount than it would have been at assessment. The exemptions or tax rate reductions are only considered in a subsequent refund procedure. This adverse effect can also occur if deductions from the taxable income, i.e. expenses, may only be considered in an assessment procedure. This is typically the case because tax collection through withholding taxes is connected with a gross taxable base.[43] The effect of gross taxation with the optional expense deduction at assessment is that the withholding tax is levied on income that would not have been taxed at assessment and the excessive amount of tax is refunded. The consequences are again over-taxation at withholding connected with the administrative burden of filing for a tax refund. To sum up, in case withholding taxes are levied in the absence of a tax liability, they do not serve to ensure the collection of taxes. Instead, they only lead to a temporary transfer of money from the taxpayer to the tax authorities and a higher administrative burden for both caused by the necessity for a refund procedure.

1.2. The payment debtor perspective

1.2.1. The withholding obligation

Withholding taxes are collected by the payment debtor, i.e., the person making a payment to the taxable person.[44] The payment debtor is required by law to collect the tax and credit it to the tax authorities.[45] Also, in order to collect the tax, the withholding agent has to calculate the tax burden.[46] In this way, the initial tax payment responsibility is transferred to the payor of the income. The taxpayer and the person paying the tax to the tax authorities do not coincide.[47] Thus, typically,

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[42] See Titz, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, pp. 157-158.

[43] On the taxable base see in detail chapter 2.2.

[44] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 4. In contrast, under the Swiss "Verrechnungssteuer", the payment debtor is the taxable person; see Bauer-Balmelli, *Sicherungszweck*, p. 105. For a similar German example see Goez, *Quellenbesteuerung als Erhebungsform*, p. 11.

[45] See Motiwalla/Ramaskrishnan, *Tax Deduction*, p. 1; Doernberg, *International Taxation*, p. 175; Moore, *U.S. Tax Aspects*, p. 751; Poissant, *Taxation in Canada*, pp. 66 and 130; Bauer-Balmelli, *Sicherungszweck*, p. 48; Goez, *Quellenbesteuerung als Erhebungsform*, p. 4; Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 180; Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 191.

[46] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 127; Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 180; Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 191.

[47] See Poissant, *Taxation in Canada*, p. 131; Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 191.

withholding taxes include a trias of persons: the taxpayer, the withholding agent, and the tax authorities.[48]

Due to the withholding obligation of the payment debtor, the public duty of tax collection[49] is transferred to the latter.[50] The withholding agent acts as in a sovereign manner[51] on behalf of the tax authority. Thus, he is entitled to withhold the tax from the payment made to the taxpayer.[52] Through the outsourcing the sovereign gives up part of its administrative duties. However, for this fulfillment of public duties the withholding agent does not receive a reimbursement for the incurred expenses or any other form of payment from the state authorities.[53]

For withholding taxes to apply, a paying agent must be identified. For passive income it is the financial institution or the distributing company; for personal services it is the recipient of the service. There must be some kind of contractual relationship between the taxpayer and the payment debtor to make the latter a paying agent for withholding tax purposes.[54] Mere informal relationships, e.g., a loan agreement between to private individuals, are not subject to withholding taxes.[55] Also, in order for the lawmaker to be able to impose a duty on the payment debtor, the latter needs to underlie the former's jurisdiction. In other words, an administrative burden can only be levied on a domestic payment debtor.[56] Thus, withholding taxes are only prescribed for income sourced in the country concerned, i.e. domestic-source income of residents and foreign-source income of non-residents.

For countries, the collection of taxes by the payment debtor is a practical way of securing the enforcement of their taxes:

> *It would be relatively simple for source countries to impose flat-rate withholding taxes on many types of passive income, due to their control over the payors of that income. Failure to withhold could be punished either by imposing joint and several liability on the payor (the*

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[48] Goez, *Quellenbesteuerung als Erhebungsform*, p. 4.
[49] See Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, pp. 179 and 181.
[50] See Goez, *Quellenbesteuerung als Erhebungsform*, pp. 121 et seq.
[51] For the distinction from a sovereign act see Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 180.
[52] See Goez, *Quellenbesteuerung als Erhebungsform*, pp. 33-34.
[53] Critically see Goez, *Quellenbesteuerung als Erhebungsform*, pp. 122 and 127 et seq.
[54] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 7; Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 199. The Austrian Constitutional Court requires a relationship of legal or economic nature between the taxpayer and the payment debtor, to make the latter the withholding agent; see Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, pp. 182-183.
[55] See Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 123.
[56] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 126; Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalverkehrsfreiheit und Steuerrecht*, pp. 86 and 89.

current rule) or in some other circumstances, the loss of a deduction for the payment being made.[57]

In regard to the taxation of non-residents, source states would have no means to ensure their taxation in an assessment procedure. In cross-border situations tax collection would require the administrative assistance of the taxpayer's residence state. With the use of a withholding tax regime there is no need for tax collection abroad, as the withholding agent has already collected the tax. Moreover, paying agents, such as employers or subsidiaries, are usually financially potent. Thus, the tax authorities do not risk non-fulfillment of the tax obligation.[58] The outsourcing of the withholding obligation to the payment debtor leads to the securing of the tax payment.[59]

In addition to securing the tax payment, the withholding obligation of the payment debtor leads to a simplification of the tax collection procedure.[60] In this way, the taxpayer does not need to get in contact with the tax authorities himself. For highly mobile non-resident taxpayers it would be especially cumbersome if they had to file a tax return in every host state. Instead, the withholding agent levies withholding taxes on a high number of taxpayers, e.g. all its employees, all its shareholders, etc.[61] Also for the tax authorities the withholding tax leads to a more efficient way of tax collection.[62] Through the withholding by the payment debtor, a reduction of the administrative efforts on behalf of the tax authorities is achieved. The payment debtor is 'closest' to the income and can easily levy the tax.[63]

From the perspective of the payment debtor, however, the withholding tax leads to an administrative burden he would not have to bear otherwise. If the payment debtor was engaged in a contractual relationship with a taxpayer who is not subject to the withholding tax, i.e., a resident, the administrative burden would not arise at all. Thus, the payment debtor is subject to a different treatment depending on the residence of his business partner.

1.2.2. The liability for the tax payment

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[57] Roin, in Aaron et al. (eds.) *Taxing Capital Income*, p. 227; see also Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 191.
[58] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 121.
[59] See Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, pp. 179 and 181.
[60] See Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 179; Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 191.
[61] See Goez, *Quellenbesteuerung als Erhebungsform*, pp. 35-36; Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 191.
[62] See Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 181.
[63] Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 182.

In connection with the withholding requirement of the payment debtor his liability for the tax payable arises.[64] In case the withholding agent does not correctly withhold the tax, he will be personally liable for the tax of another person and, additionally, potential penalties with his whole fortune.[65] Thus, both the taxpayer and the withholding agent are liable for the payment of the tax. In some cases and under some national tax laws, the taxpayer has to be held liable primarily.[66] However, it may also be possible that the tax authority can choose from which of the liable persons it will request the tax payment.[67] The difference may lie in the closeness of the relationship between the taxpayer and the payment debtor.[68] In any case, through the liability of the withholding agent, the payment of the tax is secured in a greater way.[69]

In case of the limited tax liability of the taxpayer the tax authorities cannot get hold of him – the reason for the withholding tax *prima facie*. Tax collection and service of process are impossible or require the mutual assistance of the taxpayer's residence country. Thus, it is very likely that the tax authorities will approach the withhold agent for tax payment.[70] This result is based on considerations of efficient and lean administration, because the costs of tax collection are minimized. Also, the efforts of the foreign administration in case of a request for mutual assistance have to be taken into account when deciding whom to approach for the tax payment.[71] This also favors holding the withholding agent liable.

The liability of the withholding agent is usually not based on his personal fault.[72] Therefore, the liability exists, no matter whether the withholding was omitted intentionally, negligently, or without any fault on behalf of the withholding agent.[73] The withholding agent is liable for another person's tax, the liability of which he has not caused himself.[74] However, the withholding agent has

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[64] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 4; Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 180.

[65] See Doernberg, *International Taxation*, p. 167; Moore, *U.S. Tax Aspects*, p. 751; Poissant, *Taxation in Canada*, p. 167; Goez, *Quellenbesteuerung als Erhebungsform*, pp. 160 et seq; Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 180.

[66] See Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, pp. 184-185.

[67] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 7; Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, pp. 191 et seq.

[68] See Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 185.

[69] See Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 184; Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 191.

[70] Goez, *Quellenbesteuerung als Erhebungsform*, p. 80; see also Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 193.

[71] See Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 196.

[72] See Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, pp. 194 and 199 et seq.

[73] See Goez, *Quellenbesteuerung als Erhebungsform*, p. 161. Günther/Paterno are suggesting but declining considerations of fault in the liability procedure; Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, pp. 196 and 199.

[74] See Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 194.

contributed to the tax liability, in that he has made the payment that is taxed.[75] For the payment debtor, the liability for the tax payment is the most adverse effect of withholding taxes. He bears the burden of correctly assessing his withholding obligation and correctly calculating the amount of taxes. He risks making a mistake and having to pay the amount of withholding taxes assessed by the tax authorities. For this reason, a payment debtor will always favor entering into a contractual relationship with a person that is not subject to withholding taxes.

It is assumed that the liability of the payment debtor must not lead to the result that tax payments are collected that would not have been collected by means of tax assessment, which could be due to the fact that the taxpayer's tax liability was not known. In other words, if the tax authorities would not have been able to collect the tax themselves, the withholding agent should neither be held liable. Otherwise, the payment debtor would take all the risk of loss of tax revenue.[76] However, in most cases the payment debtor will prefer to withhold the tax due to the liability for the tax payment. In case he does not withhold the tax even though there is a withholding obligation, he can be held liable, even primarily. Also, his liability is dissociated from fault and arises even if he had good faith in the lack of a withholding tax obligation.

1.2.3. Assessment of the withholding obligation

In order to rightly assess his withholding obligation the payment debtor has to ascertain whether the payee is personally subject to withholding tax[77] and whether the payment constitutes income that is subject to withholding tax.[78] Moreover, the payment debtor may be bound to take into account tax exemptions that are applicable to the payment. It has been shown in chapter 1.1.3. that a withholding obligation for the payment debtor may persist even if the income on which the withholding tax is levied is tax-exempt. However, it may also occur that the tax exemption leads to a waiver of the withholding obligation. Thus, the payment debtor does not need to withhold the tax if he reaches the conclusion that the income is tax-exempt. This result may be achieved, if a tax exemption under national law leads to a simultaneous cancelation of the withholding obligation. Also, if the source country prescribes or allows the application of a tax treaty at withholding, a loss of the source state's taxing right also discharges the payment debtor from his withholding obligation.

It follows that in order to assess the withholding tax obligation correctly, the payment debtor has to answer the following questions:

1) Personal tax liability of the payee: unlimited or limited?

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[75] See Gast-de-Haan, in Stolterfoht (ed.) *DStJG No. 9*, p. 165.
[76] Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 199.
[77] See chapter 1.1.1.
[78] See chapter 1.1.2.

2) Income category: active or passive income?
3) Tax exemption under national law: does the payment constitute taxable income of the payee?
4) Tax exemption under a tax treaty: does a tax treaty restrict the national taxing right?

The payment debtor has to assess the above mentioned questions in order to know whether a withholding obligation exists and what the amount of tax to be withheld is. Because of uncertainty concerning the answers to the questions, the withholding agent may prefer to withhold the maximum amount of withholding taxes in order to minimize his liability. The adverse effects for the taxpayer in case of an initial withholding and a subsequent tax assessment or refund have been shown in chapter 1.1.3.

The following uncertainties may arise in connection with the questions 1) to 4):

Question 1): For the payment debtor it may be difficult in some cases to ascertain whether the payee is a resident or a non-resident. If the methods of tax collection are different due to the different availability of residents and non-residents for the tax authorities, only in the latter case will the payment debtor have to withhold the tax.[79] The payee might lack incentives to provide all the necessary information to the withholding agent. Also, even if the recipient claims to be a non-resident, he might not be aware of the host state's tax law.[80] In some countries, a vacation home[81] or citizenship[82] trigger resident status. In the opposite way, the taxpayer could claim to be a resident, while it turns out later that he is not.[83] Considering the uncertainty, the withholding agent may prefer to withhold the tax to limit his liability even if the recipient claims to be a resident.[84]

Question 2): The tax collection method may vary between different categories of income. As mentioned in chapter 1.1.2. some countries do not prescribe a withholding tax for non-residents' income that is effectively connected with a permanent establishment in the source state, i.e. active income. Thus, e.g., interest payments made to a non-resident may constitute active income that is connected with a tax collection at assessment, or they may constitute passive income that leads to a

[79] See chapter 1.1.1. See further Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 210.
[80] See Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 210.
[81] Austria
[82] E.g., the U.S.; see Doernberg, *International Taxation*, pp. 19 et seq.; Isenbergh, *International Taxation*, pp. 211 et seq.
[83] See Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 210 referring to the Austrian regulation on secondary homes. According to this regulation, the taxpayer is considered not to have an Austrian domicile if he has had his centre of vital interests abroad for at least 5 years, uses his Austrian domicile(s) for not more than 70 days within one calendar year, and keeps a register showing the number of days the domicile is used (see BGBl II 2003/528). In this way, it lies in the taxpayer's hands if he is treated as a resident or as a non-resident for Austrian tax purposes.
[84] Under U.S. tax law a withholding agent will not be liable for any tax if he relied on the presumptions concerning residence status provided for by the U.S. Treasury Regulations; see Doernberg, *International Taxation*, pp. 168-169.

withholding obligation of the payment debtor. The payment debtor has to receive information from the payee on the existence of a permanent establishment or similar activities of a fixed nature. The question whether a permanent establishment does or does not exist is one of the most difficult ones to answer is real life. Therefore, the payment debtor may not rely on the information provided by the payee and prefer to withhold the tax prescribed for passive income.

Question 3): Withholding taxes are a mere tax collection method. They are not a separate set of taxes. Thus, when no taxes have to be collected, because an exemption applies, there should be no withholding obligation.[85] However, a withholding obligation that is provided by national tax law can only be waived by national tax law. Thus, even in cases of a tax exemption, if no explicit provision releases the payment debtor from his withholding obligation, he has to collect the withholding tax.[86] If the tax is not collected, even though the withholding obligation is not waived, the withholding agent may still be held liable although the income is tax-exempt.[87] It may be argued that the tax authorities should refrain from holding the withholding agent liable when the income is tax-exempt because the tax payment that should be secured by ways of a withholding tax does not even exist.[88] However, the payment debtor may not rely on this interpretation and, therefore, collect the withholding tax even if the taxpayer claims that the income is tax-exempt. The payment debtor may even risk his liability for the withholding tax due if the withholding obligation is waived in case of a tax exemption. This may occur if the payment debtor refrains from the withholding, because the taxpayer claims the application of a tax exemption, which, however, turns out not to apply. In this case the tax liability of the payee leads to a withholding obligation of the payment debtor, which the latter did not fulfill due to wrong assumptions.

Question 4): The source state's taxing right may also be limited by a tax treaty. The taxing right may be fully eliminated, e.g., for royalty payments or business income that cannot be attributed to a permanent establishment in the source state. Also, the taxing right may be limited to a maximum tax rate, e.g., for dividend income. According to the OECD Model Convention and Commentary, the source state is free to allow an application of the tax treaty at withholding or a subsequent refund procedure to bring about a treaty-consistent taxation. However, the OECD Model Commentary articulates a preference for the first alternative. Thus, if the tax treaty grants a tax exemption, no withholding taxes have to be collected. For the withholding agent an application of

[85] See Achatz, *ÖStZ* 1982, p. 254; Zehetner, *Kapitalertragsteuer*, pp. 50 et seq.
[86] For the taxpayer perspective see chapter 1.1.3. See further Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, pp. 204-205; Quantschnigg/Schuch, *ESt-Handbuch* § 94 Rz 2; Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalertragsteuer*, pp. 27-28. See also Englisch, *Dividendenbesteuerung*, pp. 74 et seq., who is of the opinion that withholding taxes may be collected on tax-free income but have to be reimbursed in a subsequent tax assessment procedure.
[87] See Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, pp. 205 et seq.
[88] See Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 207.

the tax treaty at withholding means that he has to ascertain the taxpayer's treaty entitlement, e.g., by requiring a certificate of residence, and the allocation rule applicable to the payment. This leads to an additional administrative burden on behalf of the withholding agent. Also, applying the tax treaty directly at withholding may potentially lead to the liability of the withholding agent,[89] if the treaty entitlement of the taxpayer was wrongly affirmed.[90] Thus, tax treaties may even enhance the disadvantages of withholding taxes for the payment debtor. Even if the application of the tax treaty at withholding is allowed by the source state, the payment debtor may prefer to withhold the tax and refer the payee to the refund procedure.

Apart from these questions another problem for the withholding agent can arise if he would be obliged to withhold taxes not from the gross income paid to the taxpayer, but to deduct expenses of a business or personal nature from the taxable base. It has been shown in chapter 1.1.3. that this would be for favorable for the taxpayer, since over-taxation and an administrative burden could be avoided. The payment debtor, however, would have to rely on the information provided by the taxpayer. If the information turned out to be incorrect, the withholding agent would be held liable for the tax he refrained to withhold. Thus, if withholding taxes were levied on a net basis, the liability of the withholding agent would be more severe.[91] In some cases, the information on expenses provided by the taxpayer might even be correct, but the expenses are not reasonable. Or the expenses are reasonable, thus, the withholding agent does not raise any doubts, but then it turns out that the taxpayer did actually not bear the expenses.[92] In this respect it is questionable whether the risk of incorrect information can be shifted to the withholding agent.[93] In the end, the withholding agent will either have to face an enormous administrative burden – due to the need to verify all the information provided by the taxpayer –[94] or he will risk his liability for the amount of tax not withheld due to the deduction of expenses from the taxable base. If the payment debtor can choose between withholding the taxes from a gross or net amount, he will probably prefer the gross amount, because it limits his liability.

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[89] See Titz, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 158.
[90] See Titz, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, pp. 159-160.
[91] Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 201 with reference to Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalertragsteuer*, p. 27.
[92] Günther/Paterno consider the withholding agent not to be liable in this case; Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 216.
[93] See Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 215.
[94] See Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 216.

2. Tax amount

2.1. Taxable income

Withholding taxes are a method of tax collection. Before collecting a tax, though, the taxable income has to be defined. This means taxable income in general and income subject to the withholding tax. The material tax liability, i.e., what kind of income is subject to tax, depends on a person's personal income tax liability. Most countries have two different kinds of personal income tax liability, differentiating between residents and non-residents.[95] Residents are those persons (individuals or legal entities) that have their domicile or seat within the country. In contrast, non-residents have no physical presence in the country. They neither have a domicile or seat, nor their usual abode or place of business within the country.

The two different kinds of personal income tax liability give rise to two different kinds of material tax liability. Residents are taxed on their worldwide income by most countries. Due to the lack of personal connection to a country, non-residents are only taxed on income that has a material connection to a country. Thus, only income that is territorially connected to the country, i.e., income sourced in the country, underlies taxation in that country.[96]

It has been shown in chapter 1.1.1. that non-residents are subjected to withholding taxes by many countries. Usually, however, tax collection at withholding is only applied to certain kinds of income derived by non-residents. This is income which is likely to escape taxation. Passive income earned by non-residents, i.e., dividend, interest, royalty and capital gains income, and services with a lack of permanent physical presence in the source country are typically subject to withholding taxes.[97] Subjecting such income to taxation at withholding also implies that the source country includes such income under the limited tax liability. If a withholding obligation does not correspond with a tax liability, the withholding taxes must not be levied or have to be refunded. The problems that arise in regard to levying withholding taxes in the absence of a tax liability have been demonstrated in chapter 1.1.3.

In general, however, the stipulation of withholding taxes also implies that the income is subject to taxation. Thus, a different treatment based on withholding taxes may occur if they lead to a different definition of the taxable income. The definition of taxable income of non-residents depends on the source state's national tax law and applicable tax treaties, which may limit a taxing

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[95] See in detail Moore, *U.S. Tax Aspects*, pp. 44 et seq.; see also Doernberg, *International Taxation*, pp. 7 et seq.; Roin, in Aaron et al. (eds.) *Taxing Capital Income*, p. 212; Plasschaert, *Schedular, Global and Dualistic Patterns*, pp. 91-92.

[96] See Avi-Yonah, *International Tax*, pp. 13 et seq.; Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 91.

[97] See chapter 1.1.2.

right provided by national law. If the applicable tax treaty confirms the taxing right provided by national law, non-residents' income may be subject to a final withholding tax, while residents are tax-exempt on the same income. The withholding tax then leads to a higher tax amount due to the different definition of the taxable income.

From a country's perspective, income sourced within its territory may be subject to tax no matter whether the recipient is a resident or non-resident taxpayer. However, countries may not want to tax certain kinds of income due to policy reasons. Inter-company dividends, for example, are tax exempt by many countries in order to avoid taxation of the same income in the hands of several taxpayers, i.e., economic double taxation. However, – also due to policy reasons – this tax exemption often only applies to dividends received by resident companies. Non-resident companies, in contrast, are not covered by the tax exemption. Thus, the taxable income of residents and non-residents is defined differently.

The reason for the tax exemption of inter-company dividends can be explained as follows: Dividends are potentially subject to triple taxation:[98] First, the profits of a company are taxed in its hands with corporate tax. The dividends paid to its shareholders are not deductible at the level of the distributing company.[99] This is because profit distributions constitute utilization of income and do not serve its creation. Second, the dividends are taxed in the hands of the shareholder. In a cross-border situation, the company's state of residence may tax the dividends because they are national source income of a non-resident.[100] Third, the shareholder may be liable to tax with the dividends in his country of residence, due to the worldwide taxation principle. Within a group of companies a profit may be distributed many times, i.e. from the subsidiary to its parent company, then from the parent company to the grandparent company, and so forth. Thus, the same profit may be taxed an unlimited number of times within the group of companies until it is distributed to an individual shareholder.

This system of double or even triple taxation is referred to as the 'classical system'.[101] The corporation and its shareholder are two different separate entities and taxpayers. The taxation of the one does not interfere with the taxation of the other. Taxing income from equity in the hands of different taxpayers favors debt financing over equity financing, because interest is deductible while dividends are taxed at least twice. Also, economic double taxation of profit distributions encourages

[98] See Avi-Yonah, *International Tax*, p. 17; Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 93; see also Aaron et al. (eds.) *Taxing Capital Income*, Introduction xx; Hall/Rabushka, *Low Tax*, p. 7; Hall/Rabushka, *The Flat Tax*, p. 59.

[99] See Slemrod, in Aaron et al. (eds.) *Taxing Capital Income*, p. 22.

[100] Where is the source really?

[101] See Plasschaert, *Schedular, Global and Dualistic Patterns*, pp. 82 et seq.; Englisch, *Dividendenbesteuerung*, p. 87.

companies not to distribute their profits.[102] Moreover, economic double taxation interferes with tax neutrality. Tax neutrality means that the tax consequences should not influence economic choices.[103] However, due to economic double taxation, the choice of legal form may be influenced to favor unincorporated forms of doing business.[104]

To overcome the disadvantages of the classical system,[105] countries have employed different methods to avoid economic double taxation. These countries operate an 'integrated system' in which economic double taxation on profit distributions is (partly) eliminated.[106] This may be achieved through a tax relief at the corporate or at the shareholder level.[107]

One of the methods that is applied at the shareholder level is the imputation system. Under this system shareholders are given a tax credit for the tax paid by the company on distributed profits.[108] Thereby, the grossed-up dividend, i.e. including the tax credit, is the tax base for the shareholder.[109] If the tax credit exceeds the shareholder's tax liability, the excess tax has to be refunded to eliminate double taxation.[110] In another alternative, the shareholder's tax base in regard to the dividend could be reduced or a reduced tax rate could be applied to the dividend. Both approaches can be referred to as shareholder-relief systems.[111] For example, when profits are distributed to an individual shareholder, Germany only taxes half of the net income derived from the dividends,[112] while Austria until recently applied only half the average tax rate on such dividend income.

A method applying at the company level would be to grant the distributing company a deduction for the dividend.[113] This would mean that the corporation tax on distributed profits is entirely eliminated.[114] Hence, only retained profits would be subject to tax.[115] In case retained profits are distributed subsequently, the tax levied thereon would be reimbursed.[116] Through a dividend deduction, equality between equity and debt capital could be achieved, since interest payments are

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[102] See Moore, *U.S. Tax Aspects*, pp. 48-49; Plasschaert, *Schedular, Global and Dualistic Patterns*, pp. 83 and 84.
[103] See Helminen, *Dividend Concept*, pp. 11 et seq; Helminen, *International Tax Law Concept*, pp. 11-12.
[104] Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 84.
[105] In which economic double taxation persists; see Helminen, *Dividend Concept*, p. 21; Helminen, *International Tax Law Concept*, pp. 17-18.
[106] Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 85; Englisch, *Dividendenbesteuerung*, p. 87.
[107] See Englisch, *Dividendenbesteuerung*, p. 87.
[108] See Moore, *U.S. Tax Aspects*, p. 49; Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 85.
[109] See Englisch, *Dividendenbesteuerung*, p. 88.
[110] See Englisch, *Dividendenbesteuerung*, p. 88.
[111] See Englisch, *Dividendenbesteuerung*, p. 89.
[112] See Englisch, *Dividendenbesteuerung*, pp. 17 et seq.
[113] See Moore, *U.S. Tax Aspects*, p. 49; Hall/Rabushka, *The Flat Tax*, p. 60.
[114] See Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 85.
[115] See Englisch, *Dividendenbesteuerung*, p. 89.
[116] See Englisch, *Dividendenbesteuerung*, p. 89.

typically deductible at the company level.[117] Another scheme of integrated systems is the split rate regime. Under this regime, distributed profits are taxed at a lower corporate tax rate than retained earnings.[118] Thus, the split rate has the same effect as a partly deduction from the tax base or a partly reimbursement of the tax levied on retained profits.[119]

In an intra-group setting, for the sake of simplicity, many countries fully exempt dividends distributed from a resident subsidiary to its resident parent company from taxation at the shareholder level in order to avoid economic double taxation.[120] This means that no tax is levied on the dividend income from resident shareholdings of resident companies. The same, however, does often not hold true for outbound dividends.[121] This means that dividend income of non-residents is not granted a tax exemption. Rather, dividends paid to non-residents are taxed at withholding.[122] This leads to the result that, in comparison with inter-country dividends, cross-border dividends may be subject to an unfavorable treatment. The disadvantage lies in the definition of the taxable income.

Within the EU, also dividend income of non-residents may have to be tax-exempt within a group of companies. The Parent-Subsidiary Directive[123] seeks to eliminate economic double taxation on dividend distributions from a company resident in an EU Member State to a parent company resident in another EU Member State. According to its third preamble, the Directive seeks to abolish the disadvantage for the intra-EU grouping of companies compared to the formation of groups that are confined to one Member State. As mentioned above, dividend income is often not included in the taxable income of residents, while in cross-border situations profit distributions are taxed at the level of the company and at the level of the non-resident shareholder.

The Parent-Subsidiary Directive is aimed both at the residence state of the subsidiary and the residence state of the parent company. Art. 4 Parent-Subsidiary Directive requires the latter not to tax the inbound dividend. This can be done by either exempting the dividend from tax or by giving a credit for the underlying tax. Art. 5 Parent-Subsidiary Directive is directed at the residence state of the subsidiary, hence, the source state of the dividend. The Directive prohibits any taxation of the outbound dividend. Thus, withholding taxes are forbidden, but also other methods of tax collection. Thus, under application of the Parent-Subsidiary Directive, non-resident companies are not taxed on

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[117] See Englisch, *Dividendenbesteuerung*, p. 89.
[118] See Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 85.
[119] See Englisch, *Dividendenbesteuerung*, p. 90.
[120] E.g. Austria and Germany.
[121] See Helminen, *Dividend Concept*, p. 21; Helminen, *International Tax Law Concept*, p. 18; The same is true for other concepts than the full exemption; see Englisch, *Dividendenbesteuerung*, pp. 90-91 on the German system and p. 77 and 93 on the Spanish system.
[122] See Helminen, *International Tax Law Concept*, p. 18; see also for dividends in general Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 83.
[123] Council Directive 90/435/EEC of 23 July 1990 on common systems of taxation applicable in the case of parent companies and subsidiaries of Member States, OJ L 225 of 20 August 1990, pp. 6-9.

their dividend income by the source state. In case a withholding obligation generally exists for dividend income, it has to be waived.[124]

The Parent-Subsidiary Directive is only applicable to a company of an EU Member State, which:[125]

(a) takes one of the forms listed in the Annex of the Directive;

(b) according to the tax laws of a Member State is considered to be resident in that State for tax purposes and, under the terms of a double taxation agreement concluded with a third State, is not considered to be resident for tax purposes outside the EU;

(c) moreover, is subject to one of the taxes listed in Art. 2, without the possibility of an option or of being exempt.

In addition, the Parent-Subsidiary Directive is only applicable to direct investment. The current minimum holding is 10 percent. Thus, the Parent-Subsidiary Directive does not mitigate economic double taxation for portfolio holdings.[126]

In cases in which the Parent-Subsidiary Directive is not applicable, e.g., the company form is not listed in the Annex to the Directive,[127] or the minimum holding requirement is not fulfilled,[128] different treatment of residents and non-residents based on withholding taxes may persist. The same is true for any cases that do not take place within the EU, but with third countries. In general, whenever taxable income is defined differently for residents and non-residents, different treatment occurs. Countries may often have incentives to refrain from taxing their residents, but to keep taxing non-residents on the same income. Due to the different definition of the taxable income, the tax amount paid by the non-resident will be higher than the one paid by the resident, which is nil in case of a tax exemption.

2.2. Taxable base

As has been mentioned above, residents are usually subject to unlimited tax liability while non-residents are usually subject to limited tax liability. In the country where the income is sourced, both categories of taxpayers underlie taxation. It has been shown in chapter 1.1.2. that the source country defines what income is subject to withholding tax. Usually, only certain categories of income earned by non-residents are subject to withholding taxes. In general, withholding taxes lead to a different tax amount than taxation at assessment. It has been shown in the last chapter that the

[124] In certain cases, also a refund of the tax withheld may apply.
[125] Art. 2 Council Directive 90/435/EEC.
[126] See Helminen, *Dividend Concept*, pp. 21 and 23; Helminen, *International Tax Law Concept*, pp. 18-19.
[127] Aberdeen, Gaz de France
[128] Amurta

source country determines which kinds of income are taxed under the limited tax liability at withholding, which might lead to a broader tax base than taxation of residents at assessment. In addition, the different treatment through withholding taxes in regard to the tax amount may be caused by the taxable base for the withholding tax.

Apart from the differentiation between residents and non-residents, many countries provide for two different taxation regimes of non-residents' income. This means that they differentiate two categories of income and tax them differently. Often, passive income of non-residents is taxed in a separate schedule and subject to a special tax rate. Also, this schedule will typically foresee taxation of gross income. Active income of non-residents and income earned by residents, in contrast, may be subject to net taxation. This is, for example, true for the U.S. tax system. It provides for two different schedules for non-residents: active and passive income. Active income is derived by a trade or business effectively connected with the U.S. While active income is taxed at the same tax rate applicable to residents and on a net basis, passive income is taxed at a 30 percent flat tax rate without the allowance of deductions.[129] A similar system is applied by Canada. Income from employment, business, and capital gains, on the one hand, is taxed at graduated rates allowing deductions.[130] Income from property,[131] on the other hand, is taxed at a fixed rate on a gross basis.[132] Poissant explains that under the Canadian system *"[t]he two types of income are subject to two different fiscal measures which are quite separate"*.[133]

Taxation at withholding is closely related to gross taxation. The application of withholding taxes makes a separate computation of the income subject to withhold necessary. The income subject to withholding has to be isolated from the rest of the income. Thus, a separate schedule is created for taxation purposes. Under schedular tax systems, each type of income is taxed separately. The tax has more of an objective character, than of a subjective one.[134] For the source country it is more important to identify the payments flowing out of the country than their recipients. Thus, the amount of the payment made is the only important factor to determine for taxation purposes.[135] Gross taxation is one of the consequences of a schedular tax regime.[136] For that reason, withholding

[129] See Avi-Yonah, *International Tax*, p. 64; Doernberg, *International Taxation*, p. 73; Isenbergh, *International Taxation*, p. 81; Moore, *U.S. Tax Aspects*, p. 742.
[130] See Poissant, *Taxation in Canada*, pp. 1 and 11 et seq.
[131] Income from property comprises receipts from investment such as dividends, interest, rents, royalties, annuities, and other similar income; see Poissant, *Taxation in Canada*, p. 1.
[132] See Poissant, *Taxation in Canada*, pp. 129 et seq.
[133] Poissant, *Taxation in Canada*, p. 130.
[134] See also Goez, *Quellenbesteuerung als Erhebungsform*, pp. 15 and 57.
[135] See Plasschaert, *Schedular, Global and Dualistic Patterns*, pp. 97 and 99.
[136] See Jachmann, *DStR* 2009, p. 131.

taxes are usually levied on a gross basis.[137] Taxpayers are typically not entitled to deductions, which include expenses incurred for the creation of the taxable income, i.e. business expenses, and personal deductions. Plasschaert explains this technique:[138]

> *Under given circumstances, incomes can be* withheld *at the source in a* "blind" manner, *i.e. without any further need to identify the beneficiary or payee of the income. This is the case when (a) the costs of obtaining or producing the gross income are negligible or can be reliably estimated by some simple and uniform formula; (b) there is no subsequent need to measure tax liabilities in the light of the overall income of the taxpayer and of his relevant personal circumstances. The tax withheld would then amount to the ultimate tax liability.*

The simplification of the tax collection procedure is another one of the reasons for applying withholding taxes on a gross basis.[139] Withholding taxes are connected with the liability of the payment debtor.[140] Thus, if the tax is not withheld and transferred to the tax authorities correctly, the payment debtor can be held liable for the amount of tax payable on his payment made to the taxpayer. Due to the gross taxation, this payment is the only figure the withholding agent has to know. Income from other sources, expenses, and the personal situation of the taxpayer are not taken into account for calculating the withholding tax. The paying agent can only be obliged to withhold taxes according to the information he possesses. If he has to undergo special investigations in order to be able to calculate the tax correctly and withhold it at the correct time, the administrative burden for the payment debtor may be disproportionate.[141] He would have to review the taxpayer's declaration of expenses and other income in order not to be held liable.[142] Thus, in case withholding taxes would have to be calculated not only from the payment made by the withholding agent, but also with regard to the taxpayer's expenses and personal situation, the administrative burden of the withholding agent would increase drastically.[143]

As far as passive income is concerned, Isenbergh also identifies another reason for gross taxation:[144]

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[137] See Avi-Yonah, *International Tax*, p. 14; Doernberg, *International Taxation*, p. 172; Poissant, *Taxation in Canada*, p. 130; Goez, *Quellenbesteuerung als Erhebungsform*, p. 73. For an explanation of the discriminatory effect see Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 745.

