Taxation of Foreign Business Income within the European Internal Market

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AN ANALYSIS OF THE CONFLICT BETWEEN THE OBJECTIVE OF ACHIEVEMENT OF THE EUROPEAN INTERNAL MARKET AND THE PRINCIPLES OF TERRITORIALITY AND WORLDWIDE TAXATION

Jérôme Monsenego

STOCKHOLM SCHOOL OF ECONOMICS

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Preface

This report is a result of a research project carried out at the Stockholm School of Economics (SSE) and the University Paris 1 Panthéon-Sorbonne.

This volume is submitted as a doctor's thesis at SSE and the University Paris 1 Panthéon-Sorbonne as part of a joint supervision agreement (*convention de cotutelle internationale de thèse*). The author has been entirely free to conduct and present his research in his own ways as an expression of his own ideas.

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Filip Wijkström
Associate Professor
SSE Director of Research

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Above all I wish to thank Liv, my wonderful wife. You are my everything. This book is dedicated to you.

Stockholm, 17 March 2011

Jérôme Monsenego

List of abbreviations

CFC	Controlled foreign companies
CJUE	Cour de justice de l'Union européenne
ECHR	European Court of Human Rights
ECJ	European Court of Justice
EU	European Union
OECD	Organisation for Economic Co-operation and Development
OCDE	Organisation de Coopération et de Développement Économiques
p.	page
para.	paragraph
pp.	pages
TCE	traité instituant la Communauté européenne
TEC	Treaty establishing the European Community
TEU	Treaty on European Union
TFEU	Treaty on the Functioning of the European Union
TFUE	traité sur le fonctionnement de l'Union européenne
TUE	traité sur l'Union européenne
VAT	value added tax
vol.	volume

"Si donc l'idée d'une organisation de l'Europe devait, un jour, prendre corps, c'est nécessairement sur la base de la territorialité que la solution de notre problème devrait être cherchée"[1].

[1] Jean-Hyppolite-Paulin Niboyet, *L'universalité des règles de solution des conflits est-elle réalisable sur la base de la territorialité?*, Revue Critique de Droit International Privé, 1950-4, p. 515.

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1 Introduction

1.1 The problem

A State is entitled to tax jurisdiction as a result of its sovereignty. A fundamental characteristic of a State's sovereignty is indeed the right to levy taxes and decide upon the geographical extent of its tax jurisdiction. Accordingly, a State may levy taxes on foreign income[2] or solely on domestic income[3]. Most often, States combine the principle of worldwide taxation and the fiscal principle of territoriality[4]. The extent of tax jurisdiction chosen by a State may depend on the connection it has with a tax subject or a tax object, as well as on tax policy considerations. As a result of the sovereignty recognised by international law, a State enjoys a significant liberty to determine the geographical extent of its tax jurisdiction with regard to companies' foreign business income. This may create asymmetries between taxable and exempted income, double taxation, double non-taxation or differences between the taxes levied on resident and non-resident companies.

Yet, Member States of the European Union do not fully enjoy the liberty recognised by international law when it comes to the taxation of companies' foreign business income. Since the *Avoir Fiscal* case[5], the European

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[2] Levying taxes on foreign income is referred to hereinafter as the principle of worldwide taxation.

[3] Levying taxes solely on domestic income is referred to hereinafter as the fiscal principal of territoriality.

[4] These concepts are defined *infra* in the introduction, as well as in chapter 2 *infra*.

[5] ECJ, 28 January 1986, case C-270/83, *European Commission v French Republic*, see particularly para. 14: "the fact that the laws of the Member States on corporation tax have not been harmonized cannot justify the difference of treatment in this case". For comments see Mat-

Court of Justice (ECJ) made clear that Member States' tax rules are subordinated to EU law and particularly to the freedoms of movement[6]. The enforcement of the fundamental freedoms is indeed crucial to the achievement of the internal market[7], which is an obligation for the Union[8]. The internal market aims at establishing "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties"[9]. Consequently, the internal market includes more than just the fundamental freedoms, as it refers to "an area without internal frontiers" in addition to a place where the free movement is ensured[10].

With regard to direct taxes EU law could be compared to constitutional law, as EU law provides merely principles and no material tax rules. Indeed,

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tias Dahlberg, *Direct taxation in relation to the freedom of establishment and the free movement of capital*, Kluwer Law International, 2005, pp. 159-161; Pasquale Pistone, *The impact of Community law on tax treaties: issues and solutions*, Kluwer Law International, 2002, pp. 104-108; Servaas van Thiel, *EU case law on income tax, Part 1*, IBFD, 2001, pp. 137-168.

[6] The importance of facilitating movements within the Community was already underlined in the Treaty of Rome. See the Preamble of the Treaty establishing the European Economic Community, signed in Rome on 25 March 1957: Member States are "decided to ensure the economic and social progress of their countries by common action to eliminate the barriers which divide Europe". See also article 52 of the Treaty establishing the European Economic Community, first indent: "Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be progressively abolished in the course of the transitional period. Such progressive abolition shall also extend to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State".

[7] The objective of establishing a "common market" has existed since the Treaty of Rome: see particularly articles 2, 3(f), 3(h) and 8 of the Treaty establishing the European Economic Community, signed in Rome on 25 March 1957.

[8] See article 3 TEU: "The Union shall establish an internal market". See also COM(2010) 608 final, 27 October 2010, *Towards a single market act – For a highly competitive social economy: 50 proposals for improving our work, business and exchanges with one another*.

[9] See article 26(2) TFEU.

[10] For a deeper analysis of the concept of the internal market, see *infra* at 6.2.1.

although the ECJ has held in numerous cases that Member States are competent to determine the criteria for allocating the powers of taxation between themselves[11], the ECJ respects Member States' fiscal sovereignty only insofar as they do not breach EU law. It is now established that "although (…) direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law"[12].

The coexistence of tax jurisdiction as determined by international law and the objective of achievement of the internal market results in an inevitable conflict. Member States' fiscal sovereignty is indeed at tension with EU law, both because of the taxing rights a State is entitled to, and the few obligations a State is subject to[13]. In addition, the exercise by companies of the freedom of establishment may tend to isolate the tax base across different countries, while the core idea of the European internal market aims at strik-

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[11] ECJ, 12 May 1998, case C-336/96, *Gilly*, para. 24: "The Member States are competent to determine the criteria for taxation on income and wealth with a view to eliminating double taxation – by means, *inter alia*, of international agreements – and have concluded many bilateral conventions based, in particular, on the model conventions on income and wealth tax drawn up by the Organisation for Economic Cooperation and Development". For a comment on the *Gilly* case, see Klaus Vogel, *Some observations regarding 'Gilly'*, EC Tax Review, 1998-3, p. 150. See also ECJ, 21 September 1999, case C-307/97, *Saint-Gobain*, para. 56: "Member States are at liberty, in the framework of bilateral agreements concluded in order to prevent double taxation, to determine the connecting factors for the purposes of allocating powers of taxation as between themselves". For a comment on the *Saint-Gobain* case see René Offermanns, Carlo Romano, *Treaty benefits for permanent establishments*, European Taxation, May 2000, pp. 180-189.

[12] ECJ, 14 February 1995, case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker*, para. 21.

[13] See Peter J. Wattel, *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?*, *in* Dennis Weber (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, p. 144: "By definition, protecting the tax turf of a national State (i.e. preserving fiscal territorial cohesion) involves a certain degree of fiscal disintegration of the internal market".

ing down borders between Member States[14]. Therefore, it is not surprising that Member States' fiscal sovereignty has been challenged by the ECJ, whether tax jurisdiction on companies' foreign business income is exercised on the basis of the fiscal principle of territoriality or on the basis of the principle of worldwide taxation. The case law of the Court results in a negative integration[15], given the lack of harmonisation or coordination by the Member States. This negative integration is not always satisfactory though, because the ECJ is not a lawmaker and may provide inappropriate solutions to the conflict between the objective of achievement of the internal market and Member States' rules on the taxation of companies' foreign business income.

It is demonstrated throughout the dissertation that the inherent conflict between Member States' taxation of companies' foreign business income and the objective of achievement of the internal market does not clearly indicate which principle of taxation best suits this objective, because both the principle of worldwide taxation and the fiscal principle of territoriality raise compatibility issues with EU law. It is also argued in the thesis that the case law of the ECJ in certain situations disturbs the balance in Member States' tax systems, is partly inconsistent, and does not clearly provide indications on the taxation principles that should be followed so as to meet the objective of achievement of the internal market. However, a study of ECJ case law and some key provisions of the EU treaties does help identify some guidance on how to design Member States' corporate tax systems to tax companies' foreign business income in a way that best suits the objective of achievement of the internal market. In that respect, it is necessary to deeply

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[14] See article article 26(2) of the TFEU: "The internal market shall comprise an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties". See also Christiana H.J.I. Panayi, *Double taxation, tax treaties, treaty-shopping and the European Community*, Kluwer Law International, 2007, p. 143: "Community law, through, *inter alia* its fundamental freedoms, aims at removing the borders between Member States. In contrast, the starting point of international tax law is the existence of these borders".

[15] "Negative integration" is opposed to "positive integration", which would assume that legislative measures are adopted by Member States.

analyse the consequences of the case law of the Court with regard to the objective of achievement of an internal market on the taxation of companies' foreign business income. Such an analysis is intended to contribute to the discussions on how to improve the taxation of European companies'[16] foreign business income when such companies enter into cross-border trade with other Member States of the European Union.

1.2 Purpose

The purpose of the thesis is to conduct a critical legal analysis of the conflict between Member States' rules on the taxation of companies' foreign business income and the objective of achievement of the internal market, on the basis of a study of ECJ case law. Indeed, the question is raised whether Member States may tax resident companies on the business income they earn directly[17] or indirectly[18] in other Member States, and whether Member States may be required to grant relief for the losses incurred by European companies in other Member States. In addition, the taxation of permanent establishments is important to analyse, as the recommendations of the OECD may not necessarily be compatible with EU law. It is also relevant to wonder whether Member States may tax business business income irrespective of the taxes possibly levied by other Member States, or if single taxation should be ensured within the internal market. All these questions trigger compatibility issues with the objective of achievement of the internal market, because the situations described above would be much less problematic if business activities were conducted within a single Member State. In that respect, it is emphasised that the internal market eventually aims at implementing between Member States the conditions of

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[16] By "European companies" it is referred to companies that are resident within the European Union. It is not the purpose of the dissertation to analyse the concept of residence. Therefore, it is assumed that "European companies" are resident in a Member State according to Member States' domestic tax laws and the tax treaties concluded between them.

[17] By "business income earned directly", it is referred to business income earned through carrying on business in another Member State through a permanent establishment.

[18] By "business income earned indirectly", it is referred to business income earned through carrying on business in another Member State through a foreign subsidiary.

a "domestic market"[19], *i.e.* conditions that are very close or even similar[20] to those of a single State[21].

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[19] ECJ, 9 February 1982, case C-270/80, *Polydor*, para. 16. For a confirmation of a requirement to achieve an internal market having the characteristics of a "domestic market", see *e.g.* ECJ, 25 April 1985, case C-207/83, *Commission of the European Communities v United Kingdom of Great Britain and Northern Ireland*, para. 17. The requirement to achieve an internal market having the characteristics of a domestic market has also been emphasised by the ECJ in tax cases: see *e.g.* ECJ, 23 April 1991, case C-297/89, *Rigsadvokaten v Nicolai Christian Ryborg*, para. 14; ECJ, 29 May 1997, case C-389/95, *Siegfried Klattner v Elliniko Dimosio*, para. 25; ECJ, 15 July 2010, case C-70-09, *Hengartner and Gasser*, para. 41: "the Court has observed that the Swiss Confederation did not join the internal market of the Community, the aim of which is the removal of all obstacles to create an area of total freedom of movement analogous to that provided by a national market".

[20] See ECJ, 5 October 1994, case C-381/93, *Commission of the European Communities v French Republic*, para. 17; ECJ, 3 October 2002, case C-136/00, *Rolf Dieter Danner*, para. 29. See also (2) of the preamble of the Mergers directive (Council Directive 2009/133/EC of 19 October 2009 on the common system of taxation applicable to mergers, divisions, partial divisions, transfers of assets, and exchanges of shares concerning companies of different Member States and to the transfer of the registered office of an SE or SCE between Member States): "Whereas mergers, divisions, partial divisions, transfers of assets and exchanges of shares concerning companies of different Member States may be necessary in order to create within the Community conditions analogous to those of an internal market and in order thus to ensure the effective functioning of such an internal market".

[21] See Frans Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, EC Tax Review, 2003-3, pp. 141-142: "Legally speaking a market is an area where economic activity can be conducted under similar legal rules, so that economic operators can offer their goods and services under similar or comparable conditions of competition. (…) The single Act of 17 February 1987 established a very radical market concept as 'an area without internal borders in which the free movement of goods, persons, services and capital is guaranteed in accordance with the provisions of the Treaty'. This is in fact the concept of a single national market as the environment of a single legal order within which economic operators carry on their activities under the same or similar legal rules". See also Eric Kemmeren, *The internal market approach should prevail over the single country approach*, *in* A vision of taxes within and outside European borders, Festschrift in honour of Prof. Dr. Frans Vanistendael, Kluwer Law International, 2008, p. 562: "for operations within the European Community, it is essential that the internal market be analogous in nature to the domestic market of a single state"; Eric Kemmeren, *Principle of Origin in Tax*

The topic of the dissertation could be analysed according to two main directions: one could either focus on the impact of ECJ case law on Member States' tax systems, or on the tax policy implications that can be understood out of a legal analysis of the Court's case law with regard to the objective of achievement of the internal market. In the first case, one would pay attention to the outcome of the cases issued by the Court and how these outcomes have been implemented in Member States' internal tax laws. A comparative analysis may be necessary to identify differences of interpretation and implementation of ECJ case law between Member States. In the second case, the purpose of the dissertation would concern the tax policy implications that can be understood out of a legal analysis of the Court's case law. One would pay attention to the reasoning of the ECJ and the spirit of certain provisions of the EU Treaties, rather than to Member States' domestic tax laws. It is this second direction that has been chosen in this thesis. The dissertation consequently formulates some tax policy recommendations on the basis of a legal and critical analysis of ECJ case law and certain key provisions of the EU Treaties. Such recommendations are, however, limited to the point of view of principle, *i.e.* it is not discussed the technical content of such recommendations, nor are economic considerations taken into account[22].

To reach the purpose of the dissertation, the main task of the thesis consists in deeply analysing the case law of the ECJ in relation to the taxation of companies' foreign business income, as well as studying certain key provisions of the EU Treaties. The case law of the Court is sometimes found

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Conventions: A Rethinking of Models, Katholieke Universiteit Brabant, Tillburg, 2001, p. 139: "The common market is analoguous in nature to the domestic market of a single state, although it should be emphasised that a genuine internal market still does not exist". For an analysis of the advantages of a European tax system that resembles the one of a single State see Malcolm Gammie, *Corporate taxation in Europe – paths to a solution*, British Tax Review, 2001-2, pp. 233-249, where the author uses the example of the usefulness of the UK tax system within the UK internal market.

[22] By "economic considerations" it is referred to analyses of the economic consequences of the tax policy recommendations made in the dissertation.

inconsistent or hard to interpret. This creates difficulties for the European institutions to be aware of which taxation policy should be favoured for the taxation of companies' foreign business income, for scholars to rely on the case law of the ECJ, and for Member States to efficiently and homogeneously design their international tax rules. Consequently, a need exists to analyse the case law of the ECJ on this topic to better understand the position of the Court and reconcile its findings, which the dissertation aims at. By trying to reconcile rulings that were issued in different situations but concerned the same kind of problem, it is possible to identify common reasonings or solutions, which would strengthen a certain line of case law. On the other hand, if inconsistencies were found out, it would imply that one may not fuly rely on certain rulings, although they may at first sight be interpreted as providing useful guidance. Also, a careful analysis of how the ECJ reasoned and ruled in different cases may reveal an implicit or explicit preference for the fiscal principle of territoriality or the principle of worldwide taxation.

By analysing the case law of the ECJ and by also taking into account certain key provisions of the EU Treaties, it will be possible to find some guidance and formulate some recommendations with regard to the taxation of companies when they carry on business activities throughout the internal market. This outcome is particularly useful as part of the discussions on the taxation of companies when they carry out business in other Member States, as the European Commission considers that the current tax systems do not sufficiently remove tax obstacles to cross-border trade in the internal market[23]. It is indeed important to design the taxation of European companies so as to enhance their well-being. This is because companies create jobs and contribute to growth, something that plays a central role to achieve the objectives of the European integration[24] and make the European Union an attractive and efficient place[25]. Accordingly, the dissertation

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[23] See COM(2001) 582 final, 23 October 2001, *Towards an internal market without tax obstacles.*

[24] See COM(2010) 2020 final, 3 March 2010, *Europe 2020 – A strategy for smart, sustainable and inclusive growth.*

[25] László Kovács, *The contribution of a sustainable EU tax policy to the Lisbon agenda*, EC Tax Review, 2006-1, p. 2. See also COM(2010) 608 final, 27 October 2010, *Towards a single market act*

serves the debate on European tax policy, although the thesis focuses solely on legal arguments and does not take into account the economic consequences of the legal aspects considered. The analyses carried out in the dissertation may also be useful as part of the discussions on the necessity of a common consolidated corporate tax base and of other legislative measures adopted at the level of the European Union[26].

Definitions and terminology that are of relevance for the dissertation are discussed in the following paragraph.

1.3 Definitions and terminology

The following concepts are used in the dissertation and are therefore defined hereunder: the principle of territoriality (in international law), the fiscal principle of territoriality and the principle of worldwide taxation (1.3.1). Second, capital import neutrality and capital export neutrality are presented (1.3.2). Last, the ability-to-pay principle and the benefit principle are defined (1.3.3).

1.3.1 The principle of territoriality (in international law), the fiscal principle of territoriality and the principle of worldwide taxation

Throughout the dissertation a difference is made between the principle of territoriality as it stands in international law and the fiscal principle of territoriality in tax law. It is important to clarify this distinction to avoid any confusion[27].

