JUDICIAL ACTIVISM OR JUDICIAL PROTECTION?

'TAX SOVEREIGNTY AND CROSS-BORDER LOSS RELIEF: THE DICHOTOMY OF THE ECJ.'

Rachael Arning[1]

'…*Although subject to much admiration and applause from many sides, including that of most Community Law specialists, irritation, dismay and wrath accumulated in other quarters…In my evaluation, the negative policy inputs were suggestive of a perception of the European Court, shared by powerful countervailing powers, that it had transgressed into the functions constitutionally vested in the political arms of government…'*[2]
[Hjalte Ramussen]

'…what can a court do when the political system fails to perform its functions? Not every problem of European Integration can be reduced to something justificable…'[3]
[T. Koopmans]

1. Introduction

Whilst arguments may be advanced, that direct tax case law has followed a similar pattern to that of other policy areas, being concerned with balancing European Union ("**EU**") objectives against potentially conflicting national interests, the argument that the European Court of Justice ("**ECJ**") is not making law when

1 Rachael Arning is a qualified solicitor, specialising in tax law. She is currently studying for the M.A. in Taxation (Law, Administration & Practice) at the Institute of Advanced Legal Studies, University of London [and will be joining the M&A team at Deloitte later this year.]

2 See Hjalte Ramussen '*Between Self-Restraint and Activism: a Judicial Policy for the European Court'* European Law Review, 1998 p.37.

3 See T. Koopmans '*The Role of Law in the Next Stage of European Integration'* International and Comparative Law Quarterly (1986), p.930.

exercising its judicial powers,[4] but is instead protecting existing Community law rights, is not easily won.[5]

This paper will discuss the reasons for this uncertainty, and more particularly (i) examine the concept of tax sovereignty and what it means in a European context, (ii) assess the ECJ's role in Europe and ask why it is so significant (iii) identify a methodology for evaluating ECJ decisions and finally (iv) apply the methodology to important cases in this area.

1.1 Tax Sovereignty in the EU: a brief summary

Although a detailed analysis of the concept of tax sovereignty is beyond the scope of this paper, it warrants limited discussion, since it has a bearing on the later case analysis. Central to the methodology in evaluating the ECJ's case law is the fact that sovereignty is a political authority, which is not delegated but derived from the body *itself*. Although this quality, sometimes referred to as a *self-referential* claim, does not have an external source, it is nevertheless a claim to ultimate authority.[6]

Whilst EU law is supreme[7] and the concept of sovereignty is often used to identify Member States' retained competence in certain policy areas, it is clear that both Member States and the EU Institutions have sovereign qualities[8] because neither could be said to have derived its authority from any other body politic.

---

4 See the comments of Prof. D. Weber who states that '…The ECJ also too often takes the place of the legislator as it tries to resolve issues that, in fact, should be resolved by the (Community) legislator. As a result, ECJ case law is confusing and difficult to apply in practice' in G Blokland '*Inaugural Lecture by Prof. Dr D.M. Weber 'In Search of a (New) Equilibrium between Tax Sovereignty and the Freedom of Movement in the EC*'' European taxation, Volume: 47, 2007, No. 2., p72.

5 See Michael Graetz and Alvin Warren, '*Income Tax Discrimination and the Political and Economic Integration of Europe*' 115 The Yale Law Journal 1186 (2006), at p1193.

6 See Dr Mathieu Isenbaert, '*The Contemporary Meaning of 'Sovereignty' in the Supranational Context of the EC as Applied to the Income Tax Case Law of the ECJ*' EC Tax Review, 2009 -6 at p265.

7 The Treaty created a supranational institution which was confirmed in the ECJ's judgment in *Van Gend,* where it held that the Community '…constitutes a new legal order of international law for the benefit of which the states have limited their sovereign rights…' and the ECJ's judgment in *Costa v ENEL,* held that EC law was supreme. See *NV Algemene Transporten Expeditie Onderneming van Gend & Loos v. Netherlands Inland Revenue Administration* [1963] ECR 1 (C-26/62) ("*Van Gend*") and *Flaminio Costa v E.N.E.L.* [1964] ECR 585 (C-6/64) ("*Costa v ENEL*").

8 A distinction must nevertheless be made between the inherent powers to govern which Member States enjoy by virtue of their constitutions and the EU's limited competence granted under the Treaty, which afford it sovereign qualities.

Thus tensions have arisen between EU law and Member State's tax sovereignty, which can be traced back to the conception of the European Community[9] (now the EU), where the Treaty of Rome's objective was to establish a Common Market,[10] through the implementation of a European Internal Market (the "**EIM**") via the exercise of various different competences.[11]

On the basis that the EU did not expressly refer to direct tax policy in its founding Treaty, Member States took the view that they had retained the sovereignty to regulate their national tax systems.[12]However, on closer scrutiny of the Treaty, it is clear that Member States' tax sovereignty is not exclusive as (i) the Council is empowered[13] to issue directives "for the approximation of such laws, regulations or administrative provisions of the Member States, as directly affect the establishment or functioning of the common market"[14] and (ii) the EU enjoys various horizontal competences, including the fundamental freedoms, which necessarily overlap with Member States' retained competence in direct tax matters.[15]

1.2 The Significance of the ECJ in the EU

Before establishing a methodology against which to examine the case law in relation to losses, it is important to examine the context in which the ECJ makes its decisions

---

9 The Lisbon Treaty entered into force on 1 December 2009, amending the Treaty Establishing the European Community or 'TEC' and renaming the Treaty 'Treaty on the Functioning of the European Union' or 'TFEU'. See http://eurlex.europa.eu/JOHtml.do?uri=OJ:C:2007:306:SOM:EN:HTML.

10 Ex Art.2 TEC.

11 Ex Art.3(1)(c) TEC states that an 'internal market [shall be established] by the abolition, as between Member States, of obstacles to the freedom of goods, persons, services and capital.'

12 Although in the case of *Humblet*, which established that the salaries of Community officials were exempt from Member States' direct tax systems, it was clear that competence in certain direct tax matters was the preserve of the EU. See *Jean-E. Humblet v Belgian State* [1960] ECR 559 (C-6/60) ("*Humblet*").

