AN EXAMINATION OF THE LIKELY ECJ RESPONSE TO CROSS-BORDER LOSS RELIEF UNDER GERMAN TAX LEGISLATION*

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A. Introduction

'The limited availability of cross-border loss relief is one of the most significant obstacles to cross-border business activity and an effective internal market[2]'.[3]

This major obstacle to cross-border activities by companies was already perceived by the European Commission in the early 1990s which attempted to tackle this impediment for the first time by proposing a Directive concerning cross-border loss

* Before articles have been accepted for publication in EC Tax Journal's peer-reviewed section, they have been subject to double-blind peer-review; that is, two academic reviewers who shall remain anonymous to the author and to each other and neither of whom are from the same country as the author have evaluated the article's academic merit. Only articles confirmed by the reviewers to show the highest standards of scholarship are accepted for publication in this section.

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2 Art. 26(2) of the Treaty on the Functioning of the European Union (hereinafter 'TFEU') defines the 'internal market' as 'an area without internal frontiers'.

3 European Commission, 'Tax Treatment of Losses in Cross-Border Situations' (Communication) COM(2006) 824 final.

relief.[4] This proposal, nevertheless, was withdrawn by the Commission in 2001. Henceforward the Commission focused on a more comprehensive system of companies' taxation, namely the establishment of a Common Consolidated Corporate Tax Base (hereinafter 'CCCTB'). However, from the establishment of this policy[5] to the actual proposal for a Directive[6] it took almost ten years and it is far from clear whether the Directive will be enacted due to the unanimity requirement under Art. 115 TFEU.[7] This development illustrates how difficult it is to establish an internal market 'without internal frontiers' with regard to companies' taxation since Member States continue to restrict cross-border loss relief to national cases in order to protect their revenue and avoid base erosion in a tax year.[8] This holds particularly true for the German government and tax administration which have always been reluctant to apply certain rules concerning company taxation cross-border under the impact of EU law. It is, therefore, highly arguable that the German Consolidated Group regime

Organschaft would not withstand an investigation under EU law, especially the substantial case-law established by the Court of Justice (hereinafter 'Court' or 'ECJ'). The overarching aim, therefore, is to analyse the compatibility of the German system with EU law. Although this issue is widely discussed in the German literature, a common viewpoint cannot be established.

This paper first analyses the jurisprudence of the Court with respect to the issue of cross-border loss relief in an EU environment. It considers the various national group of companies regimes which came under the scrutiny of the Court and examines to what extent the principles set out in those cases may be applied as guidelines by the various Member States and, in particular, Germany.

The second part commences with an investigation of the main characteristics and requirements of the provisions regarding the *Organschaft* and consequently pursues to analyse the compatibility of the *Organschaft* with EU law and the principles est-

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4 European Commission, 'Proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States' COM(1990) 595 final.

5 European Commission, 'Towards an Internal Market without tax obstacles. A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities' (Communication) COM(2001) 582 final.

6 European Commission, 'Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)' COM(2011) 121.

7 Due to the fact that the proposal of the Directive has not yet been agreed by the European Council a discussion is refrained in this paper. An analysis would furthermore be out of scope of this work. Since the application of the CCCTB would be optional it is expected that the Member States will maintain their tax legislation regarding groups of companies.

8 Adrianto D Nugroho, 'Treatment of Losses in an EU Corporate Tax Group: Ending a Series of Unfortunate Events' (2009) 1 EC Tax Rev 29.

-ablished by the ECJ.[9] Recent developments within the German administrative practice and judicature are emphasised in particular.

The third part of this paper examines certain proposals as to how the *Organschaft* might be made compatible with EU law and provides some suggestions.
Thereby, a particular focus has been put on cross-border loss relief in respect of multinational groups although reference to the treatment of foreign permanent establishments (hereinafter 'PE') is made where appropriate since certain aspects are essential in order to provide an in-depth analysis of the topic.

B. Guidance Given by the Court

As an instrumental starting point of a comprehensive examination of the German *Organschaft* it is appropriate to analyse the case-law established by the Court in detail at first.

The groundbreaking case of *Marks & Spencer*[10] can be seen as the actual commencement of the development of a comprehensive jurisprudence regarding the treatment of losses or profits in a cross-border situation although prior decisions had already been delivered about this issue, such as *Futura*[11], *ICI*[12] and *Bosal*[13].

However, it needs to be analysed whether the ECJ provided in its case-law satisfactory guidance for taxpayers in order to structure their cross-border business activities, and tax administrations and governments in order to satisfy sufficient taxation of those cross-border activities. In this instance, three remarkable decisions *Oy AA*[14], *Papillon*[15] and *X Holding*[16] with regard to the development of cross-border loss

9 However, an in-depth analysis of all issues in applying the ECJ jurisprudence at the national level is not conducted in the course of this paper, but may give reason for further research.

10 Case 446/03 *Marks & Spencer* [2005] ECR I-10837.

11 Case 250/95 *Futura* [1997] ECR I-2471, which concerned the refusal by the Luxembourg tax authority to allow a set-off of losses by the French head office against profits of its Luxembourg branch.

12 Case 264/96 *ICI* [1998] ECR I-4695, where UK group relief was only granted when the holdings company's business consists wholly or mainly in the holding of shares in UK subsidiaries.

13 Case 168/01 *Bosal* [2003] ECR I-9409, where under Dutch law the deduction of financing costs was only permitted when the costs were indirectly instrumental in making profits which are taxable in the Netherlands.

14 Case 231/05 *Oy AA* [2007] ECR I-6373.

15 Case 418/07 *Papillon* [2008] ECR I-8947.

16 Case 337/08 *X Holding* [2010] ECR I-0000 (not yet reported).

treatment are examined in more detail, although cross-references to certain other decisions are provided in order to present a substantial analysis of the ECJ jurisprudence.

This paper focuses on the relevant issues with respect to cross-border loss treatment rather than investigating each of the judgements in full detail.

a. *Marks & Spencer* – 'One of the most Significant Corporate Tax Cases'[17]?

Marks & Spencer plc (hereinafter 'M&S') is a company incorporated and registered in the UK acting as the principal trading and holding company for a number of UK and overseas companies. In order to become recognised as an international retailer for clothing, food, homeware and financial services M&S established certain subsidiaries in, inter alia, Continental Europe, such as in France, Belgium and Germany. However, from the mid-1990s there was a trend towards an increase in losses incurred by the overseas establishments. As a result, in 2001 M&S decided to divest itself from the Continental European market and subsequently sold the French subsidiary whereas the Belgian and German companies ceased trading.

Due to the losses incurred by the subsidiaries in the accounting periods between 1998 and 2001, M&S applied for tax relief pursuant to the group relief regime at the material time. The claims for loss relief, however, were rejected by the tax authority on the ground that such relief was only available for losses recorded in the UK.
The question asked of the ECJ was whether the UK legislation complied with the freedom of establishment under Art. 49 and 54 TFEU (Art. 43 and 48 EC), and hence whether the UK had to grant relief for those cross-border losses since it grants such relief domestically, although the UK did not have a right to tax profits of the overseas subsidiaries.

aa. Restriction of a Fundamental Freedom / Comparability

First of all the Court ascertained whether the UK legislation leads to a restriction on the freedom of establishment. In para 32 the Court explained that the possibility of an immediate loss-offsetting provided under the UK group relief regime constitutes a tax advantage. However, according to the rules at issue this advantage was only available domestically, that is when both companies are resident of the UK. Hence, the ECJ had to investigate if this difference in treatment, though, violated the 'national treatment principle' under which, according to the holding in *Schumacker*[18],

17 Former Deputy Head of Tax of M&S, Philip Martin, 'The *Marks & Spencer* EU group relief case – a rebuttal of the 'taxing jurisdiction' argument' (2005) 2 EC Tax Rev 61.

18 Case 279/93 *Schumacker* [1995] ECR I-225.

the Member States are obliged to treat a comparable[19] cross-border situation no 'less favourably' than a domestic situation.[20]

A major issue of the case, which was widely discussed by certain academics[21], was the matter of comparability. For instance, in the case at hand, the Special Commissioners expressly rejected the comparison of a UK subsidiary with a non-resident subsidiary, but made the comparison between a UK company setting up subsidiary and a UK company setting up a branch in another Member State.[22] This so-called 'horizontal approach' is also advocated by Lang.[23] Advocate General (hereinafter 'AG') Maduro, however, rejected this approach and reasoned that it must be compared a domestic with a cross-border situation rather than two cross-border situations.[24] This approach was also applied in the final judgement and recently in *X Holding*.[25] Consenting O'Shea, who refers to this analytical tool as the 'migrant/non-migrant test'.[26]

bb. Justification – 'Taken Together'

At first, to justify the restriction the UK put forward the principle of territoriality as accepted as a valid general interest in *Futura*.[27] Despite the fact that the Court made clear in para 40 of *Marks & Spencer* that this justification ground does not 'in itself' justify a restriction of group relief to domestic situations merely on the basis that the Member State of the parent company does not tax the profits of the non-resident

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19 It is settled case-law that in order to find a restriction the cross-border situation has to be comparable to the domestic situation: see with further references Daniela Hohenwarter in Lang M/Schuch J/Staringer C (eds), *Tax Treaty Law and EC Law* (Kluwer Law International 2007) 99.

20 See for a comprehensive discussion of the national treatment principle Tom O'Shea, 'National Treatment' (2009) Issue 965 Tax Journal 22, who is particularly referring to para 94 of Case 385/00 *De Groot* [2002] ECR I-11819, where it was made clear that the national treatment principle applies from both the host and origin perspectives.

21 See eg Micheal Lang, 'Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions' (2009) 3 EC Tax Rev 98; Tom O'Shea, '*Marks and Spencer v Halsey (HM Inspector of Taxes)*: restriction, justification and proportionality' (2006) 2 EC Tax Rev 66.

22 Special Commissioners' Decision in *Marks & Spencer v Halsey (Inspector of Taxes)* [2003] STC 70, 85/88.

23 Lang (n 21) 113.

24 *Marks & Spencer* (n 10), Opinion of AG Maduro, para 50.

25 *Marks & Spencer* (n 10) paras 36/37; *X Holding*(n 16) para 23.

26 O'Shea, '*Marks & Spencer*' (n 21) 82. See for an in-depth analysis of this issue Tom O'Shea, 'European Tax Controversies – Quis Custodiet Ipsos Custodes?' (2011-12) 1 EC Tax Journal 39.

27 *Futura* (n 11) para 22.

subsidiary (so-called 'symmetry thesis' or 'two-sides-of-the-same-coin argument')[28], the scope is far from entirely clear and needs further analysis.

