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Non-discriminatory Income Taxation of Non-resident Taxpayers by Member States of the European Union: A Proposal

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NON-DISCRIMINATORY INCOME TAXATION OF NON-RESIDENT TAXPAYERS BY MEMBER STATES OF THE EUROPEAN UNION: A PROPOSAL

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PREFACE

This contribution to the debate focuses on a subject that Michael Graetz has expressly left open: The application of the concepts of fairness and reciprocity to the taxation of non-residents in light of the increasing mobility of individuals. This mobility has become particularly important with respect to smaller countries that are in geographic proximity of one another such as the Member States of the European Union (EU). Discriminatory tax treatment by both source countries and residence countries in dealing with cross-border income of individuals is widespread and clearly has a restrictive effect on such mobility.

After an introductory paragraph, an overview is given on the various levels at which discriminatory tax treatment occurs, followed by a proposal to overcome such differential treatment in a world—and certainly in an economic and monetary union such as the European Union—where disparities among tax systems are large.[1]

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1. This proposal is based on a contribution the author wrote in 1997 for the Liber Amicorum for Jean-Pierre Lagae (CED, SAMSON, Diegem [Belgium] 1998) under the title "Niet-discriminerende belastingheffing van beperkt belastingplichtigen door EU-lidstaten" (Non-discriminatory taxation of non-resident taxpayers by EU Member States).

I. INTRODUCTION

In its 1995 decision in *Wielockx*[2] the Court of Justice of the European Communities (EC Court or Court) observed that, "[A]lthough direct taxation falls within the competence of the Member States, the latter must none the less exercise that competence consistently with Community law and therefore avoid any overt or covert discrimination by reason of nationality."[3]

In other words, while the income tax law among the EU Member States hardly has been harmonized, it must meet the requirements regarding non-discrimination laid down in the EC Treaty rules on the fundamental freedom of movement. These rules went largely unnoticed by the Member States' legislators and executives until 1986. In May 1986, the EC Court issued its first decision on the compatibility of a domestic income tax rule of an EU Member State with the fundamental freedom of movement provisions of the EC Treaty. Since that time, the Court has rendered over 20 decisions on that issue. About half of these decisions deal with the question of whether the tax treatment of non-resident taxpayers, as compared to resident taxpayers, meets the non-discrimination standards of the freedom of movement provisions of the EC Treaty.

The EC Treaty contains the following fundamental freedom provisions that are relevant in income taxation:

Article 39: Freedom of cross-border movement of employees.
Article 43: Freedom of cross-border establishment of businesses.
Article 49: Freedom of cross-border rendering of services.
Articles 56-58: Freedom of cross-border movement of capital and payments.

In the first two provisions the freedom of movement is defined expressly as including a prohibition to discriminate on the basis of nationality. With regard to the two latter types of provisions the EC Court has ruled that, since nationality-based

2. Case C-80/94, G.H.E.J. Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. I-2508.
3. *Id.*

discrimination effectively restricts cross-border movement, these provisions equally forbid such discrimination.

It should be noted that, while "nationality" generally is not used by EU Member States as a relevant criterion in the taxation of individuals, the EC Court has interpreted the Treaty's prohibition on discrimination on the basis of nationality as forbidding not only overt discrimination on the basis of nationality, but also covert forms of such discrimination. In its *Schumacker* decision,[4] the Court ruled that differential treatment of non-resident taxpayers as compared to resident taxpayers may amount to a covert form of nationality discrimination:

> [N]ational rules . . . , under which a distinction is drawn on the basis of residence in that non-residents are denied certain benefits which are, conversely, granted to persons residing within national territory, are liable to operate mainly to the detriment of nationals of other Member States. Non-residents are in the majority of cases foreigners.[5]

The pattern that arises from the various decisions by the EC Court on the tax treatment by source states of non-resident taxpayers is not entirely coherent. In the following paragraphs these decisions briefly will be analyzed and a proposal will be discussed for cohesive non-discriminatory income taxation of non-resident taxpayers.