13 Art.115 TFEU (Ex Art.94 TEC).

14 Since direct taxation plays a significant role in the functioning of the EIM, the EU clearly has legislative competence in direct tax policy. However, an argument may also be run that Art.115TFEU (ex Art. 94 TEC) read in conjunction with Art.114 TFEU (ex Art. 95(2) TEC) indicates that Member States have kept their sovereignty. See Dr. Axel Cordewener and others, '*The Tax Treatment of Foreign Losses: Ritter, M&S, and the Way Ahead (Part 2*)' European taxation Volume: 44, 2004, No. 5.

15 See para.21 *Schumacker* in which the ECJ states that 'although…direct taxation does not fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law…' See *Finanzamt Koln-Altstadt v Roland Schumacker, [1995] ECR I- 00225* (C-279/93) ("*Schumacker*").

because that context may affect the perception of whether ECJ decisions is judicially active or merely protecting the fundamental freedoms.

It has been suggested that there are three main reasons[16] why the ECJ's role in the EIM has taken on increasing significance. Firstly, the ECJ's relationship with Member States was historically not easy to define, since it had to operate in a hybrid system of national law, international law and EU law. Secondly, the checks and balances that a proactive legislative body would otherwise provide in the context of a national legal system are absent;[17] the Council's legislative powers in fiscal matters are restricted by the absence of qualified majority voting procedures and therefore cannot react quickly to judicial acts,[18] and unlike many constitutions, the Treaty gives the ECJ the power[19] to review the legality of acts adopted by the Parliament and other EU Institutions, which are intended to produce legal effects *vis-à-vis* third parties.[20] Thirdly, because national budgets fall strictly within the competence of the Member States, ECJ decisions in the field of direct tax are of particular political sensitivity.[21]

Although the ECJ's role in the EIM landscape is undoubtedly significant, the extent to which the Court is permitted, by virtue of the powers afforded to it under the

16 See Isenbaert (n.5) at 266.

17 By developing various justifications in its case law, firstly in *Cassis de Dijon* 'the effectiveness of fiscal supervision' (para.8) then in *Bachmann* 'coherence of the tax system' (para.28) *M&S*, the 'balanced allocation of taxing rights' (para.45) 'double-dipping' (para.47) and 'tax avoidance' (para.49) and later the concept of 'symmetry' in *Lidl Belgium* (para.33) the ECJ creates its own system of checks and balances, thus preserving vestiges of Member States' sovereignty where appropriate. See Dr. Axel Cordewener and others (n.13) at p.222.

See *Rewe-Zentrale AG v Bundesmonopolverwaltung für Branntwein* (C-129/78) *("Cassis de Dijon"), Hanns-Martin Bachmann v Belgian State, [1992] ECR I-249* (C-204/90) *("Bachmann"), Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)* [2005] ECR I-10837 (C-446/03) ("*M&S*") and *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn* [2006] ECR I-0000 (C-414/06) ("*Lidl Belgium").*

18 See Michael Graetz and Alvin Warren (n.4) at p1190.

19 Art.263 TFEU (ex Art.230 TEC).

20 Contrast the position of the ECJ with that of national courts in the UK, which adhere to the doctrine of Parliamentary Supremacy. See Takis Tridimas, *'The Court of Justice and judicial activism'* 1996 European Law Review at p.4.

21 Anticipating the decision in *M&S*, several Member States' Governments prepared 'damage limitation legislation', in the event that unlimited cross-border compensation resulted from the ECJ's decision. See Pim M. Smit, *'Marks & Spencer: The Paradoxes'* European Taxation Volume: 46, 2006, No. 9 at p.411.

Treaty, to interfere with Member States' tax sovereignty is not easy to determine.[22] In light of the lack of positive harmonisation at EU level, the ECJ has, throughout the EIM's existence, regularly interfered with national direct tax law in order to pursue its Treaty objectives, via the mechanism of negative (judicial) integration.

However, in order to develop its jurisprudence,[23] the ECJ has had to pursue its path of market integration by 'plugging the gaps' in the EU's direct tax framework, by reference to and in sole reliance on its interpretation of EU law rules.[24]

1.3 Methodology in Evaluating ECJ decisions

Against this backdrop, evaluating the correct balance between the EU's direct tax competence and the sovereign powers of Member States is not an easy task, partly due to the absence of primary external sources of law, against which to examine ECJ decisions.

However, two evidential sources[25] may be identified. Firstly, there are internal sources, contained in the ECJ's judgments themselves: the theory being that if the ECJ is merely protecting EU rights, its judgments should show a clear, logical analysis and consistency of approach.

Internal sources, although helpful, cannot be solely relied upon: even consistent decisions must also fall within the ECJ's authority under the Treaty. Therefore it is also important to identify a second evidential source, incorporating an external reference point, which should logically be Member States' retained sovereignty, on the basis that the ECJ should not infringe areas of sovereignty, which have been exclusively retained.

---

22 Even if the ECJ is being judicially active in its judgments, it may not be a bad thing. Although some commentators claim that judicial activism may undermine the power of the legislature, others point out that the view that the legislature holds when implementing legislation, may not be consistent with the view the same legislative body holds at the time that legislation is interpreted by the judiciary. Therefore in the absence of positive harmonisation measures and against the backdrop of the changing business landscape of the EIM, the role judicial activism plays in interpreting legislative acts, is arguably a legitimate one. See John Hart Ely, *Democracy and Distrust*. Cambridge: Harvard University Press, 1980, chapters 4-6.

23 There is no positive integration except for a few directives.

24 In practice, this has resulted in the extensive application of two basic principles in the area of direct tax, the non-discrimination principle and the restriction-based or 'market access' principle. See Malcolm Gammie QC, '*Workshop on the ECJ case law and double taxation treaties'* University of Cambridge, Queens' College, on 30 October 2009 at p.5.

25 See Isenbaert (n.5) at p.268.

1.4 The Importance of Loss Relief

The issue of cross-border loss relief has become particularly urgent with the advent of modern commerce, since businesses are increasingly being carried out trans-nationally. Where an entity forms part of a larger EU-wide group, consolidation of results on a macro-scale ensures that there is no stranding of losses in a particular Member State, and that the group does not end up paying tax on an amount that exceeds its total EU-wide revenue.

