Compensation regimes – an innovative tax treaty provision when applied to cross-border regions

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Abstract: *Cross-border workers fall within a broader category of non-residents as they maintain their original tax residence while often earning income from both the source state and the residence state. They may as a result not always utilize the same tax deductions and/or allowances as residents. States that have a large amount of cross-border workers and/or problems due to the taxation and social security contributions applicable to these workers have chosen to implement specific provisions into their tax treaties. Compensation regimes would be examples of such tax treaty provisions. These regimes are, as of today, rare. As an example, Sweden and Denmark have implemented a horizontal compensation regime between themselves and Belgium and the Netherlands have implemented both a horizontal- and vertical compensation regime. A horizontal compensation regime aims to compensate revenue losses attributable to cross-border working between the contracting states while a vertical compensation regime aims to regulate a compensation between the contracting state and the individual cross-border worker. This article comprises a discussion and an analysis of how compensation regimes may be utilized as tax treaty instruments dividing tax revenues between the contracting states and involved municipalities in addition to strengthening predictability, tax neutrality and non-discrimination in the case of the individual cross-border worker. Benefits which assist in increasing the economic integration in cross-border regions as both individual workers and employers would be more inclined to work/employ transnationally.*

Keywords: tax treaty design; cross-border working; compensation regimes; cross-border worker; tax neutrality; non-discrimination; predictability; mismatches

1. Introduction[1]

The ongoing globalization contributes to an increase in cross-border working. The escalating number of cross-border workers, and problems attributable to these workers, are not limited to the EU. Yet cross-border working within the EU will be utilized as an illustrative example in this article. Cross-border workers are not only subject to taxation but also social security contributions, which may result in problems due to legal pluralism (the existence of parallel legal systems) in addition to legal polycentricity (national tax administrations interpreting and applying legal sources differently from each other). Taxes remain unharmonized within the EU resulting in a clash between national tax systems, general principles of EU law and international tax law as all of these legal areas are applicable to the taxation of these workers.[2]

Initially, cross-border workers fall within a broader category of non-residents, than the worker who reside in the source state on a more permanent basis (henceforth referred to as the traditional non-resident). The cross-border workers may not always utilize the same tax deductions and/or allowances as residents or traditional non-residents as they often earn income from both the source state and the residence state. The general assumption would be that cross-border workers only earn a smaller part of their total income from sources outside the residence

1. I was fortunate enough to have the possibility to present the topic at a seminar at the Max Planck Institute for Tax Law and Public Finance and as a result receive valuable comments. These comments, in addition to latter discussions, greatly improved the article. Further, Harald and Louise Ekmans Research Foundation provided me with a week's stay at Sigtunastiftelsen in order to finish the article. The article itself is an extension of my doctoral thesis Yvette Lind, »Crossing a Border – A Comparative Tax Law Study on Consequences of Cross-Border Working in the Öresund- and the Meuse-Rhine Regions« (PhD thesis, Umeå University 2017). In my thesis I studied taxes and social security contributions referable to cross-border working in Sweden, Denmark, Belgium and the Netherlands. Parts of the final analysis comprised an extensive de lege ferenda proposal called »Lex Öresund«. The possibility to implement a vertical compensation regime into the Swedish-Danish DTT (applicable to cross-border workers in Sweden and Denmark) was discussed. This article summarizes the discussion of the thesis but also expands the description and analysis of compensation regimes in regard of cross-border worker definition, background, comparative elements (primarily political, geogrpahical and historical context of the four states), national legislations, tax treaty design as well as the practical application of the legal framework. The linking between non-discrimination included in a vertical compensation regime and Article 24 of the OECD MTC is for instance included in this article in comparison to the thesis. Additionally, consideration is also done to tax effects referable to joint taxation vs. individual taxation in the involved states.
2. Consolidated Version of the Treaty on the Functioning of the European Union [2012] OJ C326/1 (TFEU) Articles 110-113 have harmonized certain areas, such as excise duties and other indirect taxes. TFEU Article 115 also stipulates that tax harmonization can only be done through directives. Based on this Article, a number of directives have been issued in the field of tax law.

state, which motivates these individuals to only use the deductions and allowances provided by the residence state.[3] These problems, and many others, have been both discussed and acknowledged on a number of levels (national, EU and international).[4]

Unlike frontier workers, seasonal workers and posted workers there is no legal definition of cross-border workers.[5] The EU Commission employs a terminology that rests on an empirical basis in line with EU labour force studies.[6] This definition encompasses EU/EFTA citizens who live in one EU or EFTA state while working in another, regardless of their precise citizenship (provided that they are EU/EFTA citizens). The definition utilized by the EU is arguably broad as it includes a variety of workers. For instance, it includes those who have moved out of their residence state (so called movers) and individuals who live in a different Member State than their state of citizenship, resulting in situations where a citizen of state A lives in state B while working in state C. Moreover, the definition also includes both employees and self-employees in addition to individuals who stay away longer periods when working (up to one year). The latter would be an indi-

