The territoriality principle in the ECJ’s case law

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Academic year: 2013-2014
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Master thesis International Business Taxation / track International Business Tax Law

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Academic year: 2013-2014

Submission Date: 24 June 2014
Preface

This master thesis is written in the context of my study International Business Taxation at Tilburg University. In the course of writing this thesis, I received advice, input and support from some people, and I wish to take the occasion to briefly pay my gratitude.

I would like to thank my supervisor, drs. Peeters, for assisting me during the writing of this thesis and for making me able to critically analyze my own text. Finally, I would also like to thank my lovely family, girlfriend and friends for their unconditional support.

Sander Diepvens

Tilburg, June 2014
Abstract

This thesis focuses on the territoriality principle. As direct taxes are not yet harmonized, Member States are in principle sovereign to determine the criteria for taxation. As a consequence, Member States must be allowed to limit their tax jurisdiction to income earned within their territory. In that respect, the territoriality principle is closely connected to the source principle (and Capital Import Neutrality) and is used as an antonym to worldwide taxation. It also leads to a compartmentalization or isolation of the tax bases across different Member States. Nevertheless, the meaning of the territoriality principle is ambiguous. Where (worldwide) taxation of residents (a resident is taxed on the basis of a stable link with the territory of the State) is regarded as a manifestation of territoriality under international law, it would be regarded as worldwide taxation under international tax law. And it appears from the settled case law, that the ECJ understands territoriality as it is used in international law and not as territoriality in international tax law. Furthermore, the ECJ sometimes considers the territoriality principle as an element of the comparability analysis and in other cases as a justification ground. Finally, the ECJ often considers the consequences of the limitation of the tax jurisdiction not as a disadvantage but as a restriction. In that case, the ECJ creates tax jurisdiction and breaches the Member States’ sovereignty.
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1. Introduction

1.1. Background

A fundamental characteristic of a State’s sovereignty recognized by international law is the right to levy taxes and decide upon the geographical extent of its tax jurisdiction. Accordingly, States may levy taxes on foreign income (worldwide taxation) or solely on income derived in territory (taxation based on the territoriality principle).

Yet, Member States do not fully enjoy the liberty recognized by international law when it comes to the taxation of companies’ foreign business income. Since the Avoir Fiscal case\(^1\), the European Court of Justice (ECJ) made it clear that Member States’ tax rules are subordinated to EU law and particularly to the freedoms of movement. The enforcement of the fundamental freedoms is indeed crucial to the achievement of the internal market, which is an obligation for the Union.\(^2\)

And although the ECJ has recognized in its case law\(^3\) that in the field of direct taxation Member States are competent to determine the criteria for (allocating the powers of) taxation, the ECJ respects Member States’ fiscal sovereignty only insofar as they don’t breach EU law. It is now established that “although (…) direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law”.\(^4\)

The coexistence of tax jurisdiction as determined by international law and the objective of achievement of the internal market results in an inevitable conflict. Member States’ fiscal sovereignty is indeed at tension with EU law, both because of the taxing rights a State is entitled to, and the few

\(^1\) ECJ C-270/83, European Commission vs French Republic, see particularly par. 14: “The fact that the laws of the Member States on corporation tax have not been harmonized cannot justify the difference of treatment in this case”.

\(^2\) See article 3 TEU: “The Union shall establish an internal market”. See also COM(2010)608 final, Towards a single market act – For a highly competitive social economy: 50 proposals for improving our work, business and exchanges with one another.

\(^3\) ECJ C-336/96, Gilly, par. 24:“The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminate double taxation – by means, inter alia, of international agreements – and have concluded many bilateral conventions based, in particular, on the model conventions on income and wealth tax drawn up by the Organization for Economic Cooperation and Development”. See also ECJ C-307/97, Saint Gobain, par. 56: “Member States are at liberty, in the framework of bilateral agreements concluded in order to prevent double taxation, to determine the connecting factors for the purposes of allocating powers of taxation as between themselves”. For a comment on the Saint-Gobain case, see R. OFFERMANS and C. ROMANO, “Treaty benefits for permanent establishment”, European Taxation 2000, p. 180-189.

\(^4\) ECJ C-279/93, Schumacker, par. 21.
obligations a State is subject to. In addition, the exercise of the freedom of establishment by companies may tend to isolate the tax base across different countries, while the core idea of the internal market aims at abolishing the borders between Member States. Therefore, it is not surprising that Member States’ fiscal sovereignty several times has been challenged by the ECJ, whether tax jurisdiction is exercised on the basis of the fiscal principle of territoriality or on the basis of the principle of worldwide taxation. In this respect, one sees from the ECJ’s case law that the Court does not always accept a limitation of tax jurisdiction (i.e. taxation based on the territoriality principle) when tested against the exercise of the Treaty freedoms.

It should be noticed that the case law of the ECJ results in a negative integration, given the lack of harmonization or coordination by the Member States. This negative integration is not always satisfactory though, because the ECJ is not a lawmaker and may provide inappropriate solutions to the conflict between the objective of achievement of the internal market and Member States’ rules on the taxation of companies’ foreign business income.

Finally, it is not clear which of the two principles fits the objective of the internal market best, because both the principle of worldwide taxation and the fiscal principle of territoriality raise compatibility issues with EU law.

1.2. Research question

Although there are two guiding principles to arrange a Member States’ tax jurisdiction, our focus will be on the (fiscal) principle of territoriality. Therefore, the following research question will be guiding throughout this thesis:

“Is the taxation based on the fiscal principle of territoriality a restriction of the freedom of establishment?”

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5 P.J. WATTEL, “Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?” in D. WEBER (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, p.144: “By definition, protecting the tax turf of a national State (i.e. preserving fiscal territorial cohesion) involves a certain degree of fiscal disintegration of the internal market”.

6 Article 26(2) TFEU; See also C. PANAYI, Double taxation, tax treaties, treaty-shopping and the European Community, Kluwer Law International, 2007, p.143: “Community law, through, inter alia, its fundamental freedoms, aims at removing the borders between Member States. In contrast, the starting point of international tax law is the existence of these borders”.

7 “Negative integration” is opposed to “positive integration”, which would assume that legislative measures are adopted by the Member States or the EU (i.e. directives, regulations).
In order to answer this question, we first need to identify what is meant by the (fiscal) principle of territoriality and which relationship this concept has with other justification grounds. In that respect, the following (sub)research questions can be defined as followed:

“How does the ECJ interpret the (fiscal) principle of territoriality? Does the ECJ pay sufficient heed to (the consequences of) the principle and its own basic assumptions? And what is the significance of the territoriality principle as a ground of justification from both the perspective of home and host State?”

1.3. Relevance, delimitation and method

The purpose of the internal market is to abolish existing barriers and therefore stimulate the competitiveness of Europe. Since Member States are in principle sovereign to design their own tax rules, it is clear that there may be a conflict between the Member States tax rules and the objective of the achievement of an internal market. In that respect, when applying the territoriality principle a Member State may choose to tax only income that is generated within its territory. Therefore, it is relevant to explore which impact this has on the establishment of an internal market (e.g. the fundamental freedoms).

This paper will mainly deal with foreign business income. Other types of foreign income, such as interests, dividends and royalties are not that relevant since passive income is partly subject to harmonization between Member States with the parent-subsidiary directive, the interest and royalties directive and the savings directive, so an important part of the study of the taxation of passive income within the internal market would be the analysis of the directives, their implementation as well as their interpretation by the ECJ.

Furthermore, it is considered relevant to analyse the case law at both the level of foreign subsidiaries and permanent establishments. By separating the analysis of the fiscal principle of territoriality according to these contexts, it is possible to make a clear analysis of the reasoning of the ECJ and to draw convincing conclusions as to the compatibility of the fiscal principle of territoriality with the objective of achievement of the internal market.

The legal method used in this paper is the traditional legal method, which consists in analysing a certain question through relying on the existing legal sources. Two main legal sources are relevant for this paper: the EU treaties and the case law of the ECJ.

Finally, this paper is linked with another discipline than tax law, particularly international law. Tax jurisdiction as an attribute of a State’s sovereignty, which is a concept of international law. To fully assess the impact of the objective of the internal market on Member States’ taxation rules, some research in the field of international law is necessary for understanding the extent of a State’s tax
jurisdiction. This research is, however, limited to what is necessary to study the conflict between the objective of achievement of internal market and Member States’ taxation rules.

1.4. Structure
The design of the research will be as follows. In the next section, I will start with describing the normative framework, which is equipped by the goal to achieve an internal market while at the same time respecting the State’s fiscal sovereignty.

In the second section, we will first look at the principle of territoriality as it stands in international (public) law and international tax law. Next, we will discuss whether there are differences between the several justification grounds accepted by the ECJ. Finally, the territoriality principle in the ECJ’s case law will be discussed. Thereby, a distinction is made between permanent establishments and subsidiaries. This analysis enables us to determine to what extent the ECJ accepts the taxation on the basis of the principle of territoriality in the light of the achievement of an internal market.

The thesis will be closed with a final summary and conclusion, in which an answer will be formulated to the research questions.

2. Normative framework

2.1. Tax sovereignty
Traditionally, tax systems were viewed largely in the context of single and sovereign jurisdictions, unaffected by the tax systems outside their borders. Sovereignty itself can be defined as “a State’s inviolable right of self-determination within a specific territory and political community”.

The expansion of the European Union has eroded that the sovereignty of State to a certain degree. Nonetheless, Member States still enjoy a high level of fiscal sovereignty in the field of direct taxation, meaning that Member States are largely free to design their tax systems in a way that meets their domestic policy objectives and requirements. This doesn’t mean that Member States are completely autonomous as the ECJ requires Member States to exercise their sovereignty consistently with EU

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10 See also: COM(2006)823 final, par. 1.
law. Nonetheless, the reluctance of the Member States to give up their autonomy in the area of direct taxation is reflected in the unanimity requirement in articles 114 and 115 TFEU.

2.2. International fiscal neutrality

According to economic theory, free competition leads to the greatest efficiency. Efficiency and productivity are best served when there are no distortions or disturbances to the market system. An efficient allocation implies that the production factors must be located there where they produce the highest possible yields. In this sense, taxation should not influence the efficient location of production factors. This being said, it is again emphasized that fiscal sovereignty has to be respected, where great value is attached to the principle of territoriality.

In general, fiscal neutrality can be defined as ensuring that taxes exercise the minimum of influence on business decisions made by taxpayers. Fiscal neutrality is an important concept for this thesis, because the EU treaties require that EU nationals are not subject to restrictions and discriminations when doing business throughout the internal market. By promoting fiscal neutrality, taxpayers are likely to be less hindered or discriminated against when considering an investment in the internal market. Also, neutrality is often considered as a desirable characteristic in taxation. Therefore, when analysing the legal conflict between Member States’ taxation rules and the objective of achievement of an internal market, attention may be paid to how neutral these rules are.

2.2.1. CIN and CEN

Several theories or views on international tax neutrality can be found in academic literature. The concept dates back to the late sixties and early seventies, and initially focused on capital import neutrality (CIN) and capital export neutrality (CEN). Later on, the discussion expanded to other ‘forms’ of international tax neutrality. As for the purpose of this research, I will not discuss the

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14See articles 2 TEU and 18 TFEU, as well as the articles of the TFEU on the freedoms of movement (i.e. articles 28, 45, 49, 56, and 63 TFEU)
15N.L. Steuben, Fundamentals of a good tax system, Tax Notes International, 2 October 2000, p. 1578: “a good tax law is a neutral tax law”.
17Such as capital ownership neutrality, market neutrality, national neutrality and national ownership neutrality, and inter-nations neutrality.
national neutrality theories, as these theories only seek to maximize the national efficiency.\textsuperscript{18} Indeed, in this thesis the scope of neutrality is at the level of the European Union, as the aim of the internal market is not to promote the freedom of movement and economic efficiency at the level of single Member States, but rather at the global level of the whole European Union. Discussing a theory aimed at maximizing national efficiency is therefore irrelevant. Consequently, I will narrow my focus on the two ‘classical’ theories on international tax neutrality, CIN and CEN.

Capital export neutrality and capital import neutrality are defined as follows:\textsuperscript{19}

- Capital export neutrality refers to a similar tax treatment of domestic and foreign investments, wherever income is earned.\textsuperscript{20} This means that an investor should pay the same ‘total tax’\textsuperscript{21}, irrespective of whether he receives the investment income from foreign or from domestic sources.\textsuperscript{22} For fully implementing capital export neutrality, a Member State should apply the principle of worldwide taxation (universality principle) and preferably eliminate double taxation through granting a full foreign tax credit to ensure the levy of tax according to the domestic tax rate, irrespective of the place of investment.\textsuperscript{23}

- Capital import neutrality refers to a similar tax treatment of investments in the host state (i.e. location of investment, the taxing jurisdiction), irrespective of the place of the investor\textsuperscript{24} (i.e. where the capital comes from).\textsuperscript{25} For fully implementing capital import neutrality, the home State should apply the fiscal principle of territoriality and disregard foreign income. This means that only a territorial tax system, or source-based tax system, would satisfy capital import neutrality.\textsuperscript{26} In such a system, the home State does not tax its residents on the income they earn abroad. Income is taxed only at its source.


\textsuperscript{19} For an analysis of capital export neutrality and capital import neutrality, see W. SCHÖN, “International tax coordination for a second-best world (part I)”, \textit{World Tax Journal} 2009, p. 79-81.

