THE EVER-EVOLVING CONSISTENCY OF THE JURISPRUDENCE OF THE EUROPEAN COURT OF JUSTICE

Agata Kozolup[1]

Introduction

On 7 November 2013, the ECJ rendered its decision in *K* (C-322/11).[2] The case is significant as an endorsement of the consistency and clarity of the jurisprudence of the European Court of Justice.

Background

K, fully liable to income tax in Finland, sought to deduct the loss he incurred on the sale of an immovable property in France from the income he received in Finland. Under the France-Finland Double Taxation Convention, both the income deriving from immovable property and the capital gains arising on the disposal of immovable property were taxable in the State in which the property was situated.

Following the sale of his property in France, K no longer had a source of income in France from which he could deduct the loss sustained. He contended that, if his action was not upheld, the non-deductibility of the loss would become definitive, which would amount to an infringement of his free movement of capital rights.

Restriction Analysis

Since discrimination on grounds of nationality is not possible from an origin

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1 Agata Kozolup completed her LLB degree at Queen Mary, University of London in July 2013. She is currently pursuing her LLM in Tax Law at Queen Mary, University of London, Centre for Commercial Law Studies (CCLS).

2 ECJ, 7 November 2013, C-322/11, *K* ("*K*"), [2013] ECR I-0000 (not yet reported).

Member State perspective[3], the Court commenced its judgment with a restriction analysis. Having established that *investments in real estate abroad by residents* constituted a capital movement[4], the Court noted that the measures prohibited by Article 63(1) TFEU included those liable to discourage a Member State's residents from making investments in other States. Therefore, national measures liable to prevent or limit the acquisition of immovable property situated in another Member State might be deemed to constitute such a restriction.

The Court subsequently compared the situation of a Finnish resident taxpayer incurring a loss on the sale of property situated in Finland with the situation of a Finnish resident taxpayer sustaining a loss on the sale of property situated in another Member State. The ECJ noted that the deductibility of losses incurred on transfers of immovable property was a tax advantage. Denying this tax advantage to taxpayers who invested in property situated in another Member State resulted in less favourable treatment of such taxpayers, constituting an infringement of the national treatment principle.

Dismissing the argument of the Finnish government, the Court held that the difference of treatment in the case was not the result of the exercise in parallel by the two Member States concerned of their powers of taxation but solely a consequence of the choice made by the Republic of Finland. Such a difference in treatment on the basis of the location of the immovable property was held to constitute a restriction on the free movement of capital.

Justification

Proceeding to the justification analysis, the Court stressed that to come within differences in treatment authorised by Article 65(1)(a) TFEU, as opposed to discrimination prohibited by Article 65(3) TFEU, the difference in treatment prescribed by national legislation *must concern situations which are not objectively comparable or be justified by an overriding reason in the public interest*.[5]

Comparability

Dismissing the arguments of the Finnish and German governments that the allocation of the power to tax income from immovable property, as it resulted

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3 See Tom O'Shea, *European Tax Controversies – Quis Custodier Ipsos Custodes? EC Tax Journal*, Volume 1, 2011-12, p. 43.

4 *K*, para 21.

5 *K,* para 36.

from the France-Finland Double Taxation Convention, rendered the situation of a taxpayer investing in Finland different from that of a taxpayer investing abroad, the Court noted that the Double Taxation Convention did not preclude the taking into account of income related to an asset situated in France in the calculation of the tax of a taxpayer resident in Finland and, more importantly, that it did not preclude a loss sustained by that taxpayer from being taken into account in the context of the sale of that asset.

The Commission argued that, since the French tax law did not recognise the principle of such deductibility, the Finnish refusal to allow deduction was justified by that difference in situation. The Court rejected this argument, emphasising yet again the fact that the decision not to take such losses into account was the result of the choice made by Finland and that the Double Taxation Convention did not preclude such losses from being taken into account.

Having established that the difference in treatment could not be justified by a difference in situation relating to the *situs* of the property, the Court proceeded to analyse whether the restriction could be justified by an overriding reason in the public interest.

