EUROPEAN UNION

The *Marks & Spencer* Case – The Open Issues Following the ECJ's Final Word

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1. JUDGMENT AND OPINION

The decision of the European Court of Justice (ECJ) in the *Marks & Spencer*[1] case has long been awaited. The ECJ's ruling of 13 December 2005, however, came as a surprise to many tax law experts:

> As Community law now stands, Articles 43 EC and 48 EC do not preclude provisions of a Member State which generally prevent a resident parent company from deducting from its taxable profits losses incurred in another Member State by a subsidiary established in that Member State although they allow it to deduct losses incurred by a resident subsidiary. However, it is contrary to Articles 43 EC and 48 EC to prevent the resident parent company from doing so where the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods and where there are no possibilities for those losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party.[2]

Advocate General Poiares Maduro[3] had proposed that the deductibility of losses should be the rule and the non-deductibility the exception:

> (1) Articles 43 and 48 EC preclude the tax legislation of a Member State, such as that at issue in the main proceedings, which prohibits a parent company established in a Member State from benefiting from the right to group relief on the ground that its subsidiaries are established in other Member States, whereas that relief would be granted if those subsidiaries were resident in that Member State.
> (2) Those provisions do not preclude national legislation from making entitlement to group relief, such as that provided for by the Member State concerned in the main proceedings, subject to the condition that it be established that the losses of subsidiaries resident in other Member States cannot be accorded equivalent tax treatment in those Member States.[4]

As in most cases, the ECJ's judgment is shorter than the Advocate General's Opinion. Since the ECJ's ruling deviated from what the Advocate General had suggested, it could be wished that the ECJ had provided a more detailed reasoning. The structure of the ECJ's decision is, however, quite traditional. Referring to its settled case law, the ECJ confirmed that "although direct taxation falls within their competence, Member States must none the less exercise that competence consistently with Community law".[5] The ECJ also took the position that Art. 43 of the EC Treaty applied:

> Even though, according to their wording, the provisions concerning freedom of establishment are directed to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation (see, in particular, *ICI*, cited above, paragraph 21).[6]

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1. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes).*
2. Id., Para. 61.
3. ECJ, Advocate General's Opinion, 7 April 2005, Case C-466/03, *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)*. For more on this Opinion, see Meussen, "Cross-Border Loss relief in the European Union following the Advocate General's Opinion in the *Marks & Spencer* Case", 45 *European Taxation* 7 (2005), pp. 282-286.
4. Id., Para. 84.
5. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 29.
6. Id., Para. 31.

The ECJ does not refer to subsidiaries and PEs as a possible comparison. As the ECJ's reasoning is shorter than that of the Advocate General, this leaves room for contradictory explanations. One is that the ECJ may have shared the Advocate General's view that subsidiaries and PEs may be in a comparable situation. Since, however, the legal situation under UK tax law was ultimately not comparable in this case, the ECJ saw no need to consider this comparison. The other explanation is that, for the ECJ, foreign and domestic corporations were the only possible comparison and that the Court implicitly rejected any other comparisons. The judgment does not allow conclusions to be drawn as to which explanation is correct.

There is no doubt that, under UK tax law, there are differences between the tax treatment of subsidiaries and branches. The differences in tax law that Advocate General Poiares Maduro referred to are, however, in no way dramatic. Groups are not entitled to consolidation, as subsidiaries are treated as independent legal and tax entities. Only the losses and not the profits are allocated to the parent. For the Advocate General, these differences are substantive enough to view the legal situation of subsidiaries and branches as not comparable. Although the legal differences between subsidiaries and branches could not be ignored, it would be wrong to conclude from these differences that the legal situation is *completely* different.[20] As the ECJ repeatedly emphasizes that discrimination not only arises through the application of different rules to comparable situations but through the application of the same rule to different situations as well, it might also be concluded that the legal treatment may only be *to a certain extent different* if the legal situation is only to a certain extent different.[21] Lyal has suggested that "very different treatment of not very different situations" can constitute an infringement of the freedoms.[22] Accordingly, the ECJ could have looked at the comparison between a subsidiary and a branch.[23]

Group taxation systems differ from Member State to Member State. In some Member States not only losses but also profits are allocated to the parent. Some group taxation systems also differ from the UK system insofar as profits and losses within a group may only be allocated to the company at the top of the group, whilst under UK tax law allocation to other companies within the group is possible. Accordingly, under other Member States' group taxation systems, it could be argued that the legal situation of PEs and subsidiaries is more comparable than that of foreign and domestic subsidiaries. If the foreign subsidiary must be treated in the same way as a PE, covered by a tax treaty providing for the credit method, the deduction of foreign losses is required. There is, however, no reason not to allocate future profits to the subsidiary as well and to recapture the deduction of losses, at least to the extent that the subsidiary has profits in future periods. The double utilization of losses, which appears to be of concern to the ECJ, is also not possible under this solution. Accordingly, it is necessary to be careful in applying the *Marks & Spencer* judgment to other Member States' group taxation systems.

It should be noted that the ECJ's ruling deviates from the Advocate General's suggestion in another respect. Whilst the Advocate General referred to "the tax legislation of a Member State, such as that at issue in the main proceedings",[24] the ECJ's judgment does not contain this reference and is phrased in a more general way:

> Articles 43 EC and 48 EC do not preclude provisions of a Member State which generally prevent a resident parent company from deducting from its taxable profits losses incurred in another Member State by a subsidiary established in that Member State although they allow it to deduct losses incurred by a resident subsidiary.[25]

It can be speculated whether or not the ECJ wanted to express that its judgment is relevant not only for a system like that in the United Kingdom, but also for other Member States' group taxation systems. The ECJ, however, arrived at its decision having examined the legal situation in the United Kingdom in detail. Accordingly, the impression is given that the specific details of UK tax law were relevant. The lack of reference to "the tax legislation of a Member State, such as that in the main proceedings" should therefore not be overemphasized.[26]

2.3. Foreign versus domestic PE

Another interesting question is whether or not the *Marks & Spencer* judgment could have any effect on the treatment of the foreign losses of PEs whose profits are exempt under a tax treaty. The treatment of exempt foreign losses is the main issue in the *Ritter-Coulais*[27] case. The facts of this case do not, however, appear ideal to obtain a decision on the question of whether or not it accords with the freedoms to deny the deductibility of foreign losses if these are covered by a tax treaty providing for the exemption method whilst domestic losses may be deducted.[28] Advocate General Léger took the view that Ritter-Coulais is not a resident, but a non-resident taxpayer.[29] The Advocate General also suggested applying the *Schumacker* case law on losses and treating losses as rules regarding personal and family circumstances.[30] This does not appear to be at all convincing.[31] For all these reasons, it can be expected that the ECJ's decision in the *Ritter-Coulais* case will not be the final word on the treatment of losses.[32]

20. See Müller, "Cross Border Consolidation and Loss Compensation: Case C-231/05 *Oy Esab*", *Tax Planning International*, European Union Focus, 09/05, p. 11.
21. See Lang, "Wohin geht das Internationale Steuerrecht?", *Internationales Steuerrecht* (2005), p. 291.
22. Lyal, note 14, p. 68.
23. Lang, note 14, p. 96.
24. ECJ, Advocate General's Opinion, 7 April 2005, Case C-466/03, *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)*, Para. 84.
25. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 59.
26. For a different approach, see Van den Hurk, Rainer, Roels, Thömmes, Tomsett and Weening, "ECJ Allows Limited Group Relief in *Marks & Spencer*", *Tax Notes International*, 19 December 2005, p. 1024.
27. ECJ, Advocate General's Opinion, 1 March 2005, Case C-152/03, *Hans-Jürgen and Monique Ritter-Coulais v. Finanzamt Germersheim*.
28. See Lüdicke, "Pending Cases Filed by German Courts I", in Lang, Schuch and Staringer (eds.), *ECJ – Recent Developments in Direct Taxation* (Vienna: Linde, 2006), p. 155 et seq.
29. ECJ, Advocate General's Opinion, 1 March 2005, Case C-152/03, *Hans-Jürgen and Monique Ritter-Coulais v. Finanzamt Germersheim*, Para. 49.
30. Id., Para. 102.
31. Lang, note 15, p. 344; and Meussen, note 3, p. 283.
32. Concurring, see Meussen, note 3, p. 283.

The ECJ then identified UK corporations with domestic subsidiaries and UK corporations with subsidiaries in other Member States as the relevant comparison and assumed that they were in a comparable situation[7] (see 2.). The following step was the search for justification[8] (see 3.). As the ECJ took the position that the restriction was justified, the next issue was proportionality[9] (see 4.), i.e. the ECJ examined whether or not the restrictive measure went beyond what was necessary to attain the objectives pursued.