– *For a highly competitive social economy: 50 proposals for improving our work, business and exchanges with one another*, in which the European Commission describes the benefits of the internal market for the European Union. See in particular at p. 2, where it is indicated that "The Commission estimates that the combined effect of internal market integration, in particular through the liberalisation of network industries, and enlargement has been to create 2.75 million additional jobs and growth of 1.85% in the period 1992–2009".

[26] However, the purpose of the dissertation is neither to exhaustively assess the need of a common consolidated corporate tax base nor to analyse its technical content.

[27] In that respect, see *e.g.* Michael Lang, *The Marks & Spencer case - the open issues following the ECJ's final word*, European Taxation, February 2006, p. 59, who considered that the principle of territoriality's "meaning is not clear at all". See also Manfred Mössner, *Source versus residence*

The principle of territoriality as it stands in international law is analysed in chapter 2 of the dissertation. It is one of the jurisdiction principles embedded in international law and entitles a State to jurisdiction based on a territorial connection between this State and a legal subject or object. It is also considered that the principle of territoriality[28] entitles a State to independently and exclusively decide within its territory, *i.e.* a State is not subject to control from other States and is not either obliged to take into consideration foreign elements. The principle of territoriality as it stands in international law is relevant in many fields of the law and particularly in tax law, because taxes are most often levied on the basis of a territorial connection between a State and a tax object or a tax subject, and also because taxes on domestic income may be levied without taking into consideration foreign elements or the taxes levied by other States[29]. This means that according to the principle of territoriality as it stands in international law, a State is normally at liberty to tax foreign income[30].

When a State exercises tax jurisdiction on the basis of the principle of territoriality as it stands in international law, this State has the choice as to the geographical extent of its tax jurisdiction: either tax jurisdiction is exercised solely on domestic income, or it is exercised also on foreign income. Throughout the dissertation, tax jurisdiction exercised solely on domestic income is described as an application of the fiscal principle of territorial-

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- *an EU perspective*, Bulletin for International Fiscal Documentation, December 2006, p. 504: "In its international aspect, direct taxation is based on the principle of territoriality, but one must immediately add that the meaning of the principle of territoriality is ambiguous".

[28] This characteristic may be described in international law literature in different ways, such as the "principle of territoriality", a State's "sovereignty", or the "principle of non-intervention". On such terminological aspects, see Frederick Alexander Mann, *The doctrine of international jurisdiction revisited after twenty years*, Collected courses of the Hague academy of international law, 1984, III, p. 20.

[29] See the famous formula stated by Lord Mansfield: "no country ever takes notice of the revenue laws of another": King's Bench, 5 July 1775, 1 Cowp. 341, 98 Engl. Rep. pp. 1120-1122, *Holman v. Johnson*.

[30] This statement is, however, subject to limitations as a consequence of tax treaties.

ity[31]. In contrast, when tax jurisdiction is exercised also on foreign income, such a tax jurisdiction is described as an application of the principle of worldwide taxation[32].

1.3.2 Capital import neutrality and capital export neutrality

Fiscal neutrality can be defined as ensuring that taxes exercise the minimum influence on business decisions made by taxpayers[33]. Fiscal neutrality is an important concept for the dissertation, because the EU Treaties require that EU nationals are not subject to discriminations or restrictions[34] when doing business throughout the internal market. By promoting fiscal neutrality, taxpayers are likely to be less hindered or discriminated against when con-

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[31] See the definition of the "territoriality principle" provided by the *IBFD International Tax Glossary*: "Term used in the context of international taxation to connote the principle of levying tax only within the territorial jurisdiction of a sovereign tax authority or country. The underlying theory is that no taxes can be levied outside this area without violating the sovereign tax authority of another state. Consequently, both residents and non-residents of a state adopting this principle are only taxed on the income from sources in that country and on property situated in that country. Residents are not normally taxed on any foreign-source income (sometimes, however, subject to anti-avoidance measures). The term may also refer to the principle that a state has the right to tax all persons, property or activity within its borders. The term is also used in a similar way in the context of EU direct taxation, although the precise meaning appears still to be evolving".

[32] See the definition of "worldwide income" provided by the *IBFD International Tax Glossary*: "Basis on which tax is levied in many countries by including income from all sources, i.e. irrespective of their geographical origin. Most countries tax worldwide income of residents only. The United States is one of the rare examples of a country which levies income tax on worldwide income of its citizens regardless of their residence".

[33] See Leif Mutén, *Inkomst eller kapitalvinst*, Norstedts Förlag, 1959, p. 119; Kristina Ståhl, *Aktiebeskattning och fria kapitalrörelser*, Iustus Förlag, 1996, p. 41. See also Klaus Vogel, General IFA Report, *Fiscal obstacles to the international flow of capital between a parent and its subsidiary*, vol. 69a, 1984, p. 103: "it is possible to formulate a concept of neutrality: *neutrality in the sense of inter-nations neutrality exists when a taxpayer who makes use of a country's facilities ("public goods") can be sure of being taxed no more than anyone else who, in the same circumstances, uses these facilities to the same extent*".

[34] See articles 2 TEU and 18 TFEU, as well as the articles of the TFEU on the freedoms of movement (*i.e.* articles 28, 45, 49, 56, and 63 TFEU).

sidering an investment in the internal market. Also, neutrality is often considered as a desirable characteristic in taxation[35]. Therefore, when analysing the legal conflict between Member States' rules on the taxation of companies' foreign business income and the objective of achievement of the internal market, attention may be paid to how neutral these rules are. In this respect, it is important to emphasise that neutrality can be discussed from several perspectives. The main distinction is between neutrality at the level of one State or at a multilateral level. In this dissertation, the scope of neutrality is at the level of the European Union[36], because the aim of the internal market is not to promote the freedom of movement and economic efficiency at the level of single Member States, but rather at the global level of the whole European Union.

It is important to emphasise that there are traditionally two opposite concepts of fiscal neutrality, depending on the State in which fiscal neutrality is sought: fiscal neutrality may be sought either in the home State ("capital export neutrality") or in the host state ("capital import neutrality"). It is usually considered that a choice between capital import neutrality and capital export neutrality must be done, as these two types of neutrality can normally not be achieved at the same time[37]. Capital export neutrality and capital import neutrality are defined as follows[38]:

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[35] See *e.g.* Norton L. Steuben, *Fundamental aspects of a good tax system*, Tax Notes International, 2 October 2000, p. 1578: "a good tax law is a neutral tax law".

[36] For a similar approach, see Kristina Ståhl, *Aktiebeskattning och fria kapitalrörelser*, Iustus Förlag, 1996, p. 92.

[37] See Kristina Ståhl, *Aktiebeskattning och fria kapitalrörelser*, Iustus Förlag, 1996, p. 111; Michael J. Graetz, Alvin C. Warren Jr., *Income tax discrimination and the political and economic integration in Europe*, The Yale Law Journal, April 2006, pp. 1217-1219, where it is argued that combining capital export neutrality and capital import neutrality may produce inconsistent results.

[38] For an analysis of capital export neutrality and capital import neutrality see Wolfgang Schön, *International tax coordination for a second-best world (part I)*, World Tax Journal, October 2009, pp. 79-81.

- Capital export neutrality refers to a similar tax treatment of domestic and foreign investments, wherever income is earned[39]. For fully implementing capital export neutrality, a State should apply the principle of worldwide taxation and preferably eliminate double taxation through granting a full tax credit to ensure the levy of tax according to the domestic tax rate, irrespective of the place of the investment[40].

- Capital import neutrality refers to a similar tax treatment of investments in the host State, irrespective of the place of the investor[41]. For fully implementing capital import neutrality, the home State should apply the fiscal principle of territoriality and disregard foreign income. It is also important that the host State respects the non-discrimination principle so that foreign investors are treated as domestic investors.

The purpose of the thesis is to conduct a legal analysis of ECJ case law on the conflict between Member States' rules on the taxation of companies' foreign business income and the objective of achievement of the internal market. Therefore, even though during the dissertation it may be observed

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[39] See the definition of capital export neutrality provided by the *IBFD International Tax Glossary*: "Public finance concept to describe the situation where investors are subject to the same level of taxes on capital income regardless of the country in which income is earned. The credit method of relieving international double taxation is often considered to illustrate this principle".

[40] See Hugh J. Ault, Brian J. Arnold, *Comparative income taxation – a structural analysis*, Kluwer Law International, third edition, 2010, pp. 454-455: "All systems have limitations on the extent to which foreign tax paid can displace domestic tax liability. While, from a theoretical point of view, an unlimited foreign tax credit is sometimes urged as the structure most consistent with complete capital export neutrality, practical revenue constraints make such a policy impossible".

[41] See the definition of capital import neutrality provided by the *IBFD International Tax Glossary*: "Public finance concept to describe the situation where investments within a country are subject to the same level of taxes regardless of whether they are made by a domestic or foreign investor. The exemption method of relieving international double taxation is often considered to illustrate this principle".

that certain rules or judgments of the ECJ tend to enforce or breach capital export neutrality or capital import neutrality, it is not the main purpose of the thesis to make an economic analysis and discuss which of capital export neutrality or capital import neutrality best suits the objective of achievement of the internal market. It can be observed that when applied to the taxation of companies' foreign business income, both capital export neutrality and capital import neutrality raise compatibility issues with EU law:

- Three problems exist with an approach based purely on capital export neutrality: first, it does not give an incentive to exercise the fundamental freedoms. Indeed, at best foreign investments are treated like domestic ones, but given the fact that a foreign investment always implies a higher amount of risks, costs and uncertainties than a domestic investment, a rational decision would tend not to exercise the fundamental freedoms. Second, by applying the rules of the home State to situations occurring in the host State, a fair competition[42] may be breached in the latter State: as a result, the foreign company receives either a better treatment (*e.g.* through obtaining loss relief that would not be available in the host State) or a worse treatment (*e.g.* if income is computed according to tax accounting rules of the home State that result in a broader tax base) than domestic competitors in the host State. Third, countries applying the principle of worldwide taxation combined with the credit method usually grant an ordinary foreign tax credit, limited to the amount of taxes levied on foreign income in the home State. However, capital export neutrality requires that a full tax credit is granted: only then are cross-border investments treated similarly to domestic investments.

- An approach based purely on capital import neutrality is not either satisfying because the fiscal principle of territoriality leads to an iso-

[42] On the importance of a sound tax competition see Wolfgang Schön, *International tax coordination for a second-best world (part I)*, World Tax Journal, October 2009, p. 85: "Sound tax competition, including respect for national sovereignty, is widely accepted as a reality and as an efficient policy option".

> lation of tax bases across different Member States. This creates a problem with regard to foreign losses, when at the same time profits are incurred in another Member State. A second problem implied by capital import neutrality is that it may encourage Member States to enter into harmful tax competition by concurring with each other for offering the lowest corporate income tax rates. An exaggerated tax competition is not always desirable, because it may decrease public revenues, thereby jeopardising the objectives of the European integration[43].

As a result, both capital export neutrality and capital import neutrality raise compatibility issues with EU law. These compatibility issues are analysed in more details in the dissertation, although it is not the purpose of the dissertation to study exhaustively capital export neutrality and capital import neutrality with regard to the objective of achievement of the internal market.

Definitions of the ability-to-pay principle and the benefit principle are provided below.

1.3.3 The ability-to-pay principle and the benefit principle

The ability-to-pay principle and the benefit principle are referred to at some points during the dissertation[44]. The "ability-to-pay principle" is defined as a principle according to which "a taxpayer's burden should reflect his economic capacity to bear that burden relative to other taxpayers"[45]. The "benefit principle" is defined as a principle according to which "taxes should be levied in accordance with the use made or benefits received from government goods and services"[46].

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[43] In that respect see COM(2010) 2020 final, 3 March 2010, *Europe 2020 – A strategy for smart, sustainable and inclusive growth*.

[44] For an analysis of the ability-to-pay principle and the benefit principle see Wolfgang Schön, *International tax coordination for a second-best world (part I)*, World Tax Journal, October 2009, pp. 71-78.

[45] See *IBFD International Tax Glossary*.

[46] *Ibid.*

The limitations to which the dissertation is subject are presented below.

1.4 Limitations

Only foreign business income is dealt with in the dissertation, *i.e.* active foreign income[47] that is normally within the scope of article 7 of the OECD Model Tax Convention[48]. Other types of foreign income, particularly passive income such as interests, dividends and royalties, are not within the scope of the dissertation. The reason why foreign passive income is excluded from the scope of the dissertation is that different types of income may be subject to different taxation principles, different problems, as well as particular considerations such as anti-avoidance rules. Therefore, conclusions that are valid for the taxation of companies' foreign business income may not be necessarily applicable to the taxation of other types of income, and *vice-versa*. Also, passive income is partly subject to harmonisation be-

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[47] As an example, a definition of "active foreign business income" is provided in US domestic tax law, at section 861(c) of the Internal Revenue Code: "For purposes of subparagraph (A), the term "active foreign business income" means gross income which— (i) is derived from sources outside the United States (as determined under this subchapter) or, in the case of a corporation, is attributable to income so derived by a subsidiary of such corporation, and (ii) is attributable to the active conduct of a trade or business in a foreign country or possession of the United States by the individual or corporation (or by a subsidiary)".

[48] However, it should be observed that the OECD Model Tax Convention does not define the term "business": see para. 10(2) of the Commentary to article 3(1) of the OECD Model Tax Convention, 2010. Therefore, business income is likely to be subject to conflicts of qualification. On the qualification of income, see Klaus Vogel, *Conflicts of qualification: the discussion is not finished*, Bulletin for International Fiscal Documentation, February 2003, pp. 41-44; John F. Avery Jones, *Conflicts of qualification: comments on Prof. Vogel's and Alexander Rust's articles*, Bulletin for International Fiscal Documentation, May 2003, pp. 184-186; John F. Avery Jones, Luc De Broe, Maarten J. Ellis, Kees van Raad, Jean-Pierre Le Gall, Henri Torrione, Toshio Miyatake, Sidney I. Roberts, Sanford H. Goldberg, Jürgen Killius, Guglielmo Maisto, Federico Giuliani, Richard J. Vann, David A. Ward, Bertil Wiman, *Treaty conflicts in categorizing income as business profits caused by differences in approach between common law and civil law*, Bulletin for International Fiscal Documentation, June 2003, pp. 237-248. It is, however, not the purpose of the dissertation to study the qualification of income. It is therefore assumed that all income dealt with in the dissertation qualifies as business income.

tween Member States with the parent-subsidiary directive[49], the interests and royalties directive[50] and the savings directive[51], so an important part of the study of the taxation of passive income within the internal market would be the analysis of the directives, their implementation as well as their interpretation by the ECJ. It is consequently decided to exclude foreign passive income from the scope of this dissertation so as to focus solely on the taxation of foreign business income, although case law on the taxation of passive income may be relevant to take into consideration at some occasions[52].

In addition, only foreign business income, *i.e.* not domestic business income, is dealt with in the dissertation. This limitation is due to the fact that the dissertation focuses on the taxation of foreign business income earned within the internal market in cross-border situations.

Given the growing number of cases issued by the ECJ, a selection of cases is necessary. In principle, only cases relating to the taxation of income with foreign sources have been analysed in the dissertation. The number of cases has been limited to those dealing directly with matters of principle that are

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[49] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States. For an analysis of the parent-subsidiary directive see Cécile Brokelind, *Une interprétation de la directive sociétés mères et filiales du 23 juillet 1990*, Lund, 2000.

[50] Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States. For comments see Marcello Distaso, Raffaele Russo, *The EC interest and royalties directive – a comment*, European Taxation, April 2004, pp. 143-154; Cécile Brokelind, *Royalty payments: unresolved issues in the interest and royalties directive*, European Taxation, May 2004, pp. 252-258.

[51] Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments. For a comment see Frans Vanistendael, *The European interests savings directive – an appraisal and proposals for reform*, European Taxation, April 2009, pp. 152-162.

[52] This is particularly the case as part of chapter 6 on the compatibility with EU law of double taxation.

central to the dissertation, instead of analysing a greater number of cases and transposing findings to the topic of the dissertation. For example, when dealing with CFC taxation, *i.e.* the right of a Member State to apply the principle of worldwide taxation and tax a foreign group company's business income, only the *Cadbury Schweppes*[53] case is analysed. Other cases that also deal with the compatibility with EU law of anti-avoidance measures are not taken into account. This choice is explained by the willingness to focus not on anti-avoidance measures as such, but on the questions of principle related to the taxation of foreign business income. In addition, it is difficult to reach convincing conclusions when transposing findings of the Court to other types of issues. Instead, it is found more convincing to focus on a certain question of principle and analyse it through different perspectives, since this approach allows drawing deeper conclusions as to the compatibility with EU law of a particular principle of taxation. This approach also allows reconciliating the solutions provided by the ECJ in different contexts dealing with the same question of principle: for example, when dealing with relief for foreign losses[54], it is considered relevant to analyse the case law of the Court with regard to losses originating at the level of foreign subsidiaries (on the basis of the *Marks & Spencer*[55] case), permanent establishments (on the basis of *Lidl Belgium*[56] and *Krankenheim*[57]) and the head office of an enterprise (on the basis of *Futura*[58] and *Centro Equestre*[59]). By separating the analysis of the fiscal principle of territoriality with regard to foreign losses according to these three different contexts, it is possible to analyse the reasoning of the ECJ on the very questions of principle that are related to the problems caused by the impossibility to off-

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[53] ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*.

[54] This question relates to the compatibility of the fiscal principle of territoriality with the objective of achievement of the internal market, as the application of the fiscal principle of territoriality leads to denying loss relief when losses are incurred on the territory of another Member State.

[55] ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*.

[56] ECJ, 15 May 2008, case C-414/06, *Lidl Belgium*.

[57] ECJ, 23 October 2008, case C-157/07, *Krankenheim*.

[58] ECJ, 15 May 1997, case C-250/95, *Futura*.

[59] ECJ, 15 February 2007, case C-345/04, *Centro Equestre*.

set losses incurred in one Member State from profits incurred in another Member State. If, in contrast, the dissertation would discuss many cases that do not deal with this very problem, it would be difficult to draw convincing conclusions as to the compatibility of the fiscal principle of territoriality with the objective of achievement of the internal market, when the application of this principle leads to denying cross-border loss relief. Consequently, the dissertation only analyses a limited number of cases, to isolate the reasoning of the ECJ in each case and reconcile the findings of the Court.

