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ECJ Recent Developments in Direct Taxation 2007

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Preface

The European Court of Justice is a driving force in the field of direct tax harmonisation. Therefore, cases pending at the ECJ are very carefully analysed both by academics and practitioners.

After the successful conference in October 2005, we organised another conference to discuss the cases pending in connection with the fundamental freedoms with respect to direct taxation and the possible consequences of future ECJ decisions, on 15-17 February 2007. About 150 leading experts on European tax law accepted our invitation. The results of this conference are published in this book.

Without the support of the Wolfgang Gassner Research Fund for International Tax Law, the Austrian Branch of the International Fiscal Association (IFA), and the City of Vienna, neither the conference nor the entire project itself would have been feasible.

We are very grateful to the authors who not only gave us impressive presentations of the pending cases but who also committed themselves to an extremely ambitious schedule. This allowed us to complete the book within days and to present the outcome to the scientific community shortly after the conference.

The publisher Linde agreed to include the following publication in his catalogue. We would like to express our sincere thanks for the co-operation and swift realisation of this publication project.

Above all, we would like to thank Mrs Necha Demirova for the smooth organisation of the conference and Mr Bernhard Fölhs who supported us in deciding on the structure of the conference and during the process of publishing.

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Contents

one step too far and that the Court must review this case law. In the meantime, the Court has taken a first step in the right direction in *Kerckhaert-Morres* by seeing no restriction in that case. Given that the *Orange European Smallcup Fund* case lies at the core of the issues in *Manninen* and *Kerckhaert-Morres* there is no knowing which direction the ECJ will take: will it be a restriction in the meaning of the *Manninen* judgment or a disparity in the meaning of *Kerckhaert-Morres*? The Supreme Court has set the trend by suggesting that there is an objective difference between *Manninen* and *Orange European Smallcup Fund.*

The question of whether foreign dividend withholding tax should be credited is not only of relevance to dividend originating from other Member States but also to dividend originating from third countries.

The Supreme Court has asked the ECJ whether the holding of a block of shares in a company if the holder of the shares holds them only as an investment and the size of the block does not put the holder in a position to exercise a decisive influence over the management or control of the company is a 'direct investment' within the meaning of the standstill provision of art. 57, para. 1, EC Treaty. In my view, it is already apparent from *KPN golden shares* that in such a situation, there is no question of a direct investment.

The Supreme Court has also asked the ECJ whether the free movement of capital between the Member States and third country has the same material scope as the free movement of capital between the Member States. It has become clear from the *FII* case that the ECJ leaves scope for objective differences and more justification grounds in situations with third countries. Accordingly, the question is whether in *Orange European Smallcup Fund,* the Member States will be able to put forward convincing objective differences and justification grounds.

Recent and Pending Cases involving Portugal

Ana Paula Dourado/Ricardo Reigada Pereira

by the aforementioned regime. Besides, the territorial limitation of the tax relief also violates the free movement of capital.[1]

Portugal did not amend its tax legislation and considered that the restriction was justified, as the Portuguese State has a constitutional obligation to assist the purchase and maintenance of homes, which should not extend to homes outside Portugal.[2]

As the Commission was not satisfied with the Portuguese reply, it decided to refer Portugal to the ECJ in January 2005.

3. Relevant Portuguese Legislation

In order to understand how capital gains are taxed, it is important to mention that the Portuguese Personal Income Tax Code uses the technique of dividing income in different and isolated categories until the deduction of personal allowances – even though most of the net income is then globally considered in order to be subject to progressive rates.

Capital gains constitute a residual category of accrued income within the Personal Income Tax Code, as capital gains are defined as any gains realised, arising from several legal types of transactions, other than those regarded as business or professional income, capital income or income from immovable property.

Among the different legal types of capital gains, the Personal Income Tax Code mentions the gains arising from the transfer for valuable consideration of rights *in rem* in immovable property occupied as a permanent residence.

However, the amount of realised capital gains, deducted from any amortisation of a loan related with the acquisition of a home, is *excluded* from taxation when it is reinvested in the acquisition of another immovable property intended for the taxable person's own and permanent residence or for that of a member of his family, within a certain time-limit and provided that the property is situated in Portuguese territory.