2. COMPARABLE SITUATION

2.1. Foreign versus domestic subsidiary

The ECJ repeatedly used the term "restriction". For the ECJ, it was relevant that there was "different treatment for tax purposes to losses incurred by a resident subsidiary and losses incurred by a non-resident subsidiary".[10] The ECJ emphasized that

> residence is not always a proper factor for distinction. In effect, acceptance of the proposition that the Member State in which a company seeks to establish itself may freely apply to it a different treatment solely by reason of the fact that its registered office is situated in another Member State would deprive Article 43 EC of all meaning (see Case 270/83 *Commission* v *France* [1986] ECR 273, paragraph 18).[11]

In the *Avoir fiscal*[12] case, to which the ECJ refers, the Court had noted:

> Even if the possibility cannot altogether be excluded that a distinction based on the location of the registered office of a company or the place of a natural person may, under certain conditions, be justified in an area such as tax law, it must be observed in this case that French tax law does not distinguish, for the purpose of determining the income liable to corporation tax, between companies having their registered office in France and branches and agencies situated in France of companies whose registered office is abroad.[13]

Accordingly, residents and non-residents in themselves are neither *always* nor *never* in a comparable situation, but only if their *legal* situation is comparable.[14] Except for the *Schumacker*[15] case law, this line of reasoning is already settled case law.[16] By referring to the *Avoir fiscal* case, the ECJ made it clear that this line of reasoning also applies if resident taxpayers with domestic income and resident taxpayers with cross-border income are treated differently. In the *Schempp*[17] case, however, the ECJ applied a different standard:

> It follows that, ... the payment of maintenance to a recipient resident in Germany cannot be compared to the payment of maintenance to a recipient resident in Austria. The recipient is subject in each of those two cases, as regards taxation of the maintenance payments, to a different tax system.[18]

If the ECJ had also used this argument in the *Marks & Spencer* case, the Court could have concluded that the non-resident subsidiaries of the UK parent were subject to a different tax system and, therefore, domestic losses could not be compared to foreign losses.

2.2. Subsidiary versus PE

The Advocate General had discussed if subsidiaries and permanent establishments (PEs) were in a comparable situation:

> In the present case foreign subsidiaries and branches are indeed governed by different tax regimes. However, that difference in treatment is not due solely to the fact that they are subject to different tax obligations but to the United Kingdom system of corporate taxation. Under that system the difference in tax treatment is determined by the legal form of the secondary establishment. Groups of companies are not entitled to consolidation for tax purposes which applies to the income of permanent establishments. In that connection, although the group relief system modifies the rule of separate taxation of group companies, it cannot have the effect of assimilating the situation of subsidiaries to that of branches. Under that regime the transfer of losses is treated in a specific way. There is no consolidated joint taxation. That is because subsidiaries are always treated as independent legal and fiscal entities. Accordingly, the difference in treatment of those two categories of establishment does not merely comprise loss of a specific benefit as a result of the option being made in favour of the establishment of foreign subsidiaries. It stems from a difference in the tax regimes applicable to the different types of establishment.[19]

Although he ultimately concluded that the legal situation of PEs and subsidiaries was not comparable under UK tax law, the Advocate General saw at least the possibility to compare the treatment of subsidiaries with that of PEs.

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7. Id., Para. 34.
8. Id., Para. 36 et seq.
9. Id., Para. 53 et seq.
10. Id., Para. 34.
11. Id., Para. 37.
12. ECJ, 28 January 1986, Case 270/83, *Commission of the European Communities v. French Republic* (*Avoir fiscal*) [1986] ECR 00273.
13. Id., Para. 19.
14. Gutmann's reasoning in "The *Marks & Spencer* case: proposals for an alternative way of reasoning", *EC Tax Review* (2005), p. 155 is convincing. See also Lang, "*Marks and Spencer* – more questions than answers: an analysis of the Opinion delivered by Advocate General Maduro", *EC Tax Review* (2005), p. 96. See again Lyal, "Non-discrimination and direct tax in Community law", *EC Tax Review* (2003), p. 69 et seq., who emphasizes that "very different treatment of not very different situations" can constitute an infringement of the freedoms. Wattel, "Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity; a plea for territoriality", *EC Tax Review* (2003), p. 197 appears to take the position that the legal situation is relevant for the purpose of comparison, but emphasizes the relevance of the different liability positions of PEs and subsidiaries. For a similar approach, see Schön, "Besteuerung im Binnenmarkt – die Rechtsprechung des EuGH zu den direkten Steuern", *Internationales Steuerrecht* (2004), p. 300. For Meussen, note 3, p. 283, a subsidiary is "in a different legal situation" because it is an "independent legal entity".
15. ECJ, 14 February 1995, Case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker* [1995] ECR I-00225. Critical, see Lang, "Ist die *Schumacker*-Rechtsprechung am Ende?", *Recht der Internationalen Wirtschaft* (2005), p. 344.
16. For references, see Lang, note 14, p. 96. See also Herzig, Englisch and Wagner, "Steuerliche Berücksichtigung von Verlusten ausländischer Konzerntöchter", *Der Konzern* (2005), p. 300.
17. ECJ, 12 July 2005, Case C-403/03, *Egon Schempp v. Finanzamt München V*. For more on this case, see HJI Panayi, "The *Schempp* Case: EU Citizenship, Rights and Taxes – A New Leaf in ECJ Jurisprudence or Just a Fig Leaf?", 45 *European Taxation* 11 (2005), pp. 482-487.
18. Id., Para. 35.
19. ECJ, Advocate General's Opinion, 7 April 2005, Case C-466/03, *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)*, Para. 48.

As in the *Marks & Spencer* case the ECJ compared the treatment of domestic taxpayers having foreign subsidiaries with domestic taxpayers having domestic subsidiaries, domestic taxpayers having domestic losses could also be compared with domestic taxpayers having foreign losses. Applying the *Marks & Spencer* doctrine, the ECJ could arrive at similar solutions. The deduction of foreign losses could be denied, unless a taxpayer demonstrates that the loss cannot be utilized in the source Member State.

Foreign PEs covered by the exemption method could also be compared with foreign PEs covered by the credit method if the residence Member State applies both methods to the same type of income in its tax treaty network. This comparison could lead to the result that losses must be deducted under the exemption method as well and may be recaptured in following years if the PE becomes profitable. The application of the credit method leads to the same result. This is the least restrictive measure to achieve the objective of excluding the double utilization of losses. Even if the ECJ did not compare foreign PEs under the exemption and under the credit method with each other, there are, however, good reasons to arrive at this result. If a Member State has accepted the deductibility of foreign losses under the credit method, this state could be estopped from arguing that there is a need to restrict the deductibility of the foreign losses in other situations. The ECJ referred to a similar idea in the *Wielockx*[33] case in which it concluded that a Member State can waive the coherence of its tax systems by concluding a tax treaty.

3. JUSTIFICATION

3.1. Protection of balanced allocation of power to impose taxes between Member States

In its *Marks & Spencer* judgment, the ECJ focused on the justification. The Court dealt extensively with three aspects of the justification submitted by the United Kingdom and other Member States. The initial factor considered was:

> First, in tax matters profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system in order to protect a balanced allocation of the power to impose taxes between the different Member States concerned.[34]

The ECJ supported this argument:

> the preservation of the allocation of the power to impose taxes between Member States might make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses. ... In effect, to give companies the option to have their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardise a balanced allocation of the power to impose taxes between Member States, as the taxable basis would be increased in the first State and reduced in the second to the extent of the losses transferred.[35]

This position is difficult to understand. The ECJ apparently assumes that applying UK group taxation rules to cross-border situations "give[s] companies the option to have their losses taken into account in the Member State in which they are established or in another Member State". In the ECJ's view, the exercise of the option results in increasing "the taxable basis ... in the first State" and in reducing it "in the second to the extent of the losses transferred".[36] The ECJ is wrong. Allowing the deduction of the loss in the parent's residence state does not necessarily exclude the possibility to utilize the loss in another Member State.[37] Specifically, the introduction of deductibility of a foreign loss in the state of residence of the parent does not prevent the state of residence of the subsidiary from applying its own domestic rules. There is neither an option to utilize the loss in one *or* the other Member State nor are the losses "transferred" in a way that they can no longer be utilized in the other state.

