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The Scope of Marks & Spencer

The applicability to permanent establishments

Master's thesis within Tax Law

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Master's Thesis in Tax Law

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Abstract

The European Union (EU) is built on the principle of freedom of establishment, meaning that companies have the possibility to establish themselves as a company or by setting up a secondary establishment in other Member States. This right has been confirmed by the European Court of Justice through case law.

A basic feature in domestic tax legislation is that losses are allowed to be set off against profits when calculating the tax liability of a company. At the moment cross-border loss compensation within the EU is restricted, unfeasible or just accepted on a temporary basis. This lack of recognition of loss-offset gives the fact that double taxation may occur and claims form two or more national tax systems leads to uncertainty in the way a company will be taxed. Depending on whether the secondary establishment is a subsidiary or a branch, the rules relating to loss compensation differs.

Taxation of secondary establishments is based on the principle of whether or not they are considered as a resident or a non-resident of the state. In regards to taxation of secondary establishments, the PE is considered to be a non-resident and a subsidiary considered to be a resident. However, the European Court of Justice approach of non discriminatory treatment and equal treatment that has been developed and seen in the history of case law leads to the question if the Marks & Spencer ruling that concerned secondary establishments in form of subsidiaries can be applied to permanent establishments.

The most vital difference between a subsidiary and a permanent establishment is connected to the taxation of the two. The subsidiary is considered to become a resident of the establishing state while the permanent establishment is seen as a non-resident. This legal difference between the two leads to different treatment under tax law. Taxation under a tax treaty leads to the situation where one of the contracting states will either credit or exempt the income deriving from the permanent establishment. Permanent establishments are often taxed under the method of exemption.

In the Marks & Spencer case it was held that losses and profits were two sides of the same coin. Applying this statement to permanent establishments gives the notion that if a contracting state exempts an income, there will be a set off of the symmetry of having losses and profits within the same tax system. This lead to the fact that if applying the Marks & Spencer ruling on permanent establishments that are taxed under the exemption method, allowing terminal losses to be taken into account at the head office will set off the symmetry. Therefore it can be considered as the Marks & Spencer ruling shall not apply to permanent establishments.

Abbreviations

AG	Advocate General
CCCTB	Common Consolidated Company Tax Base
EC	European Community
ECJ	European Court of Justice
EEA	European Economic Area
EU	European Union
HST	Home State Taxation
MS	Member State
M & S	Marks & Spencer
PE	Permanent Establishment
OECD	Organization for Economic Co-operation and Development

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1 Introduction

1.1 Background

This thesis has its starting point in the Marks & Spencer-case[1] (M & S). The question raised in the case was whether domestic legislation was allowed to have conditions restricting the possibility of loss-compensation to concern only parent companies with resident subsidiaries within the same tax jurisdiction, based on the justifications of a balanced allocation of the taxing powers, preventing that the losses would be taken into account twice and preventing tax avoidance.

Today, cross-border relief may be provided by the Member States (MS) in the European Union (EU) on a voluntary basis and only in certain situations the MS are obliged to provide cross-border loss compensation. This means that the possibility to transfer losses between companies in the EU is restricted, unfeasible or just accepted on a temporary basis.[2] From an EU perspective, the question regarding cross-border losses is a balance between the Member States sovereignty in the area of direct taxation, in lack of harmonised rules, and the fulfilment of the internal market.

On domestic level losses between a permanent establishment and the principal office are automatically taken care of. Loss offsetting between a subsidiary and the parent company in a group is available under specific rules in the MS.[3] Losses that incurs in another MS can lead to that the overall tax burden becomes greater than it would have if the company stayed within the same national boundaries, because of the restrictive treatment of losses. The lack of cross-border loss relief within the EU can lead to double taxation. According to the European Court of Justice (ECJ) the possibility to take into account any foreign losses, is to be seen as a tax advantage, since it will lower the all over tax burden.[4]

The EU is built on the principle of freedom of establishment, meaning that companies have the possibility to establish themselves as a company or by setting up a secondary establishment[5] in other Member States (MS).[6] This right has been confirmed by the ECJ trough case law.[7]

Taxation of secondary establishments is based on the principle of whether or not they are considered as a resident or a non-resident of the state. In regards to taxation of secondary establishment, the PE is considered to be a non-resident and a subsidiary as a

[1] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837.

[2] Terra, B & Wattel, P, *European Tax Law*, 5 ed., Kluwer Law Inernational, Alphen aan den Rijn, 2008, p. 641.

[3] COM (2006) 824 final *Tax treatment in Cross-Border Situations*, p. 3.

[4] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 32 and C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn [2008] ECR* I-03601 para 23.

[5] Secondary establishments can be a subsidiary, a branch or an agent.

[6] Articles 43 and 48 EC Treaty. (Treaty establishing the European Community).

[7] See e.g. C-212/97 *Centros Ltd. v Ervhervs- og Selskabsstyrelsen* [1999] ECR I-01459.

resident. However, the ECJ’s approach of non discriminatory treatment and equal treatment leads to the question if the M & S ruling concerning foreign losses in subsidiaries can be applied to PEs.

In the Marks & Spencer case it was held that losses and profits were two sides of the same coin. Applying this statement to permanent establishments gives the notion that if a contracting state exempts an income, there will be a set off of the symmetry of having losses and profits within the same tax system. This lead to the fact that if applying the Marks & Spencer ruling on permanent establishments that are taxed under the exemption method, allowing terminal losses to be taken into account at the head office will set off the symmetry. Therefore it can be considered as the Marks & Spencer ruling shall not apply to permanent establishments.

1.2 Purpose

The aim and purpose of this thesis is to examine whether the Marks & Spencer ruling is applicable to permanent establishments.

1.3 Methodology

When examining whether the M & S ruling is applicable to PEs, the starting point has obviously been the ECJs ruling of the case. Nevertheless, the methodology that will be applied will be a traditional legal methodology,[8] together with a problem based angle when examining if the Marks & Spencer ruling is applicable to permanent establishments. A traditional legal methodology means that hierarchy of the sources will be as followed; law, preparatory work, case law and literature. Using this method contributes to the understanding of the relations between the legal sources and how and when they are to be used.

When working with EC law the EC Treaty is the starting point of finding out the objectives and aims for the Union. On the area of direct taxation there is not much guidance from the EC Treaty and secondary legislation. The Commission Papers will be used as a source for information. They are of the political type but fulfil the task of giving an overall and general picture of the work within the EU.

Therefore, the ECJ has gotten the role of being the instrument that fills the gaps and developing the principles of Community law.[9] Further, the ECJ has the role of being the interpreter of EC-legislation. Given that role as interpreter of law, the rulings from the ECJ have an important role for giving the picture of how the Member States shall apply community rules. The cases chosen for this thesis do all individually have a purpose to fill, they each and one make a piece of the puzzle in the thesis, with the M & S case as the basis. The cases that will be discussed after the M & S case are mainly cases that have been chosen to show the development after the M & S case and cases were the criteria set out in the M & S case is applied to PEs. The cases that will be discussed more in depth do all have a connection to the M & S case in some way, often because they refer back to the M & S case. However, because of the large amount of case law, some

[8] Lomino, J. P & Spang-Hanssen, H, Legal research methods in the US and Europe, DJØF Publishing, Copenhagen, 2008, p. 127.

[9] Craig, P & De Burca, G, *EU Law-Texts, cases and materials*, third edition, Oxford University Press, Hampshire, 2003 p.97.

cases in the thesis may not be fully discussed but only mentioned to highlight a principle in EC law or in order to give understanding and meaning to the reader. Case law will be used as the most informative source giving guidance on how the ECJ attributes and argues the interpretation of EC law. Case law will be the basis for the understanding of the current legal situation. The ECJ case law is based on a chronological order, which means that the cases are built on each other and therefore to most extent will be presented in such order.

When tax treaties will be used as reference, the OECD model convention will be the source of use in connection with the commentaries of it.[10] Domestic legislation may be mentioned but only in the context of highlighting issues and to illustrate problematic situations.

Legal literature will be used as a basic source in understanding the problem related to direct taxation such as cross-border losses. Most of the literature will be articles by scholars published in European Law Journals. These articles often reflect the opinion of a specific person but the articles are helpful for the general understanding regarding the already existing rules and rulings. The articles will be used as a source of information, argumentation and presenting different opinions and show how the different rulings from the ECJ has been taken among scholars. The articles used have been selected from well established legal journals within the EU.

1.4 Delimitations

This thesis has as its aim to investigate the applicability of the Marks & Spencer ruling on permanent establishment. That will be the scope of this thesis and as far as this thesis will go.

In order to fulfil the purpose, taxation of secondary establishments will be discussed, but leaving taxation of individuals outside this thesis. This will also be the fact in issues relating to cross-border situations related to third countries. Tax treaties between specific countries will not be discussed in detail.

When using the OECD model convention with its commentaries, the observations by different countries will not be taken into account and presented as a possibility of showing different aspects to the commentary.

1.5 Disposition

This thesis will have the structure as follows: since the area of direct taxation lacks harmonised rules, a brief introductory chapter in chapter two will be given on different legal sources and the methodology of the ECJ in order to present the reader with some basic understanding.

Chapter three will then focus on loss compensation as it stands today within the EU. This chapter will also present the M & S case and the issues of it will be dealt with thoroughly.

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[10] 2005 OECD Model Convention on Income and Capital, used from, Raad, van Kees (editor), *Materials on International & EC Tax Law*, Volume 1, 2007/2008.

After that, chapter four will highlight the effects of the M & S ruling, shown through the cases that have been referred to the ECJ after the M & S. This chapter will also feature several attempts the EU has taken in order to minimize tax obstacles.

The following chapter five will then examine the differences between permanent establishments and subsidiaries in order to examine whether it is possible to apply the M & S ruling to permanent establishments. Cases where the M & S ruling has been applied to permanent establishments or the criteria set out in the M & S have been used in order to justify restrictive provisions will be presented and commented.

The last chapter will then be used to analyse the above chapters and identifying the differences between a subsidiary and a permanent establishment and a conclusion on the topic, whether the M & S ruling can be applied to permanent establishments will be given.

2 Basic Concepts of EC Law - the EC Treaty, Tax Treaties and Direct Taxation

2.1 Introduction

In 1957 when signing the Treaty of Rome, the area of direct taxes was not the main objective in order to establish the internal market giving the result that direct taxation was left outside the scope of the Treaty.[11] Thus the Treaty does not contain any provisions addressing direct taxation of companies. Consequently this area has stayed within each Member State (MS) to decide upon. In absence of any uniform or harmonising Community measures in the area of direct taxation gives the Member States the power to define and create the criteria for taxing income in their own state. This exclusive right can be interpreted as the function of taxes in the Member States serve as a useful tool in the work for social and economic goals. Therefore it can be understandable why there is reluctance among the Member States to give up this right.[12] Article 94 EC states that unanimity is needed in order for Directives to be adopted, also regarding direct taxation which confirms the sovereign right of each MS to decide upon provisions relating to income taxation. Nevertheless, still each MS of the EU must observe and take EC rules into consideration in this field so they will not hinder the objectives of the Treaty.[13]

The objectives of the European Community are set through Articles 2 EC and 14 EC.[14] These state that one of the aims of the Community is to work towards a common market. To achieve this objective, the Community shall strive for the establishment of the internal market which is characterised by that the obstacles of free movement of goods, persons, services and capital shall be abolished according to the timetable set in the Treaty.[15] This means that when Member States enters into the EU, they approve the concept of the internal market and therefore on a voluntary basis limits their own sovereignty. [16] In order for there to be an internal market, Member States shall abolish obstacles that will hinder the fundamental freedoms[17] adjust their national legislation and take all appropriate measures in order for there to be a functional internal market.[18] Further all discriminatory measures based on nationality are prohibited.[19]

[11] Adamczyk, L, *The Sources of EC Law Relevant for Direct Taxation*, p.20, in Lang, M, Pistone, P Schuch, J, Staringer, C (eds.), *Introduction to European Tax Law on Direct Taxation. Linde, Vienna, 2008.*

[12] Adamczyk, L, *The Sources of EC Law Relevant for Direct Taxation*, p.20, in Lang, M, Pistone, P, Schuch, J, Staringer, C (eds.), *Introduction to European Tax Law on Direct Taxation*.

[13] National tax measures that hinders the objectives of the Treaty will fit within the scope of the Treaty.

[14] EC Treaty , Treaty Establishing the European Community (consolidated text), Official Journal C/325 of 24 December 2002.

[15] Articles 3 EC and 4 EC.

[16] The impact of the different principles has been established through case law, i.e. C-26/62 *Van Gend & Loos*, C-6/64 *Costa v Enel*.

[17] Free movement of goods, services, capital and persons.

[18] Article 10 EC.

[19] Article 12 EC.

As a consequence of the lack of direct taxation provisions in the Treaty, several legal sources may affect a company when using their right of establishment. The establishment of a secondary establishment can be affected by domestic legislation, tax treaties between MS and the EC Treaty. This chapter will give an introduction to the different concepts relevant to matters of cross-border situations and taxation of secondary establishments.

2.2 EC Treaty and the relation to national tax legislation

Even if it can be held that rules relating to direct taxation falls under the competence of the MS themselves, the ECJ has in several tax law cases expressed that MS needs to take Community rules into consideration when forming tax rules, giving EC law supremacy over national tax rules. By stating that in case law, the ECJ expanded the scope of Community rules to also involve issues relating to taxation, the quote the ECJ uses can be recognized in several different cases[20] and just an example of it is:

> *"According to settled case-law, although direct taxation falls within the competence of the Member State, the latter must none the less exercise that competence consistently with Community Law…"*[21]

In order to work for the fulfilment of the internal market, tax obstacles needs to be eliminated. An example of obstacles as such can be double taxation and can leads to disintegration between the Member States.[22] When a company is doing business in a cross-border situation, the results in a situation where both states, the origin state as well as the source state have the possibility to claim taxes.[23] MS must as far as possible work towards and enter into negotiations in order to eliminate double taxation.[24] In situations where a taxpayer is subject to double taxation and more than one MS wants to tax the income deriving from the establishment, tax treaties are concluded in order to solve such a situation.[25]

2.3 Tax treaties

The second indent of Article 293 EC lays a responsibility on MS of the EU to enter into tax treaties in order to avoid double taxation.[26] However, the article explicitly does not force MS to enter into tax treaties, but with the objectives of the internal market in mind, Article 293 EC can be interpreted as tax treaties forms a basis of integration on

[20] See e.g cases C-279/93 *Finanzamt Köln-Altstadt v Roland Schumacker* [1995] ECR I-00225, para 21 and C-264/96 *Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her majesty's inspector of Taxes)* [1998] ECR I-4695, para 19.

