Cross-Border Group Tax Relief under EU Law

Tax Sovereignty vs. Internal Market

Master Thesis by

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I would like to express my sincerest appreciation and gratitude
To my supervisor Mart van Hulten for his guidance and support.

I dedicate this thesis
To my parents, Ana and Manuel,
Without whose support nothing would be possible
And
To my grandmother, my dear Sarinha,
Who has been always there for me.

"…a common market entails the elimination of all obstacles to intra-Community trade in order to merge the nationals markets into a single market bringing about conditions as close as possible to those of a genuine internal market"

Case 15/81, Gaston Schul, 1982

Glossary

AG – Advocate general

CEN – Capital Export Neutrality

CIN – Capital Import Neutrality

ECJ or the Court – European Court of Justice

EU – European Union

MS – Member State

M&S – Marks & Spencer case

PE – Permanent Establishment

TEU – Treaty on European Union

TFEU – Treaty on the Functioning of the European Union

UK – United Kingdom

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I. Introduction

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

By establishing the European Union (EU), Member States agreed on limiting their sovereign rights in order to create a single market: an area free of barriers to people, goods, services and capital.[1] The idea was (is) to form a system that is comparable to the domestic market of a Member State. However, taxation within the European Union is an aspect of national sovereignty for which Member States are unwilling to relinquish control. Member States retain their tax sovereignty, namely the right to allocate taxing rights between themselves and therefore, the right to define their income tax bases. As far as direct taxation is not harmonized at the level of the EU the paradox is evident as there is meant to be one single market yet there remains twenty-eight different tax-systems.

Although Member States preserved a considerable *power* regarding direct taxation, the primacy of EU law dictates that the exercise of Member States' fiscal sovereignty, like any other field of a State competence, is subordinated to EU law and particularly to the freedoms of movement.[2]

Freedom of establishment, laid down in articles 49 and 54 of the Treaty on the Functioning of the European Union (TFEU), plays an essential role in the achievement of the internal market. A company is free not only to establish itself through a primary establishment in any Member State but also to open up a secondary establishment (e.g. a subsidiary) in another Member State. In a single-market context, Member States must be prevented from creating or maintaining in force measures that prohibit, impede, or render less attractive the exercise of the freedoms of movement throughout the EU.[3] In *an area without internal frontiers*,[4] companies wanting to expand to a Member State other than its home State should not be placed in a disadvantageous position compared to companies wishing to expand in their home jurisdiction.

As the European Commission already stated more than 20 years ago, one of the obstacles which might hinder companies from expanding their activities beyond national *borders* is their

[1] See Article 26 of the Treaty on the Functioning of the European Union (TFEU)
[2] See, e.g., Case 128/08 *Damseaux* [2009] ECR I-6823, para. 24
[3] See, e.g., Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, Opinion of AG Poiares Maduro, para. 35
[4] See article 26 TFEU

"inability to deduct from their profits the losses incurred by (…) subsidiaries situated in Member States other than the one in which the company in question is resident for tax purposes".[5]

In fact, most Member States of the EU allow, for tax purposes, the automatic aggregation of national profits and losses incurred by group companies, i.e. some form of loss relief. Accordingly, group companies may offset the losses of one of the companies with profits of another company of the group. As a result the group will be paying tax only on the balance of its results as a group.

However, loss relief or consolidation mechanisms are most often limited to group companies with residence in the same Member State. A group may therefore, end up better off in domestic situations rather than in cross-border situations. Group companies wishing to expand into another Member State are placed in a disadvantage situation – as they are unable to use the potential losses against profits – in comparison with domestic group companies. Consequently, group companies are being hindered from, in the exercise of their freedom of establishment, expanding throughout the European Union.

As Member States are under the obligation to exercise their fiscal competence consistently with EU law, the Court of Justice of the European Union (ECJ) has been called upon to interpret and apply the free movement provisions of the TFEU to assess the compatibility of national tax measures concerning cross-border loss relief with the freedom of establishment. In doing so, the Court has the difficult task of balancing the consequences of Member States' tax sovereignty, chiefly the Member States' right to define their income tax bases, with the imperatives of the single market.[6] In the absence of EU harmonization in the area of cross-border loss relief,[7] the jurisprudence of the ECJ has, for more than a decade, been the only *source* of EU law, at least binding the Member States, existent in the field. Hence, one can say that ECJ case law has shaped European tax law, in particular cross-border loss relief under EU law, into what it is today.

Notwithstanding, the current *state of art* of the cross-border loss relief scene under EU law has been described as chaotic and desperate.[8] More than 10 years after the first decision of the ECJ

[5] Commission Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States, COM(90) 595 final, OJ C 53, 28 February 1991, Explanatory Memorandum, para. 1
[6] Christiana HJI Panayi, *Reverse Subsidiarity and Cross Border Loss Relief: Can Member States Be Left to their Own Devises?*, 55(3) British Tax Review (2010)
[7] In 2001, the Commission withdrew its Proposal of 6 Dec. 1990 (Communication from the Commission: Withdrawal of Commission Proposals which are no longer topical, COM (2001) 763 final/2, 21 December 2001, OJ C 5 of 9 Jan. 2002, 2). In 2006, the Commission published a Commission Communication on the Tax Treatment of Losses in Cross-Border Situations, COM (2006) 824 final, OJ C 126, 19 December 2006
[8] See Case C-123/11 *A Oy* [2013] EU:C:2013:84, Opinion of AG Kokott, para. 1

regarding cross-border group relief – the famous *Marks & Spencer* Case[9] – it seems like the issue has not been resolved so far and legal uncertainty still rules.[10] In *Marks & Spencer* the Court proposed a ground-breaking solution to the issue of cross-border loss relief in the EU. After recognizing that the allocation of taxing rights among Member States, the risk of double utilization of tax losses and the risk of tax avoidance, taken together, may justify restrictions on the freedom of establishment, in paragraph 59 of the decision the Court set forth the circumstances in which Member States may be obliged to take into account foreign losses in spite of the abovementioned justifications. This is known as *the Marks & Spencer exception*. Today the impact of the decision is still felt as the Court has been recalling the *Marks & Spencer* Case and upholding *the Marks & Spencer exception* in recent cases.[11]

This Master Thesis aims to investigate whether the *Marks & Spencer exception* is a proper reflection of the balance between tax sovereignty and the obligations owing from EU law – an internal market without frontiers – and if not, what the alternative should be judged from the EU's main aims and principles. So as to do so, classic international legal research will be used as the main method: the existing legal framework and the European Court of Justice’s jurisprudence will be analysed, specially the *Marks & Spencer* case, as well as other sources of such as the EU Treaties (TEU and TFEU) and scholarly literature. The emphasis is on cross-border loss relief between group companies rather than within the same company. Being primary EU law the testing framework in this study, a particular relevance to the teleological method of interpretation will be given to it, i.e. the spirit of the law in the achievement of the internal market is decisive in this Master Thesis.

Chapter two will analyse the concepts of internal market and tax sovereignty in order to understand their meaning and most importantly the relation between the two in the context of the European Union.

In chapter three the focus will be on EU cross-border loss relief from the view point of group taxation – first domestic group relief schemes will be presented; then it will be shown that loss relief schemes are generally not extended to cross-border situations and the drawbacks of such limitation for the taxpayer as a restriction to the freedom of establishment within the European Union; after, a

[9] Case C-446/03 *Marks & Spencer* [2005] ECR I-10837

[10] On the questions (and legal uncertainty) raised by *Marks & Spencer*, see, e.g., Axel Cordewener, *Cross-Border Relief and the “Effet Utile” of EU Law: Are We Losing it?*, EC Tax Review vol.20 (2), 58 et seq., 2011 Kluwer Law International, p. 58. Michael Lang, *Has the Case Law of the ECJ on Final Losses Reached the End of the Line?*, European Taxation (volume 54), No 12, 530 et seq., December 2014, Journals IBFD; Michael Lang, *The* Marks & Spencer *Case – The Open Issues Following the ECJ’s Final Word*, European Taxation (volume 46), No 2, 54 et seq., February 2006, Journals IBFD, p. 54; Dennis Weber, *Highlights & Insights on European Taxation*, 3, 2010, p. 28

[11] See for instance, Case C-388/14 *Timac Agro Deutschland* [2015] EU:C:2015:829, para. 53 and Case C-172/13 *Commission v United Kingdom* [2015] EU:C:2015:50, para. 33

background to the issue of non-deduction of foreign losses in an internal market context will be given in order to understand the reasons behind the lack of cross-border loss relief in the Union. Here it will also be discussed the principles of residence taxation and source taxation as well as the methods for eliminating double taxation in order to assess whether they allow cross-border group relief in the EU.

In chapter four, the *Marks & Spencer* Case will be introduced and analysed in detail. Throughout the analysis references will be made to more recent ECJ decisions regarding not only group loss relief but also cases involving the relief of losses incurred in foreign permanent establishments in order to better understand the Court's reasoning and its development until today.

Finally in chapter five, the main findings of this Thesis are put together in order to give an answer to the proposed research question.

II. The Internal Market and Fiscal Sovereignty

2.1 EU as a Tool

The European Union is a *tool* to maintain peace and security throughout its Member States. Moreover, according to Article 3 (1) of the Treaty on European Union, it is the Union's aim to promote "its values and the well-being of its people".[12] Having witnessed the cruelties of the Second World War, the call for permanent peace via the cooperation of the European States, through a "kind of United States of Europe"[13], culminated in 1952 with the creation of the European Coal and Steel Community. It was founded in order to tie the coal and steel industries of Belgium, Luxembourg, the Netherlands, Italy, France and Germany. The idea was to deepen the economic and political integration between the European MS by diminishing the barriers to trade, while ensuring economic cooperation and growth.[14] Shortly it was understood that the creation of a common market was key for the achievement of these goals.

