CROSS BORDER DEDUCTION OF LOSSES IN EUROPE TAX LAW: THE «ECONOMIC LINK» AND TERRITORIALITY PRINCIPLE, WHAT FUTURE?

Sintesi: The cross border offsetting of losses is a thorny issue that may hardly be solved with a uniform approach on the basis of law sources and principles currently available. The lack of harmonization at the EU level, the huge differences among the tax and accounting legislations of the Member States, the absence of guidelines and certainties in the OECD MC (exemption vs. credit systems) are the main sources that contribute to feed and exacerbate this issue.

The outcome is that, due to market globalisation and the increasing number of cross border activities a solution needs to be found at least for two basic issues: 1) situations where specific events would determine a «final loss» (see par. 1.3.2 point 2 and comments on Marks & Spencer case para. 4.2.) and 2) situations where, despite different legal entities are involved, income of companies within a same group in the EU market - due to a tax consolidation or a fiscal unity - should be aggregated/consolidated in order to equalize profit and losses, disregarding any difference deriving from the tax system involved, i.e. credit or exemption (see par. 1.3.2 point 1). The Draft Directive of 1990 shows a clear impetus toward this direction and still offers in author's view viable solutions to harmonize the treatment of losses. The «reincorporation method» suggested in the Directive could still cool down the fear that countries have of loosing tax revenues in cross border offsetting of losses. Due to the wise tool of the recapture of the amount of losses previously deducted, there is no risk for the residence country in reckoning the losses as determined in accordance with the rules of the Member State in which the foreign permanent establishment or subsidiary is situated (see in this respect exp. mem. par. 9). At the same time this tool seems to me beneficial for enterprises since it allows them to reduce the risks of cash flow issues (see supra note 27) arising when foreign losses may not be set off against domestic profits. Further, the reincorporation method suggests us that, under an EC law compatibility test, Member States may find it difficult to prove the «proportionality» of domestic provisions denying cross border offsetting of losses.

In its previous decisions concerning losses and costs the ECJ made reference to terms such as «territoriality and economic link» to allocate such losses and costs under a tax jurisdiction. Unfortunately, it seems that those references are not consistent. On one hand EU governments used them either on the ground of the justifications (see *Futura* and *ICI* cases) or as a tool to exclude a comparability analysis and therefore a breach of the fundamental freedoms from the outset (see *Bosal* case). On the other hand the concepts underlying those terms have also been characterised under a different wording as happened with the ideas of the cohesion or coherence of the tax system. The ECJ didn't clarify where the territoriality principle should play a role (at the level of justification or on the ground of the comparison) in testing the compatibility with EC Treaty of a domestic rule thus avoiding a standard answer to EU governments' plea. Further, it is hard to think that the territoriality principle and the economic link concept equally apply to single entities and groups (see para. 3.3. at the end).

Should such terms lead to a uniform interpretation of the territoriality principle (what some scholars define as «strict territoriality principle» see para. 3.3) a possible way out in the different treatment of losses under the current legal system could be found and a uniform set of rule could be suggested by denying a cross-border offset for losses. However, practice shows a different pattern, particularly when dealing with countries adopting a credit method. In EU Member States where domestic legislations provide for group relief or consolidation regimes for tax purposes, the territoriality principle does not seem to constitute a valid justification in order to deny the cross-border offset of losses. Inasmuch as a restriction of the freedom of establishment is deemed to arise, for those groups – actively involved in various countries – that may not import losses from foreign subsidiaries, the ECJ will likely decide those cases – as the Marks & Spencer case will show in the author's opinion – in favour of the taxpayer by requiring the resident country (UK or another EU country) to allow for cross-border loss consolidation.

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1. – *Introduction*

After the 1990 Draft Directive on cross-border compensation of losses, the idea of harmonization in the field of losses has not been properly addressed at EU level. It might well have been addressed but there haven't been concrete proposal.

The aim of facilitating the grouping together of companies is widespread in the European Community and often called upon in EU Council's documents (*e.g.* Par-Sub Directives) especially when comparing a group of companies carrying on activities in a single Member State with one performing activities in different countries. Obviously, as long as differences arise in these cases, in the tax treatment of transfer of profits (and losses) from one country to another, it will be difficult to reach the aimed harmonization and thus increase the competitiveness at international level for the EU groups. Apparently, so far, the lack of a clear set of rules both in the EC law and in the international tax law (DTCs) jeopardizes a uniform treatment in the field of losses. Nonetheless, a clear

opportunity to make a step further arises in these years (2004-2005) since an important case on the cross border offsetting of losses is pending before the ECJ (*i.e.*, *Marks & Spencer*). The ECJ will tackle a dangerous choice, which, in one way or in another, will put a milestone in the treatment of losses for groups in Europe.

In its previous decisions concerning losses and costs the ECJ made reference to terms such as «territoriality and economic link» to allocate such losses and costs under a tax jurisdiction.

After a recognition of the issue arising with cross border offsetting of losses this paper analyses the two concepts of territoriality and economic link as so far developed with ECJ decisions. Finally, the work deals with the *Marks & Spencer* case and tries to focus on the possible outcome.

2. – *The issue of cross-border offsetting of losses*

2.1. – *Definition of losses*

As already pointed out in the introduction, the present analysis will focus on the tax treatment of losses for corporations regardless of the impact of such elements in the individual wealth taxation.

Business results for commercial accounting purposes are normally the starting point for computation of corporations' taxable base and therefore for the levying of taxes on corporations' profits.

Generally speaking, whenever the actual performance of a corporation yields a positive income (operational income) lower than its negative income (*i.e.* expenses and costs), a loss arises for both commercial accounting and fiscal purposes. In fact, a corporation showing a loss before tax in the profit and loss account would end up with a negative taxable base and therefore no taxes will be levied in the taxable period concerned. On the other hand, even if a corporation ends a given year with a profit for commercial accounting purposes, the taxable base may result again in a negative value, a loss for tax purposes, (or a nil base) due to the offset of negative taxable bases from previous business years or due to temporary (*e.g.* deferred tax liabilities) or permanent differences for commercial accounting and fiscal purposes arising in that same year.

Due to these main features, a common definition of losses arises neither across domestic law of EU Member States nor in the international law of treaties nor even in the EC law.

Some scholars (1) have attempted to characterise losses as negative profits. Indeed, losses and profits share a common background: the same

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(1) A. 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), 135-142 and 218-233, paragraph 1.

goals that usually lead an enterprise to make profits may drive results in the opposite direction. Thus, it is undoubtedly correct to create an idea that losses, being able to reduce profits and to reach negative results, may be defined as negative profits.

With these basic definitions in mind, it is now worth analysing some features of the tax treatment of losses, which may vary to a great extent from country to country due to huge differences in fiscal legislations and accounting conventions (*i.e*. GAAT, IAS).

This analysis will focus on two main aspects:

– how domestic, international and EC law principles involving the tax treatment of losses, as they currently stand, may solve cases on cross-border offsetting of losses for corporations, as the one currently pending before the European Court of Justice (ECJ): the *Marks & Spencer* case (2);

– how the interaction between the territoriality principle, the concept of «economic link» and the EC law principles as interpreted by the ECJ may affect the decision of the *Mark & Spencer* case and the future treatment of losses for groups of companies.

The former point will be discussed in this chapter having regard to domestic international and EC secondary laws principles (basically the Draft Directive on losses) (3), while chapter three will deal with the discussion on the territoriality principle and the concept of economic link, as developed by the recent ECJ decisions. Chapter four will focus on how the outcome of these reflections may drive the ECJ in the solution of the *Marks & Spencer* case.

2.2. – *Tax treatment of losses (a domestic point of view)*

The tax treatment of losses may have to be analysed from a range of angles that keeps into account the diverse approaches adopted according to tax laws and accounting principles of the various countries.

Some scholars have summarized with a detailed analysis the basic tools and mechanisms of the tax treatment of losses under domestic laws (4), based on such analysis it is possible to gather many criteria some of which need to be recalled upon in this framework.

Having regard to the sources (not in a geographical sense), losses for companies may derive from ordinary business activities or extraordinary events such as reorganizations, winding up of PEs or liquidation

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(2) ECJ, Pending, Case C-446/03 *Marks & Spencer v. David Hasley, Inspector of taxes*.

(3) The 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 COM (90) 595 final of 6 December 1990, O.J. No. C 53 of 28 February 1991.

(4) A. Cordewener et al., 44 *European Taxation* (2004-4 and 5), supra note 1, paragraph 2.

of subsidiaries. In the former case tax systems may introduce specific limitations to allow deduction of losses and costs only if income or gains of the same categories arise (*e.g.* basket systems applied to losses from immovable properties or capital losses) (5).

Losses may also stem from accounting differences on the basis of specific fiscal and accounting rules of a given country rather than form economic events involving the companies incurring them.

As to the timing relevance, tax law may provide that, if a corporation suffers a tax loss for a given year, such a loss may not only trigger non-taxation in that same year, but also interact with previous or following fiscal accounts, thus reducing the tax burden in other taxable years (6). In other terms, a loss may be considered in the period of its accrual, carried forward and allowed as a deduction in a subsequent tax year, or carried back and allowed as an additional deduction in a previous tax year.

Of course, due to countries fear for abusive schemes that undermine the integrity of tax bases, limitations on carry forward and carry back are provided for by domestic legislations usually with a time limit (*i.e.* an available time frame to offset after which an expiration occurs) or with maximum amount ceilings and this holds particularly true when company ownerships change.

Furthermore, as some scholar already pointed out (7), the exploitation of carry-back and carry-over mechanisms is available inasmuch as the tax administrations sophisticated administrative resources are able to keep monitoring taxpayers taxable base over a certain length of time without difficulties.

All these features in tax treatment of losses as well as other categorizations (8) may be blended in a single tax jurisdiction or show overlapping when two or more tax jurisdictions are involved.

Finally, for the purposes of this analysis two differences are more relevant than other in considering the tax treatment of losses and these differences arise often as two sides of the same coin being strictly related to each other, as the *Marks & Spencer* case shows.

On the one hand, losses can be suffered by one and the same tax-

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(5) For a recognition on US basket system and other systems see H. J. Ault et al., *Comparative income taxation* (The Hague: Kluwer law international, 1997), 394.

(6) We may think to a legislation allowing a tax loss carry forward to be translated into a deferred tax asset on the commercial balance sheet of the company suffering it. That loss could be utilised against future taxable income.

(7) L. Burns and R. Krever, in V. Thuronyi (Ed. 1996), *Tax Law Design and Drafting* (Washington D.C: International monetary fund), p. 619.

