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Tricky Taxation

The evolution of EU rules regarding cross-border loss shifting and their impact on business locational decisions

Master thesis

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Abbreviations List

EU	European Union
ECJ	European Court of Justice
FDI	Foreign Direct Investment
OECD	Organisation for Economic Cooperation and Development
QMV	Qualified Majority Voting
SEM	Single European Market
SME	Small and Medium Enterprises
MNE	Multinational Enterprise
M&A	Mergers and Acquisitions

Contents

1. Introduction

While the adoption of a single currency within the Euro zone and the Eastern enlargement has created an additional spur to European businesses to establish across the national borders any attempt to prescriptively harmonise 25 diverse laws on European Union's (EU) company taxation is doomed to failure. Because of the political sensitivity of taxation corporate tax harmonisation in the EU has not been fully realised, yet increasing integration of economic activity is placing greater pressures on corporate income taxes, as the companies whose profits are being taxed operate increasingly across national borders, both within Europe and beyond. It could be argued that tax differentials now have greater importance on the real behaviour of companies and their strategic decision-making, as other differences between countries within the EU diminish.

The prospect of harmonising corporate taxes has caused great controversy among different actors within the EU. Harmonisation of tax rates within the EU is refused because the tax is seen as a competition tool between the Member States rather than the classic 'race to the bottom' scenario. Yet, governments are worried about losing tax revenues as businesses seek out Member States with the most advantageous tax regime. As a result elegant and indirect *tax incentives*- tax credits, tailor- made packages for companies, tax packages for experts, various dividend policies, tax deductions and tax holidays - are offered in most of the EU's Member States[1]. Such government policies might foster economic activity, but it can also impede the normal functioning of business: regulatory regimes can discourage business formation and different tax systems can impose excessive burdens on cross-border income producing activities. Therefore, the Commission's tax initiatives have attempted to mitigate the extent to which tax differences dictate resource allocation within Europe. Moreover, the ECJ interfere in tax competition taking positions on the conformity or non- conformity of national corporate tax laws with the freedom of establishment contained in the EC Treaty. Although corporate taxes are not meant to fall within the scope of the EU law, the ECJ tries to

[1] Bruzelius, A., 'Skattekonkurens – hinder eller förutsättning för en nationell välfärdsstat?' (2004) as cited in Gustavsson, S., Oxelheim, L., Wahl, N., 'EU, Skatterna och Välfärden' (Santerus, 2004), p.111-112

coordinate national tax laws at a Community level and hence to eliminate tax barriers to the single market. However, while the ECJ's attempts towards greater direct tax harmonisation erode national tax systems, it alone cannot build a new EU level tax system- established principles are not generalised and cause high legal uncertainty. Thus, the question asking whether direct tax harmonisation in the EU is substantial remains open.

1.1. Research purpose and structure

This research was encouraged by the idea to contribute to the discussion that more corporate tax harmonisation is needed in order to ensure effective functioning of European Single market. In order to consider whether we need more tax harmonization, it is important to analyze how corporate taxation at a Member State level affects companies' strategic decisions over the FDI in the light of the legal parameters already established in the EU. The desire of most governments to attract foreign direct investment (FDI) directs special attention to the way in which policies affect the location and activities of multinational firms. The thesis continues this line of research focussing on a specific tax policy question – possible harmonisation of the rules of transfer of losses within an EU wide group of companies, in particular as regards subsidiaries. Cross border loss relief can be defined as a tax incentive that reduces the tax burden of enterprises in order to induce them to invest in particular projects or sectors. It is one of the mechanisms used by governments to lower the effective tax rate and constitutes an exception to the general tax regime allowing investors to carry losses forward (or backward) for a specified number of years for tax accounting purposes[2]. This measure is assumed to be attractive by investors whose projects are expected to run losses in the first few years as they try to increase production and penetrate markets. Although such rules of transfer of losses differ in all EU Member States, recent Commission incentives and ECJ case law attempts to put this issue on the EU level.

[2] 'Tax incentives and FDI: a Global Survey' (2002), United Nations Conference on Trade and Development, ASIT Advisory Studies, No. 16, p.19

The purpose of this thesis is to analyze the significance of the potential harmonization of transfer of losses rules to the FDI flows within the EU in the light of established legal parameters. Based on the hypotheses above, the thesis will address following main questions:

- Are possibilities to transfer losses within the groups of companies in the EU significant for location of investment? What are the economic implications of cross- border loss shifting rules' harmonisation?
- Is there a need for intra-group relief for losses in the EU?

The result determines whether and in which circumstances transfer of losses rules could be harmonised in the EU and what is likely to result from such harmonisation.

The question consists of two interconnected components, a business and a legal one. The business perspective deals with the position that corporate taxation rules occupy in the strategic MNEs' decisions around the issue of FDI, in particular as regards secondary establishment. The significance of possibility to transfer losses within an EU wide group of companies to effective capital allocation and economic implications of such harmonization are identified. Cross border transfer of losses for tax purposes might be a major element in an effective tax system and one that is highly attractive to foreign investors. In order to test such hypothesis theories of international trade and multinational enterprise as well as empirical studies and EU's approach on the issue are overviewed. The determinants of firms' FDI decisions in general are first introduced following the analysis of the effect of taxes on investment location. The impact of cross-border loss relief on strategic business decisions is then discussed providing evidence of significance of harmonisation of transfer of losses rules in the EU.

The legal perspective investigates the current legal situation in the EU Member States and overviews the EU's attempts to establish a legal framework for cross- border loss relief as well as the content and implications of the ECJ's decisions on the freedom of establishment for the harmonization of corporate taxation issue over transfer of losses in the EU. These parts are coupled with a general reference to the concept of corporate tax

harmonization, and a short discussion over the potential direction of future developments on this issue in the EU.

1.2. Delimitations

While it is relevant to investigate the evolution of the EU rules on cross-border loss relief by analysing Commission's studies and the ECJ cases, the impact of those rules on companies' locational decisions requires more than that. One could argue that a survey or interviews are necessary to establish a business approach to the question at issue. However, no interviews were taken and it was not chosen to analyse the behaviour of companies through questionnaires because of a high risk of pure effectiveness determined by the lack of exhaustive and appropriate data, limited number of responses possible to receive in scheduled time as well as the bias of companies' representatives possible to reach. Therefore, the thesis relies on the survey by the Federation of Swedish Industries of losses on cross border activities within the EU data.

For the purpose of this thesis the main question rests on the discussion whether and in what way direct taxation influences strategic business decisions. The extent to which cross- border transfer of losses rules actually affects the locational decisions of companies is not measured and analysed in the light of other FDI determinants.

The thesis focuses on the impact of the rules of transfer of losses within an EU wide group of companies as regards secondary establishment only. Implications of such rules to other forms of FDI, such as mergers and acquisitions or joint ventures, are left out of the scope of this research.

Harmful competition is explained but not extensively analysed in this paper. Interactions between imperfectly co-ordinated corporate income taxes present numerous opportunities for firms to benefit from perfectly legal forms of tax planning exploiting differences between tax rules and tax rates in different countries to reduce their tax bills. However, tax avoidance issues referring to the behaviour of companies are only briefly discussed.

The opportunities for tax avoidance that add to the perception that corporate tax revenues are under threat because such activity is highly responsive to tax rates and tax structure is not further elaborated. Discussion of measures designed to combat with harmful tax competition is limited to the EU's introduced initiatives.

The thesis does not provide detailed introduction of the differences in cross-border transfer of losses rules in the EU Member States in order to be able to analyse the failure of the proposed Council Directive in this areqa and its possible application in today's situation.

While discussing possible developments of corporate tax systems, the Commission's idea of piloting the common consolidated EU tax base with the European Company Statute/*Societas Europaea* (SE) is left out of the scope. Without proper EU tax rules the European Company Statute will be unlikely to be of any practical benefit. However, this debate is left untouched.

1.3. Methodology

Theoretically, the thesis involves a synthesis of legal and business analysis. The project comprises analysis of the dilemmas present and policy options available concerning EU company tax matters and ECJ rulings in the field of direct taxation. To present up to date view of the research problem the thesis includes reports on the findings by scholars, EU Commission's studies, the ECJ case law analysis of the most relevant cases and discussion on other legislative attempts. A research synthesis perspective where the stated aim is to find generalizations, cause and effect connections, develop theories and seek practical applications[3] has been chosen to complete the task. The purpose of the research synthesis in this thesis is to be integrative so that the business and law perspectives can be used as a platform for joint analysis of present situation and also to show areas where problems exist. The following points illustrate why such perspective was used:

[3] Backman, J., (1998) *Rapporter och uppsatser*, Studentlitteratur, Lund.

- The area of study lacks a coherent oversight using the chosen perspectives as a backdrop.
- The amount of data and research is plentiful and is rapidly increasing.
- There are contradictory statements and evidence circulating.
- There is a lack of theoretical support in the general debate and legal cases.

The contribution of the thesis is to introduce a theoretical perspective in order to offer a more practical solution from a legal perspective. Only the most seminal work and the most relevant cases have been chosen as reference work. The theoretical chapter deals with OLI theory and literature in the field of business strategy in order to make the case law and legislation better understood and help to point out what the court's decisions are lacking and what implications they have.

Discussions and analysis are based on knowledge from books, articles and statements from experts in the field. The data collected for this thesis is secondary in its nature, a common trait of the research syntheses process[4]. Because of the possibility that using secondary sources the text is biased towards a particular viewpoint, the data selection process had to apply four criteria: answers and statements had to be valid, relevant, reliable and truthful.[5] Reports, essays and other written material have been evaluated in terms of consistency of arguments, assumptions and stated implications.

Traditional legal method of analysis is chosen for the legal part of the research. The relevant case law pertaining to the free movement of establishment is analyzed using a textual analysis, examining the words the ECJ have used to interpret the Treaties. Statements from key participants, implications for the future and application of relevant law are discussed. The underlying principles as laid out in the freedom of establishment

[4] The bulk of the source material used for this thesis is written, secondary data; this includes books, articles, Internet homepages, case law, databases (ELIN & Kluwerlaw) and information gathered from news reports. Search engines like yahoo.com and google.com were used to further the search and find material perhaps not included in traditional research databases. The only data used from the search engine searches were from online versions of newspapers and additional research papers and reports to complement the ones gathered from the academic databases. Research articles from databases, which are heavily used in this thesis, have gone through a rigorous academic feedback process; there are certain conditions that have to be met in order for the article to be published.

[5] Alvesson, M & Sköldberg, K (1994) *Tolkning och reflektion*: *Vetenskapsfilosofi och kvalitativ metod*, Studentlitteratur, Lund

cases are then compared to the case law discussing the removal of barrier to transfer of losses across the borders in the EU.

2. Determinants of firms' FDI decisions in general

2.1. Definitions and introduction to MNE

The main drive behind firms' deliberations on the place and structures of their establishment is the positive development of their profitability. According to the "new trade theory", to increase their profits firms exploit economies of scale and pursue strategies of product differentiation in an international imperfectly competitive environment where market sizes, transport costs and trade policy regimes differ[6]. The quest to exploit market opportunities in other countries by locating production activities wherever they can be conducted most efficiently has caused business internationalisation through two mechanisms: trade and foreign direct investment (FDI)[7].

FDI is, according to the IMF guidelines, defined as foreign investments in which the investor owns more than 10% of the stock that is invested in[8]. This generally refers to investments by multinationals in foreign controlled corporations such as affiliates or subsidiaries. FDI flows consist of two broad categories:

- Direct net transfers from the parent company to a foreign affiliate, either through equity or debt;
- Reinvested earnings by a foreign affiliate[9].

Additionally, a new definition of FDI was proposed by DIGET[10] arguing that due to their composition, the overall total of FDI results loses their analytical strength and their

[6] Markusen, J., R., (1995) 'The Boundaries of Multinational Enterprises and the Theory of International Trade', The Journal of Economic Perspectives, Vol.9, No.2, p.169
[7] Grant, R., M., 'Contemporary Strategy Analysis' – 4th ed. (Blackwell Publishing, 2002), p. 411
[8] FDI is a cross-border investment made by an investor with a view to establishing a lasting financial interest in an enterprise and exerting a degree of influence on that enterprise's operations and where the foreign investor holds an interest of at least 10% in equity capital (dictionary definition).
[9] Mooij, R., A., Ederveen, S., 'Taxation and FDI' (2001), CPB Discussion Paper, No.003, p.10

comparability across the countries. One of the reasons is the aggregation of investments in the "real" economy and of operations via fiscal and financial vehicles. The group suggested to redefine FDI by adding an employment criterion that would exclude special purpose entities which do not carry out a real economic activity on the territory in which they are located. Concretely, an FDI relation would be defined by the present criterion- at least 10 % of the capital, and an employment criterion- at least X persons employed.

Statistical information on FDI involves financial flows that do not necessarily correspond to the allocation of real investment in plant and equipment, either in the form of new plant and equipment or plant expansions. A major part of FDI consists of the financial flows associated with mergers and acquisitions[11]. This implies a change in ownership without any real investment taking place. Other components of FDI are joint ventures and equity increases. The latter component typically comprises investment in financial capital. The distinction between the different types of FDI is important because the different components may respond differently to taxes[12].

Firms that engage in FDI, defined as investments in which the firm acquires a substantial controlling interest in a foreign firm or sets up a subsidiary in a foreign country, are MNEs[13]. Industries, characterized by scale economies and imperfect competition, are often dominated by MNEs[14].

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[10] Schuller, G., 'A proposal for new definition of FDI', Background document for DIGET (Direct investment technical expert group) issue#2, IMF committee on balance of payments statistics and OECD workshop on international investment statistics, May 2004 p.4-5

[11] OECD (2000) suggests that M&A account for more than 60% of all FDI in developed countries.

[12] Auerbach, A., J., Hassett, K., (1993), 'Taxation and foreign direct investment in the United States: a reconsideration of the evidence', as cited in Giovannini, A., R., Hubbard, G., Slemrod, J., (eds.), Studies in International Taxation, Chicago University Press.