3. Bent Greve and Maj Rydbjerg, *Cross-border Commuting in the EU: Obstacles and Barriers. Country Report: the Øresund Region* (Research Papers/Department of Social Science, no. 11, Roskilde Universitet 2003) <https://forskning.ruc.dk/en/publications/cross-border-commuting-in-the-eu-obstacles-and-barriers-country-r-2> accessed 4 February 2019, p. 19.
4. The expert group discussed the lacking coherence between domestic tax legislations of the Member States combined with the application of these legislations by national judges and tax administrations (problems referable to both legal pluralism and legal polycentricity) and acknowledged that these problems result in tax obstacles for cross-border workers. See the report Commission, *Report of Expert Group: Ways to Tackle Cross-Border Tax Obstacles facing Individuals within the EU* (European Commission 2015) <https://publications.europa.eu/en/publication-detail/-/publication/faa0871d-ca40-11e5-a4b5-01aa75ed71a1> accessed 4 February 2019.
5. Frontier workers are defined in Regulation (EC) No 883/2004 of the European Parliament and of the Council of 29 April 2004 on the coordination of social security systems [2004] OJ L166/1 Article 1(f) as »any person pursuing an activity as an employed or self-employed person in a Member State and who resides in another Member State to which he returns as a rule daily or at least once a week«. Seasonal workers were previously defined in Regulation (EEC) No 1408/71 of the Council of 14 June 1971 on the application of social security schemes to employed persons and their families moving within the Community [1971] OJ L149/2 Article 1(c) as »any worker who goes to the territory of a Member State other than the one in which he is resident to do work there of a seasonal nature for an undertaking or an employer of that State for a period which may on no account exceed eight months, and who stays in the territory of the said State for the duration of his work; work of a seasonal nature shall be taken to mean work which, being dependent on the succession of the seasons, automatically recurs each year«.
6. See for instance Directorate-General for Employment, Social Affairs and Inclusion, *2017 annual report on intra-EU labour mobility* (2nd edn, European Commission 2018) <https://publications.europa.eu/en/publication-detail/-/publication/cd298a3c-c06d-11e8-9893-01aa75ed71a1/language-en> accessed 4 February 2019.

vidual who works solely in another state but who returns regularly to his or her family dwelling.

Problems attributable to the taxation of cross-border workers are primarily resolved, or lessened, through the design and application of tax treaties.[7] Tax treaties assist in the determining of both tax residence (Article 4 OECD MTC), the taxation of income from employment (Article 15 OECD MTC), non-discrimination provisions (Article 24 OECD MTC) and the elimination of double taxation (Article 23a and 23b OECD MTC). However, tax treaties are less suitable to deal with problems due to the taxation of cross-border workers, as these workers are more mobile than traditional non-residents. Member States, which often find themselves struggling with the taxation of these workers,[8] have chosen to implement specific provisions into their tax treaties. Compensation regimes would be examples of such tax treaty provisions and are not included into the OECD MTC. These regimes are, as of today, rare.[9] As for example, Sweden and Denmark have implemented a *horizontal compensation regime* between themselves and Belgium and the Netherlands have implemented both a *horizontal-* and *vertical compensation regime* (compensation regimes will henceforth be shortened to comps. and a compensation regime will be shortened to comp.) in their present tax treaty.[10] A horizontal comp aims to compensate for revenue losses due to the tax allocation between the contracting states. A vertical comp aims, on the other hand, to regulate compensations between the contracting state and the individual cross-border worker. The former regime therefore acts as an instrument dividing tax revenues between the contracting states while the latter strengthens both predictability, tax neutrality and non-discrimination with regards to individual cross-border worker.

This article does not aim to describe or discuss cross-border working comprehensively but instead to illustrate how compensation regimes may be applied to this specific category of workers. Hence, a more narrow definition of a cross-

7. Tax treaties are supplemented through domestic legislation, e.g. tax laws specifically aimed at specific groups of mobile workers such as researchers and experts. EU tax law, primarily through the principle of non-discrimination and ECJ case law also plays a vital part.
8. For instance: The tax treaty between Sweden and Denmark utilizes the source state principle. The main share of these workers reside in Sweden while they work in Denmark. As a result, Denmark receives the lion part of the tax revenues while Sweden ends up paying for public services utilized by these workers.
9. Germany and Switzerland have also implemented a horizontal compensation regime in their tax treaty in order to share tax revenues. This treaty will not be dealt with in this article.
10. The Belgian-Dutch DDT also comprises a special compensation scheme applicable to frontier workers in Article 27(2). This scheme comprises those workers previously included in the frontier worker regulation and may result in additional compensation added to the compensation stemming from the vertical comp. This provision is merely aimed to compensate those workers who could still be eligible for the old provision and will, through time, be deprecated. This article will therefore not include this compensation.

border worker is employed. A cross-border worker in this article is an individual who resides in state A while working as an employee in both state A and B, through daily commuting. Mobile workers such as artists and athletes could fall under this definition yet, they will be excluded as the article does not deal with *lex specialis,* such as the Swedish Madonna tax etc. The individual must work at least 25% of the time, in each state, in order to qualify.[11] Individuals who do not fulfill these criteria are not included in the further discussion and analysis. A definition such as this effectively captures individuals who are often subject to mismatches between legal systems (including both taxation and social security contributions). Mismatches such as these are not covered by EU law (primarily the principle of non-discrimination) as the cross-border worker is not subject to harsher treatment due to nationality or tax residence. This is simply a result of the worker earning income from both states, yet not qualifying for domestic tax provisions (E.g. deductions) as he or she does not fulfill the domestic requirements in one or both of the states. The ECJ refers to this as tax disparities; a consequence of the uncoordinated tax laws between the Member States.[12] This article therefore focuses, through the application of a more narrow definition of the term cross-border worker, primarily on mismatches between legal systems when cross-border working.

