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Taxation of companies: the influence of EU law on the taxation of profits and the deduction of losses

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Introduction. The role of the Court of Justice of the European Union in matters of direct taxation: Discriminations and Restrictions

As regards direct taxation, the Court of Justice becomes involved following either an infringement procedure initiated by the Commission (and possibly by a Member State – Article 259 TFEU ((Art. 227 EC)) or the request of a national jurisdiction for a preliminary ruling concerning the interpretation of EU law. Contrary to infringement procedures, where the Court may declare national rules to be incompatible with EU law, preliminary rulings admit merely indirect control of national legislation. In fact, in a preliminary decision, the Court interprets Community law to the extent it may affect the specific legal provisions at stake in particular proceedings before a national judge.

Member States are obliged to accept all the consequences of the Court's rulings and to implement them in their national law, in accordance with general principles forming part of the Community's legal order, such as effectiveness, equivalence and legal certainty. According to the Court, when a national tax measure is found to infringe European law, taxpayers may obtain a refund of unduly paid taxes by claiming it before national jurisdictions according to the national procedural rules, which can lead to serious financial repercussions for the budget of a Member State.

The role of the Court is not limited to the strict application and interpretation of the Treaty and of secondary legislation. The Court has also developed an array of general legal principles which are relevant in the area of taxation. An eloquent example can be found in the principles of protection of the taxpayers' legitimate expectations or of legal certainty. Although this principle is not written in the Treaty or in any tax directive, it is part of Community law, and it can protect taxpayers against, for example, retroactive tax laws, at least in harmonised areas. Another important principle in the area of taxation is the principle of proportionality, according to which national measures restricting the individual freedoms cannot exceed what is necessary to attain their legitimate objectives.

Directives leave to Member States the choice of form and means for implementation. That principle will often be used by the Court of Justice to decide whether national measures impeding the basic freedoms can be justified : those measures cannot be accepted if other measures would be less detrimental to the objectives of the Treaty.

In tax matters, the Court has made applications of this principle in order to limit the scope of national anti-abuse provisions.

Some cases concern the application and interpretation of the direct tax Directives.

However, the overwhelming majority of the cases decided by the Court of Justice deal with the compatibility of direct tax provisions of the Member States with the EU/TFEU Treaty freedoms, in particular the free movement of persons, the free provision of services and the free movement of capital.

The free movement of persons and the freedom of establishment covers the right of employees to take up residence for work purposes (Article 45 TFEU (Art. 39 EC)) and the right of undertakings (i.e. companies) and self-employed people to set themselves up or to open branches, subsidiaries or agencies in other Member States (Articles 49 to 54 TFEU (Art. 43 to 48 EC)). As regards shareholders, the Court has held that the situation must be appreciated from the perspective of the freedom of establishment when the "holding gives [the shareholders] definite influence over the company's decisions and allows them to determine its activities."

In contrast to the right of establishment, which addresses permanent establishments, the free movement of services encompasses temporary economic activity carried out in another Member State. Article 56 TFEU (Art. 49 EC) not only assures the provider of a service the

right to enter the market of another Member State and to be treated there in the same way as a domestic service provider, but it also protects the recipient of that service.
The free movement of capital prohibits obstacles to cross-border investments such as direct investments, portfolio investments, or the acquisition and sale of immovable property. It applies in situations where a person neither pursues an economic activity nor has a permanent presence in the State in which the tax measure under challenge has been enacted, or where a shareholder has an "insufficient level of participation" in a company in order to benefit from Article 43 EC (now Article 49 TFEU).

In ascertaining which freedom is to be applied, the Court states that "the purpose of the legislation concerned must be taken into consideration". The distinction between the free movement of capital and the other freedoms is of particular importance with regard to non-EU States, since the free movement of capital extends to such third States, whereas the exercise of other freedoms is restricted to Community borders.

Our study analyses the case-law of the Court and of its implementation by the Member States (Negative harmonization).

In the field of direct taxation, the Court of Justice is faced primarily with questions referred to it for a preliminary ruling. The Court provides to the national judges' answers enabling them to decide the case pending before them. Furthermore, the number of infringement procedures launched by the Commission against Member States potentially not complying with EU law that comes before the Court is growing.

Member States have the obligation under the Treaty to respect the Court's decisions, be it preliminary rulings or decisions in infringement procedures. Therefore, national jurisdictions must apply Community law as interpreted by the Court and Member States have to adapt their domestic rules accordingly. While they are free as to the means, they must respect efficient implementation. Court's decisions are part of the "acquis" to be implemented by candidate countries before their accession.

However, the Court's rulings give rise to interpretation. In this context, it is not surprising that implementation of the Court's rulings varies amongst Member States, even at the level of domestic jurisdictions.

Two preliminary observations are in order as they apply to most situations considered.

If a situation restricts both the freedom of movement of capital and the freedom of establishment, it will be examined only under the latter if the restriction to the free movement of capital is the unavoidable consequence of the obstacle to the free establishment.

A restriction to the freedom of establishment may not be justified solely because the registered office or principal place of business of a company is located in another MS. This would deprive article 49 TFUE of substance. The freedom of establishment prohibits discrimination according to the location of the registered office or seat of a company.

Starting with the early “Avoir fiscal” case, the majority of judgments issued by the Court regarding company taxation concerns direct tax provisions which hinder the freedom of establishment. A specific section focuses on the much-debated question of the application of EU freedoms to national mechanisms for the compensation of cross-border losses and to consolidation. The corporate tax aspects of the Court’s case-law on the taxation of dividends, interest and capital gains on shares, and the application of the free movement of capital and payments in this respect are not analysed here.

Section 1. Profits : Right to elect the form of establishment: Permanent establishment (PE) or subsidiary

The treaty (art. 49) provides for a right of establishment and prohibits “restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State (MS) established in the territory of any MS”. It includes the right to set up or manage firms “under the conditions laid down for its own nationals” by the country of establishment.