[13] MNEs are defined as exporters of the services of firm-specific assets, which include management, engineering, marketing, and financial services. Subsidiaries import these services in exchange for repatriated profits, royalties, fees, or output. /Markusen, J., R., (1995), p.170

[14] MNEs tend to be important in industries with four characteristics: high levels of R&D relative to sales, a large share of professional and technical workers in their workforces; products that are new or technically complex; and high levels of product differentiation and advertising. /Markusen, J., R., (1995), p.172/ Multinational industries internationalise through FDI- either because trade is not feasible (service industries such as banking, consulting or hotels) or because products are nationally differentiated (frozen dinners, recorded music). Most large-scale manufacturing industries tend to evolve towards global structures (automobiles, consumer electronics, semiconductors, pharmaceuticals, beer). /Grant, R., M., (2002), p. 412

2.2. FDI determinants: where does the tax rank?

Decisions by multinationals to undertake FDI are usually complex since they involve strategic decisions. If foreign MNE are exactly identical to domestic firms, they will not find it profitable to enter the domestic market. There are added costs of doing business in another country, including communications and transport costs, higher costs of stationing personnel abroad, barriers due to language, customs and being outside the local business and government networks[15].

The advantages and conditions under which FDI would occur despite higher costs were examined by Hymer and Kindleberger confirming that the multinational enterprise must arise due to the fact that it possesses some special advantage such as superior technology or lower costs due to scale economies[16].

The most widely accepted theory of FDI identifying valuable market power or cost advantage of the firm sufficient to outweigh the disadvantages of doing business abroad is the eclectic approach developed by Dunning (1981). For a multinational that seeks to maximize the value of the firm, investment is attractive if the so-called OLI conditions are met, referring to Ownership, Location and Internalisation[17]:

1) There must be an ownership advantage for the multinational relative to ownership by local firms. It could be a product or a production process to which other firms do not have access, such as a patent, blueprint, or trade secret. It could also be advanced technology or something intangible, like a trademark, reputation for quality or managerial and marketing expertise.

[15] Markusen, J., R., (1995), p.173
[16] Hymer, S., H., (1976), 'The International Operations of National Firms: a Study of Direct Foreign Investment' as cited in Markusen J., R., Kindleberger, C., P., (1969), 'American Business Abroad: Six Lectures on Direct Investment', New Haven:Yale University Press
[17] Dunning, John H., (1981) 'International production and the multinational enterprise', Allen&Unwin, London, as cited in Mooij, R., A., Ederveen, S., 'Taxation and Foreign Direct Investment' (2001), CPB Discussion Paper No. 003, p.10

2) It must be attractive for the multinational to produce abroad because of some comparative locational advantage. Otherwise, the multinational would have chosen to export, rather than to invest. Tariffs, quotas, transport costs, and cheap factor prices are the most obvious sources of location advantages. In addition access to customers can also be important.

3) Internalization advantage is the most abstract explaining that it should be attractive to undertake activities within the multinational, rather than buying or leasing them from other firms. The product or service is exploited internally within the firm rather than at arm's length through markets.

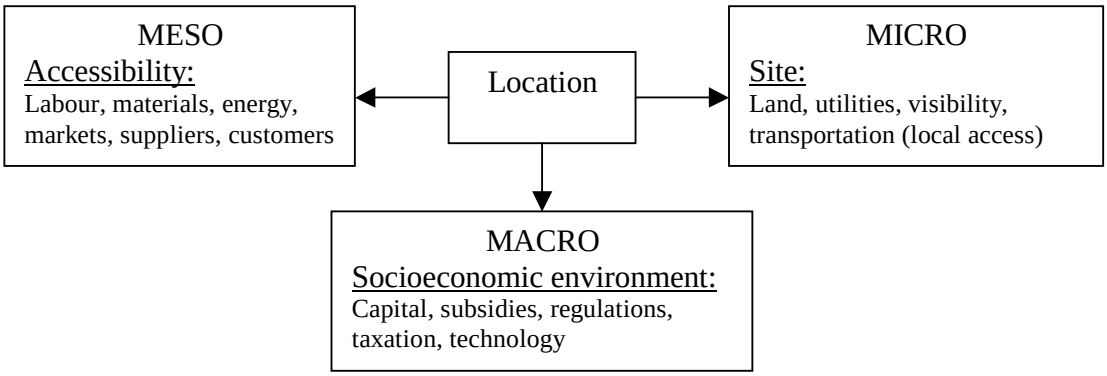
Taxes can affect all three OLI conditions. It can affect the tax treatment of a foreign firm, relative to domestically owned firms.[18] Forssbaeck and Oxelheim argue that, in addition to proprietary knowledge and know-how, financial ownership advantages influence the FDI decisions and deserve an explicit recognition in the OLI framework[19]. Authors identify proactive financial strategies, such as the negotiation of financial subsidies and/or reduced taxation to increase free cash flow, as constituting ownership specific advantage[20] enabling a firm to minimize its cost of capital and maximize its availability of capital relative to its competitors[21]. By lowering the discount factor of any investment (both domestic and global) the firm's likelihood of engaging in FDI as compared to its competitors would be enhanced[22]. Indeed, MNE is more likely to engage in FDI when it is able to negotiate reduced taxation.

For the purpose of this thesis taxation is treated as a locational advantage. Tax rates and tax systems can be a factor that determines the attractiveness of location for undertaking investments (see *Figure 2.2*).

[18] Mooij, R., A., Ederveen, S., 'Taxation and FDI' (2001), CPB Discussion Paper No. 003, p.11
[19] Forssbaeck, J., Oxelheim, L., (2004) 'Proactive Financial Strategies and the OLI paradigm of FDI- evidence from the European Mergers and Acquisitions', Discussion Paper presented at European Economic Integration in Swedish Research Conference in Molle, May 2004.
[20] Only non- financial firms are not covered by the OLI paradigm. If the firm is a bank or financial institution the case is already recognised as an advantage within the OLI paradigm.
[21] Forssbaeck, J., Oxelheim, L., (2004), p.9

[22] Ibid., p.6

Figure 2.2. Location factors[23]



However, taxation is merely one of several factors influencing companies' decision on the location of their investment, the others being different political, economic and social factors such as a good infrastructure, access to natural resources, the availability of high-skilled workers, proximity to markets, or the proximity of other businesses due to network and agglomeration benefits.[24] Primary industries are usually found where the resources are found[25], while market and labour supply are very important in service industries. The location of manufacturing industry is influenced by labour supply, transport, site, raw materials, market, power supply, and government aid[26]. Most firms first choose foreign production locations, and then instruct their tax departments to minimize taxes[27].

Further analysis is focused on different approaches to corporate taxation affects on investment location decisions. To define whether, why, and which tax point matters in firms' FDI decisions, tax competition is introduced identifying economic implications of such process and discussing arguments for harmonization of corporate taxation rules. Brief literature review and EU's approach on the issue is then applied to define possible significance of harmonization of transfer of losses rules within the EU.

[23] Kogut, B., 'Designing Global Strategies and Competitive Value- Added Chains' (Summer 1985), Sloan Management Review, p. 15-38
[24] Mooij, R., A., Ederveen, S., (2001), p.11
[25] For example, coalmines have to be found on coalfields.
[26] Kogut, B., (1985), p. 15-38
[27] Markusen, J., R., (1995), p. 171

3. The effect of taxes on investment location

3.1. Taxation – a tool for competition

Because of globalisation of the economy and progressive removal of barriers to international investment particularly due to the presence of organisations such as EU, WTO, OECD, a decreasing gap between the factors other than taxation affecting companies' decisions on where to invest has made the tax variable increasingly important in this choice[28]. One could assume that within the EU tax rate differentials exert a substantial impact on the allocation of foreign capital as restrictions on capital movements were fully removed in the early 1990s. The attractiveness of cross-border investment is reinforced with the functioning of the single currency, which has eliminated exchange risks and costs within the euro area. Therefore, countries involve in the process of tax competition by lowering the tax burden in order to improve economy and welfare by increasing the competitiveness of domestic business and/or attracting FDI[29].

Taxation is understood by each Member State to be a characteristic of its sovereignty and protected as such because it has overriding significance as the means of financing national budgets and determining economic policy[30]. In the area of tax harmonization the countries would agree only for what is essential for a common market to function[31]. This relates to all border-crossing activities such as the value- added tax (VAT). Otherwise, there are strong arguments for competition in taxation to stay[32]. It all depends on the further political integration of Europe and on the willingness to give up national sovereignty.

[28] Pinto, C., 'Tax Competition and EU Law', (Kluwer, 2003), p.12-16
[29] Pinto, C., (2003), p. 1
[30] Laule, G., Weber, R., 'Harmonisation of the Tax Systems in Europe', at http://www.whitecase.com
[31] The EU policies are guided by the principle of subsidiarity (Article 5 EC). This requires that the Member States should be able to determine their own fiscal policies (as they do not fall within community's exclusive competence) unless those policies have negative spillover effects on the entire Union.
[32] Siebert H., 'How to improve Economic Governance in Europe' (2003), Statement at the Aspen Institute Dialogue, Redesigning Europe, Challenges for the Italian Presidency of the Union, Rome

3.2. Statutory and effective tax rates

Statutory rates of corporation tax in the EU Member States have fallen substantially over the last two decades. The average rate among the EU countries in the early 1980s was nearly 50%; by 2001 this had fallen to under 35%. In 1992, the European Union's Ruding Committee recommended a minimum rate of 30% - then lower than any rate in Europe (with the exception of Ireland). Ten years later, already one third of the members of the European Union have a rate at or below this level (see *Table 3.1*).

Table 3.1.2 Statutory corporate income tax rates in the EU countries 1979- 2003, %

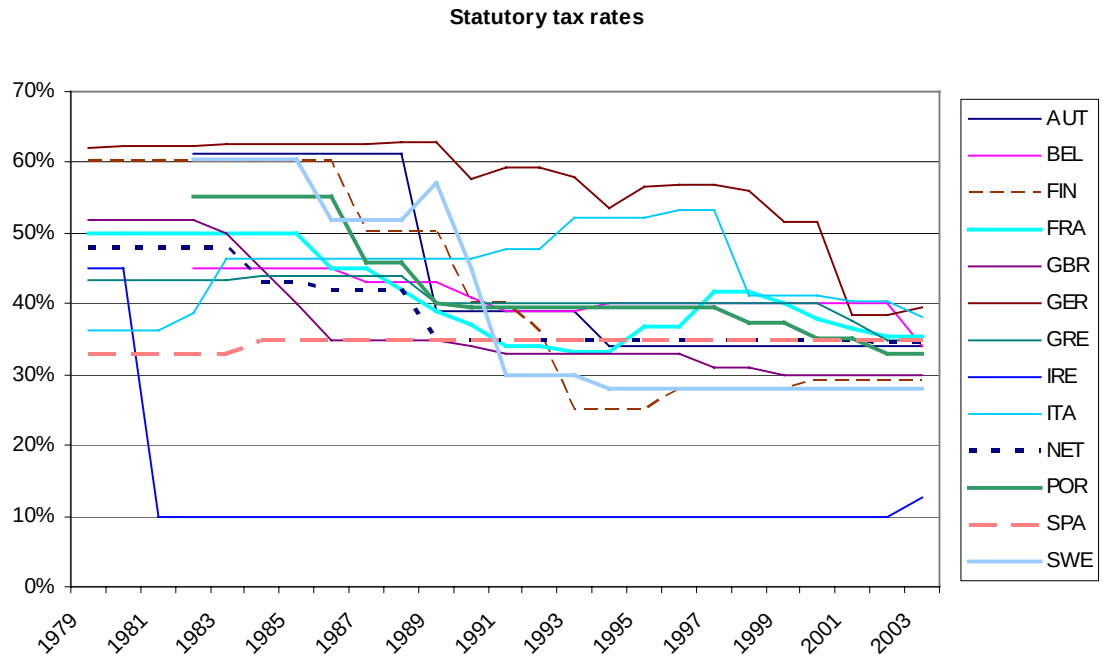
	AUT	BEL	FIN	FRA	GBR	GER	GRE	IRE	NET	POR	SPA	SWE
1979			60	50	52	62	43	45	48		33	
1980			60	50	52	62	43	45	48		33	
1981			60	50	52	62	43	10	48		33	
1982	61	45	60	50	52	62	43	10	48	55	33	60
1983	61	45	60	50	50	63	43	10	48	55	33	60
1984	61	45	60	50	45	63	44	10	43	55	35	60
1985	61	45	60	50	40	63	44	10	43	55	35	60
1986	61	45	60	45	35	63	44	10	42	46	35	52
1987	61	43	50	45	35	63	44	10	42	46	35	52
1988	61	43	50	42	35	63	44	10	42	40	35	52
1989	39	43	50	39	35	63	40	10	35	40	35	57
1990	39	41	40	37	34	58	40	10	35	40	35	45
1991	39	39	40	34	33	59	40	10	35	40	35	30
1992	39	39	36	34	33	59	40	10	35	40	35	30
1993	39	39	25	33	33	58	40	10	35	40	35	30
1994	34	40	25	33	33	54	40	10	35	40	35	28
1995	34	40	25	37	33	57	40	10	35	40	35	28
1996	34	40	28	37	33	57	40	10	35	40	35	28
1997	34	40	28	42	31	57	40	10	35	40	35	28
1998	34	40	28	42	31	56	40	10	35	37	35	28
1999	34	40	28	40	30	52	40	10	35	37	35	28
2000	34	40	29	38	30	52	40	10	35	35	35	28
2001	34	40	29	36	30	38	38	10	35	35	35	28
2002	34	40	29	35	30	38	35	10	35	33	35	28
2003	34	34	29	35	30	40	35	13	35	33	35	28

Definition: For countries using different tax rates, the manufacturing rate is chosen. Local taxes (or the average across regions) are included where they exist. Any supplementary taxes are included only if they apply generally.

Source: Price Waterhouse Coopers, 2004

EU Governments are further launching proposals to reduce the average tax burden on companies. To illustrate, Germany, Ireland and Portugal have reduced their taxes while the Netherlands, Italy and France are discussing proposals for tax reform and relief[33]. The growing internationalisation of business and the increasing mobility of capital motivates these proposals. The figure below reflects corporate tax rates and their changes during 1979- 2003 in the EU.

Figure 3.1.2(a) Changes in statutory corporate income tax rates in the EU countries 1979-2003, %



Source: Price Waterhouse Coopers, 2004

Falling corporate tax rates in the EU provide strong circumstantial evidence that governments are trying harder to fulfil desires of international firms and investors to lower taxes on profits, which makes them involved in the process of tax competition. In the EU, the most notable example of a production 'tax heaven' is Ireland, which offers 12.5% general corporate tax rate. New Member States are also attracting volumes of

[33] Joumard, I., (2001), 'Tax systems in EU countries', Economic department working papers, Nr. 301, OECD

investment from companies headquartered in the high-tax Member States, combining their low-tax regimes with much lower labour cost levels: Slovakia and Poland impose just a 19 %, Hungary a 16%, and both Latvia and Lithuania a 15% tax on corporation earnings, while Estonia does not charge any tax at all on reinvested profit[34].