\textsuperscript{20} See the definition of CEN provided by the IBFD International Tax Glossary: “Public finance concept to describe the situation where investors are subject to the same level of taxes on capital income regardless of the country in which income is earned. The credit method of relieving international double taxation is often considered to illustrate this principle”.

\textsuperscript{21} i.e. domestic plus foreign tax


\textsuperscript{24} Tax considerations should not influence whether a particular investment is made by domestic or foreign investors.

\textsuperscript{25} See the definition of CIN provided by the IBFD International Tax Glossary: “Public finance concept to describe the situation where investments within a country are subject to the same level of taxes regardless of whether they’re made by a domestic or foreign investor. The exemption method of relieving international double taxation is often considered to illustrate this principle”.

country where the investor resides foreign income and capital is exempt from tax.\textsuperscript{27} It is also important that the host State respects the non-discrimination principle so that foreign investors are treated as domestic investors.

The purpose of this thesis is to conduct a legal analysis of ECJ case law on the conflict between Member States’ taxation rules and the objective of achievement of an internal market. Therefore, even though it may be observed that some judgments of the ECJ tend to enforce or breach capital import neutrality or capital export neutrality, it is not the main purpose of this research to make an economic analysis and discuss which of the two systems fits the internal market best.

As our focus will be on the fiscal principle of territoriality, CIN seems to be the most appropriate benchmark. In this respect, CIN may raise the following compatibility issues with EU law:

- The fiscal principle of territoriality leads to an isolation of the tax bases across different Member States. This may create a problem with regard to foreign losses, when at the same time profits are incurred in another Member State. A second problem implied by CIN is that it may encourage Member States into harmful tax competition by concurring with each other for offering the lowest corporate income tax rates.

As a result, capital import neutrality raise compatibility issues with EU law. These compatibility issues are analyzed in this paper, although it is not the purpose of the paper to study exhaustively the capital import neutrality with regard to the objective of the internal market.

3. The principle of territoriality and a balanced allocation of taxing rights between Member States

In the \textit{Futura Participations} decision\textsuperscript{28}, the ECJ mentioned for the first time the fiscal principle of territoriality. On the basis of that principle, the ECJ ruled that since only profits arising from the local activities of non-resident companies are taxable in Luxembourg, that Member State is allowed to only take into account the losses that are linked to such local activities.


\textsuperscript{28} ECJ C-250/95, \textit{Futura Participations}. 
Throughout the case law of the ECJ the principle of territoriality has taken an ambiguous nature. Sometimes it is considered by the Court as an element of the comparability analysis\textsuperscript{29} and in other cases it is considered as a justification ground\textsuperscript{30}.

\textbf{3.1. The principle of territoriality}

Before looking into the case law of the ECJ, it is important to make the distinction between the principle of territoriality as it stands in international law and the (fiscal) principle of territoriality in tax law.\textsuperscript{31}

\textbf{3.1.1. Principle of territoriality as used in international law}

As observed earlier, international law acknowledges the sovereignty of States. Sovereignty implies jurisdiction, including fiscal jurisdiction.\textsuperscript{32} In that respect, the territoriality principle can be regarded as a jurisdiction principle embedded in international law and entitles States to tax their citizens and the income connected to their territory.\textsuperscript{33} It is also considered that the principle of territoriality\textsuperscript{34} entitles a State to independently and exclusively decide within its territory, \textit{i.e.} a State is not subject to control from other States and is not either obliged to take into consideration foreign elements.

Further, a distinction can be made between personal bases\textsuperscript{35} of jurisdiction and territorial bases of jurisdiction. In international tax law, the territorial bases are of more importance. These territorial bases include taxation on the basis of residence and source. It is important to note that taxation of residents is, in this context (\textit{i.e.} in the international law context, rather than in international tax practice), regarded as a manifestation of territoriality (a resident is taxed on the basis of a stable link with the territory of the State), even though tax lawyers would call that worldwide taxation, as opposed to territorial taxation.\textsuperscript{36}

\textsuperscript{29} For instance in the Futura Participations case. See also F. VANISTENDEAEL, “Bosal?!”, \textit{EC Tax Review} 2003-04, p. 192.
\textsuperscript{30} For instance in the Bosal case. See also D. WEBER, “The Bosal Holding Case: Analysis and Critique”, \textit{EC Tax Review} 2003-04, p. 228.
\textsuperscript{31} In that respect, see M. LANG, “The Marks & Spencer case – the open issues following the ECJ’s final word”, \textit{European Taxation} 2006, p. 59, who considered that the principle of territoriality’s “meaning is not clear at all”; see also M. MÖSSNER, “Source vs residence – an EU perspective”, \textit{Bulletin for International Fiscal Documentation}, December 2006, p. 504: “In its international aspect, direct taxation is based on the principle of territoriality, but one must immediately add that the meaning of the principle of territoriality is ambiguous”.
\textsuperscript{33} \textit{i.e.}, jurisdiction based on territorial connection between this State and a legal subject or object.
\textsuperscript{34} This characteristic may be described in international law literature in different ways, such as “the principle of territoriality”, a State’s “sovereignty” or the “principle of non-intervention”. On such terminological aspects, see F.A. MAN, \textit{The doctrine of international jurisdiction revisited after twenty years}, 1985, p.20.
\textsuperscript{35} f.e. nationality or domicile.
3.1.2. Principle of territoriality as used in international tax law

In international tax law, a distinction is commonly made between objective and subjective criteria for allocating tax jurisdiction. These subjective criteria include nationality and residence. The objective criteria boil down to the taxation of income produced in (i.e. sourced in) the State concerned. If tax liability is based on a subjective criterion, the taxpayer is typically taxed on its worldwide income, whereas tax liability based on the source principle, as a matter of principle, limited to the income of that is sourced within the State’s territory. In this context, the limitation of the tax base solely on income that is sourced in a State’s territory, either for non-residents only or for both residents and non-residents, is referred to as the (fiscal) principle of territoriality. The term territoriality is thus used as an antonym to worldwide taxation. One should bear in mind that the meaning of this term is different from the meaning in international law context as described above: under international law, worldwide taxation of residents is regarded as a manifestation of territoriality.

3.2. The difference between fiscal cohesion, fiscal territoriality and the preservation of the balanced allocation of taxing rights

Until now, only four justifications for direct tax impediments to cross border movement have been recognized: (1) the need to preserve the coherence of the national tax system (fiscal coherence); (2) the need to prevent abuse of law in the form of tax avoidance; (3) the need for effective fiscal supervision; and (4) preservation of the (balanced) allocation of taxing rights. Apart from these four justification grounds, there is a fifth concept: the fiscal principle of territoriality. As said earlier, it is unclear whether this is a justification for restrictions or a categorization of rules which fall outside the scope of the EU treaty freedoms.

Further, it can be observed that all four accepted excuses are not so much justifications (for different treatment of comparable cases), as they are descriptions of differences of fact, connected to (a transfer or mismatch of) jurisdiction.\footnote{P.J. WATTEL, “Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?”, in D. WEBER (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, p. 140.}

The ‘fiscal cohesion’ justification was first mentioned in the \textit{Bachmann}\footnote{ECJ C-204/90, \textit{Bachmann}.} case, concerning the deduction of annuity contributions and later taxation of the annuity benefits. In the cases like \textit{Bosal}\footnote{ECJ C-168/01, \textit{Bosal}.} and \textit{Manninen}\footnote{ECJ C-319/02, \textit{Manninen}.}, the ECJ sized down the fiscal cohesion defense to virtual non-existence. Nevertheless, the fiscal coherence justification was accepted again by the ECJ in the \textit{Krankenheim}\footnote{ECJ C-157/07, \textit{Krankenheim}.} case. And in the recent \textit{K}\footnote{ECJ C-322/11, \textit{K}.} case, the ECJ also accepted the coherence argument (taken together with the preservation of the balanced allocation of taxing rights) as a valid justification ground.

The fiscal cohesion concept does not really exist as a justification, at least not separately from the analysis of the comparability of the cross border and the internal situation. As said earlier, what we’re looking at then, is really a description of differences of fact, rather than a justification for different treatment of comparable cases.

Since the fiscal cohesion concept concerns cohesion between tax base reductions and corresponding tax base increases within the same tax jurisdiction, one might wonder what the difference, if any, is between the fiscal cohesion principle and the fiscal principle of territoriality.\footnote{P.J. WATTEL, “Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?”, in D. WEBER (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, p. 144.}

As said earlier, the ECJ introduced the principle of fiscal territoriality for the first time in the \textit{Futura Participations} case, concerning loss relief within a Luxembourg branch of a French company. The judgment states rather straightforwardly that if a national tax system (its delineation of jurisdiction) is in accordance with the fiscal territoriality principle, it will not be found to offend the EU treaty freedoms.

In this case, it seems that the fiscal principle of territoriality has the appearance of a categorization of rules falling outside the scope of the treaty prohibitions altogether, rather than a justification for a restriction found. According to the ECJ, a tax system which consistently observes the fiscal principle of territoriality cannot be considered to amount to any discrimination prohibited by the treaty.
Commentators thus read in *Futura Participations* a reiteration or even a bolstering of the fiscal cohesion principle, albeit framed differently and possibly in a wider conceptual framework, confirming that consistent fiscal territorial matching of profits (base increases) and corresponding losses (base reduction) was all right.\(^{50}\)

Nevertheless, in a later case, the *Bosal*\(^ {51}\) case, the ECJ sized down the fiscal territoriality principle. This case concerned a national measure which provided that expenses incurred by a parent company (wherever established) to finance its subsidiary (wherever established) were deductible only insofar as they were instrumental in earning subsidiary profits subject to tax in the same jurisdiction as where the parent sought to deduct those connected expenses. Despite this perfect territorial match of exemption of income and denial of deduction of corresponding expenses, the ECJ limited the territoriality defense to strict one-taxpayer, one-tax situations, without clarification why.

After the rejection of the territoriality principle in *Bosal*, the ECJ accepted the territoriality plea in the *Marks & Spencer*\(^ {52}\) case. The ECJ accepted that losses of a (non-subjected) foreign subsidiary were excluded from attribution to a domestic parent company in order to be set off against its taxable profits, although losses of a domestic subsidiary could be so transferred and set off. It did so because of territorial ‘symmetry’ (‘profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system’). Although the ECJ accepted the fiscal territoriality principle in this case, an exception was made where jurisdictional coherence would cause loss relief possibilities. In that case, the ECJ does not accept jurisdictional cohesion and thus disrupts the ‘symmetry’ of the system and the ‘balanced allocation’ of taxing rights.\(^{53}\)

The reasoning of the ECJ in *Marks & Spencer* implies that the fiscal territoriality principle is treated as if it were a justification for discrimination instead of the description of a set of rules outside the scope of the treaty freedoms. Indeed, the ECJ finds that there’s a different treatment of foreign and domestic subsidiaries, accepts a justification for this different treatment, and finally checks whether this justification is applied in a proportional manner.

It may be clear that, as the ECJ does not apply the fiscal principle of territoriality in a consistent matter, conceptually it still remains a murky concept. It is even difficult to see the difference between fiscal territoriality and fiscal cohesion. Both concepts refer to the necessity to treat base increases and


\(^{51}\) ECJ C-168/01, *Bosal*.

\(^{52}\) ECJ C-446/03, *Marks & Spencer*.

connected base reductions symmetrically within the same tax system, i.e. to protect the balanced allocation of taxing rights.  

Finally, the concept of a ‘balanced allocation’ is developed on the basis of the ‘principle of territoriality enshrined in international tax law and recognized by EU law’, and justifies exclusive territorial matching of profits and losses made/suffered within the same taxing jurisdiction. What the ECJ’s reasoning in Marks & Spencer boils down to, is that Member States may protect their tax jurisdictions (their definition and allocation of taxing power) against inappropriate parachuting of losses or expenses not attributable to activities or income connected to their territories (base erosion). If this is what ‘the need to preserve the allocation of taxing rights’ means, then this justification ground is just another description of the need for fiscal (territorial) cohesion, thus of the territoriality principle.  

The above shows that is difficult to see the conceptual difference between the three concepts discussed. All three are an expression of the ECJ’s struggle to reconcile the internal market, and the almost complete absence of EU harmonization, which legitimizes the jurisdiction to protect their tax base against territorial mismatches of profits and corresponding losses, income and corresponding expenses, etc.  

3.3. Balanced allocation and the principle of territoriality in the ECJ’s case law

In this paragraph, we will discuss the relevant case law of the ECJ with respect to the interpretation of the fiscal principle of territoriality. Furthermore, it is considered to be relevant to make a distinction between the case law concerning permanent establishments and the case law concerning (foreign) subsidiaries.

This being said, it may be useful to, before analyzing the ECJ’s case law, discuss briefly whether a head office with a permanent establishment and a parent company with a subsidiary may (at all) be in comparable situations.

In that respect, it must be noted that a foreign subsidiary can be regarded as a non-resident legal subject, while a permanent establishment is legally part of the resident company.57

In principle, the ECJ accepts this difference and does not assimilate foreign subsidiaries and permanents establishments per se, as shown from the perspective of both the home State (e.g. *Marks & Spencer*)58 and the host State (e.g. *Futura Participations*59).60

However, in *Lidl Belgium*, the ECJ mitigated the difference between foreign subsidiaries and permanent establishments from the perspective of the home State. It considered that “a permanent establishment constitutes, under tax convention law, an autonomous fiscal entity”61. “That definition of a permanent establishment as an autonomous fiscal entity is consonant with international legal practice, as reflected in the model tax convention drawn up by the OECD, in particular articles 5 and 7 thereof”.62

This is an acknowledgment that a permanent establishment may receive the same tax treatment as a foreign subsidiary, i.e. the fiscal principle of territoriality was respected although applying the principle of worldwide taxation to permanent establishments is a very common practice in international tax law.