II. THE ELEMENTS IN THE COMPUTATION OF INDIVIDUAL INCOME TAX LIABILITY

In most countries an individual's income tax liability is computed by taking into account the following elements:

(a) Items of gross income reduced by pertinent expenses;
(b) Personal deductions, *i.e.*, deductions that are related not to items of income but to the personal circumstances of the taxpayer himself and his family (*e.g.*, medical expenses, alimony payments, charitable contributions); and,
(c) Tax rate.

4. Case C-279/93, Finanzamt Köln-Altstadt v. Roland Schumacker, 1995 E.C.R. I-249.
5. *Id.* at I-259.

The total amount of the gross income items minus pertinent expenses (*a*) is reduced by the total amount of the personal deductions (*b*). To the resulting amount the tax rate (*c*) is applied. In the paragraphs that follow each of these elements briefly is discussed.

III. GROSS INCOME ITEMS AND DEDUCTIBLE (BUSINESS) EXPENSES

The EC Court has not yet decided any case that directly deals with the issues: (1) whether a source country may tax a non-resident taxpayer on items of income in respect of which residents of that country are not taxed (*e.g.*, non-business capital gains, in respect of which in a given country resident individuals are not subject to tax, are taxed to non-resident individuals that derive such a gain); and, (2) whether a source country may deny to a non-resident taxpayer a (business) deduction in respect of a given item of income to which a resident taxpayer is entitled (*e.g.*, while resident employees are entitled to a deduction for commuting expenses, frontier workers who are resident of the other country are denied such a deduction).

While there is indeed no precise case on point, from the Court's decision in *Avoir fiscal*,[6] it may be derived that the Court interprets the EC Treaty's freedom rules as indeed requiring equal treatment of non-resident and resident taxpayers with regard to both the taxable items of income and the deductibility of expenses. The *Avoir fiscal* decision dealt with the denial by France of the imputation credit that it grants to its resident (corporate and individual) shareholders, to a company that was a resident of Italy and that operated in France through a permanent establishment whose business capital included the French shares concerned. The Court ruled that:

> Since the rules at issue place [resident] companies and [non-resident] companies on the same footing for the purposes of taxing their profits, those rules cannot, without giving rise to discrimination, treat them differently in regard to the grant of an advantage related to taxation such as shareholders' tax credits.[7]

6. Case 270/83, Commission of the EC v. French Republic, 1986 E.C.R. 285.
7. *Id.* at 305.

It must be acknowledged that France, unlike most countries, does not subject resident companies to tax in respect of foreign source income. Strictly speaking, there is, therefore, no difference between the income in respect of which resident companies and non-resident companies are liable to tax. In effect, however, the denial of the imputation credit to non-resident shareholders results in a taxation of non-resident taxpayers with respect to a given item of income that is less favorable than the taxation of resident taxpayers on the same type of income. It, therefore, seems that the *Avoir fiscal* decision provides a strong indication of the Court's feeling vis-á-vis cases in which items of income of gain of non-resident taxpayers are subjected to less favorable taxation than such income and gains that are in the hands of residents.

Where dividends, interest, and royalties are concerned (and in some states also other items of income) that typically are taxed to non-residents on a gross basis (and at a flat rate), the Court may take a different approach. By not taxing such items on a net basis as is done where resident taxpayers are concerned, discrimination arises in cases where the amount of tax that would be due under a net basis is lower than the gross-basis tax.

IV. PERSONAL DEDUCTIONS

In its *Schumacker* and *Wielockx* decisions, the EC Court ruled that a source state must grant personal deductions to non-resident taxpayers if they derive their worldwide income "entirely or almost exclusively" from sources in that country.[8] The Court based its decision on the reasoning that such taxpayers cannot effectuate their personal deductions in their residence state in the absence of (adequate) income from that country. These decisions are in line with the 1993 Recommendation of the EC Commission that non-resident taxpayers, who derive at least 75 percent of their worldwide income from the source country, are entitled to taxation by that country on equal footing with resident taxpayers.

