Tax obstacles to the cross-border movement of companies: direct investment

As explained in previous chapters, there is no competence to harmonise corporate taxes in the European Union. Basic issues such as the test of company residence for tax purposes, the tax rates, the rules on the taxable base, loss relief, attribution of profits and expenses and so on are not regulated by EU law. It is only when national tax rules discriminate against foreign nationals or restrict EU nationals from exercising their freedoms, or distort competition in a prohibited way, that there can be intervention at EU level.

Whilst at this juncture textbooks based on national tax law would devote much space on the structure of their corporate tax systems, this is where a book on EU corporate tax law is largely silent – being an issue pertaining to tax harmonisation. The reasons for this were explained in previous chapters. The most substantial initiative to provide some uniform rules is the CCCTB, which was discussed in Chapter 3. Other than that, an investor wishing to set up a company (or group of companies) in the EU is faced with twenty-seven corporate tax regimes. This chapter looks at some of the tax obstacles faced by single companies, group companies and branches in the context of direct investment.

5.1 Company residence

States invariably use corporate residence as the connecting factor for imposing taxes on companies, that is for exercising their tax jurisdiction. This is also enshrined in the OECD Model, pursuant to which companies are taxed on the basis of tax residence. Outside of the tax field residence does not tend to be very relevant and is an indeterminate connecting

1 In this chapter and throughout this book, unless stated otherwise, the terms ‘branch’ and ‘permanent establishment’ are used interchangeably.
2 See Art. 4 OECD Model.
3 As mentioned in an English case, ‘[r]esidence is not a concept for company law purposes of any importance; it is very important for taxation purposes but for purposes of
factor. As a result, States often prescribe additional criteria or tests in determining corporate tax residence, for example place of incorporation, place of registered seat, place of management and so on. These are very similar to the connecting factors used in determining the applicable company law, but they should not be confused as they serve different purposes. Tax residence links a company with the tax jurisdiction of a State. Corporate residence, if used as a connecting factor in company law, links the ‘proper law’ of a company (lex societatis) with the (non-tax) laws of a State. The existence of the one does not presuppose the existence of the other.

EU law shows no preference for any specific connecting factor (or criteria in delineating a connecting factor) either for corporate law or direct tax law purposes. As discussed in Chapter 4, Article 54 TFEU extends entitlement to freedom of establishment to ‘companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Union [...]’. Therefore, all types of connecting factors under company law are included in this description.

Unsurprisingly in a Treaty that does not purport to deal with tax matters, corporate tax residence is not discussed. As a matter of fact, corporate tax residence is not at all relevant. It has been reiterated numerous times by the Court of Justice that the allocation of tax jurisdiction – and as a corollary the control of the statutory books such as the share register it is of no significance whatever’. International Credit and Investment Co. v. Adham [1994] 1 BCLC 66. Corporate residence may also be important for ascertaining the company’s amenability to jurisdiction. See A. V. Dicey and J. H. Morris, The Conflict of Laws (London: Stevens, 1974), Rule 160(2).

4 E.g. nationality, domicile, residence, legal seat, place of incorporation, place of management, place of registration, place of registered office, etc. See Peter Behren, ‘General Principles on Residence of Companies’, Chapter 1 in Guglielmo Maisto (ed.), Residence of Companies under Tax Treaties and EC Law, EC and International Tax Law Series, Volume 5 (Amsterdam: IBFD, 2009).


6 This is particularly relevant in the context of corporate mobility, as shown in Chapter 7.

7 As regards the allocation of taxing rights in the VAT legislation, see Rita de la Feria, ‘Place where the Supply/Activity is Effectively Carried Out as an Allocation Rule: VAT v. Direct Taxation’, in Michael Lang, Peter Melz, Eleanor Kristoffersson and Thomas Ecker (eds.), Value Added Tax and Direct Taxation – Similarities and Differences (Amsterdam: IBFD, 2009).
criteria for establishing residence for tax purposes – falls within the domain of Member State competence. As Advocate-General Geelhoed stated in the *ACT GLO* case, ‘the power to choose criteria of, and allocate, tax jurisdiction lies purely with Member States (as governed by international tax law).’

Member States have the power to determine their own tests and criteria that would allow them to exercise their tax jurisdiction. Some Member States may choose an objective test (e.g. place of incorporation or place of registered office), other States may choose a subjective test (e.g. place of management), while others may choose a combination of the two.

Moreover, the domestic definition of corporate residence may be qualified under tax treaties, in so far as the application of treaty rights as agreed between contracting States are concerned. The tax treaty ‘residence’ provision focuses on when tax jurisdiction is triggered and how it ought to be allocated. Some companies may be excluded even if they satisfy the domestic test, for example if the company is liable to tax in that State only for income or capital from sources of that State, or if it is also resident in another State where its place of effective management is situated and a tie-breaker clause is in place.

To this extent, one would think that the treatment of corporate tax residence under EU law is straightforward: it is the Member States that determine whether a company falls under their tax jurisdiction and they can agree between themselves (or with a third country) on how to allocate this tax jurisdiction. EU law does not prescribe what connecting factors a Member State ought to have. Neither does it prescribe how tax jurisdiction is to be shared. Furthermore, as shown in Chapter 4, recent cases, the high-water mark of which is the *D* case, seem to suggest that the Court is paying more deference to tax treaties and to the OECD Model, on which Member States rely in concluding their tax treaties.

One may argue that a company incorporated in the home State cannot demand from the host State where its place of management is located to

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10 See, for example, Art. 4(1) of the OECD Model. In some UK tax treaties this has been rephrased to exclude ‘any person who is liable to tax in that State in respect only of income or capital gains from sources in that State’. See, for example, UK–Chile DTC (2003) and the UK–Poland DTC (2007).
11 See Art. 4(3) of the OECD Model.
consider it tax resident if the host State adopts the incorporation test for tax residence. The host State is not in breach of its obligations under EU law to refuse to recognise the company as tax resident.

This statement is deceptively simple. The protective scope of EU law does not end where the Member State’s power to determine tax residence begins. Whilst formally that power remains intact, in reality in certain cases it is circumscribed. This is because, irrespective of whether a Member State recognises a company as (tax) resident, to the extent that the company is in a comparable situation to a (tax-)resident company, it cannot be treated in a discriminatory manner. As with everything else left within the competence of Member States, what EU law does demand is that whatever rules are chosen, they should not be applied in a discriminatory manner. Therefore, if a UK-resident company is given certain tax reliefs and these are not extended to the permanent establishment of a non-resident company that is in an objectively comparable situation with a resident company, then there could be a question of incompatibility. This, however, has no effect on how a Member State chooses to define who is tax resident and who is not. It is a question of how national tax legislation applies to resident and non-resident persons after these are categorised as resident and non-resident according to domestic rules. Nevertheless, it could be argued that even if residence is respected as a connecting factor, by requiring the extension of national benefits linked to it to non-residents, this takes away some of its essence.

A notable exception where ‘residence’ is given heightened importance is within tax treaties. It has been shown that the fact that treaty benefits are restricted to residents of contracting States is not a breach of EU law. There is no EU obligation to extend those benefits to residents of other Member States that are not a party to the tax treaty, as those benefits are an integral part of the treaty. The Court has refused to enter into a discussion of whether a resident of a third Member State can ever be in a comparable situation to a resident of one of the contracting States to a tax treaty. Therefore, it would seem that there is nothing per se wrong in restricting tax treaty benefits to residents of contracting States – notwithstanding the bilateralism of this approach. Even some Directives limit their scope to Member State resident companies, though these instruments are multilateral.

13 See 4.3.3.
14 For example, the Parent–Subsidiary Directive applies to companies resident in a Member State under domestic law and subject to taxation there. The Interest and Royalties Directive and the Merger Directive contain similar requirements. See Chapter 2.
Overall, whilst the importance of residence for the attainment of certain benefits in a tax system may effectively have been eroded, it still remains important as a connecting factor when it comes to treaty benefits and entitlement to some direct tax Directives.

5.2 Issues with the taxation of corporate groups

EU law has had a substantial impact on domestic rules imposed by Member States on company structures and strategies. This is not only as a result of the direct tax Directives, examined in Chapter 2, but also – and perhaps primarily – through negative integration. As mentioned above, EU law does not impose any immediate obligations on Member States on how to structure their corporate tax system in terms of rates, taxable base, depreciation and so on. What it does is to prevent Member States from imposing rules that restrict the ability of companies to exercise their freedom of establishment or that discriminate between resident and non-resident companies when they are in an objectively comparable situation. Therefore, national tax rules affecting a single company cannot be subject to scrutiny under EU law, unless there is a cross-border element to these rules that falls within the scope of the fundamental freedoms, as considered in Chapter 4.

The most important freedom for the establishment of companies and, generally, for direct investment,\footnote{For a criticism of the distinction between direct (non-portfolio) investment and portfolio investment, see Wolfgang Schön, ‘International tax coordination for a second-best world (Part II)’, (2010) 2(1) World Tax Journal, 65–94.} is freedom of establishment. As with the other freedoms, this freedom has an outbound (home State) angle and an inbound (host State) angle. From an outbound perspective, a home State must not impose obstacles to nationals who are exercising their freedom to set up and have an establishment in another Member State. This reflects capital export neutrality concerns.\footnote{For a discussion of capital export neutrality and capital import neutrality, and the literature on these principles, see Christiana HJI Panayi, Double Taxation, Tax Treaties, Treaty Shopping and the European Community, EUCOTAX Series (Alphen aan den Rijn: Kluwer Law International, 2007), Chapter 1.} From an inbound perspective, a host State has to give national treatment to persons from other Member States, whether they are organised as a primary establishment or as a secondary establishment through a branch, agency or subsidiary. This reflects capital import neutrality concerns. As shown in this chapter and in subsequent
chapters, a Member State may be under different obligations as a home State and as a host State.

Typically, therefore, there are two types of obstacles: the home State obstacles where a domestic company is hindered by its national rules from carrying on its business in another Member State, and the host State obstacles where a non-resident company is hindered by another Member State’s rules from carrying on its business there in a similar way to domestic companies. Depending on the scope of the business activities, that is whether an establishment is involved such as a branch or agency or subsidiary company in which a company has definite influence and control or whether it is an instance of portfolio investment, freedom of establishment or the free movement of capital are triggered.

Examples of home State obstacles discussed in this book are where a parent company is not able to deduct costs or expenses or losses relating to a foreign subsidiary or a foreign branch where such items would have been deductible in case of a domestic subsidiary or branch, or where a parent company is taxed more heavily as a result of controlling a foreign company in a low-tax jurisdiction rather than a resident company, or where higher withholding taxes are imposed on outbound payments of dividends or interest or royalties, or where a company is taxed more heavily when it transfers assets to a foreign group company or a foreign branch than a domestic one, or where exit taxes are imposed on a company transferring its tax residence abroad and so on.

Host State obstacles arise where a non-resident company, either through its branch or on its own, is taxed more heavily than a domestic company. This could be as a result of the non-resident company being taxed on its profits on a gross basis rather than net basis, or when it is subject to higher tax rates, or where stricter depreciation rules apply, or where returns from foreign investments are taxed more heavily or receive less beneficial treatment and so on.

As with most principles arising under negative integration, the Court of Justice does not take a structured approach. Perhaps it cannot do so, due to the unsystematic nature of negative integration, as discussed in 4.1. An implication of this is that the Court does not ab initio adopt a different approach according to whether the impinged national tax rules affect a single company or a group or a branch. Whilst such factors may be relevant when it comes to comparability or justifications, they do not pre-empt the Court’s restriction or discrimination analysis. By contrast, because of some characteristics of group companies (e.g. separate legal entity), whether a rule relates to such companies or branches may be an
important consideration in international tax law. Some of these issues are examined in this chapter and in following chapters. Throughout the analysis a comparison is made with the rules under international tax law and the OECD Model to highlight the divergence of approach, if any.

5.2.1 Expenses in foreign holdings

There have been a few cases dealing with the non-deductibility of expenses or charges incurred by parent companies in relation to shareholdings in cross-border subsidiaries. In international tax law this is an issue that tends to fall under each country’s expense allocation rules. The OECD Model does not deal with it at all. By contrast, within the EU these non-deductibility rules have to conform to the fundamental freedoms.

The *Bosal* case has already been mentioned in Chapter 2. Here a Dutch parent company, which carried on holding, financing and licensing royalty-related activities, borrowed funds to invest in the share capital of subsidiaries in nine other Member States. The Dutch tax authorities refused deduction for the interest on the funds because the dividends received from these subsidiaries were exempt. The Dutch legislation made the deductibility of costs connected with a company’s shareholding in a subsidiary in another Member State conditional on those costs being indirectly instrumental in making profits that were taxable in the Netherlands. Had the funds been invested in a Dutch subsidiary, interest would have been deductible, even if domestic dividends were effectively exempt. The option to deny the parent company’s holding costs was a common practice at the time, also permitted under the Parent–Subsidiary Directive.

Notwithstanding this, the Court of Justice found the rules to be incompatible with freedom of establishment. By allowing costs to be deducted only if they were instrumental in taxable profits being made in the Netherlands, the legislation hindered the exercise of the freedom of establishment, as it penalised the creation of subsidiaries in another Member State. A parent company would be dissuaded from carrying on its activities through the intermediary of a subsidiary established in another Member State as such subsidiaries did not usually generate profits that were taxable in the Netherlands.