Finally, from the perspective of the host State the ECJ sometimes tend to require the host State to grant national treatment to non-residents as a consequence of the non-discrimination principle. A PE may therefore benefit, to a certain extent, from the tax treatment a resident is entitled to. An example is *Royal bank of Scotland* in which the State of source was found in breach with EU law as it applied a higher tax rate to permanent establishments than to resident companies.


58 In *Marks & Spencer*, the ECJ accepted that foreign subsidiaries’ losses are in principle not deductible in the State of the parent, while a head office could deduct the losses of its permanent establishment; see ECJ C-446/03, *Marks & Spencer*.

59 In *Futura Participations*, the ECJ accepted that a permanent establishment is taxed on a pure domestic basis, foreign losses not being deducted in the State of the permanent establishment. In contrast, a resident could claim deduction of its losses. See ECJ C-250/95, *Futura Participations*.

60 Both cases will be discussed further in more detail.


62 ECJ C-414/06, *Lidl Belgium*, par. 22.
3.3.1. Case law concerning subsidiaries

When it comes to losses incurred by foreign group companies, it is the fiscal principle of territoriality that conflicts with the objective of the achievement of the internal market. As said earlier, a State is sovereign and as such, it is independent. That is, a State is in principle at liberty to take into account – or not – foreign elements. Consequently, international law acknowledges a fundamental right to exclude all foreign elements. Applied to taxation, a State has the right to strictly apply the fiscal principle of territoriality and refuse to take into account foreign income, whether it is positive or negative. The lack of a general right to offset losses within a group has led many countries to adopt domestic rules that allow for some degree of loss relief. These rules are most often limited to companies residing in the same State, because this State has by definition jurisdiction over all resident companies. This difference of treatment between foreign and domestic losses is in accordance with international law, which accepts that a State applies its laws on a strict domestic basis. A group may therefore end up better off in domestic situations rather than in cross-border situations, when the rules are limited to the home State. However, in the context of the European Union, such a limitation might hinder the objective of achievement of the internal market. The ECJ dealt with this problem in Marks & Spencer, and completed its reasoning in Rewe Zentralfinanz, Oy AA and X holding.

During this section, these cases will be analysed in more detail.

Further, we will also discuss the Bosal case. In Bosal the home State applied the fiscal principle of territoriality and refused to grant a deduction right for the participation (often interest) costs incurred by a parent company. Those interest costs could only be deducted if the subsidiary had taxable profits in the Netherlands. Finally, the Keller Holding case will be discussed due to the similarities with Bosal.

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63 J. MONSENEGO, Taxation of foreign business income within the European internal market, Doctoral series, 2012, 146-147.
64 Some States, such as Austria, France, Italy and Denmark, may however extend loss-relief to foreign losses; see A. MICHELS, The treatment of corporate losses, General IFA report, vol. 83a, 1998.
65 ECJ C-347/04, Rewe Zentralfinanz eG, as Universal Legal successor of ITS Reisen GmbH v. Finanzamt Köln-Mitte (hereafter referred to as “Rewe Zentralfinanz”).
66 ECJ C-231/05, Oy AA.
67 ECJ C-337/08, X Holding v Staatssecretaris van Financiën (hereafter referred to as “X Holding”).
3.3.1.1. Bosal

The principle of territoriality as a justification ground was examined in the Bosal case. At issue in the Bosal case was a Dutch provision that allowed the participation costs incurred by a parent company in connection with the participation only to be deduction by the parent company if the subsidiary had taxable profits in the Netherlands. The Dutch authorities argued that the subsidiaries which make taxable profits in the Netherlands and those which do not are not in a comparable situation. Therefore, following the same authorities, a different treatment of the financing expenses according to whether or not they relate to subsidiaries that generate taxable profits in the Netherlands does not constitute discrimination.

In the decisions in which the preliminary ruling was requested, the Dutch Supreme Court (Hoge Raad) had observed that there was an economic link between the participation costs incurred by the parent and the profits of the subsidiary, but in cross-border situations a connection between costs and taxable profits within one tax system was lacking.

The ECJ ruled that the Netherlands’ limitation of the deduction of costs infringed the freedom of establishment. With respect to the Netherlands’ contention that the deduction limitation was justified on the grounds of fiscal cohesion, the ECJ held that there was no direct link between the participation costs and the subsidiary’s profits. An attempt to justify the provision on the grounds of the territoriality principle was also unsuccessful. In its first consideration, the ECJ appears to recognize that it has accepted the principle of territoriality as a justification ground in Futura Participations. However, the Court immediately adds that the latter case concerned the taxation of a single company that carried on business in two Member States: in the State where it had its principal establishment and in another Member state through a secondary establishment. In that regard, it is irrelevant that subsidiaries that generate taxable profits in the Netherlands and those which do not are in a comparable situation. As regards the tax situation of the parent companies in relation to the profits of their subsidiaries, the ECJ notes that such profits are not taxable in the hands of the parent companies, regardless of whether the profits are generated by subsidiaries taxable in the Netherlands or by other subsidiaries. In other words, even though resident and non-resident subsidiaries may not be in a comparable situation, their parent companies are since they are never taxed on the profits generated by their respective subsidiaries. So not the fact that the domestic and non-domestic subsidiaries are not comparable is at stake, but the tax treatment of the parent company is. By ruling so, the ECJ takes a

69 Contrary to the submission of the Netherlands, the Court considers the principle of territoriality as a justification ground in this case. This can be deduced from the fact that the Court considers the principle of territoriality after the cohesion argument; see G. MEUSSEN, “Bosal Holding Case and the Freedom of Establishment: A Dutch Perspective”, European Taxation 2004, p. 61.

70 ECJ C-168/01, Bosal, par. 37: “The principle of territoriality, as recognized by the Court of Justice in Case C-250/95 Futura Participations and Singer”.

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strictly legalistic approach to companies belonging to the same group by considering them as separate legal entities and taxpayers.

In its ruling, the Court ignored the more economic approach that was suggested by the referring Dutch Supreme Court (including its Advocate-General Wattel)\(^{71}\), the European Commission and the majority of Dutch legal doctrine.\(^{72}\)

More precisely, it is striking that the ECJ, in examining the fiscal cohesion justification and the territoriality principle, did not give weight to the Netherlands Supreme Court’s observation that there is an economic link between the parent company’s participation costs and the subsidiary’s profits.

It could be argued that the ECJ went too far in this case and eroded the Member States’ sovereignty. The starting point is that it is up to the Member States to define the criteria for taxation and in doing so a Member State may allocate the costs of a taxpayer on the basis of objective criteria (such as an economic link) to the profits of another taxpayer. This may result in a disadvantage in a cross-border situation, since the costs are not deductible, but this is a disadvantage that everyone understands: the Netherlands does not have tax sovereignty over the profits of foreign subsidiaries. If the Netherlands may not tax these foreign profits, it does not have to take into account the costs that are allocated to them. This view was also upheld by Advocate-General Geelhoed in the *ACT class IV* case. In his opinion, he observed that in the *Bosal* case the ECJ showed insufficient respect for the allocation of taxation rights among the Member States:

“The division of tax jurisdiction between the Netherlands and the Member States of residence of the subsidiaries was such that jurisdiction to tax the foreign subsidiaries’ profit fell solely to the latter – source State. As a result it would seem to be wholly consistent with this division of jurisdiction for the Netherlands to allocate those charges paid by the Dutch parent which were attributable to the exempted profits of the foreign subsidiaries, to the Member State of the subsidiaries. In other terms, it would seem clear that the position of a domestic parent company with a subsidiary whose profits are taxable in the Member State, on the one hand, and such a parent company with a subsidiary whose profits are not taxable (exempt) in that Member State, on the other hand, are not comparable. In sum, this would appear to be a classic example of a difference in treatment resulting directly from dislocation of tax base. It seems to me that the result of the ECJ’s judgment was to override the

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“Member States’ choice of division of tax jurisdiction and priority of taxation – which choice, lies solely within Member States’ competence.”

According to this reasoning, the fact that the Netherlands did not take the participation costs into account, should have been allowed.

3.3.1.2. Marks & Spencer
Marks & Spencer is a UK resident company. Through an intermediary holding subsidiary, M&S had established locally incorporated and operating subsidiaries in Belgium, France and Germany. The subsidiaries only operated in the respective Member States of their establishment. These subsidiaries continued to make considerable and unsustainable losses. The UK group relief system provides for tax consolidation within a group of resident companies or permanent establishments of foreign companies by allowing the loss-making group company to “surrender” its losses to another company (the “claimant company”). Since the losses incurred by the subsidiaries could no longer be taken into account in the Member States of their establishment, due to the fact that they were sold and liquidated, M&S claimed group relief for those losses in the hands of the UK parent company.

The UK tax authorities denied the group relief since the subsidiaries were neither resident nor economically active (i.e. no other activities that would create tax liability) in the UK. Had the non-resident subsidiaries been established in the UK, the group relief regime whereby losses of the subsidiaries could be transferred to the parent company and set off against its profits would have applied. Thus, the fiscal principle of territoriality was interpreted by the British tax authorities as forbidding the deduction of foreign losses when no corresponding taxable base was available to the UK tax authorities.

M&S considered the condition for the UK group relief system incompatible with the EU freedom of establishment. The ECJ considered that the UK legislation was justifiable by the need to protect a balanced allocation of the power to impose taxes between the different Member States concerned, the danger that losses would be used twice, and the risk of tax avoidance. The British legislation was

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73 Opinion in ECJ C-374/04, Test Claimants in Class IV of the ACT Group Litigation, point 63.
75 ECJ C-446/03, Marks & Spencer plc v. David Halsey (Her Majesty’s Inspector of Taxes).
77 Opinion of Advocate General Maduro in ECJ C-446/03, Marks & Spencer, par. 58: According to the UK Government, the principle of territoriality means “that it cannot offer a tax advantage where it has no power of taxation”.

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found disproportionate, however, where the possibilities for having the losses taken into account in the subsidiary’s State of residence had been exhausted.\textsuperscript{78}

\textit{Observations: the justification level}

The \textit{Marks & Spencer} decision has caused a lot of debate in literature. In that respect, some authors found that the ECJ was wise not to accept the principle of territoriality as a justification whilst other found that the ECJ show insufficient respect for a Member State’s right to limit its taxation rights. Following \textit{Futura}\textsuperscript{79}, one may have been confident in believing that a Member State should not fear EU law as long as it shapes its tax legislation in accordance with the fiscal principle of territoriality, through excluding foreign positive and negative income from the domestic tax base. In \textit{Bosal}, the ECJ stepped back from \textit{Futura} and found that the fiscal principle of territoriality, as such, was not an acceptable justification ground when it was applied not applied to a single taxpayer. In \textit{Marks & Spencer}, although the ECJ considered the UK regime was “in accordance with the principle of territoriality enshrined in international tax law and recognised by community law (see, in particular, \textit{Futura Participations and Singer}, par. 22)”\textsuperscript{80}, it did not accept the fiscal principle of territoriality as a justification ground.\textsuperscript{81} This solution might appear incompatible with \textit{Futura} since in both cases a Member State applied the fiscal principle of territoriality and refused to grant a deduction right for losses with foreign origin, while on the other hand it did not tax corresponding positive income.\textsuperscript{82}

The State of a parent company cannot, however, according to MONSENEGO and LANG, claim that the principle of territoriality as it stands in international law legally prevents it from granting relief for losses incurred by a foreign subsidiary.\textsuperscript{83} In addition, MONSENEGO states that “such an argument is convincing neither from a legal point of view\textsuperscript{84} nor from a practical point of view\textsuperscript{85, 86}”. In LANG’s view, it would have been difficult for the ECJ to give reasons why the principle of territoriality should be “enshrined in international tax law”: “By concluding tax treaties, contracting states agree to

\textsuperscript{78} J. MONSENEGO, \textit{Taxation of foreign business income within the European internal market}, Doctoral series, 2012, p. 151-152.

\textsuperscript{79} See section 3.3.2.1.

\textsuperscript{80} ECJ C-446/03, \textit{Marks & Spencer}, par. 39.

\textsuperscript{81} ECJ C-446/03, \textit{Marks & Spencer}, par. 40.


\textsuperscript{83} J. MONSENEGO, \textit{Taxation of foreign business income within the European internal market}, Doctoral series, 2012, p. 166; M. LANG, “The Marks & Spencer case – the open issues following the ECJ’s final word”, \textit{European Taxation} 2006, p. 60.

\textsuperscript{84} This is because international law and tax treaties prevent neither the deduction of foreign losses nor the recapture of subsequent profits.

