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Tax Treatment of Losses in the
European Union-
Possibilities and Challenges

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Summary

The European Union today consists of 25 Member States. The Member States all have different tax systems and different rates of taxation. A few Council Directives have been adopted in order to harmonize direct taxation between the Member States, but none regarding cross-border losses.

Losses are negative profits, they do not give rise to the levy of taxes but they may reduce the tax burden that would have been imposed on positive income. So the tax treatment of losses can prove to be of great significance for companies wishing to make expansions, either domestically or abroad.

There is currently an increase in tax competition between states. This means that states lower their taxes to attract capital and establishments from foreign investors. The investments create job opportunities as well as economic growth in these countries. Within the EU, tax competition between the 25 Member States is possible as long as neither the tax rates nor bases are harmonized.

The treatment of losses for groups of companies in most European countries today provide for a different taxation depending on if a group has undertakings domestically or abroad. If a group has domestic subsidiaries, their losses can be taken into consideration by the other companies within the same group. If a loss is incurred in a foreign subsidiary, many European countries are reluctant to let these losses be taken into consideration within their own jurisdiction.

In recent case law developed by the ECJ there are arguments pointing to that such national legislation, that provides different tax treatment for foreign and domestic losses, can constitute an infringement of the EC Treaty. This infringement can consist of either indirect discrimination or a restriction of the freedom of establishment conferred on all Community nationals.

The pending Marks and Spencer case before the ECJ is regarding the tax treatment provided for losses suffered in foreign subsidiaries. The UK group relief system is only applicable to UK parent companies with subsidiaries established domestically, or carrying out economic activity within the UK.

Seven Member States intervened in this case, allegedly, because the tax treatment carried out by the UK is similar to the way most European countries are dealing with losses incurred in foreign subsidiaries. The Member States expressed at the hearing in February their fear of losing tax revenue if they must give the same treatment to foreign as to domestically suffered losses.

The Advocate General Poiares Maduro recently delivered his Opinion regarding the M&S case. His view is that the UK legislation contains a clear restriction on the freedom of establishment.

However, the AG has expressed his concern that a completely open system could give rise to the use of the same losses twice, which would be contrary to the EC Treaty objectives. Therefore, AG Maduro has suggested that national provisions, which exclude foreign losses afforded equivalent tax treatment within the suffering company's home jurisdiction, may be justified under the ground of fiscal coherence.

The solution provided by AG Maduro is contrary to the ECJ case law as it stands at present. The justification ground of fiscal coherence, has always been rejected by the ECJ, when the advantage and the tax levied does not affect the same taxpayer. Moreover, according to the author, the solution provided by AG Maduro can still entail further restrictions.

The judgment of the ECJ is expected at the end of the year and has been anticipated by scholars, because of the impact it may cause on different Member States national legislation. Many are expecting the outcome to be similar to the proposal of the AG Maduro. Hopefully, this judgment will be clear in what treatment needs to be provided for foreign losses as compared to domestic in order not to infringe any of the articles in the Treaty. Moreover, it will be clear in what grounds if any can justify a differentiated treatment of foreign and domestically suffered losses.

Preface

EC Tax Law has proven to be an area of law far more fascinating than one might presume. The area is in the borderline between technical tax law and political aspects. The political aspect consists of two opposing objectives; the single Member State's strive to save its tax revenue and the objective of the proper functioning Community market guarded by Community institutions. The ECJ case law is dynamic and goal orientated, and has taken the harmonization process further in the area of direct taxation.

I would like to take the opportunity to thank all people that have given me support during my years of studies. This is especially my family, friends and Justin. My tutor Lars Pelin has also showed me valuable support, and given me inspiration for this essay and my future career.

Emma Sandberg Thomsen

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Abbreviations

AG	Advocate General
Art.	Article
AHH	Animal Health Holding
BFH	Bundensfinanzhof
C-	Court case number
CEN	Capital Export Neutrality
CIN	Capital Import Neutrality
COM	Document of the Commission of the EC
EC	European Community
ECR	Reports of cases before the Court
ECJ	European Court of Justice
EU	European Union
ICI	Imperial Chemical Industries
ICTA	Income and Corporation Taxes Act 1988
Ltd	Private limited company
OECD	Organization for Economic Cooperation and Development
OECD Model	OECD Model Double Taxation Convention on Income and on Capital
OJ	Official Journal of the European Communities
M&S	Marks and Spencer
Plc	Public limited company
RBS	Royal Bank of Scotland
UK	United Kingdom of England, Scotland, Wales and the Republic of Northern Ireland
US	United States of America
VAT	Value added tax

1 Introduction

1.1 Background

The European Union today consists of 25 Member States, all with individual tax systems. This thesis will examine direct taxation within the Member States as well as the tax treatment of company groups established in more than one Community country with losses suffered in a foreign subsidiary.

Direct taxation falls under the remaining competence of the Member States, but the European Court of Justice has repeatedly stated that:

“Although direct taxation is a matter for the Member States, they must nevertheless exercise their direct taxation powers consistently with Community law.”¹

For a company group established in more than one country of the Community, different legal systems will be applicable when analysing the tax effects for their economic activities. First, the national tax rules of each Member State, where the company group has an undertaking, or is carrying out any form of economic activity. Secondly, the double taxation treaties applicable between the different Member States in question and thirdly, EC law which consist of general principles in the EC Treaty and secondary legislation in specific matters.

In most of the Member States, the national tax system provides for some sort of equalization of the taxable result within a domestic company group. The same treatment is then normally not offered when one of the subsidiaries is established abroad, even if it is established within the Community.

Equalization of taxable results means that a company group's profits are reduced by the losses incurred before taxation. Within one company this is not normally a problem even if the company has branches abroad. This is because one company is considered one taxable entity. Problems can occur within groups of companies. If the company group cannot equalize their result, it means that they pay full taxes for the undertakings showing profits of the group, but cannot deduct losses occurred by other undertakings within the same group. This can lead to a higher tax burden for company groups that choose to establish subsidiaries abroad.

¹ Quote from C-264/96 ICI para. 19, also stated in C-250/95 Futura para. 19, C-80/94 Wiecklockx para. 16 and C-279/93 Schumacher para. 21.

The European Union is supposed to be a market free of all obstacles for intra community trade. The provisions in the Treaty, especially those regarding the four freedoms are guarding the European market. Therefore, the ECJ have the power to interpret the Treaty and to guide the Member States in preliminary rulings on how to interpret the Treaty in relation to their national provision. There have been some cases rendered by the ECJ regarding the tax treatment of foreign losses. None of these cases has clearly stated if foreign suffered losses must be given the same tax treatment as domestic one in order to not to constitute a restriction according to the Treaty.

The EU Member States are reluctant to provide rules that do not differentiate between losses suffered in domestic and foreign subsidiaries. The reason why Member States are so reluctant to provide for equalization rules valid throughout the Community, could be the fear of losing tax bases to other Community Countries. The problem is that the profits shown in the subsidiaries abroad will not be taxed in the state of the parent company. These profits will only be taxed in the state where the subsidiary is resident according to general principles of international tax law.

National and international tax provisions have always made distinctions between residents and non-residents, between domestic source income and foreign source income and between domestic payments and cross-border payments. However, the EC Treaty guarded freedoms are not always compatible with these types of distinctions. To give differential treatment to taxpayers because they are non-resident can in certain cases prove to be an obstacle to the intra community trade. However, the question remains unsolved, if foreign suffered losses must be provided the same tax treatment as those suffered domestically in a group situation not to infringe the freedom of establishment. Moreover, if this is viewed as a restriction, are there any grounds for justifying this restriction?

The competence of direct taxation remains with the Member States and in order to pass a directive in a certain issue every Member State has the right to veto. This has lead to very little harmonization as regards to direct taxation, whereas indirect taxation is completely harmonized within the Union. This harmonization is accomplished by positive integration, such as EC regulations and Directives, since the competence of indirect taxation falls under the first pillar and is provided for the Community.

There have been some directives agreed upon in order to harmonize the direct taxes.² However, the harmonization of direct taxes has not yet involved the tax treatment of foreign losses, even though a directive on this

² The Council Directive 90/434/EEC on mergers, The Council Directive 90/435/EEC on parent companies and subsidiaries, The Council Directive 2003/48/EC on taxation of savings income in the form of interest payments, The Council Directive 2003/49/EC on interest and royalty payments.

matter has been proposed in 1990.³ The same directive was later withdrawn, and the Commission is continuing to work on a new solution.⁴

There are currently two cases pending before the ECJ, which identify the problem of member States providing different treatment to losses depending on whether they occurred domestically or abroad. One of them is the Ritter case regarding a German couple suffering losses at the sale of immovable property in France. The other case is the Marks and Spencer case regarding the UK group relief provisions that only allow group relief when both companies involved are resident or economically active in the UK.

The outcome of these cases can prove to have great impact on the different tax treatments regarding losses applied by the Member States today. The opinion of the Advocate General has been published in both cases, and the judgments of the ECJ are expected at the end of the year.

If the ECJ judgments are in favour of Marks and Spencer and Ritter, then the national tax provisions in many European Countries, similar to the provisions in these countries, might have to be changed. This to comply with the doctrine of Community loyalty. Moreover, these judgements can bring new openings for companies wanting to make cross border expansions. They can also mean new ways of treating losses domestically, where the possibilities for groups to equalize their tax burden will be reduced. This can lead to groups of companies being over taxed as compared to single companies, when examining the total company group result and the taxation thereupon.

The difference in tax treatment for cross border losses is viewed by the Commission as a “*fundamental obstacle to the proper functioning of the Internal Market*”. The commission stated that they hope the developments before the ECJ⁵ “*will provide additional clarification of the legal situation and contribute to an increasing acceptance of the need for action in this area among European tax policy makers*”.⁶

³ “The 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”. The directive proposed two different methods to account for company group losses. One of them was the credit method, which only could be used on losses related to permanent establishments within the union. The second method is the deduction and reincorporation method. This could be used on foreign subsidiaries, and it gave Member States an option to decide on an ultimate time limit of five years, when previously deducted losses, had to be reincorporated. (COM (1990) 595 final).

⁴ The Ruding Committee, the Commission and the European industry had all been urging the Council to adopt the proposed directive; nevertheless, it was withdrawn since the Member States could not agree in the matter. The Commission has stated that they will consult the Member States with a view to present an initiative in late 2004 or early 2005 to tackle the current limits on cross border relief within the EU. Whether this will result in a new directive was not mentioned. (Com (2003) 726 Final p. 9).

⁵ See the pending cases Ritter C-152/03 and Marks & Spencer C-446/03.

⁶ Com (2003) 726 Final p. 9.

1.2 Purpose

The purpose of this thesis is to establish whether the differentiated treatment of domestic and foreign losses for tax purposes in most European countries constitute an infringement of the EC Treaty. To be more precise, is the reluctance not to provide the same treatment for losses suffered abroad as for those suffered domestically a restriction of the freedom of establishment as it should be interpreted according to the Treaty? If this is viewed as a restriction, what possibilities is there to justify such a restriction?

Furthermore, the purpose is for the author to try to find solutions to this international problem, acceptable in international tax law and compatible with the EC Treaty. If the ECJ judgements are in favour of Marks & Spencer and Ritter, then the different systems of equalizing the income tax burden for groups of companies that are in presently place in most European Countries, may have to be changed. The solutions put in place must also be able to deal with the current world globalization, and the impact it has on international taxation.

Many European scholars suspect that tax legislation in force today in many of the European countries is contrary to the objectives of the Treaty. This can either be accepted by the Community with reference to a ground for justifications of the current rules, or new alternatives must be found. The Member States also have the opportunity to unite in a harmonized directive, where a solution appealing to all the Member States can be ratified. However, this thesis does not give a proposition of a new directive, rather some thoughts about what tax implications new solutions will bring.

1.3 Method and Material

The method used in constructing this thesis is a traditional legal dogmatic method. The technique used is descriptive and analytical. The basis of the thesis consists of primary EC law, such as the EC Treaty and ECJ case law. Articles published in various journals and relevant textbooks on the tax treatment of losses have been a great inspiration. Articles analysing the opinion of the AG in the Marks and Spencer case has also been studied in order to conduct the analysis on the AG's Opinion and on the possible outcome of the case. To be able to draw further conclusions on the outcome of the Marks and Spencer case there has been thorough studies of the sources of EC law, including recent case law developed by the ECJ. Primary focus has been set on deriving information from primary sources such as the Community Treaty and ECJ case law. The authors analysis of the material will be preseted throughout the thesis and is not reserved for the final chapter.

1.4 Delimitations

The author will provide an analysis of the AG's Opinion in the Marks & Spencer case currently pending for the ECJ. The issue of cross-border losses will hereby be put in a wide EC perspective. It can be noted that this thesis will not include an analysis of the ECJ judgement, since it has not yet been delivered.

The topic of this thesis has been analyzed by many scholars in various tax journals. This thesis presents the latest opinions raised in the matter in the European debate, as well as the authors own analysis and conclusions regarding the topic. Moreover, information regarding international tax law and relevant judgments made by the ECJ that can lead to a conclusion on how to solve the problem in current international tax law has also been included.

The main focus of the thesis is the AG's opinion of the Marks & Spencer case as well as the implications of the ECJ's likely judgment. The opinion has been thoroughly analysed by the author. The Ritter-Coulais case also incorporates the problem of cross-border losses within the European Union. However, this case falls outside the scope of this thesis since the case concerns the tax year of 1987, and several important developments within the EC law had yet not occurred. As an example, the Treaty provisions on free movement of capital could not be relied upon directly until 1994. The author therefore believes that more up to date conclusions can be drawn from the M&S case.

1.5 Disposition

This thesis will start with a general presentation of losses and their implications on taxation in a broad European perspective and will include international tax law as well as the double taxation treaties and their relevance for cross-border situations.

Chapter three will then examine the relevant aspects of EC law and the most relevant cases determined by the Court regarding direct taxation. This chapter will also include an analysis of how the Court's reasoning in these cases might lead to any conclusions regarding the now pending Marks and Spencer case, which is the focus of the thesis.

