Using EU Law to Challenge Irish Tax Law and Policies

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Introduction

When it comes to tax and the European Union, much of the current focus is on the arguments for and against harmonisation of corporation tax rates.[1] Recently, however, another phenomenon has emerged, which should be in the back of every tax practitioner's mind. With increasing frequency, the European Court of Justice (ECJ) is declaring national tax measures inconsistent with the EC Treaty and invalid. Most view EU law as grandiose and remote, but it may prove very useful when advising a client with limited options.

The ECJ is charged with interpreting and applying the EC Treaty. That treaty is the fundamental law for the European Union and is supplemented by legislation. The powers retained by the Member States (including direct taxation) must be exercised consistently with this Community law.[2] This principle was first applied to direct tax laws in the mid-1980s[3] and has been invoked with increasing frequency ever since. The evolution of the ECJ's case law has been dealt with comprehensively elsewhere.[4] This article is intended to identify the methods employed by the ECJ in reviewing national tax provisions that practitioners can use when assessing a client's circumstances.

Statements of Principle

To begin with, in a consistent line of decisions by the ECJ in the past decade, the following paragraphs have emerged as standard in any judgment where a national tax law is challenged:

› According to the settled case law of the ECJ, although direct taxation falls within their competence, Member States must nonetheless exercise that competence consistently with Community law.[5]

1 See "Higher Taxes Feed Fatter Government" speech by Charlie McCreevy, European Commissioner for Internal Market and Services, at the ITI/Revenue Joint Conference, 9 February 2007.

2 *Commission v United Kingdom* [1991] C-246/89 ECR I-4585, para. 12.

3 *Commission v France ('Avoir Fiscal')* [1986] C-270/83 ECR 273.

4 See Barry Sullivan and Jilly Riley, "The Role of the ECJ in Fostering Tax Harmonisation via the Back Door", *Irish Tax Review*, 20/3 (2007): 58-63; and Suzanne McDonnell, "The Impact of Community Law on Irish Taxation Over the Last Thirty Years", *Irish Tax Review*, 19/5: 54-57.

5 See *Commission v France* [2004] C-334/02 ECR I-2229, para. 21, and *Marks & Spencer* [2005] C-446/03 ECR I-10837, para. 29.

- The provisions of the EC Treaty on freedom of movement for persons[6] are intended to facilitate the pursuit by Community citizens of occupational activities of all kinds throughout the Community and to preclude measures that might place Community citizens at a disadvantage when they wish to pursue an economic activity in the territory of another Member State.[7]
- It is clear from the case law of the ECJ that, even if, according to their wording, the rules on freedom of movement for workers are directed, in particular, at ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that state, they also preclude the state of origin from obstructing the freedom of one of its nationals to accept and pursue employment in another Member State.[8]
- National measures that are liable to hinder the exercise of fundamental freedoms guaranteed by the treaty or to make them less attractive may nevertheless be allowed if they pursue a legitimate objective in the public interest, are appropriate to ensuring the attainment of that objective and do not go beyond what is necessary to attain it.[9]

Method of Analysis

When reviewing a client's circumstances, one should always bear in mind that a tax provision might be open to challenge for breach of EU law and, in particular, of the fundamental freedoms enshrined in the treaty.[10]

The following method of analysis might be employed:

(1) Does the measure in question involve EU law (e.g., is there an intra-Community dimension to it)?

(2) Does the measure breach EU law (i.e., treaty provisions or directives)? For example:

(a) Does it discriminate on grounds of nationality?

and/or

(b) Does it at least dissuade a taxpayer from:

(i) migrating to another Member State to take up employment?

(ii) providing its services in another Member State?

(iii) establishing[11] in another Member State?

(iv) moving capital between Member States?[12]

(3) (a) Is there a legitimate objective in the public interest that the measure is designed to attain? For example:

(i) Is there a tax levy that offsets the tax advantage?

(ii) Does it prevent tax avoidance?

(iii) Does it prevent double taxation in a manner that results in equal treatment?

(iv) Does it prevent the jeopardising of the Member State's right to tax activity within its borders?

(b) Is the measure **appropriate** to the attainment of that objective?