\textsuperscript{85} This is because the State of the parent company may easily levy taxes on a resident shareholder.

restrict themselves in exercising their taxing rights. The rules contained in tax treaties vary greatly between different types of income and are, understandably, as their contents depends on the negotiation power of the contracting states, not really based on principles at all. As far as losses are concerned, tax treaties usually do not impose any obligation on contracting states not to allow a deduction. Contracting states are always free to be more generous than they have to be under their tax treaty obligations. (...), it can be learnt that there are good reasons to assume that tax treaties do not prevent contracting states from taxing even the foreign profits of non-resident companies. For all these reasons, the ECJ was wise not to accept the principle of territoriality as a justification. 87

And if the fiscal principle of territoriality were accepted as a justification, it would imply that Member States have a right to apply a symmetry between a taxation right and an obligation to grant a tax deduction, thereby making cross-border loss relief impossible within the internal market, and thus undermining the achievement of an internal market. 88 As a result, MONSENENGO agrees with the ECJ that the fiscal principle of territoriality was not an acceptable justification per se in Marks & Spencer. 89

This view was not shared by WEBER and (to a large extent) by WATTEL. According to WEBER, the ECJ has actually created, despite the fact that the UK chose not to tax non-resident subsidiaries, tax liability for the losses of non-resident subsidiaries in the UK, since, in principle the losses of the subsidiary have to be taken into account at the level of the parent company. In his opinion, this is a major breach of Member States’ sovereignty. A Member State may limit its taxation rights since it is sovereign and making political choices lies in its hands. 90 Also Advocate General Geelhoed’s observation on Marks & Spencer in his opinion in the ACT class IV is striking: “Conversely, in Marks & Spencer, the Court held that, in principle, insofar a Member State does not exercise tax jurisdiction over a non-resident subsidiary of a resident parent company, then it does not have to give loss relief. Put otherwise, if a home State has divided its tax base so that it does not exercise tax jurisdiction over a foreign subsidiary of one of its corporate residents, it is in principle consistent for that State to refuse to take into account deduction relating to that foreign-source income in assessing its resident’s tax.” 91

From this observation, WEBER draws the conclusion that the Advocate General reads into Marks & Spencer exactly what the ECJ did not decide and agrees with him that in Marks & Spencer the ECJ

87 M. LANG, “The Marks & Spencer case – the open issues following the ECJ’s final word”, European Taxation 2006, p. 60.
88 Therefore, if the non-deduction of losses is compatible with international law, such a denial may still be incompatible with EU law.
90 D. WEBER, In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC, Kluwer Law International, 2006, p. 27.
91 Opinion of Advocate General Geelhoed in ECJ C-374/04, Test Claimants in Class IV of the ACT Group Litigation, par. 59; see also his opinion in ECJ C-524/04, Test Claimants in the Thin Cap Group Litigation, par. 89.
should have decided that there was no restriction, because the UK does not have tax jurisdiction over a subsidiary established abroad.\textsuperscript{92}

TERRA and WATTEL, at their turn, considered \textit{Marks & Spencer} as a two-country problem, i.e. a disparity issue. This is demonstrated by the fact that the effect was that the UK had to asymmetrically extend its taxing jurisdiction to a part of foreign income (the terminal negative part) of a non-subject nonresident company over which it had symmetrically not asserted any taxing jurisdiction. That is odds with a correct comparability analysis, i.e. on the basis of a comparison within the area of assumption of taxing power.\textsuperscript{93} TERRA also criticizes the fact that the UK is forced to extend its taxing jurisdiction to definitive losses of a non-subject nonresident company, solely because of the fact that this company has a UK parent company (shareholder) who could set off such losses in a, not in his view, comparable domestic situation. In this way, the ECJ violates the Member States’ sovereignty to determine its tax jurisdiction. In his opinion, there’s no basis in the EU treaty for such an extension of the tax jurisdiction over the (definitive) losses of a nonresident subsidiary.\textsuperscript{94}

Finally, KEMMEREN criticizes the fact that the ECJ, in \textit{Marks & Spencer}, holds on to the wrong interpretation and application of the territoriality principle in the Bosal case. Instead of attaching the principle to the tax object, the ECJ attaches this principle to the tax subject. In this view, the territoriality principle is a derivative of the sovereignty principle. However, these principles do not concern the scope of the tax object. This scope is determined by the universality principle (i.e. worldwide taxation) and the territoriality principle (i.e. taxing only the income that is generated within the territory). This distinction is, however, falsely ignored by the ECJ.\textsuperscript{95}

Yet, the outcome in \textit{Marks & Spencer} leans toward the fiscal principle of territoriality since the ECJ held that as a rule, EU law does not impose an obligation on the State of residence to take into account losses incurred by foreign subsidiaries.\textsuperscript{96} The losses had first to be deducted in the host State.

It is important to note that the ECJ did not deal with this solution under the fiscal principle of territoriality as a formal justification ground, but under a combination of the justification grounds taken together: the need to preserve a balanced allocation of the power to impose taxes, the need to prevent tax avoidance as well as to avoid a double utilization of losses.\textsuperscript{97} The fact that the UK does

\textsuperscript{92} D. WEBER, \textit{In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC}, Kluwer Law International, 2006, p. 27.


\textsuperscript{94} P.J. WATTEL, “note to \textit{Marks & Spencer}”, BNB 2006/72, points 9 through 11.

\textsuperscript{95} E.C.C.M. KEMMEREN, “Marks & Spencer: balanceren op grenzeloze verliesverrekening”, WFR 2006/211, point 5.3.

\textsuperscript{96} F. VANISTENDAEL, “In defence of the European Court of Justice”, \textit{Bulletin for international Fiscal Documentation} 2008, p.93: “\textit{Marks & Spencer} is, of course, the hallmark case of territoriality.”

\textsuperscript{97} For a discussion on justification grounds, see …; See also F. VANISTENDAEL, \textit{General report on the fundamental freedoms and national sovereignty in the European Union}, EATLP Congress 2007, p.201: “The concepts of coherence, cohesion and territoriality that have been used by the governments of the member States can be seen as an expression of a larger concept, \textit{e.g.} the right to operate a functioning national tax
not tax the profits of the non-resident subsidiaries of a parent company and thus applies the principle of territoriality in a consistent manner cannot, according to the ECJ, in itself justify restricting group relief to losses incurred by resident companies.\textsuperscript{98}

Hence, with regard to the principle of territoriality, the ECJ reaches a conclusion very similar to the one reached in \textit{Bosal}, i.e. the fact that subsidiaries and the tax characteristics thereof are situated in another jurisdiction does not justify a restrictive treatment of the domestic parent company.\textsuperscript{99}

\textbf{Observations: the proportionality level}

The reasoning of the ECJ in the proportionality test excluded any cross-border relief for non-final losses and could be qualified as an “all in, all out” solution: final losses should be deducted at the level of the ultimate parent company, while in other situations, no relief has to be granted whatsoever. In that respect, one may wonder what the fundamental difference is between current and definitive losses. Therefore, WATTEL and TERRA have some questions: “\textit{Why does the need to protect a balanced allocation of taxing power selectively work only for non-definitive losses? Why is evaporation in the correct jurisdiction less balanced then erasing domestic positive tax base in the wrong jurisdiction?}”.\textsuperscript{100}

They consider the fact that the foreign subsidiary was liquidated as a result of particularities of the economy of the subsidiary State, just like non-deductibility or expiry of losses in the subsidiary State is a particularity of the legal system of the subsidiary State. Furthermore, they continue by saying that “from a conceptual and consistency point of view, it is difficult to see why it is ‘disproportionate’ to refuse a definitive loss, which, in terms of ‘symmetry’ and ‘coherence’, is just as wrong-placed as a current loss in the jurisdiction which symmetrically did not assert taxing power. If the subsidiary State does not or cannot provide loss relief, then that is that. The parent State cannot be required to take over.”\textsuperscript{101}

\textbf{3.3.1.3. Keller Holding}

Keller Holding, a German resident company, was the sole shareholder of Keller Grundbau, also a German resident company.\textsuperscript{102} Keller Grundbau, in turn, owns all the shares of Keller Wien, a company established in Austria. Keller Wien distributed dividends to Keller Grundbau. Under the tax treaty system”\textsuperscript{98}; P.J. WATTEL, “Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?”, in D. WEBER (ed.), \textit{The influence of EU law on direct taxation, recent and future developments}, Kluwer Law International, 2007, p. 139-156.


\textsuperscript{102} ECJ C-471/04, \textit{Finanzamt Offenbach am Main-Land v. Keller Holding GmbH} (hereafter: “Keller Holding”).
between Germany and Austria, these dividends were exempt in Germany. Keller Grundbau consequently redistributed the dividends to Keller Holding. Again, the redistributed dividends were exempt from corporate income taxation in the hands of Keller Holding.

In order to acquire its shareholdings in Keller Grundbau, Keller Holding had concluded a loan, the interest of which it deducted as operating expenses. The German tax authorities, however, refused the deduction of those costs to the extent that they corresponded to the exempt dividends received – indirectly – from Keller Wien. In contrast, if the dividends had originated from a company established in Germany, this rule would not have been applicable since German dividends received are added to the tax base and the tax already paid at the level of the distributing company was set off against the tax payable by the company receiving the dividends. As a result, even though the dividends were included in the tax base of the company receiving them, that company was ultimately exempt from tax on those dividends. Nevertheless, because the dividends had been included in the tax base, the financing cost relating to those dividends could be deducted. Thus, the German measure at issue in Keller Holding is very similar to the Dutch measure in the Bosal case.

Keller Holding argued that the German regime infringed the freedom of establishment because it introduced a difference in treatment between resident companies on the basis of the seat of their indirect subsidiary. The ECJ concluded that there was indeed a restriction of the freedom of establishment for which no justification could be found.

The German and the UK government argued that the situation of a resident parent company with a non-resident indirect subsidiary was not comparable to that of a resident parent company with a resident indirect subsidiary. The restriction on the deductibility of financing costs was the corollary of the non-taxable nature of the dividends from abroad. Accordingly, the fact that Keller Holding did not benefit from the method of offsetting tax was due to the fact that Keller Wien was established in Austria and, therefore, subject to Austrian corporate tax.\(^{103}\)

The ECJ disagreed. The ECJ held that parent companies subject to unlimited tax liability in Germany are in a comparable position whether they receive dividends from an indirect subsidiary established in that Member State or from an indirect subsidiary having its registered office in Austria. In both cases, the dividends received by the parent company are, in reality, exempt from tax.\(^{104}\)

The ECJ continues by noting that, in this regard, the fact that indirect subsidiaries established in Austria are not subject to corporation tax in Germany is irrelevant. The different tax treatment introduced by the German measure related to parent companies based on whether or not they had indirect subsidiaries in Germany, even though those parent companies were all German residents. As

\(^{103}\) ECJ C-471/04, Keller Holding, par. 36.

\(^{104}\) ECJ C-471/04, Keller Holding, par. 37.
far as their tax situation is concerned as regards the dividends paid by their indirect subsidiaries, those dividends did not give rise to tax being levied on the parent companies, whether they were derived from indirect subsidiaries taxable in Germany or in Austria.\footnote{ECJ C-471/04, Keller Holding, par. 38.}

Accordingly, the basic comparability as explained in \textit{Bosal} and \textit{Marks \& Spencer} also holds in the context of the German measure at issue in \textit{Keller Holding}.

Apart from this argument relating to the dividend income, the German government asserted the territoriality argument as it was recognized in \textit{Futura Participations}, but the ECJ rejected this argument, as well. \footnote{Opinion of Advocate General Maduro in ECJ C-347/04, \textit{Rewe Zentralfinanz}, par. 32.} The German measure at issue cannot be regarded as an application of the territoriality principle since it excludes the deductibility of financing costs incurred by a parent company subject to unlimited tax liability in Germany and receiving dividends from an indirect subsidiary established in Austria by reason of the fact that they are exempt from tax in Germany, whereas dividends paid to the same parent company by an indirect subsidiary subject to unlimited tax liability in Germany and having its registered office there also benefit in fact, by means of offsetting the tax paid by the distributing company, from such an exemption.\footnote{ECJ C-471/04, \textit{Keller Holding}, par. 44.} Consequently, the different scope of tax liability at the level of the subsidiaries (limited vs. unlimited taxation) could not affect the comparability at the level of the parents.