Under international law, Member States are concerned with eliminating double taxation and maintaining consistency of their tax systems. As a result, providing taxpayers with cross-border loss relief, which may lead to the erosion of their tax bases[26] is not standard practice. On the other hand, the threat that the non-alleviation of cross-border losses poses to the freedom of establishment within the EIM is clear, because in the absence of relief in cases where it would otherwise be provided domestically, domestic investment is favoured over participation abroad.[27]

1.5 PEs vs. Subsidiaries

Since a company may exercise its right of establishment under Article 49 TFEU (ex. Art.43 TEC) by setting up a secondary establishment in another Member State through a permanent establishment ("**PE**") or subsidiary, ECJ case law concerning cross-border loss relief may generally be divided into two sets of cases, those concerning head offices and their PEs and those concerning parent companies and their foreign subsidiaries.

In applying the methodology to the case law, it is important to establish whether the group structure affects the ECJ's decisions.

1.5.1 *Comparability*

As a starting point, if the legal position of PEs and subsidiaries are compared, PEs have no separate legal personality and are subject to 'natural consolidation' whereas subsidiaries are separate economic entities from their parent companies, although they may be subject to legal consolidation.

However, the position under EU law is that restrictions on freedom of establishment are prohibited regardless of legal form i.e. whether a company is setting up

---

26 The OECD Model Convention 2008 does not specifically provide for loss relief, although it is mentioned in the Commentary.

27 See Commission Communication COM (2005) 532 final, sub 2.1.1. p. 3 and Prof. L.A. Denys, '*Previous EU Proposals for Cross- Border Loss Relief*' European taxation Volume: 46, 2006, No. 9 at p.444.

branches, agencies or subsidiaries in another Member State.[28]

In the host state case of ***Futura***,[29] the ECJ seems to confirm this approach, and held that Singer, the Luxembourg PE of the non–resident company, Futura, was comparable to a fictitious independent company established under the laws of Luxembourg.[30] However, there was no cross-border element in relation to the host state rules at issue, since the case was concerned with Luxembourg rules affecting the carry-forward of losses in a PE in Luxembourg.

In a host state situation, such as ***Futura***, the relationship between the controlling entity i.e. the parent company or head office, and the PE/subsidiary is not relevant in determining whether the national rules were in breach of the freedoms. The choice of legal form of the secondary establishment is only relevant in as far as it results in the distinction in treatment of domestic and foreign-controlled taxpayers *vis a vis* each other, rather than in relation to their controlling entities. In fact it could be

---

28 See the second sentence of Art.49 TFEU (ex Art.43 TEC).

29 The facts: Futura, a French company with a Luxembourg PE, Singer, wanted to carry-forward past losses against its Luxembourg income. However, the Luxembourg tax authorities made the carry forward of losses subject to two conditions, (i) losses must be economically linked to the profits being offset in Luxembourg and not related to French profits, and (ii) a separate set of accounts were kept at the PE. Although the first condition did not apply to the carry-forward of losses of Luxembourg residents and was therefore potentially discriminatory, the ECJ held that it, was in 'conformity with the principle of territoriality' since income earned outside Luxembourg was not taken into account in calculating liability to tax in Luxembourg and therefore it was not contrary to EU law. The second condition, although it was a non-discriminatory even-handed rule, which applied to both resident subsidiaries and the Luxembourg PE, it was held to be a disproportionate rule from an EIM perspective, since a French company would have to prepare a second set of accounts to be held at the Luxembourg PE. See *Futura Participations SA and Singer v Administration des contributions* [1997] ECR I-02471 (C-250/95) *("Futura").*

30 This is consistent with the ECJ's case law on residents and non-residents, which provides that a host state should not treat a non-resident less favourably than its own resident where it is in a comparable situation. See *Schumacker*, which concerned a Belgian worker, Mr Schumacker, residing in Belgium but working in Germany, where he earned more than 90% of his wages. The German government refusal to grant certain allowances to Mr Schumacker which were available to German residents on the basis that he was not resident in Germany, and he did not earn enough income in this residence state, Belgium. Therefore he appealed and his case was referred to the ECJ. In its judgment, the ECJ set out a definition of discrimination, which could arise through the application of different rules to comparable situations or the application of the same rules to different situations. The German government argued that a difference in treatment was justified because Mr Schumacker was non-resident. However, the ECJ held that since Mr Schumacker earned the major part of his income in Germany, he was in a comparable situation to that of a Germany resident, and therefore the different treatment could not be justified. See para.37.

argued that the ECJ is comparing the same legal form in this case i.e. a non-resident company with a resident one.[31]

Similarly, in origin state cases, where there is a cross-border element in relation to the losses, the situation of a foreign PE is fundamentally different to that of a foreign subsidiary, since head office and PE profits are subject to "natural", rather than "legal" consolidation by way of group relief, and there is always some sort of consolidation when PEs are used by a company to exercise their freedom of establishment. Therefore in an origin state situation, the correct comparator will be an origin state company.

The ECJ judgments reflect this approach and accordingly, it held in the origin state case of ***M&S***[32] that a UK parent company with loss-making subsidiaries in France, Belgium and Germany, was not in a comparable situation to a UK parent with PEs in those Member States. Instead the correct comparator was held to be a UK parent with domestic subsidiaries.[33]

Over the years academic commentators have debated whether it is possible to create legal comparability between PEs and subsidiaries in origin state cases. After some uncertainty,[34] the law has recently been clarified in this area. In ***X Holding***, the ECJ

31 Tom O'Shea made this point in his lunchtime seminar on 23 March 2010 at the Institute of Advanced Legal Studies.

32 The facts: Marks & Spencer, a UK parent company claimed group relief for trading losses made in its subsidiaries in Belgium, France and Germany but was prohibited from doing so under the UK rules on the basis that the subsidiaries were not resident in the UK. The ECJ, applying the 'migrant/non-migrant test' to compare the treatment of the UK parent setting up subsidiaries abroad (the migrant) with that of a UK parent setting up domestic subsidiaries (non-migrant), held that the UK rules constituted a restriction on the UK parent company's freedom of establishment, since it was treated less favourably, than it would have been had it remained in a purely domestic situation. However, the ECJ held that the UK rules were justified on the basis that (i) the profits and losses were symmetrical and that there was a need to preserve the balanced allocation of taxing powers (ii) losses may be taken in to account twice if relief was granted in the UK and (iii) if the losses were not taken into account in subsidiaries' Member States there was a risk of tax avoidance. In deciding whether the justifications were proportional, the ECJ held that where the non-resident subsidiaries (or if a third party to which they had been sold) were not able to use the losses in their home state immediately or in future periods i.e. where the 'no possibilities test' was satisfied, the origin state was obliged to provide relief for the losses.