As the dissertation focuses on the taxation of companies' foreign business income, case law concerning individuals is in principle excluded from the scope of the dissertation. However, in certain situations case law relating to individuals may be studied, but only to the extent that the outcome of such case law is interesting for the taxation of companies' foreign business income. For example, *van Hilten*[60] provides an interesting benchmark for analysing the taxation of a non-resident's foreign income. Another example is the *Renneberg*[61] case, which concerns the opportunity for a non-resident to include foreign negative income in his tax base in the Member State of source. Also, *Kerckhaert and Morres*[62], *Block*[63] and *Damseaux*[64] are very important cases for the analysis of the compatibility of international double taxation with EU law. Consequently, case law relating to the taxation of individuals that does not provide interesting input for the taxation of companies' foreign business income is excluded from the scope of the dissertation.

Another limitation that should be emphasised is the limitation of the dissertation to cross-border activities carried on between Member States of the European Union, as the purpose of the dissertation is to study the taxation of companies' foreign business income within the internal market. Indeed,

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[60] ECJ, 23 February 2006, case C-513/03, *van Hilten*.

[61] ECJ, 16 October 2008, case C-527/06, *Renneberg*.

[62] ECJ, 14 November 2006, case C-513/04, *Kerckhaert and Morres*.

[63] ECJ, 12 February 2009, case C-67/08, *Block*.

[64] ECJ, 16 July 2009, case C-128/08, *Damseaux*.

the EU Treaties do not intend at fully implementing an internal market with third countries, so issues in relation to third countries are not analysed in the thesis. Such issues would anyway be rather unusual given the topic of the dissertation, as only the provisions on the free movement of capital are applicable to third countries, while it is essentially the freedom of establishment that is relevant for the issues discussed in the dissertation.

Given the purpose of the dissertation, which is to analyse the conflict between Member States' taxation of companies' foreign business income and the objective of achievement of the internal market, rules on the prohibition of State aid are excluded from the scope of this dissertation[65]. Indeed, the core provisions of the internal market are the freedoms of movement. Also, the provisions on the prohibition of State aid have not yet been relied on by the ECJ in cases relating to the taxation of companies' foreign business income, which means that it would be necessary to make assumptions during the whole dissertation. This would weaken the conclusions and the recommendations, which are primarily based on the case law of the ECJ. Consequently, rules on the prohibition of State aid are excluded from the scope of this dissertation.

Previous research relevant for the dissertation is presented in the next paragraph.

1.5 Previous research

Abundant material touches upon the extent of States' tax jurisdiction in the context of international tax law[66]. Such research has often relied on general

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[65] For analyses on the conflict between Member States' tax systems and the rules on the prohibition of State aid see Bernard Castagnède, *Précis de fiscalité internationale*, Presses Universitaires de France, third edition, 2010, pp. 45-52; Raymond H.C. Luja, *Tax-related difficulties of State aid rules*, *in* Accounting and taxation & assessment of ECJ case law, 2007 EATLP Congress, pp. 83-97; Mona Aldestam, *EC State aid rules applied to taxes – an analysis of the selectivity criterion*, Iustus Förlag, 2005.

[66] See for example Maxime Chrétien, *A la recherche du droit international fiscal commun*, Sirrey, 1955; Martin Norr, *Jurisdiction to tax and international income*, Tax Law Review, March 1962, pp. 431-462; Rutsel Silvestre J. Martha, *The jurisdiction to tax in international law - Theory and practice*

principles of international law to analyse whether or not, and if so to what extent, international law may limit the extent of a State's tax jurisidiction. Research has also been conducted on the impact of EU law on the tax sovereignty or the tax jurisdiction of Member States of the European Union[67], given the fact that the principles of the EU Treaties are applicable to direct tax law since the ECJ ruled in 1986 in the *Avoir Fiscal*[68] case. In addition to

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of legislative fiscal jurisdiction, Kluwer Law International, Series on International Taxation, no. 9, 1989; Michael J. Graetz, Michael M. O'Hear, *The "original intent" of U.S. international taxation*, Duke Law Journal, 1997, volume 46, pp. 1021-1109; Nicolas Melot, *Territorialité et mondialité de l'impôt, étude de l'imposition des bénéfices des sociétés de capitaux à la lumière des expériences française et américaine*, Nouvelle Bibliothèque des Thèses, Dalloz, 2004; Angel Schindel, Adolfo Atchabahian, General IFA Report, *Source and residence: new configuration of their principles*, vol. 90a, 2005, pp. 21-99; Reuven S. Avi-Yonah, *International tax as international law – an analysis of the international tax regime*, Cambridge Tax Law Series, 2007.

[67] See for example Klaus Vogel, *Taxation of cross-border income, harmonization, and tax neutrality under European Community law, an institutional approach*, Foundation for European Fiscal Studies, Kluwer, 1994; Frans Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, EC Tax Review, 2003-3, pp. 136-143; Frans Vanistendael, *Marché interne et souveraineté fiscale*, *in* Regards critiques et perspectives sur le droit et la fiscalité, Liber Amoricum Cyrille David, LGDJ, 2005, pp. 255-268; Krister Andersson, *An economist's view on source versus residence taxation - the Lisbon objectives and taxation in the European Union*, Bulletin for International Fiscal Documentation, October 2006, pp. 395-401; Manfred Mössner, *Source versus residence - an EU perspective*, Bulletin for International Fiscal Documentation, December 2006, pp. 501-506; Dennis Weber, *Is the limitation of tax jurisdiction a restriction of the freedom of movement?*, *in* Accounting and taxation & assessment of ECJ case law, 2007 EATLP Congress, pp. 113-133; Peter J. Wattel, *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?*, *in* Dennis Weber (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, pp. 139-156; Melchior Wathelet, *Souveraineté fiscale des Etats membres et Cour de justice: nouvelles tendances ou confirmation?*, Revue de Jurisprudence Fiscale, February 2008, pp. 90-102; Pasquale Pistone, *The impact of ECJ case law on national taxation*, Bulletin for International Fiscal Documentation, August/September 2010, pp. 412-428; Alexandre Maitrot de la Motte, *Souveraineté fiscale et construction communautaire – Recherche sur les impôts directs*, LGDJ, 2005; Emmanuel Raingeard de la Blétière, *Les relations entre le droit communautaire et le droit fiscal international – nouvelles perspectives*, 2008.

[68] ECJ, 28 January 1986, case C-270/83, *European Commission v French Republic.*

the research conducted from a pure legal perspective, tax policy aspects have also been subject to research, often from an economic perspective[69].

In the field of European tax law, a significant amount of doctrine has been published by scholars. Among the different authors, one can hardly classify them in different schools of thoughts. One may be tempted to distinguish between guardians of Member States' fiscal sovereignty and scholars who

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[69] See for example Klaus Vogel, General IFA Report, *Fiscal obstacles to the international flow of capital between a parent and its subsidiary*, vol. 69a, 1984; Klaus Vogel, *Worldwide vs source taxation of income – a review and re-evaluation of arguments, (part I)*, Intertax, 1988-8/9, pp. 219-229; Klaus Vogel, *Worldwide vs source taxation of income – a review and re-evaluation of arguments, (part II)*, Intertax, 1988-10, pp. 310-320; Klaus Vogel, *Worldwide vs source taxation of income – a review and re-evaluation of arguments, (part III)*, Intertax, 1988-11, pp. 393-402; Klaus Vogel, *Federal Republic of Germany, Taxation of foreign income – principles and practice*, Bulletin for International Fiscal Documentation, January 1985, pp. 4-14; Klaus Vogel, *"State of residence" may as well be "State of source" – there is no contradiction*, Bulletin for International Fiscal Documentation, October 2005, pp. 420-423; Daniel Gutmann, *Globalisation et justice fiscale*, L'Année Fiscale, Presses Universitaires de France, 2003, pp. 109-127; Daniel Gutmann, *Droit fiscal des affaires*, Montchretien, 2010, pp. 410-417; Eric Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models*, Katholieke Universiteit Brabant, Tillburg, 2001; Eric Kemmeren, *Source of income in globalizing economies: overview of the issues and a plea for an origin-based approach*, Bulletin for International Fiscal Documentation, November 2006, pp. 430-452; Reuven S. Avi-Yonah, *Back to the future? The potential revival of territoriality*, Bulletin for International Fiscal Documentation, October 2008, pp. 471-474; Dale Pinto, *Exclusive source or residence-based taxation – is a new and simpler world tax order possible?*, Bulletin for International Fiscal Documentation, July 2007, pp. 277-291; Nancy H. Kaufman, *Fairness and the taxation of international income*, Law & Policy in International Business, 1998, pp. 145-203; Claude Emonnot, *Intégration financière européenne et fiscalité des revenus du capital*, Economica, 1998; Salvador Barrios, Harry Huizinga, Luc Laevan, Gaëtan Nicomède, *International taxation and multinational firm location*, Taxation papers, European Union, 2009; Peggy B. Musgrave, *Sovereignty, entitlement, and cooperation in international taxation*, Brooklin Journal of International Law, 2001, pp. 1335-1356; Michael J. Graetz, *Taxing international income: inadequate principles, outdated concepts, and unsatisfactory policies*, Tax Law Review, 2001-3, pp. 261-336; Richard A. Musgrave, Peggy B. Musgrave, *Public finance in theory and practice*, McGraw Hill, Fifth edition, 1989; Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (eds.), *Source versus residence*, Kluwer Law International, 2008.

are more European enthusiasts, but such a classification would not always be relevant. In contrast, what could be more relevant is to observe that certain scholars have a particular interest in the tax policy of the European Union, while others are perhaps more interested in the legal analysis of the case law of the ECJ. Both categories of publications are interesting for the purpose of the dissertation, given the fact that the thesis aims at reaching tax policy recommendations that rely on a legal analysis of the case law of the ECJ.

Even if many publications have studied the case law of the ECJ on the taxation of companies' foreign business income and focused on the justifications accepted or rejected by the Court, no study has analysed the reasoning of the ECJ in the way of the dissertation, *i.e.* through distinguishing between the taxation of resident companies on income of foreign group companies, the taxation of resident companies on income of permanent establishments, and the taxation of permanent establishments. By studying these situations separately and reconciliating the findings of the ECJ, it is possible to better understand and criticise the reasoning of the Court with regard to the principles of taxation of companies' foreign business income. In addition, the analyses of chapter 2 on tax jurisdiction in international law and chapter 6 on double taxation make the study more complete, instead of focusing on the sole case law of the ECJ in relation to the taxation of companies' foreign business income. Moreover, since the *Marks & Spencer* case, the ECJ has made clear that a strict application of the fiscal principle of territoriality can, in certain cases, be incompatible with the freedom of establishment. Final loss relief has consequently become an obligation for Member States of the European Union. In that respect, the dissertation provides in chapter 7 analyses of and original ideas relating to the very mechanism imposed by the Court, since the method according to which final foreign losses shall be relieved is an area that has not yet been subject to significant research in the tax literature. The thesis also suggests, from the point of view of principle, alternative ways of relieving final foreign losses that could contribute to discussions on how Member States could design a common legislative mechanism for the relief of final foreign losses, outside the scope of a common consolidated corporate tax base. Consequently, the dissertation fills a gap in the doctrine in relation to the very rationale of the *Marks*

& Spencer doctrine, which is all the more important as final loss relief is now an obligation for Member States granting loss relief in a domestic context.

The method used in the dissertation is described below.

1.6 Method

1.6.1 Legal method used in the dissertation

The legal method used in the dissertation is the traditional legal method, which consists in analysing a certain question through relying on the existing legal sources[70]. Two main legal sources are relevant for the dissertation: the EU Treaties and the case law of the ECJ. The EU Treaties are analysed according to the teleological method[71]. This method aims at discovering the true intention of the legislator by emphasising the objectives of a text, since the very wording of a text may not be entirely clear or complete. The importance of considering the object and purpose of an international treaty is underlined by article 18 of the Vienna Convention on the Law of Treaties and should therefore be applied to the EU Treaties. The Vienna Convention on the Law of Treaties[72] also attaches strong importance to the intentions of States concluding a treaty, particularly with regard to non-written provisions. The ECJ has also indicated that "every provisions of Community law must be placed in its context and interpreted in the light of the provions of Community law as a whole, regard being had to the objectives thereof and to its state of evolution at the date on which the provisions in question is to be applied"[73]. Therefore, the legal analysis may have to go beyond the very drafting of the EU Treaties, particularly if its meaning is

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[70] On the use of legal sources see Stig Strömholm, *Rätt, rättskällor och rättstillämpning: en lärobok i allmän rättslära*, fifth edition, Norstedts Juridik, 1996.

[71] On the method of interpretation of EU law see Marjanna Helminen, *EU tax law – direct taxation*, IBFD, 2009, pp. 42-45.

[72] Vienna Convention on the Law of Treaties of 23 May 1969. It should be observed that not all signatories to this convention have ratified it.

[73] ECJ, 6 October 1982, case C-283/81, *Srl CILFIT and Lanificio di Gavardo SpA v Ministry of Health*, para. 20.

not entirely clear[74]. Such an interpretation seems very important as part of research conducted with regard to the internal market and the fundamental freedoms, since they are drafted in general terms.

As corporate taxation has been harmonised by Member States only to a very limited extent, ECJ case law is the central legal source for the purpose of the dissertation. The Court interprets primary law and the case law has, as such, the same legal status as provisions of the EU Treaties. Article 267 TFEU indeed gives the ECJ the responsibility of interpreting the EU Treaties. Consequently, the study of the case law of the ECJ constitutes an important source of law for fully understanding the meaning and implications of the EU Treaties. Opinions of Advocates General may also be discussed, but they have, as such, no legal standing.

Although preliminary rulings are deeply analysed in the thesis, it should not be overlooked at the very wording of ECJ case law, partly because the Court often answers to questions in the terms employed by the referring courts or by the parties to a case. Such terminology may not always correspond to the traditional meaning of certain technical terms, as recognised by the ECJ: "Community law uses terminology which is peculiar to it. Furthermore, it must be emphasised that legal concepts do not necessarily have the same meaning in Community law and in the law of the various Member States"[75]. Therefore, emphasis should be put on the actual content and the practical outcome of preliminary rulings rather than on the very wording used by the Court.

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[74] Additional support for using the teleological method is found in several cases issued by the Court. For a recent example see ECJ, 15 July 2010, case C-70-09, *Hengartner and Gasser*, para. 36: "an international treaty must be interpreted not solely by reference to the terms in which it is worded but also in the light of its objectives. Article 31 of the Vienna Convention on the Law of Treaties of 23 May 1969 provides in that respect that a treaty is to be interpreted in good faith in accordance with the ordinary meaning to be given to its terms in their context and in the light of its object and purpose".

[75] ECJ, 6 October 1982, case C-283/81, *Srl CILFIT and Lanificio di Gavardo SpA v Ministry of Health*, para. 19.

Preliminary rulings may also be compared to each other despite different wordings, like *e.g.* the *Futura* and *Renneberg* cases, which both dealt with limited tax liability in the State of source without referring to similar concepts and justification grounds.

1.6.2 Links with other disciplines

The dissertation is linked with other disciplines than tax law, particularly international law and economics.

Tax jurisdiction is an attribute of a State's sovereignty, which is a concept of international law. To fully assess the impact of the objective of achievement of the internal market on Member States' taxation of companies' foreign business income, some research in the field of international law is necessary for understanding the extent of a State's tax jurisdiction. This research is, however, limited to what is necessary to study the conflict between the objective of achievement of the internal market and Member States' taxation of companies' foreign business income, *i.e.* only a brief analysis of international law is made with regard to several questions that are particularly relevant for the dissertation.

The topic of this dissertation touches upon questions of international tax policy, as the thesis discusses the different options available to Member States to tax companies' foreign business income. In that respect, one possible way of dealing with this topic would be to conduct economic research and assess the possible consequences of different principles of taxation on European companies' profitability and Member States' public revenues. This is, however, not the path chosen in this thesis, as discussed *supra* in the limitations to the dissertation. The dissertation is a legal one and does not aim at taking into consideration the economic aspects of the legal questions discussed. Consequently, the conclusions reached and recommendations made in the thesis should preferably be completed by economic research to be fully relevant for Member States and the European institutions. In the concluding chapter of the dissertation (chaper 8), indications are provided on the research that could be considered useful to deepen the analysis of the conflict between Member States' rules on the taxation of companies'

foreign business income and the objective of achievement of the internal market.

1.6.3 Language

The language of the thesis is English. This choice is primarily based on the European nature of the topic. Indeed, the case law of the ECJ and, more generally, the conflict between the taxation of companies' foreign business income and the objective of achievement of the internal market, is relevant for European scholars, the European institutions, as well as all Member States. Therefore, by writing the thesis in English, the analyses carried out in this dissertation are made more easily available throughout the European Union. However, academic material used for this thesis is not limited to English, but includes publications in French and Swedish.

Versions of the EU Treaties and secondary law have the same legal status in all official languages of the Union[76]. Yet, differences of interpretation may exist between different versions of the same source. In that case, the Court is supposed to stand back from the wording of the text and look for the intention of the provision at stake[77]. For ECJ case law, in case of conflict or incompatibility between different languages, or to fully understand the reasoning of the Court, the French version will be given preference since it is the working language of the ECJ.

Upon changes of name, the most recent one is used throughout the whole dissertation. Consequently, it is primarily referred to the TEU and the TFEU and not to the TEC, even in cases ruled by the ECJ before the entry into force of the Treaty of Lisbon.

1.6.4 Research method applied to the dissertation

To analyse the conflict between Member States' taxation of companies' foreign business income and the objective of achievement of the internal mar-

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[76] *C. cit.*, para. 18: "Community legislation is drafted in several languages and (…) the different language versions are all equally authentic".