(8) For other aspects of the tax treatment of losses such as direct or indirect equalization *(e.g.* through depreciation of the participation) or the detailed ways of undoing a previous loss consideration, see A. Cordewener et al., *European Taxation*, *supra* note 1, para 2.9 and 2.10.

payer or by different taxpayers though parts of the same group. This typically occurs in a parent - subsidiary relationship within a group of companies.

Likewise, though with slightly different nuances the same taxpayer may decide to make a direct investment or to run his business through a Permanent Establishment. In the latter situation, losses may be attached to each of the relevant parts of the enterprise, *i.e.* the Head Office or the Permanent Establishment (in other words losses may be attributable to the PE or not) as the case maybe.

On the other hand, the other side of the coin – and the thorniest issue – is the difference in tax treatment between domestic and cross-border offsetting of losses.

This last issue is at stake in both the cases of a single taxpayer involved in foreign investments through a permanent establishment and of a parent profitable company with a subsidiary in a different country incurring losses or vice versa.

For the sake of completeness, one should also mention the fact that due to differences in tax systems adopted by different jurisdictions in order to tax world wide income and to provide relief from double taxation, losses may not only be «offset» in cross border situations but also disregarded at all or sold along with the loss making company.

The aim to ascertain how international and EC tax (secondary) law cope with cross border offsetting of losses is the main purpose of this first part of the work while the second one will address the suitability of the territoriality principle and the «economic link» concept in order to solve cross border cases of loss offsetting such as the *M&S* case.

2.3. – *International taxation and cross-border losses*

When tackling the cross border treatment of losses, two or more jurisdictions are at least involved. Therefore, the analysis requires an assessment of the most exploited methods of taxation in the international tax arena and a basic understanding of how, in case of overlapping of those methods, relief from double taxation tools interact with the cross border offsetting issue.

2.3.1. – *Worldwide vs. source taxation*

As above mentioned, both profits and losses, generated by corporations in cross border situations, are likely to be taken into account twice for tax purposes in two different countries. In order to understand how losses can be eventually taken into account between the two or more taxing jurisdictions concerned in a cross-border scenario, the following considerations may be made hereby. Broadly speaking, a nexus between

a country and the activities or the legal entities (9) that generate an income is required in order to let the State exert its right to claim taxation on that item of income (or take a loss into account for tax purposes).

It has been held that tax jurisdiction is one of the aspects of a state's sovereignty, which is not limited as a rule (10) and may be exercised in two ways: on the basis of a «personal attachment» (*e.g.* residence of tax subjects, nationality, etc.) or on the basis of an «economic attachment» (economic interest in a given state) (11).

Each situation that gives rise to a «personal attachment» – in the sense above stated – is also the origin of the unlimited tax liability on worldwide income. As a matter of fact, most countries tax their residents on a worldwide basis, *i.e.* for worldwide income and assets attributable to those residents. At the same time non-residents are taxed on the basis of the source principle *i.e.* with a limited tax liability only for income sourced within the country.

These two previous situations, worldwide versus source taxation, may overlap and cause double taxation. Usually, worldwide taxation with respect to residents (or nationals as far as individuals are concerned in US) and source taxation with respect to non-residents are strictly related methods in a single tax system of a country. Nevertheless, a country could adopt a «strict territoriality principle» (12), whereby both residents and non-residents are taxed only for income and assets which are situated/sourced within the territory of that country (13). Both the source and the territoriality principle adopt a reference to the source of the income in order to provide a nexus with a taxing jurisdiction and allow the taxation in a given state. However, inasmuch as it applies to both residents and non-residents, it seems to me that the territoriality principle differs to some extent in the international taxation language from the pure «source» principle used to characterize only the limited liability for taxation of non-residents as opposed to the worldwide principle usually applied to tax residents. Thus, it seems that the strict territoriality principle, as explained by authors referring to it, would practically apply and should be interpreted as a base income exemption for both residents and

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(9) Individual treatment is disregarded in this respect since the analysis focuses on taxation of corporations.

(10) Tax treaty network may to a certain extent reduce the taxing power of countries by restricting their domestic tax legislations and curbing their sovereignty in that respect.

(11) For these definitions see H. Hamaekers, *The Source principle versus the residence principle*, *Revista dos tribunais No. 3* 1 (1993), 164 et seq. at 166.

(12) See in this respect P.J. Wattel, *Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity; a plea for territoriality*, *EC Tax Review* (4-2003), 194-202, at 201 and D. Gutmann, *The Marks & Spencer case: proposal for an alternative way of reasoning*, *EC Tax Review* (2003-3) 154-158, at 158.

(13) For a further discussion upon the ECJ decisions and the territoriality principle see chapter 3.

non-residents. In other terms, the source state would completely disregard the foreign income in order to tax residents and non-residents.

Finally, in considering the tax treatment of income and losses it is also worth noting that a big difference for cross border offsetting purposes may derive from the relief method adopted by each country in order to avoid double taxation of business profits, *i.e.*, credit, income exemption or exemption with progression. The credit method usually considers the foreign losses of PEs in the world wide income subject to tax, the income exemption method completely disregard both profit and losses of foreign PEs in determining the world wide taxable income of the resident HO, the exemption with progression method take both PEs profit and losses into consideration in order to determine the tax rate applicable to the HO world wide income. Losses will affect the tax rate with a negative progression effect.

2.3.2. – *Two basic issues with cross-border offsetting of losses*

Once analysed the basic principles and criteria adopted to allocate income and therefore losses into different jurisdictions (worldwide, source and strict territoriality), one should verify what are the issues that losses may create for corporations engaged in activities across the borders. In particular, it is important to understand what happens when foreign losses derived from activities carried on in the source countries may not be set off in the residence country where the enterprise started its business.

I would summarize here below two separate issues according to the sources where they come from (14):

1) The pure cross-border issue for both branches and different legal entities (foreign subsidiaries);

2) The timing issue (carry back - carry forward) in the same or different jurisdictions and the concept of final losses.

1) Where a PE or a foreign subsidiary incurs in losses a first issue arises as to whether the residence (*i.e.*, the HO or parent) country allows the losses to be set off against domestic profits of the HO or parent company. As a matter of fact, while, as a rule, income in the same jurisdiction is aggregated either among branches and head office or through some forms of fiscal consolidation between subsidiaries and the parent company, the same mechanism never applies where those losses have to cross the borders in order to be set off. This obstacle holds true as far as subsidiaries are concerned and sometime even when PEs are in-

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(14) For a clear explanation of these issues, though with a different classification see B.J.M. Terra and P.J. Wattel, *European Tax Law,* Third Edition (Deventer: Fed, 2001), 440-452.

volved (15). This lack of neutrality in equalization of profits is currently under examination before the ECJ (16) but even in a non-EU environment, absent a uniform treatment for cross border offsetting of losses for tax purposes, it is not easy to foster the competitiveness for groups of companies.

For the sake of clarity, however, it is important to stress that the situation is different when analysing the HO/PE relationship as compared to the Parent-Subsidiary relationship since, as well pointed out by some scholars (17), «established international tax law does not treat foreign branches and foreign subsidiaries alike».

As a general rule (18), losses suffered by foreign branches are taken into account in the worldwide tax liability to offset the head office profits reducing its taxable base and thus creating, even if temporarily (19), a cross border losses offsetting scheme. The reason of this specific treatment is that PE forms a single unit with the undertaking and from a legal standpoint they are not separate legal entities. This means that PEs are not residents of the country where they are located and thus are taxed with a limited liability on income sourced therein.

On the contrary, it is a widespread principle in international taxation that profits deriving from a subsidiary in another state are disregarded for tax purposes up to the moment of the repatriation as well as losses incurred by a foreign subsidiary that may not be offset against a resident parent company income (Danish consolidation and other worldwide consolidation regimes (20) make exception to this rule as well as CFC legislations according to which profits from foreign subsidiaries are immediately attributable to the resident parent company). This is because subsidiaries are separate legal entities and are residents and subject to full tax liability in the source state. Therefore, those los-

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(15) The principle does not apply when an income exemption country is at stake since due to exemption of foreign profit foreign losses are disregarded either.

(16) See ECJ, Pending cases, Case C-446/03 *Marks & Spencer v. David Hasley, Inspector of taxes* and Case C-152/03 *Ritter v. Bundesfinanzhof.*

(17) P.J. Wattel, *EC Tax Review* (4-2003), *supra* note 12, at 194.

(18) Some exception to this principle arises in exemption countries that disregard foreign PE losses as well as they do for profits.

(19) This mechanism of cross border offsetting of losses incurred by foreign branches against HO profits is usually coupled with a recapture mechanism. Such a recapture excludes relief form double taxation of future foreign PE income in the residence country to the extent that the amount of the losses previously deducted are not added on the HO income. Some country provides for an automatic recapture when foreign PE is not profitable anymore (*e.g.* after a maximum time limit of 5 years) or wound up, sold, transformed in a corporation.

(20) French adopts a kind of world wide consolidation regime known as *bénéfice consolidé* and Italy has also recently issued o set of rules within its tax reform providing for a world wide consolidation regime applicable as from 2004. In both cases the head of the group should own at least 50% of the consolidated subsidiaries.

ses may only be carried back or forward in the foreign country where the subsidiaries are located.

The reason of this difference in treatment between PE and subsidiaries could be deemed the outcome of their different legal forms (21). However, if we look at these relationships from an economic perspective there are grounds to support the idea that a same equal treatment should be granted irrespective of the legal form adopted to run a business, at least within the EU market if the main goal is that of achieving Europe as the most competitive economic power in the world (22).

True, even if this equal treatment between PE and subsidiaries would go beyond their legal background and would not be always accepted it would probably help to foster the economic growth in Europe.

In my view, these considerations on the difference of legal forms should have a different weight at least when a group consolidation for fiscal purposes arises.

Whenever a group consolidation is involved one question may be brought forward: should the idea of an economical unit, regardless of how the group is organized from a legal point of view, govern the tax result?

At least in the EU context where a single market should be developed with the idea of an internal market (23), a common taxable base including profits and losses of the companies within a group actively involved in the EU and the equalization (24) of such profits and losses should be achieved. The European territory should be considered as a single market whereby tax sovereignty of each Member State leaves precedence to a sovereignty of EU taxation on the basis of some principles for the allocation of the taxable base to be agreed upon.

In these circumstances the relationship between the head of the group and the subsidiaries wherever located should be the same of that applicable between HO and PE, or a Parent and a subsidiary consolidated in the same jurisdiction for tax purposes, provided a certain ownership requirement is met and irrespective of the fact that each company within the group is a different legal entity.

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(21) For a detailed analysis of the main differences between PEs and subsidiaries under an EU perspective see P.J. Wattel, *EC Tax Review (4-2003), supra* note 12.