(c) Is the measure **proportionate** (i.e., is it no more than is necessary to attain the objective)?

The examples that follow illustrate the steps set out above.

Breaches of EU Law

Discrimination on grounds of nationality

When considering whether a measure amounts to discrimination on grounds of nationality, it is important to be aware that different treatment of residents and non-residents may, in fact, be an attempt to achieve equality between those groups; for example, where non-residents are charged a higher rate of tax on a transaction because residents will be subjected to a further, separate tax later on.

An example of discrimination based on a taxpayer's nationality is found in *Wielockx*,[13]

6 Articles 18, 39 and 43 of the EC Treaty.

7 See *Commission v Denmark* [2005] C-464/02 ECR I-7929, para. 34 and the case law cited.

8 See *De Groot* [2002] C-383/00 ECR I-11819, para. 79.

9 See *De Lasteyrie du Saillant* [2004] C-9/02 ECR I-2409, para. 49, and *N* [2006] C-470/04 ECR I-7409, para. 40.

10 See, for example, O'Connell and Brennan, "Taxation of Charities: The European Dimension", *Irish Tax Review*, 1/1, p. 65.

11 "The freedom of establishment conferred by Article 52 of the Treaty on Community nationals, which entails for them access to, and pursuit of, activities as self-employed persons and the forming and management of undertakings on the same conditions as those laid down for its own nationals by the laws of the Member State of establishment, includes, pursuant to Article 58 of the Treaty, the right of companies or firms formed in accordance with the laws of a Member State and having their registered office, central administration or principal place of business within the Community to pursue their activities in the Member State concerned through a subsidiary, a branch or an agency" (*Saint-Gobain ZN* [1999] C-307/97 ECR I-6161, para. 35).

12 Article 56 of the EC Treaty.

13 C-80/94 [1995] ECR I-2493.

where a Belgian resident was not afforded a tax deduction for pension contributions made in The Netherlands. If he had been Dutch, he would have received the deduction. This *prima facie* discrimination could not be justified by the Dutch Government.

Free movement of workers

There are many instances where the court has found that the guarantee of free movement for workers has been infringed. For example:

In *Commission v Portugal*[14] a Portuguese law that deprived a taxpayer of the equivalent of Irish principal private residence relief if he or she reinvested the proceeds of the sale in a residence outside Portugal was held to dissuade a taxpayer from moving to work in another Member State.

In *Commission v Denmark*[15] a Danish law that allowed a tax deduction for contributions to pension schemes that were established in Denmark only was held to dissuade workers from other Member States from moving to work in Denmark if they had already established pension arrangements with non-Danish pension providers.

When considering whether a measure amounts to discrimination on grounds of nationality, it is important to be aware that different treatment of residents and non-residents may, in fact, be an attempt to achieve equality between those groups.

Freedom to provide services

A French law that provided a corporation tax credit for research activities but only where those activities were carried out in France was challenged in *Laboratoires Fournier SA*.[16] The ECJ held that legislation that differentiates according to the place where services are provided is contrary to the freedom to provide services.

Freedom of establishment

Cadbury Schweppes[17] concerned a UK measure that attempted to eliminate an advantage resulting from a parent company having a subsidiary based in a jurisdiction with a lower tax rate.[18] It required the parent to make up the difference between the lower rate and the UK rate. Such a measure would dissuade a taxpayer (the parent company) from establishing in the Member State with the lower tax rate and, thus, infringed the freedom of establishment.

Another argument put forward by Member States is the prevention of tax avoidance. Again, the ECJ has recognised this as a legitimate objective.

In the very recent case of *Oy AA*,[19] it was held that a Finnish provision that permitted a deduction (similar to Irish "group relief") for transfers from a subsidiary company to its parent but only when the parent was resident in Finland constituted an obstacle to the freedom of establishment: companies from other Member States seeking to establish subsidiaries in Finland would not receive the relief and so would be at a competitive disadvantage.

Free movement of capital

Stauffer[20] concerned a German law that effectively denied an exemption from corporation tax to charities based outside Germany. In this case an Italian-based charity had no branch or representation in Germany, although it owned a building there from which it derived rent. The ECJ found that, by providing German-based charities with an exemption from tax on rental income but denying the exemption to charities based in other Member States, the law constituted an obstacle to the free movement of capital.

