COMPATIBILITY OF THE DUTCH TAX INTEGRATION SCHEME WITH THE FREEDOM OF ESTABLISHMENT

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On the 12th of June 2014, the Court of Justice of the European Union (CJEU) in *SCA* (*Joined cases* C-39/13, C-40/13 & C-41/13) delivered a judgment on the compatibility of the Dutch Corporate Tax Integration scheme for corporate groups. This is not the first time the Court has pronounced on this Dutch rule.[2] The CJEU held here that the scheme which granted a "single entity status" to corporate groups for tax purposes only when the holding companies were resident in the Netherlands but neither where the Dutch parent company held its sub-subsidiaries through companies resident in another member State nor where resident sister subsidiaries were owned by a common parent company not established in the Netherlands, was incompatible with the freedom of establishment as guaranteed by Articles 49 & 54 of the Treaty on the Functioning of the European Union (TFEU).

Facts

The cases involve three sets of proceedings having regard to formation of tax entities under the Dutch Law on Corporation tax of 1969 (Wet op de venootschapsbelasting 1969). Under the law, for a "single tax entity status" to be granted to the corporate group, both the parent and the subsidiary company must be resident (established) or liable to be taxed in the Netherlands e.g. by the connection of a permanent establishment situated in the Netherlands.[3] Consequently, a corporate group comprising Dutch parent companies with Dutch sub-subsidiaries owned through subsidiaries resident in Germany was refused this

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2 See *X Holding B.V* Case C-337/08 [2010] ECR I-1215

3 *SCA* para. 3 & 4

"single tax entity status" on the ground that the subsidiaries/intermediate companies were neither established in the Netherlands nor had a permanent establishment there.[4] Similarly, in a corporate group where the parent company was established in Germany with three subsidiaries resident in the Netherlands, these subsidiaries were also refused "single tax entity status" on the ground that their common parent company was neither established in the Netherlands nor had a permanent establishment there.[5]

In these circumstances, the companies involved brought an action on the ground that the refusal to grant the "single tax entity status" was contrary to the freedom of establishment enshrined in the **TFEU**. What is instructive in this case is that the issues were referred by the Dutch Court to the CJEU in the manner that the CJEU usually carries out its analysis in coming to a decision on compatibility of national rules with TFEU freedoms i.e. restriction analysis, comparability analysis, justification analysis and proportionality analysis.[6] Nevertheless, the CJEU did not carry out the proportionality analysis because the restrictive Dutch Rule was found to be unjustifiable in the circumstances.

Restriction Analysis by the CJEU[7]

The issues in cases C-39/13 and C-41/13 were taken together. Summing up all the eight issues raised in the two cases, the CJEU stated that the basic issue was whether Articles 49 & 54 of the TFEU must be interpreted as preventing a Member State legislation under which a resident parent company can form a single tax entity with a resident sub-subsidiary where it holds that sub-subsidiary through one or more resident companies, but cannot form such single tax entity where it holds that sub-subsidiary through non-resident companies which do not have permanent establishment in that Member State.[8]

Restating the concept of freedom of establishment under the TFEU, the CJEU held that this entails for companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the European Union, the right to exercise their activity in the Member State concerned through a subsidiary, a branch or an agency.

4 *SCA* para. 9

5 *SCA* para. 15

6 *SCA* para. 12 & 18

7 *SCA* para. 20-27 & 45-49

8 *SCA* para. 19

The Court noted that the "single tax entity status" granted by the Dutch law to a resident parent company and resident subsidiary, constituted a "cash-flow advantage for the companies concerned". This is because the single entity scheme allows the profits and losses of the companies constituting the entity (group) to be consolidated at the level of the parent company and transactions carried out within the group remain neutral for tax purposes.[9]

