

CHAPTER 3

THE SCOPE OF APPLICATION OF DIRECTLY APPLICABLE COMMUNITY LAW ON THE FREE MOVEMENT OF PERSONS AND INCOME TAXATION

3.1. Applicability of the Treaty Articles on free movement of persons to income tax cases

A first series of questions in our normative framework relates to the scope of application of Community law. Logically, we first need to know whether the Treaty Articles are at all capable of affecting income tax measures or whether income taxation is an area of exclusive domestic jurisdiction that remains unaffected by directly applicable Community law (sovereignty exception - section 3.2). Once this issue is settled, more traditional questions arise concerning the material scope of the free movement provisions (limited to economic activities⁵⁵⁵ – section 3.3 – that cross intra-Community borders, section 3.4) as well as their personal scope (limited to Community nationals who have exercised their right to free movement⁵⁵⁶ – section 3.5). In addition, following entry into force of the Maastricht Treaty, the question arises of whether the principle of subsidiarity could serve as a basis for the European Court deciding to abstain from interpreting the directly applicable Treaty provisions concerning the internal market in a way that jeopardizes the tax sovereignty of the Member States (section 3.6).

Before embarking on these questions, a preliminary remark is in order about the fact that the EC Treaty makes a distinction between the free movement of goods, persons, services and capital, for which the applicable rules vary slightly. A question thus arises about which of the four freedoms a particular cross-border economic activity must qualify under.⁵⁵⁷ Whereas the distinction between movement of persons as opposed to goods is relatively straightforward, it may not always be easy to distinguish between the movement of persons (workers and establishment) on the one hand and the movement of services and capital on the other hand. With regard to the distinction between the free movement of workers and services, for instance, the Court had to decide whether workers who cross a border to perform an activity in the framework of a temporary service contract concluded by their employer exercise their right of free movement or whether the entire economic activity, including the work performed by the workers, is governed by the Treaty provisions on the free movement of service.⁵⁵⁸ Likewise, the Court decided

⁵⁵⁵ When a particular situation does not fall under the free movement provisions for lack of economic substance, but nevertheless falls within the scope of application of the Treaty, the general prohibition of discrimination of Article 6 ECT (now Article 12 ECT) applies.

⁵⁵⁶ Member States are, in the present state of Community law, allowed to discriminate against their own nationals who have not exercised their right to free movement and against third-country nationals, who cannot invoke Community law.

⁵⁵⁷ It is recalled that the Treaty's general prohibition of discrimination on grounds of nationality applies independently only to situations governed by Community law for which the Treaty lays down no specific non-discrimination rules. Case 305/87 Commission v. Greece [1989] ECR 1461 (points 12 and 13). Case C-22/98 Becu and others [1999] ECR not yet reported (point 32), as confirmed in the Court's income tax case law, including Halliburton (point 12), Royal Bank of Scotland (point 20), Vestergaard (points 16 and 17) and Baars (points 23 to 25).

⁵⁵⁸ Joined Cases 62 and 63/81 Seco [1982] ECR 223.

that the distinction between establishment and movement of services depends on whether or not the economic activity concerned is carried out from a durable presence in the country in which the services are supplied.⁵⁵⁹

Particularly interesting for this research is the distinction between the Treaty Articles on free movement of persons and capital. Whereas both sets of provisions are directly applicable⁵⁶⁰ and likely to be interpreted by the Court in a similar way, there are a number of differences that are important. First, the Treaty Articles on capital are restriction-oriented in their wording, whereas those on persons are restriction-oriented by Court interpretation, which means that the Court has the discretion to apply a discrimination-based reading of the Articles on free movement of persons when it considers it desirable (see chapter 4). Second, the distinction is important in the tax area, because the Treaty Articles on capital contain exceptions that are not found in the Treaty Articles on persons.⁵⁶¹

As regards workers, the question of whether the tax treatment of wages resulting from a cross-border employment activity should be tested against the provisions on persons or on capital has, at least implicitly, been answered by the Court in its income tax case law concerning migrant or frontier workers (Biehl, Bachmann, Werner, Schumacker, Wielockx, Asscher, Gilly, Gschwind). In all of these cases, the Treaty provisions on free movement of persons were at the centre of the Court's decision.⁵⁶² Less evident, on the other hand, is the relationship between the Treaty's establishment provisions and those concerning the free movement of capital. Looking at the wording of the Treaty, the provisions on freedom of establishment seem to cover only partly the elements necessary to realize an investment across borders. In theory, establishment of a practice or an enterprise in another Member State may involve movement across the border of goods (machinery and equipment), persons (professionals and workers), know-how (industrial and intellectual property) and capital (shares or loans). The freedom of establishment provisions clearly do not cover the cross-border transfer of machinery or equipment, as these are governed by the Treaty Articles on the free movement of goods. Likewise, the establishment provisions do not cover the cross-border movement of employees, as Articles 48 to 51 ECT (now Articles 39 to 42 ECT) are applicable. Establishment provisions may, however, cover the cross-border movement of corporate management.⁵⁶³

⁵⁵⁹ Case 205/84 Commission v. Germany (insurance) [1986] ECR 3755.

⁵⁶⁰ For a long time, the distinction between establishment and capital movements was crucial, as the Treaty provisions on establishment were directly applicable whereas those on capital movements were not. Since the Maastricht Treaty, however, that difference has disappeared as its Articles on the free movement of capital are directly applicable.

⁵⁶¹ Article 73d para 1 ECT (now Article 58 ECT) confirms the right of Member States to apply tax laws that distinguish between taxpayers who are not in the same situation with regard to their residence or the place where their capital is invested.

It also allows Member States to take measures that prevent infringements of national laws or that are justified on grounds of public policy or security.