(22) 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* and more recently Introduction of *An Internal Market without company tax obstacles achievements, ongoing initiatives and remaining challenges*, Brussels 24 November 2003 COM (2003) 726.

(23) See Explanatory memorandum par.1 of COM (90) 595 final of 6 December 1990, *supra* note 3.

(24) For the possibilities of having a tax equalization system developed in Europe see B. Wiman, *Equalizing the Income Tax Burden in a Group of Companies*, 28 *Intertax* (2000-10), 352-359.

2) Timing limit plays an important role in this subdivision of issues for cross border offsetting of losses.

In principle, for both PE and subsidiaries suffering losses, carry back or carry over provisions in tax legislations of many countries would allow the offset of those losses in the same jurisdiction against profits of previous or following fiscal years with some time limits. However, it might well happen that:

a) there were not enough profits in previous years against which offset the losses; or

b) a country has only carry-over provisions and a time limit prevent losses to be absorbed by following profits; or

c) a company is liquidated or wound up or transformed in a branch or vice-versa.

In all the situations of final losses, as above described, the lack of a proper and uniform set of tax rules either in international tax law or in the domestic one, prevent a fair taxation of the profits for undertakings. Eventually, it is possible that the enterprise suffers a tax burden higher than its own tax liability worldwide thus resulting in overkill taxation. The *M&S* case clearly shows this shortcoming of the actual system in UK and the same drawbacks arise in many European countries. A group of companies where the overall taxable income would be negative due to foreign subsidiaries losses should not pay any tax on domestic HO's or parents' profits at least for the part of those profits which could be offset against foreign losses. However, where domestic legislations and international tax laws along with EC Treaty law and its interpretation, as provided by the ECJ, do not grant to the residence state the right to import the foreign losses of subsidiaries, the parent company or the HO – where the foreign losses excluded from cross border offsetting pertain to a PE (25) – will suffer a cash flow issue and an interest loss (26).

A strict territoriality principle could be of some assistance or one of the possible solution to avoid the issue of cross border offsetting of losses and to grant neutrality for domestic and cross border investments. Indeed, a strict territoriality approach would force a country adopting it to allocate foreign income and investment out from its tax jurisdiction and to take into consideration income and losses inasmuch as they are generated within the territory under its sovereignty. Thus, no issues of cross border migration, exchange and offset of losses of PEs or subsidiaries would arise since the taxable base would be calculated allocating only domestic (*i.e.*, within the territory of that country) income. Reference is made to Chapter 3 for further considerations on the territoriality principle under the EC law perspective and how it may solve cross border offsetting of losses.

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(25) The issue for PEs may arise if certain conditions arise both in French and in Germany see H.J. Ault et al., *Comparative income taxation, supra* note 6, p. 408.

(26) Along this line of reasoning see P.J. Wattel, *European Tax Law, supra* note 14, p. 442.

2.3.3. – *Tax treaties law, OECD MC* (27) *and losses*

Before entering the delicate field of how EC law (both for primary and secondary level (28)) and ECJ decisions deal with the treatment of losses in cross-border situations, it is useful to check whether the law of treaties provides any possible solution or helps in that respect.

As already pointed out by some scholars (29), both the relief systems of credit and exemption as dealt with in article 23 A and B of the OECD MC and its commentaries are clear with this respect. Those systems do not bind residence states to adopt certain behaviours whenever the issue of allocation of losses from foreign business activities carried on by their residents arises. In other terms, countries are left free to either consider these «negative profits» or disregard them at all when taxing the worldwide income of their residents.

Reading paragraphs 44 of the Commentary to article 23A and 62 of the Commentary to article 23B, the idea one may gather is that, as far as loss treatment is concerned, it is not feasible to adopt a uniform solution to be proposed in those articles due to substantial differences among countries legislations. Thus, precedence should be given to domestic laws and bilateral agreements or mutual agreement procedures.

However, while credit systems do not create particular issues in considering foreign losses (at PE level) as part of the worldwide income for tax purposes, a thorny issue seems to arise with exemption systems. Since exemption countries usually disregard foreign profits (an exception for positive progression effect may arise) the issue arises because for neutrality purposes and also if one thinks to a strict territoriality approach (*e.g.* a pure income exemption system) foreign losses should be disregarded. Nonetheless, again, there is not a uniform pattern with this respect as highlighted by many authors (30). According to these scholars, High Courts in France and Germany used in the past a neutral approach according to which exemption should apply for both profits and losses.

In more recent decisions there is not a consistent approach and again differences arise from country to country. A recent German case (31) regarding losses from letting of immovable property suffered by individuals help us in finding patterns of exemption countries where, at least for certain types of income, foreign losses are completely disregarded for exemption purposes even for negative progression purposes.

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(27) Reference is made to the OECD Model Convention and (MC) Commentaries on the Articles of the MC as updated on January 2003, unless a different reference is provided for in the text.

(28) When quoting: «Primary law», reference is made to the EC Treaty law while with «secondary law» reference is made to the law of Directives.

(29) See A. Cordewener et al., *European Taxation*, *supra* note 1, para. 3.

(30) See A. Cordewener et al., *European Taxation*, *supra* note 1, para. 3.2 and 3.4 and A. Cordewener, *Foreign Losses, Tax Treaties and EC Fundamental Freedoms: a new German Case before the ECJ*, *European Taxation* (September, 2003), 294-303, at 294.

(31) ECJ, Pending, Case C-152/03 *Ritter v. Bundesfinanzhof.*

However, in another recent decision (32), in Austrian Courts there has been a clear tendency to exclude the idea that exemption of foreign income should necessarily include both profits and losses.

In order to sum up what above highlighted, unless restrictions included in provisions *ad hoc* bilaterally negotiated in tax treaties signed country by country apply, the OECD MC and its commentaries leave free countries' legislation to import or disregard foreign losses in the computation of worldwide taxable income for residents of both credit and exemption countries.

Besides, nothing is of course provided for in the OECD MC and commentaries related thereto as far as the loss treatment in groups of companies is concerned for both the cases of the simple Parent-Subsidiaries relationships or fiscal consolidation patterns. The reason of this lack is obvious; the main purpose of tax treaties is to avoid (juridical) double taxation of taxpayers engaged in cross-border operations, the situations of losses incurred in a consolidated group of companies or in a Parent-Subsidiary relationship do not trigger such juridical double taxation.

2.4. – *Losses in PE and Sub under EC secondary law (Draft proposal for cross-border loss compensation and proposal for losses carry over)*

After a brief recognition of the domestic and international state of the art in the tax treatment of losses a further analysis of the EC law principles available on this topic is required and constitutes the main purpose of this work.

Before going through the main principles of the EC primary law under the Treaty and the role of the four fundamental freedoms, an investigation of the EC secondary law of the Directives (though only at the embryonic *status* of proposals) is recommended. They represent on one hand a clear sign that a step toward a uniform treatment among Member States of the cross border offsetting of losses is needed to remove a huge obstacle to a common market in the EU and on the other hand, a missed opportunity to harmonize this delicate issue since unanimous consensus so far has not been reached and therefore the proposals never turned into Directives.

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(32) I quote this source making reference to the decision number as provided by a cross reference made in two articles referring to it since it was not possible to find the original source while writing this paper: Austrian *Verwaltungsgerichtshof* of 25 September 2001, Case 99/14/0217, *IStR* 2001. However, one of these sources has been written by one of the members of the same Supreme Administrative Court: see U. Zehetner, *Austrian Supreme Administrative Court: exemption method and foreign losses – a change in the interpretation of DTC*, *EC Tax Review* (2002-1), 39-40.

2.4.1. – *Draft Directive on losses* (33)

Some of the most relevant issues regarding the cross border offsetting of losses, referred to in previous paragraphs, have been already tackled at the level of the European Commission despite the final step in order to reach an EC secondary law act (Directive) has never been accomplished. True, one could spend time and words trying to find the reasons why this Draft Directive never developed further with a final act but, as some scholars pointed out (34), it seems that many of these proposals and more recent initiatives didn't reach their goal due to «EU governments' lack of determination to put direct tax harmonization on the agenda».

Further, the real issue for the Draft Directive developments could have been that of the unanimous vote. As a matter of fact, some scholars (35), pointed out that one of the main obstacles to the development of secondary tax legislation at the EU level is the unanimous voting requirement in tax issues. According to this opinion, the qualified majority would be the solution to harmonize and to «define the cohesion of the national tax systems».

However, despite Member States disagreement and policy issues behind the lack of the adoption of this Directive, in my view, the Draft still represents a huge contribution for both the aims it wants to achieve and the means through which cross border offsetting of losses could be reached for either permanent establishments or subsidiaries investments in countries other then the residence country of the HO or parent company.

The proposal aimed at removing obstacles created by the absence of national provisions among Member States allowing an undertaking to set against its profit the losses incurred by its permanent establishment or subsidiaries abroad. The idea was that of providing common rules to improve the competitive position of Community undertakings.

As far as permanent establishment is concerned, the proposal recognised that the problem of losses beyond the border of the Head Office country of establishment did not arise in credit countries since both profits and losses of foreign PEs were taken into account in the overall results of the undertaking. On the contrary for exemption countries the problem could have arisen since in principle profit and losses of foreign PEs were not taken into account. Therefore, the Commission found that the so called «reincorporation method» would have been the right solution for those situations where foreign losses

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(33) COM (90) 595, Brussels, 24 January 1991, See *supra* note 3.

(34) M. Mbwa-Mboma, *The Push Toward Pan-European Tax Consolidation: A French Perspective on the Marks & Spencer Case*, 30 *Tax Notes International* 5 (5 May 2003), 457 et seq.

(35) F.J. Vanistendael, *European Taxation in the 21st Century The road towards Integration*, *European Taxation* (October 1998), 331-335 at 334.

were not incorporated in the residence country (art. 7 and explanatory memorandum paragraph 4).

The «reincorporation method» allows foreign PEs losses to be deducted in the residence state while also provides for taxation of subsequent profits of the permanent establishment by reincorporating them into the results of the head office to the extent of the amounts previously deducted. This method with some arrangements would be also a viable solution for those cases above defined as «final losses» (see above paragraph 1.3.2). As a matter of fact, Member States might safeguard their revenue interest by reincorporating automatically amount of losses previously deducted if reincorporation has still not occurred after five years or if the permanent establishment ceases to exist in that form (exp. mem. paragraph 8).