Using the phrase the "allocation of the power to impose taxes between Member States" is also misleading.[38] The power to impose taxes between the Member States is not allocated amongst the Member States. They can impose taxes whenever there is the necessary genuine link required by international customary law.[39] In the *van Hilten-van der Heijden*[40] case, Advocate General Léger is, under Community law, even willing to accept a rule that extends worldwide taxation to non-residents if they are still citizens and left the country less than ten years ago. Not even under tax treaty law does it appear to be problematic to apply a look-through approach via foreign entities and to tax the income of the entity at the level of the shareholder.[41] In any case, it is not at all a breach of international law to deduct foreign losses.[42] The only argument that the deduction of foreign losses could endanger the "balanced allocation" of the Member States' power to impose taxes is the possible revenue loss. In this respect, the ECJ, however, makes it clear that

> it must be borne in mind that the reduction in tax revenue cannot be regarded as an overriding reason in the public interest which may be relied on to justify a measure which is in principle contrary to a fundamental freedom.[43]

33. ECJ, 11 August 1995, Case C-80/94, *G.H.E.J. Wielockx v. Inspecteur der Directe Belastingen* [1995] ECR I-02493, Para. 24 et seq.
34. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 43.
35. Id., Paras. 45-46.
36. Id., Para. 46.
37. Lang, "*Marks & Spencer* – Eine erste Analyse des EuGH-Urteils", *Steuer & Wirtschaft International* (2006), p. 6 et seq.
38. Id., p. 7.
39. For more details, see Lang, *Einführung in das Recht der Doppelbesteuerungsabkommen*, 2nd edition (Vienna: Linde, 2002), p. 21.
40 ECJ, Advocate General's Opinion, 30 June 2005, Case C-513/03, *Erven van M. E. A. van Hilten-van der Heijden v. Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen*. For a detailed analysis, see Hohenwarter and Plansky, "Besteuerung von Erbschaften nach Wegzug in einen Drittstaat im Gemeinschaftsrecht – Schlussanträge des GA Léger in der Rs. *van Hilten-van der Heijden*", *Steuer & Wirtschaft International* (2005), p. 417 et seq.
41 See, in more detail, Lang, "CFC Regulations and Double Taxation Treaties", 57 *Bulletin for International Fiscal Documentation* 2 (2003), pp. 51-58.
42 Lang, note 14, p. 97.
43 ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 44.

3.2. Danger of double utilization of losses

The second justification submitted by the Member States was the danger that the losses could be allowed twice if they were taken into consideration in the parent's state. The ECJ reacted as follows:

> As regards the second justification, relating to the danger that losses would be used twice, it must be accepted that Member States must be able to prevent that from occurring. ... Such a danger does in fact exist if group relief is extended to the losses of non-resident subsidiaries. It is avoided by a rule which precludes relief in respect of those losses.[44]

The ECJ appears to accept the rules of the Member States that ensure single taxation and avoid double non-taxation, as in the *Schempp*[45] case, or avoid the double utilization of losses, even if the price is that an intra-Community cross-border situation is treated worse than a purely domestic situation, at least from the viewpoint of a single taxpayer. As soon as the tax base is harmonized within the European Union, it makes sense to ensure that income is taxed once and losses can be deducted once. As long as direct taxation is not harmonized, it is not convincing to derive from Community Law that the Member States may justify their discriminatory measures by arguing that they intend to ensure single taxation or exclude the double utilization of losses. If the Member States are free to determine their tax base and, therefore, determine the taxable events, the consequence may be that parts of income are taxed twice and parts of income are taxed nowhere.[46] If double non-taxation is acceptable, then the double utilization of losses should not be a problem either.

It should also be considered that tax treaties, whose conclusion is encouraged by Art. 293 of the EC Treaty, could lead to double non-taxation. If one contracting state loses its taxing rights under a tax treaty whilst the other refrains from exercising its taxing rights, double non-taxation is unavoidable.[47] It is difficult to argue that the possibility of double utilization of losses must be excluded in every case if the same state concludes a tax treaty that leaves room for double non-taxation. Under tax treaties providing for the credit method, the danger of double non-taxation is reduced.[48] Accordingly, it may be relevant that the United Kingdom is a credit state. A Member State that has adopted a tax treaty policy that does not leave much room for double non-taxation is more credible when it is concerned with the danger of the double utilization of losses than Member States that have implemented the exemption method in their tax treaty network, without providing for a subject-to-tax clause. As a result, exemption states have an even harder time defending rules that do not allow the deductibility of foreign losses because of the danger of the double utilization of losses.

3.3. Risk of tax avoidance

The ECJ accepted a third and final justification:

> As regards, last, the third justification, relating to the risk of tax avoidance, it must be accepted that the possibility of transferring the losses incurred by a non-resident company to a resident company entails the risk that within a group of companies losses will be transferred to companies established in the Member States which apply the highest rates of taxation and in which the tax value of the losses is therefore the highest. ... To exclude group relief for losses incurred by non-resident subsidiaries prevents such practices, which may be inspired by the realisation that the rates of taxation applied in the various Member States vary significantly.[49]

Previously, the ECJ had never accepted justifications intended to prevent tax avoidance by general measures. The ECJ's reasoning in the *De Lasteyrie du Saillant*[50] case is a typical example of settled case law. By referring to other judgments dealing with companies and using a similar wording, the ECJ makes it clear that, in this respect, it does not distinguish between individuals and other taxpayers:

> As regards justification based on the aim of preventing tax avoidance, referred to by the national court in its question, it should be noted that Article 167a of the CGI is not specifically designed to exclude from a tax advantage purely artificial arrangements aimed at circumventing French tax law, but is aimed generally at any situation in which a taxpayer with substantial holdings in a company subject to corporation tax transfers his tax residence outside France for any reason whatever (see, to that effect, *ICI*, paragraph 26, and *X and Y*, paragraph 61). ... However, the transfer of a physical person's tax residence outside the territory of a Member State does not, in itself, imply tax avoidance. Tax evasion or tax fraud cannot be inferred generally from the fact that the tax residence of a physical person has been transferred to another Member State and cannot justify a fiscal measure which compromises the exercise of a fundamental freedom guaranteed by the Treaty (see, to that effect, Case C-478/98 *Commission* v *Belgium* [2000] ECR I-7587, paragraph 45; *X and Y*, cited above, paragraph 62).[51]

Similar wording could have been used to reject the danger of tax avoidance as a possible justification in the *Marks & Spencer* case, without a need for further deliberation.

In addition, previously, differences in tax rates could not serve as a justification for the worse treatment of cross-border situations. In the *Eurowings*[52] case, the ECJ was very clear:

> Contrary to that what was argued by the Finanzamt, that difference of treatment can also not be justified by the fact that the lessor established in another Member State is there subject to lower taxation. ... Any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters

44. Id., Paras. 47-48.
45. ECJ, 12 July 2005, Case C-403/03, *Egon Schempp v. Finanzamt München V*, Para. 35.
46. Lang, note 37, p. 7.
47. Lang, "Double Non-Taxation – General Report", *Cahiers de droit fiscal international*, Volume 89a (Amersfoort: Sdu Fiscale and Financiële Uitgevers, 2004), p. 83 et seq.
48. Id., p. 103 et seq.
49. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Paras. 49-50.
50. ECJ, 11 March 2004, Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie* [2004] ECR I-02409.
51. Id., Paras. 50-51.
52. ECJ, 26 October 1999, Case C-294/97, *Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna* [1999] ECR I-07447. See also ECJ, 3 October 2002, Case C-136/00, *Rolf Dieter Danner* [2002] ECR I-08147, Para. 56.

> given to recipients of services established in the latter State ... As the Commission rightly observed, such compensatory tax arrangements prejudice the very foundations of the single market.[53]

The approach taken by the ECJ in the *Marks & Spencer* case is completely different from that taken in the *Eurowings* case.

In the light of the *Marks & Spencer* judgment, it may be much easier for the Member States to defend controlled foreign companies (CFC) legislation in the cases pending before the ECJ.[54] Almost the same wording could be used as the ECJ did in the *Marks & Spencer* case, but replacing "losses" with "profits" to justify CFC legislation:

> As regards, ... the ... justification, relating to the risk of tax avoidance, it must be accepted that the possibility of transferring the *profits realised* by a *resident taxpayer* to a *non*-resident company entails the risk that within a group of companies *profits* will be transferred to companies established in the Member States which apply the *lowest* rates of taxation ... To exclude the *transfer of profits to* non-resident subsidiaries prevents such practices, which may be inspired by the realisation that the rates of taxation applied in the various Member States vary significantly.[55] (Author's changes in italics)

3.4. Three justifications "taken together"

Having dealt with the three justifications discussed in 3.1. to 3.3., the ECJ drew its conclusion:

> In the light of those three justifications, *taken together*, it must be observed that restrictive provisions such as those at issue in the main proceedings pursue legitimate objectives which are compatible with the Treaty and constitute overriding reasons in the public interest and that they are apt to ensure the attainment of those objectives.[56] (Emphasis added)

For the ECJ, it is relevant that these three justifications had to be "taken together". What this means is not completely clear. Obviously, each one of the justifications is not sufficient for accepting different treatment. Having considered more closely each of the justifications, it becomes clear that none of these justifications is as such very convincing.[57] Neither is it, however, very convincing that the three justifications "taken together" may justify different treatment. The impression is that the ECJ did not want to admit formally that it had changed its case law.