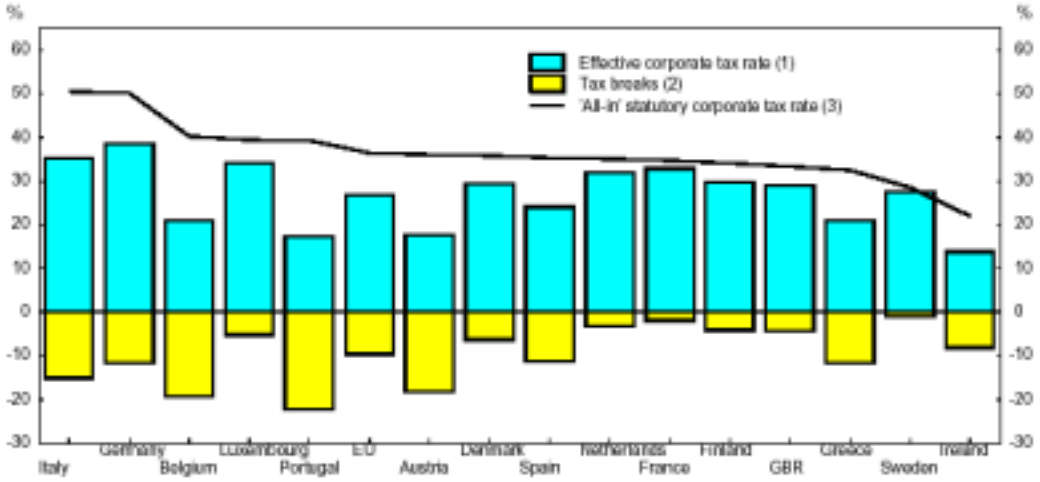
However, there is no single rate of corporate tax applied to taxable profit. One important element is the proportion of capital expenditures that can be set against profit in any year defined as the capital allowance. A typical average tax rate is likely to be a poor approximation of an effective marginal tax rate, simply because it does not capture investment incentives at the margin. This means that the statutory rate does not usually affect decision making by firms.

Devereux argues[35] that the effective marginal tax rate, - which is the excess of the marginal cost of capital with the tax over that cost without the tax - determines marginal or incremental investment of firms already based in a country. On the other hand, the decision whether to locate in county A rather than country B at all is governed by the *effective average tax rate*, which is the ratio of corporate tax paid to pre-tax profit. Both the effective marginal and average rates differ from the statutory rate, and are lower the more generous allowances are.[36]

In a number of cases, countries have introduced special regimes to attract FDI in specific geographical areas or activities. Over 1990-96, the effective corporate tax rate was almost 10 percentage points lower than the statutory rate in the EU area in the manufacturing sector, with large variations across countries in the conditions and generosity of the associated tax allowances (see *Figure 3.1.2(b)*).

[34] Ministries' of Finance data
[35] Devereux, M., P., (2003)'Measuring Taxes on Income from Capital', Institute for Fiscal Studies Working Paper 03/04, p.42
[36] Ibid.

Figure 3.1.2(b) Statutory and effective corporate taxation in the EU area (1990-96)[37]



Definitions:
1. These estimates are drawn from the consolidated financial statement data of non-financial EU firms, mainly listed and manufactured companies.
2. Difference between the effective corporate tax rate and the statutory corporate tax rate.
3. Including local government taxes and temporary surcharges.
Source: OECD, 2001

According the OECD definitions, tax relief often include: investment tax credits, accelerated depreciation allowances for investment in equipment goods and in intangible assets (such as R&D), tax breaks for employment creation, and tax incentives for deprived areas. Generous investment tax credits in some EU countries, combined with depreciation rates higher than economic depreciation, produce a bias in favour of capital intensive activities. In addition, many countries have recently introduced or raised tax measures that favour small enterprises, newly created firms and/or information technology companies (France, Netherlands, Portugal, Spain, and the United Kingdom). These measures are designed to offset the disadvantages of new, or small, enterprises in financing their investment projects and/or the disproportionate costs stemming from administrative complexities, including tax compliance[38].

The number of countries offering some type of tax incentives targeted at attracting FDI is increasing. The economic implications and alternatives of such policy are discussed bellow.

[37] Joumard, I., 'Tax systems in EU countries' (2001), Economic department WP No. 301, OECD, p.35
[38] Joumard, I., (2001), p.34

3.3. The economic alternatives: tax competition or tax harmonisation

From the economic perspective tax competition is a positive concept, yet scholars tend to make a distinction between 'good' or desirable form of tax competition as opposed to a 'bad' or harmful form depending on whether the alleviation of the direct tax burden is intended to boost a country's economy and to benefit all taxpayers (race to the top) or whether it is mainly directed at attracting foreign business or capital at the expense of other countries' economies (race to the bottom). [39]

3.3.1. "Good" tax competition

From the broad economic perspective, the process of tax competition would likely bring benefits for countries, such as economic growth and development of their territory, increased employment, and increased overall domestic welfare.

Variations in tax rates across different countries could be considered as a good thing, because they give taxpayers more choice, and thus more chance of being satisfied. They also create pressure on governments to be efficient forcing them to maintain reasonable levels of public expenditure and improve the efficiency of public administration.[40]

From the business perspective, tax competition is beneficial in that it provides the best economic environment at the lowest possible tax cost to undertake investments and free up capital.[41] As a result of tax competition, each country has its own "offer" of (reduced) tax burden and public services, and individuals and firms are free to choose the one that best suits their needs.

[39] Avi- Yonah, R., S., 'Globalisation, Tax Competition and the Fiscal Crisis of the Welfare State', 113 Harward Law Review, 5/2000, p. 1573
[40] Tiebout, Ch., 'A Pure Theory of Local Expenditures' (1956) as cited in The Economist Survey: Globalisation and Tax, The Economist of 27/01/2000
[41] Pinto, C., (2003), p.10

As each country opt for its optimal "tax mix", or distribution of a country's overall tax revenue needed to fund the public services among the various taxable bases, tax competition is expected to be beneficial or at least not harmful.[42] Even though countries offering some type of tax incentives have been referred to as "production tax heavens", as they try to increase productive activities carried out by foreign companies, they are not considered to be engaged in harmful tax competition whenever they have a general low tax rate on productive activities for both resident and foreign investors.

3.3.2. Harmful tax competition - "Race to the bottom"

The Ruding-report of 1992[43], the European Commission's report 'Development of Tax Systems' of 1996[44] and the 1998 OECD report 'Harmful Tax Competition'[45] have summarized the arguments against tax competition. These reports hold that main harmful effects appear in the cases when equity among domestic and foreign taxpayers is impaired, and large foreign-based MNEs are able to enjoy public goods without contributing significantly to their provision through the payment of corporate tax. The main arguments rest on the fact that countries, which grant tax incentives to attract highly mobile activities (management, financial, coordination, insurance, and distribution activities) performed in a multinational group, usually reduce overall costs of the group without any significant improvement of real wealth. Such countries are engaged in harmful competition and referred as "headquarters tax heavens". They usually gain little tax revenue and the countries from which the activities and capital are relocated loose heavily. In this case, fiscal degradation is possible if other countries retaliate with the same kind of tax incentives causing the need to seek alternative sources of revenue without bringing about substantial advantage for any of the countries involved[46].

[42] Various taxable bases include direct taxes on individual and corporate income, social security contributions, indirect taxes on consumption, environmental taxes, etc.
[43] Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation, Office for Official Publications of the European Communities, Brussels/Luxembourg, 1992 (referred to as 'Ruding Report'), p. 151
[44] Commission of the European Communities, 'Taxation in the European Union- Report on the Development of Tax Systems', COM(96) 546 final of 22 October 1996
[45] OECD, 'Harmful Tax Competition - An Emerging Global Issue', (1998)
[46] Pinto C., (2003), p.15

However, it is doubtful that paying direct taxes countries contribute significantly to improvement of welfare. Thus, the argument that countries engage in tax competition and give out the tax incentives in order to gain from investments is more compelling.

However, one can not overlook that tax competition may reason harmful economic effects which are potential "race to the bottom" caused by a significant decrease in corporate tax revenue and a drastic reduction in public services and social security benefits associated with an increased burden on alternative tax bases, such as consumption, which causes regressive effects on income redistribution, or labour, which may bring about higher unemployment and a misallocation of resources[47].

3.3.3. Harmonisation in order to achieve tax neutrality

The starting point of the classical theory of coordination or harmonisation of tax systems is the recognition that the levying of taxes necessarily involves distortions of economic decisions[48]. If the existence of taxation as such has to be accepted, then the individual decision on the "if" and "how" of an allocation of resources shall not be influenced by interregional differences of tax bases, tax rates, and enforcement of taxation[49]. Such demand of tax neutrality has found two major expressions: capital export neutrality and capital import neutrality[50].

Capital export neutrality looks at taxation from the perspective of the investor who is about to decide whether to employ his resources domestically or abroad. The tax systems involved behave *neutrally* towards this decision when the investment is burdened equally

[47] Pinto, C., (2003), p.372
[48] Tax harmonisation is generally understood as a process of adjusting tax systems of different jurisdictions in the pursuit of a common policy objective and involves the removal of tax distortions affecting commodity and factor movements in order to bring about a more efficient allocation of resources within an integrated market. Such harmonisation is a result of action at the Community level by the Commission or other agencies of the Community such as the ECJ. /Kopits, G., (ed.), 'Tax Harmonisation in the EC, Policy issues and analysis' (1992), IMF Occasional Paper, p.3
[49] OECD ' Harmful Tax Competition -An Emerging Global Issue', (1998)
[50] Schon, W., (2002) 'Tax competition in Europe– the Legal Perspective', EC Tax Review, No.2/2002, p.92

irrespective of where it takes place.[51] This can be guaranteed by taxing the investor's world-wide income according to the residence principle granting a credit for foreign taxes, which serves to lift the total burden on all foreign income up to the level existing in the country of residence[52]. Tax neutrality is important because for investors from tax credit countries a higher tax rate in a host country may yield ambiguous effects: it may reduce real investment to the extent that parents are in an excess credit position or it may encourage foreign ownership of capital in the host country.[53]

From the perspective of capital import neutrality, the objective is to provide domestic and foreign investors with a tax framework of the same kind, particularly without any tax discrimination of permanent establishments and subsidiaries of foreign enterprises compared to domestic businesses. This ideal corresponds to a full taxation of income and property in the country of source with simultaneous exemption of this income and property in the residence country of the investor.[54] It is based on an argument that a higher tax rate in the host country is likely to reduce FDI from the country of residence, because it makes the host country less attractive as a location for investment in plant and equipment[55].

Schön argues that it is quite plausible that, within an international tax order leaving it to the countries involved to decide freely on the kind, level and enforcement of taxation and merely providing for an elimination of double taxation according to the credit or exemption method[56], capital export and import neutrality can never be realized at the same time - only one of the two aspects can be taken into account to the greatest possible extent by way of double tax conventions[57]. Comprehensive cross-border neutrality would

[51] Ibid.
[52] Capital export neutrality on the basis of a combination of global income taxation with the credit method also has its limits: the `tax deferral' effect of separate corporate enterprises prevents the investor's residence country from having direct access to profits accumulated by subsidiaries located in other countries.
[53] Mooij, R., A., Ederveen, S., 'Taxation and Foreign Direct Investment' (2001), CPB Discussion Paper No. 003, p. 13
[54] Farmer, P., Lyal, R., 'EC Tax Law' (Clarendon Press, 1994), p. 248
[55] Mooij, R., A., Ederveen, S., (2001), p. 13
[56] In the EU, the Parent-Subsidiary Directive ensures that countries wither adopt a credit system or an exemption system to avoid international double taxation within the Union. Most countries avoid double taxation by means of bilateral tax treaties based on the OECD Model Tax Convention.
[57] Schon, W., (2002) 'Tax competition in Europe– the Legal Perspective', EC Tax Review, No.2/2002, p.92

be established only when a taxpayer is faced with equivalent, equally high and equally enforced tax burdens. For the ideals of capital import and export neutrality to be simultaneously realized, greater harmonisation is required.

Perhaps the most widely accepted argument for harmonisation involves convergence in the definition of product value or income for tax purposes. Such tax base harmonisation would contribute to transparency for economic decision- making and, thus, to improved efficiency in resource allocation[58]. However, although it is argued that continued existence of 25 separate corporate income taxes within the EU has some significant economic distortions as investment attracted to certain locations by the promise of low tax charges rather than low production costs makes production less efficient, from an economic point of view efficiency of production can never be increased by paying higher taxes.

Nevertheless, a common income tax base for multinational companies operating in different jurisdictions would be instrumental in preventing overlaps or gaps in tax claims by different countries. Tax competition causes difficulties for international companies to structure their European operations efficiently as a result of having to deal with different national tax systems, favouring a collection of national subsidiaries rather than a pan-European organisation. Differences in tax systems cause administrative and compliance costs as companies are required to prepare tax accounts for different revenue authorities and as disputes arise as a consequence of tax planning[59].

The above discussion shows that arguments about company tax harmonisation rely heavily on the belief that tax rates have important and negative economic implications. The costs of these distortions to economic activity are difficult to quantify, but they are likely to become more significant in the future as companies become increasingly international. However, there is still high uncertainty as to how different tax burdens affect behaviour of MNEs and their decisions where to locate. This issue is fundamental

[58] Kopits, G., (ed.), 'Tax Harmonisation in the EC, Policy issues and analysis' (1992), IMF Occasional Paper, p. 3
[59] Bond, S., Chennells, L., Devereux, M., 'Corporate tax harmonisation in Europe', The Institute for Fiscal Studies, 2004

because tax competition is likely to be a real problem only if direct taxation is decisive in affecting the actual behaviour of companies and in particular their locational decisions[60]. Next chapter is looking for the support in literature to uphold the arguments that taxes affect the location of capital. For this purpose empirical studies will be briefly overviewed and the EU's approach from Commission's studies will be established.

[60] Pinto, C., (2003), p.28

3.4. Literature review

3.4.1. Methodology shortcomings

A sizable literature is devoted to measuring behavioral responses to international tax rules. This literature focuses on the impact of corporate tax rates on investment behavior, most directly, the location and scope of international business activity, as well as various financial and organizational practices used to avoid taxes. However, none of the studies have clearly proven the relationship between direct taxation and the locational decisions of companies, or the extent to which the former actually affects the latter, for the lack of an effective general methodology currently used for this purpose[61].

