The 2005 Leiden Forum on Recent and Pending Direct Taxation Cases before the European Court of Justice

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1. IMPUTATION CREDIT: THE MEILICKE (C-292/04), TEST CLAIMANTS CLASS IV (C-374/04) AND TEST CLAIMANTS F II (C-446/04) CASES (ANGEL JUAREZ, LL.M. 2003)

1.1 Introduction

Four recent cases dealing with imputation credits in the context of the taxation of dividend distributions have been resolved or are pending before the European Court of Justice. These are Case C-319/02 Petri Manninen⁷, decided on 7 September 2004, Case C-292/04 W Meilicke and others, pending⁸, Case C-374/04 Class IV of the ACT Group Litigation v Commissioners of Inland Revenue, pending, and Case C-446/04 Test Claimants in the FII Group Litigation v Commissioners of Inland Revenue, also pending.

Imputation credits are means through which states seek to eliminate the economic double taxation that arises in the context of dividend distributions when dividends are taxed as income in the hands of the shareholder whereas the profits from which the dividends are paid would already have been taxed at the level of the company by way of corporation tax. The effect of collapsing the two levels of taxation into one can be achieved by cross-crediting to some extent the corporate income tax paid by the company against the tax liability of the shareholder, or by granting refundable credits (in respect of individuals' income tax) conditional upon the distribution of dividends.

The mitigation of such two-level taxation assimilates the overall tax burden borne by dividends (being the return on equity contributions to companies) with the tax burden borne by interest paid on debt contributed to those companies. Should that mitigation not be pursued the taxation of interest would generally be at advantage compared to the taxation of dividends, as interest is usually deductible for the borrower and only taxed in the hands of the lender (i.e. one level of tax), whereas dividends are generally taxed in the hands of the shareholders at the same time that the profits from which those dividends have been paid out have also been taxed in the hands of the dividend paying company. From a corporate finance perspective, such difference in the tax treatment of corporate equity and corporate debt will generally result in an incentive for companies to be financed with debt rather than with equity. From a fiscal policy perspective, states do in many cases try to mitigate or eliminate such an incentive for undercapitalization of enterprises. In that context, what countries do is that they eliminate one of the levels of tax (whether the company level or the shareholder level) or that they eliminate part of the company level taxation or the shareholders level taxation or part of both.

However countries do not typically cross-credit foreign corporate income tax against individuals' income tax. They do that sometimes at corporate income tax level (the indirect foreign tax credit is just one example), but countries do not do so at the individuals' shareholder level. Similarly, countries tend to grant refundable imputation credits to resident taxpayers (as well as to residents in certain treaty partner states, subject to limitation on benefits clauses) but they refuse to grant refundable credits to non-residents in general (other than those treaty partners).

That is precisely where the issue of the compatibility with the EC Treaty freedoms starts, particularly both in connection with the freedom of establishment under Article 43 EC Treaty (which will be relevant in connection with cross-border distributions of dividends paid⁹ to or received by¹⁰ EC residents of countries different from that EC Member State where the company distributing the dividends is resident) as well as in connection with the free movement of capital.
of capital under Article 56 EC Treaty (which will be relevant in connection with cross-border distributions of dividends paid by EC resident companies to both EC and non-EC resident shareholders resident in a state different from the host state, as well as in connection with dividends received by EC resident shareholders from companies resident both within and outside the EC but in a different state from that where the company distributing the dividends is resident).

1.2 Comparability Analysis

Two of the cases under analysis concern imputation credits granted by the state of residence of the shareholder receiving the payment of the dividend from a foreign company. These are Petri Manninen and W Melilicke.

In W Melilicke and others the facts are similar to those of Manninen. At the time relevant to the case, a payment of dividends by a German resident company to a German resident individual gave rise to a 3/7 imputation credit. The credit was added to the taxable income of the individual shareholder and both the cash dividend and the imputation credit were taxed at the then applicable tax rate\(^\text{11}\). The imputation credit was then credited against the individuals’ tax liability. In the case of Germany there is no indication that there was any adjustment to the company’s tax liability when the same did not match the value of the imputation credit.

The above was the case at a domestic level. When the dividend was received from a non-German resident company no cross-crediting was available, with the result that either international economic double taxation was not mitigated/eliminated, or that the taxation of equity financing was left higher than the taxation of debt financing (whereas such taxation was to be the same in a purely domestic situation). The issue was then whether the German 3/7 imputation credit available in purely domestic situations should, on a proper construction of EC Law, be also made available to the taxpayer in W Melilicke and others, who received dividends from companies resident in the Netherlands and Denmark.

The first issue that was discussed in Manninen was whether rules such as those relevant to the case infringed Article 56 EC Treaty, which prohibits any restriction on the movement of capital between Member States and between Member States and third countries. Similar to what it had established in Verkooijen, the ECJ in Manninen reiterated that although measures as those relevant to the case do not directly restrict the movement of capital, they constitute an indirect restriction to Article 56 EC Treaty. In that sense, those measures deterred Finnish individuals from investing in foreign companies and they also made it more difficult for foreign companies to raise capital in Finland. The position that indirect restrictions\(^\text{12}\) also infringe Article 56 EC Treaty is well established, but it is necessary to state that this has not always been the prevalent position in the case law of the ECJ, as in Bachmann\(^\text{13}\) the ECJ had refused the argument that indirect restrictions similar to those in Verkooijen and Manninen were in fact prohibited by the article equivalent to the present Article 56 EC Treaty. It was only after the adoption of Directive 88/361/EEC and the adoption of the Treaty of Maastricht that indirect restrictions on the free movement of capital have also been consistently held by the ECJ to be prohibited by the EC Treaty.

The second issue addressed by the ECJ was whether Manninen, having received a dividend from a Swedish company was in a comparable situation to a Finnish individual resident having

\(^{11}\) Unlike in Manninen, in W Melilicke the tax rate applicable to dividend receipts resulted from the application of the general table of progressive (i.e. marginal) individuals’ income tax rates.

\(^{12}\) i.e. restrictions that do not directly hinder the transfer of capitals but “operation[s that are] indissociable (sic) from a capital movement”, as the ECJ put it in Verkooijen.

\(^{13}\) ECJ, Decision, 28.01.1992, case C-204/90, Bachmann
received a dividend from a Finnish resident company. In that regard, the ECJ established that “[i]n the face of a tax rule which takes account of the corporation tax owed by a company in order to prevent double taxation of the profits distributed, shareholders who are fully taxable in Finland find themselves in a comparable situation, whether they receive dividends from a company established in that Member State [i.e. Finland] or from a company established in Sweden”\textsuperscript{14}. The Court however had also pointed out that “in relation to such legislation, the situation of persons fully taxable in Finland might differ according to the place where they invested their capital. That would be the case ... where ... the Member State in which the investments were made already eliminated ... double taxation ...”, by, for example, subjecting to corporation tax only such profits by the company concerned as were not distributed\textsuperscript{15}.

Such an approach by the ECJ raises two questions: one is whether the comparability analysis undertaken by the ECJ in \textit{Manninen} would also hold good in the event that one might not agree with the contention that measures such as the grant of imputation credits are addressed to relieve economic double taxation on the payment of dividends (but, for instance, to put the taxation of equity and debt financing of companies on an equal footing). The second question relates to whether the ECJ is correct in stating that individual resident taxpayers resident in the same Member State would not be in a comparable situation based on whether the State where the company paying the dividend has already eliminated “the risk of double taxation” or otherwise.

In the author’s view the comparability analysis undertaken by the ECJ is often based on the intended objectives of the legislation under examination, whether those objectives are explicit or implicit. If, for Finland, imputation credits are means to relieve economic double taxation, then the analysis would probably be whether economic double taxation existed both at the domestic and at the cross-border level. On the other hand, if the intended objective would have been granting the same (or a similar) tax treatment to the equity and to the debt financing of companies, and if that had to be done by means of eliminating or reducing the tax borne by the shareholder on the dividend, the ECJ would probably have to arrive to the same conclusion it reached in \textit{Manninen} in connection with the economic double taxation, as the risk that equity financing could be at a disadvantage when compared to debt financing existed both in domestic as well as in cross-border cases.

As to the second question, i.e. whether the comparability analysis would also hold true in case that such economic double taxation would have been eliminated in the host state, it is submitted that the statement of the Court in Paragraph 34 of \textit{Manninen} is nothing more than \textit{obiter dictum}\textsuperscript{16}. Had Sweden exempted the company profits from tax it is the author’s view that there is still room to argue that Finland still restricted the free movement of capital by imposing a higher individuals’ income tax burden on its residents investing in Sweden than it would have imposed on resident individuals investing in a resident company. In that context it seems fair to submit that the issue is not yet resolved.

The two other cases of under analysis concern imputation credits granted by the state of residence of the company effecting the payment of the dividends. The facts of \textit{Class IV of the ACT Group Litigation} are probably similar to those in \textit{Metallgesellschaft}, as both cases concern advanced corporation tax (or ACT). However, in \textit{Metallgesellschaft} the case concerned ACT payments, while \textit{Class IV of the ACT Group Litigation} concerns ACT credits. Furthermore, whereas in \textit{Metallgesellschaft} the comparison was established between a foreign corporate

\textsuperscript{14} Paragraph 38.
\textsuperscript{15} Paragraph 34.
\textsuperscript{16} \textit{i.e.} an opinion in a matter related but not essential to the case.
shareholder and a domestic corporate shareholder, in Class IV of the ACT Group Litigation there are several comparability tests presented, none of them being the same presented in Metallgesellschaft. One is the comparison between a foreign corporate shareholder and certain other foreign corporate shareholders, thus more in line with the comparability analysis in the implied most favoured nation treatment case D. v Rijksbelastingdienst. Second, Class IV of the ACT Group Litigation also raises issues concerning the compatibility of “limitation of benefits” clauses (LOB Clauses) with EC law. Third, two new terms of comparison are put forward. One is the comparison between foreign corporate and domestic individual shareholders and the other is the comparison between foreign corporate and foreign individual shareholders. None of the comparison terms is formulated along the lines of Metallgesellschaft, which would have opened room for arguments similar to those in the EFTA Court case Fokus Bank. Not having done so makes difficult to say whether the Court will indeed adopt the approach taken in Metallgesellschaft or Fokus Bank.

Test Claimants in the FII Group Litigation concerns a variety of issues, including liability to corporate income tax in the context of dividends received by UK companies from foreign subsidiaries, and liability to ACT in the context of dividends paid by UK companies out of dividends received from foreign subsidiaries. Additionally the case presents issues regarding the utilization of ACT credits by foreign group companies of the UK company paying ACT. In that context, it seems fair to submit that the comparability tests put forward in Test Claimants in the FII Group Litigation have certain similarities with those present in ICI, Saint-Gobain, Verkooijen, Metallgesellschaft and Marks and Spencer.

The first question presented by Test Claimants in the FII Group Litigation is whether the UK can tax its resident companies on dividends received from foreign subsidiaries in circumstances where such tax would have not been imposed had the subsidiary been resident in the UK. This seems to be a situation similar to that in Verkooijen, where the ECJ established that the two situations (i.e. investing in a domestic company and investing in a foreign company) were objectively comparable and where there was no room for fiscal cohesion arguments. One of the differences between Verkooijen and Test Claimants in the FII Group Litigation is that the former concerned an individual resident taxpayer, whereas the latter concerns domestic corporate taxpayers, but such difference does not seem to justify a different outcome of the case.

The second question presented by Test Claimants in the FII Group Litigation concerns liability to ACT in the context of dividends paid by UK companies out of dividends received from foreign subsidiaries. Apparently, companies resident in the United Kingdom were required to pay ACT on dividends paid out to its shareholders – wherever resident – to the extent that such dividends had been paid out of profits originating from dividends received by the UK resident company from subsidiaries resident outside the UK, but such UK resident companies were not required to pay ACT insofar as the profits from which the dividend was paid out originated from subsidiaries resident in the UK. The issue is whether that difference in treatment is permitted by Articles 43

17 The issue in Metallgesellschaft (ECJ, Decision, 8.03.2001, joined cases C-397/98 and C-410/9898, Metallgesellschaft Ltd and Others), was whether ACT payments could operate as an earlier collection of tax in cross-border situations where such earlier collection would not have occurred in purely domestic situations.
18 ECJ, Decision, 05.07.2005, case C-376/03 D. v Inspecteur van de Belastingdienst / Particulieren / Ondernemingen buitenland te Heerlen.
19 EFTA Court Decision, 23.11.2004, case E-1/04 Fokus Bank ASA and the Norwegian State, represented by Skattedirektoratet (the Directorate of Taxes), where a comparison between a foreign and a domestic corporate shareholder was put forward by the taxpayer. A situation similar to that in Fokus Bank is likely to be examined by the ECJ in Case C-170/05 Denkavit International BV and Sari Denkavit France, OJ C 155 25.06.2005 p.4
20 ECJ Decision, 16.07.1998, case C-264/96 Imperial Chemical Industries plc (ICI) v Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes).
or 56 EC Treaty.

The ECJ established the characteristic elements of ACT in *Metallgesellschaft*, where it stated that ACT was “not a sum withheld on a dividend, which is paid in full, but is rather corporation tax borne by the company distributing the dividends, paid in advance and set off against the mainstream corporation tax payable in respect of each accounting period”\(^2\). The shareholder was then given – under certain circumstances – an imputation credit in the same amount of the ACT collected, but this did not jeopardize the classification of ACT as a prepayment of corporation tax (against which ACT was also credited).

If that analysis is maintained by the ECJ it seems that the comparability analysis relevant to this second question could be similar to that in *Verkooijen*. Here, like in *Verkooijen*, (corporate) income tax\(^2\) was imposed on the resident taxpayer on the receipt of foreign dividends that was not imposed in domestic situations. However while *Verkooijen* concerned individual residents, *Test Claimants in the FII Group Litigation* concerns corporate residents\(^2\). On the other hand, *Verkooijen* concerned free movement of capital, whereas *Test Claimants in the FII Group Litigation* concerns both free movement of capital and freedom of establishment. But none of these seem to be sufficiently relevant to impede the application of the principles in *Verkooijen* to this case. What is relevant, however, is that *Verkooijen* concerned free movement of capital within the EC, while *Test Claimants in the FII Group Litigation* concerns both free movement of capital within the EC and between the EC and third countries. In that connection it is conceivable that Article 57(1) EC Treaty could play a role in preventing that the principles established in *Verkooijen* could be applied to *Test Claimants in the FII Group Litigation* in what concerns the free movement of capitals between the EC and third countries.

The third question in *Test Claimants in the FII Group Litigation* concerns utilization of ACT credits against mainstream corporation tax. At the time relevant to the case such credits could be set off against the mainstream corporation tax of the company paying the dividend as well as against the mainstream corporation tax of group companies resident in the UK, but (i) those credits could not be used to offset corporation tax paid by group companies not resident in the UK – whether resident in the EC or not – and (ii) furthermore, the mainstream corporation tax against which the ACT credits could be used had to be reduced by any (international) double tax relief enjoyed by the resident company using the ACT credits.