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19 Case C-168/01 *Bosal*, para. 27.
The restriction was not justified. As far as coherence of the tax system was concerned, the Court found that there was no direct link between, on the one hand, the granting of a tax advantage (the right to deduct costs connected with holdings in the capital of their subsidiaries from their taxable profit) to parent companies established in the Netherlands and, on the other, the tax system relating to the subsidiaries of parent companies where the latter were established in that Member State.\(^\text{20}\) Interestingly in this context, the Court emphasised that ‘[u]nlike operating branches or establishments, parent companies and their subsidiaries are distinct legal persons, each being subject to a tax liability of its own, so that a direct link in the context of the same liability to tax is lacking and the coherence of the tax system cannot be relied upon’.\(^\text{21}\)

Could one deduce from this statement that a non-deductibility rule may be justified in the context of loans taken by the head office to finance the business of its foreign branch? Does it make a difference if the home State exempts foreign branch profits or taxes them with a credit? This point has not yet been addressed but could be relevant in the discussion of notional payments/expenses between a head office and its permanent establishment.\(^\text{22}\)

The Court also rejected the argument that the different tax treatment of parent companies was justified by the fact that subsidiaries that made profits taxable in the Netherlands and those that did not were not in comparable situations. This was not the right comparator test. Rather, the difference in tax treatment concerned whether or not parent companies had subsidiaries making profits taxable in the Netherlands, even though those parent companies were all established in that Member State.\(^\text{23}\)

A similar approach was followed in later cases. In Keller\(^\text{24}\) the Court of Justice found that German rules that precluded the deductibility of shareholder expenses on foreign tax-exempt dividends were not compatible with freedom of establishment. In this case a German-resident company, Keller Holdings, owned a German subsidiary, which itself had a substantial holding in an Austrian company. Dividends distributed by the Austrian subsidiary to the German subsidiary were tax exempt under the Germany–Austria tax treaty. Dividends further distributed by the German subsidiary to Keller Holdings were also tax exempt. Keller Holdings tried to deduct the interest on loans raised to acquire

\(^{20}\) Ibid., para. 31. \(^{21}\) Ibid., para. 32. 
\(^{22}\) See 5.3.3. \(^{23}\) Case C-168/01 Bosal, para. 39. 
\(^{24}\) Case C-471/04 Keller Holding [2006] ECR I-2107.
the participation in its German subsidiary and other administrative expenses. The German tax authorities refused to deduct these expenses on the basis that they had an immediate economic connection with tax-exempt income (i.e. the income from the Austrian company).

The Court of Justice found this treatment to be incompatible with freedom of establishment under the EC Treaty and the EEA Agreement.²⁵ Even though the issue was whether the German group parent could deduct costs incurred in respect of its shareholding in a German subsidiary, this was not considered to be an internal situation. As the disallowance of the deduction was linked to the receipt of dividends from a second-tier Austrian subsidiary, the case fell within the scope of the EC and EEA Treaties.²⁶

The Court of Justice thought that a German parent company with a German subsidiary was in a comparable situation to a German parent with a foreign subsidiary. This was because in so far as the dividends received by the German parent were concerned, they were, in reality, all exempt from taxation whether paid by a German or a foreign subsidiary.²⁷ However, holding costs could only be deducted in a domestic situation because of the economic link requirement. As a result, the tax position of a company with an indirect subsidiary in Austria was less favourable than that of a company with an indirect subsidiary in Germany.²⁸ This difference in treatment could dissuade a parent company from carrying on its activities through direct or indirect subsidiaries established in other Member States.²⁹ The Court concluded that the restriction could not be justified.

Similarly, in Rewe³⁰ the Court of Justice found that German rules restricting depreciation of holdings in non-resident subsidiaries violated EU law. Under German tax law applicable at the time of the case, write-downs on resident participations were immediately tax deductible, irrespective of the nature of the participation (passive or active). By contrast, write-downs on non-resident participations were only immediately tax deductible if the company generated active income abroad or if it held an interest of at least one quarter in another foreign company that generated active income.³¹

²⁵ The claim arose between 1993 and 1995. As Austria had not joined the EU until 1 January 1995, this case was examined under the provisions of both the EC Treaty and the EEA Agreement.
²⁶ Case C-471/04 Keller Holding, paras. 23–24.
²⁷ Ibid., para. 31. ²⁸ Ibid., para. 34. ²⁹ Ibid., para. 35.
³¹ Ibid., para. 10.
Rewe was a German-resident company with subsidiaries in other Member States. In 1993 and 1994 Rewe depreciated the going concern book value of its participation in a Dutch subsidiary and wrote down the value of bad debts against its Spanish and UK indirect subsidiaries. The German tax authorities denied a deduction of the write-down. Rewe argued that this denial was contrary to the freedom of establishment and the free movement of capital.

The Court of Justice decided the case only on the basis of freedom of establishment. German law distinguished between write-downs on resident companies, which were immediately tax deductible, and write-downs on non-resident companies, which were only immediately tax deductible if certain kinds of activities were carried out. German subsidiaries were not subject to the limitation, irrespective of their activities. Even if the loss derived from the non-resident subsidiary could be set off against subsequent profits, the immediate deduction of a write-down constituted a cash-flow advantage.

Therefore, the tax situation of a German parent company with non-resident subsidiaries was more onerous than if it had resident subsidiaries. Such German parent companies were in a comparable situation as regards losses suffered from the depreciation of their shareholdings in subsidiaries. These were losses suffered by the German parent company and not the subsidiary. In addition, the profits of the subsidiaries – whether resident or non-resident – were not taxable in the hands of the parent companies. This difference of treatment gave rise to a tax disadvantage. A parent company might be dissuaded from carrying on its activities through subsidiaries established in other Member States. The Court of Justice concluded that the German rules restricted the freedom of establishment and were not justified.

In the Glaxo Wellcome case the Court’s judgment was more nuanced. Here German law disallowed a deduction of losses arising from a write-down on the value of participations acquired from non-residents.

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32 The relevant subsidiaries were wholly owned by Rewe.
33 Case C-347/04 Rewe Zentralfinanz, paras. 27–28.
34 Ibid., para. 29.
36 Ibid., para. 34.
37 Ibid., para. 31.
38 Ibid., para. 70.
39 Ibid., para. 39.
41 In this case the reduction in value of shares as a result of a dividend distribution did not affect the basis of assessment for a resident taxpayer when that taxpayer had acquired shares in a resident company from a non-resident shareholder. Had those shares been
The Court of Justice found that the German legislation was not in breach of the free movement of capital, even though such write-down was allowed for resident participations. This legislation was put in place under the former imputation system to prevent a non-resident from benefiting economically from the imputation credit in case of a disposal of shares to a resident shareholder.  

Although the legislation restricted the free movement of capital, this restriction could be justified. The Court of Justice rejected the argument that the restriction was justified by the government’s need to preserve the coherence of its imputation system. However, the restriction could be justified by the need to maintain a balanced allocation of the power to impose taxes between the Member States. It was also justified by the need to prevent wholly artificial arrangements that do not reflect economic reality and whose only purpose is to obtain a tax advantage unduly. It was for the national court to examine whether the legislation at issue in the main proceedings was limited to what was necessary in order to attain those objectives.

Notwithstanding the conclusion in the Glaxo Wellcome case, the important point to note in all of these cases is that the Court had no qualms about requiring the depreciation of the value of a foreign subsidiary or the deduction of financing costs to be taken into account in the home State. The Court looked at it as a home State restriction: a parent company was dissuaded from establishing subsidiaries abroad. The fact that the different treatment was because the home State could not tax the profits of the non-resident subsidiary or deduct the loss relating to the non-resident subsidiary was not relevant. If anything, the fact that the resident parent company and the non-resident subsidiary were different legal persons was a reason, at least in Bosal, why the restriction was not justified. This raises the question whether the Court of Justice will be more tolerant with non-deductibility rules relating to foreign branches compared to foreign subsidiaries.

Arguably, in all of the above cases there was some – limited – jurisdictional nexus: the loss/expense was that of a resident parent company, albeit suffered as a result of the non-resident subsidiary or investment in

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42 For a discussion of the classical and imputation systems of taxation, see Chapter 6.
43 Case C-182/08 Glaxo Wellcome, para. 81.
44 Ibid., para. 88. 45 Ibid., para. 92. 46 Ibid., paras. 94–98.
47 For a discussion of the rules on the attribution of branch profits and expenses, see 5.3.3.
the non-resident subsidiary. What if there is absolutely no jurisdictional link? What if the loss is one of a non-resident subsidiary? Could it be set off against the profits of the resident parent company, even if that company could not normally tax the profits of the non-resident subsidiary? This issue was dealt with in group relief cases, discussed next.

5.2.2 Cross-border loss relief

Group relief, that is the possibility of losses incurred by one company being set off against the profits of another company of the same group, is very important. Domestic relief of losses within a group of companies is available in most Member States under specific circumstances. In such circumstances the group is effectively treated as an economic unit. However, most Member States conferring domestic relief require that the surrendering and the receiving group companies be resident companies or that the losses are domestic losses. As a result, loss relief is rarely available in cross-border situations. This may lead to over-taxation and create obstacles to cross-border movement. Whilst the unavailability of cross-border loss relief is not treated as discrimination under the OECD Model, the unavailability or limitation of cross-border loss relief is thought to be especially problematic in the EU context. It influences business decisions on whether and how to enter a new market, creating ‘a barrier to entering other markets, which perpetuates the artificial segmentation of the internal market along national lines’.

The issue of cross-border loss relief between group companies was considered by the Court of Justice in Marks & Spencer plc v. IRC. Before this case is analysed, it is important to explain the precursor to the UK tax legislation that was at issue in that case.

In ICI v. Colmer the Court of Justice looked into the UK group relief rules applicable at the time. These rules allowed tax relief between consortium members when the business of the holding company (owned by the consortium) consisted wholly or mainly in the holdings of shares in UK subsidiaries. Here ICI and Wellcome Foundation Ltd were resident in the

48 See discussion on Art. 24(5) OECD Model below, p. 195.
50 Case C-446/03 Marks & Spencer plc v. IRC [2005] ECR I-10837.
UK and had formed a consortium through which they owned respectively 49 per cent and 51 per cent in a UK holding company. The sole business of the UK holding company was to hold shares in twenty-three trading companies. Four of these subsidiaries were resident in the UK, six in other Member States and thirteen in non-Member States. For a given accounting period, ICI tried to set off 49 per cent of one of the UK subsidiary’s losses against its chargeable profits. The UK tax authorities denied the relief on the basis that the majority of the holding company’s subsidiaries were non-resident companies and the case was eventually referred to the Court of Justice. The Court found the residence requirement to be in breach of freedom of establishment. Companies belonging to a resident consortium that had, through a holding company, exercised their right to freedom of establishment in order to set up subsidiaries in other Member States were denied tax relief on losses incurred by a resident subsidiary where the majority of the subsidiaries controlled by the holding company were non-UK resident.\(^{51}\)

Following this case, the UK loss relief rules were amended and the focus of the new legislation shifted from the surrendering company’s ownership structure to the location of the loss. Under the amended legislation, broadly, group relief could only be granted for losses considered to be within the scope of UK taxation. As a result, losses made by a UK branch of a non-resident company could be surrendered to another group company for offset against its UK taxable profits. In addition, losses made by a UK group company could be surrendered to the UK branch of a non-resident company for offset against any UK branch profits.

In *Marks & Spencer* the condition that the surrendering and claimant companies be resident or be carrying on an economic activity in the UK was challenged. This case is one of the most high-profile and extensively discussed cases in the jurisprudence of the Court of Justice.\(^{52}\) In this case the profitable UK parent company, Marks & Spencer plc (M&S), claimed group tax relief in respect of losses incurred by its French, Belgian and German subsidiaries. These non-resident subsidiaries had no UK branch and had never traded in the UK. As a result, they were not within the scope

\(^{51}\) Ibid., para. 22.

of the UK group relief rules. The tax inspector, therefore, refused group relief and M&S’s appeal was rejected by the Special Commissioners.\textsuperscript{53} M&S appealed against that decision before the High Court, which decided to stay the proceedings and refer the matter to the Court of Justice for a preliminary ruling.

The Court of Justice decided that the non-availability of group relief for losses from foreign subsidiaries prima facie hindered cross-border groupings. Group relief constituted a tax advantage for the companies concerned, as it speeded up relief of the losses of the loss-making companies by allowing them to be set off immediately against the profits of other group companies.\textsuperscript{54} The exclusion of such an advantage led to the different treatment of losses incurred by a UK-resident subsidiary and by a non-resident subsidiary with no UK branch. This deterred parent companies from setting up subsidiaries in other Member States and it restricted freedom of establishment.\textsuperscript{55}

This restriction could be justified on the following grounds, taken together.\textsuperscript{56} Firstly, there was a need to preserve the allocation of taxing rights between Member States. Giving companies the option to have their losses taken into account in different Member States would significantly jeopardise the balanced allocation of a Member State’s power to impose taxes.\textsuperscript{57} Secondly, it was necessary to prevent double relief of losses both in the Member State of the subsidiary and the Member State of the parent company.\textsuperscript{58} Thirdly, the risk of tax avoidance would exist if companies were free to transfer losses from Member States with lower levels of taxation to those with higher levels of taxation, thus increasing the value of the losses.\textsuperscript{59}

\begin{footnotesize}
\begin{itemize}
\item Decision SpC 00352, reported at [2003] STC (SCD) 70.
\item Case C-446/03 Marks & Spencer, para. 32.
\item Ibid., para. 33.
\item Ibid., para. 51. In subsequent cases the Court held that this was not a cumulative requirement. See, for example, Case C-470/04 N v. Inspecteur Van de Belastingdienst Oost/ Kantoor Almelo [2006] ECR I-7409, para. 42; Case C-231/05 Oy AA [2007] ECR I-6373, paras. 51–60; and Case C-379/05 Amurta SGPS v. Inspecteur van de Belastingdienst [2007] ECR I-9569, paras. 57–59. In a later case, Case C-311/08 Société de Gestion Industrielle v. Belgian State [2010] ECR I-487, the Court of Justice reverted to the position that the two justifications (preservation of balanced allocation of taxing powers and prevention of tax avoidance) are to be taken together. See Christiana HJI Panayi, ‘Reverse subsidiarity and EU tax law: Can Member States be left to their own devices?’, [2010] 3 British Tax Review, 267–301, 278; Mathieu Isenbaert, \textit{EC Law and the Sovereignty of the Member States in Direct Taxation}, IBFD Doctoral Series, vol. 19 (Amsterdam: IBFD, 2010), pp. 543–4.
\item Marks & Spencer, paras. 43–46.
\item Ibid., paras. 47–48.
\item Ibid., paras. 49–50.
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However, for the restrictive measure to be justified, it could not go beyond what was necessary to attain the essential part of the objectives pursued. In other words, the restriction had to be proportional. In order to assess the proportionality of the restrictive measure, the Court of Justice took into account whether the non-resident subsidiary had exhausted all possibilities for relief available in its Member State of residence. The possibilities were set out in paragraph 55 of the judgment. The Court of Justice considered that the restrictive measure went beyond what was necessary to attain the essential part of the objectives pursued 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, 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.  

Therefore, the availability of carry-back, current year relief against other local profits or carry-forward, either by the subsidiary or a third party to which those losses were transferred or sold, meant that not all possibilities for relief had been exhausted. It was only when the resident parent company demonstrated to the tax authorities of its Member State that those conditions were fulfilled (i.e. that all possibilities for relief had been exhausted) that it became contrary to freedom of establishment 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. The Court of Justice emphasised that Member States were:

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.  