Non-taxation of such capital gains may be interpreted as connected to the constitutional right to accommodation (Article 65 of the Constitution), as was argued by the Portuguese Government in the case (Par 31), and also to a personal income tax that must take into account the needs of the family (Article 104 [1] of the Constitution).

The Portuguese Constitution is in force since 1976 and has been characterised as a legislator-directing constitution,[3] as it requires that many social rights and measures aimed at a certain idea of justice are implemented by law. For example,

[1] See http://europa.eu.int/comm/secretariat_general/sgb/droit_com/index_en.htm: IP/04/938, Brussels, 16th July 2004.

[2] ECJ 26 October 2006, C-345/05 *Commission v. Portuguese Republic*, Par 31.

[3] Canotilho, *Constituição dirigente e vinculação do legislador* (1982) pp 149 et seq., 209 et seq., 359 et seq.

it contains a chapter on social rights and duties typical of welfare states (originally some of those rights were even Marxist-oriented) and a title on the financial and tax system, which includes substantive tax principles (i.e. on taxation of real income, on taxation according to ability-to-pay, on progressive rates, etc.). The right to accommodation belongs to the mentioned chapter on social rights and duties, and the provision establishing the right of being taxed according to the needs of the family is included in the afore mentioned title on the tax system.

It is worth mentioning that there is another rule in the Personal Income Tax Code, that is coherent with the policy of non-taxation of realised capital gains reinvested in an immovable property intended for the taxable person's permanent residence (or for that of a member of his family). It is a rule providing that payments of interest and amortisation of debts related with the acquisition, construction or improvement of an immovable property occupied as the person's permanent residence are deductible, up to a certain amount, as personal allowances under the Personal Income Tax Code.

Whether Article 10 of the Personal Income Tax Code is in fact connected with the constitutional right to accommodation and the constitutional material tax principles will be discussed in the observations below.

The realised capital gains will be subject to taxation if the conditions in Article 10 (5), are not fulfilled, namely because the gains arising from the transfer for valuable consideration of rights *in rem* in immovable property are not reinvested in a home situated in Portuguese territory. Another distinction in taxation between resident and non-resident taxpayers is made by law: if the taxpayer is a non-resident, capital gains will be subject to a tax rate of 25%, whereas if the taxpayer is a resident only 50% of the capital gains will be taxed according to the applicable progressive rates.

4. Questions referred to the ECJ

By applying to the Court, the Commission sought a declaration that, by maintaining in force fiscal provisions making entitlement to *exemption* from tax on capital gains arising from the transfer for valuable consideration of real property intended for the taxable person's own and permanent residence or for that of a member of his family subject to the condition that the gains realised should be reinvested in the purchase of real property situated in Portuguese territory, the Portuguese Republic has failed to fulfil its obligations under Articles 18 EC, 39 EC, 43 EC and 56 (1) EC, and under Articles 28, 31 and 40 of the Agreement on the European Economic Area of 2 May 1992.

5. Observations

According to the ECJ, Article 10 (5), of the Portuguese Personal Income Tax Code, is likely to restrict the exercise of the free movement "by having at the

very least a deterrent effect on taxable persons wishing to sell their real property in order to settle in a Member State other than the Portuguese Republic" (Par 20 of the ECJ decision).

Furthermore although the rules on freedom of movement of 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" (See Par 17 of this Commission v. Portugal case; Par 79 of the De Groot case[4]).

In addition to considering the Portuguese legislation under analysis contrary to the fundamental freedoms (Articles 18, 39 and 43 of the EC Treaty and the corresponding Articles in the EEA Agreement), the Court did not accept any of the justifications invoked by Portugal. It neither accepted reasons pertaining to the cohesion of the tax system, as there is no offsetting of the tax advantage by a particular tax levy (Par 25 et seq. of the ECJ decision); nor that Article 10 (5) intended to implement a constitutional right, as such objective could be attained without there being any need to limit the reinvestment in the national territory and therefore Article 10 (5) was not considered proportional to reach that aim (Paras. 32-33 of the ECJ decision); thus, there were no overriding reasons of public interest justifying the domestic legislation.

