Justifications - EC perspectives for justifications of discriminatory and restrictive tax measures of Member States

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The justification of national tax measures contravening fundamental Treaty freedom principles is based, in the absence of Community measures, on an equitable balance between Community interests those Treaty freedoms and public interests of Member States. It thus forms a key issue in discussing "Fundamental freedoms and national tax sovereignty in the EU".

The discussion could be based on a more or less complete analysis of the applicable case law of the European Court of Justice ("ECJ"). Not only would such analysis of some 40 ECJ tax decisions dealing with this issue, be disproportionately lengthy; it would show that those decisions often lack transparency, consistency or consideration of the underlying rules, both with respect to the Court's assessment of admissible grounds of justification and of the required of proportionality of the derogation and the aim pursued. Our discussion will rather focus on the following critical issues:

A. The legal basis of the rule of reason ("r.o.r.") as it was developed by the ECJ;
B. The assessment of the main grounds for derogation and of the proportionality of the derogating measures in the income tax field;
C. Other approaches to the issue of (non-) compatibility of tax measures and r.o.r. borderline cases;
D. Search for the right balance between Community freedoms and functional tax sovereignty of Member States in absence of Community tax measures.

A. Legal basis and rules of exceptions

1. Treaty-based exceptions

A first category of justifications is laid down in the Treaty provisions relating to the individual freedoms viz. Articles 30, 39(3) and (4), 45 and 46 (1), 55 and 58 (1)b. They provide a limitative listing of justifiable public causes which, being exceptions to the fundamental freedoms, must be strictly interpreted.

The excusable grounds mentioned in the Treaty are differently worded in the aforementioned articles, but relate essentially to public order, public security, public health and public sector activities. Those are grounds that, by their nature, are not particularly suitable or relevant for defending the EC compatibility of the sort of national income tax measures that may restrict the exercise of the freedoms. Such is also the conclusion reached by the ECJ in several tax decisions and the opinions of several Advocates General. The limited tax potential of the Treaty-based justifications manifested itself in cases dealing with measures designed to prevent of loss of tax revenue and tax avoidance. Point 28 of ICI: "It must be pointed out that diminution of tax revenue occurring in this way is not one of the grounds listed in (new Article 46) of the Treaty" In other words little or no strict "public policy" defense is available on those traditional grounds for discriminatory income tax cases. However the Court eventually accepted to apply also to such cases the broader, open end grounds of public interest which it applies to its rule of reason justifications in parallel with its restriction-based application of the freedom principles. The text of aforementioned point 28 of ICI is thus completed as follows and cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify unequal treatment that is, in principle, compatible with Article (43) of the Treaty".

The chances of successful income tax application of that Treaty-based justification ("public policy") are, in that same context, much better for national measures that are designed to prevent tax evasion (assuming that they are necessary and proportionate)[1] Tax law infringements are even expressly included in Article 58(1)b of the EC Treaty, authorizing Member States under the capital freedom "to take all requisite measures to prevent infringements of national law and regulation in particular in the field of taxation". It was applied by the ECJ in it decisions Bordessa and Sanz de Lera[2]. The reference in Article 58(1)b to "requisite measures" and probably also the exclusion of "arbitrary discrimination and disguised restriction on the free movement" in paragraph (3) of that Article, are essentially a reminder, respectively, of the condition of proportionality of the tax measures and part and parcel of the tax codification of the general prohibition of Article 56, and of related ECJ case-law also under the freedoms other than the free capital movement.

Unlike the rule of reason, Treaty-based justifications also apply to discriminatory tax measures; like the rule of reason, they impose a proportionality condition. The ECJ is well aware of this different treatment of discriminatory and non-discriminatory restrictions of the freedoms and applies the distinction to tax measures in principle in the same way as it does in its non-fiscal settled case law. See point 32 of its Royal Bank of Scotland decision (rejecting the argument

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[1] While the assessment of those grounds for justification purposes is made under national law, it may not prejudice or frustrate the full effect and uniform application of the Community freedoms (Case C-307/96 (Kefalas) cf. infra.
[2] ECJ, cases C-358-83 (Bordessa) points 21 and 22; C-163/94 (Sanz de Lera) point 22.

that the higher tax rate for the branch of a non-resident company is justified by the limited fiscal sovereignty of the State in which the profit arises): " Finally, it is necessary to examine whether discrimination such as that in question in the main proceeding may be justified. According to settled case law, only an express derogating provision, such as (new Article 46) of the EC Treaty, could render such discrimination compatible with Community Law (see Case 352/85 Bond van Adverteerders and others (1988) 2085, paragraphs 32 and 33, and Case C-288/89 Stichting Collectieve Antennevoorziening Gouda and Others (191) ECR I-4007, paragraph 11)."[3]

2. Rule of reason

As Treaty-based exceptions effectively offer very limited scope and prospect for application in the area of direct taxation, Member States turn, for the defense of restrictive (as well as discriminatory) national tax rules, to the alternative justifications acceptable under r.o.r.

R.o.r. is defined, for this purpose, as the principle developed by the ECJ on equity grounds to the effect of authorizing Member States to derogate, under fixed conditions, from their obligations under the Treaty freedoms, and this by reference to imperative reasons of general interest. R.o.r. is also known under the name of "Cassis de Dijon" by reference to its case-law origin, specifically the ECJ decision which, in 1979, started the process of its development. It is also identified as "mandatory requirements", by reference to the phrase used in that same Court decision to describe the condition under which obstacles to intra-Community trade are excusable.

R.o.r. is also applied in the fiscal case law of the ECJ, for instance in Futura Participations (1997), referring to "overriding requirements of general interest capable of justifying a restriction on the exercise of fundamental freedoms guaranteed by the Treaty". It had been clear from the beginning that r.o.r. also applied to tax restrictions because such exception figured prominently among the examples listed in the Cassis de Dijon decision: "mandatory requirements relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defense of the consumer." [4]

Also for the tax application of r.o.r., important lessons can be learned from its Cassis de Dijon origin and from the case law under this rule in the other areas of national legislation and under other Treaty freedoms and even under other Treaty provisions that may have inspired the ECJ in developing the exception.