2.2 Concept of Single Market

2.2.1 Origins of the Concept

The concept of single market arose in response to the need for greater economic, legal and political unity between the EU Member States.[15] The origins of the concept of *common market* are reflected in the jurisprudence of the European Court of Justice (hereinafter also referred as ECJ or the Court). According to the Court, it follows from Articles 3 TEU, 3-6 TFEU and 8 TFEU that "the treaty, by establishing a common market and progressively approximating the economic policies of the Member States, seeks to unite national markets into a single market having the characteristics of a domestic market".[16]

With the Single European Act (1987), the concept of common market was complemented by that of *internal market*, which in accordance with Article 26 TFEU, comprises an "area without

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[12] See article 3 (1) of the TEU

[13] Winston Churchill, The tragedy of Europe (Speech at the University of Zürich 19 September 1946) http://www.cfr.org/europe/churchills-united-states-europe-speech-zurich/p32536

[14] Berthold Busch *Europe's Single Market – Exploiting untapped Potentials*, first edition, Konrad Adenauer Stiftung (2013), p. 6, available at http://www.kas.de/wf/doc/kas_35341-1522-24-30.pdf?130909102632

[15] Sjaak Jansen, *Fiscal Sovereignty of the Member States in an Internal Market – Past and Future*, Eucotax Series on European Taxation (volume 28) 2010, Kluwer Law International, p. 52

[16] Case 270/80 *Polydor and Others v Harlequin and Others* [1983] ECR 329, para. 16; Case 207/83 *Commission v United Kingdom* [1985] ECR 1201, para. 17

internal frontiers in which the free movement of goods, persons, services and capital is ensured”.[17] The two concepts can be seen as two sides of the same coin, i.e., the free movement (internal market) cannot exist without a system where competition is not distorted (common market).[18] This might explain why both expressions are very often used as substitutes.[19]

It follows from a consistent line of judgements that, before and after the insertion of the term “internal market” in the TFEU,[20] a common market “involve(d) the elimination of all obstacles to intra-Community trade in order to merge the national markets into a single market bringing about conditions as close as possible to those of a genuine internal market”.[21]

2.2.2 **The Four Freedoms Enshrined in the TFEU**

The realization of the single market depended on the so-called four freedoms: the free movement of people, goods, services and capital. Therefore, being the cornerstones of the internal market, these freedoms are enshrined in the TFEU.[22]

Given that the aim of these treaty provisions is to establish a functioning single market, these rules constitute fundamental rights to protect EU nationals against disproportional public or private interference.[23] To put it differently, the basic idea behind the single market concept is the freedom of movement in every aspect, including for instance the right of individuals or companies to invest, to establish, to work, to sell or buy goods or services anywhere in the EU, according to their own preferences and without any unjustified hindrance from national public or private law.

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[17] Sjaak Jansen, *Fiscal Sovereignty of the Member States in an Internal Market – Past and Future*, Eucotax Series on European Taxation (volume 28) 2010, Kluwer Law International, p. 53

[18] Case 32/65 *Italy v Council of the EEC and Commission of the EEC* [1966] ECR 389; Case C-202/88 *France v Commission* [1991] ECR I-1223, para. 6; Case 231/83 *Cullet v Leclerc* [1985] ECR 305, para. 11; Case C-177/94 *Perfili* [1996] ECR I-161, para. 11

[19] For the purpose of this Thesis, the concepts “common market”, internal market” and “single market” are used indistinctly

[20] With the treaty of Lisbon the expression “common market” in the treaties was replaced by “internal market”

[21] Case 15/81 *Schul* [1982] ECR 1409, para. 33; Case C-297/89 *Ryborg* [1991] ECR I-1943, para. 14; Case C-389/95 *Klattner v Elliniko Dimosio* [1997] ECR I-2719, para. 25; Case C-41/93 *France v Commission* [1994] ECR I-1829, para. 19

[22] See article 26 (2) TFEU; See also Gianluigi Bizioli, *Balancing the Fundamental Freedoms and Tax Sovereignty: Some Thoughts on Recent ECJ Case Law on Direct Taxation*, European Taxation (volume 48), No 3, 133 et seq., March 2008, Journals IBFD, p. 133

[23] Sjaak Jansen, *Fiscal Sovereignty of the Member States in an Internal Market – Past and Future*, Eucotax Series on European Taxation (volume 28) 2010, Kluwer Law International, p. 56

2.2.3 The Primacy of EU law and the Direct Effect of the Treaty Freedoms

The direct effect of European law is, along with the principle of precedence, a fundamental principle of EU law developed by the Court of Justice of the European Union.

In 1964, in the famous *Costa v. E.N.E.L.* judgement, the ECJ settled that, if a common market was to be achieved, European law must take priority over the national laws of the Member States.[24] Without such priority, EU law validity and effectiveness would depend on whether the scope of the various national constitutions of the Member States would allow it and subsequently agree with it or contradict it.

Moreover, EU nationals (individual persons and undertakings) would not be able to rely on and evoke their EU rights if those were not contemplated in their own national systems. On that account, to prevent EU law from being inconsequential not only priority over national law is need but also direct effect. According to the *Van Gend & Loos* judgment, it is ECJ settled case law that some EU law provisions have direct effect, i.e., individuals and undertakings may rely and evoke those provisions in court against their administrations, if certain conditions are met. In order for the provision to have direct effect it has to be sufficiently precise, clear and unconditional to be applied by the administration and in court.[25] Hence, an EU national may, in proceedings against a Member State, rely on sufficiently precise, clear and unconditional provisions of EU law, such as Treaties and Directives, to "block" any incompatible domestic provision or measure, including constitutional provisions.[26]

The TFEU's provisions on the free movement of goods, persons, services and capital are considered to meet the criteria of direct effect.[27] As a result, not only EU law, and especially the fundamental freedoms, "must be fully and uniformly applied in all Member States"[28] but also any national (tax) measure that contradicts a free movement provision is "rendered automatically inapplicable".[29]

The principle of primacy coupled with the direct effect principle ensure the application and effectiveness of European law in all signatory Member States. Consequently, the treaty freedom provisions constitute fundamental rights for all European citizens, which stem *directly* from European law and are part of the legal system of each signatory Member State. That is to say, the four freedoms

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[24] Case 6/64 *Costa v E.N.E.L.* [1964] ECR 614
[25] Case 26/62 *Van Gend & Loos v Administratie der Belastingen* [1963] ECR 1
[26] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, 6th edition, Kluwer Law International (2012), p. 81
[27] E.g. Case 26/62 *Van Gend & Loos*
[28] Case 106/77 *Aministrazione delle finanze dello Stato v Simmenthal* [1978] ECR 643, para 14
[29] Case 106/77 *Simmenthal*, para 17

enshrined in the TFEU can be compared to the fundamental rights laid down in national constitutions and Member States are, therefore, under the obligation to ensure their full application and effect.[30]

2.3 Tax Sovereignty in the EU

2.3.1 The Principle of Sovereignty

Sovereignty can be defined as a State's inherent right of self-determination within a specific territory and political community.[31] From an international law perspective, the principle of sovereignty expresses the supreme authority of a State over a territory and its citizens.[32]

Having this said, States are always free to limit their sovereignty unilaterally or by means of an international agreement.[33] By establishing the European Union, Member States agreed on limiting their sovereign rights in order to create a supranational entity. In doing so, Member States retained their independence but by entering into a supranational alliance they have voluntarily transferred part of their sovereignty to the Community. The reason they did so was for the sake of the unity of the internal market and uniformity of EU law.[34] In fact, achieving the goals for which the EU was established for depends on this transfer of powers, i.e. Member States needed to relinquish some of their sovereign rights to the Union and its institutions for them to be able to carry out their tasks.[35]

2.3.2 Tax Sovereignty

Tax sovereignty is an expression of a State's sovereignty. The principle of sovereignty as a State's supreme authority over its territory and its citizens implies jurisdiction, including fiscal

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[30] Axel Cordewener, *Cross-Border Relief and the "Effet Utile" of EU Law: Are We Losing it?*, EC Tax Review vol.20 (2), 58 et seq., 2011 Kluwer Law International, p. 58

[31] Sjaak Jansen, *Fiscal Sovereignty of the Member States in an Internal Market – Past and Future*, Eucotax Series on European Taxation (volume 28) 2010, Kluwer Law International, p. 233

[32] Otto Marres, *The Principle of Territoriality and Cross-Border Loss Compensation*, Intertax (volume 39 issue 3), 112 et seq., 2011 Kluwer Law International, p. 112

[33] Sjoerd Douma, *Optimization of Tax Sovereignty and Free Movement*, Doctoral Series (volume 21) December 2011, IBFD, p. 79

[34] Norbert Reich, Christopher Goddard and Ksenija Vasiljeva, *Understanding EU law: objectives, principles and methods of Community law*, Intersentia, 2003 p. 15

[35] Nigel Foster, *EU Law Directions*, Oxford University Press, 4th edition, p.79

jurisdiction.[36] Tax sovereignty is, therefore, the inseparable relation between a sovereign State and its inherent right to levy taxes within its territorial jurisdiction.[37]

Having a State to secure its own existence, a person who benefits from public expenses made by a State, which enables him to produce income, should also contribute to those expenses.[38] This is known for the direct benefit principle. Such contribution should be done in accordance with the proportion the taxpayer benefits from the State enabling him to acquire and/or possess wealth. In other words, a taxpayer contribution is limited to its ability to pay, i.e. wealth.

In order to achieve a greater integration in the Union, Member States voluntarily transferred part of their sovereignty to the EU. Notwithstanding, as far as direct taxation is concerned any competence was given to the EU. Taxation within the European Union is an aspect of national sovereignty for which Member States are unwilling to relinquish control. The paradox is evident as there is meant to be "one single market" yet there are twenty-eight different tax systems.

There is in fact no express reference to direct taxation in the Treaties allowing EU institutions to create laws in this field. Nevertheless, article 115 TFEU opens the possibility of doing so if there is an unanimous vote. Although it is not easy to achieve such a vote, five directives[39] have been previously generated through unanimity, which shows some progress in this area.