The uncertainty has grown. The ECJ has already rejected many different justifications in its previous case law. Each of these justifications could, however, "taken together" with one or two other justifications that had been rejected in the past, come into play again.[58] The ECJ is now in a position that it may change its case law in any way without admitting doing so. Nevertheless, the new approach that more than one reason "taken together" could serve as a justification is a change. It should be noted that the ECJ has quite often rejected several justifications put forward by the Member States in a single case, without examining whether or not these justifications "taken together" could lead to a different result.

3.5. Territoriality

The Advocate General discussed at length as to whether or not the principle of territoriality could be a justification. The ECJ also touched on this issue:

> In a situation such as that in the proceedings before the national court, it must be accepted that by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law (see, in particular, *Futura Participations and Singer*, paragraph 22). ... However, the fact that it does not tax the profits of the non-resident subsidiaries of a parent company established on its territory does not in itself justify restricting group relief to losses incurred by resident companies.[59]

The reasoning of the ECJ in this respect is very short. The ECJ is, however, right in rejecting the principle of territoriality as a possible justification. Although the ECJ had discussed this principle several times already, its meaning is not at all clear.[60] In the *Marks & Spencer* case, the ECJ assumed that the principle of territoriality is "enshrined in international tax law and recognised by Community law". By referring to its decision in the *Futura*[61] case, the ECJ gave the impression that it is either already settled case law that this principle is "enshrined in international tax law" or that the Court in the *Futura* case presented its reasoning for this position. Neither assumption is true. In the *Futura* case, the ECJ did not express this thought at all.

This discussion appears to originate from the Advocate General's Opinion. Advocate General Poiares Maduro, however, presented the issue slightly differently:

> In accordance with the requirements of international law the exercise of the fiscal competence of any Member State necessitates connection either to the nationality of the taxable person or to the localisation of taxable income in its territory. It follows that, although a State is entitled to make taxpayers resident on its territory liable to unlimited tax obligations, it can only charge foreign taxpayers to tax on income arising on its territory.[62]

Whilst the ECJ found the principle of territoriality "enshrined in international *tax* law", Advocate General

53. Id., Para. 43 et seq.
54. See Baker, "Pending Cases Filed by UK Courts II", in Lang, Schuch and Staringer (eds.), note 28, p. 311 et seq.
55. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Paras. 49-50.
56. Id., Para. 51.
57. Lang, note 37, p. 8.
58. Id., p. 8.
59. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Paras. 39-40.
60. See also Wattel, note 14, p. 201; Cordewener, Dahlberg, Pistone, Reimer and Romano, "The Tax Treatment of Foreign Losses: *Ritter*, *M & S* and the Way Ahead (Part Two)", 44 *European Taxation* 5 (2004), p. 220; Englisch, "The European Treaties' Implications for Direct Taxes", *Intertax* (2005), p. 330 et seq.; Martin, "The *Marks & Spencer* EU group relief case – a rebuttal of the 'taxing jurisdiction' argument", *EC Tax Review* (2005), p. 61 et seq.; and Kofler, "Einige Überlegungen zur steuerlichen Kohärenz nach dem Urteil des EuGH in der Rs *Manninen*", *Österreichische Steuer-Zeitung* (2005), p. 30 et seq.
61. ECJ, 15 May 1997, Case C-250/95, *Futura Participations SA and Singer v. Administration des contributions* [1997] ECR I-02471.
62. ECJ, Advocate General's Opinion, 7 April 2005, Case C-466/03, *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)*, Para. 60.

Poiares Maduro referred to the "requirements of *international law*" (emphasis added). The Advocate General apparently assumed that, under international law, taxes may only be levied if the taxpayer is a citizen of the country levying the tax or the income is localized in its territory. This approach appears to be very narrow. Under international law, a "genuine link" between the state, on the one hand, and the taxpayer or the taxable event, on the other, is sufficient to levy tax.[63] Accordingly, in addition to citizenship, domicile, habitual abode and other criteria can give rise to unlimited taxation. The taxation of non-residents is not limited to the territory. It is not disputed that customary international law does not prevent states from taking into account foreign income to determine the tax rate or, as can be seen in the *Saint-Gobain*[64] decision of the ECJ, even the tax base of non-residents. CFC legislation is also accepted under international law.[65] Under CFC legislation, the only link between the taxing state and the income is usually the shareholder's residence. This is considered to be sufficient to levy tax. These examples illustrate that the position taken by the Advocate General was too narrow.[66]

In the author's view, it would have been difficult for the ECJ to give reasons why this principle should be "enshrined in international *tax* law" as well (emphasis added). By concluding tax treaties, contracting states agree to restrict themselves in exercising their taxing rights. As a result of a bargaining process, contracting states try to achieve a balance between source and residence taxation. The rules contained in tax treaties vary greatly between different types of income and are, understandably, as their contents depends on the negotiation power of the contracting states, not really based on principles at all. As far as losses are concerned, tax treaties usually do not impose any obligation on contracting states not to allow a deduction.[67] Contracting states are always free to be more generous than they have to be under their tax treaty obligations. From the debate regarding whether or not CFC rules are compatible with tax treaties, it can be learnt that there are good reasons to assume that tax treaties do not prevent contracting states from taxing even the foreign profits of non-resident companies.[68] For all these reasons, the ECJ was wise not to accept the principle of territoriality as a justification.

3.6. Cohesion

The Advocate General's Opinion also contained a lengthy discussion on the principle of cohesion. Advocate General Poiares Maduro took the position that the

> concept of fiscal cohesion performs an important corrective function in Community law. It serves to correct the effects of the extension of the Community freedoms to the tax systems whose organisation is in principle a matter for the sole competence of the Member States. In fact, the application of the freedoms of movement has to be prevented from giving rise to unwarranted interference with the internal logic of national tax regimes.[69]

He suggested redefining or "relaxing" the criteria developed by the ECJ so far[70] to conclude that "justification based on cohesion of the system of relief can be accepted only if the foreign losses may be accorded equivalent treatment in the State in which those losses arise".[71]

The ECJ came to a similar solution, although it avoided using the term "cohesion". A possible reason for avoiding cohesion could be that the ECJ was convinced by the Advocate General's argument that the use of cohesion as a justification would require the Court to make the change in its case law explicit. Although the concept of "cohesion" has never been clear, it was apparent that it was not broad enough to take into account the tax situation of another taxpayer in another state.[72] The ECJ has, however, never hesitated to change its case law whenever the Court found it appropriate to do so. Recent case law, in particular, gives the impression that the ECJ is about to make a "u-turn". Nevertheless, the ECJ apparently dislikes making such a change explicit.

An illustrative example of this approach is the *Schempp* decision. The ECJ was willing to justify a different treatment of a cross-border alimony payment because the person receiving the payment, who was no longer related to the taxpayer, was taxed by another Member State. The traditional concept of cohesion would never have been sufficient as a justification in this case. The ECJ avoided making its deviation from its previous case law explicit by declaring the taxation of alimony payments made to domestic taxpayers and foreign taxpayers to be not comparable.[73]

The author does not miss the use of cohesion at all, as this justification always has an arbitrary element to it.[74] Although the ECJ has rarely accepted cohesion to date, it has never formally given it up as a possible justification. The ECJ has often insisted that, in principle, a different treatment may be justified by cohesion. In the *Marks & Spencer* case, the ECJ replaces cohesion by three other justifications that must be "taken together". The fact that the ECJ arrived at similar results to the Advocate General by replacing cohesion with three justifications "taken together" speaks for itself. A well-reasoned decision should neither be based on a justification like cohesion nor on an unclear combination of three other reasons.[75]

63. For more details, see Lang, note 39, p. 21.
64. ECJ, 21 September 1999, Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt* [1999] ECR I-06161, Para. 14
65. Avi-Yonah, "International Tax as International Law", *Tax Law Review* (2004), p. 486 et seq. See also Scheunemann, "Europaweite Verlustberücksichtigung im Konzern", *Internationales Steuerrecht* (2005), p. 306.
66. It should be noted that the UK Special Commissioners (John F. Avery Jones and Malcolm Gammie, 17 December 2002, SpC 00352, Para. 37) used the phrase "international tax practice" instead of "international law".
67. See for example, Lang, note 39, p. 141 et seq.
68. Lang, note 41, p. 51 et seq.
69. ECJ, Advocate General's Opinion, 7 April 2005, Case C-466/03, *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)*, Para. 66.
70. Id., Para. 71.
71. Id., Para. 76.
72. As a possible exception, see ECJ, 7 September 2004, Case C-319/02, *Petri Manninen* [2004] ECR I-07477, Para. 45 et seq.
73. Lang, "Das EuGH-Urteil in der Rechtssache *Schempp* – Wächst der steuerpolitische Spielraum der Mitgliedstaaten?", *Steuer & Wirtschaft International* (2005), p. 414.
74. See, for example, Thömmes, "Tatbestandsmäßigkeit und Rechtfertigung steuerlicher Diskriminierungen nach EG-Recht", in Schön (ed.), *Gedenkschrift Knobbe-Keuk* (Cologne: Schmidt, 1997), p. 826.
75. For a different approach, see Wunderlich and Albath, "Der Europäische Gerichtshof und die direkten Steuern", *Deutsche Steuer-Zeitung* (2005), p. 553; and Seer, Kahler, Rüping and Thulfaut, "Die Rechtsprechung des EuGH auf dem Gebiet der direkten Besteuerung in den Jahren 2003 und 2004", *Europäisches Wirtschafts- und Steuerrecht* (2005), p. 300.