In that context, it seems fair to conclude that the relevant comparability analysis in this respect seems to be similar to that required in *Marks & Spencer*. There the issue was whether losses incurred by non-UK resident subsidiaries of a company resident in the UK could be used to offset profits of the UK-resident parent company. Here the issue is whether credits arising from ACT payments made by a company resident in the UK can be used to offset the mainstream corporation tax liability of group companies not resident in the UK. If that position is upheld by the ECJ it is the author’s view that there do not seem to be many reasons for which the conclusions in *Marks & Spencer* should not be extended to the third question of *Test Claimants in the FII Group Litigation*. Whether (international) double taxation relief may reduce the UK tax liability against which ACT credits can be used is a matter that seems to share the same logic as aforesaid. However, letting ACT credits reduce the UK tax liability first, could conceivably shift the matter from a non-discrimination plane to a double taxation treaty compliance plane. Finally, *Test Claimants in the FII Group Litigation* concerns not only free movement of capital within the EC but also the free movement of capital between the EC and non-Member States. This, as in the second question of the same case, could bring in the applicability and limits of

\(^{22}\) Paragraph 6.

\(^{23}\) Collected by way of ACT.

\(^{24}\) This opens the room for a potential argument under Articles 4(1) or 6 of the Parent Subsidiary Directive, which is also put forward in *Test Claimants in the FII Group Litigation*. 
Finally, the fourth question of Test Claimants in the FII Group Litigation raises the issue of whether it is compatible with Articles 43 and 56 EC Treaty for the UK to oblige its resident companies to pay ACT and reclaim a reimbursement of such ACT when dividends are paid out of profits arising from dividends received from non-resident companies (whether resident in the EC or not) and not to allow ACT imputation credits to the shareholders of such ACT paying company when ACT has been reimbursed as aforesaid.

Such question seems to present similarities with Metallgesellschaft, where ACT could not be collected on dividend payments made by a company resident in the UK to EC corporate shareholders not resident in that country, under circumstances where ACT would not have been collected in a purely domestic situation. If that position was to be confirmed in connection with Test Claimants in the FII Group Litigation that could militate in favour of exempting the dividend payments relevant to its fourth question from ACT completely. The particularity of Test Claimants in the FII Group Litigation is that, in contrast with Metallgesellschaft, the free movement of capital between the EC and non-Member States is also involved and, in that context, such case could well extend the principles in Metallgesellschaft to companies resident outside the EC. What in the author’s view seems more difficult to understand and accept is why ACT credits should be granted at all in respect of ACT payments that are reimbursed completely.

1.3 Fiscal Cohesion

The need to preserve the fiscal cohesion of the Finnish tax system was one of the arguments put forward in Manninen. Finland, the United Kingdom and France argued that the Finnish rules were necessary to ensure that the same income was taxed only once in Finland. The system ensured that the tax charged to a Finnish resident company by way of corporate income tax was granted as a credit to Finnish individual resident shareholders by way of an imputation credit. Thus, there was a direct link between the tax imposed on the resident individual receiving the dividend and that imposed on the resident company paying such dividend.

The EC Commission and Manninen contended on their part that the Finnish rules regarding imputation credits were not totally coherent, as they did not provide for Finnish imputation credits to be granted to individual shareholders not resident in Finland. This being a proof of the lack of cohesion of the Finnish legislation, the parties contended, made it unacceptable for Finland to argue that its restrictive legal measure should be saved under fiscal cohesion merits. Such a manner of reasoning seemed to have gained favour with the ECJ in Bosal.

The Advocate General did not follow the Bosal-type of reasoning. Indeed, departing from the interpretation of many as to the traditional ECJ’s formulation of fiscal cohesion, the Advocate General wondered whether the “same tax, same taxpayer” test was effectively required for fiscal cohesion to justify a national measure otherwise incompatible with the EC Treaty or whether such test was a mere indicator that the required direct link existed. The Advocate General proposed a new approach to fiscal cohesion whereby the “same taxpayer” requirement would not be necessary provided that (a) the tax is levied if not on the same taxpayer, at least on the

25 Permitting the applicability to third countries of restrictions which existed on 31 December 1993 under national or Community law in respect of the movement of capital to or from third countries.

26 Instead of exempting such dividend payments from ACT completely.

27 Rather than requiring collection of ACT and granting a refund of such ACT paid subsequently.

28 Although this could also bring in the issue as to the applicability of the exception to the free movement of capital between the EC and non-Member States in Article 57(1) EC Treaty.

29 ECJ Decision 18.09.2003, case C-168/01 Bosal Holding BV v Staatssecretaris van Financiën.
same income or the same economic process and (b) the system ensures that the tax advantage accrues to one taxpayer only if the disadvantage to the other taxpayer is real and in the same amount. This was allegedly in line with the principle of “only-once taxation” whereby fiscal cohesion would be defined as “no more than avoiding double taxation or ensuring that income is actually taxed, but only once”.

The ECJ did not explicitly refer to the principle of “only-once taxation” or to whether the “same taxpayer, same tax” test constitutes a requirement or just an indicator of a direct link in connection with fiscal cohesion. On the other hand, it did not reiterate the line of reasoning in Bosal. Instead, in refusing the fiscal cohesion argument, the Court stated that the Finnish legislation under analysis went beyond what was necessary in order to ensure the cohesion of the national tax system because, in view of the purpose of the relevant domestic tax measure, it would have been sufficient for the imputation credit in cross-border situations to match the corporate income tax borne by the non-resident company paying the dividend.

In connection with Test Claimants in the FII Group Litigation, potential fiscal cohesion arguments in connection with the first and the second questions raised by such case seem to have been already addressed by the ECJ in Verkooijen. Not taxing domestic companies on dividends received from domestic subsidiaries, while taxing them on dividends received from foreign subsidiaries, could only be justified by the fact that the profits from which the former dividends have been paid have already been taxed domestically. However, in Verkooijen the ECJ refused to uphold such fiscal cohesion argument on the basis that no direct link could be established between the grant and the offsetting of the tax advantage, as the domestic link existed in connection with two different taxpayers and two different taxes and it seems that the argument could well be extended to this case.

However, the opposite result could conceivably arise from the third question in Test Claimants in the FII Group Litigation, at least in connection with granting ACT refunds to foreign group companies not subject to any UK tax liability. In that context there seems to be a direct link as to the grant and the offset of the tax advantage in connection with one and the same tax and one and the same taxpayer which could allow the UK, under fiscal cohesion principles, not to grant ACT credits to corporate taxpayers who are not subject to any kind of UK tax liability.

A similar argument, under the same circumstances, seems to be possible in connection with the different questions posed by Class IV of the ACT Group Litigation.

1.4 Article 58(1) (a) EC Treaty

In Manninen the litigating governments argued that Article 58(1)(a) EC Treaty contained an exception that allowed them to apply rules, which distinguish between taxpayers that have different places of residence or that invest in different jurisdictions. That argument was overruled by the ECJ. In doing so, the Court followed four principles that had been summarized by the Advocate General, i.e. (i) Article 58(1)(a) EC Treaty does not give carte blanche; (ii) it further shall be interpreted strictly, because it is a derogation from a fundamental principle, (iii) It must be read in conjunction with Article 58(3) EC Treaty, which prohibits arbitrary discrimination, and (iv) it shall be interpreted in the light of case law preceding to its adoption.

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30 Paragraph 51 of the Opinion of the Advocate General.
31 i.e. whether the UK can tax its resident companies on dividends received from foreign subsidiaries in circumstances where such tax would have not been imposed should the subsidiary have been resident in the UK.
32 i.e. refundable ACT credits are not granted to foreign corporate taxpayers who are not subject to any UK tax liability.
33 In this context it is probably worth mentioning that the UK does not impose withholding tax on dividends paid by companies resident in the UK.
34 i.e. where the foreign taxpayer is not subject to any kind of UK tax liability.
The Court distinguished between unequal treatment, permitted by Article 58(1)(a) EC Treaty, and arbitrary discrimination, prohibited by Article 58(3) EC Treaty. For the Court permitted unequal treatment would exist if the difference in treatment: (i) concerns situations which are not objectively comparable; or (ii) is justified by overriding reasons in the general interest; and (iii) does not go beyond what is necessary in order to attain the objective of the legislation. Otherwise such difference will amount to forbidden arbitrary discrimination.

In the face of a tax rule which takes account of the corporation tax owed by a company in order to prevent double taxation of the profits distributed, shareholders who are fully taxable in Finland find themselves in a comparable situation, whether they receive dividends from a company established in that Member State or from a company established in Sweden. Having obtained the profits subject to tax in the Member State where the shareholder was resident was not an objective difference that could be saved under Article 58(1) (a) EC Treaty.

It is submitted that such a delimitation of the term “arbitrary discrimination”, which will also apply to capital movements to or from third countries, might make plausible claims under Article 56 EC Treaty by EC investors in third countries and by non-EC investors within the EC.

1.5 Limitation on Benefits

Class IV of the ACT Group Litigation raises the issue of whether it is contrary to Article 43 or 56 EC Treaty for the United Kingdom not to confer a partial tax credit in respect of dividends paid by a company resident in the UK to a corporate shareholder resident in the Netherlands which is controlled by a company resident in Germany, when the UK would confer such credit on dividends paid by UK companies to corporate shareholders resident in the Netherlands which are controlled by residents in the Netherlands or Italy.

LOB clauses have been the subject of the decisions of the ECJ in the so-called Open Skies cases where the Court condemned, as contrary to the freedom of establishment, a clause whereby a third state (in this case the United States) could withdraw, suspend or limit certain permissions of an airline designated by a Member State but of which a substantial part of the ownership and effective control is not vested in that Member State or in national of that Member State. In Class IV of the ACT Group Litigation the LOB clause operates at a purely EC level. However, whereas in the Open Skies cases the question was whether a British airline controlled by a shareholder national of a Member State other than the UK could be subject to a less favourable treatment in the UK than a British airline controlled by a British shareholder, in Class IV of the ACT Group Litigation the issue is whether a Dutch company controlled by a German company can be treated less favourably in the UK than a Dutch company controlled by either a Dutch or an Italian corporate shareholder. Thus, while in the Open Skies cases the LOB clause introduces an issue of direct discrimination between nationals and non-nationals, in Class IV of the ACT Group Litigation the LOB clause introduces an issue of most favoured nation treatment. Whereas national treatment is clearly demanded by Articles 43 and 56 EC Treaty, the ECJ has already had the opportunity to establish that Article 56 EC Treaty does...
not demand most favoured nation treatment\textsuperscript{43}.

\subsection*{1.6 Temporal Effects of the Decisions of the ECJ}

The Opinion of the Advocate General in \textit{W Meilicke} maintains that the effects of the ECJ decision on such case should be limited in the sense that it should not give rise to new claims in connection with imputation credits that should have accrued in Germany in situations similar to that in \textit{W Meilicke} before 6 June 2000 (i.e. the publication date of \textit{Verkooijen}), provided that such restriction should not apply to taxpayers having filed claims before 11 September 2004 (i.e. the publication date of the Order for Reference in \textit{W Meilicke}).

In the view of the Advocate General, such a limitation on the effects of a decision of the ECJ can be established, in exceptional situations, if the following requirements are cumulatively met: (i) where there is a risk of serious economic repercussions owing in particular to the large number of legal relationships entered into in good faith on the basis of rules considered to be validly in force; and (ii) where it appeared that both individuals and national authorities had been led into adopting practices which did not comply with Community legislation by reason of objective, significant uncertainty regarding the implications of Community provisions, to which the conduct of other Member States or the Commission may even have contributed\textsuperscript{44}.

The contention of the Advocate General seems to be based on the German argument that a decision in favour of the taxpayer in \textit{W Meilicke} could give rise to a potential exposure to repayments of tax in the amount of €5 billion (0.25\% of the German GNP in 2004). Additionally, on 31 October 1995 the EC Commission had sent a letter to the German government where the Commission stated its view that the German imputation credit rules (i.e. those relevant in \textit{W Meilicke}) were contrary to the EC Treaty, but such letter was never followed by subsequent legal action, given that with effect as of 1 January 2001 Germany amended its imputation credit rules and substituted them by the so-called 50\% exemption. In the view of the Advocate General, that lack of activity of the EC Commission may have caused the German government reasonably to believe that the legislation at issue was in conformity with Community law at least until the date of publication of \textit{Verkooijen}, on 6 June 2000.

The alleged uncertainty as to whether the rules in \textit{W Meilicke} were compatible with the EC Treaty before 6 June 2000 could only be based on the fact that in \textit{Verkooijen} the Court made for the first time explicit that indirect restrictions to the free movement of capital were also contrary to the EC Treaty, thus departing from the opposite statement that it had made in \textit{Bachmann}. However, it is also clear that the rules were incompatible with the EC Treaty since the adoption of the Maastricht Treaty in 1992 (and probably also since the adoption of Directive 88/361/EEC in 1988). It is true that the ECJ did not make that point explicit until \textit{Verkooijen}, and that it refrained from doing so in \textit{Safir, Baars and Metallgesellschaft}. However, it is difficult to understand why the consequences of such inactivity shall be borne by taxpayers that have been discriminated in a manner incompatible with the EC Treaty. Thus, it remains to be seen whether the ECJ will follow the position of the Advocate General as to the limitation of effects of the decision of the Court and, if positive, whether that will give rise to any kind of liability of the EC institutions or whether the consequences of such lack of activity (as to the clarification that certain domestic rules were incompatible with the EC Treaty) will be borne by the taxpayers that have been discriminated in a manner inconsistent with the EC Treaty.

\subsection*{1.7 Conclusion}

The four cases under analysis will set the path of the ECJ’s position as to the compatibility of

\textsuperscript{43} Case \textit{D}, Paragraph 63.

\textsuperscript{44} ECJ Decision, 15.03.2005, case C-209/03 \textit{Bidar}, Paragraph 69.
cross-border restrictions on the grant of imputation credits with the EC Treaty provisions on freedom of establishment and the free movement of capital. Manninen has already made clear that the analysis in Verkooijen should in principle be extended to imputation credits at least from the perspective of the taxation of residents in the home state. Class IV of the ACT Group Litigation and Test Claimants in the FII Group Litigation will probably set the rule as to whether, and to what extent, those principles be extended to the taxation of non-residents in the host state. More than that, they will also help establish to what extent the Court is willing to extend those principles to the free movement of capital between the EC and non-Member States. In that connection, the role of Articles 57(1), 58(1)(a) and 58(3) EC Treaty will also be tested, although the Court already made its position clear as to the dividing line between Articles 58(1)(a) and 58(3) EC Treaty in Manninen, and it seems that there is no reason for which the position of the Court in that respect should decide differently in connection with a purely intra-EC movement of capital as against a case concerning the movement of capital between EC Member States and third countries. On the other hand, it remains to be seen whether the Court would ever support the position of the Advocate General in Manninen as to the boundaries of fiscal cohesion, namely whether fiscal cohesion can be equated to the so-called “principle of only-once taxation” and whether the “same tax, same taxpayer” requirement will ever be abandoned by the Court. The same can be said in connection with the Advocate General’s position as to the limitation of the effects of the future decision of the ECJ in W Meilicke and who will bear the consequences of such potential limitation of effects. Finally, it is expected that Class IV of the ACT Group Litigation will bring further clarity from the Court in connection with two contentious issues that the Court has had the opportunity to address: one is the most favoured nation treatment and the other one is the compatibility of LOB clauses with the fundamental freedoms of the EC Treaty.

