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The *Denkavit Internationaal* Case and Its Consequences: The Limit between Distortion and Discrimination?

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1. Introduction

The decision of the European Court of Justice (ECJ) in the *Denkavit Internationaal* case[1] is an important one, which supplements European case law on direct taxation and, more particularly, on the taxation of dividends. Double taxation, whether juridical or economic, has been the subject of several recent ECJ decisions on the treatment of outbound dividends[2] and inbound dividends.[3]

The *Denkavit Internationaal* decision confirms that a State cannot tax dividends paid to a non-resident parent company if an exemption applies to dividends paid to a resident parent company in a comparable situation. The ECJ has considered the effect of double taxation treaties, which constitutes an important aspect of the decision, even if, in practice, it held more specifically that the fact that a tax credit is theoretically available does not remove the discriminatory nature of the withholding tax, since the parent company in the Netherlands could not actually avail itself of the tax credit.

After describing the facts of the case (2.), the author will comment on the principles raised in the decision and its effect in relation to the two matters settled by the Court: Is the French withholding tax on outbound dividends discriminatory within the meaning of Art. 43 EC (3.)? Can a tax credit granted pursuant to a tax treaty eliminate the discrimination existing under national law (4.)? The author will then comment on the practical consequences of the case (5.)

2. Facts of the Case

The case concerned dividends that were distributed by two French companies to their holding company, Denkavit Internationaal BV, a company located in the Netherlands.[4] The dividends were paid between 1987 and 1989, i.e. at a time when the EC Parent-Subsidiary Directive[5] did not yet apply.

The French tax system applies different rules to resident and non-resident parent companies:

– A French shareholder that is eligible under the French participation exemption regime[6] is exempt on the dividends it receives. However, an amount equal to 5% of the dividends, deemed to correspond to costs and expenses relating to the exempt dividends, is not deductible.
– Non-resident shareholders are subject to a 25% withholding tax on the gross dividend. The treaty concluded between France and the Netherlands reduces this withholding tax to 5%[7] and grants a tax credit to Dutch shareholders.[8]
– However, under the Dutch system, dividends are fully exempt and this credit could not actually be used by the Dutch holding company.

Denkavit Internationaal argued that the French system was discriminatory because it granted an exemption to

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1. ECJ 14 December 2006, Case C-170/05, *Denkavit Internationaal BV*. This is in fact the second case involving the Denkavit company; the first one (C-283/94, 17 October 1996) also concerned the treatment of dividends, the application of the EC Parent-Subsidiary Directive and the calculation of the two-year minimum holding period required to benefit from the exemption.
2. ECJ 12 December 2006, Case C-446/04, *TestCclaimants in the FII (Franked Investment Income) Group Litigation ()*.
3. ECJ 12 December 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*.
4. The Dutch entity owned 99.9% of the first subsidiary and 50% of the second subsidiary; the remaining 50% stake was held by the first French subsidiary.
5. Directive 90/435/EEC of 23 July 1990.
6. Arts. 145 and 216 of the French *Code Générale des Impôts* (General Tax Code).
7. Art. 10 of the France–Netherlands tax treaty.
8. Art. 24 of the France–Netherlands tax treaty.

French parent companies, but taxed non-resident parent companies.

The case came before the French Supreme Administrative Court, the *Conseil d'Etat*, after a local Court of Appeals[9] had rejected the company's request on the grounds that the situations of residents and non-residents were not comparable. The French Supreme Administrative Court decided to refer the case to the ECJ[10] and submitted the following three questions for a preliminary ruling:

(1) Is a provision which imposes the burden of taxation on a parent company in receipt of dividends which is not resident in France, while relieving parent companies which are resident in France of a similar burden, open to challenge in the light of the principle of freedom of establishment?

(2) Is such a withholding tax itself open to challenge in the light of the principle of freedom of establishment, or, where a tax convention between France and another Member State authorising that withholding tax provides for the tax payable in that other Member State to be set off against the tax charged in accordance with the disputed system, must that convention be taken into account in assessing the compatibility of the system with the principle of freedom of establishment?