A. In Host State: State of the secondary establishment or of source of income

In the Host State, the establishment of a non-resident EU company can be effected through the creation of permanent establishments (i.e. branches) or subsidiaries. Contrarily to a subsidiary, a branch, although it may constitute an economic entity separate from the head office of the company, is not endowed with a distinct legal personality, but is part of the legal entity identified as the company. With regard to branches, EU law requires – in respect of certain tax benefits – that the Host State treat a branch of a non-resident company in the same way as it would treat the branch of a domestic company. Concerning subsidiaries, the Host State must treat equally subsidiaries of non-resident parent companies and those of resident parent companies.

1. Tax treatment of permanent establishment of EU companies

Commission of the European Communities v French Republic ("Avoir fiscal"), 28 January 1986 (270/83)

French law, whereas the corporation tax rate was 50%, granted a tax credit called "avoir fiscal" to the recipients of dividends in order to reduce tax effects of cumulative taxation of dividends first in the hands of the distributing company and then in the hands of the individual or corporate shareholder. The tax credit constituted income to the shareholder (art. 158bis CGI).

However, the credit was not granted to non-residents such as the PE in France of a foreign company (art. 158ter CGI) (art. 242quater CGI).

A foreign insurance company active in France through a PE, having to establish technical reserves consisting of assets located in France, was particularly prejudiced.

Double discrimination was alleged by the Commission. Branches of foreign companies, although subject to the same tax regime as French companies, were deprived from an advantage granted to the latter. Foreign (insurance) companies were discouraged from doing business in France through a branch and induced to elect the formation of a subsidiary.

The French government replied first that the positions of residents and non-residents are different under tax law and that branches enjoyed other advantages over French companies.

The Court held that if freedom of establishment could be encroached upon on the sole basis of non-residence, it would be deprived of all meaning.

Besides, French tax law treats the two forms of establishment – branch and subsidiary – in the same way and admits therefore the absence of a difference between them.

Eventual advantages resulting from the branch form cannot justify discrimination. Neither does the fact that the foreign company could create a subsidiary to enjoy the credit. Freedom of establishment implies a free choice between legal forms, be it branch or subsidiary.

The French government invoked the non-harmonization of tax laws and the risk of tax evasion. The Court answered that freedom of establishment was independent of difference between tax systems and that the risk of tax avoidance in this context did not justify a derogation. The Court was not convinced by the argument that foreign companies would invest their French shares in French branches to benefit from the credit.

The double tax agreements provide no justification, as they do not deal with the problem.

According to Articles 49 and 54 TFEU (Art. 43 and 48 EC), as interpreted by the Court, the freedom of establishment includes the freedom to elect the appropriate legal form in which an economic operator established in a Member State wishes to pursue activities in another Member State. Discriminations or restrictions which can only arise when two “objectively comparable” situations receive a different tax treatment can be found in the corporate income tax systems of the Member State, but can also concern other types of taxes imposed on companies, as Halliburton demonstrates. In this case, an exemption from the Dutch tax on transactions between companies relating to immovable property was considered to be contrary to Article 43 EC (Article 49 TFEU) insofar as it did not apply when the transferring company was incorporated under the law of another Member State.

A distinction can be drawn between, on the one hand, rulings concerning national tax measures of the State of the secondary establishment of a non-resident company (the Host State) and, on the other hand, cases which deal with tax measures adopted by the Member State where a company has its primary establishment (the Home State) that hinder the establishment of subsidiaries or branches in another Member State.

Royal Bank of Scotland, 29 April 1999, C-311/97

Greece applied to profits earned by a branch of a non-resident company a tax rate higher than the rate applicable to profits earned by a resident company. The Court considered that this difference could not be justified by objective differences between resident and non-resident companies, even though these two categories of taxpayers are generally not comparable as to the extent of their tax liability (worldwide income v. domestic source income) and although many treaties allowed such differentiation. The Court made a comparison with the situation of individuals earning income in a foreign State (Schumacker-Wielockx). In Commission v. Greece (C-406/07), the Court confirmed its viewpoint as regards the same discriminatory tax treatment applied to unincorporated companies. In CLT-UFA, the Court condemned under Article 43 EC (Article 49 TFEU) German legislation subjecting the profits of a branch of a non-resident EU company to a higher tax rate than the one that would have applied if this company had chosen to establish a German subsidiary distributing its profits in full to its parent company.

Saint-Gobain v Finanzamt Aachen-Innenstadt, 14 September 1999, C-307/97

Furthermore, to ensure freedom of establishment, a Member State must treat equally branches of non-resident companies and resident companies with regard to measures avoiding double taxation of foreign dividends provided by domestic law (credit) or treaties (exemption). The fact that a tax exemption is granted even by virtue of a DTC concluded with a third state outside the EU does not relieve the State from this obligation. A tax relief provided by the DTC concluded between Germany and the other countries was denied by Germany to the German branch of a French company, on the ground that the DTC applied only to companies subject to unlimited tax liability in Germany. The same was true for a tax credit granted by domestic law. This practice was held to be incompatible with the right of establishment.

Discrimination may also be found in procedural rules. In Commerzbank, the Court had to examine UK legislation under which interest on a repayment of overpaid tax was granted to companies with "fiscal residence" in that Member State but was refused to non-resident companies. The Court ruled that the "fiscal residence" criterion, even if it were applied without discrimination on the ground of the location of a company's seat, would most likely work more particularly to the disadvantage of companies having their seat in other Member States, and held that difference to be discriminatory.

2. Tax treatment of subsidiaries of EU companies

Subsidiaries have an independent legal personality and are therefore always "nationals" or residents of the Host Member State. However, subsidiaries of non-resident EU parent companies are sometimes treated differently from subsidiaries of domestic parent companies. This situation has been considered to be incompatible with the Treaty freedoms in a number of cases.

Oy AA, 18 July 2007, C-231/05

AA Ltd, a UK parent company holds through other companies all the shares of Oy AA, a Finnish company.

Finnish law provides that a parent company holding nine tenths of the capital of another Finnish company may deduct an intra-group financial transfer made in favour of its subsidiary. The same is true for transfers made in favour of its Finnish parent or another Finnish subsidiary of that parent.

The purpose of the provision is to allow to balance within a group the situation of profit-making and loss-making companies.