Chapter four will provide the AG's opinion, thoroughly analysed by the author. Moreover, this chapter will include the latest opinions in the matter raised in the European debate.

The last chapter will present the conclusions drawn by the author. These conclusions will involve the predicted judgment of the ECJ in the Marks & Spencer case and also some thoughts about the impact of the judgment and solutions proposed on how to treat foreign losses for tax purposes in a way

that will be satisfying both to companies working in an international environment and governments concerned about losing tax revenue.

2 Cross-Border Losses

2.1 The Use of Losses for Tax Purposes

What constitutes losses and what makes them relevant for tax purposes? This is an important question to answer before examining the tax treatment of such losses.

A Company's main objective is normally to generate profits. These profits can be distributed to the shareholders of the company or reinvested in the business. A national tax system normally taxes such profits each year before they are distributed or reinvested in the company. What constitutes the taxable profit varies between different countries. They can use different methods when establishing what costs are deductible from the gross profits, and different methods for letting companies reinvest some profits without tax being deducted on these investments. A national tax system is the result of a country's development through history and present political status.

If a company during an accounting period is not showing a profit and the costs are higher than the income, then this company has made a loss. Losses do not give rise to the levy of taxes, but they may reduce the burden of tax that would otherwise have been imposed on profits.⁷ This is why losses play an important role in taxation, even though companies try to generate profits, previous losses are always valuable to reduce taxation during profitable periods.

What constitutes a final loss and the tax treatment such losses are granted, is something that varies between different jurisdictions. In the European Union, there are 25 different countries with different tax provisions. This leads to the different methods described here being general methods used in different countries throughout the Union, and they may not at all be applicable in all Member States.

2.2 Single Companies

Single companies are taxable entities resident for tax purposes in the state where they are established. They pay tax on their income based on national provisions in the state where they are liable to pay tax.

In national tax law, a company normally has the right to offset their losses from previous years to profits during the following years or sometimes the other way around as well (carry-back, carry-forward principles). It can be up to the taxpayer to decide whether he wants losses to be carried back or

⁷ Cordewener Axel, Dahlberg Mattias, Pistone Pasquale, Reimer Ekkehart and Romano Carlo, European Taxation 2004 p.136.

forward, or this decision may be made by the legislator or tax inspector. These principles can sometimes be subject to final time limits. They can also depend on the non-occurrence of certain events such as an essential change in the taxpayers business, change in the structure of shareholders or a change in the taxpayer's assets.⁸

Moreover, this could mean that the right to deduct losses suffered in previous tax years can be void after a company has been sold to another economic operator, or that there will be a certain time limit before the new owner can use these losses. The new owner may only be allowed to use the old losses to offset against profits within the company the losses occurred, and not in the whole group, if these companies did not have a connection when the losses were incurred. These types of provisions are normally designed to hinder losses from becoming an attractive prospect for buyers. Losses should not have a value for buyers of a company, since they are simply a sign of a company that did not do well previous years, and in a healthy market such companies should not be given a positive value because of their previous poor performance.

A company also aggregate income from national branches automatically. When it comes to branches in other jurisdictions, this income will normally be aggregated automatically to the income of the head office in the resident state. This is because a permanent establishment or branch is part of the head office and not a separate legal entity.

The reason for this is that the head office is resident in the home jurisdiction for tax purposes, and the same legal entity is a non-resident taxpayer in the jurisdiction where it has set up a branch. Taxation will therefore incur in the resident state on the worldwide income (the domicile principle), where double taxation of the income allocated to the permanent establishments (the source state will also have a right to tax this income, by the source state principle) will be avoided through double taxation treaties. The double taxation treaty will determine which of the jurisdictions will waive its right of taxation in order to avoid double taxation. The EC Member States are obliged to enter into double taxation treaties with each other according to Community law.

Established international tax law states that the source country has the prior right to tax income sourced within its territory, and the home country provides relief for double taxation. In general, residence countries do this by applying either the credit method or the exemption method.⁹

⁸ Cordewener Axel, Dahlberg Mattias, Pistone Pasquale, Reimer Ekkehart and Romano Carlo "The Tax treatment of Foreign Losses: Ritter, M&S, and the Way Ahead (Part One and Part Two) European Taxation 2004 p.137.

⁹ Terra & Wattel p. 153. This will be further explained in chapter 2.6.

2.3 Company Groups

A company group consists of different legal entities, and normally the legislator has chosen to have the single company as the taxable entity. This means that all companies within a group are different legal taxpayers, with separated accounting.¹⁰

In most European countries, there are systems to neutralize the tax burden for company groups with subsidiaries within the same jurisdiction. This means that a company group will only have to pay tax on the equalized result within the whole group. The method could be some form of consolidation between the results of the different companies within the group, where the group are being taxed on the net income.¹¹ Equalization can be done either horizontally (between subsidiaries) or vertically (between a parent company and its subsidiary).¹²

However, if a subsidiary were set in another jurisdiction than the parent company, there would normally not be a possibility to equalize the result the same way as is provided for in the domestic group.

Moreover, the foreign subsidiary will still have the right to use its previous losses in a way accepted in the country where it is established. Most of the European Member States let their companies take into account their own losses when they starts showing profit again as the carry-back/ carry-forward principle provides.

However, there are still two remaining disadvantages for companies that want to establish cross-border subsidiaries. These are disadvantages in the tax treatment as compared to purely domestic company groups.

One is the loss of cash flow, an expansion might be costly, and the company might only generate losses during the first years. The parent company might be successful in its jurisdiction and generate high profits. However, these cannot be offset against each other, as the parent company still has to pay full taxes in its own jurisdiction and may experience problems with cash flow due to this. The company will also loose the interest it could have made during those years before it is able to offset the losses incurred to profits in the same jurisdiction. If the subsidiary were placed in the same jurisdiction of the parent company these problems would normally not occur.

The second problem is that if the cross-border expansion fails and the subsidiary never shows a profit, the losses incurred will never be offset and the parent company will still have to pay full tax on its profits in the national

¹⁰ Wiman Intertax 2000 p. .352.

¹¹ Wiman, Intertax 2000. p. 352.

¹² Terra, Wattel European Taxation p. 441.

jurisdiction. This parent company will then be over taxed as compared to a single company or a domestic company group in the same situation.

2.3.1 Why Should a Company Group be Taxed as a Group?

One of the aims of equalizing the taxable result within a company group is to make the net tax burden for the group equal the net tax burden of single companies. This can be realized by establishing some form of consolidation within the group. In Sweden and in Norway the rationale behind this has been described as the “principle of neutrality”. The meaning of this principle is that activities of a group of companies should not be more heavily taxed than if the same activities had been pursued within one company.

Another reason for letting the group be taxed on a consolidated result is to tax an economic unit as a unit, regardless of how it is organized. Taxation should not be the reason behind how companies or groups of companies choose to organize their economic activities.¹³

2.3.2 Different Methods for Equalizing the Tax Burden for Groups of Companies

There are different methods to equalize the tax burden within company groups. Around Europe, there are some different models in use in the different national tax laws. These models could be divided into three groups.

The first model can be found in countries without any regulations of how to equalize the tax burden within company groups. The second model is found in those countries, which have certain regulations on how companies can claim offset of losses against profits in other owned companies at their final taxation. Moreover, the third model is applied by countries who consolidate the income of their company groups and tax them as they were only one taxpayer.¹⁴

The first model is not to have any regulations regarding equalization of the tax burden for groups of companies, as seen in Belgium, Greece and Italy.¹⁵

One method could then be to let company groups consolidate their income by allowing pricing between different companies within the group to be

¹³ Wiman, Intertax 2000 p. 352.

¹⁴ Wiman, Intertax 2000 p. 352.

¹⁵ Wiman, Intertax 2000 p. 352.

decided by the company, in order to equalize the tax burden within the group.¹⁶

This phenomenon is called transfer pricing and according to the OECD guidelines there are regulations set up to avoid transfer pricing cross-border.¹⁷ If a country were to allow transfer pricing cross-border it could lead to tax revenue loss, since the companies with subsidiaries abroad can decide in what jurisdictions to pay tax. However, if transfer pricing takes place within the same tax jurisdiction no revenue is lost for the country, and allowing this could be a solution if no other provisions are in place to equalize the tax burden for company groups. If transfer pricing is not permitted for company groups within these countries without any equalizing provisions, then groups of companies could be over taxed as compared to single companies. Moreover, this could lead to economic operators not organizing themselves in company groups, but rather as one company, within these jurisdictions.

The second model, provides some form of offsets of losses against profits between group companies. This is presently the most common system used in the European countries, even if the methods of implementation varies between the different legislations.¹⁸

The third model, as seen in Denmark and Austria, allows consolidation between all companies within a group. These countries have systems allowing their resident companies to aggregate their worldwide income and consolidate, foreign losses will also be taken into account. The *Tax Reform 2007* published by the Netherlands Ministry of Finance, proposed possibilities for foreign subsidiaries to be joined in a Dutch fiscal unity.¹⁹ This would then also be some form of consolidated system.

The benefits of the consolidated systems, is that they could be applied to the groups worldwide economic activities, therefore problems with unequal treatment of cross-border losses would not occur.

2.4 Tax Treaties

Tax treaties have developed through the world in order to avoid double taxation. The Member States of the European Community are obligated by the EC Treaty to avoid double taxation by entering into tax treaties with each other.²⁰ The double taxation treaties presently operating between the

¹⁶ Wiman 2005 p. 352.

¹⁷ OECD transfer pricing guidelines.

¹⁸ Sweden and the UK are two of these countries and their legislation will be discussed further on, The Swedish legislation in chapter 4.4 The UK legislation will be described and discussed in chapter 5.

¹⁹ Paul M de Haan, Marcel Jakobsen International tax Review "European Union: When international tax law clashes with EU law".

²⁰ Art. 293, second indent EC.

different European Member States have a significant role in resolving different tax issues concerning cross border relations.

The OECD model treaty does not contain any clauses regarding cross border losses in groups of companies. Therefore, explicit tax clauses regarding this issue are rare in the bilateral tax treaties.²¹

The main objective with the tax treaties is to avoid double taxation. The problem that occurs with cross-border losses is not double taxation as such, but the non-occurrence of deduction of losses because of a cross border situation. This problem can still lead to “over-taxation” for groups as compared to single companies. Nevertheless, there is no obligation in the EC Treaty to avoid this problem through double taxation treaties.

The double taxation treaties are very important when establishing the right to tax certain income, when two states are invoking taxation on the same income according to their internal tax law. This is due to two states claiming the right to tax on either the domicile or the source state principle. This problem normally occurs for companies who have branches established abroad rather than subsidiaries. The domicile principle gives the right to taxation of all residents in a state, and then to tax residents on their worldwide income, which can consist of capital investments, immovable property, permanent establishments etc. situated in another jurisdiction. The source state principle provides the right to taxation of all income generated from a source within a jurisdiction. This can be a permanent establishment or immovable property etc. For a single company having branches established within the Community, double taxation of these sources is resolved via double taxation treaties.²²

Established international tax law postulates that the source country has the prior right to taxation. Therefore, the home country has to provide relief for double taxation.²³

There are two different methods provided for in double taxation treaties to avoid the same income being doubled taxed, the credit and the exemption method. Which method is applied depends on if the state adheres to capital import neutrality (CIN) or capital export neutrality (CEN). Capital export neutrality is normally applied by countries with large or closed home markets such as USA, UK, Japan, Spain, Italy and Germany. The CIN principle on the other hand is normally applied by smaller countries with open economies such as Finland, Belgium, Luxembourg and the Netherlands.²⁴

²¹ Cordewener Axel, Dahlberg Mattias, Pistone Pasquale, Reimer Ekkehart and Romano Carlo, *European Taxation 2004*, p.139.

²² Terra & Wattel, *European Tax Law*, p. 153.

²³ Terra & Wattel, *European Tax Law*, p. 153.

²⁴ Terra & Wattel, *European Tax Law*, p. 156-157.

The countries adhering to CIN can also limit the scope of the exemption method to active income, such as business profits, dividends from subsidiaries, employment or self-employment income. Passive income such as dividends from ownership or other capital investments are subject to tax treatment under the credit method. Some countries use both methods depending on what type of income or which taxpayer is concerned. The OECD model treaty provides both methods, and the EU has provided both methods in adopted directives and proposals for new directives regarding direct taxation.²⁵

2.4.1 The Credit Method

The credit method is applied in countries that adhere to capital export neutrality. This means that the state neither encourages nor discourages their undertakings to make investments abroad, because foreign investments are taxed on the same level as domestic ones. The state in this case is opting for taxation of its residents' worldwide income, even if the income is from a foreign source. The taxpayer may then credit the foreign state tax already paid abroad, against the home state tax attributable to the foreign source income.²⁶

The result will then be that the home state will levy additional tax on the foreign source income if the tax rate in the foreign state is lower than in the home state. This means that the home state level of tax will always be levied on an income earned by a residential taxpayer, regardless of where the income is deriving from. The purpose of this method is to create neutrality between the taxation of domestic income and foreign source income.²⁷

2.4.2 The Exemption Method

The exemption method is applied by countries adhering to Capital Import Neutrality. This principle provides for a national state to exempt foreign source income of its resident, since that income has already been taxed in the source state. The purpose of the capital import neutrality is to let the domestic investors on foreign markets be able to compete within these markets with equal tax treatment as other investors. The effect of the principle is that income earned within a state's jurisdiction suffers only that states tax treatment.²⁸

²⁵ See the Parent-Subsidiary Directive, Council Directive 90/435/EEC of 23 July 1990 and "The 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 (1990) 595 final.

²⁶ Terra & Wattel p. 153-155.

²⁷ Ibid.

²⁸ Terra & Wattel p. 155-156.