Balanced allocation

As a result of applying the France-Finland Double Tax Convention in conjunction with the Finnish tax legislation, profits deriving from transfers of immovable property situated in France were neither taxed nor otherwise taken into account in Finland. *If it were accepted that losses incurred on the sale of immovable property situated in another Member State must be deductible in the Member State in which the taxpayer resides, regardless of the allocation of taxing powers agreed between the Member States, that would effectively allow the taxpayer to choose freely the Member State in which the taking into account of those losses is most advantageous from the tax perspective*.[6] Therefore, following the Opinion of Advocate-General Mengozzi, the Court held that the refusal to allow deduction of losses arising from the sale of immovable property situated in France permitted the symmetry between the right to tax profits and the right to deduct losses to be safeguarded. This contributed to the objective of ensuring a balanced allocation of the power to impose taxes between the Member States.

‘Double dipping’

Following the Opinion of Advocate-General Mengozzi, the Court quickly

6 *K*, para 54.

dismissed this justification put forward by the German and the Swedish governments, stating that there was no danger of deducting the same loss twice in the main proceedings.

Need to prevent tax avoidance

Dismissing the argument of the Swedish and the UK governments, the Court held that the Finnish tax legislation in question was not specifically designed to prevent wholly artificial arrangements from benefitting from a tax advantage but was directed, generally, at any situation in which the losses derived from immovable property in another Member State.

Cohesion of tax system

Noting that, in the absence of the Double Taxation Convention, Finland would have had the right to tax the gains made by a taxpayer residing in Finland from the sale of property situated in France, the Court held that *in providing that a resident taxpayer who incurs a loss on the sale of a property situated in France cannot make use of that loss in Finland, the Finnish system reflects a logic of symmetry*.[7]

Proportionality

According to K the requirements of the principle of proportionality were not met due to the loss becoming definitive.

However, the Court dismissed this argument, holding that K could not be regarded as having exhausted the possibilities available in the Member State in which the property was situated of having the losses taken into account because no such possibilities had ever existed. The ECJ noted that *according to the Court's case-law, a Member State cannot be required to take account, for the purposes of applying its tax law, of the possible adverse consequences arising from particularities of legislation of another Member State applicable to a property situated in the territory of that State which belongs to a resident in the first State*.[8] Further, *the free movement of capital cannot be understood as meaning that a Member State is required to adjust its tax rules on the basis of those of another Member State in order to ensure, in all circumstances, taxation which removes any disparities arising from national tax rules, given that the decisions made by a*

7 *K*, para 68.

8 *K*, para 79.

taxpayer as to investment abroad may be to the taxpayer's advantage or not, according to circumstances.[9]

The Court's Conclusion

Accordingly, the Court held that the Finnish legislation at issue was compatible with Articles 63 and 65 TFEU.

Analysis

No possibilities test

The argument that France did not provide for a right to deduct losses arising on the sale of property was of importance for two different stages of the analysis.

Firstly, the Commission alluded to it at the comparability stage, arguing that the Finnish State's refusal to allow the deduction was justified by that difference in situation. While this argument was rejected by the Court, the decision not to take such losses into account was the result of the choice made solely by Finland, the Court deployed the same argument when upholding the coherence justification to be proportionate. Had K met the *no possibilities* test (as propounded in the *Marks and Spencer* case[10]), Finland would have had to allow him to deduct the loss in question. However, this was not the case, since, according to the ECJ, K could not be regarded to have exhausted the possibilities available in France of having the losses taken into account since *such a possibility has never existed*.

Individual taxpayer/Company

The referring court sought to distinguish the present case from *Lidl Belgium*[11] and *Krankenheim*[12] on the basis that the loss sustained by K was not connected with any professional/trade activity carried on through a permanent establishment in another

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9 *K*, para 80.

10 ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* ("*Marks and Spencer*"), [2005] ECR I-10837.