It is my opinion that the most important merit of the «reincorporation method» was that it cooled and could still now cool down the fear that countries have of loosing tax revenues in cross border offsetting of losses. Due to the wise tool of the recapture of the amount of losses previously deducted, there is no risk for the residence country in reckoning the losses as determined in accordance with the rules of the Member State in which the permanent establishment is situated (see in this respect exp. mem. par. 9). At the same time this tool seems to me beneficial for enterprises since it allows them to reduce the risks of cash flow issues (see supra note 27) arising when foreign losses may not be set off against domestic profits. Further, the reincorporation method suggests us that, under an EC law compatibility test, Member States may find it difficult to prove the «proportionality» of domestic provisions denying cross border offsetting of losses. This latter aspect will be discussed below at para. 4.1.

Finally, in order to grant a coordination between the timing issue of the carry over and carry back in the source country of the PE and the reincorporation mechanism in the residence country of the HO, the explanatory memorandum to the proposal suggests a contemporary issuing of both the Directives on cross border offsetting and carry over of losses (see below par. 2.4.2).

With respect to subsidiaries, instead, at the moment the proposal was submitted, only three countries among EU member states had provisions that granted to a certain extent the option of taking into account foreign subsidiaries losses under a group tax consolidation regime (France, Denmark and the Netherlands). The problems of losses affecting subsidiaries were seriously considered. It was already clear at that time that the choice between the investment through a subsidiary or a permanent establishment would not be neutral if the arrangements for deducting losses incurred by foreign subsidiaries were less favourable than those applicable to permanent establishment (see in this respect exp.mem. par. 5).

Thus, the best solution to be adopted in order to grant a uniform treatment was that of extending the reincorporation mechanism also to

foreign subsidiaries provided a minimum ownership test (both voting rights and holding in capital are required in art. 2) was fulfilled in order to grant importation of losses in the state of the enterprise (art. 9 and exp.mem. par. 15). Of course, the same automatic reincorporation tricks available for PEs were provided also with respect to subsidiaries including the hypothesis of reductions in holding thresholds (art. 10).

As some scholars pointed out (36), the automatic reincorporation tool, applicable if after 5 years a recapture of the losses did not occur due to the lack of profit in the source state, has the function of sending back the losses where they come from. Indeed, this line of reasoning would create a further element to support the territoriality principle as it will be explained in the next chapter.

2.4.2. – *Draft Directive for carry-over of losses*

Also the proposal submitted by the Commission to the Council on September 1984 and later amended on June 1985 on the harmonization of the laws of the Member States relating to tax arrangements for the carry-over of losses of undertakings was never adopted.

The purpose of this proposal was that of approximating tax burdens on undertakings by admitting a carry over not only to later but also to earlier (two in the first draft, three on the basis of the amendments) years. In the latter case the proposal provided for a refund of tax to be obtained. The proposal left free also Member States with legislations providing for different rates applying to different categories of profits to manage the offset of losses category by category.

Finally, the proposal included – for countries granting the imputation credit on profits distributed – a mechanism for the offsetting of the refund with the tax credit to be collected and a payment for the excess of the former amount.

2.5. – *Preliminary results on the basis of the first part of the analysis*

On the basis of what stated so far, the cross border offsetting of losses is a thorny issue that may hardly be solved with a uniform approach on the basis of law sources and principles currently available. The lack of harmonization at the EU level, the huge differences among the tax and accounting legislations of the Member States, the absence of guidelines and certainties in the OECD MC (exemption vs. credit systems) are the main sources that contribute to feed and exacerbate this issue.

The outcome is that, due to market globalisation and the increasing number of cross border activities a solution needs to be found at least for two basic issues: situations where specific events would determine a «final loss» (see par. 1.3.2 point 2), and situations where despite diffe-

(36) See P.J. wattel, *European Tax Law, supra* note 14, at p. 449.

rent legal forms, income of companies within a same group – due to a tax consolidation or a fiscal unity – in the EU market should be aggregated/ consolidated in order to equalize profit and losses as already often happens for the HO/PE relationship and irrespective of the tax system involved, *i.e*. credit or exemption (see par. 1.3.2 point 1).

The Draft Directive on losses (see par. 1.4.1) and that on carry-over (see par. 1.4.2) tackle some of the issues above mentioned and offer viable solutions to be upheld. Nonetheless those Commission acts were never transposed into Directives.

However, what has not been unanimously decided via Directives could be reached, in the next future, if the ECJ states in a decision (*Marks & Spencer* case, indeed, could be the right chance to do so) a principle according to which, if certain conditions are met, cross border offsetting of losses is to be allowed among Member States on the basis of the EC Treaty principles stemming from the fundamental freedoms.

In order to understand what could be the rationale behind this type of statement it is worth analysing how the ECJ has so far addressed cases regarding loss treatment.

The following chapter will deal with two concepts recurring in the ECJ decisions that need to be further evaluated: «territoriality and economic link». The analysis aims at ascertain whether these concepts as used in previous ECJ decisions may contribute to build up a route that will lead the Court to solve the *Marks & Spencer* case and other cases on cross border treatment of losses.

3. – *Territoriality and economic link applied to losses in EC law and ECJ decisions*

3.1. – *Cross-border losses under the test of the EC law and the fundamental freedoms*

As above highlighted (see paragraph 1.3.1), in order to understand where a company or a group of companies engaged in cross border activities has to be located for income tax purposes (*i.e.* for the taxation of its profits and losses), three different layers of rules have to be checked whenever companies involved are residents or carry on their activities in a European framework:

– Domestic legislations;

– International tax law (the law of Double Tax Conventions *alias* tax treaties);

– EC law.

True, broadly speaking and not only in a EU context, one should always look at domestic legislations involved and the criteria they adopt (residence or worldwide – source or territoriality) to establish a nexus

between *a*) a state jurisdiction to tax and *b*) the person or the activity carried on in the State.

On the other hand, one should also look at international tax law that as a rule may shift the nexus as above determined and lay down principles to restrict the application of domestic legislations deciding where to allocate the income to be taxed between different states.

Among Member States of the European Union, however, there is another source that may to a great extent provide for further limits to their sovereignty and therefore to the right to exert their jurisdiction to tax. As a matter of fact, law stemming from the EC Treaty and the secondary EC law, (*i.e.* the Directives), represents another important ground of compliance for potentially unlimited taxing powers of EU Member States. In the same setting, it is also worth remembering that under art. 234 of the EC Treaty, the ECJ has the jurisdiction to give preliminary rulings concerning the interpretation of the EC Treaty to member states' courts and tribunals (37) so that along with the primary and secondary law also ECJ decision will be analysed in this context.

With these basic rules in mind it is now worth understanding how the EC law principles of EC Treaty, *i.e.* the so-called fundamental freedoms, may interact with the issues of cross border offsetting of losses.

What is the function and content of the fundamental freedoms within the EC law?

The creation of a common market within the EU is one of the means through which the goal of the high competitiveness for European undertakings may be achieved (38). The ECJ so far has made clear the need for the «elimination of obstacles to intra-community trade in order to merge the national markets into a single market bringing about conditions as close as possible to those of a genuine internal market» (39). In order to reach these goals, EC Treaty requires the abolition of obstacles to free movement of goods, persons, capital and services, the so-called *four fundamental freedoms* (Italics MR).

The treatment of losses as well as profits and therefore, generally, the income treatment for tax purposes, is a matter of direct taxation so that, starting from the outset, one may think that it falls within the competence and the indisputable sovereignty of each member state (40). Nonetheless, the ECJ has been consistent so far in its decisions and par-

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(37) See with this respect G. Meussen, *The Mark & Spencer case: reaching the boundaries of the EC treaty*, *EC tax review*, (2003-3), 144-148 at 144.

(38) See, among others, Communication from the Commission to the Council, the European Parliament and the european economic and social committee: *An internal market without company tax obstacles achievements, ongoing initiatives and remaining challenges*, COM (2003) 726, Brussels 24.11.2003.

(39) ECJ - Case 15/81 *Gaston Schul.*

(40) Member States sovereignty in the field of direct taxes may be gathered from articles 93 and 94 of EC Treaty.

ticularly in almost all cases regarding treatment of losses in stating a principle that reads as follows:

«Although direct taxation is a matter for the Member States, they must nevertheless exercise their direct taxation powers consistently with Community law» (41).

Consequently, Member State may face restrictions in their legislations as a result of the negative integration (42) provided by the ECJ decisions whenever a domestic rule is in breach of Treaty freedoms and that rule is disputed before the Court.

The compatibility of a national measure with one of the fundamental freedoms, according with the reasoning adopted by the ECJ in previous decisions, requires an assessment of the rule under different steps analysis (43). It is necessary to ascertain:

– whether a domestic measure introduces discriminations or restrictions (44) within the scope of a Treaty's freedom;

– whether such a measure is justified on the basis of the written justifications of the Treaty (45) or in accordance with the unwritten rule of reason (46);

– whether the measure even if justified is in accordance with the principle of proportionality (47).

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(41) ECJ - Case C-250/95 *Futura Participations and Singer* at para. 19; Case C-264/96 *ICI v. Colmer* at para. 19; Case C-141/99 *AMID* at para. 19.

(42) The concept of «negative integration» refers to restrictions (applied generally through ECJ Decisions) as opposed to the concept of «positive integration»» providing rules via the primary and secondary law of Regulation and Directives. See in this respect P.J. Wattel, *European Tax Law* , *supra* note 14, pp. 2 and 22.

(43) For this subdivision see A. Cordewener et al., *European Taxation*, *supra* note 1, para. 4.2.

(44) For a description of the differences between the concepts of discrimination and restriction see P.J. Wattel, *European Tax Law*, *supra* note 14, p. 30

(45) The so-called written justifications are those included in the EC Treaty such as reasons of public policy, security, health, under article 39.

(46) The rule of reason test has been summarized by the Court in the Case C-55/94 *Gebhard*, at para. 37, according to that principle «(…) national measure liable to hinder or make less attractive the exercise of fundamental freedoms guaranteed by the Treaty must fulfil four conditions: they must be applied in a non-discriminatory manner, they must be justified by imperative requirements in the general interest, they must be suitable for securing the attainment of the objective that they pursue and they must not go beyond what is necessary in order to attain it».

(47) The principle of proportionality has been defined as an unwritten principle of primary law that should be applicable to domestic legislations in matters of Community law as well as it applies to activities on the side of the community due to art. 5 (3) EC Treaty. See A. Cordewener et al., *European Taxation*, *supra* note 1, para. 4.4.

A further element to be mentioned when addressing the compatibility of a measure with EC law within the first step above highlighted is that a comparison must be made between the case at hand and a similar situation that fits the rule requirements (in this analysis the deduction of losses in a group relief situation). As a matter of fact, ECJ case law (48) shows that a rule may be discriminatory if a different rule applies to comparable situations or if the same rule applies to different situations.