Further, the article analyzes both taxation and social security contributions. Provisions dealing with social security contributions, and the coordination of these, are therefore included. This includes the EU's social security regulation, which aims to deal with some of the problems referable to cross-border working,[13] e.g. working in several states, working from home, etc. The regulation constitutes a framework, which assists in coordinating the social security contributions between Member States, setting a minimum level of social services provided to these workers by the Member States in addition to allocating the responsibility for providing social security.[14] Further, the Nordic states have concluded a multilateral social security convention with the purpose of strengthening this coordina-

11. This specific amount of time was influenced by the EU regulation coordinating social security Regulation 883/2004 (n 5).
12. For further discussion see Commission, Report of Expert Group: Ways to Tackle Cross-Border Tax Obstacles facing Individuals within the EU (n 4).
13. Regulation 883/2004 (n 5).
14. The motives behind the implementation of such a regulation are of course more complex. The welfare systems within the individual Member States differ significantly in regard of scope, inclusion, legal principles and financing. The regulation attempts to remove barriers to the internal market in order to promote the free movement of workers rather than addressing the underlying issue to why these systems vary and clash. For a more elaborated discussion of this see Thomas Erhag, *Fri rörlighet och finansiering av social trygghet, en rättslig studie av EG-rättens inverkan på medlemsstaternas uttag av avgifter för finansiering av social trygghet* (Santérus 2002).

tion.[15] There are however still problems, which may not be solved through the EU´s social security regulation as the Member States finance their welfare systems differently, e.g. Sweden finances parts of its system through pay-roll taxes while Denmark utilizes income taxes.[16] These contributions also vary significantly between states with regards to the amount which is contributed, i.e. Swedish payroll taxes exceeds 30 percent of the gross salary while Denmark deducts less than 10 percent of the gross salary through taxation in order to finance the welfare system.[17] This would be another example of mismatches referable to cross-border working. A lack of coherence can be seen between the EU social security regulation and social security conventions in general compared to the OECD Model Treaty Convention (henceforth referred to as the OECD MTC). The former utilizes the source state principle and the latter the residence state principle. This incoherence is aggravated through the inherent mismatches between the individual Member States tax- and social security systems.

2. Aim, methodology and theoretical framework

To begin with, the primary aim of this article is to describe and discuss *how* compensation regimes are designed, *why* they are utilized as tax treaty provisions and

15. Lag (2013:134) om nordisk konvention om social trygghet [The Nordic Social Security Convention].
16. Swedish pay-roll taxes are paid by the employer based on the employee's wages and are regulated through Chapter 2 Socialavgiftslagen 2000:980 [Swedish Social Security Contributions Act]. The Danish tax structure differs from the ones in other states. Danish social contributions are very low, compared to other states, as most welfare spending is financed out of the general taxation, primarily personal income taxation. Pension savings in Denmark are also seen as a private matter as opposed to a public matter as in the Swedish case. Pension savings in Denmark are therefore normally resolved as a part of the salary package, making the public pensions relatively small and the private pensions relatively high.

    ATP contributions (Danish labour market supplementary pension), combined contribution and mandatory industrial insurance corresponds to the Swedish payroll tax. Employees in Denmark are as a result subject to municipal taxes and health system contribution (sundhedsbidrag), and also pay a labour market contribution (AM-bidrag). The labour market contribution should does not fund social secuirty contributions as a pay-roll tax but is instead aimed to cover, among other things, unemployment and sickness benefits and expenditure for training and activation. The labour market contribution is calculated on the number of hours the employee works at a rate of approximately 8 per cent of the taxable base and is in practice deducted from the salary by the employer. All individuals who are taxed in Denmark must also pay contributions to the Danish labour market supplementary pension fund (ATP). ATP is deducted from the paycheck and acts as an extra insurance to the regular state pension (folkepension).
17. Chapter 2, 26 § Socialavgiftslagen 2000:980 [Swedish Social Security Contributions Act]. 1 § Lov nr. 471 af 12/6/2009 APT contributions and the current percent of the taxation years may be found at www.skat.dk and www.atp.dk.

what they may contribute in regard of tax allocation, tax neutrality, predictability and non-discrimination. This could include discussions if both the benefits and costs (seen from an individual taxpayer perspective) with regards to cross-border working, yet focus lies upon the cost side, i.e. taxes and social security contributions. Descriptions, discussions and argumentation are done through the application of three perspectives. These would be the perspectives of the contracting states, the municipalities geographically located in cross-border regions and the individual cross-border workers.

Normally, states involved in cross-border transactions will struggle with the allocation of tax revenues. This »struggle« is to the largest extent resolved through the application of tax treaties. The source state principle or the residence principle are applied in order to resolve or at least lessen international double taxation in addition to allocating these tax revenues. However, the application of these principles may result in additional revenue problems when applied to employment income referable to cross-border working. The source state may find itself dissatisfied in the case where the residence principle is applied, as the residence state receives all tax revenues referable to the employment income, despite the income having been generated in the source state. In in case of the reverse, where the source state principle is applied, the residence state may find itself dissatisfied as they provide public services to cross-border workers but without receiving tax revenues. This dissatisfaction is further enhanced in those situations where strong welfare states are included. The same applies to situations where there is an asymmetry due to the location of these cross-border workers. Sweden and Denmark displays both of these characteristics, as (1) they are strong welfare states dependent on taxes and social security contributions in order to finance their welfare systems, and (2) 93% of all cross-border workers in the Öresund region work in Denmark while residing in Sweden.[18]