By restricting its ruling to taxpayers who derive all, or

8. Case C-279/93, Finanzamt Köln-Altstadt v. Roland Schumacker, 1995 E.C.R. at I-263; Case C-80/94, G.H.E.J. Wielockx v. Inspecteur der Directe Belastingen, 1995 E.C.R. at I-2515.

virtually all, their income from a country other than their country of residence, it left unrelieved all cases where a taxpayer derives all, or virtually all, of his worldwide income from more than one non-residence state, as well as cases where the fraction of a taxpayer's foreign income is lower, but still too high to be able to obtain full relief in his residence country. Unlike the Court's (probable) treatment of items of gross income and related expenses[9] the Court's rulings on personal deductions fall short of providing adequate relief.

V. TAX RATE

The first case decided by the EC Court of Justice, on possible discriminatory application of tax rates, was *Biehl*.[10] The case did not concern the taxation of a non-resident taxpayer but of a person ("Mr. Biehl") who was a resident of Luxembourg for only a part of the taxable year concerned. The issue was whether, in determining which rate of the progressive tax rate structure should be applied to the taxpayer's monthly salary, Luxembourg was allowed to refer to the income that the taxpayer would have earned in the entire taxable year (12 months), while the given individual earned his monthly salary only during a period of 10 months. This issue has some similarity to the question whether, with regard to the taxation of non-resident individuals, a source country may determine the applicable individual income tax rate on the basis of the worldwide income of the non-resident taxpayer rather than on the income this person derives from the source country only.[11]

In its *Biehl* decision, the Court ruled that to determine the appropriate tax rate, Luxembourg only may take into account the income the taxpayer earned during the part of the year that he lived and worked in Luxembourg. On the basis of this ruling it may be concluded that also the country to which the taxpayer moved from Luxembourg (*i.e.*, Germany) would be allowed, in determining the applicable tax rate, to take into account only the income earned in that country. As a result, Mr. Biehl would not only pay a lower effective tax on the in-

9. *See supra* Part III.

10. Case C-175/88, Biehl v. Administration des Contributions of the Grand-Duchy Luxembourg, 1990 E.C.R. I-1779.

11. This issue was addressed by the Court in the *Asscher* case, discussed *infra*.

come earned in his first residence country (Luxembourg)—in comparison to a taxpayer that earns during the entire taxable year the same amount of income as Mr. Biehl earns in the first and second country combined—but Mr. Biehl also pays less tax in his new residence country (*i.e.*, Germany) than a full year resident of that country would pay on the same monthly income earned during the months that Mr. Biehl resides and works in Germany. As a result of the Court's ruling, Mr. Biehl is treated *by each of the two countries* more favorably than either a Luxembourg or a German resident taxpayer who earns exactly the same monthly salary in the given year as Mr. Biehl does.

A few years later the Court took the same approach in the *Asscher* case.[12] This case did not concern a person who was a resident of an EU Member State during only part of the taxable year as in the *Biehl* decision, but a person who received a part of his income from sources in one EU Member State (the Netherlands) a resident of another EU Member State (Belgium) where he also derived income. In the year under consideration, the Netherlands applied a 25% rate to the first bracket of income instead of the 13% rate that was applicable to resident taxpayers. One of the arguments forwarded by the Netherlands was that non-resident and resident taxpayers are, with regard to rate application, not in the same position because the tax rate to which resident taxpayers are subject in respect of their Netherlands-source income is upwardly adjusted by the amount of their foreign income with respect to which they are entitled to an exemption from Dutch taxation. It, therefore, should be considered non-discriminatory if, in determining the tax rate at which non-resident taxpayers are subject to Dutch taxation, non-Dutch income is taken into account. (It should be noted, however, that rather than effectively requiring non-residents to report their foreign source income for purposes of establishing the applicable tax rate, the Netherlands simply applied a somewhat higher first bracket rate than it applied to resident taxpayers.)