Well before the issues of the freedom principles and the conditions of proportionality for their exceptions were analyzed under the four freedoms and applied to direct tax measures, similar issues had been dealt with in regard to indirect taxes, not under those Treaty freedoms but under (present) Article 90. The Article left it to the ECJ to find a workable concept for applying the discrimination prohibition to restrictions on cross border trade and for determining when taxation corresponds to a difference in substance (under its second paragraph). This case law is thus also helpful in the application and interpretation of Article 28 concerning the fundamental freedom of movement of goods and its prohibition of discrimination (on basis of origin) and of (direct tax) measures having equivalent (obstacle-based) effect as quantitative restrictions on imports. Under the latter Article of the EC Treaty the ECJ ruled, in its Dassonville decision, that "all trading rules enacted by Member States which are capable of hindering, directly or indirectly, actually or potentially, intra-Community trade are to be considered as measures having an effect equivalent to quantitative restrictions. In the absence of a Community system (…) if a Member State takes measures (…) it is, however, subject to the condition that these measures should be reasonable (…) they must not constitute a means of arbitrary discrimination or a disguised restriction on trade between Member States." [5]

In Cassis de Dijon (r.o.r.) the ECJ looks for a reasonable or equitable balancing of Community and national interests involved, and formulates to this effect, in the following conditions of its application ("the rule of four"): absence of Community harmonization; no discrimination; justified by mandatory requirements; necessary for its aim suitability which cannot be achieved by less restrictive measures (proportionality).

In Dassonville the ECJ had ruled that, for purposes of ensuring the free movement of goods and furthering the internal market objective, the mere prohibition of non-discrimination as to the origin of the goods is insufficient. It must also cover restrictions or hindrances on free market access, even if these measures do not make a distinction between imports and domestic flows of goods. At the same time the Court was also aware that this obstacle-based interpretation considerably widened the scope the prohibition and, thereby, also its tasks where it would have to deal with the many tax obstacles resulting from the disparities between national tax legislations and as there was little prospect for Community legislation to deal with them. There was also the awareness that the ECJ might be considered by Member States and traditional doctrine to overstep its constitutional role by giving itself these newfound semi-legislative tasks. It, therefore,

[3] ECJ, case C-311/97 (Royal Bank of Scotland), point 32.
[4] ECJ, cases C-120/78 (Rewe Zentral –"Cassis de Dijon") of 20 February 1979, point 8; C-250/95 (Futura Participations) of 15 May 1997, point 31.
[5] ECJ, case 8/74 (Dassonville) of 11 July 1974.

accepted by way of self-restraint the r.o.r. exception as a concession and derogation to the widened scope of the prohibition within the general objective of establishing a reasonable balance between the interests.[6]

For some time it looked as if its Dassonville obstacle-style reading and extension of the prohibition of restrictions on the free movement of goods might not extend to all other freedoms and also not to income tax restrictive measures. Farmer and Lyal examined in 1994 possible catalyzing effects of the developments in the ECJ case law regarding their extension of the scope of (present) Article 39, 43 and 49 and the circumstances in which a Member State may rely on public interest grounds in defense of restrictive income tax rules and emphasized that any conclusions as to such extension were highly speculative. [7] It looked as if the restriction-based extension of the prohibition might not be suitable under the other freedoms of movement of persons and services, and that the ECJ might content itself for the application of r.o.r. in the income tax area to the prohibition of discrimination. Various causes for justification of national tax measures were proposed by the parties in the main proceedings and by the referring national court. They were routinely investigated by the ECJ as to their merits, on a case by case basis, without proper prior determination of their admissibility without much consideration of the underlying principles and distinctions.

It is an established practice of the ECJ to systematically stress similarities and convergence in its determination of compatibility of national measures with Treaty freedoms. This streamlining of the Court's case law is justified by the common objective of realizing an internal market and the effectiveness of Community law, irrespective of the markets (for products, services and production factors) and irrespective of the area of applicable national legislation (also income tax measures). Advocate General Léger, referring to non-fiscal decisions Sail and Hubbard, concluded that the effectiveness of Community Law cannot vary according to the various areas of national law affected by it: "Clearly, direct taxation, like taxation in other areas within the competence of the Member States, is an area in which the fundamental freedoms laid down in the Treaty, must be observed. It is appropriate to cite the Court's words in Hubbard in connection with (new Article 49): "The effectiveness of Community Law cannot vary as between the various areas of national law on which it has an impact" (Opinion in the Schumacker decision).[8]

Even so, the Court hesitated long to apply to income tax measures the restriction-based reading of the prohibition which it had developed in Dassonville. It held firmly to its sole principle of non-discrimination, and this notwithstanding the explicit reminder of Advocate General Léger in the Wielockx case: "Until now, the Court has always considered that (present Article 43) of the Treaty, applied to the area of taxation, required – in the same way as (present Article 39) – evidence of overt or covert discrimination. It may, however, be noted in passing that measures applied without distinction have an equally restrictive effect on freedom as discrimination."[9] The Court's hesitation was inspired by concerns about intrusive and undermining effects of such expansive reading of the prohibition in the area of income tax legislation.

Finally, in the Futura Participations decision of 15 May 1997, the ECJ applied an obstacle-based reading of the prohibition to restrict the freedom of establishment to a Luxembourg tax measure imposing extra tax accounting requirements on the Luxembourg branch of a French company. They constitute an obstacle arising from the existence and interaction of two tax systems. The new interpretation was consistently applied in the fiscal case law in the aftermath of Futura Participations: Baars (2000), Verkooijen (2000), AMID (2000), X and Y (2002), Lanhorst- Hohorst (2002), Bosal (2003) and others, leading, for the first time in the de Groot decision, to a new, more comprehensive standard formulation of the two-track EC-compatibility test of tax measures under the converged freedom principles: "The answer to the second question must therefore be that Community law contains no specific requirement with regard to the way in which a State must deal with a tax situation, except that the conditions must not constitute discrimination, either direct or indirect, on grounds of nationality, or an obstacle to the exercise of a fundamental freedom guaranteed by the Treaty."[10] In that same case (point 78) the ECJ also explained that "provisions which preclude or deter a national of a Member State from leaving his country of origin 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 (case C 10/90 Masgio (1991) ECRI-1119 paragraphs 18 and 19, and Terhoeve, paragraph 39, and Sehrer, cited above, paragraph 33)".