According to para 69 of *Rewe Zentralfinanz* the purpose of the principle of territoriality is to establish the need to take into account the limits in the Member States' power of taxation.[29] Therefore, the principle of territoriality as a justification ground is enshrined in international tax practice and describes the restriction of a tax jurisdiction to sources within its territory that is source based taxation as opposed to residence taxation on a worldwide basis.[30] AG Maduro pointed out in his opinion to *Marks & Spencer* that the principle of fiscal territoriality prevents conflicting tax jurisdictions between the Member States.[31]

In *Futura*, the State where the branch was established, acting in the capacity of a source State, had only limited taxing rights regarding the profits attributable to the branch, but had no right to tax income of the non-resident enterprise derived abroad, which otherwise would conflict with the unlimited right to tax of the State of residence of the enterprise.[32]

On the other hand, from the perspective of the Member State where the parent company was established, acting in the capacity of a residence State as in *Marks & Spencer* and *Rewe Zentralfinanz,* the question was whether this State must grant relief to its own resident company subject to unlimited taxation. Hence, those cases were not concerned with conflicting tax jurisdiction.[33]

In conclusion, the principle of fiscal territoriality is by its very nature not a valid justification ground for a restriction on the freedom of establishment in case the Member State is acting in its capacity as the State of residence of the company rather than may only be applied when the Member State is acting in the capacity as the source State.

In addition to that, the UK government mentioned three further grounds in order to justify the restriction, namely the preservation of the balanced allocation of taxing

28 As argued by the UK: *Marks & Spencer* (n 10), Opinion of AG Maduro, para 58.

29 Case 347/04 *Rewe Zentralfinanz* [2007] ECR I-2647, concerning the deduction of losses incurred in respect of write-downs in book value of shareholdings in subsidiaries which, in a cross-border environment, where limited to certain activities, whereas such write-downs were always possible domestically.

30 See Axel Cordewener (and others), 'The Tax Treatment of Foreign Losses: *Ritter, M & S*, and the Way Ahead (Part Two)' (2004) 5 ET 218, 220; *Marks & Spencer* (n 10) para 39; *Rewe Zentralfinanz* (n 29) para 69.

31 *Marks & Spencer* (n 10), Opinion of AG Maduro, paras 61-62.

32 Ibid.

33 Ibid para 63.

rights[34], the prevention of the danger that losses may be used twice ('double-dipping') and the prevention of tax avoidance ('loss-trafficking').[35]

First, the Court elucidated a justification based on the preservation of a balance in the allocation of taxing rights.

In para 45 the ECJ explained that this ground might make it necessary that a Member State applies 'to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses'. Furthermore, the Court elaborated in para 46 that giving companies the option to choose in which State losses may be taken into account would:

> significantly jeopardise a balanced allocation of the power to impose taxes between the Member States, as the taxable basis would be increased in the first State and reduced in the second to the extent of the losses transferred.

The remarkable point of this reasoning is that the ECJ upheld the symmetry thesis from a balanced allocation of taxing rights viewpoint although expressly rejected it in para 40 from a fiscal territoriality perspective. First of all, as explained above, fiscal territoriality may only be invoked as a justification by Member States acting in the capacity of a source State. Moreover, more important, the Court pointed out that the mere fact that Member States have allocated their taxing rights based on source and residence taxation does not 'in itself'[36] justify a restriction. By linking para 40 to paras 45/46 it becomes clear that the symmetry thesis constitutes a valid argument in case the allocated taxing rights might be 'jeopardised'.[37]

Second, the ECJ determined that the danger of double-dipping actually exists in case of cross-border loss relief and accepted that justification ground without further investigation.[38]

Third, the Court went on to examine whether the last justification ground, the risk of tax avoidance, may be accepted and stated that in a cross-border loss situation there

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34 For an interesting investigation of the origin of this justification in the health services and social security field see Tom O'Shea, *EU Tax Law and Double Tax Conventions* (Avoir Fiscal Limited 2008) 135 et seq.

35 *Marks & Spencer* (n 10) para 43: see in this regard Case 336/96 *Gilly* [1998] ECR I-2793, para 30; Case 513/03 *Van Hilten* [2006] ECR I-1957, para 47, clarifying that in absence of unifying or harmonising rules Member States have the power to allocate their jurisdiction to tax, either bilaterally or unilaterally.

36 *Marks & Spencer* (n 10) para 40.

37 See O'Shea, 'European Tax Controversies' (n 26) 91.

38 *Marks & Spencer* (n 10) paras 47-48.

is the risk that a company transfers the losses to the Member State with a higher tax rate in order to gain the highest value of those losses with regard to taxation.[39]

In its conclusion the ECJ determined that the 'three justifications, taken together,' pursue legitimate objectives compatible with EU law and suitable to ensure the attainment of those objectives according to the '*Gebhard*-formula'.[40]

cc. Proportionality – 'No-Possibilities Test'

The decisive factor in *Marks & Spencer* was the question of proportionality. In paras 55 and 56 the ECJ provided significant guidance to determine whether a national rule which grants the benefit of loss relief only domestically may be compatible with EU law. The Court established a test, which is generally referred to as the 'no-possibilities test' by scholars.[41] Under this test a national rule restricting loss-relief to domestic situations must be regarded as proportional as long as it is granted in case the foreign subsidiary has exhausted all possibilities to offset losses available in its State of establishment, namely by carrying back or forward the losses or by transferring the losses to a third party, in particular where the subsidiary has been sold to the third party[42] ('final' loss situation).[43]

It is also interesting to mention that in para 57 the Court clearly accepted the prevention of tax avoidance as a stand-alone justification if the national rules have the specific purpose of targeting wholly artificial arrangements.[44]

Since national group regimes operated within the EU, as a general rule, are not pure anti-avoidance rules 'specifically' targeted at 'wholly artificial arrangements' rather than a comprehensive system of group taxation with various aims, this justification ground is of no value in a cross-border loss-offsetting discussion.

In a nutshell, the important points determined by the Court in *Marks & Spencer* are that under certain circumstances restrictive measures may be compatible with EU

39 Ibid para 49.

40 Ibid para 51: Case 55/94 *Gebhard* [1995] ECR I-4165, para 37, according to which a restrictive measure may be justified if it applies in a non-discriminatory manner, is justified by imperative reasons in the general interest, suitable for securing the attainment of the objective which it pursues, and does not go beyond what is necessary in order to attain it.

41 See the UK Upper Tribunal in *Revenue and Customs Commissioners v Marks & Spencer plc.* [2010] BTC 1559, 1571; Tom O'Shea, 'Tribunal Finds in Favour of Marks & Spencer' [2009] Tax Notes International 739.

42 Which was the case with the French subsidiary of M&S.

43 However, with respect to the difficulties regarding the interpretation of the no-possibilities test at the national level merely compare the litigation of *Marks & Spencer* following the Court's judgement and the discussion concerning the *Organschaft* in this paper.

44 This notion of tax avoidance was firstly referred to in *ICI* (n 12) para 26.

law under the premise that they are aimed at preserving the balanced allocation of taxing rights, preventing double-dipping and tax avoidance, taken together, and that the no-possibilities test is fulfilled.

b. *Oy AA* – Developing 'Taken Together'

AA Ltd, a company incorporated under UK law, indirectly holds through two other companies 100% of the shares of Oy AA. AA Ltd was making losses and since its business was also important for Oy AA the latter applied for an intra-group financial transfer[45] in favour of AA Ltd in order to secure its financial position. Under Finnish law such a financial transfer is treated as a tax-deductible expense for the contributing company. The application by Oy AA, nevertheless, was precluded on the ground that the corresponding income at the parent level must be taxable in Finland.

In the *Oy AA* judgement the ECJ basically reiterated and confirmed its reasoning in *Marks & Spencer*. However, notably *Oy AA* led to an important clarification in the development of the meaning of para 51 of *Marks & Spencer*. Though the fact that all 'three' justifications must be 'taken together' was acknowledged in *Rewe Zentralfinanz*[46], in *Oy AA* the Court elaborated that 'the combination of two factors', namely the preservation of a balanced allocation of taxing rights and the prevention of tax avoidance, 'pursues legitimate objectives compatible with the Treaty'.[47]

Noteworthy, this rationale was confirmed in *Lidl Belgium* with regard to the preservation of the balanced allocation of taxing rights and double-dipping, taken together.[48, 49]

c. *Papillon* – 'Double-Dipping': Coherence v Allocation

Papillon, a company incorporated in France, held 100% of the capital in a Dutch company, which in turn held 99.9% in a French company.

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45 According to Yoshihiro Masui, 'Group Taxation' (2004) 89b IFA Cahiers 21, 29, a similar 'group contribution' regime is established in Finland, Sweden and Norway.

46 *Rewe Zentralfinanz* (n 29) para 41; interestingly, with hindsight to the outcome of *Oy AA* it may be argued that the decision in *Rewe Zentralfinanz* would be decided differently as it was established that the balanced allocation of taxing rights is at danger but the German government failed to show that the national rule is specifically targeted at wholly artificial arrangements in order to tackle tax avoidance, which, under the *Marks & Spencer* rationale as developed in *Oy AA*, is not necessary.

47 *Oy AA* (n 14) paras 60/63.

48 Case 414/06 *Lidl Belgium* [2008] ECR I-3601, where the deduction of losses of a foreign PE were prohibited since under the relevant double tax convention (DTC) income of PEs was exempted, para 42.

49 See for a detailed analysis of the 'allocation of taxing rights, *taken together*' doctrine point B.d.aa. below in this paper.

French tax legislation provided for the possibility for a group of companies to elect for a 'tax integration' regime with the result of offsetting of losses and neutrality of intra-group transfers. The French tax authority, however, refused the request by Papillon to consolidate with its French sub-subsidiary since, because of the Dutch intermediate subsidiary, it did not meet the condition that every group member is subject to corporation tax in France.

Noteworthy with regard to the *Papillon* judgement is the point that the Court first ascertained the case under the *Marks & Spencer* doctrine as developed by *Oy AA* and came to the conclusion that the balance in the allocation of taxing rights and tax avoidance are not at stake since the question at issue concerned the consolidation of a resident parent company with its resident sub-subsidiary, that is a pure domestic situation.[50]

However, the ECJ went on and applied the *Bachmann*[51] justification of preserving the coherence of the tax system[52]. The most important point with regard to this justification is that the Court referred in para 46 and 51 to the 'use of losses twice' as the conduct which undermines the coherence of the tax system. In effect, that means that double-dipping may be a stand-alone justification based on the coherence of the tax system general interest ground[53], as long as it does not violate the national treatment principle which is ensured when double-dipping is also prevented domestically.[54]

Although at first stance this reasoning appears to be unequivocal an in-depth analysis, nevertheless, generates a certain degree of ambiguity. This becomes clear by scrutinising the opinion of AG Kokott. According to that, the German and Netherlands governments submitted that possible justifications may be the preservation of the allocation of taxing rights and additionally the prevention of double-dipping and tax avoidance. However, Kokott rejected these arguments since the case at issue concerned the consolidation between two French companies and therefore a pure domestic situation.[55] This reasoning was apparently applied in paras 38 and 39 of the judgement.

