The Limited Deductibility of Costs Incurred by Non-residents in the Restriction Test applied by the Court of Justice of the European Union

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Abstract

The Court of Justice of the European Union has played an active role in the process of the negative integration of direct tax laws in the European Union. Among the targets of the Court have been tax rules under which the right to income- or activity-related deductions is denied or limited for non-resident taxpayers. As a result, the gross basis taxation regimes have been shaken to their foundations throughout the EU.

In order to establish whether such restrictions constitute discrimination against non-residents prohibited by the Treaty on the Functioning of the European Union, the Court conducts two-stage restriction test (the focus of this thesis) followed by the justification test (not covered in the essay). As regards the first phase of the restriction test (the comparability analysis), it has been clearly demonstrated in the case law that residents and non-residents are in comparable situation when incurring costs that are directly linked to the source or the item of income. Therefore, the application of the Schumacker doctrine, which requires verification of the taxpayer’s tax position in the state of residence, is mainly limited to allowances related to the ability to pay. Nonetheless, it is not always obvious where the dividing line between the mentioned allowances and the other deductions lies.

Another issue discussed in the essay concerns the concept of expenses directly linked to an activity or an income of a taxpayer. According to the author’s view, the Court has been developing its own concept(s) of this category of costs which, in the light of the Brisal case, may also cover a certain proportion of overhead expenses. Therefore, the Court in principle should not be bound by definitions of direct costs under domestic tax laws of the Member States. At the same time, it is highly desirable that the Court in
the future makes an attempt to harmonise its slightly erratic approach to the directly linked expenses and to formulate one uniform concept thereof.

In the second phase of the restriction test, the less favourable treatment is established by the Court. The two contradictory theories of the prohibited discrimination seem to be present in the case law concerning directly linked expenses. A non-resident taxpayer is discriminated against already when being denied certain deductions of costs (the first approach) or, alternatively, such conclusion may be reached only upon establishing that a non-resident has been subject to a heavier tax burden than a resident in the comparable situation (the second approach). The author inclines to the latter interpretation of the less favourable treatment as it better reflects the nature of the gross basis taxation by taking into account other features of a tax regime that may potentially compensate for the limited deductibility of costs. Particularly, a favourable tax rate available to non-residents should be considered in this respect. On the other hand, in the light of falling rates of corporate income taxes in many Member States, the difference between them and the lower rates applicable to non-residents may be not large enough to mitigate the restrictions on the deductibility of costs. For the same reason, the likelihood of neutralisation of the less favourable in the state of residence (through tax credit provided for in a tax treaty) is relatively low.
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<table>
<thead>
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<th>Description</th>
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<tr>
<td>CIT</td>
<td>Corporate Income Tax</td>
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<tr>
<td>Court</td>
<td>Court of Justice of the European Union</td>
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<td>EU</td>
<td>European Union</td>
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<td>Member State</td>
<td>Member State of the European Union</td>
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<td>OECD Model Tax</td>
<td>Model Tax Convention on Income and on Capital: Condensed Version 2017</td>
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<tr>
<td>tax treaty</td>
<td>Treaty for the avoidance of double taxation (not a specific one unless indicated otherwise)</td>
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<td>Treaty</td>
<td>Treaty on the Functioning of the European Union</td>
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<td>UN Model Tax</td>
<td>United Nations Model Double Taxation Convention between Developed and Developing Countries 2017 Update</td>
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1. Introduction

1.1. Problem

Taxpayers resident in one Member State and subject to limited tax liability in the other Member State may be taxed in the latter state on gross amounts of income sourced there. Non-residents could be also taxed on the net profits, for example if they operate in the source state through a permanent establishment. Nonetheless, even if taxed on a net basis, they may still face limitations on the deductibility of certain types of costs as compared with residents earning similar income. If the tax levied is final, they are generally unable to deduct all or part of income-related costs. These costs may be both directly linked to the income (or the activity giving rise to the income) and overhead expenses.

Therefore, non-resident taxpayers could be disadvantaged compared to resident taxpayers who are generally permitted to deduct all of their income-related costs. On the other hand, however, the rate of withholding tax can be significantly lower than the one applicable to resident taxpayers, especially if two Member States concerned are parties to a tax treaty. Hence, in the end, the non-resident may not be necessarily worse-off than the resident when the actual tax liabilities of both categories of taxpayers are calculated.

The different treatment of taxpayers depending on their tax residency have led to many controversies in the jurisprudence of the Court. Numerous Court’s decisions provide guidance on the issue of whether and under what circumstances those differences may constitute prohibited discrimination contrary to the basic freedoms provided for in the Treaty.\(^1\) Therefore, the problem that is dealt with in the thesis concerns the approach that was adopted by the Court towards limitations on deductibility of costs by non-residents in the restriction test.

1.2. Objective of the thesis

The objective of the thesis is to analyse the Court’s decisions on tax regimes providing for prohibition or limitation of deduction of costs by non-resident taxpayers and the conformity thereof with the EU law. The deductions examined in the essay will be mainly income- or activity-related costs such as business expenses. The other category of deductions, i.e. allowances connected to the general ability to pay of a taxpayer, will be discussed briefly just in order to establish dividing line between two categories of tax base reductions. In other words, the scope of application of the Schumacker doctrine from the perspective of particular types of deductions will be the first main research question to be examined in the thesis.

The next issue addressed in the essay will be the concept of expenses directly linked to an activity or an income of a taxpayer. A number of research questions is to be discussed, particularly the understanding of the term in the light of the volatile Court’s jurisprudence. Also the question of the extent to which the Court should be bound by the national tax laws of the Member States when determining that certain costs are directly linked expenses is going to examined. Furthermore, the issue of establishing a direct link between an activity or an income and overhead or indirect expenses will be addressed.

Upon determining the understanding of the term ‘directly linked costs’, the problem of finding the less favourable treatment is to be examined. In the Court’s case law, two contradictory concepts of the prohibited discrimination seem to be present. Therefore, the another objective of the thesis is to establish whether a non-resident taxpayer is discriminated against already when being denied certain deductions of costs (the first approach) or, alternatively, such conclusion may be reached only upon establishing that a non-resident has been subject to a heavier tax burden than a resident in the comparable situation (the second approach). Finally, the likelihood of neutralising implications of limited deductibility of costs is to be assessed in
both the state of source (through a lower tax rate) and the state of residence (through a tax credit).

1.3. Delimitations

Gross taxation typically occurs through withholding at source, which means that a person or an entity making a payment to a taxpayer is obliged to deduct tax from the amount of income and provide it to tax authorities. This method of settling tax liabilities may also raise questions from the perspective of the EU law when it is compared to the technique of tax assessment. Nonetheless, based on the case law of the Court it seems that the application of withholding method to non-residents is justified. As a result, the situation of a payment debtor obliged to withhold tax has not been the object of interest in the analysis. The thesis concentrates on the potential restrictions of basic freedoms resulting from the way the tax liabilities are calculated with respect to residents and non-residents, not the collection method employed.

Furthermore, at the level of the comparability analysis between residents (subject to the general income tax regime) and non-residents (subject to the gross income tax regime or the tax regime with limited right to deductions), the Court has developed the Schumacker doctrine mainly with respect to personal situation of a taxpayer and its influence on the ability to pay. The Schumacker doctrine is generally not applicable to a situation of incurring income- or activity-related expenses by a taxpayer. Therefore, as already mentioned in the preceding section, the doctrine has been referred to and briefly discussed in the thesis but merely in order to investigate where lies the boundary between allowances covered by the doctrine and the other

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3 Doctrine worked out in the case C-279/93 Finanzamt Köln-Alstadt v Roland Schumacker [1995] ECR I-225 and further developed in the subsequent case law. It has been extensively covered in the literature, for example in: Martin Berglund, Schumackerdoktrinen: i ljuset av nyare rättspraxis och med beaktande av dess inverkan på svensk skatterätt (Uppsala Universitet 2014).
deductions. The focus of the remaining part of the essay is on the expenses to which the *Schumacker* doctrine is not applicable.

The scope of the thesis is also limited to the restriction test, i.e. the first out of the two main steps in the analysis carried out by the Court. The second phase which is the justification test has not been analysed due to restricted length of the essay and time limitation.

1.4. Method and materials used

The traditional dogmatic legal method has been employed in the work on the thesis. The sources used have been particularly the Treaty provisions concerning basic freedoms and the case law of the Court. The adopted approach is reasonable from the perspective of the current state of the EU law in the area of direct taxation. It has remained largely not harmonized\(^4\) because direct taxation “does not as such fall within the purview of the Community”, however, at the same time, “the powers retained by the Member States must (…) be exercised consistently with Community law”.\(^5\) Therefore, a Member State’s legislation concerning direct taxation should be consistent with the Treaty provisions and the Court’s role is to ensure that this is the case through the negative integration.

Taking into account that the Treaty has framework nature, it requires ‘substantial supplement’ not only from the EU legislation but also from the Court’s decisions.\(^6\) Furthermore, the Court has not limited itself to general

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\(^5\) This is a standard formula consistently repeated in the decisions of the Court concerning direct taxation, including case C-279/93 *Schumacker* (n 3) para 21 or case C-80/94 *G. H. E. J. Wielockx v Inspecteur der Directe Belastingen* [1995] ECR I-2493, para 16.

interpretation of the primary or secondary law but “signalled a clear departure from reliance on the treaties only (...) by the development of some of the most fundamental doctrines of (...) EU law” which are now part of the secondary law. In the area of direct taxation a number of principles developed by the Court may be mentioned, for example, a rule of reason principle applicable in the justification test or already mentioned the Schumacker doctrine. Therefore, the Treaty rules concerning basic freedoms are just a starting point of the analysis or the backdrop against which the substantial case law has been developed that is the main focus of the thesis.

In order to provide as complete picture of the issue as possible, not only decisions of the Court have been discussed in the thesis but also opinions of the Advocates General that constitute a valuable supportive source of law interpretation. Furthermore, as the problems of gross income taxation or limitations on deductibility of costs are not new and have been already discussed extensively in the literature, numerous publications of legal scholars and practitioners will be referred to.

Due to time and space limitations, domestic tax laws of the Member States have been considered mainly as the background of the Court cases with the exception of the Polish corporate income tax legislation that will be referred to on its own. The reason for making reference to the CIT Act and its amendments is to better exemplify one of the problems addressed in this thesis. Furthermore, out of all the Member States’ legal systems, I am the most familiar with the Polish tax legislation. Finally, the provisions of tax treaties, the OECD Model Tax Convention and the UN Model Tax

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7 ibid.
Convention\textsuperscript{10} have been discussed in order to provide information on the framework of taxation regimes applicable to non-residents and the general rules thereof.

1.5. Outline

The analysis has been carried out in accordance with the technique used by the Court in its decisions concerning application of the Treaty freedoms at the stage of the restriction test.\textsuperscript{11} Therefore, the material part of the thesis is divided into two main chapters: the comparability analysis and the establishment of the less favourable treatment.

The introductory chapter of the thesis (\textit{General comments on the limited deductibility of costs in the source state}) will provide basic information on the source taxation with a focus on the taxation on a gross basis. States’ practice of taxing incomes earned by non-residents will be discussed, taking also into account the impact of tax treaties. Finally, the reasons for and the negative implications of the introduction of gross income tax regimes are to be considered as well.

In the next chapter (\textit{The comparability analysis}), the first phase of the restriction test conducted by the Court will be discussed. The aim of this part of the thesis is to establish under what circumstances the situations of non-resident taxpayers and those subject to full tax liability in a given Member State become comparable. It is important to determine the criteria for making distinction between, on the one hand, allowances related to the general ability to pay of a taxpayer and, on the other hand, income- or activity-related deductions related to, for example, business expenses. The \textit{Schumacker} doctrine (which will be briefly discussed) applies only to the first mentioned


\textsuperscript{11} Martin Berglund, Katia Cejie, \textit{Basics of International Taxation From Methodological Point of View} (Jutus Förlag 2014) 97.
allowances, not to the latter deductions which makes the distinction between two categories of a tax basis reductions crucial.

In the following section of the chapter the concept of expenses directly linked to an activity or an income of a taxpayer will be examined in the light of the Court’s case law. Two categories of costs will be distinguished in the separate subsections: costs necessary for the performance of an activity that produces income and costs directly related to an activity in question. Furthermore, the question of the Court being potentially bound by definitions of direct costs under the domestic tax laws of the Member States will be addressed. Finally, the issue of the concept of directly linked expenses being narrowed will be raised in the light of the recent developments in the jurisprudence of the Court.

The next section of the chapter will be devoted to the issue of overhead and indirect expenses. The objective of this part of the thesis is to analyse if it is possible to establish a direct link between an activity or an income and the expenses in question. If the answer is positive, then comparability of resident and non-resident taxpayers may be significantly extended. Furthermore, the issue of the comparability of residents and non-residents will be discussed with respect to potentially different tax rates applicable to these two categories of taxpayers. Establishing comparability also in this respect is important from the perspective of the subsequent determination of the less favourable treatment. Lastly, the chapter on the comparability analysis will be concluded with the analysis of the Truck Center case and, ultimately, its limited impact on the case law of the Court.

The third chapter of the thesis (Identification of the less favourable treatment) will concern the second step of the restriction test. It will begin with the examination of two conflicting interpretations of the discriminatory treatment presented in the case law of the Court. It will be examined whether discrimination arises already with the denial of certain deductions of costs or, alternatively, only if a non-resident has been subject to a heavier tax burden.
than a resident in the comparable situation. A number of the Court’s decisions as well as opinions of Advocates General is to be discussed in detail in particular subsections. This part of the chapter is concluded with the author’s own opinion on the issue.

In the final part of the thesis the question of counterbalancing the limitations on deductions of costs is raised. The neutralisation in question will be discussed from the perspective of the both states concerned, i.e. the state of source offering potentially lower tax rates for non-residents and the state of residence which in case of shared taxing rights to a given category of income may provide a tax credit. These scenarios will be examined against the backdrop of the falling CIT rates in many EU countries.

2. General comments on the limited deductibility of costs in the source state

2.1. Source taxation and the principle of territoriality

Under the principle of territoriality states extend their taxing powers to incomes generated within their borders based on objective connecting factors.\(^\text{12}\) The emphasis is put on the connection to the object of an activity giving rise to taxable income (a transaction or part of it) as opposed to the subject (taxpayer) which is the focus of the universality principle based on personal nexus.\(^\text{13}\) The principle of territoriality is the foundation for limited tax liability of non-residents in the source state while the universality principle is the basis for full tax liability of residents.