Devereux and Griffin maintain that methodological shortcomings are first caused by difficulties in measuring the dependent variable: FDI flows have an unclear relation to investment in real activity by MNEs and may therefore be a poor measure of the variable of policy interest. On the other hand, real activity data are only available for a few countries and therefore, it may be difficult to generalize the results from studies based on these data. The authors emphasise that inherent difficulties in measuring tax rates and insufficient control for other variables influencing the location of capital, as well as insufficient care being taken when distinguishing the effects on decisions taken at different levels are so severe that it is impossible to summarize the literature in a quantitative measure of the effect of corporate taxation on the location of capital.[62] Nevertheless, there is some evidence on the influence which direct taxation has on such decisions: the main conclusion reached in most papers is that taxes do influence the location and investment decisions of firms, but it is impossible to say how much.

[61] Some of the studies are based on economic models mainly relying on macroeconomic and microeconomic data (e.g. figures on FDI or investment paterns og specific MNE). The shortcomings of these models are linked to the lack of exhaustive and appropriate data. Other studies are based on empirical evidence and are meant to analyse the behaviour of companies through questionaires. Their effectiveness suffers from the limited number of responses received as well as from the bias of companies' representatives./ Pinto, C., (2003), p.28-29

[62] Ekholm, K., (2002), 'Comment on Michael P. Devereux and Rachel Griffith: The impact of corporate taxation on the location of capital: A review', Swedish Economic Policy Review, No. 9/02, p.103-105

3.4.2. Empirical lessons from international taxation

The economic literature tends to support the claim that international taxation influences the volume and location of FDI, corporate borrowing, transfer pricing, dividend and royalty payments and is responsible for a wide range of tax avoidance[63]. To illustrate, Hines, while summarising 20 quantitative studies on US direct investment abroad and on FDI into the US, indicates that direct taxation significantly influences magnitude and location choices of FDI[64]. Author concludes that sensitivity of MNEs investment decisions to their tax treatment carries numerous implications for tax policy, including the standard incentive for governments to compete with each other to offer firms ever lower-tax rates to attract activities that are believed to be beneficial to their economies.

Further looking for evidence on the influence of taxation on locational decisions one should consider results of empirical study based on specific survey provided in Ruding Report[65]. The survey, among other issues, assessed the impact of taxation on the location of real business activities (FDI decisions) and analysed the impact of taxation on the choice of the legal form and the way of financing of the investment[66]. Results showed that not only do differences in taxation affect firms' direct investment decisions, but they appear to have an even greater impact on the companies' financial and legal structures. According to the survey undertaken on behalf of the Committee, roughly two-thirds of respondents claimed that taxation is always or usually a major factor in financial decisions of multinational firms, including whether to finance new investment locally or through the parent, the type of finance used in either case, whether to set up a new operation in the form of a branch or a subsidiary, and whether to channel income from

[63] Gordon, R., Hines, J, 'International Taxation' (2002), National Bureau of Economic Research Working Paper, Cambridge, p.2

[64] James R. Hines, Jr., 'Tax Policy and the Activities of Multinational Corporations' (1996), NBER Working Paper 5589, which summarises 20 quantitative studies on US direct investment abroad and on FDI into the US.

[65] Commission of the European Communities, Report of the Committee of Independent Experts on Company Taxation, Office for Official Publications of the European Communities, Brussels/Luxembourg, 1992 (referred to as 'Ruding Report')

[66] The survey was distributed to a number of companies based in EU and EFTA countries (Austria, Finland and Sweden, who later joined the EU, Switzerland and Iceland. Responses were provided by 965 companies or about 11% of targeted companies. These companies were active in the manufacturing sector (68%) and represented the retail and the financial sector.

foreign operations through holding companies or other intermediaries in countries other than those where the parent or its foreign operations are located. The survey also showed that the factors of a country's tax system considered important for locational decisions were the statutory corporate tax rate and special investment incentives, defined as effective tax rate. It is noted in the Report that perhaps not only locational decisions are responsive to company tax rates, but also the amount of capital invested in each of these locations.

Providing analysis of the 1992 Ruding Report, the 1996 Monti Memorandum and Commission Report, and the 2001 Commission study on Member States corporate tax systems, Pinto supports the findings that direct taxation does play significant role in companies' decisions, especially for the location of the intra-group centres and finance entities[67].

Furthermore, Mooij and Ederveen research suggested that foreign direct investment is responsive to company tax rates and, therefore, tax rate differences within the EU have distorting effects on the functioning of the internal market. On average, if a country reduces its effective tax rate on companies by 1%-point, it attracts an additional foreign direct investment of approximately 3.3%[68].

However, Morck and Yeung notice that often claimed benefit of tax avoidance does not appear to be valued by investors in most cases in some studies[69]. Research results show that there appears to be one primary justification for international expansion: it enhances the scope for using the firm's intangible assets. These studies do not support theories of the advantages of multinationality based either on tax avoidance using transfer pricing, tax havens, or use of cheaper labour and other production inputs in low-cost countries and do not consider that risk diversification or tax avoidance as important motives for

[67] Pinto, C., p. 52
[68] There is, however, substantial variation of the responsiveness of investment depending on the type of investment considered and the tax rate./ Mooij, R., A., Ederveen, S., 'Taxation and Foreign Direct Investment' (2001), CPB Discussion Paper No. 003
[69] Morck, R., Yeung, B., 'Why Investors Value Multinationality', Journal of Business, 1991, No 64/2, p. 165-187

FDI. The authors argue that most firms first choose foreign production locations, and then instruct their tax departments to minimize taxes.

Furthermore, tax treatment rarely seems to be the determinant in the final decision on where to locate production facilities[70]. In the company tax study[71] the Commission refers to various empirical studies based on European and US data[72] and concludes that only at the stage of "macro-location" decision, where all the location factors are treated in a hierarchical way to single out a group of suitable locations, would taxation play an important role in affecting the actual locational decision, which is known as "micro-location" decision.

One should note that within the EU all the other factors used for the "macro-location" decision are largely equivalent in the Member States. Thus, direct taxation is likely to play a significant role in companies' locational decisions affecting the volume and location of FDI: higher tax rates are capable to reduce after-tax returns, thereby reducing incentives to commit investment funds. However, Mihir and Hines rightly observe that all other considerations are seldom equal[73]. Countries differ not only in their tax policies, but also in their commercial and regulatory policies, the characteristics of their labour markets, the nature of competition in product markets, the cost and local availability of intermediate supplies, proximity to final markets, and a host of other attributes that influence the desirability of an investment location. Furthermore, the various tax and regulatory policies that are relevant to foreign investors may be correlated with non-tax features of economies that independently affect FDI levels. Consequently, it is necessary to interpret evidence of the effect of taxation with considerable caution.

[70] Wilson G., P., 'The role of taxes in Location and Sourcing Decisions'(1993), Studies in International Taxation, as cited in Pinto, C., (2003), p. 29

[71] Commission Staff Working Paper, Company Taxation in the Internal Market, SEC (2001) 1681, Brussels, 23/10/2001, p.87

[72] The empirical literature on the effect of taxes on FDI considers almost exclusively US data, either the distribution of US direct investment abroad, or the FDI patterns of foreigners who invest in the US. The simple explanation for this focus is not only that the US is the world's largest economy, but also that the US collects and distributes much more, and higher-quality, data on FDI activities than does any other country.

[73] Mihir, A., D., Hines, Jr., R., (2002) 'Chains of Ownership, Regional Tax Competition, and FDI', Working Paper 9224, National Bureau of Economic Research, Cambridge, p.6

4. The impact of cross-border loss relief on business decisions

4.1. Transfer of losses as a tax incentive

Tax incentives are a part of Governments' promotional efforts to facilitate the entry of FDI among other increasingly adopted measures that include liberalizing the laws and regulations for the admission and establishment of FDI projects, providing guarantees for repatriation of investment and profits, and establishing mechanisms for the settlement of investment disputes. However, it is clear from the above analysis that as a factor in attracting FDI, taxation is secondary to more fundamental determinants, such as market size, access to raw materials and availability of skilled labour. Only those countries that pass these criteria on fundamental determinants go on to the next stage of evaluation where tax rates, grants and other incentives may become important. Thus, it could be recognized that cross-border loss relief, defined a tax incentive for investment, has only moderate importance in attracting FDI.

However, among EU countries with similar attractive features the importance of tax incentives may be more pronounced. Possibilities to transfer losses within the groups of companies may be even considered as a major factor in the investment location decisions for footloose, export-oriented investors. Moreover, governments can quickly and easily change the range and extent of the tax incentives they offer while changing other factors that influence the FDI location decision may be more difficult and time consuming, or even outside government control entirely.[74]

[74] Agreed Conclusions of the UNCTAD Expert Meeting on Investment Promotion and Suggested Measures to Further Development Objectives, TD/B/COM.2/EM.2/L.1, p.2

Cross border loss relief can be used as a mechanism to lower effective tax rate. Governments that employ a low corporate profit tax rate often allow investors to carry cross- border losses forward (or backward) for a specified number of years (usually three to five years) for tax accounting purposes[75]. This measure is particularly valued by investors whose projects are expected to run losses in the first few years as they try to increase production and penetrate markets. It also allows investors to reduce their tax burdens in the years immediately following investment when cash flow is important to pay off debt. Taken together, a low tax rate accompanied by loss carry forwards for tax purposes is considered to be a major element in an effective tax system and one that is highly attractive to foreign investors[76].

4.2. The evidence of significance of cross border loss-compensation

Although governments may argue that in reality cross- border loss relief does not influence the choice by enterprises whether or not to structure a secondary establishment across borders[77], the EU's approach established analysing Commission's studies and reports clearly defines that loss-compensation in general and the difficulties encountered by businesses with loss offset are considered to be tax obstacles to cross-border economic activity in the Internal Market. The evidence that the differing cross- border loss-compensation arrangements impact on the decision on where to locate and also on how to carry out an investment was provided in the Commission study[78] overviewed bellow.

[75] Usually, only a fixed ratio of the loss with an upper limit is allowed to be carried forward (or backward).
[76] 'Tax incentives and FDI: a Global Survey' (2002), United Nations Conference on Trade and Development, ASIT Advisory Studies, No. 16, p.19
[77] When an enterprise decides to establish a permanent establishment in another Member State, the enterprise does not know whether the permanent establishment will consistently make losses or profits, and the enterprise certainly does not know whether the losses will occur in the new permanent establishment or at the main seat of the business./ C-141/99 *AMID* decision, para. 24
[78] Commission Staff Working Paper, Company Taxation in the Internal Market, SEC (2001) 1681, Brussels, 23/10/2001, p. 248-249

As regards cross border loss- compensation arrangements the Commission emphasised significance of carry-forward and carry- back for small businesses and start-up companies as important criteria in deciding whether to take an economic risk in a country[79]. The Commission stated that loss-compensation is a particularly important element in the tax systems and the different prospective tax treatment of possible losses resulting from the investment in different Member States affects significantly investment decisions. Therefore, companies based in countries with more generous rules for cross-border loss compensation will be put in a favourable competitive position compared to those who are not.

Generally, the company tax law of Member States contains a bias towards favouring domestic investment, thus indirectly hampering cross-border economic activities. In this context, the Commission noted that the domestic market of larger States may be large enough to accommodate one important enterprise, while an enterprise of the same size operating from a smaller Member State is immediately confronted with the lack of cross-border loss compensation of some parts of its business operating in other Member States. The Commission also referred to the fact that, subject to the appropriate Federal consolidation rules, US companies benefit from offset of losses within their home market.

Other important effects of the different group taxation schemes are considered to be reflected in the group structure when cross-border losses of permanent establishments (which can immediately be transferred to the parent company) and subsidiaries (which can generally not be offset against parent profits) are treated differently. Where operations are initiated abroad with foreseeable substantial start-up losses, the possibility of cross-border loss compensation offered by branches (forming permanent establishments) will induce companies to opt for this legal form rather than for immediate

[79] Small businesses are particularly hit by not being able to carry back losses, and small start-up companies in particular risk losing the benefit of losses which they are not able to carry forward long enough for offsetting (or only when their value has effectively diminished).

incorporation of the foreign operation (as a subsidiary), even though the latter may well be the preferred structure for other reasons[80].

The Commission argues that the limitation of cross-border loss-compensation results in (economic) double- and over-taxation and in certain cases constitutes a discriminatory treatment[81]. Where limited cross-border compensation is available specific corporate structures may be required, thus influencing commercial decisions. Industry considers this one of the most important impediments to cross-border economic activities and in conflict with the very concept of the Internal Market.

Survey by the Federation of Swedish Industries of losses on cross border activities within the EU[82] revealed that for 96% of the participating companies having suffered cross border losses, it had not been possible or only partly possible to offset these losses against profits of other companies in the group. According to the survey, in 56 % of the cases this has resulted in permanent double taxation to at least some degree. The survey also provided clear evidence that numerous EU-based groups were paying substantial amounts of corporate taxes in specific Member States while the overall EU group result was negative [83]. The survey proves that EU-based multinationals could have made considerable savings if they had been allowed to offset losses incurred by subsidiaries in

[80] It is therefore not uncommon to see permanent establishments being transformed into subsidiaries when they become profitable (an activity is initially operated via a permanent establishment so that its losses can be offset in the head office but when it moves into profitability it is converted into a subsidiary).

[81] Generally, the varying availability of loss-compensation is often influenced by the arrangements in double-taxation treaties and the double taxation relief method (exemption vs. credit method) applied./ Commission (2001), p. 251

[82] The Federation has approximately 6 000 member companies from the manufacturing industry, transportation, telecommunication and information technology. The member companies count for approximately 90 % of the industrial export from Sweden. The survey was carried out by sending out a questionnaire concerning the frequency of losses on cross-border activities and inquiring to what extent it had been possible to set off the losses suffered against profits in other Member States. It was also asked to what extent these difficulties had influenced their activities and/or the organisation of their businesses. The questionnaire was distributed to all member companies (or groups of affiliated companies) having more than 25 employees, in all 1086 companies (only one questionnaire per group of companies). Out of these 1086 companies 706, or 65 %, have answered the questionnaire./ 'Survey of losses on cross border activities within the EU' by the Federation of Swedish Industries published in Lodin, S. & Gammie, M. 'Home State Taxation'(IBFD Publications, Amsterdam, 2001), p.252- 253

[83] An example is given of a company having in 1993-1995 overall losses of 880 m. ECU in various EU Member States whereas it had taxable profits in other Member States amounting to 870 m. ECU, resulting in the payment of corporate taxes in the latter countries of 320 m. ECU. Clearly, full cross-border loss compensation would have prevented this tax payment in this period.

other EU Member States with the profits of the parent company or within the group as a whole.