(3) In the event that the second alternative set out [in Question 2] is held to apply, is the existence of the aforementioned convention sufficient to ensure that the disputed system may be regarded merely as a means of apportioning the taxable item between the two States concerned without any effect on the undertakings, or must the fact that a parent company which is not resident in France may be unable to set off tax as provided for by the convention mean that this system must be regarded as incompatible with the principle of freedom of establishment?

3. Is the French Withholding Tax on Outbound Dividends Discriminatory?

3.1. Introductory remarks

The *Denkavit Internationaal* case concerns the freedom of establishment as defined in Art. 43 EC. The decision makes it possible to further clarify the principles established by the numerous decisions that the ECJ has handed down on this fundamental freedom, which requires Member States to treat residents and non-residents equally when they are in a comparable situation. Discrimination has been defined by the ECJ as "the application of *different rules* to *comparable situations*, or the application of the same rules to different situations".[11]

The *Denkavit Internationaal* decision calls for several comments in relation to the ECJ's reasoning on both the comparability of residents and non-residents (3.2. below), and on how to evaluate whether the tax rules applicable to each category were different (3.3. to 3.5.).

3.2. Comparability of situation of residents and non-residents

The ECJ, in the *Denkavit Internationaal* case held that the situation of residents and non-residents is comparable, but this is not an affirmation of principle. As we will see below (in 3.3.), a comparison of the *Denkavit Internationaal* case and the *ACT Group Litigation*[12] case shows that states are not necessarily obliged to grant the same benefits to residents and non-residents, when the non-resident (who is not subject to local taxation and receives no tax credit) is not in a comparable situation to a resident (who is taxable and receives a tax credit) with respect to the law of that state.

The *Schumacker* case[13] was the first case in which the ECJ ruled on this question by holding that "in relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable". More recent decisions[14] have since confirmed that residents and non-residents *may* be in comparable situations if residence creates no objective difference with respect to the applicable rule, and the *Denkavit Internationaal* case is an example of this. In the *Marks & Spencer* case,[15] the ECJ held (Para. 34) that a rule "constitutes a restriction on the freedom of establishment, in that it applies different treatment for tax purposes to losses incurred by a resident subsidiary and losses incurred by a non-resident subsidiary", even if it afterwards mentioned (Para. 37) that "the taxpayer's residence may constitute a factor that might justify a national rule involving different treatment for resident and non-resident taxpayers [...]".

In *Denkavit Internationaal*, the ECJ has confirmed that non-residents cannot be treated differently from residents when there is no "objective difference" (Para. 25) in their situation with respect to the taxation of French-source dividends. Thus, if a state decides to avoid double taxation of income for resident holding companies, the benefit must be enjoyed by resident and non-resident companies that are in a comparable situation.

3.3. Different treatment of residents and non-residents: discrimination or distortion?

In the *Denkavit Internationaal* case, the difference of treatment is regarded as discrimination but the decision should not be interpreted as a general and absolute confirmation that any difference of treatment between residents and non-residents is discriminatory.

The ECJ's decision in *D.*[16] had already shown that this comparability is not absolute. In his Opinion in the *ACT Group Litigation* case, Advocate General Geelhoed makes a distinction between "quasi-restrictions" and "restrictions".

Quasi-restrictions result from distortions of taxation and from the fact that in absence of a harmonized system of direct taxation within the European Union, the coexistence of the various national tax systems may generate unfavourable situations for taxpayers in a cross-

9. Court of Appeals of Nantes, 13 March 2001, N 97-1922.
10. Conseil d'Etat 15 December 2004, No. 235 069.
11. ECJ, 29 April 1999, Case C-311/97, *Royal Bank of Scotland*, Para. 26.
12. ECJ 12 December 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*.
13. ECJ, 14 February 1995, Case C-279/93, *Schumacker*.
14. ECJ, 21 September 1999, Case C-307/97, *Saint-Gobain*; ECJ, 15 July 2004, Case C-315/02, *Lenz*.
15. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer*.
16. ECJ, 5 July 2005, Case C-376/03, *D.*

border context. Such "quasi-restrictions" or "distortions" could be eliminated by the implementation of directives containing, for example, common rules on the elimination of juridical and/or economic double taxation, or on loss relief, but they cannot be removed by the courts. In contrast, real discrimination can be censured by the courts when the situation goes beyond the above distortion.