Despite of any fruitful cooperation between the Member States the harmonization of direct taxation, especially in the field of corporate taxation, has not been achieved. As long as direct taxation is an area not yet harmonized, the Member States retain their tax jurisdiction.[40] In the exercise of their tax sovereignty, States may define their income tax base and, therefore, determine the taxable events. Consequently, the EU internal market is fragmentized into twenty-eight different tax systems. The consequence of such parallel exercise of Member States' fiscal sovereignty is that parts of income may be taxed twice (double taxation) and other parts of income may not be subject to tax *anywhere* (double non-taxation).[41]

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[36] Otto Marres, *The Principle of Territoriality and Cross-Border Loss Compensation*, Intertax (volume 39 issue 3), 112 et seq., 2011 Kluwer Law International, p 112

[37] Sjaak Jansen, *Fiscal Sovereignty of the Member States in an Internal Market – Past and Future*, Eucotax Series on European Taxation (volume 28) 2010, Kluwer Law International, p. 58

[38] See, for instance, Eric C. C. M. Kemmeren, *Principle of Origin in Tax Conventions: A rethinking of Models*, Tilburg University Press (2011), p. 22-24

[39] Directive 77/779 EEC; 90/434 and 435 EEC; and 2003/48 and 49 EEC

[40] Otto Marres, *The Principle of Territoriality and Cross-Border Loss Compensation*, Intertax (volume 39 issue 3), 112 et seq., 2011 Kluwer Law International, p. 113

[41] Michael Lang, *The* Marks & Spencer *Case – The Open Issues Following the ECJ's Final Word*, European Taxation (volume 46), No 2, 54 et seq., February 2006, Journals IBFD, p. 58

2.3.3 **Direct Taxation – Outside the Scope of EU Law?**

It is settled ECJ case law that "the Member States as a matter of principle retain extensive competences in tax matters".[42] Notably, Member States remain free to determine the organization and conception of their tax system as well as the need to allocate taxing powers between themselves.[43] In *Bachmann v. Belgium*,[44] the ECJ has made clear that sovereignty in (direct) tax matters rests with the Member States,[45] namely the right to allocate taxing power between them and thus, the right to define their income tax base.

Nevertheless, corporate tax laws play an essential role in the economy of each EU Member State. While indirect taxes are a more obvious impediment to intra-Community trade, visibly and immediately affecting the freedom to *trade*, direct taxes distort the market in a more diffuse way. Direct taxation, falling within the competence of the Member States, influences investment, establishment and employment decisions and for this reason must not be seen as minor obstacle to the functioning of the internal market.[46]

As the EU Treaties require European nationals not to be subject to discriminations or discriminatory restrictions[47] when doing business throughout the internal market, direct taxation may be an obstacle for the exercise of the fundamental freedoms within the EU market – specifically when, for tax purposes, a cross-border situation is treated less favourably than a comparable domestic situation.[48]

With this in mind, over the past twenty years it has been accepted that "although, as EU law stands at present, direct taxation does not fall within the purview of the Union, the powers retained by the Member States must nevertheless be exercised consistently with EU law."[49] Accordingly, the *assumption* of taxing jurisdiction is an expression of a Member State's national sovereignty however "the *exercise* of the jurisdiction so assumed is subject to Court scrutiny".[50] National (tax) sovereignty is, hence, restricted by negative integration. Therefore, in a single market context, even in areas where

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[42] Case C-446/03 *Marks & Spencer* [2005] ECR I-10837, Opinion of AG Poiares Maduro, paras 23-24

[43] Sjoerd Douma, *Optimization of Tax Sovereignty and Free Movement*, Doctoral Series (volume 21) December 2011, IBFD, p. 251

[44] Case C-204/90 *Bachmann v Belgium* [1992] ECR 1-249

[45] Sylvia Elwes, *The Internal Market versus the Right of Member States to Levy Direct Tax-A Clash of Fundamental* Principles, Intertax (volume 41 issue 1), 12 et seq., 2013 Kluwer Law International, p. 18

[46] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 124

[47] See articles 2 TEU and 18 TFEU, as well as articles of the TFEU on the freedoms of movement (i.e. articles 28, 45, 49, and 63 TFEU)

[48] As well as when States maintain selective incentives, i.e. State Aid; Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 24

[49] See, e.g., Case 128/08 *Damseaux* [2009] ECR I-6823, para. 24

[50] E.g. Case C-307/97 *Saint-Gobain* ZN [1999] ECR I-6161; See also, Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 460

the EU lacks competence, the exercise of Member States' exclusive rights, i.e., sovereign powers, is fully subject to all constraints of the EU treaties, especially to the Treaty freedoms.[51]

Arguably, accepting that the exercise of Member States' tax sovereignty falls outside the scope of EU law and the fundamental freedoms would mean denying "the existence of (the) obligations to which the Member States have committed themselves when they concluded the TEU and the TFEU with the creation of an internal market as the primary objective". [52] This might explain why the ECJ's jurisprudence plays an essential role in areas such as direct taxation, where the EU, in fact, lacks competence.

All things considered, it can be said that despite Member States retain a large competence with regards to direct taxation – chiefly the right to allocate taxing power between themselves and, therefore, define their income tax base – it must not be seen as an absolute power falling outside the scope of EU law, i.e. the exercise of those taxation powers must always be done in accordance with EU law, namely with the fundamental freedoms enshrined in the TFEU.

[51] Sjoerd Douma, *Optimization of Tax Sovereignty and Free Movement*, Doctoral Series (volume 21) December 2011, IBFD, p. 251

[52] Sjoerd Douma, *Optimization of Tax Sovereignty and Free Movement*, p. 251.

III. Cross-border Group Relief

3.1 The issue

3.1.1 Group Taxation and Loss Relief

"Group taxation[53] is designed to reduce the effect that the separate existence of related companies has on the aggregate tax liability of the group".[54]

Typically, losses incurred in a subsidiary (or a PE) can be used against its own profits in a previous year or in future years. However, if in a given year, a subsidiary incurs losses and the rest of the group has profits, a cash-flow disadvantage and interest loss exist if the group may not offset the subsidiary's losses in the year in which they were incurred. For that reason, group taxation enables companies that form part of the same group of companies a possibility to pool their results. Consequently, losses can be used against profits in the year in which they occurred and therefore the group will be paying tax only on the balance of the results of the group. Rightly so as such a balance represents the group's *real* ability-to-pay in a given tax year.

Group taxation may either entail total tax consolidation or be limited to loss trading (loss carry-over mechanism) or profit contribution (profit carry-over mechanism). Moreover, these group taxation schemes may be applied both horizontally, i.e., between subsidiaries also known for sister companies, and vertically, i.e., between the parent company and its subsidiaries.

By allowing group companies to pool their results, a State promotes equal treatment as compared to a company that expands or invests by setting up branches rather than subsidiaries. This kind of neutrality is achieved, among other means,[55] by the possibility to offset profits and losses between companies belonging to the same group, reducing, thus, their tax exposure.[56]

[53] Applied by all Member States of the European Union currently, at least at the domestic level, i.e., to national group companies.
[54] Jones Day, Group Taxation #1, 2003, p.1, available in: http://www.jonesday.com/files/Publication/6f660ab8-97d0-4230-9c5b-71822ff023d9/Presentation/PublicationAttachment/dcd768bf-489c-4b58-8dbd-b510aaba5b69/Group%20Taxation_1.pdf
[55] As, for instance, neutral transactions within the group.
[56] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 551

3.1.2 (No) Cross-Border Group Relief

Although this may be true in most Member States, when there is a border between the parent company and its loss-making subsidiary, i.e., when the parent company is resident for tax purposes in one Member State and the subsidiary has its tax residence in another Member State, the *taking into account* of losses made by the foreign subsidiary[57] – i.e., *cross-border group relief* – is typically not available.[58]

In order to illustrate the consequences of the above mentioned to group companies let's take a look at the following example:

> *"Company A", which is a parent company resident in State A, made a profit of 200 in the year of 2015. "Company A" has a subsidiary in State B, which made, in the same year of 2015, a loss of 300. For the simple reason that the subsidiary is not resident (nor carrying on economic activities) in the same Member State as the parent company, "Company A", the group may find itself in a position where it cannot offset the foreign losses made by the foreign subsidiary with the profits made in the parent residence State, State A – the loss suffered in State B stay locked in that jurisdiction awaiting better times for setting off. Thus, "Company A" ends paying corporate income tax in State A although the group on balance on an EU base have made an overall loss. While, if the subsidiary had been set up in the parent residence State, State A, instead of in State B, no tax would be due.*

As it can be seen from this simple example, this *fragmentation of the loss relief* along national borders may leave the taxpayer in a situation where tax must be paid on profits that, from an overall perspective, were not made. Consequently, the group will be paying more corporate income tax than is justified by the balance of the results of the whole group. It, thus, conflicts with the taxpayer's ability-to-pay from an EU-wide view since within an internal market the group should be taxed on the balance of its results. Such a balance represents the group's economic situation and, therefore, its real ability-to-pay corporate income tax. The drawbacks of this fragmentation are specially felt by groups of companies headquartered in smaller Member States. This is explained by the fact that the larger the home market of a group of companies, the larger the odds that profits and losses will take place in the same tax jurisdiction and cancel each other out.[59]

Moreover and most importantly, it is a clear hindrance to cross-border investment in

[57] "Foreign" meaning here resident in a Member State of the European Union other than the State of the head office or parent company/ sister company

[58] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 551

[59] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 552; See also "Tax Treatment of Looses in Cross-Border Situations" (SEC (2006) 1690)

comparison to investment within one single tax jurisdiction and, therefore, to the freedom of establishment within the EU. An enterprise that chooses to take its business EU-wide suffers a cash-flow disadvantage on the offsetting of losses when compared to an enterprise that chooses to remain within one single tax jurisdiction. Additionally, when the loss is "final", such as when the subsidiary is liquidated, the group suffers the disadvantage of losing the possibility to offset the loss completely.

Furthermore, when establishing abroad, companies are typically undertaking large investments and may therefore suffer losses in the first years of its activity. Certainly, when taking a decision on the opening of a subsidiary, companies are discouraged to do so in other MS due to the lack of availability of cross-border loss relief within the EU.