There appear to be good grounds to conclude that generally cross border loss-compensation, defined as a tax incentive does affect companies' locational decisions, although it is impossible to estimate the extent of impact of such rules because of lack of clear empirical evidence. Hence, possibility to transfer losses within the groups of companies in the EU could be defined as a locational advantage.

Because the Commissions' initiatives for harmonisation of transfer of losses rules in the EU seem to have support from businesses, it is interesting to analyse the evolution of transfer of losses rules within the EU from the legal perspective. Differences in cross-border loss relief rules across the Member States will be introduced and the EU legal parameters will be investigated in the next chapter. The content and implications of ECJ's decisions on the freedom of establishment for the harmonisation of corporate taxation issues over transfer of losses in the EU will be then analysed and arguments against and for such harmonisation will be introduced.

5. Current legal situation in the EU

This chapter overviews the legal situation of loss compensation in the EU Member States and examines the absence of the EU rules on cross-border loss relief.

5.1. Current legal situation in the EU Member States

This chapter briefly introduces differences of domestic and cross border loss-compensation rules in the EU as they are described in the Commission study.[84] There is a clear distinction between such rules for incorporated companies with a proper legal personality within a group (subsidiaries) and for unincorporated separate units of one company (branches).

Although the detailed conditions differ substantially, on the domestic level the possibility to set off losses against profits for assessing the tax liability of a single domestic company is available in all Member States and by definition includes losses from domestic branches[85]. Most Member States permit domestic group taxation as well. Tax is assessed for the group and not for the individual corporations forming the group. Therefore, losses of the parent can be offset against profits of the subsidiaries (downstream vertical) and the other way round (upstream vertical) and if, say, the parent is making neither a loss nor a profit or when its profits are not sufficient for full loss-absorption, losses in one subsidiary can be offset against profits in another subsidiary (horizontal). The horizontal offsetting of profits and losses between subsidiaries is in principle available in almost all Member States.

[84] Commission (2001), p. 242-247

[85] In a given period, a single domestic company establishes the taxable income by taking into account all profits and losses of the company headquarter and all branches in the national territory and abroad in the worldwide taxation system. The entity is taxed as one company and thus by definition full loss-offset is ensured.

However, the tax treatment of cross-border losses is much more complicated. Most Member States restricts group relief for trading losses to cases where the relevant group companies are resident in one Member State or trading in a Member State through a branch[86]. In Denmark and France group taxation provisions are extended to foreign subsidiaries, thus extending the potential cross-border loss-relief. In Denmark this applies to subsidiaries and in France this applies because of a different notion of the territoriality principle.

Considering technical possibilities for cross border loss-offset the Commission stressed that the lack of common definition of 'losses' is the first problem concerning cross-border loss relief - a loss in one Member State is not necessarily recognised as such in another. The issue of loss compensation cannot be separated from the general determination of the taxable base and taxable income leading to a loss. Rules differ significantly between Member States in this respect. There are various aspects to this: the definition of various categories of income, the recognition of business expenses for tax purposes, the interrelation between specific (positive or negative) elements of the tax base and the deductibility of the overall loss.[87] The EU's legal framework is further analysed to identify other problems causing the absence of EU level cross border loss-relief rules.

5.2. The EU's approach to establish a legal framework for cross-border loss relief

The European Commission has attempted to bring about the corporate tax harmonisation among the Member States largely without concrete results. Because direct taxation falls within the competence of Member States the EC Treaty provides no special basis for the harmonisation of corporate taxes[88]. The preconditions required for harmonisation, in

[86] Member States generally allow only for the offsetting of losses of foreign permanent establishments (branches) but not for those of subsidiaries belonging to the same group but located in different EU countries.
[87] Commission (2001), p. 247
[88] Member States generally allow only for the offsetting of losses of foreign permanent establishments (branches) but not for those of subsidiaries belonging to the same group but located in different EU countries.

particular, the European Council requirement for unanimity [89] and the principle of subsidiarity, which is particularly relevant to matters of direct taxation, limited the issue of EU measures for the approximation of laws. The Commission explained that subsidiarity requires that 'Member States should remain free to determine their tax arrangements, except where these would lead to major distortions'[90]. The only possibility for action by the Community in this field lies in Article 94 of the EC Treaty, general legal harmonisation provision applicable to all areas and allowing for the adoption unanimously measures for the approximation of laws which "directly affect the establishment or functioning of the Common Market". Because qualified majority voting is excluded by Article 95 (2) of the EC Treaty for approximation in the field of direct taxation, harmonisation has not progressed significantly. So far, this process is limited to the adoption into national laws of a number of directives and multi-lateral Treaties having the aim of facilitating cross border trade.

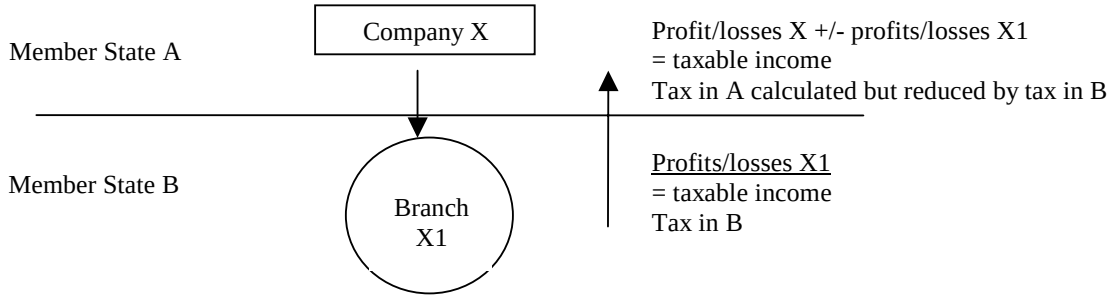
5.2.1. The proposed Directive for cross- border loss relief

The current limits to cross-border loss relief within the EU, in particular as regards subsidiaries, can lead to (economic) double taxation [91] and constitute significant impediment to cross-border business activities in more than one Member State[92]. The absence of cross-border loss relief or full consolidation at EU level is considered to run directly against the basic principles of the Internal Market and requires action as a matter of priority[93]. Thus, the Commission has withdrawn its proposal for a Council Directive

[89] Articles 94, 95 (2) EC
[90] 'Removal of tax obstacles to the cross frontier activities of companies' (1991), Bulletin of the European Communities, Supplement 4/91
[91] In cross-border investment, both home and host countries may tax income from foreign affiliates. Overlapping assertions of jurisdiction result in international double taxation, a phenomenon generally deemed not conductive to business transactions in general and FDI particular./ 'Tax incentives and FDI: a Global Survey' (2002), UN Conference on Trade and Development, ASIT Advisory Studies, No. 16, p.30
[92] Commission Communication, 'An internal Market without company tax obstacles, achievements, ongoing initiatives and remaining challenges' (COM, 2003) 726 final, Brussels 24/11/2003, p.9
[93] UNICE position paper on the consolidation of losses, Brussels 1990

on cross-border loss compensation[94]. However, Member States are reluctant to consider any EU initiative in this area and the Council was not willing to adopt the proposed Directive. The Directive would oblige Member States to recognise and relieve the losses incurred by permanent establishments and subsidiaries situated in another Member State [95] . The proposal provides for two methods for loss-offset for permanent establishments: the credit (or imputation) method and the method of deducting losses and reincorporating subsequent profits (deduction/reintegration method). These methods are already now current practice for branches (permanent establishments) in most Member States. According to the credit/imputation method the parent company includes the income (positive or negative) of its permanent establishments and receives a tax credit equal to the tax paid by the permanent establishment (see *Figure 5.1*).

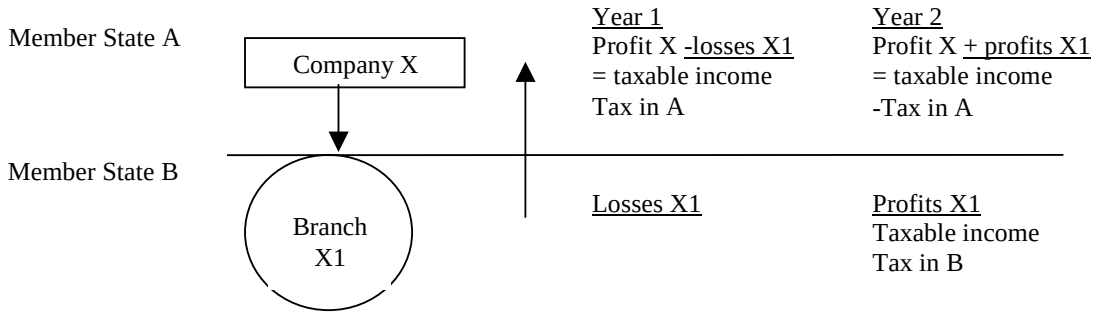
Figure 5.1. Treatment of losses of foreign branches – credit method[96]



Under the deduction/reintegration method the losses incurred in a certain period by a permanent establishment (or a subsidiary) of a company are credited against the Head Office's tax liability. In the subsequent years, the profits of the permanent establishment (or subsidiary) are also included in the taxable base of the company (see *Figure 5.2*).

[94] Proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States (COM (90) 595), O.J. C 53 of 28 February 1991, p. 30.
[95] Permanent establishments are generally defined as a fixed place of business through which an enterprise of a Member State carries on all or part of its activities. For 'subsidiary', there are two requirements: minimum holding of 75% (an indication of sufficient influence on the management of the subsidiary) and majority of voting rights.
[96] Commission (2001), p. 244

Figure 5.2 Treatment of losses of foreign branches – deduction/reintegration method[97]



Should proposed Directive be adopted, these principles would also apply to cross- border operations concerning subsidiaries.

However, the absence of definitions such as how the differing tax periods between Member States should be dealt with and how is the exchange rate to be determined while translating losses into the currency of the country where the enterprise is resident are left outside the scope of solutions established in the Directive. The differences between existing double taxation treaties can create problems as well as which country's rules are to be applied (those of the parent company or those of the subsidiary/permanent establishment) must be determined[98]. The feasibility of technical improvements in order for convince the Council to adopt it is doubtful as there is still no common definition and concept of 'losses' in the EU. Member States would be still concerned about the revenue consequences affected by cross-border loss relief as opportunities for profit/loss-shifting and appropriate tax planning would increase substantially.

The likelihood of achieving cross border loss relief rules harmonisation through directive adopted into national laws diminishes because of the lack of political will within the Member States to advance the course of such harmonisation. EU's legislation in the field

[97] Commission (2001), p. 245
[98] For detailed analysis of shortcomings of the proposed Directive see Commission study (2001), p.332-338

of direct taxation is limited to five Directives: The Mutual assistance Directive[99], the Parent-Subsidiary Directive[100], the Merger Directive[101], the Interest-Royalty Directive[102], and the Savings directive[103]. The instruments adopted so far in the EU do not attempt to eliminate the differences in returns on cross-border investment resulting from the lack of uniformity in rates of tax, tax systems, and the basis of assessment. They only have a limited aim of eliminating specific obstacles to cross-border cooperation between companies established in the EU, namely setting up and functioning of such companies and groups[104].

5.2.2. Other initiatives to achieve cross- border loss relief

Even though there is still high uncertainty about how taxes affect MNEs' locational decisions, from a Member State's perspective, it is clear that direct taxation constitutes a significant competition tool in order to gain FDI from EU countries, especially after introduction of the single currency and removal of barriers by the EU four fundamental freedoms. In order to avoid a possible "race to the bottom" scenario, this has led to a number of attempts at international coordination in order to maintain revenue from corporation taxes. Both the European Union and the OECD introduced initiatives in the late 1990s designed to combat with "harmful" tax competition. The EU's initiatives are overviewed below.

In the absence of unification of harmonisation of particular tax provisions at Community level, Member States are not prohibited from granting tax advantages in the form of reduced rates applicable to certain products or producers. To eliminate tax measures

[99] Council Directive 77/799/EEC on Mutual assistance by the competent authorities of the Member States in the field of direct taxation
[100] Council Directive 90/435/EEC of 23 July 1990 (The Council adopted Directive 2003/123/EC on 22 December 2003 to broaden the scope and improve the operation of the Parent Subsidiary Directive)
[101] Council Directive 90/434/EEC of 23 July 1990
[102] Council Directive 2003/49/EC of 3 June 2003
[103] Council Directive 2003/48/EC of 3 June 2003 (The Directive is expected to be effective as of 1 January 2005)
[104] Farmer, P., Lyal, R., 'EC Tax Law' (Clarendon Press, 1994), p. 246

which could induce harmful competition between EU countries, a Code of Conduct on business taxation to co-ordinate some aspects of business tax policy within the EU was agreed in December 1997.[105] The Code is not legally binding on Member States, and much of its impact will depend on the extent to which this initiative is now translated into changes to legislation in individual countries. EU countries, however, have committed themselves not to introduce new tax measures which might be considered as harmful and to roll back existing ones by the end of 2002. Since the Code of Conduct on business taxation in the EU prohibits the use of tailor- made tax measures to attract businesses, it is argued that countries may compete more and more on the basis of overall tax burden[106].

It is doubtful, however, that the scope of the Code of Conduct will be sufficient to deal with many of the opportunities for tax avoidance and distortions to economic activity that currently exist. Furthermore, Commission survey reveals that about 30% of State aid is allocated by means of tax measures[107]. Therefore, it has become common ground for the Commission and the Council, which has established a high level group in charge of the implementation of the Code of Conduct, that the proceedings against harmful tax competition under this Code of Conduct shall be supported by an extensive use of Article 87 EC in tax matters[108]. Any uniform reduction in the general rate will not involve aid being granted, since all undertakings are equally affected, although derogation from the normal rate of taxation for an entire sector of the economy, such as the manufacturing sector, will be regarded as entailing State aid[109].

