Belgian Method of Imputing German National's Income Violates EU Treaty, Advocate General Says

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Advocate General Cruz Villalón of the European Court of Justice on June 13 issued his opinion in *Guido Imfeld, Nathalie Garcet v. Belgium* (C-303/12), finding that Belgium's method for imputing earnings that are tax exempt in another member state, and for granting tax advantages for dependent children, is incompatible with the EU freedom of establishment.

The Facts

Imfeld is a German national living in Belgium but working as a lawyer in Germany. His wife is Belgian and is employed in Belgium. In 2003 and 2004, they filed separate tax returns in Belgium without mentioning that they were married. Imfeld did not declare his German income or any dependents. His wife declared her earnings and two dependent children and claimed a deduction for mortgage interest and child care.

The tax authorities issued a corrective joint tax assessment on the income of both spouses. Imfeld and Garcet contested the assessment and demanded split taxation to safeguard the freedom of establishment as well as the total exemption for Imfeld's German-source income.

It appears that the couple had been denied the benefit of the joint taxation regime in Germany because his income was less than 90 percent of the couple's total income and his wife's income was more than 10 percent of the couple's worldwide income (and was over the threshold of €12,372). This was confirmed by the German courts with reference to the ECJ judgment in *Gschwind* (C-391/97).

In Belgium, the case was brought before the court of first instance in Liège, which submitted it to the ECJ for a preliminary ruling on the question of whether a reduction in tax benefits resulting from the application of the Belgium-Germany income tax treaty and mismatches between German and Belgian tax rules results in a violation of the EU freedom of establishment. (Reference document.)

The Tax Rules in Question

Basically, the referral relates to the compatibility with EU law of the tax treatment of a Belgian resident couple in a situation in which one partner has an independent professional activity in another member state, where he receives all his earnings, and those earnings account for the larger part of the couple's income and are taxable in Germany and tax exempt in Belgium.

However, the actual situation is much more complex in light of the tax treatment in Belgium, taking into account the German tax legislation.

Although the husband's income is tax exempt in Belgium, it is taken into account for determining the tax payable in Belgium under article 23 of the Belgium-Germany tax treaty and article 155 of the Belgian Income Tax Code 1992 (ITC). The tax liability has been established in the name of Mr. and Mrs. Imfeld and it is precisely that cumulation that is being contested, because article 126, section 1(d) of the ITC states, on the one hand, that "the spouses' income other than earned income is

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accrued with the earned income of the spouse who has the most," and on the other hand, that "the assessment is established in the name of both spouses."

The allowance for dependent children is a tax exemption of €3,050 (for two children), which comes on top of the personal exemption of €4,610 that is deducted from the taxable income of each spouse. The additional exemption for dependent children is added, by priority, to the personal exemption of the spouse who has the higher earned income. In this case, that was the husband, whose earned income was exempt, so the benefit of the additional exemption for dependent children was lost to the couple.

Imfeld was taxed in Germany, in accordance with the Belgium-Germany tax treaty, on his German-source earnings, but was taxed as a single taxpayer (that is, without the benefit of the German joint taxation regime) because he did not satisfy the requirements for joint filing under the German tax legislation. However, it appears that he had an allowance for dependent children in the form of an exemption of a percentage of his earnings.

The Tax Rules in Light of the Freedom of Establishment

Villalón reformulated the question referred for a preliminary ruling as follows: Must article 49 TFEU be interpreted as precluding the application of the tax legislation of a member state (in this case, Belgium) that has the effect of depriving a couple residing in that state and receiving income both in that state and in another member state from receiving a specific tax benefit because of the first state's imputation rules, while the couple would be entitled to the benefit if they had received all or most of their income in their member state of residence?

As usual, Villalón noted that based on settled case law, direct taxation falls within the competence of the member states, but they must exercise that competence in accordance with EU law. In that context, the member states are free to determine the factors for the allocation of fiscal jurisdiction in income tax treaties.

According to settled case law, it is in principle a matter for the state of residence to grant the taxpayer all tax allowances relating to his personal and family circumstances because that state is best placed to assess the taxpayer's personal ability to pay tax.

However, the obligation to take into account the taxpayer's personal and family situation can only be required from the member state of employment, where the taxpayer derives all or almost all of his taxable income, if he has no significant income in his state of residence. Therefore, in situations such as the one at issue, the state of residence is unable to grant the taxpayer the benefits that would result from taking into account his personal and family circumstances.