[21] C-250/95 *Futura Participations SA and Singer v Administration des contributions* [1997] ECR I-02471, para 19.

[22] Terra, B & Wattel, P, *European Tax Law*, p. 3.

[23] The structure and criteria of the MS tax system is the MS sovereign right to decide upon.

[24] Article 293 EC.

[25] Hilling, M, Free, *Movement and Tax Treaties in the Internal Market*, Iustus Förlag, Halmstad, 2005, p.20.

[26] Cordewener, A et al, *The Tax Treatment of Foreign Losses: Ritter M & S, and the Way Ahead (part one)*, p. 139, European Taxation, April 2004, p.135-142.

fiscal matters within the EU.[27] The primacy of EC law has been settled in case law,[28] and includes all spheres of national legislation of the MS as well as international conventions. Tax treaties and the EC Treaty do not have the same objective. The EC Treaty is broader and has a different approach to the purpose of non-discriminatory principles and clauses.[29] Tax treaties are concluded between MS and are considered to be national legislation that will allocate the right of taxation between countries, in order to eliminate double taxation.[30] Eliminating double taxation is not considered to be a goal directly attainable to the EU institutions according to the EC Treaty.[31] Even if the goals and the objectives are different in tax treaties and the EC Treaty, the ECJ has taken tax treaties into the scope of application through case law. Through case law the ECJ has tried to set up the conditions and the effects of the distributive rules provided for in tax treaties in the direction of EC law as long as those effects are in relation to the allocation of taxing power in cross-border situations.[32] The ECJ has also set up conditions when determining the connecting factors when it comes to the allocation of the taxing powers of MS in the *Saint-Gobain*-case.[33] This means that the ECJ has included tax treaties as part of the area which has to be compatible with EC law.

2.4 The ECJ and direct taxation

2.4.1 The interpreter of Community rules

According to Article 220 EC the ECJ is the sole interpreter of Community rules and have the task of ensuring that the rules are applied throughout the EU in a uniform manner. A great part of the influence on direct taxation can be said deriving from the case law from ECJ. Therefore it can be said that the most relevant primary law provisions regarding direct taxation is the provisions of the fundamental freedoms as they are interpreted by the ECJ.[34] Next to this it should be understood that the ECJ by ensuring

[27] Cordewener, A et al, *The Tax Treatment of Foreign Losses: Ritter M & S, and the Way Ahead (part one),* p.139.

[28] C-6/64 *Costa v Enel* ECR 585.

[29] Alfredo García Prats, F, *EC law and direct taxation: towards a coherent system of taxation?* p. 77 in *Accounting and taxation & assessment of ECJ case law,* edited by Lang and Vanistendael, Accounting and taxation & assessment of ECJ case law, EATLP International Tax Series Volume 5, Helsinki, 2007.

[30] Lindencrona, G, *Dubbelbeskattningsavtalsrätt, , Juristförlaget, Stockholm, 1994,* p. 11.

[31] Alfredo García Prats, F, *EC law and direct taxation: towards a coherent system of taxation?* p. 77 in *Accounting and taxation & assessment of ECJ case law,* edited by Lang and Vanistendael.

[32] See e.g C-336/96 *Mr and Mrs Robert Gilly v Directeur des services fiscaux du Bas-Rhin* [1998] ECR I-2793.

[33] C-307/97 *Compagnie de Saint-Gobain, Zweigniederlassung Deutshland v Finanzamt Aachen-Innenstadt*[1999] ECR I-6161.

[34] Adamczyk, L, *The Sources of EC Law Relevant for Direct Taxation,* p.20 in Lang, Pistone, Schuch, Staringer (eds.) *Introduction to European Tax Law on Direct Taxation*.

that Community rules are applied in a uniform manner contribute to the fulfilment of the internal market.[35]

According to Article 234 EC, national courts have an obligation under certain conditions to refer questions regarding the four freedoms to the ECJ in order to get a preliminary ruling and bring clarity to the interpretation of Community rules.

Up until the ECJ examined the case *Avoir fiscal*[36], often referred to as the first case where the ECJ examined the compatibility between Community rules and national tax legislation, it was the general belief that because direct taxation was not included in the Treaty, those rules were not affected by the Treaty.[37] In the judgment of *Avoir fiscal* the ECJ for the first time extended the area of ruling from the four freedoms to also include direct taxation. The case stated that all discrimination of the freedoms that fits within the scope of the Treaty is prohibited,[38] and discriminatory tax law towards branches and other secondary establishments by taxing them on the same basis as registered companies in the MS but not giving them the same benefits was incompatible with Community rules and an infringement of Article 43 EC (former Article 52).[39] This meant that the EC Treaty has precedence over national rules and tax treaty rules.

Since the cases in the area of direct taxation increases every year, a result of such increase can be seen as that the ECJ gets the opportunity to clarify Community rules and straighten out questions that has been raised by scholars. On the other hand one must also be aware of the fact that there is a possibility that the ECJ when revising its own judgements can cause tension and contradiction between already existing case law.[40]

2.4.2 The ECJ methodology in case law

2.4.2.1 Comparable situations

The ECJ when identifying whether or not a national set of rules is used in a discriminatory manner, a comparable situation must be identified. The comparable situation is a key element in ECJ judgments.[41] Therefore it can be held that in *Schumacker*[42] case, the ECJ set up criteria's for identifying comparable situations and these criteria have had impact on the case law that has followed the case.

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[35] Kemmeren, E, *The Internal Market Approach,* p. 561, in Hinnekens, L, Hinnekens, P, (eds) *A Vision of Taxes within and outside European Borders – Festschrift in honor of Prof. Dr. Frans Vanistendael*, Kluwer Law, 2008.

[36] C-270/83 *Commision v France* [1986] ECR 273 (*Avoir fiscal).*

[37] Dahlberg, M, *Direct Taxation in Relation to the Freedom of Establishment and the Free Movement of Capital,* Kluwer Law, 2005, p.159.

[38] C-270/83 *Commission v France* [1986] ECR 273 (*Avoir fiscal),* para. 21.

[39] C-270/83 *Commission v France* [1986] ECR 273 *Avoir Fiscal,* para. 22.

[40] Lang, M, *Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions,* p. 98, EC Tax Review, 2009-3, p.98-113.

[41] Lang, M, *Recent Case Law of the ECJ in Direct Taxation: Trends, Tensions, and Contradictions,* p. 98.

[42] C-279/93 *Finanzamt Köln-Altstadt v Roland Schumacker* [1995] ECR I-00225.

In tax matters the fist criteria to identify is the distinction between resident and a non-resident.[43] In the *Schumacker* case the court did a comparison to the OECD model convention and stated that when a non-residents who receives income from another MS it is likely that the income is only a part of his overall income and the ability to pay taxes is usually connected to where the person has his family life and usual abode.[44]

The *Schumacker* case concerned an individual. Referring to literature, Dahlberg has expressed that an objectively comparable situation for companies has not been examined widely in relation to direct taxation. He constitutes that many of the cases that involves companies does not include a discrimination analysis where two situations, seen as objectively comparable, can be established and evaluated. It is more common that the court more often states that transactions made in a cross-border situation is likely to be treated stricter than if the same transaction were made within a Member State.[45]

In case law where matters of direct taxation is at hand the ECJ uses the methods of comparing situations against each other, the court examines how one set of rules apply to another situations. This process has been developed through years of case law.[46]

The concept of restrictive measure which is the way the ECJ has chosen in the area of direct taxation deals with the statement that the Member States national tax legislation should be as favourable to a non-member as to a member. The outcome of many cases on direct taxation from the ECJ has been that often national tax legislation is not compatible with the fundamental freedoms.[47]

In the history of case law, the ECJ has established a test which they use in order to establish whether or not a measure from a Member State is compatible with the freedom of establishment. Firstly it must be settled if the discriminatory measure falls within the scope of one of the freedoms. The next step is to examine if the measure can be justified by one of the grounds of justification,[48] established by the Court and finally it all renders down to if the measure is proportionate or not. In direct taxation cases, the ECJ always uses these criteria when beginning to analyse every new case.[49]

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[43] Regarding resident and non-resident; these terms should not be confused with nationality since tax residence is not the same as nationality.

[44] C-279/93 *Finanzamt Köln-Altstadt v Roland Schumacker* [1995] ECR I-00225, para 32.

[45] Dahlberg, M, *The European Court of Justice and Direct Taxation: A Recent Change of Direction?,* p. 171, in Andersson, K, Erbhartinger, E & Oxelheim, L (eds), *National Tax Policy in Europe – To Be or not to be?* , Springer, Heidelberg, 2007.

[46] See e.g. C-279/93 *Finanzamt Köln-Altstadt v Roland Schumacker* [1995] ECR I-00225, para 30 and C-330/91 *The Queen v Inland Revenue Commissioners, ex parte Commerzbank AG* [1993] ECR I-04017, para14.

[47] Dahlberg, M, *The European Court of Justice and Direct Taxation: A Recent Change of Direction?*, p.167 in Andersson, K, Erbhartinger, E & Oxelheim, L (eds), National Tax Policy in Europe – To Be or not to be?

[48] Examples of such grounds is the balanced allocation of taxing power between MS and tax avoidance.

[49] Cordewener, A et al, *The Tax Treatment of Foreign Losses: Ritter M & S, and the Way Ahead (Part Two)*, p. 219, European Taxation, May 2004, p.218-233.

The definition of discrimination: *'Discrimination occurs when equals are treated differently or when unequals are treated the same without such treatment having an objective justification'*[50] has been adopted by the ECJ and is used when examining comparable situations. This definition taken into EC law as the non-discrimination rule derives from international law and Article 24.1 of the OECD model convention and has been adopted by the ECJ to such extent that the principle of non-discrimination cover not only situations of discrimination of nationals, but also situations where the MS may apply other criteria to differentiate that will have the same effect of discrimination.[51]

2.4.2.2 Grounds for justification

Even if a provision in a national legislation is in conflict with the EC freedoms it can be justified. In addition to the grounds of justifications set out in the EC Treaty,[52] there are grounds of justifications established through the *rule of reason*-doctrine established by the rulings from the ECJ,[53] and especially the *Gebhard*[54] case where the criteria for justification was set out. In this case the Court established that in order for a rule to be justified to make it less attractive or to be a hinder to the freedom of establishment, the provision must meet four conditions: the national measure must be applied in a non-discriminatory manner, it has to be justified by the imperative requirements in the general interest, it must be suitable for securing the attainment of the objective which it pursue and lastly the provision must not go beyond what is necessary in order to attain it.[55] So if a national rule meets these criteria the court may accept the measure as a justifiable ground.

The grounds of justification accepted by the ECJ are the coherence of the fiscal system, the effectiveness of fiscal supervision, the prevention of tax avoidance and abuse (the balanced allocation of taxation between the Member States in the Community) and the principle of fiscal territoriality.[56]

Since the level of harmonisation of direct tax legislation in the Community is limited, national tax measures which are restrictive may have potential of being justifiable under the rule of reason as long as it they are not discriminatory on a national basis.[57]

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[50] Caamaño Anido, Calderón Carrero, *Accounting, the permanent establishment and EC law: Futura Participations case*, p. 26.

[51] Caamaño Anido, Calderón Carrero, *Accounting, the permanent establishment and EC law: Futura Participations case*, p. 26.

[52] Art 46 EC, which constitutes of imperative reasons for public health and safety.

[53] Dahlberg, M, *Internationell beskattning*, p.236, Studentlitteratur, Lund, 2007.

[54] C-55/94 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano*[1995]ECR I-04165.

[55] C-55/94 *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano*[1995]ECR I-04165 para 37.

[56] Dahlberg, M, *Internationell beskattning*, p.239.

[57] De Broe, L, *International tax planning and prevention of tax abuse: a study under domestic tax law, tax treaties and EC law in relation to conduit and Base companies*, IBFD, Amsterdam, 2008, p.881.

3 Loss Compensation and the Marks & Spencer case

3.1 Introduction

Loss compensation is limited within the union and especially in cross-border situations. This chapter will further aim to clarify the current situation on the possibilities of loss-compensation for secondary establishments in EU. As the *Marks & Spencer*-case[58] (M & S) is an important case in regards to loss compensation it will be examined and the understanding of the issues in the case will be the foundation in this thesis.

3.2 Treatment of losses within the EU

A basic feature in domestic tax legislation is that losses are allowed to be set off against profits when calculating the tax liability of a company. Loss relief for PEs in a domestic situation is available in all the MS in EU. However different conditions may be at hand regarding the treatment of losses. It works in the way that a single company establishes the income to be taxed by taking into account the losses and the profits from the branches to the principal office. The result gives that the company is taxed as a single entity, not the branches separately.[59] Group taxation which may apply to subsidiaries is available in most MS, but the systems for group taxation differ from MS to MS.[60] Domestic systems for group or consolidation taxation of the profit and losses is based on the possibility of transferring losses or profits from the parent company to the subsidiary (*downstream vertical*) or the other way around, from the subsidiary to the parent (*upstream vertical*). If the group has more than one subsidiary and the parent breaks even in the aspect of not making either profit or loss, the subsidiaries may transfer losses or profits in between them (*horizontal*).[61] The possibility to carry-forward the losses is also available in the MS but there is a difference in the period of time losses can be carried forward. The possibility to carry-back losses is only available in a few MS.[62] In relation to the freedom of establishment it must be held that since the tax system is closely linked to each MS means that when exercising the freedom of establishment, other MS tax rules will apply to the secondary establishment. It is instead the establishing state's rules on taxation, financial accounting and established conventions between states that shall apply to the PE and subsidiary.[63]

At the moment cross-border loss compensation within the EU is restricted, unfeasible or just accepted on a temporary basis.[64] This lack of recognition of loss-offset gives the fact that double taxation may occur and claims from two or more national tax systems

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[58] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837.