4. PROPORTIONALITY

4.1. Less restrictive measures

The question of proportionality is discussed in the *Marks & Spencer* judgment at greater length. Specifically, the ECJ

> considers that the restrictive measure at issue in the main proceedings goes beyond what is necessary to attain the essential part of the objectives pursued if:
> – the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods, if necessary by transferring those losses to a third party or by offsetting the losses against the profits made by the subsidiary in previous periods, and
> – there is no possibility for the foreign subsidiary's losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party.[76]

The ECJ makes its line of reasoning clear:

> Such a restriction is permissible only if it pursues a legitimate objective compatible with the Treaty and is justified by imperative reasons in the public interest. It is further necessary, in such a case, that its application be appropriate to ensuring the attainment of the objective thus pursued and not go beyond what is necessary to attain it (see, to that effect, Case C-250/95 *Futura Participations and Singer* [1997] ECR I-2471, paragraph 26, and Case C-9/02 *De Lasteyrie du Saillant* [2004] ECR I-2409, paragraph 49).[77]

There is no risk in predicting that proportionality will play a greater role in the future. To date, the ECJ has been very cautious in accepting justifications as overriding reasons in the public interest. If the ECJ changes its attitude and continues to be willing to accept justifications more readily, the question of "whether the restrictive measure goes beyond what is necessary to attain the objectives pursued" will arise more often.

In the *Marks & Spencer* case, the ECJ did not, however, explain why it did not require the Member States to adopt an even less restrictive measure. To avoid double non-taxation and to prevent tax avoidance, it would be sufficient to allow the deduction of losses and to combine this with the introduction of a recapture rule for future profitable periods.[78] This method is also applied to PEs covered under the credit method in a tax treaty. The ECJ appears to have been interested in arriving at a solution that is easier to accept for the Member States. Whilst the Advocate General had taken into consideration the fact that "the budgetary equilibrium of the States concerned" should not be threatened,[79] the ECJ did not refer to this factor. This does not, however, necessarily mean that the ECJ was not influenced by such deliberations.

The Advocate General's Opinion had been heavily criticized because he suggested that the freedoms

> do not preclude national legislation from making entitlement to group relief ... subject to the condition that it be established that the losses of subsidiaries resident in other Member States cannot be accorded equivalent tax treatment in those other Member States.[80]

The Advocate General failed to define the term "equivalent tax treatment". Instead, he gave the example of a loss carry-forward.[81] The economic value of a loss that is deductible in a following year, however, never equals the value of the same nominal amount of a loss deductible in the year in which it was incurred.[82] The later a loss carry-forward is utilized, the less its value. The Advocate General apparently accepted that the deductibility of a loss in a following period could be considered as "equivalent tax treatment". In the *X and Y*[83] case, the ECJ decided that even refusing "the benefit of deferring capital gains tax, thus depriving the transferor of a cash flow advantage" can be an infringement of the freedoms.

The *Marks & Spencer* judgment does not refer to the requirement of "equivalent tax treatment". For the ECJ, it is sufficient that there is the possibility of utilizing the loss in the subsidiary's state of residence. The ECJ ignores that neither a loss carry-forward nor an immediate offset of a loss with other profits in a jurisdiction that levies a lower tax rate can be an equivalent substitute for granting group relief in the parent's state of residence.[84] Nevertheless, as the ECJ had already accepted that group relief can be refused in general and must only be granted in exceptional cases, it saw no reason to demand that, in such an exceptional case, "equivalent tax treatment" must be accorded. This reversal of rule and exception prevented the ECJ from getting into the delicate problem of explaining how a loss carry-forward could be considered to be "equivalent tax treatment" to an immediate deduction of the loss.

4.2. Utilization of loss by subsidiary in its state of residence

The ECJ decided that a loss had to be deducted, but did not define what is meant by "loss". A loss could arise either under the domestic law of the parent's residence state or the subsidiary's. The ECJ did not take a position of its own, but referred only to that taken by the parties:

76. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 55.
77. Id., Para. 35.
78. Similar positions are taken by Petritz and Schilcher, "*Marks & Spencer* – Erste Erkenntnisse aus dem Schlussantrag von Generalanwalt M. Poiares Maduro", *Steuer & Wirtschaft International* (2005), p. 240; Persoff, "*Marks & Spencer*: More questions than answers", *British Tax Review* (2005), p. 263; Thömmes, "Anmerkung", *Internationale Wirtschafts-Briefe* (2005), Fach 11a, p. 854; and Craig, Van den Hurk, Lyons, Rainer, Roels, Thömmes and Tomsett, "Advocate General Backs Marks & Spencer's Claim for Loss Relief", *Tax Notes International*, 18 April 2005, p. 197.
79. ECJ, Advocate General's Opinion, 7 April 2005, Case C-466/03, *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)*, Para. 78.
80. Id., Para. 84.
81. Id., Para. 82.
82. Lang, note 14, p. 98 et seq.; Meussen, note 3, p. 284; Persoff, note 78, p. 262 et seq.; and Herzig, Englisch and Wagner, note 16, p. 309.
83. ECJ, 21 November 2002, Case C-436/00, *X, Y v. Riksskatteverket* [2002] ECR I-10829, Para. 38. For a similar approach, see ECJ, 8 March 2001, Joined Cases C-397/98 and C-410/98, *Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd v. Commissioners of Inland Revenue, HM Attorney General* [2001] ECR I-01727, Para. 44.
84. Lang, note 14, p. 98 et seq.; and Thömmes, note 78, Fach 11a, p. 854.

> It is clear from the file before the Court that both parties to the main proceedings agree that the losses must be computed on a United Kingdom tax basis. At the tax authority's request, Marks & Spencer therefore recomputed the losses on that basis.[85]

Considering that the situation of UK companies with foreign and domestic subsidiaries is compared, it is apparently convincing that UK law should provide the same treatment in both situations. There are, therefore, good reasons to compute the loss under UK law.[86]

The ECJ requires the taxpayer to demonstrate that the loss cannot be utilized by the subsidiary or a third party in the subsidiary's residence state. The mere existence of loss carry-back or loss carry-forward rules in the subsidiary's residence state does not exclude the entitlement to group relief in the United Kingdom. The losses must be deducted if the taxpayer demonstrates that they cannot be utilized in the actual situation.[87] Otherwise, it would not have been necessary to transfer the burden of proof to the taxpayer.[88] Gaining sufficient knowledge of the existence of loss carry-back and carry-forward rules in 24 other Member States should not be that difficult.[89]

There can be many different situations in which a parent may demonstrate that it cannot utilize the loss in a subsidiary's residence state. An example is a situation in which a loss arises only under the tax law rules of the parent's residence state. If the application of the tax rules in the subsidiary's residence state results in the subsidiary realizing a profit in the same period, the "loss", computed under the law of the parent's residence state, would not be utilized. The same would be true if the subsidiary is tax exempt or the relevant income of the subsidiary is not included in the tax base in the subsidiary's state of residence.[90] A utilization of the loss in the subsidiary's residence state would not be possible in this situation. If, however, there is a low tax rate in the subsidiary's state of residence, it could, if the other requirements are fulfilled, be possible to utilize the loss there, although their value would be very low.[91]

The subsidiary's losses must be deducted in the United Kingdom if "there are no possibilities for those losses to be taken into account in its State of residence for future periods".[92] The ECJ does not say when the taxpayer must demonstrate that these requirements are met. Timing can, however, make a significant difference.[93] Assume that, in the subsidiary's residence state, the possibility to carry forward losses expires after five years. The amount of information available to the parent regarding the utilization of losses in the other state may differ over time. At the end of the tax year for which the group relief is claimed, the parent may be unable to demonstrate that the losses cannot be utilized in the subsidiary's residence state, as it is possible that the subsidiary will realize profits in the five-year period. When the parent files its tax return, or, if required, is assessed by the tax authorities, the loss-making subsidiary may have already been liquidated, so that the taxpayer can demonstrate that the loss cannot be utilized. If the subsidiary remains in business for the whole five-year period but fails to be profitable, the parent can demonstrate after the expiry of the five-year period that the losses have not been utilized. In this situation, the question arises as to whether or not it is too late to provide the necessary evidence at this stage. If, however, the parent is precluded from demonstrating that the loss cannot be utilized at a certain stage, it could be the case that the group relief is neither granted nor the loss utilized in the other state. Although the ECJ appears to be more concerned with the interest of governments than that of taxpayers, this does not appear to accord with the object and purpose of the judgment.