In the *Denkavit Internationaal* case, France's taxation of non-residents was at issue and the discrimination did not result from the juxtaposition of two national systems, but from the French rules only. This is considered to be discrimination and not a distortion.

In the other case concerning outbound dividends, the *ACT Group Litigation* decision,[17] the ECJ held that it was not discriminatory to grant a tax credit to a resident and to not grant one to a non-resident. The reason is that the United Kingdom did not tax these non-residents (unlike the French situation in *Denkavit Internationaal*), and they were therefore not in a situation comparable to that of residents, who were taxed in the United Kingdom and could consequently utilize the tax credit. Thus, a State must grant resident and non-resident beneficiaries of "outbound dividends" the same tax treatment only if it taxes the dividends paid to these non-residents.

The recent *Kerckhaert* case[18] provides another example of a quasi-restriction that is not condemned by the ECJ. Here, Belgium was taxing inbound dividends and national dividends in the same way (at a rate of 25%) and refused to take into account tax credits for foreign withholding taxes. The situation was not satisfactory for Belgian shareholders investing in foreign shares because there is no elimination of juridical double taxation. There is however nothing in EC law that compels a State to take taxes paid abroad into account and to avoid double taxation. The ECJ consequently decided that such a treatment was not in breach of the EC Treaty. One could argue, however, that the Belgian approach fulfilled the second part of the above-mentioned definition of discrimination given by the Court as "the application of different rules to comparable situations or the application of the same rules to different situations".[19] Hence, a distortion becomes discrimination when it results from the rules of one State, but cannot be attacked under Art. 43 EC when the distortion results from the juxtaposition of two national systems.

3.4. Method of comparing the tax treatment of residents and non-residents

Firstly, it is worth mentioning that in *Denkavit Internationaal,* like in other cases, the comparison is made only with respect to direct taxes paid in France (corporate tax is compared to withholding tax) but the overall taxation of the two companies is not compared (by taking into account other direct or indirect taxes that would be suffered by the Dutch holding company if it were established in France).

Second, the ECJ's comparison – as in all previous decisions – is limited to the tax suffered by the direct shareholder, the parent company, resident or non-resident.

The decision seems logical at first glance, when making the comparison of the treatment of French versus non-resident holding companies. However, the coherence of the comparison made by the court could nevertheless be questioned, and the discrimination could be less obvious if the comparison is not made at the level of the direct shareholder but at a more global level. Indeed, a country like France, which applies a system that eliminates the double taxation of parent companies through exemptions, finds itself forced to apply this exemption to non-resident parent companies, without taking into account the fact that, in most cases, the French parent company is merely an intermediary that redistributes its income. Nevertheless, the dividends distributed in this way by a French parent company can result in tax liability for the shareholder, unless it itself is a parent company eligible for the exemption.

In France, dividends are taxed and economic double taxation of the shareholder is only partially avoided. Until 2003, relief for double taxation was given by means of a tax credit (*avoir fiscal*), although this did not necessarily reduce the entire tax liability of the French shareholder. Following the *Manninen* case,[20] France abolished this tax credit. Today tax is paid on the entire dividend if it is paid to a French resident company that is subject to corporate tax and does not qualify for the participation exemption. For individuals, dividends are taxed at the progressive income tax rate, subject to an allowance of 40%. Therefore, the existence of discrimination is less obvious if one takes into account that the tax on dividends paid to a French parent company is eliminated because, in France, the taxation of the dividends occurs at a later stage.

This observation concerning the coherence of the French system of avoiding double taxation could have been put forward by France either as an argument against the existence of a discrimination or, rather, as a "justification" of a restriction to freedom based on the "coherence" of the national tax system.

Indeed, the ECJ has accepted in the past to take into account the existence of such "justifications" to limit the freedom, based on arguments such as the coherence of the tax system (see below), the control of tax avoidance, or efficiency of tax audits.