2.2. States’ practice of taxing active and passive income at source

States shape tax policy and legislation towards non-residents in accordance with their sovereignty in tax matters. In many jurisdictions, taxpayers subject to limited tax liability are taxed on a net basis (after deduction of costs) when


\(^{13}\) ibid 27.
it comes to active income (for example, from business or employment) and on a gross basis (with no deductions) as regards passive income (for example dividends, interest or royalties). In the latter case, tax is usually collected by way of withholding meaning that a payment debtor that is the resident of a given state is obliged to deduct the amount of tax liability from the payment made and transfer it to tax authorities. Withholding tax generally is final and, as a result, the non-resident taxpayer may not subsequently recalculate its tax liability on a net income and apply for the partial or the full refund.

The distinction between active and passive income for the purposes of its tax treatment discussed above is not always followed. By way of example, income from immovable property may be subject to taxation on a net basis and employment income on a gross basis. Furthermore, with respect to active income, even though it is principally taxed on a net basis, there could be certain limitations of deductions available to non-residents.

### 2.3. Gross basis taxation in the light of tax treaties

Tax treaties are mainly bilateral agreements under which contracting states may allocate taxing rights between each other with respect to particular types of income and also decide on the method of elimination of double taxation, among other issues. Many tax treaties are modelled on the OECD Model Tax Convention or the UN Model Tax Convention.

When taxing rights to particular item of income are shared, tax treaties may place certain limitations on tax burden in the source state. The OECD Model

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15 ibid 495.
16 ibid.
17 ibid 508.
18 ibid 511.
19 As the backgrounds of a number of decisions issued by the Court clearly demonstrate, by way of example the decision in the case C-440/08 F. Gielen v Staatssecretaris van Financiën [2010] ECR I-02323, paras 13-21.
20 OECD, *Model Tax Convention* (n 9).
Tax Convention in its articles concerning two categories of passive income (dividends and interest) sets the maximum rate at which they may be taxed in the source state.\textsuperscript{22} The rates are indicated with reference to the gross income (“the tax so charged shall not exceed […] per cent of the gross amount of the […].”\textsuperscript{23} The UN Model Tax Convention contains similar provisions on the maximum thresholds of source taxation with reference to gross amounts of three categories of passive income (dividends, interest and royalties) and one category of active income (fees for technical services).\textsuperscript{24} Nonetheless, the wording of the provisions does not necessarily mean that contracting states are obliged to introduce gross basis taxation. The model articles merely provide for the maximum tax burden in the source state.

\subsection*{2.4. The advantages and disadvantages of the gross basis taxation}

One of fundamental advantages of the gross basis taxation (and reasons for its introduction) is simplicity for both tax authorities and a taxpayer. As the computation of tax due requires just two pieces of information (on the amount of gross income and the applicable tax rate), the tax may be collected through withholding. Therefore, a taxpayer is not generally required to submit tax return (this obligation may be shifted to a person or an entity making a payment), keeping books in accordance with local regulations and, most importantly, allocating and calculating costs related to received income. As a result, workload for tax authorities may be significantly reduced as the subsequent tax audit is likely to be simplified as well.

Gross basis withholding taxation may be also seen as very reliable way of collecting tax revenues by states. Nature of passive income that is mostly subject to withholding taxation does not require significant presence in the source state. Therefore, for tax authorities it may be more difficult to hold non-resident taxpayers accountable or to secure tax claims on their assets.

\textsuperscript{22} OECD, \textit{Model Tax Convention} (n 9) Art. 10(2) and Art. 11(2).
\textsuperscript{23} ibid.
\textsuperscript{24} UN, \textit{United Nations Model Double Taxation Convention} (n 10) Art. 10(2), 11(2), 12(2) and 12A(2).
especially if there is no or limited cooperation in tax matters between the state of residence and the source state. By obliging a resident making payment to non-resident to withhold tax, a resident becomes liable for any tax arrears of a taxpayer.

Simplicity and reliability of the gross basis taxation carried through withholding are particularly important aspects for developing countries. It was emphasized that they “have limited administrative capacity and need a simple, reliable and efficient method to enforce tax imposed on income from services derived by non-residents”.25

Another argument in favour of the gross basis taxation is the need to counter tax base erosion.26 If the full amount of payment made by a resident decreases its taxable income as a tax-deductible cost, states are naturally interested in taxing the same payment in full in order to restore the balance.27

As regards disadvantages of the gross basis taxation, it was emphasized that such a method might lead to significant reduction of a non-resident’s net profit (due to excessive taxation) or shifting tax burden to a resident customer.28 The shift in question may occur through so-called grossing-up clauses.29 According to the clause, a service provider should receive given amount of consideration net of any taxes, including income taxes withheld at source. This makes situation of a resident service recipient more difficult (as payable consideration is higher) but it is also harmful for international trade relations. Services rendered by local providers (subject to net basis taxation) may be relatively cheaper which results in the competitive disadvantage for non-residents.30 Furthermore, gross basis taxation is more likely to cause unrelieved double taxation.31 This may be explained in the case of the

25 ibid 333 (para 32 of the general considerations in the commentary on the Art. 12A).
27 ibid.
28 UN, United Nations Model Double Taxation Convention (n 10) 299 (para 2 of the general considerations in the commentary on the Art. 12).
29 ibid 327 (para 14 of the general considerations in the commentary on the Art. 12A).
30 ibid 329 (para 21 of the general considerations in the commentary on the Art. 12A).
31 Ibid 329 (para 20 of the general considerations in the commentary on the Art. 12A).
ordinary tax credit method used in the residence state as the method of elimination of double taxation. The maximum deduction available there is likely to be set by taking into consideration all income-related expenses that were ignored for tax purposes in the source state. Therefore, the amount of maximum deduction may be lower than tax paid in the source state.

3. The comparability analysis

3.1. The methodology applied by the Court in the cases concerning income tax

The comparability analysis is the first step of the restriction test. However, the test itself is generally preceded by the initial analysis of facts of a given case aiming at finding out whether the situation in question has cross-border dimension.32 If the outcome is positive, then one of the five basic or fundamental freedoms may be applicable: free movement of citizens (art. 21 of the Treaty), free movement of workers (art. 45 of the Treaty), freedom of establishment (art. 49 of the Treaty), freedom to provide services (art. 56 of the Treaty) and free movement of capital (art. 63 of the Treaty). These freedoms are directly applicable in the EU. As the case law of the Court shows, basically any of the abovementioned freedoms could apply to a situation of a taxpayer subject to limited tax liability in one Member State that is resident of the other Member State or, if free movement of capital is concerned, any third country. By way of example, such limited tax liability may be a result of receiving pensions by a pensioner who permanently moved to the other Member State (free movement of citizens),33 earning interest income upon granting a loan to a resident (free movement of services)34 or earning business income from the activity carried on by a non-resident in a state concerned (freedom of establishment)35.

32 Berglund, Cejie (n 11) 93.
If the applicability of the Treaty freedom is confirmed, the Court proceeds to the comparability analysis, the purpose of which is to find a purely domestic situation in the Member State concerned that is fully comparable to the cross-border situation apart from the transnational aspect thereof.\(^\text{36}\)

### 3.2. The Schumacker doctrine

#### 3.2.1. General incomparability of residents and non-residents

When faced with situations of taxpayers subject to unlimited tax liability and limited tax liability in a Member State, the Court indicated that they “are not, as a rule, comparable”.\(^\text{37}\) This conclusion follows from the fact that usually the non-resident receives a minor part of his overall income from the source or host state whereas a majority of it comes from the state of residence.\(^\text{38}\) Therefore, in most cases the state of residence, not the source country, is best placed to assess a taxpayer’s ability to pay tax.\(^\text{39}\) Based on the ability-to-pay principle, tax should be levied “according to the taxpayer’s capacity to contribute to public spending” and in order to assess that capacity, tax authorities should take into account both overall income of the taxpayer and his personal or family circumstances.\(^\text{40}\) In the tax law doctrine, the subjective ability to pay has been distinguished from the objective one, the first one being related to the personal situation of the taxpayer and the latter one to establishing the taxable income.\(^\text{41}\) It can be concluded that the subjective ability to pay may only be attributed to individuals whereas the objective one could be also characteristic for other taxpayers as companies.\(^\text{42}\)

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\(^{36}\) BerglUND, CEJIE (n 11) 99.

\(^{37}\) Case C-279/93 Schumacker (n 3) para 31; case C-80/94 Wielocks (n 5) para 18.

\(^{38}\) Case C-279/93 Schumacker (n 3) para 32.

\(^{39}\) ibid.


\(^{41}\) ibid 3-4.

\(^{42}\) ibid 4.
3.2.2. _Comparability in the light of the non-resident’s tax position_

Regardless of the general incomparability of residents and non-residents, the Court found that the situation of the non-resident receiving a “major part” of income from the source state may become comparable to the one of a resident.\(^{43}\) This is due to the fact that the amount of tax payable in the residence state may be simply not sufficient for that state to take into account the taxpayer’s personal situation.\(^{44}\) Furthermore, even if a “major part” of non-resident’s income is not received in the source state, this country may be still obliged to consider the overall ability to pay of the non-resident if it cannot be taken into account in the state of residence because of the insignificant amount of tax due there.\(^{45}\)

Under such circumstances, situations of the resident and the non-resident become comparable when it comes to tax benefits related with personal and family situation, for example, favourable rules of taxation available for spouses \(^{46}\) or tax allowances \(^{47}\). In the tax law literature, it was concluded that this so-called _Schumacker_ doctrine is based on the factual comparability between residents and non-residents.\(^{48}\)

**3.2.3. The blurred line between the Schumacker-doctrine advantages and other deductions**

Furthermore, the doctrine is applicable not only to advantages linked to the personal situation of a taxpayer but also the overall ability to pay if decisions of the Court concerning deductions of contributions to a pension reserve\(^{49}\) or

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\(^{43}\) Case C-279/93 _Schumacker_ (n 3) paras 36 and 41, case C-80/94 _Wielockx_ (n 5) para 20.

\(^{44}\) ibid.


\(^{46}\) _Schumacker_ (n 3) para 12.


\(^{49}\) Case C-80/94 _Wielockx_ (n 5) paras 4-5.
rental income losses\textsuperscript{50} are concerned. In fact, in the \textit{Lakebrink} decision the Court offered a different and maybe even bizarre perspective by indicating that “the ability to pay tax may (…) be regarded as forming part of the personal situation of the non-resident”.\textsuperscript{51} Therefore, the \textit{Schumacker} doctrine does not concern solely situations related to the subjective ability-to-pay principle (personal and family situation within the “classical” meaning) but seems to have expanded to cover certain other tax advantages that reflect the objective ability-to-pay principle, too.

Taking the above into account, the question of the scope of the doctrine’s application remains. As was explained in the tax law literature, benefits or advantages to which the \textit{Schumacker} doctrine was applicable had one feature in common: they were “not attributable to any specific source or item of income”.\textsuperscript{52} Deductions or allowances should be classified in the light of, on the one hand, their (closer) connection with the taxable subject (taxpayer) and his or her ability to pay or, on the other hand, the taxable object (income or capital).\textsuperscript{53} If a closer link could be established between a given tax advantage and an item or source of income rather than the taxpayer, the \textit{Schumacker} doctrine should not be applicable. This could be explained in the light of the \textit{Gielen} case concerning the refusal of the Dutch tax authorities to provide a German tax resident with a self-employed person’s deduction due to the fact that he did not meet the “hours test” based on the number of hours spent at work in the Netherlands.\textsuperscript{54} The amount of the deduction was degressive, i.e. it fell with the amount of income which clearly demonstrates its close relation to the ability-to-pay-principle.\textsuperscript{55} Nonetheless, the referring


\textsuperscript{51} Case C-182/06 \textit{Lakebrink} (n 50) para 34.


\textsuperscript{53} Eric C.C. M. Kemmeren, “The Netherlands: What Are the Right Comparators under Article 63 TFEU When Assessing a Dividend Withholding Tax Refund Claim? – Cases C-10/14 (Mijoen), C-14/14 (X), and C-17/14 (Société Générale)” in Michael Lang and others (eds), \textit{ECJ – Recent Developments in Direct Taxation 2014} (Linde 2014) 148.

\textsuperscript{54} Case C-440/08 \textit{Gielen} (n 19) paras 14-15.

\textsuperscript{55} ibid para 5.
court indicated the deduction was “not related to the personal capacity of taxable persons but rather to the nature of their activity”, therefore suggesting the existence of a link to the source of income (business activity). As a result, although the Court ruled that situations of residents and non-residents were comparable when the deduction was concerned, no reference to the Schumacker doctrine was made at all.

However, the Court in its recent decision in the case X (part of the joint cases Miljoen and others) does not seem to fully follow the logic put forward in the preceding paragraph. Individuals subject to income tax on the yield from savings and investments that were Dutch tax residents could have enjoyed tax-free capital allowance in the amount of EUR 20,014. The purpose of this measure was to alleviate the tax burden of taxpayers with low incomes, however, it was universally applicable to all taxpayers regardless of their taxable basis. The referring court indicated that the allowance was closely related to the ability-to-pay principle and the taxpayer’s personal situation, not her activity that gave rise to the taxable income. There was no link between the allowance and the items or sources of income and therefore it was argued that the Schumacker doctrine should be applicable to the case denying the comparability of the non-resident and residents. However, the Court took a different view. Upon establishing that the allowance was granted to every resident taxpayer regardless of his or her personal situation, it ruled that the deduction could not be treated as an advantage related with the subjective ability to pay and the Schumacker doctrine was not referred to. This outcome contradicts approach adopted in the earlier case Wallentin

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56 ibid para 45.
57 ibid para 47.
58 Joint cases J. B. G. T. Miljoen (C 10/14), X (C 14/14), Société Générale SA (C 17/14) v Staatssecretaris van Financiën [2015] ECLI:EU:C:2015:608.
59 ibid para 12.
60 Kemmeren, ‘The Netherlands: What Are the Right Comparators under Article 63 TFEU When Assessing a Dividend Withholding Tax Refund Claim?’ (n 53) 143.
61 ibid 144.
62 Ibid 147.
63 Joint cases C-10/14, C-14/14, C-17/14 Miljoen and others (n 58) para 53.
which concerned the basic tax allowance presumably available as a flat
deduction to all Swedish tax residents. The lack of taxable income in the
residence state (resulting in inability to benefit from allowances therein) was
a basis for establishing comparability between a non-resident and residents
of the source state.