Free movement generally

In the case of *N* the ECJ appeared to entertain the notion that a restriction on the fundamental right of a citizen of the EU to move and reside freely within the territory of the Member States alone and without specific reference to one of the economic freedoms might be sufficient to render a measure invalid.[21]

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14 *Commission v Portugal* [2006] C-345/05 ECR I-0000. .

15 *Commission v Denmark* [2007] C-150/04.

16 *Laboratoires Fournier* [2005] C-39/04 ECR I-2057.

17 *Cadbury Schweppes* [2006] C-196/04 ECR I-7995.

18 In this case, the IFSC in Dublin.

19 *Oy AA* [2007] C-231/05 judgment delivered on 18 July 2007.

20 *Centro di Musicologia Walter Stauffer v Finanzamt München für Körperschaften* [2006] C-386/04 ECR I-0000 . See O'Connell and Brennan, "Taxation of Charities: The European Dimension", *Irish Tax Review*, 1/1, p. 65.

21 At para. 22.

Justification

Where a measure offends against EU law, one should not go "popping the champagne" or "high-fiving" the client straightaway – the measure may still be permitted. For it to be so, the impugned measure must be in the pursuit of a legitimate objective, appropriate to the attainment of that objective and proportionate.

Legitimate objectives

Through its decisions the ECJ has recognised a number of legitimate objectives that may justify measures that otherwise offend.

Maintaining the cohesion of the tax system

On several occasions, Member States have put forward the need to maintain the cohesion of their tax systems as a legitimate objective. This means that the Member States allege that, in the absence of the offending measure, the taxpayer would be receiving an unfair tax advantage over other taxpayers. The standard paragraph used in judgments is:

> *"… the Court has recognised that the need to maintain the cohesion of the tax system can justify a restriction on the exercise of the fundamental freedoms guaranteed by the Treaty. However, for an argument based on such a justification to succeed, a direct link must be established between the tax advantage concerned and the offsetting of that advantage by a particular tax levy."*[22]

In *Commission v Portugal* the Member State argued that a taxpayer who reinvested the proceeds of the sale of a principal private residence in a Portuguese residence would eventually be liable to pay Portuguese tax whenever he or she disposed of the principal private residence without reinvesting. Thus, the tax advantage afforded by the relief would be offset by this tax later on. The ECJ rejected this argument – a taxpayer will normally never sell his or her principal private residence without reinvesting in another.

Measures that pursue legitimate objectives and are appropriate to the attainment of those objectives must also do no more than necessary to attain that objective.

In *Keller Holding* a German company sought a tax deduction for interest paid on monies borrowed to acquire control of a subsidiary. Normally, this deduction would be allowed. However, the subsidiary was an indirectly owned Austrian company, and distributions could be made to the parent company tax-free. The German Government argued that advantage conferred on companies with German subsidiaries by allowing the deduction for such interest was offset because distributions to the parent company were taxable. This argument failed. Although the distributions were taxable in the hands of the parent, they were deductible by the subsidiary in calculating corporation tax. Thus, there was no offset of the advantage within the group of companies.

Preventing tax avoidance

Another argument put forward by Member States is the prevention of tax avoidance. Again, the ECJ has recognised this as a legitimate objective.[23]

In *Cadbury Schweppes* the UK argued that, by openly seeking to pay less tax by establishing a subsidiary in another Member State, the taxpayer was abusing the freedoms guaranteed by the Treaty. The UK argued further that the measure taxing the parent company for the difference between the lower tax rate and the UK rate prevented tax avoidance. The ECJ held that:

> *"… the fact that the company was established in another Member State for the purpose of benefiting from more favourable legislation does not in itself suffice to constitute abuse* [of the freedom of establishment]*."*[24]

> *"… any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company."*[25]

However, the ECJ went on to hold that a national measure may be justified where it relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned. The court looked to the concept of "establishment", which, it held, entails "the pursuit of genuine economic activity".[26] "Letterbox" or "front" subsidiaries would be "wholly artificial arrangements" and not establishments in pursuit of genuine economic activity.