33 AG Maduro rejected the comparability of subsidiaries and PEs from an origin state perspective, stating that "the provisions on freedom of establishment do not preclude different tax treatment from being accorded to legal or natural persons in different legal situations"AG's Opinion *M&S*, Para. 48.

34 Some academic commentators have expounded the theory of *horizontal* discrimination which involves comparing two cross-border situations rather than a cross-border situation and a purely domestic one i.e. comparing two different types of secondary establishments which have been established in another Member State (foreign PEs and foreign subsidiaries). See Prof. Dr Axel Cordewener, '*EC Law protection against 'horizontal' tax discrimination on the ise-or how to play snooker in an Internal Market*' EC Tax Review 2007-5 at p. 210.

held that in an origin state situation, non-resident subsidiaries and PEs are not objectively comparable, and instead it is necessary to compare 'like with like'.[35]

1.5.2 *Tax Sovereignty*

The ECJ's view that PEs and subsidiaries are not comparable probably stems from the differing reasons for the conflict between EU law and Member States' tax sovereignty, depending on whether the case concerns overseas PEs or overseas subsidiaries.

The position is fairly straightforward in relation to parent companies and their overseas subsidiaries. Since there is ordinarily[36] no natural 'connecting factor' between the parent and its subsidiary (assuming the overseas subsidiary is not resident for tax purposes in the parent company's origin state) which would enable the origin state to extend its tax jurisdiction to include the subsidiary's cross-border profits, the Member State of origin is free to choose how it defines its tax *base* i.e. whether to include the subsidiary as part of its taxing jurisdiction or not.

However, in cases concerning loss relief between head offices and their PEs, the position is more complicated. Since these entities comprise a single economic unit with their head office, a natural connecting factor exists which enables the origin state to extend its taxing jurisdiction to include the PE's cross-border profits and losses.[37] Consequently, there is no problem where the Member state of origin has opted to use the credit method in the double taxation convention ("**DTC**") with the source state, since any losses incurred by the PE will automatically be taken into account in determining a company's worldwide income, with credit given for any overseas tax paid. However if the exemption method is used, although the profits (and losses) are technically included in the head office's tax base, the origin state will disregard them by applying a notional 'zero rate' or exemption.

Therefore, in cases where the ECJ finds that Member States' tax rules which deny cross border loss relief are contrary to EU law, the ECJ may necessarily infringe upon Member States' tax sovereignty in two different ways (i) by circumventing the principle of territoriality i.e. Member States' ability to define their taxing jurisdiction in relation to an overseas subsidiary or (ii) by disregarding Member States' ability to allocate taxing rights under a DTC in relation to an overseas PE.

---

35 See *X Holding BV v. Staatssecretaris van Financiën* (C-337/08*) ("X Holding")* para.40 and Tom O'Shea, '*Dutch Fiscal Unity Rules Receive Thumbs up From ECJ*' Tax Notes International Volume 57 Number 10 March 2010 at p.3.

36 Unless CFC rules are applicable.

37 See para.38. *X Holding*.

2. The Case Law

2.1 Permanent Establishments

All of the cases discussed concerning PEs, look at the interplay of the exemption method and cross-border loss relief.

2.1.1 *AMID*

In ***AMID***,[38] the ECJ held that a Belgian rule which provided for the set-off of head office losses against exempt profits of a Luxembourg PE was contrary to EU law. In effect, the ECJ denied the consolidation of Belgian losses with Luxembourg profits under Belgian law, due to the exemption of Luxembourg income under the DTC between Belgium and Luxembourg.

Applying the methodology to this case, it can be seen that the ECJ's judgment in ***AMID*** is consistent with prior and subsequent case law. This is because the losses were, in effect *final* losses because under the Belgian rules, offset against Luxembourg profits was the only option. The ECJ followed its case law in ***De Groot,***[39] ***Schumacker*** and later in ***M&S*** by providing for offset of final losses in AMID's home state.

However, when examining whether the ECJ's decision respected the limits of Member States' tax sovereignty, the decision has been criticised by a number of commentators[40] who argue that (i) the ECJ did not select the correct comparator in

---

38 The facts: *AMID*, concerned a Belgium Head Office, which had a PE based in Luxembourg. Under DTC between Luxembourg and Belgium, Luxembourg profits are exempt in Belgium. In the 1981 accounting period, the Head Office incurred losses of approximately BEF2.1M in Belgium. However in the same year, the Luxembourg PE made profits of approximately LUF3.5M, which were exempt under the DTC. In the subsequent tax years, the Head office became profitable and AMID sought to offset its 1981 Belgian losses against Belgian profits made in subsequent accounting periods. However the Belgian tax authority insisted Belgian losses were offset against Luxembourg profits in the 1981 accounting period even though the Luxembourg profits were exempt, thus resulting in the Belgian losses being disallowed. As a result, AMID received no reduction for its 1981 losses resulting in economic double taxation. AMID challenged this decision in the national court and the matter was referred to the ECJ. The ECJ applied the migrant/non-migrant test and compared the tax treatment of a Belgian company with its operations abroad (AMID) with that of a Belgian company with a PE in Belgium and held that '*…an objective difference in the companies' positions had not been established…*' therefore concluding that the Belgian rules were contrary to Art.43 of the Treaty. See *Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v Belgian State* [2000] ECR I-11619 (C-141/99) ("*AMID*").