2. THE CADBURY SCHWEPPES CASES (C-196/04) (LINDA FAVI, LL.M. 2000)

2.1 The issue

Reference has been made to the Court of Justice of the European Communities by the UK Special Commissioners for preliminary rulings in three cases involving CFC taxation45, all based on the main question whether articles 43, 49 and 56 of the EC Treaty preclude a national tax legislation, which provides in specified circumstances for the imposition of a charge upon a company resident in a Member State in respect of the profits of a subsidiary company resident in another Member State and subject to a lower level of taxation.

UK CFC legislation provides, by way of exception to the rule that profits of a foreign subsidiary are not taxed in the UK as they arise, that where the subsidiary is resident outside the UK and is subject to a ‘lower level of taxation’, i.e. where in any accounting period in which the tax paid by the foreign subsidiary in its country of residence is less than three-quarters of the amount of UK tax that would be paid on the profits of the subsidiary as computed for UK tax purposes, the income of the foreign subsidiary – with a number of exceptions – is attributed to the UK parent and taxed with credit for foreign tax paid by the subsidiary.

In substance, CFC rules constitute a peculiar way of computation of the taxable income of a resident company with foreign subsidiaries which is not applicable when domestic subsidiaries are involved, and which prevents enjoyment of the tax deferral that, rather than representing a form of tax avoidance, is a basic feature of most tax systems, whereby the income of non-resident companies, treated as separate taxable entities as is the case for domestic companies, is not taxed when realised abroad.

45 In cases C-196/04 (Cadbury Schweppes PLC v. the Commissioners of Inland Revenue), C-203/05 (Vodafone) and C-201/05 (Test Claimants in the CFC and Dividend Group litigation).
As a measure applicable solely to resident taxpayers by the “Home State”, i.e. by the residence state of the targeted taxpayer, CFC legislation cannot discriminate by reason of nationality (nor can it be said to impose “other covert form of discrimination which, by application of other criteria of differentiation, lead in fact to the same result”); the question is therefore whether it imposes any restriction in the exercise of fundamental freedoms. The person whose rights are to be investigated is a (real) national of the State applying CFC rules, or a (real) EU national residing in that Member State, and the tax treatment it enjoys when incorporating and managing a subsidiary in another Member State has to be compared with the (hypothetical) tax treatment it would have been subject to had it held a domestic subsidiary or invested domestically.

With reference to CFC legislation, it is worth recalling that the prohibition of Home State restrictions applies where a national of a Member State or an EU national residing in a Member State is deterred from creating or exploiting an entity in another EU country. In this respect, the ECJ ruled in the IC\(^{48}\) decision that the legislation of a Member State which, depending on the location of the subsidiaries – e.g. domestic subsidiary vs. subsidiary in another Member State – differentiates the tax burden on the parent company from the profits earned by its subsidiaries, brings about an inequality of treatment that, if not justifiable, amounts to a prohibited restriction.

A very important outcome that may be derived from such case is the settlement of the principle under which the conditions of the internal market are only met when the same – meaning “not more burdensome” – tax treatment to (parent) companies applies in both cases of the ownership of a domestic subsidiary and the ownership of a subsidiary in another Member State. The Court decided the case on the basis of Art. 52 (now Art. 43) and construed any difference in treatment between (resident EU national) taxpayers based on the criterion of the seat of the companies of which those taxpayers are shareholders as being in principle contrary to the right of free establishment protected by the Treaty\(^{49}\).

Indeed, reference will be made in the following paragraphs mostly to features of CFC legislation hindering the exercise of the freedom of establishment; however, it is intended that any restrictive effect might be held to hinder also the free movement of capital and the freedom to provide services.

### 2.2 Effects of operation of CFC legislation

In case of application of CFC rules, insofar as a resident taxpayer holds or has substantial influence over a foreign entity, which fulfils the requirements of CFC legislation, it would not be able to get the same (\textit{mutatis mutandis}) tax treatment as that applicable to the holding of a domestic entity: rather, the applicable tax treatment may easily result in a restriction. Indeed, the tax imposed on a resident taxpayer when the CFC regime does not apply is much lower than the tax paid as a consequence of the application of the CFC regime, as in the latter hypothesis the CIT base is increased of the profits of the foreign subsidiary.

In this respect, the ECJ\(^{50}\) clearly affirmed that “…even though, according to their wording, the provisions concerning freedom of establishment are directed mainly to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of

\(^{46}\) C-152/73 (the Sotgiu case).

\(^{47}\) One of the questions remitted to the ECJ by the Order for reference of the Cadbury Schweppes case reads “If it (i.e. the claimant) is exercising the fundamental freedoms, whether the correct approach in the circumstances of this case is to consider whether the United Kingdom’s controlled foreign companies’ legislation may be viewed as a restriction on the exercise of those freedoms, or whether it involves discrimination”; the order goes further in asking what comparison should be made to answer to this question.


\(^{49}\) More precisely, the prohibited difference in treatment resulted from the fact that a tax advantage was conferred by the Member State concerned to nationals of Member States residing in its territory and owning a substantial holding in a company having its seat in the same Member State, while it was denied to nationals of Member States residing in its territory who, exercising their right of free establishment, managed a company having its seat in another Member State.

\(^{50}\) ICI, C-264/96 (1998).
that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation which comes within the definition contained in Art.5851. The ECJ confirmed this interpretation in 1999 in its decision on the X AB and Y AB case52.

Clearly, the increase of the effective tax liability caused by application of CFC regime constitutes a hindrance to the exercise of Treaty freedom. In any event, the least significant consequence brought into being by the application of CFC rules is the anticipation of the taxation of the profits realised by the controlled foreign entity in the hands of the qualifying taxpayers. In March 200153, the ECJ resolved that a difference in treatment causing a cash-flow disadvantage to companies exercising their right to free establishment is prohibited by Art. 52 (now Art. 43) of the treaty where it is not justified by overriding reasons of general interest. The reasoning of the Court was based on that a cash-flow disadvantage imposed on EU cross-border participation compared to a domestic participation constitutes per se a restriction on the free establishment.

Further, if a qualifying resident taxpayer had been in a loss situation, since CFC taxation does not amount to a form of consolidation, it would nonetheless have to pay taxes on the CFC’s profits. This outcome – which, besides other implications, ignores the Constitutional principle of ability to pay – would not have occurred had the resident taxpayer invested domestically or in a non-targeted Member State. Moreover losses of a foreign permanent establishment would generally be consolidated with domestic profits of the parent company. The non-attribution of losses of a subsidiary qualified as a CFC, the profits of which are attributed to the domestic shareholder, may result in a difference in treatment between the holding of a subsidiary or a permanent establishment by a resident taxpayer that cannot be explained by objective or logical reasons. Differential treatments based on the legal form chosen for the foreign establishment by a national of a Member State, where the treatment is not reasonably related to the legal form, are prohibited under the freedom of establishment principle. Indeed, the Avoir fiscal54 judgement showed that the same (ut supra) tax treatment should be available to corporations, whether they hold a subsidiary or a permanent establishment subject to corporate income tax in another Member State. Freedom of establishment entails the right for nationals of a Member State to choose the appropriate legal form in which to pursue their activities in another Member State, and that freedom of choice must not be limited by discriminatory tax provisions. This principle has been expressed by the ECJ with regard to a discriminatory tax provision applied by a host state55. In the opinion of the Court, where the tax law of a Member State treats the two forms of establishment (i.e. subsidiary and permanent establishment) in the same way for the purposes of taxing their profits, so that resident and non-resident companies are considered in the same position in relation to the source of income, there would be no reason to accept any differential treatment.

If the whole argument has to be considered relevant for the tax provisions of the home state – because “art. 52 (now Art. 43) would be rendered meaningless if the Member State of origin could prohibit undertakings from leaving in order to establish themselves in another Member

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51 By means of Art. 58 (now Art. 48), the right of free establishment is granted to companies or firms – i.e. legal persons governed by public or private law of one of the Member States, with the exception of non-profit-making – formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community. As highlighted by the ECJ (Commission v. France C-270/83 (1986) ECR 273, at paragraph 18), the registered office, central administration or principal place of business for companies serve as the connecting factors with the legal system of a particular state, like nationality for legal persons.

52 XAB, YAB vs. Biksskatteverket, 18th November 1999, in case C-200/98, at paragraph 27.

53 ECJ, Decision, 08.03.2001, Metallgesellschaft Ltd and Others (C-397/98), Hoechst AG, Hoechst UK Ltd vs. Commissioners of Inland Revenue. (C-410/98)


55 Avoir fiscal, C-270/83, paragraph 22.
State\textsuperscript{56} — in the case of CFC regime applied to a wholly-owned subsidiary, the non-attribution of the losses of the CFC to a resident parent company may, in some circumstances, amount to an unjustified restriction in the above sense. In fact, when the CFC regime is applied utilising an entity approach\textsuperscript{57}, all of the income of the CFC is attributed pro-rata to resident shareholders, unless the CFC is exempt. As a consequence, all the profits of a wholly-owned subsidiary qualified as a CFC will be attributed to the resident parent company. Taxing such profits in this way, the home state is actually treating a non-resident company (the subsidiary) as a resident company (a permanent establishment) in relation to the source of income. In this example, the allowance for the consolidation of losses only to companies which conduct their business abroad through a permanent establishment may be considered an unjustifiable differential treatment imposed by the home state.

A restrictive effect may also be caused through the operation of the provisions related to accounting requirements or compliance duties, which are inherent in the taxation under CFC legislation. With specific reference to the nature of the restraints arising from the imposition of supplementary accounting requirements, the ECJ decided in the \textit{Futura}\textsuperscript{58} that Art. 52 (now Art. 43) of the treaty prohibited a company in addition to keeping its own accounts being obliged to comply with the tax accounting rules applicable in the Member State of its seat, and keep separate well-regulated accounts for its branch’s activities complying with the tax accounting rules applicable in the state of establishment of the branch in order for the latter to be eligible to offset losses in future tax years. In other words, the ECJ declared the requirement to keep double accounting contrary to the freedom of establishment principle, in that, in particular, such requirement was found disproportionate with respect to the aim pursued by the provision imposing it.

Considering the actual functioning of CFC taxation in light of the above, one cannot fail to note that CFC legislation imposes even heavier accounting requirements on qualifying taxpayers, namely as a consequence of the fact that they need to re-calculate and re-characterise the income of the CFCs under the tax accounting rules applicable in their state of residence; such imposition might by itself bring about, therefore, a restrictive effect on their right to free establishment, especially when it does not meet the requirements of the proportionality principle (see discussion below). In this regard, the Advocate General in his opinion on the \textit{Futura} case considered that "a foreign company will be able to carry forward losses for its branch in Luxembourg only if it accepts additional cost"\textsuperscript{59}.

The 1996 OECD Report on CFC legislation disclosed that compliance costs associated with a CFC regime are higher than those incurred by domestic taxpayers within the same corporate group. The costs and difficulty of compliance depend to some extent on the nature of the CFC's income and the extent of differences between domestic and foreign tax law; the difficulties may be exacerbated by language differences. Concern has also been shown for the cases in which it is the CFC that prepares the necessary information for its shareholders, because the costs involved would not be deductible in the state of residence of the CFC (since they are not business expenses but rather expenses incurred on behalf of its shareholders). It would not be particularly objectionable to impose significant compliance costs on large multinational corporations that can afford to bear them. The costs may be a substantial deterrent to the international operations of smaller corporations, or, as can happen under several CFC regimes, of individual shareholders. Moreover, some CFC regime applies where just minority holdings are held by domestic taxpayers, for which it might be very difficult to obtain the necessary information from the CFC.

\textsuperscript{56} \textit{Daily Mail}, C-81/87 (1988) ECR 5483, paragraph 16.

\textsuperscript{57} The inability to consolidate losses of a CFC with domestic profits of the shareholder is instead consistent with attributed income of the CFC being considered a deemed dividend (as in Germany).

\textsuperscript{58} C-250/95 (1997) ECR I-2471.

\textsuperscript{59} Point 34 of the Opinion.
Generally, the application of a CFC regime can be held to result in a home state restriction in the sense described above. There are circumstances, however, where such a piece of legislation might be held to be contrary to Community freedoms on different grounds. Amongst others, for example, CFC rules bring about a form of discrimination against the foreign targeted entities, in that the heavier tax burden to be suffered by their shareholders actually hampers the raising of capital in the residence country of those shareholders. It is clear that the latter would find it more attractive to invest domestically or elsewhere. As CFC regimes are generally applied within the EU with respect to investments in some Member States, but not in others, discrimination among nationals of other Member States might be held to occur in the sense described above. It is to be noted that inequalities of treatment of such kind arise from the application of CFC regimes only indirectly. In fact, generally CFC regimes do not affect the tax treatment of the targeted foreign entities, but only the tax treatment of the qualifying resident taxpayers. However, this so-called horizontal tax discrimination is not prohibited by EC law, and its effects can assume relevance only from a general perspective of a lack of harmonisation of tax legislation at Community level.

Even though tax discrimination among nationals of other Member States is not technically prohibited by primary EC law, the application of the principles developed by the case law of the ECJ might actually neutralise the horizontal discrimination on the fund-raising described above. The prohibition of Home State restrictions demands equivalent tax treatment for investments carried out by EU nationals in the Home Member State of residence and in other Member States, in that for instance, Mr X (an EU national residing in Member State A) shall get equivalent tax treatment for investments in Member State B and in his Home Member State A; the same holds true for Mr X’s investments in Member State C. Therefore, given that the investments in B and in C cannot receive differential tax treatment in the hands of Mr X, the horizontal discrimination on the fund-raising of the entities resident in B and C could be neutralised through this route.

A similar conclusion might be drawn on the basis of the free flow of capital principle, the scope of application of which is much wider than that of the freedom of establishment, as will be shown in the following paragraphs.

2.3 Possible justifications

Only one argument has been accepted by the Court as a justification in the field of direct taxation, namely the one based on the need to maintain the cohesion of the tax system. The concept of fiscal cohesion has been described by the ECJ as the necessary existence of a direct link between the deductibility of certain sums and the liability to tax the income related to such sums. For this argument to be accepted by the ECJ as a sufficient justification, the existence of specific and absolute cohesion and the impossibility to implement the tax policy by less restrictive means must be proven. Clearly, fiscal cohesion cannot be invoked as an argument to defend the application of CFC rules.