The cash-flow advantage of the Dutch legislation was only extended to parent companies seeking to be taxed as a single entity with their sub-subsidiaries as long as the intermediate subsidiaries were resident in the Netherlands or had a permanent establishment in the Netherlands. In other words, where the intermediate subsidiaries were not resident in the Netherlands, such a tax advantage could not be obtained by the Corporate Group. Accordingly, the CJEU pointed out that such conditions created a "difference in treatment" between: (i) resident parent companies holding resident sub-subsidiaries through resident intermediate subsidiaries and (ii) resident parent companies holding resident sub-subsidiaries through non-resident intermediate subsidiaries. This is because the ability to elect for the "single tax entity regime" was dependent on whether the parent company held indirect stakes through a subsidiary established in the Netherlands or in another member state.[10]

The Court similarly held that there was a difference in treatment as shown in the facts of Case C-39/13 where it was the resident sub-sub-subsidiaries that could not be integrated into a single tax entity with the parent company because the intermediate subsidiary and the intermediate sub-subsidiary were not resident in the Netherlands.[11] Consequently, the CJEU determined that as long as the Dutch law placed cross-border (Community) situations at a disadvantage compared to domestic situations, the Dutch legislation amounted to a restriction on the freedom of establishment as guaranteed by the TFEU.

Using the same restriction analysis in Case C-40/13, where the common parent company was resident in Germany and its subsidiaries in the Netherlands, the CJEU held that there was a difference in treatment between (1) resident parent companies with resident subsidiaries on the one hand & (2) non-resident parent companies with Dutch resident subsidiaries. As the law puts Community (cross-border) situations at a disadvantage compared to purely domestic situations, the law constitutes a restriction on the freedom of establishment which is prohibited

9 *SCA* para. 21

10 *SCA* para. 24

11 *SCA* para. 26

under the TFEU.[12] Further, the Court held that there was still a restriction, notwithstanding the fact that the common parent company of the subsidiaries to be consolidated was situated at a higher level in the group's chain of interest, as the non-resident intermediate companies without a permanent establishment in the Netherlands, cannot themselves form part of the single tax entity.[13] The CJEU also observed another advantage of the "single tax entity regime" which was that loss making companies within the group were able to set off their losses against the profits of other companies in the group.[14]

Justification Analysis by the CJEU

Having found that the Dutch rule was a restriction on the freedom of establishment, the Court went on to analyse the justifications put forward by the Dutch Government. Summing up the justification analysis, the CJEU stated that for such a difference in treatment to be compatible with the provisions of the Treaty on freedom of establishment, (1) it must either relate to situations which are not objectively comparable- in which case the comparability of a cross-border situation with an internal situation must be examined having regard to the aim pursued by the national provisions in issue or (2) it must be justified by an overriding reason in the public interest.[15]

Objective difference in situation argument[16]

The CJEU started its comparability analysis by determining the objective pursued by the Dutch legislation in question. It determined that the aim of the law was to treat corporate groups (consisting of parent company, subsidiaries & sub-subsidiaries) in the same way as a single entity with a number of establishments, through making the results of companies in a corporate group to be consolidated for tax purposes. i.e. allowing companies in the same group to be treated for tax purposes as if they constituted one and the same tax payer.[17]

Having determined the objective of the law, the CJEU went on to state that this objective can be achieved both in situations where all the members of the group

12 *SCA* para. 48

13 *SCA* para. 49

14 *SCA* para. 46 & 47

15 *SCA* para. 28

16 *SCA* para. 28-31 & 50-52

17 *SCA* para. 29 & 51

are resident in the Netherlands and in Community (cross border) situations where the intermediate subsidiary was not resident in the Netherlands, as in cases C-39/13 & C-41/13.[18] Consequently, these two situations are objectively comparable to the extent that the benefit of the advantages of the Dutch single tax entity regime is sought in both situations for the group formed by the parent company and the sub-subsidiaries.[19]

Furthermore, in case C-40/13, having found that the Dutch Law allowed consolidation of subsidiaries in the case of a group the parent of which is resident, the court stated that this same objective can be achieved by both groups the parent company of which is resident and by groups the parent company of which is not resident, at least so far as concerns the taxation of solely the sister companies which are taxable in the Netherlands.[20] As a result of this, the difference in treatment as regards the possibility of fiscally integrating sister companies was not justified by an objective difference in situation.