More recently, the European Commission has proposed extensive changes for corporation tax[110], although these proposals are a response to what are perceived as

[105] Report by the Code of Conduct Group (Business Taxation), SN 4901/99, Brussels 23/11/1999 (Primarolo Report)
[106] Mooij, R., A., Ederveen, S., 'Taxation and Foreign Direct Investment' (2001), CPB Discussion Paper No. 003
[107] Commission 5th Survey on State Aid in the European Union (COM, 1997), Brussels, p.13
[108] Schon, W., 'Taxation and State aid Law in the EU' (1999), Common Market Law Review No.36, p.912
[109] Quigley, C., Collins, A., 'EC State aid law and policy' (Oxford-Portland Oregon, 2003), p. 54
[110] Commission Staff Working Paper, Company Taxation in the Internal Market, SEC (2001) 1681, Brussels, 23/10/2001; Commission Communication, 'An internal Market without company tax obstacles, achievements, ongoing initiatives and remaining challenges' (COM, 2003) 726 final, Brussels 24/11/2003

obstacles to doing business in Europe, rather than the threat of tax competition. The Commission's strategy 'An internal Market without company tax obstacles, achievements, ongoing initiatives and remaining challenges' presented in 2003[111] was designed to tackle the tax related inefficiencies and obstacles within the internal market via steps towards a long term goal of providing companies with a common consolidated tax base for their EU wide activities: companies would no longer have to calculate the taxable profit earned in each Member State, but only the total taxable profit earned in the EU as a whole. The Commission considered various ways in which this total taxable profit could then be allocated to individual member states including adoption of Formula Apportionment (used by the US States and Canadian provinces) [112] and Denmark's 'worldwide' system[113]. If implemented in full, it will effectively tackle the tax obstacles and reduce distortions while fully respecting Member States' fundamental prerogatives in tax matters, in particular their right to set their tax rates[114].

Another ambitious proposal leading to common EU tax base is the *Home State Taxation* project as a possible solution for small and medium enterprises (SME) in the EU - where a multinational group would be able to opt to calculate the taxable profits for all its EU operations according to the tax rules of the Member State where its headquarters are based. Tax compliance costs in an international context seem to be regressive in relation to the size of the company and are often disproportionally high for SMEs. The administrative tax formalities and book-keeping requirements are relatively harder to sustain for SMEs than for large enterprises. Furthermore, the absence of rules in many

[111] Commission Communication, 'An internal Market without company tax obstacles, achievements, ongoing initiatives and remaining challenges' (2003) 726 final, Brussels 24/11/2003

[112] Formula apportionment would attribute a fraction of the total income of a multinational company to each member state in which the company carries out its business. This fraction is equal to the weighted average of the Member State's share in various economic activities, represented by apportionment factors such as its payroll, property and sales./ McLure, C., Weiner, J., 'Deciding whether the EU should adopt formula apportionment of company income' (2000) in Cnossen, S., (ed.) 'Taxing capital income in the EU' (Oxford University press, 2000), p.243-292

[113] This system enables, in certain cases, Danish parent companies, their branches and also their foreign subsidiaries to be taxed jointly in Denmark, thereby enabling the parent to take into account losses incurred not only by their foreign branches but also their foreign subsidiaries./ Commission Communication, 'An internal Market without company tax obstacles, achievements, ongoing initiatives and remaining challenges' (COM, 2003) 726 final, Brussels 24/11/2003, p.9

[114] Bolkestein, F., 'EU Corporate Tax Reform: Progress and New Challenges, Opening address European Commission Conference on company taxation' (2003), EC Tax Review, No. 2004/1

Member States allowing the offsetting of cross-border losses hit SMEs particularly hard, especially as regards start-up losses that almost by definition occur in the first years of an international investment[115]. Because of the possible simplification and reduction of the administrative and regulatory burden to their cross-border economic activity the scheme was welcomed by SMEs, now further political initiative is expected.

Concerning the fact that the Council is not willing to adopt the proposed Directive on cross border loss relief and the common consolidated tax base would be difficult to implement, the Commission also considers some less ambitious solution to face the issue. The possibility for the taxpayer to elect for five years that the subsidiary is treated for taxation purposes as if it was permanent establishment could prove effective as companies have the incentive to run a loss-making foreign start-up for the first 3-5 years as permanent establishment and as subsidiary in the subsequent profit-generating phase[116]. Yet, even such proposal is deemed to be difficult to introduce to all Member States which constantly hold that corporate taxes are not meant to fall within the scope of European Law. The most resent example of the absence of political will in regard of advanced tax harmonisation is the failure of the attempted initiatives in the European Convention.

The debate in European Convention[117]

The issue of taxation has been at the forefront of the debates concerning economic governance in the European Union generating great controversy among EU partners - some have highlighted in particular the need to extend the potential for greater fiscal harmonisation, while others have argued strongly against any new initiatives to harmonise direct taxation. In the Final report drafted by the Working Group VI on Economic Governance, there was no clear consensus on what should be done in the field of taxation, but all the members agreed some changes needed to be made to improve the functioning of the internal market. The Report suggests that there should be some

[115] http://europa.eu.int/comm/taxation_customs/taxation/consultations/home_state_sme.htm
[116] Commission (2001), p. 343
[117] The European Convention, 'Draft Treaty Establishing a Constitution for Europe' (2003), Brussels, 18/07/2003

progress in EU fiscal policy through changes to existing decision-making procedures, implying expansion of qualified majority voting[118]. Corporation taxes could eventually be harmonised by majority vote, but only if countries first agreed unanimously to take such a vote. Then the EU could possibly move, by unanimity, to give itself its own resources—tax-raising powers. In an effort to ease the tough decisions, a new form of "super majority voting" for particularly sensitive issues like tax or foreign policy was considered[119]. This proposal, however, was unlikely to assuage the British and the Irish, who see national control of tax policy as an uncrossable line and expect support from among the ten mainly Central European countries that joined the Union and regard the ability to set its own tax rules as a necessary tool to close the economic gap with Western Europe. The Final Report text suggested that changes should not aim at establishing unified taxation systems[120]. In the draft Constitution, the harmonisation process is put forward, submitted to a unanimous vote from the Council of Ministers. However, the qualified majority voting decision process, advised by the working group in areas related to the fundamental freedom, has been restricted to combat fraud and tax evasion[121]. It should be noted that the draft text did not distinguish between potential tax harmonisation in the EU as a whole, and in the Eurogroup specifically either.

However, despite the continuing need under the EC Treaty for unanimity regarding mandatory tax measures such as cross- border tax consolidation, which is on the Commission's agenda, the principle that direct taxes are the province of individual Member States has increasingly been eroded by the ECJ by interpretation of the freedoms enshrined in the EC Treaty[122]. Recent and forthcoming developments before the ECJ provide additional clarification of the legal situation and contribute to an increasing acceptance of the need for action in the area of cross- border loss relief among European tax policy makers.

[118] Final Report of Working Group VI on Economic Governance, (Brussels, 21/10/2002)
[119] This would prevent a single country from blocking EU decisions (as cited at 'Let's start harmonising taxes', The Economist of 14/11/2002)
[120] The European Convention, 'Draft Treaty Establishing a Constitution for Europe' (2003), Brussels, 18/07/2003, Chapter 3, Article III-63 Section 6 fiscal provision
[121] ibid, Article III-62
[122] The ECJ under Article 220 EC has the primary tasks of interpreting Community law and ensuring its uniform application throughout the Community.

6. Cross border loss relief in the light of the ECJ rulings

Since the creation of the European Communities the Community law has required clarification by an independent and non-political institution. In the Treaty this role is assigned to the Court, which under Article 220 EC has the primary tasks of interpreting Community law and ensuring its uniform application throughout the Community.

An important part of the Court's jurisprudence is concerned with the provisions of the Treaty which establish the Internal Market - free movement of goods, services, persons and capital. That it has fallen to the ECJ to progress movement in a field of direct tax matters is due to the national veto enjoyed by Member States and their lack of political will to provide a European tax code. Applying the principle of non-discrimination and non-restriction of 'the four freedoms', the court has been the most effective of all the Community institutions at removing direct tax obstacles to cross-border economic activities within the EU and has consistently ruled that, even in the absence of harmonisation and despite the fact that taxation is a matter for Member States, direct tax can only be levied in accordance with European law. The ECJ is striking down some well-established national tax principles as not only have domestic tax laws come under scrutiny but also tax treaties that create illegal inequality of treatment for EU residents.[123]

The restriction of group loss relief in most of the Member States to locally-resident taxpayers or permanent establishments (branches) of non-resident taxpayers could be considered as a breach of the freedom of establishment. To analyse such possibility, this chapter first studies ECJ's case law to confirm that principle of freedom of establishment is clearly articulated in the field of direct taxation. Then, the ECJ's approach and influence to cross border loss relief within the groups of companies in the EU is established to consider the evolution of such rules in the absence of political will for such corporate tax harmonisation.

[123] Cussons, P., Frankland, M., 'Why the ECJ is the most powerful tax force in Europe' (PWC, 2002)

6.1. Freedom of establishment clearly articulated in the field of direct taxation

The freedom of establishment is guaranteed in Articles 43 and 48 EC. Article 43 provides that 'restrictions on the freedom of establishment of nationals of a member state in the territory of another member state shall be prohibited. Such prohibition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any member state established in the territory of any member state'. Article 48 then extends article 43 to 'companies or firms formed in accordance with the law of a member state and having their registered office, central administration or principal place of business within the community'. Both those articles concern persons who work or carry on business in a Member State, having exercised their freedom of movement. It is clear that, so long as a company is formed in accordance with the law of a Member State and has its registered office there and its principle place of business somewhere in the Community, it will be established in the first Member State within the meaning of the Treaty[124].

The ECJ articulated in *Segers* that it's true even if company conducted no business of any kind in that Member State, but instead conducted its business through one of the various forms of a secondary establishment – such as subsidiary, branch or agency – in another Member State[125]. This was affirmed in *Centros*, where the ECJ ruled that a company was lawfully established in the UK even though it had never traded there[126]. In *The Queen v. Secretary of State for Transport ex p. Factortame* the ECJ reiterated that 'the concept of establishment within the meaning of Article 52 (now 43) of the Treaty involves the actual pursuit of an economic activity through a fixed establishment in another Member State

[124] Craig, P., De Burca, G., 'EU Law/ Text, Cases, and Materials.-3rd ed, (Oxford University Press, 2003), p. 793
[125] Case 79/85 *Segers* [1986] ECR 2375, para.16
[126] Case C- 212/97, Centros Ltd. v. Erhvervs – og Selskabsstyrelsen [1999] ECR I – 1459

for an indefinite period' [127]. In this context the Court defended the freedom of establishment, especially as regards the secondary form.

However, the right of companies to move their primary establishment from one Member State to another must be read subject to the Court's decision in *Daily Mail*[128]. This case made clear that the provisions on freedom of establishment do not give companies the right, without any restriction or impediment from the Member State in which they are registered, to move their registered office of their central management and control to another Member State, whilst retaining an establishment in the first Member State[129]. It may, if it does seek to move its registered office or its central place to a state in which the tax position would be more favourable, be subject to certain conditions laid down by the Member State from which it wishes to move. Because of incomplete harmonisation of national corporation tax laws within the EC, the Court regarded the problem of the transfer of registered office as one which is unresolved. Yet, *Daily Mail* was overruled in *Centros* in spite of previous hesitations where the ECJ has made a crucial step in overtly safeguardening the freedom of establishment in its totality. The Court ruled in this case that a Member State cannot prevent a company, which has its registered office in another EC country, from establishing a branch in its territory even if the purpose may be an evasion of the national company law rules[130].

The ECJ case law has defined the obligation to exercise the fiscal competence consistently with EC law as prohibition in the field of freedom of establishment of any discrimination or restriction (barrier) except if they are justified. It follows that transposed to corporate tax 'Community law contains no specific requirement with regard to the way in which a Member State must deal with corporate tax, provided that the conditions governing it do not constitute a discrimination, either direct or indirect, on

[127] Case C- 221/89, *In The Queen v. Secretary of State for Transport ex p. Factortame* [1991], ECR I- 3905, para. 20
[128] Case C-81/87, R. v. HM Treasury and Commissioners of Inland Revenue, ex p. Daily Mail and General Trust PLC [1988] ECR-5483
[129] Craig, P., De Burca, G., (2003), p.794
[130] Case C- 212/97, Centros Ltd. v. Erhvervs – og Selskabsstyrelsen [1999] ECR I – 1459

grounds of nationality or an obstacle to the exercise of a fundamental freedom guaranteed by the EC treaty'[131].

In 1986 the ECJ extended its case law on the four freedoms to the sphere of direct taxation when it gave judgement on the *Commission v. France (Aivor Fiscal)* case[132]. The Court ruled that the discrimination in tax laws against branches or agencies in a Member State by taxing them on the same basis as companies whose registered office is in that state yet not giving them the same tax advantages as such companies was an infringement of Article 43, which 'expressly leaves traders free to choose the appropriate legal form in which to pursue their activities in another Member States and that freedom of choice must not be limited by discriminatory tax provisions'[133]. In *Commerzbank*[134] the Court added that the rules regarding equality of treatment forbade not only overt discrimination by reason of companies real seat or registered office but all covert forms of discrimination (tax refund in this case) which would lead to the disadvantage to companies having their seat in another Member State[135]. Furthermore, in *Royal Bank of Scotland*[136] the Court made it clear that it is not sufficient simply to state that residents and non residents are in a different situation and may thus be taxed differently. It is necessary in respect of each tax advantage to determine whether there is a relevant difference between them, such as to provide objective justification for a specific difference in treatment (higher rate of tax to the income of foreign banks)[137].

The ECJ rulings overviewed above confirm that the right to freedom of establishment includes the freedom to choose the business form, whether subsidiary or branch, to be established in another Member State. Different tax treatment based on the residence of the legal person is prohibited as well as covert discrimination which typically is directed

[131] Wathelet, M., 'EU corporate tax reform: Progress and New challenges', Speech delivered in European Commission Conference on Company Taxation, (Rome, 2003)
[132] Case C- 270/83 *Commission v. France* [1986] ECR 273
[133] Case C- 270/83 *Commission v. France* [1986] ECR 273, para.22
[134] Case C- 330/91, R. v. Inland Revenue Commissioners, ex p. Commerzbank AG [1993] ECR I-4017
[135] Roussos, A., 'Realising Free Movement of Companies', European Business Law Review, Jan/Feb 2001, p.10
[136] Case C – 311/97, *Royal Bank of Scotland v. Greece* [1999] ECR I-2651
[137] Lyal, R., 'Non discrimination and direct tax in Community law', EC Tax Review 2003/2, p.70

against foreign resident companies. In other words, discrimination which arises when two taxpayers in the same situation are treated differently or vice-versa is prohibited

Whilst initially, in direct tax cases the ECJ concentrated on the principle of non-discrimination and defined this to prohibit overt, covert, direct, indirect and reverse discriminations, in more recent decisions it appears to have also accepted that a non-discriminatory restriction based approach (measures that hinder or make less attractive free movement, irrespective of distinction on the basis of nationality) to determining direct tax measures prohibited by the EC Treaty is appropriate, thereby broadening the potential range of direct tax obstacles falling within the scope of its provisions[138]. The rules at issue are those which discriminate against persons established in Member States other than that of the subsidiary's residence, particularly in that they restricted the right to exercise freedom of establishment by setting up, acquiring or maintaining a subsidiary in the Member State of residence.