In order to comment the ECJ decision, it is convenient to understand whether Article 10 (5), of the Personal Income Tax Code, provides for a tax exemption as it results from the English translation of the provision.

Taxation or non-taxation of income accruing to a taxable person results from a complex set of provisions within a tax code, some of which belong to the core of the regime in a Rule of Law State (e.g., taxation of net income according to the ability-to-pay principle) and have, in this sense, a *structural function* within the code. However, many other tax provisions are not part of the core taxation and fulfil other functions, and interpretation of their meaning within the whole set requires that they are interpreted according to their function.

Since the tax expenditure concept has been introduced and associated with tax benefits in order to control the hidden loss of tax revenue, several tax law studies have a suggested classification of tax rules.

Among the most well-known classifications, we shall choose the following, which divides "tax" rules into three groups: tax rules aimed at dividing the tax burden among taxable persons; tax rules aimed at fulfilling different administrative objectives other than collecting tax revenue (social policy objectives, economic policy objectives, cultural objectives); tax rules aimed at simplifying the tax administration activity.[5]

[4] ECJ 12 December 2002, C-385/00 *De Groot*. The same applies to the freedom of establishment, as was decided, for example, in ECJ 27 September 1988, 81/87, *Daily Mail*, Par 16; ECJ 16 July 1998, C-264/96, *ICI*, Par 21); ECJ 13 April 2000, C-251/98, *Baars*, Par 28), ECJ 11 March 2004, C-9/02, *De Lasteyrie du Saillant*, Par 42, and ECJ 23 February 2006, C-471/04, *Keller Holding*, Par 30.

The first (and third) group of rules is composed of the pure tax law rules, i.e., the ones subject to the tax law principles, whereas the second group does not really belong to tax law, but rather to constitutional and/or administrative economic law.

This classification may be relevant for the purposes of compatibility of domestic legislation with EC Law, as it is settled case-law that the State of residence must take into account the personal and family circumstances of a worker who, in a particular year, received income in that State (See De Groot, Schumacker[6] and Gilly[7] cases).

In other words, in a domestic law perspective, personal income tax rules aimed at dividing the tax burden among resident taxable persons must include, according to a hitherto (worldwide) *general consensus*, rules that take into account personal and family circumstances of a worker or of any individual (*normative elements*). Those rules have to be applied to residents in a non-discriminatory way, i.e., independently of the origin of the income (again, De Groot).

On the other hand, tax benefits or tax incentives belonging to the second group of rules are not connected to an idea of justice in taxation, to the ability-to-pay principle and therefore those rules may not discriminate against non-residents.

The issue is then whether Article 10 (5) of the Portuguese Personal Income Tax Code, contains a type of tax provision belonging to the aforementioned first group of tax rules or to the aforementioned second group of those rules.

Article 10 (5) of the Portuguese Personal Income Tax Code, uses the expression *"exclusion"* from tax on capital gains – "são excluídos da tributação".

The English, Spanish and Italian versions of the case translated that word to "exemption", "exención", "esenzione". The German version refers to "Steuerbefreiung" and the French version to "exoneration".

Let us suppose that the word "exclusion" in the original language of Article 10 (5) meant a tax exemption for the aforementioned capital gains.

The next step is then to understand what is the function of the tax exemption within the code is.

One possible interpretation of Article 10 (5) would be, that the tax exemption of the capital gains reinvested in the acquisition of a home, was itself a *normative element* of the Personal Income Tax Code, that should not be judged differently from health expenses, and therefore could be expressed by several techniques –

[5] See Vogel, Die Abschichtung von Rechtsfolgen im Steuerrecht. Lastenausteilungs-, Lenkungs- und Vereinfachungsnormen und die ihnen zuzurechnenden Steuerfolgen: ein Beitrag zur Methodenlehre des Steuerrechts, *StuW* 1977, pp. 97 et seq. (p. 107); Tipke/Lang, Steuerrecht, 17th Ed. 2006, § 4, 3.2..

[6] ECJ 14 February 1995, C-279/93.