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50 *Papillon* (n 15) paras 38/39.

51 Case 204/90 *Bachmann* [1992] ECR I-249.

52 Significantly, post-*Bachmann* this justification ground was first accepted again by the Court in Case 157/07 *Krankenheim* [2008] ECR I-8061 16 years later – here Germany operated a loss-offsetting regime with subsequent recapture in case the foreign branch generates a profit.

53 Also Stefan Kolbe in Herrmann/Heuer/Raupach, *Einkommensteuer und Körperschaftssteuer. Kommentar* (loose-leaf, Verlag Dr. Otto Schmidt 2006) § 14 KStG K 23 refers to coherence of a tax system which may be jeopardised by double-dipping.

54 Nevertheless, it can be concluded that due to the harmonisation at the EU level with regard to exchange of information by Council Directive 77/799/EEC such a justification must be regarded as disproportional, *Papillon* (n 15) para 55.

55 *Papillon* (n 15), Opinion of AG Kokott, para 46.

Conversely, the further analysis of justification by AG Kokott and subsequently by the Court is somewhat a mystery. Although expressly rejected, 'the use of losses more than once' has later on been accepted as a justification ground in accordance with the preservation of the coherence of the tax system.[56] It needs to be questioned how this reasoning may be reconciled. The uncertainty has already begun with *Marks & Spencer* where AG Maduro in his opinion based the examination of justification particularly on the coherence of the tax system by expressly referring to double-dipping in para 72.[57] Although applying the double-dipping rationale the Court, nevertheless, did not at all refer to the coherence of the tax system.[58]

The answer for this reasoning, however, is that in a cross-border group environment the double-dipping justification ground can be examined from two different perspectives, namely taken together with the balanced allocation of taxing rights and the coherence of the tax system. Hence, as a preliminary question the relationship between both justification grounds must be ascertained. By comparing the jurisprudence of the ECJ in respect of these justifications it becomes clear that the coherence of the tax system applies from a one-country perspective[59] whereas the balance in the allocation of taxing rights requires, by its nature, a two-country examination[60].[61] Vanistendael, however, argues that the Court in *Manninen*[62], and subsequently in *FII GLO*[63], followed AG Kokott by applying the coherence justification cross-border.[64]

This opinion must be rejected. In the aforementioned cases, the Court, in fact, has not extended the coherence justification cross-border rather than clarified that a Member State cannot claim the preservation of the coherence of a national tax system if it would also be coherent to apply the provisions at issue cross-border. Thereby, the argument by the Member State that there is a specific direct link do-

56 *Papillon* (n 15), para 46/50; *Papillon* (n 15), Opinion of AG Kokott, para 60.

57 *Marks & Spencer* (n 10), Opinion of AG Maduro.

58 The CFE argues that the Court did deliberately not mention 'coherence' since the judges could not agree on the meaning of this justification ground: CFE, 'Opinion Statement of the CFE Task Force on ECJ Cases on the Judgement in the Case of *Marks & Spencer plc v. Halsey* (Case C-446/03) – Judgement Delivered 13 December 2005' (2007) 1 ET 51, 51/52.

59 Cf *Bachmann* (n 51), *Krankenheim* (n 52); *Papillon* (n 15).

60 *See Marks & Spencer* (n 10), *Oy AA* (n 14); *Lidl Belgium* (n 48).

61 See also Axel Cordewener, Georg Kofler and Servaas van Thiel, 'The Clash between European Freedoms and National Direct Tax Law: Public Interest Defences Available to the Member States' [2009] CML Rev 1951, 1974, rejecting the position taken by Lang that both justifications are 'exchangeable' (n 21) 109.

62 Case 319/02 *Manninen* [2004] ECR I-7477, para 46.

63 Case 446/04 *FII GLO* [2006] ECR I-11753, para 93.

64 Frans Vanistendael, 'Cohesion: the phoenix rises from his ashes' (2005) 4 EC Tax Rev 208, 220.

-mestically has been rejected by the ECJ.[65] The cases where the Court determined that there is a direct link, moreover, entirely concern a one-country perspective rather than the application of the coherence justification cross-border, which leads to the conclusion that the Court has not followed the reasoning of AG Kokott in *Manninen* which was subsequently applied by AG Maduro in *Marks & Spencer*.[66, 67]

In conclusion, with regard to *Papillon* it is decisive to understand that the scope of the double-dipping justification depends on whether a one-country or a two-country examination is required. That is, in a one-country situation the preservation of the coherence of the tax system justification may be triggered, whereas from a two-country perspective double-dipping may be a justification, 'taken together', with the preservation of the allocation of taxing rights.[68]

d. *X Holding* – Departure from *Marks & Spencer*?

The last step in the development of the ECJ jurisprudence highlights the *X Holding* decision which was heavily criticised in the academic world.

X Holding concerns the correspondent company, established in the Netherlands, which is the sole shareholder of a Belgian company. In order to benefit from the Dutch 'fiscal unity' regime[69] X Holding applied for recognition of consolidation with its Belgian subsidiary. This request was rejected by the Dutch tax authority on the ground that under the Netherlands corporation tax law it is required that participating companies are established in the Netherlands.

aa. Allocation of Taxing Rights as a Stand-Alone Justification?

With respect to the prior mentioned cases[70] the most important issue which arose in *X Holding* was that the Court merely referred to the preservation of the allocation of

65 In this instance also Tom O'Shea in 'Dividend Taxation Post-*Manninen*: Shifting Sands or Solid Foundations?' [2007] Tax Notes International 887, 895, who made clear that the ECJ did not find a direct link.

66 See *Bosal* (n 13) para 30, which was recently confirmed in Case 287/10 *Tankreederei* [2010] ECR I-0000 (not yet reported), para 26.

67 Therefore, the critique by the CFE is unfounded since *Marks & Spencer* concerns a two-country situation.

68 As opposed to *Marks & Spencer* where losses were located cross-border, losses concerned in *Papillon* would have been located domestically.

69 According to Hugh J Ault and Brain J Arnold, *Comparative Income Taxation: A Structural Analysis* (2nd edn, Kluwer Law International 2004) 323, the Netherlands operates a complex system of consolidation under which all assets/liabilities and profits/losses are deemed to be those of the parent company.

70 *Marks & Spencer* (n 10); *Oy AA* (n 14).

the power to impose taxes which at first sight appears to be a clear departure from the *Marks & Spencer* rationale, as argued by certain scholars.[71]

Therefore, a comprehensive analysis of this outcome and reconciliation with the abovementioned decisions is essential.

O'Shea considered that the Court, by stating that the 'acceptance of the possibility of including a non-resident subsidiary in such an entity would have the consequence of allowing the parent to choose freely the Member State in which the losses of the subsidiary are to be taken into account'[72], implicitly refers to the thread of loss-trafficking, that is tax avoidance according to *Marks & Spencer*.[73] However, although in substance clearly right as will be seen in the further analysis, this interpretation has to be investigated more closely. By examining para 32 of *X Holding* in more detail, it is apparent that the Court referred to paras 56 of *Oy AA* and 34 of *Lidl Belgium*[74].

First of all, it must be made clear that in *Lidl Belgium* tax avoidance (loss-trafficking) was not at stake and the Court examined that the German rules were justified on the grounds of preservation of the balanced allocation of taxing rights and double-dipping[75], taken together.

Moreover, on the one hand, systematically paras 56 of *Oy AA* and 34 of *Lidl Belgium* only refer to the preservation of a balanced allocation of taxing rights, as the second justification ground is mentioned in paras 57 and 35. On the other hand, the possibility 'to choose freely' in which Member State losses are to be taken into account is effectively the definition of preservation of the allocation of taxing rights given by the Court in *Marks & Spencer* in para 46 ('*option* to have their losses taken into account in the Member State in which they are established or in another'[76]).
However, a comparison of the definitions of the preservation of the allocation of taxing rights and loss-trafficking shows that there is no material difference, which is evident from *Marks & Spencer*.

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71 CFE, 'Opinion Statement of the CFE on *X Holding* (C-337/08)' (2011) 4 ET 150, 151; Vanessa E Englmair in Lang M and others (eds), *Introduction to European Tax Law: Direct Taxation* (2nd edn, Spiramus 2010) 71/72.

72 *X Holding* (n 16) para 32.

73 Tom O'Shea, 'Dutch Fiscal Unity Rules Receive Thumbs up From ECJ' [2010] Tax Notes International 837-838.

74 *Lidl Belgium* (n 48).

75 Which, therefore, cannot be regarded as 'tax avoidance'. See *Lidl Belgium* (n 48), Opinion of AG Sharpston, para 15.

76 Emphasis added.

> [T]o give companies the *right to elect* to have their losses taken into account in the Member State in which they are established or in another Member State would *seriously jeopardise a balanced allocation* of the power to impose taxes between the Member States.[77]
>
> (preservation of the allocation of taxing rights)
>
> [I]t must be accepted that the *possibility of transferring the losses* incurred by a non-resident company to a resident company *entails the risk* that within a group of companies losses will be transferred to companies established in the Member States which apply the highest rates of taxation and in which the tax value of the losses is therefore the highest.[78]
>
> (prevention of tax avoidance)

The decisive point in order to reconcile both definitions is perfectly clear from para 53 of *Oy AA* where it has been stated that there need to be some 'conduct' which jeopardises the balance in the allocation of taxing rights.[79] Moreover, in para 62 the ECJ clarified that both objectives are 'linked'.

Therefore, the conduct necessary to jeopardise the balanced allocation of taxing rights must be seen in the transfer of losses in order to gain the most favourable tax treatment with regard to those losses.[80] The same is true with respect to double-dipping since taking losses into account in both Members States jeopardises the allocated taxing rights in this regard that losses are also taken into account in the

Member State of the profit-making parent company, which leads to the result that some profits would not be taxed at all.[81, 82]

bb. Proportionality – Arguable?

Notwithstanding the clarification provided in the above discussion some further issues with regard to the proportionality question have to be addressed.

77 *Marks & Spencer* (n 10), para 46 (emphasis added).