In summary, starting with the decisions in the cases Lakebrink and
Renneberg but particularly upon issuing the decision in the joint cases
Miljoen and others, it became more difficult to clearly determine the dividing
line between advantages to which the Schumacker doctrine was applicable
and other deductions. The close(r) connection with the taxpayer (tax subject)
than the activity giving rise to income (tax object) may be treated as an
important argument in favour of the doctrine applicability. However, the
decision in the Miljoen and others demonstrates that the general availability
of the “flat” tax advantage to all taxpayers regardless of their material
situation may have a crucial impact on the final conclusion.

3.3. Comparability analysis applicable to activity-related
deductions

The amount of tax due is determined based on a number of factors, including
the amount of expenses borne in order to receive income. Activity-related
costs affect the objective ability to pay of a taxpayer. When confronted with
cases concerning the taxation of cross-border payments and denial of costs’
deduction in the source state, the Court was simply stating that a non-resident
taxpayer was in a comparable situation to a resident taxpayer who was
permitted to deduct expenses directly linked to the activity generating

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64 Case C-169/03 Wallentin (n 47) paras 7, 19.
65 ibid, para 20.
income\textsuperscript{66} or the income (payment) itself\textsuperscript{67}. The existence of a direct link allows for a clear attribution of costs to a given item or source of income in the territory of a Member State.\textsuperscript{68} Therefore, unlike benefits related to the personal or family situation or overall ability to pay of a taxpayer with presence in two or more Member States, the directly linked expenses should not in general cause similar problems when it comes to their allocation to tax bases in particular states.

Taking the above into account, contrary to the decisions based on the Schumacker doctrine, factors such as amounts of taxable income and tax due in the source state and the residence state as well as the personal or family situation of a taxpayer were irrelevant. In other words, not the factual but the legal comparability was taken into account.\textsuperscript{69} Of course, this does not mean that other circumstances of the factual background were ignored when residents and non-residents were compared. As the Advocate General Léger found in the case concerning taxation of income from artistic performances, situations of a resident and a non-resident are similar as both “supply the same kind of service and have to incur expenses of comparable nature and scale in order to be able to provide their services”.\textsuperscript{70} That being said, the Court looks at the availability of costs’ deduction for residents under a Member State’s tax law (legal perspective) in a situation similar to the one of


\textsuperscript{67} Case C-265/04 Margaretha Bouanich v Skatteverket [2006] ECR I-00923, para 40; case C-346/04 Contijn (n 35) paras 22-24; joined cases C-10/14, C-14/14, C-17/14 Miljoen and Others (n 58), para 57.

\textsuperscript{68} Karin Simader, Withholding Taxes and the Fundamental Freedoms (n 48) 148.

\textsuperscript{69} ibid 155 (referring to Michael Lang, ‘Ist die Schumacker-Rechtsprechung am Ende?’ (2005) RIW 336, 342).

\textsuperscript{70} Opinion of the Advocate General Léger in the case C-345/04 Centro Equestre (n 66) [2006] ECR I-01425, para 47.
a non-resident, not the amount of taxable income or of tax due from a non-resident in the home state and the source state (factual approach).

These different approaches to comparability under the Schumacker doctrine and in directly linked costs’ cases were well described by Advocate General Ruiz-Jarabo Colomer in the Gielen case who referring to the restriction test indicated that: 71

unequal treatment becomes lawful where personal and family circumstances vary significantly between residents and non-residents. However, discrimination becomes unlawful if the difference concerns deductions which are directly linked to the activity that generated the taxable income.

3.4. The expenses directly linked to taxable income or taxpayer’s activity

3.4.1. It all began with the Gerritse case

In the Gerritse case the Court referred to the concept of “the business expenses (…) directly linked to the activity” that generates income for the first time. 72 The case concerned income of the Dutch resident from artistic performances that had been subject to gross basis taxation in Germany. In the subsequent decisions of the Court the concept of directly linked expenses was further developed. The costs in question may fit into two categories: costs necessary for the performance of an activity that produces income and costs lacking such quality but still directly related to the activity giving rise to taxable income.

3.4.2. Costs necessary for the performance of an activity that produces income

In the decision in the case Centro Equestre regarding gross taxation of non-resident’s income from artistic performances, the Court described directly

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72 Case C-234/01 Gerritse (n 66) para 27.
linked costs as “expenses which have a direct economic connection to the provision of services which gave rise to taxation (…) and which are therefore inextricably linked to those services, such as travel and accommodation costs”.

“Inextricably” means “inseparably” which demonstrates that the connection must be close enough to determine direct “casual economic nexus” between expenses and taxpayer’s activity generating income.

This view was further developed in the decision in the case Grünewald (concerning deductibility of annuities from the business income) in which the Court found that the directly linked costs are “expenses occasioned by the activity in question” that “are accordingly necessary in order to carry out that activity”.

The Court referred to its previous decision in the case Schröder involving similar circumstances. It was stated that:

> the existence of a direct link (…) results, not from a correlation, of whatever kind, between the amount of the expenditure in question and that of the taxable income, but from the fact that that expenditure is inextricably linked to the activity which gives rise to that income.

Therefore, it may be concluded that although costs that are taken into account should be necessary for the performance of an activity producing income, it does not mean that the actual interdependence between an amount of expenses and an amount of income must be established. In other words, in the light of the quoted conclusion from the Schröder case, for comparability purposes, the cost borne by a non-resident taxpayer does not necessarily have to be translated into a concrete amount of taxable income.

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73 Case C-345/04 Centro Equestre (n 66) para 25.
75 Expression used by the Advocate General Léger in the opinion in the case C-345/04 Centro Equestre (n 70), para 57.
76 Case C-559/13 Grünewald (n 66) para 30.
77 Case C-450/09 Schröder (n 66) para 43.
3.4.3. *Costs directly related to the activity giving rise to taxable income*

In the *Conijn* case, the Court confirmed that not only costs conditioning performance of a taxable activity are directly linked thereto. The decision concerned a Dutch national and tax resident who was subject to limited tax liability in Germany on his business income. The German tax authorities refused to accept the deduction of tax advisory costs related to the preparation of a tax return. The Court ruled that a duty to fill in and submit a tax return is a legal obligation of the taxpayer that follows from the fact he had received income in Germany, and as a result, costs of tax advisory were “linked directly to the income taxed in that Member State”.78 Furthermore, residents and non-residents were in a comparable situation when faced with the complexity of the German tax legislation.79

Similarly, in the decision in the *Brisal* case, the Court indicated that business activity consisting in granting loans and generating taxable income in the form of interest “necessarily gives rise to business expenses such as, for example, travel and accommodation expenses, and legal or tax advice”.80 Those expenses, admittedly, are not conditioning the provision of services as opposed to, for example, costs of loans’ financing. Nonetheless, the link between the expenses in question and the income may be relatively easily established.

The *Commission v Finland* decision concerned non-resident pension funds that were taxed on the amounts of Finland-sourced dividends with no possibility to deduct amounts thereof transferred to pension reserves, contrary to pension funds resident in Finland.81 The case is interesting for two reasons. Firstly, the receipt of dividends did not seem to be dependent in any way on the transfer of amounts thereof that was occurring afterwards. In that sense, the situation was different from those discussed above in the

78 Case C-346/04 *Conijn* (n 35) para 22.
79 ibid para 23.
80 Case C-18/15 *Brisal* (n 34) para 47.
81 Case C-342/10 *Commission v Finland* (n 66).
section 3.4.2 of the thesis concerning costs that are necessary to be incurred in order to receive income. In the Commission v Finland case transfers were carried out to cover future pension liabilities. Nonetheless, as the Commission submitted “[i]n practice, all the income generated by those [i.e. resident] pension funds is naturally oriented towards that purpose.”,\(^82\) suggesting that transfers to reserves are typical operations occurring upon receiving dividends by Finnish pension funds. Similarly, the Advocate General Sharpston indicated that the major part of income received by pension funds was typically transferred to reserves out of which pensions would be paid to pensioners in the future.\(^83\) The argument of the Finnish government that reserves’ deductions are “related to the nature of the business” or the overall activity of a pension fund \(^84\) rather than any specific income did not have any impact on the outcome of the case.

Secondly, in order to assert the existence of a direct link between costs and income-generating activity, the Court referred directly to the Finnish tax law under which reserved amounts constitute “expenses … incurred in order to acquire or maintain the income from economic activity”.\(^85\) This is an interesting aspect of the comparability analysis: has the Court created its own concept of directly linked expenses (discussed in this section of the thesis and the preceding one) or should one rather refer to the domestic tax laws for that purpose?

3.4.4. Scope of reference to domestic tax laws of Member States

To paraphrase words of Advocate General Jääskinen, the first stage of the comparability analysis is the identification of expenses directly linked to an activity or an income; the second step is to determine whether identified costs

\(^{82}\) ibid para 29.  
\(^{83}\) Opinion of Advocate General Sharpston in the case C-342/10 Commission v Finland (n 66) [2012] ECLI:EU:C:2012:474, para 2.  
\(^{84}\) Case C-342/10 Commission v Finland (n 66) paras 39-40.  
\(^{85}\) ibid paras 40-41.
may be deductible by a resident taxpayer in the comparable situation.\textsuperscript{86} Without doubt, the reference to the domestic tax law is indispensable in the second phase of the analysis in order to establish what kind of costs may be actually deductible from the taxable income in a given Member State. But when it comes to the determination of the direct link (the first stage), it is not that clear.

It may be argued that the Court, in its case law, has been developing the concept of directly related costs as discussed in detail in sections 3.4.2 and 3.4.3 above (“inextricably linked”, “expenses occasioned by the activity in question”) and, as a result, the factual nexus between costs and an activity or an income is decisive, not the domestic tax law provisions. This has been suggested by Advocate General Kokott in her opinion in the \textit{Brisal} case in which she referred to “the definition developed in the case-law” based on which “every expense which is necessary in order to carry out the taxed activity is directly linked to that activity”.\textsuperscript{87} The Court also applied its own concept of directly linked expenses in the joined cases \textit{Miljoen and others} although, as discussed in more detail in the following section, that notion seems to be much narrower than the one developed in the preceding case law. The Court denied the existence of the direct link between certain costs and dividend income.\textsuperscript{88} The costs in question were “all expenses which are economically linked to the shares from which the dividends arise or, otherwise, any (…) dividend included in the purchase price of the shares and any financing charges resulting from ownership of the shares concerned”.\textsuperscript{89} The Court referred to its judgement in the case \textit{Commission v Germany}\textsuperscript{90} and determined that as regards dividend income, directly linked expenses were

\textsuperscript{86} Opinion of Advocate General Jääskinen in the joint cases C-10/14, C-14/14, C-17/14 \textit{Miljoen and others} (n 58) [2015] ECLI:EU:C:2015:429, para 92.
\textsuperscript{87} Opinion of Advocate General Kokott in the case C-18/15 \textit{Brisal} (n 34) [2016] ECLI:EU:C:2016:182, para 33.
\textsuperscript{88} Joint cases C-10/14, C-14/14, C-17/14 \textit{Miljoen and others} (n 58) para 60.
\textsuperscript{89} ibid para 39.
only the costs related to the actual income payment.\textsuperscript{91} According to the decision, there was no direct link established between the part of the shares’ acquisition costs (in the form of dividends included therein) and the payment of dividends.\textsuperscript{92} Similarly, financing costs were deemed to be related to the “ownership of the shares \textit{per se}” not the income payment.\textsuperscript{93}

The decision was met with criticism due to the fact that the Court allegedly ignored the Dutch tax law provisions (under which resident portfolio shareholders were allowed to deduct both the financing costs and purchased dividends’ expenses from their dividend income), thereby creating its own concept of directly linked expenses.\textsuperscript{94} It was argued that interest on financing related to purchase of shares was actually deductible from dividends under the Dutch law which clearly demonstrated the existence of the direct link.\textsuperscript{95} Furthermore, contrary to the hypothesis on the concept of directly related costs being developed by the Court, the authors rather claimed that generally in the case law (except for the decision in the \textit{Miljoen and others} case) “the regular extended comparison based on national tax law of the Member State concerned” was adopted, not “a limited comparison based on its self-developed standard”.\textsuperscript{96}

It was indicated that the decision in this respect clearly contradicted the Court’s decisions in the case \textit{Commission v Finland} \textsuperscript{97} in which the reference to the domestic tax laws of Member States was made in order to establish the existence of the direct link in question.\textsuperscript{98} Also in the case \textit{Brisal} concerning deductibility of costs from gross interest income, the Court ruled that “[i]t is

\textsuperscript{91} Joint cases C-10/14, C-14/14, C-17/14 \textit{Miljoen and others} (n 58) para 58.
\textsuperscript{92} ibid para 60.
\textsuperscript{93} ibid.
\textsuperscript{97} Case C-342/10 \textit{Commission v Finland} (n 66) para 41.
\textsuperscript{98} van der Werf (n 94) para 6.2.
for the referring court (...) to determine in the main proceedings, first, which of the expenses claimed by KBC may be regarded as business expenses directly related to the financial activity in question for the purposes of national legislation”.\textsuperscript{99} This approach was supported in the doctrine because as a result of its application “the expenses directly linked to an activity are determined consistently for non-residents and comparable residents”.\textsuperscript{100} But what if under the domestic tax law of a Member State there is no distinction made between directly linked costs and the other costs? According to the solution put forward in the literature, only then the concept of activity- or income-related costs developed by the Court could be applicable.\textsuperscript{101}

Regardless of the critical comments on the \textit{Miljoen and others} decision discussed above, I do not share the view that the Court in its judgements on the direct link between costs and income is limited by the strict reference to the tax laws of Member States. This would basically mean that the Court is obliged to blindly follow the national rules in this respect, regardless of facts of particular cases. Furthermore, by reaching the disputed conclusion, part of the Court’s case law (besides \textit{Miljoen and others}) seems to be overlooked. Based on the background of the case \textit{Schröder}, taxpayers with limited tax liability in Germany could deduct business and occupational costs if they were economically linked to income sourced in Germany.\textsuperscript{102} Annuities that had “no economic link to income” were treated as special expenditures under the German tax law, therefore non-residents (contrary to German residents) were not allowed to deduct such expenses from income.\textsuperscript{103} Based on the differentiation between special expenditures and business or occupational expenses as well as nature of annuities, the German government claimed that the expenses in question lacked direct link to the taxpayer’s activity within

\textsuperscript{99} Case C-18/15 \textit{Brisal} (n 34) para 52, emphasis added.  
\textsuperscript{100} van der Werf (n 94) para 6.2.  
\textsuperscript{101} Turner (n 96) 128.  
\textsuperscript{102} Case C-450/09 \textit{Schröder} (n 66) para 7.  
\textsuperscript{103} ibid paras 6 and 31.
the meaning of the Court’s case law. The Court dismissed this argument and based on the background of the case found the casual nexus between annuities and the acquisition of property that gave rise to taxable income, thus clearly demonstrating the existence of the direct link (while leaving the matter to be ultimately decided by the referring court). In other words, the Court did not seem to care much about the notion of special expenditure lacking “economic link to income” under the German tax law and instead swiftly shifted to the notion of the “direct link” as understood in its own case law. In the similar case Grünewald concerning the same German tax law rules, the Court reached analogous conclusion.