A last point relates to the different justifications available under to the two readings of the prohibition to restrict the freedoms. Whereas the Treaty-based exceptions are applied to discriminatory as well as restrictive (tax) measures, the wider overriding public interest justification developed by the ECJ is not available for discriminatory measures. In practice the ECJ case law on this point lacks often transparency or consistency. In some decisions the ECJ investigates the grounds as they are submitted by national court and without bothering to first establish their admissibility under the applicable principle. In other cases the ECJ applies indistinctly both legal grounds as in aforementioned point 28 of ICI and point 50 of Saint-Gobain. In still other cases it applied the test of r.o.r. to discriminatory tax measures. In Svensson and Gustavsson, it even investigated all justifications submitted by the defense and, only after that exercise, concluded that a discriminatory national tax measure is only eligible for the exceptional justifications set forth in the Treaty.

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[6] A second derogation and self-restraint ensuing from the same extension of the freedom principles is that of the Keck and Mithouard case law. It is only briefly discussed hereinafter (point C) as it operates at a different level of the EC-compatibility decision tree than r.o.r. and was, therefore, discussed in earlier contributions.
[7] Farmer P. and Lyal R., EC Tax Law, Clarendon Press, 1994, p. 328.
[8] ECJ, C-279/93 (Schumacker), point 30; 81/71 (Sail); C-20/92 (Hubbard).
[9] Opinion of Advocate General Léger in Wielockx case (C-80/94), point 17.
[10] ECJ, case C-385/00 (de Groot), point 115.

Part of the problem was that it was difficult for the Court to avoid that confusion as long as it had not embraced a distinct, restriction-based reading of the prohibition under the freedoms and not properly distinguished discrimination and unequal tax treatment. In several cases, it applied a difference between cases of direct (overt) and indirect (covert) discrimination. In Bachmann, the ECJ, following the Opinion of Advocate General Mischo, accepted a justification on grounds of public interest going beyond those listed in the Treaty (need to preserve cohesion of the national tax system), and did so after pointing out that the case is not one of (direct) discrimination as it applies to all workers, regardless of their nationality. After Bachmann, it even agreed to investigate cases of direct and indirect discrimination and to consider the wide range of public interest grounds proposed by the national governments for their justification, but eventually denied their effective application or ignored them in the discussion.

The new fiscal case-law in the aftermath of Futura Participations, applying a new terminology, the maintains prohibition and expression of (direct and indirect i.e. over and covert) discrimination on basis of nationality, except that now that concept no longer covers "difference of treatment" of (intra-Community) tax measures. Together with access and exit tax restrictions, unequal treatment now constitutes an obstacle or barrier and is prohibited as such. This clarification of the categorical distinction in the application of principles is important for a more transparent application of the r.o.r. exception. Wide public interest grounds raised in the defense were considered and even accepted in principle by the ECJ also in discriminatory income tax cases that are now identified as difference in tax treatment. This has lead some commentators to question the validity of the justification on ground of coherence of the tax system in the successful Bachmann defense, because of its dependence on discrimination by virtue of nationality, being at that early stage the only principle implementing the prohibition of tax restriction of freedom. [11] Under the newfound restriction – based reading, the applicable principle in the Bachmann decision would probably have been more consistently identified as one of the different or unequal treatment (first category of tax obstacles) as distinct from (true) discrimination on basis of nationality or residence, and would thus have paved the path for its justification on ground of preservation of coherence of the tax system.

B. The substantive discussion of r.o.r.

After looking for lessons to be learned from the origin of r.o.r. and its process of case law development as it gradually fixed its framework conditions, we look at the substance of the r.o.r. issue, its conditions of application and its role in the process of establishing the compatability of Member States income tax rules with the fundamental freedoms and in determining the terms of the reasonable balance of national and Community interests. We found that from the outset the ECJ retained four conditions for the r.o.r. derogation:

1. No Community legislation in the field

The case law makes it clear that Community measures should eventually occupy the field concerned by the national (tax) rules. Kapteyn and VerLoren van Themaat explain the link between Member State regulation of the wide range of public interests and values and Community regulation in the field as follows: "The rule of reason is essentially a temporary acceptance of State regulation of the interest or value concerned pending Community regulation which will replace the need (and thus the justification)for unilateral national measures. It has been submitted that the development of the rule of reason is essentially an equitable development, acknowledging that the strict application of the basic principle may in certain circumstances lead to an unconscionable result. The rule of reason can also be seen as the reverse side of the coin in relation to the wide basic principle in Dassonville and the development in Cassis de Dijon (and more clearly subsequently) of the principle of the mutual acceptance of goods".

Is r.o.r. thus built on shifting sands? Is it doomed to soon disappear as a result of the blocking effect of future Community legislation? It is theoretically possible, but considering the current lack of significant income tax harmonization in this field and of better prospects in the enlarged Community, as well as the continious need of sovereign dealing with public (state) affairs r.o.r. is unlikely to stray into the area of Community legislation in the foreseeable future ("given the unlikelihood any move (of Community legislature) to harmonize public morality!" [12]

2. No discrimination

We learned from the case law development of this r.o.r. condition how the ECJ struggled with its application, especially in its income tax decisions, and we noted their lack of clarity, consistency and legal certainty. It lead Advocate General to

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[11] It is, however, noted that the Court avoided in Bachmann the express reference to the discriminatory nature of the Belgian tax measure, but pointed out in point 9 "that there is a risk that the provision in question may operate to the particular detriment of those workers who are, as a general rule, nationals of other Member States. Comp. point 14 of Biehl judgment: "there is a risk that it will work in particular against taxpayers who are nationals of other Member States".