Concerning the justification based on "coherence of a tax system", the ECJ accepted this type of argument in the *Bachmann* case[21] in 1992, but it seemed afterwards to take a restrictive view of such a justification in the fol-

17. ECJ, 12 December 2006, Case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*.
18. ECJ, 14 November 2006, Case C-513/04, *Kerckhaert and Morres*.
19. ECJ, 29 April 1999, Case C-311/97, *Royal Bank of Scotland*, Para. 26.
20. ECJ, 7 September 2004, Case C-319/03, *Manninen*.
21. ECJ, 28 January 1992, Case C-204/90, *Bachmann*.

lowing years.[22] Still, the reasoning followed by the Court in the *Marks & Spencer* case relies on a similar justification (Para. 35):

> A restriction is permissible if it pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest. It is further necessary in such a case, that its application be appropriate to ensuring the attainment of the objective thus pursued and not go beyond what is necessary to attain it (Para. 35).

It further holds that (Para. 38) "It is necessary to consider whether the fact that a tax advantage is available solely to resident taxpayers is based on relevant objective elements apt to justify the difference in treatment".

Hence, the approach of the Court seems to be in three steps:

– Are the resident and the non-resident in a comparable situation?
– If yes, is the difference a mere distortion, or are the rules applied by a Member State different and result indiscrimination?
– If yes, are there imperative reasons in the public interest justifying the difference of treatment (a "justification")?

This argument based on the coherence of the French tax system was not used by the French tax authorities, which did not invoke any "justification" to explain the difference in treatment. However, one can see the ECJ's difficulty in taking the entire dividend taxation system into account and the reasons that consequently led it to limit the comparison to the first shareholder, the shareholding parent company, when making the comparison and assessing whether or not discrimination exists.

In this respect, Advocate General Geelhoed has made some interesting comments in his Opinion (Point 62) on the *ACT Group Litigation* case, concerning the appraisal of "fiscal cohesion" by the Court in *Bosal*[23] and *Baars*[24]. In the *Baars* case, the ECJ refused to take into account a "justification" for discrimination based on the "fiscal cohesion" of a tax system (i.e. justifying a difference of treatment by the need to preserve the coherence of a tax system). The ECJ required that a "direct link"[25] exist between the discriminatory rule and its counterpart. No direct link exists, according to ECJ, when fiscal cohesion refers *to different taxes* and *different taxpayers.* This is of course an important limit of this justification based on the "coherence of a tax system", which explains why, in the current state of the ECJ's case law on this restrictive "direct link" criterion, the taxation of French shareholders receiving dividends from an exempt French holding company is not taken into account to make the comparison with the 5% taxation of dividends paid to a Dutch holding company.

3.5. Partial or total exemption of French parent companies

It is useful to discuss the exemption of French parent companies, to which reference is made in the *Denkavit Internationaal* case, in more detail.

The decision refers to the fact that French holding companies benefited from a "partial exemption" and the Advocate General's Opinion also refers to such a partial exemption. If this rule could indeed be interpreted as such, it would have been possible to consider that a French parent company was taxed on 5% of the dividends at a rate of 45% in 1987,[26] thus generating a tax of 2.25% of the dividend paid, i.e. an amount equal to almost one half of the withholding tax of 5% at issue in the case. It is strange that, in its conclusion, the ECJ refers to the fact that France "was allowing resident companies almost full exemption", without taking into account the partial taxation that that implies when making comparison between the taxation of a French and Dutch holding company. The Court held that even discrimination of minor importance must be removed, but this should then apply to both terms of the comparison between the taxes suffered by the resident and by the non-resident.

In the author's opinion, however, this is a mistaken interpretation of the French legislation,[27] the drafting of which, on this point, closely resembles that of the Directive of 23 July 1990 establishing the parent-subsidiary regime.[28] Indeed, under the French legislation, dividends received by a parent company must be deducted from its taxable income, after being reduced by a charge of 5% of these dividends. Therefore, dividends are actually totally exempt, and as a result, the expenses related to this exempt income are non-deductible.

The 5% charge is merely one way of calculating these non-deductible charges on a lump-sum basis, which is also allowed by the Directive. Under current French rules, these non-deductible expenses may also be valued on a real basis if this method should prove more favourable. However, one has to ask which costs should be taken into account should the company opt for that later "real-costs" method: all expenses borne by the company or only those related to the investment portfolio? The French Supreme Court recently held against the second method.[29] In the same decision, it decided to submit a preliminary question to the ECJ, concerning the calculation of the 5% lump-sum estimation of expenses and whether it should be assessed on dividends including tax credits.