[77] ECJ, 27 October 1977, case C-30/77, *Régina v Pierre Bouchereau.*

ket, an extensive analysis of the case law of the ECJ is necessary. Two main research methods could be followed to carry out such analyses: on the one hand, one could distinguish between the taxation of foreign positive income and foreign negative income. On the other hand, one could distinguish between the different levels of taxation according to which States exercise their taxing rights. The first research method presents the advantage of regrouping the different cases issued for one particular issue, so their reconciliation would be made easier. However, the problem with this research method is the lack of link between the taxation of profits and the deduction of losses. Indeed, profits and losses may be taxed symmetrically and according to the connection existing with a tax subject or a tax object, or depending on tax policy considerations. Tax claims are usually higher when the connection is strong and lower when the connection is weak. Although this gradual jurisdiction is not a result of binding customary international law, it has become a traditional way of exercising tax jurisdiction. Therefore, in my view it makes sense to follow this gradual distinction in the dissertation for efficiently confronting rules of international tax law to EU law. This research method makes the analysis more consistent with the way tax jurisdiction is actually exercised by Member States: for example, it is consistent, when analysing the tax jurisdiction of the Member State of establishment, to consider both the taxation of profits and losses incurred by a permanent establishment, because the attribution of profits and losses to permanent establishments is subject to the same recommendations of the OECD. This research method also makes the findings of the dissertation more practical to use and discuss, and it does not prevent from making a reconciliation of the findings after having considered the different points of tension between EU law and Member States' tax jurisdiction. Consequently, it is this research method that has been chosen for the dissertation.

The different levels of tax jurisdiction according to which the dissertation is written are group taxation, the taxation of resident companies, and the taxation of permanent establishments. Tax jurisdiction is indeed traditionally exercised differently in these three situations, which is why it is relevant to distinguish between them:

- Chapter 3 analyses the tax jurisdiction of the State of the parent company when taxes levied on resident companies but with regard to foreign subsidiaries. In this case the connection is weak with the tax object.

- Chapter 4 analyses the taxation of resident companies on foreign business income earned directly through permanent establishments. In this case, the connection is strong with the tax subject and weaker with the tax object.

- Chapter 5 analyses the taxation of foreign business income attributable to permanent establishments. Here, the connection is weak with both the tax subject and the tax object, although a permanent establishment is traditionally seen as being a tax presence of a non-resident in the host State.

In addition to the study of ECJ case law according to the different connections identified between a State and a tax subject or a tax object, the dissertation focuses on three other aspects: tax jurisdiction in international law, the compatibility of double taxation with EU law and the attribution of final foreign losses to the home State according to the *Marks & Spencer* doctrine. These chapters complete the findings of the preceding chapters of the dissertation.

Material available until 3 March 2011 has been taken into account in the dissertation.

1.7 Outline

As mentioned above, the analysis of ECJ case law is divided in chapters depending on the connection between a taxing State and a tax object or a tax subject. This distinction aims at analysing Member States's tax jurisdiction as they often exercise it, either through domestic tax law or through tax treaties. In addition, three other chapters complete the study[78]. Two of

[78] These are chapters 2, 6 and 7.

these additional chapters (tax jurisdiction in international law and the compatibility of double taxation with EU law) are found necessary to analyse the topic of the dissertation. The third additional chapter (chapter 7) completes the analyses of chapters 3 and 4 and provides a criticism to the very rationale of the *Marks & Spencer* doctrine.

It is emphasised that when certain issues are common to several chapters, such issues are analysed when they are encounted for the first time. Accordingly, when such issues are encountered again at a later point in the dissertation, it is referred to the analysis performed previously. This is for example the case for the question of whether or not the EU Treaties give preference to neutrality in the home State or neutrality in the host State: this issue is discussed in chapter 3, and the outcome of this analysis may be referred to at later points in the dissertation. This is also the case for the discussion on discrimination-based analyses[79] and restriction-based analyses[80], which takes place in chapter 4 of the dissertation but may be referred to later in the dissertation.

The thesis is written according to the following outine:

- Chapter 1: Introduction

Chapter 1 gives a brief presentation on the topic, the purpose of the thesis, provides some definitions that are important for the thesis, clarifies the limitations that have been chosen, relates this dissertation to the existing doctrine, explains the method chosen, and presents the outline of the thesis.

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[79] A discrimination-based analysis is defined as an analysis according to which a national tax rule may infringe EU law only if it treats differently comparable domestic and cross-border situations.

[80] A restriction-based analysis is defined as an analysis according to which a national tax rule may infringe EU law even if its applies similarly to comparable domestic and cross-border situations, as long as it has a restrictive effect on the exercise of the freedoms of movement.

- Chapter 2: International law and tax jurisdiction over foreign business income

This chapter analyses jurisdiction and tax jurisdiction over foreign business income in international law. The purpose of this chapter is to identify the possible limits imposed by international law on the exercise of tax jurisdiction, whether international law requires a minimum connection to exercise tax jurisdiction or gives priority to a certain connection, and lastly if international law prohibits double taxation. This chapter sets important grounds for the whole dissertation, because it is necessary to have an understanding of a State's tax jurisdiction before discussing its limitations as a result of EU law. Consequently, this chapter comes first after the introduction, to be able to rely on its findings throughout the whole thesis.

- Chapters 3: Taxation of resident companies on foreign group companies' foreign business income

Chapter 3 studies the impact of the objective of achievement of the internal market on the taxation of resident companies on foreign group companies' foreign business income. This chapter focuses on the taxation of foreign group companies' foreign profits through CFC rules, and the deduction of foreign group companies' foreign losses when the State of the parent company grants relief for domestic losses in the domestic context.

It should be observed that group taxation (chapter 3) is discussed before the taxation of head offices on foreign business income earned through permanent establishments (chapter 4). This choice is explained by the fact that the ECJ has first dealt with group taxation with regard to both profits (*Cadbury Schweppes*) and losses (*Marks & Spencer*) before taking position on these issues with regard to permanent establishments (particularly in *Columbus Container* and *Lidl Belgium*). Consequently, group taxation is studied before analysing the taxation of resident companies on foreign business income earned through permanent establishments.

- Chapter 4: Taxation of resident companies on foreign business income earned through permanent establishments

Chapter 4 discusses the taxation of resident companies in relation to the business income they earn in other Member States through permanent establishments. As in chapter 3, it is distinguished between foreign profits and losses, *i.e.* it is distinguished between profitable and loss-making permanent establishments. This chapter partly relies on an analysis of how the ECJ transposed the findings relating to group taxation to the taxation of resident companies on foreign business income earned through permanent establishments. Indeed, foreign subsidiaries and permanent establishments are subject to several legal differences, which may justify different solutions to the compatibility issues existing with the objective of achieving the internal market.

- Chapter 5: Taxation of permanent establishments' foreign business income

Chapter 5 analyses the tax jurisdiction of the Member State where a permanent establishment is located in relation to foreign business income attributable to such a permanent establishment. Contrary to the taxation of resident companies, the tax jurisdiction of the State of establishment is in principle limited by domestic law or tax treaties to income attributable to permanent establishments, which raises particular compatibility issues with EU law. This chapter relies partly on the findings of the previous chapters, but most of the analyses carried out in this chapter are exclusively relevant for the State of establishment, given the particularities of the taxation of permanent establishments. Since chapters 3 and 4 are tightly related to each other, it is logical that the tax jurisdiction of the Member State of establishment is studied after the two preceding chapters.

- Chapter 6: EU law and international double taxation

Chapter 6 analyses the compatibility with EU law of international double taxation, both with regard to certain provisions of the EU Treaties and with regard to the case law of the ECJ in cases related to direct taxation and social contributions. Although this chapter does not analyse the taxation of companies' foreign business income as such, the outcome of this chapter is

crucial for the study of the conflict between Member States' rules on the taxation of companies' foreign business income and the objective of achievement of the internal market. Indeed, depending on the outcome of this chapter, one or several Member States may have to limit their tax jurisdiction, if the exercise of such a tax jurisdiction results in a taxation possibly prohibited by EU law. This means that the outcome of this chapter may influence the right to tax according to the principle of worldwide taxation or the fiscal principle of territoriality, thus having direct consequences on the taxation of companies' foreign business income.

This chapter completes the analyses of chapters 3, 4 and 5. It is considered relevant to have this chapter on the compatibility with EU law of international double taxation after the chapters analysing the very tax jurisdiction on companies' foreign business income, as the main purpose of the thesis is to analyse the case law of the ECJ on the taxation of companies' foreign business income, not the compatibility with EU law of international double taxation. Therefore, chapter 6 comes as an additional guidance to reach the purpose of the dissertation.

- Chapter 7: Reconsidering cross-border loss relief – alternative approaches to relieving final losses incurred by foreign subsidiaries and permanent establishments subject to the exemption method

Chapter 7 formulates particular criticisms to the *Marks & Spencer* doctrine and suggests alternative approaches to providing cross-border loss relief, which could be implemented by secondary legislation at the level of the European Union. This chapter completes the findings of the thesis, when final loss relief has to be granted as a consequence of EU law. Given the importance of relieving final foreign losses to mitigate some of the drawbacks of the fiscal principle of territoriality, but also with regard to the shortcomings of the *Marks & Spencer* doctrine, it has been found relevant to try to improve the possible grounds for providing final loss relief within the internal market. As this chapter does not consist of a legal analysis of ECJ case law, nor of some of the key provisions of the EU Treaties, but rather discusses the rationale of the *Marks & Spencer* doctrine and assesses alternative approaches to relieving final losses, it has been considered consistent

with the structure of the thesis to have this chapter at the end of the dissertation. This is also a way to finish the thesis by opening on future possible perspectives for cross-border loss relief within the internal market. However, only the rationale for an alternative approach to cross-border loss relief is considered in this chapter, *i.e.* no comprehensive *de lege ferenda* proposals are made.

- Chapter 8: Conclusion

Chapter 8 summarises and reconciliates the findings of the dissertation. Some tax policy observations are made with regard to the taxation of companies' foreign business income earned within the internal market, together with suggestions on possible future research that could be helpful for the analysis of the conflict between Member States' taxation of companies' foreign business income and the objective of achievement of the internal market.

- Chapter 9: Résumé en langue française

This chapter contains a detailed summary of the dissertation in French. It is not a translation of chapter 8. Instead, chapter 9 describes comprehensively the steps and findings of each of the chapters of the dissertation.

2 International law and tax jurisdiction over foreign business income

"territoriality, which is a relatively easy concept to define in international law in general, becomes very hard when tax law is concerned"[81].

2.1 Introduction

The purpose of the thesis is to conduct a legal analysis on the conflict between Member States' rules on the taxation of companies' foreign business income and the objective of achievement of the internal market. However, before analysing the case law of the ECJ and some key provisions of the EU Treaties, it is very useful to first analyse jurisdiction over foreign business income as it stands in international law. Indeed, determining a State's taxing rights according to international law helps understand why Member States tax companies' foreign business income the way they do. It is also important to deepen the connection between international law and the extent of a State's tax jurisdiction[82] given the importance that this connection has in many cases issued by the ECJ that are of relevance for the dissertation[83]. Also, the Court refers to concepts such as "fiscal sovereignty"[84], "tax

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[81] Reuven S. Avi-Yonah, *International tax as international law – an analysis of the international tax regime*, Cambridge Tax Law Series, 2007, p. 28.

[82] This chapter only provides a brief description of jurisdiction in international law and applies it to the field of international tax law. A deep study of this issue would, indeed, be out of the scope of this dissertation.

[83] The importance of the study of how international tax law interacts with international law can be illustrated by the statements of Advocate General Maduro who considered that "In accordance with the requirements of international law the exercise of the fiscal competence of any Member State necessitates connection either to the nationality of the taxable person or to the localisation of taxable income in its territory": see Opinion of Advocate General Maduro, delivered on 7 April 2005, case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, para. 60.

sovereignty"[85], "sovereignty in matters of direct taxation"[86], "territorial competence"[87] as well as the "fiscal principle of territoriality"[88]. Analysing the extent of a State's tax jurisdiction as it stands in international law allows understanding this tax jurisdiction without having to take for granted the different wordings used by the ECJ. These wordings may be misleading without a proper analysis of the grounds set by international law for the taxation of companies' foreign business income. In particular, the principle of territoriality in international law and the fiscal principle of territoriality in international tax law deserve special attention since these principles may be found unclear or hard to define[89]. Consequently, tax law is not sufficient a

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[84] See *e.g.* ECJ, 29 April 1999, case C-311/97, *Royal Bank of Scotland plc v Elliniko Dimosio (Greek State)*, para. 29; ECJ, 14 November 2006, case C-513/04, *Mark Kerckhaert and Bernadette Morres v Belgische Staat*, para. 19, 20 and 23; ECJ, 6 December 2007, case C-298/05, *Columbus Container Services B.V.B.A. & Co. v Finanzamt Bielefeld-Innenstadt*, para 42 and 43; ECJ, 20 May 2008, case C-194/06, *Staatssecretaris van Financiën v Orange European Smallcap Fund NV*, para. 37, 47, 79, 105 and 113; ECJ, 12 February 2009, case C-67/08, *Margarete Block v Finanzamt Kaufbeuren*, para. 31 and 34.

[85] See *e.g.* ECJ, 28 February 2008, case C-293/06, *Deutsche Shell GmbH v Finanzamt für Grossunternehmen in Hamburg*, para. 35.

[86] ECJ, 12 May 1998, case C-336/96, *Gilly*, para. 48.

[87] ECJ, 18 July 2007, case C-231/05, *Oy AA*, para. 34.

[88] See *e.g.* ECJ, 15 May 1997, case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, para. 22; ECJ, 18 September 2003, case C-168/01, *Bosal Holding BV*, para. 37; ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 39; ECJ, 29 March 2007, case C-347/04, *Rewe Zentralfinanz eG v Finanzamt Köln-Mitte*, para. 59.

[89] See *e.g.* Klaus Vogel, *Klaus Vogel on double taxation conventions*, Kluwer Law International, third edition, 1997, para 7a, p. 11: "the criterion of 'territoriality' in itself is not clear". This resulted in Klaus Vogel avoiding this term: "the term 'territoriality principle' is avoided here because a variety of different meanings have been attributed to it", *Klaus Vogel on double taxation conventions*, Kluwer Law International, third edition, 1997, para. 2, p. 10. See also Michael Lang, *The Marks & Spencer case - the open issues following the ECJ's final word*, European Taxation, February 2006, p. 59, who considered that the principle of territoriality's "meaning is not clear at all". See also Axel Cordewener, Mattias Dahlberg, Pasquale Pistone, Ekkehart Reimer, Carlo Romano, *The tax treatment of foreign losses: Ritter, M & S, and the way ahead (part two)*, European Taxation, May 2004, p. 220; Reuven S. Avi-Yonah, *International tax as international law – an analysis of the international tax regime*, Cambridge Tax Law Series, 2007, p. 28.

tool to analyse the extent of Member States' tax jurisdiction on foreign business income. This chapter also provides arguments for assessing whether ECJ case law or the solutions suggested in the dissertation may contradict tax jurisdiction as recognised under international law.

The link between tax law and international law was fundamental to establish taxation principles at the beginning of globalisation in the early 20th century[90]. Most of the taxation principles found at that time are still applied today[91], but the relation between international law and international tax law may have been neglected since then[92]. Therefore, jurisdiction should first be considered in international law[93] (2.2) before analysing it in the context of international tax law (2.3).

2.2 Jurisdiction in international law

2.2.1 Introduction

Jurisdiction is a consequence of a State's sovereignty. As a State is by definition sovereign, it is automatically entitled to jurisdiction. Sovereignty stems

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[90] For a historical perspective on the U.S. international tax rules, see Michael J. Graetz, Michael M. O'Hear, *The "original intent" of U.S. international taxation*, Duke Law Journal, 1997, volume 46, pp. 1021-1109. See also Charles E. McLure, *Globalization, tax rules and national sovereignty*, Bulletin for International Fiscal Documentation, August 2001, pp. 333-334.

[91] It is to be observed that such principles are subject to some criticism with regard to their suitability to meet the challenges of the modern economy. In that respect, see *e.g.* Kees van Raad, *Fractional taxation of multi-State income of EU resident individuals – a proposal*, *in* Liber Amicorum Sven-Olof Lodin, Kluwer Law International, 2001, pp. 211-212: "the court is simply not equipped for renovating outdated taxation regimes". See also Michael J. Graetz, *Taxing international income: inadequate principles, outdated concepts, and unsatisfactory policies*, Tax Law Review, 2001-3, pp. 261-336.

[92] Rutsel Silvestre J. Martha, *The jurisdiction to tax in international law - Theory and practice of legislative fiscal jurisdiction*, Kluwer Law International, Series on International Taxation, no. 9, 1989, p. 11.

[93] International law is discussed here only to the extent necessary for the purpose of the dissertation. This chapter does not intend to perform a comprehensive study of (tax) jurisdiction in international law.

directly from statehood, *i.e.* it follows from the very existence of a State[94]. The famous arbitration award rendered by Max Hubert emphasised already in 1928 that sovereignty implies the independence of a State on its territory: "Sovereignty in the relations between States signifies independence. Independence in regard to a portion of the globe is the right to exercise therein, to the exclusion of any other State, the functions of a State. The development of the national organisation of States during the last few centuries and, as a corollary, the development of international law, have established this principle of the exclusive competence of the State in regard to its own territory in such a way as to make it the point of departure in settling most questions that concern international relations"[95]. This arbitration award makes it clear that States are sovereign and, as such, are independent. Their sovereignty is "plenary and not subject to control by other States"[96]. This means that a State is not bound by other States on its territory, nor can it bind other States on their territories[97]. The principle of non-intervention, found at article 2(7) of the Charter of the United Nations[98], illustrates the

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[94] See Malcolm N. Shaw, *International Law*, Cambridge University Press, fourth edition, 1997, p. 331: "International law is based on the concept of a state. The state in its turn lies upon the foundation of sovereignty, which expresses internally the supremacy of the gouvernmental institutions and externally the supremacy of the state as a legal person".

[95] Permanent Court of Arbitration, 4 April 1928, *Island of Palmas (or Miangas)*.

[96] Colin Warbrick *in* Malcolm D. Evans, *International law*, Oxford University Press, 2003, p. 231. See also Maxime Chrétien, *A la recherche du droit international fiscal commun*, Sirrey, 1955, p. 11, para. 14: "la souveraineté de l'Etat sur son territoire est une compétence non seulement exclusive (par rapport aux autres Etats et aux organisations internationales) mais encore illimitée: c'est à la fois la *suprema potestas* et la *plena potestas*. Elle signifie que chaque Etat est seul maître et maître absolu de ses décisions en toutes matières, à l'intérieur de son territoire. Ainsi entendue, la souveraineté – pouvoir exclusif et absolu – est synonyme et d'indépendance à l'égard des autres Etats et d'égalité entre les divers Etats".