Germany and Belgium both have taken account, at least partially, of the plaintiff's personal and family situation. Under the German tax legislation, Imfeld was entitled to an exemption for dependent children despite being ineligible for the joint taxation scheme. The couple were also entitled to the exemption for dependent children and a deduction for child care under Belgian tax legislation, but they did not materially benefit from the exemption for dependent children. The portion of the couple's income that could be exempted in connection with their dependent children was indeed deducted from the plaintiff's German-source income (because it accounted for the larger part of the couple's income), but that income was then subtracted from the couple's taxable base in

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Belgium to the extent that they were exempt under the income tax treaty so that ultimately, no specific part of the couple's income was exempted in connection with the supplement for dependent children.

The interaction of article 23 of the Belgium-Germany tax treaty -- which allows Belgium to take account of the exempted income in the calculation of the tax -- and the method of imputation of the additional exemption for dependent children established in article 134 ITC disadvantages couples in the plaintiffs' position -- namely, that the most important part of their income is received in another member state, as compared with couples who receive all or most of their income in Belgium, the advocate general said.

The Belgian tax legislation establishes a difference in tax treatment between couples residing in Belgium, depending on the origin and significance of their income, and that is likely to have a dissuasive effect on the exercise by those citizens of the freedoms guaranteed by the TFEU, most notably the freedom of establishment, he said.

Villalón countered an argument put forward by the Belgian government that this obstacle to the freedom of establishment is not necessarily the consequence of the national legislation at issue in the main proceedings. The couple has indeed been deprived of some of the exemptions for resident couples because of the exercise by one of them of his freedom of establishment and only in relation to the method of imputation of the "additional exemption for a dependent child" under Belgian tax law, Villalón said.

He also rejected the Belgian government's argument that its tax rules do not constitute an obstacle to the freedom of establishment because the exercise by the plaintiff of his freedom of establishment has not aggravated his tax situation. In other words, the government said that because Imfeld did not have to pay a higher tax in Germany than he would have paid in Belgium and his personal circumstances and family were taken into account in Germany, Belgium should be fully released from any obligation in that regard.

The advocate general did not agree that the granting of the tax benefit in Germany compensated to some extent for the loss of the tax benefit in Belgium. The granting of the exemption of a percentage of the plaintiff's earnings in Germany as an exemption for dependent children was, in fact, a purely economic circumstance that could change at any time, Villalón said. Germany could take away that benefit or reduce the amount, and that would not alter the conditions for the additional exemption for a dependent child in Belgium.

As the ECJ has repeatedly held, an unfavorable tax treatment that is contrary to a fundamental freedom cannot, in principle, be justified by the existence of other tax benefits. A member state cannot rely on the existence of an advantage granted unilaterally by another member state to escape its obligations under the TFEU, particularly under the provisions on the freedom of establishment.

The fact that in this case, the personal and family situation of the plaintiff was partially taken into account in Germany in his taxation as a single taxpayer, and the fact that he was therefore able to

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receive a tax benefit, does not exonerate Belgium of its obligation to ensure the same tax treatment to all its residents who are in a similar situation.

The advocate general held that there was no justification for this obstacle to the freedom of establishment. The Belgium-Germany tax treaty does not impose on the member state of employment any obligation to take into account the personal and family circumstances of taxpayers resident in the other member state, he said.

It cannot fall to the ECJ to ensure the coordination of national tax regulations in order to prevent a couple, both of whom are taxed jointly in a member state and one of whom is also taxed individually in another member state, from deriving a double tax benefit as a result of the partial consideration by the two member states of the couple's personal and family situation, Villalón said. He noted that the Belgian tax legislation does not establish any correlation between the tax benefits it provides to its residents and the tax benefits available to them through taxation in another member state. If the plaintiffs were not able to benefit from the additional exemption for dependent children, that was not because they had received an equivalent benefit in Germany but only because the benefit is canceled out by Belgium's rules of imputation, he said.

Villalón therefore answered the question referred for a preliminary ruling as follows:

Article 49 TFEU must be interpreted as precluding the application of the tax legislation of a member state that has the effect of depriving a couple residing in that state and receiving income both in that state and in another member state from receiving a specific tax benefit because of the first state's imputation rules when the couple would be entitled to the benefit if they received all or most of their income in their member state of residence.

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