Oy AA is denied the deduction of a transfer to its UK parent which is in a loss situation.

Although it is true that Finland is not able to control whether the transfer by the Finnish subsidiary could be treated as taxable profit to the UK parent, Finland could make the deductibility subject to such conditions. With regard to the objective of the regime, the position of subsidiaries of parents having their seat abroad is comparable to the position of subsidiaries of parents having their seat in Finland.

The need to safeguard a balanced allocation of taxing powers may not justify the refusal to grant a tax advantage to a subsidiary on the ground that it may not tax the parent (Rewe Zentralfinanz).

However, here, the extension of the regime to a foreign parent would grant the subsidiary the power to decide where its profits would be taxed, affecting the right of Finland to tax the profits of a company resident there and therefore this allocation of taxing powers between States.

It may be conducive to tax avoidance, favouring transfers of profits where they are untaxed or taxed at a lower rate that in the country of residence of the transferor.

Does the prohibition go further than necessary? It could be limited to artificial arrangements not reflecting economic reality (Cadbury-Schweppes Overseas). The imposition of such condition would not remove the discretion of a group of companies to choose where profits would be taxed. Outright prohibition is therefore justified.

B. In the State of residence

The freedom of establishment does not only restrict the tax competence of the Host State, but also the taxing power of the State of (principal) establishment of a company wishing to move or expand its activity in another Member State.[1] Although the freedom of establishment may also apply to the setting-up of a branch (permanent establishment), most of the cases concern the establishment of foreign subsidiaries and are often linked to group schemes and the deduction of foreign losses or expenses. The question whether EU law may mitigate the negative tax consequences of a transfer of seat remained debated at that time.

1. Tax treatment in the State of residence of permanent establishments located in other Member States

Deutsche Shell v Finanzamt für Grossunternehmen in Hamburg, 28 February 2008, C-293/06

Another case deserves particular attention as regards the determination of the Member State competent to avoid an undue restriction following from the combined application of the legislations of two Member States. In Deutsche Shell a German resident company allotted capital to its permanent establishment in Italy. The allotted capital was shown both on the Italian balance sheet and on the German head office's balance sheet in their respective national currencies (LIT and DM). When the permanent establishment was wound up and the allotted capital was repatriated to Germany, the exchange rate had fallen and the German company suffered a substantial currency loss. This loss, however, was not tax-deductible, neither in Germany nor in Italy. According to the Court, which finally concludes to the existence of an unjustified restrictive effect, "although it is true that any Member State which has concluded a double taxation convention must implement it by applying its own tax law and thereby calculate the income attributable to a permanent establishment, it is unacceptable for a Member State to exclude from the basis of assessment of the

[1] *Daily Mail*, para. 16. See also *ICI*, para. 21, and ECJ, 13 December 2005, Case C-446/03, *Marks & Spencer, ECR* I-10837 para. 31.

principal establishment currency losses which, by their nature, can never be suffered by the permanent establishment”.

2. Tax treatment of subsidiaries established in other Member States

The Court of Justice has issued various rulings on the taxation of multinational groups of companies. Some of these cases, such as such as ICI, Marks and Spencer, Rewe Zentralfinanz, Lidl Belgium and Krankenheim refer to the deductibility of foreign losses and are discussed infra.

Lammers & Van Cleef, 17 January 2008, C-105/07

Under a thin capitalization rule, Belgium applied l/l thin cap rule on interest of advances made by a foreign parent company director and not by a Belgian company director. This was found discriminatory.

Anti-abuse rules may also conflict with the freedom of establishment. Cadbury Schweppes and CFC and Dividend Group Litigation concerned UK Controlled Foreign Company (CFC) legislation which commended the inclusion in the tax base of a resident company of the profits made by a CFC in a lower tax State. The Court found that companies with a CFC in low-taxation Member States were treated less favourably than resident companies with subsidiaries in the UK or in a Member State which does not apply a lower level of taxation than in the UK. The UK CFC legislation was considered contrary to the freedom of establishment. Nevertheless, it was found to be justified if applied only to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned.

Cadbury-Schweppes, 12 September 2006, C-196/04

The group formed by Cadbury-Schweppes Plc (CS) and Cadbury-Schweppes Overseas Ltd (CSO) had two subsidiaries in Ireland: Cadbury-Schweppes Treasury Services (CSTS) and Cadbury-Schweppes Treasury International (CSTI) in the

International Financial Services Centre (IFSC) of Dublin where the tax was 10%. Both companies were in the business of financing the group.

If a foreign subsidiary (CFC) was subject to tax less than 3/4ths of UK tax on profits, it was treated as transparent and its profit taxed to 50% parent in the UK.

Exceptions were:

- Acceptable distribution policy: 10% profits distributed within 18 months and taxed to resident company;
- Exempt activities: trading activities;
- Public quotation: 35% of voting rights held on public-recognized stock exchange;
- A d*e minimis* rule.

The law could be disapplied on the basis of a motive test when the reduction in UK tax was not the main purpose of transactions giving rise to profits or when the main reason of existence of CFC was not diversion of profits.

The question for a preliminary ruling was whether articles 56, 65 and 79 (now 49, 56 and 63) preclude national tax legislation such as that in issue in the main proceedings, which provides in specified circumstances for the imposition of a charge upon a company resident in that Member State in respect of the profits of a subsidiary company resident in another Member State and subject to a lower level of taxation.

It had been held in the field of corporate law that the purpose to benefit from a favourable legislation was not an abuse.

In Centros, the right to incorporate in UK and open secondary establishments in Denmark avoiding minimum paid up capital requirements was upheld. In Inspire Art, Dutch legislation adding to conditions for incorporation applicable to local companies in the event of registration of a branch of foreign company was found not to be admissible.

Once more, the Court recalled as to hindrances to freedom of establishment that Member States have competence in direct taxation but must exercise it consistently with Community law, that freedom of establishment implies right of self-employed to set up and manage undertakings under the same conditions as nationals and that companies have the right to act through a subsidiary, a branch or an agency.