Freedom of establishment is clearly a part of EU law and there is nothing that Member States can do about it. Now even foreign “mailbox” companies have legal capacity and are protected against discrimination in tax system[139]. This could have unintended effect for taxation of groups within which the income of one company can be attributed for tax purposes to another group company.

6.2. The ECJ’s approach to cross-border loss relief

For the purpose of this thesis further analysis of the ECJ’s case law is analysing weather in the current EU’s legal situation there is a possibility for a parent company in one Member State to offset against its own taxable profits losses of a subsidiary established and resident in another EU Member State.

[138] Aigner, D., ‘Freedom of establishment and deduction of participation expenses’, SWI 2003, p.63
[139] Case C- 212/97, Centros Ltd. v. Erhvervs – og Selskabsstyrelsen [1999] ECR I – 1459

The ECJ issue on the cross border loss relief is that the deemed taxation on the parent company of the profits of a subsidiary established in another EU member state, as compared with the absence of such deemed taxation for a domestic subsidiary, is contrary to the freedom of establishment enshrined in articles 43 and 48 of the EC treaty.

Assurance that restriction to cross- border loss relief is EC Treaty compatible can be found in the ECJ decision of *Futura Participations.* The Court held that Luxembourg was entitled to demand that losses of a French company with a permanent establishment in Luxembourg should have an economic link in order to be taken in an account. The tax rule limiting loss compensation to losses economically connected to Luxembourg income was considered acceptable by the ECJ because of the fiscal territoriality principle. The limitation was said to be justified because Luxembourg only exercised source taxation[140].

The further *ICI* judgement[141], where the ECJ ruled against the consortium relief arrangements used by the UK to restrict deduction of losses by resident subsidiaries from the profits of the resident parent if the parent also had foreign subsidiaries, does not establish that cross-border relief is required by EU law either. The latter case concerned only deductibility of losses originating in one Member State's territory from profits generated in the same territory.

However, the *AMID* case[142] suggests that the absence of cross-border loss relief is a breach of the freedom of establishment, even though the case concerned losses made in Belgium that could not be set off against profits made in Belgium. In this case different loss treatment applied to Belgian residents with a foreign permanent establishment than that afforded to a Belgian company operating solely in Belgium was ruled to be a contravention of the freedom of establishment clause. According to the ECJ, the fact that the foreign permanent establishment's profits were tax-exempt in Belgium under the Double Tax Agreement between Belgium and Luxembourg was not sufficient objective

[140] Case C- 250/95, Futura Participations SA Singer v. Administration des Contributions [1997] ECRI - 2471, para. 21, 22
[141] Case C- 264/96, Imperial Chemical Industries plc (ICI) v.Kenneth Hall Colmer [1998] ECR I- 4695
[142] Case C- 141/99 Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v. Kingdom of Belgium

justification to justify different loss treatment[143]. In order to define why Belgian tax law must allow tax relief for losses suffered the *Amid* case is analysed below.

The Amid case - facts

Amid was a company incorporated in Belgium and had also established itself in Luxembourg by opening a branch in that country. In 1981, *Amid* incurred a tax loss in Belgium of approximately BEF 2 million while its Luxembourg branch had a profit of approximately BEF 3 million. Pursuant to the treaty between Belgium and Luxembourg, the profits of the Luxembourg branch were taxed in Luxembourg and exempt from corporation tax in Belgium. In 1982, *Amid* made a profit in Belgium and in its Belgian corporation tax return for the 1982 accounting year, *Amid* deducted the Belgian loss incurred in 1981 from the Belgian profits realised in 1982. The Belgian tax authorities denied the deduction referring to the Article 66 of the Royal Decree according to which the Belgian loss incurred in 1981 should have been set off (for Belgian tax purposes) against the (treaty-exempt) profits made in the same year in Luxembourg, with the result that the loss could not be deducted (again) from the Belgian profits made in 1982. *Amid* lodged a complaint against the decision of the tax authorities and put forward an argument that Article 66 of the Royal Decree was contrary to Community law insofar as Article 66 penalises, from a tax perspective, a Belgian company wishing to establish a branch in another Member State, as compared to a Belgian company that operates only in Belgium. The Court of Appeals requested a preliminary ruling from the ECJ questioning weather Article 52 EC (now Article 43 EC) preclude the application of such national legislation of a Member State.

The ECJ observed that, by setting off domestic losses against profits exempt by treaty, the legislation of that home Member State establishes a different tax treatment as between companies incorporated under national law having establishments only on national territory and companies having establishments in another Member State. According to the ECJ, as the Belgian government itself recognized, where such companies have a permanent establishment in a Member State other than that of origin and a double taxation treaty binds the two States, those companies are likely to suffer a tax disadvantage which they would not have to suffer if all their establishments were situated in the Member State of origin[144].

The Belgian government argued that the legislation at issue must be considered in its overall context. The Belgian government admitted that the specific situation under examination constituted a disadvantage for Amid[145], yet, maintained that in reality, this system does not influence the choice by enterprises whether or not to create a foreign

[143] ibid., para. 23
[144] Amid decision, para. 23
[145] A Belgian company in general with one or more of its establishments in other Member States could find itself at a disadvantage in some cases and at an advantage in others, compared to a Belgian company having operations in Belgium only.

establishment and that it does not create a hindrance contrary to the Treaty[146]. Despite the fact that the legislation could also produce a situation where a company benefited (a profitable Belgian Head Office with a loss making Luxembourg permanent establishment could relieve the Luxembourg losses against both the Belgian Head Office profits for Belgian tax purposes and also relieve them against subsequent Luxembourg permanent establishment profits for Luxembourg tax purposes) the Court found that AMID suffered an inequality of treatment in relation to companies without establishments outside Belgium and thus creating a hindrance to the freedom of establishment guaranteed by Article 52 EC[147].

The Belgian government also argued that Belgian enterprises that have a permanent establishment abroad are not in the same position as enterprises that have concentrated all their operations in Belgium. In terms of their tax treatment, the two categories of enterprises will always be in a different situation; thus, the application of a system leading to different results does not necessarily constitute discrimination[148]. Regarding the argument based on the differences between Belgian companies having a permanent establishment abroad and those without, the differences referred to by the Belgian government, according to the ECJ, cannot in any way explain why the former cannot be treated in the same way as the latter for purposes of deducting losses. A Belgian company that has no establishments outside Belgium and incurs a loss during a given tax year finds itself, for tax purposes, in a comparable situation with that of a Belgian company which, having an establishment in Luxembourg, incurs a loss in Belgium and makes a profit in Luxembourg during that same tax year. Since an objective difference in the respective positions of the companies has not been established, a difference in treatment regarding the deduction of losses in calculating the companies' taxable income cannot be accepted. In the absence of justification, that difference in treatment is contrary to the provisions of the EC Treaty on the freedom of establishment and such legislation is precluded by Community Law[149].

[146] *Amid* decision, para. 24
[147] *Amid* decision, para. 27
[148] *Amid* decision, para. 25
[149] *Amid* decision, para. 28 to 31

Implications of the Amid decision

As stated by the ECJ in *Commission v. France (Aivor Fiscal)* case[150], to which the *Amid* decision made reference, the freedom of establishment can be exercised by a company in two ways: either by setting up a local branch or by incorporating a local subsidiary. The choice between these two options is for the company to make, and its freedom of choice may not be hindered by tax restrictions. Thus, the freedom of establishment cannot be restricted by Belgian legislation which makes establishment abroad, at least in some cases, more onerous tax-wise than operating in Belgium only.

The AMID case illustrates the application of the non-discrimination principle in relation to the taxation of permanent establishments. It may have wider implications for the situation where losses incurred by foreign subsidiaries are currently not relievable against domestic profits, but losses incurred either by foreign permanent establishments or by domestic subsidiaries are relievable. The crucial point is that *AMID* suggests that the proper comparison to be made as regards a parent company in one Member State looking to offset against its own profits the losses of its subsidiaries in another Member State is with the same commercial operations but carried out by a subsidiary resident in the parent company's home state. It appears to call into question the tax prohibition on cross border group loss relief. As only Belgium and Greece do not grant group relief or tax grouping for losses of domestic subsidiaries, this leads to the conclusion that in other member states, offset of losses of subsidiaries elsewhere in the EU should be available against a parent company's profits[151].

Further, in the *Bosal* case[152] the ECJ ruled that restrictions under Dutch tax law, which prevented Bosal Holdings BV, a Dutch parent company, from deducting interest expenses incurred in financing subsidiaries based in other EU Member States, in circumstances where such expenses would have been deductible had the subsidiaries

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[150] Case C- 270/83 *Commission v. France* [1986] ECR 273
[151] Why the ECJ is the most powerful tax force in Europe?, PWC
[152] Case C- 168/01, Bosal Holding BV v. Staatssecretaris van Financien [2003] ECR 00000

been based in the Netherlands, are discriminatory and therefore in breach of EU law. The direct consequence is that costs incurred by companies relating to subsidiaries established in other EU countries will be fully deductible. But the scope of this decision is much broader as any difference in treatment created by national provisions is also caught by that prohibition on imposing restrictions because such treatment renders less attractive the exercise of fundamental freedom for any person who is consequently placed at a disadvantage[153]. Granting of a tax advantage in a form of a domestic loss compensation that renders less attractive the exercise of freedom of establishment through the acquisition of subsidiaries which make their profit exclusively abroad consequently leads to a situation that parent companies may be deterred from acquisition of subsidiary which makes profit exclusively abroad in favour of acquiring holdings in their state of residence.

Given consideration to the ECJ decisions in *AMID* and *Bosal*, the pending *Marks & Spencer*[154] case may result in the possibility of cross-border relief for tax losses incurred by subsidiaries in other Member States. In that case the UK Special Commissioners rejected a claim by the parent company of a UK multinational, Marks & Spencer, that EU law enabled it to offset losses of subsidiary companies resident in other EU countries against profits of the UK parent for the purposes of UK group relief. The Special Commissioners agreed that the UK group relief rules created an obstacle to the right of establishment in other Member States, but as the EU subsidiaries were outside the scope of UK tax, they were therefore not in an objectively comparable position to that of subsidiaries which were UK resident/trading in the UK through a branch. Further, even if this was not the case, the restriction was justifiable on the basis that it maintained the coherence of the UK tax system. This case, now pending before the ECJ, might establish a jurisprudence that upholds the principle of full and total transparency of groups' cross-border losses[155].

[153] Aigner, D., 'ECJ- The Bosal Holding BV Case: Parent – Subsidiary Directive and Freedom of establishment' (2004), Intertax, Vol.32/3, Kluwer Law International, p. 148
[154] Pending Case C- 446/03, Marks and Spencer v. Halsey
[155] Tesauro, F., 'EU corporate tax reform: Progress and New challenges', Speech delivered in European Commission Conference on Company Taxation, (Rome, 2003)

Moreover, although the pending *Ritter* case[156] questioning whether EU law requires the deductibility of losses in the residence state from leasing and letting property in another Member State is concerned with individuals, it would also have impact on corporations. Should the ECJ classify the denial of cross border loss relief as infringing EU Law, corporations having their seat and head office in a Member State and a permanent establishment in another Member State would have the right to deduct losses made in the permanent establishment from the head office's profits, even if profits generated in permanent establishment were exempt from tax in the state of the head office by virtue of a double tax convention[157].

An insight into the case law concerning national rules on direct taxation shows that the Court has enforced the principle of non-discrimination very strictly systematically rejecting the justifications put forward by the Member States. Under an existing line of ECJ case law, indirect discrimination (*Cassis de Dijon*) against the parent in respect of its subsidiary in another EU member state is nonetheless discrimination. Then the question is whether such discrimination could be justified.

6.3. Justification of discriminatory rules for cross-border loss relief

The principle of equal treatment can only be overlooked if the discriminatory national rule can be justified on the ground of public policy, public security, and public health.[158] The adverse treatment, however, has to be proportionate to the objectives pursued by the rule. In order to satisfy the proportionality test it must be necessary in the sense that there would be no other, less restrictive means to protect the public interest in question. [159] The

[156] Pending case C- 152/03 Hans-Jürgen and Monique Ritter-Coulais v. Finanzamt Gersheim OJ C 158 05.07.2003 p.8
[157] Korner, A., 'Reference to the ECJ by the German Federal Fiscal Court for a Preliminary Ruling: Does European Law Require Cross- Border Loss Relief?', Intertax, Vol.31/12, Kluwer Law International, 2003, p. 495
[158] Art.46 (1) EC
[159] Commission (2001), p. 314

most important arguments that have been rejected by the ECJ in the cases potentially important for cross border loss relief are discussed below.

Loss of revenue

The case law of the ECJ shows that the limitations on the deductibility off losses are not justified by 'the aim of avoiding an erosion of the tax base going beyond mere diminution of tax revenue'. Such a justification does not appear among the grounds listed in Article 46 (1) EC and does not constitute a matter of overriding general interest which may be relied upon in order to justify a restriction on the freedom of establishment[160].

Risk of tax avoidance

In ICI v. Colmer, the UK Government sought to raise a justification of tax avoidance, arguing that the legislation at issue was designed to reduce the risk of tax avoidance arising from the possibility for members of the consortium to channel the charges of non resident subsidiaries to a subsidiary resident in the UK and to have profits accrue to non resident subsidiaries. The purpose of the legislation was accordingly, in the view of the Government, to prevent the creation of foreign subsidiaries from being used as a means of depriving the UK Treasury of taxable revenues. The Court dismissed this argument[161]. It must be borne in mind that what is at issue is tax avoidance, namely the lawful exploitation of lacunae in fiscal legislation to the tax payer's advantage, and not tax evasion, which involves the contravention of fiscal legislation. Tax evasion is conceptually more akin to fraud than it is tax avoidance, and a genuinely substantiated risk of tax evasion may more properly be considered to be a matter of public policy and fall within the article 46 (1) exception[162]. It would appear that the ECJ will only accept restrictive anti-abuse measures, if disregarding the tax effects the corporate arrangement is 'wholly artificial' - tax jurisdiction shifting is not considered abusive.

It is unfortunate that the Court did not take the opportunity to give some more useful guidance on the scope of tax avoidance as a justification. It would seem to be

[160] Case C- 264/96, Imperial Chemical Industries plc (ICI) v.Kenneth Hall Colmer [1998] ECR I- 4695, para. 28, Case C- 168/01, Bosal Holding BV v. Staatssecretaris van Financien [2003]

[161] Case C- 264/96, Imperial Chemical Industries plc (ICI) v.Kenneth Hall Colmer [1998] ECR I- 4695, para. 25-26

[162] Edwards, V., (1999), p.370

unnecessarily restrictive if only legislation which was wholly and exclusively designed to combat tax avoidance could fall within the scope of the justification[163].