The exemption method means that the foreign source income will not be included in the home state tax base. This results in foreign state tax incentives automatically benefiting the investors and not the home state, as it would under the credit method. However, the exemption method might encourage domestic investors to invest in foreign low tax regimes rather than home, which can be seen as a negative impact for the country applying this principle.²⁹

2.4.3 Cross-border Group Relief in Tax Treaties

As mentioned earlier, tax treaties do not provide for any solutions to the problem with losses occurred in intra community groups. However, there is no reason why this problem could not be solved via double taxation treaties. As Prof. Meussen argues, “there cannot be a proper cross-border group relief, without the cooperation of two Member States.”³⁰

Through double taxation treaties, there would be a possibility to provide for group relief in the same way as being done under the UK legislation.³¹ The losses could then be transferred from one member of a group to another, with the same tax treatment as if it had occurred in the receiving company. The problem today is that even if a loss were to be taken into account within the jurisdiction of the parent company, it would not change the treatment of the loss incurred in the jurisdiction of the subsidiary. The loss may still be offset according to the tax provisions within this jurisdiction. This may lead to the opportunity to take the same loss into account twice, in two different jurisdictions. This is something that could be prevented through double taxation treaties.

²⁹ Ibid.

³⁰ Meussen European taxation 2005 p. 282.

³¹ See chapter 5.2.

3 The EC Treaty

Article 2 of the EC Treaty provides the principle objectives of the European Community, and the means to reach the objectives is the establishment of a common market and an economic and monetary union. This requires free movement of goods, services, persons and capital, the four freedoms. Differences in the Member States national tax law can cause problems in establishing a common market with fair competition for all participants. Therefore, a level of harmonization of tax law between the Member States is required.

Harmonization through European Council directives has proven difficult to achieve by the Member States, due to their right to veto. There have also been a significant number of cases brought before the ECJ, where the Member States judiciaries have requested a preliminary ruling according to art. 234 EC, on how to interpret a Treaty provision that could prove their national legislation to be contrary to the EC law. The ECJ has then interpreted the Treaty provision in such way that the Member States national legislation was found to entail discrimination or restrictions.³²

The Member States have remained the competence of direct taxation. The only provision in the Treaty regarding direct taxes is art. 94, which states that the Council must act unanimously in order to pass a directive that involves direct taxation. This means that all Member States has the ability to stop a directive. When a directive has been passed, the Member States have given away their exclusive competence in that particular area. There have been a few directives passed regarding direct taxation. These are the Parent-Subsidiary Directive,³³ the Merger Directive,³⁴ the Interest and Royalty Directive³⁵ and the Taxation on Savings Directive.³⁶

The Parent-Subsidiary Directive seeks to abolish double taxation on dividends distributed cross-border to a parent company. This directive does not deal with any form of unequal tax treatment of losses.

However, some Treaty provisions have proven great importance in the field of direct taxation in the ECJ case law. Even if the Member States have remained the competence of direct taxation, these Treaty provisions have been found applicable in cases before the ECJ regarding national tax

³² An example is Sweden, where their legislation regarding group contributions (koncernbidragsreglerna) was changed after the case C-2000/98 X AB, Y AB, delivered in 1999. Also the UK rules regarding Group relief was changed after the C-264/96 ICI judgment in 1998.

³³ Council Directive 90/435/EEC of 23 July 1990.

³⁴ Council Directive 90/434/EEC of 23 July 1990.

³⁵ Council Directive 2003/49/EC of 3 June 2003.

³⁶ Council Directive 2003/48/EC of 3 June 2003.

provisions. The Treaty provisions proven applicable by the ECJ are those regarding discrimination and the four freedoms.³⁷

Art 10 EC states the principle of community loyalty. The article requires Member States to co-operate loyally in order to achieve the objectives of the Treaty, and to abstain from any measures that could jeopardize the community objectives. This article has founded important community principles such as the reconciliatory interpretation of national law and state liability for breaches of EC law.

3.1 The Four Freedoms

3.1.1 General

The four freedoms can be found in the EC Treaty, they are the right of free movement for goods,³⁸ persons,³⁹ services,⁴⁰ and capital.⁴¹ All four freedoms have direct effect according to the ECJ, which means that they can be relied upon before national courts. They are highly relevant concerning the Member States direct taxation because internal tax laws can prove to be obstacles for these freedoms. The EC law then provides for abolition of such obstacles to realize the internal market.⁴²

Two principles can be found in establishing the four freedoms. It is the right to market access and the right to market equality.⁴³ This means the right for all resident individuals and companies within the union to access any market or country and a right to be treated in a non-discriminatory way in that country.

The Treaty provisions regarding the four freedoms have direct effect, so the Member States have to make their internal tax laws compatible with these freedoms. Even in cases when the national law is not compatible with the rights granted by the four freedoms, nationals of the Community can still rely upon them and invoke them in national courts. This is because the principle of direct effect, which is applicable on all the four freedoms. In recent case law, the ECJ has clarified the interpretation of these Treaty provision as regards to direct taxation. In many of these cases before the Court, the principles deriving from Community law, was found to give certain rights superior to the national legislation at issue, to all Community Nationals wishing to make use of these rights.⁴⁴

³⁷ See for example cases: X AB, Y AB C-200/98, ICI C-202/92, Bosal C-168/01.

³⁸ Art 23-31 EC.

³⁹ Art 39-48 EC.

⁴⁰ Art 49-55 EC.

⁴¹ Art.56-60 EC..

⁴² Terra & Wattel p. 30.

⁴³ Terra & Wattel p. 31.

⁴⁴ See for example C-319/02 Manninen, C-168/01 Bosal, C-35/98 Verkooijen, C-264/96 ICI.

3.1.2 Freedom of Establishment

Article 43 EC provides for the freedom of establishment (included in the freedom of movement of people), which allows primary establishments (undertakings) and secondary establishments (agencies, branches, subsidiaries) to operate without restrictions within the Member States. When a national from one Member State chooses to make use of the right of establishment in another Member State, they have the right to be treated non-discriminatory as compared to a national of the host state. The right of establishment is conferred upon individuals being nationals of an EU Member State or companies and firms having their registered office within the Community.⁴⁵ For a long time it was the right to national treatment which was the main usage of the freedom of establishment, the Member States have to treat nationals of other Member States within the Community as their own nationals in tax matters.⁴⁶

The main purpose of the freedom of establishment is to realize the internal market and to make it easier for individuals and companies to establish themselves in another Member State. This does not only include the right to national treatment but also the prohibition of restrictions. Hence, the freedom of establishment has often been used in ECJ case law when a state has tried to hinder its nationals from establishing companies abroad; rather then, the state where the establishment is taking place is trying to hinder it.⁴⁷

3.2 Discrimination

The prohibition of discrimination of nationality is stated in article 12 EC. According to case law from ECJ, discrimination occurs when alike cases are treated differently and when different cases are treated alike.⁴⁸ Discrimination of nationality is called direct discrimination. Indirect or covert discrimination is also prohibited by the ECJ case law. This is the case when a rule has another criteria then nationality, but when the effect of the rule gives the same result as if nationality would have been the criteria.⁴⁹

Article 12 has never been applied independently in cases regarding direct taxation before the ECJ, only combined with any of the articles of the four freedoms.

⁴⁵ Terra & Wattel p. 37.

⁴⁶ Royal Bank of Scotland C-311/97 para.29.

⁴⁷ Ex. Centros C-212/97, Bosal C-168/01, X,Y C-436/00.

⁴⁸ C-279/93 Schumacher para. 30, C-311/97 Royal bank of Scotland para. 26.

⁴⁹ C-254/94 Baxter Schumacker para.26

3.3 Restrictions

A national provision can form a restriction on the right to pursue any of the four freedoms even though it is not discriminatory. The treatment might be general, but still hinder the right of establishment. This is then called a restriction and is prohibited by the EC treaty. This is because everyone has the right to pursue the four freedoms and a provision that hinders that right is considered restrictive.

A restriction can still be accepted by the Court if it passes the Treaty justification grounds or the rule of reason test. The advantage of providing a rule to be restrictive rather than discriminating is that one never needs to make the comparison between to objectively alike situations. Restrictions are normally provisions with some form of exit treatment such as exit taxes, equal for all nationals wishing to exit a Member State.⁵⁰

3.4 Justification

The Treaty provides grounds for justification of rules that are found to be either discriminating or restricting. Discrimination and restrictions of the free movements of persons can be justified on the grounds of public policy, public security and public health.⁵¹

In the ECJ case law, there are justification grounds other than those stated in the Treaty. These grounds are based on the rule of reason test. The rule needs to meet four criteria in order to pass the rule of reason test. These were summarized by the Court in the Gebhard⁵² judgment:

1. They must be applied in a non-discriminatory manner:
2. They must be justified by imperative requirements in the general interest:
3. They must be suitable for securing the attainment of the objective which they pursue: and
4. They must not go beyond what is necessary in order to attain it.

Three measures have been accepted by the ECJ case law as justification grounds that passed the rule of reason test.

The first one was fiscal coherence, the need to protect the integrity of a national tax system, which was accepted in the Bachman⁵³ case. This principle is supposed to correct the effect of the Community freedoms,

⁵⁰ See exit taxes in C-9/02 Lasteyrie and C-258/98 Baars.

⁵¹ Art 46 EC.

⁵² Gebhard C-55/94 para. 37.

⁵³ Bachman C-204/90. It has never been accepted by the ECJ since even though member states often refer to it, and some scholars think this ground has now been overruled, due to the court reducing its scope in later judgments such as Wiecklockx C_80/94, Verkooijnen C-35/98, Lankhorts-Hohorst C-324/00 and Danner C-136/00.

when they interfere with the logical organisation of a national tax system. However, it should not be accepted if the Member States arrange their internal tax systems in such way as to favour national traders.⁵⁴ The concept also ensures that Community nationals do not use the Community provisions to secure advantages from them, which are unconnected with the Community freedoms.⁵⁵

The second justification ground is the need for effective fiscal supervision, which was introduced in the *Futura Participations and Singer* case.⁵⁶ Effective fiscal supervision means that a country has the right to implement certain rules regarding accounting etc. for tax purposes to be fulfilled before granting certain tax advantages.

The third justification ground is the need to prevent the abuse of law. The third ground has never been applied by the ECJ, but it has been accepted in principle. The UK government tried to use it to protect the national group relief system in *ICI*⁵⁷, and the Danish government claimed this justification ground in the *Centros* case,⁵⁸ in both cases it was rejected by the ECJ.

The Court has also been unclear regarding when the rule of reason test is applicable. The Court has stated that in principle measures making a direct or indirect discrimination based on nationality, incorporation and origin can only be justified by the requirements stated in the Treaty⁵⁹, whereas measures seen as being restrictive can be saved by the rule of reason test. The Court has however not been consistent in this matter and cases regarding indirect discrimination have been justified by the rule of reason test in recent case law regarding taxation. The provisions found indirectly discriminatory by the ECJ in the *Bachmann* case, was justified via the rule of reason test by the Court.⁶⁰ The Court has also stated in the *Royal Bank of Scotland*⁶¹ case that the rule of reason test can only be applied in cases regarding covert discrimination or restrictions. Not in cases regarding direct discrimination. This would then lead to that the conclusion that the rule of reason test is applicable in tax cases regarding indirect discrimination and restrictions, but not direct discrimination.

In summary it is apparent from the ECJ case law that there are three types of provisions that may be incompatible with the Treaty provisions :

⁵⁴ AG Maduro, Opinion on C-446/03 *Marks & Spencer* para. 6.

⁵⁵ A. Cordewener, M. Dahlberg, P. Pistone, E. Reimer, C. Romano, *European Taxation* 2004 p. 221.

⁵⁶ C-250/95 *Futura Participations and Singer*.

⁵⁷ C-202/92 *ICI*.

⁵⁸ *Centros* C-212/97.

⁵⁹ This is the general approach set by the ECJ in C-113/80 *Commission v. Ireland* and C-2/90 *Commission v. Belgium*.

⁶⁰ C-204/90 *Bachmann*.

⁶¹ C-311/97 *RBS*.

1) Measures discriminating openly on the grounds of nationality or origin. These provisions can only be justified if there is justification ground found in the Treaty, regarding to the public interest.

2) Measures which seem to be based on a neutral criterion, but which indirectly puts economic operators, products or capital from other Member States in a worse position. These provisions can be justified by Treaty provisions or sometimes the rule of reason test has been found applicable in these cases.

3) Measures without distinction, which could be acknowledged as being restrictive because they hinder or make it less attractive to exercise the Treaty provisions. These restrictions can be justified with the use of the rule of reason test.

Nevertheless, it seems unprecedented for the Court to differ between the rules that are openly or covertly discriminatory for these purposes. If the rule of reason test is applicable even for the provisions that are covertly discriminatory, it would seem justified to apply the test to all discriminatory provisions. It could be argued that by applying the rule of reason test to both discrimination and restrictions the principles of EC law would become clearer and simpler to the Member States adhering to them.

4 ECJ Case Law

4.1 General

The ECJ has rendered many cases regarding the tax treatment of losses and costs occurred for establishments when there is an intra Community aspect. These cases have clarified the interpretation of the Treaty articles regarding the four freedoms. This presentation will include the most important judgments made by the ECJ regarding tax treatment of losses. They are presented in chronological order, whereas the most important interpretations by the ECJ will be discussed. The presentation will also include an analysis with regard to the impact these cases could have in the rendering of the Marks & Spencer case.

4.2 Futura Participations and Singer C-250/95

This case involved a French company (Futura), with a branch (Singer) in Luxembourg, where the Luxembourg tax authorities determined Singers liability for tax revenue pertaining to the year of 1986.⁶² According to Luxembourg law, locally earned income of non-resident companies is chargeable to tax.⁶³ However, non-residents are not obliged to keep separate accounts for their Luxembourg activities, and they can to determine their taxable income in Luxembourg based on an apportionment on their total income.⁶⁴

The Luxembourg tax law also allows non-residents to deduct previously incurred losses that have been carried forward from their taxable income. This is under condition that separate accounts have been kept and that the losses are related to the income earned locally. In order to carry forward the previously incurred losses, the accounts had to be kept according to Luxembourg law.⁶⁵

Singer did not have accounts kept according to Luxembourg law (proper accounts) for 1986 and determined the taxable income for that year based on an apportionment of Futura's total income. They also wanted to offset this income against losses incurred between 1981 and 1986, during these years Singer did not have proper accounts and the losses they tried to deduct where a result of an apportionment of all Futura's losses during that period.⁶⁶

⁶² Futura Participations and Singer C-250/95 para.1.