Those rules are directed to the host Member States which must grant national treatment but also to the Member State of origin which may not hinder establishment in other Member State of its nationals. Here a difference on the basis of level of taxation was at stake. If a CFC was located in a low tax Member State, its profits were attributed to its resident parent if it were established in the UK or in a « normal tax » Member State, its profits were not taxable to its parent.

The answer of the UK was that the CFC tax was not higher than the tax of a UK subsidiary. The rebuttal was that a resident company was taxed on profits of another legal person which is not the case of a subsidiary in the UK or in a « normal tax » Member State. The law dissuaded a company from having a subsidiary in a low tax Member State.

A justification of the hindrance could be found in overriding reasons of public interest (art. 59, formerly 52) which could not go beyond measures necessary to attain the goal pursued, for the UK, the prevention of tax avoidance by a transfer of profits to a low tax State by transactions with a subsidiary.

The Court held that the reduction of tax revenue is not a valid reason, that a Member State may not offset advantage of the low taxation of a subsidiary in another Member State and that the creation of a secondary establishment entails no general presumption of tax evasion.

One had to check whether the company pursued its activity through a fixed establishment for an indefinite period and not through a wholly artificial arrangement. Finding otherwise would jeopardize allocation of taxing power on the basis of factors to be considered as objective, such as the existence of premises, staff and equipment to perform services taxed in Host States, the genuine nature of services made possible by the competence of the staff, decision-making, value added by the subsidiary's activity

Conclusion is that CFC legislation is suitable to thwart tax avoidance and does not enable to conclude to an artificial arrangement, but may not apply when there are tax motives but also economic reality. The National Court must judge when motive test enables the taxpayer to give evidence of an actual establishment and genuine activities.

Columbus Container v Finanzamt Bielefeld-Innenstadt, 6 December 2007, C-298/05

However, the Court considered in Columbus Container that CFC legislation (in the case at hand, the provision challenged provided for a switch from the exemption to the credit method) does not contravene the freedom of movement when it does not submit to an additional tax burden the economic operator having cross-border activities, as compared to a person operating in a purely national context.

This case concerned a German mechanism providing a switch from the exemption to the credit method in the case of a significantly lower taxation in the State of source. Interestingly enough, the German Bundesfinanzhof ruled in a judgment of 21 October 2009 that despite the ECJ ruling, the provision containing this switch-over clause was contrary to EU law.

SGI, 21 January 2010, C-311/08

A Belgian company had granted a loan at low interest to a subsidiary and paid a management fee to a foreign parent which did not perform services. An abnormal advantage granted to a foreign company was taxable whereas such an advantage granted to a domestic company was not taxable. The Court found the distinction justified because it aimed at the protection of the domestic tax base and secured a balanced allocation of taxing powers. It was admissible even if the arrangement was not wholly artificial. However, the burden of proof rested in the tax administration.

Section 2. Losses and consolidation

When a company has several places of business in the same country, profits and losses are aggregated. When those places are in different countries, either the head office country will deny deduction of the foreign loss if it is not “final”, i.e. if it cannot be carried over abroad or the head office country will accept the deduction of the loss but “recapture” it when there is a profit in the branch because the foreign loss will then be deducted abroad.

§ 1. Losses of Eu companies with a permanent establishment in another Member State

A. Deduction of foreign branch losses in the State of residence

Amid, 14 December 2000, C-141-99

In AMID the issue concerned the tax treatment of a loss incurred in the State of residence by a company which had a permanent establishment in another Member State (Luxembourg), the profits of which were exempt according to a DTC. According to the worldwide income taxation principle, the company's Belgian losses were set-off against the profits of its foreign permanent establishment, which were normally exempt according to the DTC. This compensation led economically to Belgian (double) taxation of the Luxembourg profits, since the Belgian loss could not be carried forward to be deducted from future Belgian income. The Court compared companies having all their branches in Belgium with companies with one or more foreign permanent establishments. The Court held that by setting off domestic losses against profits exempted by treaty, the legislation of that Member State established a differentiated tax treatment as between those two categories incompatible with EC law.

However, it results from more recent ECJ case-law that there would be an obligation for the State of residence to grant relief for losses incurred by foreign (EU) permanent establishments only where all the possibilities to carry-over the losses in the Host

State have been exhausted. This statement results in timing differences detrimental to foreign established entities.

Mertens c Belgian State, 12 September 2002, C-431/01

A similar situation regarding an individual was solved in the same way. In Mertens, the loss incurred by a Belgian resident in the exercise of his professional activities in Belgium had been set off against the profits from another professional activity in Germany, despite the fact that this profit was exempt from taxation in Belgium according to the DTC between the two countries. The Court pointed out “that the unfavourable tax treatment … is the direct result of the application of the Belgian legislation, not of an inevitable disparity between the Belgian and German tax legislation”. In the absence of justification, the Court ruled that the provisions in question contravened the free movement of persons.

Stahlwerk Ergste Westing v Finanzamt Düsseldorf-Mellmann, 6 November 2007, C-416/06

The company’s Home State can also create an unfavourable tax treatment for losses of a permanent establishment incurred in the Host State. In Stahlwerk Ergste Westing, a German company had two loss-making permanent establishments in the United States. Germany refused the deduction of the US losses from the profits taxable in Germany. The company claimed that this was contrary to the EC Treaty and especially to the free movement of capital. The Court, however, decided in an Order that such a situation involved the right of establishment which cannot be invoked in relations with third countries.

Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn, 15 May 2008, C-414/06

Lidl Belgium was a German limited partnership originally active in distribution in Belgium which created a PE in Luxembourg.

It suffered a loss in Luxembourg and sought to deduct it in Germany.

According to the 1958 treaty between Germany and Luxembourg, amended in 1973, profits from a PE in Luxembourg were exempt in Germany (art. 20). The Finanzamt disallowed the loss as the income would have been exempt.

The case must be examined on the basis of the freedom of establishment (now art. 49) and not on the basis of the freedom of movement of capital (now art. 63) as the effects of the restriction on the latter freedom would have been an unavoidable effect of the restriction of freedom of establishment.