11 ECJ, 15 May 2008, Case C-414/06, *Lidl Belgium* GmbH & Co. *KG v Finanzamt Heilbronn* ("*Lidl Belgium*"), [2008] ECR I-03601.

12 ECJ, 23 October 2008, Case C‑157/07, *Finanzamt fur Korperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt* ("*Krankenheim*"), [2008] ECR I-08061.

Member State. Therefore, it could not be assumed that the taxpayer would subsequently receive income in France, from which the loss could be deducted anew.

While the ECJ did not address this issue, Advocate-General Mengozzi forcefully argued that there was no objective difference justifying different treatment of companies and individual taxpayers.[13]

Final Thoughts

Professor Dr Michael Lang argued that it was *the responsibility of academics not so much to praise the Court where its case law is convincing but to point at possible tensions or contradictions.*[14] Be that as it may, from the practitioner's perspective, surely the actual understanding of the Court's judgments and the ability to explain them remain absolutely crucial in order to predict possible outcomes of new claims and advise clients accordingly.

As per Article 26 of the TFEU, the Union shall adopt measures with the aim of establishing and ensuring the functioning of the internal market, *an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties.*[15]

At this point it is worth to reiterate that the task of the ECJ conferred on it by the Treaties[16] is merely to *interpret* EU law. As noted by Dr Tom O'Shea, such a *negative* role in the integration process means that the ECJ has no jurisdiction to force a Member State to change its national provisions or introduce new legislation to remedy its breach of a fundamental freedom.[17] Therefore, the key to understanding the jurisprudence of the ECJ might be the appreciation the difficulties involved in the guarding of the internal market, *steady expansion,*

13 Conclusions de l'avocat general Mengozzi, 21 mars 2013, para 38: (...) *aucune raison objectivene parait, en principle, devoir justifier de distinguer lest contribuables selon qu'ils sont des personner morales and personner physiques*.

14 http://www.wu.ac.at/taxlaw/institute/staff/publications/langectaxrev2009leuven.pdf, accessed 26.02.2014, 22.07.

15 Article 27 TFEU.

16 Article 267 TFEU.

17 Tom O'Shea, *Double Tax Conventions and Compliance with EU Law*, *EC Tax Journal*, Volume 11, 2010, p. 102.

balanced trade and fair competition[18], the ECJ being charged solely with ensuring *that in the interpretation and application of the Treaties the law is observed.*[19]

Globalisation and constant developments necessarily require a *sui generis* purposive dynamic interpretation which constantly evolves in order to adequately take into account the rapidly changing economic and business environment. An example of this process might be the gradual development of the concept of freedom of establishment. In *SEVIC Systems AG,*[20] the Court found cross-border mergers to be a way of exercising such a freedom. Subsequently, in *Cartesio,*[21] the ECJ held that the freedom of establishment might cover a conversion situation where a company seat is transferred to another Member State with an attendant change in the national law applicable. As per *National Grid Indus*,[22] cases of cross-border migration may also fall within the scope of freedom of establishment.

The proliferation of justifications (i.e. the recognition of the balanced allocation of the power to impose taxes between the Member States in the *Marks and Spencer* decision) might be understood merely as the Court's response to the more sophisticated justification arguments put forward by the claimant in the case.

The Court's ruling in the *K* case was, in principle, very much in line with the Opinion of Advocate-General Mengozzi. The latter, however, following the Opinion of Advocate-General Kokott in the *A Oy* case, was highly critical of the *Marks and Spencer* decision, the uncertainties surrounding its applicability and its dubious provenance.[23] In the author's view, the origins of the *no possibilities* test can be explained as endeavours by the ECJ to fulfil its role as the guardian of the internal market, acting within the mandate conferred on it by the Treaties. As indicated above, the very aims of the European Union imply such a dynamic, evolving interpretation of the EU law provisions. The *Marks and Spencer* judgment may therefore be understood as the Court's venture to continue safeguarding individual fundamental freedoms while ensuring the effective functioning of the internal market through curbing tax avoidance. According to Professor Dr Hans van den Hurk, the ECJ approached the European internal