Coherence of the Dutch Tax System[21]

The CJEU stated that although the need to preserve the coherence of a tax system may justify a restriction on the exercise of a fundamental freedom, a *sine qua non*[22] for the acceptance of this justification is that a "direct link" must be established between (1) the granting of the tax advantage concerned and (2) the offsetting of the advantage by a particular tax.

The Court distinguished the case of *Papillon* (EU: C:2008: 659)[23] from the current case. According to the Court, there was a "direct link" in *Papillon* unlike in the present case.[24] The direct link existed between (1) the possibility of transferring losses between the companies and (2) the neutralisation of certain intra-group transactions between those companies, such as: provision for doubtful claims or

18 See point 34 of the opinion of the Advocate General (A.G). The A.G observes that the objective can be attained so long as the parent company and sub-subsidiaries are established on National territory.

19 *SCA* para 31

20 *SCA* para. 51

21 *SCA* para. 32-41 & 53-54

22 Necessity

23 Case C-418/07

24 In *Papillon* however, the CJEU using a proportionality analysis held that the French National Legislation in Issue went beyond what was necessary to achieve its objectives. See: paragraph. 52-63 of the Judgment

risks, waivers of debt etc. The Court stated that the purpose of neutralising these intra-group transactions was to avoid the double use of losses at the level of resident companies falling under the tax integration regime and hence preserve the coherence of that tax system.[25]

Restating the *raison d' etre*[26] behind the decision in *Papillon*, the Court stated that: "If the legislation of the Member state at issue in *Papillon*... had granted the benefit of tax integration where the intermediate company was not resident, it would have been possible for a loss suffered by a resident sub-subsidiary to be taken into account in the first instance with respect to the resident parent company, as a result of the tax integration, and in the second instance with respect to the non-resident intermediate subsidiary, as a result of the reduction of value stemming from the same losses on its shares in the sub-subsidiary or its claim against it. That reduction of value would have not been neutralised since the neutralising transactions could not apply to the non-resident intermediate company."[27]

According to the Court, the major distinguishing factor between the current case and *Papillon,* lay in the fact that Dutch Law had a *"general holding exemption rule"* through which it sought to prevent the double use of losses within a tax entity. In contrast, the legislation in *Papillon* had specific provisions for the neutralisation of certain transactions, as in the system at issue, in the case giving rise to the judgment. As a result of the Dutch general holding exemption, the profits or losses resulting from the possession, acquisition or disposal of a holding were not taken into account in determining the taxable profit of a taxable entity.[28] In other words, Dutch law prevented the double use of losses in a different manner from the legislation in *Papillon*. Moreover, it was established that the *"general holding exemption rule"* was designed in such a way that a resident parent company can never take into account a loss linked to a holding in one of its subsidiaries, even where that subsidiary had its seat in another Member state.[29] Consequently, no direct link could be established between (1) the granting of the tax advantage linked to the formation of a single tax entity for a corporate group and (2) offsetting that advantage by a particular tax.

Similarly, in Case C-40/13, the Court held that it was neither apparent from the order of reference nor from the observations submitted to the Court that the granting of the benefit of the single tax entity to sister companies would break any

25 *SCA* para. 34

26 Reasoning

27 *SCA* para. 35

28 *SCA* para. 36-38

29 *SCA* para. 39

direct link between (1) that advantage and (2) a particular tax within the meaning of the decision in *Papillon*. [30]

Hence, the public interest reason of coherence of the Dutch tax system was not an acceptable justification for the restriction on the freedom of establishment by Dutch Law.