78 Ibid para 49 (emphasis added).

79 See O'Shea, 'Dutch Fiscal Unity Rules Receive Thumbs up From ECJ' (n 73) 837.

80 This important point has been occasionally missed by the literature criticising the judgement. For instance, Servaas van Thiel and Marius Vascega, '*X Holding*: Why Ulysses Should Stop Listening to the Siren' (2010) 8 ET 334, 338.

81 See *Oy AA* (n 14), Opinion of AG Kokott, para 56, referring to the principle of 'once-only taxation' which is fundamental to the international allocation of taxing rights.

82 This reasoning has also been accepted by Tom O'Shea in his recent article 'Tax Avoidance and Abuse of EU Law' (2010-11) 11 EC Tax Journal 77, 105.

First, harshly criticised in the literature is the fact that the Court dismissed the argument by X Holding and the Commission that it would be less restrictive to apply a temporary loss-offsetting regime with a recapture rule by treating foreign subsidiaries as foreign PEs.[83] Those voices object that the Court allegedly rebutted this argument by shifting the discrimination analysis into the proportionality examination for a second time. This opinion, however, cannot be endorsed. By referring to the issue of non-comparability of foreign PEs and foreign subsidiaries the Court merely reiterated its well-established case-law that from an EU law perspective it must be compared a domestic and a cross-border situation rather than two cross-border situations.[84] Therefore, it cannot be claimed that such a treatment would be less restrictive since it is outside the scope of EU law. It must be stressed in this regard that those voices lose sight of the fact that the Court does not have the competence to impose this requirement to amend legislation of a particular Member State as long as the legislation is compatible with EU law.[85] According to Art. 19(3)(b) of the Treaty on European Union (hereinafter 'TEU') the ECJ has only the competence to interpret EU law with regard to legislation as referred to it. As a consequence, as long as the Court ascertains that a national provision is compatible with EU law competence remains with the national legislature.[86]

Also a major issue which must be considered as unclear is the question of whether the Court did overrule the no-possibilities test as established in *Marks & Spencer*.

Mitschke for instance concluded that the fact that the ECJ remained silent on this issue implicates a renunciation from this doctrine.[87] This position, however, must also be rejected. O'Shea and Weber argue that the Court's conduct may be explained by the fact that there was no final loss situation but on the other hand in case of final losses the Dutch regime must be regarded as disproportionate according to *Marks & Spencer*.[88] Weber also pointed out that although the Dutch regime provides for a

83 *X Holding* (n 16) paras 35 et seq. See CFE, 'Opinion on *X Holding*' (n 71) 151/152; Dennis Weber, 'X Holding. Refusal of advantage of a cross-border tax consolidation a justified restriction of the freedom of establishment. Court of Justice (comments by Weber)' (2010) 7 Highlights & Insights on European Taxation 60, 68/69.

84 With regard to this issue see the discussion above B.a.aa.

85 Similarly, Markus Eisenbarth and Ulrich Hufeld, 'Die grenzüberschreitende Verlustverrechnung in der Konsolidierungsphase. Das Verfahren „X Holding" und die Grenzen der negativen Integration' [2010] IStR 309, 311.

86 See *Schumacker* (n 18) para 21.

87 Wolfgang Mitschke, 'Keine grenzüberschreitende Organschaft zum europarechtlichen „Nulltarif"! Erwiderung auf den Beitrag von Klaus Brocke in DStR 2010, 964 ff.' [2010] DStR 1368, 1669/1370.

88 O'Shea, 'Dutch Fiscal Unity Rules Receive Thumbs up From ECJ' (n 73) 838; Weber (n 83) 71.

cross-border relief of liquidation losses this rule is too limited in scope as there are other situations conceivable where losses may become final.[89]

e. Conclusion

Although it must be concluded that the Court was relatively consistent in its case-law with regard to cross-border loss relief the discussion has shown that the principles established cannot entirely be applied as general guidance by taxpayers, tax administrations and governments.[90]

The reason for this rather unsatisfactory result might be that the Court in the cases at hand dealt with specific sets of facts and specific national regimes which vary substantially within the EU. However, from a legal certainty perspective it is desirable that the Court and especially the AGs in their opinions follow a coherent line of arguments and explanation.

In this instance it is noteworthy that the UK Upper Tribunal referred the *Philips Electronics* case to the Court expressly asking whether the allocation of taxing rights and the prevention of double-dipping may each be regarded as stand-alone justifications or whether they must be 'taken together'.[91] It is highly desirable that the ECJ takes a clear stand in this case and brings the discussion about cross-border loss relief to an end.

C. Compatibility of the German legislation with EU law

After a detailed analysis of the guidance given by the Court in its cross-border group relief cases the underlying question is whether the German regime can be regarded as compatible with EU law.

a. The *Organschaft*

As a preliminary remark, however, it is decisive to provide for an understanding of the German group regime *Organschaft*. Thereby, the analysis is focusing on those elements which may have an impact on the compatibility with EU law.

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89 Weber (n 83) 71. According to Otto Marres in Brokelind C (ed), *Towards a Homogeneous EC Direct Tax Law* (IBFD 2007) 111 it has been announced by the Dutch State Secretary of Finance that with this rule the no-possibilities test is satisfied.

90 Axel Cordewener, 'Cross-Border Loss Relief and the "Effet Utile" of EU Law: Are We Losing It?' (2011) 2 EC Tax Rev 58, 61, claiming legal certainty to be given by the Court.

91 Case 18/11 *Philips Electronics* [2011] OJ C 89 19.03.2011, p 11 (pending).

The concept of *Organschaft* for corporate tax law purposes, whose origin is a complex and highly developed case-law based system of de facto consolidation,[92] provides for the possibility for corporate members controlled by a common parent to establish a consolidated group, under which the profits and losses of the members are attributed to the parent.[93] Neumann, furthermore, stressed that a major advantage is that in an associated group not only profits/losses of subsidiaries or sub-subsidiaries may be attributed to the parent but also profits/losses of 'sister-companies' may be consolidated through the common parent.[94] According to Masui the members are deemed to be inner 'organs' of the parent, which means they are treated as if they 'become the hands and feet of a living creature'.[95]

However, it is noteworthy that the concept of *Organschaft* does not create an independent taxpayer meaning profits or losses are calculated on a separate basis and subsequently transferred to the common parent which includes that amount in its income calculations.[96] Furthermore, intercompany transactions generate income which is taken into account immediately.[97]

According to s 14(1) of the Law on Corporation Tax (*Körperschaftssteuergesetz*; hereinafter 'KStG') the common parent (*Organträger*; hereinafter '*Organschaft* parent' or 'parent') may consolidate for tax purposes with its subsidiaries (*Organgesellschaft*; hereinafter '*Organschaft* subsidiary' or 'subsidiary'). Certain requirements must be fulfilled in order to gain the benefits of consolidation.

First of all, according to s 14(1) the *Organschaft* subsidiary must be a corporate entity with corporate seat and place of management in Germany ('dual domestic link requirement'). Unlike the parent the *Organschaft* subsidiary, furthermore, must not be commercially active, as according to s 8(2) KStG a corporate entity is *qua* legal status commercially active regardless of the activity which is actually exercised.

Significantly, contrasting to the *Organschaft* subsidiary the *Organschaft* parent does not need to have a specific legal form. Under s 14(1)(No 2) KStG it is merely required that the parent is subject to unlimited tax liability, which means that even natural persons or partnerships may be an *Organschaft* parent.

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92 Ault/Arnold (n 69) 323.

93 Masui (n 45) 29.

94 Steffen Neumann in Gosch D, *Körperschaftssteuergeset: Kommentar* (2nd edn, Beck Juristischer Verlag 2009) 1146.

95 Masui (n 45) 29.

96 Ault/Arnold (n 69) 323.

97 Ibid 324.

A foreign parent may, moreover, consolidate with a national subsidiary under the conditions set out in s 18 KStG under which the foreign parent must operate in Germany through a registered branch which holds the required voting rights in the national subsidiary which has the effect that profits of the subsidiary attributable to the branch through its holding are subject to (limited) tax liability in Germany.

According to s 14(1)(No 2) a dual domestic link is not required for the parent in case that s 18 KStG does not apply. It must only have its place of management in Germany; however, on the other hand it is not possible to act as an *Organschaft* parent in case that only the seat is in Germany.[98]

In addition, the parent must be commercially active in accordance to s 2 of the German Trade Tax Law ('*Gewerbesteuergesetz*').

In accordance with s 14(1)(No 1) the parent must control, directly or indirectly, the majority of the voting rights in the *Organschaft* subsidiary.[99] Furthermore, Sädtler is clarifying that an intermediate subsidiary does not need to be an *Organschaft* subsidiary and hence not a corporate entity as required under s 14(1) KStG, even a foreign subsidiary is possible.[100] This reasoning may be supported by *Papillon* where this question was the subject-matter before the Court.[101]

The minimum holding requirement must be established without interruption from the beginning to the end of the relevant financial year.

Finally, the German Consolidated Group concept requires that a profit and loss pooling agreement in accordance with ss 291 and 302 of the German Stock Companies Act (*Aktiengesetz*, hereinafter 'AktG') has been concluded between the *Organschaft* parent and the *Organschaft* subsidiary which generally must be actually enforced for the minimum duration of five years. For corporate entities other than those expressly referred to in s 14(1) KStG s 17 KStG mandates the application of the provisions of the AktG by analogy.[102] Thereby, the profit and loss pooling agreement must be a valid contract under civil law, hence legal capacity of the parties is a decisive factor.[103]

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98 Wolfgang Sädtler in Dötsch E and others (eds), *Körperschaftssteuer* (15th edn, Schäffer-Poeschel 2009) 297.

99 However, the method of calculation with respect to a sufficient indirect holding is disputed within German legal literature and administrative practice.

100 Sädtler (n 98) 302.

101 *Papillon* (n 15).

102 This applies with regard to the *GmbH*.

103 Neumann (n 94) 1194.

Subject of the profit and loss pooling agreement is that the subsidiary is obliged to transfer all its profits to the parent, whereas the parent is legally responsible for all the losses the subsidiary incurs. The conclusion of the profit and loss pooling agreement effects that the activities of the subsidiary are exercised on the account of the parent.[104]

In case of s 18 KStG the agreement has to be concluded between the subsidiary and the foreign parent since a branch has no legal capacity and, hence, is not able to conclude contracts under civil law.[105]

b. EU-Compatibility?

The conditions set out in s 14(1) KStG have now to be explored under EU law principles.

aa. Which Freedom Applies

As a preliminary question it needs to be ascertained which freedom applies. According to Annex I to Directive 88/361, which pursuant to para 21 of *Trummer and Mayer* has still indicative value for the purposes of defining the notion of capital movements[106], setting-up a subsidiary may also come under the scope of Art. 63(1) TFEU.