3.4.5. Towards the new narrower concept of costs directly linked to income payment?

As indicated already, in certain cases the Court referred to direct connection to income payment, not the activity generating income. In the Bouanich case concerning the refusal of the deduction of shares’ acquisition costs at the time of repurchase thereof by a company, the Court found that the expenses in question were “directly linked to the payment”. In that case it did not lead to the limitation of costs that could be treated as directly linked for the purposes of the comparability analysis. However, as mentioned in the preceding sections, in the decision in the joint cases Miljoen and others, the Court denied existence of the direct connection of the cost of the purchased dividend in the acquisition price of shares and financing costs with the payment of income (dividends).

When the cases Bouanich and Miljoen and others are compared, the conclusion may be reached that the costs of the purchase of shares (including financing expenses) are directly linked only to income from the sale of

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104 ibid para 42.
105 ibid paras 43-45.
106 ibid para 46.
107 Case C-559/13 Grünewald (n 66) paras 33, 36, 37.
108 Case C-265/04 Bouanich (n 67) para 41.
109 Joint cases C-10/14, C-14/14, C-17/14 Miljoen and others (n 58) para 60.
shares, not from distribution of profits in the form of dividends even if under domestic tax law of a Member State concerned both items of income are treated as dividend or dividend-like income. Such approach was suggested by the Advocate General Jääskinen in the opinion on the case by reference to the allocation of taxing powers between France (the residence state where capital gains were exclusively taxable) and the Netherlands (the source state where dividends were taxed).\(^{110}\) Certainly, there is a logic behind this statement,\(^{111}\) nonetheless the decision in the Miljoen and others cases was criticized in the tax law doctrine. Some authors indicated that “the acquisition price of a share which includes a purchased dividend directly relates to future dividend income up to the amount of the purchased dividend” and in that sense the decision actually contradicted the Bouanich decision by excessively narrowing the scope of directly linked expenses.\(^{112}\)

It was argued that the Court might have erroneously followed the decision in the Commission v Germany case, in which it had been merely indicated that the Commission had not proved the existence of the direct link between certain bank charges or transaction costs with dividend income but actually stopped short of ruling out such link in general.\(^ {113}\) According to the another view, the difference between the Miljoen and others ruling and the previous case law could stem from potential difficulties in tracking expenses directly related to capital income (presumably, as opposed to the business income),\(^ {114}\) however, the case Brisal shows that those difficulties should be overcome at least with respect to the another type of capital income, i.e. interest.

Taking the above into account, it remains to be seen whether the Court will decide in its future judgements to follow the approach from the decision in

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\(^{110}\) Opinion of Advocate General Jääskinen in the joint cases C-10/14, C-14/14, C-17/14 Miljoen and others (n 58) paras 94-96.


\(^{112}\) van der Werf (n 94) para 6.1.3.

\(^{113}\) ibid para 6.1.1.

the *Miljoen and others* case. Only two decisions concerning deduction of costs have been issued by the Court afterwards in the cases *PMT* and *Brisal*. The former case concerned taxation of dividends in the hands of resident (Swedish) and non-resident pension funds. As regards deductibility of costs, the Court left it to the national court to decide whether “any professional expenses directly connected to the receipt of dividends” might have been deducted by resident pension funds and if it was the case, the non-residents should not have been treated less favourably.\(^{115}\) Some authors claimed that the decision in the *PMT* case was a sign of departure from the *Miljoen and others* case approach.\(^{116}\) However, laconically described “professional expenses directly connected to the receipt of dividend” do not necessarily coincide with the acquisition price of shares and financing costs that were subject matter of the *Miljoen and others* decision. Therefore, such conclusion seems to be premature.

However, the decision in the *Brisal* case seems to clearly indicate that the narrow understanding of costs directly linked to an income was not confirmed with respect to the expenses related to interest income. Therefore, in the doctrine it was suggested that the Court with this decision returned to its pre-*Miljoen and others* approach.\(^{117}\) Different understanding was put forward by Advocate General Kokott who tried to differentiate between situations of a portfolio shareholder receiving dividends and a creditor receiving interest by an analogy to the VAT treatment thereof,\(^{118}\) although this standpoint was criticized in the doctrine.\(^{119}\)

\(^{115}\) Case C-252/14 *PMT* (n 66) paras 64-65.
\(^{116}\) Kemmeren, ‘Gross Withholding Taxes’ (n 95) 6-7.
\(^{117}\) ibid 8.
\(^{118}\) Opinion of Advocate General Kokott in the case C-18/15 *Brisal* (n 87) paras 33, 35.
3.5. Establishing a direct link between overhead expenses and taxable income?

3.5.1. Difficulties in attributing overhead expenses to items or sources of income

As discussed in the preceding sections of the thesis, the main reason behind the need to establish the tax position of a taxpayer in the source and residence states for the purposes of the comparability analysis under the Schumacker doctrine is the fact that allowances and deduction related to the ability-to-pay principle can hardly be attributable to particular sources or items of income. The question may be raised if the same approach should be adopted with respect to operating or overhead expenses as well as indirect costs. Both legal academics and the European Commission acknowledged the difficulty in attributing costs to a particular source or item of income of a non-resident as compared to a situation of a resident taxable on its worldwide net income in the state of residence.120

Therefore, the solution proposed in the tax law literature was that situations of a non-resident and a resident are not comparable with respect to expenses other than those directly linked to income sourced in a Member State.121 However, in the light of the recent developments in the case law, particularly the decision in the Brisal case, such a standpoint remains valid only to the extent that the taxpayer is not able to provide evidence for the direct link between income and costs referred to as overheads or indirect expenses.

3.5.2. **Understanding of the terms “overhead expenses” and “indirect costs”**

According to the definition formulated for the purposes of transfer pricing, overhead costs may be understood as: 122

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\text{[t]he general expenses of a business as a whole (such as supervisory, general and administrative expenses) opposed to the direct costs of producing particular goods or providing a particular service. Such expenses may also be distinguished from indirect costs.}
\]

Indirect costs could be defined as expenses of manufacturing process but not directly linked to specific products or services. 123 By way of example, a famous pianist who is a nationals and a tax residents of Member State X is giving concerts while on a tour in a number of the EU Member States, including one in Member State Y. She has her own one-man business enterprise. The pianist receives income from ticket sales’ for her concert in the capital city of State Y. While in State Y the pianist may incur certain expenses in case of which the direct link with Y-sourced income is obvious like costs of hiring a concert hall, staying at the hotel, transport from an airport or to a concert hall.

However, the link and the actual amount of costs borne is more difficult to establish in case of other expenses that, based on the above-mentioned definitions, could be classified as overhead expenses or indirect costs. For example, the pianist may pay remuneration to an agent representing her in all organizational matters before the tour and throughout it. The pianist may also incur costs of depreciation of her world-class piano and other fixed assets (used on rehearsals in State X before the tour and during the tour in a number of countries) or depreciation of immovable property owned by her in State X like a music studio (used for rehearsals before the tour). Furthermore, the pianist may require assistance from an accountant and a tax adviser not just

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122 IBFD International Tax Glossary (5th edn, 2005) 293.
123 ibid 223.
on issues concerning the settlements directly related with the tour but on the bigger scale and on a day-to-day basis. In case of all of the abovementioned expenses, attributing them to the income from the artistic performance in State Y may turn out to be relatively difficult or at least more burdensome than with respect to the costs directly related to the particular concert which have been indicated in the preceding paragraph (costs of concert hall, transport or hotel).

3.5.3. Overhead and indirect expenses in the comparability analysis

Therefore, the question is whether the pianist from State X is in situation comparable to the State Y tax resident performing in State Y as far as overheads or indirect costs are concerned. Certainly, it may be argued that those costs are necessary to provide services in the form of the artistic performances. On the other hand, they are linked not only to income sourced in State Y but also in the other Member States. Therefore, only certain proportion thereof could be actually related to particular item or source of income which raises doubts about the existence of the actual direct link.124

Some authors voiced their objections against different treatment of overhead costs in the restriction test as compared to direct expenses.125 One of the arguments was a practical one and was based on the overall tax burden. Two non-resident taxpayers may recognize the same amount of net income while at the same time having completely different proportions of overheads to direct expenses. Therefore, it would be unfair to ignore overhead costs in the comparability analysis in case of a taxpayer that incurred mostly this kind of expenses.126 According to the another argument, although less convincing, in its decisions preceding the case Brisal, the Court had been mostly tasked with

124 Gärtner (n 111) 28.
126 ibid 105.
issues related to directly linked expenses and as a result in fact it had not ruled against deductibility of overheads or indirect expenses. The case Centro Equestre concerned the deductibility of a number of costs of equestrian presentations during a tour in Europe. The costs in question included, among others, “communications, travel, accommodation, advertising and personnel costs, in addition to day-to-day expenses relating to the horses (...) together with writing down costs for the horses”. As 11 out of 14 shows took place in Germany, the taxpayer sought to deduct 11/14 of the total costs from income sourced in Germany. However, the Court did not rule on the question of a direct link between those expenses and activity of a taxpayer but merely repeated its standpoint from the earlier case law and left it to the referring court to decide. Also the Court’s decision on the case Scorpio does not provide a definitive answer. The Court merely stated in the part of the judgment concerning the restriction test that the EU law does not “preclude the taking into account if appropriate of expenses that are not directly linked (...) to the economic activity that generated the taxable income, in a subsequent refund procedure”. This statement certainly should not be understood as the obligation of a source state to allow deduction of overheads or indirect costs by a non-resident.

The Court finally shed light on the issue of overhead expenses in its decision in the Brisal case. The Court admitted in the context of granting loans and receiving interest income by financial institutions that it could be problematic to prove existence of a direct link between a particular loan and both actual amount of financing costs and fraction of overheads. However, at the same time the potential difficulty in gathering evidence should not mean that a Member State could deny the deduction of costs by non-resident taxpayers if

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127 Kemmeren, ‘Gross Withholding Taxes’ (n 95) 4, where the author refers to the case Schröder indicating that directly linked costs were just an example of expenses incurred.
128 Case C-345/04 Centro Equestre (n 66) para 10.
130 Case C-290/04 Scorpio (n 66) para 59.
131 Case C-18/15 Brisal (n 34) para 48.
residents were allowed to deduct expenses. The Court indicated that “it cannot \textit{a priori} be ruled out that a non-resident is able to provide relevant documentary evidence enabling the tax authorities of the Member State of taxation to ascertain, clearly and precisely, the nature and genuineness of the business expenses”. However, as in the case Center Equestre it was left to the referring court to decide what was the proportion of overhead expenses that might have been considered to be directly linked to the taxpayer’s activity.

3.5.4. Conclusions

After the Brisal case it is clear that the Schumacker doctrine is not necessarily applicable to overhead expenses. The decision demonstrates that when it comes to incurring general or overhead expenses by a resident of a Member State and a non-resident, taxpayers are in a comparable situation if two conditions are met. Firstly, only the part of overheads that is directly linked to the non-resident’s activity in the source state may be taken into account. Secondly, the taxpayer should provide evidence of not only incurring costs in question but also of their direct link with his activity and income sourced in a given Member State. The kind of evidence required as well as the method of splitting general costs and attributing them to the source of income are not the issues regulated under the EU law. Therefore, decisions of the national courts in this respect should be based on the assessment of facts of the particular case\textsuperscript{135} in the light of the domestic tax laws of Member States concerned.

Taking the above into account, it is a question of fact whether the pianist from State X is in comparable situation to the tax residents of State Y as regards overhead or indirect expenses. Only based on that knowledge and evidence that could be produced by taxpayers, it could be determined whether

\begin{thebibliography}{10}
\bibitem{132} ibid para 49.
\bibitem{133} ibid.
\bibitem{134} ibid para 52.
\bibitem{135} Beretta (n 119) 200.
\end{thebibliography}
certain share of costs in question is directly linked to the artistic performance in State Y.

3.6. **Comparability as regards applicable tax rates**

In the calculation of the tax burden a number of factors needs to be taken into account, including the amounts of gross income, deductible costs or tax-free allowances which have been discussed from the comparability analysis’ perspective in the preceding sections of the thesis. The remaining important aspect that also needs to be covered is the issue of the applicable tax rate. The income of a non-resident may be subject to taxation at the same,\(^{136}\) lower \(^{137}\) or higher nominal rate \(^{138}\) than the income of a resident. The lower tax rates are often characteristic for gross income tax regimes in an attempt to compensate for non-deductibility of costs. The question whether residents and non-residents are in comparable situations with respect to applicable tax rates is crucial if the overall tax burden determines the existence of the less favourable treatment as discussed in sections 4.2 and 4.4. of the thesis below (and as opposed to the approach focusing solely on the non-deductibility of costs).

3.6.1. **Progressive tax scale**

In many Member States taxpayers subject to unlimited tax liability, particularly individuals, are taxed in accordance with progressive tax rates. Progressivity of tax rates is one of the features of tax systems designed to take into account taxpayer’s ability to pay and his or her personal situation.\(^{139}\) Therefore, the question may arise whether the *Schumacker* doctrine should be applicable when considering the issue of progressive tax rates. In other words, it is necessary to determine whether the fact that a non-resident

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\(^{137}\) Case C-18/15 *Brisal* (n 34) paras 4, 5.

\(^{138}\) Case C-107/94 *Asscher* (n 136) paras 7, 8.

taxpayer receives most of income in the source state or is not sufficiently taxed in the state of residence makes his situation comparable to the one of a resident.

The Asscher case concerned Belgian tax resident that was subject to limited tax liability in the Netherlands on his employment income. The tax rate applicable to him in the first tax band was higher than the rate enjoyed by Dutch residents. At the same time, however, only tax residents were obliged to make social security contributions in the Netherlands on the top of income tax payments, which was considered by the national court as the reason for taxing non-residents at the higher rate. Under the tax treaty the income in question was taxed in the Netherlands and exempted in Belgium but Belgium was entitled to take the exempt income into account when determining the tax rate applicable to Mr Asscher on his worldwide income (the method of exemption with progression).