If, however, the parent can demonstrate that no loss utilization is possible in the subsidiary's residence state, the period for reopening the assessment in the parent's residence state may already have expired. The question arises as to whether or not the parent's residence state must, under Community law, provide for a taxpayer's claim in this situation. One option could be to assume that the parent's residence state must grant group relief for a later tax year. This could, however, lead to arbitrary results if the parent had profits in the tax year when the subsidiary incurred the loss, whilst it has a loss in the later tax year. Granting group relief for the later tax year could, in this situation, practically exclude the offsetting of the loss. The more appropriate solution is to assume that the parent must reopen the assessment for the tax year in which the loss was incurred.

The ECJ has already elaborated on the relationship between the exercise of Community rights, on the one hand, and domestic procedural rules, on the other:

> It has consistently been held that in the absence of Community rules on the recovery of national charges levied though not due, it is for the domestic legal system of each Member State to lay down the detailed procedural rules governing such actions for repayment, provided, however, that they are not less favourable than those governing similar domestic actions (principle of equivalence) and that they do not render impossible in practice or excessively difficult the exercise of rights conferred by the Community legal order (principle of effectiveness) (see, in particular, *Metallgesellschaft and Others*, paragraph 85, and Case C-255/00 *Grundig Italiana* [2002] ECR I-8003, paragraph 33).[94]

85. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 22.
86. See Herzig, Englisch and Wagner, note 16, p. 312; and Lang, note 37, p. 9.
87. This point has already been made in Lang, "*Marks & Spencer* und die Auswirkungen auf das Steuerrecht der Mitgliedstaaten", *Steuer & Wirtschaft International* (2005), p. 256.
88. Lang, note 37, p. 9.
89. For an overview, see Scheunemann, note 65, p. 309.
90. Lang, note 37, P. 9.
91. Lang, note 14, pp. 98 et seq.
92. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 59.
93. Lang, note 37, p. 9.
94. ECJ, 2 October 2003, Case C-147/01, *Weber's Wine World Handels-GmbH, Ernestine Rathgeber, Karl Schlosser, Beta-Leasing GmbH v. Abgabenberufungskommission Wien* [2003] ECR I-11365, Para. 103. See also ECJ, 16 December 1976, Case 33-76, *Rewe-Zentralfinanz eG et Rewe-Zentral AG v. Landwirtschaftskammer für das Saarland* [1976] ECR 01989, Para. 5; ECJ, 16 December 1976, Case 45-76, *Comet BV v. Produktschap voor Siergewassen* [1976] ECR 02043, Para. 5; ECJ, 27 March 1980, Case 61/79, *Amministrazione delle finanze dello Stato v. Denkavit italiana Srl* [1980] ECR 01205, Para. 25; ECJ, 10 July 1980, Case 811/79, *Amministrazione delle finanze dello Stato v. Ariete SpA* [1980] ECR 02545, Para. 4; ECJ, 10 July 1980, Case 826/79, *Amministrazione delle finanze dello Stato v. Sas Mediterranea importazione, rappresentanze, esportazione, commercio (MIRECO)* [1980] ECR 02559, Para. 4; ECJ, 9 Novem-

It is, therefore, possible that it is insufficient to reopen the assessment under the same conditions as in merely domestic situations. The exercise of rights conferred by the Community legal order must not be made "impossible in practice or excessively difficult". According to Scheunemann, in 11 Member States the loss carry-forward is limited from five to fifteen years, whilst in 13 Member States there is no limitation.[95] Accordingly, it may very often take time until it is clear whether or not a loss can be utilized. Consequently, there are good reasons to believe that a claim for a reopening of an assessment in the subsidiary's residence state cannot be rejected just because a short period of a few years has expired. It is even possible to go so far as to consider whether or not the parent's residence state must allow the reopening of an assessment until it is clear whether or not the loss can be utilized. If the introduction of such procedural rules were too burdensome for the parent's residence state, it could quite easily avoid the situation by allowing the deduction of losses irrespective of the possibility of utilizing the loss in the subsidiary's residence state and combining this with a recapture rule.

4.3. Utilization of loss by third party in subsidiary's state of residence

One of the requirements imposed by the ECJ is that the loss may not be utilized "by the subsidiary itself or by a third party, in particular if the subsidiary has been sold to that third party".[96] The ECJ was explicitly asked by the High Court of Justice of England and Wales

> what significance, if any, is to be attached to the fact that ... a subsidiary resident in another Member State has been sold to a third party and, although there is provision under the law of that State for the losses to be used under certain conditions by a third party purchaser, it is uncertain whether they were so used in the circumstances of the case.[97]

If there is also a group taxation system in the subsidiary's residence state, it could be that the subsidiary can transfer its loss to its sub-subsidiary or another company within the group. If the loss could be utilized by one of the other group companies, no group relief can be claimed in the parent's residence state. In this situation, it might be expected that the parent would provide the necessary information.

This is, however, very difficult if the subsidiary is sold to an unrelated company and if the parent must demonstrate that the loss cannot be utilized. After the shares have been sold, the former parent does not have any right to obtain information regarding the future fate of the subsidiary. How could the former parent know if, for example, the new parent plans to merge with its subsidiary to utilize the losses? Even if the former parent has that knowledge and the transfer of a loss in the case of a merger is not generally excluded, the utilization of the loss depends on whether or not the new parent has sufficient profits against which the losses can be offset. Again, this offsetting of losses may not take place at once but only in future years if sufficient profits exist. If the purchaser is a competitor of the former parent, the purchaser may not be interested in sharing knowledge regarding its profitability with the former parent. The utilization of the losses may also depend on the fact that the merger of the subsidiary into its new parent is not classified as an abuse of tax law, which might be established by the tax authorities in an audit many years later to deny all the tax benefits that were envisaged.[98]

4.4. Utilization of loss by parent in subsidiary's state of residence

Interestingly, the ECJ imposed the requirement that the loss may neither be utilized by *the subsidiary* nor by *a third party*, but did not explicitly refer to the situation in which the loss is utilized by *the parent*. This situation could arise if the subsidiary is merged with its parent. Consequently, the former subsidiary that was a resident of the other state is transformed into a PE located in that state. If this country's tax law allows the loss to be transferred to the PE of the parent, the loss could be utilized at the level of the PE. The parent, nevertheless, could claim group relief, as the loss could neither be utilized by the subsidiary nor by a third party, but by the parent itself.

Initially, it is apparently puzzling that the loss utilization by the parent in the PE state does not jeopardize the loss utilization in the parent's residence state. Nevertheless, at least within the scope of the credit method, losses incurred by PEs may also be deducted at the level of the head office in the other state. Under the exemption method, many countries allow the deduction of the loss in the head office state, despite the fact that they cannot tax the profits of this PE under tax treaty law. If these countries have adopted measures to ensure that a loss cannot be utilized twice, this measure also applies in this situation. If, however, these countries are not concerned about a possible double utilization of a loss in the head office state and in the PE state, there is no reason to require that the double utilization does not occur if a subsidiary has been transformed into a PE.