However, since s 14(1)(No 1) defines that the parent must hold the majority of the voting rights in the subsidiary in order to qualify for an *Organschaft* and, hence, in accordance to the *Baars*-doctrine[107], there is the requirement of a minimum shareholding which 'gives [the shareholder] definite influence over the company's decisions and allows him to determine its activities', it must be concluded that the freedom of establishment (Art. 49 TFEU) is solely applicable.[108]

bb. Restriction of a Fundamental Freedom / Comparability

The second point which needs to be considered is the question whether the German legislation leads to a restriction on the freedom of establishment.

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104 Sädtler (n 98) 304.

105 Neumann (n 94) 1192.

106 Case 222/97 *Trummer and Mayer* [1999] ECR I-1661.

107 Case 251/98 *Baars* [2000] ECR I-2787, para 22.

108 If the legislation at issue is intended to apply to the freedom of establishment, which is the case with a minimum-shareholding requirement, restrictive effects on another freedom are an 'unavoidable consequence of any restriction on freedom of establishment', Case 196/04 *Cadbury Schweppes* [2006] ECR I-7995, para 33 (see, to that effect, Case 157/05 *Holböck* [2007] ECR I-4051, para 23).

The notion of restriction as defined by the Court in *Gebhard* covers all national measures which are 'liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty'.[109]

However, while analysing s 14(1) KStG from an EU perspective it is important to note that there have been two important decisions by lower finance courts in Germany.

In this regard particular emphasis is put on the decision by the Lower Saxony court[110] as it decided for the first time post *Marks & Spencer* a case with regard to the *Organschaft* and because the Rhineland-Palatinate court[111] basically applied the reasoning as established by the Lower Saxony court.

Because of the significance of the first mentioned decision it should be subjected to a detailed analysis.

The claimant was a German holding company which, inter alia, held loss-making subsidiaries in Italy. Its request to offset the losses against taxable profits of the German parent according to s 14 KStG was refused by the tax authority due to the fact that the requirements of an *Organschaft* were not fulfilled.

Importantly, the court first came to the conclusion that the reasoning of *Marks & Spencer* is applicable to the *Organschaft*.[112]

Since the decision by the Lower Saxony finance court was appealed to the German Federal Finance Court (*Bundesfinanzhof*, hereinafter 'BFH'), it was expected that the issue of EU-compatibility will finally be decided by the supreme finance court. However, it issued an unsatisfactory judgement by merely referring to a prior decision with regard to the issue of finality of losses (as further elucidated below).[113] Therefore, the compatibility of the *Organschaft* with EU law is still an open question and needs to be examined.

What can be derived from s 14(1) KStG is that the effects of the *Organschaft* are limited to purely domestic situations, which implicates a difference in treatment between a cross-border and a pure domestic situation. Thus, the main criteria for qualifying for an *Organschaft* have to be analysed separately.

109 *Gebhard* (n 40) para 37.

110 FG Niedersachsen 11.2.2010 – 6 K 406/08, IStR 2010, 260.

111 FG Rheinland-Pfalz 17.3.2010 – 1 K 2406/07, DStRE 2010, 802.

112 It is noteworthy that the German government in 2007 opined that the *Marks & Spencer* reasoning is not applicable to the *Organschaft*, see: BT-Drucks 16/4281 question 10.

113 BFH 9.11.2010 – I R 16/10, IStR 2011, 111.

(a) *Organschaft* Subsidiary: Seat And Place of Management in Germany

It is required that the *Organschaft* subsidiary provides for a dual domestic link to Germany (seat and place of management) which has the result that EU subsidiaries are excluded from the scope of this provision.

The Lower Saxony court came to the conclusion that the dual domestic link requirement infringes EU law and must be disregarded as to EU subsidiaries without the seat and place of management are covered by s 14(1) KStG.

In this regard the German Ministry of Finance (*Bundesministerium der Finanzen*; hereinafter 'BMF') announced in a March 28, 2011 letter that a corporation incorporated in another EU/EEA State with its place of management in Germany can attribute its profits/losses from domestic taxable earnings to an *Organschaft* parent.[114] The reason for this development is an infringement procedure under Art. 258 TFEU initiated by the European Commission, stating that the dual domestic link requirement set out in ss 14 and 17 KStG does not comply with the freedom of establishment under Art. 49 TFEU.[115] According to the BMF letter and Sädtler[116] this requirement is incompatible with the jurisprudence of the Court in *Centros*[117], *Überseering*[118] and *Inspire Art*[119] regarding the seat theory. Under s 14 KStG as it stands at the material time a company set up in accordance with the company law of another Member State with its place of management in Germany, and thus subject to unlimited tax liability in Germany, may not function as a group company within an *Organschaft*.[120] In support of this conclusion it can be argued that the German legislature has shown in 2001 that the dual domestic link requirement is dispensable by eliminating it with respect to the *Organschaft* parent.[121] Pache/Englert stressed that it cannot be justified that the dual domestic link requirement is maintained with regard to the *Organschaft* subsidiary, but was abolished with regard to the *Organschaft*

114 BMF 28.3.2011 – IV C 2 - S 2770/09/10001.

115 European Commission, 'Direct taxes: The European Commission formally requests Germany to end discrimination relating to the treatment of group companies (Organgesellschaften) formed in other EU/EEA states but having its place of effective management in Germany.' Reference Number 2008/4909. However, noteworthy is that the issue of cross-border loss relief is expressly not dealt with in this procedure.

116 Sädtler (n 98) 300.

117 Case 212/97 *Centros* [1999] ECR I-1459.

118 Case 208/00 *Überseering* [2002] ECR I-9919.

119 Case 167/01 *Inspire Art* [2003] ECR I-10155.

120 Neumann (n 94) 1151.

121 BGBl I 2001, 3864.

parent which in the end is taxable concerning the consolidated profits/losses.[122] A contrary view is expressed by Mitschke, who merely referred to the fact that the Dutch rules in *X Holding* also limit consolidation to pure domestic situations.[123] This argument, however, cannot be accepted. There is a major difference between the Dutch and the German legislation. In *X Holding* the Dutch legislation solely requires that the participating companies are resident in the Netherlands. In contrast, regarding the *Organschaft*, the condition of having the place of management in Germany ensures the taxing right of Germany in the same way as the residence requirement under Dutch law in *X Holding*. Since the place of management under domestic law has about the same scope than the 'place of effective management' according to Art. 4(3) OECD Model, and the German DTCs based thereon, it is furthermore ensured that Germany retains its right to tax subsidiaries with their seat in another Member State in case this Member State also considers them as residents.[124] Therefore, based on the fact that the Court in *X Holding* upheld the Dutch residence requirement, it can by no means be concluded that also the dual domestic link requirement is compatible with EU law. Nevertheless, the law has not been formally amended but is waived by the BMF letter.

(b) *Organschaft* Parent: Place of Management in Germany

On the other hand s 14(1)(No 2) KStG sets out the condition that the *Organschaft* parent must have its place of management in Germany. Even though according to s 18 KStG the parent may also be a foreign business, the parent must still operate through a branch in Germany.[125] Pache/Englert, therefore, are right in pointing out that the effect of s 18 KStG is still that the *Organschaft* ends at the German border since it only exists to the extent that profits attributable to the registered branch are taxable in Germany.[126]

(c) Profit and loss pooling agreement

Furthermore, an issue that has been extensively discussed by scholars is the question whether the condition of the profit and loss pooling agreement also leads to a

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122 Sven Pache and Max Englert, 'Die Rechtssache X Holding BV – das endgültige Ende der Hoffnung auf ein vom EuGH postuliertes europäisches Gruppenbesteuerungssystem' [2010] IStR 448, 450; furthermore, Stefan Homburg, 'Die unheimliche Nummer Sechs – Eine Entscheidung zum Ausgleich grenzüberschreitender Konzernverluste' [2010] IStR 246, 248.

123 Wolfgang Mitschke, 'Ergebnisabführungsvertrag „über die Grenze" und Abzug finaler Verluste ausländischer Tochtergesellschaften – Zugleich eine Erwiderung auf die Anmerkung von Homburg zu BFH-Urteil I R 16/10 (IStR 2011, 111)' [2011] IStR 185, 188.

124 Neumann (n 94) 1166.

125 Cf Sven Pache and Max Englert, 'Grenzüberschreitende Verlustverrechnung deutscher Konzerspitzen – Ist die Organschaft noch zu retten?' [2007] IStR 47, 49

126 Pache/Englert, 'Die Rechtssache X Holding BV' (n 122) 450.

restriction. Consequently, there are two differing views which must be analysed in more detail.

First of all, it has been argued that due to the general absence of the possibility to conclude a profit and loss pooling agreement in a cross-border situation there is no comparability to a domestic situation.[127] The Rhineland-Palatinate finance court advocated a comparison between a domestic and a cross-border situation where in both cases a profit and loss pooling agreement has not been concluded and deduced that in both cases loss compensation was not available.[128] This position, however, must be dismissed from the outset since otherwise it would open the possibility for Member States to enact restrictive measures by arguing non-comparability through the inclusion of requirements which cannot be met in other Member States. The overarching aim of an Internal Market (Art. 3(3) TEU and Art. 26 TFEU) would be called into question. The exact comparability, therefore, must be established between a domestic situation where an *Organschaft* is available and a cross-border situation where it is impeded.[129]

Mitschke has argued strongly that the requirement of a profit and loss pooling agreement is 'neutral' in nature since it does not establish any relationship to Germany in particular.[130] He opined that a territorial tie must be allowed as long as it does not differentiate in a discriminatory manner and points to the feature of national sovereignty which, in his view, is expressly stipulated in Art. 114(2) TFEU.[131]

On the other side of the spectrum, however, it has been argued that the profit and loss pooling agreement leads to a restriction.[132] This reasoning is based on the fact that, although s 14(1) KStG applies irrespective of any relationship to Germany, generally in an EU environment the conclusion of a profit and loss pooling agreement in accordance to ss 291 et seq AktG is not possible.[133] Homburg referred to Austria, Portugal and Slovenia where it might be possible to conclude such an

127 Gerrit Frotscher in Frotscher/Maas, *Kommentar zum Körperschaft-, Gewerbe- und Umwandlungssteuergesetz* (loose-leaf, Haufe 2009) § 14 20; Mitschke, 'Keine grenzüberschreitende Organschaft zum europarechtlichen „Nulltarif"!' (n 87) 1368.

128 FG Rheinland-Pfalz (n 111).

129 That is a pure application of the 'migrant/non-migrant test' (or national treatment test) as established by O'Shea, n 26.