This decision forced the UK to amend its group relief rules. In the Finance Act 2006 entitlement to claim group relief for EU losses was finally granted, but under strict conditions. Broadly, the amended legislation allows non-resident group companies without a UK branch to surrender losses to a UK company in the same group when certain conditions are

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60 Ibid., para. 55.  
61 Ibid., para. 56.  
62 Ibid., para. 57.
Tax obstacles: direct investment

fulfilled. However, the Commission found that the amended legislation was still restrictive and not aligned with the spirit of the Court’s decision in *Marks & Spencer* and has referred the UK to the Court of Justice. The case was pending at the time of writing.

By contrast, in *Oy AA* the Court of Justice seemed to pay more deference to Finnish legislation, which prevented a resident company from deducting an intra-group transfer unless the recipient company was also resident in Finland. Under Finnish law, an intra-group transfer was tax deductible for the contributor and taxable income for the recipient, if both the contributor and the recipient of the group were domestic companies. Here *Oy AA*, a Finnish-resident company, was a wholly owned indirect subsidiary of a UK-resident company. *Oy AA* wanted to make a group contribution to the UK parent company. All other requirements set out in the Finnish legislation were satisfied, other than the requirement that the contributor and recipient be Finnish companies.

The Court of Justice found that the Finnish legislation constituted a restriction to the freedom of establishment. The difference in treatment between resident subsidiaries according to the seat of the parent company made it less attractive for companies established in other Member States to exercise their freedom of establishment in Finland. Parent companies could ‘refrain from acquiring, creating or maintaining a subsidiary in the State which adopts that measure’.

According to the Court of Justice, the restriction was justified on the basis of safeguarding the balanced allocation of the power to tax between Member States and the prevention of tax avoidance, taken together. The Court of Justice concluded that the Finnish group contribution regime was suitable for the attainment of these objectives. Rather surprisingly, the Court found that ‘taken as a whole’ the Finnish regime was proportional, even though it was not specifically designed to prevent purely

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63 For an analysis of the new legislation, see HJI Panayi, ‘Reverse subsidiarity and EU tax law’, 289ff.
66 The parent company also had to hold at least 90 per cent of the shares of the subsidiary or both had to be held by a joint parent company that held 90 per cent in these companies.
67 Case C-231/05 *Oy AA*, para. 39.
68 Ibid., para. 63.
artificial arrangements. In this statement the Court not only deviated from its previous judgments on anti-abuse provisions, but it was also conspicuously silent vis-à-vis the Marks & Spencer exhaustion of possibilities test.

Obviously, the Court of Justice was concerned that Finland would lose the power to tax the transferred profit if the recipient was a non-resident company. However, why was the inability to tax the profit a relevant concern for profit contribution regimes (or for this specific regime) when the inability to reincorporate a terminal loss was not a concern in Marks & Spencer? Given the similarities of profit contribution and loss relief regimes, one would have thought that similar conclusions ought to apply. In fact, in Sweden a group contribution regime that was similar to the Finnish regime was found by national courts to be contrary to freedom of establishment if contributions for final losses of subsidiaries could not be deducted. In this case the Marks & Spencer exhaustion of possibilities test was applied though, again, not in its full rigour.

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69 Ibid.
70 See analysis in Chapter 8.
71 As the Court of Justice stated in para. 64, any extension of the advantage of the Finnish legislation to cross-border situations would 'have the effect of allowing groups of companies to choose freely the Member State in which their profits will be taxed, to the detriment of the right of the Member State of the subsidiary to tax profits generated by activities carried out on its territory'. The disadvantage could not be removed by imposing conditions concerning the treatment of the income in the other Member State. Case C-231/05 Oy AA, paras. 64–65.
73 See advance rulings given by the Swedish National Board in Dnr 206–04/D and Dnr 193–04/D, 29 September 2006. On appeal to the Swedish Supreme Court, the decision of the National Board was confirmed on 11 March 2009. See analysis in see HJI Panayi (2010), 'Reverse subsidiarity and EU tax law', p. 17.
74 In these Swedish cases deduction was allowed for final losses suffered only by EU/EEA subsidiaries and only if such subsidiaries were dissolved through liquidation.
Société Papillon is another important case dealing with the French integration regime. Here the French parent company, Société Papillon, included in its tax group French subsidiaries that were indirectly held through a Dutch company. The French tax authorities did not allow tax consolidation because the shares in the French company were held through a non-resident (Dutch) company without a French branch. The Conseil d'État referred the question of compatibility of this regime with freedom of establishment.

The judgment of the Court of Justice was along similar lines to the opinion of the Advocate General. The Court found that the situation of a parent company that was resident in a Member State and held sub-subsidiaries in that Member State through a resident subsidiary was comparable to the situation of a parent company with sub-subsidiaries resident in the same Member State but held through a non-resident subsidiary. The aim of the French legislation was to treat, as far as possible, a group company in the same way as an undertaking with a number of permanent establishments, by allowing the results of each company to be consolidated. Therefore, the French consolidation regime led to unequal treatment of French parent companies depending on whether they held their lower-tier subsidiaries through intermediary companies established in France or abroad. This was a restriction to the freedom of establishment.

The Court of Justice agreed with its Advocate General in that the restriction could be justified by the need to preserve the coherence of the French group tax system. The tax integration regime provided for the tax consolidation of companies and, to offset this, for the neutralisation of certain transactions between group companies. In other words, a direct link existed between the tax integration regime (the tax advantage) and the elimination of internal transactions (the compensating disadvantage). The neutralisation of transactions that were internal to the group avoided losses being used twice: the deduction of a loss at the level of the sub-subsidiary as an ordinary loss and the deduction at the level of the parent company as a loss of the parent company for the depreciation of its holding in the subsidiary.

76 Advocate General Kokott’s opinion was delivered on 4 September 2008. The judgment was delivered on 27 November 2008.
77 Case C-418/07 Société Papillon, para. 29.
78 Ibid., para. 28. 79 Ibid., para. 31.
80 Ibid., paras. 31–32. 81 Ibid., para. 45. 82 Ibid., para. 47.
However, internal transactions would not be neutralised, and the losses would be taken into account twice, when the intermediary subsidiary was a non-resident company. This was because a non-resident company was not subject to the tax integration regime. In such circumstances, resident companies would enjoy the advantages of the tax integration regime, as regards the consolidation of results and the immediate taking into account of the losses of all the companies subject to that regime, without the losses of the subsidiary and the provisions made by the parent company being capable of being neutralised. As a result, the direct link between the tax advantage and the compensating disadvantage would be eliminated, thus affecting the coherence of the regime.

Even if the restriction was justified, the Court of Justice stated that it still had to be proportional. The French government had argued that the rules were necessary due to the difficulties that the French tax authorities had in ascertaining whether losses would be used twice. The Court of Justice pointed out that practical difficulties could not themselves justify the infringement of a freedom. In a domestic situation the risk of multiple deduction of losses would have been prevented by the elimination of internal transactions. The Mutual Assistance Directive could have been used to obtain information regarding the intermediate EU entity. Furthermore, France could have asked for such documents from the French parent company as was necessary in order to determine whether the provisions made by that company for the losses in the share value in the subsidiary could be explained indirectly by a loss of the sub-subsidiary through the provisions of that subsidiary.

Therefore, the Court of Justice found the outright prohibition of the French rules to be disproportional. As a corollary, the French consolidation regime was incompatible with freedom of establishment. Arguably, this was not a representative case on consolidation systems because here the parent company was not asking to consolidate with the intermediary

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83 Ibid., para. 48.  
84 Ibid., para. 49.  
85 Ibid., para. 50.  
86 Ibid., para. 53.  
87 Ibid., para. 54.  
89 Case C-418/07 Société Papillon, para. 55.  
90 Ibid., para. 56.  
91 It is noteworthy that although the Advocate General also doubted whether the regime was proportional, she left it to the national court to decide whether there were less restrictive means to deny inclusion of a sub-tier subsidiary for tax group purposes. See para. 67 of the opinion.
Dutch company. Rather, it challenged the French rules that prevented it from forming a consolidated group with its other French sub-subsidiaries, as a result of those sub-subsidiaries being held by a non-resident company. Therefore, there was no question of foreign losses being offset by French taxable profits.

In *X Holding*, a case dealing with the Dutch fiscal unity regime, the Court of Justice was specifically asked whether a Dutch parent company should be allowed to form a consolidated group with non-resident subsidiaries. Under the Dutch regime, resident group companies could be treated as a fiscal unity if the parent company owned at least 95 per cent of the shares in the subsidiary and only for overlapping accounting periods. Non-resident subsidiaries could not be included in a fiscal unity unless they had a Dutch permanent establishment to which the shares in the subsidiary were attributed. When a fiscal unity was formed, then a subsidiary was effectively treated as a permanent establishment of the parent company. The profits and losses of companies within the fiscal unity were calculated on a fully consolidated basis, intercompany transactions were ignored and only one corporate income tax return was filed for the entire entity.

In this case a Dutch parent, *X Holding BV*, was prevented from forming a fiscal unity with its wholly owned Belgian subsidiary, *F NV*, as the latter did not have a Dutch permanent establishment. The Netherlands Supreme Court questioned whether the inability to form a cross-border fiscal unity violated the freedom of establishment. Advocate General Kokott and the Court of Justice found that it did not. Although the regime restricted freedom of establishment, the restriction was justified on the basis of safeguarding the allocation of the power to impose taxes.

The optional nature of the arrangement, combined with the ability to alter the fiscal unity on a yearly basis, raised concerns that the tax base of the unity would be manipulated. The parent company could choose to consolidate with loss-making foreign subsidiaries in one year and exclude them from the fiscal unity in a following year when they become profitable. Conversely, the parent company could choose to exclude profitable foreign subsidiaries from the fiscal unity in one year and include them in a following year when they are making losses. Therefore, the Court of Justice

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92 See Case C-337/08 *X Holding BV* [2010] ECR I-1215.
93 Ibid., para. 19.
94 Ibid., para. 33.
95 Ibid., para. 32.
thought that the restriction was justified on the basis of safeguarding the allocation of the power to impose taxes between Member States.

Moreover, the restriction did not go beyond what was necessary to achieve this objective. The Court of Justice followed the Advocate General’s interpretation of proportionality. Even though non-resident subsidiaries were completely excluded from a fiscal unity, this did not render the regime disproportionate. The fact that a more proportional recovery arrangement applied to foreign permanent establishments was not a relevant consideration because permanent establishments and subsidiaries were not in a comparable situation having regard to the allocation of the power to impose taxes. Hence, the Netherlands was under no obligation to extend this advantage to foreign subsidiaries.

To an extent, these remarks were made somewhat pre-emptively, as the arguments used to justify non-comparability between the two legal forms were very general ones, not tailored to the specific facts of the case. Both the Advocate General and the Court of Justice refrained from explaining why permanent establishments and subsidiaries were not in this instance in a comparable situation, given that when a fiscal unity was formed, domestic subsidiaries were effectively treated as if they were domestic permanent establishments. It is noteworthy that this comparability point was raised by the Dutch Advocate General Wattel in the Netherlands Supreme Court. It was also an issue raised by Advocate General Maduro in his opinion in Marks & Spencer. Perhaps Advocate General Kokott and the Court of Justice did not want to get embroiled in this debate, preferring to conclude that ‘the Member State of origin is not obliged to apply the same tax scheme to non-resident subsidiaries as that which it applies to foreign permanent establishments’.

Another peculiarity of the judgment is that the Court of Justice used as a ground to show proportionality the fact that parent companies would be able to choose freely the Member State in which the losses of their non-resident subsidiary were to be taken into account. However, this was a ground that was used to accept the balanced allocation of taxing

96 Ibid., para. 42.
97 Ibid., paras. 36–38.
98 Ibid. The Dutch Supreme Court followed the Court’s judgment in rendering its final decision in the case of X Holding on 7 January 2011.
99 See case comment by Dennis Weber in (2010) 1 Highlights & Insights on European Taxation.
100 Case C-446/03 Marks & Spencer, para. 48 (Advocate General).
101 Case C-337/08 X Holding, para. 40.
102 Ibid., para. 41.
powers as a justification.\textsuperscript{103} In fact, the Court cross-referred to it.\textsuperscript{104} Has this ground now become so important as to satisfy the proportionality test, however pre-emptively prohibitive the national rule is?

Overall, it would seem that the Court has not applied the \textit{Marks & Spencer} test in a very consistent or theoretically coherent way. Arguably, the Court of Justice has been more lenient towards profit contribution and consolidation regimes (or the Dutch consolidation regime), compared to its approach vis-à-vis the UK group relief regime. Undeniably, there are structural differences between the targeted, ad hoc and bilateral-based approaches of loss relief and profit contribution arrangements and the more comprehensive consolidation arrangement. In fact, there could even be substantial differences within the same category. The Court could very legitimately have used these fundamental differences to justify a variable application of the \textit{Marks & Spencer} principles and more specifically the terminal loss test. It does not do so though, without giving any cogent justifications for this.

More cases are likely to follow that may question the jurisprudential value of some of the Court’s judgments in this area. The Commission has recently asked the Netherlands to amend its fiscal unity tax regime on the grounds that it is incompatible with freedom of establishment.\textsuperscript{105} Furthermore, the Commission has referred Germany over the tax treatment of group companies under its fiscal unity regime (\textit{Organgesellschaften}).\textsuperscript{106} There has also been a reference from a Finnish court questioning whether final losses in a cross-border merger between a Swedish limited company and a Finnish LLC without a remaining permanent establishment should be permitted under freedom of establishment when it was allowed in mergers between resident companies.\textsuperscript{107} It will be interesting to see how these and other cases develop.