⁶³ Futura Participations and Singer C-250/95 para. 7.

⁶⁴ Futura Participations and Singer C-250/95 para. 8.

⁶⁵ Futura Participations and Singer C-250/95 para. 9.

⁶⁶ Futura Participations and Singer C-250/95 para. 10.

The Luxembourg tax authorities refused to allow a offset on this basis, since according to the Luxembourg provisions losses could only be offset if they were related to the locally earned income and if they were recorded in proper accounts.⁶⁷

Conceil d'État du Grand-Duché de Luxembourg (Council of State of the Gran Duchy of Luxembourg) referred questions to the ECJ for preliminary ruling. The question involved the interpretation of art 52 (now art. 43 EC) and Luxembourg taxation of non-resident taxpayers and the fact that they can only offset losses related to income received locally and if proper accounts have been kept. The reason for the provision regarding proper accounts is to establish that these losses have been related to income received locally.⁶⁸

The ECJ first determined that the right to carry forward losses for non-residents in Luxembourg consisted of two criteria. 1) the existence of an economic link 2) the keeping of proper accounts.⁶⁹ The ECJ deals with the economic link by establishing that Luxembourg law only provides for taxation if non-residents income or losses are deriving from activities within the country. This system is in conformity with the fiscal principle of territoriality and cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty.⁷⁰

The second condition, keeping of proper accounts may constitute a restriction according to the ECJ. This is because a company that wishes to establish a branch in the Luxembourg jurisdiction must not only keep accounts according to the rules of the country where it has its seat and is resident, but also separate accounts for its branch in order to be able to carry forward any losses occurred within this branch.⁷¹

In principle, it is prohibited by the Treaty to impose a condition, which especially affects companies choosing to have their seat in another member state. However, such a condition can be legitimate if it pursues an aim compatible with the Treaty and the provision does not go beyond what is necessary for the purpose.⁷²

The ECJ states that the effectiveness of fiscal supervision is a general interest capable of justifying a restriction of the freedom of establishment, and Member States may therefore apply measures to ascertain clearly and precisely what income and losses have occurred within their jurisdiction.⁷³

⁶⁷ Futura Participations and Singer C-250/95 para. 11.

⁶⁸ Futura Participations and Singer C-250/95 para. 12-13.

⁶⁹ Futura Participations and Singer C-250/95 para. 17.

⁷⁰ Futura Participations and Singer C-250/95 para 17-22.

⁷¹ Futura Participations and Singer C-250/95 para. 23-25.

⁷² Futura Participations and Singer C-250/95 para. 26.

⁷³ Futura Participations and Singer C-250/95 para. 31.

However, the Court did not accept the fact that the non-resident had to have kept accounts according to the Luxembourg law during the year the losses had occurred as long as the taxpayer can prove that such losses did occur based on Luxembourg fiscal accounting and allocation rules.⁷⁴

Conclusions to be drawn from this case is that the ECJ accepts a fiscal principle of territoriality, which can be concluded as Member States only have to take into account profits and losses incurred in their jurisdiction when determining the tax treatment of non-resident companies.

The UK government is arguing the in international tax law accepted fiscal principle of territoriality as a justification ground in the M&S case. The UK government is claiming that the fiscal principle of territoriality was accepted by the ECJ in this case. The difference is that the M&S case involves a resident taxpayer as opposed to a non-resident taxpayer, which Singer is in this case. However, the interpretation of this principle by the UK government is that because the UK has no right to charge tax for the foreign subsidiaries they do not either have the obligation to offset losses deriving from foreign subsidiaries.

The Court in this case also accepts the justification ground of the effectiveness of fiscal supervision as constituting an overriding requirement of general interest. This justification ground was accepted regarding the requirement to keep separate accounts when establishing which losses was occurred within the jurisdiction.

4.3 ICI C-264/96

This was a case brought forward by the House of Lords of the United Kingdom, regarding the UK provisions of group relief. Imperial Chemical Industries (ICI) are resident in the UK for tax purposes; they founded a consortium together with Wellcome Foundation Ltd, where they own the company Animal Health Holdings (AHH).⁷⁵ The holding company then owned 23 subsidiaries whereof 4 was resident in the UK, 6 in other Member States and 13 outside the European Union.⁷⁶

AHH was suffering losses during the 1985-1987 period, ICI wanted to deduct those losses from their own profits according to the group relief scheme applicable in the UK. However, this was not possible according to the group relief provision. According to the provisions, the holding company must only hold shares in companies resident in the UK in order to have their losses transferred under the UK group scheme.⁷⁷ The ECJ did not

⁷⁴ Futura Participations and Singer C-250/95 para.39-43.

⁷⁵ C-264/96 ICI para. 3.

⁷⁶ C-264/96 ICI para. 4.

⁷⁷ C-264/96 ICI para. 5-9.

find this compatible with the Treaty, since such provisions imposed a restriction on the freedom of establishment.⁷⁸

The Court stated that the freedom of establishment entails a right for companies established within the Community to be treated as nationals in the host Member State. The ECJ continued that the provisions regarding the freedom of establishment also prohibits the Member State of origin from hindering companies incorporated under its legislation, the establishment in another Member State.⁷⁹

The group relief provisions in the UK have since been altered. It is now possible to claim group relief when the subsidiaries of the parent company are resident or carries out economic activity in the UK.

One might say that the Marks and Spencer case is taking the problems with the UK group relief system a step further. M&S are claiming group relief on losses that incurred in foreign subsidiaries, these subsidiaries do not carry out any form of economic activity in the UK, and their only connection to the UK is the ownership. It remains to be seen whether this also is viewed as a restriction on the freedom of establishment by the ECJ.

4.4 X AB, Y AB C-200/98

The Swedish Regeringsrätten (Administrative Court) referred this case to the ECJ.⁸⁰ Parent company X AB, resident in Sweden owned 58% directly of Y AB, also resident in Sweden. Indirectly X AB owned up to 99.8% of Y AB, with the rest being owned through other subsidiaries established and resident abroad.⁸¹ The Swedish intra group transfer rules at the time were designed to let the transfers between two group members, to be treated for tax purposes as a deductible expense for the transferring company and a taxable income for the receiving. This was only allowed if both companies were resident in Sweden for tax purposes and if the parent owned at least 90% of the subsidiary.⁸²

Since X AB owned part of the subsidiary Y AB through other subsidiaries abroad, these companies could not make use of the group transfer provisions. This was the case even though both of the group members were resident in Sweden.⁸³

X AB and Y AB claimed that this was in breach of the Community law, and the ECJ determined that the Swedish rules were incompatible with the interpretation of art 52 and 58 (now 43 and 48) of the EC Treaty.⁸⁴ The

⁷⁸ C-264/96 ICI para. 22-23.

⁷⁹ C-264/96 ICI para.21.

⁸⁰ C-200/98 X AB, Y AB para. 1.

⁸¹ C-200/98 X AB, Y AB para. 5.

⁸² C-200/98 X AB, Y AB para. 4.

⁸³ C-200/98 X AB, Y AB para. 6-10.

⁸⁴ C-200/98 X AB, Y AB para.11 and para.28.

Swedish government did not try to justify the Swedish legislation in this case; on the contrary, they admitted that the legislation imposed a restriction on the freedom of establishment.⁸⁵

The group transfer rules in Sweden have now been changed, and the provisions applicable at present allow group transfers if the companies wanting to make use of them are either resident or carrying out economic activity in Sweden.⁸⁶

However, the Swedish rules are still not applicable when a subsidiary established abroad is suffering losses. These losses cannot be transferred to a Swedish group member, unless it has some activity in Sweden. In the Swedish debate, this situation has been viewed as a possible restriction of the freedom of establishment.⁸⁷ When the ECJ presents the judgment of the Marks and Spencer case, this may be a guideline to whether the type of legislation in force in Sweden entails any restrictions of the freedom of establishment and whether they can be justified or not.

4.5 Bosal C-168/01

This case was referred to the ECJ from the Hoge van Raad der Nederlanden (Supreme Court of the Netherlands) and the judgment of the ECJ was delivered in 2003.⁸⁸

Bosal is a holding company, which is resident in the Netherlands and is subject to corporation tax within the Netherlands. The company claimed deduction of costs relating to the financing of its holding in nine other Member States.⁸⁹ The Dutch provisions did not allow deduction on these costs since they were not instrumental in the making of profits taxable in the Netherlands. This because the subsidiaries were set in other Member States.⁹⁰

The Netherlands government argued before the Court that the subsidiaries established abroad and the domestically established subsidiaries are not in comparable situations, and therefore no infringement of the Treaty had occurred. This was due to the principle of territoriality.⁹¹ They also argued that if there was a restriction it could be justified on the ground of fiscal coherence.⁹² Moreover, the Netherlands government suggested there was a ground for justification due to possible erosion of the tax base.⁹³

⁸⁵ C-200/98 X AB, Y AB para. 29.

⁸⁶ Swedish legislation "Income tax regulation" (Inkomstskattelagen) 35th chapter.

⁸⁷ Lena Lindström-Ihre Skattenytt nr 5 2005.

⁸⁸ C-168/01 Bosal para.1.

⁸⁹ C-168/01 Bosal para. 9.

⁹⁰ C-168/01 Bosal para. 7 and para. 10.

⁹¹ C-168/01 Bosal para. 18.

⁹² C-168/01 Bosal para.19.

⁹³ C-168/01 Bosal para. 20.

The ECJ stated that the Dutch provisions constituted a hindrance of the freedom of establishment.⁹⁴ The argument that ground for justification was found in the coherence of the tax system was not applicable according to the Court. The ECJ has stated in previous case law that coherence of the tax system can only be used as a justification ground when there is a direct link between the grant of an advantage and the fiscal levy, if one is dealing with different taxes or different taxpayers, the argument based on coherence cannot be relied upon.⁹⁵

The relevant comparison in the case was the comparison between two parent companies wishing to make expansion either domestically or abroad according to the ECJ. Not as the Netherlands government proposed, the different subsidiaries. The Court stated the comparison between the subsidiaries were irrelevant.⁹⁶

The ECJ also explained clearly that the erosion of the tax base does not constitute a matter of overriding general interest, which may be relied upon to justify a restriction on the freedom of establishment.⁹⁷

The most important statements made by the Court in this case, were to explain how to make the relevant comparison in order to establish whether a restriction of the freedom of establishment exists or not. The relevant comparison shall be made between a company that chooses to make use of its Community freedoms, and a company that does not. If the company who wants to make foreign investments is in a less favourable position for tax purposes than the company making domestic investments, this constitutes a restriction on the freedom of establishment. The Court also clearly stated that the justification ground of fiscal coherence may only be relied upon when there is direct link between the same tax and the same taxpayer. Moreover, the ECJ held that the erosion of the tax base could not be accepted as a ground for justification.

The Conclusion to be drawn from this case is that it seems highly unlikely that the Court will ever accept the erosion of the tax base as an argument for justification. It also seems highly unlikely that the ECJ will relax the justification ground of fiscal coherence as proposed by the AG Maduro in the Marks and Spencer case. Maduro is proposing the ground of fiscal coherence to include even situations that do not comprise the same tax and same taxpayer.

⁹⁴ C-168/01 Bosal para.27.

⁹⁵ C-168/01 Bosal para. 29-30 C-35/98 Verkoijen para. 57, C-251/98 Baars para. 40.

⁹⁶ C-168/01 Bosal para. 37.

⁹⁷ C-168/01 Bosal para. 42.

5 The Marks and Spencer case

5.1 Background

Marks and Spencer Plc (M&S) is resident in the UK for tax purposes. They are the principal trading company and a holding company for many national and overseas subsidiaries. The group specialises in general retail, clothing, food, home ware and financial services. Most of the overseas operations were owned via a Dutch holding company.

In 2001 M&S decided to withdraw from its continental European activity. By December 2001 the French subsidiary was sold, and in the remaining ones, including the German and Belgian subsidiaries, the trading had ceased. In the years from 1998 until 2001, the French, German and Belgian subsidiaries only generated losses. These losses had never been offset against profits in the source countries. The purchaser of the French subsidiary was prohibited from making use of the previously occurred losses, so they did not effect the purchase price for the French subsidiary.⁹⁸

The British parent company M&S therefore applied for a group relief to offset the domestic profits against the foreign losses occurred during the accounting periods ending in 1998, 1999, 2000 and 2001. UK legislation enables parent companies under certain circumstances to offset the subsidiaries' losses against the parent company's profits.⁹⁹ The group relief claim was submitted to Mr Halsey, HM inspector of taxes, in the UK. He rejected the group relief claims on the 13 August and 2 November 2001 because the UK rules do not apply to subsidiaries, which are neither resident nor economically active in the UK.¹⁰⁰

The decision was then challenged by M&S before the UK Special Commissioners of Income Tax. M&S claimed that the UK rules were incompatible with community law, in particular art. 43 and art. 48 regarding the freedom of establishment. In the case before the Special Commissioners, the parties agreed to regard the chain of ownership and try it as if M&S had directly owned 100 per cent of the foreign companies. The application was dismissed on 17 December 2002, where the Special Commissioners choose not to refer the case to the ECJ. The Special Commissioners were arguing that the principles established by the ECJ in this matter were clear, and the UK provisions did not entail any infringements to the freedom of establishment.¹⁰¹

⁹⁸ AG opinion C- 446/03 para.8.

⁹⁹ AG opinion C- 446/03 para.9.

¹⁰⁰ Ibid.