As a tax advantage – the deduction of losses – is disallowed whereas it would be allowed if the PE was located in the residence country – Germany -, there is a restriction to the freedom of establishment which may discourage a company from creating a PE in another State.

Is the restriction justified by overriding reasons of public interest appropriate to reach the objective thereof and not exceeding what is necessary to reach it?

Two justifications are put forward:

1. The allocation of the power to impose taxes between MS requires that only the rules of the State which taxes profits be also applied to the deduction of losses. There must be a symmetry between both rights.

   Otherwise, a company could choose in which State to deduct losses.

2. Failing this, the same loss could be deducted twice, once in the State of residence and subsequently in the State of source, in a year in which profits arises against which the loss could be set off. Those two justifications are sufficient without the third requirement mentioned in Marks & Spencer, namely the prevention of tax avoidance.

The regime is appropriate and proportionate. It would be possible to make the deduction of the loss in the residence country subject to recapture on future profits of an amount equal to the loss previously deducted.

In Marks & Spencer, the Court held that the denial of the deduction would be disproportionate when the foreign entity – a subsidiary in that case – has exhausted the possibilities of deduction of losses in the MS of its situation for past and future tax years.

This is not the case here. Lidl Belgium did deduct its 1999 loss in 2003 from profits.

A/S Bevola, Jens W Truck ApS v Skatteministeriet, 12 June 2018, C-650/16

Bevola is a Danish manufacturing company which is a member of the group controlled by Jens W. Trock as group parent company.

Bevola had a Finnish PE which closed in 2009 with a loss which cannot be deducted in Finland. Danish law provides that income and expenditures of foreign PE's are not part of taxable income (par. 31). However, group affiliates may elect joint taxation. In that case, losses of foreign PE's can be taken into account (par. 31).

The Danish tax authorities disallowed the deduction of the Finnish loss. The referring Court wonders whether this is justified when the group has not opted for international joint taxation. The ECJ notes that the lack of consideration of income and losses of foreign PE's may lead to an advantage in the event of profit, eventually taxed at a lower rate then in the residence country or to a disadvantage in the event of a foreign loss.

The option for international joint taxation is subject to strict conditions and is for 10 years. Therefore, Danish law establishes a difference between companies having a PE in Denmark and those having a PE abroad.

Both situations are not comparable as in one case the residence State does not tax.

When the loss of a foreign PE can no longer be deducted in the country of its localisation, the situation of the company having a foreign PE is the same as the situation of a company having a domestic PE from the point of view of ability to pay.

The link between taxation of foreign PE income and deduction of foreign PE loss is justified by a balanced allocation of the power to tax and by the coherence of the tax system as well as the prevention of a double deduction of losses.

However, the legislation lacks proportionality when there is no more possibility to deduct the loss abroad.

Finanzamt B v W AG mit Bundesministerium der Finanzen, 22 September 2022, C-538/20

W is a trading bank, which closed its branch in the UK in 2007. The German tax administration refused to allow the deduction in Germany of the loss which could not be carried forward in the UK.

The referring Court wonders whether the final loss of a foreign PE must be taken into account in the residence country when the exemption of foreign profits results from a double tax convention.

When a MS where a company is resident has waived pursuant to a double taxation convention its power to tax in respect of a foreign PE, the situation of the company is not comparable to that of a resident company having a domestic PE in the light of the objective of mitigating the double taxation of profits and the double taking into account of losses. The denial of the deduction of the final loss of the PE constitutes no restriction on the freedom of establishment.

Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstadt GmbH, 23 October 2008, C-157/07

KR Wannsee, a German company, operated a PE in Austria from 1982 to 1994, when it disposed of the PE.

The German-Austrian double tax convention exempted an Austrian PE from tax in Germany. The 2000 Protocol provided that losses incurred in Austrian PE's between 1990 and 1997 would be taken into account in Germany on the basis of reciprocity. As from 1998, losses had to be taken into account in the State where the PE is situated.

The German Auslandsinvestitionsgesetz of 1969 provided that when losses of a foreign PE were deducted in Germany, the deducted amount would be reintegrated into profits when the foreign PE realized profits exonerated under the double tax convention in the foreign State. This would not apply when the PE is not allowed abroad to deduct the losses from profits other than those of the year during which they were incurred, in other words when the foreign country does not grant a loss carry-forward. Since 1989, Austria allowed a carry-forward of losses of PE's, i.e. partially taxable taxpayers, but only if the taxpayer did not make an overall profit and insofar as the loss exceeded that overall profit.

The German tax office allowed the deduction of the Austrian losses sustained before the end of 1990 but added them to the profits taxable in Germany between 1991 and 1994. The litigation relates to 1994. In Austria, the losses incurred were not deducted from profits made by the PE in 1992 and 1993 as KR Wannsee had made profits in Germany.

Under the EEA Agreement, applicable since 1994, before Austria joined the EC in 1995, freedom of establishment was applicable between Germany and Austria in the same way as within the EC (art. 31).

The Court found that Germany had granted a tax advantage to the taxpayer by deducting the losses of its Austrian PE in Germany and subsequently withdrawn that advantage, subjecting it to a less favourable treatment than the treatment applicable to German companies having a domestic PE.

The restriction to the freedom of establishment was however justified by the coherence of the German tax system, creating a link between the deduction and the reintegration in a symmetrical way.

The taxpayer objected that Austrian law did not allow him in practice to claim the deduction of the loss in a year other than the year in which it was incurred. The Court answered that in the absence of tax harmonization, MS define criteria of elimination of double taxation as they wish. The restriction of the freedom of establishment was not the consequence of German law but of Austrian law. German law could be applied.

Nordea Bank Danmark A/S v Skatteministeriet, 17 July 2019, C-48/13

Nordea Bank has its seat in Denmark and PE's in Finland, Sweden and Norway. In 2000, it closes the PE's and transfers their business to newly created subsidiaries.

The double tax convention between the Nordic countries of 1996 provides that profits of foreign PE's are taxable in both States but that double taxation is avoided by the credit method.

Danish law provides that, if the business of a PE is transferred to a third party or to a company of the same group, the transferor is taxed in the basis of the market value of the assets transferred calculated at arm's length. Previously deducted losses which have not been matched by profits become taxable at that point (§ 33, D (5)).