Indeed, the aim underlying CFC legislation is to avoid a loss in tax revenue. In the ICI case, the UK put forward that the aim of the legislation at issue was to prevent the creation of foreign subsidiaries from being used as a means of depriving the treasury of taxable revenue. The ECJ rejected the argument and considered that the diminution of tax revenue cannot be relied upon in order to justify unequal treatment that is, in principle, incompatible with Art. 52 (now Art. 43) of the treaty. Again in 2001, the ECJ confirmed that a loss in tax revenue, since it has

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60 Bachmann C-204/90.


62 Cf. At this regard Paragraph 28 of the opinion of Advocate General Tesauro on the ICI case.

63 Paragraph 25 of the decision.

64 This argument has been rejected also in Avoir fiscal C-270/83, Biehl C-175/88 (1990), Saint Gobain C-307/97, ICI C-264/96.
not been explicitly included in Art. 56 of the Treaty (now Art. 46), cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify a measure which is, in principle, contrary to a fundamental freedom. CFC legislation fails to qualify for justification under the rule of reason test. In this respect, paragraph 15 of the Svensson and Gustavsson decision\textsuperscript{66} states that "...the rule in question entails discrimination based on the place of establishment. Such discrimination can only be justified on the general interest grounds referred to in Art. 56 (now Art. 46) of the treaty...which do not include economic aims" such as a loss in tax revenue.

A possible argument that might be put forward to justify CFC regimes could be based on the fact that the foreign entities enjoy advantages (i.e. lower taxation) vis-à-vis companies established in the State applying CFC, which could balance out the disadvantages resulting from the add-on taxation, but the ECJ has always rejected this argument. The Court repeatedly held\textsuperscript{67} that any tax advantage resulting from the low taxation to which a taxpayer is subject in the Member State in which it is established cannot be used to justify less favourable treatment in tax matters. In the \textit{Eurowings}\textsuperscript{68} decision, the Court firmly stated that "compensatory tax arrangements prejudice the very foundations of the single market".

The ultimate purpose of CFC legislation is to prevent the use of foreign entities as means to avoid taxes. CFC rules are based on the premise that tax deferral constitutes in any event tax avoidance. This might not be the case in many instances, especially when the income generated abroad is actually enjoyed exclusively abroad (e.g. because it is not repatriated and re-invested \textit{in loco}), with the result that CFC taxation would simply occur without an acceptable connecting factor. However, tax avoidance has never been concretely accepted as a possible justification by the ECJ.

In the \textit{Avoir fiscal} case, the French Government sustained that the contested rules were necessary in order to prevent tax avoidance. The Court replied that "...the risk of tax avoidance cannot be relied upon in this context. Article 52 (now Art. 43) of the EEC treaty does not permit any derogation from the fundamental freedom of establishment on such a ground."\textsuperscript{69}

Paragraph 26 of the ICI decision reads: "As regards the justification based on the risk of tax avoidance, suffice it to note that the legislation at issue in the main proceedings does not have the specific purpose of preventing wholly artificial arrangements, set up to circumvent UK tax legislation, from attracting tax benefits, but applies generally to all situations in which the majority of a group’s subsidiaries are established, for whatever reason, outside the UK. However, the establishment of a company outside UK does not, of itself, necessarily entail tax avoidance, since that company will in any event be subject to the tax legislation of the state of establishment". This means that the risk of tax avoidance is not considered by the Court to be a sufficient ground to justify the existence of a restrictive measure\textsuperscript{70}; it follows that a restrictive tax avoidance measure can be justified only where it applies exclusively to real tax avoidance schemes. Therefore, the proportionality principle can be the main obstacle to justification of CFC regimes in Europe.

2.4 Meeting the requirements of the proportionality principle

The proportionality test forms part of the rule of reason test. The questions that need to be answered to ascertain the compliance of a national measure with the proportionality principle are: "Is the restrictive measure appropriate for the protection of the recognised public interest

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\textsuperscript{65} \textit{Metallgesellschaft} C-397/98.
\textsuperscript{66} In C- 484/93, (1995), ECR I-3955.
\textsuperscript{68} ECJ, Decision, 26.10.1999, \textit{Eurowings}, C-294/97 (1999), paragraph 45.
\textsuperscript{69} Paragraph 25 of the decision.
\textsuperscript{70} This interpretation has been confirmed by the ECJ in its decision \textit{Metallgesellschaft}. 
and is the restrictive effect proportionate in relation to the goal pursued? Are there no equally effective measures that would be less restrictive to Treaty freedoms?" The principle of proportionality requires Member States to choose measures (and, in particular, anti-avoidance measures) that are appropriate and go no further than is necessary in order to achieve their lawful purpose.

In this respect, it is to be noted in the first place that CFC legislation makes a wide use of presumptions; the broad discretion in the use of the criteria to build up such presumptions can lead to arbitrary results. The general presumption underlying the application of CFC regime consists in the assumption that the participation in foreign entities meeting certain requirements can absolutely be qualified as a tax avoidance scheme; the burden of proving the contrary always lies with the taxpayer. In general, the use of absolute presumptions in the drafting of national tax provisions has been considered by the ECJ as conflicting with the proportionality principle.\(^{71}\)

It is worth remembering that the \textit{ICI} decision settled the principle under which, if in a given case a set of facts would fall within the purview of an anti-abuse provision, while not amounting to abuse, the proportionality test is not satisfied. Anti-abuse provisions should apply in a way such as counteracting effective tax abuse only. It could be concluded that the use of general predetermined criteria, which automatically include certain cases in the scope of a CFC regime, whether or not tax avoidance was actually underlying the transaction, might not be compatible with the proportionality principle, being too widely drawn and having too large a range of application, therefore going beyond what is necessary to obtain the result of counteracting abuse.

Even though CFC legislation generally contain sets of rules that exclude certain cases from the application of the regime – the most diffused relating to the conduct of business activities by the foreign entity – still an abuse test on a case-by-case basis would be more appropriate to comply with the proportionality principle. The ECJ, in fact, maintained in the \textit{Leur Bloem} decision that it should be judged on a case-by-case basis whether a given transaction has as objective tax avoidance or tax abuse\(^{72}\) and that the taxpayers should be granted the opportunity to prove it.

Following such a decision, the “commercial purpose test” itself, has been criticised; it has been proposed that in each case, even in the absence of commercial reasons, it should be determined whether or not tax avoidance or abuse has actually occurred.

However, the exclusion of a given case from the application of CFC regime by means of statutory exemptions depends to a large extent on the interpretation of domestic laws and on the conditions that each tax administration considers sufficient as a proof of requisites such as the “effectiveness” of the activity (with regard to which relevance can be attached to the profit side of the activities performed by the CFC, or rather to the cost side, i.e. for example the presence of structures and personnel), or the “prevalence” of a commercial activity, and so forth.

The principle of proportionality would require only entities (or income) which actually suffered a low taxation to be targeted under a CFC regime. This may not always be the case due to the actual functioning of CFC regime. The designation of a certain entity as a CFC depends on the comparison between its tax burden and the notional domestic tax burden (France, United Kingdom) or a fixed rate (Germany). In order to make this comparison, the profits of the CFC are re-computed using domestic tax and accounting rules. Such automatic mechanism combined with differences in accounting rules may lead to the application of CFC regime to cases which do not involve any low taxation.


\(^{72}\) \textit{Leur Bloem} decision reads in paragraph 41: "...in order to determine whether the planned operation has such an objective (tax avoidance) the national competent authorities cannot confine themselves to applying predetermined general criteria, but must subject each particular case to a general examination."
Assuming, for example, that different rules on the application of the accrual method or cash method of accounting are used in the jurisdictions involved. If the country applying the CFC regime times a receipt as being taxable in year two, while the CFC’s residence country taxes it as a receipt in year one, the foreign entity may well be subject to a qualifying lower level of taxation in year two but to a very high level of taxation in year one. Thus, it could be qualified as a CFC in one year even if, over the two years together, the entity pays just as much tax locally as it would have paid had it been resident in the country applying CFC regime, or pays tax above the fixed rate. Such a situation would involve, furthermore, double taxation at a high rate of the profits taxed under the CFC regime.

The application of the CFC regime to entities which did not actually suffer low taxation may also occur because foreign taxes paid by the CFC are not taken into account when making the comparison between taxes. Indeed, CFC rules apply regardless of the method for the elimination of double taxation used in the CFC country. So, as an example, if the CFC country uses the exemption method, usually adopted in the form of exemption with progression, the profits of a permanent establishment of the CFC may effectively have suffered a lower level of taxation. But if the credit method, usually adopted in the form of ordinary credit, is used, the profits of a CFC’s permanent establishment actually suffer taxation at the higher of the head office residence country’s tax rate and p.e. country’s tax rate. If the tax rates are high in the head office residence country, the profits of the p.e. are effectively taxed at that rate, and do not suffer low taxation. The general application of the rule is not consistent with the proportionality principle.

The application of its own accounting and tax rules by the country applying the CFC regime may also result in the recovery not only of the difference in tax rate between the two countries involved, but of a part of the income which probably did not suffer a lower taxation, as a consequence, for example, of the application of different rules regarding the deduction of given items of income in the computation of the taxable income of the companies involved.

The application of CFC legislation may also give rise to double taxation, thus producing a disproportionate effect (the measure used to counteract a perceived form of abuse produces effects which are disproportionate to the goal pursued). What is more, the Commission considers that international double taxation directly affects the establishment and the functioning of the common market. Double taxation may arise when countries do not grant relief in respect of subsequent capital gains arising from the transfer of the participation in the CFC. If a resident taxpayer who had previously been taxed on the undistributed income of the CFC disposes of the shares of the CFC, the previously taxed income may be reflected in the gain on the sale of the shares. Relief should be allowed as in case of subsequent distribution of dividends, in order to ensure that the undistributed income of the CFC is taxed only once in the hands of the resident taxpayer.

Double taxation may also arise when more CFC regimes apply at the same time, which can easily happen as a result of the application of indirect ownership requirements. While countries probably ensure that CFC charges are levied at only one level within their own jurisdiction, there could be real costs for a person holding shares through an intermediate holding company situated in another country that also applies the CFC regime, as he would hardly get double taxation relief for the CFC charge suffered by the intermediate company. A form of relief would be appropriate for the losses incurred by some CFC as well.

Further, the attribution of losses, likewise income, of a CFC would be consistent with the CFC being in substance considered transparent, as in cases of the “piercing the veil” approach. This is the case in France, Italy and the U.K, where no such relief is provided for. Where CFC legislation uses a “piercing the veil” approach, the domestic taxpayer is deemed to earn the income of the CFC directly; the losses of the CFC should likewise be attributed to the resident.

73 As explained in the Commission Communication and recommendation concerning bilateral Double Taxation Conventions (1992).
taxpayer. Furthermore, a qualifying resident company, which is in a loss situation in its country of residence, nevertheless has to pay tax under the CFC regime.

Many other issues may arise in respect of losses\textsuperscript{74}. Taking an example where losses should offset each other: in a transactional approach losses in respect of one component of tainted income may probably offset profits in other components of tainted income; losses from non-tainted income will probably offset tainted income. Moreover, if the CFC incurs a loss in a year, consolidation with domestic shareholders not being permitted, the CFC should be entitled to carry over the loss. From the point of view of the taxpayer it may be appropriate to offset losses of one CFC with profits of other CFCs, or to offset his own losses with the profits of a CFC.

Another problem regarding the compatibility of CFC rules with the principle of proportionality is caused by the fact that the application of those rules requires the re-determination and re-qualification of the foreign income under the rules of the country applying CFC. A transactional approach requiring taxpayers to examine all the operations of their foreign subsidiaries on a transaction by transaction basis, adds considerable and arguably unnecessary compliance costs compared to a designated jurisdiction approach. Nonetheless also under such jurisdictional approaches, the need to re-determine the income of the CFC imposes enormous compliance problems. Taking as an example the Italian regime: an Italian resident taxpayer needs “at least” to keep the account books of the CFC in order to be able to determine its income, and the tax credit he should be entitled to. It is worth remembering that the ECJ in the \textit{Futura} judgement considered that the condition imposed to keep double accounting might constitute a restriction on the freedom of establishment of a company or firm.

The indirect control requirement may exacerbate compliance problems. Some CFC regimes apply to individual taxpayers as well. For example, assume that a resident taxpayer has a wholly-owned foreign subsidiary X, which in turn has 100% control over two other foreign subsidiaries, Y and Z, in different countries, one of which, company Y, qualifies as a CFC under CFC rules. Due to the indirect control requirement, the profits of the CFC are attributed directly to the resident taxpayer. Companies Y and Z distribute dividends of 500 each to company X, which then pays out dividends to the resident taxpayer of 1500. In such a scenario, in Italy, the profits distributed by the CFC should not be included in the income of the resident taxpayer up to the amount corresponding to the income previously attributed to him. In order to ascertain the exempt part of the total dividends of 1500 received by company X, the taxpayer should have access to the account books of the intermediate non-CFC company X, and should be able to verify the exact amount of profits distributed by the CFC.

In order to meet the rule of reason’s requirements a national measure must also be effective. Most CFC regimes apply when resident taxpayers control a corporation (or other entities) which is (are) resident in a privileged tax regime. If a country of incorporation or head office test is used, a CFC may well be incorporated in or have its head office located in a high-tax country which imposes tax on the basis of a place of management test of corporate residence; thus the CFC may be exempt even though it is subject in the country where it is resident to a privileged tax regime. Some CFC regimes may apply taking into consideration the nominal tax rates in the foreign jurisdiction; it may very well happen that a company which actually suffers a low effective tax burden can fall outside the scope of CFC rules.

\textsuperscript{74} As highlighted by the OECD Report, \textit{Controlled Foreign Company} legislation, 1996.
3. **TAX TREATMENT OF CROSS-BORDER LOSSES: THE M&S (C-446/03), RITTER (C-152/03) AND REWE (C-347/04) CASES (MASSIMILIANO RUSSO, LL.M. 2003-2004)**

3.1 **Introduction**

After the 1990 Draft Directive\(^\text{75}\) on cross-border compensation of losses, the idea of harmonization in the field of losses has not been properly addressed at EU level.

The European Commission, in its Communications\(^\text{76}\) to the European Council and Parliament, has referred several times to the issue of cross-border offsetting of losses. More recently\(^\text{77}\), it confirmed its commitment to identifying innovative ways of dealing with cross-border loss relief among the strategies aimed at tackling the inefficiencies of cross-border economic activities. On this same issue, the European Commission seemed to expect additional clarification to result from the outcome of a judgment recently delivered by the ECJ on the Marks & Spencer case\(^\text{78}\).

The Marks & Spencer decision, among direct tax cases on losses\(^\text{79}\) dealt with so far by the ECJ, might have been the most influential one as some authorities have highlighted\(^\text{80}\), however, due to the narrow approach adopted by the Court in the judgment it represents just a step forward in the long road toward harmonization in the tax treatment of losses within the EU.

There are two other cases on loss compensation, the Rewe\(^\text{81}\) and the Ritter\(^\text{82}\) cases, pending before the ECJ, so it is likely that the Court will have further occasions to tackle the issue of the compliance of loss treatment across borders within the EU with the EC treaty on fundamental freedoms and foster an harmonization between Member States legislations.