It follows from the facts of the case, that taxation on the gross basis or non-deductibility of part of costs was not the issue. Non-residents were not compensated with preferable tax rate but quite the contrary: taxed at the higher rate than residents. Hence, the decision of the Court is not directly related to the topic of the thesis but still may be helpful in assessing comparability of residents and non-residents with respect to tax rates.

It should be noted that according to the legal background of the case, non-residents were allowed to be taxed as residents (at more preferential tax rate in the first tax band) if at least 90% of their worldwide income was sourced in the Netherlands. Therefore, the influence of the Schumacker doctrine over the Dutch legislation is clear. The Court, however, established that discrimination was a result of the fact that residents earning less than 90% of their worldwide income sourced in the Netherlands could enjoy lower tax

140 Case C-107/94 Asscher (n 136) paras 6-8.
141 ibid para 21.
142 ibid paras 14-15.
143 ibid para 6.
rate while meeting this threshold was mandatory for non-residents.\textsuperscript{144} In the light of such conclusion, the authors noted that proportions of amounts of income sourced in the source state and the other states became immaterial.\textsuperscript{145} This was the clear departure from the \textit{Schumacker} doctrine.

The Court also did not accept the argument of the Dutch government that “certain non-residents escape the progressive nature of the tax because their tax obligations are confined to income received in the Netherlands”.\textsuperscript{146} The Court noted that due to the method of elimination of double taxation under the tax treaty (exemption with progression), the progressive character of income tax was preserved in the state of residence (Belgium).\textsuperscript{147} Therefore, “[b]oth categories of taxpayer are (…) in comparable situation with regard to (…) rule” of progressivity.\textsuperscript{148}

The Court reached similar conclusion in the decision in the \textit{Gerritse} case. The Court ruled that “with regard to the progressivity rule, non-residents and residents are in a comparable situation”.\textsuperscript{149} Therefore, the legal comparability (as in the case of directly linked costs’ deductions) not the factual one (as in the case personal deductions or tax-free allowances) should be considered with respect to the issue of progressive tax rates.\textsuperscript{150} At the same time, however, the restriction test should be carried out upon necessary adjustments that require artificial increase of tax basis by the allowances or deductions related to taxpayer’s ability to pay if a non-resident has not received most of the income from the source state (in accordance with the \textit{Schumacker} doctrine).\textsuperscript{151} As a result of the adjustment, the tax rate applicable to residents that is established for the purposes of restriction test (and comparable to the one applicable to non-residents) may be different than the

\begin{footnotes}
\footnotetext[144]{ibid para 45.}
\footnotetext[145]{Vanistendael (n 139) 126.}
\footnotetext[146]{Case C-107/94 \textit{Asscher} (n 136) para 46.}
\footnotetext[147]{ibid paras 47-48.}
\footnotetext[148]{ibid para 48.}
\footnotetext[149]{Case C-234/01 \textit{Gerritse} (n 66) para 53.}
\footnotetext[150]{Simader, \textit{Withholding Taxes and the Fundamental Freedoms} (n 48) 157.}
\footnotetext[151]{Case C-234/01 \textit{Gerritse} (n 66) para 54.}
\end{footnotes}
nominal tax rate that would be actually determined in purely domestic situation.

3.6.2. Proportional tax rates

If progressive tax scale may be related to the ability-to-pay principle, in case of proportional (flat) tax rates no similar connection could be established as resident taxpayers are subject to the same single tax rate regardless of the amount of taxable income they earn or their personal or family situation. Therefore, non-residents are generally in the comparable situation with residents when it comes to the application of the proportional tax rate reserved for taxpayers subject to unlimited tax liability. This conclusion is supported in the case law of the Court.\footnote{For example, two decisions may be mentioned in which the Court compared overall tax burdens of non-residents and residents (taxed at flat rates): the decision in the joint cases C-10/14, C-14/14, C-17/14 Miljoen and others (n 58) paras 39, 46, 48 and the decision in the case C-265/04 Bouanich (n 67), paras 3 and 55.}

3.7. The confusing case of Truck Center

In the light of the Court’s decisions on deductibility of directly linked expenses, there should be no doubt that resident and non-resident taxpayers are in comparable situations in this respect. However, after the first early judgements confirming comparability (Gerritse, Scorpio, Bouanich, Centro Equestre), the decision in the case Truck Center could have cast doubt on correctness of this assumption\footnote{Case C-282/07 État belge – SPF Finances v Truck Center SA [2008] ECR I-10767.}. Also from the perspective of the Court’s rulings that followed it, the judgement in Truck Center may be considered surprising as it is one of the very few cases in which situations of residents and non-residents subject to taxation at source were found to be not comparable.\footnote{Spindler-Simader, ‘Dividend Withholding Taxes after Miljoen, X and Société Générale’ (n 114) 73.}

The case concerned the Belgian company that was required to withhold income tax on interest accrued on a loan granted by the parent company from Luxembourg. The national court asked if the mechanism of withholding
taxation applicable to income of non-residents was in conformity with the basic freedoms. Although the question did not refer to the issue of costs’ deductibility by a non-resident, the comparability analysis carried out by the Court could have more far-reaching implications not limited to the method of tax collection.

The Court indicated three different grounds for the lack of the objective comparability between situations involving resident and non-resident creditors. Firstly, “the position of the Belgian State is different” due to the fact that it acts as the residence state or as the source country only depending on taxpayer’s residence.\textsuperscript{155} The acceptance of this quite self-evident statement would mean that situations of non-residents and residents are always not comparable and, as a result, a significant part of income tax regimes of Member States would remain outside the scope of application of the EU basic freedoms\textsuperscript{156}

Secondly, two different charges (regular income tax and withholding income tax) were involved based on the different pieces of tax legislation.\textsuperscript{157} This argument was strongly criticized in the literature as well. It was pointed out that the existence of different charges applicable to residents and non-residents should be rather verified in the restriction test in terms of the potential less favourable treatment than treated as the ground for the lack of comparability.\textsuperscript{158}

Thirdly, different arrangements for charging taxes were involved (tax assessment and withholding\textsuperscript{159}) which resulted from the fact that in purely domestic situation the creditor was under full supervision of the Belgian tax authorities contrary to the cross-border transaction in which jurisdiction over

\begin{footnotes}
\item\textsuperscript{155} Case C-282/07 Truck Center (n 153) para 42.
\item\textsuperscript{156} Simader, Witholding Taxes and the Fundamental Freedoms (n 48) 131.
\item\textsuperscript{157} Case C-282/07 Truck Center (n 153) para 43.
\item\textsuperscript{158} CFE ECJ Task Force, ‘Comment by the CFE Task Force on ECJ Cases on the Judgment in Belgium SPF Finance v. Truck Center SA, Case C-282/07, Judgment of 22 December 2008’ (2009) 10 European Taxation para 17; Simader, Witholding Taxes and the Fundamental Freedoms (n 48) 131.
\item\textsuperscript{159} Case C-282/07 Truck Center (n 153) para 46.
\end{footnotes}
the non-resident was greatly limited and recovery of tax might have required assistance from the other state.\textsuperscript{160} It was pointed out that “this amounts to saying that residents and non-residents are different because residents and non-residents are different”\textsuperscript{161} and also that the argument in question should have been rather considered in the justification test, not in comparability analysis.\textsuperscript{162}

Therefore, the Court’s decision on the \textit{Truck Center} case was met with criticism. Legal scholars rightly indicated that the approach of the Court could be summarized in the following way: “once the legal situations [of a resident and a non-resident] are different, even if only to a small extent, the legislator is permitted to treat these situations completely differently”.\textsuperscript{163}

Also the Court seemed to try to distance itself from the ruling in the subsequent judgments or at least limit its impact to cases concerning the method of tax collection. By way of example, in the decision on the joint cases \textit{Miljoen and others}, the Court indicated that the questions referred by the national court were in principle related to potentially higher tax burden of non-residents and as a result were different than the one considered in the \textit{Truck Center} case concerning tax collection method.\textsuperscript{164} Also it was mentioned with respect to the case \textit{Brisal} that: \textsuperscript{165}

\begin{quote}
[b]y considering residents and non-residents comparable in respect of outbound interest, the CJEU (…) followed the Miljoen decision, thus implicitly reviewing its position on the non-comparability of the two categories of taxpayers which constitutes, instead, the puzzling outcome of Truck Center.
\end{quote}

\begin{itemize}
\item \textsuperscript{160} ibid paras 47–48.
\item \textsuperscript{161} CFE ECJ Task Force, ‘Comment by the CFE Task Force on ECJ Cases on the Judgment in Belgium SPF Finance v. Truck Center SA’ (n 158) para 18.
\item \textsuperscript{164} Joint cases C-10/14, C-14/14, C-17/14 \textit{Miljoen and others} (n 58) para 71.
\item \textsuperscript{165} Beretta (n 119) 196.
\end{itemize}
4. Identification of the less favourable treatment

4.1. Five basic freedoms but principally one outcome of the restriction test

Each of the basic freedoms mentioned in the section 3.1. of the thesis has different scope of application, however, the Court developed the uniform standard of verification whether the domestic legislation of a Member State violates them.\textsuperscript{166} As a result, examination of a given case should lead to the same conclusion as regards incompatibility with the Treaty regardless of the basic freedom which is the basis for the Court’s decision, except for the free movement of capital which is applicable to the third-country situations.\textsuperscript{167}

Taking into account the above-mentioned convergence of the fundamental freedoms,\textsuperscript{168} in the following sections of the thesis the less favourable treatment of non-resident taxpayers will be analysed not in reference to particular freedoms, but in a more general manner.

4.2. Restriction arising from the higher tax burden or merely inability to deduct costs?

When a non-resident is prevented from deducting costs that are directly linked to income sourced in a Member State while residents of that Member State are taxed therein on their net incomes, the two categories of taxpayers are subject to different treatment. The question is, however, whether this different treatment may translate into prohibited restriction of the basic freedoms just as a result of the refusal of deduction of costs. Alternatively, it could be merely the first step in the analysis in which the hypothetical tax burden of a resident subject to national treatment should be calculated and subsequently compared with the actual tax burden under income taxation regime applicable to a non-resident. This alternative should be considered of

\textsuperscript{166} Vanessa E. Englmaier, ‘The Relevance of the Fundamental Freedoms for Direct Taxation’ in Michael Lang and others (eds), \textit{Introduction to European Tax Law on Direct Taxation} (4\textsuperscript{th} edn, Linde 2016) 61.

\textsuperscript{167} ibid.

\textsuperscript{168} ibid.
course only if apart from non-deductibility of costs, there are other differences between tax rules applicable to residents and non-residents, particularly regarding tax rates. Otherwise, if only costs are the issue, the outcome of both scenarios will be the same.

As an illustration of this problem, the example of the pianist from the Member State X performing in the Member State Y may be considered again. Assuming that State Y taxes the musician’s income on the gross basis with no right to deduct any expenses and at the same time allows its own tax resident to deduct costs, two taxpayers are treated differently. According to the first approach discussed in the preceding paragraph, such difference itself constitutes discrimination, therefore the musician from State X should be allowed to deduct directly linked expenses under any circumstances.

Based on the alternative solution, account should be taken not only of costs but also of the potentially higher tax rate applicable to residents, as well as other circumstances like deductions that are not based on the personal situation of a taxpayer.\(^\text{169}\) Therefore, discrimination may arise only if tax on gross income of the musician is higher than the hypothetical one of the State Y resident receiving income from the same source.

The difference between the two scenarios may be explained on numbers:

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>The gross income in State Y</td>
<td>100</td>
</tr>
<tr>
<td>Costs directly linked to the income</td>
<td>50</td>
</tr>
<tr>
<td>Tax rate applicable to non-residents on gross income</td>
<td>10 %</td>
</tr>
<tr>
<td>Tax rate applicable to residents on net income</td>
<td>30 %</td>
</tr>
<tr>
<td>The tax due if the gross income is taxed (100 x 10 %)</td>
<td>10</td>
</tr>
<tr>
<td>The tax due if the net income is taxed (50 x 30 %)</td>
<td>15</td>
</tr>
</tbody>
</table>

If the discrimination is understood as the prohibition of costs’ deduction, then the less favourable treatment would be identified regardless of the less

\(^{169}\) Joint cases C-10/14, C-14/14, C-17/14 Miljoen and Others (n 58) para 53.
advantageous tax position of the tax resident in the comparable situation (the first scenario). However, if the restriction test requires further analysis and comparison between tax burdens, then based on the abovementioned example no discrimination would arise. The outcome of the restriction test could be therefore completely different and what is even more striking is the fact that the Court adopted different approaches in its case law and also authors are far from reaching consensus regarding the method that should be applicable.

4.3. **The first approach: no right to deduct costs as the prohibited discrimination**

4.3.1. Gerritse case as interpreted by Advocate General Kokott

It was the very first decision concerning non-deductibility of costs by non-residents in the *Gerritse* case that had already sown doubt about the proper way of carrying out the restriction test. The Court first acknowledged that refusal to allow costs’ deductions by non-residents constitutes discrimination that is “in principle” contrary to the freedom to provide services,\(^\text{170}\) and upon finding no justification for that measures concluded that they are precluded by the relevant treaty provisions.\(^\text{171}\) In the subsequent part of the judgement, the Court determined the comparability of residents and non-residents as regards progressive tax rates and acknowledged that discrimination could have arisen only if the effective tax rate applicable to a resident based on the progressive table had been lower than the one in the gross income taxation regime.\(^\text{172}\)

Therefore, the final conclusions of the Court in the *Gerritse* case were separated with respect to deductibility of costs and applicable tax rates.\(^\text{173}\) The way in which the decision was structured was criticized in the doctrine

\(^{170}\) Case C-234/01 *Gerritse* (n 66) para 28.
\(^{171}\) ibid para 29.
\(^{172}\) ibid paras 53-54.
\(^{173}\) Ibid para 55.
as the first answer (leading basically to the abolition of the gross income taxation) seems to contradict the other one (making the outcome of the restriction test contingent on the actual levels of tax burdens). The first part of the decisions prompted Advocate General Kokott in her opinion in the case Brisal to indicate that “refusing the deduction of operating costs directly linked to the taxed activity of a person subject to limited taxation in itself infringes the freedom to provide services” and as a result cannot be compensated by the lower tax rate. The way the decision was structured could indeed lead to such a conclusion. This means that a “non-resident has to be granted the most favourable treatment with regard to the taxable base and the tax rate” which would put taxpayers subject to limited tax liability at the significant advantage compared to residents. However, in the doctrine also an alternative approach to the Gerritse case was discussed, which rather looked at the tax burden being “a combination of the taxable base and tax rate”.