Risk of Tax Avoidance[31]

The Court held that for this justification to be accepted, the national legislation in issue must have the specific objective of combating wholly artificial arrangements which do not reflect economic reality and the purpose of which is to escape the tax normally due. Clearly, and as indicated above, this was not the objective of the Dutch Law. The aim of the Dutch Law in issue was to allow companies in the same corporate group to be treated for tax purposes as if they constituted one and the same tax payer.

Hence this justification was rejected by the court.

Holding of the CJEU[32]

The Court held that in Cases C-39/13 & C-41/13, Articles 49 & 54 of the TFEU preclude a Member State's legislation under which a resident parent company can form a single tax entity with a resident sub-subsidiary where it holds that sub-subsidiary through one or more resident companies, but cannot where it holds that sub-subsidiary through non-resident companies which do not have permanent establishment in that Member State.

And, in Case C-40/13, Articles 49 & 54 of the TFEU preclude a Member State's legislation under which treatment as a single entity is granted to a resident parent company which holds resident subsidiaries but is not granted to resident sister companies the common parent company of which neither has its seat in that Member State nor has a permanent establishment.

30 *SCA* para 54

31 *SCA* para 42 & 55.

32 *SCA* para 43, 56 & 57

The *X Holding* Nexus

The current case is connected with the *X Holding BV* Case[33] because in both cases, the same legislation[34] was construed by the CJEU. However, the distinction lies in the facts of both cases and that in *X Holding*, a Belgian-Dutch Double Tax Convention[35] was construed in contrast to the current case.

In *X Holding*, a company (the Belgian subsidiary) in the group which was not established (taxable) in the Netherlands sought to enjoy the benefit of the "single tax entity status"[36]. While the facts of the present case show that all the companies in the group that sought to enjoy the benefit of the "single tax entity status", were all taxable (established/resident) in Netherlands. This goes to show that the application of the same law to two different facts may lead to different results.

In *X Holding*, the corporate group lost because from the facts, the Belgian subsidiary which was not resident (taxable) in the Netherlands sought to enjoy the benefit of the Dutch "single tax entity regime". While in the current case, the corporate groups won from the given facts which was that all the companies in the group that sought to benefit from the Dutch "single tax entity regime" were all resident (taxable persons) in the Netherlands, though some of them (i.e. the sub-subsidiaries) had non-resident holding companies.

In its justification analysis, the CJEU did not examine whether the tax rule of the other Member State (Germany) where the intermediate subsidiary was located also granted single tax entity to corporate groups in a similar manner as the Dutch Rule in issue. Similarly, in Case C-40/13, it did not examine whether the tax rule of the Member State (Germany) where the common parent company was located also granted single tax entity to corporate groups in a similar manner as the Dutch Rule in issue.[37] It is submitted that this might perhaps be as a result of its earlier decision in *X holding* where it had held that in such circumstance, the Dutch parent company and the Dutch sub-subsidiary will not be able to benefit from the German "single tax entity regime". In other words, it is only the intermediate subsidiary and all other subsidiaries (including sub-subsidiaries) resident/taxable in Germany

33 Case C-337/08 [2010] ECR I-1215.

34 Dutch Law on Corporation tax of 1969(Wet op de venootschapsbelasting 1969).

35 See Paragraph 3 of *X Holding case*

36 See Paragraph 6 & 7 of *X Holding case*

37 See T O'Shea, *EU Tax Law & Double Tax Conventions* (Avior Fiscal Limited, London 2008) 146-147. The author here is of the view that this justification requires a two-prong investigation namely (i) An examination of the aim and objective of the national tax rule & (ii) An analysis of the extension of that rule in a cross-border setting where the tax situation or treatment in the other Member State must be taken into consideration.

that would be able to benefit from the German "single tax entity regime". And from the decision in the current case, such German sub-subsidiaries will still be entitled to the benefit in Germany even if the direct holding company is not resident or taxable in Germany.