The EC Court ruled that the Netherlands may not apply to non-resident taxpayers a higher tax rate than it applies to

12. Case C-107/94, Asscher v. Staatssecretaris van Financiën, 1996 E.C.R. I-3089.

resident taxpayers in order to take into account that the nonresident may have received items of income from other countries. It is not known, of course, whether the Court would have decided differently if the source state (the Netherlands) would have applied to non-resident taxpayers not a generally applicable approximating rate but, on a case-by-case basis, a rate based on the worldwide income of the nonresident taxpayers (as, for example, Switzerland does). From the Court's approach in the *Biehl* case, however, it does not seem likely that the judgment would have been different. The *Asscher* ruling itself provides an indication for such a conclusion. The ground for the Court's decision appears not to be the general applicability of a higher rate (instead of an application on a case-by-case basis), but the (incorrect) belief of the Court that, since Belgium as a residence country provides an exemption with progression, there is no need for the Netherlands to take into account in determining the applicable tax rate the income derived by the taxpayer from sources in Belgium or third countries.

> According to the Netherlands Government, the higher rate of tax is intended to offset the fact that certain non-residents escape the progressive nature of the tax because their tax obligations are confined to income received in the Netherlands.
>
> It must be noted that, under Article 24(2)(1) of the [tax treaty between the Netherlands and Belgium], modelled on Article 23A(1) and (3) of the OECD Model Convention (exemption with maintenance of progressivity), income received in a State in which the taxpayer pursues an economic activity but does not reside is taxable exclusively in that State and exempt in the State of residence. The State in which the taxpayer resides may nevertheless take that income into account in calculating the amount of tax on the remaining income in order, inter alia, to apply the rule of progressivity.
>
> The fact that a taxpayer is a non-resident thus does not enable him, in the circumstances under consideration, to escape the application of the rule of progressivity.[13]

In other words, the Court believes (again, incorrectly) that since Belgium as the residence country takes into account the

13. *See id.* paras. 46-48.

Netherlands source income in determining the appropriate tax rate on the Belgian part of the income, there is no need for the Netherlands to do the same in respect of the Netherlands part of the income. The Court thus demonstrates a complete lack of understanding of the operation of "exemption with progression" as applied by many exemption countries in determining the amount of double taxation relief.

A simple example may illustrate the foregoing. Let us assume that both EU Member States R(esidence) and S(ource) apply in their individual income taxes the following rate structure: On the first income slice of 10 the tax rate is 0% (tax on this slice amounts to 0). On the second income slice of 10 the tax rate is 10% (tax on this slice amounts to 1). On the third income slice of 10 the tax rate is 20% (tax on this slice amounts to 2). On the fourth income slice of 10 the tax rate is 30% (tax on this slice amounts to 3). On the fifth income slice of 10 the tax rate is 40% (tax on this slice amounts to 4).

The tax due by a State R resident, who has income of 50 that is entirely derived from sources in State R, therefore amounts to 0 + 1 + 2 + 3 + 4 = 10. (The same is true for a resident of State S who receives income amounting to 50 from sources in State S). If the State R resident derives of his worldwide income of 50, an amount of 20 from sources in State S, and State R relieves double taxation through "proportional tax exemption" (often, imprecisely referred to as "exemption with progression") State R will compute the amount of the tax reduction as follows: 20/50 x 10 = 4, indeed resulting in tax to be paid of 10 – 4 = 6.

It will be clear that if State S, which is assumed to apply exactly the same tax rates as State R, will subject the income that is sourced in State S (20) to a tax of 4 only if it would take into account in determining the applicable tax rate not only the 20 of income derived from sources within its territory, but also—as Switzerland does—the 30 income from State R, and computes the amount of tax by deducting from the tax computed in respect of the worldwide income of 50 (10), that part of the tax of 10 that refers to the income derived from sources in State W (30/50 x 10 = 6), resulting in a tax to be paid to State S of 10 – 6 = 4.

Instead of having State S apply such an "exemption with progression," an equitable result also would be obtained if State R would apply an "exemption at the bottom," *i.e.*, reducing its tax computed on the basis of the worldwide income by that part of such tax that would have been imposed on income that the taxpayer derives from the source country (*i.e.*, 1). In this approach State R would compute the tax to be paid as follows: 10 – 1 = 9.