In making this comparison two different perspectives may be chosen. An inbound perspective would analyse the situation from the point of view of the host state, comparing for instance, a resident and a non-resident, who exercised his fundamental freedom establishing a PE or a subsidiary in the host state, in order to understand if any discrimination arises. An out-bound perspective would, instead, encourage a perspective from the home state point of view, comparing, for instance, the situation of a resident investing exclusively in his country with that of a resident, exercising his freedom of establishment, investing in a foreign country through a PE or a sub, in order to check whether a restriction or a discrimination arise. A further dichotomy in the latter case may be made between horizontal and vertical discrimination (49). The latter kind of discrimination is based on a comparison (from the home state perspective) between a Parent company and a subsidiary within a single jurisdiction with a Parent company with a subsidiary in a different jurisdiction. The former kind of discrimination, instead, is based on a comparison (from the home state perspective) between the two different secondary establishment of a subsidiary and a permanent establishment.

In tackling cases with a discriminatory rather than a restriction-based approach the ECJ is not consistent, both approaches could be used as far as cross border cases of losses are concerned. As some scholar (50) has highlighted, the «ECJ show convergence (…) in the application of the four freedoms so that in line with the principles stated in paragraph 37 of the *Gebhard* case, it is clear that measures without distinction (*i.e.* both restrictions and discriminations, MR) which nonetheless restrict the exercise of Treaty freedoms are in principle prohibited under all four freedoms, and will be accepted only if they pass the rule of reason test».

Having made some preliminary remarks on how the domestic rules may be tested and restricted under the EC law fundamental freedoms as applied by the ECJ, the analysis should now focus on the possible EC law issues that cross border offsetting of losses may create.

For the purpose of this work a specific situation involving tax treatment of cross border offsetting of losses will be hereby analysed under the test of compatibility with EC law. This situation is the same

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(48) See ECJ Case C-279/93 *Schumacker v. Finanzamt Koln-Altstadt* para. 30.

(49) For this different kind of comparisons see, A. Cordewener et al., *European Taxation*, *supra* note 1, para. 5.3.2 and 5.3.3.

(50) See P.J. Wattel, *European Tax Law*, *supra* note 14, p. 41.

that has been brought before the ECJ recently with the *Marks & Spencer* case.

Domestic consolidation regimes are the typical set of national rules among Member States legislations dealing with set off of profits and losses that may show incompatibilities with the freedom of establishment test of article 43 read in conjunction with article 48 of the EC Treaty.

These EC Treaty articles introduce the principle of the freedom of establishment for companies carrying on their activities in a cross-border situation within the EU. They prohibit any form of restriction in the setting up and management or, generally, other forms of restriction to the establishment of branches or subsidiaries within the territory of any Member State.

Usually, under a domestic tax consolidation regime (a group relief in UK, fiscal unity in the Netherlands, *consolidato domestico* in Italy, contribution system in Sweden) profits and losses even between different legal entities may be compensated, set off, in the same tax jurisdiction.

However, as Marks and Spencer case shows, a domestic group consolidation regime (in this case UK law adopts a relief for losses regime under which subsidiaries may surrender their losses to the Parent company) that does not allow the domestic parent company to set off against its profit the losses of a foreign subsidiary may appear to fall foul of articles 43 and 48 of the treaty.

Indeed, a restriction may arise in these cases for groups carrying on their activities abroad – *i.e.* having already exercised their Treaty access due to cross border investments – as compared to groups actively involved only in a pure domestic situation since in the former case losses intra-group could not be offset. Thus, countries adopting a form of domestic tax consolidation between profits and losses, only to the extent that legal entities involved in the consolidation have their residence within the Home state jurisdiction, create a situation whereby groups might find less attractive to establish subsidiaries in foreign countries due to a less favourable treatment as compared to the domestic one: *i.e.* the impossibility to import losses of foreign subsidiaries.

There is no doubt that each measure that make less attractive the exercise of a fundamental freedom may qualify as a restriction, but as already seen before, in the analysis of the steps to be accomplished in the assessment of the compatibility with EC law, a measure that provides for a restriction may still comply with the fundamental freedoms if it is *justified* and *proportionate*.

Taking into account these considerations, the question to be answered is whether the exclusion of cross-border offsetting of losses by domestic consolidation regimes is against EC law and the fundamental freedoms or if that exclusion is justified and proportionate.

In order to answer this question a further analysis on the territoriality principle and the concept of economic link as interpreted by the ECJ is required.

3.2. – *Territoriality and economic link concepts, their interrelation with cross-border losses*

At an earlier stage of this work (par. 1.3.1) it was argued that the territoriality principle in the International tax law terminology is sometimes used as a synonym of the source principle in order to characterize the taxation of non-residents within a jurisdiction – due to an economic event attributable to them and arising in the territory of that jurisdiction – as opposed to the world-wide principle, under which the taxation of residents apply for income wherever produced.

On the other hand, it was also pointed out that it is possible to find among scholars (51) a different use of the term when the concept of territoriality is considered in a narrow sense. A «strict territoriality» principle would apply to both residents and non-residents only for income and assets that are situated/sourced within the territory of a given country.

However, based on the research carried on during this paper, one certainty is that the concept of territoriality is not interpreted in a consistent way between international tax law and in the ECJ decisions (52) as the following paragraphs will demonstrate.

3.2.1. – *Territoriality and economic link in the ECJ decisions*

The first issue arising when dealing with the relationship between the territoriality principle and the tax treatment of cross border offsetting of losses in a group consolidation within the EU, is whether one should consider such a principle on the ground of the justifications (second layer of the analysis on the compatibility of national laws with EC law) or on a discrimination/restriction level, (first layer of analysis) thus, excluding a violation of the fundamental freedoms from the outset.

If it is possible to build up a common concept of territoriality among International law and ECJ decisions, a concept which would withstand the test of compatibility with EC law under the first ground of the analysis, that concept would be indeed a good tool to avoid and exclude discrimination or restriction claims. With this main purpose, some ECJ decisions on losses and costs are hereby commented.

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(51) D. Gutmann, *EC tax review*, *supra* note 12 at 156; P. J. Wattel, *EC Tax Review*, *supra* note 12, at 201, A. Cordewener , *European taxation, supra* note 30, p. 303.

(52) See A. Cordewener et al., 44 *European Taxation* 4 and 5 (2004), *supra* note 1, para. 4.3.2, the authors consider the concept of territoriality as «ambiguous».

3.2.1.1. – *Futura*

In *Futura* (53), for the first time in a case dealing with a loss issue, the ECJ laid down the territoriality principle. A French company with a Luxembourg PE could have carried forward losses in Luxembourg on the basis of two conditions. Out of the two conditions required, the one that has relevance for this analysis is that, as per Luxembourg law, losses may be carried forward if *economically linked* to the income earned in Luxembourg (para. 18). The ECJ considered this principle as being in compliance with the principle of *territoriality*.

As a matter of fact, in order to ascertain a possible discrimination based on the difference in taxation of a resident and a non-resident (a PE of a foreign company) the ECJ ruled that, with respect to the calculation of the taxable base, taking into account only profits and losses arising from the Luxembourg activity, «such a system which is in conformity with the fiscal principle of territoriality cannot be regarded as entailing any discrimination, overt or covert prohibited by the treaty» (para. 22).

It is worth, however, highlighting that in *Futura*, in order to assess whether the EC Treaty prevented the Luxembourg domestic law from disregarding the loss carry-forward, the comparison made by the Court was that between the treatment of a PE of a non-resident company – a Luxembourg PE of a French company – and the position of a resident – a Luxembourg company. The Court was clearly facing an inbound perspective case and the position of one and the same taxpayer.

What is not predictable and yet to be discovered is whether the territoriality principle applies also to a domestic rule dealing with tax consolidation, such as the UK group relief, involving more than one taxpayer (54). Such a rule would likely bring the Court to make a comparison between a resident subsidiary of a resident parent company and a foreign subsidiary of a resident parent company (*i.e.* adopting what has been called a «vertical discrimination approach»). Thus, differently from what happened in *Futura*, (domestic carry forward and inbound case) the Court will deal with an outbound perspective case and a cross border losses issue (55).

At this point of the analysis, the question arising is if, in the latter mentioned scenario, the Court would apply a strict territoriality principle to reject the cross- border offsetting of losses or whether other principles

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(53) ECJ Case C-250/95 *Futura Participations SA and Singer v Administration des contributions.*

(54) The territoriality principle may not be extended where more than one taxpayer is involved. Along this line of reasoning see D. Weber, *The Bosal Holding Case: Analysis and Critique*, *EC Tax Review* (2003 - 4) p. 220-230, at 228.

(55) See in this respect P. Pistone, *Tax treatment of foreign losses: an urgent issue for the European Court of Justice*, *EC Tax Review* (2003-3), p. 149-154, at 150. See also below note 82.

enshrined in EC law (*e.g.*, the freedom of establishment) would force the ECJ to accept a compensation of losses across the borders.

In other terms, should one rely on the statement above mentioned and held in paragraph 22 of *Futura* even when dealing with a case whose features are those typically requiring the adoption of an outbound perspective? Would it be possible to apply that principle to both credit and exemption countries and in cross border situations? Does it make any difference whether a group of companies or a single entity is at stake? Does it matter whether the rule tested under the fundamental freedoms (*i.e.*, the group relief) deals with a relationship between at least two different legal entities instead of jeopardizing the tax treatment of a single taxpayer?

Again, these are thorny issues when reading ECJ decisions since a lot of confusion may be made on the basis of the different wording used and the meaning of awkward terms often interrelated: *economic link, direct link, territoriality, fiscal cohesion or coherence of tax systems.*

The concept of territoriality as stated in *Futura* seems to resemble the concept provided by the general definition of territoriality already investigated under International tax law. The concept is called upon in a source situation where non-resident may set off losses if economically linked to income arising under the same jurisdiction.

Unfortunately the relationship between the territoriality principle and the concept of economic link as stated in *Futura* is not consistent in other ECJ decisions and other terms are used that exacerbate the difficulties of finding common features and answer to the above questions. The Court often used other terms to answer questions that were strictly related to the concept of territoriality so that it is almost impossible to build up a territoriality concept at EC law level. Consequently it is difficult to predict that the ECJ will use a territoriality principle as stated in international tax law in order to support the denial of a cross border offset of losses.