[138] Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 123.

[139] See Goez, *Quellenbesteuerung als Erhebungsform*, pp. 35, 120 and 122.

[140] See chapter 1.2.

[141] See Schuch, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, pp. 183-184 with reference to case law of the Austrian Constitutional Court.

[142] Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 201 with reference to Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalertragsteuer*, p. 27.

[143] Günther/Paterno, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 201 with reference to Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalertragsteuer*, p. 27.

[144] Isenbergh, *International Taxation*, p. 84; see also Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 109.

A further characteristic [...] is that the tax base is readily identified. Most rents, royalties, and wages, and all interest and dividends, come in measurable amounts that have the character of gross income. Typically (but not always) these amounts arise without substantial expense by the recipient, and therefore have a large component of net gain. This is at least in part the justification for taxation at flat rates without allowance for deductions.

Thus, three reasons can be identified for withholding taxes being levied on a gross basis. First, withholding taxes require the computation of income in a separate schedule, which typically leads to gross taxation. Second, through gross taxation a simpler administration of the tax payment procedure may be achieved. The withholding agent should not be burdened with the consideration of the taxpayer's expenses. Third, many income categories subject to withholding taxes are considered to arise without substantial expenses. Considering the first two arguments, it may be seen critically that simplification of the tax collection is valued higher than equality among the taxpayers. The third argument has to been criticized particularly, because it does not hold true in general. Even in regard to passive income, expenses may arise. This is even more apparent in cases of active income being subject to withholding taxes, as, for example, income from personal activities. In extreme but realistic cases, a taxpayer's expenses may even be higher than his revenue. However, by calculating the withholding taxes from the gross payment, withholding taxes are even levied when the taxpayer is in a loss situation.

In cross-border situations also tax treaties have to be considered. In general, tax treaties do not interfere with the computation of the taxable base by the source state. If the source state is provided a taxing right, it may freely decide in what way the income is taxed. However, tax treaties that follow the OECD Model Convention contain a reference to the taxable base in Arts. 10 and 11:[145]

However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed: a) 5 per cent of the ***gross amount*** *of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends; b) 15 per cent of the* ***gross amount*** *of the dividends in all other cases.*

However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the ***gross amount*** *of the interest.*

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[145] Emphasis added.

These provisions effectively limit the taxing right of the source state to a certain amount. If the gross amount of interest is, for example, 100, the tax levied by the source state must not exceed 10. Thus, the gross amount of the income serves as a calculation base of the maximum tax amount. However, Arts. 10 and 11 OECD Model Convention do not oblige the source state to tax dividends and interest on a gross basis. If the source state taxes those kinds of income on a net basis, however, it would be allowed to apply a higher tax rate. Taken the above example, expenses in connection with the interest income of 100, e.g., re-financing costs, may arise in the amount of 10. The net income would then be 90. The maximum tax allowed being 10 (same as above), the maximum tax rate to be applied by the source state would be 11.11 per cent, which is slightly more than 10 per cent. The relationship between the taxable base and the tax rate is further explained in chapter 2.3. Most importantly, Arts. 10 and 11 OECD Model Convention stipulate the maximum tax amount that may be levied by the source state. The source state is free to tax a smaller amount, e.g., by allowing deductions from the taxable base without raising the tax rate.

Due to the fact that withholding taxes are levied on a gross basis, different treatment compared to taxation at assessment arises. At assessment, the income is usually taxed in a global way, meaning that all kinds of income are taxed jointly and equally. This is in line with the postulate of equal treatment, according to which income of each category should be taxed in the same way.[146] Global income tax regimes have a person-based character, rather than an object-based one. They are, consequently, based on the principle that the personal and overall situation of the taxpayer has to be taken into account when calculating the taxable base. This is due to the ability-to-pay principle. This principle should ensure that each taxpayer contributes to the tax revenue according to his relative ability to pay taxes.[147] This capacity is based on the taxpayer's amount of income.[148] By taking into account the taxpayer's income situation, the tax system becomes personalized.[149] The ability-to-pay principle can be split up into the objective net-taxation principle and the subjective net-taxation principle.[150]

The objective net-taxation principle requires that a taxpayer is entitled to deduct the expenses that he incurred to earn his income from his gross receipts.[151] Respecting this principles ensures that only a person's real income is taxed, i.e. the balance between the receipts and the expenses. Thus, taxing a person's turnover, cash-flow, or earnings – i.e. any gross receipt – is against

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[146] See Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalverkehrsfreiheit und Steuerrecht*, p. 65.
[147] See Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 111; Beiser, *ÖStZ* 2000, p. 413.
[148] See Doralt/Ruppe, *Steuerrecht Band I* (2007) p. 17; Beiser, *ÖStZ* 2000, p. 414.
[149] See Plasschaert, *Schedular, Global and Dualistic Patterns*, pp. 111-112.
[150] See Doralt/Ruppe, *Steuerrecht Band I* (2007) pp. 17-18; Beiser, *ÖStZ* 2000, p. 415; critically see Gassner/Lang, *ÖStZ* 2000, p. 643.
[151] See Jachmann, *DStR* 2009, p. 129.

the objective net-taxation principle.[152] Through the net-taxation principle, equal taxation among the taxpayers is achieved. Every taxpayer contributes according to his economic ability to pay.[153]

In contrast, under gross taxation regimes, the taxpayer's real ability to pay is not taken into account.[154] Comparing gross to net taxation, Plasschaert observes the following:[155]

> *Basing income taxation on a gross concept would violate the essence of the income tax. A netted-out taxable base is also a prerequisite to achieve an equitable distribution of the income tax burden. Only net income represents purchasing power to the taxpayer.*

Due to gross taxation income is taxed twice, with the payor and the payee of expenses.[156] Within a group of companies this is referred to as the 'cascade effect'. Roin gives an example:[157]

> *In the simplest case, assume a Corporation X is established and operating in Country E. Assume further that Country E levies a 30 percent withholding tax on income earned within its borders by foreign passive investors. Corporation Z is established and operating in Country D, which has a 25 percent withholding tax on the income of foreigners, and Corporation Y is established and operated in Country F. Now suppose Corporation X pays a royalty of $10 to Corporation Z, on account of which Corporation Z pays a royalty of $6 to Corporation Y. What taxes should be levied in such a situation? Surely X should withhold and pay $3 (30 percent of 10) to E, leaving Z with $7. But should Z withhold another $2 from its payment to Y, and remit this money either to E or D? If so, what started as a royalty of $10 would be subject to taxes of $5, for an effective tax rate of 50 percent. And the rate would go up if Y pays royalties to yet another party.*

The subjective net-taxation principle requires that the income of the taxpayer and his personal and family situation, i.e., his personal expenses, are taken into account. This is the dividing line to the net-taxation principle, which prescribes the deduction of business expenses. The most important requirement of the subjective net-taxation principle is that the taxpayer does not pay taxes under the subsistence level.[158] This is usually ensured by granting a tax-free amount.

An important part of the taxpayer's personal situation are losses that he incurred from an income category. According to the subjective net-taxation principle, losses from one category of income can be offset against profits from other categories.[159] Without the consideration of losses the

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[152] See Beiser, *ÖStZ* 2000, p. 415.
[153] See Jachmann, *DStR* 2009, p. 129.
[154] See Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalverkehrsfreiheit und Steuerrecht*, p. 66.
[155] Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 41.
[156] See Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 41.
[157] Roin, in Aaron et al. (eds.) *Taxing Capital Income*, pp. 227-228.
[158] See Doralt/Ruppe, *Steuerrecht Band I* (2007) p. 18.
[159] See Doralt/Ruppe, *Steuerrecht Band I* (2007) p. 17.

taxpayer's ability to pay cannot be determined accurately. Apart from losses, other special expenses of the taxpayer may also be deducted from his taxable base. Under withholding taxes no attention is paid to other income sources of the taxpayer, which may potentially also result in a loss. This loss is not taken into account for withholding tax purposes. And even a loss resulting from the income subject to withholding itself does not eliminate the withholding tax, because it is levied on a gross basis.

The different treatment through withholding taxes in regard to the taxable base is apparent. Even though there are sound reasons for the gross taxation, it leads to a higher tax amount of non-residents compared to residents. Through withholding taxes, the equal taxation of taxpayers should be guaranteed. No taxpayer should have the possibility to escape taxation, because he does not declare his income or the tax authorities cannot get hold of him. However, equal taxation of taxpayers also requires levying an equal amount of taxes. This is, however, not achieved if under a withholding tax regime the personal situation of the taxpayer is not considered and personal deductions are disallowed. The same holds true for the object-based approach of withholding taxes, by means of which only the payment is taken into account for tax calculation.

2.3. Tax rate

Besides the taxable base, the tax rate is crucial for calculating the tax amount. The tax rate of withholding taxes is typically flat.[160] By applying a uniform tax rate to all taxpayers, the total amount of income and the taxpayer's personal situation are not taken into account. The flat tax rate means simple administration of the withholding tax. If withholding taxes are applied to certain taxpayers (i.e. non-residents) and certain income (i.e. passive income and service payments), the taxpayer's residence and income category are the only facts that have to be determined by the withholding agent.[161] The gross payment, which serves as the taxable base, is known by the payment debtor. The tax rate, because it is flat, is stipulated by law.

In order to apply a flat tax rate to certain categories on income of non-residents, these categories have to be separated from the other ones. This is known as 'schedular taxation of income'. Plasschaert describes it as follows:[162]

> *In a* schedular *income tax system, each of the various categories of income, or (partial)* incomes, *such as salaries, dividends or business profits, flowing to the same taxpayer, is subjected to a separate tax rate.*

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[160] See Avi-Yonah, *International Tax*, p. 14; see also Goez, *Quellenbesteuerung als Erhebungsform*, p. 131.
[161] See Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 123 and 126.
[162] Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 17.

In contrast to non-residents, residents are typically taxed in a global income system, meaning that their total income is subject to one single tax rate. Under this system, the gross receipts from different sources of income are added up. After deducting expenses, the tax rate is applied to the tax base.[163] Most countries tax their residents at progressive tax rates. Under this system, tax rates rise as income rises.[164] Hall/Rabushka briefly explain this system as follows:[165]

> *A tax system is progressive when it takes an increasing share of a taxpayer's income in taxes as that person's income rises.*

Progressive tax rates seek to implement the ability-to-pay principle.[166] The ability to pay taxes is assumed to increase progressively with increasing income.[167] In other words, progressive tax rates are based on the theory that a high income earner can spend a bigger portion of his income on taxes. Plasschaert explains this theory as follows:[168]

> *The justification for progressive rates on income has traditionally been cast in terms of sacrifice theories, which, in essence, apply the marginal utility theory to income and taxation. Additional units of income, it is claimed, afford less utility; or, in other words, as income rises, its marginal utility declines. Proportional rates, applied to discretionary income, would imply that rich men would sacrifice a smaller proportion of their utility than the poor men.*

This means that under progressive tax systems the average tax rate is not the same as the marginal tax rate. The average tax rate is the share of taxes in income.[169] If a taxpayer has income of 1,000 and pays a total 300 in taxes, his average tax rate is 30 percent. A flat tax rate coincides with the average tax rate and is the same for all taxpayers, no matter how high their income. Progressive tax rates, in contrast, vary across taxpayers depending on their taxable income. The marginal tax rate may therefore be higher than the average tax rate.[170]

> *The marginal rate is the amount by which the tax goes up for each additional dollar of income. [...] Marginal tax rates apply only to the last dollar earned. As increases in income*

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[163] See Plasschaert, *Schedular, Global and Dualistic Patterns*, pp. 39 and 106.
[164] See Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 105.
[165] Hall/Rabushka, *Low Tax*, p. 25.
[166] See Plasschaert, *Schedular, Global and Dualistic Patterns*, pp. 111 and 160; critically see Beiser, *ÖStZ* 2000, p. 416 with reference to Tipke, *Steuergerechtigkeit*, p. 97 and Elicker, *StuW* 2000, p. 17.
[167] See Doralt/Ruppe, *Steuerrecht Band I* (2007) p. 18.
[168] Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 112.
[169] Hall/Rabushka, *Low Tax*, p. 7; Hall/Rabushka, *The Flat Tax*, p. 44.
[170] Hall/Rabushka, *The Flat Tax*, p. 45; Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 105.

push people into higher tax brackets, a greater proportion of each additional dollar of income is paid in taxes.[171]

Also, under progressive tax rates, the nominal and the effective tax rate usually do not coincide. This is because progressive tax regimes are usually combined with deductions and allowances for the taxpayer, i.e., net taxation.

Exemptions, deductions and allowances, on the one hand, or evasion and avoidance, on the other hand, may plunge the effective *rate well below the nominal one.*[172]

Under flat-rate tax regimes, nominal and effective tax rates are often the same, because no deductions are allowed from the taxable base. Thus, by not varying across different amounts of income and disallowing expenses, flat-tax regimes do not respect the ability-to-pay principle. Plasschaert makes the following remark:[173]

In sum, the object-centred schedular taxes can only inadequately perform the role of a redistributive progressive tax which is meant to influence the personal distribution of income.

As has been mentioned in chapter 2.2. tax treaties may have an influence on the tax amount levied by the source state. For dividend and interest income, the OECD Model Convention prescribes a maximum tax amount that is calculated as a percentage of the gross amount of the income. In general, it is up to the source state to determine how to compute the taxable base and the tax rate for income of non-residents. The combination of the two figures, however, must not exceed the maximum tax amount stipulated in Arts. 10 and 11 OECD Model Convention.

Art. 10 (2) OECD Model Convention[174] reads as follows:[175]

However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed: a) ***5 per cent*** *of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the*

[171] Hall/Rabushka, *Low Tax*, p. 7.
[172] Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 106.
[173] Plasschaert, *Schedular, Global and Dualistic Patterns*, p. 115.
[174] The U.S. Model Convention provides for a similar Art. 10 (2) on dividend taxation. However, some U.S. tax treaties only require a 10 percent share in the voting stock for a reduction of the maximum source tax rate to 5 percent. Some U.S. tax treaties provide for a zero percent source tax rate in case of intercompany dividends. See Doernberg, *International Taxation*, pp. 144-145; Isenbergh, *International Taxation*, p. 250; Helminen, *Dividend Concept*, p. 31; Helminen, *International Tax Law Concept*, p. 24.
[175] Emphasis added.

capital of the company paying the dividends; b) ***15 per cent*** *of the gross amount of the dividends in all other cases.*

Similarly, Art. 11 (2) OECD Model Convention[176] provides:[177]

However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ***10 per cent*** *of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.*

Thus, if the national law of the source state provides for a taxation of outbound dividends and interest on a gross basis, its tax treaties that follow the OECD Model Convention explicitly stipulate the maximum flat tax rate than may be applied to such income. If the taxable base is a net base, the flat tax rate may accordingly be higher. The taxable base and the tax rate always have to be considered in a combined way to determine the tax amount.

The question whether a flat tax rate amounts to unfavorable treatment depends on the circumstances of every special case. Compared to a progressive tax rate, a flat tax rate can be higher, lower, or equal. However, as far as withholding taxes are concerned, flat tax rates are usually connected to gross taxation.[178] Therefore, taxation of net income at a progressive tax rate has to be compared with gross taxation at a flat tax rate. A low tax rate on gross income may equal a high tax rate on net income.[179] To determine the tax liability, the tax rate and the tax base have to be considered in a combined way.[180] Avi-Yonah presents the following example:[181]

In the U.S. in 1980 the gross rate for non-residents was 30 percent, while the net rate for residents was 70 percent[182]. The income of the taxpayer is 100. Deductions are 50. Even though the deductions are 50 percent of the income, net taxation is not favorable, since the tax rate is relatively high. In the net scenario the taxpayer pays 35 tax (50*0.7). In the gross scenario, however, the taxpayer only owes 30 tax (100*0.3). With the differences in the tax rates and the special size of deductions in this case, gross taxation at a flat rate would be favorable.

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[176] The U.S. Model Convention, however, provides no taxing right for the source state of interest income; see Doernberg, *International Taxation*, pp. 125-126 and 146; Roin, in Aaron et al. (eds.) *Taxing Capital Income*, p. 215.
[177] Emphasis added.
[178] See Jachmann, *DStR* 2009, p. 131.
[179] See Doernberg, *International Taxation*, p. 10; see also Isenbergh, *International Taxation*, p. 81.
[180] See Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalverkehrsfreiheit und Steuerrecht*, p. 84.
[181] Avi-Yonah, *International Tax*, p. 65.
[182] This rate and base also applied to active income of non-residents, i.e., income from a trade or business in the U.S.

The outcome is, however, different if the U.S. tax law of 2006 is applied. The taxation of non-residents is the same compared to 1980. The tax rate for residents, though, has declined to 35 percent. In the same situation, with income of 100 and deductions of 50, the tax payable by the resident would be 17.5 (50*0.35). This is compared to a tax of 30 owed by the non-resident taxpayer. In this scenario, taxation as a resident is more favorable than it is for non-residents. The discriminatory effect of a flat tax rate, thus, depends on the number of deductions and the difference between the tax rates.[183]

Passive investment income, in particular, will often involve no or only very low expenses. In these cases, a comparison can be made only on the basis of the tax rate. The flat tax rate does not correlate with the amount of income earned by the taxpayer, while a progressive tax rate is low for low incomes and higher for high incomes. Thus, if a comparison is made between two low-income-earners, the one being subject to a withholding tax at a flat tax rate will usually be at a disadvantage.[184]

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[183] See Avi-Yonah, *International Tax*, pp. 64 et seq.

[184] For the same example in the case of inbound dividends see Tumpel, in Lechner/Staringer/Tumpel (eds.) *Kapitalverkehrsfreiheit und Steuerrecht*, p. 84. However, Tumpel comes to the conclusion that the taxpayer who is subject to the flat tax rate regime will always be treated favorably or equally compared to a taxpayer who is subject to a progressive tax rate. This result is achieved due to the assessment option under Austrian tax law, though, which gave the taxpayer the chance to opt into tax assessment instead of being subject to a withholding tax, if his average tax rate was lower than the 25 percent withholding tax (ex-Sec. 97 (4) ITA). Thus, the tax rate in the withholding regime was not 25 percent flat, but rather 25 percent maximum. The withholding tax rate could never be higher than the average tax rate, but only lower.

3. Summary

Different treatment may be caused by withholding taxes in two ways: The tax collection and the tax amount.

In regard to tax collection, the withholding tax may lead to an earlier payment of tax compared to a tax assessment procedure. The taxpayer, thus, may face liquidity disadvantages. Withholding taxes may also lead to taxation despite the lack of a tax liability. This occurs in cases of a tax-exemption or a lower tax amount that are not considered at withholding. The taxpayer has to make a payment that is refunded at a later point in time, leading to a payment without a real obligation. Also, the taxpayer is burdened with the administrative duty of a refund procedure.

For the payment debtor, the tax collection through withholding taxes may also lead to different treatment. The administrative burden caused by the withholding obligation and the liability for the tax payment are adverse effects of withholding taxes compared to a tax assessment procedure in which the payment debtor does not interfere. The payment debtor has to assess whether a withholding obligation applies. The failure to fulfill an existing withholding obligation causes his liability. Thus, the payment debtor has to rely on information provided and declarations made by the taxpayer in order to correctly withhold the tax. In this regard, uncertainty may lead to the payment debtor's preference to over-withhold, which causes the negative effects for the taxpayer that have been described in the last paragraph.

Withholding taxes, besides the procedural aspects, may also lead to a material disadvantage for the taxpayer, i.e., a higher tax amount. This may occur if the levy of withholding taxes leads to a final taxation of income that is exempt for other taxpayers. Dividend income was presented as an example for a tax exemption, which does often not apply to non-residents who are taxed at withholding. In this case, the taxable income is defined differently, which makes withholding taxes lead to a higher tax amount.

If income is covered by a tax liability without the application of tax exemptions, the tax amount is the result of combining the taxable base and the tax rate. Withholding taxes lead to a higher tax amount if the taxable base or the tax rate is higher. The taxable base for withholding taxes is usually a gross amount. This means that no deductions are allowed. The non-deduction covers business expenses and personal expenses. The payment that is made from the payment debtor to the taxpayer is the amount from which the withholding tax is calculated. Assuming the existence of expenses, compared to a net taxation, the taxable base for gross taxation is always higher.

Withholding taxes are levied at flat rates. They do not vary among taxpayers. Compared to a progressive tax rate the flat rate itself may be higher, if the taxpayer's income is very low. In case of high income, progressive tax rates are high, too. A comparison of the tax rates may show that a flat

tax rate is even favorable. However, as has been mentioned above, the tax amount is a combination of the tax rate and the taxable base. In regard to withholding taxes, a flat tax rate is applied to a gross taxable base. The different treatment caused by a different tax amount can only be determined by comparing flat, gross taxation with progressive, net taxation. This has to be done in a case-by-case basis. Depending on the circumstances, taxation at withholding or at assessment may be favorable in regard to the tax amount. Only theoretically will the tax amount be equal. Thus, different treatment occurs.

III. THE FUNDAMENTAL FREEDOMS AND FREE MOVEMENT UNDER THE TFEU AND EU-AGREEMENTS

1. General principles of primary EU law

1.1. The single market and direct taxes

The Treaty on the Functioning of the European Union seeks to guarantee a single market among the Member States of the European Union. However, direct taxes are not harmonized within the EU.[185] They fall within the competence of the Member States.[186] Harmonization in the direct tax area may be based on Art. 115 TFEU, the general harmonization provision contained in the Treaty.[187] Art. 114 TFEU may not be applied, as fiscal matters are excluded from its ambit.[188] Art. 115 TFEU gives an authorization to the Council to issue directives to approximate laws, regulations and provisions in order to establish the internal market.[189] It requires, though, unanimity of the Member Countries, which is hard to achieve in direct tax matters.[190] To date, only 4 directives were adopted on the basis of Art. 115 TFEU: The Merger Directive,[191] the Parent-Subsidiary Directive,[192] the Interest and Royalty Directive,[193] and the Savings Directive.[194] The last three mentioned Directives are

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[185] See further Adamczyk, in Lang et al. (eds.) *Introduction to European Tax Law*[2], pp. 23 et seq.
[186] See Englmair, in Lang et al. (eds.) *Introduction to European Tax* Law[2], p. 43.
[187] See Terra/Wattel, *European Tax Law*[5], p. 19; Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, p. 2; Moritz, *Das Diskriminierungsverbot*, p. 283; Hakenberg, *Grundzüge*, p. 204.
Concerning a possible harmonization of withholding tax regimes see Goez, *Quellenbesteuerung*, p. 87.
[188] See De Witte, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 310; Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 742; Moritz, *Das Diskriminierungsverbot*, p. 283.
[189] Directives have to be transformed into national law to become effective; see Moritz, *Das Diskriminierungsverbot*, pp. 283 et seq.
[190] See Adamczyk, in Lang et al. (eds.) *Introduction to European Tax Law*[2], p. 24; Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, pp. 2 et seq.
[191] Council Directive 90/434/EEC of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, OJ L 225 of 20 August 1990, pp. 1-5; Council Directive 2005/19/EC of 17 February 2005 amending Directive 90/434/EEC on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, OJ L 58 of 4 March 2005, pp. 19-27; Council Directive 2006/98/EC of 20 November 2006 adapting certain Directives in the field of taxation by reason of the accession of Bulgaria and Romania, OJ L 363 of 20 December 2006, pp.129-136; Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States (codified version), OJ L 310 of 25 November 2009.
[192] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, OJ L 225 of 20 August 1990, pp. 6-9.
[193] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States, OJ L 157 of 26 June 2003, pp. 49-54.

relevant for the area of withholding taxes. The Parent-Subsidiary Directive prohibits the levy of withholding taxes on intra-EU inter-company dividends. It should ensure the avoidance of economic double taxation of company profits at distribution.[195] The Interest and Royalty Directive prohibits the levy of withholding taxes on intra-EU inter-company interest and royalty payments. It should ensure the effective taxation of such payments by the residence state of the taxpayer. The Savings Directive, on the contrary, introduces a special withholding tax to be applied by the Member States Austria, Belgium, and Luxembourg[196] on outbound interest on savings of individuals. The withholding tax is credited by the taxpayer's residence state upon declaration of the interest income. Besides the aforementioned Directives on material aspects of taxation, the Mutual Assistance Directive[197] and the Recovery Assistance Directive[198] were issued to enhance the cooperation between the tax authorities of the Member States. They are also highly relevant in the area of withholding taxes as will be shown in chapter V.

Apart from the secondary law on direct taxes, the fundamental freedoms have gained significant importance in the direct tax area.[199] They aim at establishing a single market by enabling the free movement of goods, services, persons, and capital.[200] The fundamental freedoms – according to the wording of the provisions – are not specifically aimed at targeting the tax laws of the Member States.[201] Still, the ECJ, in interpreting their meaning, has applied them also to tax law provisions; for the first time in 1986 in the *Commission vs France* – better known as the *'avoir fiscal'* – case.

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[194] Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments, OJ L 157 of 26 June 2003, p. 38; Council Directive 2004/66/EC of 26 April 2004 adapting Directives 1999/45/EC, 2002/83/EC, 2003/37/EC and 2003/59/EC of the European Parliament and of the Council and Council Directives 77/388/EEC, 91/414/EEC, 96/26/EC, 2003/48/EC and 2003/49/EC, in the fields of free movement of goods, freedom to provide services, agriculture, transport policy and taxation, by reason of the accession of the Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia, OJ L 168 of 1 May 2004, p. 35; Council Decision 2004/587/EC of 19 July 2004 on the date of application of Directive 2003/48/EC on taxation of savings income in the form of interest payments, OJ L 257 of 4 August 2004, p. 7; Council Directive 2006/98/EC of 20 November 2006 adapting certain Directives in the field of taxation, by reason of the accession of Bulgaria and Romania, OJ L 363 of 20 December 2006, p. 129; Proposal for a Council Directive amending Directive 2003/48/EC on taxation of savings income in the form of interest payments, 13 November 2008, COM(2008) 727 final.

[195] See chapter II.2.1.

[196] The other Member States, instead of levying a withholding tax, exchange information on outbound interest on savings of individuals. The three Member States were allowed to levy withholding taxes because of their provisions on bank secrecy.

[197] 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 and taxation of insurance premiums, OJ L 336 of 27 December 1977.

[198] Council Directive 2008/55/EC of 26 May 2008 on mutual assistance for the recovery of claims relating to certain levies, duties, taxes and other measures, OJ L 150 of 26 May 2008.

[199] See Adamczyk, in Lang et al. (eds.) *Introduction to European Tax Law*[2], p. 24; Moritz, *Das Diskriminierungsverbot*, p. 255; Haslehner, *IStR* (2008) p. 565.

[200] See Behrens, *EuR* 1992, p. 145; Haslehner, *IStR* (2008) p. 565.

[201] See Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, p. 4.

Thus, the main part of the harmonization in the direct tax area is not based on legislative efforts. Rather, the ECJ, in applying its monopoly for interpretation of Union legislation, achieves harmonization in a judicial way. This effect of harmonization through the ECJ is called 'negative integration'.[202] The ECJ has held in settled case law that despite a lack of harmonization of direct taxes, the fundamental freedoms must be obeyed by the Member States:[203]

> *Although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law (see the judgment in Case C-246/89 Commission v United Kingdom [1991] ECR I-4585, paragraph 12).*

1.2. Primacy and direct effect of TFEU provisions

The effectiveness of Union law – the 'effet utile' – is secured by various characteristics,[204] above all the primacy of Union law over national law and the direct effect of all Union law provisions which are unconditional and precise enough.[205] The ECJ has confirmed the direct effect of the provisions governing the fundamental freedoms.[206] The principles of direct effect and primacy are closely linked with each other and should ensure the uniform application of Union law.[207]

'Primacy' means that Union law takes precedence over national material law, national procedural law, constitutional law, and international law, e.g. tax treaties.[208] Unlike public international law, the primacy of Union law is not embodied in the national laws of the Member States, but in Union law itself. Thus, Union law is a new, *sui generis*, system of law.[209] It is not *inter*national, but *supra*national law.[210] In contrast to international law, a state cannot choose

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[202] See Terra/Wattel, *European Tax Law*[5], p. 29; see also Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, p. 5; Dourado, *EC Tax Review* (1994) p. 177.
[203] ECJ 14 February 1995, C-279/93, Schumacker [1995] ECR I-00225, para. 21. The influence of the fundamental freedoms on the tax laws of the Member States can also be implicitly deduced from the tax clause contained in Art. 65 TFEU, which allows for restrictions of the free movement of capital by tax laws; see Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 756.
[204] Also the consistent interpretation of national law according to Union law, State liability for serious damages caused by a breach of Union law, and the effective access to judicial protection to enforce rights derived by Union law; see Terra/Wattel, *European Tax Law*[5], p. 83; Kapteyn, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 545 et seq.
[205] See Terra/Wattel, *European Tax Law*[5], p. 83; Kapteyn, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 515.
[206] ECJ *Van Gend & Loos*; see Behrens, *EuR* 1992, p. 147; Eberhartinger, *EWS* 1997, p. 43. The free movement of capital was only granted direct effect in 1994; see chapter 2.5.
[207] See Kapteyn, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 537 et seq.
[208] ECJ 15 July 1964, 6/64, *Costa/ENEL* [1964] ECR 585; see Timmermans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 77.
[209] See Adamczyk, in Lang et al. (eds.) *Introduction to European Tax Law*[2], p. 15.
[210] See Kingreen, *Die Struktur der Grundfreiheiten* 24; Hakenberg, *Grundzüge*, p. 18.

whether to comply with Union law, as there is an enforcement body, namely the ECJ.[211] This is due to the fact that the Member States have partly given up their sovereignty for the benefit of the EU.[212]

The ECJ has the monopoly to interpret Union law. Its judgments are binding for the legislative, administrative, and judicial bodies of the Member States.[213] If national provisions are in conflict with Union law, they must not be applied by either of three branches.[214] However, this non-application only reaches as far as Union law is infringed.[215] In these cases, Union law replaces the national provision.[216] However, if the ECJ finds a national law provision to be in conflict with Union law, it does not create a new legal basis. Rather, it leaves the national provision without replacement, creating a kind of 'vacuum'.[217]

If possible, the national provision that is in conflict with Union law can simply be interpreted differently to be in line with Union law. This means of interpretation can be classified as a form of systematic interpretation.[218] However, if the wording, as well as the teleological and historical interpretation do not allow for a meaning that is in line with Union law, the provision in question has to be changed by the lawmaker.[219]

The fundamental freedoms do not interfere with the tax laws of the Member States per se, i.e., they do not have a harmonizing effect. Rather, they prohibit discrimination and restriction within the EU compared to the treatment that is provided for internal cases.[220] Thus, a tax law provision may only infringe the fundamental freedoms if it provides for different treatment of persons that are in a comparable situation.[221] Also, the fundamental freedoms only protect the cross-border situation. The fundamental freedoms set a minimum standard for the tax laws of the Member States dealing with cross-border movements: The treatment has to be at least as good as for the internal situation.[222]

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[211] See Timmermans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 75.
[212] See Timmermans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 76 et seq (with reference to ECJ 5 February 1963, 26/62, *Van Gend & Loos* [1963] ECR 1, para. 10) and 78. However, the EU only has sovereignty where it was given to it by the Member States in the treaties founding the Community; see Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, p. 5; Hakenberg, *Grundzüge*, p. 25.
[213] See Lang, in Tipke et al. (eds.) *FS Lang*, p. 1004.
[214] See Kapteyn, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 538; Lang, in Tipke et al. (eds.) *FS Lang*, p. 1004.
[215] See Hakenberg, *Grundzüge*, pp. 64 et seq.
[216] See Timmermans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 78 et seq.; Lang, in Tipke et al. (eds.) *FS Lang*, p. 1013.
[217] See Kingreen, *Die Struktur der Grundfreiheiten*, p. 34.
[218] Lang, in Tipke et al. (eds.) *FS Lang*, p. 1004.
[219] See Lang, in Tipke et al. (eds.) *FS Lang*, p. 1004.
[220] And towards third countries as far as the free movement of capital is concerned. See in detail chapter 4.1.
[221] See Lang, in Tipke et al. (eds.) *FS Lang*, p. 1015.
[222] See Lang, in Tipke et al. (eds.) *FS Lang*, pp. 1007-1008.