¹⁰¹ AG opinion C- 446/03 para.10.

The applicant then referred the case to the High Court of Justice England and Wales, Chancery Division, which decided to stay the proceedings and refer their questions to the ECJ for preliminary ruling.¹⁰²

The hearing of the case before the ECJ was in February 2005. In addition to the UK, there were presentations by Finland, France, Germany, Greece, Ireland, The Netherlands and Sweden, as well as the European Commission. The Commission supported M&S, and the seven Member States all supported the UK government. The opinion of Advocate General Poiares Maduro was delivered on 7 April 2005.

5.2 The UK Legislation

The UK legislation regarding group relief authorises any company in a group (the surrendering company) to surrender its losses to another company in the same group (the claimant company). The claimant may then deduct those losses from its taxable profits. However, the surrendering company thereby loses any right to use the losses surrendered for tax purposes such as the right to carry them forward (which is also allowed under UK law).¹⁰³

The purpose of the Group relief is to make the taxation of companies as neutral as possible, whether they choose to establish themselves as one company or as a group. This is done by limiting the negative effects that could occur when establishing a company group, such as paying a higher amount of total taxes when one company within the group is showing losses and another is showing profits.¹⁰⁴

Even though the group relief is neutralizing these effects, it does not equalize how different types of companies are charged with tax. The regime still does not give entitlement for consolidation for tax purposes, such as for companies with branches rather than subsidiaries.¹⁰⁵

The regime of group relief was also subject to a change after the ECJ decision in ICI¹⁰⁶ was rendered.¹⁰⁷ The provisions are applicable today not only for UK resident companies, but also for companies that are non-resident but carry out economic activity in the UK through a branch or agency.¹⁰⁸

¹⁰² AG opinion C-446/03 para. 11. The questions referred will follow in supplement A.

¹⁰³ AG opinion C-446/03 para. 15.

¹⁰⁴ AG opinion C-446/03 para. 16.

¹⁰⁵ AG opinion C-446/03 para. 17.

¹⁰⁶ C-264/96 ICI.

¹⁰⁷ See chapter 4.3.

¹⁰⁸ Income and Corporation Taxes Act (ICTA) 1988 section 402, AG opinion C-446/03 para. 18.

5.3 Analysis of Advocate General's Opinion

The Advocate General Poiares Maduro summarizes the UK High Courts questions referred into three main questions.¹⁰⁹

1. Does excluding a company with subsidiaries in other Member States from the benefit of consolidating for tax purposes applicable to a company with branches in other Member States constitute a restriction on the freedom of establishment?
2. Does excluding a company with subsidiaries in other Member States from the benefit of the group relief regime applicable to a company with subsidiaries in the same Member State constitute a restriction of the freedom of establishment?
3. In the event that the UK legislation does create a restriction which is prohibited by the treaty, can that restriction be justified on legitimate grounds recognised by Community law?

In the Opinion, AG Maduro analyses the Community law, and draws conclusions upon previous judgments by the ECJ. The role of the Advocate General is not to anticipate the judgment by the Court, but to assist the Court by submitting an argued opinion and where needed criticise the present case law. The Opinion presented by AG Maduro in this case is certainly challenging the present case law of the Court, and not just anticipating the judgment.

AG Maduro divides the analysis of the questions referred to the ECJ by the UK High Court into three sections in his own analysis. These sections are starting with principles of interpretation, then the concept of restrictions and last justifications of restrictions. The outline here will follow this structure.

5.3.1 Principles of Interpretation

AG Maduro is first establishing the principles of interpretation, which are valid for the determination of cases regarding direct taxation brought before the ECJ.¹¹⁰ These principles are derogated from the Treaty, which is the foundation of the Community and its legislature. In the Treaty, it is clear that the Member States have remained the competence of direct taxation. The only provision in the Treaty regarding direct taxes is art 94, which states that the Council must act unanimously in order to pass a directive that

¹⁰⁹ AG Opinion C-446/03 para. 19.

¹¹⁰ AG Opinion C-446/03 para. 21-24.

involves direct taxation. However, this does not stop the ECJ from having the competence to determine this case since it has a Community aspect. This case involves the four freedoms established in the Treaty. Maduro is quoting ECJ when explaining the principle of superiority of the Community law in relation to national tax law: “Although, as Community law stands at present, direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with community law”¹¹¹

The two main Treaty articles concerned with in this case are art. 43 and art. 48 EC. Art. 43 constitutes one of the fundamental provisions of community law. It constitutes the prohibition to restrict the freedom of establishment conferred on nationals of the Community. Art. 48 ensures that companies constituted according to the law of one Member State are entitled to carry on their business in another Member State through the intermediary of a branch, subsidiary or agency.

Maduro is explaining that Member States can no longer disregard the constraints imposed on their activities by Community law. The Member States must make sure that the choices made in tax matters are depending on the consequences these choices might have on the proper functioning internal market.¹¹² Therefore, even though taxation is supposed to be of the Member States competence, they still have an obligation not to let their legislation be contrary to Community law.

The question in this case is whether EU law precludes legislation such as in force in the UK on group relief. Under this legislation, the transfer of losses within a group of companies is subject to the condition that those companies are resident or carry out economic activity in the UK.

Many countries intervened in this case and one of the arguments put forward by these countries was that this issue has been under negotiations in the Council previously.¹¹³ There was a proposed directive regarding cross border losses from 1990,¹¹⁴ which was never adopted as the Council could not agree on the matter. This directive has now been withdrawn from the agenda.¹¹⁵

The Member States intervening argued that since the Member States could not agree on the matter it is not up to the ECJ to take harmonization further. This is an issue to be resolved politically rather than legally.¹¹⁶ AG Maduro argues that the absence of harmonization cannot prevent the Court from

¹¹¹ C-279/03 Schumacker para.21, AG Opinion para. 21.

¹¹² AG Opinion C-446/03 para. 24.

¹¹³ AG Opinion C-446/03 para.5.

¹¹⁴ COM (1990) 595 final. See footnote 2.

¹¹⁵ COM (2001) 763 final.

¹¹⁶ AG Opinion C-446/03 para. 5.

performing its function, which is to ensure that the fundamental principles and objectives of the Treaty are safeguarded.¹¹⁷

The point Maduro is making here is correct and Member States cannot rely on failed negotiations to implement national legislation that is contrary to the Treaty. However, if these Member States are willing to begin new negotiations in the matter and make all 25 Member States unite in a directive they have the opportunity to do so. Professor Meussen, who states that the lack of harmonization is what brings all these cases before the ECJ to be determined, also supports this view.¹¹⁸

Maduro also points out that this case is raising the same fundamental difficulty as other cases regarding secondary establishments and taxes have raised.¹¹⁹ This is the conflict between power conferred on the Member States to tax income arising on their territory and the freedom conferred on Community nationals to establish themselves within the Community. This gives rise to a tension between the two opposing systems.¹²⁰

Maduro makes a statement on the conflict of powers. Since the Community law is superior to national legislature, this means that the power of taxation is restricted for the Member States. The Member States do still have the power of taxation within their jurisdiction, but they can only have national provisions not conflicting with the rights given to all Community nationals. The Treaty provisions can be seen as rights for all Community nationals to be treated non-discriminatory and for governments to not impose restrictions to hinder those nationals that wish to make use of the rights provided for them in the Treaty.

5.3.2 Discrimination

Discrimination occurs when like cases are treated differently and when different cases are treated alike according to ECJ case law.¹²¹ Does this case involve any discrimination?

The UK legislation regarding group relief does not entail any discrimination on the criteria of nationality, since all foreign subsidiaries are being excluded if they do not carry out economic activity in the UK. Therefore, no direct discrimination is at hand in this case. However, the case could still involve covert discrimination. This is when another criteria than nationality gives the same result as if nationality would have been the criteria.¹²²

¹¹⁷ AG Opinion C-446/03 para. 4.

¹¹⁸ Meussen, European Taxation 2005 para. 283.

¹¹⁹ See C-250/95 Futura Participations and Singer, C-264/96 ICI, C-200/98 X and Y, C-141/99 AMID, C-307/97 Saint-Gobain, C-410/98 Metallgesellschaft and others, C-168/01 Bosal.

¹²⁰ AG Opinion C-446/03 para. 6.

¹²¹ C-279/93 Schumacher para. 30, C-311/97, Royal bank of Scotland para. 26.

¹²² C-279/93 Schumacker para.26.

Maduro is also commenting on the difference between the non-discrimination clauses adopted in double taxation treaties and the principle manifested in the EC Treaty. The non-discrimination clauses in the double taxation treaties are normally interpreted in a very restrictive way, whereas the principle in the Treaty has an extensive application made by the ECJ in its case law. This was seen in the Schumacker¹²³ case where the situation between a resident and a non-resident in this particular case was viewed to be the same.¹²⁴

In international tax law it has been a well-established principle that countries can have separate taxation for residents and non-residents. This differential treatment is made without looking at the specific situation, whether they are in a like situation or not. In the ECJ case law developed in Schumacher, however, the Court took the factual circumstances into account as well. In this case, it was established that residents and non-residents normally are in different situations, and then it is not discrimination to treat them differently. Nevertheless, in the specific situation that was at hand in the Schumacher case, residents and non-residents were in the same situation and therefore treating them differently was a form of covert discrimination.¹²⁵

The question in this case is if the subsidiaries or the parent companies are in a similar situation and treated differently, and if this treatment entails discrimination? To be able to establish this, one must first examine which comparison is relevant in this case. Should one compare the situation of the subsidiaries established in different jurisdiction or the parent companies established in the UK?

5.3.2.1 Comparability

According to AG Maduro; in cases regarding restrictions imposed on nationals of a Member State wanting to pursue one of the four freedoms provided in the Treaty, the comparison must be made between different nationals of that Member State, whether they reside in it or choose to pursue any of these freedoms.¹²⁶

Therefore, in this case the relevant comparison is not between the different subsidiaries being established abroad or domestically, but rather between the parent companies. UK parent companies are treated differently for tax purposes if they choose to establish subsidiaries abroad compared to if they want to establish subsidiaries within their own jurisdiction. In this case, there is a question of alike cases treated differently, and this leads to the possibility of invoking the discrimination ground. Nevertheless, since this

¹²³ C-279/93 Schumacker.

¹²⁴ AG opinion C-446/03 para. 29

¹²⁵ C-279/93 Schumacher para. 36.

¹²⁶ AG opinion C-446/03 para.32

treatment is general it can entail a restriction on the freedom of establishment. If there is restriction, this is normally the best way to argue a case, since with restrictions there is no need to make a comparison between different taxpayers.

5.3.2.2 The Comparison between Subsidiaries and Branches

The UK legislation does not provide the same tax treatment to UK resident companies with foreign subsidiaries and resident companies with foreign branches, if they suffer losses. The UK companies with branches consolidate their result for tax purposes; this includes aggregating the result of foreign branches. The UK companies with foreign subsidiaries are treated less favourable than those with branches if losses occur in the foreign establishments. This can be viewed as a disadvantage connected to the choice of legal form. The Court has already determined cases where the freedom of establishment was said to entail a condition not to discriminate between the different choices of legal forms.¹²⁷

Does different tax treatment of different legal forms of establishments entail a restriction on the freedom of establishment?

AG Maduro is stating that the comparison should only take the legal situation into account, not the factual situation. In this view, subsidiaries and branches are two different legal forms of establishments and therefore they cannot be compared.¹²⁸ Professor Gutmann also proposes taking only the legal situation into account but reaches a totally different conclusion. He states; “One should never forget that the comparability between two situations does not depend on factual reality.”¹²⁹

According to Prof. Gutmann the UK Group relief system applies to the parent-subsidiary relationship and this can be compared with the company-branch relationship. This comparison can be made in a cross-border situation as well, and is based on purely the legal, not the factual situation. His position is that the necessity to ensure equal treatment to comparable situations compels the UK government to allow a foreign subsidiary in the EU to surrender its losses to a UK company under the group relief system, since this is provided for branches.¹³⁰

This is a way of reasoning that was not mentioned by AG Maduro in his Opinion. Maduro states that the different treatment of subsidiaries and branches stems from a difference in the tax regimes applicable to different kinds of establishments. According to Maduro the freedom of establishment

¹²⁷ Commission v. France 270/83 Royal bank of Scotland C-311/97, Saint Gobain C-307/97.

¹²⁸ AG Opinion C-446/03 para. 47-50.

¹²⁹ Daniel Gutmann EC tax review 2003 p.155.

¹³⁰ Daniel Gutmann EC Tax Review 2003 p. 156.

do not preclude different tax treatment from being accorded to different legal persons in different legal situations.¹³¹ This view is also supported by Prof. Meussen, Prof. Ben Terra, Peter Wattel, Timothy Lyons and Mark Pershoff.¹³²

In UK law foreign branches and foreign subsidiaries are governed by different tax regimes. The difference in taxation is determined by the legal form of the establishment. Groups of companies are not entitled to consolidation for tax purposes, which is the treatment applicable for permanent establishments. The group relief system is purely a modification of the rule of separate taxation between separate legal entities; it does not assimilate it to taxation of a company with branches. The reason for this treatment is that the subsidiaries are separate legal and fiscal entities. This is not the situation with foreign branches, since they form part of the same legal and fiscal entity as the head office.

Professor Lang proposes that the factual circumstances should be taken into account by the ECJ, when rendering whether any discrimination or restriction is at issue. He argues that there is no big difference between these two types of establishments and there might be reasons for treating them more similar for tax purposes. His conclusion is that if the ECJ would consider the factual situation in the M&S case, this could open up for making a comparison between foreign branches and subsidiaries.¹³³

Michael Lang is also proposing that AG Maduro should have looked closer at the comparison between subsidiaries and branches established abroad before he went on to examine the comparison between domestic and foreign subsidiaries. He proposes that the result achieved by such a comparison might not differ from the one Maduro proposed after comparing domestic and foreign subsidiaries and the grounds for justification.¹³⁴

However, one must not forget the reason for adopting two forms possibilities to make foreign establishments, even if the tax treatment should not be decisive in the choice of legal form according to principles of neutrality. There are factual differences between the two forms of establishments and to make the taxation of them equal seems unmotivated. A company that chooses to establish a subsidiary abroad should not be forced to pay tax for this subsidiary in the state where the parent is established. This could lead to companies being reluctant to make investments in high tax jurisdictions, since they might have to be taxable for their worldwide income in this jurisdiction. The main difference between branches and subsidiaries is that a subsidiary is an independent legal entity. This leads to the conclusion that a subsidiary must be in a different situation

¹³¹ AG Opinion C-446/03 para.48-49.