[12] Kapteyn and Verloren van Themaat, o.c., 654 (referring to Article 30, recourse on ground of public to restrict imports).

make the following suggestion in his Opinion in the Danner case: "I think it is inappropriate to have different grounds depending upon whether the measure is discriminatory (directly or indirectly) or involves a non-discriminatory restriction on the provision of services. Once it is accepted that justifications other than those set out in the Treaty may be invoked, there seems to be no reason to apply one category of justification to discriminatory measures and another category to non-discriminatory restrictions. Certainly the text of the Treaty provides no reason to do so: Article 49 EC does not refer to discrimination but speaks generally of "restrictions on freedom to provide services". In any event, it is difficult to apply rigorously the distinction between (directly or indirectly) discriminatory and non-discriminatory measures. Moreover, there are general interest aims not expressly provided for in the Treaty (e.g. protection of the environment, consumer protection) which may in given circumstances be no less legitimate and no less powerful than those mentioned in the Treaty. The analysis should therefore be based on whether the ground invoked is a legitimate aim of general interest and if so whether the restriction can properly be justified under the principle of proportionality. In any event, the more discriminatory the measure, the more unlikely it is that the measure complies with the principle of proportionality."[13]

In the absence of any positive reaction on the part of the ECJ, we may conclude that the ECJ is not prepared to dispose of a condition (one of the four) that was laid down in Cassis de Dijon, the very origin of r.o.r.. It would thus appear to refuse the extension of the field of national regulatory measures that may infringe the fundamental freedoms for imperative reasons of national interest, although it had accepted the exception because of the regulatory deficit of the Community; it also appears to attach, in the r.o.r. act of balancing interests , greater intensity of Community interest in the non-discrimination principle than in that of non-restriction of the freedoms. It does so even as the "great divide" created by this distinction, is often elusive and artificial. Consider for instance the defense in Bachmann (which is the only case of successful r.o.r. application). The defense would, in the new two-track system of the prohibition, have to be based on the non-restriction (rather than the non-discrimination) approach in order to rely again on the preservation of internal coherence as ground for the r.o.r. exception. Now suppose that that same case would be submitted and decided not under the freedom of persons (i.e. the standpoint of the Mr. Bachmann) but under the freedom of providing trans-frontier services (i.e. the standpoint of the foreign insurance companies). The defense for the very same tax measure would thus become very different, not to say unjustifiable, as for those foreign insurance companies the deductibility of premiums for national companies only, would constitute a true discrimination and thus not be excusable by the need to safeguard coherence.

3. Imperative reasons of general or public interest.

In order to override fundamental freedom principles as they apply to restrictive national (tax) measures, the public interests which those derogations seek to protect must be legitimate. They must also be of a non-economic nature. The case-law of the Court consistently held that interests of a purely economic nature cannot be successfully invoked; but it does not deny r.o.r. justification for tax measures if their aim transcends or runs parallel with their economic context.[14]

This (non-economic) requirement to explains the declared indifference of the ECJ for budgetary implications of the freedoms. In several decisions the Court concluded that the diminution of tax revenue is not per se an overriding public interest reason.[15] Even so, there may be room for nuances or evolution. In some decisions the Court seems to accept the maintenance of the financial balance of a social security system as an overriding reason of general interest (but did not accept those restrictions being proportionate to the aim pursued)[16]. We also refer to the reasoning of the Court in point 48 of its Gilly decision: "Furthermore, as has been observed by the French, Belgian, Danish, Finnish, Swedish and United Kingdom Governments, if the state of residence were required to accord a tax credit greater than the fraction of its national tax corresponding to the income from abroad, it would have to reduce its tax in respect of the remaining income, which would entail a loss of tax revenue for it and would be such as to encroach on its sovereignty in matters of direct taxation.„

The list of admissible public interest justifications under r.o.r. is open-ended and wide-ranged. We will focus on four categories in view of their relevance and potential for justifying direct tax measures.

One legitimate cause, that was already expressly included in the examples given by the ECJ in its Cassis de Dijon decision, relates to maintaining the effectiveness of fiscal supervision. Its admissible nature was confirmed in Schumacker, Baxter, Futura Participations and Vestergaard. It may dictate a sufficient degree of flexibility in accepting the constraints of administration, collection and control of transfrontier activities which are more cumbersome than those required from domestic activities. If this defense was rejected, it was mostly because of ECJ reservations with respect to the necessity and proportionality of the restrictive measures (cf. infra.).

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[13] Opinion of Advocate General Jacobs in Case C-136/00, Danner.
[14] G. Straetmans and non-fiscal case law cited by the author, Comments on cases C-124/97 Läärä and C-67/98, Zenatti; Common Market Law Review - 37, 2000, p. 1003.
[15] We refer again to aforementioned point 28 of the ICI decision, points 29 and 30 of St-Gobain and point 59 of Verkooijen: "it need merely to be pointed out that reduction in such revenue cannot be regarded as an overriding reason in the public interest which may be relied on to justify a measure which is in principle contrary to a fundamental freedom" (with reference to ICI).
[16] ECJ case C-120/95 (Decker) and C-158/96 (Kohll).

A second ground for r.o.r. defense is based on the fiscal principle of territoriality (if it is not alternatively applied at the level of establishing (non-)infringement of the prohibition of discrimination, considering its acknowledgment of objective difference between residents and non-residents (in view of their different capacity to pay and other personal tax attributes). The defense was accepted by the Court in Futura Participations but turned down by it in X and Y, Gerritse and Bosal. [17]

A third category of imperative public interests is probably the most important one for fiscal r.o.r. purposes. As it is until today, the only defense and tax case in which r.o.r. was successfully accepted, is the exception of coherence of national tax system. It was unavoidably invoked in most subsequent cases. However, it was, time after time, rejected either because it was deemed waived by the application of a double taxation agreement (Wielockx, X and Y) or because the ECJ subjects the concept to increasingly strict conditions and definitions that were not fulfilled (ICI, Metallgesellschaft, Bosal, Danner, Lankhorst, Asscher, Baars, Verkooijen).