3.2 Background

3.2.1 Territoriality, the Right to Define the Income Tax Base and the Unity of the Tax Base

Member States of the European Union, in the absence of harmonization, retain the right to organize their taxing systems, chiefly the right to allocate taxing rights between themselves and, therefore, to define their income tax base. In general, States determine their taxing rights based on a sufficient relationship or nexus between the production of a certain income and the territory of their States. Normally, States are allowed to tax their citizens and the income connected to their territory.[60]

In order to determine whether there is a sufficient connection for the assignment of tax jurisdiction, States choose connecting factor(s) – e.g., citizenship, place of incorporation, residence, source – to determine their income tax base.[61] The ECJ acknowledges, for example in its *Gilly*,[62] *Saint-Gobain*[63] and *Van Hilten*[64] judgements, that Member States are free to determine, unilaterally or by means of tax treaties, the connecting factor for the delineation of their taxing jurisdiction. In general, most Member States tax their residents for their worldwide income[65], whereas non-residents

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[60] Otto Marres, *The Principle of Territoriality and Cross-Border Loss Compensation*, Intertax (volume 39 issue 3), 112 et seq., 2011 Kluwer Law International, p. 112

[61] Eric C. C. M. Kemmeren, *Principle of Origin in Tax Conventions: A rethinking of Models*, Tilburg University Press (2011), p. 19

[62] Case C-336/96 *Gilly v Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793, paras. 24 and 30

[63] Case C-307/97 *Saint-Gobain* ZN [1999] ECR I-6161, para. 56

[64] Case C-513/03 *Van Hilten-van der Heijden* [2006] ECR I-1957, para. 47

[65] Also known as *residence taxation*; *home State taxation*; *unlimited tax liability*. Accordingly, a resident is taxed on the basis of a stable link with the territory of a State

tax liability is often limited to income that is sourced in a State's territory.[66]

In the next paragraphs it will be shown the consequences of the application of such principles regarding the availability to have non-resident subsidiary losses taken into account in the parent company residence State, i.e. cross-border group relief.

3.2.1.1 **Worldwide Taxation and Foreign Subsidiary Losses**

Most states apply the principle of worldwide income taxation in respect of their residents. Accordingly, a Member State taxes its residents not only on income *sourced* within its territory but also on foreign-sourced income. Hence, a State may tax a resident company not only on its domestic income but also on income the company sourced through, for instance, a foreign branch.

Although this may be true in respect of foreign branches' income, the same cannot be said with regard to income of foreign subsidiaries. These are separate legal and fiscal entities and have their own residence for tax purposes normally in the State of their location. Typically, foreign subsidiaries are not subject to tax in the State of residence of the parent company, as long as they do not carry any economic activity there. Under those circumstances, foreign subsidiaries fall outside the taxing jurisdiction of the State of residence of the parent company.

Typically, where there is no assumption of taxing power there is, symmetrically, no allowance to deduct from the taxable base costs or losses. This is called unity of the tax base, which in cross-border situations is seen as symmetric treatment of profits and losses.[67] If a State finds no sufficient connection between a taxpayer's production of positive income (profits) and its territory to assume taxing jurisdiction, the same sufficient nexus will, symmetrically, fail to exist between the taxpayer's production of negative income (losses) and its territory. In other words, profits and losses can be seen as "two sides of the same coin" and, therefore, where a State assumes taxation rights on profits, a State, symmetrically, allows deduction of the losses.

Having this said, where the taxable base of the foreign subsidiary is not part of the taxable base of the parent company, automatic cross-border carry-over of losses (or profits) made by a foreign subsidiary to its parent company abroad is often not available.[68] Being the parent company and its (foreign) subsidiary two separate legal entities, both are taxed on their own results, in their own tax

[66] Also known as *source taxation*, *limited tax liability*

[67] Yariv Brauner, Ana Paula Dourado and Edoardo Traversa, *Ten Years of Marks & Spencer*, Intertax (volume 43 issue 4), 306 et seq., 2015 Kluwer Law International, p. 309

[68] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 552

jurisdiction and symmetrically, their negative results (losses) are to be taken into account by the State assuming taxing jurisdiction over the corresponding positive income (profits).

3.2.1.2 The Source Principle and Foreign Subsidiary Losses

Often Member States limit the assumption of taxing rights over non-residents to income that is "sourced" in the State's territory. To tax non-residents according to the source principle means levying tax solely on income directly linked to a State's territory, i.e., the tax base is limited to the income sourced within that State's territory.

Evidently, when a State levies taxes based on the source principle, foreign elements (positive or negative) are completely ignored. Moreover, States may adhere to the source principle – and disregard foreign income – not only to tax its non-residents but also to tax their residents.[69] Where a State disregards foreign-sourced income the possibility of cross-border loss compensation is precluded. As a result, a loss-making foreign subsidiary may not offset its losses against the results of a profitable parent (or sister) company that has its residence in another State.

As a result of the exercise in parallel by two Member States of their taxing jurisdiction residence taxation and source taxation may overlap and tax on foreign-sourced income will be levied twice, once in the source State and once in the residence State of the taxpayer deriving the income. Being international double taxation a serious hindrance to inter-state economic intercourse (persons, goods, services, capital), the need to prevent it arises.[70]

3.2.2 Methods to avoid International Double Taxation

In order to prevent international double taxation of foreign-sourced income, the resident State should either *exempt* the foreign source income (CIN) or *credit* the foreign tax (CEN).[71]

3.2.2.1 The Credit Method

Under the credit method, the residence State of the taxpayer levies taxes on his worldwide-income and grants him a credit corresponding to the foreign tax already paid in the source State,

[69] Case C-414/06 *Lidl Belgium* [2008] ECR I-3601

[70] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 130

[71] Since the starting point for prevention of international double taxation in established international (OECD-modelled) tax law is source country entitlement; Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 132

avoiding international double taxation on the foreign-sourced income. States adhering to capital export neutrality (CEN) take the view that residents should not be influenced on where to invest, work, i.e., earn income. For this purpose, applying the credit method the taxpayer will pay, at least, the home State level of tax, regardless of where the income derives from. Moreover, when a State levies taxes on the basis of worldwide taxation, with the subsequent credit for the prevention of double taxation, the State aims not only to achieve CEN but also to tax the total ability to pay of the taxpayer.

As it was said above, when in order to avoid international double taxation a State applies the credit method tax on foreign-sourced income is levied, as part of the taxpayer's worldwide income. What if the foreign-sourced income is negative? In such a case, the State includes the loss suffered in the source State in the total income of the taxpayer, and, therefore, the loss is automatically set-off against domestic profits, i.e., provides for cross-border loss relief. This is completely understandable if one thinks that if a State wants to tax the total ability to pay of a certain taxpayer, the State must not only take into account positive income (profits) but also negative income (losses). So, worldwide taxation by the home State ensures that foreign losses are imported and deducted currently from positive domestic income, thus reducing the overall tax burden of the taxpayer to the amount of tax corresponding to his real overall income in that year.[72]

However, one could argue that if the losses arose in the source State, they belong to that jurisdiction and must, therefore, be offset there. Although that may be true, that may also be the reason why the importation of foreign losses by the home State is (most of the times) temporary since a *recapture mechanism* is often applied, i.e., if in subsequent years profits arise in the foreign State, from where the losses were imported, no prevention of double taxation will be extended by the home State – meaning, no credit will be given on the foreign tax paid in the source State – until the loss deducted in previous years has been recaptured.[73] A recapture mechanism is applied to ensure that the importation of the foreign losses is merely temporary, i.e., only until the foreign source becomes profitable to offset its losses against its own profits.

In a word, although worldwide taxation with relief for double taxation and CEN (credit system) may be seen, at first glance, as hindering cross-border economic activities in the EU-market, especially since it exposes taxpayers, at least temporarily, to international double taxation and to the administrative cumbersome mechanisms to eliminate it, it has one very important justifying merit serving the objectives of the internal market: horizontal cross-border loss relief.[74]

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[72] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 456

[73] Ibid.

[74] Ibid.

3.2.2.2 **The Exemption Method**

Under the exemption method, the resident State should exempt the foreign-sourced income of its residents, since that income was already taxed, or is to be taxed, in the source State. States adhering to CIN take the view that the level of tax on income sourced within a certain jurisdiction is to be determined by the source State, so that neutrality is achieved in the source State and foreign and domestic investors compete in the foreign market on the same tax conditions.[75]

There are two types of exemption methods for the relief of double taxation: *base exemption*[76] and *tax exemption*[77].

If the residence State applies the *base exemption method* to avoid double taxation, the State eliminates the foreign-sourced income from the tax base altogether, i.e., ignores both foreign profits and foreign losses – meaning no cross-border loss relief. Thus, one single taxable base is split up over two taxing jurisdictions, which is disadvantageous for the taxpayer if he has positive income (profits) in one of the States and negative income (losses) in the other State. The *rationale* for not providing the possibility to deduct foreign-source losses is the following: if a State exempts positive foreign-sourced income from the taxable base, then it is perfectly fair, from the State perspective, to disallow the deduction of negative foreign-sourced income, i.e., losses.[78]

However, if the residence State applies the *tax exemption method*, in order to avoid double taxation, the State levies "tax on a company's worldwide income with subsequent deduction of the part of the home State total tax on worldwide income which is attributable to the foreign part of the total result".[79] Therefore, foreign losses as well as foreign profits are included in the taxable base, which allows automatic cross-border loss relief with subsequent recapture of the deducted loss once the foreign source becomes profitable. Thus, in order to ensure that the import of foreign losses is merely temporary, the home State will not grant exemption for positive foreign source-income in subsequent years, until the loss deducted is recaptured.

All things considered, under an exemption method, in principle, residents compete on foreign markets at source State tax conditions and, therefore are, in principle, encouraged to invest abroad. However, the base exemption method, i.e., strict (base) territoriality, although it is considered a simple and neutral system that incentives cross-border investment and, therefore, serves the internal

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[75] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 134
[76] Also known for *strict territoriality principle*.
[77] Also known for *exemption with progression*.
[78] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, pp. 66, 134, 553
[79] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 553

market purpose while preserves national tax sovereignty, "is it also because it preserves territoriality, an internal market fragmentizer".[80]

As it can be seen from the above mentioned, the treatment, i.e., the *taking into account* or not, of foreign-source losses (and profits) depends on the method applied to eliminate international double taxation. While the credit method and the tax exemption method, allow, in principle and at least temporarily, cross-border loss relief, the base exemption method disregards foreign income (whether positive or negative), as that income is excluded from the taxable base in the home State. Therefore, cross-border loss relief is not allowed.