Safeguarding the allocation of taxing rights justification successfully relied upon[38] in *X holding* could obviously not have been successful here.[39] This is because all the companies that sought the benefit of the "single tax entity" were resident (taxable persons) in the Netherlands. In other words, profits and losses which are two sides of the same coin[40] were symmetrically treated in one tax system (the Dutch Tax System) and there could have been no room for the threat of loss trafficking or loss tax-planning by resident companies in this group.

The decision here complements the previous principles enunciated in *X holding*.[41] The CJEU elaborates on the principles on the application of a "single tax entity regime" on corporate groups operating cross-border but within the European Internal Market (EIM). It is clearly developing the European Union direct tax jurisprudence for corporate groups operating in the EIM. The CJEU is merely giving guidance on circumstances when such restrictive Dutch Rule will be applied and when it will be disapplied. In the *X Holding* circumstance, the Dutch Rule is to be applied. While in the *SCA* circumstance the Dutch Rule is to be disapplied with a view to safeguarding the freedom of establishment rights that have be given to European Union nationals.

Papillon distinguished

The Case appears to be on all fours with the *Papillon* Case.[42] However, the CJEU distinguished both cases. In *Papillon*, the specific objective(s) of the French law was consolidation results and neutralisation of intra-group transactions to avoid use

38 See paragraph 33 of *X Holding* case.

39 See point 45 of the opinion of the Advocate General (A.G) in *SCA*. The A.G observed here that as the tax entity intended to be formed was between taxable persons subject to the Netherlands taxation, the fiscal sovereignty of the Netherlands cannot therefore be impaired by the taking into account of foreign situations that are not subject to its fiscal sovereignty.

40 See the Argument of the United Kingdom together with other Member States and the CJEU's Treatment in *Marks & Spencer* (C-446/03) paragraphs 43, 45, 46

41 See point 28 of the opinion of the Advocate General (AG) in *SCA*. The AG observed that the judgment in *X Holding* did not explore the issue of the consequence of excluding from the "single tax entity" a domestic sub-subsidiary with a holding non-resident subsidiary.

42 See paragraph 17 of *Papillon* & Paragraph 19 of *SCA* for the similarity in issue for determination

of losses twice at the level of resident companies.[43] Notwithstanding, the corporate group won on the principle of proportionality, despite the fact that the coherence of tax system justification was accepted by the CJEU.[44]

On the other hand, the Dutch law in *SCA* did not have the specific objective of neutralisation of intra-group transactions, it was a general holding exemption under which profits or losses resulting from the possession, acquisition or disposal of a holding are not taken into account when determining the taxable profit of a tax entity.[45] In other words, there is a difference in objective(s)/purpose(s) sought to be achieved by the two Laws.

Conclusion

The *SCA* case solves the challenge which corporate groups face when they are liable to tax in more than one jurisdiction and on occasions when one or more of the jurisdictions use a "single entity approach" in the taxation of such corporate groups.[46]

Comparability Analysis:

In carrying out a comparability analysis, the Court used the Dutch resident parent company with a Dutch resident subsidiary and the Dutch resident parent company with a foreign subsidiary as comparator (Case C-39/13 & C-41/13).[47] While in Case C-40/13, the Court used the Dutch resident parent company with Dutch resident subsidiaries and a foreign parent company with Dutch resident subsidiaries.[48] This is an application of the European Union National Treatment Principle (Migrant/Non-Migrant Test)[49] in the corporate group sphere. It demonstrates that from both an origin and host State perspective, companies that operate cross border but within the European Internal Market (EIM) must also be given national treatment.