Again in *Oy AA*, the ECJ recognised that preventing companies from using wholly artificial arrangements to transfer profits to Member States with lower tax rates was a legitimate

22 See *Keller Holding* [2006] C-471/04 ECR I-2107, para. 40.
23 See *Commission v Denmark* [2007] C-150/04, para. 51.
24 Para. 37.
25 Para. 49.
26 Para. 54.

objective that could justify an obstacle to the freedom of establishment.

Preventing double taxation

In *N* the ECJ held that a measure that reflected international conventions that sought to prevent double taxation was in pursuit of a legitimate objective. The law taxed gains in the value of a taxpayer's shareholdings while that taxpayer was resident in The Netherlands up to the point when he migrated to the UK. After that, any gains fell within the remit of the UK tax authorities.

Preventing conduct capable of jeopardising the right of Member States to exercise their taxing powers in relation to activities carried on in their territory

This objective is quite complex in that the ECJ envisages what the state of play would be if the impugned measure did not exist. It goes to the core of the division of power between the EU and the Member States and was central to the recent decision in *Oy AA*.

As stated above, *Oy AA* concerned a Finnish provision that permitted a corporation tax deduction (similar to Irish "group relief") for transfers from a subsidiary company to its parent but only when the parent was resident in Finland. In the absence of the impugned measure, companies could ensure that income earned in Finland would not be taxed in that country. If EU law prohibited the impugned measure, that would effectively deprive a Member State of the right to tax the profits of a company resident in its territory. Therefore, the measure was in pursuit of a legitimate objective.

Appropriateness of the measure

In *N* the ECJ held that a law that mirrored the OECD's Model Tax Convention on Income and on Capital was an appropriate means of attaining the elimination of double taxation.

In *Cadbury Schweppes* the ECJ accepted the appropriateness of a measure that included in the tax base of the parent resident company the profits of a subsidiary that is subject to lower taxes as it made it possible to thwart practices that have no purpose other than tax avoidance.

Proportionality

Measures that pursue legitimate objectives and are appropriate to the attainment of those objectives must also do no more than necessary to attain that objective.

In *N* the requirement that the taxpayer lodge security with the Dutch tax authorities pending the determination of tax due was, given the information-sharing regime between tax authorities in Member States, unnecessary.

The impugned measure in *Cadbury Schweppes* caught not only "wholly artificial arrangements" but also subsidiaries engaged in genuine activity and, therefore, went too far.

However, in *Oy AA* the ECJ held that a provision preventing the transfer of profits to the lower tax jurisdictions that caught not only artificial transactions (to avoid tax) but also genuine ones was proportionate as there was no other way to prevent the tax avoidance.

Bringing a Claim

No doubt, for anyone who has read this far, some Irish measure or practice will have sprung to mind that, when viewed in the light of EU law, stands on thin ice. If a practitioner believes that an Irish provision may fall foul of EU law, what can be done?

The majority of cases that come before the ECJ are by way of preliminary rulings or direct actions taken by the European Commission. A preliminary ruling comes about where the taxpayer claims the breach of EU law before its national court and that court refers the matter to the ECJ. Understandably, the cost to a taxpayer of bringing a matter before the ECJ may be prohibitive.

However, a taxpayer may initiate a process that leads to the Commission taking a case against the Member State for breach of EU law. The taxpayer first makes a complaint to the Commission. The procedure for making a complaint to the Commission is very straightforward: a standard complaint form can be downloaded from the Commission's website.[27] Complaints are filtered, so it is important that this form is completed carefully. The Commission will consider the complaint and, if it sees fit, will:

(a) investigate the matter,

(b) make representations to the national authorities,

(c) notify the taxpayer that it wishes to close the case,

(d) bring an infringement action against the Member State in the ECJ.[28]

Conclusion

A new age dawned for tax practitioners more than twenty years ago. From then on, Irish tax provisions could be put under a European spotlight. Despite this, EU law has not been to the fore of practitioners' minds when advising clients. Perhaps it should be. As professional advisers, we can be found liable for failing to advise a client fully, and full advice for a growing number of clients will include the European dimension.

27 http://ec.europa.eu/community_law/complaints/form.

28 On this procedure in operation, see *Commission v Belgium* [2007] C-522/04.