Indeed, as highlighted by Advocate General Maduro in his Opinion\(^\text{83}\) on the Marks & Spencer case delivered in April 2005, “it is not for the ECJ to determine a uniform scheme for all the Member States”. However, as previously indicated, it seems that the Community institutions are waiting for some ECJ clarification to rely upon, in order to reach a proposal for a Directive, something that would bring new energy in order to dismiss the fear of the lack of unanimity between Member States, as has already been illustrated in the context of the 1990 Proposal for a Directive. These expectations seem to be confirmed by the Advocate General’s Opinion, when he points out that “even if it is not for the Court to substitute itself for the Community legislature,… the absence of harmonization between Member States’ law cannot prevent it from performing its function, which is to ensure that the fundamental principles and objectives of the Treaty are safeguarded”.

Marks & Spencer, in addition to Rewe or Ritter, is the starting point for the expected developments in this tax area. The three cases share a common aspect: the potential weakness

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\(^{75}\) See COM (90) 595 final, “A proposed EC Directive concerning arrangements for the taking into account, by enterprises, of the losses of their permanent establishment and subsidiaries situated in other Member States”, Brussels, 24 January 1991.

\(^{76}\) See Point 5 of the Presidency Conclusion from the Lisbon European Council, 23 and 24 March 2000 COM (2001) 582: “Towards an Internal Market without tax obstacles. A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities”.


\(^{78}\) ECJ, Decision, 13.12.2005, case C-446/03, Marks & Spencer v. David Halsey, Inspector of taxes.


\(^{81}\) Case C-347/04 Rewe Zentralfinanz e.G. v Finanzamt Koln-Mitte.

\(^{82}\) Case C-152/03 Ritter-Coulais v Finanzamt Germersheim.

\(^{83}\) See Opinion of Advocate General Poires Maduro delivered on April 7 2005, Case C-446/03, paragraph 83.
of the Member States’ legislation with respect to tax treatment of losses\textsuperscript{84}, in light of the EC Treaty fundamental freedoms. Both the UK and the German tax rules under dispute in these cases do not grant equal treatment to domestic and foreign losses in the state of residence of the person claiming the right to deductions. Marks & Spencer (M&S) and Rewe deal with cross border loss compensation for companies within the same group, whilst the Ritter case deals with losses incurred by individuals.

The purpose of this brief analysis is to identify the status of the three mentioned cases on cross-border loss compensation and highlight the progress of EC law interpretation in this tax area, based on the arguments adopted by the Advocate General’s Opinions or the decision where available\textsuperscript{85}.

3.2 M&S

In the M&S case, a UK holding company of a group sought to obtain relief\textsuperscript{86} for losses incurred by overseas subsidiaries (i.e. subsidiaries established in Belgium, France and Germany) against profits made by the UK group companies. The UK Inland Revenue refused M&S’s claim on the grounds that the UK group relief system requires that both the surrendering and the claimant company must be resident within the UK (or in the case of the overseas subsidiaries, must perform at least some activity in the UK through e.g. a branch).

The UK High Court, once it had received M&S’s claim, decided to request a preliminary ruling from the ECJ in order to ascertain whether:

1) the group relief rules restrict the Freedom of Establishment, due to the fact that they prevent a UK parent company from reducing its taxable profits- by setting off losses incurred by subsidiaries resident in other EU Member States- where such a set off would be possible if the losses were incurred by UK subsidiaries or by a branch established in another EU Member State;

2) the answer to the first question depends on whether it is possible to obtain relief for the losses incurred by a non-UK subsidiary against the taxable profits in the State of the subsidiary itself, or on whether such relief has in practice been obtained.

Before analyzing some of the arguments on EC law interpretation provided by Advocate General P. Maduro in his Opinion\textsuperscript{87} and to a certain extent accepted by the ECJ in its decision it is worth clarifying what the main issue behind the M&S case and similar cases, is: the cash flow issue.

The starting point in the analysis of the issue, is the relationship between domestic rules and EC Treaty law. It is a widespread EC law principle that the concept of an Internal Market brings about the elimination of tax impediments to cross-border investments. Domestic laws should always follow this basic principle and not contravene it. Therefore, a Member State rule granting a tax advantage in a purely domestic situation might infringe EC law whenever, in the same circumstances in a cross-border EU setting, it does not allow for similar treatment. If we now examine the UK group relief rules and their correspondent rules in EU countries more closely, we notice that the main purpose of Member States’ legislation adopting domestic consolidation

\textsuperscript{84} In general, on cross-border relief, see Axel Cordewener et al., “The Tax Treatment of Foreign Losses: Ritter, M&S, and the Way Ahead” (Part One and Two), 44 European Taxation 4 and 5 (2004).

\textsuperscript{85} Out of three cases discussed, the Advocate General’s Opinions are only available for M&S and Ritter.

\textsuperscript{86} The UK “group relief” system allows UK companies with 75 percent common ownership to claim and surrender losses from one another. The company surrendering the losses may receive a non-taxable payment in exchange, on the other hand, once the loss is used by the claimant company it will cease to be available to the surrendering company.

\textsuperscript{87} For criticisms on Advocate General Maduro’s Opinion see Michael Lang, “Marks and Spencer – more questions than answers: an analysis of the Opinion delivered by Advocate General Maduro”, EC Tax Review, 2005, 2, p. 95.
rules (e.g., group relief in the UK, fiscal unity in the Netherlands, Consolidato domestico in Italy and Organschaft in Germany) is that of achieving neutrality in the tax treatment of the group as a whole. This concept implies that taxes should be paid on the balance of profits and losses of the group on an aggregate basis. In other words, the rules are aimed at preventing situations where a group in a loss position on aggregate is forced to pay taxes due to profits rising in another part of it and therefore facing cash-flow issues. Thus, if a group relief system avoids cash flow issues for groups located within a single jurisdiction, why should the end result be different for groups based in the EU market in several States?

Insofar as a group is able to reach tax neutrality whenever it is established in a single Member State, it should not be hampered from achieving the same result in a EU cross-border setting.

As a consequence, in light of the above, the result is that a rule such as the UK group relief - whereby a profit making parent company with foreign loss-making subsidiaries suffers a cash-flow disadvantage compared to a UK profitable parent company with UK loss-making subsidiaries - would potentially infringe EC Treaty law, since it puts cross-border investments at a disadvantage compared to pure domestic ones.

Apparently and without any valid justifications, such a rule gives rise to an exit restriction, an obstacle dissuading the establishment of subsidiaries in other Member States in violation of the EC Treaty.

With these preliminary thoughts in mind, some comments on the Opinion released by Advocate General may be made, due to the advances that his arguments may make to EC law interpretation and due to some slight differences between his reasoning and the conclusions reached by the Court in the judgment.

It is the Advocate General’s Opinion, that the answers to the questions referred by the High Court to the ECJ should be in the affirmative. In particular, the UK group relief system, as it now stands, is not compatible with the EC fundamental freedoms (art. 43 - 48 EC Treaty) since, in calculating the taxable base, it puts a UK parent company with foreign subsidiaries (without PE in the UK) at a disadvantage as compared to a UK parent company with domestic subsidiaries (the so called "Vertical discrimination approach").

Furthermore, the tax regime accorded to losses in subsidiaries located in foreign countries may indeed affect the functioning of the group relief system. Generally speaking, if the loss incurred by foreign subsidiaries in their country of residence is taken into account for tax purposes through a carry back or carry forward provision, or is made available to a third party after a loss-making company sale, a dual use of that loss might arise whenever a cross-border offsetting is claimed and granted. Thus, group relief rules should apply subject to the condition whereby it is established that the losses of subsidiaries resident in other Member States cannot be accorded equivalent treatment as that of the Member State of origin.

On the contrary, the Court said that EC law does not preclude provisions of the UK legislation which prevent a resident parent company from deducting losses incurred by its non-resident subsidiaries unless those losses would be made unavailable due to the legislation of the Member State where they were sourced.

Does the reasoning adopted by AG Maduro in his answers, or the different conclusions reached by the ECJ with a different wording in the decision, solve all cash-flow disadvantages that may arise in cross-border situations based on currently available loss-relief systems?

No, they do not. Both conclusions limit the cross-border offsetting to “final loss” situations only, i.e. to those cases where it is established that losses in the country where they occurred may not be used anymore. The outcome reached does not seem to consider the principles.

88 For a description of the differences between a vertical and an horizontal comparison for discrimination/restriction purposes see Axel Cordewener et al. supra note [1].
suggested by the 1990 Draft Directive on cross-border loss relief. The answer to the question as to whether there is a restriction on the freedom of establishment under the UK group relief system, should not depend on whether the foreign losses have been utilized abroad.

Indeed, making entitlement to claim group relief for losses of a foreign subsidiary subject to the further requirement that an “equivalent tax treatment” does not arise in the source country, where the loss-making subsidiary is established (AG approach) or allowing group relief only for pure domestic situations unless losses incurred by foreign subsidiaries are “final” (ECJ approach) means creating unnecessary restrictions on the cross-border offsetting of losses. The fear of a double use of the losses - in the source country where the subsidiaries incurred them and in the country of the parent claimant company - may well be dismissed by adopting the deduction and reincorporation method suggested in the 1990 Draft Directive (art. 9)89. That method has been criticized as one with some disadvantages. Namely, it relies on the tax rules of the subsidiary Member State, this could trigger a fear of legal uncertainties and a trade in losses among Member States. However, it is an authoritative opinion that its use would be effective to avoid a double use of the loss and still represents a sound suggestion on how to harmonize Member States’ legislation.

Assuming that a restriction arises under the UK group relief system, the Advocate General went on in his Opinion to consider whether any justification could be raised by the UK government to save the group relief regime.

The Advocate General used the occasion to draw the boundaries of the territoriality argument. According to the UK government, the group relief may concern only companies established or carrying on an economic activity within the UK, thus by being overseas subsidiaries or non-taxable persons in the UK, they may not surrender their losses to UK parent companies either81. In the “Futura” case92, the first case dealing with loss offsetting across borders, the Court recognized the applicability of the fiscal principle of territoriality in Community law, however, the situation there was slightly different. Futura was an inbound perspective case, where a single French taxpayer with a limited liability to pay tax in Luxembourg - through its permanent establishment (PE) - was involved. The territoriality principle was adopted in that case in order to limit the taxing power of Luxembourg with respect to non-residents. Losses incurred in Luxembourg by the French company through its PE could have been carried forward subject to an economic link with profits yielded in Luxembourg. The M&S case dealt with an unlimited liability to tax a resident parent company, head of a group with foreign subsidiaries; the UK government could not rely on the territoriality principle due to the unlimited taxing power the UK had with respect to the head of the group as the ECJ decision confirmed.

Another interesting point, in the justification analysis, raised by Mr. Maduro is the approach to the “coherence” principle. Due to the nature and the features of this principle - i.e. the grant of a tax advantage and the offsetting of that advantage with a fiscal levy - expert opinions93 have pointed out its interchangeability with the territoriality principle and the use of it as a synonym for the coherence principle in ECJ decisions.

Authoritative case law specifies that a direct link only exists in the context of the same tax

89 According to article 9 of the Draft Directive, losses of the foreign subsidiary are deducted from the taxable profit of its parent company, followed by the incorporation of subsequent profits of the subsidiary into the taxable base of its parent until the losses previously deducted have been recaptured. The loss and the subsequent profits must be determined in accordance with the tax rules of the State in which the subsidiary is situated.


92 Futura Participations case C-250/95, paragraph 22.

payment and of the same taxpayer. Mr. Maduro suggested a different approach to the cohesion principle, as previously suggested by Advocate General Kokott in the Manninen case. Mr Maduro again suggested relaxing the rigid criteria characterizing the cohesion principle in ECJ decisions issued so far. In the case at hand this means that “cohesion must be adjudged in light of the aim and logic of the tax regime at issue.” The aim and the logic of the UK group relief rule is to ensure the neutrality of the effects of the creation of the group of companies (for tax purposes). This also implies that i) the advantage conferred on the parent company is neutralized by the tax charged to the surrendering company; ii) the relief should not be granted whenever a risk of a double deduction arises (e.g. carry forward in the source state).

Based on the above, the UK group relief rule cannot prohibit transfer of losses merely on the grounds that it is impossible to tax the foreign subsidiaries. Should this be the case, the restriction would go beyond what is necessary to protect the cohesion of the group system (i.e. the aim of neutrality).

It is the author’s opinion that the Advocate General’s arguments may be shared, however, due to the ECJ’s previous decisions’ reasoning it would have been more appropriate to tackle the group relief attitude of going beyond what is necessary to achieve the aim of neutrality, under a different paragraph of the Opinion, labeled “lack of proportionality”. Also with this respect the ECJ decision highlighted a preference for the lack of proportionality argument rather than the coherence one.

As a final remark on the M&S decision, it is also worth mentioning that the cross-border loss relief issue is tackled in this case with respect to its compatibility with the freedom of establishment of legislations having regard to a group of companies established within the EU. A more complex scenario might require, however, the analysis of the compatibility with the freedom of capital for groups of companies with non-EU resident subsidiaries or with small participations.

All things considered, UK group relief rules are not proportionate and all Member States’ fiscal unity regimes might run the same risk should the ECJ decides in favor of the M&S group. Repealing those regimes from domestic legislations would not be the most appropriate solution to comply with EC Treaty principles. Indeed, a positive integration, by means of an EC Directive, is certainly required in order to achieve harmonization in the field of cross-border loss relief, furthermore, some of the suggestions stemming from the old Draft Directive on loss compensation may still be useful.

3.3 Rewe

German law is another example of a Member State’s legislation which has given rise to a cross-border loss compensation issue involving a multinational group of companies and which ended up in a dispute before the ECJ. The scenario involved an indirect loss compensation following the depreciation of a participation.

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94 Bachmann, case C-204/90, paragraph 28 and ECJ, Decision, 13.04.2000, case C-251/98, Baars, paragraph 40.

95 Manninen, case C-319/02.

96 See paragraph 71 AG Opinion.

97 See paragraph 75 AG Opinion.

98 See paragraphs 52 et seq.


100 See supra note [*].
For tax purposes Rewe Z.Co., a German based company, wrote down the book value of a 100% holding owned in a Dutch subsidiary for the tax years 1994-1995, due to losses incurred by its sub-tier subsidiaries. German tax authorities disallowed the deduction on the basis that the foreign subsidiary did not pursue an “active” business, as defined by German law. Rewe claimed the right to use those losses, since losses stemming from domestic subsidiaries in the same situation would result in a deduction being made. According to German legislation, the “active” business test was then required for foreign subsidiaries only. On these facts, the Cologne tax Court referred the case to the ECJ with the aim of obtaining a preliminary ruling ascertaining whether: “articles 43 and 48, in conjunction with article 56 et seq. of the EC treaty, are to be interpreted as precluding a rule which restricts the immediate tax set-off of losses stemming from write-downs to the book value of subsidiaries in other EC countries, where those subsidiaries pursue passive activities within the meaning of the national provision and/or where the subsidiaries pursue active activities within the meaning of national provisions only through their own second tier subsidiaries, whilst write-downs to the book value of domestic subsidiaries are possible without these restrictions”.