It follows that the lawmaker has different options when bringing their national law in line with Union law. Either, they can grant the favorable treatment of the internal situation also to the cross-border situation. Or, they can abolish the provision that provides less favorable treatment of the cross-border situation.[223] Both approaches have the same effect, namely that in the end internal and intra-EU situations are both given the more favorable treatment. However, the lawmakers can also achieve accord with Union law if they cancel the favorable treatment of the internal situation and give them the same – but worse – treatment as the cross-border situation.[224]

Due to the fact that ECJ judgments only interpret Union law provisions, they are also valid retroactively.[225] Also, even though ECJ judgments in the form of a preliminary ruling concern a specific case pending at a Member State's court, the interpretation given by the ECJ also affects other open cases and even similar provisions of other Member States. Thus, cases that are pending at administrative bodies and courts in any Member State have to be decided based on the ECJ judgment, even if the national law still contains the provision in conflict with EU law. Like the legislative organs, the administrative and judicial branch can often choose between various options to achieve conformity of their decisions with EU law.[226] However, in contrast to the legislative body, they can only change the treatment of the cross-border situation in applying the fundamental freedoms, because they do not interfere with the treatment of the internal situation.[227] The primacy of EU law only concerns cross-border situations.[228] Thus, administration and courts can only apply the more favorable treatment to both situations.[229]

If the different treatment based on withholding taxes that has been demonstrated in chapter II. was found to infringe the fundamental freedoms, there would be several options to achieve a

[223] See Lang, in Tipke et al. (eds.) *FS Lang*, p. 1005.
[224] See Lang, in Tipke et al. (eds.) *FS Lang*, p. 1006.
[225] Under certain circumstances the ECJ can deny the retroactive effect of a judgment.
[226] See Lang, in Tipke et al. (eds.) *FS Lang*, pp. 1005 et seq.; Zorn, *SWK* (2008), p. S 470.
[227] See Lang, in Tipke et al. (eds.) *FS Lang*, p. 1015. It is debated whether the fundamental freedoms lead to the non-application of the conflicting national provision – possibly leading to non-taxation – or to the application of a similar provision governing internal cases. In favor of the latter see Lang, in Tipke et al. (eds.) *FS Lang*, p. 1029.
[228] See Lang, in Tipke et al. (eds.) *FS Lang*, pp. 1015-1016.
[229] See Lang, in Tipke et al. (eds.) *FS Lang*, pp. 1006-1007. However, due to the fact that the fundamental freedoms only set a minimum standard based on the internal treatment, cross-border situations can also be treated more favorably than the internal situation.
For the alternative choices of EU-law-conform interpretation by the administration and the courts see in detail Lang, in Tipke et al. (eds.) *FS Lang*, pp. 1008 et seq.
If there are various options, Zorn argues that the option which represents the smallest change of national law has to be chosen by the judiciary. This will usually not be non-taxation, even though it would be a possible solution to respect the fundamental freedoms (Zorn, *RdW* 2009, pp. 171 et seq.; see also Zorn, *SWK* 2008, pp. S 469 et seq.).
Lang argues that the cross-border situation should be treated in accordance with the law that does not contradict Union law. The result would be an analogous application of the law concerning internal situations (Lang, *SWI* 2009, p. 219).

situation that respects Union law. In regard to tax collection at withholding, the lawmaker could introduce tax collection through withholding taxes also for residents. Or, the lawmaker could abolish withholding tax regimes that are solely aimed at non-residents and also tax non-residents at assessment. The lawmaker could even refrain from taxing non-residents at all, because the fundamental freedoms always allow better treatment of the cross-border situation compared to the internal situation. If a Member State's withholding obligation was held to be against Union law and a change in law was not yet initiated, the tax authorities and the judiciary could grant a tax exemption to non-residents to achieve an EU-law-conform interpretation. This interpretation, however, would be farfetched if residents were taxed at assessment. Rather, tax assessment should also be applied to non-resident taxpayers.[230]

In regard to the different tax amount levied at withholding, the lawmaker could abolish tax exemptions that are only granted to resident taxpayers and provide for gross taxation at flat tax rates also for residents. Or, the lawmaker could expand tax exemptions to non-residents and apply net taxation at progressive tax rates to them. The tax authorities and the judiciary could equally adopt the second alternative, but not the first one. It may be argued that instead of granting analogous tax exemptions,[231] the tax authorities and the judiciary may also provide for taxation of non-residents that is in line with EU law and restricts the national law in a lesser way than a tax exemption.[232]

Besides the primacy of EU law, the direct effect is the second cornerstone of the 'effet utile'. Due to the direct effect, persons can rely on EU legislation in court proceedings against Member States.[233] The requirements for the direct effect of Union law are that the provision is precise, clear and unconditional.[234] 'Sufficiently precise' means that the provision is written in unequivocal terms in order to be relied on by private persons and to be applied by the Court.[235] 'Unconditional' means that the provision is not subject to any measure by the Union or the Member State in its implementation or effects.[236] If a provision has direct effect, it confers legally enforceable rights.[237] This is called the 'vertical direct effect'.[238] The 'horizontal direct effect' refers to cases where private

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[230] Analogous application of persisting law according to Lang (*SWI* 2009, pp. 216 et seq.).
[231] Analogous application of persisting law according to Lang (*SWI* 2009, pp. 216 et seq.).
[232] Lowest restriction of national law according to Zorn (*RdW* 2009, pp. 171 et seq.).
[233] See Timmermans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 79; Kapteyn, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 512; for the free movement of capital see Ståhl, *EC Tax Review* (2004) p. 47 (with reference to ECJ 14 December 1995, C-163, 165 and 250/94 *Sanz de Lera* [1995] ECR I-4821).
[234] ECJ 5 February 1963, 26/62, *Van Gend & Loos* [1963] ECR 1.
[235] See Kapteyn, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 516.
[236] See Kapteyn, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 515 et seq.
[237] See Adamczyk, in Lang et al. (eds.) *Introduction to European Tax Law*[2], p. 14.
[238] For the vertical direct effect and the inverse vertical direct effect of directives see Kapteyn, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 531 et seq.

parties rely on Union law against other private parties.[239] The fundamental freedoms all have direct effect.

Again, the direct effect of Union law is a proof for the difference to public international law. Union law confers directly enforceable rights. In contrast, public international law only binds the contracting states. The individual cannot rely on international law provisions and cannot be bound by them.[240]

Direct applicability of EU law, on the other hand, means that EU law does not need to be transformed into national law.[241] The TFEU forms part of the national laws of the Member States.[242] Therefore, if national law infringes provisions in the TFEU, e.g. the fundamental freedoms, the national law must not be applied in the extent of the infringement.[243] In contrast, public international law has to be transformed into national law in order to be applicable in the states concerned.[244]

1.3. Convergence of the fundamental freedoms

The fundamental freedoms are the core of the provisions embodied in the TFEU that establish the single market.[245] The TFEU does not establish a single market by granting free movement in general. Rather, the Treaty provides for free movement concerning each kind of commercial activity: for the trade in goods and services, for the exchange of production factors (capital and labor), and for the payment for these transactions.[246]

Despite the separate framing and different wording of the fundamental freedoms provisions, the ECJ applies the same reasoning to all of them.[247] Due to the converging interpretation of the fundamental freedoms by the ECJ,[248] it is not decisive which freedom is applied, as the standards of examination are the same. If one of the freedoms is applicable, the same result should be achieved, no matter which one it is.[249] This principle of convergence of the fundamental freedoms is essential

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[239] See Kapteyn, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 515 and 532 et seq; Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 591 with further references to the discussion in literature.

[240] See Kingreen, *Die Struktur der Grundfreiheiten*, p. 24; Hakenberg, *Grundzüge*, p. 18.

[241] See Kapteyn, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 512.

[242] See Adamczyk, in Lang et al. (eds.) *Introduction to European Tax Law*[2], p. 15.

[243] See Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*[2], p. 44; Kingreen, *Die Struktur der Grundfreiheiten*, p. 34.

[244] See Hakenberg, *Grundzüge*, p. 18.

[245] See Behrens, *EuR* 1992, p. 145.

[246] See Behrens, *EuR* 1992, pp. 145-146.

[247] See Terra/Wattel, *European Tax Law*[5], p. 51.

[248] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 593; Moritz, *Das Diskriminierungsverbot*, p. 328; Eberhartinger, *EWS* 1997, p. 43.

[249] See Terra/Wattel, *European Tax Law*[5], p. 56; Eberhartinger, *EWS* 1997, p. 48.

to ensure the functioning of the internal market through practicability and legal certainty.[250] Thus, the ECJ may also examine various applicable fundamental freedoms at once and achieve one single decision.[251]

The fundamental freedoms seek to ensure the free flow of goods, services, persons, and capital. However, they do not set common rules for all the Member States. Rather, they provide for a treatment of cross-border flows that is equal to that of flows within a single Member State. Thus, the fundamental freedoms only function in connection with the national laws of the Member States. When a Member State's law provides for different regimes for cross-border and internal situations, the fundamental freedoms come into play.[252]

The fundamental freedoms have a twofold effect: They should enable movement of goods, services, persons, and capital within the Union, thus, make a circulation possible. Therefore, the country of origin should not erect any barriers to free movement. This perspective is called 'market access'. The freedoms, however, also bind the country of destination. It must not discriminate against goods, services, persons, and capital from other countries.[253] This rule is called 'market equality'.

The fundamental freedoms typically forbid discrimination on grounds of nationality. This is referred to as 'overt' or 'direct' discrimination.[254] However, tax law usually does not differentiate according to nationality. Rather, the residence of persons serves as a connecting factor and leads to different treatment, either world-wide taxation or taxation based on a territorial connection. However, the fundamental freedoms also prohibit 'covert' or 'indirect' discrimination, which does not explicitly foresee a different treatment based on nationality, but whose effect is such a different treatment.[255] Thus, also discrimination on grounds of residence is forbidden, as it leads to covert discrimination mainly disadvantaging nationals of other Member States.[256] However, the fundamental freedoms are now considered to prohibit unfavorable treatment of cross-border cases

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[250] See Terra/Wattel, *European Tax Law*[5], p. 51; Hohenwarter, *Verlustverwertung*, p. 49.
[251] See Eberhartinger, *EWS* 1997, pp. 47 and 48 with reference to ECJ 20 May 1992, C-106/91, *Ramrath* [1992] ECR I-3351.
[252] See Classen, *EWS* 1995, pp. 97 and 105.
[253] The fundamental freedoms only protect cross-border movements and not mere internal cases; see Kingreen, *Die Struktur der Grundfreiheiten*, p. 75.
[254] See Classen, *EWS* 1995, p. 97.
[255] See for example ECJ 8 May 1990, C-175/88, *Biehl* [1990] ECR I-01779; see further Gudmundsson, *Intertax* (2006) p. 83.
[256] See Terra/Wattel, *European Tax Law*[5], p. 44; Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, p. 17; Moritz, *Das Diskriminierungsverbot*, pp. 311 and 312 et seq.; Behrens, *EuR* 1992, p. 151; Haslehner, *IStR* (2008) pp. 565-566.

compared to internal cases in general. For this reason the differentiation between overt and covert discrimination is not of great importance anymore.[257]

The TFEU contains explicit justifications for discriminations under the fundamental freedoms. They are similar across the converging fundamental freedoms that are applicable to direct taxes.[258] The justification based on public policy, public security and public health are included in the free movement of workers,[259] the freedom of establishment,[260] the freedom to provide services,[261] and the free movement of capital.[262]

Withholding taxes lead to a different treatment of residents and non-residents by the host state. The fundamental freedoms, however, require market equality in the host state. Thus, the different treatment might cause discrimination that is prohibited by the fundamental freedoms. Withholding taxes may only cause covert discrimination, because the differentiation in the tax collection method which may also have consequences for the tax amount is made between residents and non-residents and is not based on nationality. The result does not depend on the applicable freedom, because the standards are equal among all fundamental freedoms.

From their wording, the fundamental freedoms provisions originally took a non-discrimination approach. Thus, they were interpreted as providing for equal treatment of a Member State's nationals and nationals of other Member States.[263] However, starting with the free movement of goods, the ECJ has interpreted the fundamental freedoms not only to prohibit discriminations but also non-discriminatory restrictions to free movement.[264] It has applied a similar reasoning for all fundamental freedoms, thus, reaching a convergence between the different freedoms.[265] Unlike the other provisions on the fundamental freedoms, the free movement of capital and payments is worded to prohibit restrictions. Still, it also covers a non-discrimination approach.[266] With the Treaty of Amsterdam the provisions governing the fundamental freedoms were reworded to explicitly prohibit restrictions.[267]

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[257] See Haslehner, *IStR* (2008) p. 566.
[258] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 594 and 775; Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, p. 20.
[259] Art. 45 (3) TFEU.
[260] Art. 51 (1) TFEU.
[261] Art. 62 TFEU refers to Arts. 51 to 54 TFEU that regulate the freedom of establishment.
[262] Art. 65 (1) (b) TFEU with the exception that public health is not included.
[263] See Behrens, *EuR* 1992, p. 148; Classen, *EWS* 1995, p. 97; Haslehner, *IStR* (2008) p. 565.
[264] ECJ *Cassis-de-Dijon*, *Dassonville*; see Moritz, *Das Diskriminierungsverbot*, pp. 317 and 322; Kingreen, *Die Struktur der Grundfreiheiten*, pp. 38 et seq.; Behrens, *EuR* 1992, p. 149; Classen, *EWS* 1995, p. 97; Eberhartinger, *EWS* 1997, pp. 44 et seq; Haslehner, *IStR* (2008) p. 566. For the fundamental freedoms apart from the free movement of goods see Behrens, *EuR* 1992, pp. 150 et seq.
[265] See Behrens, *EuR* 1992, p. 151; Eberhartinger, *EWS* 1997, p. 48; Haslehner, *IStR* (2008) p. 566.
[266] See Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 755. For the particularities of the free movement of capital prior to the Treaty of Maastricht see Behrens, *EuR* 1992, pp. 154-155.
[267] See Haslehner, *IStR* (2008) p. 566.

In regard to non-discriminatory restrictions to free movement, the ECJ made the following statement in its *Bosman* decision:[268]

> *Provisions which preclude or deter a national of a Member State from leaving his country of origin in order to exercise his right to freedom of movement therefore constitute an obstacle to that freedom even if they apply without regard to the nationality of the workers concerned.*

For the direct tax area this means that even if tax measures are applied without distinction, they may be infringing the fundamental freedoms if they make cross-border movement less attractive. Such measures can only be upheld if they fulfill the following four criteria, referred to as the 'rule of reason':[269]

> *they must be applied in a non-discriminatory manner; they must be justified by imperative requirements in the general interest; they must be suitable for securing the attainment of the objective which they pursue; and they must not go beyond what is necessary in order to attain it.*

The rule of reason is applicable to all fundamental freedoms.[270] However, originally only non-discriminatory measures were open to a justification based on the 'rule of reason'.[271] Discriminatory measures could only be justified by reasons explicitly written in the TFEU, which are public policy, public security, and public health.[272] Thus, it made a difference for the case law of the ECJ whether a discriminatory measure or a measure without distinction was tested against the fundamental freedoms. There was a greater possibility to justify a non-discriminatory measure.[273] However, the ECJ is not very consistent in this respect and now accepts a justification under the rule of reason also for discriminatory measures.[274] Thus, if withholding taxes were found to be discriminatory, it would have to be examined if they are justified by imperative requirements in the general interest.[275]

Maybe due to this lack of a clear separation, some scholars argue that the distinction between discrimination and restriction is unnecessary. In most cases the ECJ follows a discrimination

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[268] ECJ 15 December 1995, C-415/93, *Bosman* [1995] ECR I-04921, para. 96.
[269] ECJ 31 March 1993, C-19/92, *Kraus* [1993] ECR I-1663, para. 32; 30 November 1995, C-55/94, *Gebhard* [1995] ECR I-4165, para. 37; see Haslehner, *IStR* (2008) p. 566.
[270] See Terra/Wattel, *European Tax Law*[5], p. 51.
[271] Starting with 'measures having an effect equivalent to a quantitative restriction on imports' in the *'Cassis de Dijon'* decision; ECJ 20 February 1979, 120/78, *Rewe-Zentral AG* [1979] 00649.
[272] See Kingreen, *Die Struktur der Grundfreiheiten*, pp. 72 and critically 114 et seq; Moritz, *Das Diskriminierungsverbot*, p. 320.
[273] See Classen, *EWS* 1995, p. 98.
[274] See Terra/Wattel, *European Tax Law*[5], p. 65.
[275] See chapter V.

test and looks for a comparison to the cross-border situation.[276] Only some direct tax cases could be seen as restriction cases.[277] However, even these cases can be solved on a discrimination basis by comparing the cross-border situation with the non-regulated internal situation or the whole legal system of the concerned Member State.[278] Moreover, Lang argues that even when applying a restriction approach tax cases require a comparison. Otherwise, every taxation of a cross-border situation may be considered as a restriction. The restriction approach is only a short version of the discrimination approach.[279]

In contrast to discrimination or restrictions, the fundamental freedoms are not infringed if disadvantages are caused by disparities.[280] Disadvantages by disparities are caused by more than one Member State, whereas discrimination or restrictions are always caused by rules of one single jurisdiction.[281] The most prominent examples for disparities in the area of direct taxes are differences in tax rates. Therefore, if the level of taxation is higher in the host state than it was in the home state of a taxpayer, this disadvantage is not prohibited by the fundamental freedoms.[282] Disparities can only be overcome by harmonization.[283]

Apart from disparities, dislocations can also cause disadvantages that are permissible under EU law. Dislocations arise due to the cross-border activity of a taxpayer. However, the disadvantage is neither caused by his home state, nor his host state but by the parallel application of both tax regimes. Also, the disadvantage does not arise because of differences in the two tax regimes, but because of the general differentiation between unlimited and limited tax liability.[284] Disparities may lead to double taxation which cannot be overcome by applying the fundamental freedoms. The Court refrains from allocating the taxing power to one of the Member States. It is not up to the Court to decide which state should be allowed to tax which income. It is not a matter of Union law to decide which system of taxation – worldwide or territorial – is the better one. Also, the fundamental freedoms do not prohibit juridical double taxation. Therefore, the problem of double taxation cannot be solved by reference to the fundamental freedoms. Not even harmonization can counter double

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[276] In a restriction test there is no need for a comparator; see Kingreen, *Die Struktur der Grundfreiheiten*, p. 39.

[277] A prominent example that is usually given for a direct tax case solved on a restriction basis is the *Futura Participations* case (ECJ 15 May 1997, C-250/95, *Futura Participations* [1997] ECR I-02471); see for many Moritz, *Das Diskriminierungsverbot*, p. 339.

[278] Lang, *Rechtsprechung des EuGH*, p. 35; see also Kingreen, *Die Struktur der Grundfreiheiten*, p. 72.

[279] Lang, *Rechtsprechung des EuGH*, pp. 34-35.

[280] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 591; Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, p. 6; Behrens, *EuR* 1992, p. 148.

[281] See Terra/Wattel, *European Tax Law*[5], p. 68.

[282] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 707 (concerning the free movement of workers).

[283] See Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, p. 6; Moritz, *Das Diskriminierungsverbot*, p. 296; See Behrens, *EuR* 1992, p. 148.

[284] See Terra/Wattel, *European Tax Law*[5], pp. 69 et seq; Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, p. 6.

taxation. Even if all EU Member States had the same tax law system, problems of double taxation could still arise because of the co-existence of unlimited and limited tax liability.

2. The fundamental freedoms

2.1. The free movement of goods

The free movement of goods[285] prohibits any restrictions on the import and export of goods including measures having an equivalent effect. Also, it prohibits any charges to be levied on the cross-border movement of goods, including taxes. It applies to the cross-border movement of goods within the EU.

The free movement of goods applies if the good originated within the EU or was brought into free circulation within the EU, without distinction between the two cases.[286] 'Free circulation' means that the import formalities have been complied with and duties have been paid in a Member State.[287] The free movement of goods applies irrespective of the nationality of the purchaser of importer of the good.[288]

The term 'good' is not defined in the TFEU. According to ECJ case law, a good is a product which can be valued in money and can be subject of commercial transactions.[289] The Court has held that intellectual property rights are not goods[290] and that electricity is.[291] The definition of a good is important to distinguish the free movement of goods from the freedom to provide services and the free movement of capital.[292] The free movement of goods is mainly applicable to tangible goods and if the supply of the good is the major characteristic of a mixed contract also including the provision of a service.[293] Also, the free movement of goods is applied to money that is no valid means of transaction.[294]

In the direct tax area, the free movement of goods plays a very minor role.[295] However, the free movement of goods has been involved in direct tax cases. Examples are the *Commission v.*

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[285] Arts. 28 et seq. TFEU.
[286] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 602 et seq.
[287] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 602 with reference to ECJ 1 December 1965, 16/65, *Firma Schwarze* [1965] ECR 877.
[288] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 601.
[289] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 599 with reference to ECJ 10 December 1968, 7/68, *Commission v. Italy* [1968] ECR 423, para. 428; Kingreen, *Die Struktur der Grundfreiheiten*, p. 21.
[290] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 599 et seq with reference to ECJ 21 October 1999, C-97/98, *Jägerskiöld* [1999] ECR I-07319.
[291] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 599 et seq with reference to ECJ 15 July 1964, 6/64, *Costa/ENEL* [1964] ECR 585; see also Haslehner, *IStR* (2008) p. 566.
[292] See Haslehner, *IStR* (2008) p. 566.
[293] See Haslehner, *IStR* (2008) pp. 566-567.
[294] See Haslehner, *IStR* (2008) p. 567; Freitag, *EWS* (1997) p. 189.
[295] See Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*[2], p. 43; Haslehner, *IStR* (2008) p. 566.

France case concerning newspaper publishers and the *Krantz* case.[296] Concerning withholding taxes, the free movement of goods has never been dealt with by the ECJ and is considered not to be relevant.

2.2. The freedom to provide services

The freedom to provide services[297] prohibits any discrimination of service providers of one Member State in the other Member State. Also, it ensures that the service provider can freely enter the market of another Member State.[298] Additionally, it also protects the recipient of the service if the receipt of foreign services is treated less favorably.[299] That concerns cases when the service provider crosses the border. Also, cases where the purchaser of the service crosses the border in order to obtain services in another Member State are protected by the freedom to provide services.[300] The latter scenario includes also tourists.[301] As a third scenario, also cases where both the recipient and the service provider move to a third Member State for the performance of the service are covered. Last, the freedom to provide services also applies if neither the service provider nor the recipient of the service cross a border, but the service itself is provided cross-border.[302] This could be the case with telecommunication services, for example.[303]

The freedom to provide services is only applicable to nationals of a Member State[304] who are established in a Member State and provide services to a person of another Member State. In contrast, the recipient of the service may also have the nationality of a third State, as long as he is established within the EU.[305] Companies, like individuals, are also covered by the freedom to provide services if they are linked to at least one Member State.[306] If employees of the service provider move together with him, they are also protected by the freedom to provide services.[307]

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[296] ECJ 7 May 1985, 18/84, *Commission v. France* [1985] ECR 1339; ECJ 7 March 1990, C-69/88, *Krantz* [1990] ECR I-583; see for more details Terra/Wattel, *European Tax Law*[5], pp. 52 et seq.

[297] Arts. 56 et seq. TFEU.

[298] See Terra/Wattel, *European Tax Law*[5], p. 53; Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, p. 13.

[299] See ECJ 3 October 2006, C-290/04, *Scorpio* [2006] ECR I-09461, para. 32.

[300] See ECJ 3 October 2006, C-290/04, *Scorpio* [2006] ECR I-09461, para. 64; see also Behrens, *EuR* 1992, p. 159.

[301] See Terra/Wattel, *European Tax Law*[5], p. 53; Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 747 et seq. For the distinction between active and passive free movement of services see Kingreen, *Die Struktur der Grundfreiheiten*, p. 22; Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, pp. 19 et seq.

[302] See ECJ 3 October 2006, C-290/04, *Scorpio* [2006] ECR I-09461, para. 64; see also Haslehner, *IStR* (2008) p. 568.

[303] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 747; Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, pp. 19 et seq.; Behrens, *EuR* 1992, p. 159.

[304] See ECJ 3 October 2006, C-290/04, *Scorpio* [2006] ECR I-09461, paras. 67-68.

[305] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 746.

[306] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 747.

[307] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 747 (with reference to ECJ case law).

Services are economic activities that are provided in exchange for remuneration.[308] They include in particular: *"activities of an industrial character; activities of a commercial character; activities of craftsmen; activities of the professions"*.[309] Terra/Wattel also name *"banking and insurance, data transmission, tourism services, broadcasting services, internet mail order services, telephone, television and the provision, via the internet, of digitalized 'goods' (or services?) like software, information, music and film"*.[310] Leasing contracts are also covered by the freedom to provide services.[311] Above all, services can be distinguished from goods in that they are intangible.[312] For direct tax cases, cross-border insurance contracts have played an important role.

According to the wording of the TFEU, the freedom to provide services is only applied if the other fundamental freedoms are not applicable. However, the ECJ has not always been consistent in following this order of application.[313] The Court has clarified in its judgment in *Fidium Finanz* that the wording of the TFEU only implies that the definition of services should function as a 'catch-all clause', but not that the freedom to provide services is applied in a subsidiary manner.[314] Services can involve goods or capital and can be delivered from a fixed base established in the other Member State. Nonetheless, they can also be provided in the absence of the goods, capital or an establishment. In these cases, the freedom to provide services should be applied.[315]

The TFEU uses the word 'temporary' to describe the freedom to provide services. The service provider may temporarily pursue his activity in the Member State of the service recipient under the same conditions as nationals of that Member State.[316] With this reference, the freedom can be distinguished from the freedom of establishment. The latter requires a permanent presence in the host state. The freedom to provide services, however, only applies if the services are provided on a temporary basis.[317]

In regard to withholding taxes, the freedom to provide services is if great importance. It has been explained in chapter II.1.1.2. that income earned by non-residents from services of a temporary nature is often subject to withholding in the source state. This is due to the fact that the lack of a

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[308] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 745 (with reference to ECJ case law); Hakenberg, *Grundzüge*, p. 117.
[309] Art. 57 TFEU; see Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*[2], p. 47.
[310] Terra/Wattel, *European Tax Law*[5], p. 53.
[311] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 745 (with reference to ECJ 21 March 2002, C-451/99, *Cura Anlagen* [2002] ECR I-03193).
[312] See Terra/Wattel, *European Tax Law*[5], p. 53; Kingreen, *Die Struktur der Grundfreiheiten*, p. 22; Haslehner, *IStR* (2008) p. 566.
[313] For the ECJ-developed order of priority in case of overlapping freedoms see chapter 3.
[314] ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, para. 32.
[315] See Terra/Wattel, *European Tax Law*[5], p. 53; See Haslehner, *IStR* (2008) p. 568.
[316] Art. 57 last sentence TFEU.
[317] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 746; Haslehner, *IStR* (2008) p. 565.

fixed nature of the activity makes the income prone to tax avoidance. Thus, withholding taxes are prescribed in order to ensure taxation. The freedom to provide services requires that non-resident service providers are not discriminated against. Equally, the service recipient must not be treated less favorably when receiving services from a non-resident. It was shown in chapter II. that both the service provider and the service recipient are treated differently due to the levy of withholding taxes.

2.3. The free movement of workers

The free movement of workers[318] provides for non-discrimination concerning employment, salary, and work conditions. It grants the rights to reside and move freely in a Member State, to apply for employment and work.

The provision covers workers who are nationals of EU Member States.[319] The free movement of workers prohibits discrimination based on nationality. However, as mentioned in chapter 1.3. also covert discrimination, which is not primarily linked to nationality, is forbidden. Also, Art. 45 TFEU grants employees the right to leave their Member State of origin.[320] The free movement of workers is addressed to public authorities, but also private parties. It can be relied on by the employee and the employer alike.[321]

In order for Art. 45 TFEU to be applicable, there must be an employment relationship. The term 'employment' must not be interpreted according to the national laws of the Member States, but has a Union-wide autonomous meaning.[322] According to case law of the ECJ, an employment takes place when an individual performs services over a certain period of time for and under the direction of another person and receives remuneration in return.[323] Also, short term employment, e.g. an internship, can be regarded as employment covered by the free movement of workers.[324] The same is true for a traineeship that serves as preparation for the pursuit of an occupation.[325] However, activities of a non-economic nature are not covered by the free movement of workers.[326] These

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[318] Arts. 45 et seq. TFEU.

[319] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 701; Hakenberg, *Grundzüge*, p. 103.

[320] See Terra/Wattel, *European Tax Law*[5], pp. 54 et seq; Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 705 et seq; Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, pp. 18 et seq.

[321] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 704.

[322] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 699 (with reference to ECJ case law).

[323] See Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*[2], p. 46 (with reference to ECJ 3 July 1986, 66/85, *Lawrie-Blum* [1986] ECR 2121, para. 17); Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 700.

[324] See ECJ 1 July 2004, C-169/03, *Wallentin* [2004] ECR I-6443.

[325] See ECJ 3 July 1986, 66/85, *Lawrie-Blum* [1986] ECR 2121.

[326] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 700.

criteria are crucial to distinguish the free movement of workers from the freedom of establishment and the freedom to provide services.[327]

For direct taxation, the free movement of workers has gained significant importance. In the area of withholding taxes, however, the free movement of workers is not considered to be relevant. First, withholding taxes, i.e. wage taxes, are often prescribed for resident and non-resident taxpayers alike. Thus, no different treatment, which could be prohibited by the fundamental freedoms, arises. Second, there is no special need to subject non-resident workers to a withholding tax, because they have a permanent link to the source state through their employer. Thus, there is no significant risk that the income from employment would escape taxation. For these reasons, withholding taxes have not been dealt with by the ECJ in the light of free movement of workers.

2.4. The freedom of establishment

The freedom of establishment[328] applies to individuals and companies alike.[329] For individuals it provides for the right to pursue independent activities and to set up undertakings in another Member State. Companies, accordingly, have the right to set up their activities in another Member State. The decisive criterion for the application of the freedom of establishment is the pursuit of an economic activity in another Member State, i.e., the supply of goods or services in exchange for money.[330] The freedom covers both primary establishment, which is the change of a person's residence, and secondary establishment, which is the establishment of branches or subsidiaries.[331] Also, the freedom of establishment provides for non-discrimination in the host state.[332] Addressees of the freedom of establishment are both public authorities and private entities.[333]

The freedom of establishment applies to nationals of a Member State. The residence of the person, however, is not decisive. The only limitation that is connected to the residence of a person is that the right to set up a secondary establishment within the EU is limited to nationals of a Member State who have a primary residence within the EU.[334] As far as companies are concerned, they are covered by the freedom of establishment if they are formed in accordance with the law of a Member State and have their registered office, central administration or principal place of business within the EU.[335]

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[327] See Haslehner, *IStR* (2008) p. 567.
[328] Arts. 49 et seq. TFEU.
[329] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 719 and 721.
[330] See Haslehner, *IStR* (2008) p. 567.
[331] See Hakenberg, *Grundzüge*, p. 112.
[332] See Terra/Wattel, *European Tax Law*[5], p. 55.
[333] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 724.
[334] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 720 et seq.
[335] Art. 54 TFEU; see Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 722.

The freedom of establishment and the freedom to provide services both apply to independent activities.[336] The distinction is made according to whether the person moves to the host state just for a limited period of time without establishing a fixed base there, or whether the activities of the person are of a permanent character.[337] The determination of a fixed base for cases concerning direct taxes can be made according to the international tax law definition of a fixed base, i.e., a permanent establishment.[338] The temporary nature of the activities consists not only of the duration, however, but also includes frequency, periodicity, and continuity.[339]

Most important, the freedom of establishment has to be distinguished from the free movement of capital. The free movement of capital applies to any purchase of shares in a company, because money is transferred cross-border. The freedom of establishment, however, only applies if the buying company can influence and control the company in which the participation was purchased. As a consequence, basically both freedoms apply to direct investments in a company of another Member State.[340]

In regard to withholding taxes levied on service payments, the freedom of establishment is typically not relevant. Withholding taxes are usually prescribed for highly mobile activities that to not include the establishment of a fixed base in the source state. Due to the fixed nature of the establishment, withholding taxes are not needed to ensure the taxation of the income.

As far as passive income is concerned, though, the freedom of establishment may influence the levy of withholding taxes by Member States. The withholding obligation for investment income may not depend on the activities of the taxpayer in the source state and also apply in the case of a fixed base in the source state. Another possibility would be that the establishment itself, i.e., the subsidiary, makes the payment to the non-resident. Then, of course, the non-resident may not pass the activity test and be classified to receive passive income, because the parent company and the subsidiary are two separate entities for tax purposes. In these cases, withholding taxes may be levied on dividend, interest, royalty, or capital gains income by the source state. Because the set-up of subsidiaries is covered by the freedom of establishment, however, the payment made from the subsidiary to its parent company is protected by it.

2.5. The free movement of capital

[336] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 744.

[337] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 719 et seq; Hakenberg, *Grundzüge*, p. 110; See Haslehner, *IStR* (2008) p. 567.

[338] See Haslehner, *IStR* (2008) p. 567.

[339] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 720 (with reference to ECJ 30 November 1995, C-55/94 *Gebhard* [1995] ECR I-04165).

[340] See Haslehner, *IStR* (2008) p. 567. Concerning the determination of the applicable freedom see chapter 3.

Arts. 63 et seq. TFEU grant the free movement of capital and payments. The freedom not only prohibits discriminatory measures, but explicitly also restrictions.[341] According to Schön, capital should be invested wherever it achieves the highest yield. Therefore, all barriers to its free movement had to be removed.[342] The free movement of capital has a special standing among all the freedoms, because it is not only applicable between Member States but also to capital movements between Member States and third countries. Therefore, and because the free movement of capital is object-based, unlike for the other fundamental freedoms, the beneficiaries of the free movement of capital are not limited in any way.[343]

Until the free movement of capital was granted full direct effect in 1994,[344] it did not enjoy great importance.[345] With the Treaty of Maastricht it was incorporated in primary EU law and granted direct effect.[346] Thereby it was brought in line with the other fundamental freedoms.[347] Before, the free movement of capital was only provided for by secondary EU law.[348] However, since its incorporation in the Treaty of Maastricht it has impressively caught up.[349]

From the TFEU itself it cannot be derived what is a movement of capital.[350] The ECJ, however, in interpreting the provisions of the TFEU has made reference to the Capital Movement Directive.[351] This directive contains a nomenclature of what constitutes capital movement, although it is non-exhaustive.[352] Capital movements include financial transactions concerning capital in kind and money capital.[353] It compromises paid and unpaid exchanges of value, e.g., direct investment, real estate investment, security transactions, loans, guarantees, gifts, and inheritances. Also the receipts for the

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[341] See Ståhl, *EC Tax Review* (2004) p. 47.

[342] Schön, in Schön (ed.) *GS Knobbe-Keuk*, pp. 745-746.

[343] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 767 et seq; Ståhl, *EC Tax Review* (2004) p. 47; Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 755; see also Haslehner, *IStR* (2008) pp. 568 and 569.

[344] While the other fundamental freedoms were granted direct effect in 1970; see Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 766; Moritz, *Das Diskriminierungsverbot*, p. 296.

[345] See Dourado, *EC Tax Review* (1994) p. 177; Moritz, *Das Diskriminierungsverbot*, p. 335; Hakenberg, *Grundzüge*, p. 125; Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 746.

[346] The European Community turned from an economic union into a monetary union, which made the free movement of capital essential; Peters/Gooijer, *ET* (2005) p. 476.

[347] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 578; Moritz, *Das Diskriminierungsverbot*, p. 333; Freitag, *EWS* (1997) p. 186.

[348] The Capital Movement Directive; see Geurts, *IStR* (2000) p. 572; Dourado, *EC Tax Review* (1994) p. 177.

[349] See Terra/Wattel, *European Tax Law*[5], p. 58.

[350] Which might be considered as a reason for the late start of ECJ case law on the free movement of capital; see Dourado, *EC Tax Review* (1994) p. 177.

[351] Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, OJ L 178 of 8 July 1988, pp. 5-18. However, secondary law is not binding for the interpretation of primary law; see Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 747.

[352] See Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*[2], p. 47 et seq.; See Haslehner, *IStR* (2008) p. 568.