[7] ECJ 12 May 1998, C-336/96.

either as an exemption or a deferral of taxation (like the Swedish tax code did) or as a deductible personal allowance like the health expenses and the interest paid for the acquisition of a home (if it were to be classified in this way). Were this the *right answer*, the tax exemption would be a formal solution or technique of still applying the ability-to-pay principle and observing the constitutional principle of taxation according to the family necessities. Article 10 (5) would accordingly belong to the first group of tax rules.

In that case, in order to be compatible with the EC Law, Article 10 (5) would only have to be applicable to residents in Portugal. As the taxable subject is a resident in Portugal if he has a permanent home available to him, that would mean, in principle, that the immovable property – both the one sold and the new one acquired with the realised capital gains – would have to be situated in Portugal, unless he did not cease to be resident in Portugal, according to other criteria (either contained in domestic tax law or in a tax treaty).

The consequence of this solution would be that the new State of residence should finance the housing of the person who had acquired an immovable property in this second State affecting the capital gains arising from the selling of his permanent residence situated in Portuguese territory. Ultimately, if the new State of residence had a rule similar to Article 10 (5), of the Portuguese Personal Income Tax Code, it should allow that the taxed capital gains according to the Portuguese law were credited against the personal income tax in that new State of residence.

The same solution would apply to a resident in Portugal who reinvests the capital gains realised in another Member State with the transfer of his permanent residence (for example, in Sweden) to Portugal in the purchase of another property intended exclusively for the same purpose.

However, in both cases, the tax event – the capital gains – arises from the transfer of immovable property at a moment where there is no relevant connection with the new State of residence. The source State of the income coincides with the State of residence of the taxable person. It would be awkward to require that the new State of residence takes into account capital gains with source in another Member State in previous fiscal years.

There is another possible interpretation of Article 10 (5). The tax exemption could be an exception to the general rule: capital gains – any capital gains –, as an integral part of the accrued income concept, are, as a rule, included in the tax base of a personal income tax code. Thus, all capital gains should be part of the tax base, as a *normative element* of the tax base of a *personal* income tax code. In the case under analysis, taking into account the constitutional right to accommodation, the exemption of capital gains would belong to the second group of tax rules and fulfil a social-economic objective. Furthermore, if this were the *right answer*, the Commission and the ECJ arguments and decisions would be totally correct, as the function of the rules either taxing or exempting capital gains

would be fulfilled, independently of the Member State where the taxable person bought a home.

This second path is however not completely satisfactory.

In fact, exemption, *alias*, exclusion, of the aforementioned capital gains means that they are not considered accrued income for the purposes of the Personal Income Tax Code. Those realised capital gains are not considered as such, as long as they are reinvested in the acquisition of a home. The personal income tax law interprets the constitutional right to an accommodation in the sense of creating a frontier to the concept of income.

The Swedish regime of deferral of taxation expresses this *ratio legis* very clearly, as capital gains are taxed when they are no longer reinvested in the purchase of another home.

Non-taxation of capital gains reinvested in the acquisition of a home would then be a *normative* and *structural element* of the tax and belong to the first group of tax rules.

But it can be objected that there is no (not any longer) *general consensus* that that type of capital gains should be excluded from the concept of income. The constitutional right to accommodation may be fulfilled not only by excluding the aforementioned capital gains from taxation, but also by another fiscal measure with similar effects.

It has to be decided whether, after all, Article 10 (5) is an extra-fiscal rule using the technique of excluding those capital gains from the concept of income.

We may at this stage reach the following conclusions:

The first one is that the purpose of the rule – whether it defines negatively and structurally the concept of income for tax purposes or fulfils an extra-fiscal objective – does not require that capital gains be reinvested in a home situated in Portuguese territory.

The second one is that, in case the purpose of the rule is to define negatively and structurally the concept of income for tax purposes, the regime has to be enlarged to include the reinvestment of the capital gains in the acquisition of a home situated outside the Portuguese territory and may not be eliminated.

On the other hand, if the rule fulfils an extra-fiscal objective, it may be eliminated instead of being enlarged to the acquisition of a home situated in any EC or EEA Member State.