The purpose of such a provision is to avoid that a company starts its business abroad in the form of a PE, deducts losses and transfers it to a foreign subsidiary when it becomes profitable, having deducted the losses in Denmark which will not tax the future profits of the transferee.

Nordea Bank questioned the compatibility of this regime with the freedom of establishment under the TFEU and the EEA treaties.

The reincorporation of losses of foreign PE's upon their transfer constitutes a tax disadvantage which is not applicable upon the transfer of domestic PE's.

The situation of PE's located abroad and in the residence country of the company are not in principle comparable. However, by taxing the profits of foreign Nordic PE's in Denmark, allied with the benefit of a foreign tax credit, Denmark has made the situation of those PE's comparable to the situation of domestic PE's so far as concerns the deduction of losses.

The reincorporation of losses has the purpose of avoiding the risk of tax avoidance as explained above. However, it goes further than necessary to reach that objective. Indeed, the profit taxable upon transfer includes the gain realized at market terms. The reintegration of previously deducted losses results not only in a recapture of profits realized before the transfer but also in the taxation to their extent of deemed profits realized upon the transfer. To that extent, the provision restricts unduly the freedom of establishment.

Timac Agro Deutschland GmbH v Finanzamt Sankt Agustin, 17 December 2015, C-388/14

The case involved the recapture of a foreign branch loss upon sale of a PE when the profits of a foreign PE is or not taxable in the residence State.

Timac Agro is a German company with a PE in Austria since 1997, which has been loss making except in 2000 and 2005. The PE was transferred in 2005 to a company of the same group. German tax law applicable in 1997 and 1998 provided that losses of foreign PE’s could be deducted in Germany but were recaptured if the foreign PE was profitable in future years, except if the carry-forward of the loss was not allowed in Austria.

German law applicable in 2005 applied the same rule in the event of a transfer of the foreign PE to a company.

The German-Austrian double tax convention of 1959 annulled in 1992 provided for the exemption of profits of an Austrian PE in Germany.

The 2000 convention provided for the exemption but stipulated that from 1990 losses incurred up to 1997 in an Austrian PE were taken into account in Germany but that from 1998 on the losses would be taken into account in the State where the establishment is located.

The German tax office reincorporated in the 2005 profits of Timac Agro the losses deducted for 1997 and 1998 and denied the deduction of losses incurred from 1999 to 2004.

The ECJ decided that the tax disadvantage resulting from the reincorporation of PE losses previously deducted in the case of a transfer was indeed a restriction of the freedom of establishment not permissible in principle if the foreign PE was in a situation comparable to the one of a PE located in Germany, which was the case as the deduction of losses was allowed in both cases.

This restriction was however justified by the symmetry between the right to tax income and the right to deduct losses, securing a balanced allocation of powers to tax. The restriction also prevents tax avoidance. The restriction is proportionate. The obligation to deduct fiscal losses according to Marks & Spencer remains but in this case there were still possibilities of deducting the losses in Austria.

Germany is also not under the obligation under its new law to take into account the losses of the Austrian PE since 1999. A PE in Austria is not in a situation comparable to the one of a PE in Germany for the purpose of measures preventing double taxation.

B. Deduction in the host State

Futura Participations é Singer v Administration des contributions, C-250/95

In Futura Participations and Singer, the questions referred to the Court dealt with the treatment of losses in the Host State. Under Luxembourg tax legislation, the carry-forward of losses for branches of non-resident companies was subject to two conditions. First, the losses had to be economically linked to the income earned by the taxpayer in Luxembourg. Second, the taxpayer had to keep and hold accounts according to Luxembourg law. Regarding the first condition, the Court ruled that a Member State does not encroach upon the freedom of establishment by insisting that there be an economic link between the losses to be carried forward and the income earned in the Member State in question such a system is in conformity with the fiscal principle of territoriality and does not entail discrimination. However, with regard to the second condition, the Court considered that a Member State cannot oblige a non-resident taxpayer to keep accounts complying with national rules to justify the carry-forward of losses, it must allow the taxpayer other means for providing eligibility for the carry-forward.

§ 2. Intra-group losses and transfers (consolidation)

Most countries restrict the setting-off of losses to the taxpayer who has incurred them. A change in the ownership of control of a company or a restructuring (e.g. a merger) can thus restrict or eliminate the right to the deduction of such losses. Moreover, as a rule, a loss incurred by a company within a group cannot be set off against the profits of another company within the same group, whether or not it is established in the same country[2], except by the application of specific tax provisions on group consolidation. Group taxation regimes generally apply only to resident subsidiaries with some exceptions and a number of jurisdictions expand the scope of the regime to domestic permanent establishments of foreign corporations.

A. Loss offset of subsidiaries within EU multinational groups

On the relation between the right to compensate losses within a group and the State of establishment of the subsidiaries, the Court has decided two cases, which both deal with the UK "group relief regime".

ICI, 16 July 1998, C-264/96

ICI was the first case regarding loss offset between companies. Together with another UK company, ICI formed a consortium through which the two companies beneficially owned the shares of a holding company, the sole business of which was to hold shares in subsidiaries operating in many countries. One of those subsidiaries

[2] This is a fundamental difference between group structuring through subsidiaries compared to permanent establishments pertaining to a single legal entity. In this latter case, as far as the [worldwide] taxation principle applies, all the profits and losses must be aggregated.

located in the UK incurred losses. ICI tried to set off its part in these losses against its chargeable profits for the corresponding periods by way of tax relief. The tax relief was denied on the basis that, under UK legislation, group relief could be refused to a UK group, as regards UK losses to be set off against UK profits, if a majority of the subsidiaries of the group were outside the UK, even if a number of them were within the EU. The Court of Justice held that such legislation constituted an unjustified inequality of treatment under the Treaty's provisions on freedom of establishment and rejected all the justifications proposed by the UK.