[97] Max Hubert underlined the fact that sovereignty is plenary within the territory and stops beyond the border: "Territorial sovereignty involves the exclusive right to display the activities of a State. This right has as corollary a duty: the obligation to protect within the territory the rights of other States, in particular their right to integrity and inviolability" (Permanent Court of Arbitration, 4 April 1928, *Island of Palmas (or Miangas)*).

[98] Article 2(7) of the Charter of the United Nations, first indent: "Nothing contained in the present Charter shall authorize the United Nations to intervene in matters which are essen-

international recognition of States' sovereignty. Article 34 of the Vienna Convention on the Law of Treaties also reflects States' sovereignty and independence, as this article indicates that "A treaty does not create either obligations or rights for a third State without its consent".

Attention should be paid to the distinction between jurisdiction to enforce and jurisdiction to prescribe. Jurisdiction to enforce is the right of a State to actually implement its legal system and court decisions, while jurisdiction to prescribe is the right of a State to legislate. A State's jurisdiction to enforce is clearly limited to its territory, *i.e.* enforcement power vanishes beyond the geographical borders since acting otherwise would jeopardise other States' sovereignty[99]. This means that domestic rules cannot be applied before foreign courts. Only the cooperation of a foreign State can permit the enforcement of laws or court decisions on the territory of another State. In contrast, jurisdiction to prescribe – *i.e.* the right to legislate – is not necessarily limited to the territory of a State[100]. It is jurisdiction to prescribe that is discussed in this chapter, as its extent is not clearly determined.

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tially within the domestic jurisdiction of any state or shall require the Members to submit such matters to settlement under the present Charter". Mann considers that between the principle of non-intervention and the principle of territoriality, the difference is "merely terminological": see Frederick Alexander Mann, *The doctrine of international jurisdiction revisited after twenty years*, Collected courses of the Hague academy of international law, 1984, III, p. 20.

[99] The exclusive limitation to the territory of jurisdiction to enforce was *e.g.* underlined in a judgment given by a US Court of Appeals, which found incompatible with international law a subpoena issued with regard to foreign nationals. See US Court of Appeals, District of Columbia Circuit, 17 November 1980, 636 F.2d 1300, *Federal Trade Commision v Compagnie de Saint-Gobain-Pont-à-Mousson*, referred to by Kees van Raad, *Nondiscrimination in international tax law*, Kluwer law and taxation publishers, 1986, p. 19. According to this judgment, "When an American regulatory agency directly serves its compulsory process against a citizen of a foreign country, the act of service itself constitutes an exercise of American sovereign power within the area of the foreign country's territorial sovereignty". The Court of Appeals mentioned that "Such an exercise constitutes a violation of international law".

[100] See Maxime Chrétien, *A la recherche du droit international fiscal commun*, Sirrey, 1955, p. 22, para. 25: "Un Etat peut prendre sur son territoire des lois qui s'étendent à des personnes ou à des biens se trouvant sur le territoire d'un autre Etat, sans le consentement de ce dernier.

Several aspects of States' jurisdiction to prescribe are discussed *infra*, the choice of these aspects being dependent on what is considered relevant for the study of jurisdiction to prescribe in the field of tax law. First, the different principles of jurisdiction to prescribe are discussed (2.2.2). Second, it will be analysed whether or not international law requires a genuine connection to exercise jurisdiction (2.2.3). Last, a possible hierarchy between the different jurisdiction principles is analysed (2.2.4).

2.2.2 Principles of jurisdiction to prescribe

It has always been necessary for States to determine the extent of their laws to be able to manage situations with a foreign element, widen their influence, and prevent conflicts of jurisdiction. Many domestic laws, in most legal fields, define the extent of their provisions through relying on different jurisdiction principles[101]. So do also many international treaties. Consequently, jurisdiction is not fixed: it varies from one State to another[102], depends on the field of law[103] and on the situation at hand.

Two approaches to jurisdiction are conceivable: a prohibitive approach according to which States' jurisdiction is unlimited unless prohibited otherwise by international law, or a permissive approach according to which States have no jurisdiction unless authorised by international law. Very little guidance is provided by international bodies, in particular the International Court of Justice, while many authors and national courts have reflected over this problematic. The Permanent Court of International Justice laid

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Mais il ne peut pas les appliquer sur le territoire de cet autre Etat, sans le consentement de celui-ci. Il ne pourra les appliquer que sur son territoire, ce qui suppose que les personnes ou les biens s'y retrouveront un jour".

[101] See *e.g.* articles 113-1 and following of the French *Code pénal*, which establish the geographical scope of its provisions.

[102] Powerful States are likely to have more extensive jurisdiction principles "since they will be able to impose their legislation on weaker States": see Cedric Ryngaert, *Jurisdiction in international law*, Oxford University Press, 2008, p. 34.

[103] Cedric Ryngaert, *Jurisdiction in international law*, Oxford University Press, 2008, p. 38.

the grounds for questions of jurisdiction in the *Lotus*[104] case dating back to 1927, which to date is the only case addressing jurisdiction as a matter of principle. The *Lotus* case adopted the prohibitive approach, thus finding that States enjoy a plenary jurisdiction, even if they may encroach upon other States' sovereignty. Following the *Lotus* case, it has become clear that jurisdiction may be exercised beyond a State's borders without breaching international law.

International law recognises several jurisdiction principles on the basis of which a State may legislate. Different schools of thoughts have followed one another and although the principle of territoriality as it stands in international law is the most common jurisdiction principle[105] (2.2.2.1), it is neither the sole nor the primary one (2.2.2.2).

2.2.2.1 The principle of territoriality as a jurisdiction principle in international law

The principle of territoriality as it stands in international law implies that a State is competent with regard to all persons and objects connected to its territory, irrespective of their nationality or origin. Foreigners' rights and obligations are therefore subject to the sovereignty of their host State. This fundamental right over persons and objects connected to a State's territory is guaranteed by its independence towards other States. Of course, a State may limit its sovereignty, either unilaterally or through an international agreement. For example, a State may refrain from exercising its jurisdiction over foreign diplomats, despite their presence on its territory. Similarly, foreigners may be dispensed from certain obligations like military service, although the State hosting them could impose such an obligation.

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[104] Permanent Court of International Justice, 7 September 1927, Ser. A, No 10, *S.S. Lotus*.

[105] In many cases it would make no sense to apply another jurisdiction principle than the principle of territoriality, since it would jeopardise the application of the rule of law on a certain territory. For example, it sound reasonable to apply the principle of territoriality when it comes to regulating car traffic in a certain country: a national of State A driving a car in State B obviously has to comply with the driving rules of State B. The nationality principle has no relevance in that situation. In contrast, it would be unconvenient to expect the same national of State A to meet the requirements of State B for obtaining a driving licence: in this case the principle of territoriality is not convenient, the nationality principle being more relevant.

The principle of territoriality as it stands in international law has since long existed in European legal systems, and in many fields of the law[106]. Although the principle of territoriality as it stands in international law is nowadays considered as fundamental, it has not always been the dominating principle of jurisdiction, at least not in continental Europe. The nationality principle has once been dominating, partly because of the absence of clear borders during ancient times. However, England has always put a strong emphasis on the principle of territoriality, which was later reflected in the US Supreme Court's early decisions. Ultimately, all European countries implemented the principle of territoriality in their laws[107], in combination with other jurisdiction principles. It is now widely established that a State is entitled to jurisdiction over persons and objects physically present on its territory. In addition, the principle of territoriality receives a broad interpretation in international law through the notions of "objective" and "subjective" territoriality, which result in attributing jurisdiction based on the principle of territoriality as long as there is a territorial connection with the prescribing State:

- Objective territoriality entitles a State to claim jurisdiction for an action having effects on its territory, but originating within another territory. For example, consider a gunman standing in State A and shooting somebody in State B. State B may have jurisdiction to prosecute the gunman, since although the shot had its origin in State A, it had objective effects in State B. Objective territoriality was recognised in international law by the Permanent Court of In-

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[106] For a historical perspective, see Daniel Gutmann, *Droit international privé*, sixth edition, Dalloz, 2009, pp. 34-37; Cedric Ryngaert, *Jurisdiction in international law*, Oxford University Press, 2008, pp. 42-84.

[107] For example, the French *Code civil* implemented the principle of territoriality in 1804 concerning safety rules (article 3, first indent of the French *Code civil*: "Les lois de police et de sûreté obligent tous ceux qui habitent le territoire") and private properties (article 3, second indent of the French *Code civil*: "Les immeubles, même ceux possédés par des étrangers, sont régis par la loi française").

ternational Justice in the *Lotus* case[108], which related to determining whether Turkey had jurisdiction to prosecute the first officer of a French vessel having collided with a Turkish vessel in the high seas. After the collision, the French ship arrived in Constantinople and the Turkish authorities prosecuted the first officer of the French vessel. The question posed to the Permanent Court of International Justice was whether Turkey, by so doing, violated international law. France argued that Turkey had no jurisdiction with regard to offences committed by foreigners abroad: the nationality of the victims would in itself not be a sufficient connection and the principle of territoriality would be inapplicable since the collision happened outside the Turkish territory. The Permanent Court of International Justice dismissed these arguments referring to the absence of judicial precedent supporting the view that the offence should happen within the territory of the prosecuting State to entitle it to jurisdiction[109]. The Court stated that "If (…) a guilty act (…) produces its effects (…) in foreign territory, (…) there is no rule of international law prohibiting the State to which the ship on which the effects of the offence have taken place belongs, from regarding the offence as having been committed in its territory and prosecuting accordingly, the delinquent"[110]. Even if the accident did not happen on the Turkish territory, the fact that the French ship collided with a Turkish one was enough to entitle Turkey to jurisdiction to prosecute the person responsible for the accident. Although several judges dissented, this case is still to be considered as fundamental when it comes to determining the scope of the territoriality principle in international law and the extent of a State's jurisdiction.

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[108] Permanent Court of International Justice, 7 September 1927, Ser. A, No 10, *S.S. Lotus*.

[109] *C. cit.*, p. 23: "offences, the authors of which at the moment of commission are in the territory of another State, are nevertheless to be regarded as having been committed in the national territory, if one of the constituent elements of the offence, and more especially its effects, have taken place there".

[110] *C. cit.*, p. 25.

- Subjective territoriality refers to the place of origin of an action and entitles a State to claim jurisdiction over all actions commencing or partly happening in its territory, even if part of the action occurs in another State. For example, a crime prepared in States A and B but committed in State C may grant jurisdiction to prosecute the delinquent both to State A and to State B[111]. Subjective territoriality was also recognised in the *Lotus* case, in which the Court stated that "offences, the authors of which at the moment of commission are in the territory of another State, are nevertheless to be regarded as having been committed in the national territory (…) of one of the constituent elements of the offence"[112]. This theory may cause difficulties of interpretation and lead to conflicts between several States claiming jurisdiction.

The theories of objective and subjective territoriality extend the scope of a State's jurisdiction, which may be necessary for efficiently applying the rule of law. It would otherwise be too easy to avoid application of the law by introducing a foreign element to a certain situation. The obvious downside of these extensive theories on the principle of territoriality is concurring jurisdictional claims, which international law does not always solve. The principle of territoriality as it stands in international law has naturally been the prevailing jurisdiction principle, mainly for practical reasons. As a result, the principle of territoriality as it stands in international law subjects to the law any person or object connected with a certain territory, which permits a homogeneous and practical application of the rule of law.

Jurisdiction to prescribe may also be exercised on the basis of other jurisdiction principles.

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[111] State C would in this case have jurisdiction over the basis on the theory of objective territoriality.

[112] Permanent Court of International Justice, 7 September 1927, Ser. A, No 10, *S.S. Lotus*, p. 18.

2.2.2.2 *Other jurisdiction principles*

A State may exercise jurisdiction without territorial connection, which is referred to as extraterritorial jurisdiction. Extraterritorial jurisdiction may be based on three principles: the nationality principle, the protective principle, and the universality principle. While the nationality principle is a common jurisdiction principle, the protective and universality principles serve as a basis for jurisdiction in very exceptional cases. They are however recognised by article 2(7) of the Charter of the United Nations[113].

The nationality principle, also called active personality, acknowledges that in certain cases a State has jurisdiction over its nationals[114] even located abroad. In criminal law, the nationality principle focuses on the nationality of the delinquent, rarely on the nationality of the victim[115]. The nationality principle is also applicable in other fields of law, like civil law[116]. The nationality principle was recognised in the arbitration award rendered by Max Hubert in 1928, in which he referred to "the rights which each State may claim for its nationals in foreign territory"[117].

The protective or security principle is used by States to protect their vital interests when they normally have no jurisdiction. For example, a State may consider having jurisdiction to act against drug traffic in international waters to protect the country from this threat. The protective principle differs from the theory of objective territoriality in that the effects are only potential.

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[113] The second part of article 2(7) of the Charter of the United Nations introduces an exception to the first part, for "the application of enforcement measures under Chapter VII". Chapter VII refers to action with respect to threats to the peace, breaches of the peace, and acts of aggression.

[114] Nationality has to be understood as citizenship.

[115] See *e.g.* article 113-6 of the French *Code pénal*: "La loi pénale française est applicable à tout crime commis par un Français hors du territoire de la République".

[116] See *e.g.* article 3, third indent of the French *Code civil*: "Les lois concernant l'état et la capacité des personnes régissent les Français, même résidant en pays étranger".

[117] Permanent Court of Arbitration, 4 April 1928, *Island of Palmas (or Miangas)*.

The universality principle refers to crimes that any State would consider terrible enough to have jurisdiction over them. For example, States may consider they have jurisdiction to prosecute people that committed genocide.

2.2.2.3 *Conclusion*

As a conclusion, it is considered in international law that a State may exercise jurisdiction to prescribe on the basis of several principles. The principle of territoriality as it stands in international law is the main jurisdiction principle since States have a fundamental right to independently rule on their internal affairs, *i.e.* on persons and objects that are connected to their territory. However, a question that needs to be discussed is whether or not international law requires a genuine or minimum connection to exercise jurisdiction on the basis of the principles discussed above.

2.2.3 Does international law require a genuine or minimum connection to exercise jurisdiction?

It has been shown above that jurisdiction may be based on several principles. It can be discussed whether international law requires a genuine or minimum connection to exercise such a jurisdiction. Part of the doctrine believes so[118], which at first sight may sound reasonable to mitigate concurring jurisdictional claims and make sure that jurisdiction is not exercised in the absence of a sufficient connection with a State. Yet, as mentioned above, the Permanent Court of International Justice in the *Lotus* case did not find limitations on States' jurisdiction and did not pose any clear thresholds or minimum requirements to exercise jurisdiction. Although many authors have been critical to this judgement and find it obsolete[119], it is still the only case in which an international court has dealt so extensively with the question of the geographical extent of a State's jurisdiction.

Since the *Lotus* case, the International Court of Justice discussed the possible existence under international law of a minimum connection to exercise jurisdiction. In the *Barcelona Traction* case the International Court of Justice

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[118] Cedric Ryngaert, *Jurisdiction in international law*, Oxford University Press, 2008, pp. 31-32, with further references.

[119] *Op. cit.*, pp. 26-27.

held that "in the particular field of diplomatic protection of corporate entities, no absolute test of the "genuine connection" has found application in practice"[120]: international law would not impose any minimum connection on the exercise of jurisdiction, so the *Barcelona Traction* case seems to confirm the *Lotus* case. Consequently, it must be concluded that jurisdiction to prescribe is, in the current state of international law, not clearly limited[121].

Nevertheless, it is possible that international law requires *some* connection in order for a State to exercise jurisdiction. After all, if the exercise of jurisdiction did not require any connection with a State, the Permanent Court of International Justice would not have needed to conduct such an elaborated reasoning in the *Lotus* case: it could simply have considered that any jurisdictional claim is valid. Consequently, since the Permanent Court of International Justice felt it necessary to discuss and assess the Turkish claim, this court may have considered that international law requires *some* connection to exercise jurisdiction. However, this interpretation is only *a contrario* and does not find support in the explicit reasoning of the Permanent Court of International Justice. It could also be argued that most domestic laws and case law require some connection for a State to exercise jurisdiction, which as such could possibly be considered as customary law. It is, however, impossible to objectively define such a connection, which may explain why the Permanent Court of International Justice (and later the International Court of Justice) remained very cautious in the *Lotus* and *Barcelona Traction* cases. Since a minimum connection cannot be objectively defined, it is not possible for the International Court of Justice to require that such a connection exists to exercise jurisdiction in accordance with international law.

Consequently, although one may instinctively support the view that some connection should be required by international law, the impossibility to objectively define it impedes this view.

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[120] International Court of Justice, 5 February 1970, *Barcelona Traction*.

[121] However, one should bear in mind that jurisdiction to prescribe is *de facto* limited by the strict territoriality of jurisdiction to enforce.

The next issue concerns a possible hierarchy between the different jurisdiction principles.

2.2.4 Is there a hierarchy between the different jurisdiction principles?

As explained above, jurisdiction to enforce is exercised exclusively by each State on its territory[122]: a State does not share the enforcement power with other States or organisations unless so agreed in an international treaty. When it comes to jurisdiction to prescribe, a conflict may arise between two or more States claiming jurisdiction based on the same or on different jurisdiction principles. For example, in the *Lotus* case, France could also claim jurisdiction based either on the principle of territoriality or on the nationality principle.

How to solve such situations? Since jurisdiction principles may be applied simultaneously by more than one State, the question is raised whether one jurisdiction principle or one application of a jurisdiction principle should have primacy. Many authors support the view that the principle of territoriality should have priority[123]. Their main argument relies on States' sovereignty, which should not be encroached upon. According to these authors, extraterritorial jurisdiction should be regulated by the permissive approach: it should be exercised only when authorised by international law, *i.e.* when the sovereignty of another State is not encroached upon. The principle of territoriality would permit avoiding part of the conflicts of concurring jurisdiction, through moderating extraterritorial jurisdictional claims. However, not all conflicts of jurisdiction would be avoided, since the principle of territoriality may be applied differently and at any rate may be interpreted broadly.