It could be argued – and the author has so argued elsewhere\textsuperscript{108} – that the Court’s approach (or lack of it) creates imbalances and that EU
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legislative action may be a better and fairer method of dealing with these issues. In fact, the developments in the case law go much further than what was envisaged in a Draft Directive on Cross-Border Loss Relief,¹⁰⁹ as well as a Commission Communication on the Tax Treatment of Losses in Cross-Border Situations.¹¹⁰

As far as the Draft Directive on Cross-Border Loss Relief was concerned, although its aim was to facilitate cross-border loss relief, there were strict qualifying conditions, especially for surrendering foreign subsidiaries.¹¹¹ Group relief was available between group companies¹¹² but only when they satisfied a minimum capital holding requirement.¹¹³ Relief was by credit,¹¹⁴ although Member States were not prevented from ‘maintaining or introducing other methods of taking into account the losses of subsidiaries of its enterprises located in other Member States, including the consolidated profit method’.¹¹⁵ Member States were able to ensure that loss relief was only temporary and reversible. Subsequent profits of the surrendering subsidiary were reincorporated in the tax base of the claimant company. There were also provisions allowing automatic reincorporation¹¹⁶ and the application of domestic anti-abuse rules.¹¹⁷ Although the Draft Directive provided clear rules¹¹⁸ and temporary entitlement, it was

¹⁰⁹ Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States, COM(90) 595 final. See discussion in 1.2.5 and 2.8.
¹¹⁰ European Commission, Loss Relief Communication. This Communication was presented within the framework of the Communication on Co-ordinating Member States’ direct tax systems in the Internal Market (COM(2006) 823 final) and provided an example of an area that could benefit from such coordinated approach.
¹¹² Technically, only upstream losses were allowed.
¹¹³ Only 75 per cent direct subsidiaries qualified – indirect shareholdings were not encompassed. However, Member States could allow a lower minimum holding. See Art. 2.
¹¹⁴ Draft Loss Relief Directive, Art. 9(1).
¹¹⁵ Ibid., Art. 12.
¹¹⁶ Member States were given the option of providing for automatic reincorporation under specific circumstances, e.g. when reincorporation had not occurred within five years of the loss becoming deductible, where the subsidiary was sold, wound up or transformed into a permanent establishment and where the enterprise’s holding in the capital of the subsidiary had fallen below the minimum level laid down by the Member State in which the enterprise was situated. See Art. 10.
¹¹⁷ Draft Loss Relief Directive, Art. 13. The application of the deduction and reincorporation method also precluded the tax recognition of value adjustments to shareholdings. See Art. 11. Therefore, double deduction of losses at the level of both the subsidiary and the parent company was prevented.
¹¹⁸ Arguably, some issues were left unaddressed. For example, the differing tax periods between Member States, the order of set-off, the overlap with tax treaties, the exclusion
not well received by Member States and the proposal was subsequently withdrawn, as mentioned in Chapter 1.

The Commission’s approach in its Communication was similar but more nuanced to take into account Marks & Spencer. As for group losses, to which most of the Communication was devoted, the Commission suggested targeted measures for effective and immediate once-only deduction of losses at least in a vertical context. These measures should not normally result in a definite shift of income from one Member State to another, unless the losses were terminal and there was no possibility for relief in the State in which such losses were incurred.\(^{119}\) It is obvious that the Communication built on Marks & Spencer (as it was released after that case but before Oy AA), but it was not confined to the exhaustion of possibilities test. The Commission stressed ‘the need for effective systems to provide cross-border loss relief within the EU’\(^{120}\) and showed its preference for clear rules and temporary entitlement.

By contrast, under the case law of the Court of Justice, the rules are neither clear nor do they provide for temporary solutions. Restrictions to cross-border group relief tend to be allowed, unless they are disproportional. The Court’s judgments are unclear as to the right of the Member State forced to absorb the losses of the foreign subsidiary to demand that future profits of the subsidiary be reincorporated in the tax base of the parent company. In fact, such right would be impossible to exercise in circumstances where there is a terminal loss – ironically, perhaps the only circumstances in which a Member State has been obliged to allow cross-border group relief. It is the actual exhaustion of all possibilities for relief that may legitimise the surrender to the parent company. If it is possible for the subsidiary to become profitable in future years and for its profits to be reincorporated in the tax base of the parent company, then, arguably, all possibilities for relief have not been exhausted for the purposes of the Marks & Spencer test – if this test is considered to have survived the latest case law. As a corollary, a national rule prohibiting cross-border group relief in such circumstances may not be precluded at all. To an extent, by confining itself to a terminal loss concept, the Court of Justice has avoided addressing the issue of the cash-flow disadvantage from the unavailability of temporary loss relief.

\(^{119}\) European Commission, Loss Relief Communication, p. 8.

\(^{120}\) Ibid., p. 10.

of partnerships, and the determination of loss deduction on a per country or an overall basis, etc. HJI Panayi, ‘Reverse subsidiarity and EU tax law’. 

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The developments in EU law are also in stark contrast with the treatment of group relief or consolidation regimes under international tax law, where the unavailability of cross-border loss relief is not treated as discrimination, even if loss relief is available domestically. The same approach is followed under the OECD Model. Whilst Article 24(5) of the OECD Model forbids a contracting State to give less favourable treatment to an enterprise, the capital of which is owned by one or more residents of the other contracting State, ‘[t]his provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital’.\footnote{OECD Commentary to Art. 24, para. 76.} The object of this provision according to the OECD Commentary is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital to identical treatment to that applied to domestic capital.\footnote{Ibid.}

Article 24(5) of the OECD Model only affects the taxation of resident enterprises and not the taxation of the persons owning or controlling their capital. Therefore, as stated in the Commentary to Article 24, it ‘cannot be interpreted to extend the benefits of rules that take account of the relationship between a resident enterprise and other resident enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfer of property between companies under common ownership)’.\footnote{Ibid., para. 77.} It has been argued that this is too widely stated and that it may not apply to some grouping provisions, depending on their details and structure.\footnote{J. F. Avery Jones et al., ‘Art. 24(5) of the OECD Model in relation to intra-group transfers of assets and profits and losses’, (2011) 3(2) World Tax Journal, 179–225.} Nevertheless, the general idea is still that a subsidiary (whether domestic or foreign) is a separate legal person from the parent company. As the parent company is not taxed on the profits of the subsidiary, it should not be required to absorb the subsidiary’s losses. This is especially important in an international context, where taxable profits and unusable losses arise in different jurisdictions.

In any case, as far as group relief is concerned, not only have the judgments of the Court of Justice challenged and eroded established principles in international tax law, they seem to have gone much further than what was originally envisaged by the legislative forces of the Union. Similar but perhaps not as controversial conclusions are reached in the context of loss relief within the same company, which is examined in 5.3.5.
5.2.3 Controlled foreign companies

In order to prevent a situation whereby the profits of a company in a high-tax jurisdiction are sheltered in a controlled subsidiary in a low-tax jurisdiction, the profits of the foreign subsidiary are subject to taxation in the State of the parent company. Such rules fall within the ambit of Controlled Foreign Company (CFC) rules, the rationale of which is explained in greater detail in Chapter 8. EU law now imposes serious constraints on the discretion of Member States to draft their CFC regimes.

In *Cadbury Schweppes*\(^{125}\) the Court held that for Member State CFC rules to be compatible with EU law, they must specifically relate to *wholly artificial arrangements* intended to circumvent the application of the legislation of the Member State concerned.\(^{126}\) The specific objective of the restrictive rules must be to prevent conduct involving the creation of wholly artificial arrangements that do not reflect economic reality.\(^{127}\) As a corollary, CFC rules must exclude from their scope situations whereby, despite the existence of tax motives, the incorporation of a CFC reflects economic reality. In determining whether or not economic reality exists in addition to the subjective element, which consists of the intention to obtain a tax advantage, objective factors must be taken into account.\(^{128}\) These objective factors, which have to be ascertainable by third parties, include, in particular, the extent to which the CFC physically exists in terms of premises, staff and equipment.\(^{129}\) The parent company of the CFC must be given the opportunity to produce evidence that the arrangement is genuine.\(^{130}\)

This and other relevant cases are examined in greater detail in Chapter 8. Suffice to note at this juncture that the freedom of a company to set up a subsidiary in a low-tax jurisdiction may only be restricted under specific circumstances.

5.3 Issues with the taxation of permanent establishments

5.3.1 Defining permanent establishments

Under the OECD Model the technical (treaty) term for a branch is ‘permanent establishment’. This is defined in Article 5 of the OECD Model

\(^{125}\text{Case C-196/04 Cadbury Schweppes [2006] ECR I-7995.}\)
\(^{126}\text{Case C-196/04 Cadbury Schweppes, para. 51.}\)
\(^{127}\text{Ibid., para. 55.}\)
\(^{128}\text{Ibid., paras. 64–65.}\)
\(^{129}\text{Ibid., para. 67.}\)
\(^{130}\text{Ibid., para. 70. The fact that the activities that corresponded to the profits of the CFC could just as well have been carried out by the parent company did not warrant the conclusion that this was a wholly artificial arrangement. More was required. See also para. 69.}\)
for the purposes of the allocation of taxing rights when an enterprise of one State derives business profits from another State. Under the first paragraph of Article 5, ‘permanent establishment’ means a fixed place of business through which the business of an enterprise is wholly or partly carried on. In the second paragraph there is a non-exhaustive list of examples of permanent establishment, such as a place of management and a branch. Certain exclusions are contained in the fourth paragraph. In addition to this physical presence test, Article 5 provides rules for determining when a person acting for the enterprise is deemed to be a permanent establishment (the agency permanent establishment clause).

The Commentary to Article 5 also provides for optional wording for States wishing to tax the services performed within their territory in the absence of a fully-fledged permanent establishment (the service permanent establishment clause). The OECD has issued a discussion draft on the interpretation and application of Article 5 of the OECD Model that mainly affects the Commentary on this provision.

There is no definition or description of the terms 'branch' or 'permanent establishment' in the European Treaties. Under freedom of establishment, the term ‘establishment’ is used but in a much broader and generic way, covering agencies, branches and subsidiaries. There is no express requirement for physical presence and auxiliary or preparatory activities are not

131 See also Art. 5(3) OECD Model, whereby a building site or construction or installation project can only be a permanent establishment if it lasts more than twelve months. In Art. 5(7) it is clarified that the fact that a resident company controls or is controlled by a non-resident company or by a company that carries on business in another State (whether through a permanent establishment or otherwise) does not of itself constitute either company a permanent establishment of the other. For an overview, see Jacques Sasseville and Arvid A. Skaar, 'General Report. Is There a Permanent Establishment? Cahiers de droit fiscal international, Volume 94a (The Hague: Kluwer Law International, 2009), pp. 17–63.

132 See paras. 5 and 6 of Art. 5 of the OECD Model. For the application of this provision in securitisation transactions, see Christiana HJI Panayi, 'Agency permanent establishments in securitisation transactions', (2005) 33(6/7) Intertax, 286–96.

133 See test in para. 42.23 of the OECD Commentary to Art. 5. See also analysis in Christiana HJI Panayi, 'Recent developments regarding the OECD Model Convention and EC law', (2007) 47(10) European Taxation, 452–66.

ab initio excluded, as in Article 5 of the OECD Model. Agency or service permanent establishments do not appear to be included. Permanent establishments are defined in the context of the Parent–Subsidiary Directive and the Interest and Royalties Directive, though the definitions are not identical, as explained in Chapter 2, raising questions as to their actual scope. The concept of permanent establishment features in the Merger Directive,\(^{135}\) but as it is not defined, it is likely to be interpreted in a variable way according to national law or the underlying tax treaty of the relevant Member States. Therefore, it is safe to say that there does not appear to be a uniform concept of permanent establishment in the context of EU direct tax law.\(^{136}\)

The importance of a ‘permanent establishment’ under EU law is not so much how it is defined or applied but rather how it is to be treated for taxation purposes. Whilst the norm under international tax law is for a host State to be able to treat permanent establishments differently from resident companies, in EU law there are certain limitations to this approach, as shown below.

\[5.3.2\] The different treatment of permanent establishments and companies

Tax rules can disrupt the principle of neutrality of legal form. If permanent establishments are taxed differently from subsidiaries, then this could create an incentive to trade through one vehicle rather than another. When there is a cross-border element to this, neutrality of legal form and market access may be impeded. This is because if the permanent establishment of a non-resident company is taxed more heavily than a resident company, this means that the non-resident company is potentially restricted from trading in the host State through that type of establishment. However, in some circumstances there could be legitimate reasons why the permanent establishment (and effectively the non-resident company) is subject to a different tax burden compared to a resident company.

\(^{135}\) Under the Merger Directive relief in the form of deferral depends on the assets remaining connected with a permanent establishment in the Member State of the transferring company. See Chapter 7.

The permanent establishment and the resident company may not be in a comparable situation and, therefore, by taxing them differently, neutrality would not be disturbed.

From a general perspective, freedom of establishment has been interpreted as guaranteeing neutrality of legal form in a cross-border situation. As such, a Member State national should not be restricted in choosing whether to trade in another Member State through a subsidiary (resident) company or a permanent establishment. The creation and the outright ownership by a natural or legal person established in one Member State of a permanent establishment not having a separate legal personality situated in another Member State is considered as falling within the scope of application of freedom of establishment. National tax rules, including rules that differentiate between a resident company and a permanent establishment, have been scrutinised to that effect.

The Court’s case law on discrimination of permanent establishments does not really indicate a de jure or de facto categorisation of a permanent establishment as regards the whole enterprise. Neither do any of the EU tax instruments in which the permanent establishment concept features suggest how this is to be taxed. So far, the focus of the Court has been on the comparability of a subsidiary with a recognised permanent establishment – however this is defined under national law.

In many cases where the comparability point was addressed, the Court of Justice assimilated the permanent establishment to a hypothetical subsidiary: it found a resident company and a non-resident company (through its permanent establishment) to be in a comparable situation. This, however, was not done automatically. In all of the cases the Court first examined the comparability of the permanent establishment and a subsidiary on the facts of each case.

In the first important case decided on direct tax matters, the Avoir Fiscal case, the Court of Justice had to deal with discriminatory taxation of French branches of non-resident companies. Under French tax law, branches of foreign insurance companies were not given the same tax credit (the avoir fiscal) as French companies. The Court found this treatment to be incompatible with freedom of establishment. It expressly acknowledged ‘that a distinction based on the location of the registered office of a company or the place of residence of a natural person may, under


certain conditions, be justified in an area such as tax law’. However, on
the facts of the case resident and non-resident insurance companies were
in a comparable situation. This was because a foreign insurance company,
through its French branch, was subject to taxation in the same way as a
French insurance company. As the Court stated, French tax law did not
‘distinguish, for the purpose of determining the income liable to corpor-
ation tax, between companies having their registered office in France and
branches and agencies situated in France of companies whose registered
office is abroad’. Therefore, the different treatment of the two entities
was discriminatory. By refusing the tax credit to the branch when this
credit was available to a resident company, the foreign company’s choice
of legal form was restricted, contrary to freedom of establishment.