Marks & Spencer, 13 December 2005, C-446/03

Academic commentators of the ICI decision have read it as implying that the losses of a subsidiary established in a Member State other than the one of the parent company must be taken into consideration within the framework of a consolidation regime. The Court of Justice dealt with the question in Marks & Spencer. Marks & Spencer, incorporated in the UK, established a number of subsidiaries in the UK and in other Member States. In the UK, Marks & Spencer claimed group tax relief in respect of losses incurred by its subsidiaries in Belgium, France and Germany. That claim for relief was rejected on the ground that group relief could only be granted for losses recorded in the UK.

The Court of Justice considered that losses incurred by a resident subsidiary and losses incurred by a non-resident subsidiary were treated differently for tax purposes, which amounted to a restriction on the freedom of establishment. Nonetheless, according to the Court, such a restriction is generally compatible with the EC Treaty, since it pursues a legitimate objective and is justified by imperative reasons in the public interest. The Court recognized the need to preserve the allocation of the power to impose taxes between Member States so that it makes “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 this context, ”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 jeopardize 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”. The Court also held that Member States must be able to prevent a double deduction of losses, and acknowledged the need to minimize the risk of tax avoidance schemes whereby losses could be transferred to companies established in those Member States which apply the highest rates of taxation.

However, the Court held that in the case at hand the restrictive measures went beyond what was necessary to attain the objectives pursued, since the non-resident subsidiary had exhausted all possibilities in its Home State to deduct or carry forward its losses.

The UK amended its legislation but required, for the setting off of a foreign subsidiary’s loss, evidence that no deduction of the loss would be available in the future, be supplied as at the time immediately after the end of the accounting period. The Commission found the condition too strict, as requiring *de facto* a liquidation of the subsidiary during the accounting period. The ECJ disagreed in Marks & Spencer

II and considered that the requirement met the proportionality rule (ECJ, 3 February 2015, Case C-172/13, Marks & Spencer I).

Société Papillon v Ministère du Budget, 27 November 2009, C-418/07

The French integration system was under scrutiny in Papillon, which was denied integration because it held its loss-making French sub-subsidiary through a 100% subsidiary in the Netherlands. This restriction on the freedom of establishment can be justified by the need for coherence which requires that the intra-group provision for depreciation on the shares be neutralized in order to avoid the risk that losses be taken into consideration twice, the French provision was nevertheless “overruled” as the Court pointed out that that risk can be avoided by the provision of documentary evidence required from the group companies.

X Holding BV v Staatssecretaris voor Financiën, 25 February 2010, C-337/08

The case concerns the exclusion of foreign subsidiaries from consolidation, whereas foreign PEs are admitted.

X Holding, a Dutch company, had a wholly owned subsidiary, F, located in Belgium. Dutch law enables a parent company holding 95% of the capital shares of a subsidiary to request that the tax be levied on them as if they were a simple taxable person. They form a tax entity. The “tax unity” regime is applicable only if both taxable persons are established in the Netherlands (art. 15 of the 1969 law on corporation tax).

Derogations are possible a.o. for the PE of a foreign subsidiary in the Netherlands provided that the subsidiary is established in the EU or that a double tax agreement grants the power to tax its profits to the Netherlands and includes a non-discrimination clause.

X Holding and F applied for recognition as a single tax entity which was rejected.

The ECJ acknowledged that the refusal of consolidation applicable to foreign subsidiaries constituted a restriction to freedom of establishment rendering less attractive the setting up of subsidiaries outside of the Netherlands.

The situations of a resident parent company wanting to form a single tax entity with a non-resident subsidiary or with a resident subsidiary are objectively comparable as to the objective of the tax advantage, namely to consolidate profits and losses of the two entities.

The difference in treatment is however justified by an overriding reason of general interest. It is necessary to apply the rules of the same MS to the economic activities of a company in respect of both profits and losses to secure a balanced allocation of taxing powers. Doing it otherwise would increase the tax base in one State and reduce it in the other one. The same is true for non-integration between parent and subsidiary. Such possibility would grant a company a choice as to the place where its losses are taken into account.

Does the prohibition go further than necessary? Non-resident subsidiaries could be treated in the same way as foreign PE's allowing the deduction of losses to the parent subject to recovery in a subsequent year.

However, a subsidiary, subject to unlimited tax liability in its State of residence, is not a situation comparable to that of a PE which remains in part subject to the taxing power of its State of origin. The latter may determine the conditions of taxation of foreign PE's of its companies. The profits of the subsidiary are not subject to the fiscal legislation of the MS of the parent, whereas the profits of a foreign PE are subject to the fiscal laws of the State of establishment.

The Commissioners for Her Majesty's Revenue and Customs v Philips Electronics UK Ltd, 6 September 2012, C-18/11

Philips Electronics UK is resident in the UK. Its ultimate parent company in the Netherlands has with a South Korean group a Dutch subsidiary which has a loss-making PE in the UK.

UK law provides that under group relief a trading loss may be surrendered by a member of a group to another one or when one company is a member of a group and the other by a consortium and another company is a member of both the group and the consortium.

Group relief is available to PE's in the OF. However, the loss must not be allowed against non-UK profits of the company surrendering its loss to a UK claimant company.

The claim of Philips Electronics was therefore rejected as the loss of its related company could be taken into account of the Netherlands.

The denial of the advantage of group relief makes the situation of the PE of a foreign company less attractive than the situation of the PE of a company residing in the UK.

Their situations are comparable in so far as it concerns the possibility of transferring by group relief losses sustained in the UK.

There is here no use of losses sustained in another MS to decrease UK profits.

No overriding reason of public interest can justify it as the power of the host MS, the UK, to impose taxes on the profits of the PE, is not affected by the transfer of the loss.

The risk that the losses be taken into account twice has no effect on the taxing power of the UK. The restriction is not justified and must be removed.

Felixstowe Dock and Railway Company Ltd and other, 18 April 2014, C-80/12

In the UK, a consortium company may assign its losses to other companies members of the group or of the consortium, provided that it is related to such companies through a liaison company established in the UK. In Felixstowe, Dock and Railway Ltd, the Court held that this possibility had to be extended to the case in which the liaison company was established in another Member State.