The case shows close similarities to the M&S case. Again, a rule that puts a cross-border relationship between a parent and a subsidiary at a disadvantage compared to a similar relationship in a pure domestic scenario is evident. This “vertical approach” and “outbound perspective”101 should probably lead the ECJ to a decision in favor of the taxpayer, since a restriction on outbound investments would be triggered. The main arguments that could be brought forward to support the German rule, in order to justify such a restriction, have already been pointed out in the M&S case analysis (e.g. the cohesion of the German tax system, the territoriality principle and other arguments usually brought forward by governments and rejected in ECJ jurisprudence; such as loss of tax revenues).

A further argument could be made with regard to the nature of the rule, namely its anti-abuse rationale. Steady ECJ jurisprudence says that an anti-abuse measure should be tailor-made to prevent artificial arrangements and thereby respect the principle of proportionality, whilst the German rule at issue generally prevents offsetting the losses that may occur in foreign investments in a certain number of cases, thus going beyond what is necessary in order to pursue its objective (anti-abuse)102.

Even if the decision is made in favor of the taxpayer, the legislation has been repealed since 2001, so the impact of a judgment in favor of Rewe would only affect actions brought before the Court for tax years, open to assessment, up to 2001.

3.4 Ritter

The Ritters are a German Couple employed in Germany as teachers in a public school and residing in France. In 1987 they wanted to deduct from their taxable income in Germany the loss resulting from their personal use of real property in France. The German tax system does not allow a deductions for losses in foreign countries, nor does Germany provide for a negatively regressive impact of those losses in order to determine the tax rate, yet in a purely domestic case a loss deduction would be available. The Federal Supreme Tax Court submitted

101 Reference Is made to the perspective of the State of residence of the parent company that made the investment in the foreign company.
two question to the ECJ in order to ascertain whether:

1) the ruling runs contrary to Article 43 and Article 56 of the Treaty establishing the European Community, when, in determining his taxable income, a natural person who has full tax liability in Germany and who receives employment income there is not allowed to deduct in Germany losses incurred in another Member State from leasing and letting property and

2) provided that the first question is answered in the negative, if it is contrary to Article 43 and Article 56 of the EC Treaty if such losses cannot be taken into account for the purposes of negative tax progression clause either.

What distinguishes the Ritter case from the two cases discussed above is not only the fact that individuals are involved in this latter situation but also that the reason remains unclear as to why the German rule at stake should be challenged on an EC treaty compliance analysis. The fact pattern of the case presents difficulties in finding the fundamental freedom applicable to the Ritter situation.

It is difficult to obtain an ECJ decision on the basis of the fundamental freedoms the Supreme Tax Court mentioned in its queries.

As confirmed by the Opinion issued by the Advocate General Lèger\(^\text{103}\): the freedom of establishment under Article 43 of the EC Treaty applies to self-employed activities, while the Ritters are employees of a public school. Furthermore, the free movement of capital under Article 56 applies to investments and nothing in the fact pattern stemming from the case suggests that a real property investment is involved: the Ritter couple own the real property for their own personal use.

Finally, the Maastricht Treaty introduced the right to move and reside freely within the European market according to article 18 of the EC Treaty and does not apply to facts occurring in 1987.

Despite these complexities, the Advocate General recommends that the Court answer the question referred to it in the affirmative and in favor of the taxpayers by stating that:

Article 39 of the EC Treaty (i.e., the freedom of movement for workers) prohibits a rule that does not grant to nationals - subject to unlimited tax liability in Germany and receiving employment income in that state - a deduction of the losses incurred in another MS, due to the letting or leasing of the real property held for personal use, from the taxable base, as well as a negative progression effect in the calculation of the tax rate.

On the other hand, a rejection of the questions referred to the ECJ might be possible, if one considers the content of certain previous ECJ decisions briefly referenced as follows. The Gilly case shows some similarities to this case, however, in that case there was a clearer cross-border character of the economic activity which helped to resolve the case in the taxpayer's favor. Mrs. Gilly, a French resident and German national, was "working" in Germany. Additionally, the Werner case might give some clue as to the possible outcome of the case at hand. Mr. Werner, a German national and a Dutch resident for non economic purposes, received self-employment income in Germany. He wanted to benefit from a "splitting tariff" in Germany, but tax authorities denied the benefit on the ground that the tax advantage could be granted to German residents only. The Court rejected Mr. Werner’s request.

Based on the foregoing, the Ritter queries could remain in line with the Werner holding due to the absence of an economic link with the French residence.

\(^{103}\) See Opinion of Advocate General P. Léger delivered on March 1, 2005.
However, the Advocate General Opinion suggests, following the Schumacker pattern\textsuperscript{104}, acceptance of Ritter’s claims as well as adoption of the suggestions of the coherent jurisprudence of the ECJ (see Gschwind, Wielockx, Gerritse\textsuperscript{105}) related to the personal ability to pay taxes keeping in consideration personal and family circumstances. According to this pattern, residents’ and non-residents’ circumstances are not as a rule comparable as far as direct tax matters are concerned\textsuperscript{106}. However, residents and non-residents are not in objectively different situations insofar as the non-resident receives no significant income in the State of his residence and obtains most of his taxable income from an activity performed in the state of employment (Germany in the Ritter case)\textsuperscript{107}. The outcome is that the State of residence is not in a position to take into consideration the taxpayer’s personal and family circumstances and that the state of employment should be the one deputed to assess the ability to pay taxes having regard to the taxpayer’s income and possible losses. Should the employment State adopt a different behavior a discrimination might arise as it seems to be the case of Ritter’s.

Finally, it is worth noting that according to Advocate General Opinion\textsuperscript{108} the Finanzgeritz rejected Ritters’ claims on the basis that German law does not grant to German residents the relief for foreign losses. What are the points of comparison between the two? Is it the resident vs. non-resident comparison with respect to foreign losses? Or is it the foreign real property income vis à vis the domestic real property income? The outcome of the case is potentially open to both the solutions, with either a favorable or negative result for the taxpayer.

3.5 Conclusions

ECJ has great power to exercise in these decisions and a long journey in the field of harmonization for cross-border loss relief is to be started. All great power create even larger responsibilities; all long journeys begin with one step. It has been an ECJ duty to begin that long journey with a first step at least to some extent in favor of M&S. However, harmonization through a Loss Directive seems still to be the only practical solution to the huge number of issues that cross-border loss compensation may create to group established within the EU market.

4. Withholding Tax Cases: The Skorpio (C-290/04), Centro Equestro (C-345/04) and Denkavit (C-170/05) Cases (Barbara Emma Pizzoni, LL.M. 2002)

4.1 Introduction

Recently, the compatibility of withholding taxes levied by source states on non-resident taxpayers with the EC fundamental freedoms has been put in doubt several times.

Income received by non-residents is often taxed by way of a withholding tax. Indeed, withholding taxes on the one hand give the source state certainty in collecting tax from non-resident taxpayers, and on the other avoid the need for non-resident taxpayers of filing an income tax return in the source state. However, withholding taxes imposed on non-resident taxpayers may not be consistent with the EC treaty essentially for the following reasons.

1) Where non-resident taxpayers are taxed by way of a flat withholding tax while resident

\textsuperscript{104} See Schumacker, case C-279/93, paragraphs 31-36.
\textsuperscript{106} See Schumacker, case C-279/93, paragraph 31.
\textsuperscript{107} See Wielockx, case C-80/94, paragraph 20.
\textsuperscript{108} See Opinion, paragraph 21.
taxpayers are taxed at progressive rates on assessment, non-residents by be subject to a higher tax than resident taxpayers, because:

(i) withholding taxes are usually levied on gross income without allowing deductions of related expenses, while taxes raised on assessment are usually levied on the net income;

(ii) the tax on the income received by non-residents in the source state applied at flat rate may be higher than the tax due on the same income applying progressive tax rates.

2) Withholding taxes are levied at the time of the payment of the income, while taxes levied at progressive rate are often levied on a yearly basis.

3) Withholding taxes are often levied at the domestic rate, thus requiring non-resident taxpayers to file a request for the reimbursement of the amount exceeding the lower withholding tax provided for by the relevant double tax treaty.

4) Both non-residents and residents could be taxed by way of a final withholding tax, but the withholding tax levied on non-residents is usually higher than that applicable to residents.

5) Non-resident shareholders taxed by means a withholding tax on dividends may not benefit from economic double taxation relief.

6) Withholding taxes may not be fully creditable in the state of residence of the taxpayer (where the latter state applies the credit method for relieving double taxation) due to the fact that they are levied on the gross income, while the residence state usually taxes the foreign income net of expenses.

The European Court of the Justice ("ECJ") has already ruled on some of the aforementioned issues, while on some others it will be required to decide in the near future.

In the Gilly\(^{109}\) case the ECJ ruled that the resident state of the taxpayer does not violate the fundamental freedoms when the foreign tax credit is not sufficient to eliminate double taxation on the foreign sourced income. From the Gilly case we understand that the compatibility of withholding taxes with the fundamental freedoms is exclusively an issue of the source state, and not of the residence state of the taxpayer.

In the Arnoud Gerritse case\(^{110}\) the ECJ stated that subjecting non-resident taxpayers to a rate of income tax higher than that on resident taxpayers on the same income constitutes indirect discrimination prohibited by EC law. Such a decision may be considered as an evolution of the former decisions Asscher\(^{111}\) and Royal Bank of Scotland\(^{112}\) in which the ECJ has affirmed that applying a higher rate of income tax to a non-resident taxpayer than that applicable to residents pursuing the same activity where there is no objective difference between the situation of the resident and the non-resident taxpayers violates the fundamental freedoms. Gerritse is a Dutch

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\(^{112}\) ECJ, Decision, 29.04.1999, case C-311/97, paragraphs 29-30.
artist who performed in Germany and was subjected to a 25% rate withholding tax on his gross income. Artists resident in Germany for tax purposes were subjected in Germany to tax at progressive rate on the net income. The ECJ did not state that withholding taxes are not compatible with the EC Treaty, but it simply stated that the withholding tax levied on a non-resident taxpayer cannot be higher than the tax levied on resident taxpayers and determined by using a progressive table. In making the comparison, according to the Court, it is necessary to add to the net income received by the non-resident taxpayer (i.e. Gerritse) in Germany an amount corresponding to the tax-free allowance provided for by German law. In fact, the non-taxable threshold, having a social purpose, has to be granted in principle, by the resident State (or by the source State in a “Schumacker” situation).

At the moment there are three significant tax cases pending before the ECJ regarding withholding taxes.

- FKP Skorpio Konzertproduktion (C-290/04);
- Centro Equestro de Leziria Grande Lda (C-345/04);
- Denkavit International BV and Sarl Denkavit France (C-170/05)

The first two concern artists and were both referred by the German Bundesfinanzhof. The third one concerns dividend withholding tax.

4.2 The Skorpio case

In the Skorpio case, the ECJ has to determine whether it is contrary to the relevant fundamental freedom to provide services that a withholding tax is levied on payments to non-residents, while no withholding tax is levied on residents, and whether the withholding tax must be reduced by the corresponding professional expenses when residents are taxed on the income net of the expenses).

The facts of the case revolve around a German concert promoter who contracted in 1993 with a Dutch concert promoter for the performances of US and European artists in Germany did not levy the withholding tax on the fee paid. As already affirmed in Gerritse, the levy of a withholding tax on gross income is compatible with the EC fundamental freedoms, albeit resident taxpayers are taxed at progressive rate on net income. However, in the light of Gerritse, it seems that a Member State should allow the taxpayer to opt for including the income in the annual tax return instead of being subject to withholding tax when taxation at progressive rates is more favourable than that with at the flat rate withholding tax on gross income.

Furthermore the Court will have to decide whether where the relevant tax treaty between the residence state and the source state does not give the source state the right to tax income received by the non-resident taxpayer, it is acceptable that the withholding tax is levied and then refunded to the non-resident taxpayer. In Commertzbank the ECJ recognised the right of a

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113 According to the OECD Model and Commentary, artists may be taxed in the source state on gross income. Paragraph 10 of the Commentary to Article 17 of the OECD Model states that: "the Article says nothing about how the income is to be computed. It is for Contracting State’s domestic law to determine the extent of any deductions for expenses. Domestic law differ in this area and some provide for taxation at source, at a low rate based on the gross amount paid to artists and sportsmen”.

114 See Schumacker, C-279/93, paragraph 36: "where the non-resident receives no significant income in the State of his residence and obtains the major part of his taxable income from an activity performed in the State of employment”.

115 See paragraph 55: “… However those articles [Articles 59 and 60 of the Treaty (now 49 and 50)] do not preclude the same provision in so far as, as a general rule, it subjects the income of the non-residents to a definitive tax at the uniform rate of 25%, deducted at source, whilst the income of residents is taxed according to a progressive table including a tax-free allowance, provided that the rate of 25% is not higher than that which would actually be applied to the person concerned, in accordance to the progressive table, in respect of the net income increased by an amount corresponding to the tax-free allowance”.

116 Another question is aimed at ascertaining whether it is necessary for a resident of a Member State to be also an EU
foreign company to receive interest on the tax refunded pursuant to an exemption provided in the relevant double tax treaty on the same grounds of tax refunds given to resident companies. In that decision the ECJ did not raise any objections about the fact that the company was taxed and then refunded, considering it enough that interest was paid on the refund. However, in "Hoechst, Metallgesellschaft et al." 118, the ECJ stated that a cashflow disadvantage may constitute a restriction of a fundamental freedom, therefore it cannot be excluded that the ECJ will go further than it did in "Commertzbank" obliging a Member State to give the right to the withholding agent not to apply it when the relevant tax treaty provides for an exemption.

4.3 The Centro Equestro case

In the Centro Equestro case, the ECJ has to decide whether it is contrary to the freedom to provide services that a non-resident taxpayer may claim repayment of taxes deducted at source in Germany on its income only when the operating expenses having a direct economic connection to that income are higher than half of the income.

The Portuguese Centro Equestro de Leziria Grande made 11 horse shows in 1996 in Germany: a withholding tax was levied on the fees received. According to German law, non-resident artists were allowed to deduct expenses only when they represented more than half of the income received. For this purpose not all expenses are deductible, but only those that are directly linked to the income. On the other hand a resident taxpayer could deduct all expenses which are incurred in the business. As already seen in "Gerritse", the EC fundamental freedoms preclude a domestic tax rule that excludes the possibility for non-resident taxpayer to deduct business expenses from their taxable income, whereas such a possibility is granted to resident taxpayers. The "Gerritse" 119 case deals only with business expenses which are "directly linked to the activity that generated the taxable income in Germany". It does not clarify whether the overhead costs (e.g. depreciation of horses in the instant case) may also be deducted. In "Futura" 120, the ECJ ruled that the fact that Luxembourg allowed a Luxembourg permanent establishment of a French company to carry forward only those losses that are economically linked to the income earned in Luxembourg is in conformity with the fiscal principle of territoriality and cannot regarded as entailing any discrimination, overt or covert, prohibited by the Treaty.