Both taxing jurisdiction principles[81] – *residence*[82] and *source*[83] – as well as the three methods above described, applied by the Member States to avoid double taxation, – the credit method,[84] the base exemption method[85] and the tax exemption method[86] – are accepted by the ECJ.

Under these circumstances, Member States retain the right to allocate taxing rights between themselves, hence, the right to define their income tax base, and the ECJ accepts all connecting factors for that allocation and all methods applied to avoid international double taxation. One can certainly say that the allocation of taxing rights based on the principle of territoriality is accepted by the Court and, so, *EU proof*. The Court, in *Futura Participations*,[87] accepted the principle of territoriality (or symmetry) as a criteria for the division of taxing rights between the Member States. It held that a system – in the case, the Luxembourg tax system – that for the purpose of calculating the taxable base of non-resident taxpayers only takes into account profits and losses arising from activities carried on within the territory of that State (the Luxembourg), "cannot be regarded as entailing any discrimination, (…) prohibited by the Treaty".[88] Therefore, it can be said that Member States, when defining their income tax base, are generally not under the obligation to take foreign losses into account, insofar as foreign profits are disregarded as well.

[80] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 457
[81] As well as a third taxing jurisdiction principle: the nationality principle
[82] Case C-96/08 *CIBA* [2010] ECR I-2911
[83] Case C-311/08 *SGI* [2010] ECR I-487
[84] Case C-513/03 *Van Hilten-van der Heijden* [2006] ECR I-1957
[85] Case C-414/06 *Lidl Belgium* [2008] ECR I-3601
[86] Case C-157/07 *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt* [2008] ECR I-8061
[87] Case C-250/95 *Futura Participations SA and Singer* [1997] ECR I-2471
[88] Case C-250/95 *Futura Participations SA and Singer,* para 22

IV. ECJ Jurisprudence Regarding Cross-Border Group Relief

As far as cross-border group relief is regarded no positive integration has been achieved. Consequently, the jurisprudence of the ECJ in this area has, for more than a decade, been the only source of EU law, at least binding the Member States, existent in the field. The Court has been called upon to interpret and apply the free movement provisions of the TFEU in direct tax matters, namely the compatibility of national tax measures concerning cross-border loss relief with the freedom of establishment. In doing so, the Court has the difficult task of balancing the consequences of Member States' tax sovereignty, chiefly the Member States' right to define their income tax bases, with the imperatives of the single market.[89]

The seminal *Marks & Spencer* Case will be introduced and analysed as the first case regarding cross-border group relief addressed by the Court. Although the case was decided more than 10 years ago, its ground-breaking "final loss" solution to the issue of cross-border loss relief in the EU still stands.[90] Throughout the analysis references will be made to more recent ECJ decisions regarding not only group loss relief but also cases involving the relief of losses incurred in foreign permanent establishments in order to better understand the Court's reasoning and its development until today.1

4.1 Marks and Spencer case

4.1.1 The facts

Marks & Spencer[91] (hereinafter referred to as *M&S*) concerned the British group relief scheme. At the time, under UK tax legislation, group relief could only be granted for losses considered to be within the scope of UK taxation. Consequently, according to the UK tax law, in order to be granted group relief, a subsidiary had to have its residence in the UK or to be economically active there. To the beneficiaries of the group relief regime was granted a cash advantage allowing an immediate offset of the loss-making group companies instead of forcing them to carry such losses forward.

A profitable parent company, *Marks & Spencer plc*, claimed group relief in respect of losses incurred by its French, Belgium and German subsidiaries, which were owned through a Dutch holding company. The tax inspector denied the application of the group relief, since the subsidiaries were

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[89] Christiana HJI Panayi, *Reverse Subsidiarity and Cross Border Loss Relief: Can Member States Be Left to their Own Devises?*, 55(3) British Tax Review (2010)

[90] See Case C-388/14 *Timac Agro Deutschland* [2015] EU:C:2015:829, para. 53 and Case C-172/13 *Commission v United Kingdom* [2015] EU:C:2015:50, para. 33

[91] Case C-446/03 *Marks & Spencer* [2005] ECR I-10837

neither residents nor economically active in the UK, i.e., had no UK branch. The British tax authorities interpreted the principle of territoriality, applied by the UK, as precluding the deduction of foreign losses when no corresponding taxable base was available to the UK authorities, i.e., where the UK has no power of taxation, the UK cannot offer a tax advantage.[92]

Although *M&S plc* appealed to the Special Commissioners, arguing that the group relief regime was incompatible with the freedom of establishment, the claim was rejected on the grounds that a loss-making foreign subsidiary was not in a comparable situation to a loss-making domestic subsidiary, as only the latter was within the scope of UK tax – *subject to tax* in the UK – and, therefore, on the basis of this comparability analysis, there was no discrimination. *M&S plc* appealed against the Special Commissioners decision before the High Court, which decided to refer to the ECJ for a preliminary ruling.[93]

The ECJ found that the denial of loss relief for foreign subsidiaries constituted a restriction to the freedom of establishment.[94] According to its reasoning, UK parent companies holding non-resident subsidiaries were treated less favourably than UK parent companies holding resident subsidiaries and, therefore, UK parent companies were being hindered from setting up subsidiaries in other Member States.[95] Following a finding of restriction, the Court argued that the restriction could be justified on the basis of three grounds, "taken together": the need to preserve the allocation of taxing rights between the Member States; the need to prevent double relief of losses (once in the parent company residence State and once in the subsidiary residence State); and the need to prevent tax avoidance.[96] Next, the ECJ examined whether the restrictive measure was proportional to its objectives. In order to assess the proportionality of the UK restrictive measure, the Court took into account whether the non-resident subsidiary had exhausted "all possibilities" for relief available in its residence Member State. Then, the ECJ held that the British group relief regime was disproportionate only when all possibilities for having the subsidiary losses taken into account in its State of residence had been exhausted. According to the Court, it is disproportional to refuse the deduction of foreign subsidiary losses in the parent company residence State when those losses are "final".[97]

Although the *M&S* judgment proposed a innovative approach to cross-border taxation in the European Union, it left a number of important issues unsolved.[98] More than ten years after the first

[92] Case C-446/03 *Marks & Spencer*, Opinion of AG Poiares Maduro, para 58
[93] Christiana HJI Panayi, *Reverse Subsidiarity and Cross Border Loss Relief: Can Member States Be Left to their Own Devises?*, 55(3) British Tax Review (2010), p. 12
[94] Case C-446/03 *Marks & Spencer,* paras 31-34
[95] Case C-446/03 *Marks & Spencer,* para 33
[96] Case C-446/03 *Marks & Spencer,* paras 43-51
[97] Case C-446/03 *Marks & Spencer,* para 56
[98] Christiana HJI Panayi, *Reverse Subsidiarity and Cross Border Loss Relief: Can Member States Be Left to their Own Devises?*, 55(3) British Tax Review (2010), p. 13.; See also Michael Lang *The* Marks & Spencer

decision regarding the issue of cross-border loss relief had passed and, even though the ECJ's jurisprudence developed and some questions were answered, its reasoning is far from being consistent leaving a lot of room for legal uncertainty.

4.1.2 Restriction and Comparability Analysis

In only four short paragraphs the ECJ found that the denial of the UK group relief regime to non-resident subsidiaries constituted a restriction to the freedom of establishment.[99] It started by adopting an obstacle approach*,*[100] at the first level of its analysis, and stated that the fact that UK parent companies holding non-resident subsidiaries were treated less favourably in comparison to UK parent companies holding resident subsidiaries was enough to find a restriction to the freedom of establishment. In fact, the UK group relief regime offered a less favourable tax treatment to resident companies holding subsidiaries in other Member States and, therefore, UK parent companies were being held from expanding throughout the European internal market by setting up subsidiaries abroad. From an EU-wide perspective, "all measures which prohibit, impede or render less attractive the exercise of (…)"[101] the fundamental freedoms shall, in fact, be regarded as restrictions to the proper functioning of the single market. This is known for *obstacle-based approach*.

However, this conceptual framework for approaching impediments to the free movement rights caused by direct tax measures may not be as appropriate as it is when the ECJ assesses the compatibility, with the Treaty freedoms, of a national measure in other fields of law.

The TFEU freedoms do not provide legal basis for choosing the connector factor for delineating a Member State's taxing jurisdiction. In the absence of EU law guidance, all connecting factors used by a Member State for the assumption of taxing jurisdiction – e.g. residence,[102] source,[103] nationality,[104] territoriality[105] – are accepted by the ECJ. Consequently, Member States retained the right to allocate the taxing power between them, defining their income tax base, and are at liberty to choose the connecting factor(s) for that allocation. Furthermore, Member States may even apply those connecting factors asymmetrically, i.e., different treatment for residents and non-residents – as it was

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Case – The Open Issues Following the ECJ's Final Word, European Taxation (volume 46), No 2, 54 et seq., February 2006, Journals IBFD, p. 58

[99] Case C-446/03 *Marks & Spencer,* paras 31-34

[100] As proposed by the AG Poiares Maduro in this opinion: Case C-446/03 *Marks & Spencer,* Opinion of AG Poiares Maduro, para. 35

[101] Case C-446/03 *Marks & Spencer*, Opinion of AG Poiares Maduro para 35

[102] Case C-96/08 *CIBA* [2010] ECR I-2911

[103] Case C-311/08 *SGI* [2010] ECR I-487

[104] Case C-513/03 *Van Hilten-van der Heijden* [2006] ECR I-1957

[105] Case C-250/95 *Futura Participations SA and Singer* [1997] ECR I-2471

already accepted by the Court in *Futura Participations*.[106] This is explain by the fact that, generally, from a State's perspective the situations of residents and non-residents are not comparable, because the former is normally subject to unlimited tax liability[107] and the later to limited tax liability.[108] Assumption of taxing jurisdiction to a certain situation is, therefore, a State's competence. Adopting an obstacle approach to assess whether a direct tax measure is compatible with the TFEU freedoms might means overlooking the Member State's right to allocate taxing powers.