[59] COM(2001) 582 final *Company taxation in the internal market,* p. 317-318.

[60] COM(2001) 582 final *Company taxation in the internal market,* p. 317.

[61] COM(2001) 582 final *Company taxation in the internal market,* p. 318.

[62] COM(2001) 582 final *Company taxation in the internal market,* p. 317.

[63] COM(2001) 582 final *Company taxation in the internal market,* p. 295.

[64] Terra, B & Wattel, P, *European Tax Law,* p. 641.

leads to uncertainty in the way a company will be taxed.[65] Depending on whether the secondary establishment is a subsidiary or a branch, the rules relating to loss compensation differ. The subsidiary becomes a legal entity of its own and therefore a resident of the establishing state, while the PE is considered as a non-resident and therefore only limited liable of taxation for the income in the state established in.[66] The lack of cross-border loss offset among the Member States within the EU can be interpreted as a tax obstacle which hinders competitiveness in the market.[67] The policy in cross-border matters is to prevent double taxation as well as double non-taxation.[68] According to most national legislation, losses made by a PE are aggregated automatically if the entities are both within the same tax jurisdiction.[69]

In the same pace as the international economic development has grown, the movement of persons/companies has increased. Such development also increases the possibility for tax avoidance and tax evasion. As tax authorities remain within the boundaries of each Member State, issues arise around the concerns of ensuring the national tax control and the collection of taxes.[70] At the moment there are 27 different tax systems within the union, all sovereign and with the permission to define their own rules as long as there are no Community rules on direct taxation.[71] This unequal treatment of allowing cross-border loss relief or not is harsher on small Member States. It is likely that companies in the larger Member States have a larger market and therefore the profits and losses of a company end up in the same tax jurisdiction.[72]

Difficulties a business may experience in cross-border situations, and especially regarding losses, have been considered to be a key element in the analysis of tax obstacles in the internal market. The aspect that the MS have different approaches to loss relief in cross-border situation has had an impact on the internal market.[73] The absence of cross-

[65] Andersson, K, *An Optional Common Consolidated Corporate Tax Base in the European Union*, p. 98 in Andersson, K, Erbhartinger, E & Oxelheim, L (eds), *National Tax Policy in Europe- To be or not to be?*

[66] COM(2001) 582 final *Company taxation in the internal market,* p. 317.

[67] Andersson, K, *An Optional Common Consolidated Corporate Tax Base in the European Union*, p. 98 in Andersson, Erbhartinger, Oxelheim, *National Tax Policy in Europe- To be or not to be?*

[68] Coredewener, A et al, *The Tax Treatment of foreign Losses: Ritter, M & S, and the way ahead (Part One)*, European Taxation, p. 138.

[69] Terra, B & Wattel, P, *European Tax Law*, p.641.

[70] De Troyer, I, *A European Perspective on Tax Recovery in Cross- Border Situations*, p. 211, EC Tax Review, 2009-5, p.211-220.

[71] Wattel, P, *Fiscal Cohesion, Fiscal Territoriality and Preservation of the (Balanced) Allocation of Taxing Power; What is the Difference?* p. 140 in *The Influence of European Law on Direct Taxation- Recent and Future Developments* (edited) Weber.

[72] Terra, B & Wattel, P, *European Tax Law*, p.641.

[73] Aujean, M, *The CCCTB Project and the Future of European Taxation*, p.25 in Lang, Pistone, Schuch, Staringer, *Common Consolidated Corporate Tax Base*. Linde, Vienna, 2008.

border loss offsetting is likely to be one of the causes to double taxation amongst companies and their secondary establishments.[74]

In the same way as a secondary establishment needs to be recognised under domestic law in the establishing state, this problem is also a fact when it comes to losses, a loss in one MS may not be recognized as a loss in another MS, this because there is no common definition of the concept of a loss. The concept can vary from MS to MS what approach to a loss that is going to be applied.[75] Further each MS have their own treatment of losses. The Commission has stated that practically all tax systems in the Union have an asymmetrical treatment of losses. In the year the profits are earned, they are taxed but the tax revenue for the losses are not given back the same year as they incurred.[76] Therefore if losses can not be considered in the period they derive from, MS tax systems offer a possibility to carry-forward or carry-back the losses into another period. This possibility to use the losses in another period of time is however subject to a time-limit which varies from state to state.[77] An example is that the possibility to carry-forward a loss in Sweden is unlimited.[78] But Sweden does not recognise the possibility to carry-back a loss.[79]

3.3 Cross-border losses and the permanent establishment

In a tax perspective, losses are negative taxable income. Within the EU most MS internally accept offsetting of losses automatically. World-wide taxation is used by most Member States in the Union. As a result all positive and negative results will be taken into account. Contrary to a subsidiary, a branch or a permanent establishment is not a legal entity of its own, therefore losses in a permanent establishment automatically imported to the head company.[80] But in cross-border situations it is not granted that a PE may set off losses from the PE against profits in the principal office (*vertical upward set-off*), this because the different national tax systems have different rules on the application of loss relief.[81]

3.3.1 Different methods for managing losses connected to a permanent establishment

Among the national tax systems there are different methods to handle losses and the recognition of them.[82] Domestic tax legislation usually includes rules that open up the

[74] COM(2001) 582 final *Company taxation in the internal market,* p. 295.

[75] COM(2001) 582 final *Company taxation in the internal market,* p. 321.

[76] COM(2006) 824 *Tax treatment of losses in cross-border situations,* p. 2.

[77] Cordewener, A et al, *The Tax Treatment of Foreign Losses: Ritter M & S, and the Way Ahead (part one),* p. 137, European Taxation, April 2004, p.135-142.

[78] 40:2 IL.(Swedish income act SFS 1999:1229).

[79] SEC/2006/1690 final, Annex to COM(2006) 824 final.

[80] Terra, B & Wattel, P, *European Tax Law,* p. 643.

[81] Aujean, M, *The CCCTB Project and the Future of European Taxation,* p.26 in Lang, Pistone, Schuch, Staringer, *Common Consolidated Corporate Tax Base*.

[82] COM(2001) 582 final *Company taxation in the internal market,* p. 317.

possibility for a company to set off losses against profits that has incurred in different areas of the establishments.[83] The Commission stated in the Communication *"Tax Treatment of Losses in Cross-Border Situations"*[84] that the lack of cross-border loss relief will distort business decisions and cross-border loss relief would diminish the chances of losses being stranded in one entity.[85] The Commission has lifted out four different approaches available within the EU in regards to the treatment of losses in cross-border situations. The MS in the EU has either adopted to use the credit method, the exemption method, no loss deduction at all or temporary loss deduction.[86] The credit method or the exemption method is used to avoid double taxation of business related income.[87] Using the credit method the tax paid by the PE is in the establishing state (source state) is credited against the tax in the home state. The exemption method can be divided into two sub-methods. These are the tax exemption and the base exemption methods. When using the methods of exemption, the results from the permanent establishment will be ignored in the state where the permanent establishment is doing business and the result will be taken into account where the head company is established.[88] Both the credit and the exemption method are used in order to achieve tax neutrality.[89]

Just as cross-border profits should be taxable only once, the losses should also be deductible only once.[90] The concept of "Double Dipping" refers to a situation where the loss is taken into account twice.[91] The possibility to claim for double deduction of losses is to be considered as abuse of Community rules and not in line with the fulfilment of the single market.[92] In order to ensure that a loss from a permanent establishment will not be taken into account more than once can be addressed with a recapture mechanism.[93] In domestic situations recapture is aggregated automatically, but as soon as a cross-border situation is at hand, the recapture mechanism must be provided expressly.

Tax avoidance in the sense that companies in Member States with low corporate tax would and could transfer losses to other corporate entities in order to save tax is also a justification ground that the ECJ has accepted. This type of tax planning does not com-

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[83] Ståhl, K, *Skatterna och den fria rörligheten inom EU – svensk skatterätt I förändring?* p.17, SIEPS 2006:8.

[84] COM(2006) 823 final, *Tax Treatment of Losses in Cross-Border Situations.*

[85] COM(2006) 823 final, *Tax Treatment of Losses in Cross-Border Situations,* p. 2.

[86] COM(2006) 823 final, *Tax Treatment of Losses in Cross-Border Situations,* p. 5.

[87] Terra, B & Wattel, P, *European Tax Law,* p. 643.

[88] Terra, B & Wattel, P, *European Tax Law,* p. 644.

[89] Terra, B & Wattel, P, *European Tax Law,* p. 169.

[90] Vanistendael, F *The ECJ at the Crossroads: Balancing Tax Sovereignty against the Imperatives of the Single Market,* p.416, European Taxation, September 2006, p.413-420.

[91] COM(2006) 823 final, *Tax Treatment of Losses in Cross-Border Situations,* p. 6.

[92] Vanistendael, F, *The ECJ at the Crossroads: Balancing Tax Sovereignty against the Imperatives of the Single Market,* p. 416.

[93] Aujean, M, *The CCCBT Project and the Future of European Taxation*, p.26 in Lang, Pistone, Schuch, Staringer, *Common Consolidated Corporate Tax Base*.

ply with the EC rules and the freedom of establishment. However, the risk of tax avoidance regarding PEs is limited for the losses that incurs in the PE, this because the losses will be taken into account in the principal office.[94]

3.4 The Marks & Spencer case

3.4.1 The facts of the case

On December 13th of 2005, the grand chamber of the ECJ delivered their ruling in the case *Marks & Spencer* (M & S). Without doubt it is a well debated case both before the ruling came but also after the ruling.

M & S is a UK registered company in the retail business. Since the subsidiaries in Belgium, France and Germany were not profitable, the company in 2001 decided to part itself from the business activity in continental Europe. Because of the fact that the subsidiaries made losses during the years 1998 until 2001, the parent company wanted to make a group relief in order to decrease the profits in the parent company and lower the total taxable amount in the group. The British tax authorities denied such request meaning that the subsidiaries had operated in MS where they had their registered office and the group relief asked for could only be granted for domestic losses.[95] According to tax treaties between the UK and the states of the subsidiaries, the trading of foreign subsidiaries would fall under UK law if the business acts of those subsidiaries would be conducted through permanent establishments in the UK.[96]

M & S appealed and the High Court of Justice (England & Wales) referred the question whether the British rules were compatible with Community rules.[97]

3.4.2 The reasoning of the ECJ

The question the ECJ were assigned to examine were if the British provisions were to be seen as incompatible with Articles 43 and 48 EC. The British rules hindered UK registered companies to reduce their taxable income from reducing it with losses from their foreign subsidiaries. However that possibility was available to companies with domestic subsidiaries. So the question whether the provision was to be seen as a restriction of the freedom of establishment?[98]

The ECJ stated in reference to the freedom of establishment and Articles 43 and 48 EC that both the origin and host state has obligations. The host state must treat the foreign entity as a national and the origin state must not hinder an entity to establish itself in another MS.[99]

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[94] Aujean, M, *The CCCTB Project and the Future of European Taxation*, p.26 in Lang, Pistone, Schuch, Staringer, *Common Consolidated Corporate Tax Base*.

[95] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 21-24.

[96] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837,para 6.

[97] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para. 26.

[98] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 27-28.

[99] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 31.

The ECJ stated that the British rules constitutes of a tax advantage which benefits the companies involved and the possibility to relief the loss-making companies confers on a cash advantage on the group. By making this rule only available to the companies in the UK, the rule constitutes a hinder for a parent company to set up subsidiaries in other MS. Therefore the rule is considered to be a restriction of the freedom of establishment since it treats domestic losses different from foreign losses.[100] A restriction as such is permissible only if it pursues a legitimate objective compatible with the Treaty and if it can be justified by imperative reasons in the public interest. Further the application of such a restriction must not go further than necessary to attain the objective of the rule.[101]

3.4.2.1 Grounds for justification

The UK and other MS that had the possibility to submit observations in the case claimed that in this case resident subsidiaries and non-resident subsidiaries are not in a comparable tax situation. The state of the parent company has no tax jurisdiction over the state where the subsidiary is established. This is because it is the state of the registered subsidiary that has the right to tax the income deriving from that subsidiary.[102] The ECJ went on by admitting that residency is such a factor that may justify different treatment of resident taxpayers and non-resident tax payers. However it can not be used in every situation, thus it would deprive Article 43 of its meaning. Every situation needs to be examined were a tax advantage is available only to the resident taxpayers and if it is based on relevant objective factors in order to justify such different treatment.[103]

It must be recognised that it is accepted to tax resident companies on their world-wide income and non-resident companies on the income deriving from their activity in the state. The fact that the subsidiaries are not taxed within the UK does not in itself justify the restriction of group relief to losses in resident companies.[104]

Three grounds for justification were put forward in the case. The first one was that profits and losses must be treated symmetrically in the same tax system in order to protect the balancing of allocation of the power to impose taxes. Secondly, MS must be able to prevent losses from being taken into account more than once. The third ground for justification had to do with prevention of tax avoidance.[105]

The ECJ agreed on the fact that the allocation of the taxing power may lead to situations where one state's rules shall apply. And if companies were given the possibility to choose the state in which their losses should be taken into account would seriously undermine the balanced allocation of the power of imposing taxes.[106] The second ground of justification the ECJ held that is must be accepted that the MS must be able to pre-

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[100] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 32-34.

[101] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 35.

[102] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 36.

[103] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 37-38.

[104] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 39-40.

[105] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 42-43.