\subsection*{3.3.1.4. \textit{Rewe Zentralfinanz}}

Following the opinion of its Advocate General Maduro\footnote{ECJ C-471/04, \textit{Keller Holding}, par. 44.}, the ECJ gives for the first time some further guidance on the scope to be accorded to the overriding requirement of the balanced allocation of the power to impose taxes between the Member States. The ECJ recalls the fact that such a justification was accepted by the Court in \textit{Marks \& Spencer} only in conjunction with two other grounds, based on the taking into account of tax losses twice and on tax evasion.\footnote{ECJ C-347/04, \textit{Rewe Zentralfinanz}, par. 41.} The ECJ continues that a difference in tax treatment between resident parent companies according to whether or not they have subsidiaries abroad connate be justified merely by the fact that they have decided to carry on economic activities in another Member State.\footnote{ECJ C-347/04, \textit{Rewe Zentralfinanz}, par. 43.} Similar to the \textit{Bosal} case, the ECJ takes a legalistic approach in determining that the losses in respect of a depreciation of a participation in a subsidiary are to be located in the hands of the parent company. It finally points out that the losses incurred by a parent company in respect of a depreciation of the value of a subsidiary established in Germany may also be offset by its positive income, even though that German subsidiary has not made taxable profits during the tax year in question.\footnote{ECJ C-347/04, \textit{Rewe Zentralfinanz}, par. 44.}
Further, the ECJ addresses the principle of territoriality, which was also invoked by the German authorities to justify the national measure at issue in the main proceedings. The ECJ recalls that, in accordance with the territoriality principle, the Member State in which a parent company is established may tax resident companies on the whole of their worldwide profits but may tax non-resident subsidiaries solely on the profits from their activities in that State.\(^{111}\) However, such a principle does not in itself justify the Member State of residence of the parent company refusing to grant an advantage to that company on the ground that it does not tax the profits of its non-resident subsidiaries.\(^{112}\) Following the opinion of Advocate General Maduro, the ECJ further recalls that the purpose of the principle of territoriality is to establish, in the application of Community law, the need to take into account the limits on Member States’ powers of taxation.\(^{113}\) However, since the tax deductible depreciation occurs in the hands of the German parent company, a competing tax jurisdiction does not become involved. It concerns German-resident parent companies which are subject, in that respect, to unlimited tax liability in that State. Accordingly, the ECJ concludes that the measure at issue cannot be considered as an implementation of the principle of territoriality.\(^{114}\)

**3.3.1.5. Oy AA**

*Oy AA*\(^ {115}\) concerned the Finnish group contribution regime. This regime allows to transfer taxable profits to other companies belonging to the same group and achieve offsetting of profits and losses. Group contributions are deductible for the contributor and taxable for the recipient. The Finnish group contribution regime requires that both the contributor and recipient (owned to 90%) are resident in Finland. Oy AA, resident in Finland, was an indirect subsidiary of AA Ltd, a UK company.\(^ {116}\) Since Oy AA was profitable and AA Ltd loss-making, the group asked the Central Board of Taxation of Finland if a group contribution could be sent to the UK company. The board refused deduction of the group contribution because of the fact that AA Ltd did not have its resident in Finland. Subsequently, the case was referred to the ECJ for a preliminary ruling. The ECJ considered that although the Finnish group contribution regime constituted a restriction of the freedom of establishment, it was justified by need to safeguard the balanced allocation of the power to tax between the Member States and the need to prevent tax avoidance.

\(^{111}\) ECJ C-347/04, *Rewe Zentralfinanz*, par. 69, with reference to ECJ C-446/03, *Marks & Spencer*, par. 39.

\(^{112}\) ECJ C-347/04, *Rewe Zentralfinanz*, par. 69, with reference to ECJ C-446/03, *Marks & Spencer*, par. 40.


\(^{115}\) ECJ C-231/05, *Oy AA*.

\(^{116}\) As in *Marks & Spencer*, the companies involved were owned through holding companies situated in the Netherlands.
Observations: the Oy AA case in the light of the territoriality principle

Oy AA concerned the opposite situation of the Marks & Spencer case: a parent company made a loss, the deduction of which was sought in the State of a subsidiary. Therefore, there were even stronger arguments than in Marks & Spencer to refuse cross-border relief. Finland had no taxation rights on the UK parent company, except if shares in the parent company were owned by the Finnish subsidiary, in which cases dividends or capital gains may have been taxed in the hands of the Finnish subsidiary.\footnote{However, taxation of foreign dividends received by Finnish shareholders has been limited by the ECJ in Manninen (see ECJ C-319/02, Manninen), because domestic dividends were exempted from taxation in the hands of the parent company.} A tax claim on a foreign parent company with which no connection exists would clearly be in breach of the established principles of international tax law, not least the arm’s length principle, and also the UK-Finland tax treaty as UK companies were taxable in Finland only if they earned income attributable to a PE situated on the Finnish territory. In addition, such a taxation would, as indicated in Cadbury Schweppes\footnote{ECJ C-196/04, Cadbury Schweppes.}, probably be in breach of EU law. Therefore, the (fiscal) principle of territoriality could have been accepted as a justification ground in Oy AA as Finland did not extend its tax jurisdiction to the foreign income of the foreign parent company.

The outcome of Oy AA tends to enforce the (fiscal) principle of territoriality: Finland was not required to apply the principle of worldwide taxation so as to deduct contributions sent to a foreign parent company. This solution is, in my opinion, satisfying. There was no reason for Finland to grant relief for a contribution sent to a foreign parent company, while other group subsidiaries situated in other Member States could also have done that. If the same group had a profitable subsidiary e.g. in Sweden, then extending the worldwide principle to allow for loss relief at the level of any subsidiary would let the group be able to choose which State, whether Finland or Sweden, should deduct the losses. The group could even try to deduct a contribution in both countries. Instead of promoting European integration, such a position would disturb the internal market. The domestic tax base would be artificially diminished, while the principle of territoriality as it stands in international law should entitle Member States “to tax income generated on their territory”\footnote{This interpretation of the principle of territoriality was made by the Finnish, Swedish and United Kingdom’s Governments. See ECJ C-231/05, Oy AA, par. 47.}. It was therefore essential that the Finnish system be found compatible with the fundamental freedoms, to safeguard what may be called the coherence of the Finnish system, a balanced allocation of taxing powers, or the fiscal principle of territoriality.\footnote{On the relation between these concepts see section 3.2.}
The territoriality principle as a justification ground was also mentioned by Advocate General Kokott in her opinion in the *Oy AA case*. In *Marks & Spencer* the ECJ recognized three justification grounds. From these three justification grounds, “taken together”, the ECJ concluded that the British group relief system pursues legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest. According to Advocate General Kokott, the formulation “taken together” makes it clear that all three elements are closely linked to one another and cannot be viewed in isolation. In this connection preserving the allocation of the power to impose taxes is at the heart of these elements.

Advocate General Kokott also points out that, in the absence of harmonization at Community level, it is likewise a matter for the Member States to lay down criteria for allocating their powers to impose taxes by the conclusion of double tax conventions or by unilateral measures. It is thereby not unreasonable for the Member States, considering the allocation of powers of taxation, to find inspiration in international practice and the model conventions drawn up by the OECD. Advocate General Kokott also recalls that the parent company’s Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law, if it taxes resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State. Such an allocation of power to impose taxes according to the principle of territoriality would be undermined if taxpayers had a free choice as to the Member State in which their profits should be taxed, by extracting a company’s profits from its tax basis and adding them to the tax basis of a group company established in a different Member State.

Advocate-General Kokott further notes that the second element of justification recognised in *Marks & Spencer*, namely preventing that losses are used twice, is closely connected to the allocation of power to impose taxes. She concludes that the allocation of power to impose taxes on the basis of elements of territoriality (an undertaking’s residence or source of income within the territory) serves to confer on a State a primary right to tax certain income. This, taken together with the rules to prevent double taxation, creates an international system of tax competence. In principle, and even if not without lacunae in particular cases, this system is intended to ensure that all income is taxed, and taxed only once.

Nevertheless, recognising cross-border intra-group transfers could lead to double non-taxation of income if the transfers could be deducted from the taxable profits of the transferor company.

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121 Opinion of Advocate General Kokott in ECJ C-231/05, *Oy AA*.
122 Opinion of Advocate General Kokott in ECJ C-231/05, *Oy AA*, par. 46.
124 Opinion of Advocate General Kokott in ECJ C-231/05, *Oy AA*, par. 50.
125 Opinion of Advocate General Kokott in ECJ C-231/05, *Oy AA*, par. 51.
126 Opinion of Advocate General Kokott in ECJ C-231/05, *Oy AA*, par. 53.
notwithstanding that they were not taxable in the country in which the recipient company had its seat.\textsuperscript{128}

Advocate General Kokott also points out that the third element of justification (i.e. the risk of tax avoidance) is closely linked to the other two elements of justification. One might regard intra-group transfers to companies resident in Member States in which such payments are not taxable in itself as tax avoidance. To that extent this justification may be considered together with the second justification. Moreover, tax avoidance can be regarded as deliberately transferring income, by means of intra-group transfers, to companies resident in low tax jurisdictions.\textsuperscript{129}

Advocate General Kokott is correct when saying that, strictly speaking, prevention of this form of ‘tax avoidance’ is not a separate ground of justification which can justify a restriction on the freedom of establishment. The fact that undertakings seek to profit from the differences between national tax systems is a legitimate form of economic conduct, and is indeed inevitable in an internal market in which taxation of corporations is not harmonized.\textsuperscript{130} Subsequently, Advocate General Kokott considers that restrictions on the fundamental freedoms can be justified only if such ‘tax optimisation’ also undermines the balanced allocation of taxing right between Member States.\textsuperscript{131}

The relevant part of this reasoning is that the prevention of tax avoidance, consisting of ‘tax optimisation’, can only be accepted as a justification element if the ‘tax optimisation’ also undermines the balanced allocation of taxing rights. And since the principle of territoriality underlies the balanced allocation of taxing rights, it plays an important role in the acceptance as a justification ground.

Moreover, I agree with Advocate General Kokott that recognising the allocation of the power to impose taxes according to the principle of territoriality as a ground of justification is not inconsistent with the principle that restrictions on the fundamental freedoms cannot be justified by reference to the purpose of preventing a reduction in tax revenue. As this principle simply means that fundamental freedoms cannot be restricted on account of purely fiscal considerations, it cannot be applied to the present case which concerns the fundamental interest of granting Member States a right at all to impose taxes according to the principle of territoriality.\textsuperscript{132}

Advocate-General Kokott therefore considers that restricting the deductibility of intra-group transfers to transfers to Finnish companies is apt to safeguard the allocation of powers to impose taxes between Member States, to exclude the possibility that income which is transferred is not taxed, and to combat tax avoidance. It ensures that profits earned by group companies in Finland are subject to tax there according to the principle of territoriality.\textsuperscript{133}

\textsuperscript{128} Opinion of Advocate General Kokott in ECJ C-231/05, Oy AA, par. 57.
\textsuperscript{129} Opinion of Advocate General Kokott in ECJ C-231/05, Oy AA, par. 61.
\textsuperscript{130} Opinion of Advocate General Kokott in ECJ C-231/05, Oy AA, par. 62.
\textsuperscript{131} Opinion of Advocate General Kokott in ECJ C-231/05, Oy AA, par. 63.
\textsuperscript{132} Opinion of Advocate General Kokott in ECJ C-231/05, Oy AA, par. 64.
\textsuperscript{133} Opinion of Advocate General Kokott in ECJ C-231/05, Oy AA, par. 65.
From this reasoning, one could argue that undermining the allocation of power to impose taxes according to the principle of territoriality could be accepted as a justification ground.

3.3.1.6. X Holding

*X Holding* is a case about the Dutch rules on the opportunity to constitute a consolidated tax entity between companies belonging to the same group, as it resulted from the law on corporation tax from 1969. According to article 15 of this law, a parent company and one or several subsidiaries owned to 95% could be taxed as one entity, i.e. tax is levied on the parent company for all the companies included in the tax unity. Consequently, internal transactions could be eliminated, assets could be transferred without tax consequences, and only one tax return could be handed in.

The Dutch rules were, however, limited to companies resident in the Netherlands, or to permanent establishments taxable in the Netherlands. Therefore, when X holding applied for tax unity with its Belgian subsidiary that had no taxable permanent establishment in the Netherlands, the tax authorities refused this request.\(^{134}\)

The ECJ was asked whether the exclusion of foreign companies from tax unity was compatible with EU law, and concluded that although a difference in treatment was at hand, it was justified by the need to preserve the balanced allocation of the power to impose taxes between Member States.\(^{135}\)

3.3.1.7. Concluding remarks

Whether a parent company with a foreign subsidiary is comparable to a parent company with a domestic subsidiary is a relevant issue. It is true that in the absence of both residence and source within the territory of a certain State, foreign companies are usually not taxed. The fact that no tax jurisdiction is exercised on foreign companies seems to result from a choice of the (home) State, not from an obligation imposed by international law. As observed earlier, international law does not set clear limits to a State’s tax jurisdiction, so that taxation of foreign subjects is not prohibited under international law. States may choose the connecting factor they like to levy taxes, since international law does not contain a set of compulsory factors. Therefore, the existence of *e.g.* residence, nationality or source is generally not required for a State to exercise tax jurisdiction.

In *Bosal*, the ECJ went even further by saying that if the resident and non-resident subsidiaries are not comparable, their parent companies are since they are never taxed on the profits generated by their respective subsidiaries. This strictly legalistic approach goes, in my opinion, too far as it shows insufficient respect for the balanced allocation of taxing rights. Member States are, in principle, allowed to limit their tax jurisdiction to profits/income produced or sourced within their territory.

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134 The Belgian Subsidiary was loss-making, although this was not indicated in the wording of the ruling. See E.C.C.M. KEMMEREN, “The Netherlands, pending cases filed by Netherlands courts”, in M. LANG, P. PISTONE, J. SCHUCH and C. STARINGER (Eds.), *ECJ – recent developments in direct taxation*, Linde, 2009, p. 179.

135 It can be observed that the Dutch Supreme Court followed the X Holding decision and found that the Dutch tax unity rules did not infringe EU law: see Hoge Raad, 7 januari 2011, nr. 43-484bis.
Therefore, since they are not taxing the positive income of foreign subsidiaries, they must also be allowed not to take into account the negative foreign income.

As regards foreign final losses, the ECJ applies a “always-somewhere” approach. If the losses cannot be deducted in the host State, the home State is obliged to take into account the losses. As a result, the ECJ forces Member States to asymmetrically extend their taxing jurisdiction to (parts of) the negative income of a non-resident subsidiary over which it symmetrically had not asserted any taxing jurisdiction. Accordingly, the fiscal principle of territoriality seems to be incompatible with the objective of the achievement of the internal market, when this principle prevents the offsetting losses against taxable profits. With respect to non-final losses, however, it follows from Marks & Spencer, Oy AA and X holding that Member States are allowed not to take them into account. Hence, this solution does lean towards a taxation in line with the fiscal principle of territoriality, as foreign losses are to be deducted first in the host State without imposing on the home State to offer an (automatic) right of deduction. This solution also respects the Member States’ fiscal sovereignty. Nevertheless, also in the case of non-final losses there’s a tension between the fiscal principle of territoriality is and the objective of achieving an internal market, as businesses still endure a less favourable treatment when crossing the border. It was argued, however, that the ECJ was right not to require Member States to offset non-final losses. Although the ECJ accepted the obstacles to the achievement of the internal market caused by the fiscal principle of territoriality with respect to non-final losses, the fiscal principle of territoriality becomes unacceptable when it prevents the relief of final foreign losses. Requiring the home State to grant loss relief for all the final losses incurred in the host State is, however, criticisable.