Municipalities in cross-border regions are also affected by the allocation of tax revenues. The tax treaty between Sweden and Denmark applies the source state principle, resulting in Denmark having the right to tax the employment income of most cross-border workers in the region as 93% works in Denmark. Swedish municipalities are left with the obligation to provide public welfare for these 93% as they reside in Sweden and fulfills the criteria for residence based benefits (and possibly also the criteria for employment based benefits if they work in Sweden as well). The horizontal compensation regime regulated in the treaty between

18. National agencies do not (in the Nordic states) include comprehensive statistics referable to cross-border workers in their statistics. These hidden numbers have been subject to several discussions and studies. Örestat keeps statistics specifically referable to cross-border workers in the Öresund region. For support of the statistics utilized in this article see: *Øresundsinstituttet* (Malmö) <http://www.oresundsinstituttet.org/fakta/pendling/> accessed 5 February 2019.

Sweden and Denmark is designed to shift back parts of the revenues in order to fund these public services. However, the compensation goes directly to the Swedish municipality compensation system on state level, resulting in a tangible tax base erosion in the affected municipalities in the south of Sweden. Their need for financial support from the Swedish municipal compensation system therefore increases over time due to steadily increasing revenue losses.

Several problems on the individual taxpayer level may be due to mismatches and incoherence between systems. Firstly, it contributes to an ambiguity in the prediction of both taxation and social security contributions in regard of the amount of taxation and the allocation of it. An uncertainty that affects not only cross-border workers but also employers and national tax administrations. Lacking predictability subsequently contributes to legal uncertainty. Further, problems referable to tax neutrality may also be seen as cross-border workers can be liable to pay more taxes and social security contributions than would have been the case if they had only worked domestically. Finally, the lack of coherence also contributes to a discrimination between residents and cross-border workers as well as differentiation between cross-border workers and traditional non-residents, so called horizontal discrimination (discrimination between non-residents). The EU principle of non-discrimination only applies as long as the situation of a non-resident worker is comparable to that of a resident worker. This is often not the case as cross-border workers maintain their original residence or, alternatively, change employer between states during the same time period (taxation year). This gap between cross-border workers and traditional non-residents, result in a »permissible« discrimination as the income of the cross-border worker is partially allocated to the source state.

Moreover, the tax treaties between the four mentioned states (the Swedish-Danish DTT and the Belgian-Dutch tax treaty) acts as primary material for this article. The tax treaty between Sweden and Denmark in addition to the tax treaty between the Netherlands and Belgium are compared, with emphasis on their comps. No comprehensive comparative study is done; comparative elements are instead applied in order to discuss tax treaty instruments. The four states (Sweden, Denmark, the Netherlands and Belgium) along with their tax treaties, provided favorable conditions for a comparative study. All four states negotiated, and implemented, their tax treaties at the same period in time (2001 and 2003), both tax treaties utilize the source state principle and have also historically experienced similar problems referable to tax allocation asymmetry. However, this article does not primarily discuss similarities between tax treaty provisions but instead focuses on the differences between them, which would be a more post-modern approach to the comparative method.[19] The study illustrates how several

19. See for instance Mathias Siems, *Comparative Law* (2nd edn, Cambridge University Press 2018).

problems referable to cross-border working may be resolved through the implementation of both horizontal and vertical comps., into the design of tax treaties. The OECD MTC, EU material and legal doctrine from the four states supplements the arguments and findings.

Additionally, a *theory of principles* comprising tax neutrality, predictability and non-discrimination is applied to discussion and argumentation. This theory is based upon the findings I did in my doctoral thesis. Initially in my study, I found that problems due to cross-border working often could be attributed to certain areas or certain legal principles. Firstly, cross-border workers would often be subject to harsher taxation and/or social security contributions than the traditional non-resident or resident, implying a need for strengthened tax neutrality. Secondly, the existence of parallel legal systems applicable to taxation and social security contributions resulted in both legal pluralism and legal polycentricity, which in turn contributes to a weakening of predictability. The lack of predictability is often one of the main obstacles for further integration of cross-border regions as individuals abstain from the option of cross-border working due to uncertainty.[20] Thirdly, the differentiation between cross-border workers and non-residents/residents with regard to taxation and social security contributions is not covered by the principle of non-discrimination as the differentiation is not based upon nationality nor residence. The principle of equality could have been applied to discussions dealing with this differentiation, yet the principle of non-discrimination is instead applied as the former is less commonly referred to in Swedish case law and the Swedish legal doctrine.

Finally, the following part describes the design and function of the comps. implemented in both the tax treaty between Sweden and Denmark (henceforth shortened to the Swedish-Danish DTT) and the Belgian-Dutch double taxation treaty (henceforth shortened to Belgian-Dutch DTT). Part three discusses and analyses, through the application of the theory of principles, these comps. in relation to tax neutrality, predictability and non-discrimination. Some final remarks concerning the OECD MTC and comps. are done in the last part.

3. Compensation regimes – design and function

The content of comps. varies between individual tax treaties as these treaty provisions are individually negotiated and not based upon the OECD MTC. This part describes the comps. included in the Swedish-Danish DTT and the Belgian-Dutch DTT. The former contains a horizontal comp. while the latter contains both a hor-

20. See for instance Commission, *Report of Expert Group: Ways to Tackle Cross-Border Tax Obstacles facing Individuals within the EU* (n 4). Also see the discussions in: Yearly reports dealing with cross-border obstacles from the Council of Nordic ministers.

izontal- and a vertical comp. The horizontal comps. in the two tax treaties differs from each other, a natural result of them being negotiated and designed in accordance to the individual needs of the contracting states and with reference to their individual legal cultures. Initially, a description of the horizontal comps. of both tax treaties is done. This is then followed by an elaboration of the vertical comp. in the Belgian-Dutch DTT.