39 See *FWL de Groot v. Staatssecretaris van Financien, [2002] ECR 1-11819* (C-385/00) *("De Groot").*

40 See Prof. Luc Hinnekens, '*AMID: A Wrong Bridge or a Bridge too far: A recent analysis of a recent decision of the ECJ*' European Taxation June 2001 at p.208.

the case, because AMID's tax base was subject to two jurisdictions rather than just one[41] (ii) since Belgian law provided for consolidation of foreign income with domestic losses in the same way as it would have done had the losses been incurred in a domestic situation, the rules were not discriminatory[42] and (iii) the effect of the DTC between Belgium and Luxembourg was not to determine the PE's tax *base* but merely to exempt certain income from taxation, and the method of relief was a matter for Belgium to determine, even though it resulted in economic double taxation[43] i.e. although Belgium had taxing rights in respect of the Luxembourg PE, it chose to apply a nil rate to the profits earned there. However, the ECJ looked at the result of the Belgian rule and held that the Belgian rules resulted in a restriction on AMID's freedom of establishment. Therefore, since losses were stranded and could not be relieved elsewhere, the ECJ held that Belgium should provide relief because such relief would have been relieved domestically. Although the ECJ's decision was clearly in pursuit of its EIM objectives, it disregarded Belgium's right to consolidate the results of AMID's head office and PE under domestic law, on account of Belgium applying the exemption under the DTC with Luxembourg.

---

41 If the tax *bases* of AMID's head office and its Luxembourg PE are compared under Belgian law with the comparator used by the ECJ, i.e. a head office with a domestic PE, the head office with a domestic PE would be allowed to consolidate its losses with its domestic PE's profits leaving net profit of BEF1.4M, whereas AMID had an overall net profit of BEF1.4M + LUX3.5, albeit with the BEF1.4M being exempt under the DTC.

42 In disallowing offset of profits against losses under the Belgian rules, the ECJ treated the PE as a separate economic entity from its head office. This approach has been criticised on the basis that the separate-entity fiction is merely a mechanism used under international law to attribute profits to the PE from the point of view of the source state. See W.C. Haslehner, '*Cross-border Loss Relief for Permanent Establishments under EC Law*' Volume: 64, 2010, No. 1 at 68.

43 This economic double taxation could have been held to be a disparity due to the effect of two tax systems, which could not be solved under EU law. See *Gilly,* an example of a two state disparity, which could not be resolved by DTC rights. *Mr and Mrs Robert Gilly v Directeur des Services Fiscaux du Bas-Rhin* (C-336/96) *("Gilly").*

The facts: *Gilly* concerned Mrs Gilly who was a German national, married to a French national, residing in France, and working in Germany for the public sector. Under the DTC between Germany and France, Mrs Gilly was taxable in Germany at a higher German progressive rate because she was a German national and was entitled to a tax credit for the lower French tax payable on the income earned in Germany. Mrs Gilly complained that she was worse off as a result of the DTC than she would have been had she been liable to tax in France. However the ECJ held that there was no discrimination: even though nationality was used as the connecting factor to allocate fiscal jurisdiction it flowed from the parties' rights to define the criteria for allocating taxing powers for the elimination of double taxation. The DTC was not in breach of Community law and tax credit system was lawful, nor did the DTC confer on Mrs Gilly the tax status, which was most favourable to her in particular, it only ensured national treatment.

2.1.2 *Lidl Belgium*

In ***Lidl Belgium***,[44] which was decided after ***M&S***, the ECJ took the approach that the decision in ***M&S*** was applicable to the facts in ***Lidl Belgium***, and that the justifications given in that case also applied. It held that since the losses in question were temporal, rather than final losses and the Luxembourg rules allowed for carry forward of losses in Luxembourg, the Luxembourg rules were proportionate and cross-border offset was not necessary.

Applying the methodology to the outcome of this case, it is clear that the ECJ demonstrated consistency with its earlier judgment in ***M&S*****.**

In relation to Member States' tax sovereignty, the ECJ also appears to have exercised restraint by respecting the balanced allocation of taxing rights under the DTC,[45] accepting the cash flow disadvantage of overseas PEs in non-terminal loss

---

44 The facts: *Lidl Belgium* concerned a German limited partnership with a PE in Luxembourg, which incurred losses and sought to deduct the losses from its tax base. However, the deduction was refused by the German tax authorities on the basis that income from the PE was exempt by virtue of the DTC between Germany and Luxembourg. Although the ECJ held that the Luxembourg rule constituted a restriction on Lidl Belgium's freedom of establishment, the rule was justified by the need to preserve the allocation of the power to impose taxes between the Member States concerned and the need to prevent the danger that losses may be taken into account twice. Unlike the decision in *M&S*, the ECJ held that the German rules *were* proportionate since the PE could deduct losses in the future, so the situation was not analogous to the M&S case where losses could not be utilised.

45 Prof. Lang has argued that *Lidl Belgium* may have been decided differently, had the Court followed its earlier approach in *Wielockx*. In *Wielockx*, which concerned a rule denying Mr. Wielockx, a Belgian national, the deduction of contributions to a pension reserve from his taxable income in the Netherlands because the subsequent income from the reserve was exempt by virtue of the DTC between the Netherlands and Belgium, the justification of fiscal cohesion was rejected by the ECJ on the basis that cohesion had been shifted to another level, "that of reciprocity of the rules applicable in the contracting states..." see para.24. See Prof. Dr Michael Lang, '*The Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions and Contradictions*' European taxation 2009, No. 3 at 109 and *G.H.E.J. Wielockx v Inspecteur der Directe Belastingen [1995] ECR I-02493* (C-80/94) *("Wielockx").*

However, although the facts of *Lidl Belgium* are similar to those in *Wielockx*, the justification of the 'need to preserve the balanced allocation of taxing rights' which was successfully argued in *Lidl*, whilst conceptually similar to the 'cohesion' justification in *Wielockx*, is not identical. In its decision in *Lidl Belgium*, the ECJ found it acceptable for companies with foreign PEs to be at a cash flow disadvantage to those with domestic PEs because the losses were not terminal losses and the cash flow disadvantage was caused by two-states rather than one, as in *X and Y* and *Metallgesellschaft*. See Tom O'Shea '*ECJ Rejects Advocate General's Advice in Case on German Loss Relief*' 2008 WTD 123-2 (25 June 2008) and "*European Commission 08 October 2009, IP/09/1461: Marksand Spencer Case Comment", (2009) H&I, 12.11* See also *Metallgesellschaft and others v Commissioners of Inland Revenue (*C-397/98*) ("Metallgesellschaft") and another and X and Y v Riksskatteverket* (C-436/00) ("*X and Y*").

situations,[46] recognising fiscal neutrality was not guaranteed where freedoms are exercised[47] and refusing to reinstate Germany's loss and recapture rules contrary to the views set out in AG Sharpston's Opinion.