¹³² Gerard Meussen *European Taxation* 2005 p. 282, Timothy Lyons, *British Tax Review* 2005 p. 254, Mark Pershoff *British Tax Review* p. 262, Terra & Wattel *European Tax Law* p. 88.

¹³³ Michael Lang *EC Tax Review* 2005 p. 96-97.

¹³⁴ Michael Lang *EC Tax Review* 2005 p. 96.

compared to a foreign branch. With this approach, it does not matter whether the Court chooses to look at purely the legal situation or not. There is a factual difference between the two types of establishments. Therefore, there is no possibility to make a comparison between these forms of establishments. Furthermore, the relevant comparison to examine a restriction is still the companies wishing to make establishments abroad according to the Bosal judgment.¹³⁵ This is also the comparison AG Maduro chooses in his Opinion.¹³⁶

The view presented by AG Maduro is accurate, and the comparison should be made between the two different parent companies expanding either abroad or domestically. The ECJ case law regarding the prohibition not to discriminate on choice of legal form takes the view of the Member State of establishment.¹³⁷ When a foreign company chooses to expand abroad in either a subsidiary or branch, the country of establishment must not discriminate against either of these two forms. However, this case concerns the restrictions set by the Country of origin. There is no support in any case law that not applying the same tax treatment to foreign subsidiaries and branches from the home state could constitute a restriction according to the Treaty.

Prof. Terra and Peter Wattel also states that the Futura case¹³⁸ was an example of that the freedom of legal form does not mean there may not be any difference in the taxation of a permanent establishment and a local subsidiary company. If there were no difference between the two legal forms, choosing between them would be meaningless according to Terra and Wattel. The liability of the parent company is the essential difference and this difference will lead to the difference in taxation.¹³⁹

5.3.3 Restrictions

Policies and legislation adopted by Community Member States must not result in a less favourable position for intra community situations as compared to purely national situations. A less favourable treatment for intra community situations constitutes a restriction as regarded by the ECJ. If the restriction is not affecting the intra community trade, it is not a forbidden restriction according to the Community principles.

AG Maduro argues that a restriction always includes some form of discrimination otherwise it would not be a restriction prohibited by the Treaty.¹⁴⁰ According to Maduro, the M&S case provides a “discrimination

¹³⁵ C-168/01 Bosal para.37.

¹³⁶ AG Opinion C-446/03 para.52.

¹³⁷ Cases 270/83 Commission v. France, C-311/97 Royal bank of Scotland and C-307/97 Saint Gobain.

¹³⁸ C-250/95 Futura participations & Singer.

¹³⁹ Terra & Wattel, European Tax Law p. 88.

¹⁴⁰ AG opinion C-446/03 para. 40.

against Community nationals wishing to assert their rights deriving from the freedom of movement.”¹⁴¹

The point Maduro is making here is accurate, in the M&S case, parent companies who wish to establish subsidiaries abroad are being discriminated against by the UK legislation. This discrimination is not deriving from their nationality, but rather from the fact that they wish to assert their rights as accorded to them in the Treaty. These companies are in a less favourable position than companies choosing to make domestic investments, this purely because they are wishing to make use of their Community freedoms. This means that the point of discrimination is still valid in the cases of nationals or companies being hindered to make establishments abroad. However, because this treatment is general it is said to entail a restriction on the freedom of establishment.

5.3.4 The Disadvantage Based Upon the Place of Establishment of Subsidiaries.

The group relief scheme applicable to groups of companies within the UK constitutes a tax advantage for the company groups benefiting from it. The total taxable profit for the group of companies is being reduced if one company is showing losses. This scheme is however only applicable for companies established within the UK, and for companies choosing to pursue their freedom of establishment, this benefit is denied them.

Maduro is in his Opinion discussing the implications that follow the tax treatment accorded by the UK. The refusal to give the same tax treatment to a company that wishes to establish itself abroad is classified as an exit restriction by the AG. Even if the subsidiary can make use of the losses in the host state, the UK provisions still entail a restriction. The treatment of the host state of the foreign establishment is not important when analysing an exit restriction, only the treatment of the home state. It is sufficient that the UK in this case is creating an obstacle for its companies to establish themselves abroad.¹⁴²

Therefore, according to Maduro the UK provisions entail an exit restriction not acceptable under art 43 of the Treaty. These provisions are creating an obstacle for companies that wish to establish subsidiaries in foreign jurisdictions purely by not giving these companies the same tax benefits as given those choosing the domestic market for expansions.¹⁴³

¹⁴¹ AG opinion C-446/03 para. 28.

¹⁴² AG opinion C-446/03 para. 53.

¹⁴³ AG opinion C-446/03 para. 53.

5.3.5 Is There any Justification of the Restrictive Measure?

Even if a provision is found to be restrictive under art 43 of the Treaty it is not prohibited if the measure pursues a legitimate objective compatible with the Treaty and is justified on public interest grounds. When justifying a restriction it is also important that the measure imposed does not exceed what is necessary in order to obtain that objective.

If a measure is said to be justified according to the provisions in the Treaty it means either of the Treaty articles justifying national provisions that are restricting the four freedoms in the Treaty are applicable.¹⁴⁴ These articles are normally only applicable in cases of public interest such as public health or safety.

However, if a measure is found to be restrictive it can also be justified by using the Rule of Reason test, which has been developed in ECJ case law. If the measures pass the four steps of the test, they can be justified without support in the Treaty.¹⁴⁵

5.3.5.1 Reduction in Tax Revenue and Budgetary Losses

The German government, intervening in the case, is claiming that a ground for justification coherent with the rule of reason test is the reduction of tax revenue and budgetary losses. If companies were allowed to offset losses suffered in jurisdictions where its profit will not be taxed in the UK, this will lead to a reduction of the tax revenue. This because such provisions can only reduce the domestic tax base and not increase it.¹⁴⁶

Maduro points out that the ECJ has repeatedly held that reduction in tax revenue cannot be regarded as a ground for justification of a restrictive measure. The loss of tax revenue is not an overriding reason in the public interest, which may be relied on to justify a measure that is in principle contrary to a fundamental freedom.¹⁴⁷

No Member State has ever been able to justify a measure through the rule of reason test because of fear of losses in tax revenue or budgetary losses, even if these losses sometimes are claimed to be very high, or form a significant part of the Member States budget.¹⁴⁸

¹⁴⁴ Art 30, 46 and 58 EC.

¹⁴⁵ See chapter 3.3.1.

¹⁴⁶ AG Opinion C-446/03 para. 56.

¹⁴⁷ AG Opinion C-446/03 para. 56.

¹⁴⁸ See Manninen C-319/02 para.49, C-168/01 Bosal para.42.

5.3.5.2 Fiscal Principle of Territoriality

The UK government is maintaining that the refusal to grant group relief to companies that have losses relating to subsidiaries established abroad is in conformity with the fiscal principle of territoriality. According to the UK government, this principle states that a country cannot offer tax advantages where it has no power of taxation. The UK government is therefore using this principle as a ground for justification of its group relief system to pass the rule of reason test.

In the judgement of Futura the court did recognize the tax principle of fiscal territoriality in Community law.¹⁴⁹ However according to AG Maduro this principle merely recognizes the fact that the Member States are equally sovereign in tax matters and the Court is not competent to interfere in the conception or organization of the tax systems of the Member States.¹⁵⁰ The AG also states that the fiscal principle of territoriality prevents conflicts in tax jurisdictions as between the Member States. It cannot be invoked to enable the Member States to evade their obligations under community law.¹⁵¹

AG Maduro rejects that this principle would form a justification for the differential treatment between foreign and domestic subsidiaries. This principle only means that states are equally sovereigns in tax matters. To be able to exercise fiscal competence over a taxable person, the Member States need to have a necessary connection to this taxable person. This connection could be either the nationality or the location. Hereby follows that a State is entitled to make taxpayers resident on its territory liable to unlimited tax obligations. The state can also only charge foreign taxpayers to tax on income arising on its territory. This is why the principle was used in the Futura case; this case involved a non-resident taxpayer.¹⁵²

The parent company in the M&S case is subject to unlimited tax obligations within the UK. The UK government cannot rely on the principle of territoriality when it denies the parent company a tax relief that would have been given to a parent company claiming the same relief for losses occurred in domestic subsidiaries.

Prof. Lang is clarifying that a genuine link between a taxpayer and a State is sufficient to establish the right of taxation, not only source and domicile as proposed by Maduro. In international tax law, taxation of citizens or income arising within the territory are two important triggers of taxation but they are not the only triggers. It is not contrary to international tax principles for states to take into account foreign income to determine the tax rate of non-residents. The CFC legislation has also been accepted under international

¹⁴⁹ Futura Participations and Singer C-250/95 para 31. See chapter 4.2.

¹⁵⁰ AG opinion C-446/03 para. 60-61.

¹⁵¹ AG opinion C-446/03 para.62.

¹⁵² AG Opinion C-446/03 para. 62-63.

law, whereby only the shareholders residence is the trigger of taxation of foreign companies' profits.¹⁵³

Many scholars support AG Maduro's interpretation of the international principle of territoriality, and the interpretation of the Futura case.¹⁵⁴ The principle does only recognize the fact that Member States are sovereign in taxing residents within their jurisdiction. The Futura judgment involved the taxation of a non-resident taxpayer, and this principle has never been accepted when involving a resident taxpayer. In the Bosal judgment, this principle was denied by the Court as a ground for justification using the same argument as AG Maduro.¹⁵⁵

5.3.5.3 Coherence of a Tax System

The UK government is also claiming the principle of coherence of their tax system as a justification ground in this case. According to the UK government, there is a direct and logical link between the tax advantage granted and the right to tax the tax payer when it starts showing profits. For subsidiaries abroad, such possibility does not exist and therefore it lies implicated in the fiscal cohesion of the tax system not to grant the tax advantage to parent companies with subsidiaries abroad. Many of the Member States intervening in this case has the same view as the UK government.¹⁵⁶

Marks and Spencer is arguing in the main proceedings that according to ECJ case law a direct link applicable for justification due to fiscal cohesion can only exist in the context of the same taxpayer and the same tax.¹⁵⁷ In this case, there are two different taxpayers concerned, the parent company and the subsidiary. There are also two different tax systems involved. Therefore, the ground for justification is not met in this case.¹⁵⁸

AG Maduro is arguing for the ECJ to have a more relaxed approach to the justification ground of fiscal coherence than it has shown in recent case law. This view has also been proposed by AG Kokott in the Manninen case.¹⁵⁹

Fiscal coherence has only been acknowledged by the court in the Bachman¹⁶⁰ case and the significance of the principle has later been eroded. This erosion has been made through several other cases when the ECJ has narrowed the possibilities for the Member States to invoke this principle as

¹⁵³ Prof. Michael Lang p. 97.

¹⁵⁴ Timothy Lyons, British Tax Review 2005 p.255. Gerard T.K. Meussen European Taxation 2005 p. 284.

¹⁵⁵ Bosal C-168/01 para. 38-40.

¹⁵⁶ AG opinion C-446/03 para. 68-69.

¹⁵⁷ See C-168/01 Bosal para. 30.

¹⁵⁸ AG opinion C- 446/03 para. 70.

¹⁵⁹ AG Opinion C-446/03 para. 71 AG Kokott Opinion para. 57 in the case C-319/02 Manninen.

¹⁶⁰ Bachman C-204/90.

defence of national tax rules. According to recent case law of the ECJ, the principle of coherence can only be invoked when regarding the same taxpayer and the same tax.¹⁶¹ This is excessively reducing the freedom of manoeuvre for the Member States in order to justify their tax regimes. According to Maduro, the cohesion argument should be judged in the light of the aim and logic of the tax regime at issue. This does not necessarily mean that it has to involve the same taxpayer and the same tax, according to Maduro there might be situations where two different taxpayers are involved, but the aim and logic of the situation calls for a possibility to justify a provision due to the coherence of the tax system.¹⁶²

According to AG Maduro the aim of the UK provision is to ensure neutrality between taxation of company groups and single companies. The UK scheme also provides for a correlation between the losses transferred from one company to benefit another company within the same group, and then the surrendering company loses the ability to make use of those losses at a later stage. The advantage conferred on the claimant company is then supposedly neutralised by the tax to be charged to the surrendering company.¹⁶³

However, this can be discussed, the advantage can rather be said to be neutralized by the impossibility to claim tax deduction for the losses twice, than the tax being charged to the surrendering company at a later stage. The fact that the surrendering company in a later stage will pay tax within the jurisdiction is not ascertained; the surrendering company might never show any profits and therefore will not be liable to pay income tax. There is no provision in the UK system, which forces the claimant company to pay back tax advantages received if this situation appears.

If the UK provisions were non-restrictive, in the way they were applied, and available for all UK company groups, then problems with unmotivated tax advantages would occur according to Maduro. AG Maduro discusses the problem with company groups being able to take twofold advantages of losses occurred abroad. First they can be offset against the parent company's profits in its home jurisdiction and then the subsidiary can carry them forward according to the national legislation in the country it is established.¹⁶⁴ Maduro argues that such a provision risk jeopardizing the aim of the UK group system, and such an advantage is contrary to the neutrality that the provisions were aiming for. According to Maduro the prohibition of foreign losses under the group relief system could therefore be justified under the ground of fiscal cohesion in a tax system.¹⁶⁵

However, Maduro also argues that the provision to exclude all foreign losses due to this risk goes beyond what is necessary to protect the

¹⁶¹ See *Wiecklockx* C-80/94, *Baars* C-251/98, *Lankhorts-Hohorst* C-324/00.