In conclusion, the ECJ's method of comparison (which assumes a total exemption of a French holding company, although it refers to it as a "partial exemption") is justified, to the extent that the 5% lump-sum charge for non-deductible expenses does not result in an effective taxa-

22. See, for example, ECJ, 11 August 1995, Case C-80/94, *Wielockx*, and ECJ, 7 September 2004, Case C-319/03, *Manninen*.
23. ECJ, 18 April 2003, Case C-168/01, *Bosal*.
24. ECJ, 13 April 2000, Case C-251/98, *Baars*.
25. See comments in ECJ, 7 September 2004, Case C-319/03, *Manninen*, Para. 42.
26. The French corporate tax rate in 1987 was 45%, reduced to 39% in 1989; now 33.33%.
27. Arts. 145 and 216 of the French *Code Générale des Impôts* (General Tax Code).
28. Directive 90/435/EEC of 23 July 1990, Art. 4.2.
29. CE, 17 January 2007, No. 262967.

tion of dividends in France. This seems open to discussion when the 5% lump-sum charge results in adding back to the taxable income expenses that are not connected to the shares (this question was not submitted to the ECJ).

4. Can a Tax Credit under a Tax Treaty Eliminate Discrimination under National Law?

The *Denkavit Internationaal* case provides a two-part reply to the question whether a tax credit granted under a tax treaty can eliminate discrimination created by national law.

– First, the decision confirms that tax treaties concluded by Member States must be taken into account when assessing whether or not discrimination exists.
  This question is probably one of the main reasons why the French Supreme Administrative Court referred the matter to the ECJ in its decision of 15 December 2004. Actually, one must remember that shortly before, the EFTA Court in the *Fokus Bank* case,[30] refused to take into account the effect of a tax credit resulting from a tax treaty. The *Denkavit Internationaal* decision overturns the EFTA Court decision in this regard by allowing tax treaties to be taken into account (which incidentally, the ECJ had already accepted in the *Bouanich* case).[31]
– Second, the ECJ pointed out that in the case referred to by Denkavit, the granting of a tax credit under the tax treaty did not actually make it possible to eliminate discrimination since the tax credit in question could not actually be used in the Netherlands, where dividends are totally exempt. Consequently, the ECJ held that the existence of a theoretical tax credit, which is not actually used in the Netherlands, cannot be invoked by France to challenge the existence of a discrimination created by the withholding tax.

In the circumstances of the *Denkavit Internationaal* case, it was easy for the ECJ to settle this point in relation to a dividend paid to a Dutch company, which is totally exempt. In contrast, in the *Bouanich* case, it left it up to the referring court to determine whether or not, in practice, there was an actual difference in tax treatment.

On the basis of the Court's decision, the same solution should apply if income is taxed in the country of residence, but the tax credit cannot actually be used there. In fact, there are many situations in which a tax credit cannot be used in practice, particularly in the case of loss-making companies, which can neither use the tax credit nor obtain a refund from the residence state. In these situations, the source state could be forced to refund the tax withheld (or even not deduct it at all, so that cash flows would not be distorted)?

Further questions may arise when the tax credit can be used in the residence state of the holding company to offset local withholding tax on outbound dividends: can this be regarded as a use of the tax credit?

5. Consequences of *Denkavit Internationaal*

5.1. Outbound dividends and free movement of capital

The case concerned dividends paid prior to the entry into force of the Parent-Subsidiary Directive of 23 July 1990. Today, the effect of this Directive is to abolish withholding tax on outbound dividends to companies that hold a qualified minimum stake in the distributing company. This deprives the *Denkavit Internationaal* case of any practical application as far as these companies are concerned.

The Directive's threshold to benefit from the exemption was initially 25%, subsequently reduced to 20%, then to 15% in 2007, and will be reduced to 10% in 2010. Critics will not fail to remark that, in practice, the *Denkavit Internationaal* case greatly reduces the usefulness of the Directive, the drafting and implementation of which were long and arduous. The Directive nevertheless established the minimum basis on which Member States had to eliminate double economic taxation, both for residents and non-residents. France has applied a minimum threshold of 5% for its residents to benefit from the parent-subsidiary exemption, which is lower than the threshold provided by the Directive. It must also apply this more favourable threshold to the non-resident parent companies in the European Union.