2.1.3 *Krankenheim*

On the face of it, the ECJ seemed to be contradicting itself in the later case of *Krankenheim*,[48]where it held that German reintegration rules that provided for the subsequent recapture of losses against profits made in Austria operated in a 'perfectly symmetrical manner' and therefore, were not only justified under the principle of fiscal cohesion but also proportionate, even though the losses could not be relieved in subsequent periods under Austrian law.

---

46 The ECJ has been criticised for not providing that the Luxembourg rules should allow immediate loss offset, with a later recapture of profits. Werner Haslehner states that "…it has to be accepted that the symmetric treatment of losses and profits as currently applied by several Member States in respect of the exemption method constitutes an infringement of the fundamental freedoms by denying multinational enterprises the cash flow advantage which is conferred on merely domestic enterprises by their state of residence." On the other hand, Tom O'Sheaargues that the ECJ would have no authority to require recapture rules to be introduced and that since the cash disadvantage in the case was caused by the rules of two Member States rather than one and did not involve terminal losses, the origin state should not be obliged to provide relief. See W.C. Haslehner, '*Cross-border Loss Relief for Permanent Establishments under EC Law*' Bulletin for International Taxation Volume: 64, 2010, No. 1 at 103 and Tom O'Shea, in '*ECJ Upholds German Loss Disallowance'* Tax Notes International (2008), p. 1081.

47 See *Schempp* where the ECJ denied a German taxpayer the right to deduct maintenance payments to his wife in Austria on the basis that the maintenance was not taxable in that Member State. The ECJ held that the Treaty did not guarantee to citizens that a transfer of activities to another Member State is neutral in respect of taxation. *Egon Schempp v. Finanzamt München* (C-403/03) *("Schempp").*

48 The facts: In *Krankenheim*, KR Wannsee, a German company, operated a PE in Austria from 1982 to 1994. The PE was loss-making up to 1990 and at the request of KR Wannsee, those losses were taken into account in that year in Germany, thus reducing Wannsee's German tax liability. Between 1991-1994, the Austrian PE became profitable and under the German recapture rules, the profits made in Austria were added to the profits of KR Wannsee in Germany up to the amount of income obtained by KR Wannsee as a result of the original deduction. The PE was disposed of in 1994 and the Austrian authorities refused to allow the losses incurred by the PE to be deducted against the profits made in Austria in 1992 and 1993. *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt* [2008] ECR I-0000 (C-157/07) ("*Krankenheim*").

The ECJ was clearly exercising restraint[49] in relation to German tax sovereignty in holding that the German rules were consistent with EU law. However, in relation to consistency, the ECJ's decision needs to be reconciled with that of its decision in ***M&S***. There are several reasons why the ECJ accepted that the German reintegration rules in Krankenheim were proportionate when the group relief rules in ***M&S*** were not. In ***Krankenheim***, the German reintegration rules were in force at the relevant time, so the German government could rely on the 'cohesion' justification, whereas in ***M&S*** no such rules existed. The case highlights a difference in the justifications used, since in ***M&S*** the justification of 'balancing the allocation of taxing rights' was clearly not decisive where final losses were concerned whilst the 'cohesion' justification argued in ***Krankenheim*** was.[50]

2.1.4 *Deutsche Shell*

The ECJ's decision in ***Deutsche Shell*** seemed to contradict its decisions in ***M&S***[51] and ***Lidl Belgium***, which upheld the symmetrical application of the exemption method, subject to losses being temporary. In ***Deutsche Shell***, which concerned currency losses incurred on the repatriation of start-up capital to the principal establishment based in Germany on dissolution of an Italian PE, the German argument, that such losses should not be deducted due to a non-coherent tax system, was rejected. However, in the author's view the facts in ***Deutsche Shell*** were more analogous to those in ***Bosal***[52]because the losses incurred by both origin state companies related to the value of host state assets held in those companies' balance

49 Some commentators have criticised this decision, stating that where Member States have national rules limiting the carry-forward of losses, the decision in *Krankenheim* represents a significant hindrance for companies operating through PEs in those states, because any losses attributable to their PEs, which could not be deducted in the Host State due to the expiry of carry-forward periods, could not be deducted in the Origin State. See the comments of Dr Tigran Mkrtchyan, 'I*n Search of Ariadne's Thread: Permanent Establishments and Losses in the European Union*' Bulletin for International Taxation, Volume: 63, 2009, No. 1 at para.3.1.

50 See Tom O'Shea, '*German Loss Deduction and Reintegration Rules and the ECJ'* Worldwide Tax Daily 20 March 2009, 2009 WTD 52-11.

51 i.e. The UK rules were not required to provide for immediate offset of losses.

52 The Facts: In *Bosal*, a Netherlands parent company sought to deduct interest costs incurred on loans to acquire participations in various subsidiaries located in other Member States but was denied the deduction on the basis that profits received from those subsidiaries were not taxable in the Netherlands, whereas in a purely domestic situation a deduction would have been allowed. Although the ECJ held that the Netherland rule constituted a restriction on Bosal's freedom of establishment, the Netherlands argued that since profits received by those subsidiaries from Dutch corporation were exempt under the DTCs the rule was justified in order to preserve the coherence of its tax system. However the ECJ did not agree, holding that the rule could not be justified on that ground, since there was no direct link between the costs of the parent and the profits of the subsidiaries. *Bosal Holding BV v. Staatssecretaris van Financiën [2003] ECR I-9409* (C-168/01) *("Bosal").*

sheets. Therefore, the losses should properly be taken into account in the origin state and the principle of symmetry argued in ***Lidl Belgium*** was not relevant.