3.2.1.2. – *ICI*

A case where the ECJ missed the opportunity to give a clear idea of the territoriality principle is the *ICI* (56) case. Another occasion to deal with UK group relief for losses. In that occasion, the UK group relief rule was under dispute because a UK domestic subsidiary couldn't surrender the losses to the Parent due to the fact that relief was not applicable when the majority of companies were residents outside the United Kingdom. As far as the present analysis of the group relief rules for losses is concerned, the Court provided an important statement on the outbound investment restrictions. According to that view, «the provisions concerning the freedom of establishment also prohibit the Member

(56) ECJ Case C-264/96, *Imperial Chemical Industries (ICI) v. Kenneth Hall Colmer.*

State of origin from hindering the establishment in another Member State of a company incorporated under its legislation» (para. 1). This statement is relevant for the typical outbound perspective that a domestic tax consolidation regime may require.

However, when was the time to consider the relationship between the loss deduction and the activity carried on in UK by companies within the group relief rule, the Court didn't show consistency with what stated in *Futura*. The relationship between losses and profit was shifted this time within the framework of the notion of «cohesion» *i.e.* on the second layer of the analysis on the compatibility of a rule with the fundamental freedoms, that of the justification.

Since the majority of the subsidiaries in the UK group were located out of the UK, the UK government in order to justify the lack of relief for (UK) subsidiaries' losses held that, had the deduction of that loss take place in UK the loss of tax revenue would not be offset by taxing foreign subsidiaries (para. 28).

Unfortunately, the idea held by the government to maintain the «cohesion» of the tax system was expressed with the argument of the «reduction of revenue». Absent any reference to a wording that included the «territoriality» idea the Court didn't take the opportunity to spell out a territoriality concept again with more clear features. There are no clue of the reasons behind this direction taken by the Court, may be a credit country was at stake so that a strict territoriality principle as theoretically built up in the international tax doctrine (57) does not apply. However, the Court «in the past (…) accepted the need to maintain the cohesion of tax systems as a justification for maintaining rules restricting fundamental freedoms (…) (58)» in those cases, however (*Bachmann and Commission v. Belgium*) (59), the *direct link* (*Italics MR*) «between a tax advantage (*e.g.* the deductibility of a loss) and offsetting that advantage with a fiscal levy (60)» were «relating to the same taxpayer and the same tax» (61). Since the latter kind of «direct link» between the consortium relief granted for losses incurred by a resident subsidiary and the taxation of profits made by non-resident subsidiaries was not available in ICI the court rejected the justification of the loss of tax revenue (fiscal cohesion) (para. 29).

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(57) For those authors who mentioned the idea of a strict territoriality principle see *supra* note 12 and 51.

(58) See *supra* note 56 *ICI v.Colmer* para. 29.

(59) ECJ Case C-478/98 *Commission v. Belgium* and Case C-204/90 *Bachmann v Belgian State*

(60) ECJ Case C-324/00 *Lankohorst-Hohorst GmbH v Finanzamt Steinfurt, para 42* and Case C-*Metallgesellschaft Ltd and others v. Commissioners of Inland Revenues, para 69.*

(61) Sometimes in ECJ cases Governments make reference to the concept of «coherence» in the same meaning as «cohesion», see ECJ Case C-324/00 *Lankhorst-Hohorst Gmbh v Finanzamt Steinfurt* para. 19. See in this respect A. Cordewener et al. *EC tax review, supra* note 1 para. 4.2.2.

If one looks at the possible effects of taking into consideration the fiscal cohesion concept, as above illustrated, in a future case dealing with a restriction or non-discrimination claim for the cross border offsetting of losses the following conclusions might apply. A national government within the EU may not rely on a domestic rule that restricts the freedom of establishment of companies by denying the set off of foreign losses in a group relief regime to the extent it pretends to justify such a rule on the basis of the fiscal cohesion principle.

Based on the foregoing reasoning some scholars (62) recently analysed the domestic French consolidation system and pointed out that «the French government – in order to defend the exclusion of EU resident companies from participating in the tax consolidated group – would argue that the rule is intended to ensure the overall logic and cohesion of the French corporation taxation, which is based on the territorial principle». Nonetheless, according to what ECJ jurisprudence above mentioned has stated so far, the principle of fiscal cohesion should not apply due to the lack of correlation between the taxation of the French parent company in France and the taxation of foreign subsidiaries in the other member states. Thus, French government, when dealing with consolidation and cross border offsetting of losses, could rely neither upon a fiscal cohesion principle nor upon a strict territoriality approach, as it would apply in France due to its domestic corporation tax regime.

If one seeks to sum up the concepts expressed by ECJ in these two decisions on losses (*Futura* and ICI) it seems to me that it is not easy to draw a common idea of territoriality and fiscal cohesion. On the other hand there are at least two main findings that may be pointed out. First, both cases (even if in *Futura* it is not so clear either) deal with the territoriality principle and the fiscal cohesion principle on the ground of the justifications adopted by Member States to reject the non-discrimination or restrictions claims. Secondly, while in the first concept there is the idea of an economic link between the deduction of losses and the income earned in the same territory (*Futura*), in the concept of fiscal cohesion there is the idea of a direct link between a tax advantage (loss or cost deduction) and a fiscal levy that the ECJ accepted only to the extent the same tax and the same taxpayer were involved (*Bachmann*).

Indeed, while the territoriality principle if clearly stated in the EC law (63) or in the ECJ decisions would represent a huge obstacle for cross border offsetting of losses, the fiscal cohesion principle would not do the same, as above highlighted, if within a group one looks at the companies offsetting profits and losses as two different legal entities and taxpayers.

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(62) M. Mbwa-Mboma, 30 *Tax Notes International* 5, *supra* note 35, at 460.

(63) See in this respect, D. Weber, *EC Tax Review* (2003 - 4), *supra* note 54, at p. 229 according to the author the territoriality principle is not stated at EC law level.

Differently, if one thinks to the group of companies benefiting from a fiscal consolidation as a single taxpayer within a same tax jurisdiction/ territory *i.e.,* that of the European market, also the territoriality principle if interpreted in a very broad sense would not create a justification against domestic rule hindering the freedom of establishment. In building up such idea another case discussed before the ECJ may be relied upon as the following paragraph points out.

3.2.1.3. – *Gerritse*

In one of the most recent cases, the *Gerritse* case (64), a rule providing for the non-deductibility of a business expense (another negative income element as well as losses) for a non-resident was held by ECJ as amounting to an indirect discrimination due to the «direct link» between the business expense and the activity generating the income in the same host state (para. 27-28).

This case might be helpful to create a stronger idea of the ECJ view on the necessary link between a cost or loss deductibility and the activity generating the income.

This view seems to follow an economic approach rather than an approach focused on the legal forms as the fiscal cohesion does. True, this idea of the economic nature of the link between the expense/loss and the activity is stressed, once again, in the same country/territory where the negative element of income arises because a single taxpayer was involved in the case. But what would happen if the Court had to face a group relief situation? Might a loss suffered by a foreign subsidiary in a group, consolidated for tax purposes, in a single market at the European level, be economically linked with the profits generated by the activity of the parent in a different Member State as two part of a same and single taxpayer?

Indeed, following this line of reasoning, one could end up with the idea that a «fiscal unity» might be deemed and treated as a single taxpayer within the EU and that the cost and loss suffered in one part of the group could be deemed economically linked with the activity of another company of the group located in another member state, as a part of one and the same taxpayer. But would the ECJ go that far?

If we compare on the basis of the two decisions *Futura* and *Gerritse* the concept of economic link and that of territoriality in the wording adopted by the ECJ close similarities arise. In *Futura*, the concept of territoriality is focused on the deductibility (carry over) of losses in the same country/territory where the activity generating the income is carried on. The same is true with respect to *Gerritse* but for one thing, the latter case seems to add something new in the ECJ cases and put the concept of the link between cost and activity as an element to be checked at the first layer of the test on compatibility with the funda-

(64) ECJ Case C-234/01 *Gerritse v. Finanzamt Neukolln-Nord.*

mental freedoms. A higher level of analysis on the compatibility means a first level of check for the non-discrimination/restriction test rather than an analysis at the level of justifications. In the previous paragraph it was possible to see that the territoriality principle was used in the past by Member States governments as a tool in order to claim the defence for the integrity, coherence, cohesion of a tax system, but the concept was always exploited as a justification for non-discrimination or a restriction already ascertained.

Should this concept of economic link, as a first layer weapon to be checked, push forward the territoriality principle, as so far stated in previous decisions, to the extent that it creates a tool to directly reject any claim of non-discrimination or restriction? A strict territoriality principle clearly stated by the ECJ in a decision would have a great impact on cross-border offsetting of losses: losses could not be set off whenever a border divides the single (HO v. PE) or different legal entities that decide to enjoy them in two different Member States (65).

On the other hand a new territoriality principle with these features - stemming with a certain degree of consistency by ECJ decisions and amounting to an EC law principle to be checked on a first layer of compatibility with EC law – if analysed together with the idea of the EU as a single market and territory and a group of companies under a consolidated regime as a single taxpayer carrying on the activity within that territory, would shift the attention to another question hereby relevant.

Could the idea of a fiscal unity in a single European market be deemed as amounting to the situation of a single taxpayer carrying on the activity in a single territory so that set off of foreign losses is allowed if economically linked to the activity of the group?

I don't think so, the principles the ECJ stated in *Gerritse*, in my opinion, are not reliable if one thinks to extend them in a complete different context.

While, on the one hand, the endeavour to find common features between what the ECJ said about the cost and loss deductions would be useful in order to predict what the Court could state in a future case on losses, on the other hand, the attempt to stretch the wording used by the Court to dream a future decision where a common idea of a single market and a consolidated group regime would permit the set off of losses and profits across the borders, due to the activity of the group within a single EU market/territory, would certainly result in an overkill.

What this case shows may not be relied upon with a certain degree of certainty and exploited when testing the compatibility with fundamental freedoms of a national group relief provision disallowing a cross border offsetting of losses. There are still too many differences between the two cases we would like to compare. *Gerritse*, is a case involving an individual and again it triggers an inbound perspective while the issue of

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(65) See in this respect P.J. Wattel, *EC Tax Review*, *supra* note 14, at 201; D. Gutmann, *EC tax review supra* note 12, at 158.

losses herewith discussed relates to a group of companies in a cross border environment and deserves an outbound perspective.

My scepticism is driven by political reasons. ECJ decisions may not curtail Member States sovereignty in direct taxation, even more in the field of cross border offsetting of losses where the lack of unanimity excluded the adoption of the Directive. Harmonization through secondary legislation is still necessary and particularly in this moment is very welcome due to the delicate situation created with the *Marks & Spencer* case in UK. However there are some rooms for the ECJ to allow cross-border offsetting of losses, as below discussed in paragraph 4.2.

3.2.1.4. – *Bosal*

In order to conclude the analysis of ECJ cases that may help in the recognition of a territoriality principle in EC law it is also worth mentioning the *Bosal* case (66).