The problem, illustrated in the preceding paragraph, with the divergence between the taxation by the source state and the relief granted by the residence state, is not so much the difference in the tax amounts as such (such difference will always arise where states apply different tax rates and compute taxable income differently), but the difference in the computation of these amounts: The source state computes the tax at the bottom of the progressive rate scale whereas the residence state provides an exemption at a (higher) average rate reflecting the worldwide income. The same phenomenon may occur when the residence state applies the foreign tax credit, namely when the limit on the credit ("*ordinary* credit") is computed through a proportional allocation of the domestic tax to the foreign income and this limit applies in the given case, while the source country applies its tax rate without taking into account any income the taxpayer receives from sources elsewhere.

VI. PROPOSAL

The various issues that have been highlighted in the preceding paragraphs can be solved if each of the EU Member States, from which a non-resident individual derives income, treats this individual *pro rata parte* with regard to the taxable items of income and related deductible expenses, the personal deductions, and the tax rate on the same footing with a resident taxpayer. At the same time, the residence state of this individual should restrict his right to personal deductions to that fraction thereof that is equal to the fraction: aggregate amount of income items derived from sources in his residence State divided by worldwide income.

Source States can effect such a *pro rata parte* approach only if they have at their disposal the necessary information with regard to the amount of income the non-resident taxpayer derives from sources abroad, along with the data required for computing his personal deductions. Because both types of information are not available in the source country, and need to be provided by the taxpayer, the source state may want to be able to verify such data. The EC 1977 Directive on Mutual Administrative Assistance provides the means to verify the information produced by the taxpayer. It is clear, however, that the administrative burden for the source state in making such verification is relatively great. It, therefore, seems preferable to restrict the application of the *pro rata parte* approach to instances where the taxpayer so requests (*i.e.*, makes such a request to *all* (source) states from which he derives income) and, in the absence of such a request, to permit the source states: (a) to tax capital income (and perhaps employment income as well) on a gross basis; (b) not to permit personal deductions; and, (c) to apply tax rates, the lowest of which is higher (*e.g.*, 30%) than the lowest rate applicable to resident taxpayers.

The *pro rata parte* approach by the source State implies that this State first determines the taxable income of the pertinent non-resident taxpayer fully in accordance with the rules that apply to residents of that State. The tax computed on the basis of that income subsequently will be restricted to that part thereof that is determined by the fraction: Net income from sources in the source state divided by net worldwide income. Both the numerator and the denominator of this fraction are determined on the basis of the tax law of the source state. Consequently, a taxpayer who is a resident of one EU Member State and who receives, in addition to income from sources in the residence state, income from two other EU Member States, and who opts for taxation by the source states on a *pro rata parte* basis, needs to compute his worldwide income under as many tax systems as there are EU Member states from which he derives income. The denominator of the fraction (the amount of the worldwide income), therefore, will differ from country to country. In this "slice of the pie" approach, the various slices will not, as a result of the existing differences among the tax systems of the individual states, jointly form a nice round pie. Given the differences among the tax systems, however, this approach represents the highest possible degree of equal treatment of a non-resident taxpayer with resident taxpayers of each of the countries concerned, because in each source state the non-resident is treated *pro rata parte* on equal footing with resident taxpayers.

An important issue is presented by how much the tax rate that source states may impose on non-resident taxpayers, that do *not* opt for taxation at a *pro rata parte* basis, may exceed the tax rate applicable to resident taxpayers of that state. Apart from the extra effort that the exercise by the taxpayer of the option to be taxed proportionally as a resident taxpayer means for him, his choice whether or not to exercise this option will be guided by any resulting tax savings that the option produces over gross basis taxation by the source state. Such saving may occur on the one hand as a result of the difference between the gross and the net amount of the income, and on the other hand because of the difference between the regular tax rate and the flat rate that is applied to non-opting non-residents.[14]

VII. CONCLUSION

In the proposal described in the preceding section, various questions that will arise upon closer examination of the approach suggested, have not been addressed. The aim of presenting the proposal in its current rudimentary form is to suggest better approaches to equitable treatment of non-resident taxpayers than are currently available under the domestic tax law of any country. The increasing mobility of individuals and the rising awareness of the unfairness of existing inatory tax practices by the states in dealing with cross-border income, makes a search for novel approaches in the taxation of such income viable.

14. *I.e.*, the 30% rate that was suggested above.