[106] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 45-46.

vent that losses are taken into account more than once.[107] The third ground, relating to tax avoidance and the possibility to transfer losses to states with higher tax rates and therefore getting a higher value of the loss is not accepted and therefore considered as a ground of justification.[108]

The ECJ applied the three grounds taken together and stated that a restriction such as the one in the case must pursue a legitimate objective that are in accordance with the Treaty. To examine if that was the case the ECJ went on to examine if the restriction went further than necessary.[109]

3.4.2.2 Proportionality

The ECJ held that the British rule went beyond what was necessary to attain the objective of the measure when the non resident had exhausted the possibilities to have had the loss taken into account in its residency state. This for both the current accounting period related to the claim for relief but also for previous accounting periods and if necessary by transferring those losses to a third party or by offsetting the losses against the profits make by the subsidiary in previous periods. The provision was also considered to go beyond what was necessary when there is no possibility for foreign subsidiary's losses to be taken into account in its state of residence for the future periods, either by the subsidiary itself or by a third party, for example in situations where the subsidiary has been sold to the third party.[110]

The ECJ then stated that member states are free to implement and preserve provisions that have a specific purpose to hinder wholly artificial arrangements to use tax benefits.[111]

3.4.3 The ruling in the case

In conclusion the ECJ stated that Articles 43 and 48 EC does not preclude MS from having provisions that restrict resident companies from deducting losses from foreign subsidiaries in order to lower the taxable income. However it is contrary to the freedom of establishment to not allow a deduction of the foreign losses in situations where the non-resident subsidiary has exhausted all possibilities in its state to having the losses taken into account and especially if the subsidiary has been sold.[112]

3.5 Comments on the case

It is not questionable that the M & S has been a discussed case. Several articles have been written about the case and some scholars are of the opinion that M & S has left

[107] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 47.

[108] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 49.

[109] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 51-53.

[110] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 55.

[111] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 57.

[112] C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837, para 59.

several issues open, giving uncertainty about cross-border losses, meaning that there is unpredictability to the ECJ case law.[113]

The M & S case stated that MS has to accept loss relief in cases where the losses are terminal and all possibilities to use them in the home state are exhausted. This means that there is an opening for cross-border loss relief in certain situations. However when determining if a loss is terminal, two aspects have to be considered; the losses must be terminal in a perspective of time and in the perspective of person. This means that the losses should not be able to be used against earlier losses in the subsidiary neither should the loss be able to be used in coming years. In the aspect of terminal out of the perspective of person means that the loss should not be transferable to another person.[114] Conclusively it can be said that the outcome from the ruling of M & S means that resident companies of a MS should only be allowed to take into account losses from their non-resident subsidiaries in cases where the loss carry-back or the loss carry-forward to other fiscal years is not at hand or no longer is possible, the offset of the loss within the group-taxing system in the subsidiaries residency state is not available and lastly the loss can not to be used by a third party.

Even if it must be agreed upon that the ECJ came to the conclusion that terminal losses should be possible to transfer cross borders, they really did not give any guidance in how it should be done. The ruling took the British rules as reference when examining the case. Tax law differs from MS to MS. In relation to the M & S case, this gives the fact that the M & S ruling may not be applicable to all cross-border loss compensation cases since group taxation regimes differ from MS to MS.

It can be held that the ground of justification, the balance allocation of taxation, the prevention of losses being used twice and the risk of tax avoidance, in the M & S may be interpreted as slightly vague since the ECJ phrased it as “in the light of those three justifications, taken together”. It is not clear what the ECJ meant by such a statement of taking the three ground together, and if they are all equally important. However, when justified as done by the ECJ, it can be held that the MS sovereignty in the field of taxation is strengthened. However it must be noticed that the M & S case recognises a need to preserve a balanced allocation of the taxing powers between MS. It is in the public interest that MS should keep a restrictive approach to tax measures.

Because the M & S recognises the need for balanced allocation of the taxing powers between MS, it has to be done on a case to case basis, meaning that the ruling in M & S can not be seen as a general rule. However the case refers to situations where profits and losses are two sides of the same coin and must be symmetrical treated in a tax system. That indicates that M & S could be interpreted as general rule of that losses and profits should be treated within the same tax jurisdiction.

It has been clear that cross-border offsetting in the EU before the M & S case was not available to groups. The available possibilities at hand were available to branches. It is therefore interesting that the M & S in the UK wanted their foreign subsidiaries to be

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[113] Lang, M *“The Marks & Spencer Case – The Open Issues Following the ECJ’s Final word*”, p. 67, European Taxation, February, 2006, p.54-67.

[114] Barenfeld, J, ”*Marks & Spencer – rätten till gränsöverskridande resultatutjämning”,* p. 30 Svensk Skattetidning, 1/2006, p.27-40.

treated as if they were branches in order for a possibility for the losses to be taken into account automatically. However, if the possibility to set off losses within the group at a domestic level had not been available, the cross-border question might not have been up for question. But the domestic subsidiaries according to the group taxation in the UK had the opportunity of loss compensation. Out of that perspective, the non-resident subsidiaries and the resident subsidiaries were not treated equally.

In the opinion to the M & S case, AG Maduro has commented on the comparability between a PE and a subsidiary (from the state of origin perspective).[115] He states that the freedom of establishment requires that there is no discriminatory treatment between the choices of secondary establishment. Further he compares earlier case law from the ECJ with the M & S and concludes that there is a difference between them, the earlier cases treated different forms of secondary differently within the same tax system in the same way. The M & S case is different in the aspect that the tax system that applies to subsidiaries and PEs are different. The comparison goes on to stating that companies with subsidiaries are not entitled to consolidation, only to group relief of the losses. The profits in the subsidiaries must remain at the subsidiary level. At this level he stops the comparison between different types of secondary establishments by concluding that the UK legislation is allowed to have different treatment of companies with foreign branches than to companies with foreign subsidiaries.

Lang has criticized the AG and the ECJ for not taking the comparison further. He seems to be of the opining that there is a difference between the two types of secondary establishments in relation to their difference in legal personality but he states that their legal situation is not that different.[116]

In my opinion I believe that it is questionable but accepted by the AG to stop his comparison at the stage he did, if the ECJ would have felt the need for developing the comparison they certainly had the opportunity to follow up on the comparison. However, the ECJ stated very clear that *"the taxpayers' residence may constitute a factor that might justify national rules involving different treatment for residents and non-resident taxpayers."*[117] In my view this indicates that the ECJ was of the opinion that there was no need for further comparison at that time. Even if the statement above was meant for the difference of treatment between the UK-subsidiary and the non-UK-subsidiary, a comparison between non-resident/PE and resident/subsidiary is not far away.

The economic perspective to it can be held that in order for there to be symmetry, the losses and profits need to be taken into account within the same tax system. This was the indication set out in paragraph 43 or the judgement.

I can understand that the case has been very well debated and questioned. The situation at hand in the ruling is quite exceptional, the ECJ grants cross-border relief, but only in very few, hard to determine situations. In my opinion the M & S case is to be regarded as an exceptional case. Terminal losses are to be seen as a very exceptional situation. The case raises questions such as when is a loss to be seen as terminal and the propor-

[115]Opinion of Mr Advocate General Poires Maduro in C-446/03 *Marks & Spencer Plc v David Halsey* [2005] ECR I-10837.

[116] Lang, M, *The Marks & Spencer Case – the Open Issues Folowing the ECJ's Final Word*, p. 56.

[117] C-446/03 *Marks & Spencer v Halsey* [2005] ECR I-10837 para. 37.

tionality test the ECJ sets out in paragraph 55, "*where the subsidiary has exhausted the possibilities available in its residence state to make use of the losses, either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party*." When shall it be applied? In the year the losses arise or from the perspective the loss can be or is granted?

It can therefore be held that the M & S case caused some confusion which lead to the development of new cases being referred to the ECJ for a preliminary ruling.

4 The effects of Marks & Spencer case

4.1 Introduction

Because the M & S is regarded to be such an important case regarding corporate taxation, it is interesting to examine the effect the case has had in the area of cross-border loss compensation. The case left uncertainty in the area of cross-border loss compensation. The effect of M & S can be seen through other cases that are related to cross-border loss offsetting. In this chapter the *Oy AA*-case[118] and the recent *X Holding BV*-case[119] will be presented showing effects from the M & S case.

4.2 The Oy AA case

4.2.1 The facts of the case

AA Ltd, a company established in the UK, held through other companies 100 percent of the shares in the Finish enterprise OY AA. The Finish enterprise planned to make an intra-group transfer to the parent company in the UK, since it was not profitable the year 2003. Oy AA applied to the Finish Central Tax Commission for a preliminary decision, asking whether the intra-group financial contribution would be regarded as a deductible group transfer according to Finish legislation.[120]

The Finish Central Tax Commission found that the Finnish rules regarding intra-group contributions were only applicable in cases where both the companies had taxable income under Finnish law.[121] Oy AA appealed to the referring court, which stayed the decision and referred to the ECJ in order for a preliminary ruling asking whether the Finish rules regarding the condition that both the receiving and the transferring companies needed to be domestically established in Finland was to be considered compatible with Article 43 EC.[122]

4.2.2 The reasoning of the ECJ

The ECJ states that the question referred must be answered in the light of Article 43 EC alone.[123] According to the ECJ and settled case law, members of the Union are entitled to establish themselves in other MS under the same conditions as the nationals of that state and that all discriminatory treatment in the establishing state is prohibited.[124] The ECJ came to the conclusion that a subsidiary to a foreign company is treated less favourable out of a tax perspective than subsidiaries to a Finnish parent.[125] Such differen-

[118] C-231/05 *OY AA* [2007] ECR I-06373.

[119] C-337/08 *X Holding BV*.

[120] C-231/05 *OY AA* [2007] ECR I-06373, para 11-13.

[121] C-231/05 *OY AA* [2007] ECR I-06373, para 14.

[122] C-231/05 *OY AA* [2007] ECR I-06373, para 15-16.

[123] C-231/05 *OY AA* [2007] ECR I-06373, para 28.

[124] C-231/05 *OY AA* [2007] ECR I-06373, para 29-30.

[125] C-231/05 *OY AA* [2007] ECR I-06373, para 32.

tiated treatment based upon the location of the parent company is to be seen as a restriction of the freedom of establishment that makes it less attractive for companies established in other MS.[126] In the case the ECJ made a connection to the M & S case and stated that such a restriction can only be justified by overriding reasons in the public interest and if it does not go beyond what is necessary to attain the objectives.[127]

4.2.2.1 Grounds for justification

Finland and other MS held that a restriction as the one in the case could be justified in order to ensure the coherence of the Finnish tax system, by the allocation of taxing powers between the MS, fear of tax avoidance and the principle of territoriality.[128]

The ECJ stated that the allocation of taxing power is not a ground of justification to be used when refusing to grant a tax advantage to a subsidiary resident in the state but the parent company to the subsidiary is not a taxpayer in the state and therefore can not be taxed in the state. Such ground of justification may be used in situations where the tax system within the state may be jeopardised be the transactions in the territory.[129] It is further held by the ECJ that if companies were allowed to choose where the losses and profits were to be taken into account would undermine the balanced taxing power between the MS.[130] The ECJ further stated since there isn't any deductibility of losses in the Finnish intra-group financial transfer system, therefore the risk of losses being used twice is not at hand in this situation.[131] By setting up artificial arrangements in form of a group and through it transfer income to other MS with lower tax rates, tax avoidance may be at hand and the Finnish rule prevents such arrangements.[132] Having the two grounds of justification, tax avoidance and the balanced allocation of taxing power in mind, the Finnish provisions have legitimate objectives and are compatible with the EC Treaty. However it must be examined if the restriction goes further than necessary in order to attain its objectives.[133]

4.2.2.2 Proportionality

The ECJ held that even if the Finnish rules do not specifically target artificial arrangements created to avoid taxes, such rules are yet to be seen as proportionate. An extension of the rule to include cross-border situations would open up the possibility for groups to determine where the profits are to be taxed, which may lead to a disadvantage of the MS of the subsidiary and the taxing rights of the profits in that territory.[134] Such

[126] C-231/05 *OY AA* [2007] ECR I-06373, para 39.

[127] C-231/05 *OY AA* [2007] ECR I-06373, para 44.

[128] C-231/05 *OY AA* [2007] ECR I-06373, para 45.

[129] C-231/05 *OY AA* [2007] ECR I-06373, para 53-54.

[130] C-231/05 *OY AA* [2007] ECR I-06373, para 55.

[131] C-231/05 *OY AA* [2007] ECR I-06373, para 57.

[132] C-231/05 *OY AA* [2007] ECR I-06373, para 58.

[133] C-231/05 *OY AA* [2007] ECR I-06373, para 60-61.

[134] C-231/05 *OY AA* [2007] ECR I-06373, para 63-64.

detriment can not be prevented by certain conditions set up regarding the treatment of the intra-group financial transfer in either the receiving or the transferring MS.[135]

4.2.3 The ruling in the case

The ECJ ruled that the Article 43 EC does not preclude a MS from having provisions that do not allow a subsidiary to deduct an intra-group financial transfer if the parent company is established in the same MS as the subsidiary.[136] Even if the Finnish rules were to be seen as incompatible with Community rules the grounds of justifications brought forth in the case were accepted by the ECJ.

4.3 Comments on the case

The ECJ uses the same grounds of justifications as in M & S in the reasoning in the case. However, it must be held that the court does not include the term terminal losses as in M & S. Yet the ruling states that the right to deduct losses is not connected to the rules concerning intra-group financial transfers.

The outcome of the *Oy AA* case follows the same line as M & S. The priority has been to secure the interest of the MS. The balance between the MS sovereignty and the internal market has yet again been tested. In the judgement the ECJ agrees with the opinions of the MS that artificial arrangements can be set up through groups and financial transfers can be made within the group from one MS to another with lower tax. However, this argument can be interpreted as contrary to the principle set out in settled case law where it is established companies have the possibility to establish themselves in other MS with more beneficial tax legislation.[137] This is also the opinion of Dahlberg who is critical to the fact that the ECJ accepted the MS argument that the restrictive legislation will hinder tax avoidance.[138]

Through case law the ECJ has accepted a segregation of cross-border parent-subsidiary relationships from advantages of a domestic group regime if it can be established that there will be a possibility to use the group in order to transfer assets, taxable income, from one MS to another in order to lower the tax burden of the income. Again the MS sovereignty has been in a favoured position.

When assessing the *Oy AA* case in relation to the M & S ruling and the question if the later ruling had changed the legal situation, I am a bit puzzled. In my opinion the case can be interpreted as being a development from the M & S case. However, there is also a possibility to see that case as a step back, confirming the M & S ruling.

Firstly I believe that the situation in M & S and *Oy AA* can be interpreted as two different situations. In M & S the losses were to be transferred to the parent company. In *Oy AA* it is the reverse situation, the losses were to be transferred from the parent to the subsidiary. A different situation and not necessarily the same treatment may be at hand

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[135] C-231/05 *OY AA* [2007] ECR I-06373, para 65.