A horizontal comp. aims to reduce revenue losses attributable to the allocation of cross-border incomes. Such a comp. is suitable for states that finance a large part of their welfare system through taxes and social security contributions and/or utilize the source state principle in their tax treaties. Sweden and Denmark fulfills both of these criteria, as they are welfare states utilizing high marginal taxes in order to finance the welfare system in addition to allocating the taxation of cross-border workers in accordance to the source principle. This tax allocation result in a shortfall in fiscal revenues for the municipalities located in the south of Sweden.[21] Sweden and Denmark therefore regulate, through Article 6 of the Swedish-Danish DTT,[22] a horizontal tax regime designed to shift some of the tax revenues from the source state (primarily Denmark) back to the residence state (primarily Sweden) in order to reduce revenue loss.

The tax treaty provision provides a calculation for the horizontal comp. in which the source state transfers a compensation to the residence state on a yearly basis. The compensation is calculated in accordance with a formula based upon the average municipal tax rate. Incomes that are included in the calculation of the compensation are: (1) income stemming from cross-border workers who has been considered tax residents of either Sweden or Denmark, (2) with a yearly gross income that exceeds 150 000 DKK (ca 20 000 or 23 000$) before deductions. The source state may, logically, desire to pay back as little compensation as possible in order to maximize its total tax revenue and may therefore, when calculating the compensation, choose to exclude those incomes that falls below the set criteria, i.e. incomes under 150 000 DKK. The source state is also allowed to exclude employment incomes from civil servants and those working on Swedish or Danish ships in international traffic. Denmark has proven to be very effective in sorting between income types, unlike in Sweden where the calculation is based on all incomes. This article will not deal with discussions referable to optimal tax burden yet it could surely produce interesting results in the matter.

21. Greve and Rydbjerg (n 3) 22.
22. Act (1996:1512) on double taxation agreement between the Nordic countries (the Nordic tax treaty) comprises all Scandinavian states, i.e. Denmark, The Faroe Islands, Finland, Iceland, Norway and Sweden. The Swedish-Danish DTT (Act 1996:1512, appendix 4) is an amendment to the Nordic tax treaty and only apply to employment income referable to cross-border workers in the Öresund region, i.e. parts of Sweden and Denmark.

The second protocol of the Belgian-Dutch DTT contains special provisions, which provides the conditions for revenue sharing with regard to taxes levied from frontier workers, i.e. a horizontal comp.[23] This comp. divides the net income tax revenue *equally* between Belgium and the Netherlands. In practice, this encompasses ca 20% of the tax and social security contributions paid by individuals on their employment income.[24] No problems referable to this comp. are discussed as the two states share the tax revenues equally between themselves.

Article 27 of the Belgian-Dutch DTT regulates the vertical comp. This provision provides for a compensation to be given from the residence state to the individual cross-border worker in order to neutralize the negative effects from both taxation and social security contributions referable to cross-border working. The provision aims to place the cross-border worker in the same position (taxation and social security wise) as a resident. Article 27(1) defines the comp. as a unilateral (individual) Dutch compensation arrangement for those individuals who fulfills the criteria for tax residency in the Netherlands. Belgian cross-border workers are not covered by the comp. due to economic aspects. This is a result of Belgium indicating that they could not afford such a compensation as they have four neighboring states.[25] The provision therefore only ensures that Dutch cross-border workers are treated equally with regard to taxation and social security contributions, compared to Dutch residents.[26] Article 27(1) Further on, cross-border workers are entitled to the same benefits (such as mortgage interest, the deductions for personal obligations and donations) as Dutch residents according Article 27(1). Every employee living in the Netherlands, and working in Belgium, are therefore to be assessed for income tax and social security purposes in an identical manner as an employee living and working solely in the Netherlands. This assessment is done on the basis of two calculations, one factual and one alternative, regulated in Article 27(3) of the Belgian-Dutch DTT. The factual calculation considers the actual taxation and social security contributions referable to the cross-border worker during the taxation year. The alternative calculation is based on the assumption that the cross-border worker works solely in the Netherlands, i.e. calculating taxation and social security contributions as if the factual work had been performed *solely* in the Netherlands. The compensation equals as a result to the dif-

23. Convention between the Kingdom of the Netherlands and the Kingdom of Belgium for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital, signed at Luxembourg on 5 June 2001.
24. See Bart Kosters »An analysis of the new tax treaty between Belgium and the Netherlands« (2001) 41 European Taxation 315.
25. In the Technical Explanation to the 2001 treaty (n 23), this was indicated as such by the Belgian Ministry of Finance.
26. This results in discrimination between cross-border workers (as Belgian cross-border workers does not receive the same treatment as Dutch ones) as well as a lack in tax neutrality between the two groups.

ference between the total of Dutch and Belgian income tax and social security contributions and the amount of income tax and social security which would be due by a Dutch employee working solely in the Netherlands.[27] To realize the compensation, the Netherlands grants cross-border workers a reduction, a tax credit referable to income tax and social security premiums. Of importance is that the Netherlands utilizes a box system for taxable income, yet some incomes and deducible items are joint between spouses. Dutch workers may as a result take further advantage of the comp. as it also takes into consideration the tax credit of a partner who is either not earning an income at all alternatively a small income. Belgium also utilizes tax returns specifically aimed at spouses, the so called joint tax returns, resulting in larger tax-free allowances and greater tax refunds, yet a Dutch cross-border worker having his or her income allocated for taxation in Belgium would not be eligible to these allowances.