[353] See Kingreen, *Die Struktur der Grundfreiheiten* 22; Hakenberg, *Grundzüge*, p. 124; Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 747.

provision of capital, i.e., dividends and interest, are covered by the free movement of capital.[354] In general, the term 'capital movement' has to be given a very broad meaning.[355] It covers also direct investment in the form of establishments.[356]

The free movement of capital potentially overlaps with the freedom of establishment and the freedom to provide services.[357] In the *Bachmann* case,[358] the ECJ applied the freedom to provide services but refrained from examining the free movement of capital, because the restriction concerning the insurance payments was not directly related to the free movement of capital, but followed indirectly from the restriction of the freedom to provide services. It could be concluded from this judgment that the free movement of capital has a subordinate function compared to the other freedoms.[359] However, later case law of the ECJ did not support the line of reasoning in the *Bachmann* case.[360] Also, it cannot be argued that the free movement of capital is subordinate to the other fundamental freedoms, just because every economic activity falling under the four other freedoms usually also involves the flow of capital.[361] In contrast, a primacy of the free movement of capital and payments could be argued on the basis that every economic activity covered by the fundamental freedoms requires the transfer of capital. However, such a primacy would render the other fundamental freedoms unnecessary and can, therefore, not be upheld.[362]

Capital movements are financial operations aimed at investment or profit-making activities. Payments, on the other hand, are remuneration for a particular transaction.[363] Thus, the free movement of payments complements the free movement of goods, services, persons and capital. None of them would make sense, if payments could not be made within the EU without restrictions.[364] Therefore, it could be argued the free movement of payments constitutes an additional freedom.[365]

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[354] See Haslehner, *IStR* (2008) p. 568.
[355] See Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 748.
[356] In the form of branches or subsidiaries; see Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 744. For the resulting overlap of the free movement of capital with the freedom of establishment see chapter 3.1.
[357] See in detail chapter 3.1.
[358] ECJ 28 January 1992, C-204/90, *Bachmann* [1992] ECR I-249.
[359] See Ståhl, *EC Tax Review* (2004) p. 49.
[360] ECJ *Svensson and Gustavsson*; see Haslehner, *IStR* (2008) p. 570; see also Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 748.
[361] See Haslehner, *IStR* (2008) p. 568; see also Dourado, *EC Tax Review* (1994) p. 179.
[362] See Geurts, *IStR* (2000) p. 572 with reference to ECJ case law.
[363] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 767. For the relationship between the free movement of capital and the free movement of payments see Schön, in Schön (ed.) *GS Knobbe-Keuk*, pp. 748-749.
[364] See Terra/Wattel, *European Tax Law*[5], p. 58; Kingreen, *Die Struktur der Grundfreiheiten*, p. 22; Hakenberg, *Grundzüge*, p. 123.
[365] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 578; Kingreen, *Die Struktur der Grundfreiheiten*, p. 20.

For the admissibility of withholding taxes within the EU, the free movement of capital plays an important role. Dividends and interest are receipts for the provision of capital and often taxed at withholding. If only non-residents are taxed at withholding on their capital income, while residents are taxed at assessment, different treatment as shown in chapter II.1. arises. Such different treatment is prohibited under the free movement of capital, if it amounts to discrimination. Also, capital must not be taxed higher because it flows cross-border. Higher taxation could keep taxpayers from investing their money abroad. Thus, a higher tax amount levied on capital income of non-residents could amount to a restriction on the free movement of capital that is prohibited by Art. 63 TFEU.

2.6. Non-discrimination under Art. 18 TFEU

The general non-discrimination clause of Art. 18 TFEU is only applicable if none of the fundamental freedoms covers a specific case. In contrast to the fundamental freedoms, it only prohibits discrimination, not restriction.[366]

Art. 18 TFEU lays down general rules for non-discrimination, also influencing the scope of the fundamental freedoms. Therefore, the interpretation of Art. 18 TFEU affects the interpretation of the fundamental freedoms provisions. Again, the convergence between the protection provisions of the TFEU becomes evident.[367]

2.7. Free movement under Art. 21 TFEU

The Treaty of Maastricht introduced the EU-citizenship.[368] Irrespective of an economic activity, Art. 21 TFEU provides the right to EU-nationals to move freely within the EU's territory. Moreover, it gives persons the right to reside wherever they want within the EU. It prohibits both restrictions on the free movement and discriminations. Therefore, it is closely related with the general non-discrimination provision of Art. 18 TFEU, which applies whenever a situation is not covered by any of the fundamental freedoms.[369]

In order for Art. 21 TFEU to be applicable, there must be a cross-border element. This means that the EU-national has to actually exercise his right of movement.[370] Moreover, if the movement is connected to an economic activity, e.g. dependent work, the free movement of workers precedes.[371]

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[366] See Kokott, in Lehner (ed.) *Grundfreiheiten im Steuerrecht*, p. 18.
[367] See Moritz, *Das Diskriminierungsverbot*, p. 308.
[368] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*^{4}, pp. 578 and 676.
[369] See Mortelmans, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*^{4}, pp. 590 et seq; Hakenberg, *Grundzüge*, p. 80.
[370] See Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*^{2}, p. 45.
[371] Art. 45 TFEU.

If, however, the former employee is already retired, the free movement of workers is no longer applicable and the retiree can call upon the free movement according to Art. 21 TFEU.[372]

[372] See Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*[2], p. 45 (with reference to ECJ 9 November 2006, C-520/04, *Turpeinen* [2006] ECR I-10685).

3. Determination of the applicable freedom

3.1. Overlap of the freedoms

The fundamental freedoms all have a very broad scope of application in order to cover a wide range of movements between the Member States. From this wide range it follows that one single situation may be covered by more than one fundamental freedom.[373] This may occur when a complex cross-border situation touches the scope of two or more fundamental freedoms at the same time or when the scope of the freedoms overlaps and a situation may be covered under both.[374] In order to find out which fundamental freedom is to be applied, it is vital to determine whether rules of priority exist among the fundamental freedoms or whether more than one freedom can be applied to the same situation.[375]

The non-discrimination clause of Art. 18 TFEU and the general free movement clause of Art. 21 TFEU function as catch-all clauses. This means that they are only applied if a cross-border situation cannot be covered by any of the five fundamental freedoms.[376] Among the fundamental freedoms, however, there are no explicit rules of priority.[377]

A potential overlap may occur between the free movement of workers and the freedom of establishment. This is true in cases in which it is not clear whether the taxpayer pursues a dependent or an independent activity. A prominent example is the one of the director of a company that also has a holding in the company. In the *Asscher* case decided by the ECJ, the Court applied the freedom of establishment because the director had a majority holding in the company and was, therefore, considered to be self-employed.[378]

Another possible conflict can occur between the freedom of establishment and free movement of capital.[379] In the case law of the ECJ, the overlap between these two freedoms has turned out to be the most relevant one. According to the wording of Art. 49 TFEU, the right of establishment covers the set-up of agencies, branches or subsidiaries. The scope of capital movement, in contrast, is not defined in the TFEU. However, the ECJ has made reference to the nomenclature of the Capital Movement Directive in order to interpret the provision.[380] The nomenclature refers to direct investment as one kind of capital movement, which also includes the

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[373] See Geurts, *IStR* (2000) p. 572.
[374] See Haslehner, *IStR* (2008) p. 566.
[375] See Haslehner, *IStR* (2008) p. 569.
[376] ECJ 21 January 2010, C-311/08, *SGI*, not yet published, para. 31.
[377] See Geurts, *IStR* (2000) p. 572.
[378] ECJ 27 June 1996, C-107/94, *Asscher* [1996] ECR I-03089, para. 26; see also Terra/Wattel, *European Tax Law*[5], p. 57.
[379] See, for example, ECJ 17 September 2009, C-182/08, *Glaxo Wellcome* [2009] ECR I-08591, paras. 39 et seq.
[380] Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty.

"establishment and extension of branches or new undertakings [...] and the acquisition in full of existing undertakings"[381] and the *"participation in new or existing undertaking with a view to establishing or maintaining lasting economic links"*[382]. Therefore, the freedom of establishment and the free movement of capital have a great area of overlap, namely concerning direct investments in the form of an establishment.[383]

In contrast to direct investment, mere financial and passive investment is only covered by the free movement of capital and not by the freedom of establishment, because it does not constitute an establishment.[384] Thus, to assess the scope of the freedom of establishment and its overlap with the free movement of capital, it has to be determined what constitutes direct investment. Schön suggests recourse to EU secondary law, more precisely the Capital Movement Directive.[385] The explanatory notes in the Capital Movement Directive give the following definition of 'direct investment':[386]

> *Investments of all kinds by natural persons or commercial, industrial or financial undertakings, and which serve to establish or to maintain* ***lasting and direct links*** *between the person providing the capital and the entrepreneur to whom or the undertaking to which the capital is made available in order to carry on an economic activity. This concept must therefore be understood in its widest sense. [...] [T]here is participation in the nature of direct investment where the block of shares held by a natural person of another undertaking or any other holder enables the shareholder, either pursuant to the provisions of national laws relating to companies limited by shares or otherwise,* ***to participate effectively in the management of the company or in its control****.*

Following this definition, direct investment requires lasting and direct links. This supports the differentiation between direct and portfolio investment with only the former falling under the freedom of establishment. If there are no lasting and direct links between the investor and the investment object, the provision of capital does not serve an establishment. Short-term investment typically has the aim to yield a high return and not to establish a fixed presence in the place of the investment. Also, in order to constitute direct investment, the shareholder must be able to

[381] Point I.1. of the nomenclature of Council Directive 88/361/EEC.
[382] Point I.2. of the nomenclature of Council Directive 88/361/EEC.
[383] See, e.g., Freitag, *EWS* (1997) p. 189.
[384] See Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 750.
[385] Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 750. Besides, Schön also refers to the "Angleichungsrichtlinien" for Art. 54 (3) (g) EEC (following a suggestion of Troberg) and the "Konzernabschlussrichtlinie" but does not support them as suitable means of interpretation; Schön, in Schön (ed.) *GS Knobbe-Keuk*, pp. 750-751; see also Geurts, *IStR* (2000) p. 573.
[386] Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, Explanatory Notes; emphasis added.

participate effectively in the management or control of the company due to his shareholding. Thus, he must be involved in decision-making. Again, if the shareholder cannot participate in the decisions of the company, his shareholding does not fulfill an establishment, but rather passive investment. It is important to stress that – according to the definition of 'direct investment' contained in the Capital Movement Directive – the shareholder must only participate in the management or control of the company, not run it alone.

The Capital Movement Directive does not further specify when it is possible for a shareholder to participate in the management or control of the company. Schön suggests assuming a possible participation in the management or control of a company beginning with a shareholding of 25 percent. He bases this assumption on the required size of shareholding for the application of the Parent-Subsidiary Directive[387] and the distinction made in Art. 10 (2) OECD Model Convention concerning direct and portfolio investment[388]. Thus, if a shareholder holds 25 percent of the stock or more, the freedom of establishment should apply according to Schön.[389]

The overlap between the freedom of establishment and the free movement of capital seems to have been taken into consideration also by the drafters of the TFEU.[390] Art. 49 TFEU, governing the freedom of establishment, is *"subject to the provisions of the Chapter relating to capital"*.[391] Similarly, the free movement of capital *"shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with the Treaties"*.[392] It is not clear what effect these cross-references have.[393] According to Schön, the references mean that neither of the two freedoms takes precedence over the other. Each of the two freedoms protects another dimension of the same activity.[394] The freedom of establishment is personalistic, whereas the free movement of capital is materialistic.[395] Advocate General Alber clarified in the *Baars* case that the cross-references do not mean that a case can only be covered by one of these freedoms. Rather, according to the case law of the ECJ up to that date (1999), the fundamental freedoms apply in parallel.[396] However, he came to the conclusion that the reciprocal reservations

[387] Recourse to the Parent-Subsidiary Directive cannot be supported, because the shareholding requirement changed over time, which would lead to an unjustified change in the interpretation of primary law.
[388] Reference to international tax law does not seem suitable for the interpretation of EU law.
[389] Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 751.
[390] And former treaties; see Ståhl, *EC Tax Review* (2004) p. 48; Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 749.
[391] Art. 49 last sentence TFEU.
[392] Art. 65 (2) TFEU.
[393] See Freitag, *EWS* (1997) p. 190.
[394] Schön, in Schön (ed.) *GS Knobbe-Keuk*, pp. 749-750.
[395] Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 752.
[396] Opinion AG Alber 14 October 1999, C-251/98, *Baars* [2000] ECR I-0278, points 13 et seq.; see Haslehner, *IStR* (2008) p. 568; differently see Geurts, *IStR* (2000) p. 572.

mean that a restriction of capital movements is not per se an infringement of the right of establishment. A national measure which directly regulated only the transfer of capital, and not establishment in another Member State, would not fall within the scope of the right of establishment [...]. [Also] any measure directly restricting the right of establishment must be judged by the criteria pertaining to that fundamental freedom; there is no scope for the alternative application of the rules relating to capital movements.[397]

Also, the freedom to provide services and free movement of capital can lead to a conflict in Treaty application. From the wording of the TFEU it follows that actions are governed by the freedom to provide services *"in so far as they are not governed by the provisions relating to freedom of movement for goods, capital and persons"*. Thus, it seems that the freedom to provide services is only applied in a subordinate manner to the other fundamental freedoms. However, in its case law the ECJ has not always been consistent with this order of priority.[398] Therefore, conflicts of application can also occur between the freedom to provide services and other fundamental freedoms. The free movement of capital, for example, covers the transfers in performance of insurance contracts.[399] The provision of insurance contracts, however, may also fall under the freedom to provide services. Thus, an overlap may occur.[400] The same is true for credit institutions which provide services to their clients but also grant loans or credits that are covered by the free movement of capital.[401] Financial services may, thus, be covered by both the freedom to provide services and the free movement of capital.[402] Schön argues in this respect that no real overlap occurs between the two freedoms, because the freedom to provide services is person-based, whereas the free movement of capital is object-based. Thus, both freedoms should be applied in parallel.[403]

3.2. Parallel application

Originally, if more than one fundamental freedom was applicable, the ECJ did not exclude any of them and applied all freedoms to the case concerned.[404] This result was also supported by legal doctrine, which considered the parallel application of the fundamental freedoms as ensuring

[397] Opinion AG Alber 14 October 1999, C-251/98, *Baars* [2000] ECR I-0278, points 24-25.
[398] See Ståhl, *EC Tax Review* (2004) p. 49 (with reference to ECJ 28 April 1998, C-118/96, *Safir* [1998] ECR I-1897; 1 December 1998, C-410/96, *Ambry* [1998] ECR I-7875).
[399] Point X. of the nomenclature of Council Directive 88/361/EEC.
[400] See Ståhl, *EC Tax Review* (2004) p. 48; for the solution to the conflict in the *Bachmann* case see chapter 3.2.
[401] Point VIII. of the nomenclature of Council Directive 88/361/EEC; ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, paras. 39 et seq.
[402] See Haslehner, *IStR* (2008) p. 568.
[403] Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 753.
[404] See Kingreen, *Die Struktur der Grundfreiheiten*, p. 77; Geurts, *IStR* (2000) p. 572; Haslehner, *IStR* (2008) p. 569.

the *effet utile* of EU law.[405] Concerning the freedom of establishment and the free movement of capital – the most obvious and practically relevant overlap – scholars have expressed the view that the application of the former in case of a direct investment should not render the latter inapplicable. The position of the shareholder should not change or even become worse when his shareholding reaches a higher level. Thus, the free movement of capital should be applicable irrespective of the size of the shareholding.[406] Haslehner, however, stresses that the free movement of capital should neither be interpreted too broadly. If it was understood to cover all forms of investment, the freedom of establishment would not have a separate scope of application anymore and its limitation to intra-EU situations would render meaningless. Any kind of investment, even if the prevailing aspect was the establishment, would be protected also in third-country situations.[407]

Within the European Union, the parallel application of several freedoms does not lead to a different result compared to the case of priority among the freedoms. Due to the convergence of the fundamental freedoms, the examination of the ECJ follows the same path for any freedom.[408] As far as third-state scenarios are concerned, a parallel application of the fundamental freedoms leads to an exclusive application of the free movement of capital. This is the only fundamental freedom that covers third countries.[409]

In the *Bachmann* case, the question referred to the ECJ sought interpretation of the free movement of capital, but also of the freedom to provide services and the free movement of workers.[410] The case treated the deduction of payments to German insurance companies by a Belgian resident employee. As the case concerned Belgium and Germany, no third country was involved. The ECJ examined both the free movement of workers and the freedom to provide services, thus, applying both freedoms in parallel. The Court ascertained a discriminatory treatment under both freedoms but found it to be justified by the need to preserve the cohesion of the tax system. The free movement of capital, however, was found not to be infringed, since the restriction concerning the

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[405] Müller, *Kapitalverkehrsfreiheit*, pp. 192 et seq; Ress/Ukrow, in Grabitz/Hilf (eds.) *Recht der EU*[19], Art. 56 no. 28, Art. 58 no. 44; Rohde, *Freier Kapitalverkehr*, p. 97; Sedlaczek, in Streinz (ed.) *EUV/EGV*, Art. 56 nos. 11 et seq; Schneider, in Mayer (ed.) *EU- und EG-Vertrag*[7], Art. 56 no. 23.

[406] Geurts, *IStR* (2000) p. 573; Haslehner, *IStR* (2008) pp. 567-568 and 569.

[407] Haslehner, *IStR* (2008) p. 575.

[408] See Hohenwarter, *Verlustverwertung*, p. 67; Haslehner, *IStR* (2008) pp. 569-570; Simader, in Lang/Schuch/Staringer (eds.) *Quellensteuern*, p. 20; basically also Ståhl, *EC Tax Review* (2004) p. 48; claiming a difference among the fundamental freedoms see Geurts, *IStR* (2000) p. 572; more reluctantly also Haslehner, *IStR* (2008) p. 565.

[409] See chapter 4.; see Hohenwarter, *SWI* (2005) p. 227; Staringer, in Lang/Schuch/Staringer (eds.) *ECJ – Recent Developments*, p. 18; Ståhl, *EC Tax Review* (2004) p. 50; Haslehner, *IStR* (2008) p. 569; Schönfeld, *IStR* (2005) p. 411.

[410] ECJ 28 January 1992, C-204/90, *Bachmann* [1992] ECR I-249.

insurance payments was not directly related to the free movement of capital, but followed indirectly from the restriction of the other fundamental freedoms.[411]

Another case where the ECJ applied two fundamental freedoms in a parallel way was the *X and Y* case.[412] First, the ECJ examined the freedom of establishment[413] and came to the conclusion that it was infringed by the provision in question.[414] After this conclusion the Court went on in examining the free movement of capital.[415] It clarified that the free movement of capital only covers cases where the holder of the shares does not have definite influence over the company's decisions.[416] As for the freedom of establishment, the ECJ came to the conclusion that the free movement of capital precludes the national legislation at hand.[417] In its judgment, the Court again examined two fundamental freedoms in parallel, testing one after the other. A similar examination was conducted by the ECJ in the cases *Svensson and Gustavsson*[418] and *Commission vs. Italy*[419] concerning the free movement of capital and the freedom to provide services. Thus, in contrast to the *Bachmann* judgment, the ECJ separately examined the free movement of capital. For this reason, it cannot be considered to be of a subordinate importance.[420]

In other cases, the ECJ only examined the situation under one fundamental freedom and subsequently found that a second freedom did not have to be tested.[421] In the case *Commission vs. France*, for example, the ECJ found that *"since an infringement of Article 73b of the Treaty* [the free movement of capital] *has been established, there is no need for a separate examination of the measures at issue in the light of the Treaty rules concerning freedom of establishment."*[422] This statement implies that the ECJ found both the free movement of capital and the freedom of establishment applicable, but examined only one of them. This result was then transposed also to the second applicable freedom. In the case X AB and Y AB the ECJ – after finding the Swedish provision at issue in conflict with the freedom of establishment – held that *"it is not necessary to examine whether the provisions of the Treaty relating to the free movement of capital preclude*

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[411] ECJ 28 January 1992, C-204/90, *Bachmann* [1992] ECR I-249, para. 34.
[412] ECJ 21 November 2002, C-436/00, *X and Y* [2002] ECR I-10829.
[413] ECJ 21 November 2002, C-436/00, *X and Y* [2002] ECR I-10829, paras. 33 et seq.
[414] ECJ 21 November 2002, C-436/00, *X and Y* [2002] ECR I-10829, para. 65.
[415] ECJ 21 November 2002, C-436/00, *X and Y* [2002] ECR I-10829, paras. 66 et seq.
[416] ECJ 21 November 2002, C-436/00, *X and Y* [2002] ECR I-10829, para. 68.
[417] ECJ 21 November 2002, C-436/00, *X and Y* [2002] ECR I-10829, para. 74.
[418] ECJ 14 November 1995, C-484/93, *Svensson and Gustavsson* [1995] ECR I-03955; see also Haslehner, *IStR* (2008) p. 570.
[419] ECJ 7 February 2002, C-279/00, *Commission/Italy* [2002] ECR I-1425.
[420] See Haslehner, *IStR* (2008) p. 570; pointing to the difference between the judgments in *Bachmann* and *Svensson and Gustavsson* see also Schön, in Schön (ed.) *GS Knobbe-Keuk*, pp. 753-754.
[421] See Haslehner, *IStR* (2008) p. 569. AG Stix-Hackl also understands these cases to support the parallel application of the fundamental freedoms; Opinion AG Stix-Hackl 16 March 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, points 55 et seq.
[422] ECJ 4 June 2002, C-483/99, *Commission/France* [2002] ECR I-04781, para. 56.

legislation such as that in question in the main proceedings".[423] A similar outcome was achieved in the cases *Safir,*[424] *Konle,*[425] *Baars,*[426] *Verkooijen,*[427] *Metallgesellschaft and Hoechst,*[428] and *Bouanich.*[429] According to Ståhl, however, if the first examined freedom was found not to be infringed, the ECJ would have to go on in examining the other applicable fundamental freedom.[430] A different result seems rather unlikely, though, since – due to the convergence of the freedoms – the discrimination test should bring the same result for all the examined freedoms.

Haslehner is skeptical whether the cases referred in the last paragraph answer the question which fundamental freedom has to be applied in situations that affect more than one fundamental freedom. He merely understands the case law as confirming the convergence of the freedoms. The ECJ only examined one fundamental freedom and concluded the same result for the other fundamental freedom that was stated in the questions referred. Haslehner does not deduce a parallel application of the fundamental freedoms from the cases referred in the last paragraph.[431]

Interestingly enough – even though newer case law tends to support an exclusivity relationship between the fundamental freedoms[432] – the ECJ seems not to have completely given up on the parallel application of the fundamental freedoms. In the 2008 decision in the case *Lammers & Van Cleeff*, the ECJ examined the freedom of establishment and later found that

> *[s]ince the Treaty provisions on freedom of establishment thus preclude national legislation such as that at issue in the main proceedings, it is not necessary to examine whether the Treaty provisions on the free movement of capital also preclude that legislation.*[433]

Also in the *Columbus Container* judgment the ECJ found that the question referred had to be examined under the freedom of establishment.[434] The Court concluded that the national provision at issue did not infringe the freedom of establishment. In the end, the ECJ simply transferred the result derived for the freedom of establishment to the free movement of capital.[435] It held that both Art. 43 EC (Art. 49 TFEU) and Art. 56 EC (Art. 63 TFEU) do not preclude the national provision at issue.

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[423] ECJ 18 November 1999, C-200/98, *X AB and Y AB* [1999] ECR I-08261, para. 30.
[424] ECJ 28 April 1998, C-118/96, *Safir* [1998] ECR I-1897.
[425] ECJ 1 June 1999, C-302/97, *Konle* [1999] ECR I-3099.
[426] ECJ 13 April 2000, C-251/98, *Baars* [2000] ECR I-2787. Concerning the parallel application of the free movement of capital and the freedom of establishment in the *Baars* case see Geurts, *IStR* (2000) p. 573.
[427] ECJ 6 June 2000, C-35/98, *Verkooijen* [2000] ECR I-4071.
[428] ECJ 8 March 2001, C-410/98, *Metallgesellschaft and Hoechst* [2001] ECR I-1727.
[429] ECJ 19 January 2006, C-265/14, *Bouanich* [2006] ECR I-923.
[430] Ståhl, *EC Tax Review* (2004) p. 49.
[431] Haslehner, *IStR* (2008) pp. 570-571.
[432] See chapter 3.3.
[433] ECJ 17 January 2008, C-105/07, *Lammers & Van Cleeff* [2008] ECR I-00173, para. 35.
[434] ECJ 6 December 2007, C-298/05, *Columbus Container* [2007] ECR I-10451, paras. 29 et seq.
[435] ECJ 6 December 2007, C-298/05, *Columbus Container* [2007] ECR I-10451, para. 56.

3.3. Exclusive application of the primarily affected freedom

In more recent case law, the ECJ has obviously changed its pattern of examination. Instead of testing a national provision against all possible fundamental freedoms or simply transposing the result of one fundamental freedom examination to another fundamental freedom, the ECJ recently applies an exclusivity approach. This approach, apparently, has no wider consequences in an intra-EU context. If more than one freedom is applicable, the ECJ chooses the primarily affected freedom and conducts its discrimination test. As the standards are the same for all of the fundamental freedoms, the result could be derived from any other freedom as well.[436]

In third-country cases, however, the exclusivity approach has a deep impact.[437] When – according to the scope of the freedom provisions – the free movement of capital and another fundamental freedom are applicable to a third-country case, and the ECJ finds the other fundamental freedom to the primarily applicable, then the free movement of capital is no longer considered. Any other fundamental freedom, however, does not provide protection for third-country cases. Therefore, the case is not covered under any of the fundamental freedoms. The third-country situation lacks protection.[438]

In the end, by applying the fundamental freedoms in an exclusive manner, the ECJ happens to achieve a narrower scope of application of the free movement of capital. Thus, in third-country situations, the fundamental freedoms grant narrower protection than it could be assumed from the wording of the TFEU.[439] This can be considered as an effort of the Court to limit the very broad extension of the internal market freedoms to third countries.[440] However, starting from the wording of the fundamental freedom provisions, the result seems more than arbitrary.[441]

In its jurisprudence, the ECJ establishes an exclusivity relationship if one fundamental freedom is entirely secondary to another. This is the case if one fundamental freedom is only affected indirectly and, therefore, a separate examination is not justified.[442] If none of the applicable

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[436] See chapter 1.3.; see Haslehner, *IStR* (2008) p. 571.

[437] Even though the determination of the applicable freedom and the scope of the case – intra-EU or third country – are not linked; see Haslehner, *IStR* (2008) p. 574.

[438] See ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521.

[439] See in contrast for the intra-EU scenario Ståhl, *EC Tax Review* (2004) p. 49, who claimed that the fundamental freedom with the most far-reaching protection will always be given priority by the ECJ.

[440] See Ståhl, *EC Tax Review* (2004) p. 52: "Therefore, total liberalization of the movement of capital would in fact indirectly affect the freedom of establishment and the free movement of services and would actually, through the back door so to speak, in many cases extend these freedoms to third countries as well (subject, of course, to the limitations in Arts. 57 to 60 in the EC Treaty). This can hardly have been the intention behind the provisions."

[441] See also Hohenwarter, *Verlustverwertung*, p. 68.

[442] See in favor of only examining the primarily affected freedom already Geurts, *IStR* (2000) pp. 573 et seq.; see also concerning the free movement of goods and the freedom of establishment Haslehner, *IStR* (2008) p. 567.

freedoms can be given priority, i.e., if both are affected directly, the freedoms might still be applied in parallel.[443] However, there have also been cases where the ECJ only applied one fundamental freedom, even though none of the freedoms applicable was entirely secondary to the freedom ultimately applied.[444]

The *Fidium Finanz* case treated the provision of loans from an institution established in a third country to residents of an EU Member State.[445] The Court ascertained that – in general – the freedom to provide services and the free movement of capital could be applicable in parallel. In the specific case, however, the German rules in question were targeted at the supervision and restriction of financial services. However, the freedom to provide services could not be relied on by Fidium Finanz, a Swiss company. The Court further held that effects on the free movement of capital would merely be an unavoidable consequence of the restriction on the freedom to provide services.[446] The primarily affected freedom was the freedom to provide services. A consideration of the free movement of capital is 'not necessary'. Thus, due to the third-country setting, the fundamental freedoms did not prohibit the German legislation.[447]

In contrast, Advocate General Stix-Hackl had found the free movement of capital to be applicable in the *Fidium Finanz* case.[448] She gave the opinion that the freedom to provide services cannot be applied to a third-country service provider.[449] As far as the free movement of capital is concerned the Advocate General affirmed its applicability and clearly criticized the Court for establishing a relationship of exclusivity between the fundamental freedoms:[450]

> *It should be pointed out in this regard, first of all, that for the purposes of deciding under which fundamental freedom a situation should be classified, the criterion of indirect adverse effect or indirect infringement is not sufficiently clear-cut and is too vague. However, even the case-law of the Court no longer requires that that criterion be used, the Court not having relied on it since the judgment in Bachmann. The same is true, moreover, of the 'principal aspect' criterion, which is used for the same purpose. Once again, therefore, this line of case-law at least does not preclude reliance on Article 56 EC.*

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[443] See Haslehner, *IStR* (2008) p. 574; see explicitly ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, para. 30; see also Perl, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, pp. 100 et seq.
[444] See Perl, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 104.
[445] ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521.
[446] ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, para. 48.
[447] ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, paras. 49-50.
[448] Opinion AG Stix-Hackl 16 March 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, point 63.
[449] Opinion AG Stix-Hackl 16 March 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, point 42.
[450] Opinion AG Stix-Hackl 16 March 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, point 62.

The most apparent and practically most relevant overlap occurs between the freedom of establishment and the free movement of capital.[451] Both freedoms cover the establishment of branches and subsidiaries. Therefore, the ECJ had to draw a line to determine the primarily affected freedom. It decided in the *Baars* case that the

> *freedom of establishment includes the right to set up and manage undertakings, in particular companies or firms, in a Member State by a national of another Member State. So, a national of a Member State who has a holding in the capital of a company established in another Member State which gives him definite influence over the company's decisions and allows him to determine its activities is exercising his right of establishment.*[452]

As a consequence, when a shareholder has a holding that allows him to exercise definite influence over the company's decisions and determine its activities, the freedom of establishment is exclusively applicable to his shareholding. When these requirements are not met, the free movement of capital is applied exclusively.[453] This leads to the result that only shareholdings that do not convey a definite influence are protected by the fundamental freedoms in third-country situations. The protection of the investment by the fundamental freedoms declines with the increasing size of the shareholding. When the shareholding reaches a size that conveys definite influence, the protection in the third-country setting ceases to exist. From a logical viewpoint, this result does not seem to make sense.[454]

The exclusivity approach applied by the ECJ in recent case law leads to non-application of the free movement of capital to direct investment. This is due to the fact that even though direct investment is covered by the free movement of capital following an interpretation according to the Capital Movement Directive, it is also – or primarily – covered by the freedom of establishment. However, in contrast to the definition of direct investment contained in the Capital Movement Directive, the ECJ requires a definite influence over the company's decision, not just participation in its management or control, to declare the freedom of establishment primarily applicable. Taking a look at the ECJ's case law,[455] holdings were considered to give definite influence starting with a 25 percent share.[456]

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[451] See chapter 3.1.; Geurts proclaims a parallel application of the free movement of capital and other fundamental freedoms than the freedom of establishment; see Geurts, *IStR* (2000) p. 573; see also concerning the freedom to provide services and the free movement of capital Haslehner, *IStR* (2008) p. 569.

[452] ECJ 13 April 2000, C-251/98, *Baars* [2000] ECR I-02787, para. 22.

[453] See Zorn, *SWK* (2008), p. S 468.

[454] See Kofler, *taxlex* (2008); Haslehner, *IStR* (2008) p. 575; Kühbacher, *SWI* (2011) p. 123.

[455] See in detail chapter 3.4.

[456] ECJ 10 May 2007, C-492/04, *Lasertec* [2007] ECR I-3775, paras. 21 et seq.; ECJ 22 December 2008, C-282/07, *Truck Center* [2008] ECR I-10767, paras. 26-27.

Non-application of the free movement of capital in (most) cases of direct investment seems odd when considering the standstill clause of Art. 64 TFEU.[457] This clause allows restrictions on the free movement of capital with third countries concerning inter alia direct investment if those restrictions are based on legal provisions that existed prior to 31 December 1993. It follows from this explicit reference that direct investment is in principle covered by the free movement of capital.[458]

The application of the primarily affected freedom has great relevance in withholding tax cases involving third countries. If withholding taxes on capital payments amount to discrimination, the free movement of capital is infringed. This applies for non-resident taxpayers who are subject to discriminatory withholding taxes no matter whether they are resident in another Member State or a third country. Should the withholding tax, however, primarily affect another fundamental freedom, the free movement of capital would no longer grant protection. The non-resident non-EU taxpayer would no longer be protected against discrimination. Most likely, the primarily affected freedom to which the free movement of capital is found to be subordinate would be the freedom of establishment. This is true in capital movement cases in which the taxpayer holds a direct investment in a company resident in the source state.

In order to apply the exclusivity approach, it is necessary to determine the primarily affected freedom. The determination of the primarily affected freedom has to be conducted on a case-by-case basis. In other words, the 'principal aspect' of the legislation in the case at issue has to be detected. It follows that the primarily affected freedom can be derived by looking at two different criteria. The first possible basis for the determination is the scope of the provision that is to be tested against the fundamental freedoms.[459] The other possible decisive factor is the facts of the case that is the reason for the preliminary reference to the ECJ. The second alternative can only function in cases of a preliminary procedure. In infringement procedures only the national provision is examined, without an initial real case. Therefore, no facts of a case can be decisive.

3.4. Determination of the primarily affected freedom

3.4.1. Provision-based determination

In the *Cadbury Schweppes* case the ECJ referred to the 'definite influence' criterion introduced in the *Baars* case in order to separate the scope of the freedom of establishment from the scope of the free movement of capital.[460] In the following, the Court looked at the provision at

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[457] See chapter 4.1.3.
[458] See Haslehner, *IStR* (2008) p. 568. See in detail chapter 4.1.3.
[459] Supported by Haslehner, *IStR* (2008) p. 572
[460] See chapter 3.3.

issue, which was a CFC-provision.[461] Therefore, the ECJ concluded that it only concerned cases of definite influence. The case referred in the preliminary ruling was only to be tested under the freedom of establishment. A separate examination of the free movement of capital, or the freedom to provide services, was not justified.[462]

Also in the *Fidium Finanz* case the ECJ took the scope of the applicable provision into account to determine which one was the primarily affected freedom.[463] In this case concerning credit institutions a line had to be drawn between the freedom to provide services and the free movement of capital. The ECJ held that a national provision may infringe both fundamental freedoms[464] and that also both fundamental freedoms were affected in the case at hand.[465] Further on, the ECJ concluded that the German provision at issue sought to regulate the provision of financial services by companies. The restriction of the free movement of capital was *"merely an unavoidable consequence of the restriction on the freedom to provide services"*.[466] The free movement of capital was entirely secondary and, therefore, did not have to be examined.[467] As the case concerned banks from third countries they could not rely on the freedom to provide services. Since the ECJ refused to consider the free movement of capital, the case did not enjoy protection by the fundamental freedoms.