In essence, in the Centro Equestro case the ECJ has to decide whether the territoriality principle set forth in Futura may also be applied to deny the deduction of overhead costs or whether the source state should allow the deduction of a share of those costs.

citizen in order to be protected by the freedom to provide services. It seems that the referring judge was not sure about the Dutch nationality of the non-resident taxpayer. The answer is probably yes (at least for the freedom to provide services, considered from the perspective of the service provider). In fact, Article 49, paragraph 1 of the Treaty states that: "Within the framework of the provisions set out below, restrictions on the freedom to provide services within the Community shall be prohibited in respect of nationals of Member States who are established in a State of the Community other that of the person for whom the services are intended". Conversely, if we consider this freedom from the perspective of the service recipient (freedom to receive services from a non-resident), it is probably enough that the service provider is a resident of another Member state, and not also a citizen. However a non-EU service provider may rely on the provisions of the free movement of capital and payments. In fact, Article 56 paragraph 2 of the Treaty states that: "Within the framework of the provisions set out in this Chapter, all restrictions on payments between Member States and third countries shall be prohibited". As already stated in the Verkooijen case (paragraphs 43-44) and in the Lenz case (paragraph 26), Article 58.1.a (then 73d.1a) of the Treaty which allows Member States to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place in which their capital is invested, are not to constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments.

118 See joined cases C-397/98 and C-410/98, paragraph 44 ff.
119 See paragraph 27 of the Decision.
120 See, Futura, C-250/95, paragraph 22.
4.4 The Denkavit case

The Denkavit case concerns the compatibility with the freedom of establishment of the French rule which – prior the implementation of EC Parent-subsidiary Directive – provided for a 25% dividend withholding tax (usually reduced by the relevant tax treaty) on dividends distributed to parent companies in other Member states, while French companies and French permanent establishments of foreign companies with a holding of at least 5% in the subsidiaries were almost exempt from taxation.

On dividends distributed from 1987 to 1989 from two French subsidiaries to their Dutch parent company Denkavit, a 5% withholding tax was levied. If the French withholding tax is incompatible with the freedom of establishment, the question was also raised whether it is relevant that (i) a tax treaty between France and another Member State provides for a tax-sharing mechanism by reducing the rate of withholding tax and providing relief from double taxation in another Member State and that (ii) the foreign parent company may not make use of the foreign tax credit provided under the tax treaty.

A case quite similar to the Denkavit case has already been decided by the EFTA Court: in the Fokus Bank case the EFTA Court was requested to rule about the compatibility with the free movement of capital of a Norwegian rule according to which dividends paid out by a Norwegian company to non-resident shareholders were subject to a 15% withholding tax, while resident shareholders were subject to income tax, but the imputation credit was granted. In 1997 and 1998 Fokus Bank ASA distributed dividends to its shareholders, including two companies residing in Germany and in the United Kingdom respectively. Neither Norway’s tax agreement with Germany nor that with the United Kingdom entitled taxpayers residing in those two countries to the same imputation tax credit as taxpayers residing in Norway. The EFTA Court’s judgement is based on the EEA Agreement which in these matters is identical to the corresponding rules of the EC treaty. The EFTA Court relied heavily on the ECJ decisions in the Lenz and Manninen cases, though these cases both concerned outbound investments whilst the Fokus Bank case concerned inbound investments. In both its cases the ECJ determined that Austria and Finland respectively had to apply their domestic economic double taxation relief not only to investments in resident companies, but also in all EU companies. As stated in the Lenz case, outbound dividends should not be treated differently than inbound dividends. The purpose of the imputation credit mechanism is to avoid economic double taxation: this purpose can only be achieved if all shareholders are given the benefit of an imputation credit irrespective of their place of residence. Economic double taxation of the same income will create the same undesirable effect, regardless of the shareholders’ countries of residence.

According to the EFTA Court, it is not relevant that the receiving companies may be entitled to a tax credit for withholding tax paid in Norway, because a restriction and discrimination, cannot be offset by advantages which shareholders may obtain in their countries of residence and

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121 On this case see S. Baranger, ‘Preliminary ruling requested from the ECJ on the compatibility of French taxation on outbound dividends with the freedom of establishment’, European Taxation, 2005, 304.

122 The freedom of establishment covers dividend distributions in case of shareholding that gives a definite influence over the company’s decision, see Baars, C-251/98, paragraph 22.


124 As stated in paragraph 30 of the judgement in Verkooijen, C-35/98 a national of a Member State who receives dividends from a company of another Member state is covered by the free movement of capital.

125 The EEA consists of the E.U. Member States plus the EFTA states (Norway, Iceland and Liechtenstein).

126 ECJ, Decision, 15.07.2004, case C-315/02. Anneliese Lenz lived in Austria and invested in companies resident in Germany. Had those companies been resident in Austria, Mrs. Lenz would have qualified for a choice of either being taxed at a fixed rate of 25% or at the general tax rates, but on only half the dividend. Instead, she was expected to pay the full rate of tax on the full dividend.
because a Member State cannot shift its obligation to comply with the EC Treaty to another Member State. Based on the above, the EFTA Court determined that Article 40 of the EEA Agreement precludes legislation whereby resident shareholders are granted a tax credit on dividends paid by a company resident in that Member State, whereas non-resident shareholders are not granted such a tax credit. It also determined that whether the taxpayer in the other Member State actually receives a credit for the withholding tax or otherwise is of no legal significance.

Turning back to the *Denkavit* case, the question is whether the Dutch parent company is in a comparable situation in respect of French corporate income tax to a French parent company (i.e. a French tax resident company or a French PE of a foreign company) benefiting from the French participation exemption. This is the first time when the ECJ has to compare a resident parent company and a foreign parent company. However, in *Lankhorst-Hohorst* and in *Metallgesellschaft*, the ECJ had compared two resident subsidiaries, one with a resident parent company and the other one with a parent company of another Member State, and in both cases the ECJ concluded that the two subsidiaries may not be treated differently because of the nationality of their parent company. In my opinion, it is likely that the ECJ will conclude that a Dutch parent company and a French parent company are in a comparable situation in respect of French corporate income tax.

As already stated in *Royal Bank of Scotland*¹²⁷ the mere fact that resident taxpayers have a general tax liability, while non-resident taxpayers are subject to tax only with respect to income produced in the source state is not enough to preclude the two categories from being considered comparable.

It is very likely, on the basis of the *Lenz* and *Manninen* cases and of the *Gerrits* case, that the ECJ will determine the case in a manner similar to the EFTA Court in the Fokus Bank case and that it will rule that to the extent that any Member State provides relief from economic double taxation on dividend distributions to resident shareholders (by way of an imputation credit or by way of an exemption), it is obliged to provide relief also from taxation at source on dividends distributed to non-resident shareholders, without taking into account whether the residence state provides a foreign tax credit for the withholding tax levied.

I do not believe that this discrimination may be justified by an overriding public interest. In particular, I do not believe that France may rely on the tax cohesion justification. As clarified in *Manninen*¹²⁸ and *De Lasteyrie du Saillant*¹²⁹, tax cohesion must be considered in the light of the objective pursued by rule under scrutiny. In the *Denkavit* case, the aim of avoiding economic double taxation of profits that would have been taxed in the hand of the distributing company will not be affected if this benefit were also extended to shareholders residing outside France.

Moreover the justification based on the offset with other advantage should not be relied upon by France. It is true that, considering the tax credit granted in the shareholder country of residence, the total tax burden may end up by not being higher than that of a resident shareholder. However, a restriction or discrimination cannot be offset by advantages which shareholders may obtain in their countries of residence. Indeed, as a general rule, unfavourable tax treatment contrary to a fundamental freedom cannot be justified by the existence of such tax advantages.¹³⁰

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¹²⁷ See paragraph 29 of the judgement.
¹²８ See paragraph 46 of the judgement.
¹³⁰ See Avoir fiscal, C-270/83, paragraph 21; *Saint-Gobain*, C-307/97, paragraph 54; *Verkooijen*, see above at [*], paragraph 61; ECJ, Decision, 12.12. 2002, *De Groot v. Staatssecretaris van Financien*, case C-385/00, paragraph 97.
5. **Most-favoured nation: the D (C-376/03), van Hiltén (C-513/03) and BuJara (C-8/04) cases (Juanita Bezzina, LL.M. 2001)**

5.1 **The D and BuJara cases**

By its decision on the *D* case, the European Court of Justice has brought an end to the highly-debated topic on Most-Favoured-Nation ("MFN") treatment, and has swept away all doubts as whether this principle could be derived from the EC Treaty in direct tax matters.

A Member State is not obliged to grant nationals of other Member States a direct tax treatment that is not less favourable than that afforded to nationals of a particular Member State or third States, at least when afforded by virtue of a treaty.

In the *D* judgement – which dealt with "classical" MFN treatment that refers to the source State’s obligations in relation to the tax treatment of two non-residents from two different Member States, or hailing from a third State and a Member State – the ECJ surprised several scholars who had anticipated that in answer to the first question the ECJ would have found that a German taxpayer, Mr D, was in a comparable situation with a Dutch taxpayer merely because Germany did not levy a wealth tax. Having determined that Mr D, a German resident, was not in a comparable situation to a Dutch resident, the ECJ in the *D* case could not pull another *Hoechst & Metallgesellschaft*, but ended face to face with the MFN challenge in determining the second question. In determining the issue of comparability between a resident and a non-resident, in line with Gerard T.K. Meussen’s thought, and in disagreement with the Advocate General’s Opinion, the ECJ concluded that the issue of equal treatment between a Dutch taxpayer and a German non-resident was not to be determined by reference to the fact that Germany did not levy a wealth tax. The fact that Germany did not take into account Mr D’s personal circumstances because it did not levy a wealth tax could not be used to assimilate the circumstances of a Dutch resident taxpayer and a German non-resident taxpayer whose wealth was mainly located in Germany, his residence State. The reason for this, though not expressly stated by the ECJ, lies in that the EC Treaty does not impose harmonisation in direct taxes and Member States at present are not obliged to have identical tax regimes.

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131 ECJ, Decision, 05.07.2005, C-376/03, *D*.

132 Treaty Establishing the European Community, 10 November 1997, as per consolidated version O.J. (C 325) 33 [2002], hereinafter referred to as the “EC Treaty”.

133 As distinguished from other areas such as air service treaties, as determined by the ECJ in its *Open Skies* judgements (C-466/98; C-467/98;C-468/98;C-469/98;C-471/98;C-472/98;C-475/98;C-476/98), or from Social Security cases such as *Gottardo*, C-55/00.

134 Through a number of judgements (*Schumacker* C-279/93; *Zurstrassen* C-87/99 among others) the ECJ has established that not only overt discrimination is prohibited but also covert discrimination where other criteria such as residence are used to differentiate on the basis of nationality. See also the correction to paragraph 63 of the *D* judgement (*supra* note 1) where the Court first referred to nationality but subsequently made a correction in order to refer to residence. Rectifying order of 15 July 2005 whereby the term “nationals” was replaced by “residents” in para. 63 of the operative part of the judgement.

135 Though it is possible to envisage beneficial treatment being granted by virtue of unilateral provisions, benefits are far more likely to be granted via treaties, and the *D* case concerns a treaty-created benefit.

136 Georg W. Koffler, “Most-Favoured-Nation Treatment in Direct Taxation: Does EC Law provide for Community MFN in Bilateral Double Taxation Treaties?” *Houston Business and Tax Law Journal*, Vol. 5 (2005), at pp 16-19. However, there is also the lesser known “inverse” MFN where the MFN obligation would be applied to the residence (Member) State which would be obliged to grant its resident who derives income from another Member State, the more favourable treatment afforded by the residence State under a treaty between it and another Member State or third State, not being the one from which income is derived.

137 Where the ECJ having determined the case on the basis of vertical discrimination, followed the AG’s Opinion and steered clear from pronouncing itself on the complex issue of MFN.


139 Opinion of the Advocate General Ruiz-Jarabo Colomer issued on C-376/03.
However, the ECJ begged to differ both from the Advocate General and from Meussen who had concluded that Mr D’s situation was comparable to a Dutch taxpayer. The ECJ analysed the position in line with the “Schumacker doctrine” and saw no similar factual situations where ninety per cent of the non-resident-taxpayer’s wealth was located in his residence State, with the result that the obligation to take into account personal circumstances was not shifted to the source State. Distinguishing the $D$ judgement from Wallentin\(^{140}\), where the ECJ had determined that exempt income is to be excluded for the purposes of the Schumacker formula, the ECJ noted that in the $D$ case, Germany did not levy a wealth tax at all. The Court was parsimonious in setting out its reasoning, but it can be concluded that from the ECJ’s perspective the distinction between the two cases lies in that taking into account the treatment in the residence State is only relevant in determining whether there is unjustified discrimination in the source State, in that reference to residence State taxation is made only in establishing whether that State is in a position that enables it to take into account personal and family circumstances and grant allowances, or whether due to such an inability the obligation to grant personal allowances is shifted to the source State. Mr Wallentin’s income in Germany was tax exempt by virtue of an allowance under German law and in the residence State his income did not constitute the major part of his income, so that it was insignificant according to the ECJ in applying the Schumacker formula. On the other hand, Mr D’s wealth in Germany was not insignificant, and had Germany imposed a wealth tax, as the residence State, it would have been able to take into account Mr D’s personal circumstances. The fact that Germany did not levy a wealth tax while the Netherlands did is a disparity between the Member States’ tax systems that cannot be remedied by applying the EC Treaty. Meussen also agrees with the conclusion that since the EC Treaty does not contain a legal obligation for the Member States to harmonise direct taxes, the Netherlands as the source State should not be obliged to grant a basic tax-free allowance to a non-resident taxpayer simply because his residence State, Germany, no longer levied a net wealth tax.\(^{141}\)

Prior to the decision scholars had argued that a MFN obligation could be read into Art.12 EC Treaty on the basis that it prohibits “any discrimination the grounds of nationality”. However, given the fact that no express MFN obligation is found in the EC Treaty in relation to direct tax matters, the ECJ refused to provide further negative integration. Indeed, a MFN obligation is likely to be invoked once the application of the Four Freedoms and the Principle of Equality cannot be relied on successfully by a non-resident because he is not in a factually comparable situation with a resident taxpayer. In the $D$ case, invocation of a MFN obligation was made by the referring judge only following a finding of lack of discrimination as between a resident and a non-resident taxpayer. Even if the referring judge in Bujara\(^{142}\) attempted to corner the ECJ into tackling directly the MFN issue without requiring a resolution of the issue of discrimination as between a resident and a non-resident, in the light of the $D$ judgement, it can be safely anticipated that in Bujara both the AG and the ECJ will nevertheless first analyse the case for comparability as between residents and non-residents. It can also be anticipated that once the ECJ finds that no comparability subsists as between the German non-resident and a Dutch resident\(^{143}\) it will once more conclude that the German non-resident in Bujara is not comparable to a Belgian non-resident.