[136] C-231/05 *OY AA* [2007] ECR I-06373, para. 67.

[137] C-294/97 *Eurowings Luftverkehers AG v Finanzamt Dortmund-Unna* [1999] ECR I-7447, para 44.

[138] Dahlberg, M, *Finländska koncernbidragsregler förenliga med etableringsfriheten- mål C-231/05 Oy AA*, p. 628, SN, 2007, p.626-628.

and applicable. If considering the two cases as being different situations the *Oy AA* can be interpreted as a complement to M & S. In his article *"The Marks & Spencer Case – The Open Issues Following the ECJs Final Word",* Lang stated that the outcome of the M & S case was linked to the group taxation system in the UK, which made the situation special. Because of this the ruling may not be applicable to other group taxation systems.

Further the perspective shifted from in M & S being the legislation in the UK and the residence that was up for question to in *Oy AA* case being the host states legislation that was tested. In addition to this, there are no terminal losses up for question; it is a transfer of taxable income that was decided upon.

Out of such a perspective it shows that the *Oy AA* case is separated from the M & S case and can be seen as a case of its own and complementary to the M & S case where the *Oy AA* case could be considered as a general rule regarding compensation of losses while M & S remains the exception.

However, if the cases are to be seen as so similar that they deal with the same situation, supporting such a statement would be that fact that the grounds of justification were taken together. That may indicate the position of not knowing what direction to choose, the internal market approach or safeguarding the balanced allocation of the taxing powers of the MS?

In my opinion I believe that even if there are similarities between the cases, they are to be seen as two different cases, with different approaches; the host versus the residence perspective.

4.4 Uncertainty in the area? – Attempts to minimize tax obstacles

It can be assumed that situations related to company taxation in cross-border situations is not still clear four years after the M & S ruling. This because new cases relating to cross-border situations and with reference to the M & S case is being referred to the ECJ.

Even though MS have the right to legislate on direct taxation, the EU has made several attempts to resolve the tax barrier that cross-border losses can be seen as. Several initiatives have been taken and presented in order to work towards minimize the tax obstacle that currently is on the internal market.

The Commission came in 1990 with a proposal[139] for a Directive regarding this matter; offsetting of losses in cross-border situations but the Council didn't approve it so the Commission declared it obsolete in 2001.[140] The fact that there was a lack of political support to the Directive was a major fact that it was abandoned.[141] Because of the politi-

[139] 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 of the 6 December 1990.

[140] Terra, B & Wattel, P, *European Tax Law,* p. 642.

[141] Adamczyk, L, *The Sources of EC Law Relevant for Direct Taxation,* p.25 in Lang, Pistone, Schuch, Staringer (eds.) *Introduction to European Tax Law on Direct Taxation.*

cal aspect there is to the sovereignty of the MS on fiscal matters, the probability to achieve cross-border loss relief trough a Directive is not too great.

In 2001 the Commission published a Commission staff working paper on *"Company taxation in the internal market"* were they addressed the issue such as an EC model treaty in line with the OECD.[142] The aim of the report was to eliminate tax obstacles for cross-border economic activities within the EU. The Commission paper emphasized that the rules on loss compensation differs between companies within a group structure such as a subsidiary or if it concerns a PE. Domestic loss offset for PEs are available in all the MS.[143]The Commission staff working paper displays two methods on how to manage losses in permanent establishments in cross-border situations. The methods proposed are the credit- or imputation method and the method of deducting losses and reincorporating subsequent profits or deduction/reintegration method, which are methods that already are established and applied by MS.[144] To conclude the Commission staff working paper, it held that the taxation of companies does not reflect the end result of business activities and the different treatment of cross-border losses may lead to a discriminatory treatment. The result of limited cross-border loss compensation or in some cases non-availability can lead to overtaxation or in some cases double taxation.

The Commission has proposed that a *Common Consolidated Corporate Tax Base*, CCCTB is a way of addressing tax obstacles that occurs to companies that conduct business in more than one MS in the EU.[145] The CCCTB aims to provide companies that have establishments in more than two Member States the option to calculate their taxable income according to one set of rules, the New Consolidated Tax base, instead of the national tax base as of today. The consolidation of tax base is to be seen as attractive, just because it consolidates the tax bases. The suggestion is therefore that the CCCTB is an opportunity to also apply to cross-border loss relief, both within the same company and between group companies.[146]

Yet another attempt to address tax obstacles is *Home State Taxation* (HST). The Commission has adopted the idea of HST as a possible solution in order to address tax difficulties for companies when they do business across borders. The basic idea behind HST is that is shall be based on mutual recognition of the national tax methods in the Member States and the allocation of both profit- and loss-offset will be according to a allocating formula.[147] A company that wishes to establish in another MS would therefore have the possibility to establish a subsidiary or a permanent establishment and use the tax rules that they already are familiar with. The system will be based on mutual recognition of the tax rules in the other MS within the EU.[148] HST and the previous men-

[142] Commission (2001) 582 final.

[143] Commission (2001) 582 final p.317.

[144] Commission (2001) 582 final p. 319.

[145] http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/index_en.htm.

[146] Communication on Common Consolidated Corporate Tax Base , COM(2007)223.

[147] EU Commission Communication COM(2004) 70, p.16.

[148] http://ec.europa.eu/taxation_customs/taxation/company_tax/home_state_taxation/index_en.htm.

tioned CCCTB are to be seen as complementary to each other and do not have the intention of being overlapping systems.[149]

4.5 Different regimes in the member states for treating group taxation

Within the EU there are different types of group taxation rules. There are MS that has no rules regarding groups. Others allows transfers if losses or financial transfers and there are MS that allows full consolidation of the result of the group. Because of the differences MS reacted in different ways to the M & S ruling. MS with no group taxation rules considered the need to adopt new legislation in the area.[150]

After the M & S case the question whether and to what extent losses deriving from foreign subsidiaries could be imported and taken care of by a parent in the Netherlands.[151] In the Dutch Supreme Court a comparison between a subsidiary and a PE and the treatment of them was done since the Dutch law sees them as being equal in the *fiscal eenheid,* tax entity, when it comes to tax purposes.[152] The conclusion of it is that the Dutch supreme court may have referred a rather broad and open question to the ECJ rather than getting a straight answer to the question of legal neutrality of secondary establishments within the union.

A result of the way group taxation is dealt with in the different MS has resulted in additional cases that have been referred to the ECJ for a preliminary ruling. Recently Advocate General (AG) Kokott gave her opinion in the *X Holding BV*-case.[153] The opinion of the AG is not binding to the ECJ, but represents a suggestion and advice to the ECJ.

4.6 The X Holding BV case

4.6.1 Facts in the case

X Holding BV, a company established in the Netherlands holds shares in a company with residency in Belgium. In 2003, X Holding BV requested to be included in a tax entity for corporate income tax purposes together with its subsidiary in Belgium. According to national provisions in the tax legislation in the Netherlands, resident companies may form a tax entity with domestic subsidiaries. The effect of such tax entity is that the profit and losses are taken into account at the parent level. The possibility to have a tax entity is limited to companies with residency in the Netherlands. The tax authorities in the Netherlands refused to acknowledge the tax entity and proceedings began. The Dutch Supreme Court referred to the ECJ the question whether the condition that a tax entity is restricted to only apply to domestic companies is justified in accordance with

[149] Meussen, G, *Recent EU Development in Relation to the Marks & Spencer Case*, p.450, European Taxation, September 2006, p.449-452.

[150] Brokelind, C, *Lindex-målet, fortsättning och slut?,* p.652-653, Svensk Skattetidning, 9/2006, p.650-660.

[151] Cordewener, A, *Comment on Direct taxation, Case Law, X Holding BV,* H&I 2008, p.101.

[152] Cordewener, A, *Comment on Direct taxation, Case Law, X Holding BV,* H&I 2008, p.102.

[153] C-337/08 *X Holding BV.*

the principle of balanced allocation of the taxing powers between MS that was established in the M & S case and cases followed after that.[154]

4.6.1.1 The opinion of the Advocate General

The AG came to the conclusion that a restriction of the freedom of establishment through a national provision that allows tax entities to only be applicable to resident companies is accepted. The situation as such that only domestic subsidiaries may be included in a tax entity is not to be seen as a restriction of the freedom of establishment and Articles 43 and 48 EC.[155]

It can not be taken for granted that the right of taxation based on the registered office of a company gives that fact that a comparison between a domestic and a non-domestic situation can be done. Each situation has to be examined based on the objective elements of the situation.[156]

A restriction such as the one at hand can only be justified by overriding reasons in the public interest. However it must not go beyond what is necessary to attain the objectives. The AG refers to M & S where the safeguarding of the allocation of the taxing power was recognised as a ground for justification even if tax avoidance and the risk of losses being used twice were at hand.[157]

The AG pointed out that the situation at hand in the case is further-reaching than the one in M & S and the following cases. *X Holding BV* has presented advantages with a tax entity. However the AG stated that it is only the one, concerning consolidation of the pre-tax results of the subsidiaries and the parent that will be examined if it can be justified.[158]

The advantage was to be examined against the need of safeguarding the balanced allocation of the taxing powers between MS. It is held that if companies were allowed to decide themselves where the profits and losses were to be taxed, it would undermine the allocation of taxing power.[159] However it must be examine if the exclusion of foreign subsidiaries is disproportionate in relation to the safeguarding of the allocation of taxing power.[160]

The AG stated that foreign PEs and subsidiaries are not comparable to each other based upon their legal personality. The difference is based on how the different secondary establishments are treated. Fiscal jurisdiction set up two criteria, the registered office and the place of economic activity. Subsidiaries are autonomous legal persons and subject to unlimited tax liability in its registered place. A permanent establishment is not an autonomous legal person and the state in which the PE is situated in has the right to tax

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[154] AG Kokotts opinion in C-337/08 *X Holding BV*, para 12-14.

[155] AG Kokotts opinion in C-337/08 *X Holding BV*, para 84.

[156] AG Kokotts opinion in C-337/08 *X Holding BV*, para 29.

[157] AG Kokotts opinion in C-337/08 *X Holding BV*, para 31.

[158] AG Kokotts opinion in C-337/08 *X Holding BV*, para 33-35.

[159] AG Kokotts opinion in C-337/08 *X Holding BV*, para 42.

[160] AG Kokotts opinion in C-337/08 *X Holding BV*, para 47.

the income deriving from the PE.[161] Further the AG states that the application of the PEs taxation according to tax treaties on subsidiaries would extend the right of taxation for the parent company states residence.[162]

Further the AG referred to the lack of harmonisation of Community rules on taxation. When comparing the types of secondary establishments against each other the method used is by comparing domestic subsidiaries to foreign subsidiaries, domestic permanent establishments to foreign permanent establishments. EC law does not hinder the MS of origin from applying different rules to foreign subsidiaries than to foreign permanent establishments. The different obligations to the host state and the origin state can not be said to be contradictory, they correspond to the differentiated scope of the right of taxation.[163] So in relation to the allocation of the taxing power gives the fact that a foreign subsidiary may not be part of a tax entity according to Dutch tax law.[164]

In regards to the second ground for justification, the danger that losses will be taken into account twice, the AG felt no need to give a definite opinion about, since it according to domestic law was not possible for the foreign subsidiary to be part of a tax entity and that restriction may be justified by the safeguarding of the allocation of the taxing power between MS.[165]

The last ground of justification set up in M & S, the risk of tax avoidance, is according to the AG not a separate ground of justification but should be seen together with the safeguarding of the allocation of taxing power. This because if a group could freely form tax groups and shift the assets from one MS to another, the allocation of the taxing power would cover a situation as such. In order to prevent that assets shifting from one MS, such transaction need to be assured to be done under normal market conditions and being recorded in the accountings.[166]

4.6.1.2 Suggestion of ruling

In her Opinion, the AG found that the Dutch rules were not incompatible with Community rules and therefore she has put forward and suggests the ECJ to rule that the Dutch rules are compatible with Community rules.

4.7 Comments on the case

In the opinion the AG compares the PE and the subsidiary by stating that the treatment of the both not necessarily needs to be the same. Further an emphasis on the choice of establishment means that when setting up a foreign subsidiary, the parent company leaves the fiscal jurisdiction of the first state. However, when setting up a PE, the connection to the principal offices, the origin state, tax jurisdiction still remains.

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[161] AG Kokotts opinion in C-337/08 *X Holding BV*, para 51-53.

[162] AG Kokotts opinion in C-337/08 *X Holding BV*, para 56.

[163] AG Kokotts opinion in C-337/08 *X Holding BV*, para 59-61.

[164] AG Kokotts opinion in C-337/08 *X Holding BV*, para 63.

[165] AG Kokotts opinion in C-337/08 *X Holding BV*, para 64-70.

[166] AG Kokotts opinion in C-337/08 *X Holding BV*, para 72, 83.

The set of grounds for justifications set out in the M & S case is effectively used and the AG in my opinion is applying them in a correct way and she comes to a conclusion that the safeguarding of each MS taxing power important.

In my opinion it seems like the ECJ is safeguarding the balanced allocation of the taxing power, at least if the follow the AG opinion in this case. However the question regarding the neutrality of the choice of secondary establishment still needs to be answered. Perhaps the ECJ will take on that question since the AG did not answer to that question. AG Maduro, in the opinion to the M & S discussed that there was no comparison to do between the PE and the subsidiary because of the different fiscal treatment and consequently could not be compared, according to the UK legislation. This is lacking in the *X Holding BV*. The AG did not discuss any differences in the treatment under Dutch law of the two forms of establishments; she just states that they are not comparable.

5 The applicability of Marks & Spencer to Permanent Establishments

5.1 Introduction

It can be seen in several cases that the ECJ makes some comparisons between a PE and a subsidiary. Therefore it is of interest in this thesis to make a comparison between the PE and the subsidiary. This is going to be dealt with in this chapter as well as the application of the M & S ruling to PEs.