It can be argued that the Marks & Spencer doctrine is flawed by the necessary obligation it imposes on the home State to grant relief for all the final losses incurred by a foreign subsidiary. Although Marks & Spencer permits to offset final losses against profits incurred in another Member State, it does not help to achieve a well-balanced allocation of the power to impose taxes within the internal market as it creates tax planning opportunities. The foreign subsidiary may deliberately make sure that a loss is not deducted in the host State so as to deduct it in the home State. Such tax planning opportunities will only be prohibited if the final losses in the host State are the result of wholly artificial arrangements. This drawback may be add to other drawbacks, such as the definition of final losses and the risk that final losses are deducted more than once. Consequently, although the Marks & Spencer doctrine may be a step in the direction for the achievement of the internal market, it does not suffice to reach this objective and, at the same time, results in other problems for the achievement of the internal market. Hence, cross-border loss relief should be addressed through positive integration rather than through negative integration. In other words, one may consider the harmonization of cross-border loss relief instead of letting final loss relief be provided by Member States’ domestic tax laws on the basis of the Marks & Spencer doctrine.
3.3.2. Case law concerning permanent establishments

Since it is part of a State’s sovereignty to decide upon the extent of its tax jurisdiction, it is an essential characteristic of this sovereignty to not exercise such a tax jurisdiction. A State is entitled to apply the fiscal principle of territoriality and exempt the foreign income from the resident taxpayers. Often the fiscal principle of territoriality is applied symmetrically to foreign positive and negative income: as a corollary to a limitation of their taxing rights, States applying the fiscal principle of territoriality usually limit the extent of the tax advantages they may offer in relation to foreign items of income. That is, if permanent establishment are not taxed at the head office level, their losses or the costs related to their activities are usually not taken into account for tax purposes in the State of residence. In principle, if a Member State does not exercise any taxing power over income from (and gains on) foreign real estate, then it is entirely fair, consistent and coherent to also disallow deduction from the domestic tax base of (financing costs for) and losses on such foreign real estate. Such a symmetry is even allowed under international law. The commentary to the OECD model tax convention indicates that States often “treat losses incurred in the other State in the same manner as they treat income arising in that State: as State of residence, they do not allow the deduction of a loss incurred from immovable property or a permanent establishment situated in the other State”.

Nevertheless, the decision to exempt foreign-source income tends to isolate tax bases in each territory. When foreign positive income is exempted, foreign negative income cannot, by way of symmetry, be offset against positive domestic income. Accordingly, the two tax bases are isolated from each other, i.e. no compensation is operated between positive and negative income. As a consequence of the fiscal principle of territoriality, the total tax burden of the enterprise is increased due to the isolation of domestic positive income from foreign negative income. The deduction of foreign negative income is postponed or even lost. Hence, a fundamentally correct and coherent tax base tracing and matching rules do produce impediments to cross-border economic activity as compared to a comparable within-one jurisdiction situation. In other words, exemption of foreign-source negative income may imply a worse treatment than in a domestic context (or if worldwide income was taxed at residence), which raises compatibility issues with the objective of achievement of the internal market.

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136 As long as international commitments, particularly tax treaties and EU law, are respected.
137 This sovereign decision can be implemented either in domestic law or a tax treaty.
138 In this paragraph, we refer to the application of the strict territoriality principle or base exemption, i.e. the income of the foreign permanent establishment (e.g. foreign-source income) is not taken into account at the level of the head office (e.g. eliminated from the tax base altogether). Furthermore, States applying the base exemption also adhere to CIN.
139 Such a symmetry is, however, not automatic. See M. LANG, *Introduction to the law of double tax conventions*, 2013, p.132: “the courts of many States (e.g. Austria, Belgium, the Netherlands and Spain) have stated that the exemption only applies with regard to positive items, while the court of other States (e.g. Germany, Greece and France) have instead maintained that it also applies with regard to negative items.”
141 Par. 44 of the OECD commentary on article 23 of the OECD model convention, 2010.
Indeed, for example losses incurred and not deductible in a cross-border context are often not deductible solely because of them being incurred within another Member State. Therefore, some argue that taxation based on the fiscal principle of territoriality is inherently harming the internal market, because it results in the compensation of profits and losses being impossible solely because they are incurred in different Member States, although these Member States should belong to the same internal market and domestic losses are normally deductible.\footnote{31} On top of that, the ensuing territorial compartmentalization of the tax base is a problem particularly for multinational groups of companies located in small home markets, therefore having a small home tax base.\footnote{31}

In this paragraph, we will analyse the two cases in which the ECJ dealt with losses incurred by permanent establishments, namely \textit{Lidl Belgium}\footnote{145} and \textit{Krankenheim}\footnote{146}. Furthermore, although the case did not concern losses incurred by the permanent establishment itself, we will also have a look at \textit{Deutsche Shell}\footnote{147} since it may have some relevance with regard to the discussion of final losses. Moreover, we will also discuss the \textit{Argenta}\footnote{148} case. Although this case is not about losses incurred by a permanent establishment, it makes clear if (and to what extent) a Member State may, according to the ECJ, deny tax advantages to the domestic head office on the basis that it does not tax the (income of the) foreign permanent establishment.

But before analyzing these cases, we will first briefly discuss the \textit{Futura Participations} case, as it is the case in which the ECJ for the first time mentioned the principle of territoriality.

\subsection*{3.3.2.1. Futura participations}

In \textit{Futura Participations}, the ECJ mentioned for the first time the (fiscal) principle of territoriality. For that reason, it might be interesting to briefly discuss this case.

Futura Participations, a company located in France, carried on an enterprise via its Luxembourg branch. The Luxembourg tax authorities refused to allow a setoff of the branch’s previous losses, on the ground that the conditions under Luxembourg law were not met. In order for a non-resident taxpayer with a Luxembourg branch to carry-forward previous losses in Luxembourg, two conditions must be met. One of the conditions, which is of importance here, was that the losses were economically related to the income earned in Luxembourg. For the purpose of calculating the basis of assessment for non-resident taxpayers, only profits and losses arising from their Luxembourg activities

\begin{thebibliography}{148}
\footnotetext{145} ECJ C-414/06, \textit{Lidl Belgium}.
\footnotetext{146} ECJ C-157/07, \textit{Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v. Finanzamt für Körperschaften III in Berlin} (hereafter: Krankenheim).
\footnotetext{147} ECJ C-293/06, \textit{Deutsche Shell GmbH v. Finanzamt für Grossunternehmen in Hamburg} (hereafter: Deutsche Shell).
\end{thebibliography}
were taken into account. The ECJ held that “such a system, which is in conformity with the fiscal principle of territoriality, cannot be regarded as entailing any discrimination, overt or covert, prohibited by the treaty”. It seems to imply that a tax system which is in conformity with the fiscal principle of territoriality does not entail any discrimination (and any restriction, although this is not explicitly mentioned).

Hence, in *Futura Participations* the ECJ considered the principle of territoriality as an element of the comparability analysis. However, as it appears from subsequent case law, the territoriality principle is often considered as a justification ground when a *Futura Participations*-alike system is regarded as prohibited by the TFEU.

### 3.3.2.2. Deutsche Shell

Deutsche Shell, a German resident company, had a permanent establishment in Italy. The company suffered a currency loss incurred on the start-up capital of the Italian PE, a loss that could not be deducted in Italy because it did not appear there. The German tax authorities refused to deduct the currency loss, based on the German-Italy DTC that provided for the exemption method. Consequently, the loss could not be deducted in either country. Deutsche Shell argued that denial of the deduction for the currency loss was incompatible with the freedom of establishment because it placed the company “in a less favourable situation than if the ‘start-up’ capital had been invested in a company established in Germany”.

The ECJ considered that the rules at issue were incompatible with the freedom of establishment. The ECJ found that there was no option for the permanent establishment to have the currency loss taken into account in Italy. At the justification level, the ECJ rejected both the preservation of the coherence of the (German) tax system and the need to ensure the balanced allocation of taxing rights. Addressing the argument about the coherence of the tax system, the ECJ noted that a direct link must be established between the deductible element and the taxable element. Such a direct link, however, did not exist between the currency gains and currency losses.

In relation to the need to preserve the balanced allocation of taxing rights between the Member States, the ECJ noted that the Member States retain the competence to eliminate double taxation by means of income tax treaties in the absence of harmonized rules at EU level. Consequently, “A Member State cannot be required to take into account the negative results of a permanent establishment situated in

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149 ECJ C-250/95, *Futura Participations*, par. 22.
150 Tax treaty between Germany and Italy, signed on 31 October 1925 and terminated on 1 January 1993.
151 ECJ C-293/06, *Deutsche Shell*, par. 37-40.
152 ECJ C-293/06, *Deutsche Shell*, par. 41.
another Member State solely because those negative results are not capable of being taken into account for tax purposes in the Member State where the permanent establishment is situated.”

Moreover, Member States do not have to draw up their tax rules to avoid disparities with other Member States. The establishment of cross-border structures “may be to the company’s advantage or not, according to the circumstances”, it said. In the case at issue, the ECJ observed that the tax disadvantage related to “a specific operational factor which is capable of being taken into consideration only by the German tax authorities”, and said it is “unacceptable for a Member State to exclude from the basis of assessment of the principal establishment currency losses, which, by their nature, can never be suffered by a permanent establishment”.

**Observations**

The ECJ’s reasoning in *Deutsche Shell* echoes its judgment in *Marks & Spencer*, in which it made similar findings in relation to the UK’s group relief rules, which failed to extend loss relief cross-border. As said earlier, the ECJ found that such tax rules were disproportionate and incompatible with the freedom of establishment in situations in which *Marks & Spencer*, the UK parent company, was unable to obtain its loss relief in the Member State of establishment of its subsidiary. Therefore, in a terminal or final loss situation, the UK may have to grant a loss relief cross-border even though it did not tax the nonresident subsidiaries on their profits in situations where it granted group loss relief to UK parent companies with subsidiaries in the UK.

*Deutsche Shell* seems to be the finest example of such a “always-somewhere” reasoning. In *Deutsche Shell*, the ECJ actually seems to say that because the currency loss does not exist in Italy, but needs to be deductible somewhere, it must be deducted in Germany – even though Germany did not assert any tax jurisdiction, *i.e.* not to the currency gains either. Thus, the ECJ obligated Germany to selectively assume taxing jurisdiction where they had symmetrically decided not to do so. Therefore, Germany was forced to welcome in their taxing jurisdiction negative items of income to which their jurisdiction did not extend.

The inadequacy of the “always-somewhere” approach, however understandable within the general idea of an internal market, and however sympathetic, is evident if one realizes that it inevitably leads to the ECJ having to delineate Member States’ taxing jurisdictions and selectively allocate positive or

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153 ECJ C-293/06, *Deutsche Shell*, par. 42.
154 ECJ C-293/06, *Deutsche Shell*, par. 43.
155 ECJ C-293/06, *Deutsche Shell*, par. 44.
negative parts of income to convenient jurisdictions, disrupting tax base coherence between causally
connected negative and positive items of income.\textsuperscript{158}

Finally, it should be noted that Germany is never entitled to take into account currency profits when
calculating the German tax base. Consequently, Germany will only be facing negative income and can
only be a ‘loser’ and never a ‘winner’. In substance, the cohesion of the German-Luxembourg tax
treaty is frustrated by unbundling the tax base exemption provision.\textsuperscript{159} And since Germany is required
to take into account the currency losses, but may not tax the currency profits based on the exemption
method of the Luxembourg-German tax treaty, the ECJ’s result is unbalanced. Germany will always
be a ‘loser’. Therefore, the ECJ should not unbundle the integrated tax systems like the tax base
exemption, but should foster it.\textsuperscript{160}

3.3.2.3. Lidl Belgium
This case concerned a German resident company that had a loss-incurring permanent establishment
located in Luxembourg. The German-Luxembourg tax treaty provided for the exemption method in
relation to the income of a PE. Therefore, the German tax authorities denied the deduction of the PE
losses. Consequently, the question was whether the freedom of establishment precluded a national tax
regime that does not allow a resident company to deduct losses incurred in connection with a
permanent establishment in another Member State, when that tax regime does allow losses incurred by
a resident permanent establishment to deduct those losses.\textsuperscript{161}

First, it should be noticed that Lidl Belgium is in essence very similar to Marks & Spencer. Both cases
concern whether losses incurred abroad should be taken into account in the Member State of origin,
whereby Marks & Spencer concerned the losses of a foreign subsidiary and Lidl Belgium concerned
the losses of a permanent establishment in another Member State. From a tax law perspective, both
situations are very similar, however, it has been pointed out correctly from a corporate law perspective
that a subsidiary is a separate entity whereas a permanent establishment is merely the factual presence
in another Member State. For those reasons, some legal scholars argued that the carry-over of losses incurred by a foreign PE required stronger justification grounds than the carry-over of losses incurred by a foreign subsidiary.\textsuperscript{162} Nevertheless, the ECJ reconfirmed the allocation of the power to impose

\textsuperscript{159} E.C.C.M. KEMMEREN, “Exemption method for PEs and (major) shareholdings best services: the CCCTB and the internal markets concerned”, \textit{EC Tax Review} 2008, p.132.
\textsuperscript{161} O. MARRES, “The principle of territoriality and cross-border loss compensation”, \textit{Intertax} 2011, p. 118.
\textsuperscript{162} W. SCHÖN, “Losing out at the snooker table: Cross-border loss compensation for PEs and the fundamental freedoms”, in \textit{A vision of taxes within and outside the European Borders, Festschrift in honor of Prof. Dr. Frans Vanistendael}, p. 824; CH. WIMPISSINGER, “Cross-border transfer of losses, the ECJ does not agree with Advocate General Sharpston”, \textit{EC Tax Review} 2009, p. 179.
taxes between Member States as a justification ground for the disallowance by the German tax regime of such foreign losses even though AG Sharpston argued elaborately to have the ECJ distinguish the *Lidl Belgium* case from the *Marks & Spencer* case.\(^{163}\)

AG Sharpston found that Lidl Belgium suffered a discrimination. The discrimination was justified, but it did not pass the proportionality test. The AG observed that Germany had until 1999 a recapture mechanism that permitted the deduction of foreign losses at the head office level, for them to be recaptured when the permanent establishment became profitable. Since such a recapture mechanism was more advantageous for the company than a rejection of the deduction of foreign losses, AG Sharpston considered that the exemption method went beyond what was necessary to attain the objectives pursued.