Nonetheless, it is easy to recognize that within an internal market treating domestic and cross-border situations differently does not serve the purpose of setting up the internal market in the first place. Under these circumstances, as far as direct taxation is concerned, a *discrimination-based approach,* may be more appropriate to assess the compatibility of the measure with the Treaty freedoms. In order to respect Member States' right to allocate taxing rights, a certain discrimination must be sought so as to consider a direct tax measure illegal under the Treaty freedoms.

Discrimination may arise either when similar (comparable) situations are treated differently or when different (not-comparable) situations receive the same treatment. Accordingly, in order to assess whether a measure is discriminatory, a comparability standard is needed, i.e., the measure cannot be considered discriminatory if the situations are not comparable, that is to say, different.

Having this said and going back to *M&S*, it is a fact that the British group relief regime did treat resident parent companies holding non-resident subsidiaries less favourably than resident parent companies holding resident subsidiaries. However, could one say that those situations were comparable? Arguably, the UK has assumed taxing power in respect of its resident parent companies (both holding resident or non-resident subsidiaries), i.e., UK resident parent companies were subject to UK tax. However, according to UK tax law resident subsidiaries were subject to tax in the UK and non-resident subsidiaries were not subject to tax in the UK. Hence, under UK law, UK parent companies holding resident subsidiaries were not in a comparable legal situation as UK parent companies holding non-resident subsidiaries. The UK assumed taxing power in respect of resident subsidiaries but did not assume taxing rights over non-resident subsidiaries, and therefore, symmetrically, the former were granted loss relief whereas the latter was not.

This *subject to tax approach* according to which the situation of residents and non-residents become comparable only when the host State subjects non-residents to taxation, was also used by Advocate General Poiares Maduro in its opinion when addressing the matter of whether a non-resident subsidiary was comparable to a foreign (i.e., non-resident) permanent establishment.[109]

[106] Case C-250/95 *Futura Participations SA and Singer* [1997] ECR I-2471
[107] Worldwide taxation.
[108] Source taxation.
[109] Comparison which the ECJ avoided not only in *M&S* decision but also in the subsequent cases

According to the AG's opinion, a non-resident subsidiary and a foreign permanent establishment were not in a comparable situation as the income of foreign permanent establishments of UK companies could be consolidated whereas the income of non-resident subsidiaries, being independent legal and fiscal entities, could not be consolidated.[110] According to the UK tax system, income from foreign branches of resident companies was subject to UK tax, whereas income from non-resident subsidiaries owned by resident parent companies were not subject to UK tax.

Hence, one may say that the situation of non-resident subsidiaries was not comparable neither to the situation of resident subsidiaries nor to the situation of foreign branches. Resident subsidiaries and foreign branches were completely inside the UK's assumption of taxing jurisdiction whereas non-resident subsidiaries were completely outside the UK's assumption of taxing jurisdiction. Consequently, on the basis of such comparability analysis, the different treatment given to (non-comparable) different situations cannot be considered discriminatory.

Notwithstanding, the Court, for the purpose of assessing the existence of a restriction, did not consider necessary to assess whether the situations to which were given a different treatment – resident subsidiaries and non-resident subsidiaries (and foreign branches) – were in fact comparable regarding their tax legal situation under the UK law. Nevertheless, the Court pushed away considerations on comparability and on the principle of territoriality to the level of the justifications.

Adopting an obstacle-approach at the first level of its analysis enables the Court to assess whether a non-discriminatory direct tax measure is proportional to attain the legitimate objectives it pursues.[111] From an internal market perspective, such approach is desirable to guarantee that all restrictive national measures do not fall completely outside the Court's scrutiny. Nevertheless, the Court must be very prudent in order to respect the Member States' right to assume and allocate taxing rights between themselves. Accordingly, to consider a direct tax measure illegal under the TFEU freedoms certain discrimination must (always) be found.

After ten years of ECJ's jurisprudence in the area of cross-border loss relief, one can argue that the Court might be moving to a subject to tax-approach. If one takes a look at the *Nordea Bank*[112] and *Timac Ago*[113] recent decisions, despite the fact that both cases evolved a loss-making permanent establishment rather than a subsidiary, the ECJ explicitly held that foreign branches become comparable with domestic branches only when the former are subject to tax in respect of their profits

[110] Case C-446/03 *Marks & Spencer*, Opinion of AG Poiares Maduro, para. 48
[111] Otto Marres, *The Principle of Territoriality and Cross-Border Loss Compensation*, Intertax (volume 39 issue 3), 112 et seq., 2011 Kluwer Law International, p. 119
[112] Case C-48/13 *Nordea Bank Danmark* [2014] EU:C:2014:2087
[113] Case C-388/14 *Timac Agro Deutschland* [2015] EU:C:2015:829

as the later are.[114] Therefore, the ECJ adopted in both cases liability for tax in respect of the foreign profits as the criteria for establishing comparability between domestic and cross-border situations.[115]

4.1.3 **Justifications**

Following the founding of a restriction, the ECJ examined whether the restriction was justified by a legitimate aim. Remarkably, after accepting the territoriality principle as not discriminatory in *Futura*,[116] in *M&S* the Court did not consider that the fact that the UK did not tax the profits of non-resident subsidiaries was, in itself, sufficient to justify the restriction found.[117] Nevertheless, the Court held that there were three justifications which, if "taken together", could legitimize the restriction found: the need to safeguard the balanced allocation of the power to impose taxes between the Member States, the need to avoid the danger that losses would be used twice, and the need to prevent tax avoidance.[118]

The *M&S* is also said to be a landmark case regarding the Court's justifications. It was the first decision where the ECJ's recognized "the preservation for the allocating of the power to impose taxes between Member States" as an imperative reason in the public interest that could justify a restriction to the TFEU freedoms. Preceding *M&S,* the coherence of the tax system argument was accepted, for example in Bachmann[119] or *Commission v Belgium*[120], however from a taxpayer centred approach. That is to say, on those decisions the Court based its acceptance of the coherence argument on the effects that the direct tax measure had on the tax position of a particular individual taxpayer. In this respect, coherence requires that the positive and negative results of the same source of income of a certain taxpayer *stay*[121] within the same taxing jurisdiction – a jurisdictional match between the deduction of losses and the taxation of profits (unity of the taxable base). With the *M&S* judgement, the Court takes a step further and assesses the coherence argument as justifying a restrictive tax

[114] See Case C-48/13 *Nordea Bank Danmark* [2014] EU:C:2014:2087, para. 24, where the situations were deemed comparable in light of the application of the credit method and *Timac Agro* (C-388/14), para. 65, where comparability was denied, due to the full exemption of the profits earned by the Austrian permanent establishment; Raul-Angelo Papotti and Carlomaria Setti, *The ECJ Decision in Timac Agro (Case C-388/14): Another Properly Shaped Piece in the ECJ' s Tax Loss Puzzle*, European Taxation (volume 56), No 6, 246 et seq., June 2016, Journals IBFD, p. 251

[115] Raul-Angelo Papotti and Carlomaria Setti, *The ECJ Decision in Timac Agro (Case C-388/14): Another Properly Shaped Piece in the ECJ's Tax Loss Puzzle*, p. 251

[116] Case C-250/95 *Futura Participations SA and Singer* [1997] ECR I-2471

[117] Case C-446/03 *Marks & Spencer,* paras 39-40

[118] Case C-446/03 *Marks & Spencer,* paras 42-43

[119] Case C-204/90 *Bachmann v Belgium* [1992] ECR 1-249

[120] Case C-300/90 *Commission v Belgium* [1992] ECR I-305

[121] For tax purposes.

measure from a state-centred approach, i.e., the balance allocation of taxing rights between Member States in relation to a certain cross-border situation.[122]

In *M&S*, if the UK had accepted the deduction of losses made by the non-resident subsidiaries it would have meant that the UK had, *asymmetrically*, extended its taxing jurisdiction only to the negative results of the subsidiaries' income where it did not, *symmetrically*, extended any taxing rights regarding the profits of those subsidiaries. That is to say, the UK would allow a deduction of such losses while, at the same time, would not tax any future profits. Hence, such deduction would be definitive, irreversible. Moreover, and most importantly, it would allow such definitive deduction from the taxable base of a resident parent company fully subject to tax in the UK. The outcome would be that the UK would be required to give up its taxation rights in relation to income sourced within its territory and completely inside the scope of its taxing jurisdiction. Under those circumstances, the Court, rightly so, accepted the need to preserve the balanced allocation of the power to impose taxes, i.e., the need to avoid requiring a State to relinquish taxation on income sourced within its territory,[123] as one of the justifications for the restrictive measure.

Nevertheless, the Court held that the restriction could only be justified on the basis of three grounds "taken together". Next to the preservation of the allocation of the power to impose taxes between Member States, the Court presented two other justifications: the risk of double deduction of losses and the prevention of tax avoidance.