The reluctance of the Court to apply more lenient conditions and definitions to the cause of coherence of the tax system is similar to its reluctance to accept more flexible conditions to admit a fourth group relating to what we describe as the protection of the integrity of the tax system. Former ECJ judge Wathelet reviewed the ECJ tax law and found in all cases raising the r.o.r. issue, that it was denied on the ground of prevention of loss of tax revenue, even if it is associated with the prevention of exploitation of tax loopholes or maneuvers of erosion of the tax base beyond the mere diminution of tax revenue. Acceptable exceptions are restrictive measures dealing with the prevention of evasion of national taxes and also of tax abuse. They are applied by the ECJ in a case-by-case approach which is not only purely dictated by national tax laws but also by the degree of frustration which the restriction may bring to the exercise of the Treaty freedoms. They thus become narrowly defined concepts beyond the requirements of fortification of national tax legislation countering tax avoidance general ant-abuse tax statutes,, closing loopholes and preventing loss of revenue. A general definition is given in Kefalas: unreasonable exercise of the right to derive to the detriment of others an improper advantage manifestly contrary to the objective of the legislation. See also the characterization of the tax abuse in ICI, point 26: “As regard the justification based in the risk of tax avoidance, suffice it to note that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent (State) tax legislation from attracting tax benefits.” Initially, in its Avoir fiscal decision, the ECJ had even flatly dismissed the ground altogether: “Furthermore, the risk of tax avoidance cannot be relied upon in this context. (New Article 43) of the EC Treaty does not permit any derogation from the fundamental freedom of establishment on such a ground.” By now, Community law cannot be relied on for abusive or fraudulent or for countering national anti-avoidance tax measures if the national measures or abuse doctrine by their broad scope risk damaging the full effect and uniform application of the freedoms in the Member States.[18]

4. Conditions of necessity and proportionality

In all tax cases (save Bachmann) in which the Court agreed to consider a cause of public interest admissible under r.o.r., the justification was ultimately denied on account of not satisfying the further condition of “necessity” (is the restrictive tax measure suitable in view of the existence of a causal link between the measure and the aim which it seeks to achieve?) and that of proportionality (can the aim of the measure be achieved by less restrictive means?).

The determination whether a measure goes beyond what is necessary to achieve its aim, is in first instance a matter of assessment by the Member States themselves, although the Court will occasionally make the point that the measure may not be disproportionate to the aim sought, and sometimes offers guidelines on how the Member State should proceed in its assessment. One can hardly say that the ECJ review of the condition is only marginal the way it is responsible for r.o.r. rejection in most tax cases. Straetmans reviewed the latest (non-fiscal) case law and found that the Court no longer seems willing to substitute its own view for that of member States unless it exceeds the limits of their discretion. Is that also true in tax cases?

The discussion, if any, by the Court of this condition in that area of r.o.r. application, can be very summary as is the case when the ECJ rejects to retain r.o.r. on grounds of effective fiscal supervision with the standard answer: ask it from the taxpayer himself, or “Directive 77/799 concerning mutual assistance in the field of direct taxation provides adequate means” (Schumacker, Baxter, Vestergaard). Does it? What if the information or documentation is not available in the home state? What with directive 1977 grounds for refusal of cooperation? What with language barriers and human, financial and technical restraints? Is it administratively feasible, proportionate and therefore reasonable for the ECJ, in the case of a Dutch drummer or other non-resident artist performing for a small fee on a transient basis in Member States, to require, in the name of unrestricted market access and at the cost of expensive tax advisers and disproportionate administrative burdens, an allocation and substantiation of costs relating to each performance and the application, at least notionally, to his net fee of the progressive tax tables of resident performers, as a condition for the

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[17] ECJ, C-250/95 (Futura Participations) point 31: “The Court has repeatedly held that the effectiveness of fiscal supervision constitutes an overriding requirement of general interest capable of justifying a restriction on the exercise of fundamental freedoms by the Treaty (…). A Member State may therefore apply measures which enable the amount of both the income taxable in that State and of the losses which can be carried forward there, to be ascertained clearly and precisely”.

[18] See D.M. Weber, Belastingenontwijking En de EG-Verdragsvrijheden, Kluwer 2003, 269.

compatible withholding taxation of his gross fee at a flat rate that is not excessive? The condition risks defeating the reasonable and even imperative objective of procedural simplicity and administrative cost saving, both for the taxpayer and the tax auditor. In its Gerritse (C-234/01) decision, the ECJ dismissed this concern in its unique summary style by referring to the Terhoeve ruling: "Considerations of an administrative nature cannot justify derogation by a Member State from the rules of Community law."

C. Distinguishing the operative level of r.o.r.

R.o.r. is subject to its own, distinct conditions of application and tax effects in the process of testing the compatibility of direct tax measures with the Treaty freedoms. In general, eight successive steps are applied to this process. They are articulated in the following "EC-compatibility decision tree":

1. Does the national tax measure fall within the scope (ratione materiae, ratione personae and ratione territorii) of Community law and hence of its fundamental freedoms? If it does not, the measure remains in the free hands of individual Member States, and r.o.r. does no more come into consideration. If it does:
2. Is it deemed in conformity with the Community principles because it belongs to a complementory category of national or bilateral tax rules that are collectively accepted by the Court without any further need of testing the compatibility of the rules thereunder ("Gilly case law"). If it does, r.o.r. does not come into play; if it does not:
3. Is the individual tax measure compatible with the Treaty principle of non-discrimination as interpreted by the ECJ? If it does, r.o.r. is no more tested and needed. If it does not:
4. Can the discriminatory tax measure be justified under the exceptions found in the limitative test of public interest causes in the Treaty and is it proportionate? If it cannot, the measure is not EC-compatible.
5. If the tax measure is not discriminatory(unequal tax treatment, exit or access tax): is it compatible with the Treaty reading prohibiting any obstacle-based restriction of the exercise of the freedoms? If it is not:
6. Is the restrictive tax measure excusable by virtue of imperative reasons of public interest admissible under r.o.r.? If the cause is in principle acceptable:
7. Is the restrictive measure an unnecessary or disproportionate infringement of the applicable freedom? If it is, the outcome of the r.o.r. test is negative. If it is not:
8. Is the non-discriminatory and non-restrictive or excusable tax measure in conformity with the principles of the Treaty, (other than the fundamental freedoms) and with tax directives? If it is not, the measure is not EC-compatible.