¹⁶² AG Opinion C-446/03 para. 71.

¹⁶³ AG Opinion C-446/03 para. 72.

¹⁶⁴ AG Opinion C-446/03 para. 74.

¹⁶⁵ AG opinion C-446/03 para. 74.

coherence of the UK tax system, and can therefore not be accepted by the rule of reason test.¹⁶⁶

The AG states that the resident state of the parent company can take into account the treatment of the losses by the Member State where the subsidiaries are established. Justification on the ground of cohesion could only be accepted if the foreign losses are subject to equivalent treatment by the state where the losses arise.¹⁶⁷ According to Maduro, group relief can in certain cases be refused, but such refusal must be justified and based on account being taken of the situation of the subsidiary in their state of residence.¹⁶⁸

According to Maduro the solution he proposes, where the home state of the parent company have to take losses in to account only if they are not provided equivalent treatment in the resident state of the subsidiary, is justified under art 43 EC. It is legitimate to afford priority to the rules of the state of establishment where such rules afford equivalent treatment to group losses.¹⁶⁹

The Netherlands government fears that this solution, which has been used by the Court in cases regards to health services in the context of national social security, could entail a general disruption of the national tax regimes.¹⁷⁰ According to them, the transfer of losses can then be systematically organised within groups of companies and directed solely to companies established in Member States with higher tax rates for company tax. This is due to that the losses will have a higher value in those states for the companies, which then chooses to pay full tax in jurisdictions with lower tax rates.¹⁷¹ Maduro hereby argues that companies shall not have the ability to choose in which country they would like to impute their losses, they will only have the ability to take into account such losses that do not suffer the same tax treatment in the jurisdiction they occur.¹⁷²

The solution AG Maduro is proposing is contrary to the ECJ case law as it stands as present. Maduro is proposing that the justification measure of fiscal coherence can be applicable even if this case does not involve the same tax and the same taxpayer. It has been stated by the ECJ in many recent cases that this justification ground cannot be invoked otherwise.¹⁷³

There are also other problems with Maduro's solution. In his Opinion, he proposes that justification on the ground of cohesion can be accepted if the foreign losses are subject to equivalent treatment by the Member State

¹⁶⁶ AG opinion C-446/03 para. 75.

¹⁶⁷ AG opinion C-446/03 para. 76.

¹⁶⁸ AG opinion C-446/03 para. 77.

¹⁶⁹ AG opinion C-446/03 para. 80.

¹⁷⁰ See cases C-56/01 Inizan and C-157/99 Smiths and Peerbooms.

¹⁷¹ AG Opinion C-446/03 para. 78.

¹⁷² AG Opinion C-446/03 para.79.

¹⁷³ See Wiclockx C_80/94, Baars C-251/98, Lankhorts-Hohorst C-324/00.

where the losses arise. However, Maduro never explains what constitutes such equivalent tax treatment.

5.3.5.4 Abuse of Law

Maduro argues that the EU freedoms cannot be used to either abusively evade national tax law or to artificially exploit differences between the Member States national tax laws, “The free movers cannot be free riders.”¹⁷⁴ This view is also in line with some recently decided cases regarding VAT.¹⁷⁵

However, Maduro is not stating abuse of law as a separate ground for justification in his opinion. The abuse of law is only discussed as together with the justification ground of fiscal cohesion, which he argues, “seeks to ensure that community nationals do not use the Community provisions to secure advantages from them which are unconnected with the freedom of movement.” The AG is here of the opinion that fiscal cohesion can be used to tackle problems with abuse of Community law, rather than making it a ground for justification on its own.¹⁷⁶

If the abuse of law is a ground for justification on its own or simply entailed in the fiscal cohesion ground, could prove significant if the Court are unwilling to make a wider interpretation of the fiscal cohesion ground than has been made until now.

Maduro believes that fiscal coherence should have wider interpretation than has been established in the ECJ recent case law.¹⁷⁷ If this suggestion will be applied by the Court, abuse of law could also be included in the justification ground of fiscal coherence. However, if the ECJ chooses to follow its precedent case law regarding the interpretation of fiscal coherence, then situations where abuse of law is at hand might not be able to justify. A separate justification ground on the abuse of law would then be needed.

5.3.6 Maduros Conclusion

Advocate General Maduro is proposing that the ECJ shall deliver the following judgment:

- (1) “Articles 43 and 48 EC preclude the tax legislation of a Member State, such as that at issue in the main proceedings, which prohibits a parent company established in a Member State from benefiting from the right to group relief on the ground that its subsidiaries are

¹⁷⁴ First stated by Cordewener Axel, Dahlberg Mattias, Pistone Pasquale, Reimer Ekkehart and Romano Carlo, *European Taxation* 2004.

¹⁷⁵ Joint cases Halifax, University of Huddersfield and BUPA C-289/03.

¹⁷⁶ AG Opinion C-446/03 para.67.

¹⁷⁷ See chapter 5.3.4.3

established in other Member States, whereas that relief would be granted if those subsidiaries were resident in that Member State.”

- (2) “Those provisions do not preclude national legislation from making entitlement to group relief, such as that provided for by the Member State concerned in the main proceedings, subject to the condition that it be established that the losses of subsidiaries resident in other Member States cannot be accorded equivalent tax treatment in those Member States.”

Maduro’s proposal for the ECJ on how to render the case in question is based on his conclusion regarding how the Treaty should be interpreted. It also states how the different justification grounds accepted by the rule of reason test should be used. Maduro suggests that art 43 and 48 EC preclude tax legislation such as the one at present in the UK, but allows the UK to take into account the treatment of the losses at the state where the surrendering company is resident. If the company is suffering equivalent tax treatment then the UK provisions regarding group relief can be justified via the rule of reason test on the ground of coherence of the fiscal tax system.

The Court will deliver its judgment later this year and the question is now in which aspects they will follow the Opinion of the Advocate General?

6 Conclusions

The Opinion of the Advocate General sheds light to many of the problems that the tax treatment of cross border losses gives rise to within the Community. However, there are still some remaining problems in his conclusion and the impact of his opinion will be analysed in this chapter. The main focus will be on the conflict of powers, the concept of equal treatment abroad, the value of losses for tax purposes and taking the legal situation abroad into account.

The Marks & Spencer case and the Opinion presented by AG Maduro have been debated by various scholars. Some of them have introduced alternative ways of reasoning and provided their own solutions to this problem. This conclusion will also analyse some of these proposed solutions and the implications on taxation and Community law.

6.1 The Conflict of Powers

As the AG points out, the problem of cross-border losses within the Union also involves a conflict between two separate powers. The power conferred on the Member States to tax income arising in their territory and the freedom conferred on Community nationals to establish themselves within the Community.

The competence of the ECJ is also an interesting aspect of the conflict of powers between the Community and the Member State. Some of the Member States intervening in this case suggested that the problem of cross-border losses has been on the Commissions agenda for a very long time. There was a suggested proposal for a directive on the matter presented in 1990,¹⁷⁸ which the Council could not agree on. The proposal was dropped in 2003, since the Member States still was not able to agree on the matter. The fact that the Council could not agree on a matter which is supposed to be a unanimous decision, does not allow the Court to substitute itself from for the Community legislature. Harmonisation of tax provision shall be dealt with by the Council with unanimous decisions according to the Treaty. It does not lie within the competence of the ECJ to undertake harmonization actions.

There have also been opinions protesting the fact that the ECJ has any competence what so ever as regards to cases involving direct taxation. This is because it is stated in the EC Treaty that the competence of direct taxation belongs to the Member States.¹⁷⁹ The ECJ should not have competence over any matters regarding taxation that does not derive from Community legislation such as Council Directives, according to a strict interpretation of

¹⁷⁸ Proposal for Council Directive (COM (1990) 595 final). See footnote 2.

¹⁷⁹ Art. 94 EC.

the Treaty. However, the ECJ seems to adhere to an object orientated interpretation of the EC Treaty, and to realize the completion of the internal market, the Court suggests a dynamic approach when interpreting the EC Treaty provisions.

Nevertheless, at present, it is unnecessary to deny the competence of the ECJ in cases involving direct taxation. It is correct that no specific article in the Treaty supports their competence in matters regarding direct taxation. However, art 10 states the principle of Community loyalty. The Court has also stated that the Member States must exercise their remaining competence with respect for the EC law. When a Member State's national legislation violates the fundamental freedoms provided in the Treaty, the Community has the power to act on this infringement. If there were no such power, the provisions in the EC Treaty would be toothless. This power has been accepted by the Member States since 1986 in the *Avoir Fiscal* case,¹⁸⁰ which was the first case on direct taxation to be determined by the Court.

One can also argue a necessity to allow this competence in order to attain the objective of a completely free and equal Internal Market. Otherwise, the Member States would be able to apply discriminatory and restrictive tax provisions contrary to the realization of a free market with equal opportunities for all participants. This could lead to Member States trying to protect their own home markets rather than the objectives in the Treaty. Another argument is that the EC Treaty is not simply a multilateral treaty ratified by the Member States, it is a Treaty for countries entering into a Community and a European Union with each other. Moreover, the Community has been provided its own competence according to this Treaty. The competence of the Community bodies is provided in order to achieve the objectives of the European Union and to safeguard the Community Nationals rights derogating from the Treaty and other Community legislation.

6.2 Equivalent Treatment

AG Maduro is proposing in his Opinion that the Treaty is prohibiting the type of restrictive tax legislation at issue in the case. Nevertheless, Member States should still be able to justify non-deduction of losses that are being accorded equivalent tax treatment in the State where they are resident.

Maduro never explains exactly what he proposes to be equivalent tax treatment. In the Opinion, he mentions transfer of losses to a third party or being able to carry the losses forward as being equivalent tax treatment.¹⁸¹ However, the right to carry a loss forward within the jurisdiction where it occurred is still a less attractive option for the company group that suffered the losses as compared to instant loss relief.

¹⁸⁰ Case C-270/83 *Commission v. France*.

¹⁸¹ AG opinion para. 82.

There is a difference between being able to deduct losses from profits during one financial year as a group, and being able to deduct the same losses at a later year. This difference consists of a disadvantage of cash flow and loss of interest for the group in question.¹⁸² Several scholars support this view.¹⁸³ Moreover, Maduro never mentioned the possibility to take losses into account during later financial years that never can be realized due to the fact that no future profits are occurring.

If the company suffering losses are being sold to a third party, there is a problem with according the correct tax treatment to these losses suffered in another jurisdiction. The tax provisions in the jurisdiction of the subsidiary will determine whether the old loss will have any value to the new owner or not. In some legislation losses can be transfer to a third party if the company containing losses has been sold, but this right can be limited in time, up to ten years. If the loss still can be used by the new owner one has to consider that the loss occurred would have had an impact on the price set on the acquisition. However, normally this would not be the exact value of the loss, and normally not even stipulated by the parties involved. Moreover, the seller probably will not get full payment for the losses if they are not free to use, until a period of time has passed. The later a loss can be used the less value it has. In this context it seems difficult to determine whether equivalent tax treatment is accorded or not.

If the company that suffered the losses has been liquidated without showing any profits, the losses suffered should be taken into account in the home jurisdiction of the parent. This was never mentioned by AG Maduro, but surely, this falls under the criteria that the loss has not been afforded equivalent tax treatment. This is then a situation according to Maduro where the foreign losses will have to be taken into account in the home state of the parent company. Prof. Meussen is also of the view that a fully developed EC Community market cannot exist without this possibility.¹⁸⁴

6.3 Value of Losses

Losses that can be offset against profits will have a certain value. As discussed earlier this value is reduced in time. The value also differs depending on the tax rate in the jurisdiction where the losses are being offset. Losses that are being offset in Member States with higher rates of taxation will therefore have a greater value than losses being offset in low tax jurisdiction. There is therefore a fear amongst Member States that companies will try to transfer losses to the Member States with high tax rates. This would lead to a type of loss trafficking to these high tax jurisdictions.

¹⁸² The amount of taxes charged, that can be deducted at a later stage could have been invested within the company or other investments could have been made, if the amount was deductible when the losses occurred.

¹⁸³ Michael Lang, EC Tax Review 2005 p. 99, Gerard T.K. Meussen European Taxation p. 284.

¹⁸⁴ Meussen p. 282, European taxation 2005.

According to AG Maduro, this situation will not be possible because the company groups will not be able to choose in which jurisdiction the losses should be offset. Moreover, the losses cannot be offset if they are being accorded equivalent tax treatment within the jurisdiction where the subsidiaries are established.

Hopefully, the situation with loss trafficking to states with high tax rates will not occur. A solution to make this form of tax avoidance as difficult as possible is to have similar types of legislation regarding the tax treatment of losses in all Member States. A solution would be to adopt a Council Directive on the matter.

6.4 Taking the Legal Situation Abroad into Account

In the solution described in the Opinion delivered by AG Maduro, Member States have to take the legal situation abroad into account before determining whether the domestic tax treatment can be justified or not.

Prof. Lang is very much opposing the idea that the home state of the parent company should take the legal situation of the subsidiary into account, in order to make sure the same loss cannot be used twice. It is very difficult to in all cases determine the legal situation for companies established abroad. This is also according to Prof. Lang shown in the US experiences with “dual consolidated loss regime.”

To take the legal situation in other jurisdictions into account every time before determining the tax treatment of certain losses suffered abroad seems like an extensive operation for tax authorities. The European Union today consists of 25 Member States with different tax provisions. Tax authorities then have to be familiar with all these systems and get current updates on changes made within these 25 Member States.