Territoriality

Concerning the argument based on the principle of territoriality to justify the differences in tax treatment the ECJ made clear that there is no discrimination among the Member States systems, as subsidiaries which do make profits taxable in the Netherlands and those which do not are in a situation which is not comparable[164]. The ECJ has already pointed out in its *Eurowings*[165] decision that even low taxation in another Member State is not a valid reason for other Member States to impose restrictions on the freedoms under the EC Treaty[166]. The door that had been slightly opened in *Futura* was closed in *Bosal* case. [167]

The cohesion principle

The need to maintain the coherence of the tax system in justifying different treatment was always invoked by Member States because the ECJ accepted it once in *Bachmann*[168]. The cohesion principle was then refused in *Wielockx*, because according to the ECJ the cohesion of the tax systems was realised, under a double taxation convention, at the level of the global relationships between two countries[169]. Subsequent *Verkooijen* case has distinguished the *Bachmann* defence to circumstances involving the same tax, the same taxpayer, and a linked fiscal disadvantage and advantage.[170] As the principle can only be invoked when one tax payer is concerned or there is a direct link between a tax relief and taxation the cohesion argument was later rejected in *Bosal*[171]. It is difficult to meet the same taxpayer criterion for groups of companies, when parent companies and subsidiaries

[163] Edwards, V., (1999), p.371
[164] Case C- 168/01, Bosal Holding BV v. Staatssecretaris van Financien [2003] ECR 00000, para.37
[165] Case C- 249/97, *Eurowings Luftverkehrs AG v. Finanzamt Dortmund- Unna* [1999] ECR I-7449
[166] Thommes, O., 'CFC legislation and EC Law', Intertax 2003, p. 189
[167] As recognised by the ECJ in Case C- 250/95, Futura Participations SA Singer v. Administration des Contributions [1997] ECRI -2471. para. 22.
[168] Case C- 204/90, *Bachmann v. Belgium* [1992] ECR I -249; Case C- 300/90, *Commission v. Belgium* [1992] ECR I-305
[169] Case C- 80/94, *Wielockx* [1995] ECR I-2493, para.24
[170] Case C-35/98, Staatssecretaris van Financien v. Verkooijen [2000] ECR I-4071
[171] Wathelet, M., 'EU corporate tax reform: Progress and New challenges', Speech delivered in European Commission Conference on Company Taxation (Rome, 2003)

are concerned. When the profits of a foreign subsidiary are imputed to the domestic parent, there are clearly two separate legal entities involved. Parent companies and subsidiaries (unlike branches/permanent establishments as was the case in *Futura*) are different taxpayers and therefore the cohesion defence cannot apply. On this basis, even the cohesion argument cannot justify the denial of cross- border loss relief rules requiring the claimant and surrendering companies to have a source of trading income in that Member State as this defence only applies in a single taxpayer situation.

In contrast to the very broad interpretation that the Court has applied to the principles of non-discrimination and non-restriction of free movement enshrined in the EC Treaty, it has given very limited application to the exceptions authorised by it. Justification in the sense of applying different treatment to differing situations is not readily accepted by the ECJ despite differences in legal form and liability of branches and subsidiaries- they are considered to be comparable and therefore deserve equal treatment. It is clear that Member States cannot justify any rules that constitute a barrier establishing subsidiary abroad or in any situation in which a parent company has its seat abroad or the parent company has a subsidiary abroad. Even though until now the ECJ has not been dealing with the issue of cross-border loss relief[172], the cases overviewed above suggest that the ECJ is inclined to favour the offsetting of cross-border losses by groups on the same basis as tax law provides for national losses, in compliance with the freedom of establishment. What is likely to result from such ECJ's attempts to harmonise direct taxes in the EU, including cross border loss relief rules, is discussed below.

6.4. The ECJ eroding national tax systems

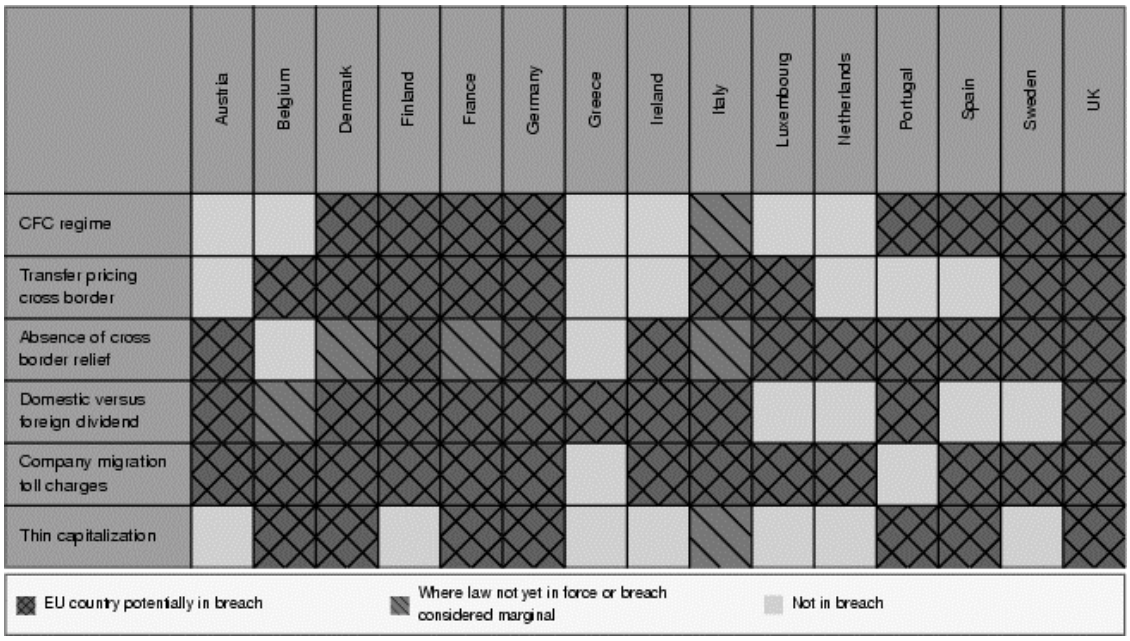
As the analysis above provides that cross- border loss relief is attempted to be considered an EU level matter, it is clear that the issues now being referred to the ECJ are becoming more and more fundamental. Unless the EC Treaty itself is amended or the role of the ECJ curtailed, the ECJ will continue to strike down well established national tax principles. The court sees its mandate as completing a single market in Europe, and its

[172] Case C- 446/03, Marks and Spencer v. Halsey on the cross- border loss relief is pending before the ECJ

verdicts on tax have been moving steadily in the direction of harmonised corporate taxation, even though the member states' governments think they have a veto over EU tax policy. If the ECJ makes a decision, the member states have to accept it.

The Court in a number of cases has taken positions on conformity or non-conformity of national corporation tax laws with the basic freedoms contained in the EC Treaty. There are many problems of consistency of national tax systems with EC law, but it is difficult to predict the compatibility of national tax systems with community law. There appears to be very little by way of available defences for the member states. A PricewaterhouseCoopers survey of the 15 EU member states on the six issues- controlled foreign companies (CFC), transfer pricing, cross-border loss relief, differential taxation of foreign as compared to domestic dividends, company migration toll charges, and thin capitalization- found that there was 70% national rules' non-compliance with the EC Treaty (see Table)[173].

Table PWC survey of six domestic tax legislation areas across the EU



[173] Cussons, P., Frankland, M., 'Why the ECJ is the most powerful tax force in Europe' (PWC, 2002)

The consequences of a member state losing an ECJ direct tax case are normally twofold. First, the member state is liable in damages for the past losses suffered by the claimant and others, subject to time limits and procedural issues. Secondly, the member state has to change its law prospectively to conform with the EC treaty. The ECJ rulings ensuring compliance of Member State tax laws with the EC Treaty with a view to achieving EU integration has resulted in billions of euros in damages and reduced tax from many Member States[174].

However, the full consequences of the ECJ case law in the area of direct taxation for national tax rules remain uncertain. The potential incompatibilities of national tax laws with Community law have not been systematically detected and tested as only a few cases have been brought to the Court as direct actions against the Member States. Most often actions begun in a national court from which references for preliminary rulings are made to the Court as provided under Article 234 of the Treaty. Moreover, the jurisdiction of the Court does not permit it to rule beyond the specific questions of law that have been posed to it. Many important questions related to direct taxation lack guidance by the Court and the full implications of the case law have not been coherently and uniformly implemented into national legislation[175].

The Commission recognised that despite the significant potential of the Court for the removal of existing obstacles to cross-border economic activities it is clear that tackling such obstacles exclusively through judicial process before the Court cannot be sufficient. ECJ rulings are confined to the particular case put to it and may therefore relate solely to individual aspects of a more general issue, the implementation of ECJ rulings is left to Member States, who often fail to draw the more general consequences which flow from them[176].

[174] Since the 1980s (until 2002), there have been around 65 direct tax cases heard by the ECJ referred from almost every state in the EU. In 60 of these, the taxpayer or the European Commission won which makes the success rate of 92%. (Cussons, P., Frankland, M., 'Why the ECJ is the most powerful tax force in Europe' (PWC, 2002))
[175] Commission (2001), p.317
[176] Ibid.

One of the effects that the ECJ rulings might have is that the tax authorities of various Member States will act to protect their tax base by toughening up their domestic tax regimes. By removing privileges granted to domestic companies rather than providing such privileges to non-domestic entities the tax rules could be saved. As the ECJ continues to take positions on conformity or non-conformity of national corporation tax laws with the basic freedoms contained in the EC Treaty, it is difficult to envisage the survival of a number of corporate tax benefits currently reserved in Member States for resident companies (group loss relief, group tax-free transfer of assets and tax-free dividend income) and tax avoidance provisions that apply to schemes which shift tax bases within the internal market to another jurisdiction. To the extent that similar transactions would not be subject to anti-avoidance measures if they were carried out in a domestic setting, this is arguably a discrimination against/restriction of cross border movement.

The ECJ is likely to continue to enforce conformity at any cost. If the case law of the ECJ can strike down national legislations by removing obstacles to cross-border economic activity within the EU, it cannot build up a new system which would be compatible with the Single Market. These elements increase the pressure for more harmonisation and co-ordination at a political level in order to further and to reinforce the progress already made by the Court[177]. The Court's rulings erect 'prohibitions', in effect producing 'negative tax integration', which is insufficient, being related to individual cases and thus neither systematic nor organic. Rulings laid down for cases should be generalised creating 'positive integration'. Positive legislation in Member States in advance of Court rulings is therefore the only constructive way forward[178]. In the absence of binding rules, 'positive integration' can flow from 'soft law': recommendations, opinions, guidelines, communications, interpretative notes, codes of conduct, and political agreements between Member States.[179]

[177] Wathelet, M., 'Direct taxation and EU law: integration or disintegration?' (2004), EC Tax Review, No. 2004/1, p.3
[178] Commission (2001), p.317
[179] Tesauro, F., 'EU corporate tax reform: Progress and New challenges', Speech delivered in European Commission Conference on Company Taxation, (Rome, 2003)

Conclusions

Following a brief introduction into the concept and the complexities of MNE's FDI determinants, the thesis proceeded with the analysis of the ways corporate taxation, and in particular cross-border transfer of losses rules, affects companies' strategic decisions to expand through secondary establishment.

There is an emerging consensus that taxation strongly influences both the volume of FDI and the operational behaviour of multinational firms and a favourable tax regime might be an incentive to move from national to international business environment. Cross-border loss relief defined as a tax incentive was proved to have implications on business decisions as it could be used as a mechanism to lower effective tax rate which allows investors to reduce their tax burdens in the years immediately following investment when cash flow is important to pay off debt. A possibility to carry losses forward (or backward) for a specified number of years is particularly valued by investors whose projects are expected to run losses in the first few years as they try to increase production and penetrate markets.

However, the present situation is that 25 different tax jurisdictions for domestic and cross-border loss relief within the EU constitute a competitive handicap for companies who operate cross-border in the EU. The businesses' desirability of tax neutrality in cross –border loss shifting within the Single European Market is supported by the Commission which has introduced various initiatives to establish consolidated tax base within the EU. However, whilst EU measures may resolve some of the distortions and difficulties arising within the EU, they can do little to deal with pressures on corporate tax rates, opportunities for tax avoidance and distortions to economic activity that arise from interactions between the EU. Member States' position stays reluctant to such rules' harmonisation because of the threat to loose tax revenues.

Trying to provide an answer to a question weather there is a need for intra-group relief for losses rules in the EU and in which circumstances such rules could be harmonised, the

focus shifted to a discussion of the ECJ's influential set of decisions on the principle of the freedom of establishment and their role as a driving force behind the harmonising tendencies of the cross- border transfer of losses rules in the EU. Taking into consideration compatibility of cross-border relief rules in the EU Member States with the principle of the freedom of establishment, the issue could be raised before national Courts, and eventually before the ECJ. The analysis of corporate income tax issues in the light of the ECJ rulings shows that groups of companies face the prospect of being taxed on profits in one Member State whilst incurring losses in another for which a relief now might be granted. In this case tax competition stays, but the tax rate is not so important for the investment decisions.

However, as the ECJ's rulings do not build a new common EU tax base and no new legislation is adopted to generalise the ECJ's established principles in the area of taxation, companies are still pressed to deal with high legal uncertainty about which national rules are compatible with the EU law. Moreover, although it is argued that first of all companies establish in a host country and then try to lower their tax bills, this thesis maintain that cross-border loss relief could be an incentive to move to international environment choosing a jurisdiction of residence in the country or region that provides the lowest tax burden. This holds especially regarding SMEs. It is clear that once cross border loss relief is granted without common EU tax base governments would loose some tax revenues, but even in this case such loss would have less significant implications than no investment at all.

One could conclude that there is a need for cross-border transfer of losses rules' harmonisation in the EU. A gradual move towards the consolidated EU tax base could achieve it, however, as long as Member States retain a veto over tax matters even the harmonisation of tax compliance costs such as tax formalities and bookkeeping requirements are hard to agree. In this case the development of the Council Directive for cross- border loss relief and the pilot schemes for a common EU tax base are welcomed. The enhanced cooperation mechanisms between a subgroup of Member States could also facilitate further progress of tax harmonisation towards complete economic integration.

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