The freedom of establishment within the union is guaranteed through Articles 43 and 48 EC and through case law it has been confirmed that establishing companies or secondary establishments will fit within the EC Treaty's scope. Since Article 48 EC states that if a companies are set up in accordance with the national law of a Member State, the company or its secondary establishment is seen as having its principal seat within the Community the prohibitions is applicable on companies as well as natural persons and the establishment therefore fits within the scope of the Treaty.[167] In regards to the ECJ rulings it can be stated that the freedom of establishment is confirmed by them but they also ensure that the choice of establishment is not limited in the respect of what type of business that is to be set up across the EU.[168]

5.2 The permanent establishment and the subsidiary

One of the fundamental principles of the European Union is the freedom of establishment. This means that a company has the possibility to establish itself in any other MS that they would like to carry out its business in.[169] Secondary Establishments can be divided into dependant and independent establishments. The difference between that independent and the independent secondary establishment is that the dependant secondary establishment, the PE, lack a legal personality of its own.[170] This gives the fact that the PE can not be separated from the general enterprise as a subsidiary can be.[171]

The possibility to carry out its business trough a PE has been approved by the ECJ several times, in *Segers*[172] the ECJ made clear that conducting business through secondary establishments stayed within the scope of the Treaty. The *Centros*[173]case then established that it is not necessary to carry out actual trade in the MS the company estab-

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[167] Craig, P, De Burca, G, *EU Law – Texts, cases and materials, fourth edition,* p. 807 Oxford University Press, Italy, 2008.

[168] C-212/97 *Centros Ltd. v Ervhervs- og Selskabsstyrelsen* [1999] ECR I-01459 and the second sentence of the first paragraph of Article 43 EC.

[169] Articles 43 and 48 EC and stated in the case law e. g. C-212/97 *Centros Ltd. V Ervhervs- og Selskabsstyrelsen* [1999] ECR I-01459.

[170] Gerson, A *Compensation of Losses in Foreign Subsidiaries within the EU*, p.32 footnote 183, JIBS Dissertation Series No.058, 2009.

[171] Aarnio, K *Treatment of permanent establishments and subsidiaries under EC law: towards a uniform concept of secondary establishment in European tax law?* p.19, EC Tax Review, 2006-1, p.18-26.

[172] 79/85 *Segers* [1986] ECR 2375.

[173] C-212/97 *Centros Ltd. v Ervhervs- og Selskabsstyrelsen* [1999] ECR I-01459.

lished itself in.[174] In *Factortame II*[175] the ECJ again looked at the concept of establishment and stated that the actual concept of establishment, in the meaning of Article 43 EC is that a genuine pursuit of an economic activity through an establishment, a "fixed place" in another MS for an unlimited period of time.[176]

When setting up a cross-border organisation, the most common way to do so is through a subsidiary. However, out of an economic perspective, in terms of registration and other administrative costs, it can be seen as a less attractive way of exercising the freedom of establishment. An alternative to this is setting up a permanent establishment.[177] According to the IFBD International Tax Glossary, the term permanent establishment is used in referring to *"a non-resident's business presence in a particular country which is of a sufficient level to justify that country's taxation of attributable profits".*[178]

Contrary to a subsidiary, a permanent establishment is not considered to have a legal personality of its own and in that sense is not a limit of the financial risks as a subsidiary can be seen as.[179] Thus the initial cost for setting up a cross-border business can be eliminated by using a permanent establishment. A company can not know whether the establishment set up is going to be profitable or not.[180] However, business plans and strategies of how to deal with losses are customary to set up for new establishments in business life.

Depending on what form of establishment that is going to be set up, there are judicial differences them in-between under private law.[181] A PE is established under private law.[182] The PE is considered to be an extension of the principal office even if the business that is conducted does not need to be of the same character.[183] It is important to examine if the establishment across the border is a subsidiary or a permanent establishment.[184] Out of a tax perspective, in order for there to be a taxable income, business activity must be conducted and it must be established that economic activity has taken

[174] C-212/97 *Centros Ltd. v Ervhervs- og Selskabsstyrelsen* [1999] ECR I-01459 para. 39.

[175] C-221/89 *In the Queen v Secretary of State for Transport ex p. Factortame* [1991] ECR I-3905

[176] C-221/89 *In the Queen v Secretary of State for Transport ex p. Factortame* [1991] ECR I-3905 para. 20.

[177] Bäckström, P, *Fasta driftsställen (filialer),* Svensk Skattetidning, no. 6-7/96 p.567.

[178] Larking, B, *IBFD International Tax Glossary, revised 5th edition,* IBFD, Amsterdam, 2005.

[179] According to Skaar a PE can be seen as a commercially separated but yet still a legally integrated entity, and therefore in some sense being able to be separated from the head office, Skaar, *Permanent Establishment – Erosion of a Tax Treaty Principle,* p.1, Ad Notam Forlag AS, Oslo, 1991.

[180] C-141/99 *Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v Kingdom of Belgium* [2000] ECR I-11619, para 24.

[181] Bäckström, P, *Fasta Driftställen (filialer),* Svensk Skattetidning no 6-7/96 p.563.

[182] Skaar, A, *Permanent establishment: erosion of tax treaty principle,* p 3.

[183] Bäckström, P, *Fasta Driftställen (filialer),* Svensk Skattetidning, no 6-7/96 p.563.

[184] Peters, C, *Non-discrimination: The Freedom of Establishment and European Tax Law*, p. 112 in editor Gribnau, H *Legal Protection against Discriminatory Tax Legislation,* Kluwer Law International, Cornwall, 2003.

place. This means that economic transaction, visibly in the state can be delivered for the establishment and therefore an income can be linked to the establishment.[185]

In the history of ECJ case law the approach has been that the ECJ has applied the same treatment to subsidiaries and branches in order to maintain equal treatment and neutrality of the choice of form of establishment.[186]

5.3 Distinction between the permanent establishment and the subsidiary

International tax law treats foreign subsidiaries and foreign permanent establishments differently. Professor Wattel distinguishes nine differences in the treatment of permanent establishments and subsidiaries, divided into groups of five from the host perspective, three from the origin perspective and one that takes the perspective of both.[187]

The first difference is related to the taxation of the two. A subsidiary is automatically subject to tax based on the status of residence. A PE is a threshold of taxation and therefore considered as a foreign investment in a form of a branch that requires certain substance and length before it qualifies to taxation in the host state and become a PE. The distinction of different tax treatments lead to that the secondary establishments have different rights in regards to tax treaties and domestic tax benefits. This difference is the most important one out of an EC perspective according to Wattel. Wattel points out that branches/PEs have no access to tax treaties since these are restricted to residents of either contracting state. A PE is not considered as a resident. However through the *Saint-Gobain*-case the difference of different treatment was not accepted and therefore also the PE can benefit tax treaties indirectly.[188]

Other distinctions that can be made between a subsidiary and a PE is in regards to the application of the capital duty, dividend withholding tax and the possibility to access group income schemes.[189]

If seeing it from the origin state perspective, there is a difference in the treatment of parent/head office costs, offsetting of losses and deferral. The profits of the PE are taxed at the head office, relieved by appropriate double taxation measures. The subsidiary's profits will be taxed twice in the parent state when it is distributed there as dividends. An aspect that also result in different treatment from both origin and host perspective is regarding interest, royalties and lease payments. Between the PE and the head office

[185] Bäckström, P, *Fasta Driftställen (filialer),* Svensk Skattetidning no 6-7/96 p.565-566.

[186] Wattel, P, *Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity; a plea for territoriality,* p. 194 EC Tax Review, 2003-4, p.194-202 and in Terra, B & Wattel, P, *European Tax Law,* p. 170.

[187] Wattel, P, *Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity; a plea for territoriality*, p. 194.

[188] Wattel, P, *Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity; a plea for territoriality*, p. 195.

[189] Wattel, P, *Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity; a plea for territoriality*, p. 195-196.

they are normally not deductible while between a subsidiary and the parent company, a deduction usually is allowed.[190]

5.3.1 The permanent establishment definition under EC law

PEs are treated in three different EC company Directives, the Parent-Subsidiary Directive[191], the Interest and Royalties Directive[192] and the Merger Directive[193]. In two of these Directives, a definition of what PE can be found. However, the definitions are not uniform and there is no universal or general definition of the PE under EC law.[194]

The European Council adopted an amendment to the Parent-Subsidiary Directive in 2003 which stated that PEs should be included in the Directive. Article 2(2) of the Directive gives this definition to PE:

> *"for the purpose of this Directive the term 'permanent establishment' means a fixed place of business situated in a Member State trough which the business of a company of another Member State is wholly or partly carried on in so far as the profits of the place of business are subject to tax in the Member State in which the is situated by virtue of the relevant bilateral tax treaty or, in absence of such a treaty, by virtue of national law."*

The definition of a PE according to the Interest and Royalties Directive is found in Article 3(c):

> *"The term 'permanent establishment' means a fixed place of business situated in a Member State through which the business of a company of another Member State is wholly or partly carried on."*

However, how a PE and the profits of it are going to be taxed is not dealt with in the definition in the Interest and Royalties Directive.

It must be recognised that even if there are correspondence between the different definitions under the Directives, it can be held that the definitions are made to suit its specific Directive.[195] And even if the concept and definitions is established by the OECD model convention, when introduced in Directives, the definition becomes a *term of EC law*, and therefore subject to interpretation by the ECJ. It is likely that the ECJ will take into

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190 Wattel, P, *Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity; a plea for territoriality*, p. 196.

191 The Parent-Subsidiary Directive (2003/123/EC).

192 The Interest and Royalties Directive (2003/49/EC).

193 The Merger Directive (90/434/EEC).

194 Baker, P, Collier, R. S, *Cahiers de droit fiscal international, Volume 91b, The attribution of profits to permanent establishments*, IFA, Amsterdam, p. 73.

195 Baker, P, Collier, R. S, *Cahiers de droit fiscal international, Volume 91b, The attribution of profits to permanent establishments*, p. 74.

account the definition and the commentaries of the definition of a PE under the OECD model convention, but they surely have to respect the purpose of the Directive.[196]

A parallel between the OECD's treatment of PE's and the approach EC law has adopted can be done. In the cases *CLT-UFA SA*[197] and *FCE Bank*[198] the AG in the cases points out that for the purpose of the calculation of direct taxes a PE should be treated as if the PE was a separate entity and dealing with its head office.[199] This approach is recognized from the OECD's model convention and Article 7, business profits.

5.3.2 The permanent establishment in tax treaties

According to tax treaties based on the OECD model convention, the PE is defined under Article 5. It states that a PE is "*a fixed place of business through which the business of an enterprise is wholly or partly carried on"*.[200] Important characteristics when defining a PE is material presence, time period and the coherence with the business of the enterprise.[201] The time period for the PE is that is shall have some permanency, meaning that the PE should not be of temporary character.[202]

In order to determine whether business is conducted through a PE in another MS, Article 5 of the OECD Model Convention is used. By establishing that there is a PE in a MS entitles the state where the PE is set up the right of taxation of a company that is residence in another MS.[203]

5.4 The taxation of the permanent establishment

In international tax law, there are different principles of taxation, resident taxation and source taxation. In case law the ECJ has accepted both principles of taxation.[204] Subsidiaries are regarded as residents in the state of establishment because of their legal personality and will be taxed as residents of the MS established in. Since the PE is not a legal person of its own, the principle of source taxation shall apply. A PE is taxed in the

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[196] Baker, P, Collier, R. S, *Cahiers de droit fiscal international, Volume 91b, The attribution of profits to permanent establishments*, p. 74.

[197] C-253/03 *CLT-UFA SA v Finanzamt Köln-West* [2006] ECR I-01831.

[198] C-210/04 *Ministero delle Economia e delle Finanze, Agenzia delle Entrate v FCE Bank Plc* [2006] ECR I-02803.

[199] C-253/03 *CLT-UFA SA v Finanzamt Köln-West* [2006] ECR I-01831 para 85.

[200] Article 5.1 OECD Model Convention.

[201] Commentary on art 5, paragraph 1, 2[2], p. 104 in OECD Model Tax Convention on income and on capital 2005, *Materials on International & EC Tax Law.*

[202] Commentary on art 5, paragraph 1, 6.[6], p. 107 in OECD Model Tax Convention on income and on capital 2005, *Materials on International & EC Tax Law.*

[203] Commentary on art 5, paragraph 1 p. 104 in OECD Model Tax Convention on income and on capital 2005, *Materials on International & EC Tax Law.*

[204] Terra, B & Wattel, P, *European Tax Law*, p. 170.

state where the economic activity is taken place,[205] and is therefore to be seen as only being liable to taxation in the state where the PE is conducting business.[206]

Even if the PE lack a legal personality and is considered in tax perspectives as a non-resident, the PE has according to EC law the right to be treated in the same way as resident companies of a stat would according to the national legislation of that state, also in the respect of carry-forward or carry-back losses.[207]

Taxation of a permanent establishment is often made under the tax exemption by the origin state. This means that the profits and losses in the permanent establishment are taken into account when calculating the primary establishments, the head offices, world-wide taxable income and then deducted by the amount that would have been taxed in the home state.[208]

However, where there is a tax treaty between the countries involved, the taxation may be different, but it shall be compatible with Community rules according to case law.[209] Tax treaties between MS allocates the right to tax an income, and the usual treatment of a PE under a tax treaty is that the host MS is given the primary right of taxation while the principal office is given the secondary right of taxation.[210] When determining the taxable amount relating to each state, the income attributable to each area of business must be recognised.[211]

Internationally it has been recognised that the allocation of profits of the PE shall be attributed to the PE based on the "separate enterprise" concept and the application of the arm's length principle as stated in Article 7(2) OECD model convention.[212]

> "*…if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions*..."

The problem in Article 7(2) is that the PE is not a separate legal person and in that respect can not be seen as a separate entity, also called the *"separate enterprise fiction"* where the fiction lies in the urge to treat the PE as and independent part of the enterprise. To clarify that the PE is not a separate entity it can be held that between the PE and the head office there can not be legally binding contracts, since they are the same

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[205] Peters, C, *Non-discrimination: The freedom of Establishment and European Tax Law,* p.112 in Gribnau, H, *Legal protection against Discriminatory Tax Legislation – The struggle for equality in European Tax Law.*

[206] Terra, B & Wattel ,P, *European Tax Law*, p. 170.

[207] See e.g. C-311/97 *Royal Bank of Scotland* [1999] ECR I-2651.