Arguably, there was a risk – in allowing the loss relief – of double deduction of losses *if* the non-resident subsidiaries' losses were also deductible in their State of residence.[124] The AG Poiares Maduro focused on this argument to justify the restriction found.[125] According to his opinion the British group relief regime was adopted in order to prevent the double deduction of losses and, therefore, the restriction could only be justified[126] as long as foreign losses could not receive "equal treatment" in the State where the loss-making subsidiary have its residence.[127] Despite the fact that the Advocate General confused the aim of the British group relief regime (losses are immediately set off resulting in a cash-flow advantage) with the effects of such regime (losses set off can no longer be used in the future), those considerations would better fit while assessing the proportionality of the measure.[128]

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[122] Yariv Brauner, Ana Paula Dourado & Edoardo Traversa, *Ten Years of Marks & Spencer,* p. 310
[123] Case C-446/03 *Marks & Spencer*, paras 46
[124] Case C-446/03 *Marks & Spencer*, paras 47-48
[125] Case C-446/03 *Marks & Spencer*, Opinion of AG Poiares Maduro, paras 28-36 and 54
[126] With all respect, I would say *proportional* would better fit for such considerations.
[127] Case C-446/03 *Marks & Spencer*, Opinion of AG Poiares Maduro, para 29
[128] Mathieu Isenbaert, Caroline Valjemark, *M&S judgment: the ECJ caught between a rock and a hard place*, EC Tax Review vol.15 (1), 10 et seq, 2006 Kluwer Law International, p.14

Lastly, the Court presented the need to prevent the risk of tax avoidance as the third justification. Arguably there was a risk that, within a group of companies, losses would be channelled to companies established in Member States applying highest rates, where the tax value of the losses is, therefore, the highest.[129] Despite being such consideration generally of great relevance, I do find this justification not easy to follow due to the particularities of the case. Contrary to established case law by the time,[130] the Court did not require that the UK proved that there was avoidance in the concrete case. Surely, the mere establishment of a non-resident subsidiary cannot be regarded as a wholly artificial arrangement, as the ECJ had already had the opportunity to confirm.[131] Moreover, at the time both the nominal and effective corporate income tax in the subsidiaries' Member States were substantial higher than in the UK. At any event, it can be argued that such risk – channelling of unrelieved losses to high tax jurisdictions – could be reduced by "allowing the deduction of those losses in the parent company residence State only up to the amount of their tax value in the State where they were incurred."[132]

This "taken together" approach was upheld in ECJ's subsequent cases. For instance, the Court admitted that preventing the balanced allocation of taxing powers when taken together with either the need to prevent tax avoidance (as *Oy AA*)[133] or the double deduction of losses (as in *Lidl Belgium*)[134] could be a valid justification for a restrictive tax measure. Lastly in *X Holding,*[135] the Court accepted the balanced allocation of taxing power as a stand-alone justification. These different approaches in relation to the acceptance of the justification are explain by the fact that each case has its particularities and the Court is called upon to assess the conformity of a specific domestic tax measure with EU law.

4.1.4 Proportionality - The M&S exception

After finding that the restrictive measure was justified by a legitimate aim, the Court assessed whether the measure did not go beyond what was necessary to attain the objectives it pursued.

To assess the proportionality of the tax measure the ECJ took into consideration the tax treatment those losses had in the subsidiary Member State of residence. Relevant for the Court was

[129] Case C-446/03 *Marks & Spencer*, para 49
[130] For example, case C-196/04 Case C-196/04 *Cadbury Schweppes plc and Cadbury Schweppes* [2006] ECR I-7995, para. 55
[131] For instance, Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779, para. 37
[132] As suggested by Mathieu Isenbaert, Caroline Valjemark, *M&S judgment: the ECJ caught between a rock and a hard place*, EC Tax Review vol.15 (1), 10 et seq, 2006 Kluwer Law International, p.15
[133] Case C-231/05 *Oy AA* [2007] ECR I-6373, para 60.
[134] Case C-414/06 *Lidl Belgium* [2008] ECR I-3601, paras. 41-42.
[135] Case C-337/08 *X Holding* [2010] ECR I-1215, para 40.

whether or not the non-resident subsidiary had *exhausted all possibilities* for loss relief in its Member State of residence. Accordingly, the UK restrictive measure would be disproportional when the foreign-sourced losses were "final", i.e. could no longer be deducted in the Member State where they were incurred either by the subsidiary itself or by a third party. Only in such a case it would be disproportional to deny such deduction in the parent company Member State of residence. This exception has since been referred to as *the M&S exception*.

The Court added that not all possibilities were to be considered exhausted if the loss-making subsidiary was allowed to offset the loss against its own profits of the previous years (carry-back of losses) or against future profits (carry-forward of losses).[136] The ECJ focused on *final losses*. The ability to carry forward the foreign losses in the subsidiary Member State of residence (*non-final losses*)[137] was enough to consider the refusal of the group relief regime as proportional. The Court accepts, therefore, the cash-flow disadvantage of having to carry losses forward instead of using them immediately.[138]

According to the Court only when the resident parent company proves to the tax authorities of its Member State that all possibilities for loss relief have been exhausted in the subsidiary residence State, it becomes contrary to the freedom of establishment to deny the possibility for the resident parent company to deduct from its taxable profits the losses incurred by its non-resident subsidiary. It can be seen as an "all in all out" solution as final losses should be deducted in the parent company MS of residence, while in other situation of losses no relief has to be granted whatsoever. In M&S the Court took the view that terminal losses must be always deducted "somewhere within the EU" whereas current losses may not be deducted nowhere. In other words, as far as terminal losses are concerned the ECJ followed a global approach according to which the overall situation of the group within the EU is taken into consideration whereas regarding annual losses (or current losses) the Court adopted a single country approach, i.e., where there is no assumption of taxing power there is, symmetrically, no allowance to deduct from the taxable base the relevant losses.[139]

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[136] Case C-446/03 *Marks & Spencer*, paras 55

[137] By "non-final losses" I mean losses that can be carried back and/or forward in the Member State in which there were incurred, i.e. current losses

[138] Mathieu Isenbaert, Caroline Valjemark, *M&S judgment: the ECJ caught between a rock and a hard place*, EC Tax Review vol.15 (1), 10 et seq, 2006 Kluwer Law International, p.15

[139] Luca Cerioni, *The never-ending issue of cross-border loss compensation within the EU: Reconciling balanced allocation of taxing rights and cross-border ability-to-pay,* EC Tax Review vol.24 (5), 268 et seq., 2015 Kluwer Law International, p. 270

4.1.5 The Concept of "final losses"

Given this solution one may wonder when it is considered that all possibilities have been exhausted in the MS of residence of the loss-making subsidiary. In other words, what is a "final loss"? Since M&S, both national legislators and Courts have been struggling about the concept of "final losses", as no further guidelines were given by the M&S judgment. Nevertheless, the ECJ upheld the *M&S exception* in later cases and, thus, had the opportunity to clarify some unanswered questions regarding the "final loss" concept.

From the M&S decision is seems that a subsidiary may find itself in a position where it cannot offset its losses in its State of residence due to either *factual reasons* such as liquidation, or to *legal reasons* such as the expiry of a limited time period for loss deduction in the subsidiary MS of residence or the non-deductibility in this State.[140]

Regarding losses that no longer can be utilized due to legal reasons, the ECJ clarified in *Commission v United Kingdom* that a loss couldn't be considered "final" in case the MS in which the loss-making subsidiary is resident does not provide for any possibility of loss carry-forward.[141]

This finding goes in line with a long-established principle according to which Member States are not under the obligation to compensate the taxpayers who are in a disadvantageous position due to peculiarities of the legislation of the various tax systems,[142] i.e., "disparities". As Wattel points out, if the legal tax system of the MS where the loss-making subsidiary is resident does not provide the possibility of having losses taking into account, the lack of loss-relief availability is not due to the exclusion of foreign losses by the parent company MS of residence but results from the fact that the subsidiary MS of residence excludes domestic losses.[143] It can hardly be considered a discrimination and therefore, the MS of residence of the parent company should not be required to "take over" and relief the taxpayer from the disadvantageous effects of differences between the laws of the Member States.[144] In a word, the concept of final losses does not included losses that cannot be used in the MS in which they were incurred due to the inexistence of any possibility of loss carry-forward in that State.

[140] Sami Douenias, *Marks & Spencer still stands: the "final loss" principle has been reaffirmed,* PwC Luxembourg Press Articles, Archive 2015, available at http://www.pwc.lu/en/press-articles/2015/marks-and-spencer-still-stands-the-final-loss-principle-has-been-reaffirmed.html

[141] Case C-172/13 *Commission v United Kingdom* [2015] EU:C:2015:50

[142] Case C-157/07 *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt* [2008] ECR I-8061, para. 50

[143] Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, p. 557

[144] In this area, a very critical approach is taken by Wattel: Peter J. Wattel, *Non-Discrimination à la Cour: The ECJ's (Lack of) Comparability Analysis in Direct Tax Cases,* European Taxation (volume 55), No 12, November 2015, Journals IBFD

Notwithstanding, the concept of *final losses* has not been settled and, therefore, there are still questions to be answered. Notably, what if the non-deductibility of losses in the MS of residence of the foreign subsidiary is a result of the time limitations, such as the expiry of the local relief time limit? I believe that in such a situation, especially if the time limit for domestic relief in the parent company MS of residence has also expired, it is not fair to require this State to absorb the foreign subsidiary losses. Freedom of establishment does not require Member States to treat cross-border situations more favourably than domestic situations. Even if the legislation of the parent company MS of residence provided for un unlimited carry-forward of losses, the expiry of such losses in the subsidiary MS of residence is due to a particularity of the legal system of that MS to which the MS of residence of the parent company is not required to compensate and adapt to.