6.5 New Solutions

Michel Lang is suggesting a solution close to how branches are being taxed, but based on deduction of losses and recapture of profits. Prof. Lang is of the opinion that taxation of profits in foreign subsidiaries could be possible. He is referring to the CFC taxation in place in many countries where the home state of the shareholder are taxing the shareholder for profits occurring in companies located in other jurisdictions. This type of legislation has been accepted in international tax law, and the similarities

between this legislation and the taxation of subsidiaries where the parent company is situated does not seem so far reached.¹⁸⁵

Professor Lang is proposing a deduction and recapture clause, which recaptures the deduction of losses made when the company is showing profits again. This can be done even if those profits are gained in another tax jurisdiction. The difference between this system and the way branches are being taxed is that there is no total consolidation. Instead, losses can be deducted so far the foreign subsidiary is showing negative results, but when they start showing profits these will be taxed in the jurisdiction where they were deducted. The same profits will then be taxed in the jurisdiction where they are established, but if this country has a system that offers deduction of losses over time, these losses will now be deducted within this jurisdiction. This system is also the same system that was suggested for the 1990 proposed directive of the tax treatment of cross border losses. The Council was however not able to agree on this solution and the proposal was later dropped.¹⁸⁶

According to Prof. Lang recapture clauses are not contrary to international tax law or international tax treaties. If the state of the parent company has to deduct foreign losses, but is also able to recapture them in case of future profits, the double utilization of losses could be avoided very effectively. The parent state will also only have to apply their domestic tax laws, the losses will be deducted under the domestic tax regime and the recapture will be done under the same regime. Both the losses and the profits will be taxed under to this regime according to the treatment applicable if they had occurred in domestic subsidiaries and therefore no breach of the EC Treaty would take place.¹⁸⁷

Professor Meussen is suggesting a system based on the Netherlands model of a cross-border fiscal unity. This system is only open for foreign branches today, but could be provided for foreign subsidiaries as well. The losses of foreign branches are deductible from the Netherlands tax base, but there is also a recapture rule. Foreign profits are only exempt in so far the losses has been recaptured. These rules prevent a double loss relief.¹⁸⁸ This system is based on the same principle as described earlier, with deduction and recapture.

The advantages with the deduction and recapture system make it very attractive as a solution to the problem with how to treat cross-border losses within the European Union. Some European States are also using similar systems for taxation on worldwide basis. For example, Denmark has a joint taxation system for groups of companies on voluntary basis for the worldwide income. If the Company group chooses to tax according to this system, they can deduct foreign losses from profits by other group members

¹⁸⁵ Michael Lang, EC Tax Review 2005 p. 97.

¹⁸⁶ COM (1990) 595 final, COM (2003) 726 Final p. 9, see footnote 2.

¹⁸⁷ Michael Lang, EC Tax Review 2005 p. 97.

¹⁸⁸ Gerard T.K. Meussen European Taxation 2005, p. 285.

in Denmark. In the Danish system also profits of participating companies will be taxed in Denmark, but this taxation is not limited to the deductions made earlier. Instead, the Danish group will tax the worldwide profits in Denmark, but can deduct foreign tax paid on the same income. This gives the same result as if the foreign companies were branches and the income were aggregated automatically. The difference is however that it is optional for Danish groups to participate; the Danish parent company can even choose the subsidiaries it wishes to include. It is also possible to leave the joint group taxation system, but recapture of previously deducted losses must be made if a subsidiary is leaving the system.¹⁸⁹ The Commission has also suggested this system as an interesting option to base a directive regarding tax treatment for cross border losses on, even though the one in 1990 was dropped.¹⁹⁰

Nevertheless, there are still some problems with the deduction and recapture systems. One of them is if the company never shows profits again, then the home state never gets back those losses deducted. This would also be the case if the subsidiary were established in the home jurisdiction, so the effect on the tax revenue should not be extensive. The other problem occurs if the foreign subsidiary is sold before it starts showing profits. Then the losses have been deducted in the home state, and might be deducted by the new owner in the state of establishment, and the same losses can then be used twice. This is then a problem that is possible to resolve by special provisions where losses have to be recaptured due to a sale, if the new owner can make use of the losses occurred in a later stage. However, this leads us back to an original problem. To be able to establish in which way losses can be used in foreign countries for every case national tax authorities have to deal with. The third problem is if the state where the subsidiary is established do not provide for rules to deduct losses over time. This will then effectively lead to that when the company starts showing profits it has to pay full tax in the jurisdiction it is established, and recapture the deducted losses in the jurisdiction where those were deducted. There is no good solution to this problem; the state can make the deduction voluntary. However, this problem is not arising from discriminatory or restrictive provisions but rather from the fact that the Country of establishment do not provide for the ability to deduct previous losses within its national legislature. The company that chooses to make an establishment in this country has to take this into consideration, and the situation will be the same for all companies within that jurisdiction.

Mark Pershoff is proposing a system where the surrendering of losses under the UK system would be valid even for foreign subsidiaries. However, it would have a claw back mechanism in order for the home state to recapture the losses if (and only if) the same losses are used in the subsidiaries state of resident.¹⁹¹

¹⁸⁹ IUR Information 8-2003 "Dansk koncernbeskatning en oversight".

¹⁹⁰ Com (2003) 726 Final p. 9-10.

¹⁹¹ Mark Pershoff, British tax Review 2005 p.264.

The problem with this system is that it would provide a choice for the company group to determine in which jurisdiction they prefer to have their losses deducted. Even if this is solved via provisions that losses must be deducted in the home state of the subsidiary if they can, there is still a problem if the subsidiary is sold before it starts showing any profits. Then it will be difficult to determine whether the subsidiary had used its foreign losses or not. This must probably be determined with account taken to the legislation in force in the country where the subsidiary is resident.

The conclusion is that the solution with deduction and recapture is still probably the easiest and most effective system for the parties involved. The difference in tax revenue for the Member States will probably not be effected. The companies that wish to make establishments abroad will not suffer disadvantages as compared to making domestic investments, and the tax authorities will only have to apply domestic provision in order to deduct and recapture those losses suffered. Nevertheless, this was the solution rejected by the Member States, so it is unlikely that a new directive would provide this solution.

The main reason to choose the deduction and recapture method over the other systems proposed is that the other systems are more complicated. Therefore, it will be more time consuming for the tax authorities to establish what tax treatment to provide for a company group with foreign subsidiaries.

For instance the Danish system, if a company group wishes to join, they will be able to deduct foreign losses, but will be forced to pay Danish tax on all profits made abroad. This could be prevented if the company group withdraw from the system when showing profits. However, it seems complicated for a company to have to join and withdraw from a system depending on what results are shown in foreign subsidiaries.

The system proposed by Mark Pershoff to introduce a claw back mechanism in order for the home state to recapture the losses if (and only if) the same losses are used in the subsidiaries state of resident, provides a problem with letting the company choose in which Member State to deduct the losses. This could constitute a possibility to traffic losses.

6.6 Final Remarks

Group relief systems such as the one at stake in the M&S is relatively common among the EU Member States today. Member States provide for different treatment whether their resident undertakings make investments in domestic or foreign subsidiaries. The developments in this case are therefore being closely watched by some governments in order to examine the outcome of the case and the implications that it could bring on their national tax legislation.

Advocate General Maduro delivered an Opinion, which analyzed the Community principles and the implications they might have on this type of national legislation. His Opinion clearly stated the UK provisions to be restrictive according to the Treaty. This could serve as a guideline for other European countries having similar provisions. However, he still proposed ways of justifying such restrictive provision adopted by Member States.

The solution AG Maduro proposed, justifies foreign investments suffering less favourable treatment for tax purposes than domestic ones within the Community. This is by taking the treatment in the host state into account, and applying the justification ground of fiscal coherence if the subsidiary is provided equivalent treatment in the host state. However, the ground for justification the AG used is one that has never been applied by the ECJ regarding two different taxpayers and different taxes, it has even been clearly rejected under these circumstances by the Court.

Moreover, even if a subsidiary is accorded equivalent treatment in the host state, the parent company will still suffer disadvantages from making foreign investments as compared to domestic ones. This is the loss of cash flow and loss of interest, if the tax treatment is not accorded in the same year as the losses occurred. One might presume this is something that the Court will take into consideration, even though it was not mentioned by AG Maduro. Furthermore, this solution is not appealing since the authorities have to take the tax treatment abroad into account when deciding the tax treatment of its resident companies.

However, the ECJ has still not delivered its judgment in this case, and they may reach a different conclusion in the matter. Most likely, the Court will determine the UK group relief scheme as clearly imposing restrictions on their nationals. The arguments put forward by the ECJ can then be studied by other affected Member States to draw conclusions on whether their own provisions are likely to be viewed as restrictive or not. Moreover, Member States might be able to draw conclusions on what types of national provisions can be justified by the rule of reason test.

If the ECJ will interpret the type of national legislation currently operating in the UK to impose a restriction on the freedom of establishment that cannot be justified, the Member States having similar provisions can change these in order not to have national legislation contrary to the Treaty.

Member States with similar provisions to the legislation at issue in the Marks and Spencer case will have at least three options. The first option is to abolish all provisions equalizing the result for even domestically situated subsidiaries. Their legislation will then no longer provide differentiated treatment of foreign and domestic investments. However, to abolish all equalization possibilities would probably have negative impacts on groups of companies established within that jurisdiction. They can no longer neutralize their tax burden, which will give a higher taxation for the group if any of their subsidiaries are showing losses.

To abolish all equalization rules could also lead to problems for the tax authorities. As an example, the tax authorities will have to make sure that companies do not use internal pricing in order to equalize their taxable result. The authorities then need to put resources to determine whether every transaction between companies in a group is being accurately priced. Intangible assets and services are very difficult to evaluate for these purposes. To abolish all equalization rules will probably not be appealing in a Community with increasing tax competition. This is because the Member States are providing simple tax rules, lower tax rates and other advantages to attract investors. Restrictions on equalization rules that can lead to groups of companies being over taxed is probably not solution attracting new investors to a Member State.

The second option is to open up existing methods for tax treatment of losses to include even foreign establishments. If the presently operating rules would be open for foreign suffered losses, this can lead to problems with tax avoidance. Losses could possibly be trafficked between Member States, and the same losses could be taken into account for tax purposes in more than one country. This alternative is therefore not very likely for any Member State to choose.

The third option is to introduce a new tax system, which allows the deduction of foreign losses. This may be a more appealing solution for the Member States. The tax system can be designed not to impose any restrictions on the freedom of establishment. If the Member State wants to protect the national tax base, a form of deduction and recapture method is suggested. This leads to that all deducted losses will later be recaptured and taxed within the jurisdiction where they were deducted.

There is also a possibility for the Member States to agree on a Council directive in the matter. The benefit of a directive is that it will not encourage states to conduct further tax competition within the Community. However, since the negotiations have failed earlier when there was a proposal, it seems unlikely they would agree on this matter in the near future.

The Marks & Spencer case has put focus on the tax treatment of losses within the union, and Member States such as the Netherlands, have currently proposed ideas for new legislation to tackle this problem. The proposal in the Netherlands is to provide the deduction and recapture model for losses suffered in foreign subsidiaries. The new legislation is not only proposed because of the developments before the ECJ, but also due to the increasing tax competition within the Community, where the Netherlands government believes that providing a solution for cross-border losses can attract companies to set up establishments within the country.

This shows that the current developments before the ECJ, can lead to positive impacts. Member States can take this an opportunity to critically examine their operating company tax legislation and implement systems that

are more competitive. These systems must however be able to combat abuse in order not to increase tax avoidance amongst Community nationals. Attractive solutions can then lead to advantages for both companies and governments active in the European Community.

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Supplement A

Notice for the OJ

Reference for a preliminary ruling by the High Court of Justice (England & Wales), Chancery Division, by order of that court dated 16 July 2003, in the case of Marks & Spencer plc against David Halsey (HM Inspector of Taxes).

(Case C-446/03)

Reference has been made to the Court of Justice of the European Communities by an order of the High Court of Justice (England & Wales), Chancery Division, dated 16 July 2003, which was received at the Court Registry on 22 October 2003, for a preliminary ruling in the case of Marks & Spencer plc and David Halsey (HM Inspector of Taxes) on the following questions:

1. In circumstances where:

.provisions of a Member State, such as the UK provisions on group relief, prevent a parent company which is resident for tax purposes in that State from reducing its taxable profits in that State by setting off losses incurred in other Member States by subsidiary companies which are resident for tax purposes in those States, where such set off would be possible if the losses were incurred by subsidiary companies resident in the State of the parent company;

.the Member State of the parent company:

subjects a company resident within its territory to corporation tax on its total profits, including the profits of branches in other Member States, with arrangements for the availability of double taxation relief for those taxes incurred in another Member State and under which branch losses are taken account of in those taxable profits;

does not subject the undistributed profits of subsidiaries resident in other Member States to corporation tax;

subjects the parent company to corporation tax on any distributions to it by way of dividend by the subsidiaries resident in other Member States while not subjecting the parent company to corporation tax on distributions by way of dividend by subsidiary companies resident in the State of the parent; grants double taxation relief to the parent company by way of a credit in respect of withholding tax on dividends and foreign taxes paid on the profits in respect of which dividends are paid by subsidiary companies resident in other Member States;

is there a restriction under Article 43 EC, in conjunction with Article 48 EC? If so, is it justified under Community law?

2.(a)What difference, if any, does it make to the answer to Question 1 that, depending on the law of the Member State of the subsidiary, it is or may be possible in certain circumstances to obtain relief for some or all of the losses incurred by the subsidiary against taxable profits in the State of the subsidiary?

(b)If it does make a difference, what significance, if any, is to be attached to the fact that:

.a subsidiary resident in another Member State has now ceased trading and, although there is provision for loss relief subject to certain conditions in that State, there is no evidence that in the circumstances such relief was obtained;

.a subsidiary resident in another Member State has been sold to a third party and, although there is provision under the law of that State for the losses to be used under certain conditions by a third party purchaser, it is uncertain whether they were so used in the circumstances of the case;

.the arrangements under which the Member State of the parent company takes account of the losses of UK resident companies apply regardless of whether the losses are also relieved in another Member State?

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