It could also be argued that the principle of non-intervention may advocate for reasonableness when exercising jurisdiction to prevent conflicts of con-

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[122] See Maxime Chrétien, *A la recherche du droit international fiscal commun*, Sirrey, 1955, p. 11, para. 14: "sur le territoire d'un Etat, deux souverainetés ne sauraient coexister".

[123] For an overview, see Cedric Ryngaert, *Jurisdiction in international law*, Oxford University Press, 2008, pp. 27-31.

curring jurisdiction. This was the opinion of dissenting Judge Fitzmaurice in the *Barcelona Traction*[124] case, who considered that international law should imply an obligation to exercise jurisdiction with moderation: international law would involve "for every State an obligation to exercise moderation and restraint as to the extent of the jurisdiction assumed by the courts in cases having a foreign element, and to avoid undue encroachment on a jurisdiction more properly appertaining to, or more appropriately exercisable by, another State". Judge Fitzmaurice's opinion was, however, not followed by the International Court of Justice, and other national court decisions failed to see a binding requirement of international law establishing a hierarchy between different jurisdictional claims[125]. Consequently, absent an international treaty, international law does not imply primacy of a certain jurisdiction principle. It is clear from the reasoning of the Permanent Court of International Justice in the *Lotus* case that this court did not consider that it had to decide which country had the most legitimate claim to jurisdiction. Rather, it would decide whether Turkey's claim was in accordance with international law. The fact that France may also exercise jurisdiction[126] did not influence the outcome reached by the Permanent Court of International Justice.

Therefore, it appears that several States may claim jurisdiction at the same time. The resulting problems of concurrent jurisdiction are not, as such, solved by international law since the International Court of Justice has never found a jurisdictional claim unfounded, nor has it imposed a hierar-

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[124] See International Court of Justice, 5 February 1970, *Barcelona Traction*, separate opinion of Judge Sir Gerald Fitzmaurice, para. 70. The issue at hand in this case was about the possibility to attribute damages to the Belgian shareholders in a Canadian company for a bankruptcy procedure in Spain.

[125] See for example the decision of the US Court of Appeals, District of Columbia Circuit, 6 March 1984, 731 F.2d 909, *Laker Airways Ltd v Sabena*: "There is, therefore, no rule of international law holding that a "more reasonable" assertion of jurisdiction mandatorily displaces a "less reasonable" assertion of jurisdiction as long as both are, in fact, consistent with the limitations on jurisdiction imposed by international law".

[126] France could indeed exercise jurisdiction based *e.g.* on the nationality of the French crew or on the flag flown by the vessel.

chy between jurisdictional claims. Accordingly, international law does not imply primacy of a certain jurisdiction principle over other principles: "the international law of jurisdiction does not seem to prioritize the bases of jurisdiction. There is no rule prohibiting States from establishing concurrent jurisdiction over one and the same situation on the basis of territoriality, nationality, or universality"[127].

Of course, national courts or domestic laws may, when dealing with concurrent jurisdiction, choose to give priority to one jurisdiction principle. For example, a US Court of Appeals considered that the issuance of a subpoena violated international law. Consequently, this court limited the US' prerogatives under the principle of territoriality as it stands in international law to let jurisdiction be exercised by another State on the basis of the nationality principle[128]. Similarly, the UK Government stated that "The nationality principle justifies proceedings against nationals of the State claiming jurisdiction in respect of their activities abroad only provided that this does not involve interference with the legitimate affairs of other States or cause such nationals to act in a manner that is contrary to the laws of the State in which the activities in question are conducted"[129]. As a result, the lack of priority or hierarchy between the different jurisdiction principles may result in several States claiming jurisdiction at the same time. Such concurring claims may be mitigated or eliminated unilaterally, either through domestic laws or by way of national court decisions, if they are not solved by international treaties. However, the elimination of concurring jurisdictional claims is not, as such, required by international law.

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[127] Cedric Ryngaert, *Jurisdiction in international law*, Oxford University Press, 2008, p. 129.

[128] See US Court of Appeals, District of Columbia Circuit, 17 November 1980, 636 F.2d 1300, *Federal Trade Commision v Compagnie de Saint-Gobain-Pont-à-Mousson*, referred to by Kees van Raad, *Nondiscrimination in international tax law*, Kluwer law and taxation publishers, 1986, page 19. According this judgment, "When an American regulatory agency directly serves its compulsory process against a citizen of a foreign country, the act of service itself constitutes an exercise of American sovereign power within the area of the foreign country's territorial sovereignty". (…) "Such an exercise constitutes a violation of international law".

[129] Cited by Fiona Beveridge, *The treatment and taxation of foreign investment under international law*, Manchester University Press, 2000, p. 59.

2.2.5 Conclusion

Among the different aspects of jurisdiction in international law, several have been described above and are particularly relevant to the study of jurisdiction in international tax law. First, it was observed that States are sovereign and independent on their territories. A State rules freely on its domestic affairs, but at the same time its enforcement power is limited to its territory.

When legislating, a State may base its jurisdiction to prescribe on several principles, the most frequent being the principle of territoriality as this principle is closely related to a State's sovereignty on its territory. However, international law does not set any clear limits to a State's jurisdiction. Therefore, it cannot be determined any genuine or minimum connection for exercising jurisdiction to prescribe, which means that foreign elements may be taken into account without any precise requirement on the existing connection with the legislating State. Nor can it be established a hierarchy between different jurisdictional claims. This may result in concurring jurisdictional claims, which are not incompatible with international law.

The findings about jurisdiction in international law can now be applied to the taxation of foreign business income.

2.3 Tax jurisdiction over foreign business income

> "All the fundamental rules concerning the taxation of residents and non-residents reflect the fact that national tax law systems are based on territoriality in its different meanings"[130].

After having described certain bases for exercising jurisdiction according to international law, these bases are transposed to the field of international tax law in the following paragraphs. First, it is discussed whether States may take into account foreign elements when exercising jurisdiction to prescribe

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[130] Manfred Mössner, *Source versus residence - an EU perspective*, Bulletin for International Fiscal Documentation, December 2006, p. 504.

in the field of tax law (2.3.1). Second, a possible requirement of genuine or minimum connection to exercise tax jurisdiction is analysed (2.3.2). Third, it is wondered if international law may prohibit double taxation resulting from the overlaps between the tax claims of several States (2.3.4). Last, it is discussed whether States may refuse to take into account foreign elements when exercising their taxing powers (2.3.5).

2.3.1 May a State take into account foreign elements when exercising jurisdiction to prescribe in the field of tax law?

2.3.1.1 Introduction

The distinction between jurisdiction to prescribe and jurisdiction to enforce, which was developed earlier in relation to international law, is also applicable in tax law. As in any other legal field, jurisdiction to enforce taxes is limited to the territory of a State: a State can levy taxes or conduct a tax audit only within its territory. A State has no enforcement jurisdiction beyond its borders. This strict territorial limitation can only be overcome by a mutual assistance provision included in an international agreement[131]. It can be observed that the ECJ has explicitly recognised that a Member State has no enforcement power on non-residents[132].

Jurisdiction to prescribe in the field of tax law is an essential attribute of a State's sovereignty[133]. The jurisdiction principles applicable in international law are, however, not identically applicable in tax law: the nationality prin-

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[131] See Maxime Chrétien, *A la recherche du droit international fiscal commun*, Sirrey, 1955, p. 70, para. 82: "A défaut de traités, aucun Etat ne permet une quelconque application sur son territoire des lois fiscales des autres Etats". See also p. 72, para. 84: "à la différence de l'assiette, le recouvrement a nécessairement un caractère territorial".

[132] ECJ, 22 December 2008, case C-282/07, *Belgian State v Truck Center SA*, para. 48: "While resident recipient companies are directly subject to the supervision of the Belgian tax authorities, which can ensure compulsory recovery of taxes, that is not the case with regard to non-resident recipient companies inasmuch as, in their case, recovery of the tax requires the assistance of the tax authorities of the other Member State.".

[133] Rutsel Silvestre J. Martha, *The jurisdiction to tax in international law - Theory and practice of legislative fiscal jurisdiction*, Kluwer Law International, Series on International Taxation, no. 9, 1989, p. 15.

ciple is not heavily relied on in international tax law[134] while it is an important criterion in international law. In addition, the protective and universality principles are, in principle, irrelevant to tax law. As a consequence, extraterritorial jurisdiction in the field of taxation is limited to taxation based on nationality, which is not very common. This means that jurisdiction to prescribe in the field of tax law is essentially territorial, *i.e.* based on the principle of territoriality as it stands in international law[135]. The most common territorial connections in the field of tax law entitling a State with tax jurisdiction based on territorial criteria, are source and residence. Source of income is a territorial connection with the tax object while residence is a territorial connection with the tax subject. Residence is – as opposed to international law – a fundamental territorial connection in international tax law. Residence is about determining whether a tax subject has a sufficient terri-

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[134] It has been a controversial issue whether or not tax jurisdiction can be exercised based on nationality. Indeed, citizenship is not a proper criterion to levy taxes because it would be too easy to manipulate it through choosing the citizenship of a tax haven and be taxed there. The nationality principle is used for example with regard to taxation of US non-resident citizens on their foreign income, see IRC sec. 7701(a)(30): "*The term "United States person" means (A) a citizen or resident of the United States*". Despite recurrent criticism, the US Supreme Court has been supporting the worldwide taxation of American citizens ever since 1924: see US Supreme Court, 5 May 1924, case 265 US 47, *Cook v. Tait*. The Court based its judgement on the benefit principle: "In other words, the principle was declared that the government, by its very nature, benefits the citizen and his property wherever found, and therefore has the power to make the benefit complete. Or, to express it another way, the basis of the power to tax was not and cannot be made dependent upon the situs of the property in all cases, it being in or out of the United States, nor was not and cannot be made dependent upon the domicile of the citizen, that being in or out of the United States, but upon his relation as citizen to the United States and the relation of the latter to him as citizen. The consequence of the relations is that the native citizen who is taxed may have domicile, and the property from which his income is derived may have situs, in a foreign country and the tax be legal, the government having power to impose the tax".

[135] From a terminological perspective it should be recalled that, as already observed in chapter 1 *supra*, there is a difference of meaning between the principle of territoriality in international law and in international tax law. This is why it is distinguished in the dissertation between the principle of territoriality as it stands in international law and the fiscal principle of territoriality, which has relevance in the field of tax law.

torial connection to a certain State to justify unlimited tax liability[136]: if that criterion is fulfilled, domestic laws and tax treaties often grant tax jurisdiction over worldwide income to the State of residence of a taxpayer[137]. With respect to taxpayers with whom a weaker territorial connection exists, *i.e.* non-residents, the host State in most cases taxes only income having its source within its territory. Accordingly, most States tax residents and non-residents[138] differently[139]. The extent of jurisdiction to prescribe in the field of tax law should therefore be discussed in the light of this distinction: tax jurisdiction is analysed first for resident taxpayers (2.3.1.2), then for non-resident taxpayers (2.3.1.3).

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[136] For a similar view considering residence as a territorial criterion, see Kees van Raad, *Non-discrimination in international tax law*, Kluwer law and taxation publishers, 1986, page 22. See also Stef van Weeghel, *Thoughts on territoriality in relation to Dutch corporate tax reform*, Liber Amicorum Jacques Malherbe, Bruylant, 2006, pp. 1129-1141. In the field of private international law, see Jean-Hyppolite-Paulin Niboyet, *L'universalité des règles de solution des conflits est-elle réalisable sur la base de la territorialité?*, Revue Critique de Droit International Privé, 1950-4, p. 519: "la résidence habituelle est un élément territorial, car elle se trouve dans un certain lieu, celui où l'individu possède le centre de ses intérêts".

[137] It is not the purpose of this dissertation to discuss the concept of residence. It can be said that for individuals several criteria may be taken into account such as a permanent home, the centre of vital interests, or the habitual abode. For companies several criteria may also be used, especially the place of incorporation (this criterion is chosen *e.g.* in the US) or the place of management (this criterion is chosen *e.g.* in the UK). A combination of several criteria is also possible (*e.g.* in Germany).

[138] To take the example of Sweden, section 6§4 of the Swedish *Inkomstskattelagen* taxes worldwide income of residents while section 6§11 of the *Inkomstskattelagen* limits taxation to source income for non-residents.

[139] On the hypothesis of implementing an exclusive taxation principle, *i.e.* not combining source-based taxation and residence-based taxation, see Dale Pinto, *Exclusive source or residence-based taxation - is a new and simpler world tax order possible?*, Bulletin for International Fiscal Documentation, July 2007, pp. 277-291. It is concluded that if an exclusive taxation principle could be theoretically justified, such a system would be very hard to implement in practice.

2.3.1.2 Tax jurisdiction on resident taxpayers: is it compatible with international law to tax residents on their worldwide income?

There has been a debate, especially in the past, on the acceptable extent of a State's tax jurisdiction with regard to foreign income[140]. In certain States it has been considered that international law prohibits the taxation of foreign income, thus limiting taxation to income with source within the State's territory. Yet, no support to this view can be found in international law: there is no principle of international law forbidding a State to take into account foreign income when taxing residents[141]. As described *supra*, international law does not set clear limits on a State's jurisdiction to prescribe. The principles enshrined in the *Lotus* case are of general nature and nothing indicates that they should not be applicable to tax law. A State may therefore tax foreign income of a resident or take into account foreign elements when determining the tax base or the tax rate of a resident.

An interesting example is the *Barclays*[142] case, in which the Supreme Court of the US was to rule on the worldwide reporting method in California. The worldwide reporting method apportioned worldwide income of a group of companies to California according to a formula based on sales, assets and payroll. This means that foreign tax subjects' foreign income was likely to be included in the tax base of a resident of California. Many States protested and put pressure on the US Federal Government to convince the State of California to refrain from such a taxation. The US Supreme Court eventually did not find the Californian worldwide reporting system contrary to international law, although it did not apply the arm's length principle and

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[140] See *e.g.* Enrique Piedrabuena, *The Model Convention to avoid double income taxation in the Andean Pact*, Bulletin for International Fiscal Documentation, February 1975, pp. 51-58; François Gendre, *The treatment of investment income under the Andean Pact Model Convention*, Bulletin for International Fiscal Documentation, February 1975, pp. 59-64.

[141] See Klaus Vogel, *Klaus Vogel on double taxation conventions*, Kluwer Law International, third edition, 1997, para. 7, p. 11: "No 'principle of State of source taxation' ('territoriality principle') of international law prohibits application of domestic law for domestic purposes to situations arising in foreign countries, including the taxation of foreign income".

[142] US Supreme Court, 20 June 1994, case 92-1384, *Barclays Bank plc v Franchise Tax Board of California*.

resulted in a very extensive tax jurisdiction. Consequently, the *Barclays* case illustrates the acceptance by the US Supreme Court of the taxation of foreign business income, even applied at a group level[143]. The *Barclays* case confirmed the findings of the US Supreme Court in the earlier *Container*[144] case, in which it was found that the unitary taxation system was compatible with the US Constitution.

A further argument supporting the view that foreign business income may be taxed in the State of residence is related to the theory of objective territoriality, according to which a State is entitled to jurisdiction if an act committed abroad has effects within its territory: a taxpayer's foreign activity may have different types of consequences on the State of residence, such as higher public expenses or lower public revenues[145]. It may also create tax planning opportunities resulting in erosion of the tax base. Therefore, the theory of objective territoriality may justify the taxation of foreign business income. Two traditional taxation principles, although not being part of binding international law, point to the same conclusion: the ability-to-pay principle indicates that a taxpayer should be taxed in accordance with its capacity to pay taxes, which is often concentrated in the State of residence[146]. Besides, the State of residence is often the State where a taxpayer

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[143] The Californian worldwide reporting method was, however, modified through federal intervention.

[144] US Supreme Court, 27 June 1983, case 81-523, *Container Corporation of America v Franchise Tax Board of California*.

[145] For example, to be competitive on a foreign market, it may be necessary to grant incentives to carry out research and development activities. Such incentives can be financed by tax credits. The State of residence may also grant temporary or definitive relief for foreign losses incurred on the foreign market during the start-up phase.

[146] For an example regarding pensions, see para. 17 of the Commentary to article 18 of the OECD Model Tax Convention, 2010: "the State of residence is in a better position to provide for adequate taxation of pension payments as it is easier for that State to take into account the worldwide income, and therefore the overall ability-to-pay tax, of the recipient so as to apply appropriate rates and personal allowances. By contrast, the source taxation of pensions may well result in excessive taxation where the source State imposes a final withholding tax on the gross amount paid. If little or no tax is levied in the residence State (*e.g.*

uses most public infrastructures, in which case the benefit principle indicates that this State should be entitled to tax a more significant part of the taxpayer's income.

Consequently, these different arguments indicate that it is in accordance with international law to tax residents on their worldwide income[147]. Still, some countries tax business income exclusively on a source basis, in which case residence is not a relevant criterion. A couple of States, particularly some Latin American countries and France, favour corporate taxation at source irrespective of whether the taxpayer is a resident or a non-resident[148]. Since the Montevideo conference in 1956, many Latin American countries considered that international law limits jurisdiction to prescribe in the field of tax law to income having its source within the territory[149]. This

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because of available allowances), the pensioner may not be able to claim a tax credit in the residence State for the tax paid abroad. For a comment on the 2010 update of the OECD Model Tax Convention see Mary Bennett, *La mise à jour 2010 du modèle de convention fiscale de l'OCDE*, Revue de Droit Fiscal, 30 September 2010, pp. 18-22.

[147] This raises the question of determining from which threshold the taxpayer is considered connected enough for his State of residence to exercise tax jurisdiction over worldwide income. This aspect is discussed *infra*, at 2.3.2.

[148] Beside Latin American countries and France, some other States apply or did apply exclusively taxation at source in their tax laws. Klaus Vogel named Argentina, Hong Kong, Uruguay, Brazil and France as reporting countries of the 1984 IFA congress that applied exclusively taxation at source. See Klaus Vogel, General IFA Report, *Cahiers de Droit Fiscal International, Fiscal obstacles to the international flow of capital between a parent and its subsidiary*, vol. 69a, 1984, p. 107. Angel Schindel and Adolfo Atchabahian in the General Report for the 2005 IFA congress cited Antonio Hugo Figueroa who in 2003 enumerated the following countries as applying exclusively taxation at source in their tax laws: Bolivia, Costa Rica, El Salvador, Guatemala, Hong Kong, Kenya, Malaysia, Nicaragua, Panama, Paraguay, Singapore and Uruguay: see Angel Schindel, Adolfo Atchabahian, General IFA Report, Cahiers de Droit Fiscal International, *Source and residence: new configuration of their principles*, vol. 90a, 2005, p. 40, footnote 58.