[208] Terra, B & Wattel, P, *European Tax Law,* p. 644.

[209] See e.g. C-307/97 Compagnie de Saint-Gobain, Zweigniederlassung Deutshland v Finanzamt Aachen-Innenstadt [1999] ECR I-6161.

[210] COM(2006) 824 final p. 5.

[211] Commentary on art 7, paragraph 1 p. 137 in OECD Model Tax Convention on income and on capital 2005, *Materials on International & EC Tax Law.*

[212] Baker, P, Collier, R. S, *Cahiers de droit fiscal international, Volume 91b, The attribution of profits to permanent establishments*, p. 26.

"person". The assets of the PE belongs to the head office, therefore no separate distinction of ownership is at hand.[213]

Together Articles 7, 23 and 25 of the OECD Model convention have the aim to ensure that double taxation is eliminated.[214] In order eliminate the double taxation one of the states either credits or exempt the taxation of the PE.[215] The usual treatment of the taxation of a PE is that the income deriving from the PE is dealt with under the methods of exemption.[216]

According to Baker and Collier, in the aspect of taxation of the PE, there is a general trend to treat the PE as a domestic subsidiary in the EU. This trend is also to be seen in the ECJ case law. In the opinion to the case *CLT-UFA SA*, the AG made reference to Article 7(2) in the OECD model convention stating that the PE and the head office were to be treated as legally distinctive entities.[217]

5.5 The Lidl Belgium case

5.5.1 **The facts of the case**

The *Lidl Belgium* case[218] is a case where losses incurred in a PE. The case is connected to the freedom of establishment in the sense that it deals with the question whether a national measure, restricting the foreign losses of the PE to be taken into account at the head office, is to be seen as compatible with Community rules.

Lidl Belgium was operating business through a branch in Luxemburg. The Luxemburg branch was not profitable and therefore the German office wanted to deduct the losses in Luxemburg. The deduction was not approved by the tax authorities. Therefore proceedings began and the issue was referred to the ECJ for a preliminary ruling.[219]

5.5.2 **The reasoning of the ECJ**

In order to determine whether or not the German rule was a restriction of the freedom of establishment the ECJ stated that a PE is included in the scope of Article 43 of the EC Treaty,[220] and further reasoned around the term permanent establishment and expressed that a PE is according to international legal practice seen as an autonomous fiscal entity.[221]

[213] Baker, P, Collier, R. S, *Cahiers de droit fiscal international, Volume 91b, The attribution of profits to permanent establishments*, p. 26.

[214] http://www.oecd.org/dataoecd/30/52/44104593.pdf, p. 3.

[215] COM(2006) 824 final p. 5.

[216] Terra, B & Wattel, P, *European Tax Law*, p.644.

[217] Baker, P, Collier, R. S, *Cahiers de droit fiscal international, Volume 91b, The attribution of profits to permanent establishments*, p. 58.

[218] C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn* [2008] ECR I-03601.

[219] C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn* [2008] ECR I-03601, para 8-13.

[220] C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn* [2008] ECR I-03601 para 15.

[221] C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn* [2008] ECR I-03601 para. 22.

The tax treaty between Germany and Luxemburg included a provision exempting income from a PE. Therefore was any positive income from the PE in Luxemburg not to be taken into account in the German tax base, and equally the losses could not be deducted in order to lower the overall taxable income, in accordance with a symmetrical treatment of income. But comparing to a domestic German PE, the treatment of the foreign PE was less favourable than to the domestic and such a question needed some clarification out of an EC perspective since the German Federal Finance Court were of the opinion that the lack of possibility to deduct the losses incurred in a foreign PE the same year they arose could be interpreted as a breach of the freedom of establishment.[222]

5.5.2.1 Grounds for justification

Any restriction of the freedom of establishment can only be justified by the overriding reasons of the public interest.[223]

The grounds for justification brought forth in the case are the allocation of the taxing power between the MS and the prevention of losses being taken into account twice.[224]

The ECJ stated that a provision that allows losses of a PE to be taken into account when calculating the total amount put up for taxation for the parent company creates a tax advantage. Since this tax advantage is only meant for the residents of the home state, this advantage constitutes of a restriction of the freedom of establishment. But since the profits of the PE in Luxemburg are not taxed in Germany neither should the losses be deductible, in accordance with the right of allocation of taxes and preventing tax avoidance.[225]

5.5.3 The ruling of the case

This argumentation brought forward by the German government was accepted by the ECJ who considered the German rules to be compatible with Community rules.[226]

The national court further asked whether the justifications set out in paragraphs 44 to 50 of the M & S case are to be interpreted cumulative. To this question the ECJ states that with the variety of situations that may be at hand within the union, it can not be necessary for all justifications to be present.[227]

5.6 Comments on the case

The case follows the line of reasoning set out in M & S and the following *Oy AA* case. The grounds of justification that was established in the M & S is used by the ECJ and applied on situations with at PE as well by the ECJ. However in the Lidl case it is stated that the PE is an autonomous entity in accordance with tax convention law. The inter-

[222] C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn [2008] ECR* I-03601 para 23-26.

[223] C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn [2008] ECR* I-03601, para 27.

[224] C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn [2008] ECR* I-03601, para 30.

[225] C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn [2008] ECR* I-03601 para .33-35.

[226] C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn [2008] ECR* I-03601, para 37, 53.

[227] C-414/06 *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn [2008] ECR* I-03601, para 38-40.

pretation of an autonomous entity is more referable to a subsidiary which is legally separated from the parent company. The Commentaries to the model convention states that a PE is a fixed place of business. The ECJ statement of the PE is also contrary to the distinction between a subsidiary and a PE that professor Wattel has stated in his article, discussed above in section 5.3.

However in the case, the ECJ compares a domestic situation to a foreign and a comparison between a subsidiary and a PE and if they are to be treated the same were never established, maybe because of the statement and the interpretation of the ECJ by the PE as the autonomous entity.

The *Lidl Belgium* follow in the same direction and emphasized that it would undermine the balancing of taxation if companies would be able to chose in what state the losses should be taken care of in. Further it was put forward that a potential solution could be a recapture rule that the PE could be subject to. However it may be confusing that the ECJ lifts out the definition of a PE from the OECD model convention as the PE being an autonomous fiscal entity. The model convention usually extends the residents of the parties of the convention, the contraction states. But in the case it can be understood that it is the *Lidl Belgium* that is the taxpayer since the PE is not a resident in Luxemburg. The *Lidl Belgium* extended the *Marks & Spencer* ruling to be applicable to PEs, accepting the restriction.

Regarding the losses in *Lidl Belgium*, it couldn't be shown that the losses in Luxemburg were not going to be able to be deducted within the PE in future fiscal years or if not the M & S ruling should be applied, meaning the losses would be able to be used in Germany if they are terminal and the possibilities to use them in Luxemburg are exhausted. In my opinion the ruling in the case is correct. Related to the matching principle and the principle of origin, the losses incurred in the PE should be deducted from the profits deriving from the PE though a possibility to carry losses forward or backward.

And again it was held that if a company is allowed to deduct a loss in their home state or in any state of their choice it can be said to undermine tax allocation.[228]

5.7 The Krankenheim case

5.7.1 Facts of the case

The case *Krankenheim*[229] is yet another case regarding cross-border loss relief. It is stated that this case might be one of *the last pieces in the cross-border loss puzzle*.[230]

In October 2008 the ECJ delivered the judgement of this case. No opinion from the AG was given since it was stated that the area is quite clear.[231]

[228] *C-414/06 Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn* [2008] ECR I para 16, 46.

[229] C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* [2008] ECR I-08061.

[230] Meussen, G, *The ECJ's Judgment in Krankenheim- The Last Piece in the Cross-Border Loss Relief Puzzle?* p. 361. European Taxation, July 2009, p.361-363.

[231] Meussen, G, *The ECJ's Judgment in Krankenheim- The Last Piece in the Cross-Border Loss Relief Puzzle?* p. 361.

KR Wannsee, a limited liability company established in Germany, had a PE in Austria from 1982 to 1994. Before the end of 1990 the losses were realized in respect to the PE. KR Wannsee asked the Finanzamt to take the losses into account when calculating the taxable amount for the company, with regards to the profits made in Germany during the period from 1982 to 1990. During the years 1991 to 1994 the PE was profitable and in 1994 the PE was disposed.[232]

The applicable German tax law added the profits from the PE from 1991 to 1994 to the taxable income deriving from Germany and retrospectively taxed the sums that had been deducted in the context of national taxation, deriving from the losses of the PE in Austria. In Austria the PE was taxed with corporate tax for the years 1992-1993, when the PE was profitable. The earlier losses from the PE were not taken into account. Losses in the PE were only allowed to be deducted in situations were the owning company of the PE had no possibility to take the losses into account. Since KR Wannsee had realized the losses in Germany between 1982 and 1990, offsetting of losses in Austria was denied in respect to the years 1992 and 1993.[233]

5.7.2 The reasoning of the ECJ

The ECJ states that measures that make the exercising of the freedom of establishment shall be seen as restrictions and is also applicable to the exercising the freedom through a PE. Further the ECJ refers to paragraph 23 of the *Lidl* judgment and states that provisions which allow losses from the PE to be taken into account when calculating the taxable income of the principle office is to be seen as a tax advantage. If allowing or not allowing such an advantage is likely to affect the exercising of the freedom of establishment. It is held that the German tax law offered such a benefit but it was withdrawn when the PE was profitable. This gives the fact that the PE is treated less favourable than if it would have been established in Germany.[234]

5.7.2.1 Grounds for justification

It is held that the less favourable treatment of the foreign PE is a restriction and the ECJ moves further to examine whether such restriction can be justified.[235]

The Court stated that the German tax system holds a restrictive provision, but it is justified in order to guarantee the coherence of the German tax system and appropriate since the treatment is symmetrical, the losses deducted are the ones reintegrated. Further the ECJ stated that it was proportionate to the objective pursued. [236]

[232] C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* [2008] ECR I-08061, para 13-15.

[233] C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* [2008] ECR I-08061, para 16-18.

[234] C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* [2008] ECR I-08061, para 30-38.

[235] C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* [2008] ECR I-08061 para. 39.

[236] C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* [2008] ECR I-08061 para. 43-44.

The ECJ states that a MS can not be required to take into account possible negative results that may arise in other tax jurisdictions that are applicable to the PE.[237]

The ECJ further refers to the case *Deutsche Shell*[238] where it is held that the freedom of establishment can not be interpreted as the MS have an obligation to form the tax provisions based on another Member States rules in order to cover all possible disparities that may arise from national tax rules and may affect a company's choice of establishment and have an impact on it. The ECJ lifts out that it is rather the combined effect of the taxation in the principal company's seat and the taxation that is to be in the state the PE is established in, that can lead a restriction of the freedom of establishment and a restriction such as shall be imputable to the state of the PE. Such a restriction is not caused by the tax legislation in either of the states but is rather the result of the allocation of the right to tax between the states according to the tax treaty.[239]

5.7.3 The ruling of the case

After the reasoning held by the ECJ the ECJ came to the conclusion that the German rules were compatible with Community rules. National tax system are allowed to have rules that does not confer any rights to carry losses forward in accordance with the tax treaty and in order to prevent double taxation.

5.8 Comments on the Krankenheim

The *Krankenheim* case makes a connection to the M & S ruling and the approach of the difference between foreign PEs and foreign subsidiaries. Again in *Krankenheim* it is stated that there is a need for symmetry between the temporary loss deduction and the recapture of the amount of the profit made by the PE. This connection can be seen as an extension of the statement from M & S, that profits and losses are two sides of the same coin. Through the *Krankenheim* ruling the ECJ has declared that losses arising from particularities in legislations in other MS need to be compensated through loss deduction in the MS where the head office has its residence when the losses are terminal. The M & S connection to this case can be seen in the aspect of where losses can not longer be used of the other part the parent company/the owner needs to take them into account.

This case is important because first the ECJ applies the ground of justification set up in the *Bachmann*-case[240], the cohesion of the tax system and secondly the court accepted that deduction and recapture mechanism were at hand in the case. Krankenheim yet again establishes that the losses must be final, not temporary in order for the there to be an obligation for the MS to be forced to recognize the losses.

[237] C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* [2008] ECR I-08061, para 49.

[238] C-293/06 *Deutsche Shell GmbH v Finanzamt für Großunterhmen in Hamburg* [2008] ECR I-01129.

[239]C-157/07 *Finanzamt für Körperschaften III in Berlin v Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH* [2008] ECR I-08061 para. 50-52.

[240] C-204/90 *Hanns-Martin Bachmann v Belgian State* [1992] ECR I-249.

6 Analysis

6.1 Introduction

In this chapter an analysis of the facts brought forth in the thesis will be done in order to answer the purpose of the thesis. The aim and purpose of the thesis is to examine whether the M & S ruling is applicable to Permanent Establishments.

6.2 Discussion

6.2.1 The permanent establishment and the subsidiary

The fundamental freedom of establishment set out in Articles 43 and 48 EC gives companies the choice of setting up secondary establishments in other MS. As long as the secondary establishment is set up in accordance with the laws of the state establishing in, no discriminatory treatment is allowed. The choice of secondary establishment is up the establisher to decide upon, and the free choice of form is set out in the second sentence of Article 43 EC.

There is a vital difference between the establishment form of a subsidiary and a branch/ PE. The subsidiary is a legal entity of its own and has a legal personality of its own. The branch on the other hand has no legal personality; it is an extension of the principal office. Rephrased it can be said that the PE is a collection of assets and liabilities owned by a company and can not be shielded off from the parent company. The difference in legal personality ends up in the difference of how the secondary establishment is regarded in the establishing state. A subsidiary will be regarded as a resident of that state while the PE will be considered as a non-resident. The differences between the two types of establishments have in literature been distinguished as at least nine. Those differences have the effect of leading to different tax treatment.

An important difference in the treatment relating to taxation is that the subsidiary automatically is subject to taxation in the state of establishment. The lack of legal personality of the branch leads to taxation first when the branch has required the substance and the duration necessary to attain economic activity in the host state. A question that arises out of this perspective is whether this difference in the legal personality still requires equal treatment of the forms of establishment.