As indicated by the order of testing of compatibility in the decision tree, r.o.r. exceptions are operative at level 6 and 7 and Treaty-based exceptions at level 4.

The distinctions applied to these different stages of the compatibility assessment are easier to make conceptually than in practice. Especially restrictive tax provisions raising the issue of their r.o.r. protected public interests, such as anti tax abuse, may be borderline cases as they may have raised the issue of their compatibility with the freedoms already at an earlier operative stage of the decision tree.

Freedom riding for tax planning purposes may therefore be challenged at the level of restriction of the applicable freedom if the infringement of the freedom is not disproportionate (step 6 and 7). The rider may, in extreme cases, alternatively be refused the access to Community law and hence freedom protection (step 1). "Thus the Court is not inclined to allow the free movement rules to be used as a rogues' charter. Accordingly, u-turn constructions simply designed to escape from legitimate national requirements in a person's home Member State will not be supported by the Court."[19]

Member States may be tempted to rely too easily on this safety net of denying access to the Treaty freedoms. Recent case law of the Dutch Supreme Court applies a controversial analysis and conclusion to a case involving a tax-driven step-to-step construction between the Netherlands and the Netherlands Antilles.[20] The Hoge Raad concluded that it was not required under Article 234 of the Treaty to refer the question for a preliminary ruling by the ECJ, as there could be no reasonable doubt, also in the light of its (non-fiscal) case law cited (acte éclairé),[21] that, in this case of evasion of national tax legislation, recourse by the evader on the protection of the Treaty and its fundamental freedom of capital movement was impossible. The interpretation was thus resolved at the level of step 1 instead of levels 6 and 7. The approach is controversial as, for lack of business purpose, the case could alternatively, and probably more appropriately, have been analyzed even under Dutch tax law as one of fraus legis rather than evasion and was hardly assessed in terms of ECJ case law of freedom tax restriction. The Hoge Raad should probably have referred it to the ECJ for preliminary ruling or, at the very least, explained more convincingly at the level of step 1 why the abuse of the capital freedom, in the particular circumstances of this case, justified its exclusion from the scope of application of that freedom, whereas the ECJ in cases of prevention of tax abuse (ICI, X and Y, Lankhorst) tends to engage its supervision of the assessment cases at the level of steps 6 and 7.

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[19] Kapteyn and Verloren van Themaat, o.c., 724 with reference to cases Krauss (C-19/92), Knoors (115/78), Bouchoucha (C-61/98).
[20] Hoge Raad, 23 january 2004, nr 38258, V-N 2004, 913 p.46.
[21] ECJ, cases C-23/93 (TV 10) of 5 October 1994, C-367/96 (Kefalas) of 12 May 1998 and C-110/99 (Elmsland-Stärke) of 14 December 2000.

Another case of controversial application of the decision tree relates to the tax application of Keck and Mithouard case law. As Kapteyn and Verloren van Themaat point out: "Since the judgment in cases C-267 and 268/91 Keck and Mithouard, rather more attention has been focused on the interpretation of the prohibition (whether present Article 28 applies) than was the case in the past, before turning to interpret the exceptions (justifications advanced for the measures involved)." [22] In other words the discussion is shifting from steps 6 and 7 to step 1. In the aforementioned cases, restrictive rules related to modes of sale (at a loss), as distinct from product norms, fall outside the ambit of Article 28 if they have the same effect on imports as on domestic products. Farmer is prepared to extend this case law to restrictive tax practices, as Keck and Mithouard "in effect limits the scope of the Treaty to rules which are covertly discriminatory. Thus, the rule reduces the number of situations in which the courts must use the proportionality principle in order to balance the Community and national interests." We have problems in extending the relevant and factual circumstances and distinctions of that case to income tax rules. Looking for support for that extension in the subsequent case law, we find that, in the rare cases in which the Court referred to Keck, it did so more by analogy, occasionally accepting to apply a distinction in terms of more or less substantial restriction of market access but usually concluding that the case is "not comparable to the rules on selling arrangements for goods which in Keck and Mithouard were held to fall outside the ambit of Article (28)." [23] We believe, for those reasons, that the Court will be reluctant to apply this case law to bring restrictive tax cases outside the scope of the freedoms (at stage 1 or 5) and will leave them subject to the more burdensome and tricky defense of steps 6 and 7.

A discussion at level 1 or 5 is certainly possible or necessary to determine the access of a taxpayer to the Treaty freedoms and the restrictive nature of the tax measure under the applicable freedom, e.g. to determine whether the tax measure is "too uncertain and indirect to warrant the conclusion that (it) is liable to hinder trade between Member States." [24] But the Court is not prepared to accept that tax rules which are only slightly restrictive for the exercise of the freedoms are not caught by Community law and its prohibition of restriction of freedoms (steps 1 or 5). Their negligible ("de minimis") nature would not even be justified under r.o.r. (steps 6 and 7) according to ECJ case law ("even if only of a limited nature").

Can it be argued, for instance by analogy to Keck and Mithouard and in the spirit of a reasonable balance of interests, that a defined category of national tax rules could be deemed compatible by means of self restraint on the part of the Court? It would do so at level 2, much in the same fashion as the group acceptance of EC compatibility of tax Treaty rules concerning allocation of taxing rights in the Gilly case.