In tackling the MFN issue, the ECJ distinguished the $D$ case from Saint Gobain, where in the

\(^{140}\) ECJ, Decision, 01.07.2004, C-169/03, Wallentin.

\(^{141}\) See supra note [*].

\(^{142}\) C-8/04, Preliminary Ruling Request. The case deals with the income tax on savings and investments which replaced the Dutch net wealth tax repealed as from 1\(^{st}\) January 2001. The case has an uncanny factual resemblance to the $D$ case: the Netherlands grants a tax-free allowance and tax credit to its resident taxpayers, non-resident taxpayers who derive 90 per cent of their income from the Netherlands, and to Belgian residents under the Netherlands-Belgium treaty even with a lower percentage, but no similar treatment is granted to German residents under the Netherlands-Germany treaty.

\(^{143}\) It is interesting to note that the taxpayer brought his case after having refused the option of being treated as a Dutch resident under Dutch law.
latter the benefits of a treaty were extended to a non-resident taxpayer even though that non-resident taxpayer was not resident in one of the Contracting States to the relevant treaty, because that non-resident taxpayer present in a Member State via a permanent establishment was in a comparable situation to a resident taxpayer of that Member State. As a consequence of that comparability the non-resident taxpayer was entitled to be treated as a resident of that Member State and thus to enjoy the benefits available under a treaty to a resident. But in the D case the German non-resident taxpayer was not in a comparable situation to a resident taxpayer in the Netherlands as determined by the ECJ in reply to the first question.\textsuperscript{144}

By its D judgement, the ECJ excluded the comparability between two non-residents\textsuperscript{145} when a relevant treaty is in place.\textsuperscript{146} Though the ECJ was not generous in setting its argument black on white, a reading of paragraph 61 of the judgement leads to the conclusion that the ECJ recognised that a treaty creates factual non-comparability between non-residents by the fact that it is bilateral in application. The ECJ stated that: “The fact that those reciprocal rights and obligations apply only to persons in one of the two Contracting Member States is an inherent consequence of bilateral tax conventions. It follows that a taxable person resident in Belgium is not in the same situation as a taxable person resident outside Belgium so far as concerns wealth tax on real property situated in the Netherlands.” The ECJ appears to compare two non-residents, only to conclude that the existence of a treaty (concluded by the source State) with one of the States of the non-residents and a different treaty with the other State will make those non-residents non-comparable. In the D case, the exercise involved a comparison between Mr D, a non-resident with 90 per cent of his wealth located in Germany, his residence State, and a Belgian non-resident with a similar amount of his wealth located in Belgium, his country of fiscal residence. These taxpayers are equal in all respects except one: the treaty as between the Netherlands and Belgium with the reciprocal rights and obligations it gives rise to. The ECJ recognised that the existence of a treaty, or of a treaty providing differently, is not a fact to be overlooked in a comparative exercise. As it had done in \textit{Gilly}, the ECJ recognised that the EC Treaty is not far-reaching enough as to impose an obligation on a Member State not to distinguish between two non-residents as a result of allocation of taxing rights in treaties. Though it never referred to the principle explicitly, the ECJ recognised that no MFN obligation can be read in between the lines of the EC Treaty. The fact that the EC Treaty does not either expressly or implicitly impose a MFN obligation in direct tax matters is supported by the fact that in Art. 293 the EC Treaty encourages Member States to enter into negotiations with a view to concluding double tax treaties as a means of reducing or eliminating double taxation. By encouraging the conclusion of double tax treaties the EC treaty recognises that a Member State will enter into non-identical agreements with other Member States leading to a scenario where two non-residents are not treated equally. The ECJ has accepted that tax treaties create non-comparability between two non-residents.

Some might be tempted to argue that when by virtue of a double tax treaty, for instance by virtue of a non-discrimination clause, a non-resident (a Belgian in the D case) is granted the same treatment as a resident (a Dutch taxpayer in the D case) the comparison can be made directly as between the non-resident (Belgian) taxpayer and another non-resident (the German taxpayer). In other words since a Belgian non-resident is treated as a Dutch resident, instead of comparing a German non-resident with a Dutch resident, a German non-resident could be compared to a Belgian non-resident. However, the extension of treaty benefits, even by virtue of a non-discrimination clause, to a non-resident does not equate that non-resident’s situation to that of another non-resident for the purposes of comparability under the EC Treaty. Though it was criticised for having done so, the ECJ in the D case acknowledged that in matters of direct taxation EC law is not harmonised beyond \textit{Schumacker} that is beyond the guarantee of equal

\textsuperscript{144} “Vertical discrimination” as between a resident and a non-resident.

\textsuperscript{145} “Horizontal discrimination” as between two non-residents.

\textsuperscript{146} In practice differences in treatment as between non-residents are likely to result from the result of treaties concluded by the Member States, rather than as a consequence of provisions in their domestic law.
treatment to taxpayers who are in a comparable situation, and that in the comparative exercise the existence of a tax treaty is a relevant fact.

Treaties concluded by Member States cannot be ignored in a comparative exercise in the D or other similar cases where MFN treatment is invoked because even if in exercising taxing rights Member States are obliged to comply with Community law, as the ECJ confirmed in Gilly, in the absence of harmonisation measures the allocation of tax jurisdiction remains within the Member States’ competence. The line between the allocation of taxing rights and the exercise of those rights is blurred, but by its D decision the ECJ clarified that a non-discrimination provision in a treaty, just like any other treaty provision, is not to be considered in isolation. Though it was argued that a non-discrimination provision does not carve out taxing rights as between the Contracting States, the ECJ acknowledged at paragraph 62 that a provision “cannot be regarded as a benefit separable from the remainder of the Convention, but is an integral part thereof and contributes to its overall balance”. Even though a particular provision in a treaty might appear to grant unilateral benefits and thus not allocate taxing rights, the ECJ held that a tax treaty provision cannot easily be severed from the whole and dismissed as non-allocating. The ECJ rejected the argument that since Belgium did not levy a wealth tax, the non-discrimination provision in question was not allocating or limiting taxing rights as between the contracting States on the basis of mutuality, but was merely a unilateral concession on the part of the Netherlands, and thus not protected by the scope of the Member States’ competence in direct tax matters. The ECJ rejected such an argument on the basis of the reciprocity that is inherent to the process of conclusion of a tax treaty. Any one provision even though apparently non-allocating in nature is the result of an exercise of give-and-take in taxing rights that the contracting States would have undergone in negotiating a treaty. The deal, and thus the allocation, might not be apparent if a provision is scrutinised apart from the others.

Had the ECJ created a MFN obligation in direct tax matters, it would have not only opened the possibility of “cherry-picking” by taxpayers of the most favourable treaty provisions, including the least stringent anti-avoidance rules, but also undermined the principles embodied in international covenants that regulate the relationships between Member States. The ECJ is not blind to the fact that these covenants create disparate treatment as between taxpayers, but if Member States want to iron out those differences, a number of non-judicial solutions are available to them. In connection with a MFN obligation, if Member States were obliged to grant the benefits under their treaties to all other Member States’ residents, any one Member State would in all likelihood be wary of a principle where any benefit it bargained away with another Member State or with a third State is extended to all other Member States. From the taxpayers’ perspective a MFN principle though admittedly attractive would not necessarily guarantee the lowest tax liability possible. As Mike Waters highlighted, by virtue of MFN treatment a taxpayer might pay less in the source State, but if double taxation is relieved by credit, he will pay correspondingly more in his residence State because less foreign tax will be available for a credit.

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148 The so-called “non-garden Community MFN”, where MFN is extended to treaties concluded by Member States with third States on the basis of the argument that a Member State that is not allowed to treat an EU non-resident less favourably than another EU non-resident should not be allowed to treat an EU non-resident less favourably than a non-EU non-resident. Stefaan de Ceulaer, “Community Most-Favoured-Nation Treatment: One Step Closer to the Multilateralisation of Income Tax Treaties in the European Union?” Bulletin for International Fiscal Documentation, October 2003, pp.493-502.

5.2 The Van Hilten-van der Heijden case

The outcome of the *D* case is indicative of the direction the ECJ might take in other cases where MFN is invoked. For instance, although it could settled on the basis of a vertical comparison between resident and non-resident shareholders, *Test Claimants in Class IV of the ACT Group Litigation* also raises the question of a comparison between the treatments by a Member State of non-resident taxpayers from different Member States. Yet another case with MFN implications is the *Van Hilten-van der Heijden* case. In his Opinion the latter case AG Léger has referred to the fact that a claim to best treatment is unsustainable in EC law as it stands at present. The fact that the Netherlands and Switzerland had agreed that the former would retain the right to tax a Dutch national for ten years after she would have become a Swiss tax resident consists of nothing other than an allocation exercise between the States and thus falls within their competence. The emigration State fulfils its obligations under EC law once it grants relief for taxation suffered in the immigration State and thus the exercise of Freedoms is not hampered in that when compared to a resident who did not exercise a Freedom no additional tax burden is suffered by the resident who did. Since the Netherlands granted relief for double taxation – so that a Dutch person who moved to or invested in Switzerland was not bound to pay more Dutch tax than a Dutch person who did not so move or invest – it fulfilled its obligations under EC law. The fact that a Dutch person who moved to or invested in Switzerland suffered tax in Switzerland, which tax exceeded the Dutch tax liability, and that the excess foreign tax credit was not recoupable cannot be remedied at EC law because there is no obligation to grant persons who exercise their Fundamental Freedoms the best treatment available. Similarly, the fact that a Dutch person would other than for the operation of the deemed residence rule be subject only to Swiss tax law that might be lower than Dutch tax, does not amount to a violation of EC law, because all that a Member State has to ensure is that persons who exercise their Fundamental Freedoms are not placed at a disadvantage or restricted in so doing when compared to a resident who did not exercise those Freedoms.

According to the AG even though as established in *Barbier* a transmission of property by inheritance qualifies as a capital movement, the relevant tax residence fiction rule does not amount to a restriction of the relevant Freedom because at the moment of emigration there is no investment effected. While admitting that the deemed residence rule could dissuade a Dutch citizen from emigrating, the AG concludes that the rule did not restrict the free of movement of persons because emigration did not trigger any additional tax burden. Taking their cue from the *Lasteyrie du Saillant* case some have argued that the residence fiction rule is similar to an exit tax in that though at the point of emigration no tax is imposed, tax is imposed at a later date. However, while an exit tax brings to charge unrealised gains on emigration, a residence fiction rule does not impose an additional tax (or require a burdensome security in lieu) placing at a disadvantage an emigrant as against a resident who did not exercise a Fundamental Freedom. A residence fiction rule merely allocates jurisdictional rights at the time of succession, and thus does not impose an additional burden, immediate or deferred. Neither does the residence fiction rule in question impose a restriction on the free movement of capital because it does not distinguish between the wealth inherited depending on its location as was the case with the rule condemned in *Verkooijen*. As the AG acknowledges, the resulting...

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150 Case C-374/04.
151 Case C-513/03.
152 Issued on 30 June 2005.
153 Freedom of Movement of persons was tackled by the AG even though the case concerned only the Free Movement of capital.
155 Understood as interpreted by the ECJ in Joined Cases C-286/82 and C-26/83, *Luisi & Carbone*, Decision, 31.01.1984 to refer to financial operations that locate or invest the relevant capital. The AG concluded that on the shifting of her residence, Mrs Van Hilten-van der Heijden did not shift all her patrimony with her to Switzerland. The only relevant movement of capital occurred upon succession.
situation is not tax neutral, but cannot be remedied in view of the lack of harmonisation in the Member States’ tax laws.

In could be argued that the deemed residence rule contains an element of reverse discrimination against Dutch nationals, in so far as it did not apply to Dutch residents who move their fiscal residence elsewhere\textsuperscript{156} with the result that the potential exposure to Dutch tax liability affects only Dutch nationals. This point is more difficult to rebut, but the AG opined that this distinction arose as part of the exercise of allocation of taxing rights that falls within the remit of the Member States’ competence. Provided that EC law is respected, citizenship can be used to determine such allocation. Although the AG did not refer to it, a relevant case is X\&Y\textsuperscript{157} where the ECJ accepted the allocation of taxing rights in the case of a change of residence (of a shareholder) by means of a deemed residence or extended tax liability provision in the Belgium-Sweden double tax treaty allocating the taxation of gains on the disposal of shares to the emigration State for shareholders who were its nationals for five years following a change of residence. The AG could have relied on Gilly in concluding that the deemed residence rule in question does not amount to a restriction of the free movement of capital or persons, but constitutes a rule of allocation of tax jurisdiction on the basis of nationality.

In Gilly, the ECJ considered it reasonable for Member States to conclude double tax treaties based on “international practice and the model convention drawn up by the OECD”\textsuperscript{158} and accepted discrimination based on nationality where the EC treaty did not specifically prohibit it. In including a deemed residence rule the Netherlands-Switzerland treaty also followed international practice and para.71 of the Commentary on Art.9A and Art.9B of the 1982 OECD Model Double Tax Convention on Estates and Inheritances and on Gifts. In Gilly the ECJ confirmed that double taxation relief need not extend to a full credit of the tax paid because the EC Treaty does not “ensure that the tax to which the taxpayer was subject in one state is no higher than that to which he or she would be subject in the other”.\textsuperscript{159} Similarly in the Van Hilten-van der Heijden case, a disadvantage arose when the immigration State adopted a different rate of taxation from the emigration State. However, at present Member States are at liberty to determine their tax rates and the connecting factors for the purpose of tax allocation. As regards those attempting to rely on citizenship of the European Union as a basis for condemning the deemed residence rule, this argument can be rebutted on the basis that any rights emanating from EU citizenship cannot supersede those derived from citizenship of a Member State because citizenship of a Member State is a sine qua non for citizenship of the Union. Thus not only is citizenship of the Union dependant on citizenship of a Member State, but also it cannot confer more rights than those found within the EC treaty at present. In the light of the obtaining state of affairs, the ECJ could conclude the Van Hilten-van der Heijden case to the effect that in establishing the criterion on which to allocate jurisdiction, even if this is nationality, the Netherlands is compliant with EC law.

5.3 The Way Forward

As a result of lack of harmonisation, the ECJ will continue to be faced with situations where disparity of treatment cannot be remedied by invocation to principles that are not incorporated in direct tax matters such as MFN. If the Member States would like to take harmonisation in direct tax matters further, positive rather than negative harmonisation constitutes the way forward.

\textsuperscript{156} The deeming provision is however applicable to non-nationals who resided in the Netherlands, though in their case the relevant period is limited to one as against ten years applicable to nationals.

\textsuperscript{157} ECJ, Decision, 21.11. 2002, Case C-436/00, X\&Y, at para. 56.

\textsuperscript{158} Ibid.

\textsuperscript{159} Ibid. at para. 46.