[149] Enrique Piedrabuena, *The Model Convention to avoid double income taxation in the Andean Pact*, Bulletin for International Fiscal Documentation, February 1975, pp. 51-58; François Gendre, *The treatment of investment income under the Andean Pact Model Convention*, Bulletin for International Fiscal Documentation, February 1975, pp. 59-64.

view was expressed in the model tax treaty elaborated by the Andean group[150] and was strongly followed in the domestic law of most Latin American countries until the 1980's[151]. Such an exclusive taxation at source did not convince many Latin American States in the long run[152]. Several countries moved to taxation of worldwide income for residents, *e.g.* Brazil[153] and Argentina[154]. Some Latin American countries still tax exclusively source income[155] and the Andean group adopted in 2004 an updated model tax treaty[156], but the Andean model tax treaty has a very limited extent since

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[150] Group originally constituted of Bolivia, Colombia, Ecuador, Peru and Venezuela. Venezuela left the Andean group in 2006. Panama has been granted the status of observer since 1983. Since 7 July 2005, countries that form MERCOSUR (Argentina, Brazil, Paraguay and Uruguay) have been granted the status of associate members.

[151] In 1980, out of 18 Latin American countries, only five applied the worldwide principle: Chile, Colombia, Honduras, Mexico and Peru. See Edison Gnazzo and Enrique Piedrabuena, *Legislation in Latin American countries and criteria applicable for the taxation of income*, Bulletin for International Fiscal Documentation, 1980, p. 379.

[152] See Leif Mutén, *Will case law do?*, *in* A vision of taxes within and outside European borders, Festschrift in honor of Prof. Dr. Frans Vanistendael, Kluwer Law International, 2008, p. 660.

[153] See Rubens Branco, Report for Brazil, Cahiers de Droit Fiscal International, *Source and residence: new configuration of their principles*, vol. 90a, 2005, p. 205.

[154] See Adolfo Atchabahian, *Argentina's tax treaty network and the distinctive features of its treaties*, Bulletin for International Fiscal Documentation, June 2001, p. 226; see also Antonio Hugo Figueroa, *International double taxation: general reflections on jurisdictional principles, model tax conventions and Argentina's experience*, Bulletin for International Fiscal Documentation, August/September 2005, p. 383.

[155] According to data collected in the IBFD database on 1 March 2011, Bolivia, Costa Rica, the Dominican Republic, El Salvador, Guatemala, Nicaragua, Panama, Paraguay and Uruguay tax business income on a source basis without taking into account foreign business income, whether positive or negative.

[156] See in particular article 3 of the Andean group income and capital tax treaty, signed on 4 May 2004: "independientemente de la nacionalidad o domicilio de las personas, las rentas de cualquier naturaleza que éstas obtuvieren, sólo serán gravables en el País Miembro en el que tales rentas tengan su fuente productora, salvo los casos de excepción previstos en esta Decisión. Por tanto, los demás Países Miembros que, de conformidad con su legislación interna, se atribuyan potestad de gravar las referidas rentas, deberán considerarlas como exonera-

most tax treaties between Latin American States and non-Latin American States are rather drafted on the basis of the OECD Model Tax Convention[157]. In addition, the adoption of anti-avoidance measures leans towards an extended tax jurisdiction of the State of residence. The doctrine supporting exclusive source taxation is, therefore, no longer prevailing in Latin America.

France is known for taxing corporate income only to the extent that it is sourced[158] on the French territory: section 209-I of the *Code général des impôts* provides that only activities carried out in France are taxable in this country, unless a tax treaty provides otherwise[159]. As a consequence, the place of business determines whether taxes will be paid in France, irrespective of residence[160]. Profits earned abroad are in principle not taxable, nor are losses deductible. However, it is not entirely correct that France taxes corporate income only to the extent that it is sourced on the French territory,

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das, para los efectos de la correspondiente determinación del impuesto a la renta o sobre el patrimonio". A multilateral tax treaty based on the Andean model is in force between Bolivia, Colombia, Ecuador and Peru since 1 January 2005.

[157] See *e.g.* the tax treaty concluded on 14 January 1994 between Sweden and Bolivia, which does not implement strict source taxation despite membership of Bolivia in the Andean group.

[158] French tax law does not provide detailed source rules, see section 164B-I indent c) of the French *Code général des impôts*: "Sont considérés comme revenus de source française (…) les revenus d'exploitations sises en France". It is case law and administrative guidelines that define the conditions for profits to be taxable in France. There are three alternative criteria determining if a business activity is carried out in France or abroad: existence of an *établissement* (establishment), of a *représentant* (agent) acting on behalf of the company, or existence of a *cycle commercial complet* (complete business cycle) separate from the other activities of the company.

[159] Section 209-I of the French *Code général des impôts*: "les bénéfices passibles de l'impôt sur les sociétés sont déterminés (…) en tenant compte uniquement des bénéfices réalisés dans les entreprises exploitées en France ainsi que de ceux dont l'imposition est attribuée à la France par une convention internationale relative aux doubles impositions".

[160] See Hervé Lehérissel, *The tax residence of companies*, European Taxation, April/May 1999, p. 157: "In the case of corporate income tax, the concept of a resident entity does not exist in the applicable articles".

with regard to numerous exceptions[161] as well as a tax treaty network highly influenced by the OECD Model Convention[162]. In addition, French resident individuals are taxed on their worldwide income, which undermines the view supported by part of the French doctrine[163] according to which international law would limit tax jurisdiction to income sourced within the French territory.

As a conclusion, States applying a tax jurisdiction limited to source income of residents do so voluntarily: international law does not limit the extent of tax jurisdiction with regard to residents[164]. It is now to be discussed whether international law limits the extent of tax jurisdiction with regard to non-residents.

2.3.1.3 Tax jurisdiction on non-resident taxpayers: is it compatible with international law to tax non-residents on worldwide income?

International law clearly allows that non-residents are taxed on source income: as mentioned *supra*, a consequence of sovereignty is a plenary competence on a State's territory. This competence is also relevant in tax law so

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[161] For example worldwide tax consolidation, deduction of contributions sent to foreign related companies, CFC rules, transfer pricing provisions, *etc.* In certain conditions, according to see section 209 C of the *Code général des impôts,* small and medium-sized enterprises may deduct losses incurred by permanent establishments or foreign subsidiaries, for them to be recaptured once the foreign entity becomes profitable or after five years. For a comment on section 209 C of the French *Code général des impôts*, see Bernard Castagnède, *Précis de fiscalité internationale*, Presses Universitaires de France, third edition, 2010, pp. 553-555.

[162] For an overview of the French rules on the taxation of French companies' foreign business income see Bruno Gouthière, *Les impôts dans les affaires internationales*, Éditions Francis Lefebvre, eight edition, 2010, pp. 115-147; Bernard Castagnède, *Précis de fiscalité internationale*, Presses Universitaires de France, third edition, 2010, pp. 262-296; Daniel Gutmann, *Droit fiscal des affaires*, Montchretien, 2010, pp. 407-496.

[163] For an overview, see Nicolas Melot, *Territorialité et mondialité de l'impôt, étude de l'imposition des bénéfices des sociétés de capitaux à la lumière des expériences française et américaine*, Nouvelle Bibliothèque des Thèses, Dalloz, 2004.

[164] Concurring, see Wolfgang Schön, *International tax coordination for a second-best world (part I)*, World Tax Journal, October 2009, p. 91: "worldwide taxation is customarily accepted under international law".

that a State has an indisputable jurisdiction to levy taxes on income having its source within its territory, irrespective of where the tax subject is resident. No connection is needed with the non-resident tax subject, since a connection with the tax object suffices to exercise tax jurisdiction[165]. Consequently, except when particularly agreed in a tax treaty, the State of source is at liberty to levy taxes on domestic income, design source rules and determine the applicable tax rate.

A more difficult issue is whether non-residents may also be taxed in the State of source on income with foreign source, or if international law prohibits taxation of non-residents on foreign income. At first sight, it may be considered that non-residents should not be taxed on their foreign income. Such a view can be supported by certain taxation principles, particularly the ability-to-pay principle and the benefit principle: the ability-to-pay principle indicates that taxes should be levied in proportion to the capacity to pay taxes, which is generally higher in the State of residence than in the State of source. The State of source should therefore be entitled to a limited tax jurisdiction, since a non-resident has only a limited ability-to-pay taxes in the State of source. The benefit principle leads to a similar conclusion: since a non-resident is likely to utilise the State of source's public infrastructures and resources to a lower extent than a resident, the State of source's public expenses related to a non-resident should be lower than for a resident. As a consequence, the State of source at first sight needs less public revenues to make available public infrastructures to non-residents than to residents.

As discussed *supra*, it has been established since the *Lotus* case that international law does not put clear limits on States' jurisdiction to prescribe. Judge Fitzmaurice tried, in the *Barcelona Traction*[166] case, to make the International Court of Justice rule that international law involves an obligation to exercise jurisdiction with moderation: he argued that international law involves "for every State an obligation to exercise moderation and restraint as to the ex-

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[165] This raises the question of whether international law requires a minimum connection to tax source income of non-residents; this question is dealt with *infra* at 2.3.2.

[166] International Court of Justice, 5 February 1970, *Barcelona Traction*.

tent of the jurisdiction assumed by the courts in cases having a foreign element, and to avoid undue encroachment on a jurisdiction more properly appertaining to, or more appropriately exercisable by, another State"[167]. Such an obligation could be transposed to the taxation context as implying an obligation for the State of source to tax non-residents with moderation, thus not taxing their foreign income in order not to encroach upon other States' sovereignty. The International Court of Justice, with fifteen votes to one, did not follow Judge Fitzmaurice. This solution, in conformity with the *Lotus* case, indicates that international law does not impose an obligation to exercise jurisdiction to prescribe with moderation, irrespective of whether another State's sovereignty is encroached upon by the legislating State.

In taxation, it is submitted that this conclusion implies that a State of source may tax non-residents on their foreign income[168], although such a taxation may add to the tax claims of other States, in particular the State of residence. An example of such a taxation concerns foreign dividends received by a permanent establishment. Article 10 of the OECD Model Tax Convention does not apply to foreign dividends received by a permanent establishment[169], the solution being provided by article 21(2): if a dividend

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[167] *C. cit.*, separate opinion of Judge Sir Gerald Fitzmaurice, para. 70.

[168] For a similar view see Michael Lang, *The Marks & Spencer case - the open issues following the ECJ's final word*, European Taxation, February 2006, p. 60: "The taxation of non-residents is not limited to the territory. It is not disputed that customary international law does not prevent states from taking into account foreign income to determine the tax rate or, as can be seen in the *Saint-Gobain* decision of the ECJ, even the tax base of non-residents". For a contrary view, see Rutsel Silvestre J. Martha, *The jurisdiction to tax in international law - Theory and practice of legislative fiscal jurisdiction*, Kluwer Law International, Series on International Taxation, no. 9, 1989, p. 54; Sjoerd Douma, *The three Ds of direct taxation: disparity, discrimination and double taxation*, European Taxation, November 2006, p. 523.

[169] See para. 8 of the Commentary on Article 10, OECD Model Tax Convention, 2010: "The Article deals only with dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State. It does not, therefore, apply to dividends paid by a company which is a resident of a third State or to dividends paid by a company which is a resident of a Contracting State which are attributable to a permanent establish-

is "effectively connected" to a permanent establishment, article 7 should be applied and "a right to tax is given to the Contracting State in which the permanent establishment is situated"[170]. This means that the State of the permanent establishment may tax foreign dividends received by a permanent establishment, although both the payer and the head office are non-residents. This example illustrates the acceptance by the OECD members of taxation of foreign income earned by a non-resident, thus not considering that international law limits the tax jurisdiction of the State of source to domestic income.

As a result of the above analysis, it is submitted that international law does not prohibit the taxation of non-residents on foreign income. Irrespective of the distinction between residents and non-residents, one may wonder whether international law imposes a minimum connection to exercise jurisdiction to prescribe in the field of tax law.

2.3.2 Does international law impose a minimum connection to exercise tax jurisdiction?

Similarly to authors writing on general international law, tax scholars have since long been debating on whether international law limits a State's jurisdiction to prescribe in the field of tax law through requiring a minimum connection. Instinctively, one may consider that a genuine connection should exist in order for a State to exercise tax jurisdiction. The four experts assigned by the Financial Committee of the League of Nations to study double taxation observed in 1923 that taxation based on "temporary residence"[171] is inadequate: "If a traveller chances to spend a week in a town when the tax collector comes around, there is no good reason why he should be assessed on his entire wealth by this particular town; the relations

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ment which an enterprise of that State has in the other Contracting State (for these cases, see paragraphs 4 to 6 of the Commentary on Article 21)".

[170] Paragraphs 4 and 5 of the Commentary on Article 21(2), OECD Model Tax Convention, 2010.

[171] Taxation based on "temporary residence" supposes that "everyone who happens to be in the town or State may be taxable there". See Report on double taxation submitted to the Financial Committee, League of Nations, document EFS73F19, 5 April 1923.

between him and the government are too slight"[172]. As one may instinctively consider that a genuine connection should be required for exercising tax jurisdiction, it should be determined whether international law imposes such a genuine or minimum connection on States for them to exercise jurisdiction to prescribe in the field of tax law. Although a minimum connection with the tax object and the tax subject is usually found in domestic laws and court judgments, such connections vary greatly between countries[173], the type of tax[174], and may change with time[175]. In addition, such rules are subject-to-tax treaty provisions. Consequently, a first observation is that there is no objectively or universally accepted minimum connection to exercise jurisdiction to prescribe in the field of tax law. Is *some* connection, however, required by international law? This question has been extensively studied in tax literature[176]. Many doctrines have been suggested and discussed, three of which supporting diverging arguments should briefly be

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[172] Report on double taxation submitted to the Financial Committee, League of Nations, document EFS73F19, 5 April 1923.

[173] States have different residence and source rules, *i.e.* the minimum connection for a tax subject to be resident in a State or for a tax subject to be taxable in a source State varies from State to State.

[174] For example, a traveller in transit stopping at an airport is likely to pay consumption taxes on products bought at the airport. The territorial connection is enough to levy consumption taxes. In contrast, the same traveller will probably not be taxed on his income or capital, not even the proportionate part of his income earned during the stay on the host State's territory, as the connection is likely to be considered to be too weak.

[175] For example, source rules evolve so as to take into account technological progress and digitization. See Niv Tadmore, *Source taxation of cross-border intellectual supplies - concepts, history and evolution into the digital age*, Bulletin for International Fiscal Documentation, January 2007, pp. 2-16.

[176] This question was mostly dealt with in earlier tax literature. See the bibliography *in* Rutsel Silvestre J. Martha, *The jurisdiction to tax in international law - Theory and practice of legislative fiscal jurisdiction*, Kluwer Law International, Series on International Taxation, no. 9, 1989. See also the bibliography *in* Nicolas Melot, *Territorialité et mondialité de l'impôt, étude de l'imposition des bénéfices des sociétés de capitaux à la lumière des expériences française et américaine*, Nouvelle Bibliothèque des Thèses, Dalloz, 2004.

accounted for: the realistic doctrine, the doctrine of closeness connection, and the economic allegiance doctrine[177].

- The realistic doctrine asserts that international law imposes no limits on a State's tax jurisdiction. The realistic doctrine considers that a State's sovereignty is unlimited: no minimum threshold would be necessary to be able to legislate and levy taxes. Only practical limitations would force States to limit their tax claims[178]. The realistic doctrine adopts the prohibitive approach referred to *supra* and based on the *Lotus* case.

- The doctrine of closeness connection purports that a genuine or reasonable link is required by international law. International law would require a minimum legal connection for a State to be entitled to a taxing right[179], either with the tax subject or with the tax object[180].

- Last, the economic allegiance doctrine[181] departs from the requirement of a formal legal connection and focuses on economic

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[177] For an overview of these schools of thoughts, see A.H. Qureshi, *The freedom of a State to legislate in fiscal matters under general international law*, Bulletin for International Fiscal Documentation, January 1987, pp. 14-15.

[178] See Martin Norr, *Jurisdiction to tax and international income*, Tax Law Review, March 1962, pp. 431-462.

[179] See Frederick Alexander Mann, *The doctrine of international jurisdiction revisited after twenty years*, Collected courses of the Hague academy of international law, 1984, III, p. 20: "as a rule jurisdiction extends (and is limited) to everybody and everything within the sovereign's territory and to his nationals wherever they may be. (…) the principle as defined is universal in the sense that prima facie it applies to all legislation and all State intervention derived or sanctioned by the competent authority".

[180] Rutsel Silvestre J. Martha, *The jurisdiction to tax in international law - Theory and practice of legislative fiscal jurisdiction*, Kluwer Law International, Series on International Taxation, no. 9, 1989, pp. 46-47, with further references at footnote 214. The author mentions that traditionally, "such connection is (juristically) deemed to exist when one is subject either to the 'personal sovereignty' or the 'territorial sovereignty' of a State".

[181] *Op. cit.*, p. 22, with further references at footnotes 97 and 98.

> allegiance due to States involved with an economic activity. This doctrine entitles a State to a taxing right depending on the economic connections between this host State and the tax subject. No formal territorial connection with the tax object would be required *per se*[182].

In my opinion, the legal reality observed in current international tax practice dismisses two of these doctrines: the doctrines of economic allegiance and of closeness connection. Economic allegiance finds no application in practice, since each State determines taxable income independently, without necessarily paying attention to whether it infringes on other States' tax claims. No State waives its tax claims considering that other States are more legitimately entitled to tax regarding economic allegiance due by a taxpayer: this doctrine, which assumes that economic allegiance is due to exercise tax jurisdiction, is not legally convincing[183] and does not correctly reflect reality. Jurisdiction to tax can therefore not be grounded on the doctrine of economic allegiance.