*Commerzbank* was decided in a similar way. Here a UK rule restricted
the so-called ‘repayment supplement’ for late tax refunds to UK compan-
ies. A German company, Commerzbank, through its UK branch, granted
loans to US companies. Commerzbank paid tax in the UK on the inter-
est received from those US companies. Subsequently, it sought repayment
of that sum from the UK tax authorities, on the basis that the interest
was exempt from UK tax under the then applicable USA–UK tax treaty.
Commerzbank received a refund of the overpaid tax. However, it also
claimed the repayment supplement. The UK tax authorities refused the
repayment supplement on the basis that Commerzbank was not resident
in the UK.

The Court of Justice found that the refusal to grant the repayment sup-
plement to the UK branch of a German company was incompatible with
freedom of establishment. This was a case of indirect discrimination. As
the Court explained, although the rule applied independently of the com-
pany’s seat, ‘the use of the criterion of fiscal residence within national ter-
ritory for the purpose of granting repayment supplement on overpaid tax
[was] liable to work more particularly to the disadvantage of companies
having their seat in other Member States’. Non-resident companies
were worse off channelling their loans through a UK branch rather than

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139 Ibid., para. 19.  
140 Ibid., para. 19.  
141 Ibid., para. 22.  
143 Convention of 2 August 1946 between the Government of the United Kingdom of Great
Britain and Northern Ireland and the Government of the United States of America for
the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to
Taxes on Income (SR & O 1946, No 1327), as amended by a Protocol of 20 September
1966 (SI 1966 No 1188).  
144 *Case C-330/91 Commerzbank*, para. 15.
a UK subsidiary. This restricted the choice of legal form that non-resident companies had in structuring their activities in the UK. The domestic provision could not be justified by the fact that the exemption from tax that gave rise to the refund was available only to non-resident companies. This was ‘a rule of a general nature withholding the benefit’. The fact that Commerzbank would not have been exempt from tax had it been resident was of no relevance to the Court.

In *Halliburton* the Court of Justice considered a Dutch concession on transfer tax that was restricted to transfers of immovable property between Dutch-resident companies. In this case, a US company, Halliburton Inc, had a German and a Dutch subsidiary. The German subsidiary had a branch in the Netherlands, through which it owned immovable property. As part of an internal European reorganisation scheme, the German subsidiary transferred its Dutch branch (and, as a corollary, the immovable property) to the Dutch subsidiary. The Dutch tax authorities levied land transfer tax on the Dutch subsidiary. Had this transfer been between two Dutch companies, it would have been exempt from transfer tax.

Again, the Court of Justice found this to be a covert form of discrimination, contrary to freedom of establishment. The conditions for the sale of property owned by a non-resident (through its branch) were more onerous than for residents. It is noteworthy that in *Halliburton* it was the Dutch subsidiary receiving the assets of the former German company that successfully claimed the relief from transfer tax charged on it, even though it had not exercised any Community (at the time) rights. As pointed out by the Court, it was the actual vendor who was ‘in a distinctly less favourable position than if it had chosen the form of a public or private limited company instead of that of a permanent establishment for its business in the Netherlands’. Even if the difference in treatment had only an indirect effect on the Dutch transferee company, this was enough to find discrimination. Therefore, a person other than the one who directly enjoyed the fundamental freedom could also benefit from it if that freedom could not otherwise be fully effective.

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145 Ibid., para. 19.
147 Ibid., para. 19.
148 Ibid., para. 19.
149 Ibid., para. 20.
150 Although Advocate General Kokott in her opinion in Case C-18/11 *Philips Electronics*, para. 83 assumes that, following this and other cases, it does not matter who challenges the application of the legislation provided the person bringing the challenge is
In other cases the Court of Justice held that the taxation of branches at a higher rate than resident companies could violate freedom of establishment. In *Royal Bank of Scotland*\(^{151}\) Greece effectively imposed a higher tax rate on foreign companies carrying on banking activities in Greece through a branch rather than through a resident company.\(^{152}\) This was found to be unjustifiably discriminatory. It was not important to the Court that resident companies were taxed on the basis of their worldwide income and non-resident companies were taxed only on the income generated domestically. As the basis of assessment for corporation taxation was calculated in the same way for both companies, they were in an objectively comparable situation.

In *Saint-Gobain*\(^{153}\) the Court of Justice even went as far as to require the extension of tax treaty benefits to branches when such treaty benefits were only applicable to resident companies. Here the Court had to decide whether the refusal to grant concessions to German branches of companies established in other Member States was compatible with the freedom of establishment, when similar benefits were available to German companies under tax treaties between Germany and third countries. The Court found that as far as the grant of the tax concession was concerned, the German branch and the German company were in a comparable situation because they were both taxed on the dividends received in the same way. Even though in this case a resident and a non-resident company were taxed on a different basis (worldwide and limited basis respectively), what was important was the fact that as regards the taxation of dividends received they were in a comparable situation. As a result, the refusal to grant those tax concessions, which primarily affected non-residents, made it less attractive for such companies to have inter-corporate holdings through branches in the Member State concerned.\(^{154}\) Therefore, it violated

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\(^{152}\) Although the same tax rate applied to both foreign and domestic companies, only domestic companies could qualify for a reduced tax rate because of conditions relating to the legal form and the nature of shares to be issued.

\(^{153}\) *Case C-307/97 Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt* [1999] ECR I-6161. The case was also discussed in 4.3.3.

\(^{154}\) Ibid., para. 42.
freedom of establishment. Germany had to extend benefits unilaterally to
German branches of companies resident in other Member States.

It could be argued that following this case, when dividend relief is
available for intra-group distributions, relief may have to be extended to
permanent establishments in respect of dividends on holdings forming
part of their assets. This should be contrasted with the situation under
the OECD Model, which does not currently impose such an obligation on
States, leaving it to them to decide whether to provide for such extension
of relief for permanent establishments.\footnote{See Art. 24(3) of the OECD Model. The
Commentary notes the divergent positions taken by countries on this point. One viewpoint is that
dividend relief should be extended to permanent establishments holding shares as direct investment
where it is widely and unconditionally available between two resident companies. In both
situations a profits tax has already been levied on profits in the hands of the subsidiary. A second
levying of tax in the State of the permanent establishment would mean that the State where
the head office of the company is situated has to give relief from double taxation, giving rise
to difficulties. Another viewpoint is that the aim of dividend relief is to avoid economic
double taxation of dividends and it should be for the recipient company’s State of resi-
dence and not the State of the permanent establishment to bear the cost of dividend
relief, because it is more interested in the aim in view. Extending the dividend relief to
permanent establishments might also lead to loss of revenue. See OECD Commentary to
Art. 24, paras. 48–54.}

In another case the Court of Justice held that Member States must not
apply a higher tax on branch profits compared to the rate applicable to
the \textit{distributed} profits of resident companies. In \textit{CLT-UFA SA},\footnote{Case C-253/03 \textit{CLT-UFA SA} [2006] ECR I-01831.} under
the then applicable German split-rate system, profits of German branches
were subject to corporate income tax at a rate of 42 per cent. The retained
profits of German companies were subject to corporate income tax at a
rate of 45 per cent. If these profits were distributed to the parent company
by 30 June 1996, the tax rate was reduced to 33.5 per cent.\footnote{Under the transitional provisions of the Parent–Subsidiary Directive, Germany was
allowed to levy a 5 per cent withholding tax on dividends until 30 June 1996.} If the profits
were distributed after that date, they were taxed at 30 per cent.

The Court of Justice found that these rules were incompatible with
freedom of establishment. The effect of the split-rate system was that
for a foreign company, forming a branch was less attractive than form-
ing a subsidiary. This restricted the foreign company’s freedom to choose
the appropriate legal form in which to pursue cross-border economic
activities.\footnote{Ibid., para. 14.}
The German government tried to argue that a branch and a subsidiary were not in an objectively comparable situation with regard to profit distributions. A subsidiary no longer owned the profits distributed to its parent company whilst the profits transferred by a branch to its head office continued to be internal assets of the same company.\(^\text{159}\) The Court of Justice disagreed with this argument. The only real difference between profit distributions by subsidiaries and profit transfers by branches was that the former but not the latter presupposed the existence of a formal decision to that effect.\(^\text{160}\) According to the Court, this was a mere technicality that did not nullify the comparable situation between the two vehicles. Having found that freedom of establishment precluded such national rules, the Court of Justice left it to the referring court to decide the rate that should apply on German branches.\(^\text{161}\)

It is important to stress that in all of the above cases the Court did not say that residents and non-residents are always in a comparable situation. Therefore, it should not be assumed that, for EU tax law purposes, subsidiaries are always assimilated to permanent establishments and entitled to the same tax treatment, although, arguably, an effort is made to that effect in some of the Directives.\(^\text{162}\) One issue to bear in mind is that, currently, the comparability exercise is undertaken from a tax perspective only. In other words, only the tax rules applying to the permanent establishment and the subsidiary are considered by the Court of Justice. However, is this approach right? What about other non-tax differences (e.g. the availability of limited liability, separate legal entity, different accounting obligations) or other general regulatory differences that may be the underlying reason for the different tax treatment in the host State – that is the State where the permanent establishment is set up? Whilst it may not be easy to take into account the whole regulatory framework that applies to a resident company and the permanent establishment of a non-resident company, one cannot help but wonder whether confining the comparability exercise to the tax factors (always) yields an accurate and fair result.

\(^{159}\) Ibid., paras. 19–20.

\(^{160}\) Ibid., para. 23. In the case of a subsidiary, even if the distributed profits were no longer part of its assets, those profits could still be made available to that subsidiary by its parent company in the form of share capital or shareholder loan. Ibid., para. 24.

\(^{161}\) Ibid., para. 37.

\(^{162}\) As stated in Chapter 2, there are certain provisions in the Interest and Royalties Directive and the amended Parent–Subsidiary Directive that seek to ensure that permanent establishments benefit from these Directives in the same way as companies.
In any case, this appears to be the Court’s stance so far. Permanent establishments are not always assimilated to subsidiaries – everything depends on the facts of the case. Nevertheless, when it comes to a non-resident company claiming equal tax treatment in the host State, the comparability criterion tends to be satisfied when the permanent establishment – whether itself or on the basis of profit distributions received – is taxed in a similar way to resident companies. Other regulatory differences are not to be taken into account. In such circumstances the host State has to ensure equal treatment of resident companies and permanent establishments of non-resident companies.

This should be contrasted with the position taken under the OECD Model. As mentioned a few times in this book, the protective scope of the non-discrimination provision of the OECD Model does not extend to non-residents, even if they are in a comparable situation to residents. The OECD Model starts from the assumption that residents and non-residents are not in a comparable situation unless residence has no relevance whatsoever with respect to the different treatment under consideration. Therefore, the starting point is that indirect/covert discrimination on the basis of residence is not accepted.

However, the non-discrimination provision of the OECD Model provides some limited protection to permanent establishments by requiring that ‘[t]he taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities’. Under this provision, discrimination on the basis of different taxation is not impugned, as long as this different taxation is not more burdensome. States may, therefore, apply specific mechanisms only for the purposes of determining profits attributable to the permanent establishment, or rules and administrative practices that seek to determine the profits that are attributable to it, as long as taxation is not less favourable than that levied on a domestic enterprise carrying on similar activities.

In calculating the tax rate on the permanent establishment’s profits, the host State might take into account profits of the whole enterprise. However, it is only the actual profits attributed according to Article 7(2) of the OECD Model that can be taxed. The Commentary clarifies that paragraph 3 of Article 24 of the OECD Model is restricted to the taxation of

\[\text{163} \text{ Art. 24(3) OECD Model.}\]
\[\text{164} \text{ OECD Commentary to Art. 24, para. 34.}\]
profits from the activities of the permanent establishment itself and does not extend to the taxation of the enterprise as a whole. As a corollary, if the more burdensome taxation relates to the whole enterprise, this is not discriminatory. It is only discriminatory under Article 24(3) when it relates to the taxation of the permanent establishment – that is if the net profits of a permanent establishment are taxed at a higher rate than the net profits of a resident taxpayer.

Sometimes the two situations may not be distinguishable. The Commentary to the OECD Model gives the examples of branch tax and branch level interest tax. These are effectively additional taxes imposed on branch profits to compensate for the fact that no dividend withholding tax can be levied on such profits when repatriated to the non-resident head office. The branch tax is considered to be contrary to Article 24(3), being a (supplementary) tax levied on the profits of the activities of the permanent establishment itself and not a tax on the enterprise in its capacity as owner of the permanent establishment. By contrast, the branch level interest tax is considered to be a tax on the enterprise and as such compatible with Article 24(3) of the OECD Model. Although, as argued, this is a tax on amounts that would be deducted in computing the profits of the permanent establishment, for instance interest, ultimately it is a tax on the enterprise to which the interest is considered to be paid. The reasoning of the OECD Commentaries on this point is not very convincing and has been criticised.

Notwithstanding the limitations of the Commentary, it still seems to be the underlying assumption of the OECD Model’s non-discrimination provision that, to the extent that it is the non-resident company that is being taxed detrimentally, this is not a problem. It is only when profits of the permanent establishment are taxed in a more burdensome way that Article 24(3) of the OECD Model may offer some protection. EU law does not make such a distinction. Even though a permanent establishment is frequently compared to a resident subsidiary as if it is a separate legal entity, the Court does not seem to exclude the effect of taxation on the profits of the enterprise as a whole in assessing compatibility with the

165 Ibid., para. 59. 166 Ibid., para. 60. 167 Ibid., para. 61.
freedom of establishment. In other words, the Court does not (yet) seem to draw distinctions between tax rules affecting profits of the permanent establishment per se compared to tax rules affecting the enterprise in its capacity as owner of the permanent establishment. If anything, the protection tends to be sought by the non-resident that exercises its freedom of establishment by setting up a permanent establishment. The aim is not of itself to neutralise the taxation of companies and permanent establishments. In other words, the aim is not unconditional neutrality of legal form. The aim is to lift restrictions in choosing the legal form of a secondary establishment, to the extent that this entails discrimination based on the location of the corporate seat. The same approach is followed as regards the attribution of profits, considered next.