130 Mitschke, 'Ergebnisabführungsvertrag „über die Grenzen" ' (n 123) 186.

131 Ibid.

132 Homburg, 'Die unheimliche Nummer Sechs' (n 122) 247; Marc Scheunemann, 'Praktische Anforderungen einer grenzüberschreitenden Verlustberücksichtigung im Konzern in Inbound- und Outboundfällen nach der Entscheidung Marks & Spencer' [2006] IStR 145, 147.

133 Kolbe (n 53) K 21.

agreement cross-border.[134] Pache/Englert put forward that the impossibility of the conclusion must be located in the other State since the law of that State leads to that situation.[135] However, they reject this argument by stating that the restrictive effect is caused, at least indirectly, by the German provision which requires a profit and loss pooling agreement. Therefore, according to this view it can be concluded that in most of the cases the requirement of a profit and loss pooling agreement restricts the possibility of a cross-border *Organschaft* from the outset.[136]

In this instance it is important to state that this reasoning applies from a foreign subsidiary as well as from a parent perspective, which has its seat in another Member State but place of management in Germany.

Neumann mentioned a further interesting point from an EU law perspective, that is to say the question whether a parent company incorporated under German law with its place of management in Germany transferring subsequently its seat to another EU Member State loses its legal capacity.[137] As Germany traditionally applies the seat theory in order to determine legal capacity, the transfer of the seat without reincorporation may result in the loss of legal capacity of the parent in accordance with the jurisprudence of the ECJ in *Daily Mail*[138] and recently confirmed in *Cartesio*[139]. Thus, the parent might not be able to be a partner of a profit and loss pooling agreement due to the fact that the conclusion might not be feasible in the other Member State.[140]

The question about the profit and loss pooling agreement was also the most remarkable point in the decision by the Lower Saxony court. First of all, it was suggested that this requirement might be indirect discriminatory and thus is infringing EU law as well, but the court decided to leave this point open since it was not relevant to the case. In a comprehensive examination of this issue the court concluded that the requirement of a profit and loss pooling agreement cannot be disregarded as a whole.[141] Notwithstanding the fact that such an agreement generally

134 Homburg, 'Die unheimliche Numer Sechs' (n 122) 247.

135 Pache/Englert, 'Die Rechtssache X Holding BV' (n 122) 451.

136 Ibid. See also: Gunter Mayr, 'Moderne Konzernbesteuerung im Lichte der EuGH-Rechtsprechung' [2008] BB 1312, 1315; Pache/Englert 'Grenzüberschreitende Verlustverrechnung deutscher Konzernspitzen' (n 125) 49; Scheunemann (n 132) 146/147.

137 Neumann (n 94) 1193.

138 Case 81/87 *Daily Mail* [1988] ECR 5483.

139 Case 210/06 *Cartesio* [2008] ECR I-9641.

140 On the other hand, the loss of legal capacity in case of emigration to Germany is incompatible with the freedom of establishment in accordance with *Überseering* (n 118).

141 Contrasting view: Scheunemann (n 132) 146, 147, who opines that also the requirement of a profit and loss pooling agreement should be disregarded.

cannot be concluded in a cross-border situation the finance court held that the *Organschaft* parent has to commit itself to absorb the losses of the foreign *Organschaft* subsidiary in a legally binding manner. Following ss 291 et seq AktG the court required an agreement for the duration of five years concluded prior the application of the '*Organschaft'* across the border. According to the court, this reasoning is justified on the ground that in a pure domestic situation s 302(1) AktG requires the mandatory absorption of losses and concluded that this requirement is an essential condition for the extension of the *Organschaft* cross-border. The court thereby applied the interpretative tool of reducing an incompatible provision to the extent that it does not further infringe EU law ('*geltungserhaltende Reduktion*'). In this instance, the court referred to the jurisprudence of the BFH in accordance to which, even though not expressed in the legislation at issue, a condition may be applied in order to comply with EU law. To support its reasoning the court mentioned, inter alia, two decisions issued by the BFH which were referred back by the ECJ in order to apply the ECJ decision on the relevant facts of the cases. On the one hand, in *Scorpio*[142] the ECJ held that business expenses must be deductible in case they are 'directly linked' to the economic activity and the BFH read this criterion into the German legislation at issue although it could not be found in the German legislation.[143] On the other hand, with regard to the German controlled foreign company regime the BFH transferred the requirement of the possibility to provide counterproof given to the taxpayer from *Cadbury Schweppes*[144] into the legislation at issue and applied this in the appeal concerning the *Columbus Container* case at the domestic level.[145]

However, this reasoning was considerably criticised by von Brocke in his response to this decision by arguing that with this condition the court merely replaced one discriminatory condition with another.[146]

Clarifying Homburg, who pointed out that in a pure domestic situation the subsidiary is obliged to transfer all its profits to the parent according to s 291(1) AktG, whereas the parent is only obliged to compensate for losses of the subsidiary in case there is a loss situation, s 302 AktG. On the other hand, in a cross-border setting, under the condition of a binding agreement providing for mandatory loss absorption as required by the Lower Saxony court, the parent would have to compensate the subsidiary for its losses but would not be entitled for a transfer of profits which, in

142 Case 290/04 *Scorpio* [2006] ECR I-9461.

143 BFH 24.4.2007 – I R 39/04, IStR 2007, 822.

144 *Cadbury* (n 108), para70.

145 BFH 21.10.2009 – I R 114/08, IStR 2010, 149.

146 Klaus von Brocke, 'Abzug definitiver Verluste deutscher Tochtergesellschaften im Rahmen der körperschaftssteuerlichen Organschaft? Zwei FG-Entscheidungen zur Anwendung der Grundsätze des EuGH in der Rs. Marks & Spencer' [2010] DStR 964, 966.

effect, would put the parent operating cross-border in a disadvantageous situation as compared to the domestic *Organschaft*.[147]

Von Brocke, therefore, concluded that the decision of the Lower Saxony court implies an interpretation '*contra legem*'.[148]

(d) *Metallgesellschaft*: Principle of Effectiveness

A further interesting side issue stressed by both scholars[149] concerns the problem that the Lower Saxony court dismissed the claim on the ground that no binding agreement providing for mandatory loss absorption was concluded. This point clearly infringes EU law on its own since it would lead to a breach of the principle of effectiveness under Art. 4(3) TEU. In paras 103 et seq of the *Metallgesellschaft* case, the Court concluded that a taxpayer cannot be 'blamed' for the fact that he complied with the national legislation at issue.[150] In other words, regarding the case at hand, that the taxpayer did not conclude such a mandatory agreement although the tax authority obviously would have refused a request to extent the *Organschaft* across the border on the ground of not meeting the conditions set out in s 14(1) KStG.[151]

(e) Conclusion

Due to the fact that the tax advantage of immediate recognition of losses is restricted to domestic situations, s 14(1) KStG leads to a restriction on the freedom of establishment, Art. 49 TFEU, in accordance to all three requirements as analysed.

cc. Justification

Finally, it must be determined whether the restriction on the freedom of establishment may be justified according to the *Gebhard*-formula.[152]

With regard to a possible justification it may be referred to the guidance given by the ECJ in its decisions with respect to cross-border loss relief, as elucidated above. Therefore, potential justification grounds which have to be analysed may be (a) preservation of the coherence of the national tax system, (b) and preservation of the

147 Homburg, 'Die unheimliche Nummer Sechs' (n 122) 251, who especially stressed that the formal requirements of such an agreement are not clear which leads to legal uncertainty.

148 Brocke (n 146) 967.

149 Brocke (n 146) 967; Homburg, 'Die unheimliche Nummer Sechs' (n 122) 251.

150 Joined cases 397/98 and 410/98 *Metallgesellschaft* [2001] ECR I-1727.

151 See Brocke (n 146) 967; Homburg, 'Die unheimliche Nummer Sechs' (n 122) 251.

152 See n 40.

balanced allocation of taxing rights, taken together with double-dipping and/or tax avoidance as established in *Marks & Spencer* and applied in *X Holding*.

(a) Coherence of the Tax System

Coherence of the German tax system, however, can be excluded as a possible justification from the outset.

First, as explained above, the coherence justification applies from a one-country perspective. With respect to subsidiaries having their seat and place of management in another Member State a two-country situation is concerned.
Second, under the specific circumstances that the parent and/or the subsidiary have their seat in another Member State but their place of management in Germany the coherence argument might be applied since, in fact, a 'domestic'[153] situation is concerned.[154] By applying *Papillon* by analogy it must, nevertheless, be concluded that due to Directive 77/799/EC such a justification must be regarded as disproportional.[155]

(b) Allocation of Taxing Rights

With regard the second justification ground it is permissible to scrutinise the three conditions set out in s 14(1) KStG on their own, where required.

In para 67 of the *Lasteyrie du Saillant* judgement, however, the Court made very clear that the justification must be examined in the light of the '*aim* pursued by the tax system'.[156]

At first, by considering the BMF letter from 28 March and the decision by the Lower Saxony court, the requirement of place of management in Germany with regard to the parent and the subsidiary have in common that they limit the *Organschaft* to a certain extent to 'domestic' situations and hence pursue the objective of the preservation of the balance in the allocation of taxing rights regarding separate legal entities established in different Member States. As a result, following the analyses in *Marks & Spencer* and *X Holding* tax-planning opportunities which allow the benefit of a double-dip or the transfer of losses are prevented from the outset. It must therefore be concluded that those requirements are suitable to attain their objective.

153 This specific setting is continuously referred to as a 'domestic' situation in this paper although establishing the seat in another Member State entails a cross-border element.

154 Cf n 68.

155 See n 54.

156 Case 9/02 *Lasteyrie du Saillant* [2004] ECR I-2409 (emphasis added).

With respect to the profit and loss pooling agreement under s 14(1)(No 3) the analysis becomes more complex. A clear line of arguments cannot be derived from the literature and the jurisprudence.