Van Thiel rejects such approach (at the level of r.o.r. exceptions) because "it would imply a certain measure of discretion in the hands of the Member States, which would be inconsistent with the standard conditionality formulated in the Court for directly applicable Community law, that the obligation for the Member States must be clear and unconditional, without need for implementation of further decision and without being dependent on any discretion of national authorities." [25]

The Court has accepted, in the exercise of balancing of Community and national interests (which is at the heart of the r.o.r. and Keck rule), an assessment that, in the absence of Community measures, is made by Member States themselves under the supervision of the Court. The ECJ is even prepared to go a step further in accepting that discretion of Member States where they pursue certain public interests which are particularly sensitive and political and relate to choices and values that involve more closely national than Community interests. A case in point is that of national regulatory restrictions for the protection of society and participants in lotteries. In Schindler, the ECJ allowed the application of r.o.r. on general grounds relating to the protection against fraud and financial harm to gamblers and society. [26] The Court refused to engage in a proportionality test explaining that the particular characteristics of lotteries justified Member States "having a sufficient degree of latitude to determining (…) whether it is necessary to restrict these activities, but also whether they should be prohibited, provided that those restrictions are not discriminatory." Straetmans concludes that the Court's remoteness in issues that involve sensitive and political national choices relating to society interests "supports the view that the Court is gradually creating a European public order exception, on grounds of which restrictions on free movement can be justified as a simple result of the Europeanized discretion of Member States in areas with the above characteristics".

Our question is whether direct taxation or certain of its doctrines might not be considered to constitute such a sensitive and political sector with a European public order character; and whether they would, on that basis, be eligible for the national public policy exception under step 4 or for r.o.r. (step 6) with no or only very marginal proportionality test (step 7), or even for a categorical acceptance deemed compatibility or complementarity with Community interest at earlier step 2.

Another aspect of the ECJ tax case law reflected in the decision tree dealing with the testing of the compatibility of tax measures with the freedoms, relates to the distinction between discriminatory and restrictive tax rules. This

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[22] Kapteyn and Verloren van Themaat, Introduction to the Law of the European Communities, 3rd ed. 1998, 657. Farmer P., The Court's case law on taxation: castle built on shifting sands? EC Tax Review 2003-2, 80.
[23] ECJ, case C-415/13, (Bosman). See also C-405/98 (Gourmet International Products).
[24] ECJ, case C-69/88 (Kranz) point 11 (income tax measure too remotely related to the freedom of importation).
[25] van Thiel S., Free movement o.c., 550.
[26] ECJ, case C-275/92 (Schindler); other cases in the area of lotteries are pending (C-243/01 Gambelli and income tax case C-42/02 Lindman). See Straetmans G., o.c., 1001.

distinction is criticized by Farmer for its untidiness. The current ECJ case tax law lacks analytical rigor and substance ("all the obstacles which the Court has had to consider in tax cases could be said to be discriminatory") and lack also of consistency in its language and creates confusion with the national courts and may thus have repercussions for the uniform application of Community law: "The various defenses are in practice concerned with much the same issue. If a rule is actually necessary to safeguard a Member State's tax system or to prevent tax avoidance, there must surely be a material difference in situations in the relevant taxpayers justifying any difference in treatment under the rule (…). For a national court, which does not have the same experience of EU law issues or instincts, it may represent a bewildering patchwork of concepts, making it difficult to identify the relevant principles. In short, it may have repercussions for the uniform application of Community Law."[27]

D. Balancing Community freedoms and functional tax sovereignty of Member States

The question in the title of our study puts r.o.r. in the perspective of the general panel issue: are fundamental freedoms of Community law kept in balance in the face of functional sovereignty of Member States, in particular in the area of income taxation? The thrust of the question holds an implicit concern that r.o.r. exceptions might undermine the economic efficiency of the fundamental Treaty freedoms, themselves the keystone of Community law and of its promise of an internal market. For Knobbe-Keuk the concern was that "slippery Bachmann" would open the backdoor by which fundamental Treaty freedoms "risk going to the dogs".

There can be no doubt that the economic benefits and increased efficiencies, achieved by unrestricted Treaty freedoms and full integration into a concept of one-market without internal tax borders, cannot be fully achieved by Member States on a stand alone basis and by EU enterprises operating in a market partitioned by 15 or 25 sovereign income tax systems. It supposes advanced positive harmonization of the tax legislations of Member States. If Member States are not prepared to make the required sacrifice of their sovereign income tax powers, part of the answer to that challenge is that of negative harmonization achieved by an active Court as custodian of the fundamental freedoms and their objective of the internal market. Reference is thereby made to its supportive case law applying a broad of discrimination concept and, later, establishing a two-track system of robust constitutional principles of non-discrimination and newfound obstacle-based reading of the prohibition to restrict those freedoms.

However, the sole reliance on the ECJ cannot assure the balanced harmonization of tax legislation required for the realization of the internal market. The authors of the Treaty, well aware of the mixed economy of Member States, called for "the approximation of the laws of Member States to the extent required for the functioning of the common market" (Article 3(1)h). The ECJ would overstep its judiciary role if it would deal with neutral tax measures having restrictive effects caused by the many disparities and arguably also the territorial fragmentations of the national income tax systems.

At the same time there can be no doubt that "there are more things in heaven and earth" than European-wide optimization of economic efficiencies, also in the world of the tax affairs of EU Member States and EU-based enterprises, Member States remain also the custodians of a variety of national public interests and general policies, e.g. to achieve social, political and other economic goals and values, to protect the integrity of the national tax system, to maintain certain quality standards of (fair, administrable, effective, hard to circumvent, coherent, etc.) national taxation, and, to this effect, to preserve a reasonable minimum level of national functional tax sovereignty.

In the longer run, the hope is justified that Community harmonization measures will occupy more of the field in the area of direct taxation. But today there exists, unlike the host of directives eliminating obstacles in most other areas, hardly a handful of direct tax directives and hardly any better immediate prospects of positive income tax harmonization in the enlarged Community.

It thus falls on the ECJ to give a very robust and pervasive interpretation to the scope of the prohibition of discrimination and restriction of the fundamental freedoms along the lines of the internal market objective. At the same time the ECJ developed the r.o.r. exception to deal with the intrusive and potentially destructive effects of such expanded prohibition. However, in practice it omitted to make good use of this possibility which it introduced national and Community as a self-restraint in the dominant build-up of the Treaty freedom principles.