4.5. Utilization of loss in third country

The ECJ is also silent on whether or not the utilization of losses in *third countries* is relevant. Assume that the subsidiary of the UK parent is a resident of Member State A and that all of its income is derived from a PE

ber 1983, Case 199/82, *Amministrazione delle Finanze dello Stato v. SpA San Giorgio* [1983] ECR 03595, Para. 12; ECJ, 15 September 1998, Case C-231/96, *Edilizia Industriale Siderurgica Srl (Edis) v. Ministero delle Finanze* [1998] ECR I-04951, Para. 34; ECJ, 15 September 1998, Case C-260/96, *Ministero delle Finanze v. Spac SpA* [1998] ECR I-04997, Para. 18; ECJ, 17 November 1998, Case C-228/96, *Aprile Srl, in liquidation, v. Amministrazione delle Finanze dello Stato* [1998] ECR I-07141, Para. 18; ECJ, 9 February 1999, Case C-343/96, *Dilexport Srl v. Amministrazione delle Finanze dello Stato* [1999] ECR I-00579, Para. 25; ECJ, 7 December 2000, Case C-482/98, *Italian Republic v. Commission of the European Communities* [2000] ECR I-10861, Para. 33; ECJ, 11 July 2002, Case C-62/00, *Marks & Spencer plc v. Commissioners of Customs & Excise* [2002] ECR I-06325, Para. 34; and ECJ, 6 October 2005, Case C-291/03, *MyTravel plc v. Commissioners of Customs & Excise*, Para. 17.

95 See Scheunemann, note 65, p. 309.

96. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 59.

97. Id., Para. 26.

98. Lang, note 14, p. 99.

located in Member State B. It is possible that the loss of the subsidiary cannot be utilized in State A, for example because the loss carry-forward period is limited, whilst the loss can be utilized in State B in which the loss can be offset against a later year's profit of the PE.

This situation could arise both if the income of the PE is exempt and if State A credits the tax levied in State B. Under the credit method, State A is in no way prevented from deducting a loss incurred by the PE. Under the exemption method, it is doubtful if the deduction of a foreign loss can be rejected because of the freedom of establishment. Many countries, however, grant the loss deduction even without feeling obliged to do so.

A literal interpretation of the ECJ's ruling could lead to the result that the utilization of a loss in a third country does not jeopardize group relief. The ECJ refers exclusively to the tax treatment in the subsidiary's residence state. It could, however, also be assumed that the only reason why the ECJ did not touch on the third country issue is that it was not asked to do so by the referring court.

It is difficult to see why the utilization of a loss in another Member State, other than the subsidiary's residence state, should not exclude granting group relief there. Of course, the underlying assumptions of the *Marks & Spencer* decision could be challenged. If, however, the relevance of the tax law in the subsidiary's residence state as a requirement for granting group relief in the parent's state of residence is accepted, the tax law of the PE's state should also be considered.[99]

The situation in which the third country is a *non-Member State*, however, deserves more thought. If non-Member State losses must be ignored, it could be asked why groups with PEs outside the European Union should obtain preferential treatment. One of the underlying assumptions of the ECJ's reasoning in the *Marks & Spencer* case is that tax planning should be less attractive. Practices, "which may be inspired by the realisation that the rates of taxation applied in the various Member States vary significantly",[100] must be prevented. There is no reason to believe that tax planning with the PEs of non-Member States should be encouraged.

Conversely, one of the other underlying ideas of the judgment is solidarity between the Member States. The ECJ explicitly referred to "the preservation of the allocation of the power to impose taxes between Member States".[101] A "balanced allocation of the power to impose taxes between Member States" may not be jeopardized.[102] The ECJ saw no need that the loss must be utilized in two Member States. Within the European Union, only one Member State must bear the burden of a reduction in tax revenue. Focusing more on this aspect, the position could be taken that the Member States should not be too concerned regarding a possible reduction in the tax revenues of a non-Member State. If the loss were not incurred in the PE of a non-Member State but in a PE of a Member State, the loss must also be taken into account in one Member State. Accordingly, the balanced allocation of taxing powers between the Member States is not jeopardized if a taxpayer can utilize the loss not only in a Member State, but also in a non-Member State.

4.6. Burden of proof

The ECJ appears to take the position that the burden of proof lies exclusively with the taxpayer:

> Where, in one Member State, the resident parent company demonstrates to the tax authorities that those conditions are fulfilled, it is contrary to Articles 43 EC and 48 EC to preclude the possibility for the parent company to deduct from its taxable profits in that Member State the losses incurred by its non-resident subsidiary.[103]

The Advocate General, however, articulated a more balanced position:

> It may perhaps be objected that it will be excessively difficult for the United Kingdom to ascertain that there is a possibility of group relief in another Member State. In that connection it should be recalled that the Member States have available to them instruments of enhanced cooperation under Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation. Under those provisions the competent authorities of one Member State have the power to request the competent authorities of another Member State to provide them with all information enabling them to establish the correct amount of corporation tax. In fact that instrument of administrative cooperation "provides for ways of obtaining information comparable to those existing between tax authorities at national level". Nor does it seem to me to be ruled out that the Member State concerned may impose on a company claiming group relief a duty of information as to the tax situation of the group to which it belongs and in particular the possibility of dealing with the losses of the subsidiaries in the State in which they are established. In such a case it will none the less be necessary to ensure that those requirements do not exceed what is necessary in order to attain the objective of securing the information sought.[104]

The position taken by the ECJ in the *Marks & Spencer* case apparently contradicts previous case law. In the past, the ECJ acknowledged that mere procedural provisions can jeopardize the Internal Market and that an infringement of the freedoms can also be constituted by moving the burden of proof to the taxpayer in cross-border situations. In the *Bent Vestergaard*[105] case, the ECJ observed

99. In addition, it could be considered that Marks & Spencer plc held its foreign subsidiaries "through the intermediary of a holding company established in the Netherlands" (ECJ, Advocate General's Opinion, 7 April 2005, Case C-466/03, *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)*, Para. 8). As the direct subsidiary had been established in the Netherlands, it could be argued that Belgium, France and Germany were already "third countries". The interposition of the Netherlands holding company is, however, neither referred to in the preliminary questions nor in the facts as they are described in the judgment.

100. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 50.

101. Id., Para. 45.

102. Id., Para. 46.

103. Id., Para. 56.

104. ECJ, Advocate General's Opinion, 7 April 2005, Case C-466/03, *Marks & Spencer plc v. David Halsey (HM Inspector of Taxes)*, Para. 81.

105. ECJ, 28 October 1999, Case C-55/98, *Skatteministeriet v. Bent Vestergaard* [1999] ECR I-07641.

that, by making the right to deduct costs relating to participation in professional training courses held in an ordinary tourist resort abroad conditional upon the rebuttal, by the taxpayer, of a presumption that such courses involve such a significant tourism element that the costs cannot be treated as deductible operating costs, while such a presumption does not exist for courses held in ordinary tourist resorts located in the said Member State, those rules subject the provision of services constituted by the organisation of professional courses to different tax arrangements depending on whether the services are provided in other Member States or in the Member State concerned. ... Rules of a Member State which, like those in question in the main proceedings, make it more difficult to deduct costs relating to participation in professional training courses organised abroad than to deduct costs relating to such courses organised in that Member State involve a difference in treatment, based on the place where the service is provided, prohibited by Article 59 of the Treaty.[106]

In this case, the ECJ also made statements that apparently make it possible to transfer the burden of proof to the taxpayer:

> In that regard, it should be remembered that Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation (OJ 1977 L 336, p. 15) can be invoked by a Member State in order to obtain from the competent authorities of another Member State all the information enabling it to ascertain the correct amount of income tax. In addition, there is nothing to prevent the tax authorities concerned from requiring the taxpayer himself to produce the proof which they consider necessary to assess whether or not the deduction requested should be allowed (see *Bachmann* and *Commission v. Belgium,* cited above, at respectively paragraphs 18 and 20 and paragraphs 11 and 13).[107]

The reference to the *Bachmann*[108] and *Commission v. Belgium*[109] cases, however, makes it clear that evidence may be demanded from the taxpayer if the tax authorities are prevented from carrying out inquiries or from collecting information. Transferring the burden of proof to the taxpayer is only possible if there are no other means of providing information:

> As regards the effectiveness of fiscal controls, it should be observed that Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation (Official Journal 1977 L 336, p. 15, hereinafter referred to as "the Directive") may be invoked by a Member State in order to check whether payments have been made in another Member State where it is necessary, as in the main proceedings in this case, for those payments to be taken into account in order correctly to assess the income tax payable (Article 1(1)). ... However, the Belgian Government points out that certain Member States have no legal basis for requiring insurers to provide the information needed to monitor payments made within their territory. ... it should be noted in that regard that Article 8(1) of the Directive imposes no obligation on the tax authorities of Member States to collaborate where their laws or administrative practices prevent the competent authorities from carrying out enquiries or from collecting or using information for those States' own purposes. However, the inability to request such collaboration cannot justify the non-deductibility of insurance contributions. There is nothing to prevent the tax authorities concerned from demanding from the person involved such proof as they consider necessary and, where appropriate, from refusing to allow deduction where such proof is not forthcoming.[110]

In the light of these decisions, it is not at all clear if the ECJ in the *Marks & Spencer* case really wanted to transfer the burden of proof completely to the taxpayer. It should be noted that the ruling in itself does not refer to the burden of proof. When the ECJ stated in its reasoning that if

> the resident parent company demonstrates to the tax authorities that those conditions are fulfilled, it is contrary to Articles 43 EC and 48 EC to preclude the possibility for the parent company to deduct from its taxable profits in that Member State the losses incurred by its non-resident subsidiary,[111]

the Court could have tried to emphasize the active role of the taxpayer, but did not want to rule out that there are situations, in which proof has to be established in another way.