Having this said, one may wonder if "final" losses are only losses upon closure of the foreign subsidiary. In fact, if the subsidiary is for instance dissolved it, thus, will not continue to carry on its economic activity in the MS in which it is resident. Consequently, it will not be able to use those losses against its own future profits in its MS of residence. In such a situation, there seems to be no risk of *double dipping*. However, the ECJ has recently in *Timac Agro* confirmed paragraph 36 of *Commission v United Kingdom*, which at the time came as a clarification of what the ECJ had indirectly accepted in *A Oy*.[145] In the Court's view the liquidation of the subsidiary is not sufficient in itself to consider its losses as "final" since when the company enters into liquidation income (limited though it may be) may still arise triggering the potential use of such losses in the subsidiary State of residence.[146] Hence, the existence of a minimal amount of income in the subsidiary MS of residence is sufficient to consider its losses upon liquidation as "non-final losses" and, therefore, non-deductible in the MS of residence of the parent company. Hence, the initial enthusiasm that surrounded M&S at the beginning slowly disappeared as it became clear to taxpayers that the availability of cross-border loss relief in the EU is still a far-reaching possibility.[147]

The outcome is that more than 10 years after the M&S judgement, the concept of "final losses" has not been settled and the ECJ has left it to the national courts to rule on the finality of the relevant losses. Since then, national courts and legislators have been struggling on how to deal with the

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[145] Case C-123/11 *A Oy* [2013] EU:C:2013:84, paras 53-54

[146] Case C-388/14 *Timac Agro Deutschland* [2015] EU:C:2015:829, para 55

[147] Sami Douenias, *Marks & Spencer still stands: the "final loss" principle has been reaffirmed,* PwC Luxembourg Press Articles, Archive 2015, available at: http://www.pwc.lu/en/press-articles/2015/marks-and-spencer-still-stands-the-final-loss-principle-has-been-reaffirmed.html

"never-ending issue"[148] of cross-border loss relief in the EU and, thus, comply with and give full force to EU law, namely to the fundamental freedoms.[149]

[148] As entitled by Luca Cerioni in *The never-ending issue of cross-border loss compensation within the EU: Reconciling balanced allocation of taxing rights and cross-border ability-to-pay,* EC Tax Review vol.24 (5), 268 et seq., 2015 Kluwer Law International

[149] Axel Cordewener, *Cross-Border Relief and the "Effet Utile" of EU Law: Are We Losing it?*, p. 58

V. *The M&S exception*: a proper balance?

In the absence of harmonization at the EU level, the *M&S exception* represents the current *state of art* of cross-border loss relief under EU law. According to the Court, "final losses" incurred by a foreign subsidiary should be deducted in the MS of residence of the parent company whereas non-final losses (annual losses) may not be deducted whatsoever. In the next paragraphs, in order to give an answer to the proposed research question it will be assessed whether or not both final and non-final losses incurred by a foreign subsidiary should be deducted at the level of the parent company taking into account the main findings of this Thesis.

5.1 (No) Relief for Final Losses Incurred by a Foreign Subsidiary

As far as "final" losses are concerned, the ECJ followed a global approach according to which the overall situation of the group within the EU is taken into consideration. Although such approach and thus, allowing the deduction of foreign losses is undoubtedly a step further in the direction of the internal market, it may the fact that those losses are (really) final that dictates its failure.

If losses are terminal for factual reasons, such as the liquidation of the subsidiary, typically no future profits will arise, as the subsidiary will not continue to carry on its economic activity in the MS in which it is resident. For this reason, allowing the transfer of *real* final losses to the MS of the parent subsidiary entails a definitive mismatch between Member States' tax bases. The MS of residence of the parent company is entitled to deduct foreign final losses while it will not be able not tax the corresponding (future) foreign profits, as they will not arise. Hence, such deduction would be definitive and thus, irreversible. Consequently, the MS of residence of the parent company would be required to relinquish taxation rights on income sourced within its territory and therefore completely inside the scope of its taxing jurisdiction, i.e., the profits of the resident parent company. And, as the Court already held in *Class IV ACT*, a MS cannot "be obliged to abandon its taxing right to tax a profit generated through an economic activity undertaken on its territory".[150]

If on one hand I agree that the Court should guarantee that Member States exercise their exclusive competences consistently with EU law, especially with the fundamental freedoms, on the other hand it seems to me that, by allowing the definitive deduction of final losses, the Court is interfering in the allocation of taxing rights among Member States in a way that seems to be disproportional. The Court is extending the taxing jurisdiction of Member States only to the negative part of the foreign income, resulting in a definitive (and thus, irreversible) mismatch between the profits and the losses. As long as direct taxation is an area not harmonized, Member States retain their

[150] Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I-11673, para 59

tax sovereignty and therefore, the (definitive) allocation of taxing rights between Member States falls outside the ECJ competences. The price of the Member States' unwillingness to harmonize direct taxation is that restrictions to the freedom of establishment may arise as a result from the parallel exercise of twenty-eight different tax jurisdictions and, as long as such restrictions are not discriminatory, it is disproportional for the Court to interfere in the competence of the Member States.

5.2 Relief for Non-final Losses Incurred by a Foreign Subsidiary

When it comes to annual losses (non-final losses), the ECJ seems to accept a cash-flow disadvantage of having to carry losses forward instead of using them immediately.

Typically, Member States allow companies to offset their current losses against their own future profits. Hence, a risk of double dipping is eminent if the group would be allowed to also use those same losses in another MS. Obviously, EU law should not allow tax-planning opportunities such as the double use of losses. Moreover, this opportunity would only be available to multinational groups and not to national groups, which is not acceptable in an open market as the European Union where free competition is a major requirement to its proper functioning.[151]

Notwithstanding, if on one hand I understand the Court's concern according to which allowing the definitive transfer of such losses to the parent company MS of residence would trigger the risk that current losses could be deducted more than once, i.e. carried forward in the MS where they were incurred and deducted also in the MS where the parent company is resident, on the other hand I do believe a less restrictive measure could significantly reduce such a risk: a temporary deduction of the foreign-sourced losses in the MS of the parent company followed by an automatic recapture of losses once the subsidiary becomes profitable. In fact, this was the solution adopted in the draft directive on cross-border loss relief[152] and considered by the Commission in its Communication on the tax treatment of losses in cross-border situations.[153]

Current losses belong to the jurisdiction where the corresponding profits are subject to tax, which is in the subsidiary MS of residence. Hence, I agree with the Court on the fact that non-final losses should not be deducted at the level of the parent company since the corresponding subsidiary profits are not subject to tax in the parent company MS of residence. Nevertheless, the lack of cross-border loss relief is a real hinder to the exercise of the freedom of establishment in the EU: foreign

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[151] See article 120 TFEU

[152] COM 90 (595) final, 24 January 1991, *Proposal for Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States, article 10*

[153] Commission Communication on the Tax Treatment of Losses in Cross-Border Situations, COM (2006) 824 final, OJ C 126, 19 December 2006, para. 3.4.2, p. 8

losses may not be deducted just because the parent company and the loss-making subsidiary are not resident in the same MS although both belong to the same internal market – the EU.

A temporary loss relief followed by a recapture mechanism once the subsidiary is profitable again, or after a fixed number of years irrespective of the fact that it has not become profitable, would not only remove the cash flow disadvantage of having to carry losses forward instead of using them in the year in which they occur, but also ensure that the importation of foreign losses is merely temporary and therefore, reversible. Contrary to the situation of final losses, the mismatch between the deduction of the foreign losses the taxation of the corresponding profits would be only temporary and not definitive. Consequently, the Court would not be interfering with the definitive allocation of taxing rights among Member States. A recapture mechanism would ensure that, in the end, the foreign subsidiary losses will not be irreversibly absorbed by Member State in which they they did not incur and thus, do not belong, i.e., the MS of residence of the parent company. Moreover and most importantly, cross-border and domestic situations would be treated less alike: at least in respect of annual losses (current losses), the group would be able to offset foreign subsidiary losses with the profits of the rest of the group as in a pure domestic situation and therefore, the group would be taxed only on the balance of its results, reducing its tax exposure.

5.3 **Concluding remarks**

Although, in the absence of harmonization at the EU level, the *M&S exception* represents the current *state of art* of cross-border loss relief scene under EU law, I am afraid it is not a proper reflection of the balance between the consequences of Member States' tax sovereignty and the obligations owing from EU law – an internal market without frontiers. The Court not only did not resolve the cash-flow disadvantage, which was in fact hindering companies from expanding throughout the EU internal market and therefore, restricting their freedom of establishment. But also, by requiring the MS of residence of the parent company to relinquish its taxation rights on income sourced within its territory – as a result of a definitive and therefore, irreversible deduction of foreign final losses – the Court is exceeding its competences and interfering with the Member States' tax sovereignty, namely with the right to allocate taxing rights among Member State, in a manner that seems to be disproportional.

The Court could have had reached a more balanced solution if it had opted for the opposite: temporary deduction of non-final (annual) foreign losses and non-deduction of (real) final losses. Such a solution would not only solve the cash-flow disadvantage caused by the unavailability of cross-border loss relief of current losses in the year in which they are incurred but also prevent losses from being irreversibly absorbed by a State in which they do not belong. Hence, Member States could ensure that the relief they were require do grant in respect of foreign losses would be merely temporary and reversible, which would have encroached less Member States' tax sovereignty than the *M&S exception*.

With *the M&S exception*, the ECJ avoided the difficulties of implementing a recapture mechanism: being terminal losses they could never be recaptured. Although it is regrettable that the Court did not address the cash-flow disadvantage due to the non-deductibility of current losses across borders and therefore, the possibility of implementing a recapture mechanism, one may not forget the fact that the ECJ is not a lawmaker. The Court is called upon to answer preliminary questions and give its interpretation of EU law.[154] Hence, the Court could hardly implement a system of recapture by answering to preliminary questions.

For this reason, a legislative instrument such as a Directive harmonizing cross-border loss relief within the internal market would be preferable. Especially since the current piecemeal approach in which each ECJ decision adds a piece in the tax loss *puzzle* lacks in precision, predictability and certainty needed for the legal practice. Moreover, if Member States, in particular national legislators, courts and administrations, are under the obligation to cooperate with the European Union and its institution, namely to fully comply with EU law, when it comes to the fundamental freedoms – being the cornerstones of the internal market – such obligation is even more evident. Accordingly, in an area such as cross-border loss relief where the ECJ case law is the only source of EU law binding the Member States, the obligation to fully comply with EU law entails assuring the effectiveness of such decisions in all MS. In order to correctly give full force and effect to decisions rendered by the Court national legislators, courts, administrations need clear guidance from the ECJ. Given that the *status quo* is not satisfactory, the *M&S exception* should be replaced by legislation at the level of the European Union.

Although a targeted measure may not solve an evident paradox: there is meant to be one single market, yet the EU is fragmentized into twenty-eight different tax systems, such inconsistency will only be resolved once Member States of the European Union agree to harmonize their direct tax systems and adopt some form of CCCTB (Common Consolidated Corporate Tax Base), creating one common base for the entire EU. Until then, the lack of cross-border loss relief is a real obstacle to the achievement of the internal market and measure must be taken urgently.

[154] See Article 267 TFEU

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