In the *Thin Cap Group Litigation* case the ECJ again referred to the national provision at issue to determine under which freedom it had to be tested. The British national court referred questions concerning the compatibility of the British thin cap provisions with the freedom of establishment, the freedom to provide services, and the free movement of capital. The ECJ clarified that the national provisions at issue

> *apply only to situations where the lending company has a definite influence on the borrowing company or is itself controlled by a company which has such an influence.*[468]

However, after this appraisal the ECJ also brought forward the facts of the case. It clarified that the test cases referred by the national court concern shareholdings of more than 75 percent,

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[461] Applicable only to shareholdings of more than 50 percent.

[462] ECJ 12 September 2006, C-196/04, *Cadbury Schweppes* [2006] ECR I-07995, paras. 31 et seq.; see also ECJ 6 November 2007, C-415/06, *Stahlwerk Ergste Westig* [2007] ECR I- 00151; 25 October 2007, C-464/05, *Geurts and Vogten* [2007] ECR I- 09325; 18 July 2007, C-231/05, *Oy AA* [2007] ECR I- 06373 (90 percent); 10 May 2007, C-102/05, *A and B* [2007] ECR I-03871. In the *A and B* case the ECJ found that the provision at issue concerns the creation of branches and, therefore, primarily affects the freedom of establishment. The free movement of capital does not allow a separate examination. Since the case concerned third countries, no protection was granted.

[463] See chapter 3.3. ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521.

[464] ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, para. 30.

[465] ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, para. 43.

[466] ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, para. 48.

[467] ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521, para. 49.

[468] ECJ 13 March 2007, C-524/04, *Thin Cap Group Litigation* [2007] ECR I-02107, para. 28.

which the ECJ obviously considered as a shareholding that gives definite influence.[469] The ECJ concluded its determination of the primarily affected freedom by stating that infringements of the freedom to provide services or the free movement of capital would only be unavoidable consequences of a possible infringement of the freedom of establishment. A separate examination would not be justified.[470]

The same approach was taken by the ECJ in the *Lasertec* decision.[471] After taking into account the provision, which concerned shareholdings granting definite influence,[472] the ECJ also referred to the facts of the case. The parent company held two thirds of the shares in the subsidiary.[473] It follows that the freedom of establishment was the primarily affected freedom; the free movement of capital did not have to be examined. Due to the fact that the parent company was a Swiss resident, it was not protected by the fundamental freedoms. Obviously assuming the clarity of the question referred, the ECJ decided by an order.[474]

Also in withholding tax cases, the ECJ had to determine the primarily affected freedom. In its *Truck Center* decision, the Court took a similar approach as in *Lasertec*.[475] The case concerned interest payments between affiliated companies in Belgium and Luxembourg. Belgium levied a withholding tax on the interest payments. The Cour d'appel de Liège referred a question for preliminary ruling in light of the free movement of capital. The ECJ, however, clarified that national provisions which apply to holdings of definite influence fall under the freedom of establishment. The tax treaty between Belgium and Luxembourg provided for a source state taxing right on interest if the receiving company holds at least 25 percent of the shares in the paying company.[476] Moreover, the Luxembourgish company referred to in the preliminary procedure held 48 percent in the Belgian company. Thus, the freedom of establishment was to be applied to the case.

A decision that led to wide discussion in literature was taken in the *Glaxo* case.[477] Before *Glaxo* the prevailing legal doctrine was of the opinion that the facts of the case were decisive for the ECJ to determine the primarily affected freedom. The *Glaxo* case reversed this opinion for some scholars. The ECJ stressed that it tests a case under one fundamental freedom only, if

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[469] ECJ 13 March 2007, C-524/04, *Thin Cap Group Litigation* [2007] ECR I-02107, paras. 32 et seq.
[470] ECJ 13 March 2007, C-524/04, *Thin Cap Group Litigation* [2007] ECR I-2107, para. 34.
[471] ECJ 10 May 2007, C-492/04, *Lasertec* [2007] ECR I-3775.
[472] The provision covered shareholdings of more than 25 percent or minor shareholdings that give the shareholder definite influence; ECJ 10 May 2007, C-492/04, *Lasertec* [2007] ECR I-3775, paras. 21 et seq.
[473] ECJ 10 May 2007, C-492/04, *Lasertec* [2007] ECR I-3775, para. 23.
[474] See Haslehner, *IStR* (2008) p. 572.
[475] ECJ 22 December 2008, C-282/07, *Truck Center* [2008] ECR I-10767.
[476] Article 11 (3) (2) (2) Belgium-Luxemburg tax treaty; see ECJ 22 December 2008, C-282/07, *Truck Center* [2008] ECR I-10767, para. 26.
[477] ECJ 17 September 2009, C-182/08, *Glaxo Wellcome* [2009] ECR I-8591.

one of them is entirely secondary in relation to the other and may be considered together with it (Case C-452/04 Fidium Finanz [2006] ECR I-9521, paragraph 34).[478]

After having held that the purpose of the legislation concerned must be taken into account,[479] the ECJ repeated its settled case law according to which national provisions that apply to holdings granting definite influence fall under the freedom of establishment.[480] According to the German government's explanation the provision at issue applies to shareholding that grant the parent company control over its subsidiary. However, the application of the provision does not depend on the size of the shareholding and is not limited to cases of definite influence.[481]

Taking this explanation into account, the ECJ concluded that

since the purpose of the legislation at issue in the main proceedings is to prevent non-resident shareholders from obtaining an undue tax advantage directly through the sale of shares with the sole objective of obtaining that advantage, and not with the objective of exercising the freedom of establishment or as a result of exercising that freedom, it must be held that the free movement of capital aspect of that legislation prevails over that of the freedom of establishment.[482]

As a result, the provision at issue was to be tested exclusively in the light of the free movement of capital. A separate examination under the freedom of establishment was not justified.[483] Also, the ECJ did not pay attention to the facts of the case, which included direct shareholdings.

The determination of the primarily affected freedom according to the provision at issue could render the free movement of capital inapplicable in withholding tax cases, if the withholding tax was primarily provided to influence the provision of services or if the tax was only prescribed in cases in which the taxpayer holds a shareholding of definite influence in the company acting as the payment debtor. Thus, above all, provisions on service payments, dividends from direct investment, and other payments between affiliated companies would be excluded from protection under the fundamental freedoms if payments to third-country residents were concerned.

3.4.2. Determination according to the facts of the case

If the provision at issue does not lead to a clear result, that means if the provision covers the scope of more than one fundamental freedom, the ECJ tends to consider the facts of the case

[478] ECJ 17 September 2009, C-182/08, *Glaxo Wellcome* [2009] ECR I-8591, para. 37.
[479] ECJ 17 September 2009, C-182/08, *Glaxo Wellcome* [2009] ECR I-8591, para. 36.
[480] ECJ 17 September 2009, C-182/08, *Glaxo Wellcome* [2009] ECR I-8591, para. 47.
[481] ECJ 17 September 2009, C-182/08, *Glaxo Wellcome* [2009] ECR I-8591, paras. 48-49.
[482] ECJ 17 September 2009, C-182/08, *Glaxo Wellcome* [2009] ECR I-8591, para. 50.
[483] ECJ 17 September 2009, C-182/08, *Glaxo Wellcome* [2009] ECR I-8591, paras. 51-52.

referred in the preliminary ruling in order not to find more than one freedom applicable.[484] In the case *ACT Group Litigation*, for example, the ECJ found that the provision at issue – which applied to intra-EU and third-country shareholdings – does not refer to a certain size of a shareholding. Therefore, the freedom of establishment as well as the free movement of capital could be applicable.[485] In order to solve this conflict the ECJ observed that

> *[t]he order for reference shows that three of the cases chosen as test cases in the proceedings before the national court concern United Kingdom-resident companies which are wholly owned by non-resident companies.*[486]

From this finding the Court concluded that the freedom of establishment was applicable. However, the ECJ could not exclude that some cases in the group litigation also concerned shareholdings that did not give the parent company a definite influence over the decisions of the subsidiary. Therefore, also the free movement of capital had to be tested by the ECJ. However, this is not a case of parallel application, since two different fundamental freedoms are applied to two different kinds of situations.[487] While cases of definite influence are covered by the freedom of establishment, the other cases are only covered by the free movement of capital. What is essential is that the ECJ could not solve the application conflict by considering the provision which was at issue, and, therefore, referred to the facts of the case(s) when determining the primarily affected freedom. The same pattern was applied in the *FII Group Litigation* case which was decided by the ECJ on the same day.[488]

A decision that led to controversial interpretation in literature was taken in the *Holböck* case. The ECJ followed its reasoning of the *ACT Group Litigation* and *FII Group Litigation* cases. Since the Austrian provision in question did not apply to a certain size of shareholding, the ECJ found both the freedom of establishment and the free movement of capital applicable.[489] Nonetheless, the ECJ did not explicitly take the facts of the situation – which included a two-thirds participation – into account. Instead, the ECJ concluded that the freedom of establishment does not cover shareholdings

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[484] See, for example, ECJ 4 June 2009, C-439/ and 499/07, *KBC* [2009] ECR I- 04409, paras. 68 et seq.; see Haslehner, *IStR* (2008) p. 573. According to Haslehner, when the provision in question primarily affects one fundamental freedom, the ECJ case law shows that this freedom is applied exclusively. When the provision in question does not apply, e.g., to a certain size of shareholding, neither the freedom of establishment nor the free movement of capital is primarily affected. Thus, both freedoms are applicable. However, this statement does not consider that the ECJ usually excludes one of the freedoms when considering the facts of the particular case.

[485] ECJ 12 December 2006, C-374/04, *ACT Group Litigation* [2006] ECR I-11673, paras. 37 et seq.

[486] ECJ 12 December 2006, C-374/04, *ACT Group Litigation* [2006] ECR I-11673, para. 39.

[487] See Haslehner, *IStR* (2008) p. 573. Nonetheless, Haslehner, refers to the *FII Group Litigation* case (see next footnote) under the heading 'parallel application'.

[488] ECJ 12 December 2006, C-446/04, *FII Group Litigation* [2006] ECR I-11753, paras. 36 et seq.

[489] ECJ 24 May 2007, C-157/05, *Holböck* [2007] ECR I-04051, paras. 22 et seq.

in third countries.[490] Therefore, Mr. Holböck, who was the shareholder of a Swiss company, could not rely on this fundamental freedom. Further on, the ECJ made the following statement:

> *However, even if a Member State national who holds two thirds of the share capital of a company established in a non-member country were justified in invoking the prohibition of restrictions on the movement of capital between Member States and non-member countries set out in Article 56(1) EC in challenging the application of that legislation to dividends which he has received from such a company, in the present case [...] that legislation is caught by the exception laid down in Article 57(1) EC.*[491]

Thus, the ECJ did not explicitly exclude a two-thirds participation from the scope of the free movement of capital.[492] Rather, it declined examining its possible application by simply putting forward the standstill clause of Art. 64 TFEU.[493] Bringing the *Holböck* decision in line with the judgments in the *ACT Group Litigation* and *FII Group Litigation* cases, the ECJ would have had to examine only the freedom of establishment, since a two-thirds participation certainly gives the shareholder definite influence over the company's decisions.

O'Shea concludes from the ECJ's statement in the *Holböck* judgment that the free movement of capital is applicable in case of a two-thirds shareholding. Accordingly, the situation is covered under both the freedom of establishment and the free movement of capital. Thus, in a third-country case, the free movement of capital protects the direct investment.[494] Also, Haslehner considers the *Holböck* decision a case of parallel application of the freedom of establishment and the free movement of capital and finds it comparable with the *FII Group Litigation* judgment.[495] These positions, however, cannot be supported. When the provision in question before the ECJ does not require a certain size of shareholding for its application, the ECJ considers the facts of the case at issue. It cannot be deduced that in such cases both the freedom of establishment and the free movement of capital are applicable.[496] In *FII Group Litigation* the ECJ examined both freedoms, because the cases that took part in the group litigation involved different sizes of shareholdings. In *Holböck*, the application of the free movement of capital was not explicitly confirmed by the ECJ. Rather, the Court simply denied an examination, because the standstill clause of Art. 64 TFEU would have led to a non-infringement of the free movement of capital, anyway.

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[490] ECJ 24 May 2007, C-157/05, *Holböck* [2007] ECR I-04051, para. 28.
[491] ECJ 24 May 2007, C-157/05, *Holböck* [2007] ECR I-04051, para. 31.
[492] In the *Lenz* case the ECJ had already ruled that the Austrian dividend taxation regime infringed the free movement of capital. The case concerned an investment of an Austrian resident in Germany; see ECJ *Lenz*.
[493] For an explanation of this provision see section 4.1.3.
[494] O'Shea, *TNI* (2007) pp. 1132-1133.
[495] Haslehner, *IStR* (2008) pp. 573-574.
[496] As proclaimed by Haslehner; see Haslehner, *IStR* (2008) pp. 573-574.

The decision that was considered to rule off the question on how to determine the primarily affected freedom was taken in the *Burda* case.[497] It concerned a profit distribution from a German company to a Dutch one. To determine the freedom under which the case should be tested, the ECJ first referred to the scope of the provision:

> *It follows from settled case-law that, in so far as any given national rules concern only relationships within a group of companies, they primarily affect the freedom of establishment (see, inter alia, to that effect Test Claimants in the FII Group Litigation, paragraph 118; Test Claimants in Class IV of the ACT Group Litigation, paragraph 33; and Oy AA, paragraph 23).*[498]

The German provision at issue in the *Burda* case did not apply to a certain size of shareholding, which rendered both the freedom of establishment and the free movement of capital applicable.[499]

In the following, the ECJ turned to the facts of the case. It held the freedom of establishment applicable in cases of definite shareholder influence. In the particular case, the size of the shareholding of the Dutch parent in the German subsidiary was 50 percent, which the ECJ considered to provide definite influence.[500] The ECJ therefore concluded that

> *the provisions of the Treaty on freedom of establishment apply to a case such as that before the referring court.*[501]

Restrictive effects on the free movement of capital would just be an unavoidable consequence of an obstacle to the freedom of establishment and do not allow a separate examination.[502]

Haslehner considers the *Burda* decision to be incompatible with the previous case law of the ECJ. In former cases the ECJ either applied more than one freedom in parallel, or transferred the result of the examination on one fundamental freedom to another one, or exclusively applied one fundamental freedom when the provision in question was bound to criteria that are also decisive for the application of a fundamental freedom. In *Burda*, however, the ECJ did not consider the provision in question, but excluded the free movement of capital from its examination merely because the shareholding at issue granted definite influence.[503]

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[497] ECJ 26 June 2008, C-284/06, *Burda* [2008] ECR I-04571.
[498] ECJ 26 June 2008, C-284/06, *Burda* [2008] ECR I-04571, para. 68.
[499] ECJ 26 June 2008, C-284/06, *Burda* [2008] ECR I-04571, para. 71.
[500] ECJ 26 June 2008, C-284/06, *Burda* [2008] ECR I-04571, paras. 69 et seq.
[501] ECJ 26 June 2008, C-284/06, *Burda* [2008] ECR I-04571, para. 73.
[502] ECJ 26 June 2008, C-284/06, *Burda* [2008] ECR I-04571, para. 74.
[503] Haslehner, *IStR* (2008) pp. 572-573.

One of the most recent references to the facts of the case in order to determine the primarily affected freedom was taken in the SGI case.[504] The ECJ first stressed the decisiveness of the purpose of the provision at issue.[505] The Belgian government explained that

> *there is a 'relationship of interdependence' within the meaning of that legislation, inter alia where one of the companies in question has a holding in the capital of the other which enables it to exercise definite influence over that company's decisions and to determine its activities within the meaning of the Baars line of case-law (Case C-251/98 [2000] ECR I-2787, paragraph 22).*[506]

The words 'inter alia' already give the hint that the legislation at issue does not merely apply in cases of definite influence. The 'relationship of interdependence' between two companies does not depend on the extent of the shareholding.[507] Therefore, following the same path as in precedent cases, the ECJ looked at the facts of the case referred. The two shareholdings concerned amounted to 65 percent and 34 percent. The ECJ acknowledged the provision of definite influence by these shareholdings. Moreover, it pointed out that there are also links between the companies concerned at management level. Thus, it concluded that the questions referred have to be answered solely in the light of the freedom of establishment.[508]

Also in the withholding tax case *Aberdeen* the ECJ had to examine a provision which applied to any size of shareholding.[509] The Finnish provision at issue provided for a withholding tax on dividends in cases not covered by the Parent-Subsidiary Directive. These could be cases of a minor shareholding (less than 20 percent) or cases in which the parent company was not covered by the Directive. The ECJ concluded that such a provision may come under the free movement of capital and the freedom of establishment.[510] In the case referred to the ECJ, the Luxembourg parent held 100 percent in its Finnish subsidiary. This fact led the ECJ to exclusively apply the freedom of establishment.[511]

In rare cases the ECJ neglected the scope of the provision completely and instead merely looked at the facts of the case to determine which freedom should be applied. In the *Rewe Zentralfinanz* case the ECJ completely disregarded the scope and purpose of the German provision on loss utilization and directly considered the facts of the case. Due to the fact that the German parent company held 100 percent of its non-resident subsidiary's shares, the ECJ found the freedom of

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[504] ECJ 21 January 2010, C-311/08, *SGI*, not yet published.
[505] ECJ 21 January 2010, C-311/08, *SGI*, not yet published, para. 25.
[506] ECJ 21 January 2010, C-311/08, *SGI*, not yet published, para. 27.
[507] ECJ 21 January 2010, C-311/08, *SGI*, not yet published, para. 29.
[508] ECJ 21 January 2010, C-311/08, *SGI*, not yet published, paras. 34 et seq.
[509] ECJ 18 June 2009, C-303/07, *Aberdeen* [2009] ECR I-5145.
[510] ECJ 18 June 2009, C-303/07, *Aberdeen* [2009] ECR I-5145, para. 30.
[511] ECJ 18 June 2009, C-303/07, *Aberdeen* [2009] ECR I-5145, paras. 32 et seq.

establishment to be applicable.[512] In the very end of its decision, the ECJ clarified that the free movement of capital did not have to be examined, since a breach of the freedom of establishment was already determined.[513]

For withholding tax cases, the determination of the primarily affected freedom according to the facts of the case has the consequence that the free movement of capital is even inapplicable in cases in which the provision at issue is targeted at capital movements in general. If the non-resident taxpayer's shareholding in the specific case conveys a definite influence over the company's decisions, the payments made from the company to its shareholder do not fall under the free movement of capital. Thus, in case of a third-country shareholder, they would not enjoy protection under the fundamental freedoms.

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[512] ECJ 29 March 2007, C-347/04, *Rewe Zentralfinanz* [2007] ECR I-02647, para. 23.
[513] ECJ 29 March 2007, C-347/04, *Rewe Zentralfinanz* [2007] ECR I-02647, para. 71.

4. The fundamental freedoms and third countries

4.1. Free movement of capital

4.1.1. Historic development

Under the current treaty governing the European Union – the TFEU – the free movement of capital has to be considered as a unique fundamental freedom: It is the only one that extends to third-country situations. Therefore, not only capital movements within the EU have to flow without restrictions, but also capital movements between Member States of the EU and third countries. Third countries are defined as all countries that are not Member States of the European Union.[514] Third countries include such countries that have signed agreements with the EU and its Member States.[515] Unlike the fundamental freedoms within the EU, the free movement of capital towards third countries does not seek to establish an internal market,[516] but to achieve liberalization in a globalized capital market.[517]

The free movement of capital towards third countries was introduced through the Treaty of Maastricht[518] in 1994.[519] Before, the Capital Movement Directive[520] and Art. 70 EEC only contained the declaration that capital movements with third countries should be liberalized to the same extent as within the EU Member States. However, as those provisions did not provide for more than a notice of intent, they did not have a great impact.[521] With the entry into force of the Treaty of Maastricht, the free movement of capital caught up with the other fundamental freedoms in that it was granted direct effect.[522] Moreover, the free movement of capital outperformed the other fundamental freedoms with its territorial extension to third countries. The direct effect of the

[514] See Peters/Gooijer, *ET* (2005) p. 475.
[515] See Pistone, *Intertax* (2006) p. 234; Taeschler, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 383. See in detail chapters 4.2. to 4.4.
[516] See Art. 26 TFEU, which contains the commitment to the single market; see Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 20.
[517] See Batra, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 73.
[518] Signed in 1992.
[519] The Treaty of Rome (1957) only provided for the liberalization as far as the achievement of the common market was concerned; see Batra, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 65.
[520] Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, OJ L 178 of 8 July 1988, pp. 5-18. The provisions of the directive also had a direct effect according to ECJ case law (23 February 1995, C-358/93 and C-416/93, *Bordessa* [1995] ECR I-361; 14 December 1995, C-163, 165 and 250/94, *Sanz de Lera* [1995] ECR I-4821).
[521] See Hohenwarter, *Verlustverwertung*, pp. 56-57 and 60; Ståhl, *EC Tax Review* (2004) pp. 49 et seq.; Teixeira, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 147.
[522] See chapter 2.5.; see also Ståhl, *EC Tax Review* (2004) p. 50; Batra, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 65.

provision governing the free movement of capital applies to the free movement of capital with third countries in the same way as it does within the EU.[523]

With its extension to third countries, the free movement of capital grants protection in a one-way direction. It is not based on reciprocity. This characteristic of the free movement of capital is called 'erga omnes' effect.[524] The reasons for this unbalanced liberalization are unclear.[525] The reason that was mentioned most often was the establishment of the monetary Union. With the world-wide liberalization of capital movements, the acceptance of the Euro should be supported.[526] However, there have also been critical remarks on this motivation. Hohenwarter argues that the extension of the scope of the free movement of capital to third countries is not in line with the territorial limitation of the other fundamental freedoms. Unlike the other fundamental freedoms, the free movement of capital does not seek to achieve a single market among the EU Member States. However, as far as the implementation of the monetary Union is concerned, it is not clear how a single currency and a common monetary policy are more important than the single market.[527] Concerning the aim of extending the free movement of capital to third countries, the ECJ made the following statement in its judgment in the *A* case:[528]

> *[T]he liberalisation of the movement of capital with third countries may pursue objectives other than that of establishing the internal market, such as, in particular, that of ensuring the credibility of the single Community currency on world financial markets and maintaining financial centres with a world-wide dimension within the Member States [...].*

It can be deduced from the above that the free movement of capital with third countries has a different objective that the free movement of capital within the EU. Therefore, its scope – despite the identical wording and the incorporation in one single provision – may be interpreted more narrowly in third-country cases.[529] Also, the free movement of capital with third countries is not accompanied by harmonization measures, a common currency, or common institutions. This

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[523] See Peters/Gooijer, *ET* (2005) p. 476.
[524] For a discussion of the 'erga omnes' effect see Batra, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, pp. 71 et seq.; see also Ståhl, *EC Tax Review* (2004) p. 51; Freitag, *EWS* (1997) p. 190.
[525] See Ståhl, *EC Tax Review* (2004) pp. 50 and 51; Hohenwarter/Plansky, *SWI*; Zorn, *RdW* (2009) p. 176.
[526] See Ståhl, *EC Tax Review* (2004) p. 52.
[527] Hohenwarter, *Verlustverwertung*, p. 61.
[528] ECJ 18 December 2007, C-101/05, *A* [2007] ECR I-11531, para. 31.
[529] See Hohenwarter, *Verlustverwertung*, p. 62; Batra, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 72; Ståhl, *EC Tax Review* (2004) pp. 50 et seq.; Peters/Gooijer, *ET* (2005) p. 476. In its early, non-tax case law, however, the ECJ did not seem to make a difference between intra-EU capital movement and capital movement with third countries; see ECJ 23 February 1995, C-358/93 and C-416/93, *Bordessa* [1995] ECR I-361; 14 December 1995, C-163, 165 and 250/94, *Sanz de Lera* [1995] ECR I-4821.

different setting could also lead to a different interpretation of the free movement of capital with third countries than among the EU Member States.[530]

4.1.2. *Scope of application*

Following the wording of Art. 63 TFEU, the free movement of capital with third countries has the same scope as is has within the EU. It explicitly prohibits restrictions, but – due to the convergence of the fundamental freedoms – also discrimination. For the definition of capital movement, recourse is made to the Annex of the Capital Movement Directive.[531] This holds true also concerning third-country capital movements, even though the Directive was only applicable to capital movements within the EU.[532] Thus, direct investments, investments in real estate, capital market transactions, loans and credits, insurances, and gifts and inheritances are protected by the free movement of capital also in relation to third countries.

Withholding taxes play an important role in the area of capital income. They are often levied on dividends and interest income. Thus, direct investment, capital market investment, and the grant of loans and credits may be affected by the levy of withholding taxes. Withholding taxes may constitute a restriction to the free movement of capital even if they are applied only to third-country residents. This is because the free movement of capital prohibits restrictions on the free movement of capital between Member States and third countries.

The case law of the ECJ, however, supports an application of the free movement of capital only in those cases, in which it is the primarily affected freedom.[533] Thus, if an activity primarily affects the free movement of workers, the freedom of establishment, or the freedom to provide services and only indirectly affects the free movement of capital, no protection is granted in third-country situations.

The most relevant conflict in recent case law turned out to be between the free movement of capital and the freedom of establishment. Both freedoms cover the establishment and participation in branches in the form of direct investments. In its principal aspect jurisprudence the ECJ developed the concept that holdings which provide definite influence over the company's decisions primarily affect the freedom of establishment. Restrictions of the free movement of capital are merely an unavoidable consequence and to not justify a separate examination there under.[534] Thus, direct investment in third countries is effectively not protected by the fundamental freedoms,

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[530] See Ståhl, *EC Tax Review* (2004) p. 51.
[531] Council Directive 88/361/EEC of 24 June 1988 for the implementation of Article 67 of the Treaty, OJ L 178 of 8 July 1988, pp. 5-18.
[532] See O'Shea, *TNI* (2007) p. 1134.
[533] See chapter 3.3.
[534] Case law…

even though the wording of Art. 63 TFEU in connection with the Annex to the Capital Movement Directive provide otherwise. This leads to the peculiar result that small investments in third countries enjoy protection under the free movement of capital, but investments reaching the level of definite influence do not. When the engagement increases, the protection decreases. Following the case law of the ECJ, the level above which a holding provides definite influence can be marked around 25 percent.[535]

Also for withholding taxes cases, the principle aspect jurisprudence applies. As a consequence, discriminatory withholding taxes may be levied on third-country residents, if the investment is considered to be direct according to the case law of the ECJ. This is because the freedom of establishment does not cover third countries. For portfolio investments, however, the TFEU requires the same level of protection for intra-EU and third-country cases. Thus, withholding taxes may be infringing the free movement of capital equally in both cases.

Through the implementation of the principal aspect jurisprudence, the ECJ has achieved a limited protection of third-country situations. However, the TFEU also contains explicit limitations of the free movement of capital, as far as third countries are concerned. These limitations are embodied in Arts. 64 to 66 TFEU. In regard to these limitations, the ECJ has held that

> *all the provisions introduced in the Treaty in the chapter concerning capital and payments show that, in order to take account of the fact that the objective and the legal context of the liberalisation of the movement of capital differ according to whether relations between the Member States and third countries or the free movement of capital between the Member States is in issue, the latter considered it necessary to provide safeguard clauses and derogations which apply specifically to the movement of capital to or from third countries.*[536]

4.1.3. *Standstill clause*

Even though the free movement of capital has been opened to third-country situations, there are limitations that apply to the free movement of capital in those cases. The rationale behind those limitations is to compensate the lack of reciprocity in the liberalization process with third countries, which can occur due to the 'erga omnes' effect of the free movement of capital.[537]

The most important limitation is the standstill or 'grandfather' clause of Art. 64 (1) TFEU.[538] It allows restrictions on the free movement of capital with third countries[539] to remain applicable if

[535] ECJ 10 May 2007, C-492/04, *Lasertec* [2007] ECR I-3775, paras. 21 et seq.; ECJ 22 December 2008, C-282/07, *Truck Center* [2008] ECR I-10767, paras. 26-27.
[536] ECJ 18 December 2007, C-101/05, *A* [2007] ECR I-11531, para. 32.
[537] See Teixeira, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, pp. 149 et seq.
[538] Introduced with the Treaty of Maastricht.

they already existed on December 31, 1993.[540] The measures that are safeguarded by the standstill clause need not be applied to capital movements with third countries exclusively.[541] However, such restriction must involve *"direct investment — including in real estate — establishment, the provision of financial services or the admission of securities to capital markets"*. For direct taxes the areas direct investment, establishment, and financial services are of utmost importance.[542]

The terms of the standstill clause do not allow for an interpretation according to the laws of the Member States. Rather, they have to be given an autonomous meaning in EU law.[543] As far as 'direct investment' is concerned, it needs to be distinguished from portfolio investment, because the latter is not covered by the standstill clause.[544] The term 'direct investment' is not defined in primary EU law. Thus, Schönfeld suggests an interpretation in line with the Capital Movement Directive.[545] This recourse is also supported by the ECJ in its case law.[546] Accordingly, the term 'direct investment' includes the formation of new companies, but also the investment in existing companies.[547] Following the explanatory notes contained in the Capital Movement Directive, investments are considered to be direct if they *"serve to establish or to maintain lasting and direct links"* and enable the shareholder *"to participate effectively in the management of the company or in its control"*.

In chapter 3.1. the same definition was suggested to determine the area of overlap between the free movement of capital and the freedom of establishment. From the wording of the TFEU it follows that the freedom of establishment only covers direct investment, while the free movement of capital covers both direct and portfolio investment. The Capital Movement Directive was taken as a means of interpretation of the term 'direct investment', which is in principle covered by both freedoms. This is also supported by the standstill clause, according to which direct investment is in principle protected by the free movement of capital.[548] Accordingly, restrictions to direct investment towards third countries would infringe the free movement of capital if they were introduced after December 31, 1993.

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[539] This means that both inbound and outbound investment is covered; see in detail Teixeira, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, pp. 155 et seq.
[540] The accession date of a Member State is not decisive in this context. Therefore, even if a country entered the EU after 1993, provisions introduced between January 1, 1994 and the accession date are not covered by Art. 64(1) TFEU.
[541] Still unclear about this matter see Peters/Gooijer, *ET* (2005) pp. 477 et seq.
[542] Critically concerning the application of the standstill clause to tax provisions Ståhl, *EC Tax Review* (2004) p. 54.
[543] See Schönfeld, *IStR* (2005) p. 411.
[544] See UFS Linz 13 January 2005, RV/0279-L/04; VwGH; Kofler/Toifl, *ET* (2005) pp. 232-242; Peters/Gooijer, *ET* (2005) p. 475; Schönfeld, *IStR* (2005) pp. 412-413.
[545] Schönfeld, *IStR* (2005) pp. 411-412.
[546] ECJ 12 December 2006, C-446/04, *FII Group Litigation* [2006] ECR I-11753, para. 178; 24 May 2007, C-157/05, *Holböck* [2007] ECR I-4051, para. 33.
[547] Capital Movement Directive; see Schönfeld, *IStR* (2005) p. 411
[548] See Haslehner, *IStR* (2008) pp. 574-575.

However, according to the principal aspect jurisprudence of the ECJ[549] the freedom of establishment is to be applied exclusively to

[...] a national of a Member State who has a holding in the capital of a company established in another Member State which gives him definite influence over the company's decisions and allows him to determine its activities [...].[550]

Thus, if this requirement is fulfilled, restrictions to the free movement of capital are an 'unavoidable consequence' of the restrictions to the freedom of establishment and do not justify a separate examination.[551] Hence, the standstill clause cannot be applied either. It seems that the standstill clause lacks applicability, since direct investment is exclusively covered by the freedom of establishment.[552]

However, an interesting difference can be found between the definition of a *"participation in new or existing undertaking with a view to establishing or maintaining lasting economic links"* contained in the Capital Movement Directive[553] and the ECJ's notion of *"exercising the right of establishment"*[554], which both can be considered as a definition of direct investment. While the Capital Movement Directive requires effective participation in the management or control of the company, the ECJ demands definite influence over the company's decisions. Thus, the requirement by the ECJ for the application of the freedom of establishment seems stricter.[555] According to Schönfeld, a participation in a company's management might be possible at a lower level of shareholding than a definite influence over the company's decisions.[556] Thus, it might occur that at a certain percentage definite influence is not fulfilled, leading to the application of the free movement of capital instead of the freedom of establishment, but a participation in the management is possible, leading to the application of the standstill clause.[557] As has been mentioned above, it can be deduced from the ECJ case law that definite influence over the company's decisions is fulfilled with holdings of 25 percent or more.

Also the decision of the ECJ in *Orange European Smallcap Fund* implies a difference in the concepts. The referring court asked the ECJ

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[549] See chapter 3.3.
[550] ECJ 13 April 2000, C-251/98, *Baars* [2000] ECR I-02787, para. 22.
[551] Case law...
[552] See Hohenwarter, *Verlustverwertung*, p. 79.
[553] Nomenclature point I.2.
[554] ECJ 13 April 2000, C-251/98, *Baars* [2000] ECR I-02787, para. 22.
[555] See Schönfeld, *IStR* (2005) pp. 411-412.
[556] Schönfeld, *IStR* (2005) p. 414.
[557] For a different definition of ‚direct investment' for purposes of the standstill clause and for the freedom of establishment see Schönfeld, *IStR* (2005) p. 414.

whether 'direct investment' within the meaning of Article 57(1) EC [Art. 64 (1) TFEU] *covers the holding of a block of shares in a company which does not put the holder in a position to exercise a decisive influence over the management or control of that company.*[558]

The ECJ replied

that a restriction is covered by Article 57(1) EC [Art. 64 (1) TFEU] *as being a restriction on the movement of capital involving direct investment in so far as it relates to investments of any kind undertaken by natural or legal persons and which serve to establish or maintain lasting and direct links between the persons providing the capital and the undertakings to which that capital is made available in order to carry out an economic activity.*[559]

It can be derived that the standstill clause possibly covers also holdings that do not convey definite influence as long as they establish lasting and direct links to the company. Therefore, an application of the standstill clause to direct investment is still valid.

As a result of the different definitions, the standstill clause still has an effect under the principal aspect jurisprudence of the ECJ.[560] Of course, its application leads to lower protection of third-country situations. However, only measures introduced before December 31, 1993 are safeguarded. Newly introduced measures would potentially infringe the free movement of capital. In contrast, if every direct investment would exclusively be covered under the freedom of establishment, protection in third-country cases would not exist at all. If the definition of direct investment for the application of the freedom of establishment and the standstill clause converged,[561] the standstill clause would lose its application to direct investment.