To support her view of the Gerritse case outcome, the Advocate General referred to other opinions of Advocates General that supposedly shared the same understanding of the Gerritse case. Although it is true that the Gerritse case was discussed in a number of opinions to which reference was made, I can hardly draw the same conclusions upon reading them carefully. By way of example, in the opinion of Advocate General Léger in the case Centro Equestre it was stated that “resident and non-resident suppliers of services must be treated identically as regards computation of taxable income and, more specifically, as regards the deduction of business

175 Opinion of Advocate General Kokott in the case C-18/15 Brisal (n 87) paras 48, 49 and 54.
176 Simader, Withholding Taxes and the Fundamental Freedoms (n 48) 150.
177 ibid.
178 Opinion of Advocate General Kokott in the case C-18/15 Brisal (n 87) para 50.
179 Opinion of Advocate General Léger in the case C-345/04 Centro Equestre (n 70) paras 49-54; opinion of Advocate General Mazák in the case Case C-43/07 D.M.M.A. Arens-Sikken v Staatssecretaris van Financiën [2008] ECR I-06887; opinion of the Advocate General Ruiz-Jarabo Colomer in the case C-440/08 Gielen (n 71) para 34; opinion of Advocate General Sharpston in the case C-342/10 Commission v Finland (n 83) para 50.
expenses directly linked to the activity that generated the taxable income in Germany”. 180 In my view this statement is far from the conclusion reached by Advocate General Kokott.

The next argument raised by the Advocate General was based on the “case-law, according to which disadvantageous tax treatment which infringes a fundamental freedom cannot be justified by other tax advantages”. 181 Therefore, according to the opinion, non-deductibility of expenses (the less favourable treatment) could not be neutralized by a lower tax rate (the benefit). Without questioning the rule that has been indeed upheld numerous times in the case law of the Court, 182 the argument put forward by the Advocate General is difficult to accept. As mentioned already in the thesis, the rationale behind gross income tax regimes is that on the one hand a non-resident taxpayer is prohibited from deducting expenses which are deductible for residents but, on the other hand, he may benefit from the lower tax rate than the one(s) residents enjoy. As a result, the beneficial tax rate should be seen as a direct implication of the unfavourable rule concerning non-deductibility of costs. In fact it may be argued that these two rules are fundamental features of the tax regime which should not be separated from each other. They are two sides of the same coin.

Therefore, the lower tax rate cannot be equated with a category of “other tax advantages, even supposing that such advantages exist”. It should be noted that the actual existence of those advantages may be uncertain and largely based on the circumstances of a given case, whereas non-resident taxpayers are principally entitled to a lower tax rate in all situations in which they find themselves subject to limited tax liability.

The final argument put forward by Advocate General Kokott in favour of her view of the less favourable treatment concerned a loss situation. It was noted

180 Opinion of the Advocate General Léger in the case C-345/04 Centro Equestre (n 70) para 54.
181 Opinion of Advocate General Kokott in the case C-18/15 Brisal (n 87) para 50.
182 By way of example, in the case C-385/00 F. W. L. de Groot v Staatssecretaris van Financiën [2002] ECR 1-11819, para 97 and case law referred to therein.
in the opinion that “[i]f the amount of the costs directly linked with the activity lead ultimately to a loss, a person subject to limited taxation is disadvantaged regardless of the tax rate”.\textsuperscript{183} That is absolutely true but at the same time it does not put into question the correctness of the another approach to the restriction test requiring comparison of tax burdens. If gross income of a taxpayer subject to limited tax liability is lower than the amount of expenses directly related to that income, it is rather self-evident that no matter how low is the tax rate applicable to non-residents subject to gross taxation, they will be always worse-off than residents.

To conclude this subsection, decision in the \textit{Gerritse} case may indeed suggest that there are two separate restriction tests: one for the issue of costs’ deduction and another for the application of different tax rates. The way the decision was structured and its wording are the most compelling grounds for that view. Nonetheless, any of the three supporting arguments put forward by Advocate General Kokott in the opinion in the \textit{Brisal} case does not seem to be convincing.

\textbf{4.3.2. PMT case: surprising outcome in spite of the general non-comparability}

In its decision on the \textit{PMT} case, the Court ruled that due to the aims the Swedish tax legislation applicable to pension funds resident in the Netherlands, the situation of a non-resident pension fund is not, as a rule, comparable.\textsuperscript{184} The objective in question was an adoption of the regime of “neutral taxation independent of the economic climate surrounding various kinds of assets as well as all the kinds of pension products”\textsuperscript{185} in which the taxable basis was calculated based on the difference between the total value of all assets and the liabilities multiplied by the standard yield rate.\textsuperscript{186} The resident Swedish pension funds were taxed on the notional income,

\textsuperscript{183} Opinion of Advocate General Kokott in the case C-18/15 \textit{Brisal} (n 87) para 51.
\textsuperscript{184} Case C-252/14 \textit{PMT} (n 66) para 63.
\textsuperscript{185} ibid 59.
\textsuperscript{186} ibid para 52
regardless of the amount of dividends received in a given year. For non-residents the dividends received and sourced in Sweden constituted the tax basis. Because of the limited taxing rights which Sweden had over the assets of non-residents located in jurisdictions different than Sweden, the objective of the neutral tax regime based on the value of total assets could not have been attained with respect to non-residents.\textsuperscript{187}

Regardless of the general incomparability of resident and non-resident pension funds, the Court also ruled that these two categories of taxpayers may be comparable if “professional expenses directly linked to an activity that has generated taxable income” were considered.\textsuperscript{188} However, it was left to the national court to find out whether due to method of tax base calculation applicable to residents (value of assets decreased by value of liabilities), any costs may be in fact deducted by resident pension funds.\textsuperscript{189} If the answer was to be positive, “it should also be admissible to take into consideration such expenses in respect of non-resident pension funds”.\textsuperscript{190} The outcome in this respect and rather evasive way of addressing the problem by the Court had been expected by authors commenting on the case before the decision was issued.\textsuperscript{191}

Therefore, the decision in the \textit{PMT} case coincides well with the interpretation of the \textit{Gerritse} case by Advocate General Kokott expressed in the opinion in the \textit{Brisal} case that was discussed in detail above. The potentially far-reaching implications of the Court’s decision were commented in the doctrine by indicating that “[t]he deduction of directly linked expenses would no longer be based on the tax burden analysis”,\textsuperscript{192} therefore occurring without any reference to the final tax positions of resident and non-resident taxpayers.

\textsuperscript{187} ibid paras 56-59.
\textsuperscript{188} ibid para 64.
\textsuperscript{189} ibid para 65.
\textsuperscript{190} ibid.
\textsuperscript{191} Katia Cejie, ‘The Hirvonen, the Pensioenfonds Metaal en Technie and the X AB v Skatteverket Cases’ in Michael Lang and others (eds), \textit{ECJ – Recent Developments in Direct Taxation 2014} (Linde 2014) 222.
\textsuperscript{192} van der Werf (n 94) para 6.3.
This would lead to the creation of “an autonomous European withholding tax base through the application of treaty freedoms”.193 In the literature it was also suggested that “blending elements of the two different regimes” in the PMT decision might have resulted in the creation of “a new international income allocation rule”.194

4.3.3. Brisal case: doubts dispelled

The decision of the Court generally coincided with the opinion of the Advocate General that was referred to in the section 4.3.1. of the thesis. Domestic tax legislation that allowed only residents to deduct expenses directly linked with the business activity was considered to restrict the freedom to provide services.195

The Court also shared the Advocate General’s view that lower tax rate applicable to taxpayers subject to limited tax liability cannot outbalance discriminatory treatment by putting it in the category of “other advantages” that may potentially exits.196 As discussed already in the section 4.3.1., this argument is particularly not convincing.

4.3.4. The Court’s decisions without a clear outcome

In a number of cases the Court confirmed that national legislation that did not allow the deduction of directly linked expenses by taxpayers subject to limited tax liability violated Treaty freedoms without any direct reference to or consideration of potentially lower tax rate that could have been available for non-residents. In some of these decisions, the description of domestic tax laws suggested existence of different tax bands for non-residents197 but the issue was not raised in the proceedings before the Court. In other decisions

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193 ibid.
195 Case C-18/15 Brisal (n 34) paras 28 and 45.
196 ibid paras 31-33.
197 Opinion of Advocate General Léger in the case C-345/04 Centro Equestre (n 70) para 6, case C-290/04 Scorpio (n 66) para 8.
no mention of tax rates was made at all in the background of the cases.\textsuperscript{198} Therefore, these decisions do not provide clear guidance on the question concerning the restriction test based on either merely non-deductibility of costs or comparison of tax burdens with the consideration of applicable tax rates.

4.4. The second approach: comparison between tax burdens

4.4.1. Miljoen and others case: looking for the comparable tax burden

Out of three cases examined jointly by the Court, in the X case (C-14/14) and in the Société Générale case (C-17/14) issue of income deductions was raised. In both cases, Dutch non-residents (the individual and the company, respectively) were subject to 15\% withholding tax on dividends paid by Dutch companies. The Dutch residents were also subject to withholding tax at the same rate, however, it was subsequently offset against income tax (individuals) or corporation tax (companies).\textsuperscript{199} As regards taxation of individuals resident in the Netherlands, 30\% income tax on dividends (against which the withholding tax was set off) was calculated on the notional basis, i.e. 4\% return “of the average value of the shares less the value of any liabilities calculated at the beginning and at the end of the calendar year”.\textsuperscript{200} The tax was levied regardless of the amount of dividends received in a given year. Corporation tax was levied on the actual income from dividends decreased by the expenses.\textsuperscript{201}

The first striking contrast between this case and the PMT case discussed in the section 4.3.2. is that the Court confirmed comparability of resident individuals and non-residents.\textsuperscript{202} As in the PMT case, taxpayers were taxed on the notional income computed as a certain fixed percentage of the difference between values of assets and liabilities. It could be argued that the

\textsuperscript{198}Case C-346/04 Conijn (n 35); case C-450/09 Schröder (n 66); case C-559/13 Grünewald (n 66).

\textsuperscript{199}Joint cases C-10/14, C-14/14, C-17/14 Miljoen and Others (n 58) para 37.

\textsuperscript{200}ibid para 46.

\textsuperscript{201}ibid para 47.

\textsuperscript{202}ibid para 69.
Dutch tax regime applicable to resident taxpayers pursued similar objective to the Swedish one: taxation “independent of the economic climate surrounding various kinds of assets” owned by a resident.\textsuperscript{203} Therefore, it is puzzling that the results of the comparability analysis of those two case are different. On the other hand, activities of pension funds and regular individual investors are hardly comparable. In the decision in the \textit{PMT} case, the Court might have acknowledged the specific nature of the yield tax as a measure to tax “all current returns (…) on the pension savings” regardless of the type of the underlying investment.\textsuperscript{204} This could explain the difference between the \textit{Miljoen and others} case and the \textit{PMT} decision.

The positive outcome of comparability analysis led the Court to the initial finding that the level of tax burdens of non-residents (subject to 15 % final withholding tax) and residents (for whom withholding was just a prepayment) should be examined while determining violation of the EU law by the Netherlands.\textsuperscript{205} This conclusion contrasted with decisions in cases discussed in the section 4.3. of this thesis in which prohibition of costs’ deduction in cross-border situations constituted in itself infringement of the basic freedoms. The comparison of tax burdens also means that situations of gross taxation (or taxation on semi-net basis with limited deductions as the case may be) applicable to non-residents generally require case-by-case analysis in the light of the specific circumstances.\textsuperscript{206}

In the discussed decision the Court also indicated how to establish the tax burden in the domestic situation. It is clear that not the withholding tax of 15 % should be considered alone as it constituted just a pre-levy. Account should be taken of the income tax for natural persons and corporation tax for companies against which withholding tax was ultimately offset.\textsuperscript{207} This

\begin{footnotesize}
\begin{enumerate}
\item Case C-252/14 \textit{PMT} (n 66) para 59.
\item Cejie (n 191) 217.
\item Joint cases C-10/14, C-14/14, C-17/14 \textit{Miljoen and others} (n 58) paras 48 and 61.
\item Spindler-Simader, 'Dividend Withholding Taxes after Miljoen, X and Société Générale' (n 114) 71.
\item Joint cases C-10/14, C-14/14, C-17/14 \textit{Miljoen and others} (n 58) paras 46-47 in the light of para 48.
\end{enumerate}
\end{footnotesize}
conclusion must have been welcomed by the legal scholars who advocated for the “extended comparison” (final withholding tax for a non-resident compared with final income tax for a resident) as opposed to the “limited comparison” (comparison of withholding taxes: a final one for a non-resident and just an interim one for a resident).\textsuperscript{208} The calculation of the final tax burden for a resident or, putting it differently, the effective tax rate was seen as a measure of “an objective, complete, fair assessment” of the resident’s situation.\textsuperscript{209} The extended comparison certainly might contribute to the creation of the internal market through providing “a level playing field” for residents and non-residents of the source state, securing the international tax neutrality and capital and labour import neutrality as well as implementing the ability-to-pay principle.\textsuperscript{210} Other authors were also rightly pointing out that “the different treatment is not triggered by different tax collection methods, but might only occur due to different tax amounts”.\textsuperscript{211}

When it comes to individuals, the tax payable was determined on a yearly basis regardless of the amount of dividends received and based on the value of all assets (shares) owned by a natural person. Therefore, the Court made it clear that the tax burden should be determined for a calendar year\textsuperscript{212} and based on the yield from all shares\textsuperscript{213} and this view was shared in the tax law literature.\textsuperscript{214}

Furthermore, as residents and non-residents were considered comparable with respect to tax-free capital allowance (as discussed in the section 3.2.3.)

\begin{footnotesize}
\begin{itemize}
\item\textsuperscript{208} Kemmeren, ‘The Netherlands: What Are the Right Comparators under Article 63 TFEU When Assessing a Dividend Withholding Tax Refund Claim?’ (n 53) 138.
\item\textsuperscript{209} ibid.
\item\textsuperscript{210} ibid 140-141.
\item\textsuperscript{211} Spindler-Simader, ‘Dividend Withholding Taxes after Miljoen, X and Société Générale’ (n 114) 71.
\item\textsuperscript{212} Joint cases C-10/14, C-14/14, C-17/14 \textit{Miljoen and others} (n 58) para 51.
\item\textsuperscript{213} ibid para 52.
\item\textsuperscript{214} Kemmeren, ‘The Netherlands: What Are the Right Comparators under Article 63 TFEU When Assessing a Dividend Withholding Tax Refund Claim?’ (n 53) 142, 143.
\end{itemize}
\end{footnotesize}
this deduction should be taken into account in the calculation of a tax burden.  