From applying the methodology to these cases, it can be seen that the ECJ's case law is consistent and that it generally exercises restraint in its judgments. However in ***AMID***, the ECJ has been accused of being judicially active by disregarding Belgium's right to allocate taxing rights under its DTC.[53]

2.2 Corporate Groups

As stated earlier, there is no 'natural' consolidation between a subsidiary and its parent. Therefore the ECJ will only find a restriction in a cross-border situation where the parent company's state provides some form of loss relief in purely domestic situations.

There are several different types of loss relief system in operation throughout the EIM, of which the three main ones are, consolidation systems[54] where companies integrate their results and the group parent pays tax on their behalf, group relief systems,[55] where companies may transfer losses to one another, and profit transfer systems,[56] where profits may be transferred to other members of the group.

Whilst the operation of these loss relief systems is fairly straightforward within Member States' own jurisdictions, the position becomes more complicated once a cross-border element is introduced. In order to protect their own tax bases, Member States' loss relief rules generally do not treat a parent's overseas subsidiaries in the same way as its domestic ones. This approach is consistent with Member States' power to decide the criteria for determining their tax jurisdiction: i.e. if a company is not within a states' tax jurisdiction, Member States should not be obliged to provide relief for losses. Although the ECJ is prepared to respect this approach in most circumstances, and whilst it is acceptable from an international law perspective, is not always acceptable from a EU perspective where loss relief is granted domestically.

53 The fact that Belgium chose to apply the exemption method under the DTC with Luxembourg which lead to a worse result for AMID when exercising its freedom of establishment cross-border, should not, in accordance with previous case law, be contrary to EU law. See *Gilly*.

54 *Papillon* [2008] ECR I-0000 (C-418/07) *("Papillon")* and *X Holding.*

55 *M&S.*

56 See *OY AA* [2007] ECR 00000 (C-231/05) *("Oy AA").*

2.2.1 *Bosal*

The ECJ had to resolve these issues in ***Bosal***, which dealt with costs incurred by a Dutch parent company in respect of its overseas subsidiaries. The ECJ held that the Dutch rules which denied the deduction of participation costs in respect of overseas subsidiaries, were not capable of being justified under EU law.[57]

In relation to tax sovereignty, this decision has been criticised by commentators who state that since the interest costs had an economic connection to profits, which the Netherlands had no jurisdiction to tax, the costs should be borne by the non-resident subsidiaries.[58] Furthermore, they argue that by negating the concept of territoriality, the ECJ was creating rights where none exist. However in the author's view, there was no direct link between the interest expense on the loan taken out by the parent to fund the share acquisition and the profits generated by the subsidiaries in the form of dividends. Therefore as in ***Deutsche Shell***, the principle of territoriality was not relevant in this case, and the ECJ's decision was correct.[59]

2.2.2 *M&S*

However, the principle of territoriality *was* relevant in ***M&S***.[60] The ECJ held that the UK group relief system, which denied deduction of losses made in foreign subsidiaries from the UK parent's profits in circumstances where profits from the subsidiaries would have been exempt, although a restriction on the UK parent's freedom of establishment was justified on three grounds 'taken together': the need to preserve the balanced allocation of taxing rights, the need to guard against losses being used twice and the need to guard against tax avoidance. However, the UK rules went beyond what was necessary to achieve the objective pursued, and therefore the UK should provide group relief in final loss situations i.e. where the 'no possibilities' test is met. This decision indicated that territoriality, and thus, Member States' tax sovereignty, although a key consideration in its decision making process, was not decisive.

---

57 In *Test Claimants in Class IV of the ACT Group Litigation v. Commissioners of Inland Revenue* (C-374/04) paras.62-64, AG Geelhoed criticises the ECJ's decision in *Bosal* stating that the "judgement did not, in my view, accord sufficient recognition to the Member States' division of tax jurisdiction."

58 See Malcolm Gammie Q.C., '*The Role of the European Court of Justice in the Development of Direct Taxation in the European Union*' Bulletin, March 2003 at note 37.

59 See also *Keller Holding* [2006] ECR I-2107 (C-471/04) for a similar ECJ response to the financing of a non-resident subsidiary.

60 For the facts in *M&S*, see note 31.

In relation to consistency, many commentators have pointed out that the justification of 'balance the allocation of taxing rights' was new, and therefore that the ECJ was being judicially active. Why had the ECJ not used this justification before?

The author suggests that the ECJ may have introduced a new justification for the following reason: it identified the situation of the UK parent company in ***M&S*** as being similar to that of the Belgian head office in ***AMID*** i.e. both cases involved secondary establishments, which had incurred unrelieved final losses. However unlike ***AMID***, the UK in ***M&S*** was not only sovereign to choose its tax rate but it also to choose its tax *base* as well and therefore chose not to include the foreign subsidiaries within its taxing jurisdiction. As a consequence the ECJ, whilst deciding that the outcome of the cases should be the same, chose to differentiate the cases in its reasoning. Therefore the ECJ took a more cautious approach in its ***M&S*** judgment, holding that whilst the UK rules were justified, they were nevertheless disproportionate, rather than merely *unjustified* as it did in ***AMID***. This difference in approach demonstrates that the ECJ's infringement of sovereignty in ***M&S*** was more fundamental, than in the earlier case.

2.2.3 *Oy AA*

The subsequent Finnish case of ***OY AA,*** concerned the Finnish profit transfer system, where a Finnish subsidiary, was denied a deduction under Finnish law, for a transfer of profits to its parent in the UK. Although the ECJ found the Finnish rules constituted a restriction on the UK company's freedom of establishment, the restriction was justified on two[61] of the grounds given in ***M&S*** i.e. the need to preserve the balanced allocation of taxing rights and to guard against tax avoidance. However, the Court found the Finnish rules were proportionate to the objectives pursued.