One question still remains as to whether or not withholding taxes may be applied in cases not covered by the Directive. To give an example, may withholding tax apply to distributions to shareholders that do not attain the threshold provided for in the Directive (25% or 10%, depending on the year in question)? Also, may they apply to other types of non-resident shareholders that are not exempt and are consequently subject to a withholding tax generally between 10% and 15% depending on whether a treaty applies (this requires that the beneficiary may be regarded as a "resident" for treaty purposes, which is not always the case) and on the clauses it contains.

Thus, in the case of a non-resident parent company that holds a stake of 15% and that received a dividend in 2006, it will be subject to a withholding tax in France that, depending on the tax treaty applied, will be between 10% and 15%. In contrast, a French parent company holding more than 5% would be exempt.

Could such a company invoke the principles laid down by the *Denkavit Internationaal* decision in order to challenge this withholding tax if it cannot use the tax credit in its residence state? Unlike the situation in the *Denkavit Internationaal* case, such an action could not be founded on Art. 43 of the EC Treaty, which concerns the freedom of establishment and applies to branches and controlled subsidiaries,[32] but would not apply to a stake

30. EFTA Court, 23 November 2004, Case E-1/04, *Fokus Bank*.
31. ECJ, 19 January 2006, Case C-265/04, *Bouanich*.
32. See Opinion Advocate General Geelhoed in the *ACT Group Litigation* case, Point 27 :"The Court has consistently held that a company established in one Member State with a holding in the capital of a company established in

of 15%. However, Art. 56 EC, which guarantees the free movement of capital, could be relied on. With respect to this freedom, Art. 58(a) EC gives more latitude to Member States in distinguishing between the situation of residents and non-residents. Nevertheless, it seems that the ECJ does not wish to interpret differently the principles applicable to the freedom of establishment (Art. 43 EC and relied on by Denkavit) and those applicable to the free movement of capital.[33] This was recently confirmed in several decisions: *Manninen*, *Bouanich* and *Meilicke.*[34] The Opinion of Advocate General Geelhoed in the *ACT Group Litigation* (Point 27) concerning the respective scope of Arts. 43 and 56 EC also makes it clear that the principles applied in the *Denkavit Internationaal* case should apply in the same way under Art. 56 EC. Art. 56 seems therefore to be a solid basis on which an EU company owning more than 5% of a French distributing company could challenge the French withholding tax.

The scope of the free of movement of capital is in some ways broader than that of the freedom of establishment, since Art. 56 EC also covers movements of capital involving third countries. However, Art. 57 EC limits the effect of Art. 56 EC by excluding from its scope "any restrictions which exists on 31 December 1993 under national or Community law adopted in respect of the movement of capital to or from third countries involving direct investment [...]". The question of the application of Art. 56 EC to the treatment of inbound dividends from a third-party state has been submitted to the ECJ with regard to the Swedish tax regime.[35]

Other situations could potentially give rise to debate: for example, the situation of non-profit associations, which in France are exempt from corporate tax on dividends (but on dividends originating in France only, which, incidentally, could also be challenged), whereas a non-resident non-profit association is subject to withholding tax. Similarly, one could wonder about the situation of SICAVS, which are exempt from corporate tax in France (taxation is made at an upper level, see above discussion in 3.4.), whereas a foreign SICAV would be subject to withholding tax on its French-source dividends.

5.2. The future of withholding taxes

It is evident that the decisions of the ECJ are making it more and more difficult for Member States to levy withholding taxes. As we saw above, the *very principle* of such taxes can be challenged when non-residents are subject to a withholding tax and residents are exempt (*Denkavit Internationaal* case). Withholding taxes can also be challenged with regard to the calculation of the *taxable base* since they are levied on gross income, whereas a resident is more often taxed on the basis of net income.[36]

The *timing* of withholding taxes is also likely to come under attack, since in most cases non-residents have to pay up earlier than residents do, yet as the *Denkavit Internationaal* decision specifies "a restriction on freedom of establishment is prohibited [...], even if it is of limited scope or minor importance". The issue of the timing of payment of the tax has already been examined in the past, in the *Metallgesellschaft Hoechst* case,[37] but also more recently in the *Marks & Spencer* case (Para. 32 of the decision).