If an investment is considered to be 'direct' in the sense of Art. 64 (1) TFEU, it is clear from the *Verkooijen* case and further case law that the investment also includes its returns, i.e., dividend payments to shareholders.[562] Therefore, dividends are also covered by the standstill clause of Art. 64 (1) TFEU.[563] If withholding tax regimes are provided for dividends from direct investment, discrimination of third-country residents may be admissible despite the free movement of capital. Either, the discrimination primarily affects the freedom of establishment, because the direct investment gives the shareholder definite influence over the company's decisions. Or, the restriction is safeguarded by the standstill clause of Art. 64 (1) TFEU, if it existed prior to December 31, 1993.

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[558] ECJ 20 May 2008, C-194/06, *Orange European Smallcap Fund* [2008] ECR I-3747, para. 98.
[559] ECJ 20 May 2008, C-194/06, *Orange European Smallcap Fund* [2008] ECR I-3747, para. 102.
[560] Supporting a limited scope of the standstill clause see also Hohenwarter, *Verlustverwertung*, p. 79; Haslehner, *IStR* (2008) p. 574.
[561] See Schönfeld, *IStR* (2005) p. 414.
[562] ECJ 6 June 2000, C-35/98, *Verkooijen* [2000] ECR I-4071, paras. 28 et seq.
[563] ECJ 12 December 2006, C-446/04, *FII Group Litigation* [2006] ECR I-11753, para. 183; 24 May 2007, C-157/05, *Holböck* [2007] ECR I-4051, para. 36; see Teixeira, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 152.

This may be the case if the investment does not provide definite influence, but allows the shareholder to participate effectively in the management and control of the company.

As for the determination of the applicable freedom,[564] it is essential to clarify whether the provision in question or the facts of the specific case are taken into account to determine whether a restriction concerns direct investment. This can, for example, be important when a national provision applies regardless of the size of the shareholding, i.e., to direct and portfolio investment. May the provision be (partially) covered under the standstill clause? Or is the scope of the provision irrelevant and are the facts of the case decisive? This would mean that a restriction of the free movement of capital may be safeguarded by Art. 64 (1) TFEU if the shareholding in question can be classified as direct.[565]

In *Sanz de Lera* the ECJ did not apply the standstill clause to a provision that covered a broader area than Art. 64 (1) TFEU does.[566] Schönfeld, thus, argues that the standstill clause does not apply at all if the national provision at issue not only covers the types of capital movement mentioned in the standstill clause, but also others.[567] Also, due to the fact that Art. 64 (1) TFEU provides for an exception to the protection by the free movement of capital, it has to be interpreted in a narrow way.[568] He achieves this result irrespective of the actual size of the shareholding in the case concerned.[569]

Besides the term 'direct investment', also the term 'establishment' needs interpretation. According to the ECJ's judgment in the *Gebhard* case, the term 'establishment' covers an undertaking of an economic activity through a fixed place of business.[570] It can be put in relation to direct investment in that it gives the taxpayer definite control over the company's decisions, not just the influence over its decisions. Just like direct investment, establishments primarily affect the freedom of establishment and are not protected by the free movement of capital. Hence, the standstill clause also loses its application to establishments. Establishments are already excluded from protection in third-country cases due to their principal aspect. Therefore, the standstill clause is not relevant for the examination anymore. In contrast to the area of direct investments, the application of the free movement of capital to establishments seems extremely unlikely. Thus, the standstill clause has lost its application to establishments in the course of the principal aspect jurisprudence of the ECJ.

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[564] See chapter 3.4.
[565] See Schönfeld, *IStR* (2005) pp. 412 et seq.
[566] ECJ 14 December 1995, joint cases C-163/94, C-165/94 and C-250/94, *Sanz de Lera* [1995] ECR I-4821 , paras. 31 et seq.
[567] Schönfeld, *IStR* (2005) p. 413.
[568] Schönfeld, *IStR* (2005) p. 412.
[569] Schönfeld, *IStR* (2005) p. 414.
[570] ECJ 30 November 1995, C-55/94, *Gebhard* [1995] ECR I-4165, paras. 23 et seq.

The provision of financial services, in contrast, is not necessarily connected with the establishment of a fixed base.[571] The financial services can also be provided directly from one Member State to another one. However, apart from the free movement of capital, the freedom to provide services can be applicable. Again, the ECJ will search for the primarily affected freedom on a case-by-case basis. If the free movement of capital is only applicable in a subordinate manner, the standstill clause is not to be considered anymore due to the non-protection of third-country cases.

Also the temporal scope of the standstill clause gives room for interpretation. In particular, it is unclear what is meant by the term 'exist'. Does it mean that the national law provision has existed and still exists, even though its content has somewhat changed? Or does it mean that the provision has not been changed at all since December 31, 1993? In other words: Does the standstill clause cover national law provisions that existed on December 31, 1993, but have changed since then?

The ECJ has answered these questions in the *Holböck* case:[572]

> *In that context, the Court has held that any national measure adopted after a date thus fixed is not, by that fact alone, automatically excluded from the derogation laid down in the Community measure in question. A provision which is, in substance, identical to the previous legislation, or limited to reducing or eliminating an obstacle to the exercise of Community rights and freedoms in the earlier legislation, will be covered by the derogation. By contrast, legislation based on an approach which differs from that of the previous law and establishes new procedures cannot be treated as legislation existing at the date fixed in the Community measure in question (see Konle , paragraphs 52 and 53, and Test Claimants in the FII Group Litigation , paragraph 192).*

Thus, the standstill clause allows changes to the relevant law. However, the provision must not be based on a different approach.[573] Also, provisions that were changed to reduce or eliminate the obstacle to the free movement of capital are covered by the standstill clause.[574] Provisions that were changed to be even more restrictive after December 31, 1993, should – according to Hohenwarter – be partially protected by Art. 64 (1) TFEU. The newly introduced aspect of the provision is not covered by the standstill clause, but the 'part' that existed before January 1, 1994, is.[575]

[571] ECJ 3 October 2006, C-452/04, *Fidium Finanz* [2006] ECR I-9521.
[572] ECJ 24 May 2007, C-157/05, *Holböck* [2007] ECR I-4051, para. 41; see also ECJ 12 December 2006, C-446/04, *FII Group Litigation* [2006] ECR I-11753, para. 192.
[573] See also Schönfeld, *IStR* (2005) p. 413. He argues that substantial changes in the law should not be allowed after December 31, 1993.
[574] See also Batra, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 74.
[575] Hohenwarter, *Verlustverwertung*, p. 65.

Concerning the temporal scope of the standstill clause, the ECJ follows a material approach. This means that the formal enactment of the law is not decisive, but its material content. However, in the *A* case the ECJ clarified that a provision is not covered by Art. 64 (1) TFEU if it existed on December 31, 1993, but was abolished and reintroduced later on. The provision must have formed part of the Member State's law continuously since December 31, 1993.[576]

Besides the standstill clause of Art. 64 (1) TFEU, Art. 64 (2) TFEU gives the ability to the European Parliament and the Council to adopt measures on the free movement of capital with third countries. Before the introduction of the TFEU, only the Council was able to adopt such measures, not the European Parliament. However, it had to act by a qualified majority and on a proposal from the Commission. It can be derived that the Commission's influence disappeared, whereas the Parliament has gained additional power. The Council is no longer in need of a qualified majority, which should render decision-making easier.[577]

Art. 64 (3) TFEU even provides for the right of the Council to adopt measures that constitute a step backwards regarding third-country capital movement. However, the requirements for the adoption of such measure are a unanimous decision of the Council, prior consultation of the European Parliament and a special legislative procedure. This provision gives the possibility to the Member States' government representatives – via the Council – to limit the application of the free movement of capital to third countries. Such power in *only* given to the Council. The European Parliament has a mere consulting function.[578]

4.1.4. Tax clause

According to the tax clause in Art. 65 TFEU the Member States are allowed to distinguish between taxpayers who are not in the same situation with regards to their place of residence or where their capital is invested.[579] Also, Member States are allowed to take measures which are justified on grounds of public policy or public security.[580] However, according to paragraph 3 of the provision it shall not allow 'arbitrary discrimination or a disguised restriction'. According to the ECJ, Art. 65 TFEU is mainly to be seen as a codification of case law.[581] Thus, it does not create a new

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[576] ECJ 18 December 2007, C-101/05, *A* [2007] ECR I-11531, paras. 48 et seq.; critically Hohenwarter, *Verlustverwertung*, pp. 64 et seq.
[577] See Oliveti, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 90.
[578] See Oliveti, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 91.
[579] Art. 65 (1) (a) TFEU.
[580] Art. 65 (1) (b) TFEU.
[581] ECJ 6 June 2000, C-35/98, *Verkooijen* [2000] ECR I-4071, para. 43; 21 November 2002, C-436/00, *X and Y* [2002] ECR I-10829, para. 72; see also Peters/Gooijer, *ET* (2005) p. 479; Schönfeld, *IStR* (2005) p. 412; Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 767.

possibility for justification for the Member States.[582] However, in third-country situations the tax clause may serve as a legal basis to differentiate between third-country residents and EU-residents, or investment in third countries and intra-EU investment. Otherwise, Art. 65 TFEU would not have a scope of application at all.[583] A difference could be made between intra-EU situations and situations that involve third countries, because the single market goal is not present in the latter cases. Of course, Art. 65 (3) would apply just as well to third-country situations as to intra-EU situations. However, discrimination may no longer be considered arbitrary or restriction disguised, if they are justified in the public interest. Such justification may be possible on broader terms vis-à-vis third countries due to the lack of the single market goal.[584]

Through the Treaty of Lisbon, a new paragraph 4 was introduced in Art. 65 TFEU:

> *In the absence of measures pursuant to Article 64(3), the Commission or, in the absence of a Commission decision within three months from the request of the Member State concerned, the Council, may adopt a decision stating that restrictive tax measures adopted by a Member State concerning one or more third countries are to be considered compatible with the Treaties in so far as they are justified by one of the objectives of the Union and compatible with the proper functioning of the internal market. The Council shall act unanimously on application by a Member State.*

The provision has an explicit connection to the afore-mentioned Art. 64 (3) TFEU, which provides for measures by the Council. As a second step, the Commission has the competence to declare restrictive measures of a Member State vis-à-vis third countries as compatible with the TFEU. If the Commission does not make use of its competence, the power is again given back to the Council. The Council, however, may only act upon request of a Member State and – again – has to act unanimously.

4.1.5. Art. 66 TFEU

This provision grants the right to the Council to adopt measures towards third countries for a maximum period of six months, if serious difficulties for the operation of economic and monetary union occur because of capital movements to or from third countries. The Council has to act on a proposal from the Commission and after consultation of the European Central Bank. Art. 66 TFEU is only to be applied in 'exceptional circumstances' and if the measures to be taken are 'strictly necessary'.

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[582] See Peters/Gooijer, *ET* (2005) p. 479.
[583] See Hohenwarter, *Verlustverwertung*, pp. 66-67.
[584] See Hohenwarter, *Verlustverwertung*, p. 67.

4.2. The EEA Agreement

The contracting parties of the EEA Agreement are the European Union and its Member States on the one side and the EFTA Member States Iceland, Liechtenstein, and Norway on the other side.[585] The Agreement entered into force on January 1, 1994. It establishes a system that comes very close to what the EU provides for. The EEA is a free trade area as far as the free movement of goods in concerned.[586] Also, it establishes a common market for the free movement of workers,[587] services,[588] and capital[589] and the freedom of establishment[590]. The EEA Agreement also contains a general non-discrimination clause that prohibits discrimination on grounds of nationality.[591] The freedom provisions in the EEA Agreement have direct effect, thus, allowing nationals of the EEA Member States to invoke the rights in their national courts.[592] Also, the EEA freedoms are applied and interpreted in the same manner, thus, converging.[593] They prohibit discrimination in the host state, but also restrictions to free movement by the home state.[594]

Even though the EEA Member States have implemented a great part of the *acquis unionaire*,[595] some of the most important EU secondary law provisions in tax law are not applicable in the EEA: The Parent-Subsidiary Directive, the Interest and Royalty Directive, the Mutual Assistance Directive, and the Recovery Assistance Directive.[596] These differences in the secondary law body are a sign for the lesser harmonization within the EEA. This may lead to differences when examining discrimination by a tax law measure. Residents of an EU Member State and residents of a non-EU, EEA Member State may not be in a comparable situation. Also, justifications of discrimination may be possible on a broader scale and proportionality of a measure may be more likely due to the lack of harmonization with the EEA States.[597] In how far this is true will be discussed in chapters IV. to VI.

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[585] The fourth EFTA Member State, Switzerland, rejected accession to the EEA by a public referendum.
[586] Arts. 8 et seq. EEA Agreement. The EEA is not a customs union, which means that there is no common customs policy regarding third countries; see Krünes, *ecolex* (1992) pp. 519 et seq.
[587] Art. 28 EEA Agreement: Discrimination on grounds of nationality is prohibited, unless it is justified by public order, public security, or public health.
[588] Art. 36 EEA Agreement.
[589] Art. 40 EEA Agreement.
[590] Art. 31 EEA Agreement.
[591] Art. 4 EEA Agreement; see Moosbrugger, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 363.
[592] See Gudmundsson, *Intertax* (2006) pp. 58 et seq.
[593] See Gudmundsson, *Intertax* (2006) p. 64.
[594] See EFTA Court 7 May 2008, E-7/07, *Seabrokers*, para. 28 on the freedom of establishment.
[595] See Hakenberg, *Grundzüge*, p. 8; Kuijper, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 1339.
[596] See Gudmundsson, *Intertax* (2006) pp. 59 and 63-64; Krünes, *ecolex* (1992) p. 519; see also Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 40.
[597] See Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 40 with reference to the exchange of information and assistance in collection of taxes.

Even if positive integration in the direct tax field does not take place in the EFTA Member States, negative integration by the fundamental freedoms still applies.[598] The EFTA Court has held in its *Fokus Bank* judgment that tax law is not covered by the EEA Agreement. However, EEA States must exercise their taxation power in consistence with EEA law.[599] Thus, the EEA Member States' tax laws must not be in breach with the EEA freedoms. These findings are identical to the settled case law of the ECJ, according to which direct taxes are a competence of the Member States, which must nonetheless exercise this competence in line with EU law.

The EEA Agreement – like the TFEU – has primacy over EU secondary legislation. Thus, the latter must be interpreted in consistency with the former.[600] Gudmundsson comes to the conclusion that, since the EEA freedoms have the same meaning as the EU freedoms, the benefits provided for by the direct tax Directives have to be granted to all EEA Member States, not just to the EU Member States.[601] This approach would mean that preferential treatment which is provided to cross-border, intra-EU cases has to be extended also to Iceland, Liechtenstein, and Norway. Gudmundsson, thus, supports the horizontal comparability between two cross-border situations.[602] Even more, his statements imply the application of a most-favorite-nation treatment to the EEA Member States.

However, the general extension of benefits granted by the EU Directives to the EEA Member States would render the discrimination test under the EEA freedoms unnecessary. Even in the field of harmonization in the direct tax area, the fundamental freedoms still apply. The correct transformation of a Directive in national law by an EU Member State does not make the infringement of the fundamental freedoms impossible. If internal situations are treated more favorably than cross-border situations that are not covered by the Directive, discrimination may still occur. However, such discrimination has to be assessed according to the examination scheme developed by the ECJ. Thus, comparability, justifications, and proportionality have to be taken into account. As has been mentioned above, the non-application of EU Directives may have an effect on the determination of discrimination.

Moreover, the EU Directives do not just grant benefits, they also contain obligations to be fulfilled by the EU Member States. A general extension of the benefits to the EEA States without the requirement to fulfill obligations would counter the aims of the Directives. If the EEA Member States enjoy the benefits of EU Directives but do not fulfill the obligations levied by them, one could even argue that the EEA States have failed to implement the Directives correctly into their national laws,

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[598] See Gudmundsson, *Intertax* (2006) pp. 63-64.
[599] EFTA Court 23 November 2004, E-1/04, *Fokus Bank*, para. 20.
[600] See Gudmundsson, *Intertax* (2006) p. 61 with reference to ECJ 1 April 2004, C-286/02, *Bellio* [2004] ECR I-3465, para. 33; 10 September 1996, C-61/94, *Commission v. Germany* [1996] ECR I-3989, para. 52.
[601] See Gudmundsson, *Intertax* (2006) pp. 72 et seq.
[602] See in detail chapter IV.3.

which would render the Directives directly effective. This would bind the EEA States without them having entered into an agreement. Anyways, the EEA Member States are free to negotiate an extension of EU secondary law to them.

The provisions on free movement in the EEA Agreement are (almost) identical to the provisions on the fundamental freedoms in the TFEU.[603] Also, the ECJ as well as the EFTA Court have held in settled case law that the provisions in the EEA Agreement shall be interpreted in the same way as the corresponding provisions in the TFEU.[604] Thus, the fundamental freedoms are practically extended to the EFTA Member States through the EEA Agreement.[605]

The ECJ has made the following statement in the Ospelt judgment:[606]

> *[I]t is apparent from those provisions* [the EEA Agreement] *that the rules laid down in them prohibiting restrictions on the movement of capital and discrimination, so far as concerns relations between the States party to the EEA Agreement, irrespective of whether they are members of the Community or members of EFTA, are identical to those under Community law with regard to relations between the Member States. [...] Furthermore, one of the principal aims of the EEA Agreement is to provide for the fullest possible realisation of the free movement of goods, persons, services and capital within the whole European Economic Area, so that the internal market established within the European Union is extended to the EFTA States. From that angle, several provisions of the abovementioned Agreement are intended to ensure as uniform an interpretation as possible thereof throughout the EEA (see Opinion 1/92 [1992] ECR I-2821). It is for the Court, in that context, to ensure that the rules of*

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[603] See Kuijper, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 1339; Moritz, *Das Diskriminierungsverbot*, p. 272; Moosbrugger, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 363; Gudmundsson, *Intertax* (2006) p. 61.

[604] See Gudmundsson, *Intertax* (2006) p. 58. Concerning the free movement of workers see ECJ 5 July 2007, C-522/04, *Commission vs. Belgium* [2007] ECR I-05701, paras. 76-77; concerning the freedom to provide services see ECJ 6 October 2009, C-153/08, *Commission vs. Spain* [2009] ECR I-09735, paras. 48 et seq.; concerning the free movement of capital see ECJ 23 September 2003, C-452/01, *Ospelt* [2003] ECR I-9743; EFTA Court 23 November 2004, E-1/04, *Fokus Bank*. For a difference in interpretation in light of the objectives of the EU and the EEA see Ståhl, *EC Tax Review* (2004) p. 51 (with reference to Opinion 1/91 of 14 December 1991 [1991] ECR I-6079).

Moosbrugger identifies an inhomogeneous interpretation of the free movement of capital in the judgments *Denkavit* (ECJ 14 December 2006, C-170/05, *Denkavit* [2006] ECR I-11949) and *Fokus Bank* (EFTA Court 23 November 2004, E-1/04, *Fokus Bank*) and, thus, questions whether the principle of uniformity has been violated by the ECJ and whether the free movement of capital under the EEA Agreement and the TFEU could have a different meaning. However, he concludes that the interpretation of the free movement of capital turned consistent again in later case law of the ECJ and the EFTA Court. See Moosbrugger, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, pp. 373 et seq. It has to be noted, however, that the ECJ case *Denkavit* concerned the freedom of establishment and not the free movement of capital. Therefore, an inhomogeneous interpretation of the free movement of capital by the ECJ and the EFTA Court could not be derived from the *Denkavit* judgment. On the different approach concerning the relevance of tax treaties in the cases *Fokus Bank* and *Denkavit* see in detail chapter V.

[605] See Gudmundsson, *Intertax* (2006) p. 63; Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 39.

[606] ECJ 23 September 2003, C-452/01, *Ospelt* [2003] ECR I-9743, paras. 28-29.

the EEA Agreement which are identical in substance to those of the Treaty are interpreted uniformly within the Member States.

A homogeneous interpretation of EU and EEA law shall be achieved by a special procedure. The Joint Committee – consisting of representatives of the contracting parties of the EEA – has the task to keep track of ECJ case law and the case law of the EFTA Court.[607] In case a homogeneous interpretation of equivalent provisions is not ensured, the contracting parties of the EEA may ask the ECJ for its ruling.[608] Moreover, Art. 6 of the EEA Agreement lays down that the provisions of the Agreement have to be interpreted in conformity with ECJ case law that dates back to before the EEA Agreement went into force. Thus, the EFTA Court is bound by earlier ECJ decisions.[609] Also, the EFTA Court shall pay due account to the decisions given by the ECJ after the signature of the EEA Agreement.[610] Both the ECJ and the EFTA court are competent to interpret the EEA Agreement. The ECJ rules on the application of the EEA Agreement within the EU, and the EFTA Court does the same for the EFTA Member States.[611]

Even though the fundamental freedoms in the TFEU and the EEA Agreement are considered by the Courts to have the same meaning, this is not obvious from a first sight. The two instruments have a different purpose after all. The EEA Agreement does not seek to establish a customs union and does not foresee common rules with regard to third countries.[612]

Also, the TFEU and the EEA Agreement differ slightly in their wording of the freedoms provisions. One such deviation can be found in Art. 40 EEA and Art. 63 TFEU, respectively. The free movement of capital in the TFEU ensures free movement of capital between the EU Member States and with third countries. The EEA Agreement, however, only provides for free movement of capital between residents of the EU Member States and the EFTA Member States.[613] Pistone argues that due to this difference, *"residents of EFTA countries will find it more convenient to invoke the application of the EC Treaty* [TFEU]*"*.[614] However, EFTA countries may only invoke the free movement of capital according to Art. 63 TFEU as a third country. Art. 63 provides that *"all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited"*. Thus, free movement of capital is only provided between EU Member States and third

[607] See Kuijper, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*^{4}, pp. 1339 et seq.
[608] See Kuijper, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*^{4}, p. 1340.
[609] See Moosbrugger, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, pp. 363 et seq.; see also EFTA Court 23 November 2004, E-1/04, *Fokus Bank*, para. 22.
[610] See Gudmundsson, *Intertax* (2006) p. 66.
[611] See Gudmundsson, *Intertax* (2006) p. 60.
[612] See Gudmundsson, *Intertax* (2006) p. 65; Krünes, *ecolex* (1992) p. 519.
[613] See Gudmundsson, *Intertax* (2006) p. 68; Moosbrugger, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 371; Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 40.
[614] Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 40.

countries – including the EFTA countries – and not among only third countries. Thus, for the non-EU, EEA Member States, Art. 63 TFEU even has a narrower scope than Art. 40 EEA. Under the former they may rely on free movement with the 27 EU Member States, under the latter with the 29 other contracting parties of the EEA.

There are also other deviations concerning the free movement of capital. Art. 40 EEA prohibits discrimination on basis of nationality, residence or the place where capital is invested. In contrast, Art. 65 (1) (a) TFEU explicitly allows Member States to distinguish between residents and non-residents taxpayers and apply tax law provisions which distinguish according to the place where capital is invested. This tax clause is not incorporated in the EEA Agreement. Also, Art. 40 EEA does not contain an explicit justification based on public policy and public security, as does Art. 65 (1) (b) TFEU.[615]

However, despite the differences in the wording of the provisions on the free movement of capital, the ECJ and the EFTA Court have applied the principle of uniformity in interpreting the corresponding provisions, thus, giving them the same meaning.[616] For the area of withholding taxes this means that the freedom to provide services, the freedom of establishment, and the free movement of capital provided by the EEA Agreement prohibit discrimination based on the tax collection and the tax amount. The same principles developed in chapters 1. to 3. apply. However, as has already been mentioned, the further examination concerning the comparability, justifications, and proportionality in regard to EEA Member States by differ from the intra-EU case.[617]

Due to the extension of the fundamental freedoms to the EEA countries, the determination of the applicable freedom[618] is equally important as regards the EEA freedoms. The ECJ as well as the EFTA Court apply the principal aspect jurisprudence also to the EEA freedoms. In the *Seabrokers* judgment, the EFTA Court had to draw a line between the freedom of establishment and the free movement of capital. In making reference to previous ECJ case law, the EFTA Court ensured a homogenous interpretation by the two courts:[619]

> *The Court notes that the case at hand concerns the situation where a company in one EEA State, the home State, establishes a branch in another EEA State, the host State, through which it runs a part of its business. Under such circumstances, the rules at issue in the main proceedings primarily affect the freedom of establishment. Therefore, they must be examined under Article 31 EEA. Should the rules have restrictive effects on the free movement of capital,*

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[615] See also Moosbrugger, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 375.
[616] See Gudmundsson, *Intertax* (2006) pp. 68 et seq.
[617] See in detail chapters IV. to VI.
[618] See chapter 3.
[619] EFTA Court 7 May 2008, E-7/07, *Seabrokers*, para. 27.

those effects would be the unavoidable consequence of a possible obstacle to freedom of establishment, and do therefore not justify an independent examination under Article 40 EEA (see for comparison Case C-231/05 Oy AA [2007] ECR I-6373, at paragraphs 23 and 24).

EEA Member States, as far as they are not EU Member States, are third countries in the sense of Art. 64 TFEU. Thus, the free movement of capital is granted to them. However, the standstill clause of Art. 64 (1) TFEU does not apply to EEA Member States.[620] The ECJ – again in the *Ospelt* judgment – has made the following statement:[621]

> *It would run counter to that objective as to uniformity of application of the rules relating to free movement of capital within the EEA for a State such as the Republic of Austria, which is a party to that Agreement, which entered into force on 1 January 1994, to be able, after its accession to the European Union on 1 January 1995, to maintain legislation which restricts that freedom vis-à-vis another State party to that Agreement by basing itself on Article 73c of the Treaty* [Art. 64 (1) TFEU].

The non-application of Art. 64 (1) TFEU is obvious when considering the aim of the EEA Agreement. It should ensure the free movement of goods, services, persons, and capital. Thus, the EEA Agreement provides for the same freedoms as the TFEU. A mere application of the free movement of capital – like it applies to third countries that are not part of the EEA – is not necessary in the EEA. Thus, also the standstill clause does not have a field of application within the EEA.

4.3. Agreements with Switzerland

Switzerland is an EFTA Member State. When the other EFTA Member States either joined the EU[622] or the EEA[623] the Swiss people decided in a referendum that they did not want to join either organization.[624] However, the EU and its Member States[625] have concluded a set of separate agreements with Switzerland, rendering it a third State of 'special character'.[626] In this way, the EU

[620] See Gudmundsson, *Intertax* (2006) p. 68.
[621] ECJ 23 September 2003, C-452/01, *Ospelt* [2003] ECR I-9743, para. 30.
[622] Austria, Finland, and Sweden.
[623] Iceland, Liechtenstein, and Norway.
[624] The Swiss people decided in a referendum in 1992 not to join the EEA. The previously transmitted request of the Swiss Government for accession to the EU was frozen after the negative referendum on the EEA membership; see Breitenmoser, *CMLR* 2003, pp. 1137 and 1140; Taeschler, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 384.
[625] Newly accessed EU Member States automatically become contracting parties of the agreements, except for the Agreement on the Free Movement of Persons, which requires a new ratification process; see Breitenmoser, *CMLR* 2003, pp. 1138-1139.
[626] The package of the seven Bilateral Agreements I includes: free movement of persons, air transport, overland transport of goods and persons, trade in agricultural products, technical barriers to trade, public procurement, and research and technological cooperation. The package was signed on 21 June 1999. It was passed in a referendum in Switzerland on 21 May 2000 (see Kahil-Wolff/Mosters, *EuZW* (2001) p. 5). It is effective since 1

and Switzerland could engage in economic cooperation in areas which are of mutual interest for both sides.[627] The agreements deepen the relations between the EU, its Member States, and Switzerland and facilitate market access for the contracting parties.[628]

The agreements with Switzerland aim at the adoption of parts of the *acquis unionaire* into the Swiss legal system.[629] Their substantive content is, thus, based on EU law. Therefore, their application and interpretation has to follow the standards set by the ECJ.[630] Technically, however, the agreements are international law contracts.[631] Thus, the ECJ does not have jurisdiction to interpret them.[632] Rather they are applied and interpreted according to the Vienna Convention on Treaties.[633] The courts of the contracting parties – the EU Member States and Switzerland – have the competence to interpret the agreements. Hereby, the ECJ can be called for a preliminary ruling by a court of an EU Member State in order to ensure conformity in the interpretation of the agreements.[634]

The most important agreements from a tax law point of view are the EU-Switzerland Agreement on the Free Movement of Persons[635] and the EU-Switzerland Savings Agreement.[636] Apart from the Savings Agreement, which has the same content as the EU Savings Directive,[637] no other EU secondary law concerning taxes is applicable with regard to Switzerland.[638]

The EU-Switzerland AFMP[639] is a mixed agreement. This means that the EU and its Member States are contracting parties on the one side, and Switzerland is a contracting party on the other side.[640] As an international agreement the AFMP is considered to be subordinate to EU primary law and to have primacy over EU secondary law.[641] The AFMP seeks to establish the whole *acquis*

June 2002. See Kuijper, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], p. 1341; Breitenmoser, *CMLR* 2003, p. 1137; Taeschler, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 385. In addition, nine Bilateral Agreements II have been concluded.

[627] See Taeschler, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 384.

[628] See Breitenmoser, *CMLR* 2003, p. 1138.

[629] See Breitenmoser, *CMLR* 2003, pp. 1139 and 1152.

[630] See Breitenmoser, *CMLR* 2003, p. 1144; see also Kahil-Wolff/Mosters, *EuZW* (2001) p. 6. This is also made clear in Art. 16 AFMP.

[631] See Breitenmoser, *CMLR* 2003, pp. 1144 and 1151.

[632] See Taeschler, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 385.

[633] See Breitenmoser, *CMLR* 2003, p. 1144; Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 44.

[634] See Breitenmoser, *CMLR* 2003, pp. 1155-1156.

[635] Hereinafter: AFMP.

[636] See also Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 41.

[637] It also implements certain aspects of the Parent-Subsidiary Directive and the Interest and Royalty Directive; see further below.

[638] See Hinny, *ET* (2001) p. 423; Taeschler, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 385.

[639] OJ L 114 of 30 April 2002, p. 6.

[640] See Kahil-Wolff/Mosters, *EuZW* (2001) pp. 6-7; Breitenmoser, *CMLR* 2003, p. 1143.

[641] See Kahil-Wolff/Mosters, *EuZW* (2001) pp. 6-7.

unionaire with regard to the free movement of persons.[642] Its intention is to enable the same level of free movement that is provided for by the TFEU.[643] However, its effect is limited to the *acquis unionaire* that existed prior to 21 June 1999, the date of signature.[644] Also, the AFMP does not extend the fundamental freedoms to Switzerland in general, but rather provides for very specific rights.[645]

Most parts of the AFMP are considered to have direct effect. Thus, they can be relied on by each person.[646] The AFMP covers only individual persons. However, for the provision of services also companies are covered.[647] Its objectives are listed in Art. 1:

> *(a) to accord a right of entry, residence, access to work as employed persons, establishment on a self-employed basis and the right to stay in the territory of the Contracting Parties; (b) to facilitate the provision of services in the territory of the Contracting Parties, and in particular to liberalise the provision of services of brief duration; (c) to accord a right of entry into, and residence in, the territory of the Contracting Parties to persons without an economic activity in the host country; (d) to accord the same living, employment and working conditions as those accorded to nationals.*

According to the provisions embodied in the AFMP, it prohibits discrimination in the host state.[648] This includes direct and indirect discrimination.[649] Moreover, scholars have expressed the view that also the home state is bound by the AFMP.[650] The AFMP grants the free movement of employees, the freedom of establishment, and the freedom to provide services.[651] Moreover, Art. 2 of the AFMP provides for non-discrimination on grounds of nationality in the areas that are covered by the Agreement.[652] The rights provided by the agreement may be refused for reasons of public order, public security, and public health, subject to a proportionality test.[653]

Doubts have been raised as to whether the AFMP is applicable in the area of direct taxes. These doubts were based on Art. 21 AFMP. According to Art. 21 (1) AFMP, the bilateral agreements

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[642] See Breitenmoser, *CMLR* 2003, p. 1161; Kahil-Wolff/Mosters, *EuZW* (2001) p. 5.
[643] See the preamble of the Agreement.
[644] See Breitenmoser, *CMLR* 2003, pp. 1161 and 1164; Hinny, *ET* (2001) p. 423.
[645] See Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 42.
[646] See Breitenmoser, *CMLR* 2003, p. 1147; Kahil-Wolff/Mosters, *EuZW* (2001) p. 7.
[647] Art. 5 AFMP; see Taeschler, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, pp. 386 et seq.
[648] See Annex I Arts. 9 and 15 AFMP.
[649] Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 42 with reference to the national reports of Austria and Belgium.
[650] Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 42 with reference to the national reports of Austria, Italy, and Poland.
[651] See Kahil-Wolff/Mosters, *EuZW* (2001) pp. 5 and 7; Taeschler, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 388.
[652] See Taeschler, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, pp. 392 et seq.; Hinny, *ET* (2001) p. 423. As under the TFEU, not just overt discrimination on grounds of nationality, but also covert discrimination leading to the same result is prohibited; see Hinny, *ET* (2001) p. 424.
[653] Annex I Art. 5 AFMP; see Breitenmoser, *CMLR* 2003, p. 1163.

on double taxation shall be unaffected by the Agreement. Art. 21 (2) AFMP allows different treatment of taxpayers who are not in a comparable situations, especially as regards their place of residence.[654] The latter provisions very much resembles Art. 65 (1) (a) TFEU. As has been explained in chapter 4.1.4., this provision is regarded as a mere codification of case law and does not constitute are carte blanche for discrimination. Pistone resolves the doubts and affirms the application of the AFMP to direct taxes.[655] Moreover, Swiss courts have also applied the AFMP to direct tax cases.

Most interestingly for the scope of this thesis, the AFMP contains a provision in Art. 21 (3) stating the following:

> *No provision of this Agreement shall prevent the Contracting Parties from adopting or applying measures to ensure the imposition, payment and effective recovery of taxes or to forestall tax evasion under their national tax legislation or agreements aimed at preventing double taxation between Switzerland, of the one part, and one or more Member States of the European Community, of the other part, or any other tax arrangements.*

Thus, it seems that the AFMP does not interfere with the levying of withholding taxes. However, according to Hinny, this only concerns the mechanism of tax collection and not the specific characteristics of the withholding tax, e.g., the tax rate.[656] Thus, if the tax amount of withholding taxes deters the free movement of persons or the freedom to provide services between the EU and Switzerland, the AFMP may be infringed.