The ECJ was clearly exercising restraint by upholding the Finnish rules. However, in relation to consistency, given that the end result of the Finnish rules if taken in isolation, i.e. the transfer of profits to a loss-making parent, was identical to that of the group relief rules in ***M&S***, commentators have questioned why the Court did not hold that the Finnish rules would be disproportionate where the losses in the UK were terminal losses. Of course, the Court may not have set out its position in relation to a "terminal loss" situation because on the facts, it did not need to decide the issue. On the other hand, it has been suggested that there is a policy reason for not allowing the cross-border transfer of profits to the UK parent as opposed to losses: under the UK group relief rules, there is a natural limit to the amount of losses which may be transferred i.e. up to the amount of profits in the parent, whereas under the Finnish rules, there is no such limit, which could mean abuse if the parent were situated in a low tax jurisdiction. Finally, it should be noted that this was a *host* state case, thus the ECJ was looking at the effect of the *Finnish* rules,

---

[61] Since the deductibility of losses was not relevant in the case of the Finnish rules. See para.57.

which dealt with the transfer of *profits* rather than UK rules, where the losses were situated.

2.2.4 *Papillon*

The more recent case of ***Papillon*** concerned the French integration regime, and whether a French sub-subsidiary, which was held by a Dutch intermediary could form an integration group[62] with its ultimate French parent company. The French rules rejected the French parent company, Papillon's entitlement to the scheme on the basis that the intermediary Dutch company was not subject to corporation tax in France. This meant that Papillon was unable to offset its profits against the results of other companies in its group and it ended up paying more tax as a result.

In its judgment, the ECJ held that the principles established in ***M&S*** and ***OY AA*** were not relevant[63] since those cases concerned the cross-border offset of losses against profits in different Member States, whilst Papillon was concerned with the offset of French losses against French profits. Nevertheless it held that although the French rules constituted a restriction, the restriction was justified in order to preserve the coherence of the French tax system[64] so that losses were not used twice. However in relation to proportionality, the French measures 'went beyond what is necessary in order to attain the objective pursued' since less restrictive measures existed in order to ascertain whether losses had already been taken into account in the other Member State.

Although the ECJ found for the taxpayer in ***Papillon***, its judgment is nevertheless consistent with its earlier decision in ***ICI***,[65] where it held that a UK company, ICI, should not be denied relief in respect of trading losses incurred by UK subsidiary which was beneficially owned by ICI through a consortium, on the basis that the

62 Under the French reintegration regime, the parent company may elect to consolidate its accounts with its 95% subsidiaries (amongst other conditions), so it is taxed as a single taxpayer.

63 In fact, Tom O'Shea noted in his lunchtime seminar on 24 November 2009 at the Institute of Advanced Legal Studies that *M&S* was highly relevant since the UK parent company in that case held its EU subsidiaries through a Dutch Holding company, and that this did not affect the ECJ's decision. As a result, the Court's Papillon decision could be predicted.

64 'Coherence of the tax system' was a justification used in *Bachmann*, a case which concerned the a German national employed in Belgium paying contributions to his insurance policy in Germany was refused a deduction for contributions paid in Germany for income tax purposes. Although the ECJ held that the Belgian rules constituted a restriction as they were likely to deter Belgian nationals taking out policies with non Belgian insurers, the restriction was justified, according to the public interest requirement of 'cohesion of the tax system', since in the Belgian rules there was a link between the deductibility of contributions and the liability to tax of sums payable by insurers.

65 See *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-04695 (C-264/96) ("*ICI*").

consortium structure included companies which were resident in other Member States.

2.2.5 *X Holding*

Finally, in its most recent decision in its line of cases concerning loss relief, the ECJ exercised restraint in ***X Holding***, where it held that a Netherlands rule, which prohibited a Netherlands parent company including its Belgian subsidiary in a fiscal unity, although restrictive, was justified in view of the need to safeguard the allocation of the power to impose taxes. As in ***Oy AA***, the issue of final losses, which was specifically dealt with in ***M&S*** was not discussed, nor, as in ***Lidl Belgium***, was the possibility that less restrictive rules may be available e.g. loss recapture in future years.

3. Conclusion

By applying the methodology to the case law in this area, it has been demonstrated that the ECJ has applied a consistent approach in its judgements concerning loss relief: in summary, losses do not need to be relieved cross-border unless domestic rules provide relief and the 'no possibilities' test is met. However, it is also apparent that the ECJ's judgments are constantly developing both in their reasoning i.e. use of justifications, and in the areas in which the ECJ is prepared to rule against Member States.

However, in relation to tax sovereignty, the picture is less straightforward. Although the ECJ exercises restraint in several cases including ***Lidl Belgium, Oy AA, Krankenheim*** and ***X Holding***, by upholding Member States' ability to allocate taxing rights and maintain symmetry in their tax systems, the ECJ has also infringed Member States' tax sovereignty (i) in ***AMID***, by disregarding Belgium's right to define its tax *rate* under a DTC (i.e. zero) and (ii) in ***M&S***, by disregarding the UK's right to define its tax *base* by overriding the 'principle of territoriality.'

Therefore, although the ECJ's two state approach in ***AMID*** and ***M&S*** i.e. looking at the taxpayer's position in both origin and source states and its requirement that the taxpayer's origin state provide relief, is not new[66] and was clearly made in pursuance of the objectives of the EIM, strong arguments may be put forward that the ECJ was being judicially active in these judgments, on the basis that it created taxing rights where none had previously existed.

---

66 In its '*Schumacker*' and '*De Groot*' case law, the ECJ held that a taxpayer's personal and family circumstances should be taken into account somewhere 'irrespective of how Member States allocated that obligation amongst themselves' (para.55, *De Groot*), in circumstances in which a cross-border situation suffered a higher tax burden than a domestic one.

However, at this point in the analysis, the limits of the methodology discussed at the beginning of this paper become apparent: since the ECJ is itself the final arbiter of how far Treaty rights infringe on national sovereignty, any external view that the ECJ is making law rather than merely protecting *existing* Treaty rights, can never be definitive – a perfect example of the *self-referential* nature of sovereignty.[67]

67 Although it is accepted that the EU is not sovereign in the same way as nation states, its exclusive competence to interpret the Treaty has imbued it with sovereign qualities.