The ECJ, however, did not follow the AG. It considered that a restriction existed but was justified by the need to preserve the balanced allocation of taxing rights and the need to prevent the risk that losses are used twice. With regard to the proportionality argument, the ECJ did not follow the argument (which was also used in *Marks & Spencer*) of Lidl Belgium and the Commission (and the AG) that Germany could make the right to deduct the losses incurred by a permanent establishment subject to the condition that subsequent profits of the permanent establishment are taxed to the extent of the losses previously offset (*i.e.* a recapture rule).\(^{164}\) Instead, the ECJ simply repeats its consideration in *Marks & Spencer* that a measure which restricts the freedom of establishment only goes beyond what is necessary to attain the objectives pursued where a non-resident entity has exhausted the possibilities for having losses incurred in the Member State where it is situated taken into account for the accounting period concerned and also for previous accounting periods, and where there is no possibility for that entity’s losses to be taken into account in that state for future periods. However, since the Luxembourg PE could carry forward its losses according to Luxembourg law and effectively offset such losses in a following accounting year, such conditions were not fulfilled. Thus, in the ECJ clearly accepts the cash flow disadvantage for transnational situations compared to domestic situations.\(^ {165}\) It can also be deduced from this decision that the ECJ did not want to change its *Marks & Spencer* reasoning with regard to the proportionality argument in the *Oy AA* case.\(^ {166}\)


3.3.2.4. Krankenheim

Krankenheim was a German resident company with a permanent establishment in Austria. Under the Austria-German DTC, Germany exempted the profits of an Austrian PE. Under German domestic rules, however, Germany agreed to give relief for the losses of a German resident company incurred by its PE in a foreign state on the condition that the deducted amount was reintegrated in a later taxation period when the PE made profits (i.e. a recapture mechanism). Although the losses were later recaptured, they could not be carried forward in Austria because they had already been taken into account against the profits of Krankenheim in Germany. Krankenheim argued that the German recapture rules constituted a restriction of the freedom of establishment.

The ECJ found that the German recapture rules were a restriction of the freedom of establishment but that they could be justified. Indeed, the ECJ noted that the reintegration of losses in those circumstances could not be dissociated from having earlier been taken into account, as this reflected the logical symmetry of the German tax system. Thus, the ECJ found that a direct and personal link existed, and it noted that the reintegration rules were “the logical complement of the deduction previously granted”.¹⁶⁷ Therefore, the ECJ concluded that the German rules were justified by the need to guarantee the coherence of the German tax system.

Furthermore, the ECJ concluded that the restriction was appropriate to attain such an objective, “in that it operates in a perfectly symmetrical manner, only deducting losses being reintegrated”¹⁶⁸ and was also proportionate, “since the reintegrated losses were reintegrated only up to the amount of the profits made”¹⁶⁹.

WATTEL finds that the discrimination found by the ECJ, is a mistake: the location of the branch was irrelevant for the tax treatment of its results in the hands of the resident company.¹⁷⁰ Losses of both foreign and domestic branches could be deducted from the company’s profits in Germany and the profits subsequently made by both foreign and domestic branches were taxed in Germany. The cross-border and domestic situation are thus treated exactly alike. Therefore, WATTEL concludes that this case certainly should have ended at the first step of the rule of reason.¹⁷¹ This view was also upheld by MEUSSEN.¹⁷²

¹⁶⁷ ECJ C-157/07, Krankenheim, par. 42.
¹⁶⁸ ECJ C-157/07, Krankenheim, par. 44.
¹⁶⁹ ECJ C-157/07, Krankenheim, par. 45.
Moreover, the disadvantage resulting for the taxpayer was a two-country problem\(^\text{173}\) (a dislocation or disparity), and not a discrimination. And the EU treaty does not provide a remedy for such a disadvantage resulting from a disparity. This problem can only be solved through positive harmonization.

Finally, the ECJ found the fact that the losses could not be offset in Austria (in other tax years) irrelevant. The ECJ observed that Germany could not be made responsible for “particularities of legislation of another Member State”\(^\text{174}\) and that if the combined effect of the two national systems was disadvantageous, then that disadvantage was only imputable to the branch state, \textit{i.e.} Austria. This seems to imply that the “always-somewhere” approach does not apply in this case. According to KIEKEBELD, it appears to be that the \textit{Marks & Spencer} doctrine does not apply to losses which have become definitive through expiration of the relief period of the branch State (\textit{i.e.} due to the particularities of the legislation of another Member State).\(^\text{175}\) The question then still remains how the ECJ would decide a case like \textit{Krankenheim} if the unsuccessful branch is not sold but closed down and the home State reintegrates all remaining losses previously deducted.\(^\text{176}\)

3.3.2.5. Argenta

Although \textit{Argenta} is not about losses incurred by foreign permanent establishments, it nevertheless concerned, just as \textit{Lidl Belgium}, the question whether a reduction in tax base by an item outside the scope of the taxing jurisdiction of that company’s residence state must be allowed and in both cases the absence of taxing power was due to an allocation made in a DTC. As a result, it may be useful to discuss the \textit{Argenta} case in more detail.

The \textit{Argenta} case concerned a Belgian corporate tax measure, most often referred to as ‘notional interest deduction’ (hereinafter ‘NID’). The measure is conceptually simple. Each company is treated as if it had borrowed its equity at a yearly rate equal to that of a ten-year Belgian government bond\(^\text{177}\).\(^\text{177}\) The NID therefore leads to a reduction of a Belgian company’s effective tax rate. In order to determine the amount of the NID several adjustments have to be made to the company’s equity. One of the adjustments relates to foreign permanent establishments: the net book value of the assets and liabilities attributable to a permanent establishment located in a country with which Belgium has

\(^{173}\) \textit{i.e.} the exercise in parallel of (uncoordinated) sovereign taxing power (negative jurisdiction conflict).

\(^{174}\) ECI C-157/07, \textit{Krankenheim}, par. 49.


\(^{177}\) Because of budgetary constraints, the rate has been reduced later.

entered into a double tax treaty is to be excluded from the company’s equity.\(^{179}\) The reason for this adjustment is obvious. Under its tax treaties, which are all patterned after the OECD model convention, Belgium exempts the income attributed to the (foreign) PE.\(^{180}\) It should thus not extend a tax benefit to the equity which a Belgian company uses in a PE abroad and which generates profits which Belgium is unable to tax under the allocation rights agreed in its tax treaties.

Argenta, a Belgian resident company, had a PE in the Netherlands. On the basis of the Belgian-Dutch DTC\(^{181}\), the Belgian tax authorities excluded the net value of the assets and liabilities of the Dutch PE from the NID’s calculation base. Argenta argued that this adjustment was an obstacle to the freedom of establishment. It is true that if Argenta’s branch would have been located in Belgium, no assets would have been excluded for purposes of the calculation of its NID. As a result of Argenta’s decision to invest in another Member State, the equity (e.g. risk capital) is reduced by the value of the investment abroad, resulting in a lower NID and thus a higher corporate income tax base (and higher effective corporate income tax rate).

However, also the counterargument seems straightforward: You can’t have the pie and eat it.\(^{182}\) Since profits of the Dutch permanent establishment are only taxable in the Netherlands, it seems unreasonable to oblige Belgium to extend the advantage of the NID to the permanent establishment. Moreover not extending the NID to the exempt PE is consistent with the refusal to grant other tax advantages in Belgium (e.g. tax deduction for interest paid on loans attributable to a Dutch PE). In that respect, one could argue that the fact that no NID is available for the Dutch PE is rather a consequence of the absence of an allowance for corporate equity in the Netherlands than of the refusal of Belgium not to extend its NID to the exempt PE.\(^{183}\)

The ECJ, however, found that there was a restriction of the freedom of establishment. Consequently, the Belgian government invoked two justification grounds to justify the exclusion of the net book value of the Dutch PE: (i) the need to ensure the coherence of the Belgian tax system and (ii) the need to ensure the balanced allocation of taxing powers in the Belgian-Dutch tax treaty which is based on the OECD recognized principle of territoriality.\(^{184}\) The ECJ dismissed both justifications.

\(^{179}\) The company’s equity is thus not reduced by the net value of the assets attributable to the permanent establishment (without taking into account the liabilities).
\(^{180}\) Belgium applies the exemption method with regard to income from permanent establishments.
\(^{181}\) As the income from the PE were exempt from Belgian CIT based on articles 7 and 23(1) of the Belgian-Dutch DTC.
\(^{184}\) ECJ C-350/11, Argenta, par. 36.
As to the argument that the exclusion is justified to ensure coherence of the Belgian tax system, the ECJ applied its traditional coherence-case law. According to this case law, there must be a direct link between the tax advantage and the tax levy setting of that advantage in the light of the objective pursued by the tax legislation. In order to establish the existence of a ‘direct link’, it is required that the tax advantage and the corresponding tax levy relate to the same tax and the applied to one and the same taxpayer. Since Bachmann, however, the coherence argument was not accepted as a justification ground by the ECJ until the Krankenheim case. As observed earlier, in Krankenheim the ECJ stressed the direct link by stating that the reintroduction (of losses) “in the case of a company with a PE in another State in relation to which that company’s State of residence has no power of taxation, reflects a logical symmetry”.

In Argenta, however, the coherence of the tax system was not withheld as an appropriate justification ground by the ECJ. The Belgian Government argued that a direct link existed between the tax advantage and the taxation of profits generated by these assets. In this respect, it seems perfectly sound that a Member State excludes assets from a tax benefit (i.e. NID) awarded to domestic companies if that Member State has no tax jurisdiction on the profits derived from such assets under the applicable DTC. Nevertheless, the ECJ refused to acknowledge the existence of a direct link. It argued that the advantage, consisting of the taking into account of the ‘assets’ of the PE for purposes of calculating the NID, had as effect the reduction of the effective corporate tax rate, and that no direct link with the tax levy exists. To underpin this assertion, the ECJ observes that to qualify for the NID it suffices that the profit generated by the permanent establishment is theoretically taxable in Belgium but it is not required that the permanent establishment actually derives any profit or that the profit is effectively subject to tax. This restrictive interpretation of the coherence argument as a justification ground and the required direct link appears to be consistent with the ECJ’s previous case law, where the ECJ required that a close relation existed between the advantage and a matching tax levy. In my opinion, however, the ‘logical symmetry’ approach which was used by the ECJ in Krankenheim to justify restrictive national rules where the Member State in question had no taxing rights over income

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185 ECJ C-350/11, Argenta, par. 42-49.
186 ECJ C-9/02, Lasteyrie du Saillant, par. 62-67; Case C-319/02, Manninen, par. 42-48.
187 ECJ C-35/98, Verkooijen, par. 58; ECJ C-251/98, Baars, par. 40; ECJ C-168/01, Bosal, par. 29-30.
188 ECJ C-157/07, Krankenheim, par. 42.
191 See also L. DE BROE, “The ECJ’s judgment in Argenta: Narrow interpretation of ‘the preservation of the balanced allocation of taxing rights between Member States’. A headache for designers of tax incentives in the Union.”, EC Tax Review 2013, p. 211: “In view of the narrow interpretation traditionally given by the ECJ to the justification based on the cohesion of the national tax system, the chances of justifying the exclusion of the PE-assets from the NID’s computation basis on that ground were very remote (...)."
realized in another Member State should also have been recognized in Argenta as a justification for the exclusion from a tax advantage of assets invested in a PE in another Member State in relation to which Belgium had no power of taxation. Therefore, I respectfully disagree with the ECJ on this point.