Inspecteur van de Belastingsdienst/Noordkantoor v SCA Group Holding BV and others, 12 June 2014, C-39/13

In SCA Group Holding BV, the Court held that the fiscal unity regime could not be denied when the subsidiaries were held through a non-resident company having no permanent establishment in the Netherlands. Neither can it be denied to sister companies held by such companies.

Finanzamt Linz, 6 October 2015, C-66/14

In Austria, in the event of the acquisition of a shareholding in a domestic company, a goodwill may be depreciated up to 50% of the purchase price. The depreciation is not allowed when the company the shares of which are acquired is non-resident. In Finanzmat Linz, the Court found an infringement of EU law.

B. Deduction of losses from intra-group participations

Rewe Zentralfinanz v Finanzamt Köln-Mitte, 29 March 2007, C-347/04

A further question is whether a parent company which is allowed to deduct from its tax base in its State of residence the loss incurred on the shares of a subsidiary located in the same State should be allowed to do it in respect of shares in a subsidiary located in another Member State.

This question mainly deals with the concept of taxable income (i.e. what is included or excluded from taxation), since a subsidiary is usually allowed to carry over its losses against its profits in its State of residence. In Rewe Zentralfinanz, the Court considered that the denial of the deductibility – in the State of the parent company – of write-downs on shares of a subsidiary located in another Member State, while such deductibility was granted in the case of the shares of a domestic (German) subsidiary, constituted a restriction of the freedom of establishment. Several justificatory arguments were rejected by the Court. In particular, in response to the argument based on the "rule of symmetry" between the right to tax the profits of a company and the obligation to take into account the losses incurred by that company, the Court held that "… a difference in tax treatment between resident parent companies according to whether or not they have subsidiaries abroad cannot be justified merely by the fact that they have decided to carry on economic activities in another Member State, in which the State concerned cannot exercise its taxing powers …". The Court rejected an analogy with Marks and Spencer, since "[s]uch a separate treatment of, first, the losses suffered by the subsidiaries themselves and, secondly, the losses incurred by the parent company cannot, on any basis, amount to using the same losses twice".

Finanzamt Speyer-Germersheim v Steko Industriemontage GmbH, 22 January 2009, C-377/07

Following the Rewe Zentralfinanz, Germany amended its Law on corporation Tax, with effect as to holdings in resident companies for tax-year 2002 and as to holdings in non-resident companies for tax-year 2001. In STEKO, this differentiation was held contrary to the free movement of capital; the transitional nature of the discrimination was no justification.

X AB v Skatteverket, 10 June 2015, C-686/13

However, if capital gains on shares are tax free, there is no obligation, said the Court in X AB to allow the deduction of capital losses, even if they are the consequence of a currency loss.

C. Intra-group tax deductible transfers

As regards the other Member States, the Court has also decided on the “contribution scheme” which is applicable in Finland and Sweden. In the case of X AB and Y AB, a Swedish group scheme according to which assets could be transferred tax-free between companies belonging to the same group was considered to be contrary to the freedom of establishment, since it did not apply to certain cross-border situations. In X AB and Y AB, the ECJ concluded that the Swedish contribution relief must be granted also when the contributing company (to a Swedish loss-making recipient) is not a Swedish resident company but an EU resident company.

In the reverse situation of a contribution made by a Finnish company to its loss-making parent in another Member State, the ECJ upheld in Oy AA the Finnish law allowing a Finnish subsidiary to make a tax deductible financial transfer to a Finnish parent but not to its non-resident (loss-making) EU parent; according to the Court, allowing a transferor to deduct an intra-group cross-border transfer from its taxable income would result in enabling groups of companies to choose the Member State in which the profits of the subsidiary were to be taxed (see above).

That would undermine the system created by a balanced allocation of taxing powers between Member States because the Member State of the subsidiary's residence, according to the choice of the group of companies concerned, would be forced to renounce its right to tax the profits of that group's subsidiary to the benefit of the Member State of the parent company's residence. Moreover, according to the Court, the possibility of transferring the taxable income of a subsidiary to a non-resident parent company carries the risk that companies establish purely artificial arrangements in order that income transfers be made to parent companies established in those Member States which apply the lowest rates of taxation, or where the income in question would not be taxed at all.

D. Deferral of capital gain taxation upon transfer within a group

Gallaher Limited, 16 February 2023, C-707/20

In the UK, disposal of assets are tax neutral between companies resident in the UK.

GL, a UK subsidiary of a Dutch company, member of a Japanese group disposed of:

- intellectual property rights to a Swiss member of the group;

- shares of a Manx company to a Dutch member of the group.

Is taxation contrary to freedom of establishment?

1. The denial would make the acquisition by the Dutch company of GL less attractive.

GL, although it is a subsidiary of a Dutch company is treated as the subsidiary of a UK company would be treated.

The sale to a group company resident of a third country member of the group is taxable.

2. The denial concerning the transfer to a Dutch group member resident in the Netherlands is a restriction on freedom of establishment.

Transfers to a MS group company are treated less favourably than transfers to a UK group company. This restriction is justified by a balanced allocation of taxing powers: a country may tax activities taking place in its territory.

The restriction is proportionate.

It cannot be compared with the taxation of unrealized capital gains upon transfers of a company abroad.

There a choice of deferral is justified by the lack of funds to pay the tax.

Here the sale was against payment.

Conclusion

Treatment of profits

In the host State, PEs of EU companies must receive the same treatment as domestic companies: same credits, same rates, even same access to double tax treaties.

In the residence State, the State may exempt foreign PEs of other MS or tax their income while granting a foreign tax credit.

Taxation by transparency of subsidiaries is justified only in the case of totally artificial arrangements.

Treatment of losses

The residence country is not compelled to allow the deduction of losses of foreign PEs except if this loss is final.

If it does, it may recoup foreign losses if the PE makes profit or is sold, if it applies the same regime within the country.

Consolidation

Deduction of foreign losses within the same group may be limited to domestic subsidiaries of the group, except if losses are “final”, i.e. can no longer be used abroad.

Capital losses on participations

Capital losses on participations must be treated in the same way for domestic and EU participations.

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