The AFMP provides for the free movement of persons (comprising of the free movement of workers and the freedom of establishment) and for the freedom to provide services.[657] Keeping in mind the declaration of the contracting parties in the preamble,[658] the provisions of the AFMP – despite the different wording – should be interpreted in the same way as the fundamental freedoms of the TFEU.[659] This intention is also referred to in the Agreement itself, namely in Art. 16.[660] This provision ensures a consistent application of the freedoms under the EU-Switzerland AFMP and the fundamental freedoms of the TFEU. Also, it provides for an interpretation of the provisions of the Agreement that is consistent with ECJ case law that was issued before its signature.[661] Through the

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[654] See also Hinny, *ET* (2001) p. 423.
[655] Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 42.
[656] Hinny, *ET* (2001) p. 426.
[657] See Taeschler, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 388.
[658] *„Resolved to bring about the free movement of persons between them on the basis of the rules applying in the European Community".*
[659] See Taeschler, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, pp. 388 et seq. with reference to Cadosch, *The influence on Swiss tax law*, p. 11.
[660] See Breitenmoser, *CMLR* 2003, p. 1152; Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 41.
[661] 21 June 1999; see Beiser, *RdW* (2005) p. 455.

reference in the AFMP to the date of signature, the Agreement has a static character.[662] Changes in EU law do not automatically lead to a change in the Agreement.[663] This makes it easier for Switzerland to comply with ECJ case law. However, differences in the interpretation of EU law and the AFMP become possible.[664] The Swiss courts are not bound by new case law of the ECJ and can, thus, interpret provisions differently than the ECJ.[665]

ECJ case law issued after the signature of the AFMP should be communicated to Switzerland. The Joint Committee then decides on the impact of new case law on the interpretation of the AFMP. It acts unanimously. Thus, the Swiss representatives can ban new case law from influencing the AFMP.[666] However, in many cases it may be hard to distinguish between a mere progress and a real change in the ECJ's case law, because the Court does not explicitly declare the latter in its judgments. A mere extension of the *acquis unionaire* that was applicable at the date of signature of the AFMP would become part of the Agreement even without participation of the Joint Committee.[667] A real change in the ECJ's jurisprudence, however, requires action of the Joint Committee. Incorporation into the AFMP would require a unanimous decision of the Joint Committee.[668]

The EU-Switzerland Savings Agreement[669] is the equivalent to the EU-Savings Directive.[670] However, it applies only unilaterally. It covers interest payments made from Swiss paying agents to residents of an EU Member State. A withholding tax may be levied by the Swiss paying agent.[671] Moreover, tax treaties concluded between Switzerland and an EU Member State do not interfere with the levy of the special withholding tax provided by the Savings Agreement.[672] Instead of the withholding tax, the beneficial owner of the interest may authorize the paying agent to disclose the

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[662] See Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 41. Taeschler mentions that some scholars support a dynamic approach. Accordingly, Art. 16 (2) AFMP does not prohibit the recognition of ECJ case law issued after the date of signature (Taeschler, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, pp. 390-391 with reference to Cadosch, *The influence on Swiss tax law*, p. 4; Cottier/Etimov, *ZBJV* (2003) pp. 108-109; Cadosch, *Intertax* (2004) pp. 588-589).
[663] See Breitenmoser, *CMLR* 2003, pp. 1159-1160.
[664] See Kahil-Wolff/Mosters, *EuZW* (2001) p. 7.
[665] See Beiser, *RdW* (2005) p. 455.
[666] See Beiser, *RdW* (2005) p. 455; see also Kahil-Wolff/Mosters, *EuZW* (2001) p. 6.
[667] See Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 41.
[668] See Breitenmoser, *CMLR* 2003, pp. 1164-1165; See Kahil-Wolff/Mosters, *EuZW* (2001) p. 7.
[669] OJ L 385/30 of 29 December 2004; signed on October 26, 2004.
[670] The first agreement between the EU and a third country exclusively covering direct taxes; Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 43. The amendments to the Savings Directive and relevant case law are not taken into account in applying the Savings Agreements. Switzerland takes a static approach. See Sarghi, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 412.
[671] Art. 1 Savings Agreement.
[672] Art. 14 Savings Agreement.

information on interest receipts to his residence state. The Savings Agreement also provides for the exchange of information from Switzerland in case of 'tax fraud and the like'.[673]

Pistone mentions two reasons for the conclusion of the Agreement: First, it should mitigate the opposition among EU Member States to the introduction of the Savings Directive. Second, it should ensure an equivalent application of rules within the EU and with Switzerland in accordance with Art. 16 AFMP.[674] Sarghi explains that from the EU perspective, the conclusion of the Savings Agreement with Switzerland[675] was vital for the Savings Directive to enter into force. For Switzerland, also, the Savings Agreement was very important to satisfy EU demands while being able to keep its bank secrecy.[676]

Also, the Savings Agreement regulates the taxation of dividends, interest, and royalty payments between associated companies.[677] In this respect, it is comparable to the Parent-Subsidiary Directive and the Interest and Royalty Directive.[678] The partial benefits of the two Directives were granted to Switzerland in order to compensate the unilateral application of the Savings Agreement on interest from savings.[679] The rules on the taxation of dividends, interest, and royalties alloy reciprocally. However, the Savings Agreement only provides for a tax exemption in the source state. Thus, as far as dividends are concerned, economic double taxation is not avoided.[680]

The Savings Agreement does not provide for non-discrimination and non-restriction between the EU and Switzerland. Thus, it does not equal the fundamental freedoms of the EU, but rather the harmonization efforts realized by the respective Directives. For the consideration of withholding taxes in the light of the fundamental freedoms, it is therefore only of limited relevance.

4.4. Association and Partnership Agreements

Beside the EEA countries Iceland, Liechtenstein, and Norway, and in addition Switzerland, there are also other third countries that have a special relationship with the EU. They may be referred to as association and partnership countries.[681] Association countries typically intend a future EU-membership. Partnership countries, in contrast, merely seek to extend some parts of the EU

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[673] This does not include tax evasion, i.e., improper declaration of private income; see Sarghi, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 405.
[674] Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 44.
[675] Among other countries.
[676] Sarghi, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 401.
[677] Art. 15 Savings Agreement.
[678] See for further details Sarghi, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, pp. 399 et seq.
[679] See Danon/Storckmeijer, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 949; Sarghi, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 406.
[680] See Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 44; Sarghi, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 411.
[681] See Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 46.

internal market to their territory.[682] However, the differentiation is vague.[683] In general, both types of agreements seek *"the progressive liberalization of the fundamental freedoms"*.[684]

The EU has concluded a wide range of association and partnership agreements,[685] which substantially vary in their content.[686] In general, though, they provide for the free movement of capital and the freedom of establishment.[687] However, despite similar or equal wording, in contrast to the EEA Agreement and the AFMP, the interpretation of Association and Partnership Agreements does not follow the TFEU. This is due to the fact that the objective and context of the specific agreement have to be taken into account when interpreting its provisions.

Under the TFEU, the freedom of establishment is not extended to third countries. The free movement of capital, in contrast, also applies between EU Member States and third countries. However, only the EU Member State is bound by Art. 63 TFEU. Association and Partnership Agreements bind EU Member States and third countries to respect the freedoms embodied therein. Some agreements, though, only bind the third country.[688]

The Association Agreement with Turkey and the Partnership Agreement with Russia are taken as examples for the great number of agreements between the EU and third countries.

The EU has concluded an Association Agreement with Turkey in 1963. The Agreement covers the four freedoms granted under the TFEU. The Agreement also contains a general non-discrimination clause in Art. 9. However, it does not provide for a common market. The Association Agreements seeks to establish a customs union[689] with free movement of workers,[690] services,[691] and capital,[692] and freedom of establishment.[693] However, the practical implementation of the customs union was problematic and is still not fulfilled.[694] This may also be due to the fact that the Agreement does not contain strict rules on the fundamental freedoms. Instead it merely stipulates that the contracting parties should take guidance in the TFEU to attain free movement of workers and abolish restrictions to the freedom of establishment and the freedom to provide services. As far as the free

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682 See Pistone, in Lang/Pistone (eds.) *The EU and Third Countries*, p. 47.
683 See Traversa, in Lang/Pistone (eds.) *The EU and Third Countries*; *Intertax* (2007) p. 594.
684 Bezborodov, *Intertax* (2007) p. 698.
685 Association and Partnership Agreements are mixed agreements which are concluded between the third country, the EU, and its Member States; see Basalykas, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 443.
686 See Basalykas, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 441.
687 See Basalykas, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 442.
688 See Basalykas, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, pp. 449-450.
689 Art. 2 (2) Association Agreement.
690 Art. 12 Association Agreement.
691 Art. 14 Association Agreement.
692 Art. 20 Association Agreement.
693 Art. 13 Association Agreement.
694 See Kuijper, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*^{4}, p. 1343.

movement of capital is concerned, the contracting parties shall consult in order to facilitate the attainment of free movement. It can be concluded that the Association Agreement with Turkey imposes to vague obligations on the contracting parties. Thus, different treatment based on withholding taxes is unlikely to infringe the Association Agreement with Turkey. This applies even more because the ECJ – and other courts to the author's knowledge – have not yet applied the Agreement to direct taxes.

In 1994, a Partnership Agreement with Russia was signed. It entered into force on December 1, 1997. The ECJ has held that

> *the Communities-Russia Partnership Agreement is not intended to establish an association with a view to the gradual integration of that non-member country into the European Communities but is designed rather to bring about 'the gradual integration between Russia and a wider area of cooperation in Europe'.*[695]

The Agreement contains many provisions on trade, which includes goods, services, establishment, and payments and capital. It also provides for a most-favored-nation clause with regard to goods and establishment.[696] As regards capital movements, current payments and direct investment are liberalized.[697]

The ECJ held in its *Simutenkov* decision, that Art. 23 of the Partnership Agreement has direct effect.[698] Thus, it can be relied on by a person before the court of an EU Member State. Art. 23 Partnership Agreement provides the following:

> *Subject to the laws, conditions and procedures applicable in each Member State, the Community and its Member States shall ensure that the treatment accorded to Russian nationals legally employed in the territory of a Member State shall be free from any discrimination based on nationality, as regards working conditions, remuneration or dismissal, as compared to its own nationals.*

Art. 23 of the Partnership Agreement prohibits discrimination of workers based on nationality in the host state. The wording is similar to Art. 45 TFEU. However, as has been mentioned above, despite the similar wording, the interpretation of Art. 23 of the Partnership Agreement has to be conducted in light of the objective and purpose of the Agreement. The freedom to provide services of Art. 36 is based on most-favored nation treatment. It is limited to the sectors listed in Annex 5 to the Agreement.

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[695] ECJ 12 April 2005, C-265/03, *Simutenkov* [2005] ECR I-2579, para. 35.
[696] Art. 28 Partnership Agreement concerning establishment.
[697] See Kuijper, in Kapteyn/VerLoren van Themaat (eds.) *Introduction*[4], pp. 1349 et seq.
[698] ECJ 12 April 2005, C-265/03, *Simutenkov* [2005] ECR I-2579, paras. 20 et seq.

Art. 28 (1) of the Partnership Agreement grants most-favored nation treatment concerning the establishment of companies. Art. 28 (2) and (3) of the Partnership Agreement provide that subsidiaries must not be treated less favorably in respect of their operation than national companies or subsidiaries of any third country company, whichever is better. Art. 28 (4) treats branches and prescribes most-favored-nation treatment for their operation. Thus, while the operation of subsidiaries is provided the better of national treatment or most-favored-nation treatment, the operation of branches and the establishment of both subsidiaries and branches are only granted most-favored-nation treatment.[699] Art. 33 of the Partnership Agreement contains the general remark that

> *[t]he Parties recognize the importance of granting each other national treatment with regard to the establishment and, where not so foreseen herein, operation of each other's companies in their territories and agree to consider the possibility of movement towards this end on a mutually satisfactory basis, and in the light of any recommendations by the Cooperation Council.*

The term 'establishment' is also defined in the Agreement. It means *"to take up economic activities by means of the setting up of subsidiaries and branches in Russia or in the Community respectively"*. Thus, freedom of establishment under the Partnership Agreement with Russia only comprises the right of secondary establishment. The freedom of primary establishment is not covered.[700] Also the term 'subsidiary' is defined in the Agreement and encompasses a company which is controlled by another company. The notion of 'control' is given in a Joint Declaration:

> *1. The Parties confirm their mutual understanding that the question of control shall depend on the factual circumstances of the particular case.*
>
> *2. A company shall, for example, be considered as being 'controlled` by another company, and thus a subsidiary of such other company if:*
>
> *- the other company holds directly or indirectly a majority of the voting rights, or*
>
> *- the other company has the right to appoint or dismiss a majority of the administrative organ, of the management organ or of the supervisory organ and is at the same time a shareholder or member of the subsidiary.*
>
> *3. Both Parties consider the criteria in paragraph 2 to be non-exhaustive.*

The free movement of capital only covers direct investment in companies and investment in establishment. The term 'direct investment' is defined in a Joint Declaration:

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[699] See Basalykas, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 452.
[700] Literature, case law on difference.

'Direct investment` is an investment for the purpose of establishing lasting economic relations with an enterprise such as investments which give the possibility of exercising an effective influence on the management thereof, in the country concerned by non-residents or abroad by residents, by means of:

1. creation or extension of a wholly owned enterprise, a subsidiary or a branch, acquisition of full ownership of an existing enterprise;

2. participation in a new or existing enterprise;

3. a loan of five years or longer.

Portfolio investment is excluded from the ambit of the Agreement. However, the Agreement contains a declaration of intent to further liberalize portfolio investment.[701]

It can be concluded from the above that the freedoms provided by the Partnership Agreement with Russia are a lot more limited than the fundamental freedoms of the TFEU. The freedom to provide services is limited to a number of services mentioned in the Annex, the freedom of establishment does not encompass primary establishment and the free movement of capital only covers direct investment. However, despite the limited scope, an overlap between the freedoms may still occur. In this regard the question arises whether the exclusive application of the primarily affected freedom as conducted by the ECJ in its recent case law is also relevant for EU Agreements.[702] In this case definite influence over the company's decisions would lead to the application of the freedom of establishment instead of the free movement of capital. The application of the free movement of capital would be obsolete, because it only covers direct investment. Basalykas is not in favor of applying the principal aspect jurisprudence to Association and Partnership Agreements. He argues that many such agreement do not include a provision on the freedom of establishment, but explicitly and exclusively cover direct investment under the free movement of capital. Concerning those Agreements, the application of the freedom of establishment to all direct investment would lead to non-protection despite the attempt to liberalize direct investment.[703]

In regard to withholding taxes, the Partnership Agreement with Russia may have an impact. Withholding taxes on service payments, however, may not be infringing the Agreement, even if they are levied in a discriminatory manner. First, the freedom to provide services is limited to the sectors listed in Annex 5. Second, it only provides for most-favored-nation treatment, and not for national treatment. Thus, different treatment of residents and non-residents based on withholding taxes is

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[701] Art. 52 (8) Partnership Agreement.
[702] See chapter 3.3.
[703] Basalykas, in Heidenbauer/Stürzlinger (eds.) *The EU's External Dimension*, p. 454.

not prohibited. The same is true if services are provided through branches of the non-resident taxpayer.

For capital income, the freedom of establishment or the free movement of capital may apply. The operation of subsidiaries and capital movements enjoy a wider scope of protection than just most-favored-nation treatment. However, the two freedoms only cover cases in which the taxpayer holds the majority of voting rights in a company or has effective influence on the management of the company. Thus, the Partnership Agreement with Russia may only influence the levy of withholding taxes on direct investment.

IV. COMPARABILITY ANALYSIS

1. Legal comparability of residents and non-residents

The fundamental freedoms prohibit discrimination based on nationality. This is referred to as overt discrimination.[704] Tax laws typically do not foresee different treatment based on the nationality of a taxpayer. Rather, the decisive factor is often the taxpayer's residence. Residents of a country are taxed on their world-wide income, while non-residents are solely taxed on income originating in the country concerned. However, residents are often granted a favorable treatment that is not given to non-residents. According to the case law of the ECJ, the fundamental freedoms also prohibit covert discrimination. That is discrimination based on other criteria than nationality, however, having the same effect.[705] The ECJ has found that the distinction in tax law according to the taxpayer's residence is capable of leading to a covert discrimination, being mainly at the disadvantage of non-nationals.

In its case law on direct taxation, the ECJ usually compares residents and non-residents. A different treatment of both categories leads to discrimination if their situation is comparable. Also, equal treatment of residents and non-residents might lead to a discrimination that is prohibited by the fundamental freedoms. This is the case if the equal treatment is applied to situations that are not comparable. If non-residents are treated less favorably by the tax law of a Member State, the ECJ will – after having found that one of the fundamental freedoms is applicable – examine whether the situation of the non-resident is comparable to that of a resident.

The examination described applies to cases where the treatment of taxpayers in the host state is concerned. A Member State treats residents of another state receiving income from sources within its territory less favorably than its own residents. Another possible scenario is that of home state discrimination. In that case a resident who exercises his fundamental freedoms is treated less favorably than a resident who does not engage in business activities with other Member States or third countries.[706]

In both cases the ECJ will examine whether comparability is given. The ECJ does that by establishing a pair of comparison. In the case of possible host state discrimination, the Court will compare the situation of the non-resident engaging in activities in his host state, thereby exercising his fundamental freedoms (the cross-border situation) with the situation of a resident engaging in activities within his state of residence (the hypothetical internal situation). When examining a possible home state discrimination, the ECJ will form a pair of comparison between the resident

[704] Distinction between overt-covert, direct-indirect discrimination

[705] Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*², p. 52.

[706] This may be referred to as restriction rather than discrimination. If there is a difference is, however, highly debated in literature.

taxpayer who exercises his fundamental freedoms by engaging in activities with another state (the cross-border situation) and a resident taxpayer who does not exercise his freedoms (the hypothetical internal situation).

As a rule, the ECJ held that residents and non-residents are not in a comparable situation.[707] In the very first case on direct taxes, *Commission v. France* or *'Avoir Fiscal'*, the ECJ held that it

> *cannot altogether be excluded that a distinction based on the location of the registered office of a company or the place of residence of a natural person may, under certain conditions, be justified in an area such as tax law [...] .*

Not least it is a basic principle in tax law that world-wide taxation is linked to a person's residence in a state and non-residence leads to mere taxation of territorially linked income. In this respect, a distinction between residents and non-residents is justified.

However, the situation of residents and non-residents might turn comparable in terms of the tax rules applied to them. If there is no objective difference between their situation, residents and non-residents have to be treated equally. In most cases, the ECJ analyzes the comparability by looking at the legal treatment of both situations. This is referred to as 'legal comparability'. Therefore, if similar or equal tax rules are applied to residents and non-residents their situation is considered to be comparable, which makes equal treatment necessary.[708]

Most important, comparability can only be assessed on a case-by-case basis. Therefore, there is no general answer on whether residents and non-residents are in a comparable situation.

In its cases on withholding taxes the ECJ has mostly acknowledged the comparability between residents and non-residents. In the cases *Denkavit*, *Amurta*, and *Aberdeen* the ECJ examined whether resident and non-resident companies were in a comparable situation as far as profit distributions from their resident subsidiaries are concerned. In all of the three cases, the Member States concerned taxed profit distributions from resident subsidiaries to their non-resident parent companies at withholding. Conversely, profit distributions within the country were exempt from taxation. In order to find out whether this different treatment led to discrimination the ECJ had to ascertain the comparability of the situations:

> *It is true that, in the context of measures laid down by a Member State in order to prevent or mitigate the imposition of a series of charges to tax on, or the double taxation of, profits distributed by a resident company, resident shareholders receiving dividends are not necessarily in a situation which is comparable to that of shareholders receiving dividends who are resident in another Member State (see, to that effect, Case C-374/04 Test Claimants in*

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[707] Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*[2], p. 53.
[708] See Schön, in Schön (ed.) *GS Knobbe-Keuk*, pp. 760-761.

Class IV of the ACT Group Litigation [2006] ECR I-0000, paragraphs 57 to 65). However, as soon as a Member State, either unilaterally or by way of a convention, imposes a charge to tax on the income, not only of resident shareholders, but also of non-resident shareholders, from dividends which they receive from a resident company, the situation of those non-resident shareholders becomes comparable to that of resident shareholders (Test Claimants in Class IV of the ACT Group Litigation, paragraph 68).[709]

In short, resident and non-resident shareholders are in a comparable situation when the Member State concerned taxes both of them on their income from the shareholding. According to the OECD Model Convention, dividends paid out by a company of one contracting State to a shareholder of the other contracting State are taxed in the latter. However, the source State may also impose a tax of not more than 15% (or 5% if the parent company holds at least 25% in the shares). Therefore, if a Member State makes use of this taxing right granted to it in a tax treaty, non-resident shareholders become comparable to residents shareholders.

In another field of withholding taxes, the ECJ has come to concurring conclusions as far as comparability is concerned. That was in cases where the withholding tax was not opposed to non-taxation in the internal situation – as in the cases *Denkavit*, *Amurta*, and *Aberdeen* – but rather to taxation at assessment. In the *Scorpio* case the ECJ acknowledged the comparability of resident and non-resident services providers. Also, it held that a service recipient is in the same situation no matter whether he purchases services from a resident service provider or a non-resident.[710] Advocate General Léger, however, denied the comparability between because "resident and non-resident service providers are in an objectively different situation with regard to the requirements concerning the collection of tax". With this statement the Advocate General referred to the lack of instruments for tax collection. Neither the Recovery Assistance Directive nor a tax treaty providing for recovery assistance was applicable between Germany and the Netherlands at the time of the case. However, for the Court, this was not a reason to negate the comparability.[711]

The ECJ, though, followed a very similar reasoning to the Advocate General Léger's in *Scorpio* in its *Truck Center* decision.[712] In this case, the ECJ had to rule on a Belgian tax provisions which levied a withholding tax on interest paid from a Belgian company to a non-resident, whereas interest payments made within Belgium were taxed as assessment. In order to determine whether this difference in treatment amounts to discrimination prohibited by the fundamental freedoms, the

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[709] ECJ 14 December 2006, C-170/05, *Denkavit* [2006] ECR I-11949, paras. 34-35; see also ECJ 8 November 2007, C-379/05, *Amurta* [2007] ECR I-09569, paras. 37-38; 18 June 2009, C-303/07, *Aberdeen* [2009] ECR I-05145, paras. 42-43.

[710] ECJ 3 October 2006, C-290/04, *Scorpio* [2006] ECR I-09461, paras. 32-33.

[711] For the reasoning of the Court see chapter V.

[712] ECJ 22 December 2008, C-282/07, *Truck Center* [2008] ECR I-10767.

Court had to ascertain whether the residents and non-residents were in a comparable situation. Most surprisingly, the ECJ denied comparability in this case. It named three reasons why residents and non-residents that receive interest payments from a Belgian resident are not in a comparable situation:

> *Firstly, when both the company paying the interest and the company receiving that interest are resident in Belgium, the position of the Belgian State is different to that in which it finds itself when a company resident in Belgium pays interest to a non-resident company, because, in the first case, the Belgian State acts in its capacity as the State of residence of the companies concerned, while, in the second case, it acts in its capacity as the State in which the interest originates.*[713]

With this statement the Court referred to the differentiation between unlimited and limited tax liability. This is a basic principle in tax law. Unlimited tax liability is applied to residents and leads to taxation of world-wide income. Non-residents are subject to limited tax liability with only the income originating in a state. The ECJ has made clear in its case law that residents and non-residents are basically not in a comparable situation. It also repeated that statement in the *Truck Center* judgment.[714] However, it is not clear why the Court emphasizes this differentiation to such great extent in its *Truck Center* decision.[715] The second reason for the ECJ to determine non-comparability was the following:

> *Secondly, the payment of interest by one resident company to another resident company and the payment of interest by a resident company to a non-resident company give rise to two distinct charges which rest on separate legal bases.*[716]

Again, it is not clear how the argument brought forward by the ECJ can be decisive to determine non-comparability. It is a fair description of the two different taxes, but not a reason to deny comparability.[717] Even more, this difference in treatment should be scrutinized by the ECJ and not taken as a reason for non-comparability. The two distinct charges levied on interest paid to non-residents and residents amount to unequal treatment. Why the ECJ points out that they "rest on separate legal basis" is unclear. Again, if anything, this is only a sign for unequal treatment. And that is the only outcome that can be derived from the ECJ's statement in the *Truck Center* judgment, and nothing more. The third – and only sensible – reason for the ECJ to hold that residents and non-residents are not comparable in the case at hand in Truck Center was given as follows:

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[713] ECJ 22 December 2008, C-282/07, *Truck Center* [2008] ECR I-10767, para. 42.
[714] ECJ 22 December 2008, C-282/07, *Truck Center* [2008] ECR I-10767, para. 38.
[715] See Simader, in Lang et al. (eds.) *Quellensteuern*, p. 27; Lang, *EC Tax Review* 2009, p. 100; Englisch, *H&I* 2/2009, p. 49; de Broe/Bammens, *EC Tax Review* 2009, p. 135.
[716] ECJ 22 December 2008, C-282/07, *Truck Center* [2008] ECR I-10767, para. 43.
[717] See also Lang, *EC Tax Review* 2009, p. 100; Englisch, *H&I* 2/2009, p. 49.

Finally, those different taxation arrangements reflect the difference in the situations in which those companies find themselves with regard to recovery of the tax. While resident recipient companies are directly subject to the supervision of the Belgian tax authorities, which can ensure compulsory recovery of taxes, that is not the case with regard to non-resident recipient companies inasmuch as, in their case, recovery of the tax requires the assistance of the tax authorities of the other Member State.[718]

As in Advocate General Léger's decision in the *Scorpio* case, recovery assistance comes into play when examining the comparability of residents and non-residents. A state can only execute taxes within its own territory. If a non-resident owes taxes, the authorities might not be able to get hold of him due to the lack of a connection to their state. If taxes have to be executed, the authorities need the assistance of another state, namely the state of residence of the taxpayer concerned. The ECJ seems to consider that this need of assistance is enough to render residents and non-residents incomparable. Obviously, the mere potential need for administrative assistance is too great a burden for the state concerned. Thus, unequal treatment can be applied to residents and non-residents, justified by their non-comparability as far as recovery of taxes is concerned.

In the *Truck Center* judgment it seems to be of no importance for the ECJ whether administrative assistance instruments are available or not. Therein lays the remarkable difference to the *Scorpio* opinion and judgment. In the latter case, the Advocate General and the Court pointed out that at the relevant time no instrument providing for administrative assistance was applicable. For Advocate General Léger this was the reason to deny the comparability of residents and non-residents in the *Scorpio* case. In *Truck Center*, though, administrative assistance would have been available to Belgium. However, the ECJ considered the need for administrative assistance to be burdensome and the levy of a withholding tax, obviously, more effective. It follows that instruments for administrative assistance, i.e. exchange of information or tax recovery, are not relevant for the ECJ when examining the comparability of two situations. The ECJ would not have come to a different judgment if no recovery assistance had been available.[719]

Another remarkable feature of the ECJ's decision in the *Truck Center* case is that the Court detects different situations of residents and non-residents and, obviously, allows any kind of different treatment.[720] Thus, even if there was only a slight difference in the situation the difference in treatment could be of great extent. The ECJ does not comment on the proportionality of the difference in treatment to the difference in the situations. In contrast, Advocate General Kokott takes

[718] ECJ 22 December 2008, C-282/07, *Truck Center* [2008] ECR I-10767, paras. 47-48.
[719] For effective tax collection as a justification see chapter V.
[720] The same result was achieved by AG Léger in the *Scorpio* case.

a more differentiated approach. Like the Court, she ascertains the non-comparability of residents and non-residents:

> *The different conditions of charging tax in the case of non-residents and residents thus create an objective difference capable of justifying the charging of withholding tax solely on the income of a non-resident company.*[721]

In the following point, however, she makes clear that different situations cannot allow any kind of different treatment by referring to the Opinion given by Advocate General Maduro in the *Huber* case[722]:

> *It is also necessary to demonstrate that the difference in their respective situations is capable of justifying the difference in treatment. In other words, the difference in treatment must relate and be proportionate to the difference in their respective situations.*[723]

This examination is also referred to as 'proportionality of second degree'. Even if the situations are found not to be comparable it must be examined whether the withholding tax levied on payment to non-residents does not go beyond what is necessary to take account of the different situations.[724] In her analysis the Advocate General makes a connection to the *Scorpio* case. She states that like in the *Scorpio* case the Recovery Assistance Directive was not applicable to the tax authorities involved in the *Truck Center* case. However, Belgium could rely on a convention governing the mutual assistance in the recovery of tax claims with Luxembourg.[725] In this regard, Advocate General Kokott questioned whether charging tax at assessment with the assistance of the Luxembourg authorities would not be a less intrusive measure than levying a withholding tax. Even in consideration of the mutual assistance convention Advocate General Kokott comes to the conclusion that a withholding tax is less burdensome than taxation at assessment with the recovery assistance of another state:

> *Despite the possibility of administrative assistance, however, it is by no means necessarily the case that collecting tax from the foreign parent company to which the interest is due in fact constitutes a less severe means than collection at source within the country from the subsidiary company. If the foreign recipient were the tax debtor of the withholding tax, it would have to make a tax declaration to the tax authorities of the Member State of the source of the income, despite not being resident there. The authorities of that State would have to register that company as a taxable person and supervise the making of the tax*

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[721] Opinion AG Kokott 18 September 2008, C-282/07, *Truck Center* [2008] ECR I-10767, point 36.
[722] Opinion AG Maduro 3 April 2008, C-524/06 *Huber* [2008] ECR I-0000, point 7.
[723] Opinion AG Kokott 18 September 2008, C-282/07, *Truck Center* [2008] ECR I-10767, point 37.
[724] Opinion AG Kokott 18 September 2008, C-282/07, *Truck Center* [2008] ECR I-10767, point 39.
[725] Opinion AG Kokott 18 September 2008, C-282/07, *Truck Center* [2008] ECR I-10767, points 41-42.

declaration and the payment of the tax. In a case of enforcement they would also have to turn to the authorities of the State of residence of the recipient of interest, by means of administrative assistance.

The outcome of Advocate General Kokott's examination is stunning. When testing the proportionality of a measure the Court should support the means which are the least burdensome for the taxpayer. The Advocate General, however, takes account of the burden for the tax authorities. They would have to register and monitor the taxpayer and – even worse – they would have to file a request for administrative assistance for enforcement of the tax. The conclusion can be drawn that even if the examination of Advocate General Kokott was more thorough than the ECJ's, her proportionality analysis takes too much account of the tax authorities and too little of the taxpayer.[726]

In the end, Advocate General Kokott achieved the same result as the ECJ did. Both found the Belgian withholding tax to be in line with the fundamental freedoms. A different treatment can be given to residents and non-residents receiving interest payments from Belgian companies, because they do not find themselves in comparable situations. Nevertheless, the examination conducted by the Advocate General seems to be more in line with the ECJ's settled case law. That is because she went through all the levels of the discrimination test: applicable freedom – comparability – justification – proportionality. The ECJ, on the other hand, stopped its examination after detecting incomparable situations. Advocate General Kokott continued her examination after the comparability analysis and took the proportionality into account, too.

In the end, the steps in the discrimination test are exchangeable. The Advocate General's examination could also have supported the comparability of the situations, found a justification in the effective tax collection, and declared that the withholding tax was a proportionate means of ensuring this objective. The result would have been the same, namely no infringement of the fundamental freedoms by the Belgian withholding tax. The ECJ, though, left out some of the steps, which might lead to an unbalanced result.

After all, the *Truck Center* decision is remarkable, because it is very seldom in the ECJ case law that residents and non-residents are found to be in different situations.[727] It is more common that the comparability of the situations is affirmed and afterwards a justification for the different treatment is accepted. Also, the recovery of taxes usually comes into play on the justification level, as 'the need for effective tax collection'. *Truck Center* has been the only case so far, were differences in the recovery of taxes were the reason for denying the comparability of residents and non-residents.

[726] For proportionality see chapter VI.
[727] See Lang, *RIW* 2005, p. 343.

However, as mentioned above, the levels of the discrimination test have blurred lines. Therefore, in most cases it will not make a difference on which level a discrimination test leads to a negative result. If unequal treatment is applied to incomparable situations, no infringement of the fundamental freedoms occurs. If unequal treatment is given to persons that find themselves in a comparable situation, the difference in treatment might still be justified by reasons of public interest, hence, not infringing the fundamental freedoms. These results could be observed in the *Scorpio* and the *Truck Center* judgment of the ECJ.

In its cases concerning the tax base and tax rate for withholding taxes, the ECJ has affirmed the comparability of residents and non-residents. In the *Gerritse* decision the ECJ had to rule on the non-deductibility of business expenses for non-residents under German law. In its comparability analysis the ECJ found

> *that the business expenses in question are directly linked to the activity that generated the taxable income in Germany, so that residents and non-residents are placed in a comparable situation in that respect.*[728]

Apart from the deduction of business expenses, the *Gerritse* case also treated the tax rate applied to non-residents. While resident were subject to a progressive tax rate, non-residents were taxed at withholding with a fixed tax rate. The ECJ affirmed the comparability also as far as the tax rate is concerned:

> *[W]ith regard to the progressivity rule, non-residents and residents are in a comparable situation, so that application to the former of a higher rate of income tax than that applicable to the latter and to taxpayers who are assimilated to them would constitute indirect discrimination prohibited by Community law, in particular by Article 60 of the Treaty (see, by analogy, Asscher, paragraph 49).*[729]

Thus, it can be concluded from the *Gerritse* judgment that residents and non-residents find themselves in a comparable situation as far as the deduction of business expenses that are directly linked to the cross-border activity and the tax rate are concerned. This result is due to the fact that residents and non-residents are subject to comparable legal provisions regarding the tax object, i.e. the source of income.[730]

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[728] ECJ 12 June 2003, C-234/01, *Gerritse* [2003] ECR I-05933, para. 27.
[729] ECJ 12 June 2003, C-234/01, *Gerritse* [2003] ECR I-05933, para. 53.
[730] Schön, in Schön (ed.) *GS Knobbe-Keuk*, pp. 760-761.

2. *Schumacker* doctrine: Factual comparability of residents and non-residents

As stated above, the ECJ mostly analyzes the comparability of two situations by looking at the legal rules applies to them. However, the ECJ does not always consider the legal comparability. In the famous *Schumacker* case, the ECJ focused on the factual situation of the non-resident taxpayer Schumacker in order to find out whether he was in a comparable situation to a resident taxpayer. This approach was heavily criticized by some scholars.[731]

The case concerned the Belgian resident Schumacker, who earned all his income in Germany. His family lived together with him in Belgium. Due to the fact that he did not have any taxable income in Belgium, he could not take in account deductions for his family there. In Germany, personal allowances were not granted to him either, because he was a non-resident taxpayer. Had he been a resident taxpayer in Germany, he would have been able to deduct personal and family allowances from his taxable income.