In this case the ECJ dealt with an issue related to the deductibility of interest costs at the level of a Parent company located in the Netherlands for financing activities of subsidiaries established within the European Community. The tax inspector denied the deduction because according to a domestic rule, within the context of the participation exemption regime, holding costs, which were indirectly instrumental in taxable profits being made abroad, were not deductible.

Once again, in *Bosal* the ECJ had the opportunity to better draw the outlines of the concept of territoriality, though in the end the Court didn't go any further in that respect. As a matter of fact, the Netherlands Government, as paragraph 18 of the judgment highlights, relied upon an argument based on the principle of territoriality as recognised by the ECJ in *Futura*. Reading the case, it is possible to understand what was the view of the Government on the territoriality principle, *i.e.*, rather than on a justification level it had to be evaluated on the first layer of the compatibility analysis, as a tool to determine whether two situations are comparable or not. «The situation of the subsidiaries of parent companies established in the Netherlands which do make taxable profits in that Member State and those which do not are not in an objectively comparable situation» (para. 18), thus if one accept this interpretation a discrimination or a restriction in this case would be excluded from the outset.

Unfortunately, as some scholars pointed out (67), the Court decided to evaluate the argument based on the territoriality principle on a justification ground after having rejected the argument on fiscal cohesion. Further, the Court held (para 38) that «(…) the application of the territo-

(66) ECJ Case C-168/01 *Bosal Holding BV v. Staatssecretaris van Financien*.

(67) See D. Weber, *EC Tax Review* (2003 - 4), *supra* note 54, at p. 228.

riality principle in *Futura* concerned the taxation of a single company (…)».

This behaviour of the Court could be interpreted, on one hand, in the sense that the territoriality principle and the fiscal cohesion may not be considered as a same principle, on the other hand in the sense that the territoriality principle may be invoked only if applied to a single taxpayer (68).

Keeping in mind the different points of view adopted by the ECJ with respect to the territoriality principle in the above mentioned cases it is possible to draw some conclusions and to see how they would apply to a case on cross border offsetting of losses (paragraph below).

Finally, it should be pointed out that *Bosal*, might be certainly a useful decision to gather the idea that ECJ may treat the deductibility of costs and losses in the same way. In fact, if in a case on costs deduction the Court made reference to a case of losses (para. 38), the same could be done on the other way around when a case on losses is at stake.

3.3. – *What a territoriality principle would suggest? Economic or legal criteria*

Coming back to the main question regarding the impact of the territoriality principle on the cross border offsetting of losses, the following answer could be provided.

EC law, as interpreted through the ECJ decisions, does not provide a consistent definition of territoriality, and however, the definition provided through the decisions above analysed, does not perfectly coincide with the definition available under international tax law.

Indeed, what worthy doctrine (69) highlighted about a strict territoriality principle would fit the needs of EC law compatibility and market equality between treatment of foreign PEs and subsidiary and therefore solve the issue of cross border offsetting of losses. According to this opinion, «the territoriality principle of taxation of company profits, should apply on the basis of economic allocation of results. That would imply base (income) exemption for positive and negative results of both subsidiaries and branches and it would involve territorial allocation of costs made within a group, on the basis of economic rather than legal criteria». In other terms this would mean no current import of foreign profits and losses.

Unfortunately, this idea of the strict territoriality principle is far from the concepts the ECJ has so far developed and I hardly expect an official confirmation by ECJ of this line of reasoning since it would

(68) For this second line of reasoning see D. Weber, *EC Tax Review* (2003 - 4), *supra* note 54 at p. 228.

(69) For this line of reasoning see P.J. Wattel *EC Tax Review*, *supra* note 12, at 201.

mean turning upside down all the Member States relief methods from double taxation.

What the ECJ holds in this field may rather be summarized as follows.

The territoriality principle as stated in *Futura*, – *i.e.* holding that deductions are allowed inasmuch as they are economically linked to an activity generating income in the same country – does not represent a valid argument against the discriminatory aspect of a domestic rule at least whenever costs (or losses) are suffered from a person/legal entity other than the one generating the income. Thus, ECJ interprets the territoriality concept adopting a legal criterion rather than an economic one. In other terms, the territoriality principle as stated in international tax law, *i.e.* on the basis of a nexus between an income and a given territory seems to be cooled down or further restricted (70) by the ECJ to the extent that costs and losses may be deducted only if they belong to one and the same taxpayer within a single jurisdiction. Again, this further requirement is not provided for by international law where the territoriality principle only refers to the nexus between the territory and the income sourced therein.

This conclusion appear to be confirmed when reading the ICI case where, due to the situation of two different taxpayers involved in the surrendering of the losses from one to the other, the concept of territoriality has been put apart and the Court made reference to the concept of fiscal cohesion a principle that once again would apply only if a single tax or a single taxpayer are at stake.

On the basis of these two decisions, countries adopting domestic losses relief provisions such as consolidation or fiscal unity regimes could not rely on a territoriality principle to justify any claim against the restrictions prohibiting the offsetting of foreign losses.

In one isolated case (*Gerritse*) the idea of cost deduction allowed due to its direct link with the activity generating the income within the same country, seems to bring the ECJ to shift the ground of analysis as far as deduction of costs is concerned on the first layer of the compatibility test with EC freedoms, (*i.e.* on the ground of the comparison in order to exclude a discrimination or a restriction). But even in this case the Court didn't provide a clear concept of territoriality useful to reject a discrimination/restriction claim.

Unfortunately, that decision, for the reasons above mentioned seems to me an exception that would not apply in the field of losses when cross border flows between different legal entities are involved.

In *Bosal*, where two different taxpayers were involved, the Court rejected the denial of the deduction of a cost at the level of the parent company even if the benefit was for a different legal entity.

A cost, directly linked with an activity generating profits out of the country of the parent company, was admitted as a deduction at the pa-

(70) See D. Weber, *EC Tax Review* (2003 - 4), *supra* note 54, at p. 229, «(…) a restriction in substance applies to this principle within the EC».

rent company level against what a territoriality principle would have suggested.

However, according to some scholars (71) the main reason behind this decision seems to be that if the cost could not be set off neither at the level of the foreign subsidiary (since it was not suffered by such entity) nor at the level of the parent (since economically attributable at the subsidiary) it would be lost by both companies forever.

This could be a further argument that helps in sustaining the incompatibility of domestic group relief/consolidation rules denying cross border losses relief at least in those situation whereby the foreign loss if not absorbed by the parent company would be lost forever (see para. 1.3.2 for «final losses exapmples»).

Finally, in the author's opinion, what would be relevant, following the ECJ reasoning in this setting – in order to disregard domestic relief rules hindering the relief from foreign losses – is that even if justified, those rules would likely be disproportionate.

These aspects will be further discussed in chapter 4.1.

4. – *Cross-border offsetting of losses: negative o positive integration?*

4.1. – *Preliminary remarks*

Once pointed out that neither a weak developed concept of territoriality nor a concept of fiscal cohesion could be successfully further opposed by Member States' Government to reject restrictions claims or to justify domestic group relief measures preventing a cross border offsetting of losses before the ECJ, it is worth understanding what could be the outcome of a decision currently pending before the Court dealing with this thorny issue.

Should the ECJ admit on this matter a cross-border relief rule, what would be the outcome for EU Member States? Is this a decision that should be left to Member States unilateral rules or bilateral agreements or to positive integration through a Directive?

4.2. – *Marks & Spencer a decision that could change the history*

In previous chapters it was pointed out what are the main theoretical issues behind a cross-border loss carry forward. Now it's time to ascertain whether the conclusions achieved with this research may help to forecast what would be the solution of a real case currently pending before the ECJ, the *Marks & Spencer* case. The case deals with the que-

(71) P.J. Wattel, *EC Tax Review*, *supra* note 12, at 200; D. Weber, *EC Tax Review* (2003 - 4), *supra* note 54, at 227.

stion of whether UK domestic legislation (the decision might have a big impact also to the legislations of all other Member States), on the basis of the freedom of establishment, should allow the compensation of losses realized by foreign subsidiaries of a domestic parent company when such a compensation is allowed for domestic subsidiaries *within a group relief regime*. Here is where the case shows its own unique features that will likely push the Court to make a choice for the equal treatment of loss relief intra-groups (*i.e.* for tax consolidation regimes) for both intra-state and inter-states perspectives. As a matter of fact, as some scholars pointed out (72), out of the group relief regime there is no obstacle (thus no freedom of establishment issue) because domestic subsidiaries will meet the same obstacles as foreign subsidiaries as far as loss treatment is concerned. Differently, what the *Marks & Spencer* group claims is a restriction of the freedom of establishment due to obstacles arising for the group relief regime in a cross border setting. While in a domestic context a loss of a deemed subsidiary could be surrendered to the profitable parent, thus reducing parent's profits chargeable to tax, an obstacle to obtain the same tax treatment would arise whenever the subsidiary incurring that loss is located in a foreign country (namely, France, Belgium and Germany) throughout the EU. This difference in tax treatment based on the residence or seat of the subsidiary would amount to a restriction of the freedom of establishment against article 43 of EC Treaty (para 22 through 26 of the dismissed appeal before the special commissioners). Further, another argument submitted by the claimant was that UK rules also restricted the freedom to chose the most appropriate form for pursuing activities in another Member State *i.e*., through PEs or subsidiaries (para. 27).

In the commissioners view (73) the *Marks & Spencer* failure to obtain relief for the losses incurred by its foreign subs in FR, BEL, GER does not amount to a non-discriminatory restriction of the freedom of establishment guaranteed by Article 43 of the EC Treaty. It derives from the allocation of fiscal jurisdiction among Member States and the failure of *Member States* to agree appropriate measures for the harmonization of their tax systems in this respect. Even if the group relief rules create an obstacle in this respect to the exercise of *Marks & Spencer* right of establishment that denial of UK relief for losses on activities the profit of which are not subject to UK tax can be justified as being for the maintenance of the coherence of the UK tax system and proportionate.

Following the steps (mentioned in Chapter 3) required in checking the compatibility of a domestic rule with the Treaty fundamental freedoms, a debate among scholars took place in order to establish what was

(72) P. Pistone, *supra* note 55, *EC Tax Review* (2003-3), p. 149-154, at 150.

(73) See Special Commissioners Dr. J.F. Avery Jones CBE and Malcom Gammie QC sitting in private in London on 25 and 26 November 2002 on the case of *Marks and Spencer* PLC v. David Hasley (HM Inspector of taxes) para. 75.

the correct comparison to carry on and eventually to understand whether a discrimination vs. restriction (74) arose in the case.