The ECJ does not escape the tricky exercise of assessing and balancing of national and Community interests and of self-restraint in applying Community principles subject to general public interest exceptions. The margin of Member States' discretion and ECJ self restraint may be applied to three levels: that of identifying prohibited tax obstacles to the exercise of the freedoms, that of identifying overriding public interest and that of finding necessity and proportionality of the restrictive tax measure. Is every risk of double taxation and every requirement of extra documentation and certification in dealing with cross border situations (residence, beneficial ownership, etc.) a prohibited obstacle to the exercise of tax applicable fundamental freedom? How far do the freedoms go in protecting freedom riders engaged in country tax shopping, tax treaty shopping and exploitation of tax loopholes, to the detriment of the integrity

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[27] Farmer, The Court's case law, o.c., 81. Farmer effectively proposes to go back, indirect tax matters, to a single, broad principle of non-discrimination with a rare purely obstacle-style exception: "Futura provides the sole example of tax obstacle arising from the interaction or existence of different tax systems. Some might argue that the same is true of Verkooijen and Bosal."

and coherence of the national tax system? How reasonable is the ECJ's present definition of anti-abuse and coherence of national system as r.o.r. exceptions?

Is it reasonable to reject the exception of effectiveness of tax supervision by a mere reference to the directive concerning mutual assistance between national administrations, without considering how operative and efficient those procedures in reality are (or are not) in fact and in law? Is it unreasonable to accept administrative feasibility as an imperative public interest?

It is even conceivable that a more lenient application of r.o.r. and a sufficient degree of latitude in Member States assessment might actually strengthen rather than weaken Community principles and economic integration. The present approach boils down to a prisoner's dilemma: either doing away defensive tax mechanisms to protect the integrity of the national tax base or extending the mechanism to domestic situation without there being a real need for such restrictive mechanism. The original development of the Cassis de Dijon rule pointed to the concern of the Court wanting to avoid, by self-restraint, the criticism that it might be overstepping its judiciary role and to deal with objections of Member States and traditional tax advisers crying foul on ECJ's acting as a substitute for a reluctant Community legislator. The common consideration of imperative public interests pursued by national tax measures may eventually inspire Community legislation that would occupy the field of those exceptions.

We have applied these views in commentaries on recent fiscal case law of the Court.[28] We believe that they effectively are not very different from the views expressed by Richard Lyal, Legal Adviser European Commission: "In such cases (if there is a robust principle of discrimination and additionally a prohibition of restriction on the effective exercise of a freedom – LH), we should be open to a broad range of justifications in the public interest."[29]

At the end, the exercise is less fiscal than political where it deals with the westfalian paradigm of shared competencies of Member States and their Community outside a federal structure. Is it reasonable to assume that the fathers of the Treaty establishing the Community and the current membership accept to effectively disregard in direct tax affairs imperative reasons of national public interest and policies and envisage such federal feature of their fiscal construction? Or is it a better approach to fill the gap of Community measures at least partly and reasonably, by ECJ acceptance of "European public tax order" exceptions, with little or no proportionality condition, or even by a categorical clearance of such public interests, thereby entrusting Member States the same "a sufficient degree of latitude" in their assessment in the direct tax area, as in some other sensitive and political areas in which the Court has allowed such limited discretion?

We do not invent a new national public value in fiscalibus that is internationally protection-worthy. The idea that national public interests may prevail on international obligations of fiscal non-discrimination is not only accepted in Community law but also in national and treaty law. An interesting example of such override of international discrimination rules by elements of the national tax system that are reasonably considered in public policy terms to be intrinsic to the functional integrity and coherence of that system, is found in the Canadian system. It is interesting to see how a Canadian IFA report makes the comparison of that protection with the Bachmann ruling, where the ECJ accepted that, in the absence of Community measures, the national interest in a coherent tax system may exceptionally prevail on the Community prohibition of tax discrimination and restriction of the freedoms.[30]

"The formative, and for this Subject most interesting and significant, question is how the inclusion in most of its tax conventions of a non-discrimination article and more generally Canada apparent accession to basic principles of non-discrimination, can be reconciled with the different treatment of non-residents (and in some cases non-Canadian nationals) in the Act and Canada's outright reservation on Article 24 of the OECD Model (…) Canada appears to consider that provisions of its domestic tax system intrinsic to its internal integrity in terms of tax and other government policy ought to prevail despite their evaluation, out of this context, as possibly discriminatory. Affecting this may be the absence of overt or functional harmonization of tax systems that could otherwise assist in balancing the tax policy objectives of Canada and other countries. Such an explanation, and indeed justification, of discriminatory domestic tax provisions recently seems to have been acknowledged by the European Court of Justice in its adjudication of an instance of Belgian tax discrimination (…) Considering the significance of reasonable requirements of a coherent national tax system and its use to further national public policy objectives, a country may be justified in insisting upon the application of seemingly discriminatory tax provisions if they are intrinsic to the orderly functioning of its tax system and are not, per se, for the purpose of direct, unprincipled discrimination. Any determination of whether the purpose or result of a country's tax provision is discriminatory must take account of the entire domestic tax law; internal obligations should be assessed similarly."

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[28] Cf. our articles : *The search for the framework conditions of the fundamental EC Treaty principles as applied by the European Court to Member States' direct taxation*, EC Tax Review, 2002-3, 120; *European Court challenges flat rate withholding taxation of non-resident artist: comment on the Gerritse decision*, EC Tax Review, 2003-4, 214; *Tendances récentes de la jurisprudence de la Cour européenne en matière de fiscalité directe*, L'année fiscale, 2004 Presses Universitaires de France (in press).

[29] Lyal R., *Non-discrimination*, l.c., 74.

[30] Lewis and Scott Wilkie, Canadian Report "Non-discrimination rules in international taxation", IFA Cahiers Vol. LXXVIIIb, 1993, p. 36-367.