4.7. Exception for artificial arrangements

The ECJ found it necessary to state that there is an exception to the exception. Under certain circumstances, group relief may be denied, although it has been established that the losses cannot be utilized in the subsidiary's residence state:

> It is also important, in that context, to make clear that Member States are free to adopt or to maintain in force rules having the specific purpose of precluding from a tax benefit wholly artificial arrangements whose purpose is to circumvent or escape national tax law (see, to that effect, *ICI*, paragraph 26, and *De Lasteyrie du Saillant*, paragraph 50).[112]

In the *ICI*[113] and *De Lasteyrie du Saillant* cases, the ECJ had referred to the concept of "tax avoidance". In the *Marks & Spencer* case, the ECJ referred to the "risk of tax avoidance" as a possible justification,[114] if "taken together" with other justifications,[115] and in addition to that referred to its case law on "wholly artificial arrangements" in a rather traditional way.[116] In the *Marks & Spencer* case, the prevention of tax avoidance serves both as one of the justifications for not granting group relief in cross-border situations as a general rule and as an exception to the exceptional rule that group relief must, in any case, be granted in situations in which it is established that the loss cannot be utilized in the subsidiary's residence state. The context in which "wholly artificial arrangements" are referred

106. Id., Paras. 21-22.
107. Id., Para. 26.
108. ECJ, 28 January 1992, Case C-204/90, *Hanns-Martin Bachmann v. Belgian State* [1992] ECR I-00249.
109. ECJ, 28 January 1992, Case C-300/90, *Commission of the European Communities v. Kingdom of Belgium* [1992] ECR I-00305.
110. ECJ, 28 January 1992, Case C-204/90, *Hanns-Martin Bachmann v. Belgian State* [1992] ECR I-00249, Para. 18 et seq.
111. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 56.
112. Id., Para. 57.
113. ECJ, 16 July 1998, Case C-264/96, *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-04695.
114. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 49.
115. Id., Para. 51.
116. Id., Para. 57.

to is different in the *Marks & Spencer* case, compared to the *ICI* and *De Lasteyrie du Saillant* cases. In the *ICI* and *De Lasteyrie du Saillant* cases, the ECJ did not accept "tax avoidance" as a justification, unless a rule is specifically designed to exclude from a tax advantage wholly artificial arrangements. In the *Marks & Spencer* case, the ECJ accepted denying group relief because of the risk of tax avoidance, "taken together" with other justifications, in general, and, in addition, especially in cases of wholly artificial arrangements.

There is another difference between the *ICI* and *De Lasteyrie du Saillant* cases and the *Marks & Spencer* case. In the *ICI* case, the ECJ noted that

> the legislation at issue ... does not have the specific purpose of preventing wholly artificial arrangements, set up *to circumvent* United Kingdom tax legislation, from attracting tax benefits[117] (emphasis added)

and, in the *De Lasteyrie du Saillant* case, that the French provision

> is not specifically designed to exclude from a tax advantage purely artificial arrangements aimed at *circumventing* French tax law[118] (emphasis added)

whilst, in the *Marks & Spencer* case, the Court made it

> clear that Member States are free to adopt or to maintain in force rules having the specific purpose of precluding from a tax benefit wholly artificial arrangements whose purpose is *to circumvent or escape* national tax law.[119] (Emphasis added)

It is possible to speculate whether the ECJ is just unclear in its terminology or whether it wanted to broaden the concept by adding that the harmful purpose of the "wholly artificial arrangement" could not only be to "circumvent" but also to "escape national tax law".

The judgment does not give any indication as to what situations the ECJ has in mind when it talks about "wholly artificial arrangements". The ECJ may have been aware of the fact that its own decision creates tax planning opportunities. Specifically, if the tax rate in the parent's residence state is higher than that in the subsidiary's, the taxpayer would be well advised to take the necessary measures to claim successfully group relief in the parent's residence state. To achieve this, the parent would have to ensure that the loss cannot be utilized in the subsidiary's residence state. If the subsidiary ceases trading, as with the Belgian and German subsidiaries of Marks & Spencer plc,[120] the parent would be well advised to liquidate the subsidiary. If the legal entity remains in existence, it may not be certain, under some jurisdictions, that a loss utilization in the subsidiary's residence state is impossible. The liquidation of a subsidiary can, however, probably, under no circumstances, be considered to be a "wholly artificial arrangement".

4.8. Need for Community measures

One other paragraph of the *Marks & Spencer* decision is puzzling:

> Furthermore, in so far as it may be possible to identify other, less restrictive measures, such measures in any event require harmonisation rules adopted by the Community legislature.[121]

It is difficult to interpret this sentence, as there is apparently no relation at all between this paragraph and the other parts of the decision. The ECJ gave no indication why the Court found it necessary to insert the sentence. As, however, the requirement of "harmonisation rules adopted by the Community legislature" is referred to, the statement cannot be ignored.

It is apparently clear that the ECJ does not want to rule out that *Member States* may adopt less restrictive measures, compared to the measures they may take under the freedoms, as interpreted by the Court and described in the decision. The ECJ simply provides the criteria for the minimum standard the Member States must apply. The Member States are, however, free to be more generous. The freedoms do not prevent the Member States from granting group relief in every cross-border situation or in adopting less restrictive measures.

The ECJ probably wanted to emphasize that secondary Community law could also force the Member States to be more generous than they have to be under the freedoms. Harmonized rules that provide for loss deduction in a less restrictive way than elaborated by the ECJ under the freedoms are not an infringement of the freedoms. On the contrary, if secondary Community law harmonized the requirements for the deduction of losses in a more restrictive way, this would not be acceptable under the freedoms.

5. CONCLUSIONS

Many recent Advocate General Opinions and ECJ judgments have come as a surprise. Scholars have argued that the ECJ is in the process of making a "u-turn" and is about to change its case law.[122] It is undeniable that the room for Member States' tax policy has grown.[123] It is possible to speculate whether these developments are the consequence of the outspoken sensitiveness of the Member States in fiscal matters or whether they are the result of the new composition of the ECJ since the accession of the ten new Member States. Worse than the changes in case law is the fact that the ECJ does not make these changes explicit.[124] The ECJ pretends that its case law is still consistent. An analysis of judgments, such as the *Marks & Spencer* case, however, illustrates that there are many tensions, and sometimes even contradictions, between recent decisions and previous case law. These tensions are the price for not making changes in case law

117. ECJ, 16 July 1998, Case C-264/96, *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty's Inspector of Taxes)* [1998] ECR I-04695, Para. 26.
118. ECJ, 11 March 2004, Case C-9/02, *Hughes de Lasteyrie du Saillant v. Ministère de l'Économie, des Finances et de l'Industrie* [2004] ECR I-02409, Para. 50.
119. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 57.
120. Id., Para. 21.
121. Id., Para. 58.
122. See, for example, *Schuch*, "Critical notes on the ECJ's *D*-Case decision on most-favoured-nation treatment under tax treaties", *EC Tax Review* (2006), in print; and Lang, note 73, p. 414.
123. Lang, "Das EuGH-Urteil in der Rechtssache *D*. – Gerät der Motor der Steuerharmonisierung ins Stottern?", *Steuer & Wirtschaft International* (2005), p. 374 et seq.; and Lang, note 73, p. 414.
124. Lang, note 37, p. 12.

explicit. Consequently, future decisions of the ECJ will be even less predictable than they have been to date.

In the *Marks & Spencer* case, Advocate General Poiares Maduro's Opinion surprised many scholars.[125] The Advocate General proposed that group relief may, in respect of foreign losses, depend on certain requirements. The ECJ went even further and declared non-deductibility to be the rule and the necessity to deduct foreign losses the exception. The ECJ arrived at a solution which came as a relief to the governments of the Member States. Although the ECJ refused to accept the fear of "reduction of tax revenues" as a justification,[126] the impression remains that the real argument for the Court was the Member States' budgetary restraints. If the ECJ had made this motive explicit, the *Marks & Spencer* decision could have been a sound basis for the start of a legal discussion on how this argument could fit in with the Court's reasoning in future decisions. It is deplorable that the ECJ missed this opportunity.

125. See, for example, Herzig, Englisch and Wagner, note 16, p. 299.
126. ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, Para. 44.