Example of how the two calculations are performed when assessing a possible compensation:

1. The total Dutch- and Belgian tax and social security contributions burden for an individual when applying *the factual calculation*:
   50 000 Euro
   - Dutch taxes/Social security contributions: 10 000 Euro
   - Belgian taxes/social security contributions: 40 000 Euro
2. *The alternative calculation* which works under the assumption that the individual had only been only subject to Dutch taxes and social security:
   48 000 Euro
3. The tax treaty grants the individual a reduction of his actual Dutch tax/social security burden with:
   2 000 Euro (compensation through tax credit)
4. The Dutch cross-border worker´s reduced combined Dutch tax/social security burden is then:
   8 000 Euro (after tax credit)
8. The individual is, after compensation through tax credit, only burdened with a total of 48 000 Euro (Dutch- and Belgian tax and social security contributions)
   - Dutch taxes/Social security contributions: 8 000 Euro
   - Belgian taxes/social security contributions: 40 000 Euro

4. The vertical compensation regime linked to tax neutrality, predictability and non-discrimination

The theory of principles comprising tax neutrality, predictability and non-discrimination are considered in the following discussions. The ambition is not to describe these principles exhaustively but rather to utilize them as tools when

27. This alternative calculation applies to Articles 15, 16, 17 and 18 of the Belgian-Dutch DDT (n 23).

discussing the comps. Discussions referable to these legal principles will therefore be applied to the function of the previously described vertical comp. in order to discuss *best practice* when designing tax treaty provisions applicable to the taxation of employment income referable to cross-border working. Initially one should acknowledge that tax neutrality, predictability and non-discrimination are all broad and to some degree vague concepts, just as concepts such as fairness and justice for instance, and should therefore be used to create conditions rather than be directly expressed. As a result, one cannot simply embed these principles directly into the wording when designing a tax treaty, and expect the application of the tax treaty to result in tax neutrality, predictability or non-discrimination. One must instead design a tax treaty, or as in this case: tax treaty provisions, with the aim of creating the conditions for tax neutrality, predictability or non-discrimination. This part therefore discusses these three principles as means to achieve further legal certainty for those individuals who finds themselves cross-border working.

Neutrality is often utilized as a tool within both the legal- and economical context. For instance, EU competition law and state aid rules focuses on the premise of competition neutrality in order to protect and uphold the single market. Neutrality is also utilized, within tax law, as a tool for achieving political goals. It is a very broad concept and is seen in a variety of settings. The concept is not static as it varies depending on different variables and differing types of economical arrangements.[28] Further, it can be seen in a variety of constellations, e.g. tax neutrality between tax subjects, tax objects etc. and requires the scholar to carefully define the relevant variables and conditions when discussing the concept. This article discusses tax neutrality between different residents, i.e. cross-border workers and individuals performing all of his or her work in the residence state. Both of these groups are categorized as residents, yet they are subject to differing tax treatment, suggesting that there is a lack in tax neutrality between them. One could of course argue that one cannot discuss tax neutrality with regard to tax residency as the conditions between these two groups differs, i.e. one group works solely domestically while the other works transnationally. The aim of vertical comp. is to strengthen tax neutrality between cross-border workers and residents as the former category often is subject to a heavier burden with reference to taxes and social security contributions. The vertical comp. compensates the cross-border worker who is subject to a heavier burden due to a tax credit. Tax neutrality is therefore effectively achieved when the same burden is placed upon cross-border workers and residents working solely in the residence state.

Problems referable to the prediction of taxation and social security contributions are common with regard to cross-border working. Both the individual tax-

28. Åsa Gunnarsson, *Skatterättvisa* (Iustus Förlag 1995) 135.

payer and the national tax administration may experience difficulties in predicting the consequences of cross-border working due to the involvement of several legal frameworks. The taxation of cross-border worker employment income involves domestic legislation of the involved states, EU tax law and international tax law through the application of tax treaties. Further, domestic legislation, the EU social security regulation and bilateral (or multilateral as in the case of the Nordic states) social security conventions is involved in order to determine social security contributions referable to these individuals. It is therefore understandable that there is a significant amount of complexity when predicting the outcome of taxation and social security contributions. Legal polycentricity may be seen as the outcome of this complexity. This may be especially noticeable in those cases where individuals choose to work in several states at the same time, e.g. a nurse may live in Sweden while working in both Sweden and Denmark, additionally working some months per tax year in Norway. Individuals residing in cross-border regions may choose to abstain from cross-border working due to the difficulty of predicting short- and long-term effects, e.g. back-taxes, having to pay one's own social security contributions in those cases the employer wants to avoid paying these,[29] pension payments etc. An increase in predictability would not only strengthen legal certainty but also act as an effective incentive for individuals to do cross-border work and as a result further integrate cross-border regions economically. Some practical measures are necessary in order to create further predictability. Reducing the effects of legal pluralism and legal polycentricity would be one measure. Another would be to remove discrimination/differentiation and legal uncertainty referable to cross-border workers compared to residents. A vertical comp. could be an effective instrument as it increases predictability from the perspective of both the taxpayer- and the tax administration as it places cross-border workers and residents in the same situation with regard to tax- and social security contribution. Another solution, albeit theoretical, could be the implementation of some sort of non-discrimination provision.