For instance, Mitschke strongly opines in favour of the Lower Saxony court by stressing that in no circumstances the *Organschaft* is for 'free'.[157] He is claiming that a 'living' *Organschaft* must include its core element, the binding obligation of loss consumption by the parent.[158] There is a broad consensus between the German literature and jurisprudence that the profit and loss pooling agreement is a constitutive element of the concept of *Organschaft* from a domestic point of view since it justifies the renunciation from the ability-to-pay principle and the principle that separate taxpayers are to be taxed separately.[159] Despite the fact that this argument may be perfectly valid from a German, especially a constitutional, perspective, however, from an EU viewpoint it cannot be accepted. Already in 1964 in its landmark decision *Costa ENEL* the Court made clear that EU law has supremacy over national law 'however framed'.[160] That means that constitutional concerns cannot be invoked in case a national provision is infringing EU law.[161]

In their 2007 article Pache/Englert concluded without further investigation that the profit and loss pooling agreement as part of the provisions regarding the *Organschaft* may be justified and is also proportional.[162] In their 2010 article, on the contrary, they conclude that this requirement cannot be justified under the allocation of taxing rights rationale by stressing that according to ss 14(1)(No 2) and 1(1) KStG there might be the situation that the *Organschaft* parent has its seat in another Member State, and might therefore be subject to this jurisdiction, but place of management in Germany.[163] Even though the conditions of s 14 KStG have been fulfilled, an *Organschaft* would still be impossible due to the fact that a profit and loss pooling agreement in the Member State of the foreign parent might not be feasible. Homburg even points out that, since the dual domestic link requirement must be disregarded, the same conclusion applies with respect to the *Organschaft* subsidiary.[164] In this instance, Homburg deduced from his analysis that the requirement of a profit

157 Mitschke, 'Keine grenzüberschreitende Organschaft zum europarechtlichen „Nulltarif"!' (n 87) 1371.

158 Ibid.

159 Cf FG Niedersachsen (n 110), Frotscher (n 127) § 14 20; Neumann (n 94) 1188.

160 Case 6/64 *Costa v ENEL* [1964] ECR 585.

161 See Case 11/70 *Internationale Handelsgesellschaft* [1970] ECR 1125, para 3.

162 Pache/Englert, 'Grenzüberschreitende Verlustverrechnung deutscher Konzernspitzen' (n 125) 50.

163 Pache/Englert, 'Die Rechtssache X Holding BV' (n 122) 450.

164 Homburg, 'Die unheimliche Nummer Sechs' (n 122) 248.

and loss pooling agreement cannot be justified by a valid reason and is therefore not only a matter of proportionality as examined by the Lower Saxony court.[165] The views expressed by Pache/Englert and Homburg, however, have to be considered more differentiated. Regarding the situation that the parent and/or the subsidiary have the place of management in Germany it is clearly right that the profit and loss pooling agreement does not pursue the objective of preserving a balanced allocation of taxing rights and must be waived because the danger of double-dipping and loss-trafficking does not exist in case the *Organschaft* members are subject to unlimited taxation in Germany. This argument does not hold true in a cross-border situation where the subsidiary does not have its place of management in Germany. In this respect the profit and loss pooling agreement must be seen as merely a condition aimed at limiting the application of the *Organschaft* to domestic situations as the other two conditions analysed.

(c) No-Possibilities Test

The final issue which must be examined is the question if those conditions do meet the no-possibilities test as developed in *Marks & Spencer*.

The Lower Saxony court disregarded *Marks & Spencer* completely by arguing on the basis of *Marks & Spencer* that in para 59 the Court ruled that under the national treatment principle[166] a Member State is only obliged to grant loss relief cross-border if it grants 'such' ('*solchen*') relief domestically. The issue with this interpretation, however, is that the emphatic reference to 'such' is very vulnerable since it is a specific peculiarity of the German translation of the judgement which cannot be found in the English version, the original language.[167] That means that it cannot be derived from the judgement that the Court only applies the final losses rationale under the same condition as under a comparable domestic situation.

The interpretation of the decision given by the Court in *Marks & Spencer* concerned the German judicature from the outset. The first cases referred to the courts regarded the issue of determining finality in case that it was requested that a German head office may offset losses incurred by its foreign branch against its taxable profits. Since the BFH in its unsatisfactory decision with regard to the extension of the *Organschaft* cross-border simply referred to its reasoning in a branch case[168], the cases in this respect need to be scrutinised because implications for the treatment according to the *Organschaft* may be derived.

165 Ibid.

166 See B.a.aa.

167 Brocke (n 146) 966.

168 BFH I R 16/10 (n 113), referring to FG Hamburg 18.11.2009 – 6 K 147/08, IStR 2010, 109.

The first case was referred to the BFH by the Hamburg finance court [169] and concerned a German company which operated in France through branches.[170] The company intended to offset losses incurred by the branches against its taxable profits since, with reference to *Lidl Belgium*[171], those losses were final as the branches were dissolved.

In its second case, which was adjudicated in first instance by the Düsseldorf finance court [172], the BFH had to decide whether losses incurred by a French branch in 1999 where final since it was dissolved in 2005, although according to French tax law a loss carry-forward was limited to a period of five years.[173]

First of all, in both decisions the BFH referred to the well established symmetry thesis[174] and made clear that, generally, losses of foreign branches may not be offset against profits of the German head office, unless the no-possibilities test as applied in *Lidl Belgium*[175] is satisfied.

However, while comparing both decisions of the lower finance courts two main issues had to be decided by the BFH. First, the court had to rule on the question of whether a legal or a factual approach is decisive in order to determine finality, and secondly, of whether the material time for a possible loss-offsetting is the year in which the branch incurred the loss ('*phasengleiche Verlustberücksichtigung*') or the year in which the loss became final ('*phasenverschobene Verlustberücksichtigung*').

According to the first issue, the BFH in both decisions decided, in accordance with the lower courts, that finality has to be determined on the basis of factual rather than legal circumstances.[176] Therefore, the outcome of both decisions compared is exemplary for this distinction. In case I R 100/09 the BFH came to the conclusion that the losses were not final since the French tax law limited the loss carry-forward to five years. That means that the losses incurred in 1999 were legally final in 2004. As a result, dissolving the branch in 2005 could not be taken into account in order to de

169 FG Hamburg (n 168).

170 BFH 9.6.2010 – I R 107/09, IStR 2010, 663.

171 *Lidl Belgium* (n 48).

172 FG Düsseldorf 8.9.2009 – 6 K 308/04 K, DStRE 2010, 935.

173 BFH 9.6.2010 – I R 100/09, IStR 2010, 670.

174 Which was confirmed from a German perspective in BFH 17.7.2008 – I R 84/04, DStR 2008, 1869.

175 *Lidl Belgium* (n 48)

176 A differing position was taken by the German Ministry of Finance in BMF 13.7.2009 – IV B 5 - S 2118-a/07/10004.

termine finality of the losses. This rationale can be explained by the fact that a Member State is not obliged to:

> [D]raw up its tax rules on the basis of those in another Member State in order to ensure, in all circumstances, taxation which removes *disparities* arising from national tax rules, given that the decisions made by a company as to the establishment of commercial structures abroad may be to the company's advantage or not, according to the circumstances.[177]

The underlying principle of this reasoning can be traced back to various cases concerning disadvantages arising out of 'disparities' between national tax systems. This issue was first addressed in *Gilly* where the Court clarified that in absence of EU legislation these disadvantageous consequences must be accepted.[178] Furthermore, in *Schempp* the ECJ confirmed this reasoning by stating that a cross-border activity may be advantageous or not, according to the circumstances.[179] The BFH stressed that it is part of the allocated taxing right that the Member States are entitled to restrict the taking into account of losses by, for example, setting time limits and that in consequence it cannot be a matter for the State of the home office to compensate for such losses.[180] However, on the other hand there is a difference to cases where losses became final due to factual circumstances rather than on ground of the legislation of the Member State where the branch is established as seen in the decision referred to the BFH by the Hamburg court.[181] Here the losses incurred by the French branches became final because the branches were dissolved. In this instance, the BFH gave some guidance regarding situations which may lead to a (factual) finality of losses which have to be taken into account by the Member State of the head office. Thereby, the court mentioned in addition to dissolving the branch, the transformation of a branch into a corporate entity and the sale of the branch to a third person.

With some concerns about the decisions given by the BFH Wittkowski/Lindscheid who pointed out that under the factual approach it might be possible that losses are not taken into account in either of the Member States, which actually was the case in BFH I R 100/09.[182] This result, in fact, is rather unsatisfactory especially with a view to the tax planning opportunities opened to the taxpayer. Had the German company

177 *Krankenheim* (n 52), para 50 (emphasis added).

178 *Gilly* (n 35) para 47.

179 Case 403/03 *Schempp* [2005] ECR I- 6421, para 45.

180 See BFH I R 100/09 (n 174); BFH I R 107/09 (n 170).

181 BFH I R 107/09 (n 170), referring to para 55 of *Marks & Spencer* (n 10).

182 Ansas Wittkowksi and Friederike Lindscheid, 'BB-Rechsprechungsreport Grenzüberschreitende Verlustverrechnung 2010' [2010] BB 3054, 3056.

dissolved the French branch prior the expiration of the time limit, it would have had the possibility of offsetting the losses according to the factual approach.[183]

Scheunemann, however, stated that under certain circumstances tax authorities may tackle such schemes under the general abuse provision of s 42(1) of the General Tax Code (*Abgabenordnung*, hereinafter 'AO') which is in accordance with para 57 of *Marks & Spencer* confined to wholly artificial arrangements.[184] Nevertheless, applying the *Eurowings*[185] and *Cadbury Schweppes*[186] reasoning, a Member State is not entitled to treat a cross-border situation less favourably than a domestic situation in case the subsidiary is established in a low tax jurisdiction but pursues commercially valid reasons.

The adoption of the factual approach, however, can also be explained by rather pragmatic considerations. Taking into account of losses which become final due to the legal framework in the State of the subsidiary might lead to a 'race to the bottom'. Scheunemann illustrated that the States' practice with regard to, in particular, the provision of loss carry-forward differs substantially within the EU.[187] For instance, in Estonia it is impossible from the outset to take losses into account since Estonia does not tax retained profits of a subsidiary. On the other hand, in Member States where a loss carry-forward is permitted this may be limited to a certain period of time, such as in Italy (5 years), Finland (10 years) or Spain (15 years). Contrasting, in other Member States a restriction with regard to a loss carry-forward is not applied, such as Germany, Luxembourg, the Netherlands, and the United Kingdom. Hence, Member States, in particular with a low corporate tax rate wishing to attract foreign investment, may limit a loss carry-forward which in effect would force the Member State of the parent company to take foreign losses into account earlier.[188] However, Mayr alluded that such a course of action might be problematic in an EU environment since, due to the national treatment principle, the Member State concerned would have to treat domestic companies alike which, as a tightening measure, would be rather unpopular.[189]

183 The BFH in decision I R 107/09 stressed that the factual circumstances are decisive and constitute in the case at hand an 'overtaking causation'.

184 Scheunemann (n 132) 150.

185 Case 294/97 *Eurowings* [1999] ECR I-7447, paras 43/44.

186 *Cadbury Schweppes* (n 108) paras 54/65.

187 Scheunemann (n 132) 148.

188 In this direction also Wolfgang Kessler and Moritz Philip, 'Zur gemeinschaftsrechtlichen Notwendigkeit der inländischen Berücksichtigung „finaler" Verluste aus EU-Betriebsstätten. Anmerkungen zur BFH-Judikatur und deren Folgen' [2010] IStR 865, 866; Ben J M Terra and Peter J Wattel, *European Tax Law* (5th edn, Kluwer Law International 2008) 654.