In the history of ECJ case law, there has been an approach of wanting to apply the treatment of resident to non-residents. However, the freedom of establishment and the freedom to choose the legal form of the secondary establishment of suited choice, can not in my opinion be interpreted as the secondary establishments is to be treated equally. Since it is established that there is a difference between the two forms of establishment, indicates in itself that there may be a difference in the treatment according to the laws of the MS established in. As held the ECJ in the *Lidl Belgium* held that the PE was to be considered as an autonomous entity has not brought clarity to the distinction between the two legal forms in ECJ case law. However, the interpretation of that concept derives from the arm’s length principle of Article 7 (2) OECD model convention. The article states that the PE is to be treated as a separate and distinct enterprise. It is likely that the ECJ is influenced by the OECD “definition” of the treatment of a PE. However it is a fact that the PE is not a legal entity of is own, it is a part of the company and can not be separated from it. Its identity is connected to the head office. In regards to the type of business conducted from the PE is an aspect that can separate the PE from the head office. As it may seem, the ECJ has adopted the approach of the definition of a PE from OECD. However, I believe the definition the OECD uses, is generally used in situations where the arms' length principle and transfer pricing is to be applied and situations when the head office and the PE are doing business with each other. In those situations I interpret that the PE is to be considered as a separate entity in order for there to be a possibility to set a market price that is in accordance with the general market. It can also be held that the use of rules that disregards the legal nature and characteristics of the secondary establishments is confusing. That concept of interpreting the PE as an autonomous entity has been accepted by the ECJ. And as the ECJ has a function of filling the gap in the interpretation of the EC Treaty, it is regrettable of them to do such interpretations.

It is quite clear that if there were no difference in the legal treatment of the two types of establishments, the meaning of having the possibility to choose either form when setting up a secondary establishment would loose its meaning. The informed investor would seriously examine the pros and cons with a possible choice of establishment. The consequences of the choice may naturally have an impact on situations such as where losses come into the picture. As stated, the possibilities to set off losses in cross-border situations are limited. The possibility to set off losses differs depending on the type of secondary establishment that is set up. Even if the Commission has made several attempts in trying to eliminate tax obstacles such as cross-border losses and the treatment of them, there is at the moment no solution to the issue. One side to the problem may be that the MS keeps the sovereign right of taxing corporate income. And the fiscal objectives to having this right may feed the reluctance to work toward letting this power shift position to the Community.

In regards to a comparison between subsidiaries and PEs, in the M & S case the parent company wanted to be able to take into account the losses in their foreign subsidiaries as that was possible to do with losses deriving from PEs. In domestic situations losses of branches are taken into account automatically and in cross-border situations depending on the MS legislation at hand, losses can be transferred. However when it comes to subsidiaries, the situation is different. The M & S case stated that only when the possibilities were exhausted in the state of the subsidiary the losses were to be transferred to the parent company in another MS. The ruling of M & S is considered as an important ruling in the area of direct taxation and cross-border loss compensation. Before the ruling many scholars expected the ECJ to take the position of allowing cross-border loss offsetting. But the ECJ accepted the ground for justification brought forth in the case; a balanced allocation of the taxing power, risk of losses being used twice and danger of tax avoidance. Even if the British rules were considered to be a restriction of the freedom of establishment it was justified by the above mentioned grounds of justifications. The Court held that *the taxpayers' residence may constitute a factor that might justify national rules involving different treatment for resident and non-resident taxpayers.* This in my opinion is a comprehensible statement that different treatment is accepted and the sovereignty of the MS in the area of direct taxation is important to uphold. And further the parent company has no tax jurisdiction over the non-resident subsidiaries. Therefore territoriality may prevail over the EC freedoms in the respect of allowing a restriction that can be justified in the interest of the MS.

It may be true that the legal situation of the two forms of secondary establishments referred to in this thesis may not differ substantially economically in the way of conducting business, but one must be aware of that initially the choice of form of establishment has consequences. Such consequence is the differences in the way of dealing with losses and profits and the possibility of taking them into account as wanted. Out of an economic perspective, a PE is probably to be considered a less expensive alternative when establishing on a new market because of less administrative burden.

Out of the legal perspective there are quite a few differences that have to be taken into account when comparing the two and it can definitely be held that the two forms of secondary establishments can be held as not comparable. There are also the differences out of a tax perspective that must be considered. The subsidiary is taxes as a resident and therefore on its worldwide income while the PE is taxed only for the income deriving from the source state, which points to a position of not comparable.

6.2.2 Is the Marks & Spencer ruling applicable to permanent establishments?

With the above stated that I believe there is a vital difference between the PE and the subsidiary. In order to determine whether the M & S is applicable to PEs, the focus will be on situations where the exemption method through tax treaties is used.

Firstly, the outcome of M & S can be said to concern rather specific situations only. Therefore the case is to be considered as an exceptional case applicable only in certain situations. The case covered only one specific part of the cross-border spectra, M & S wanted to deduct losses from the subsidiaries in Europe applying the group relief system applicable to UK resident companies arguing that denying that possibility to the foreign subsidiaries would be a breach of Community rules. As known, the ECJ denied that there was a general obligation to the UK to allow the deductions from the losses of the foreign subsidiaries. The ECJ held that such obligation to take into account the losses from foreign subsidiaries is only present in exceptional cases. Those situations are when it can be determined that the losses in the foreign subsidiary may not be used by itself. This was stated in the proportionality test in the ruling. The outcome of the ruling merely states that the parent company has a responsibility to take the losses into account when they cannot be used in the foreign subsidiary. How it is going to be done were never decided upon by the ECJ, because in the M & S it was assumed that it was the British rules that were going to be used when calculating the losses. This in itself raises a question how that is going to be done in other cases. How it is to be determined what rules to apply, and especially since losses may have a different value, depending on what MS they derive from. However, as stated the M & S ruling is to be used in exceptional cases, as the ones stated in paragraph 55 of the ruling, *"where the subsidiary has exhausted the possibilities available in its residence state to make use of the losses, either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party"*.

Even if it can be stated that the ruling decided that it was terminal losses that was allowed to set off across border, it has in literature been held that several issues have been left open. If reflecting over what those situations might be, I believe that it is fairly vague. Is it situations where there is no carry-forward function to the subsidiary in its resident state? Another reflection that has risen is how it to be determined when the possibilities are exhausted? Is it the taxpayer or the authorities? Is their view the same?

Nevertheless, I believe that the ruling in M & S is narrow, but it brought out a set of grounds of justifications, balanced allocation of the taxing power, risk of losses being used twice and the danger of tax avoidance, that has been used in case law after the M & S case.

Group-taxation systems within the union differ from MS to MS which can be interpreted as the M & S ruling as a whole might be seen as an exception of the allowing rule in the *Oy AA* case, where again losses wanted to be transferred within a group. In that situation the ECJ decided that the Finish rules were acceptable and the losses were not terminal resulting in the fact that the deduction was not accepted. Also in the *Oy AA* case a discussion about artificial arrangements was brought up. Artificial arrangement can not be used as shifting taxable income to a state with another tax rate in order to benefit and choose where the income is going to be taxed.

I am of the opinion that the *Oy AA* case is to be seen as a development from the M & S case. However after the case, the picture of cross-border loss offsetting could not be determined to be clear. It is yet a fact that the losses that are allowed to be set off are to be terminal. In *Lidl Belgium*, the ECJ extended the ruling from M & S to be examined on PEs. Another aspect that came into the picture in the case was that there was a tax treaty between the concerned countries. The treaty held that the income could be deducted in the state of the PE or elsewhere. It was held that a provision that allows a parent company to take into account the losses from a PE when calculating profits and losses, constitutes of a tax advantage and if such a rule is not given to a PE in another MS, it puts that PE in a less attractive position which can be seen as a restriction of the freedom of establishment. If connecting it to the M & S case, where the ECJ held that the foreign subsidiary losses had to be taken into account if the possibilities to use the loss in the subsidiary itself was exhausted, the *Lidl Belgium* case the ECJ applied the same principle stating that the same was true if the MS uses the exemption method in a symmetrical manner to the losses and profits of the PE. After the *Lidl Belgium* case therefore it could be assumed that if the possibilities to carry losses forward the losses needed to be considered. However, after the *Krankenheim* case, still the losses that are to be taken into account by obligation of the MS is the terminal ones.

An interesting aspect in the *Krankenheim* case is that the ECJ applied the principle of cohesion of the tax system. As I know there has been reluctance by the ECJ in using that principle and identifying a link between the will to grant a deduction of a loss and the future taxing of income which is related to the deduction. Nevertheless, in *Krankenheim* such link may be identified through the tax treaty. That is also an issue that had to be taken into account by the ECJ; the tax treaty stated a deduction and recapture rule that in fact existed, which was not the case in M & S.

In the M & S case the ECJ brought out a concept of a *balanced allocation of the taxing power*. The M & S used the statement in relation to subsidiaries; therefore it must be questioned if such statement actually applies to a PE. In my opinion a balanced allocation of the taxing power is connected to that the profits and losses should both be taken into account in order to uphold symmetry. Where the exemption method is used, there is no such symmetry since the income is exempted. Naturally the losses would therefore not then either be taken into account if the profits are exempted. Therefore it is to me not sure that there is such statement applicable from the M & S that will be functionally applicable to a PE.

In situations were losses may be deducted, there is a risk of them to be deducted more than once. This risk is at hand just because there is no harmonisation in the area of direct taxation. In the M & S case it was argued that the MS were allowed to have measures preventing losses being used twice. If taking into account losses more than once leads to a distortion between the MS tax system, it would naturally put pressure on the politicians to work harder in order to eliminate such possibilities.

The ruling of M & S stated that MS could prevent tax avoidance through having measures preventing it. In the opinion to the *Oy AA* case the AG held that the M & S approach to tax avoidance was to take it too far. Again in the opinion to the *X Holding BV* this was brought up by the same AG. She stated that the tax avoidance ground is not a ground standing on its own. One could reflect over the situation in EU, where tax law is not harmonised; tax planning and using the benefit of establish in countries with lower tax rates, where do we draw the line of tax avoidance?

In my opinion I think that it is a questionable result that accepting that losses have to be taken into account when terminal in both cases relating to PEs and subsidiaries. If we consider the PE and subsidiary as different the situations they are in are also in my opinion different. And if we are to uphold a symmetrical treatment of incomes, it can be stated that the profits in the PE are exempted by the MS where the owner of the PE is. So, in accordance with the principle of symmetry of the taxation it would to be considered as setting off the balance of this principle if the losses were to be taken into account in the state were the profits is not taxed. In situations where a deduction of the losses could be argued for may be in situations where the credit method is used. In cases where the exemption method is used under tax treaties it can be held that a justification of not allowing cross-border offsetting of losses is at hand.

It is interesting to see in the *X Holding BV* case the question about legal neutrality of the form of secondary establishments is raised. However it can be held that the national court in the Netherlands narrowed the referred question to the ECJ by asking if Article 43 EC precluded national legislation from having tax provisions allowing there to be fiscal entities restricted to domestic residents only.

Kemmeren has expressed that through the ECJ case law in the area of loss compensation, the ECJ has adopted an internal market approach because the ECJ looks at the overall effect of the tax system and on its aim of realizing the internal market and concluded that ECJ also has the aim of working towards the internal market or contribute to the realizing of it. However, as the ECJ has a part of its task the working towards the internal market, it must be considered how far the distinction between the safeguarding of the sovereignty of the MS in relation to the fulfilment of the internal market and the freedom of establishment? Yes, it may be as he states that the ECJ takes into account all 27 MS tax systems. It may be so, but I am both puzzled and critical to the approach that the ECJ allows losses to be taken into account if considered terminal, either from a PE or a subsidiary. This mainly because of the legal differences between the two forms of secondary establishments but also if losses that are considered to be treated under the method of exemption are allowed to be taken into account. Out of an economic point of view but also connected to tax law and stated in the M & S, *profits and losses are two sides of the same coin*. The M & S cases through this statement states that in fact losses and profits can be seen as needed to be taken care of within the same tax system. If the profits from the PE are exempted from taxation in another MS it should not be out of the symmetrical perspective be possible to take them into account even if they are terminal. By treating losses and profits within the same tax system will prevent situations were double use of the losses will be at hand as well as income shifting from MS A to MS B. It may be a fact that the symmetry will be set aside when allowing the offsetting of losses from a PE to the owning company, but on the other hand, if considering that they are terminal and there really is no other option, it may be in line with the freedom of establishment, the internal market and the elimination of tax obstacles. A compromise it seems to me.

I believed that after the *Krankenheim* case the ECJ will probably have to deal with issues such as how to determine when a loss is terminal and according to what MS legislation it is considered as terminal and how the terminal losses are to be calculated. In connection to this it must also be determined which country's legislation that shall apply when calculating on the terminal losses.

Certainly the EU has tried several times to eliminate tax obstacles such as double taxation which is an effect of lack of cross-border loss relief. However the domestic tax sovereignty is yet very strong and the reluctance to shift the taxing power over to the EU seems to be far away.

The taxation of PEs and subsidiaries differ. The differences derive from a perspective of source base taxation and resident based taxation. If the ECJ really would like to attain equal treatment of the two forms of secondary establishments, the fundamental question of taxation of residents and non-residents and the legal neutrality of the choice of secondary establishments has to be raised. Unfortunately, the chance was missed in when the Dutch Supreme Court referred the question in the *X Holding BV* case to the ECJ. The issue was discussed in the national court but when referred to the ECJ the question was rephrased.

The answer in my opinion, based upon the above analysis, is that the M & S ruling is not to be applied to PE. Both because of the difference of legal personality and especially not when the PE is taxed under a tax treaty using the exemption method. In those cases it is hard to argue for the statement from M & S regarding the balanced allocation of the taxing power, since the symmetry is off balance when both profits and losses is not taxed in the same tax system.

6.3 Conclusion

The purpose of this thesis was to examine whether the Marks & Spencer ruling is applicable to permanent establishment. As stated above, the ECJ has several times applied the concept of residence to non-residents in order to achieve equal treatment. However, my opinion is that the differences between permanent establishments/non-residents and subsidiaries/residents are to the extent so great that they are not in an equal situation whereby an equal treatment can not be at hand. Therefore the Marks & Spencer ruling in my opinion is not applicable to permanent establishments.

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