

What we can expect from the CJEU's decision in X v Staatssecretaris van Financiën (Case C-283/15) with respect to the Schumacker doctrine

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Shaomei Chen (PhD Candidate at International Tax Centre Leiden)

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General

On February 9, 2017, the Court of Justice of the European Union ('CJEU') rendered its decision in the *X v Staatssecretaris van Financiën* ('X'). The case concerned the possibility of applying the *Schumacker* doctrine to a non-resident taxpayer in the situation where he earned almost all his income not in one but in several source states, none of which were his state of residence. In the X case, the taxpayer, resident in Spain, earned 60% of his total taxable income from the Netherlands and 40% from Switzerland. Though he had the option to be taxed as a resident in the Netherlands, he challenged the Dutch tax legislation at issue, under which he could not deduct the negative income generated from his dwelling in Spain against his taxable income in the Netherlands, as being taxed as a non-resident. The question referred to the CJEU is whether the Netherlands, as the source state, is obliged to deduct the taxpayer's negative income from dwelling against his taxable income in the Netherlands, granting him a tax advantage connected to his ability to pay, in view of the *Schumacker* doctrine.

The *Schumacker* (Case C-279/93) as a landmark case established a couple of very well-known rules that may be summarized as follows: (1) in general, it is the state of residence that takes into account the personal and family circumstances of the individual taxpayer as it is in a better position to assess the taxpayer's ability to pay; (2) but in the situation where he obtained all or almost all of his taxable income from a source state, while the state of residence with no significant taxable income was not in a position to grant him the benefits, the source state is required to do so. However, the *Schumacker* case did not deal with the situations where a taxpayer earns his income in several source states instead of only one. Before the X case, there was on-going debate regarding those situations in which the *Schumacker* doctrine may apply.

Compared to the *Schumacker* case, the decision in the X case takes a few steps forward. The CJEU in the X case required the source state to take into account the taxpayer's ability-to-pay in proportion to the share of his income earned within that state even though the taxpayer did not earn all or almost all of his income in a single state, a similar fact pattern to that of the *Schumacker*. It remains to be seen whether this bold approach would be supported by future decisions of the CJEU.

Discrimination

In the *X* case, by referring to *Lakebrink* (Case C-182/06), *Renneberg* (Case C-527/06), and *Kieback* (Case C-9/14), the CJEU first confirmed that deduction of negative income relating to a dwelling located in the taxpayer's Member State of residence formed a tax advantage connected to the taxpayer's personal and family circumstances (CJEU, C-283/15, *X*, para. 26). It also confirmed that, as it has been explained in previous case law, the *Schumacker* doctrine can be extended to any tax advantage connected to the person's ability to pay (CJEU, C-9/14, *Kieback*, para. 27).

Before deciding whether there is any discrimination entailed in the Dutch legislation in question, the CJEU had to determine the comparability of the non-residents and the residents within the meaning of the national provision at issue. Non-residents and residents are generally not comparable (CJEU, C-279/93, *Schumacker*, para.s. 30-31) and previous case law only established the rule that a non-resident taxpayer would be in a comparable situation with a resident taxpayer where the non-resident taxpayer obtains all or almost all of his taxable income from another Member State other than his Member State of residence provided that the Member State of residence is not able to grant him the benefits resulting from taking into account his personal and family circumstances. After the *Schumacker* case, there was an intensive discussion on how to interpret the phrase "almost all of his taxable income" and to determine the proportion of income to be earned in the source state in order for the non-resident to be considered comparable to a resident.

Though the CJEU in the *X* case was aware of this point, it took a bold approach by concluding that the fact that the taxpayer received almost all of his income within not one but several States other than that where he is resident was not relevant and the non-resident taxpayer in this case was in a comparable situation with the resident taxpayers in the Netherlands as long as his residence state, i.e. Spain, with no taxable income, was not able to take into account the negative income (CJEU, C-283/15, *X*, para. 42). This interpretation was based on the principle that the personal and family circumstances of the taxpayer had to be taken into account somewhere and the source state should do so if the residence state is not able to.

Notwithstanding the position taken by the CJEU is quite favorable for taxpayers, there is doubt as to whether such approach is consistent with the *Schumacker* doctrine. In order to determine whether the non-resident taxpayer is comparable with the resident taxpayer, the *Schumacker* case actually laid down two prerequisites: (1) that the taxpayer derived almost all of his income in another Member State other than the Member State of residence, and (2) that the Member State of residence is not in a position to take into account the taxpayer's personal and family circumstances. The judgment in the *X* case completely disregarded the first prerequisite without considering whether 60% of the taxpayer's total income derived within the Netherlands satisfied the requirement of "almost all", for the purpose of the first prerequisite. Instead, in its view, satisfying the second condition, that the residence state was not able to take into account his negative income, is sufficient for the non-resident taxpayer in this case to be considered comparable to a resident in the Netherlands.

Any justifications?