4.4.2. Bouanich case

Based on the background of the Bouanich case, when a company repurchased its own shares from a Swedish shareholder for the purposes of a capital reduction, the shareholder was allowed to deduct costs of shares’ acquisition and was subsequently taxed on a net capital gain at the rate of 30%. At the same time, the proceeds from shares’ repurchase were classified as dividend-like income for non-residents taxable at the lower rate of 15% but without possibility of deducting costs of shares’ acquisition. Only nominal value of repurchased shares could be deducted under such circumstances.

The non-resident taxpayer in the proceedings before a national court was demanding a full refund of tax which suggests that the original cost of shares’ acquisition exceeded the income. Therefore, from the perspective of this specific case, the issue of different tax rates applicable to non-residents and residents could have been immaterial. Still, the Court made a clear reference to the comparison of tax burdens as a proper way of carrying out the restriction test.

In the light of the Bouanich case, it was concluded that if:

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\text{a non-resident is treated no less favourably overall, a Member State may assess a form of income or profit on a non-resident in a different manner and may compensate for a resulting over-assessment of the taxable amount by applying a lower rate of tax to it.}
\]

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215 ibid paras 53 and 59.
216 Case C-265/04 Bouanich (n 67) para 3.
217 ibid paras 3 and 10.
218 ibid para 16.
219 ibid para 18. Nonetheless, it was suggested otherwise by Cécile Brokelind in ‘Three New Swedish Direct Taxation Cases on Their Way to the ECJ’ (2014) 9 European Taxation 385, 387.
220 ibid para 55.
221 Turner (n 96) 125.
4.4.3. *The Hirvonen case: cannot have your cake and eat it*

The *Hirvonen* case concerned the deduction of interest costs on a loan in Sweden by a non-resident. The costs did not constitute expenses directly linked to a taxpayer’s activity but at the same time they could not be deducted in the state of residence due to insufficient income generated there. Therefore, the *Hirvonen* decision is part of the *Schumacker* doctrine case law. Nonetheless, the outcome of the case is also interesting from the perspective of the tax burden analysis.

In order to deduct interest, the non-resident had to opt to be taxed under the ordinary tax regime applicable to residents. However, Ms Hirvonen (Finnish tax resident) preferred to be taxed as the non-resident due to the preferable tax rate which in turn resulted in a lower overall tax burden than the one under the ordinary regime. Still, Ms Hirvonen requested a deduction of interest expenses from the gross income which was denied by the Swedish tax authorities. The Court ruled that the Treaty freedoms were not violated as a result because non-residents were still treated more favourably under gross taxation regime (without costs’ deduction) than residents (with costs’ deduction).\(^{222}\) What mattered was the overall tax burden.\(^{223}\)

This outcome of the case must have been welcomed by the Member States. It was argued in the light of the background of the case that any potential restriction of the Treaty freedoms should be neutralized if a non-resident taxpayer had the choice to be treated as a resident assuming that it was more favourable in terms of the overall tax burden.\(^{224}\) If taxation at source on the gross basis is more advantageous as regards the actual amount of tax liability, a taxpayer cannot expect to be allowed to deduct the expenses on the top of that.

\(^{222}\) Case C-632/13 *Hirvonen* (n 33) paras 37, 43, 44.
\(^{223}\) ibid para 48.
\(^{224}\) Cejic (n 191) 215.
4.4.4. “Schumacker-doctrine adjustment” of the tax burden

As the *Gerritse* case shows, the comparable tax burden of a resident taxpayer may require certain adjustments related with the allowances or deductions to which the *Schumacker* doctrine applies. By way of example, if a non-resident does not receive major part of an income in the source state, the allowances or deductions related to personal situation of a taxpayer (or more broadly his or her ability to pay, not a specific activity or income) should not be taken into account in the calculation of a resident’s hypothetical tax burden. As the Court confirmed in the *Gerritse* case this could be done through the “artificial” increase of a taxable income by an amount of a tax-free allowance.225

4.5. Concluding remarks: which approach should prevail?

Taking into account discrepancies between outcomes of the cases, it is difficult to predict which approach will be followed by the Court in the future. In my view, the overall tax burden solution is better reflecting the economic circumstances and the logic of gross income taxation. A non-resident taxpayer should not be allowed to enjoy a “double-dip”: both the advantageous tax rate and the possibility to deduct expenses to the same extent as a resident. Otherwise, the systems of withholding taxes imposed on gross amounts of income would be questioned in the European Union. In my view this would be a step too far in the negative integration of the Member States’ legal systems that is carried on by the Court.

Furthermore, only the overall tax burden approach seems to be consistent with the treaty-based approach to the neutralisation of the less favourable treatment which will be discussed in detail below in the section 4.6.3. of the thesis. Whichever path is taken, it is certainly desirable that the Court finally dispel doubts as to the proper way of conducting the restriction test.

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225 Case C-234/01 *Gerritse* (n 66) para 54.
4.6. Attempts to counterbalance the less favourable treatment

4.6.1. Introductory comments

If a non-resident is denied the deduction of directly linked costs but the less favourable treatment is established only upon comparing tax burdens (approach discussed in the section 4.4. of the thesis), then the lack of costs’ deduction may be counterbalanced by a compensatory tax rate. In the section 4.6.2. below potential issues with this compensation will be discussed due to a trend of falling income tax rates.

If the rate applicable in gross basis taxation is not low enough to prevent the less favourable treatment (higher tax burden for taxpayers subject to limited tax liability), the source state may seek to defend its tax rules by referring to the tax treaty concluded with the residence state and the method of mitigating double taxation provided therein. Such attempts and the source state’s chances of succeeding in this respect will be analysed in the section 4.6.2.

Finally, if the discrimination is understood as the inability to deduct expenses in the source state as such (section 4.3. of the thesis), then it is clear that any of the scenarios of neutralisation of the unfavourable treatment must be ruled out.

4.6.2. Impact of falling rates of income taxes on comparison of tax burdens

As discussed in detail in the section 4.4. of the thesis, according to one of alternative approaches to the restriction test, comparison of tax burdens is crucial in order to establish existence of prohibited discrimination. Therefore, if under the special taxation regime for non-residents tax due in a source state is lower than under the ordinary regime (with necessary adjustments related to the Schumacker doctrine as indicated in the Gerritse case), no discrimination should be found. This was basically the outcome of the exemplary situation of the pianist from State X performing in State Y which was discussed in the section 4.2. Even though the pianist was taxed on the
gross amount of income, still she was not worse-off in terms of the tax burden comparing to a resident taxpayer thanks to much lower tax rate available to her. Of course the outcome would have been different if either amount of directly linked costs had been much higher or the difference between applicable tax rates lower. The former factor is a purely factual one but the latter one may be analysed in the light of the trends and developments in domestic tax legislations of the Member States.

In the doctrine it was already noted that due to cuts of tax rates in the domestic tax regimes applicable to residents, the compensatory impact of lower tax rates available to non-residents could be greatly diminished assuming that the latter rates are kept at the same level. The example of the United States may be mentioned where in 1980 the tax rate for residents could have reached 70 % while non-residents enjoyed tax rate of 30 % (on income other than active income).226 Reportedly, by 2016 the situation had changed but only for residents (tax rate of 35 %) as the rate for non-residents remained the same.227

However, reduction of income tax rates is not just the US phenomenon and reforms of the systems of corporate income tax in the EU states may serve as good example. The long-term trend of cutting corporate income tax rates was noticed among OECD member countries (many of which are members of the EU). According to the figures, the average standard CIT rate stood at 32,2 % in 2000 and was reduced to 24,7 % in 2016.228 According to the data, in the period between 2008 and 2016 the standard CIT rate fell in 12 EU and OECD member countries (France, Luxembourg, Spain, the Netherlands, Sweden, Denmark, the United Kingdom, Finland, Estonia, the Czech Republic, Hungary, Slovenia), went up in 3 states (Portugal, Greece and Slovakia) and remained the same in 7 countries (Ireland, Latvia, Poland, Austria, Germany,

Italy, Belgium). Further rate cuts were introduced in 2017 or are expected to be implemented in the near future in 10 Member States (Estonia, France, the United Kingdom, Italy, Luxembourg, Slovakia, Hungary, the Netherlands, Poland, Portugal). The question is whether corresponding reductions were also introduced with respect to non-resident corporate taxpayers operating in the abovementioned countries without permanent presence there (i.e. without permanent establishment) and, as a result, generally subject to taxation at the gross basis. If the answer is negative, then the US exemplary case discussed in the preceding paragraph is likely to be an issue also in the EU Member States.

In order to illustrate the problem, the provisions of the Polish CIT Act could be discussed in the light of the circumstances known from the *Brisal* case. The proportional rate of CIT was reduced from 27 % to 19 % in 2004. Furthermore, the preferential rate of 15 % was introduced in 2017 for small enterprises or enterprises launching activity. At the same time, the tax rate applicable to gross income from interest earned by non-residents not having a permanent establishment in Poland has remained at the level of 20 % unless the lower tax rate provided for in a tax treaty has been applicable. This flat-rate tax has been withheld only on interest payable to non-residents.

Although successive amendments to the CIT Act introduced reduced rates and, ultimately, exemption of interest in accordance with the Interest Royalties Directive, interest income of non-residents that were not related with payment debtor generally has remained taxable at the statutory rate of

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229 ibid 55.
230 ibid 56.
231 The CIT Act (n 8).
234 Art. 21(1)(1) of the CIT Act (n 8).
20% or a reduced one under a tax treaty. The tax treaties concluded by Poland with the other Member States generally provide for an exemption of interest or taxation thereof at the rate of 5% or 10%. The latter rate is applicable to interest payable to creditors from Hungary, Italy or Portugal among other countries.

If circumstances of the Brisol case are adjusted to the Polish situation, it may be assumed that it is the Italian company with no permanent establishment in Poland that grants the Polish company an interest-bearing loan. The Italian company may have acquired funds for its financing activity in Poland by intra-group borrowing or from deposits of its clients. In 2018 the Italian taxpayer received EUR 100 000 in interest from the Polish company but at the same time calculated the costs directly linked to its activity in Poland (direct costs or proportion of overheads) in the same period in the amount of EUR 60 000.

The Polish payment debtor should withhold from EUR 100 000 of interest (gross income), the PLN equivalent of the amount of EUR 10 000 (10%) as provided for in the CIT Act and the tax treaty between Poland and Italy. However, if the Italian company has been taxed based on rules applicable to Polish tax residents, the net income of EUR 40 000 would be taxed at the rate of 19% at most. As a result the tax due should not generally exceed the PLN equivalent of the amount of EUR 7 600. The less favourable treatment of the Italian taxpayer under gross income taxation regime is clear and amounting to EUR 2 400. Therefore, there is no doubt that in this example the tax rate of 10% which is lower by 9 percentage points from the general CIT rate could not compensate for the non-deductibility of costs. However, the situation would be different if the general CIT rate had remained at its pre-

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236 ibid.
2004 level of 27%. Then, the tax due would amount to EUR 10 800 which is a bit more than tax on gross income.

4.6.3. Neutralisation by the residence state through credit

Throughout this thesis the emphasis was put on the source state, as generally the partial or total prohibition of income deductions in that state has been considered to be the cause of the unfavourable treatment of non-residents. Therefore, the treatment of a taxpayer in the country other than the source state has not been generally taken into consideration in the restriction test. However, the Court acknowledged a treaty-based approach “to allow for the neutralisation of a discriminatory withholding tax in the source state through a treaty-based tax credit in the taxpayer’s residence state”.

If the risk of double taxation occurs as a result of the limited tax liability in the source state and the full tax liability in the country of residence, generally the latter state may undertake measures aimed at elimination of double taxation in accordance with its domestic legislation or a relevant tax treaty. In the first place, a tax treaty may provide for an allocation rule under which an item of a given income is taxable merely in the source state (or the residence state, as the case may be), as a result of which double taxation is avoided. However, if taxing rights are shared between both states, generally three methods of elimination of double taxation may be distinguished: the exemption of the foreign income, the tax credit for the foreign tax and the deduction of the foreign tax from a tax basis. Under the OECD Model Tax Convention two alternative methods were recognized, i.e. the exemption method and the credit method. The latter one was suggested in the ordinary form meaning that deductible amount of the foreign tax “shall

238 ibid 685.
240 ibid 30.
241 OECD, Model Tax Convention (n 9), 42-43 (art. 23A and 23B).
not (…) exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable (…) to the income or the capital which may be taxed in that other State” (maximum deduction).\textsuperscript{242} On the other hand, the full credit method allows for a complete offset of foreign tax or even reimbursement thereof.

Taking into account methods of mitigating double taxation, it is clear that the unfavourable treatment in the source state cannot be neutralised by the residence state if the latter country waives its taxing rights by either accepting the full allocation thereof to the former state or by providing a tax exemption. Therefore, the potential neutralisation considered below could be only analysed with respect to the tax credit mechanism in both of its forms (the full one and the ordinary one).

\textit{(i) Case law concerning double taxation of dividends}

The Court expressed its view on the neutralisation of the source state restriction of basic freedoms by the residence state in a number of decisions concerning the double taxation of dividends.\textsuperscript{243} The cases involved dividends that were subject to withholding tax when paid to corporate shareholders resident in the other Member States while dividends paid to companies resident in the same country were exempt. There are a few conclusions that may be drawn from these decisions.