As to the argument that the exclusion is justified to ensure the balanced allocation of taxing rights, the ECJ applies a narrow interpretation. The ECJ limits this justification to cases where the conduct of the taxpayer erodes a Member States’ tax base and jeopardizes the right of that Member State to assert its tax jurisdiction on profits generated in its territory. Accordingly, this justification ground seems not capable to justify legislation enacted by a Member State that reserves a tax benefit only to income that comes within the purview of that Member State’s tax jurisdiction where there is no evidence of manipulative conduct of the taxpayer.193 Because of its similarities with the question at stake in the Argenta case, Lidl Belgium offered a strong argument for the Belgian government194. In its Argenta judgment, however, the ECJ distinguishes the two cases, arguing that Lidl, unlike Argenta, deals with the conduct of a taxpayer that would lead to erosion of the tax base of the Member State of residence. This requirement of manipulative behaviour of the taxpayer is an unnecessary restriction to the justification. Also, the ECJ’s conclusion that the inclusion of PE-assets in the NID’s computation base would not affect the taxing rights allocated to Belgium under the tax treaty is questionable since the deduction of the PE-related NID from Belgian source profit would lead to a clear reduction of the Belgian tax base by means of a tax relief that relates to assets on which Belgium has no tax jurisdiction. Furthermore, the ECJ’s observation that such inclusion would not affect the taxpayer’s is also discussable, as the judgment may encourage Belgium companies to allocate assets to PE’s in a low tax jurisdiction and claim the extra NID against the Belgian profits. Hence, the distinction between Lidl Belgium and Argenta seems to be ill-founded.195

194 See L. DE BROE, “The ECJ’s judgment in Argenta: Narrow interpretation of ‘the preservation of the balanced allocation of taxing rights between Member States’. A headache for designers of tax incentives in the Union.”, EC Tax Review 2013, p. 211: “Lidl Belgium also concerned a taxpayer resident in a Member State who claims a tax base reduction that is alien to the tax jurisdiction of that Member State. The ECJ held that allowing a German company to deduct from German profits the losses which it incurred in a Luxembourg PE, on which Germany did not assert any taxing power, would endanger the balanced allocation of taxing rights because the company would be able to freely choose the Member State in which the losses could be deducted.”
Finally, DE BROE argues that the judgment in Argenta may cause a headache to tax legislators in Member States who wish to limit the scope of tax incentives to profit which comes within the purview of their tax jurisdiction.\footnote{L. DE BROE, “The ECJ’s judgment in Argenta: Narrow interpretation of ‘the preservation of the balanced allocation of taxing rights between Member States’. A headache for designers of tax incentives in the Union.“, \textit{EC Tax Review} 2013, p. 212.} If such tax incentives are restrictive, they should be crafted in such a manner that they can be justified by the need to preserve the coherence of the tax system. The traditionally strict interpretation of this justification grounds seems even to be somewhat softened in the recent \textit{K} case. K., a Finnish resident taxpayer, realized a loss on the sale of a French immovable property. French law did not provide for a possibility to deduct the loss and under Finnish law the loss was also not deductible. The ECJ observed that if it were to be accepted that a taxpayer’s losses incurred in another Member State must be deductible in that taxpayer’s residence State, without having proper regard to the allocation of taxing rights as agreed between the two States concerned, such situation “would effectively allow the taxpayer to choose freely the Member State in which the taking into account of those losses is most advantageous from the tax perspective”.\footnote{ECJ C-322/11, \textit{K}, par. 54.} With respect to the cohesion argument, the ECJ agreed that the refusal to take into account capital losses incurred on the sale of real estate in France reflected a ‘logic of symmetry’ since the gains that could be derived from the transfer of that real estate would also escape all form of taxation because of the applicable DTC.\footnote{ECJ C-322/11, \textit{K}, par. 67-68.} Subsequently, the ECJ accepted coherence as a justification ground for this restriction and observed that “a direct link thus exists, in the case of the same taxpayer and the same tax, between, on the one hand, the tax advantage granted, namely the taking into account of losses generated by a capital investment, and, on the other, the taxation of returns on that investment”.\footnote{ECJ C-322/11, \textit{K}, par. 69.} What is interesting in the \textit{K} judgment is that the justification ground coherence was accepted together with the justification ground balanced allocation (and thus leading to a broader interpretation of the first justification ground). Nevertheless, it remains to be seen whether the ECJ in \textit{K} has offered an aspirin to relieve the headache it caused in Argenta to designers of tax incentives.

\subsection*{3.3.2.6. Concluding remarks}

One could argue that the fiscal principle of territoriality raises compatibility issues with EU law with regard to losses incurred by permanent establishments, because such losses are isolated in the Member States in which they occur. This tension is inherently incompatible with the objective of achievement of an internal market, because within an internal market no such isolation of profits from losses would occur. However, when dealing with this issue, the ECJ did not oblige the home State to take into account (non-final) losses of foreign permanent establishments. Furthermore, in the ECJ assimilated permanent establishments to subsidiaries and simply transposed the solution of \textit{Marks & Spencer}, without adapting it to the particular context of the relation between head office and its permanent
establishment. With respect to the proportionality test, the ECJ seems to accept cash-flow disadvantages. Nonetheless, the AG and EC proposed a recapture mechanism as an alternative to the disallowance of the foreign PE losses. Although such a mechanism may be beneficial as it leads to the encouragement of the freedom of establishment and a certain level of both CIN and CEN, it is, in my opinion, not up to the ECJ to design or elaborate on such a mechanism. This should be done through positive integration.

In *Deutsche Shell*, however, the ECJ again applied its “always-somewhere” reasoning: (currency) losses should always be deductible somewhere in the EU. Such a reasoning would lead to the fact that the home State will always be a loser if it did not assert any tax jurisdiction, *i.e.* not to the (currency) profits either. Indeed, the home State will only be facing negative income as it is not entitled to take into account positive items of income (*i.e.* due to the exemption method). Hence, by applying this reasoning, the ECJ seems to delineate Member States’ taxing jurisdiction.

Finally, in *Argenta*, the ECJ should have allowed Belgium not to extend the advantages of the NID to the foreign PE as it did not assert any taxing power over the foreign PE. In addition, the fact that no NID is available for the Dutch PE seems to be rather a consequence of the absence of an allowance for corporate equity in the Netherlands than of the refusal of Belgium not to extend its NID to the exempt PE. Furthermore, it can be argued that the ECJ’s reasoning falsely deters national legislators from limiting the scope of tax incentives to profit which comes within the purview of their tax jurisdiction.

As observed, the ECJ often seems to qualify a disadvantage (*e.g.* two country problem, disparity) as a restriction to preserve the possibility to interfere in the competence of Member States in cases where the disadvantage is considered disproportional by the ECJ.
4. Summary and conclusions
Firstly, I have tried to identify what is meant by the principle of territoriality. In that respect, we have seen that the principle of territoriality is interpreted differently by international (public) law and international tax law. In the international (public) law, the territoriality principle is one of the jurisdiction principles and entitles a State to jurisdiction based on a territorial connection between this State and a legal object or subject. In other words, States are in principle allowed to tax their citizens and the income connected to their territory.
In international tax law, the limitation of the tax base to income that is sourced within the State’s territory is referred to as the principle of territoriality. In that respect, the territoriality principle is often aligned with tax liability based on the source principle.
According to settled case law, a Member State acts in accordance with the principle of territoriality if it taxes resident taxpayers on their worldwide income and non-resident taxpayers on their income sourced in that State. It appears from that case law that the ECJ understands territoriality as it is used in international law and not as territoriality in international tax law, although it refers to international tax law. In that respect, the ECJ regards the taxation of residents on their worldwide income as a manifestation of territoriality (i.e. a resident is taxed on the basis of a stable link with the territory of that State), even though tax lawyers would call that worldwide taxation, as opposed to territorial taxation. Even more, exempting resident’s foreign-sourced income is not regarded as a manifestation of territoriality by the ECJ, although such an exemption would be regarded as a manifestation of territoriality under international tax law.
As observed, Member States have maintained their jurisdiction, or competence, in the field of direct taxation, and they remain competent to determine the criteria for taxation of income with a view to eliminate double taxation. As a consequence thereof, the EU is fragmentized in as many systems as there are Member States. That the Member States have the power to determine the criteria for taxation means that Member States are, in principle, also free to limit their tax jurisdiction and (thus) to not levy tax on a certain person or income. Nevertheless, the Member States must exercise their jurisdiction in accordance with EU law. Therefore, the assumption of taxing jurisdiction is national sovereignty, but the exercise of the jurisdiction is subject to Court scrutiny.
With respect to the principle of territoriality, it follows from the case law that the ECJ considers it sometimes as an element of the comparability analysis and in other cases as a justification ground. In Futura, for example, the ECJ considered the territoriality principle as an element of the comparability analysis and found that a tax system which consistently observes the (fiscal) principle of territoriality cannot be considered to offend the EU treaty freedoms and thus to amount to any discrimination prohibited by the treaty.

200 Either for non-residents only or for both residents and non-residents.
201 Territoriality sensu strictu.
The territoriality principle was first examined as a justification ground in Bosal. In Bosal, however, the ECJ rejected the territoriality principle and limited the territoriality defense to strict one-taxpayer, one-tax situations, without clarification why. After the rejection of the territoriality principle in Bosal, the ECJ accepted the territoriality plea in Marks & Spencer under the balanced allocation of taxing rights argument. This is true, in my opinion, because the concept of a ‘balanced allocation’ is based on the (by the OECD) recognised principle of territoriality. Although the ECJ mainly uses the term ‘the need to preserve the balanced allocation of the power to impose taxes’ for this justification ground, it also uses metaphors such as ‘two sides of the same coin’ and ‘symmetrical treatment in the same tax system’. This makes it difficult to distinguish this justification ground from another important justification ground: ‘fiscal coherence’\(^\text{202}\). Both concepts seems to boil down to the territorial matching of negative and positive elements of income within the same taxing jurisdiction. Hence, cohesion and balanced allocation of taxing power seem to be exchangeable and could lead to a large amount of uncertainty. Therefore, one could argue that the ECJ should refrain from introducing new grounds of justification that lead to uncertainty and avoid combining different grounds of justification (as it did in Marks & Spencer).

Finally, it seems to me that often when the ECJ is using the ‘balanced allocation’ concept, there’s no need for a justification, as the disadvantage identified in cross-border situations usually is not a discrimination, but a disparity or a dislocation.\(^\text{203}\) In that respect, the ECJ often in fact applies a discrimination test, but presents indiscriminateness of the tax measure as a justification for the ‘restriction’ found. Such a reasoning enables the ECJ to continue to keep an eye on the Member States, and if so desired, to still (partly) condemn indiscriminate tax measures if it considers them to intolerably hinder the internal market (as it did, for example, in Marks & Spencer).

It could be said that, although the ECJ has explicitly accepted that exercise in parallel by two States of their tax jurisdiction may lead to double taxation which is irremediable under the free movement rights, it is very reluctant in accepting the logical implication that, inversely, such exercise in parallel may also lead to double non-deductibility of certain charges or losses. Nevertheless, (strict) territoriality leads to the fragmentation of the EU and this fragmentation results in the disadvantage that cross-border loss compensation is, in principle, not available. By qualifying the disadvantage as a restriction, the ECJ preserves the possibility to interfere in the competence of the Member States in cases where the disadvantage would be disproportional. This appears to be the case if losses cannot (or not longer) be taken into account in any Member State. This position can be regarded as a manifestation of the “always-somewhere” approach: losses should always be deductible somewhere within the EU. In that respect, the ECJ forced, in Deutsche Shell and Marks & Spencer, the home

\(^\text{202}\) Also called ‘fiscal symmetry’.

\(^\text{203}\) Or as the ECJ calls it in cases of double taxation: a consequence of (indiscriminate) ‘exercise in parallel’ of taxing power.
States to welcome into their tax jurisdiction negative items of income to which their jurisdiction did not extend. Hence, the ECJ often obliges Member States to assume taxing jurisdiction where they had symmetrically decided not to do so. It seems evident that such an “always-somewhere” approach inevitably leads to the ECJ having to delineate Member States taxing jurisdiction and selectively allocate negative and positive parts of income to convenient jurisdiction, disrupting tax base coherence between causally connected negative and positive items of income, and even requiring national tax jurisdiction to be extended to persons entirely not liable to tax (f.e. Marks & Spencer). By doing so, the ECJ seems, in my opinion, to overstretch its judicial powers. Nonetheless, considering the ‘recent’ age, Deutsche Shell and Marks & Spencer, this “always-somewhere” reasoning seems to be not (yet) obsolete.

As a final conclusion, one could argue that the ECJ’s reasoning often conflicts with its own assumption that Member States are free to determine the criteria for taxation. As Member States have to power to determine the criteria for taxation, they are, in principle, also allowed to limit their tax jurisdiction (to certain persons or types of income). In Lidl Belgium, the ECJ has accepted a territoriality system for resident taxpayers and hence seems to accept the compartmentalization of the tax base. In other cases such as Bosal, Marks & Spencer, Deutsche Shell, however, the ECJ does not want to accept the consequences of the limitation of the tax jurisdiction. And in the Argenta case, the residence State was obliged to grant tax advantages with respect to a permanent establishment over which it did not (symmetrically) asserted any taxing power. Hence, the ECJ often considers the disadvantages that arise from the independent application of various tax systems as restrictions of the fundamental freedoms. In my opinion, the ECJ should, nevertheless, have held that there are disadvantages that arise from allowable disparities or dislocations. The ECJ, nonetheless, as it follows from the case law discussed, often still seems to use an obstacle-based approach (instead of a discrimination-based approach), whenever it feels competent to solve a two-country problem of the taxpayer without guidance from the Union legislator.
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