II. Hollmann v. Fazenda Pública (C-443/06)

1. Introduction

The Hollmann case is not very different from the Commission v. Portugal case commented on the previous pages.

It also concerns the tax treatment of capital gains arising from the transfer for valuable consideration of the property of an immovable property situated in Portuguese territory. Non-residents are subject to more unfavourable tax treatment than that enjoyed by a resident in Portugal (by a person who maintains his residence in Portugal).

2. Facts of the Case and Relevant Portuguese Legislation

Ms. Hollmann is a resident in Germany and sold an immovable property situated in the Algarve. The transfer of the immovable property gave rise to capital gains, which were completely subject to taxation, according to Article 43, §§ 1 and 2 of the Personal Income Tax Code.

If Ms. Hollmann had been a resident in Portugal only 50% of the realised capital gains would had been taxed.

Ms. Hollmann claimed to the competent Portuguese administrative and tax court, and subsequently to the Administrative Supreme Court, arguing that Article 43 of the Personal Income Tax Code was contrary to Articles 12, 18, 39, 43 and 56 of the EC Treaty, as it discriminated against residents of other Member States.

3. Questions referred to the ECJ

The Administrative Supreme Court referred the following question to the ECJ: Does Article 43 (2) of the Personal Income Tax Code, as amended by Law n.º 109-B/2001 of 27 December, which limits the incidence of the tax to 50% of the capital gains realised by persons residing in Portugal, infringe Articles 12, 18, 39, 43 and 56 of the EC Treaty, by excluding from that limitation realised capital gains by persons residing in another Member State of the European Union?

4. Observations

Following the classification of tax rules adopted above, taxation of only 50% of the realised gains arising from the transfer for valuable consideration of rights *in rem* in immovable property by residents in Portugal could hardly be justified as a rule belonging to the *normative structure* of the personal income tax. If capital gains are, as a rule, included in the concept of accrued income, limiting the tax base to 50% of the income, creates a breach in that *normative structure*. Article 43 subjects capital gains to a more favourable treatment, not only in comparison to other types of income, but also in relation to certain kinds of capital gains. Article 43 may therefore not belong to the first group of tax rules.

Thus, it may only be justified as a tax benefit, belonging to the second group of tax rules, as it certainly aims at some extra-fiscal objective. One could argue that Article 43 of the Personal Income Tax Code aims at stimulating the real estate market. But if this is the case, there is no valid reason for discriminating against residents in other Member States.

Furthermore, there seems to be no legitimate justification for such discrimination, which means that the ECJ will not hesitate in declaring Article 43 of the Personal Income Tax Code incompatible with Articles 18, 39, 43 and 56 of the EC Treaty.

III. Discriminatory taxation of outbound dividends

1. Introduction

The European Commission sent Portugal a reasoned opinion on 25 July 2006 requesting the change of the relevant Portuguese tax law and after decided to refer Portugal to the ECJ for its domestic tax rules under which certain dividend payments to foreign companies ("outbound dividends") may be taxed more heavily than dividend payments to domestic companies ("domestic dividends"). The Commission considers that the Portuguese rules are contrary to the EC Treaty and the EEA Agreement, as they restrict both the free movement of capital and the freedom of establishment.

Belgium, Spain, Italy and the Netherlands were also referred for having a similar legislation. Furthermore, the Commission sent Latvia a formal request in the form of a 'reasoned opinion' to amend its tax legislation concerning outbound dividend payments to companies.

2. Facts of the Case

According to the Commission, the tax rules in Portugal may in certain cases lead to higher taxation of outbound dividends than of domestic dividends. While providing for no or lower levels of taxation on domestic dividends, outbound dividends that do not qualify under the Parent-Subsidiary Directive,[8] are liable to withholding taxes ranging from 10% (lowest tax rate foreseen in the Portuguese relevant double taxation treaties network) to 20% (domestic applicable withholding tax rate). The discrimination concerns outbound dividends paid to Member States and to those EEA/EFTA countries that provide appropriate assistance (i.e. exchange of information).

[8] Council Directive 90/435/EEC of 23 July 1990, as amended, 'on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States'.