18 TFEU 2010, *Preamble*.

19 Article 19(1) TEU.

20 ECJ, 13 December 2005, Case C-411/03, *SEVIC Systems AG* ("*SEVIC Systems*"), [2005] ECR I-10825.

21 ECJ, 16 December 2008, Case C-210/06, *CARTESIO Oktató és Szolgáltató bt* ("*Cartesio*") [2008] ECR I-9641.

22 ECJ, 29 November 2011, Case C-371-10, *National Grid Indus BV v Inspecteur van de Belastingdienst Rijnmond/kantoor Rotterdam* ("*National Grid*"), ERC I-12273.

23 Conclusions de l'avocat general Mengozzi, 21 mars 2013, para 67: *(...)«l'exception Marks & Spencer», dont elle relevait du reste l'origine obscure et inexpliquée...*

market in the same way as a Member State approached its domestic market, the internal market thus being an analogy for the domestic market of a Member State.[24] As he went on to emphasise, *in a domestic market, losses are deductible only once*.[25]

On a close reading of the Court's judgments, all of the alleged contradictions disappear. The aforementioned *Marks and Spencer* judgment[26] is necessarily one with a very limited practical scope of application, situations covered being rarely encountered. Its applicability depends on the factual matrix of a claim at issue and its similarity to that of *Marks and Spencer*, hinging thus on determinations of domestic judges. In this context, therefore, domestic pronouncements from other jurisdictions may constitute a useful aid in interpreting and applying the ECJ's decisions.

As if in anticipation of the factual situation of the case at issue, Professor van den Hurk, when analysing the *Marks and Spencer* judgment, wrote that it was *not correct to conclude (...) that the ECJ ruled that a loss in general should be deductible at least somewhere, either by the subsidiary or the parent. The ECJ's ruling should be interpreted in relation to the facts of the case*.[27] As explained by Dr T. O'Shea, Marks and Spencer is an *'origin state' national (...), was impeded, hindered, discouraged, deterred or hampered from exercising its right of establishment by the denial of group relief in a cross-border situation* ***when it was granted in a purely UK setting***.[28] Applying the national treatment principle from an origin state perspective, the Court highlighted that *in a terminal or final loss situation, the United Kingdom may have to grant loss relief cross-border even though it did not tax the non-resident subsidiaries on their profits in situations* ***where it granted group relief to UK parent companies with subsidiaries in the United Kingdom***.[29] These singularly perceptive statements allow the reader to fully appreciate not only the proportionality aspect of the *K* case, but also the

24 Prof. Dr H. van den Hurk, *Cross-Border Loss Compensation – The ECJ's Decision in Marks & Spencer and How It was Misinterpreted in the Netherlands*, IBFD Bulletin, May 2006, p 181.

25 Ibid.

26 Explained by Dr T O'Shea, *Marks and Spencer v Halsey (HM Inspector of Taxes): restriction, justification and proportionality*, EC Tax Review, 2006/2, pp. 66-82.

27 Prof. Dr H. van den Hurk, *Cross-Border Loss Compensation – The ECJ's Decision in Marks & Spencer and How It was Misinterpreted in the Netherlands*, IBFD Bulletin, May 2006, p 181.

28 Tom O'Shea, *Marks and Spencer v Halsey (HM Inspector of Taxes): restriction, justification and proportionality*, EC Tax Review, 2006/2, p 72 (emphasis added).

29 Tom O'Shea, *German Currency Loss Rules Incompatible With EU Law, ECJ Says*, Tax Analysts, March 2008, p 6 (emphasis added).

consistency of the ECJ's jurisprudence. In 2006, upon careful perusal of the *Marks and Spencer* judgment, Professor van den Hurk and Dr O'Shea predicted the outcome of the case **from 2013**.

Cases such as *K*, informally described by Dr Tom O'Shea as *'re-run of de Groot in the context of the free movement of capital',* confirm the consistency which, while constantly evolving, constitutes the fundamental value which underpins the jurisprudence of the ECJ.