EU law contains a general prohibition on discriminatory treatment in order to uphold the single market along with its free movement.[30] Treating a non-resident differently than a resident with regard to taxation might therefore potentially

29. The employer pays high social security fees in Sweden while Denmark deducts these, through a small sum, on the income tax of the employee. Historically, before the implementation of the EU regulation, could situations where a cross-border worker worked both in Denmark and Sweden result in the Danish employer being liable to pay all social security contributions. Danish employers would not employ Swedish cross-border workers unless they agreed to take responsibility (pay) for their individual social security contributions.
30. TFEU (n 2) Article 45 regulates the free movement of workers, TFEU (n 2) Articles 49 and 56 regulates the right to establishment and freedom to provide services and TFEU (n 2) Articles 63-66 states that there is free movement of capital.

constitute discriminatory treatment.[31] There are different forms of discrimination, e.g. direct discrimination based upon nationality or indirect discrimination where distinctive criterions such as residence are utilized in order to treat nationals and foreigners differently. However, a cross-border worker may still be treated differently than a resident without it constituting unlawful discrimination. EU law ensures equal treatment, through the application of the principle non-discrimination between non-residents and residents. Cross-border workers fall outside of this application, as they are not considered residents. However, cross-border workers are not in a comparable situation, with respect to taxation and social security contributions, as either a resident or the traditional non-resident as they often earn income in both the residence and the source state yet does not qualify for the same tax treatment with regard to deductions etc. The CJEU argues that this differentiation between cross-border workers and residents is to be considered as a tax disparity due to the lack of positive harmonization in the field of taxation.

Article 24 of the OECD MTC also provides for non-discriminatory treatment, yet similar to EU law and the principle of non-discrimination, the provision does not deal with tax disparities referable to cross-border working. Article 26 of the Belgian-Dutch DTT contains a non-discrimination provision which goes further than Article 24 OECD MTC. The provision grants individuals resident of one state and who simultaneously earn income in the other state the same tax privileges as a resident of the other state. Privileges such as a proportionate part of the personal allowance in addition to relief and reduction due to civil status or family responsibilities. One can therefore argue that Belgium and the Netherlands aim to resolve these tax disparities partially through Article 26(2) as the provision is effective in removing the discrimination of cross-border workers. In fact, it has been argued to be *too* effective as it may result in a cross-border worker receiving better tax treatment than the resident who performs all of his or her work in one of the contracting states.[32] This is a result of Article 26(2) permitting allowances, relief and reduction in both states, if the individual earns income in both states. Both EU tax law and international tax law (primarily through the DTTs and accompanying principles) aim to lessen, or remove, double taxation and the discrimination between non-residents and residents.[33] Tax treatment that results in better

31. See TFEU (n 2) Article 45. Also see case law such as Case C-279/93 *Finanzamt Köln-Alstadt v Schumacker* [1995] ECR I-225; Case C-169/03 *Florian W. Wallentin v Riksskatteverket* [2004] ECR I-6443; Case C-385/00 *F.W.L. de Groot v Staatssecretaris van Financiën* [2002] ECR I-11819; Case C-303/12 *Imfeld and Garcet v Belgian* State [2013] ECR I-822. See literature such as Martin Berglund, *Schumackerdoktrinen: i ljuset av nyare rättspraxis och med beaktande av dess inverkan på svensk skatterätt* (Uppsala Universitet 2014) 33.
32. See for instance discussions in Kosters (n 24) 322-323.
33. One may refer to the international tax principle which states: »*all incomes would be taxed once and only once*«. Also see ECJ case law such as C-279/93 (n 31); C-391/97 *Frans Gschwind v Finanzamt Aachen-Außenstadt* [1999] ECR I-5451.

treatment of non-residents has not been dealt with.[34] Those disparities that cannot be resolved through the application of Article 26(2), e.g. higher social security contributions, are instead resolved through the vertical comp. as it aims to place the cross-border worker in the same situation as the resident working purely domestically with regard to tax- and social security contributions.

To conclude: a vertical comp. aims to place the individual cross-border worker in the same situation as resident regarding tax- *and* social security contributions, unlike the non-discrimination provision in Article 26(2) of the Belgian-Dutch DTT. The national tax administration needs to make two calculations each year in order to ensure equal treatment. In cases where the individual has had a heavier tax and social security burden, he or she will be compensated by the residence state. This ensures tax neutrality, and removes any discrimination, between cross-border workers and residents. This equal treatment and tax neutrality leads to a strengthening of the predictability referable to taxes and social security contributions.

5. Concluding Remarks

The following part initially describes the positive- and negative effects referable to both comps. with reference to the descriptions and discussions already included in this article. The three perspectives of state, municipality and individual taxpayer are applied in order to more easily structure argumentation. The inclusion of these perspectives also allows a more holistic approach, broadening the analysis to not only include purely legal factors.