6. Conclusions

In principle, Member States are responsible for direct taxation and the number of directives in matters relating to direct taxation remains very limited. Nevertheless, in the past ten years Community cases have contributed to the formation of a body of rules, founded on the great principles of liberty as laid down by the Treaty, namely the freedom of establishment, the freedom to provide services, the free movement of workers and, somewhat more recently, the free movement of capital.

One can see the difficulty of building a coherent tax system on the basis of the ECJ's decisions, as long as real harmonization based on an EC directive does not exist. The accumulation of these decisions allows some taxpayers to obtain a more favourable treatment, but sometimes to the detriment of the cohesion of the national tax system, since the ECJ has taken a restrictive stance concerning the situations in which such cohesion should be protected. The *Marks & Spencer* decision gave a signal that the ECJ's views might evolve, but the Court limited the effect of this "cohesion approach".[38] At the same time, the ECJ acknowledges that it cannot condemn a country which taxes national dividends and foreign inbound dividends in the same way and which refuses to avoid juridical double taxation by granting a tax credit on foreign inbound dividends.[39] This falls in the category of "tax distortion" or "quasi-restriction", which the ECJ refuses to challenge, and the tax sovereignty of the Member States still prevails in this case.

It would be unfair to blame the ECJ for playing its role, which is to address specific questions put to it, and not to build a harmonized system by itself. Still, it remains uncertain whether in the end, this exercise will result in a satisfying system and whether the Member States, taking into account the

another Member State which gives it 'definite influence over the company's decisions' and allows it to 'determine its activities' is exercising its right of establishment.", and ECJ, 13 April 2001, *Baars,* C-251/98. See also ECJ, 17 September 2006, Case C-470/04, *N*.

33. See ECJ, 6 May 2000, Case C-35/98, *Verkooijen*.

34. ECJ, 7 September 2004, Case C-319/02, *Manninen*; ECJ, 19 January 2006, Case C-265/04, *Bouanich*; and ECJ, 6 March 2007, Case C-292/04, *Wienand Meilicke*.

35. Case C-102/05, *A and B v. Skatteverkett,* pending.

36. See, for instance, ECJ, 12 June 2003, Case C-234/0,1 *Gerritse*; ECJ, 19 January 2006, Case C-265/04, *Bouanich*; ECJ, 3 October 2006, Case C-290/04, *FKP Scorpio*.

37. ECJ, 8 March 2001, Case C-397/98, *Metallgesellschaft*.

38. See the comments on the *Marks & Spencer* case in the Opinion of Advocate General Geelhoed in *ACT Group Litigation*, Point 65.

39. ECJ, 14 November 2006, Case C-513/04, *Kerckhaert and Morres*.

ECJ's restrictive approach on the "cohesion of the tax system", will not be tempted to take a conservative view, which could end up working against taxpayers.

Another important limit of this case law approach versus a legislative approach is, of course, that non-residents are protected against discrimination but residents are not, as the French Supreme Court[40] recently recalled: residents have no recourse if they are treated in a worse way than non-residents in their state of origin. In other words, the freedom not to move is not protected. In the absence of harmonization and given the diversity of Member State's tax policy, one could argue that the solution for an unhappy taxpayer may be to exercise his freedom of movement, hoping not to be taxed upon exit, which initially would have appeared to be forbidden[41], but which now seems possible under some conditions.[42]

This case law approach has proven to be an effective tool against discrimination and the various Administrations have integrated it to adapt their legislation, concerning for example tax relief, tax avoidance and elimination of double taxation. Still, it could be regarded in some respects as an incentive to tax arbitrage by taxpayers in the European Union, partly due to the ECJ's restrictive approach to arguments related to the coherence of tax systems. The current state of the case law leaves the door wide open to interesting litigation and claims by European, and at some stage non-European, taxpayers. Is this good or bad news? Each reader will have his own answer.

40. CE, 17 January 2007, No. 262967.
41. ECJ, 11 March 2004, Case C-9/02, *Lasteyrie du Saillant*.
42. ECJ, 17 September 2006, Case C-470/04, *N*.