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43 See paragraph 45-49 of *Papillon*

44 See footnote 24

45 See paragraph 38 of *SCA*

46 See point 1 of the opinion of the Advocate-General.

47 *SCA* para 25 & 26

48 *SCA* para 47

49 For a proper discussion of the "migrant/non-migrant test" in the CJEU's Jurisprudence, see T O'Shea, *EU Tax Law & Double Tax Conventions* (Avior Fiscal Limited, London 2008);

Certainty of Law through the consistency of the CJEU[50]

At least four principles which have been applied in previous cases were used in the *SCA* case. Specifically, the principle of the freedom of establishment entailing the right of companies to exercise their activity in the Member State concerned through a subsidiary, a branch or an agency; so long as they are formed in accordance with the law of a Member State and have their registered office, central administration or principal place of business within the community.[51] Secondly, the principle that for the justification of coherence of a national tax system to succeed, the Member State concerned must establish a direct link between the granting of the tax advantage concerned and the offsetting of the advantage by a particular tax.[52] Thirdly, the principle that for the justification of tax avoidance to succeed within the EIM context, the legislation in issue must have the specific objective of combatting wholly artificial arrangements which do not reflect economic reality and the purpose of which is to escape the tax normally due.[53] Fourthly, the principle that acceptance of the proposition that the Member State in which a company seeks to establish itself may freely apply to it different treatment solely by reason of the fact that its seat is situated in another Member State would deprive the establishment freedom of all meaning.[54] In as much as the same principles are being used in all these cases, it is argued that there is consistency here. However, there may be variation in the results of the application of these similar principles because circumstances and/or the facts of the cases differ.

The above is a commendable feature of the European Union direct tax legal system. This is because consistency of the CJEU which leads to some level of certainty or predictability is an admirable quality of any legal system from the

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50 For a detailed analysis of arguments supporting the consistency of the CJEU, see Tom O'Shea, 'European Tax Controversies- A British-Dutch Debate: Back to Basics and Is the ECJ consistent?' *World Tax J.,* Feb 2013, 1, pp. 100-127, at 119

51 *Cadbury Schweppes* (C-196/04) paragraph 41; *Thin Cap* (C-522/04) paragraph 36; *SCA* (Joined cases C-39/13, C-40/13 & C-41/13) paragraph 20.

52 *Commission v Belgium* (C-300/90) paragraph 14-21; *Bachmann* (C-204/90) paragraph 21-23; *Verkooijen* (C-35/98) paragraph 56-58; *De Groot* (C-385/00) paragraph 106-109; *Thin Cap* (C-522/04) paragraph 68; *SCA* (Joined cases C-39/13, C-40/13 & C-41/13) paragraph 33.

53 *Cadbury Schweppes* (C-196/04) paragraph 51 & 55; *Thin Cap* (C-522/04) paragraph 72; *SGI* (C-311/08) paragraph 65; *SCA* (Joined cases C-39/13, C-40/13 & C-41/13) paragraph 42.

54 *Commerzbank* (C-330/91) paragraph 13; *Thin Cap* (C-522/04) paragraph 37; *SCA* (Joined cases C-39/13, C-40/13 & C-41/13) paragraph 20 & 45.

perspective of all stakeholders.[55] Legal Advisers can confidently advise their clients when similar issues arise in this area.

Businessmen/Companies/Investors/taxpayers in the EIM can invest without fear of being caught by the law. Member States are able to know beforehand whether national legislation which is restrictive can be properly justified in the general interest of the public.

This *SCA* decision is a step in the right direction and requires commendation of the CJEU in its consistent steps in developing the jurisprudence as it pertains to the direct taxation arena in the EIM more particularly with regard to corporate groups. At the time when the *X Holding* decision was given, sub-subsidiaries with non-resident holding companies were not in the scheme, consequently the CJEU has used this current case to clarify what the position of the law is where sub-subsidiaries with non-resident holding companies are involved in the scheme.

55 See David Southern, *Taxation of Loan Relationships and Derivative Contracts* (9th edn Bloomsbury Professional Ltd 2012) 1. The Author states here that in the tax field, certainty is a component of the rule of law. "It embodies the fundamental principle of legality to which the tax system should conform".