Based on the features one can gather from the *Marks & Spencer* case one cannot but agree with those authors (75) who considered – from an outbound perspective of the state of origin (see *supra* para 1.3.1) – the vertical comparison as the more reliable approach to check the compatibility of the UK rule (76). This approach was also followed by the High Court when referring the case to the ECJ (77). Further, if one considers the pattern of some more recent ECJ cases, it seems likely that the Court will follow a vertical comparison as well as a restriction approach in this case. As far as the vertical comparison is concerned, in *Bosal*, in order to ascertain the compatibility with the freedom of establishment (Artt. 43-48 EC Treaty) of a domestic rule disallowing the deduction of costs the Court referred to a comparison between a parent company having the subsidiaries in the same country (pure domestic situation despite more than a single legal entity involved) and a parent company with subsidiaries in foreign countries (para. 39). As far as the restriction approach is concerned, as highlighted by some scholars (78), in Amid (79) – another case of losses decided by the ECJ – the Court, in order to ascertain the compatibility with the freedom of establishment (Artt. 43-48 EC Treaty) of a domestic rule disallowing the carry forward of losses, referred to a comparison between a pure domestic investment situation and a situation where foreign investment through a PE arose. According to this view the difference in legal forms was the only difference between these two cases. In Amid, a Belgian company with a PE in Luxembourg could not carry forward the losses accrued in the previous year in the home state, according to Belgian law, since the company had foreign profits – at the Luxembourg PE level – to set off for the year the losses accrued. As *Marks & Spencer*, AMID exercised its right of market access within the EU investing in a foreign country

(74) As clearly pointed out by A. Cordewener et al., *EC tax review, supra* note 1 para. 5.3.3. «the fundamental freedoms do not only inhibit the host state from discriminating against foreign investors. Under the non restriction label they equally inhibit the home state from discriminating against investments abroad by its own nationals or residents».

(75) See A. Cordewener et al., *EC Tax Review supra* note 1 para. 5.3.2, L. Hinnekens, *The Marks and Spencer Case: UK Special Comissioners Find UK Group Relief Rules Compatible with Freedom of Establishment*, *European Taxation* (2003-5), p. 175-182 at p. 180.

(76) For further arguments to support also an horizontal comparison in the specific context of a group taxation see D. Gutmann, *EC Tax Review*, *supra* note 12 at p. 155.

(77) See D. Evans et al., *What the Marks & Spencer case will mean*, *International tax review*, (July- August 2003), p. 34-36, at p. 34.

(78) F. Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national systems of the Member States* , *EC Tax Review* (2003-3) p. 136-143, at p. 140.

(79) ECJ Case C-141/99 *AMID v Belgische Staat.*

(LUX) through a PE and in enjoying this freedom it suffered a tax disadvantage that it would not have to suffer if all the establishments were situated in the Member State of origin (see para 23 of the decision). Indeed, this resulted in a hindrance that Belgian Government tried to justify on the grounds of the coherence of the tax system without any success. The same reasoning may apply to *Marks & Spencer*, if one thinks that the possibility to set off losses would be available only whether those losses derive from a domestic rather than a foreign subsidiary, it is simple to predict that a restriction of the freedom of establishment would be declared by the ECJ. Once a restriction of the freedom of establishment is ascertained the question at that stage would be whether such restriction can be justified according to EC principles. With this respect it is worth remembering again that in several cases the ECJ accepted that a Member State may justify a barrier if it pursues a legitimate aim compatible with EC Treaty and it can be justified on the basis of the public interest, provided the measure is able to achieve the aim and proportionate to it (80). Before checking the rule under a proportionality test it is worth focusing on the ground of the justifications.

Unfortunately, from a UK Government perspective, some of the most relevant causes of justification seem to be not applicable, namely territoriality and coherence (or cohesion) of the tax system. It is difficult to predict how the Court reasoning would take into account these two justifications, some scholars (81) pointed out that between territoriality and coherence there is a great exchangeability and this research confirmed this point but again, for the reasons already mentioned in chapter 3, it is hard to imagine that those arguments even if separately raised by Governments before the Court would be successful. Whenever it does not arise a direct link within a same person and the same tax, the coherence of a tax system should not be relied upon (82). Also the territoriality principle would be rejected as a justification since the link between a loss deduction and the activity generating the income in the same territory lacks in the case. Nor a justification based on the fear of the UK Government to loose tax revenue could be brought forward successfully in my opinion. The ECJ, in fact, has in several cases stated that the loss or reduction of tax revenue cannot be considered as an overriding justification in the public interest for measures that are contrary to the freedoms guaranteed in the EC Treaty (83).

One might also think that policy reasons to preserve Member States sovereignty in the field of direct taxes and tax revenues could lead the Court to the denial of the cross border offsetting of losses. Indeed, this

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(80) See ECJ Case C-415/93 *Bosman,* para 104; Case C- 250/95 *Futura* para 26; Case C-436/00 *X&Y* para 49.

(81) See A. Cordewener, *EC Tax Review, supra* note 1 at para 5.3.1.

(82) See P. Pistone, *EC Tax Review, supra* note 55, at 150.

(83) See ECJ Case C-264/96 *ICI* para. 28; Case C-234/00 *Lankhorst* para. 36; Case C-410/98 *Metalgesellschaft and Hoechst* para. 39; Case 436/00 *X & Y* para. 50.

delicate issue might be a piece of land where the lack of consensus among Member States would push the Court to avoid a dangerous decision as if it triggers the invasion of a private property. To this extent one could expect that in order to avoid thorny decisions the Court would adopt some tricks («excamotage») to leave to Member States the decision on the cross border offsetting of losses. The Court imagination and fantasy could go so far as to use the concept of the group relief rule with a new meaning in the EU tax arena and a new rationale behind. For instance, if the Court states that a group relief regime brings the group of companies into the position of one and a single taxpayer resident for tax purposes in the country of origin, then, the territoriality principle could be exploited to include in the group relief only losses deriving from companies within the UK group thus rejecting the infringement of the freedom of establishment on the ground of the justifications (84).

Apart from the difficulties and consequences that such a statement would trigger under an international tax law perspective (*e.g.* entitlement to treaties of the «group», allocation of the income, etc.), even if the group relief rule resulted into a restriction justified under a brand new and different concept of group relief built up by the ECJ expressly for this decision a further obstacle would obstruct the ECJ route towards the rejection of the incompatibilities with EC Treaty raised with the case: the proportionality test.

As already pointed out before in this paper (see para. 1.3.1), under a compatibility analysis with EC Treaty principles, a domestic rule should also not go beyond what is necessary in order to reach the aim that is pursued. If UK group relief rule does not allow a foreign subsidiary's loss to be surrendered to a UK parent company the main purpose could be that of keeping a consistency in the UK tax system on one hand avoiding a double dip of the loss, once in the source state and again in the residence state of the parent company (85), and on the other hand avoiding a double taxation of profits that due to relief from double taxation tools (unilaterally or via DTC) are normally taxed only once.

However, if one analyses the situation of group relief rules the problem arising rather than a double dip risk for losses is that some kind of losses could be lost forever.

For those subsidiaries that *Marks & Spencer* held in Belgium and Germany the foreign losses could not be carried forward in the foreign countries since those companies ceased their activities ending up with what we called in the first chapter a «final loss».

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(84) I would exclude in any case the hypothesis that the Court considers the territoriality principle in order to establish whether a restriction arises or not, *i.e.* on the first layer of the compatibility with EC Treaty freedoms rather than on the justification grounds. The rationale of this exclusion derives from the lack of substance of such idea in previous ECJ decisions.

(85) For this line of reasoning see A. Cordewener, *EC Tax Review, supra* note 1 at para. 5.3.2.

Due to the lack of chance of a future profitability and a loss carry over in the foreign countries the only way to incorporate those losses would be that of admitting an immediate cross border offsetting through a surrendering with UK parent's profits in the year the losses are accrued and a future recapture in the following year as suggested in the Draft Directive on losses (deduction and reincorporation method see para 1.4.1).

Indeed, as highlighted by some scholars (86) this solution would be «less burdensome» for the group due to a cash flow advantage for the year the loss accrued and would also permit to recover a loss, even if temporarily, that would otherwise be lost forever.

My perception is that even if accepting a cross border offsetting of losses could be a difficult decision for policy reason, the ECJ should at least states and declares the need to allow cross border offsetting whenever a final loss arise (*i.e.* in those situations whereby the loss if not absorbed by a company in another Member State would be lost forever).

5. – *Conclusions*

Indeed, the *Marks & Spencer* decision would be of great interest not only to all Member States adopting a group consolidation regime but also to all UK multinationals that have been lodging claims so far following the same route *M&S* covered.

A comparison between the tax treatments of losses in a group of companies carrying on activities within a single jurisdiction and that within a group operating in a cross border situation clearly shows a less favourable treatment in the latter case. Territoriality and coherence of tax systems seem to be weak arguments to justify such discrimination/restriction under an EC law perspective.

However, one might wonder whether the solution to such extremely delicate issue from an international tax perspective should be left to the developments of the Court of Justice or to EU Member States legislations.

A decision in favour of *Marks & Spencer* will force UK either to repeal the group relief regime from domestic tax provisions or to extend it to losses stemming from foreign subsidiaries within the group either. The same reasoning would hold true also for other EU Member States adopting a consolidation regime under which losses and profits may be blended within a group of companies in a single jurisdiction.

Under a positive integration approach, the Proposal for a loss Directive submitted in 1990 did not introduce any common rule in this field since a final Directive was not adopted and the content and principles suggested in it were put in a corner without any further development or act brightening the route towards harmonization. Due to the differences in tax legislations among 25 Member States, it is highly re-

(86) A. Cordewener, *EC Tax Review, supra* note 1 at para. 5.2.1.

commended to find a common set of rules creating some basic standards for cross-border loss relief.

Among the strategies aimed at tackling the inefficiencies and obstacles to cross-border economic activities in the Internal Market, the Commission recently (87) confirmed its commitment to identify innovative ways of dealing with cross-border loss relief even if it seems to expect additional «clarification of the legal situation and contribute to an increasing acceptance of the need for action in this area» from an ECJ case currently pending (*Marks & Spencer*).

Based on the foregoing assumptions, it is easy to understand what kind of pressure may push the ECJ to carefully weight its words in the first decision on cross-border relief for losses within a group.

Certainly, it could be less onerous for the Court to state that Member States should allow cross-border relief only to the extent a «final loss» situation (see supra para. 1.3.1) arises thus leaving to harmonization instances the right to establish a common set of rules for such a delicate issue.

In the latter case the Court would confirm once again the need for domestic rules to respect the proportionality test for EC law compatibility while it would shift the more onerous burden of a complete harmonization to the more appropriate institutions: the legislators.

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