The *X* case did not consider any justifications for the discrimination found by the Court. The fact that the taxpayer had an option to be taxed as a resident in the Netherlands and therefore to be able to deduct the negative income from his dwelling in Spain seems to have no effect on its finding. That position is consistent with the previous case law, which found that the choice offered to non-resident taxpayers by means of the option to be treated as resident taxpayers does not remove the discriminatory nature of that advantage (CJEU, C-440/08, *Gielen*, paras. 50 to 53).

Some may argue that the refusal of granting the personal allowance is an element inherent to the

source-based taxation and is compensated by a lower tax rate applied to the non-residents (CJEU, C-632/13, *Hirvonen*, paras. 43 to 46). However, such interpretation has been rejected by the CJEU in other pieces of case law because, in the opinion of the CJEU, the question of whether or not discrimination exists does not depend on the overall outcome for the taxpayer. According to the Court, the examination of the difference in treatment between non-resident and resident taxpayers should be assessed only in relation to the specific tax advantage granted (CJEU, C-446/04, *FII Group Litigation*, para. 162; C-440/08, *Gielen*, paras. 49 to 54 and C-168/11, *Beker*, para. 62).

How to allocate the obligation amongst the states

The second question referred to the CJEU was whether or not the source state should take into account the full amount of the negative income or should do so on a pro-rata basis. In the first place, the CJEU emphasized that no matter how the states concerned decided the allocation, all the personal and family circumstances of the taxpayer must be duly taken care of. However, the Court took the position that, in order to avoid the accumulation of tax advantages, the Member States must allow the taxpayer to claim an equivalent deduction of negative income in proportion to the share of his total income received within that Member State. But the Court did not address clearly what the outcome would be if a third state is involved.

Proportional granting of personal tax reliefs was also discussed in *De Groot* (Case C-385/00). In *De Groot*, the residence state, the Netherlands, in applying exemption-with-progression method to relieve the double taxation, only took into account the deduction of partial personal expenses corresponding to the fraction of the overall income of the taxpayer earned within that state. In order to do so, the tax amount was first calculated on the worldwide income taking into account all the personal deductions and allowances. Then the tax amount was reduced by the fraction of tax calculated by multiplying the worldwide tax liability by the ratio of foreign income to the worldwide income. Therefore, the resident taxpayer would lose a fraction of personal allowances attributable to his foreign income. The CJEU in the *De Groot* ruled that the residence state's measure was incompatible with the provisions under TFEU.

It seems that there might be contradictions between the findings in the *De Groot* case, which ruled out the proportional granting of personal tax relief, and those in the *X* case, which confirmed the proportional granting. But that is not true. The decision in *De Groot* was actually based on the fact that the source state concerned did not take into account the personal allowances of the taxpayer and because all personal circumstances must be duly taken care of, the residence state could not therefore free itself from its obligation by applying proportional deduction. In light of the *X* case, which now requires the source state to take into account the taxpayer's personal circumstances on a pro-rata basis in the case where the residence state is not in a position to grant the benefits, proportional granting of personal tax reliefs by both residence and source states could possibly be supported by the CJEU in future cases.

Before the *X* case, some scholars had already proposed the *Schumacker* rule should be extended to all non-residents on a pro-rata basis in any situations. In Wattel's opinion, it is because granting personal tax reliefs is to take into account a taxpayer's personal ability-to-pay and is not linked to any specific income. Therefore, it should be proportionally split between the various jurisdictions in which the taxpayer earns his total income, including his residence state and the source states. In order to solve the issue of lack of information, the source state could require the taxpayer to report his worldwide income and his personal circumstances (See Peter J Wattel, "Progressive Taxation of Non-Residents and Intra-EC Allocation of Personal Tax Allowances: Why Schumacker, Gilly and Gschwind Do Not Suffice", *European Taxation* 217 (2000): p. 214-215). If the CJEU in future cases does support the proportional allocation of personal allowances amongst all residence and source states in which the taxpayer earns his income, it would ensure that the taxpayer would not lose part of his personal

tax reliefs because he works in several states and would allow the residence state to be relieved from the burden of taking into account all personal circumstances of the taxpayer, as that required by *De Groot* case.

Last but not least, in most countries source-based taxation is imposed at a lower tax rate (either a flat tax rate or a progressive rate applied to the foreign income earned within that source state) than that applied by those countries when they act as residence states. If the rule in the *X* case is upheld by the CJEU in future cases and source states are obliged to take into account personal circumstances proportionally in certain situations, we can expect that some countries will probably consider a reform for its source-based tax regime to compensate its tax loss due to the granting of personal deductions. These changes may take the form of applying progressive rates corresponding to the worldwide income of the individual taxpayer rather than that applied to foreign income earned within that state, among other options. If that happens, we may start seeing that fewer and fewer differences will exist between the source-based taxation and the residence-based taxation of individuals, though the full range of consequences of such a choice is still to be seen.



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