5.3.3 Rules for the attribution of profits and expenses

The case law above shows how much more difficult it has become for Member States to tax permanent establishments (of non-resident companies) in a more burdensome way than resident companies. Rules on the attribution of profits to permanent establishments, set out in Article 7 of the OECD Model, may have been affected in a similar way.

Following the 2010 update to the OECD Model, which adopted the Authorised OECD Approach (AOA) for the purposes of Article 7, the profit attribution rule of the OECD Model is to be interpreted in accordance with the arm’s length principle, irrespective of the fact that a permanent

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169 See also the 2010 version of the OECD’s Report on the Attribution of Profits to Permanent Establishments, which updates the 2008 version. The 2010 version does not change the conclusions of the previous version of the report but aligns its wording with the text of the new Art. 7 and the revised Transfer Pricing Guidelines.

170 The method of calculating the profits to be attributed has been the subject of debate in OECD circles and was one of the topics discussed at the International Fiscal Association conference in 2006. Broadly, there were two competing approaches. Under the relevant business activity approach, a permanent establishment was considered to form part of a single enterprise. The profits of this single enterprise could only be earned from transactions with third parties and with associated enterprises and not between the permanent establishment and the enterprise. Under the functionally separate entity approach, a permanent establishment was treated as a separate entity. Here the profits could be earned from (deemed) transactions between the permanent establishment and the enterprise. Accordingly, profits could accrue and be attributed to the permanent establishment, even though no profit had been realised by the enterprise as a whole. See Philip Baker and Richard Collier, ‘General Report’, The Attribution of Profits to Permanent Establishments, Cahiers de droit fiscal international, Volume 91b (The Hague: Kluwer Law International, 2006).
establishment is not a legal entity distinct from the head office. The aim of this amendment was to align the rules on taxing business profits under Article 7 of the OECD Model with the transfer pricing rules of Article 9 by allocating profits to permanent establishments as if they were separate legal entities. Under Article 7(2) of the OECD Model, the profits that are attributable to the permanent establishment in the host State are the profits that it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through other parts of the enterprise.

EU law does not seem to interfere with the separate entity approach and the application of the arm’s length principle of the AOA. The issue of attribution of profits is not as developed and is perceived as a question of allocation of taxing powers. By way of example, in the SGI case\textsuperscript{171} the Court refrained from striking down the Belgian transfer pricing rules on the allocation of expenses between related companies, even if they restricted the freedom of establishment in a rather pre-emptive manner. The Court found the rules to be justified on the basis of preventing tax avoidance, taken together with the need to preserve the balanced allocation of the power to impose taxes between Member States. The case is analysed in greater detail in Chapter 8.

Neither has the EU imposed by way of legislation any rules dealing with attribution of profits. As discussed in Chapter 2, there is an Arbitration Convention that seeks to establish an arbitration procedure that eliminates double taxation in the course of transfer pricing disputes, including disputes on profit attributions between Member States.\textsuperscript{172} The Arbitration Convention is based on the arm’s length principle. However, unlike a Directive or Regulation, the Convention is merely an agreement under public international law and, as such, subject to the jurisdiction of national courts only. Therefore, the issue of attribution of profits has so far remained within the ambit of the powers of Member States.

There is one aspect of attribution of profits where EU law might be relevant – the allocation of expenses. Under Article 7(3) of the OECD Model, expenses incurred by an enterprise for the purposes of the permanent

\textsuperscript{171} Case C-311/08 Société de Gestion Industrielle (SGI) v. État belge [2010] ECR I-487.

\textsuperscript{172} See analysis in 2.5.
establishment\textsuperscript{173} will be directly deducted in determining its profits. In addition, other expenses attributed to another part of the enterprise for functions performed for the benefit of the permanent establishment (e.g. overhead expenses) may be reflected in a notional charge to the permanent establishment.\textsuperscript{174} As a result of these rules, companies have an incentive to manipulate their tax bases by allocating expenses where profits are taxed or where profits are taxed at higher rates. Both host States and home States may impose limits to such practices.\textsuperscript{175} For example, the State of the permanent establishment, as host State, may refuse to take into account all expenses incurred by the permanent establishment or expenses that seem to be linked to the carrying on of the business by both the permanent establishment and the head office. However, even if the host State treatment is compliant with Article 7(3) and the AOA approach, it still has to be questioned whether it is compatible with EU law.

The Court of Justice dealt with the issue of expenses in \textit{Gerritse},\textsuperscript{176} a seminal case in the context of the cross-border provision of services. Here a Dutch musician, who performed in Germany, was not allowed to deduct business expenses unless they exceeded 50 per cent of the receipts. On this point the Court found that the inability of a non-resident to deduct business expenses was incompatible with the freedom to provide services. The Court noted that business expenses were ‘directly linked to the activity that generated the taxable income in Germany, so that residents and non-residents [were] placed in a comparable situation in that respect’.\textsuperscript{177} As the rule risked operating mainly to the detriment of nationals of other Member States, it constituted indirect discrimination on grounds of nationality.\textsuperscript{178}

\textit{Gerritse} was followed in the \textit{Centro Equestre} case,\textsuperscript{179} where the facts were very similar. Here a Portuguese company organised a tour of equestrian

\begin{itemize}
\item It should be pointed out that this is not the same as saying that the expenses have been incurred as part of the activity carried on through the permanent establishment, which is the test for taking into account payments received by a permanent establishment. Therefore, expenses incurred in carrying on activities through a permanent establishment are not deducted unless the expenses have been incurred for the purposes of the permanent establishment. See discussion in Peter Harris and David Oliver, \textit{International Commercial Tax} (Cambridge University Press, 2010), pp. 159–60.
\item OECD Commentary to Art. 7, para. 34.
\item See also analysis in 6.1.
\item Case C-234/01 \textit{Arnoud Gerritse v. Finanzamt Neukolln-Nord} [2003] ECR I-5945.
\item Ibid., para. 27. \textsuperscript{178} Ibid., para. 28.
\end{itemize}
shows in various European countries, including Germany. Under German law at that time, non-resident companies were subject to a fixed withholding tax. They could claim a refund of that tax for business expenses if two conditions were satisfied. Firstly, the operating expenses claimed must have had a direct economic connection to the income generated in Germany. Secondly, the expenses exceeded half of the overall income. In contrast, German-resident companies could deduct all of their operation expenses in Germany. The business expenses of the Portuguese company were less than half of the overall income. Accordingly, the non-resident company was denied the refund. It was questioned whether this was compatible with the freedom to provide services.

The Court of Justice held that the second condition was incompatible with the freedom to provide services but not the first condition. Giving some guidance on the concept of direct economic connection, the Court noted that operating expenses directly connected to the income received in the Member State in which the activity was pursued must be understood as being expenses that have a direct economic connection to the provision of services giving rise to taxation in that State and that are inextricably linked to those services, such as travel and accommodation costs.\textsuperscript{180} The place and time at which the costs were incurred were immaterial.\textsuperscript{181}

Although these cases were in the context of the freedom to provide services and dealt with non-resident individuals and companies without a permanent establishment in the host State (i.e. the State of activity), there is no reason why the principles set out by the Court cannot be applied in this context too. If anything, the existence of the permanent establishment of the non-resident individual or company in the host State lends further support to the argument that these non-resident persons are in a comparable situation with a resident person and, as such, deserve to have their expenses deducted in a similar way. Even though the non-resident person in the above cases was seeking to deduct the expenses it incurred in the host State from its taxable base and not that of its permanent establishment, the fact remains that the taxable base was linked to the host State. Whilst the two situations are not identical, arguably the effect is rather similar. Furthermore, the requirement for direct economic connection may not be too dissimilar with the current approach in Article 7(3) of the OECD Model, to the extent that the host State follows this approach. It may be more difficult to decide this point if the host State consolidates the profits/losses of the permanent establishments and uses

\textsuperscript{180} Ibid., para. 25. \textsuperscript{181} Ibid.
formulary apportionment, as the link between the taxable base and the host State becomes more tenuous.

Home State restrictions on expense allocation may be more fine-tuned. In the context of exemption countries, as the allocation of expenses to a foreign permanent establishment reduces the (exempt) foreign income, this creates an incentive for a company to allocate the expenses to its domestic taxable profits. Home States may not recognise such expenses or deem them to have arisen in the host State. To the extent that these expenses are linked with the company’s business in the home State, this may lead to a restriction of the freedom of establishment. By having a foreign permanent establishment, the resident company is not able to use up (some of) its expenses.

The allocation of foreign expenses may also give rise to home State issues even if that State imposes worldwide taxation, as the expense allocation might have an impact on the amount of foreign tax relief given. This is because the deductibility of foreign expenses reduces the foreign tax payable and, as a corollary, limits the amount of foreign tax credit that a home State may be obliged to give. To the extent that rules on expense allocation reduce the allowable foreign tax credit, they create a disincentive for the setting-up of a permanent establishment in another Member State, contrary to freedom of establishment.

This issue was encountered in the Seabrokers case. Here one of the questions that the EFTA Court had to deal with was whether Norway was in breach of its obligations under the EEA Agreement for apportioning part of the debt interest expenses of a Norwegian company to its UK branch, when those expenses were linked to the company’s business activities in Norway (the home State). As this led to a reduction of the maximum credit allowance given by the home State, it restricted the Norwegian company’s freedom of establishment.

The Court distinguished three situations. Firstly, when expenses were linked to the income of a company’s branch in the host State (here another EEA State) and not linked to the company’s income in the home State, such company was not in a comparable situation to a company whose expenses were all incurred in the home State. Therefore, such company

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182 For a discussion on the exemption and credit methods of relief, see 1.1 and 6.1.
183 On foreign tax relief and limitations to it, see Chapter 6.
184 For the mechanisms of this, see 6.1.
186 The Court also examined the treatment of deductible group contributions and decided the question the same way as for interest expenses.
could not expect the same tax treatment by the home State with regard to expenses related to the branch in the host State. To the extent that the host State did not grant a deduction for expenses relating solely to the income of the branch, the resulting burden for the taxpayer was simply a consequence of the two States exercising their different tax regimes in parallel.\textsuperscript{187}

The same conclusions followed when expenses were not linked to any particular business activities of a company in the home State or the host State (through its branch) and expenses were attributed in proportion to the parts of the global net income earned in these two States. Again, here the company was not in a comparable situation to one whose expenses arose solely in the home State. If the host State did not grant a similar proportional deduction for expenses when calculating the tax on the income of the branch, the resulting burden for the company was simply a consequence of the disparity from the exercise of tax powers of the two States.\textsuperscript{188}

By contrast, a company conducting all its business in its home State and having all its debt interest expenses linked to that State was in a comparable situation to a company conducting its business in its home State and through a branch in the host State but having all its debt interest expenses linked to the home State. Therefore, these companies had to receive the same tax treatment in the home State.\textsuperscript{189} Here, as the different treatment led to a reduction of the maximum credit allowance given by Norway, there was a restriction to the freedom of establishment.\textsuperscript{190} The Court did not assess justifications to these restrictions, as none were given.\textsuperscript{191}

\subsection*{5.3.4 Notional payments and expenses}

What may be even more problematic in the EU context are the taxation of notional payments and the allocation of (notional) expenses as a result of internal dealings between the permanent establishment and the head office. In the current OECD Commentary, the AOA – the separate and independent enterprise approach – only applies to determine the profits attributable to the permanent establishment for the purposes of Articles 7 and 23A and 23B, and does not change the nature of the income derived by the enterprise.\textsuperscript{192} Therefore, notional payments for internal dealings

\begin{flushleft}
\begin{itemize}
\item \textsuperscript{187} Ibid., para. 54.
\item \textsuperscript{188} Ibid., para. 55.
\item \textsuperscript{189} Ibid., para. 56.
\item \textsuperscript{190} Ibid., paras. 56–57.
\item \textsuperscript{191} Ibid., para. 69.
\item \textsuperscript{192} OECD Commentary to Art. 7, para. 28.
\end{itemize}
\end{flushleft}
between the head office and the permanent establishment or between permanent establishments do not give rise to taxation.

Nevertheless, if States decide to extend the separate and independent enterprise fiction beyond these confines, then internal dealings can be recognised. In that case, notional charges for dealings will be deducted in computing the profits of the permanent establishment in the same way as a payment made by a subsidiary to its parent company would be deducted. This would not lead to the creation of notional income for the enterprise that a State could tax under another provision.

Whilst the Commentary discusses the possibility of notional payments/expenses in the context of Articles 6 and 11 of the OECD Model only, in some States this approach may be extended to other tax-deductible (notional) income such as royalties. As a result, withholding taxes could be imposed on such notional rents, interest and royalties. This may even be extended to dividends considered to be a notional return on ‘free’ capital, having a similar effect to branch profit taxes. Arguably, the limitations of Article 10 of the OECD Model would not apply in this situation, as they do not apply to intra-company dividend payments.

It is unclear whether the taxation of such notional payments is compatible with EU law. Arguably, the Directives do not apply as they can only cover payments between two companies (albeit with the insertion of permanent establishments in some cases). Therefore, intra-company payments do not benefit from the Directives and it is unlikely that such a broad interpretation of the Directives will be adopted by the Court.

However, the fundamental freedoms may be applicable. If the comparability analysis focuses on the payment and the discriminatory withholding tax on it, then case law on withholding taxes on outbound payments by companies may be relevant. If the comparability analysis focuses

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193 Ibid., para. 29.
194 E.g. rent under Art. 6 of the OECD Model when the economic ownership of a building used by a permanent establishment is attributed to the head office, or interest under Art. 11 of the OECD Model.
195 See para. 28.
196 See 5.3.2. See also Georg W. Kofler and Servaas Van Thiel, ‘The “authorized OECD approach” and European tax law’ (2011) 51(8) European Taxation, 327–33, 331–2.
197 See, for example, Case C-247/08 Gaze de France – Berliner Investissement SA v. Bundeszentralamt für Steuern [2009] ECR I-09225, where the Court refused to imply another type of company in the Annex to the Parent–Subsidiary Directive. See also Case C-48/07 Les Vergers du Vieux Tauves [2008] ECR I-10627, where the Court did not recognise a company with a right of usufruct as a parent company. See 2.1.2.
198 See analysis in 6.3. So far, only withholding taxes on outbound dividends have been struck down. Withholding taxes on interest payments were left intact in Case C-282/07
on the discriminatory taxation of a permanent establishment in the host State, because payments are deemed and taxed that would not have been deemed and taxed if the head office were in the same State as the permanent establishment, then the case law examined in this chapter is relevant. It is noteworthy that in the CLT-UFA case the Court of Justice compared the tax treatment of profits made by a permanent establishment of a non-resident company with the distribution of profits of a subsidiary to its parent company – and it appeared to assimilate the two. Therefore, if no outbound tax is allowed for distributions between group companies, either because of the Directives or the application of fundamental freedoms, should the same treatment be extended to notional payments by permanent establishments?