189 Gunter Mayr, 'Endgültige Verluste im Sinne von Marks & Spencer' [2008] BB 1816, 1818.

Simpson also pointed out that the Court's jurisprudence regarding cross-border loss relief does not provide a clear indication for the restriction of cross-border loss relief under a factual approach.[190]

However, in spite of certain critiques, it can be concluded that the reasoning by the BFH is in line with the ECJ 'disparities jurisprudence' and, therefore, may be upheld.

The second issue regarding the question of the material time for finality caused a lot more discussion in the academic world, the administrative practice and the jurispru--dence. In its decision with regard to *Lidl Belgium* the BFH referred to loss compensation in the year it was incurred.[191] The BMF reacted to this decision and ordered that this reasoning, due to the specific circumstances of the case, cannot be applied to comparable cases.[192]

The ambiguity of this issue can be exemplified by the two judgements given by the Hamburg and the Düsseldorf finance courts which came to completely contrasting results. For instance, the Hamburg court concluded that loss-offsetting must be provided retrospectively for the year in which the loss was incurred.[193] The court based its decision, in particular, on the ability-to-pay principle since economically the head office had to bear the loss in the year it was incurred by the branch.[194]

However, the Düsseldorf finance court ruled that the decision by the BFH[195] cannot be interpreted in a way that a loss-offsetting must be provided in the year of incurring, rather than that such loss-offsetting is only possible if the losses are also final in this year.[196, 197] Notably, in the *Lidl Belgium* case before the BFH it was indeed the case that loss-offsetting was claimed in the year the losses were incurred due to alleged finality. Therefore, it could be argued that hence this decision is of low value as an argument for both sides of view.

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190 David Simpson, 'Is *M&S* Restricted to Terminal Losses?' [2010] Issue 1022 Tax Journal 19, who also refers to the Swedish Supreme Administrative Court which, like the BFH, applied the factual approach.

191 BFH I R 84/04 (n 174).

192 BMF 13.7.2009 (n 176).

193 FG Hamburg (n 168).

194 Ibid.

195 BFH I R 84/04 (n 174).

196 FG Düsseldorf (n 172).

197 This reasoning was also applied by the Rhineland-Palatinate finance court: FG Rheinland-Pfalz (n 111).

However, in the appeal against the decision by the Hamburg court the BFH finally clarified the legal situation in respect of this issue and thereby overruled the finance court and rejected the position represented by the BMF.[198] Although this decision has led to much more certainty it may be opined that, nevertheless, the actual legal situation is rather unsatisfactory. On the one hand, though the *Lidl Belgium* outcome at the national level was discussed in the academic world and even the BMF took a position the BFH did not refer to its prior ruling in order to clarify this decision. On the other hand, although mentioning that the ability-to-pay principle and the principle of equal treatment to domestic situations generally presuppose a taking into account of losses in the year of incurring, the BFH completely disregarded both principles on the basis of the symmetry thesis. Moreover, the court stated that this result may be supported by practicability considerations. Both arguments, however, are rather vulnerable. First, from a German Constitution perspective it is somewhat questionable whether a difference in treatment in this regard may be justified solely on the basis of the symmetry thesis although it is accepted in an EU environment. As explained above, the ECJ did not provide any requirements in its decisions of how to deal with this issue at the national level. Second, it is clear from the Court's case-law that practical considerations cannot be invoked in order to justify a difference in treatment[199]. Von Brocke/Auer have pointed out that this outcome is contrary to the principles set out in the KStG under which according to ss 30(No 3) and 7(3) corporate tax is due at the end of the calendar year.[200] Moreover, s 175(1)(No 2) AO expressly provides for a procedural measure in case an event occurs retrospectively so that the tax assessment of the relevant year may be changed. This argument which is also stressed by part of the academic world[201] was put forward by the Hamburg finance court as to which the BFH has not responded at all.

In conclusion, as indicated above and highly criticised, in general the decision BFH I R 16/10 was rather unsatisfactory since the BFH avoided ruling on the basic problem of compatibility with EU law by merely referring to its prior decision with respect to finality and dismissed the claim on a 'formality issue'.[202] This must especially be highlighted as the lower court in this litigation adopted the requirement of a binding agreement providing for a mandatory loss absorption which is not expressed in the legislation and might infringe EU law as well.

198 BFH I R 107/09 (n 170).

199 Cf inter alia *Rewe Zentralfinanz* (n 29) para 58.

200 Klaus von Brocke and Jakob Auer, 'Praxisrelevante Probleme in Zusammenhang mit dem Abzug finaler ausländischer Betriebsstättenverluste' [2011] DStR 57, 58

201 Cf Frotscher (n 127) § 14 20b; Scheunemann (n 132) 151/152.

202 The BFH dismissed the action on the ground that the loss relief was claimed for the wrong time period.

Thus, a reference to the ECJ has been acclaimed in the academic world[203]. However, the problem is that the legal uncertainty remains until an 'adequate' case is litigated and in the end it is up to the courts whether they refer the case to the Court.

D. *Organschaft De Lege Feranda*

As elucidated, the German rules infringe EU law on certain points. The question which, in consequence, arises is how to deal with this issue at the national level.

Two stages, though, have to be considered. On the one hand, it needs to be made clear that the onus must be put on the German legislature which has to take initiative in order to achieve legal certainty which is of utmost importance for German groups of companies operating cross-border and also for Germany as a location for parent companies. On the other hand, this problem has to be dealt with at the present legal status.

Regarding the latter, the approach advocated by von Brocke and Homburg must be endorsed which means that both the dual domestic link requirement and the requirement of a profit and loss pooling agreement must be disregarded.[204] That holds true at least for current claims concerning final losses. More problematic is the question for future cases which highlights the urgency of legislative initiative. Although two lower finance courts took a stand on this issue it was not confirmed by the supreme finance court which leads to an unendurable legal uncertainty.

With regard to second stage, however, it is clear that the German legislature is not willing to open the *Organschaft* cross-border entirely since it was reluctant in this respect from the beginning due to fiscal considerations. However, certain proposals have been put forward by scholars which have to be examined.

Schreiber, for instance, refers to two possible solutions.[205] On the one hand, it may be possible to grant cross-border loss relief irrespective of finality of losses but utilise a recapture regime in case the foreign subsidiary gains subsequent loss relief in its Member State of establishment.[206] On the other hand, the amended legislation

203 Oliver Heinsen and Martin Ribbrock, 'BFH I R 16/10' [2011] BB 613, 615 (note); Stefan Homburg, 'BFH I R 16/10' [2011] IStR 110, 112 (note); Kai Schulz-Trieglaff, 'Der BFH und finale Verluste bei ausländischen Tochtergesellschaften: das falsche Vergleichspaar. Anmerkung zum Urteil des BFH vom 9.11.2010, I R 16/10' [2011] IStR 244, 245.

204 Brocke (n 146) 967; Homburg, 'Die unheimliche Nummer Sechs' (n 122) 251.

205 Ulrich Schreiber, *Besteuerung der Unternehmen: Eine Einführung in Steuerrecht und Steuerwirkung* (2nd edn, Springer 2008) 435.

206 Which was presented by the Commission as a possible approach (n 3).

could subject the whole group to unlimited (worldwide) taxation but at the same time grant credit for taxes paid on foreign profits.[207]

As a final solution in this paper, however, it is argued that the concept of *Organschaft* should be maintained since as seen above, as a general rule, cross-border loss relief is only required in certain narrowly defined circumstances, namely in case of finality. It has furthermore been examined that a profit and loss pooling agreement serves as an eligible justification for a breach of the ability-to-pay principle and the principle that each taxpayer should be taxed separately. Nevertheless, in order to comply with EU law certain amendments are required.[208]
First of all, the requirement of a profit and loss pooling agreement should be dissociated from ss 291 et seq AktG. That may be reasoned by the fact that it cannot be concluded and thus infringes the freedom of establishment in a pure cross-border as well as in a 'domestic' situation, in case the parent and/or subsidiary have the seat in another Member State but maintain the place of management in Germany. In this instance, a solution as established by the Lower Saxony court would be desirable which would lead to the same treatment of domestic and cross-border situations. The required period of five years would ensure the prevention of loss-trafficking schemes.

Furthermore, there should be a provision which, exceptionally, allows relief for losses incurred by a foreign subsidiary which does not have its place of management in Germany in case those losses are final according to para 55 of *Marks & Spencer*. That would ensure that the German legislation is compatible with EU law as established by the Court and would furthermore prevent double-dipping since losses cannot anymore be taken into account in the State of establishment of the subsidiary.

E. Final Conclusion

This paper has examined the jurisprudence of the Court of Justice regarding cross-border loss relief and has investigated to what extent the principles established by the Court can be deduced and applied as general guidelines by taxpayers, tax administrations and governments.

It has been illustrated that, although the Court demonstrated a relative consistency, many issues remain unclear and have to be analysed and interpreted which leads to a certain degree of legal uncertainty in applying the decisions on an EU basis.

Furthermore, an in-depth analysis of the German Consolidated Group regime *Organschaft* has been conducted by elucidating the system under the German rules

207 Ibid.

208 This approach is also endorsed by Kolbe (n 53) K 23/24.

as they stand and elaborating on its compatibility with EU law. In this instance, the principles established in the Court's case-law have been applied, as analysed in the first part of this paper.

While discussing the different positions represented by the German literature and jurisprudence, in particular, it has been concluded that the *Organschaft* infringes EU law on certain points. Therefore, in order to comply with EU law the dual domestic link requirement with regard to subsidiaries established in another Member State as well as the requirement of a profit and loss pooling agreement according to ss 291 et seq AktG must be disregarded.

In the final chapter of this paper it has been made clear that the *status quo* of the Organschaft is highly unsatisfactory since taxpayers and also tax authorities are subjected to legal uncertainty.

Therefore, this paper has concluded that taking action by the German legislature is urgent. In this respect, certain proposals have been examined. However, in order to comply with EU law only minor, but nevertheless important, amendments are required. First, although the profit and loss pooling agreement should be dissociated from ss 291 et seq AktG it should, nevertheless, be maintained in the form of a binding, mandatory agreement regarding loss compensation by the parent company since it has been pointed out that such an agreement has definitely a justification from a German Constitution perspective. This agreement should have the condition that is must be concluded on a five-year basis in order to prevent loss-trafficking schemes. Second, a provision should be drafted which allows cross-border loss-offsetting in the exceptional case of finality, which would have the result that the possibility of a double-dip is precluded.