⁵⁶² In Bachmann, however, questions also arose concerning the free movement of capital.

⁵⁶³ In Asscher, the Court confirmed that the director of a company qualified under the Treaty provisions on professionals, rather than under those on workers.

The question, moreover, arises as to the extent to which financial flows connected with establishment are governed by the provisions on freedom of establishment or by the provisions on the free movement of capital. In theory, the distinction between freedom of establishment and free movement of capital should be easy to make, as the Treaty explicitly provides that the (secondary) right of establishment is subject to the Treaty Articles concerning capital.⁵⁶⁴

In practice, however, it is not always easy to determine the extent to which capital movements that are connected with a cross-border establishment are governed by the provisions on free movement of persons or those on the free movement of capital or even by Article 221 ECT (now Article 294 ECT).⁵⁶⁵ Establishment in the form of a subsidiary, for instance, necessarily implies the "acquisition" of shares and thus the cross-border transfer of capital, in cash or in kind, and, subsequently, the repatriation of dividends and possibly liquidation proceeds. Are those flows governed by the provisions on establishment or those on capital movements? The same questions arise with respect to the creation of a branch and the realization of branch profits.⁵⁶⁶ A clear indication that these capital transfers are governed by the treaty provisions on capital seems to be the fact that they were all listed in the annex to the directives on free movement of capital.⁵⁶⁷ On closer examination, however, that does not necessarily exclude this form of cross-border activity completely from the scope of application of the establishment Chapter, for several reasons. First, the very text of Articles 52 to 58 ECT (now Articles 43 to 48 ECT) explicitly refers to secondary establishment in the form of a subsidiary or a branch and thus seems to apply to all aspects of that cross-border activity. Second, even if capital transfers connected with establishment *stricto sensu* are governed by the Treaty provisions on capital, a discriminatory treatment of those capital flows would indirectly hinder a cross-border establishment and thus be in violation also of the establishment provisions. The Treaty can therefore not reasonably be interpreted as excluding all establishment-related capital flows from the scope of the Treaty Articles on free movement of persons, as such restrictive interpretation might render the freedom of establishment illusory. This conclusion was confirmed by the Court in *Commerzbank and St Gobain*.

An interesting criterion to distinguish between pure capital flows and capital flows that also represent establishment was suggested by Troberg. He submitted that cross-border capital movements that come with "entrepreneurial activity" are governed by the Treaty

⁵⁶⁴ Article 52 para 2 ECT (now Article 43 ECT) provides that the right to take up self-employed activities and to set up and manage undertakings under national conditions is subject to the provisions of the Chapter relating to capital.

⁵⁶⁵ Article 221 FET (now Article 294 ECT) provides: "Member States shall accord nationals of the other Member States the same treatment as their own nationals as regards participation in the capital of companies or firms within the meaning of Article 58 ECT, without prejudice to the application of the other provisions of this Treaty".

⁵⁶⁶ See Everling (1964) at 53 to 55 (para 210 to 213).

⁵⁶⁷ The first and second directives (OJEC 1960 at 921 and OJEC 1963 at 62), as well as Directive 88/361, cover capital movements necessary for the acquisition of assets, the cross-border provision of equity or loan capital, the repatriation of investment income and liquidation proceeds.

Articles on establishment. The Court seems to have been inspired by this distinction in its income tax case law, in particular as regards inter-corporate dividend flows. Whereas it avoided a correct qualification of cross-border insurance premium payments in *Bachmann*, it implicitly treated shareholdings by parent companies in their subsidiaries as governed by the establishment provisions (*Baxter*, *St Gobain*, *ICI*, *XAB-YAB*). In *Baars*, the Court, contrary to a submission by the Dutch government, explicitly held that a 100% shareholding in a company with its seat in another Member State necessarily implies control or management of the company (which are factors connected with the exercise of the right of establishment) and that this undoubtedly brought the shareholders and the cross-border dividend flows within the scope of the establishment provisions (points 18 to 21). In general, it held that a national of a Member State who has a holding in the capital of a company established in another Member State, which gives him definitive influence over the company's decisions and allows him to determine its activities, is exercising his right of establishment (points 22 and 26). Subsequently, in *Verkooyen*, the Court ruled that dividends received by a national of a Member State residing in that Member State from a minority holding of shares in a company whose seat is in another Member State are covered by Community law on capital movements, even though receipts of dividends were, as such, not mentioned by the Annex to Directive 88/361, which refers merely to "participation in new and existing undertakings" and to "acquisition by residents of foreign securities dealt with on the stock exchange" (points 26 to 30). We may thus conclude that active equity investments and the related income flows (dividends, capital gains, liquidation proceeds) are governed by the establishment provisions, whereas passive equity investments and related income flows (dividends, capital gains, liquidation proceeds) are governed by the Treaty Articles on capital and/or Article 221 ECT (now Article 294 ECT).⁵⁶⁸ Though *Troberg* used that criterion only in respect of equity investment, it can be usefully applied to various cross-border capital flows. As such, "active loan investments" (i.e. loans that in one way or another are linked to the exercise of decision-making powers in the receiving entity) and related interest income would constitute establishment. Under the same criterion, even the transfer of intellectual property and the related royalty payments could be qualified as establishment rather than capital flows to the extent that the licensing of the intellectual property creates or is linked to the exercise of managerial influence.

As the Court has not yet clearly decided on the distinction between establishment and capital movements in these latter cases, prudence dictates that we leave open the possibility that, in the future, certain other establishment-related cross-border income flows (interest and royalties) might in specific circumstances be covered by the Treaty provisions on the free movement of persons.

⁵⁶⁸ *Troberg* in *Von der Groe* (1991) at 937 to 940 discusses the problem of cross-border shareholding without establishment as governed by Article 221 ECT (now Article 294 ECT).