In my view, this analogy should not be assumed. In CLT-UFA the Court focused on the taxation of the permanent establishment itself and not its notional payments. The comparison with the subsidiary was to show that the profits of a permanent establishment were effectively treated the same way as the (corporate) profits of a subsidiary and, as such, should not be subject to a higher tax burden. The tax treatment of any future distributions to the parent company was merely one aspect of the comparison, which perhaps should never have been raised at all. In my view, it is not possible from this case to deduce a general assumption as to the comparability of notional payments of permanent establishments (effectively being profits of permanent establishments) and corporate distributions. The fact that the Parent–Subsidiary and Interest and Royalties Directives do not expressly follow such approach, nor have they been interpreted as doing so, would corroborate this conclusion. Nevertheless, it cannot be excluded as a possibility that the Court will apply its case law on outbound and inbound dividends in the context of (notional) cross-border payments of a permanent establishment to its head office, whatever the theoretical objections to this approach.

5.3.5 Cross-border loss relief

Cross-border group relief was examined in 5.2.2. Intra-company loss relief is just as problematic. While relief is almost always available if both

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État belge – SPF Finances v. Truck Center SA [2008] ECR I-10767, though as argued in Chapter 6 this is likely to be reversed.

199 See above, 5.3.2. 200 Case C-253/03 CLT-UFA.
the head office and the permanent establishment are in the same State, if they are not, relief may be available but often subject to conditions. Here the issue is not whether there has been proper allocation of the expenses to the foreign branch. Rather, the issue is whether the branch losses (effectively, the excess of expenses over proceeds), which are foreign losses, can be surrendered to the head office. This is a home State question. There are broadly two different approaches to this in international tax law. Either both foreign branch profits and losses are always exempt without exceptions, or foreign branch losses are included in the domestic tax base but recaptured when the branch becomes profitable. The OECD Model Convention, together with its Commentary, does not take a position on this point, and leaves the choice to the contracting States.

In two cases the Court of Justice looked at the reverse scenario: profits of foreign branches being used to reduce losses of the head office. The Court examined this from a host State perspective in Case C-250/95 Futura and from a home State perspective in Case C-141/99 AMID.

In the first case, Futura was a French company that wanted to carry forward losses against the profits of its Luxembourg branch. Under Luxembourg law, local branches of non-resident companies could only carry forward losses if these losses were economically linked to the branch, provided that resident taxpayers did not receive more favourable treatment. The branch was also required to keep accounts according to Luxembourg law. The Luxembourg tax authorities refused relief because they considered the losses to be attributable to the French head office rather than to the Belgian branch.

The Court of Justice found that the source (host) State rule restricting the loss carry-forward to losses that had an economic link with income earned in that State could be justified under the territoriality principle. As the Court stated, ‘[s]uch system, which is in conformity with the fiscal principle of territoriality, cannot be regarded as entailing any

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201 See also European Commission Loss Relief Communication, pp. 3–4.
202 See CFE, Opinion Statement of the CFE ECJ Taskforce on Losses Compensation within the EU for Individuals and Companies Carrying Out their Activities through Permanent Establishments, July 2009, p. 1.
203 OECD Commentary to Art. 23A and 23B, para. 44.
206 Case C-250/95 Futura, para. 43.
discrimination, overt or covert, prohibited by the Treaty’. Nevertheless, the requirement for the Luxembourg branch to keep accounts according to Luxembourg law was held to be disproportionate.

In any case, Futura stands for the proposition that a host State (i.e. the State of the permanent establishment) cannot be obliged to set off the losses of the foreign head office against the permanent establishment’s profits due to territoriality concerns. There is nothing to prevent the host State from requiring evidence of the economic nexus of the losses with the branch. Whilst at the time Futura may have been seen as a logical decision, following Marks & Spencer its strength as a precedent is questioned. If in certain circumstances a parent company is forced to absorb the losses of its foreign subsidiary – a completely separate entity – then why is the profitable part of one company not also to be forced to absorb losses of another (foreign) part of the same company? If anything, the latter appears more justifiable, as there is no separate entity and no piercing of the corporate veil involved. Furthermore, the qualification of the Court that the host State can ignore foreign losses provided its resident taxpayers do not receive more favourable treatment (i.e. Luxembourg companies being able to use foreign branch losses) suggests that the territoriality justification is not absolute.

In AMID the Court of Justice examined the situation from the perspective of the home State and reached a different conclusion from that in Futura. The Court found that a Belgian company with a Belgian branch was in a comparable situation to a Belgian company with a Luxembourg branch. There was a difference in treatment in so far as the deduction of losses was concerned. Losses incurred in Belgium could be carried forward by companies established exclusively in Belgium. By contrast, if the loss-making Belgian company had a profit-making foreign branch, then these losses had to be set off against the branch profits (here the Luxembourg branch) even though the profits were tax exempt under the applicable tax treaty between the two Member States.

The Court of Justice found that, by setting off domestic losses against profits exempted by the tax treaty, the Belgian legislation established a differentiated tax treatment as between companies incorporated under national law having domestic establishments only and those having establishments in another Member State. Those companies were likely to suffer a tax disadvantage that they would not have suffered if all their

207 Ibid., para. 22. 208 Ibid., para. 43.
establishments were situated in the Member State of origin. This difference in treatment was not justified. Therefore, the home State was prevented from demanding the offsetting of domestic losses against (exempt) income of the foreign branch before the carry-forward of unrelieved losses could be allowed.

There has been a lot of criticism that the reasoning in this case was flawed. The problem with the Court’s analysis in AMID is that the same tax treatment would have occurred in a domestic context. Losses of the head office would have been set off against the profits of a domestic branch first, before being carried forward. Therefore, Belgian companies with Belgian branches were treated the same way as Belgian companies with Luxembourg branches.

Furthermore, the Court ignored the fact that foreign branch profits and foreign branch losses were in essence treated symmetrically under Belgian law. By allowing the carry-forward, Belgium would have given relief domestically for foreign branch losses even if branch profits were exempt. Nevertheless, this asymmetrical treatment was not a relevant consideration. To an extent, other than the comparability argument, which was misapplied, the Belgian government had not really made an effort to justify the difference in treatment – a point raised by the Court. This does not, however, change the fact that the reasoning was flawed.

Perhaps AMID was the Court’s (wrong) reaction to the Futura case. As the host State (i.e. the State of the permanent establishment) was not obliged to absorb the losses of the foreign head office following Futura, if no obligation was imposed on the home State, then losses may have gone unrelieved. The problem with this approach, though, is that it shifts the burden onto the home State. Whilst this could have been permissible as regards losses that could never be relieved elsewhere (e.g. if the Belgian company ceased trading and its losses were final, a reverse Marks & Spencer scenario), this was not the situation in AMID. Here the taxpayer did not complain of unrelieved losses – it complained of the fact that it did not have the choice of carrying forward those losses rather than setting them off against profits of the branch.

Arguably, a better approach would have been to question whether, by taking into account exempt branch profits that were also taxed in the host State, the home State created unrelieved double taxation. Following

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209 Case C-141/99 AMID, para. 23.
210 See analysis of legislation in para. 4 in Case C-141/99 AMID.
211 Ibid., para. 24.
212 Ibid., para. 32.
Kerckhaert–Morres and Damseaux, however, this argument is more likely to fail, being the result of disparities from the exercise in parallel of the fiscal sovereignty by two Member States. 213 Neither is it likely that the host State will be required to take into account the Belgian treatment of the Luxembourg branch profits, especially since this was contrary to the underlying tax treaty – that is the allocation of taxing powers between those States. If anything, with hindsight it seems that the most appropriate way to deal with such a situation would have been to seek redress in the home State for the treaty override, if any.

It is uncertain whether the end result of AMID is more appropriate in the context of a home State that adopts a credit system for taxing foreign profits. 214 The argument is as follows: if domestic losses have to be set against foreign branch profits first and cannot be carried forward, this would lead to fewer losses being carried forward and more excess foreign tax credits. As excess foreign tax credits are more difficult to use than carried-forward losses, this leads to detrimental treatment. Whilst there is some logic in this argument, the Court of Justice may be reluctant to get embroiled in the controversy of whether restrictions on the use of excess foreign tax credits, an inherent feature of today’s credit systems, breach EU law.

Subsequent cases dealt with the inability to set off foreign branch losses vis-à-vis domestic profits. Whether the principles arising from these judgments also apply in the reverse scenario – that is whether foreign branch profits can be used to absorb domestic losses – remains to be seen. The principles set out in these judgments do not appear to make a distinction.

In Lidl Belgium 215 German legislation prevented losses incurred by the Luxembourg branch of a German company from being set off against the profits of the company. 216 The Court of Justice found this to be a restriction to the freedom of establishment. A provision that allowed losses incurred by a branch to be taken into account in calculating the profits and taxable

213 See 4.3.3 and 6.2.3.
215 Case C-414/06 Lidl Belgium. A similar case dealing with a non-EU branch was dismissed by the Court of Justice by order for not falling within the protective scope of freedom of establishment: Case C-415/06 Stahlwerk Ergste Westig GmbH/Finanzamt Düsseldorf-Mettmann [2007] ECR I-152.
216 This is because, under the tax treaties with Luxembourg, Germany exempted both profits and losses of foreign branches. Therefore, both profits and losses of a Luxembourg branch were removed from the taxable base of the German company.
income of the head office was a tax advantage.\footnote{217} This tax advantage was only available to companies with domestic branches.\footnote{218} Therefore, the tax situation of a German company with a branch established in another Member State was less favourable than it would be if the branch was established in Germany. This restricted the freedom of establishment of the German company.\footnote{219}

It is rather unfortunate that, prior to the comparability analysis, the Court felt the need to make general, and to an extent inaccurate, statements on the nature of a permanent establishment as constituting ‘under tax convention law’ an autonomous fiscal entity,\footnote{220} such characterisation also being consonant with ‘international legal practice as reflected in the [OECD] model tax convention’.\footnote{221} This conclusion is not in line with the common understanding of the nature of a permanent establishment in international tax law, which is definitely not considered as a separate fiscal entity by OECD Member States but rather as part of a single legal entity.\footnote{222} Whilst the OECD Model through the AOA of Article 7 may apply a fiction for the purposes of attributing profits to the permanent establishment in the host State,\footnote{223} this does not render the permanent establishment an autonomous legal entity. In any case, there was no need to justify the application of the Marks & Spencer case by erroneously assimilating the legal nature of a permanent establishment with that of a subsidiary. It was enough to compare the tax treatment of a resident company with a domestic permanent establishment with that of a resident company with a foreign permanent establishment – something that the Court in fact did.

The Court found the restriction to be justified on the basis of two of the Marks & Spencer grounds: the preservation of allocation of taxing powers and the prevention of double relief of losses.\footnote{224} There was no need for all three justifications to be applicable.\footnote{225} The restriction was also sufficiently targeted and proportional.\footnote{226} The Court of Justice found that the Marks

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\item \footnote{217} Case C-414/06 Lidl Belgium, para. 23.
\item \footnote{218} Ibid., para. 24.
\item \footnote{219} Ibid., para. 25.
\item \footnote{220} Ibid., para. 21.
\item \footnote{221} Ibid., para. 22.
\item \footnote{223} See 5.3.3.
\item \footnote{224} Case C-414/06 Lidl Belgium, paras. 30–37.
\item \footnote{225} Ibid., paras. 40–41. The Court of Justice referred to the Oy AA judgment, where again only two of the Marks & Spencer grounds for justification were applicable. Case C-231/05 Oy AA, para. 60.
\item \footnote{226} Ibid., para. 43.
\end{itemize}
& Spencer test of exhaustion of possibilities\textsuperscript{227} had not been satisfied. This was because the branch losses were not terminal losses. The Luxembourg tax legislation provided for the possibility of deducting the branch losses in future tax years.\textsuperscript{228} The branch had, in fact, benefited from this provision in 2003, when it generated profits.\textsuperscript{229} Therefore, there was no need for an immediate deduction of losses and future recapture.

The Court of Justice reiterated the importance of respecting the allocation of taxing powers attained in the tax treaty between Germany and Luxembourg.\textsuperscript{230} It concluded that the German rule was not in breach of the freedom of establishment even if the unavailability of immediate loss relief led to cash-flow disadvantages.

The judgment should be contrasted with Advocate General Sharpston’s opinion, where the unavailability of immediate loss relief was decisive. The Advocate General thought that there were less restrictive means of attaining the objective of the legislation, such as allowing the deduction of losses while providing for the recapture of the loss relief in future profitable periods,\textsuperscript{231} with a provision for automatic reincorporation after a certain amount of time or if the permanent establishment ceased to exist in that form.\textsuperscript{232} The carry-forward of the losses was not an acceptable substitute. Compared to the immediate offsetting of losses and subsequent recapture of profits, the carry-forward resulted in a cash-flow disadvantage.\textsuperscript{233} This opinion was not surprising given Advocate General Sharpston’s earlier stance in the Deutsche Shell case.\textsuperscript{234} Here, in a slightly different context but looking at the same issues, the Advocate General opined that the non-deductibility of foreign currency losses in respect of foreign permanent establishments was incompatible with freedom of establishment. In Deutsche Shell the profits of an Italian permanent establishment of a German company were tax exempt in Germany. Currency losses in respect of the Italian permanent establishment were non-deductible under German law, as this was an expense directly linked to exempt income. The Advocate General found this to be an unjustified restriction to the

\textsuperscript{227} See para. 55 of the judgment in Case C-446/03 Marks & Spencer.
\textsuperscript{228} Case C-414/06 Lidl Belgium, para. 49.
\textsuperscript{229} Ibid., para. 50. \textsuperscript{230} Ibid., para. 52. \textsuperscript{231} Ibid., para. 24.
\textsuperscript{232} Ibid. This was in fact what the German legislation provided until 1999, when it was repealed.
\textsuperscript{233} Ibid., para. 28.
freedom of establishment. What was crucial to her analysis was the fact that the currency loss could only be taken into account in Germany. In other words, in this case the *Marks & Spencer* test of exhaustion of possibilities was satisfied.