In order to examine whether the difference in treatment amounted to discrimination the ECJ had to compare the situation of a non-resident taxpayer who was not granted personal deductions with the situation of a resident taxpayer who was. However, the ECJ did not just look at any kind of non-resident taxpayer, but rather at the very situation of Schumacker. For the Court it was decisive that he earned all of his income in Germany although he was a resident of Belgium. Therefore, not the legal rules applying to a non-resident like Schumacker were considered, but Schumacker's factual situation. According to the ECJ, the fact that Schumacker earned almost all his income in Germany and had no considerable income in his state of residence, Belgium made his situation comparable to that of a German resident.

The ECJ acknowledged the comparability because the general rule that personal allowances have to be deducted in the residence state could not be applied in Schumacker's case.[732] He did not earn any income there from which a deduction could be made. Therefore, as an exception, the host state must take account of the taxpayer's personal situation. It is important to note that this result is only due to the factual situation of Schumacker and must not be transferred to any other case. However, the ECJ held that personal deductions have to be deducted in the host state whenever a taxpayer earns almost all of his income in the host state and has no significant income in his state of

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[731] See, e.g., Schön, in Schön (ed.) *GS Knobbe-Keuk*, pp. 759-760; Wattel, *ET* (1995) pp. 347 et seq.; Wattel, *CMLR* (1996) pp. 223 et seq.; van Raad, *EC Tax Review* (1995) pp. 195-196.
Supporting the ECJ's decision in Schumacker see Avery Jones, *ET* (1996) pp. 46 et seq.

[732] According to international practice and the OECD Model Convention; critically Lang, *RIW* 2005, pp. 337 et seq.

residence.[733] Therefore, when a non-resident taxpayer fulfills these requirements his situation is comparable to that of a resident.[734]

The critics of the *Schumacker* decision considered that the factual comparability test applied by the ECJ was likely to bring about arbitrary results. Rather, the ECJ should only take into account the legal provisions applied to residents and non-residents for the determination of comparability. Moreover, the practical implementation of the judgment seemed difficult, since not all non-residents were to be granted personal and family deductions, but only those who earn almost all their income in the host state and do not earn a significant amount of income in their residence state.

Lang criticized in retrospect ten years after the *Schumacker* decision that the ECJ did not make clear in this or later decisions why it is compulsory that either the residence or the source state take into account the personal and family situation of a taxpayer. The ECJ only determined which one of the states has to take account of the taxpayer's situation but not why any of them can be forced by Union law to do so.[735] The ECJ referred to international practice in the consideration of the taxpayer's personal situation in its *Schumacker* decision. According to Lang, however, the OECD Model Convention only allocates taxing rights to either of the contracting states. It does not interfere with the countries' determination of the tax base or tax rate. Thus, the OECD Model Convention does not prescribe the deduction of certain expenses. 'Over-taxation' due to the ignorance of the taxpayer's personal situation or is not forbidden by the OECD, as is non-taxation.[736]

As far as withholding taxes are concerned, personal deductions have not been addressed by the ECJ in particular. Thus, the *Schumacker* doctrine is also applied to the field of withholding taxes. A Member State has to allow personal and family deductions in the same way for its residents and non-residents who earn almost all their income in the host state and have no significant income in their state of residence.

The case is, however, different for business expenses, as can be seen from the *Gerritse* decision described above.[737] Here, the ECJ does not apply the *Schumacker* doctrine.[738] Thus, the

[733] Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*^{2}, p. 58. Critically Lang, *RIW* 2005, pp. 339-340: The criteria applied by the ECJ might lead to difficulties in cases, where more than two countries are involved. If the decisive criterion is 'earns almost all of his income in the source state' and more than one source country is involved, the deduction of expenses might not be mandated by Union law in any of the source countries. If the decisive criterion is 'has no significant income in his state of residence' than more than one source country might be obliged to grant a deduction.

[734] See also cases *Gschwind*, *Zurstrassen*, *De Groot*, *Gerritse*, *Wallentin*, *D.*, *Conijn*, *Lakebrink* and *Renneberg*. This means that the Member State has to grant equal treatment to this group of non-residents and its residents. It does not mean, however, that Union law prescribes an absolute rule for the deduction of personal and family allowances, in light of the ability-to-pay principle. If a Member State does not grant deductions to its residents it neither has to grant deductions to its non-residents. See Lang, *RIW* 2005, pp. 341-342.

[735] Lang, *RIW* 2005, p. 337.

[736] Lang, *RIW* 2005, pp. 337-338.

[737] See chapter 1.; ECJ 12 June 2003, C-234/01, *Gerritse* [2003] ECR I-05933.

Schumacker doctrine only applies to personal deductions and not to object-based deductions.[739] This means that for determining comparability it is not decisive whether the non-resident taxpayer earns almost all his income in the host country. In contrast, the ECJ held that concerning the deduction of business expenses residents and non-residents find themselves in comparable situations.[740] Therefore, as far as business expenses are concerned the ECJ ascertained the comparability from a legal perspective rather than a factual one.[741]

In withholding tax cases, not only the deduction of expenses but also the tax rate has been an issue. Again, the ECJ held that residents and non-residents are in a comparable situation concerning the tax rate applied to their income, without considering the *Schumacker* doctrine.[742] Therefore, equal treatment has to be granted to them, i.e. the same tax rate. In this respect, Lang finds it difficult to draw the border between personal and family deductions, where the Schumacker doctrine applies, and the tax rate, where it does not.[743] In his view, a progressive tax rate can also have the objective to take into account the taxpayer's personal situation. Low income is taxed at a low tax rate, thus, leaving a greater part of the income at the disposal of the taxpayer. In this way, the taxpayer is kept from falling below the subsistence level. The ability-to-pay principle is respected.[744]

Indeed, the ECJ has referred to its *Schumacker* decision in the *Gerritse* case when treating the 25% fixed tax rate. The Court again acknowledged the objective differences between residents and non-residents and repeated its findings that the personal ability to pay tax is easier to assess at the taxpayer's usual abode.[745] The Court divided its comparability analysis concerning the tax rate into two parts, one treating the tax-free allowance and the other treating the progressive tax rate granted to residents. As mentioned above, the ECJ held residents and non-residents to be in a comparable situation with regard to the progressive tax rate. The ECJ's findings were, however, different for the tax-free allowance:

> *Concerning [...] the tax-free allowance, since [...] it has a social purpose, allowing the taxpayer to be granted an essential minimum exempt from all income tax, it is legitimate to*

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[738] See Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*^{2}, p. 56.
[739] See in favor of this result already Schön, in Schön (ed.) *GS Knobbe-Keuk*, p. 760.
[740] ECJ 12 June 2003, C-234/01, *Gerritse* [2003] ECR I-05933, para. 27.
[741] Lang, *RIW* 2005, p. 342.
[742] ECJ 12 June 2003, C-234/01, *Gerritse* [2003] ECR I-05933, para. 53.
[743] Lang, *RIW* 2005, p. 342.
[744] Lang, *RIW* 2005, p. 343. Hall/Rabushka also explain that the ability-to-pay principle can be realized by progressive tax rates or personal allowances, respectively. A flat tax rate combined with a personal allowance results in a progressive tax system. See Hall/Rabushka, *Low Tax*, pp. 25-26.
[745] ECJ 12 June 2003, C-234/01, *Gerritse* [2003] ECR I-05933, paras. 43-44.

reserve the grant of that advantage to persons who have received the greater part of their taxable income in the State of taxation, that is to say, as a general rule, residents.[746]

With regard to the tax-free allowance, the ECJ found residents and non-residents only to be in comparable situations if the latter received the greater part of their income in the host state. Thus, the *Schumacker* doctrine was applied by the Court in this respect.

[746] ECJ 12 June 2003, C-234/01, *Gerritse* [2003] ECR I-05933, para. 48.

3. Horizontal comparability of non-residents

In rare cases, the ECJ did not compare a cross-border situation with a hypothetical internal situation, but rather one cross-border situation with another one. This has been known in literature as 'horizontal comparison'.

In the *Denkavit* case dividends paid by a French company to its Dutch parent were taxed at withholding, whereas dividends paid to a French parent were exempt from tax.[747] However, the non-resident parent company could also benefit from the exemption if it set up a branch in France. The ECJ, thus, had to compare the situation of a non-resident company with that of a resident company (vertical comparison) and that of another non-resident company having a permanent establishment in France (horizontal comparison). The Court did accept to compare different cross-border situations:

> *In the present case, parent companies receiving dividends paid by resident subsidiaries, are, as regards the taxation in France of those dividends, in a comparable situation, whether they receive those dividends as resident parent companies or as non-resident parent companies which have a fixed place of business in France, or as non-resident parent companies which do not have a fixed place of business in France. In each of those cases, the French Republic imposes a liability to tax on dividends received from a resident company.*[748]

The *Denkavit* case shows that the ECJ is ready to compare different cross-border situations with each other. This can be deduced from the *Denkavit* judgment, however, only for two cross-border situations concerning the same countries. The ECJ compared a Dutch company with a permanent establishment in France to a Dutch company without a permanent establishment in France.

Another type of horizontal comparison is closely linked to the free choice of legal from acknowledged by the ECJ. This means that a taxpayer must be free to choose whether to set up a subsidiary or rather a branch in another Member State. The former is treated as a separate taxpayer, while the latter's income is taxed at the level of the head office. Nonetheless, equal treatment should be given to a branch, i.e. a permanent establishment, of a non-resident taxpayer and a resident subsidiary of a non-resident taxpayer. Again, clearly, two cross-border situations are compared that take place in the same two countries. The ECJ has referred to the free choice of legal form already in its *Avoir Fiscal* judgment:

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[747] ECJ 14 December 2006, C-170/05, *Denkavit* [2006] ECR I-11949.
[748] ECJ 14 December 2006, C-170/05, *Denkavit* [2006] ECR I-11949, para 36.

The second sentence of the first paragraph of Article 52 expressly leaves traders free to choose the appropriate legal form in which to pursue their activities in another Member State and that freedom of choice must not be limited by discriminatory tax provisions.[749]

Again, in the *Marks & Spencer* case the comparability of branches and subsidiaries was a central issue. The case was about the utilization of losses, which was not possible in a parent-subsidiary relationship, because of the legal independence of the subsidiary. Advocate General Maduro in his Opinion referred to the cases *Avoir Fiscal,*[750] *Royal Bank of Scotland,*[751] and *Saint-Gobain*[752] in which the different legal forms where treated alike, though.[753] The different treatment in the cited cases was rather based on residence.[754] For the question at hand in the *Marks & Spencer* case, the Advocate General decided that because branches and subsidiaries are governed by different tax regimes, the difference in treatment is inevitable.[755] Thus, it does not amount to discrimination, because the situation of a UK company with a non-resident branch is not comparable to that of a UK company with a non-resident subsidiary. What is of importance, however, is that Advocate General Maduro in general accepted to compare two different cross-border situations.

The same path was taken by the ECJ in the *CLT-UFA* decision.[756] The tax rate that applied to a German branch of a Luxembourg company was higher than the one that applied to a German subsidiary of a Luxembourg company. The Court concluded that

the freedom to choose the appropriate legal form in which to pursue activities in another Member State primarily serves to allow companies having their seat in a Member State to open a branch in another Member State in order to pursue their activities under the same conditions as those which apply to subsidiaries. [...] In those circumstances, it seems that German subsidiaries and branches of companies having their seat in Luxembourg are in a situation in which they can be compared objectively.[757]

The ECJ has also had the opportunity to comment on the comparability of two cross-border situations that concerned different countries. In the *Cadbury Schweppes* case the ECJ was confronted with CFC legislation.[758] As inherent to CFC regimes, the UK CFC legislation only applied when the profits of the foreign subsidiary were taxed at a low tax rate in the subsidiary's residence state. The

[749] ECJ 28 January 1986, 270/83, *Commission v. France (Avoir Fiscal)* [1986] ECR 00273, para 22.
[750] ECJ 28 January 1986, 270/83, *Commission v. France (Avoir Fiscal)* [1986] ECR 00273.
[751] ECJ 29 April 1999, C-311/97, *Royal Bank of Scotland* [1999] ECR I-02651.
[752] ECJ 21 September 1999, C-307/97, *Saint-Gobain* [1999] ECR I-06161.
[753] Opinion AG Maduro 7 April 2005, C-446/03, *Marks & Spencer* [2005] ECR I-10837, point 43.
[754] Opinion AG Maduro 7 April 2005, C-446/03, *Marks & Spencer* [2005] ECR I-10837, point 47.
[755] Opinion AG Maduro 7 April 2005, C-446/03, *Marks & Spencer* [2005] ECR I-10837, point 48.
[756] ECJ 23 February 2006, C-253/03, *CLT-UFA* [2006] ECR I-01831.
[757] ECJ 23 February 2006, C-253/03, *CLT-UFA* [2006] ECR I-01831, paras. 15 and 30.
[758] ECJ 12 September 2006, C-196/04, *Cadbury Schweppes* [2006] ECR I-7995.

ECJ compared the cross-border situation at hand with an internal situation, but also with another hypothetical cross-border situation, involving a country whose tax rate would not give rise to the CFC regime:

> *Where the resident company has incorporated a CFC in a Member State in which it is subject to a lower level of taxation within the meaning of the legislation on CFCs, the profits made by such a controlled company are, pursuant to that legislation, attributed to the resident company, which is taxed on those profits. Where, on the other hand, the controlled company has been incorporated and taxed in the United Kingdom or in a State in which it is not subject to a lower level of taxation within the meaning of that legislation, the latter is not applicable and, under the United Kingdom legislation on corporation tax, the resident company is not, in such circumstances, taxed on the profits of the controlled company.*[759]

Most interestingly, in a rather similar case concerning a switch-over from the exemption to the credit method the ECJ refrained from comparing different cross-border situations. The German national law provided for an 'override' of the tax treaty between Germany and Belgium. Instead of the exemption method the credit method should be applied in cases where the profits of a Belgian permanent establishment were taxed at a rate below 30%. In its *Columbus Container* decision, the ECJ merely compared the situation of a German resident having a partnership – treated as a permanent establishment due to its transparency – in Belgium with the situation of a German resident without a foreign operation, by saying that the German legislation

> *does not make any distinction between taxation of income derived from the profits of partnerships established in Germany, and taxation of income derived from the profits of partnerships established in another Member State which subjects the profits made by those partnerships in that State to a rate of tax below 30%.*[760]

The ECJ did not consider comparing German residents operating a Belgian partnership with German residents operating a partnership in another Member State, to which the switch-over clause did not apply. Thus, the *Columbus Container* decision cannot be brought in line with the *Cadbury Schweppes* decision.[761]

In a withholding tax case, the ECJ has clearly affirmed the comparability of two cross-border situations that involved different countries. In an infringement procedure against the Netherlands the ECJ had to rule on the dividend taxation regime in the Netherlands, which exempted dividends paid to residents or non-residents of EU Member States from taxation, but levied a withholding tax

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[759] ECJ 12 September 2006, C-196/04, *Cadbury Schweppes* [2006] ECR I-7995, para. 44.
[760] ECJ 6 December 2007, C-298/05, *Columbus Container* [2007] ECR I-10451, para. 39.
[761] Lang, *IStR* 2009, p. 541; Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*^{2}, pp. 59-60.

on dividends paid to residents of Iceland or Norway, both being EEA Member States. The Court affirmed the comparability of EU companies receiving dividends from the Netherlands and companies resident in Iceland and Norway receiving dividends from the Netherlands.[762] Thus, the ECJ compared two cross-border situations; one within the EU and one with third countries.

Also connected to horizontal comparability is the questions whether 'most favored nation' treatment has to be granted within the EU. This means that if two Member States agree on a certain treatment in a tax treaty, does this treatment also have to be expanded to other Member States? The ECJ has held in several cases (*D.*,[763] *ACT Group Litigation*,[764] *Orange European Smallcap Fund*[765]) that is in not the case. The fundamental freedoms do not prescribe a most favored nation treatment. Again, this is about comparing two cross-border situation involving different countries. The ECJ has held in the D. case as follows:

> *The fact that those reciprocal rights and obligations apply only to persons resident in one of the two Contracting Member States is an inherent consequence of bilateral double taxation conventions. It follows that a taxable person resident in Belgium is not in the same situation as a taxable person resident outside Belgium so far as concerns wealth tax on real property situated in the Netherlands.*

In other words, the cross-border situation between Belgium and the Netherlands cannot be compared to a cross-border situation between Germany and the Netherlands.

[762] ECJ 11 June 2009, C-521/07, *Commission v. Netherlands* [2009] ECR I-04873, paras. 38 et seq.
[763] ECJ 5 July 2005, C-376/03, *D.* [2005] ECR I-05821.
[764] ECJ 12 December 2006, C-374/04, *ACT Group Litigation* [2006] ECR I-11673.
[765] ECJ 20 May 2008, C-194/06, *Orange European Smallcap Fund NV* [2008] ECR I-03747.

4. Comparability and third countries

4.1. Third countries under the free movement of capital

The free movement of capital is the only fundamental freedom that also grants protection towards third countries.[766] Most interestingly, this protection is not bound to any reciprocity requirement. Thus, third country situations must not be discriminated by the EU Member States, while the same need not hold for the third countries in return. The rationale behind this one-way protection is anything but clear.

The wording of Art. 63 TFEU does not differentiate between the free movement of capital within the EU and with third countries. However, in interpreting the provision from a teleological standpoint, the ECJ has partly given the free movement of capital with third countries a different meaning than it has between the Member States.[767] In order words, a tax provision that discriminates against other EU Member States might infringe the free movement of capital, while the same provision might not infringe the free movement of capital as far as third countries are concerned.

This result may be achieved by ascertaining non-comparability between the cross-border situation involving a third country and a hypothetical internal situation. If the ECJ comes to the conclusion that the situations are not comparable, it need not continue its examination of a possible infringement at all, as was seen in the *Truck Center* decision, involving an intra-EU situation, though.[768]

The ECJ may find that a cross-border, third-country situation is not comparable to an internal situation when looking at the legal provision applied to both situations. While within the EU, there is a common legal framework that might render an intra-EU situation comparable to an internal situation, this does not hold true for third-country situations. However, the ECJ has regularly found the situation involving a third country to be comparable to the hypothetical internal situation.[769]

However, as far as tax law is concerned, it has been supported in literature that non-comparability in a third country scenario might stem from the different tax rate applied by the third country. If the tax rate applied by the third country is considerably lower than in the Member State concerned, the cross-border situation may not be comparable to the internal situation.[770] This is due

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[766] See chapter III.4.1.
[767] See Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*², pp. 63-64.
[768] ECJ 22 December 2008, C-282/07, *Truck Center* [2008] ECR I-10767, see chapter 1.
[769] See Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*², p. 64.
[770] Englmair, in Lang et al. (eds.) *Introduction to European Tax Law*², p. 63.

to the lack of reciprocity concerning the protection granted to third countries under the fundamental freedoms.

In the *Amurta* case, the ECJ examined withholding taxes under the free movement of capital.[771] Shareholders resident in the Netherlands were exempt from taxation on the profits distributed by a Dutch company if they held at least 5% of its shares. Non-residents shareholders, in contrast, were only entitled to a tax exemption if they held at least 25% of the share capital of the distributing company.[772] This led to an unequal treatment of residents and non-residents for shareholdings between 5% and 25%.[773] The ECJ had to examine whether such unequal treatment led to discrimination. Thus, it had to ascertain whether resident and non-resident shareholders were in a comparable situation. In line with its *Denkavit* judgment,[774] the ECJ held that the situation of residents and non-residents is not necessarily comparable as far as the prevention of economic double taxation is concerned.[775] However, the situation becomes comparable when the Member States not only taxes dividends distributed to its residents but also to its non-residents either according to national law or to a tax treaty concluded with another country.[776]

The *Amurta* case treated a profit distribution from a Dutch company to its Portuguese parent company. Thus, no third country was involved. However, the tax provision was tested under the free movement of capital – due to the portfolio shareholding of 14% – which is also applicable to third countries under the same conditions as within the EU. The question is, therefore, whether a different outcome for the comparability analysis would have been achieved, if the resident country of the parent company had not been Portugal, but a third country. From the wording of the ECJ's judgment, no such conclusion can be drawn:

> *[...] as soon as a* ***Member State****, either unilaterally or by way of a convention, imposes a charge to income tax not only on resident shareholders but also on* ***non-resident*** *shareholders in respect of dividends which they receive from a resident company, the position of those* ***non-resident*** *shareholders becomes comparable to that of resident shareholders [...].*[777]

The ECJ refers to a 'Member State' at one point. That is when the country that is bound by the fundamental freedoms is concerned. Of course, only EU Member States have to obey the TFEU;

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[771] ECJ 8 November 2007, C-379/05, *Amurta* [2007] ECR I-09569.
[772] ECJ 8 November 2007, C-379/05, *Amurta* [2007] ECR I-09569, para. 26.
[773] ECJ 8 November 2007, C-379/05, *Amurta* [2007] ECR I-09569, para. 27.
[774] See chapter 1.
[775] ECJ 8 November 2007, C-379/05, *Amurta* [2007] ECR I-09569, para. 37. The exemption of Dutch resident companies from the withholding tax sought to eliminate economic double taxation which would otherwise occur because the profits distributed by the company were already subject to corporate tax.
[776] ECJ 8 November 2007, C-379/05, *Amurta* [2007] ECR I-09569, para. 38; emphasis added.
[777] ECJ 8 November 2007, C-379/05, *Amurta* [2007] ECR I-09569, para. 38.

third countries do not. This is the core element of the free movement of capital with third countries, namely the lack of reciprocity. When the ECJ refers to the cross-border situation in the above-cited statement, it only speaks of 'non-residents'. It does not specify whether residents of other EU Member States or of third countries are referred to. Thus, no such differentiation can be deduced from the wording of the *Amurta* judgment. This leads to the conclusion that also non-resident shareholders of third countries are in a situation comparable to that of a resident shareholder as far as the prevention of economic double taxation is concerned.

In the infringement procedures against Italy[778] and Spain[779] – both concerning discriminatory dividends taxation – the ECJ also examined the free movement of capital. In the case *Commission v. Italy* the ECJ examined the admissibility of the Italian system of dividends taxation in light of the free movement of capital, as far as EU Member States were concerned, and the EEA Agreement, as far as the EEA Member States were concerned. As the *Amurta* case, the infringement procedure did not concern third countries.[780] The Commission only referred to EU and EEA Member States in its action before the Court. Still, it has to be examined whether the findings of the ECJ on the free movement of capital also hold for the comparability analysis in third-country cases.

In *Commission v. Italy*, the ECJ drew the same conclusion as in its *Amurta* decision, namely that the situation of resident and non-resident shareholders is comparable. In addition to the statement already made in the *Amurta* decision,[781] the Court added:

> ***Non-resident*** *recipients of those dividends thus find themselves in a situation comparable to that of resident companies as regards the risk of economic double taxation of dividends distributed by resident companies, so that* ***non-resident*** *recipients cannot be treated differently from resident recipients.*[782]

Again, the ECJ merely refers to 'non-resident recipients' in its comparability analysis. No explicit comment can be found that would make this statement invalid for third-country non-residents.

The Spanish dividends taxation regime was under scrutiny in *Commission v. Spain*.[783] Under Spanish law, dividends paid from a Spanish company to its resident parent company were tax-exempt when the shareholding amounted to at least 5%. Non-resident shareholders of other EU Member States, in contrast, could only enjoy tax exemption if their shareholding in the Spanish

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[778] ECJ 19 November 2009, C-540/07, *Commission v. Italy* [2009] ECR I-10983.
[779] ECJ 3 June 2010, C-487/08, *Commission v. Spain* [2010] not yet published.
[780] Other than EEA Member States.
[781] See above; reference in ECJ 19 November 2009, C-540/07, *Commission v. Italy* [2009] ECR I-10983, para. 52.
[782] ECJ 19 November 2009, C-540/07, *Commission v. Italy* [2009] ECR I-10983, para. 54; emphasis added.
[783] ECJ 3 June 2010, C-487/08, *Commission v. Spain* [2010] not yet published.

company reached 20%. Obviously, between 5% and 20%, there was a difference in treatment of internal and EU-outbound dividend payments.[784]

In contrast to the infringement procedure against Italy, the action before the Court did not only refer to EU Member States, but to the free movement of capital without exceptions. However, the Spanish tax provision that was challenged by the Commission merely referred to parent companies resident in other EU Member States.[785] As far as the comparability analysis is concerned, the ECJ, once again, affirmed the comparability of resident and non-resident shareholders by referring to its decision in *Amurta* and *Commission v. Italy*.[786] Thus, as for the previous two cases, it cannot be concluded that the comparability test would have led to a different outcome if a third-country scenario had been examined.

4.2. EEA countries

Unlike third countries in general, the EEA Member States enjoy protection not only under the free movement of capital, but under all fundamental freedoms. The EEA Member States comprise the EU Member States and the three EFTA countries, namely Iceland, Liechtenstein, and Norway. The EEA Agreement provides for the same fundamental freedoms as the TFEU and the ECJ has held in settled case law that the provisions should be given the same meaning.[787] Thus, while EEA countries are technically third countries, they are equal to the EU Member States as far as protection under the fundamental freedoms in concerned. Nevertheless, despite the analogous interpretation of the freedoms provisions, differences can be found between the relation among the EU Member States and the relation of the EU Member States with the three other EEA Member States. Above all, the harmonizing measures taken within the EU – also in the field of direct taxation[788] – are not extended to the EFTA countries. Those are, for example, the Parent-Subsidiary Directive and the Directives on administrative assistance.

As a consequence, the ECJ might achieve different outcomes in its comparability analysis. If the ECJ finds an intra-EU cross-border situation to be comparable with an internal situation, this is due to the equal legal provisions applied to both situations. As far as the EFTA countries are concerned, the same might not hold true. Therefore, the same cross-border situation, however, occurring between an EU Member State and an EEA Member State might turn out not to be comparable with an internal situation.

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[784] ECJ 3 June 2010, C-487/08, *Commission v. Spain* [2010] not yet published, para. 42.
[785] ECJ 3 June 2010, C-487/08, *Commission v. Spain* [2010] not yet published, para. 7.
[786] ECJ 3 June 2010, C-487/08, *Commission v. Spain* [2010] not yet published, paras. 50 et seq.
[787] See chapter III.4.2.
[788] See chapter III.4.2.

The ECJ had to deal with the EEA freedoms in several infringement procedures on withholding taxes.[789] In *Commission v. Netherlands* the Dutch taxation of dividends distributed to companies in Iceland and Norway was under scrutiny.[790] According to Dutch law, dividends paid from a Dutch company to another Dutch company were tax-exempt if the shareholding amounted to at least 5%. The same treatment was extended to parent companies resident in other EU Member State as a result of a letter of formal notice sent and a reasoned opinion issued by the Commission.[791] However, as far as the EEA Member States Iceland and Norway were concerned, there remained a difference in treatment which the Commission thought to infringe the free movement of capital in Art. 40 EEA Agreement.[792] While internal and intra-EU dividends were tax-exempt above a shareholding of 5%, the same was only true for dividends paid to an Icelandic parent with a share of more than 10% and for dividends paid to a Norwegian parent with a share of more than 25%.[793]

In the *Commission v. Netherlands* case, the same legal provision as in the *Amurta* case was challenged before the Court.[794] While the *Amurta* case concerned a dividend payment from the Netherlands to Portugal, the infringement procedure was about dividend payments to Iceland and Norway. In the *Amurta* case, the ECJ had affirmed the comparability of resident and non-resident shareholders as far as the avoidance of economic double taxation was concerned.[795] Concerning the comparability of non-resident shareholders of the EEA countries the Commission and the Netherlands, obviously, had different opinions. The Commission affirmed the comparability:

> *The Commission maintains, but the Kingdom of the Netherlands denies, that the situation of Icelandic and Norwegian companies is objectively comparable to that of Netherlands companies with regard to the risks of double taxation on the profits of Netherlands companies of which they hold part of the capital.*[796]

The Netherlands, in contrast, denied the comparability of a cross-border situation involving the EFTA Member States:

> *The Kingdom of the Netherlands argues that the obligations which flow from the free movement of capital between Member States of the Community cannot be purely and simply*

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[789] In the infringement procedure against Spain the freedoms of the EEA Agreement were brought forward. The ECJ, however, did not consider them due to lack of information on the legal treatment of dividends paid to the EEA countries under Spanish law. ECJ 3 June 2010, C-487/08, *Commission v. Spain* [2010] not yet published.
[790] ECJ 11 June 2009, C-521/07, *Commission v. Netherlands* [2009] ECR I-04873.
[791] ECJ 11 June 2009, C-521/07, *Commission v. Netherlands* [2009] ECR I-04873, paras. 10 et seq.
[792] ECJ 11 June 2009, C-521/07, *Commission v. Netherlands* [2009] ECR I-04873, para. 14.
[793] This treatment was due to the tax treaties concluded between the Netherlands and Iceland, and the Netherlands and Norway, respectively; ECJ 11 June 2009, C-521/07, *Commission v. Netherlands* [2009] ECR I-04873, para. 9.
[794] ECJ 11 June 2009, C-521/07, *Commission v. Netherlands* [2009] ECR I-04873, para. 19.
[795] ECJ 8 November 2007, C-379/05, *Amurta* [2007] ECR I-09569, paras. 37-38.
[796] ECJ 11 June 2009, C-521/07, *Commission v. Netherlands* [2009] ECR I-04873, para. 21.

transposed to the relations between the latter and the EFTA Member States of Iceland and Norway. That, it argues, follows from the fact that, in those two latter States, 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 (OJ 1977 L 336, p. 15; 'Directive 77/799') does not apply.[797]

The Netherlands argued that a company must fulfill certain criteria in order to benefit from the tax exemption, which could not be verified for parent companies resident in Iceland and Norway, because the Mutual Assistance Directive was not applicable and the exchange of information under the respective tax treaties could not be enforced.[798] The Court did not explicitly dismiss the Netherlands' argument, but it did not take account of it due to the specifics of the case:

It should, however, be noted that, even if such a difference in the system of legal obligations of the States in question in the tax area, in comparison with those of the Member States of the Community, is capable of justifying the Kingdom of the Netherlands in making the benefit of exemption from deduction at source of the tax on dividends subject, for Icelandic and Norwegian companies, to proof that those companies do in fact fulfil the conditions laid down by Netherlands legislation, it does not justify that legislation in making the benefit of that exemption subject to the holding of a higher stake in the capital of the distributing company. [...] Therefore, the Court cannot accept the argument of the Kingdom of the Netherlands based on the different situations of, on the one hand, companies having their seat in Member States of the Community and, on the other hand, Icelandic and Norwegian companies in order to justify the requirement that the latter companies hold a higher stake in the capital of the Netherlands companies distributing the dividends in order for them to benefit, like the former companies, from exemption from the deduction of tax at source on the dividends which they receive from Netherlands companies.[799]

From this statement it can be deduced that the ECJ would consider denying the comparability of a cross-border situation involving one of the EFTA Member States with an intra-EU situation,[800] due to the lack of obligations present within the EU. However, in the specific case, the Court could not find a connection between the need for administrative assistance and the size of the shareholding. Thus, the alleged non-comparability was not supported by the Court.

In the case *Commission v. Italy* described in chapter 4.1. the ECJ not only examined the Italian dividend taxation under the free movement of capital of Art. 63 TFEU, but also under the free

[797] ECJ 11 June 2009, C-521/07, *Commission v. Netherlands* [2009] ECR I-04873, para. 25.
[798] ECJ 11 June 2009, C-521/07, *Commission v. Netherlands* [2009] ECR I-04873, paras. 27-28.
[799] ECJ 11 June 2009, C-521/07, *Commission v. Netherlands* [2009] ECR I-04873, paras. 47 and 50.
[800] See 'horizontal comparability' in chapter 3.

movement of capital of Art. 40 EEA and the freedom of establishment of Art. 31 EEA.[801] For the intra-EU cases the Court ascertained the comparability to internal situations. For situations involving the EFTA Member States, the Court held the following:

> *Consequently, and for the reasons set out when examining the action in the light of Article 56(1) EC, the less favourable treatment which the Italian legislation accords to dividends distributed to companies established in States party to the EEA Agreement constitutes a restriction on the free movement of capital for the purposes of Article 40 of the EEA Agreement.*[802]

Thus, the ECJ simply transferred its findings on comparability of non-resident and resident shareholders within the EU to the scenario within the EEA. In contrast to the decision in *Commission v. Netherlands*, the ECJ does not seem to apply another standard for the comparability analysis for a cross-border situation involving an EEA Member State than between two EU Member States.

4.3. Switzerland

The freedoms included in the AFMP are to be interpreted in line with the fundamental freedoms contained in the TFEU. Thus, the same standards for the comparability analysis apply. Art. 21 (2) AFMP explicitly allows different treatment of taxpayers who are not in comparable situations, especially as regards their place of residence. This provision is very similar to Art. 65 (1) (a) TFEU, which is considered not to have any normative effect. Thus, in the ambit of the AFMP, like for the TFEU, it is necessary to determine the comparability of situations on a case-by-case basis.

Even though free movement of workers, freedom of establishment, and freedom to provide services are granted under the AFMP in the same way as under the TFEU, secondary EU law on direct taxation is not extended to Switzerland. The only exception is the EU-Switzerland Savings Agreement, which provides for the rules contained in the Savings Directive and parts of the Parent-Subsidiary and the Interest and Royalty Directive. The Mutual Assistance Directives, in particular, are not applicable in relation to Switzerland. From the perspective of an EU Member State, this could lead to the conclusion that a resident and a Swiss non-resident are not in a comparable situation in regard to the levy of withholding taxes.

4.4. Associated and partnership countries

It has been shown in chapter III.4.4. that a number of Association and Partnership Agreements have been concluded between the EU and third countries. The Association Agreement

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[801] ECJ 19 November 2009, C-540/07, *Commission v. Italy* [2009] ECR I-10983.
[802] ECJ 19 November 2009, C-540/07, *Commission v. Italy* [2009] ECR I-10983, para. 67.

with Turkey was provided as an example. Already the scope of the freedoms under this agreement was considered not to interfere with the levy of withholding taxes. This makes the comparability analysis obsolete.

The Partnership Agreement with Russia, which was provided as a second example, clearly has a greater impact on the tax laws of the EU Member States in regard to Russian non-residents, and vice versa. However, a protection against the levy of withholding taxes was found only to arise in case of direct investment. Thus, the question of comparability arises for a resident and a non-resident investor, who exercises definite influence. It is difficult to answer this question due to the absence of case law. However, it may be assumed that due to the reciprocity contained in the Partnership Agreement, comparability between residents and non-residents will be more likely than for any third country under the free movement of capital. However, as for the EEA States and Switzerland, the absence of secondary law harmonization in the direct area may lead to a different outcome in the comparability analysis than among EU Member States.