From a state perspective, there are several benefits associated with the implementation of comps. States may expect further economic integration between them, as legal problems are resolved through the application of a vertical comp., e.g. individuals will be motivated to cross-border work to a greater extent. However, such a comp. also places a heavier financial burden on the residence state compared to the source state as the former compensates the individuals. Additional administrative burden on part of the residence state (primarily the tax administration when calculating both factual and alternative taxation and social security contributions) is also to be expected. These burdens are most noticeable in cases where the source state principle is applied, and may in such cases be relieved by adding a horizontal comp. that shifts back more tax revenues.

Asymmetries with regard to tax allocation between contracting states involved in cross-border regions are not uncommon. Individual taxpayers will naturally

34. Although one might argue that the Commission has observed this problem when applying state aid rules on tax schemes referable to multi-national companies when approved by individual Member States, e.g. double non-taxation as a tax scheme.

exploit possibilities offered by cross-border working, e.g. choosing to work in the state with higher salaries while being taxed in the state with lover income taxation etc. Non-legal (and less predictable) factors will also influence the individual taxpayer, e.g. lower house prices, lower living costs etc. Further, asymmetries referable to tax allocation are more noticeable between strong welfare states, i.e. states that provides a large amount of public and economic well-being through systems financed with tax revenues and social security contributions. These asymmetries are particularly noticeable in situations where the residence state carries the burden of providing public welfare while tax revenue from to the financed individuals are allocated to the source state. This implies that tax treaties utilizing the source state principle are in greater need of comp. than tax treaties utilizing the residence principle. The primary purpose of a horizontal comp. would be to either soften, or remove, asymmetries referable to the allocation of taxation. The contracting state who receives the main share of the tax revenues (source state or residence state depending on the principle utilized in the individual tax treaty) would, as a result, shift back parts of the revenue to the other contracting state. One may of course argue that there always will be some asymmetries in the tax allocation between contracting states and that other factors will assist in evening it out. For instance, taxpayers paying taxes to the source state will still spend their earnings in the residence state, generating incomes from VAT. The source state may offer job opportunities which otherwise would not have been the case in the residence state, relieving some fiscal burden from the residence state as it does not need to provide financial support to unemployed individuals etc.

There are also benefits to be gained for municipalities located in cross-border regions. Municipalities geographically in the residence state will generally provide public welfare services to individuals residing in the municipality while they work in the other state. These municipalities will not receive financing to cover their costs if taxation of the employment income is allocated to the source state. A horizontal comp. could correct, or at least lessen, this problem. However, the municipality will not benefit from the comp. if the compensation provided by the source state is transferred to state level as in the Swedish/Danish case. Leaving the municipality in the same situation as without the comp., i.e. relying on financial support from the state. Contracting states may therefore need to adjust the design of the horizontal comp. in accordance with their individual needs, and the domestic structure with regard to tax allocation and tax redistribution.

The implementation of a vertical comp. would be highly beneficial for the individual taxpayers. Initially, the provision provides an efficient instrument to strengthen tax neutrality between cross-border workers and residents. This may be of special importance in those cross-border regions where one of the contracting states utilizes higher taxes on employment income and/or higher social security contributions. Also, problems referable to predictability when determining taxation and social security contributions (foremost legal polycentricity) are resolved as taxpayers will always find themselves in the same situation as if the work had been solely performed domestically. Moreover, problems to the differentiation between cross-border workers (tax disparities) have not been, at present time, resolved through EU law. A vertical comp. resolves problems to differentiation between cross-border workers and residents/traditional non-residents efficiently on a national/transnational level. Finally, cross-border workers residing in states who utilize joint taxation, or similar provisions such as higher tax-free allowances for spouses etc., will receive additional compensation than would have been the case of having the income taxed in a source state not offering such tax benefits.[35]

To summarize, a horizontal comp. may be utilized either by its own or in combination with a vertical comp. Such a comp. will, when applied on its own, result in a more even distribution of tax revenue between the contracting states, depending on how the comp. is designed and very much depending on whether the source state principle or the residence principle is applied. A more even distribution would lessen, or even remove, asymmetries to tax allocation. If there is a significant difference in the number of cross-border workers between states as in the Swedish-Danish case, where 93% of all cross-border workers reside in Sweden, there might be a need for a horizontal comp., which shifts significant amounts of tax revenue back to the residence state who provides and finances the public welfare. The combination of the two comps. may in such cases be necessary in order for a vertical comp. to not drain the residence state´s resources (as the residence state grants tax credits in order to compensate individual cross-border workers).

In conclusion, implementing a vertical comp. offers several benefits to individual workers, employers, tax administrations, municipalities and states, yet it may be difficult to carry out such changes due to several practical reasons. The EU may have attempted to coordinate social security through the social security regulation, yet the Member States welfare systems remain highly differentiated due to their individual legal cultures. A partial implementation of the regime in order to strengthen EU policy on non-discrimination could be a more plausible and interesting alternative. Lifting the issue from a national/transnational level to an EU level could therefore be more fruitful. However, due to the need for political consensus in regard of taxes on an EU level this could prove to be a difficult task. Comps. may not constitute the missing keystone of tax treaty design, yet they may still be of value. As their success depends on the individual design, which is determined in accordance to the needs of the contracting states, they can merely act as rough sketches rather than a provision in the OECD MTC. The need

35. One might of course argue if this is a positive effect depending on the perspective of the taxpayer or that of the state.

for provisions dealing with asymmetries referable to income allocation and the financing of welfare will not decrease over time, quite the opposite. Instruments that lessen or resolve problems referable to cross-border working, such as discrimination, the lack of tax neutrality and predictability, will be necessary as the need for further economic integration of cross-border regions grows steadily.