The Court of Justice reached the same conclusion but without relying on *Marks & Spencer*. In so far as the restriction was concerned, the Court acknowledged the argument of allocation of taxing powers. A Member State was not required to take account of the negative results of a foreign permanent establishment just because those negative results were not capable of being taken into account for tax purposes in the host State. However, the Court of Justice distinguished this situation from that arising as a result of a mere disparity between national tax rules. It focused on the fact that the tax disadvantage concerned related to a specific operational factor that was capable of being taken into consideration only by the German tax authorities. A currency loss was not the same as a typical loss of a permanent establishment. What was important to the Court’s analysis was the fact that the currency loss was not a loss that could ever be suffered by the permanent establishment. It was a loss of the head office. Therefore, to exclude it from the tax base of the head office, when it could never be deducted in the Member State of a permanent establishment, was an unjustifiable restriction to the freedom of establishment. The German Ministry of Finance has now published a decree for the application of the Court’s decision in *Deutsche Shell*. However, it is thought that the decree is more restrictive than the actual decision.

In any case, the facts of the case in *Deutsche Shell* are much more distinct than in *Lidl Belgium* and the former case is unlikely to provide a

235 Case C-293/06 *Deutsche Shell*, paras. 50–51. This loss was invisible in Italy as at the time Italy operated in Italian Lira. Therefore, all computations for tax purposes were carried out solely in that currency. The currency loss only appeared when the sums were converted to the German mark.

236 In fact, Case C-446/03 *Marks & Spencer* was only cited once, on a general proposition. By contrast to the reasoning of Advocate General Sharpston, the *Marks & Spencer* justification test was not referred to explicitly.

237 Case C-293/06 *Deutsche Shell*, para. 42.

238 Ibid., para. 44.


240 The decree allows currency losses of a foreign permanent establishment to be taken into account in the German head office but only in the year of the permanent establishment’s liquidation.
stronger precedent than the latter case. What seemed to be decisive in both cases was the availability (or unavailability) of loss relief in the host State. However, in a later case, Krankenheim, the Court showed reluctance to interfere with the home State practice of recapturing a previously deducted loss, irrespective of whether the host State provided relief for this loss.

In this case a German-resident company had a branch in Austria. The Austrian branch had incurred losses from 1982 but generated profits from 1991 until 1994. Under the Germany–Austria tax treaty, the branch was exempt in Germany and only taxed in Austria. In addition, under German law at the time a German company was allowed to deduct the losses of its branch, whether domestic or foreign. However, in the case of foreign branches there was provision for subsequent recapture if they became profitable. In other words, the losses of a foreign branch would later be reintegrated in the tax base of the German company if such branch subsequently made profits.

Austria allowed carry-forward of branch losses unless, after taking its worldwide income into account, the company made an overall profit. In this case, as the worldwide income of the German company exceeded the losses of its Austrian branch, no carry-forward was allowed in Austria. Germany allowed deduction of the branch losses but then recaptured them. The Austrian Federal Finance Court referred the case to the Court of Justice, asking whether this recapture mechanism was compatible with the freedom of establishment as set out in Article 31 of the EEA Agreement.

The Court found that the recapture mechanism for foreign branches restricted freedom of establishment. Although Germany gave a tax advantage – loss relief – to both German and domestic branches, this advantage was withdrawn in the case of foreign branches as a result of the recapture mechanism. Therefore, a German company with an Austrian branch was in a less favourable situation than a German company with a German branch, thus discouraging such a company from carrying on

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242 This was irrespective of the fact that the losses may not have been deductible in the State of the head office.

243 The recapture occurred in 1994, before Austria had acceded to the EU. Therefore, the EEA Agreement was applicable. See para. 26.
its business through an Austrian branch. Nevertheless, this restriction could be justified by the need to guarantee the coherence of the German tax system:

the reintegration of losses provided for by the German tax system at issue in the main proceedings cannot be dissociated from their having earlier been taken into account. That reintegration, in the case of a company with a permanent establishment in another State in relation to which that company’s State of residence has no power of taxation, as the referring court indicates, reflects a logical symmetry. There was thus a direct, personal and material link between the two elements of the tax mechanism at issue in the main proceedings, the said reintegration being the logical complement of the deduction previously granted.

The Court of Justice found the restriction appropriate to achieve this objective because it ‘operate[d] in a perfectly symmetrical manner, only deducted losses being reintegrated’. Moreover, the restriction was entirely proportionate to the objective pursued, since the reintegrated losses were reintegrated only up to the amount of the profits made.

The fact that the recapture mechanism applied even though the German company was unable to set off the losses in Austria as a result of the Austrian tax rules did not affect this conclusion. As the Court of Justice stated, in the absence of any unifying or harmonising Community measures, Member States retained the power to define the criteria for taxing income and wealth with a view to eliminating double taxation, by means of tax treaties if necessary. This competence also implied that a Member State was not required to take account, for the purposes of applying its tax law, of the possible negative results arising from particularities of legislation of another Member State (here the Austrian rules on the carry-forward of losses). Therefore, host State rules were ignored and Germany could apply the recapture mechanism. The Court of Justice refused to strike down an established practice in international tax law.

244 Case C-157/07 Krankenheim, para. 38.
245 Ibid., para. 42. 246 Ibid., para. 44.
247 Ibid., para. 45.
248 Ibid., para. 48. 249 Ibid., para. 49.
250 This is the so-called asymmetric approach, whereby losses of a foreign permanent establishment can be included in the domestic tax base but are recaptured in future years. Under the symmetric approach, profits and losses of a foreign permanent establishment are always exempt. See Tigran Mkrtchyan, ‘In search of Ariadne’s Thread: permanent establishments and losses in the European Union’ (2009) 63(12) Bulletin for International Taxation, 586–99; CFE, ‘Opinion Statement – Lidl Belgium’. 

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This approach was aligned with the treatment of losses of a foreign permanent establishment under the Draft Cross-Border Loss Relief Directive. In the Draft Directive, as discussed in Chapter 2, two methods were available to home States: the credit method and the method of deduction of losses and subsequent reincorporation of profits. Furthermore, home States were given the option of providing for automatic reincorporation under specific circumstances. This suggests that under the Draft Directive no relief would have been allowed for terminal losses of a permanent establishment. By contrast, under some of the earlier case law on losses of a foreign permanent establishment, relief could only be permitted if the losses were final. Krankenheim seems to deviate from this line of reasoning as, by allowing the recapture mechanism to remain in place irrespective of the ability of the permanent establishment to set off the losses in the host State, the Marks & Spencer principle of final/terminal losses is effectively eroded. Moreover, by ignoring the tax treatment in the host State, the assessment of terminal losses can no longer be made. In other words, Krankenheim brings us closer to the approach of the Draft Directive.

The host State may also be required to ignore home State rules as suggested by the opinion of Advocate General Kokott and the Court of Justice in Philips Electronics. This was a preliminary reference questioning the compatibility of the UK’s group relief rules on permanent establishments with freedom of establishment. Under UK law the profits and losses of a company incorporated and tax resident in another Member State were taxable in the UK to the extent that the profits were attributed to a business carried on in the UK through a permanent establishment. However, UK losses of a UK permanent establishment of a non-resident company could not be surrendered to a UK company by way of group relief where any part of those losses or any amount brought into account in computing them ‘corresponds to, or is represented in, any amount which, for the purposes of any foreign tax is (in any period)

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251 Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States, COM(90) 595 final.
252 Ibid., Arts. 5–7. See also analysis in 2.8.
253 Ibid., Art. 8.
deductible from or otherwise allowable against non-UK profits of the company or any person’. \(^{255}\)

In this case Philips Electronics UK Ltd, the UK taxpayer, made various consortium claims for group relief in its tax returns, in respect of losses incurred by the UK permanent establishment of a Dutch company, which was also the parent company of the taxpayer. The claims were refused on the basis that the losses could have been taken into account in the Netherlands. The referring court\(^ {256}\) questioned whether this refusal was compatible with the freedom of establishment. In essence, this was not a case of foreign loss relief but rather a case of inability to use domestic losses, as the permanent establishment that incurred them was of a non-resident company.

Advocate General Kokott and the Court of Justice found in favour of the taxpayer. National legislation imposed certain conditions on the possibility of transferring, by means of group relief to a resident company, losses sustained by the permanent establishment of a non-resident company situated in that Member State, while the transfer of losses sustained in that Member State by a resident company was not subject to any equivalent conditions. This difference in treatment made it less attractive for companies having their seat in other Member States to exercise the right to freedom of establishment through a branch. Therefore, the UK legislation restricted the freedom to choose the appropriate legal form in which to pursue activities in another Member State. \(^ {257}\)

The Court of Justice found that a foreign company with a UK permanent establishment was in an objectively comparable situation to a UK company. This was notwithstanding the fact that a non-resident company with a permanent establishment in the UK was taxable only on the amount of profits generated in the UK and attributable to that permanent establishment, whereas a resident company was taxable on all its income. Comparability was assessed only as regards losses – that is the possibility

\(^{255}\) Ibid., paras. 4 and 10 of the judgment.

\(^{256}\) The First-Tier Tax Tribunal in this case: see fn. 151.

\(^{257}\) Case C-18/11 Philips Electronics, paras. 15–16. See also reasoning of Advocate General Kokott in para. 29, who discussed the twofold nature of the restriction. Firstly, as it was not possible to surrender losses of UK permanent establishments of foreign companies, it became more difficult for foreign companies to form a consortium with UK companies. Secondly, because of the refusal to surrender losses, the foreign company was unable to receive a payment from the company that benefited from the surrender of losses.
of transferring, by means of group relief, losses sustained in the UK to another company in that group.\(^{258}\)

The restriction could not be justified by the preservation of the allocation of taxing powers since only UK losses were to be surrendered against the profits of the UK taxpayer. Such losses as well as profits were within the scope of UK tax.\(^{259}\) This justification ground was designed to safeguard the symmetry between the right to tax profits and the right to deduct losses. However, in this case it was irrelevant to the safeguarding of the UK’s power of taxation that the losses to be surrendered could also be taken into account in the Netherlands. The power of the host State to impose taxes was not at all affected by the possibility of transferring, by group relief and to a resident company, the losses sustained by a permanent establishment situated in its territory.\(^{260}\) As Advocate General Kokott noted, the UK’s power of taxation would only be impaired if foreign losses were to be taken into account, because such losses would reduce the tax revenue of the UK while the (foreign) profits from the activity could not be taxed.\(^{261}\)

Neither was the restriction justified by the need to prevent the double use of losses. Although there was a risk of double use of losses (both in the host State where the permanent establishment was situated and also in the Member State where the non-resident company had its seat), the host State’s power of taxation was not affected.\(^{262}\) The UK’s tax revenue was the same irrespective of whether losses of the permanent establishment were also taken into account in the Member State of the head office.\(^{263}\) In any case, the prevention of double use of losses did not constitute an autonomous justification – it had to be in combination with another

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258 Ibid., paras. 17–20 (Court of Justice).
259 Under Art. 7 of the UK–Netherlands tax treaty, the UK was able to tax the income of domestic companies and that of UK permanent establishments of Dutch companies. See para. 47 of the Advocate General’s opinion.
260 Ibid., para. 25 (Court of Justice).
261 Ibid., para. 50 (Advocate General). See also the Court’s judgment, para. 26, where it was noted that the situation was distinguishable from that where the losses sustained in another Member State could be used, and for that reason would be linked to that other Member State’s power to impose taxes. In such a case the symmetry between the right to tax profits and the right to deduct losses would not be safeguarded and, arguably, the justification would succeed.
262 Ibid., paras. 30–31 (Court of Justice).
263 In fact the Advocate General thought that the use of losses of a UK permanent establishment whose profits were taxed in the UK was not double but single. When income was taken into account for tax purposes by two different Member States, the double use of losses was a logical consequence. Ibid., paras. 62–65.
justification.\textsuperscript{264} In this case the restriction could not be justified by these grounds, whether on their own or combined.\textsuperscript{265}

The Advocate General argued that the restriction was not proportional. The surrender of losses was ruled out even where only a part of the losses was allowable in the host State.\textsuperscript{266} Moreover, the provision did not differentiate according to the manner in which the losses were taken into account for the purposes of the foreign tax, that is whether host State loss relief was temporary or permanent.\textsuperscript{267} The Court of Justice saw no need to address the proportionality issue, given that the restriction could not be justified.\textsuperscript{268}

It was also irrelevant to the Court that it was not the freedom of establishment of the UK-resident company that had been unjustifiably restricted, but rather that of the non-resident company with a permanent establishment in the UK. In order to be effective, freedom of establishment had to extend the benefit of group relief to such situations.\textsuperscript{269} The Advocate General explained this point further. Whilst it was the Dutch parent company that exercised the freedom, it was the UK taxpayer who suffered the disadvantage. The restriction for the Dutch company lay in the fact that its contracting partner – the taxpayer – was denied an advantage, itself suffering disadvantages as a result.\textsuperscript{270} The freedom of establishment of the Dutch parent company could only be guaranteed if its contracting partner was accorded the advantage. Only that company could invoke the advantage of surrendering losses.\textsuperscript{271}

This is a very interesting development in the Court’s case law in this area and, to an extent, an endorsement of the per-country approach. It remains to be seen whether the statements made in this judgment will be followed in other cases. The arguments are compelling, but perhaps the only opportunity to deviate from this decision is by placing more emphasis on the availability of relief in the other State (here the home State) either in the justification grounds or in the proportionality analysis. While the availability of relief in the other States was also irrelevant in the Krankenheim case, there it led to the principle that host State rules should not be interfered with. Perhaps in future cases the Court’s judgments will

\textsuperscript{264} Ibid., para. 33 (Court of Justice) and para. 67 (Advocate General).
\textsuperscript{265} Ibid., para. 35 (Court of Justice).
\textsuperscript{266} Ibid., para. 73 (Advocate General).
\textsuperscript{267} Ibid., para. 74 (Advocate General).
\textsuperscript{268} Ibid., para. 36 (Court of Justice).
\textsuperscript{269} Ibid., para. 39.
\textsuperscript{270} Ibid., para. 85 (Advocate General).
\textsuperscript{271} Ibid.
become more nuanced, and the other State’s treatment may be factored in, especially when this is agreed upon in tax treaties.\textsuperscript{272}

The next chapter continues the analysis by examining obstacles arising from the taxation of portfolio investment.

\textsuperscript{272} See also analysis in 4.3.4.