First of all, the state of source cannot defend its treatment of the taxpayer subject to limited tax liability based on the mitigation or elimination of double taxation in the state of residence which is undertaken as the unilateral measure and not in execution of a tax treaty obligation.\textsuperscript{244} Therefore, the

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{242} ibid 43 (art. 23B(1)).
\item \textsuperscript{244} Case C-379/05 Amurta (n 243) para 78.
\end{enumerate}
\end{footnotesize}
Treaty freedoms are not violated only if the relevant tax treaty provisions are applicable which enable “effects of the restriction (…) to be neutralised”.\textsuperscript{245} This result certainly cannot be achieved if the residence state in its domestic legislation did not implement the treaty-based method of elimination of double taxation and instead chooses to exempt the foreign-sourced income.\textsuperscript{246} The requirement for the existence of a tax treaty was explained in the doctrine by the fact that compliance of a Member State with the EU legislation should not be based on purely domestic tax laws of the other Member State, but rather a bilateral agreement that is binding for both countries.\textsuperscript{247} Without such a legally binding instrument, the source state that has caused discrimination cannot guarantee neutralisation of the less favourable treatment by the residence state.\textsuperscript{248} Furthermore,\textsuperscript{249} 

\begin{quote}
[t]his approach also avoids an overt contradiction to the well-established general prohibition of counterbalancing tax disadvantages with unrelated tax advantages in other jurisdictions.
\end{quote}

This treaty-based perspective clearly contrasts with the judgement of the EFTA Court in the case E-1/04 \textit{Fokus Bank} in which the impact of tax credit mechanism provided for in tax treaties was ignored.\textsuperscript{250} In the light of the Court’s case law it seems that this standpoint was ultimately rejected.\textsuperscript{251} Furthermore, the Court ruled that the discrimination in the state of source could be counterbalanced only if “tax withheld (…) under national legislation can be set off against the tax due in the other Member State in the full amount of the difference in treatment”.\textsuperscript{252} The Court also indicated that tax credit

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{245} ibid paras 79, 80.
\item \textsuperscript{246} Case C-170/05 \textit{Denkavit} (n 243) paras 46-47.
\item \textsuperscript{247} Kofler (n 237) 687.
\item \textsuperscript{248} Michael Lang, ‘ECJ case law on cross-border dividend taxation - recent developments’ (2008) 2 EC Tax Review 67, 71.
\item \textsuperscript{251} Englisch (n 249) 217-218; Kofler (n 237) 686.
\item \textsuperscript{252} Case C-540/07 \textit{Commission v Italy} (n 243) para 37, emphasis added. Similarly: Case C-387/11 \textit{Commission v Belgium} (n 243) para 55.
\end{itemize}
\end{footnotesize}
could neutralise the less favourable treatment only if the income is “sufficiently taxed” in the state of residence.\textsuperscript{253} It was noted that the tax withheld at source should be credited “in its entirety” in the other state.\textsuperscript{254} As a result, if the ordinary credit method is adopted it is not possible for the source state to guarantee neutralisation in the residence state in “all cases” as the amount of tax payable on the same income in the state of residence may be insufficient.\textsuperscript{255} This categorical approach led the Court to dismiss the argument based on the neutralisation of the restriction by reference to tax treaties containing ordinary tax credit provisions.\textsuperscript{256} However, some authors presented an alternative interpretation of the case law (“result-oriented approach”) based on which the ordinary credit method should not be ruled out as a measure of neutralisation because it may be as effective as the full credit in particular circumstances in which the amount of tax in the residence state is sufficient to offset the tax paid at source.\textsuperscript{257}

(ii) Miljoen and others case

The Court examined the issue of neutralisation of unfavourable treatment through application of methods of elimination of double taxation in the residence state in its decision in the joined cases \textit{Miljoen and others} (cases C-14/14 and C-17/14). The situation was different than in the case law discussed above as dividends paid domestically were not exempt. Therefore, the potential neutralisation under a tax treaty was involving the less favourable treatment in the source state consisting in the higher tax burden of non-residents as compared to the one of residents that were taxed more favourably.

\textsuperscript{253} Case C-540/07 Commission v Italy (n 243) para 38.
\textsuperscript{254} Case C-487/08 Commission v Spain (n 243) para 60.
\textsuperscript{255} Case C-540/07 Commission v Italy (n 243) para 39; Similarly: Case C-487/08 Commission v Spain (n 243) para 64 and case C-387/11 Commission v Belgium (n 243) para 57.
\textsuperscript{256} Case C-487/08 Commission v Spain (n 243) para 67.
\textsuperscript{257} Kofler (n 237) 688.
The Court considered the question of neutralisation as a part of justification test.\textsuperscript{258} nonetheless it should be rather considered as “an argument to negate different treatment of the taxpayer”\textsuperscript{259}. The views expressed in the case law referred to above concerning unilateral advantages, role of tax treaties, necessary (full) scope of neutralisation were acknowledged by the Court.\textsuperscript{260}

Against the backdrop of the case C-14/14 (X) the Court ruled that double taxation in Belgium (state of taxpayer’s residence) is mitigated based on the unilateral measure and the method applied did not allow for the full compensation of the less favourable treatment in the source state.\textsuperscript{261} As regards the case C-17/14 (Société Générale), although the ordinary tax credit was provided for in the French-Dutch tax treaty, the Dutch withholding tax could not be offset against French income tax due to overall loss incurred by the taxpayer in France. Therefore, the restriction could not be counterbalanced.\textsuperscript{262} The Court unfortunately shied away from the answering the question on the potential neutralisation in the subsequent years as a result of the carry-forward of the unused tax credit when the taxpayer would return to profitability.\textsuperscript{263} The authors, however, indicated that under the EU law a residence state was not required to provide a carry-forward option to taxpayers.\textsuperscript{264} Furthermore, the OECD Model Tax Convention which is a basis for many tax treaties concluded between the Member States of the EU does not contain any provisions on the carry-forward of the unused credit. Therefore, such an option could be treated as merely an unilateral advantage provided by the other Member State that cannot counterbalance the less favourable treatment, at least unless the countries concerned have decided to amend a tax treaty and make the carry-forward obligatory as suggested in the

\begin{footnotesize}
\begin{enumerate}
\item Joint cases C-10/14, C-14/14, C-17/14 Miljoen and others (n 58) paras 75-90.
\item Spindler-Simader, ‘Dividend Withholding Taxes after Miljoen, X and Société Générale’ (n 114) 74.
\item Joint cases C-10/14, C-14/14, C-17/14 Miljoen and others (n 58) paras 77-80.
\item ibid paras 82-83.
\item ibid para 87.
\item ibid para 88.
\item Smit, ‘The Société Générale Decision’ (n 2) para 4.2.
\end{enumerate}
\end{footnotesize}
Complementary to the Art. 23B of the OECD Model Tax Convention.\textsuperscript{265} Besides, even if the carry-forward option is available, it cannot be guaranteed that the credit will be used ultimately as a taxpayer may remain in a tax-loss position for a longer period of time.\textsuperscript{266} Finally, the carry-over of unused credit does not tackle the issue of cash flow disadvantage.\textsuperscript{267}

Although the decision in its part related to the case C-17/14 (Société Générale) concerned the year in which the loss was incurred (2008), the Court also referred to the preceding periods indicating that “restriction alleged was entirely neutralised by the fact that, in France, the tax on dividends for the tax years 2000 to 2007 inclusive were offset in full”.\textsuperscript{268} That statement confirms that the Court does not seem to require a full credit to be available to a taxpayer under a tax treaty, as the French-Dutch tax treaty provided for the ordinary credit method.\textsuperscript{269} It is crucial as the ordinary tax credit is a typical solution applied in tax treaties while previous decisions in the cases concerning double taxation of dividends seemed to suggest that only a full credit could be taken into consideration because it allowed for the elimination of double taxation in any event, also when a taxpayer was in the loss position. It could be therefore argued that in the case C-17/14 (Société Générale) the Court adopted more flexible “case-by-case” or “factual” approach and acknowledged that under specific circumstances ordinary tax credit could lead to the effective neutralisation of the restriction.\textsuperscript{270} This view should be supported. I do not see the reason why tax treaty rules on the mitigation of double taxation should allow for neutralisation of restriction in absolutely all circumstances. If the less favourable treatment consisting in

\textsuperscript{265} OECD, *Model Tax Convention on Income and on Capital* (n 9), 400 (para 66 of the Commentary to the Art. 23).

\textsuperscript{266} CFE ECJ Task Force, ‘Opinion Statement ECJ-TF 1/2016 on the Decision of the European Court of Justice in Joined Cases Miljoen (Case C-10/14), X (Case C-14/14) and Société Générale (Case C-17/14) on the Netherlands Dividend Withholding Tax’ (2016) 6 European Taxation 255, 260; Spindler-Simader, ‘Dividend Withholding Taxes after Miljoen, X and Société Générale’ (n 114) 75.

\textsuperscript{267} Spindler-Simader, ‘Dividend Withholding Taxes after Miljoen, X and Société Générale’ (n 114) 76.

\textsuperscript{268} Joint cases C-10/14, C-14/14, C-17/14 *Miljoen and others* (n 58) para 85.

\textsuperscript{269} CFE ECJ Task Force, ‘Opinion Statement ECJ-TF 1/2016’ (n 266) 260.

\textsuperscript{270} Smit, ‘The Société Générale Decision’ (n 2) para 4.2.
higher tax burden in a source state is assessed on the case-by-case basis, the same should be allowed when the neutralisation thereof is considered from the perspective of a residence state. However, some authors put forward a different understanding of the Court’s decision by emphasizing that neutralisation should be ensured in all cases regardless of the amount of tax due in a state of residence, thus accepting the full credit method as the only way out for the source state.  

(iii) Neutralisation in practice: potential issues

In the preceding subsection of the thesis (4.6.2.), the impact of falling rates of general income taxes in the Member States has been discussed from the perspective of the source state. However, similar conclusions may be drawn with respect to the residence state and potential neutralisation of less favourable treatment therein. Therefore, the difference between withholding tax rates in the source state and income tax rates in the residence state may be not large enough to allow for a full offset of the withholding tax against the net income tax especially if net margin on a given transaction is low.  

It should be also emphasized that the ordinary tax credit article that is modelled on the art. 23B of the OECD Model Tax Convention is relatively general. It leaves much leeway to parties to a treaty when it comes to the technique of granting tax credit or calculation of maximum deduction. Therefore, depending on the residence state domestic tax legislation, the income deductions that are taken into account there may greatly impact the amount of foreign-sourced income and, as a result, significantly reduce the amount of the available tax credit. These deductions may include (leaving aside costs directly related to the foreign-sourced income) overheads, tax allowances or losses carried forward from the previous tax years.

271 Spindler-Simader, ’Dividend Withholding Taxes after Miljoen, X and Société Générale’ (n 114) 75.
272 Palma (26) 624, 627.
273 OECD, Model Tax Convention on Income and on Capital (n 9) 399 (para 62 of the commentary to the art. 23 of the OECD Model Tax Convention).
274 ibid 399 (para 62 of the commentary to the art. 23 of the OECD Model Tax Convention).
Consequently, tax credit may be insufficient to fully neutralize the less favourable treatment in the source state.

5. Concluding remarks

In this thesis, it has been demonstrated that the Court has played active role in the process of the negative integration of direct tax laws in the European Union. Among the targets of the Court have been tax rules under which the right to income- or activity-related deductions was denied or limited for non-resident taxpayers. As a result, the gross basis taxation regimes have been shaken to their foundations throughout the EU.

The Court issued some landmark and far-reaching decisions thanks to much relaxed approach to the issue of comparability between residents and non-residents. The Schumacker doctrine that requires taking into account tax position of a non-resident in the state of residence was not extended to costs directly linked to income or income-generating activity. When confronted with cases concerning the taxation of cross-border payments and denial of costs’ deduction in the source state, the Court was simply stating that a non-resident taxpayer was in a comparable situation to a resident taxpayer who was permitted to deduct directly linked expenses.

The concept of costs directly connected to the activity generating income or the income (payment) itself has been developed in the case law of the Court. The casual economic nexus between expenses and the source or the item of income needs to be established. It may concern both the costs which are absolutely necessary to be borne in order to earn income and costs that are lacking this quality but are still directly related with income-generating activity. In my view this concept of directly linked expenses is largely independent of the definitions formulated in domestic tax laws of the Member States which was confirmed in the decisions in cases Miljoen and others, Schröder and Grünewald. At the same time, it must be admitted that in the decision in cases Commission v Finland and Brisal, the Court referred
to national tax laws of the Member States concerned in order to support its view on the costs in question.

Therefore, the line of the case law is far from being uniform in this respect. The outcomes of the Court cases are also slightly erratic when it comes to definition of the directly linked expenses, especially if the relatively narrow approach presented in the case *Miljoen and others* is taken into account. Future decisions of the Court should definitely bring some clarity in this respect.

Another conclusion drawn in the thesis concerns overhead or indirect expenses. In the light of the *Brisal* case, the concept of directly linked costs should not be equated with the colloquial notion of direct costs. The former category of expenses may include a portion of overheads and indirect costs if a taxpayer is able to prove existence of the direct link between them and a given source or item of income.

Comparability between non-residents and residents was also confirmed as regards the application of income tax rates generally reserved for tax residents. This conclusion remains valid with respect to the progressive tax rates upon necessary adjustments related with the increase of taxable income by tax allowances in accordance with the *Schumacker* doctrine.

As regards the second phase of the restriction test (identification of the less favourable treatment), two contradictory concepts seem to be present in the case law concerning directly linked expenses. The part of the case law, particularly the recent decisions in the *PMT* and *Brisal* cases, clearly suggests that a non-resident taxpayer is discriminated against already when being denied certain deductions of costs. I do not share this view as it ignores potentially advantageous characteristics of a tax regime, especially lower tax rates comparing to tax scale applicable to resident taxpayers. Therefore I find much more convincing the alternative approach adopted by the Court in, inter alia, the *Miljoen and others* case. The restriction of the Treaty freedoms
should be established only when a non-resident has been subject to a heavier tax burden than a resident in the comparable situation. Comparison of tax burdens should be made between the final tax in the source state due from a non-resident and the income tax payable by a resident (not just a prepayment in the form of the withholding tax).

Finally, the question of the potentially lower tax rate applicable to non-residents was raised. It may generally compensate for non-deductibility of costs, however the positive outcome in this respect may be difficult to achieve at least in the case of corporate taxpayers. The trend of falling CIT rates in many Member States is noticeable, therefore the difference between them and the lower rates applicable to non-residents may be not large enough to mitigate the restrictions on the deductibility of costs.

For the same reason, an attempt to neutralise less favourable treatment through ordinary tax credit in the state of residence may be unsuccessful. The amount of the maximum deduction therein is affected not only by the applicable tax rate but also deductions available to a resident taxpayer. Nonetheless, contrary to some interpretations of the Court’s case law, the full credit should not be a prerequisite for neutralisation of the less favourable treatment. The ordinary credit method may still prove to be as effective, although, it should be determined on the case-by-case basis.
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