The doctrine of closeness connection may appear convincing *prima facie*, since it is instinctive[184] that "jurisdiction requires some link, some nexus or minimum connection, between the country asserting the jurisdiction and

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[182] This theory was suggested by the experts invited by the League of Nations to formulate the "general principles as the basis for an international convention to remove the evil consequences of double taxation": the experts considered that "A part of the total sum paid according to the ability of a person ought to reach the competing authorities according to his economic interest under each authority. The ideal solution is that the individual's whole faculty should be taxed, but that it should be taxed only once, and that liability should be divided among the tax districts according to his relative interests in each": see Report on double taxation submitted to the Financial Committee, League of Nations, document EFS73F19, 5 April 1923.

[183] See Nicolas Melot, *Essai sur la compétence fiscale étatique (1re partie)*, Journal du Droit International, 2004-3, p. 764: "la notion d'allégeance économique est, comme sa denomination l'indique, un concept économique, développé par des économistes, qui ne repose en rien sur des fondements juridiques".

[184] Or even "axiomatic": see A.H. Qureshi, *The freedom of a State to legislate in fiscal matters under general international law*, Bulletin for International Fiscal Documentation, January 1987, p. 19.

the taxpayer or the income sought to be taxed"[185]. In addition, the fact that the Permanent Court of International Justice did find it necessary to assess the legitimacy of the jurisdictional claims of Turkey in the *Lotus* case supports the view that international law seems to require some connection to exercise jurisdiction to prescribe.

However, the doctrine of closeness connection is not totally convincing, because it cannot be determined a common minimum connection to exercise tax jurisdiction. Indeed, the connecting factors for the levy of taxes vary between States and the type of tax at hand, evolve throughout the different periods of time, and are dependent on tax treaties. In addition, the International Court of Justice considered in the *Barcelona Traction* case that international law does not impose a requirement of reasonableness to exercise jurisdiction. It is true that some national courts may find that international law requires a sufficient link to exercise taxing rights[186], but nothing says that their findings will also be felt as binding by other States: it is the right of a national court or of a lawmaker to be more demanding than others and require that a certain threshold is met to exercise taxing rights. On the other hand, a national court or a lawmaker may not require a minimum connection, or may require a connection that other national courts or lawmakers would not find sufficient to exercise jurisdiction to prescribe.

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[185] See Martin Norr, *Jurisdiction to tax and international income*, Tax Law Review, March 1962, pp. 431-432.

[186] See for example Frederick Alexander Mann, *The doctrine of international jurisdiction revisited after twenty years*, Collected courses of the Hague academy of international law, 1984, III, pp. 29-30, who refers to a German judgment from 22 March 1983 considering that "The imposition of taxes upon a foreigner living abroad, which is founded upon a set of facts wholly or partly implemented abroad requires sufficiently appropriate points of contact for taxation by the taxing State to prevent interference, contrary to public international law, with the foreign State's claims to sovereignty. These points of contact and their factual closeness must, from the point of view of public international law, satisfy a minimum of reasonableness. (…) The legal possibility of imposing taxes upon foreigners is subject to clear limits by the necessity of contact, for instance, with nationality, establishment, residence or sojourn, the realization of a set of taxable facts or the achievement of a legally relevant result within the State".

An interesting example is provided by the *Agassi v Robinson*[187] case, in which the UK tax authorities claimed a taxing right over a share of sponsorship payments proportionate to the participation of a sportsman in a UK sport competition. Payments were made by non-resident sport manufacturers to a non-resident company owned by the sportsman, who was neither resident nor national of the UK. The House of Lords found that taxes were due, in particular with regard to the ease with which taxes could be avoided otherwise. This judgement reached an extensive outcome as the connection between the sportsman and the UK territory was very weak. The House of Lords reached a more far-reaching solution than what is normally taxable in the State of source under article 17 of the OECD Model Tax Convention, as the income was not sourced in the UK.

Is the *Agassi v Robinson* decision, in its jurisdictional aspect, contrary to international law? Only the International Court of Justice could say so. So far, case law from this international court does not require any explicit minimum connection to exercise jurisdiction nor does it require that jurisdiction is exercised with moderation. In addition, it is quite possible that another supreme court would not have found the defendant liable to taxes in a similar case, or that another legislation would have set even less demanding criteria to establish tax liability. In the absence of a decision by the International Court of Justice, one cannot conclude that the House of Lords violated international law. This judgement shows that the doctrine of closeness connection is not convincing, at least if one tries to identify a common or customary requirement of connection to exercise jurisdiction. No close connection existed between the UK and the sportsman in the *Agassi v Robinson* case, which did not prevent the House of Lords from ruling as it did. As a consequence, solely the realistic doctrine seems to correctly reflect the current status of international law.

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[187] House of Lords, 17 May 2006, (2006) UKHL 23, *Agassi v her Majesty's Inspector of Taxes*. For comments, see Christopher Norfolk, Agassi v Robinson*: territorial limitation on withholding obligation – some confusion in the House of Lords*, British Tax Review, 2006-6, pp. 684-687. This author observed at p. 684 that in previous case law of the House of Lords, "having some form of UK tax presence was seen as necessary". See also Navraj Singh Ghaleigh, Agassi v Robinson*: caution! Intentionalism at work*, British Tax Review, 2006-6, pp. 687-692.

It could be argued that customary international tax law imposes requirements on States, particularly as to a minimum threshold to be entitled to tax jurisdiction[188]. For example, it is quite common to tax business profits of non-resident companies only if a permanent establishment is situated in the State of source and as much of the profits as is attributable to this permanent establishment. Is the permanent establishment threshold a binding requirement of customary international tax law? Probably not[189]. Definitions of the permanent establishment criterion vary greatly and it may be subject to different interpretations. The definition suggested in the OECD Model Tax Convention cannot be considered as binding, because the OECD Model Tax Convention is only a suggestion:

- First, tax treaties may depart from this model or be based on other models.

- Second, the OECD Model Tax Convention is constantly evolving with time. On the other hand, a custom can hardly be binding if it does not remain stable over a certain period of time. It is indeed the purpose of the OECD to be a forum that adapts tax concepts to business realities. It would be inconsistent with the purpose of

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[188] For an analysis on the role and the binding power of customary international law on international tax law, see Reuven S. Avi-Yonah, *International tax as international law – an analysis of the international tax regime*, Cambridge Tax Law Series, 2007.

[189] Concurring, see Nicolas Melot, *Territorialité et mondialité de l'impôt, étude de l'imposition des bénéfices des sociétés de capitaux à la lumière des expériences française et américaine*, Nouvelle Bibliothèque des Thèses, Dalloz, 2004, p. 238: "La notion d' « établissement » viendrait caractériser cette « activité suffisante », c'est-à-dire, sous peine de nous répéter, un seuil de pénétration dans la vie économique des États de la source suffisant pour légitimer leur droit d'imposer les revenus effectivement rattachables à un tel « établissement ». La théorie de l'équivalence paraît fonder l'existence d'un tel seuil minimal d'imposabilité. Pourtant, le critère de l'allégeance économique n'est selon nous en rien un chef de compétence juridique. Aussi faut-il admettre qu'en vertu de sa compétence fiscale normative chaque État peut imposer tout revenu, actif ou passif, de source nationale sans qu'un quelconque seuil d'imposabilité ne vienne limiter son droit d'imposer ces revenus".

the work of the OECD to consider that its old work is binding, thus hampering the updating process.

- Third, the OECD Model Tax Convention may be subject to criticisms or reservations, thereby preventing any attempt to necessarily consider its work as binding customary international tax law.

- Fourth, it would be difficult to determine the scope of binding OECD provisions: would it apply only to OECD members? Or should non-Members concluding treaties based on the OECD model also be subject to its provisions?

In my opinion, the necessary conclusion of the above analysis is that there is no legally binding definition of a permanent establishment as a consequence of the drafting of the OECD Model Tax Convention. As a conclusion, this example supports the view according to which it cannot be argued that customary international law imposes a precise minimum connection on States when they exercise jurisdiction to tax business profits[190]. At most, one may observe that it is usually required the existence of a permanent establishment for the State of establishment to tax business profits of non-resident companies, without however customary international tax law defining such a permanent establishment.

Last, could it not be argued that most courts and lawmakers still require *some* connection, and that this requirement is, as such, a binding custom? This view may be supported by the *Lotus* case, since the Permanent Court of International Justice found it relevant to assess whether the Turkish claim was in accordance with international law. The Court found the Turkish claim in accordance with international law as long as a connection ex-

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[190] For a contrary view see Reuven S. Avi-Yonah, *International tax as international law – an analysis of the international tax regime*, Cambridge Tax Law Series, 2007, p. 5: "Can a country simply decide to tax nonresidents who have no connection to it on foreign-source income? The answer is clearly no, both from a practical perspective and, I would argue, from a customary international law perspective".

isted between the offence and the Turkish State[191]. In addition, lawmakers do require a minimum connection to exercise tax jurisdiction through determining the criteria for the levy of taxes. It has also been argued that international law imposes an obligation "to ensure the minimum standard (…) in favour of foreigners"[192]. However, no legal argument convincingly supports this "minimum standard", which has not either been discussed by the International Court of Justice. A defined minimum connection cannot be established with regard to the current state of international law. It can only be concluded that international law may require *some* connection to exercise jurisdiction, *i.e.* in the absence of any connection it seems that a State would not be entitled to tax jurisdiction: in the *Lotus* case it was necessary that the offence produced effects on the Turkish vessel to entitle Turkey with jurisdiction[193].

As a conclusion, no internationally accepted minimum connection is required from and binding on States to exercise jurisdiction to prescribe in the field of tax law[194], but at the same time it seems that jurisdiction may

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[191] Permanent Court of International Justice, 7 September 1927, Ser. A, No 10, *S.S. Lotus*: "once it is admitted that the effects of the offence were produced on the Turkish vessel, it becomes impossible to hold that there is a rule of international law which prohibits Turkey from prosecuting Lieutenant Demons because of the fact that the author of the offence was on board the French ship".

[192] A.H. Qureshi, *The freedom of a State to legislate in fiscal matters under general international law*, Bulletin for International Fiscal Documentation, January 1987, p. 16.

[193] Permanent Court of International Justice, 7 September 1927, Ser. A, No 10, *S.S. Lotus*: "once it is admitted that the effects of the offence were produced on the Turkish vessel, it becomes impossible to hold that there is a rule of international law which prohibits Turkey from prosecuting Lieutenant Demons because of the fact that the author of the offence was on board the French ship".

[194] For a similar view, see Arnold A. Knechtle, *Basic problems in international fiscal law*, Kluwer, 1979, p. 37: "Up to the present there has been no internationally recognized principle in public international law which limits the sovereignty of States in fiscal matters". See also Martin Norr, *Jurisdiction to tax and international income*, Tax Law Review, March 1962, p. 431: "No rules of international law exist to limit the extent of any country's tax jurisdiction". For a different opinion see Michael Lang, *Introduction to the law of double taxation conventions*, Linde/IBFD, 2010, p. 23, para. 1: "Tax sovereignty, however, is not unlimited. Not all situa-

not be exercised in the lack of any connection. A consequence of the absence of determined limits on States' tax jurisdiction is the overlap of concurring claims by different States asserting jurisdiction over the same tax subject or tax object. The question is therefore raised whether international law regulates such overlapping tax claims.

2.3.3 Overlaps between tax claims of several States: does international law prohibit double taxation?

Does international law tolerate overlaps between tax claims of several States? This raises the question of whether or not double taxation is compatible with international law. In that respect, it has been observed that "customary international law does not forbid double taxation (…). Double taxation, resulting from the interaction of the domestic laws of two (or more) States, will be consistent with international law as long as each individual legislation is consistent with international law"[195]. If international law would not tolerate double taxation, it would imply that one or more States should partly or totally give up their taxing rights, which is not required in the current state of international law. In addition, forbidding double taxation would suppose choosing which State should give up its taxing rights, something that would breach the fundamental principles of sovereignty, independence and equality of States.

The effects of double taxation are not desirable, though. States try to mitigate it, whether unilaterally or by way of double taxation conventions. The way double taxation is mitigated may involve a limitation of the taxing rights of either or both States[196]. However, there is no obligation for one State to eliminate double taxation to let the other exercise a primary tax ju-

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tions can be taxed. There must either be a personal or an objective nexus, or connection, between the taxpayer and the State".

[195] Klaus Vogel, *Klaus Vogel on double taxation conventions*, Kluwer Law International, third edition, 1997, para 8, p. 12.

[196] A tax treaty may allocate taxing rights exclusively to one State (*e.g.* royalties are taxed exclusively in the State of residence according to the OECD Model Tax Convention) or to both (*e.g.* the taxation of dividends and interests according to the OECD Model Tax Convention).

risdiction. The view according to which the State of source is entitled to a priority[197] is supported neither by international law[198] nor by customary international tax law[199]. This can be illustrated by the following example: a national of State A, resident in State B and owning an asset in State C, moves to State D. These four countries may claim tax jurisdiction over a capital gain, without the overlap of tax claims being contrary to international law[200].

After having demonstrated that international law allows States to tax foreign income, it should be considered whether States may refuse to do so.

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[197] See *e.g.* Opinion of Advocate General Geelhoed, delivered on 23 February 2006, case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue*, para. 51: "Under international tax law, the generally accepted rule of taxation priority is that of 'source country entitlement': that is, priority of taxation right over source country income lies with the State of source. Insofar as juridical double taxation is to be relieved, therefore, this is in principle a matter for the home State, which can choose whether and how it wishes to provide such relief".

[198] See Klaus Vogel, *Klaus Vogel on double taxation conventions*, Kluwer Law International, third edition, 1997, para 8, p. 12: "customary international law does not forbid double taxation (…). Double taxation, resulting from the interaction of the domestic laws of two (or more) States, will be consistent with international law as long as each individual legislation is consistent with international law".

[199] For a similar view considering that the State of source is not entitled with a primary tax jurisdiction, see Mattias Dahlberg, *The European Court of Justice and direct taxation: a recent change of direction?*, *in* Krister Andersson, Eva Eberhartinger and Lars Oxelheim, *National tax policy in Europe – to be or not to be?*, Springer, 2007, pp. 181-182.

[200] Concurring, see Nicolas Melot, *Territorialité et mondialité de l'impôt, étude de l'imposition des bénéfices des sociétés de capitaux à la lumière des expériences française et américaine*, Nouvelle Bibliothèque des Thèses, Dalloz, 2004, p. 387: "L'obligation de supprimer la triple imposition qui résulte des situations triangulaires ne s'impose à aucun des États dès lors que les doubles ou multiples impositions ne sont, aujourd'hui encore, nullement contraires au droit international public".

2.3.4 May States refuse to take into account foreign elements when exercising their taxing powers?

The above developments show that States may tax foreign income, both for residents and non-residents. As a consequence of the right to tax foreign income, States should *a fortiori* be free not to tax foreign income or take into account foreign elements. Indeed, the right to exercise tax jurisdiction is based on sovereignty, which in its turn guarantees that a State is independent from other States. Therefore, the same arguments that plead for a right to take into account foreign elements indicate that a State is not obliged to do so.

The Permanent Court of International Justice clearly indicated in the *Lotus* case that States are sovereign and, as such, are independent on their territory. An author has observed that States are "not subject to control by other States"[201]. In the field of taxation, this consequence of sovereignty is in my view to be interpreted as a fundamental right to tax independently from taking into account what is related to other States. This fundamental principle of independence is illustrated by a famous formula in a British case dating back to 1775, in which Lord Mansfield held that "no country ever takes notice of the revenue laws of another"[202]. When it comes to determining the tax base in relation to foreign elements, a State's independence implies that it is not obliged to take into account foreign elements: a State is not obliged to tax foreign positive income, nor is it obliged to grant relief for foreign losses or costs. Consequently, a State has the right to de-

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[201] Colin Warbrick *in* Malcolm D. Evans, *International law*, Oxford University Press, 2003, p. 231.

[202] This formula was stated by Lord Mansfield: see King's Bench, 5 July 1775, 1 Cowp. 341, 98 Engl. Rep. pp. 1120-1122, *Holman v. Johnson*. For a comment, see Jürgen Basedow, Jan von Hein, Dorothee Janzen, Hans-Jürgen Puttfarken, *Foreign revenue claims in European courts*, Yearbook of private international law, 2004-6, pp. 5-6. This formula is also found in recent cases, which demonstrates that it is still adhered to, at least within Anglo-Saxon jurisdictions. See *e.g.* House of Lords, 20 January 1955, case 1955 AC 491, *Government of India v. Taylor*; US Court of Appeals, Fourth Circuit, 18 July 2003, case 01-4463, *United States of America v. David B. Pasquantino*.

sign freely its domestic tax base without having to pay attention to foreign items of income.

It should be kept in mind that domestic legal principles, like the principle of equal treatment, may require that a State grants the same advantages in domestic and foreign situations. A tax treaty may also require a similar treatment as part of a non-discrimination clause. However, such requirements are not imposed by international law.

2.4 Conclusion

The conclusion is divided in two parts: first, the findings of this chapter are summarised and illustrated by a four-point scale representing the acceptability of tax jurisdiction with regard to different levels of connection between a State and a tax object or a tax subject (2.4.1). Second, as a transition to the other chapters of the thesis, Member States' fiscal sovereignty with regard to EU law is discussed (2.4.2).

2.4.1 Summary of the findings and illustration of the acceptability of tax jurisdiction with regard to different levels of connection between a State and a tax object or a tax subject

Absent a tax treaty, it can be concluded that States' sovereignty implies jurisdiction to tax both residents and non-residents on their worldwide income. But at the same time, a State is not obliged to take into account foreign elements. These characteristics are linked to each other and imply the absence of hierarchy between claims from different States: overlaps resulting from concurring tax claims are a natural consequence of the current state of international law.

An obvious conclusion from this study is that international law results in a misbalance between a State's rights and obligations. Jurisdiction to prescribe in the field of tax law is not clearly limited by international law, whereas a State is subject to the only obligation of respecting other States' sovereignty through not enforcing its tax rules abroad. Accordingly, international law does not oblige States to tax profits and losses in a symmetrical

way[203]. For example, foreign tax subjects may be taxed through CFC rules while their losses are not deducted in the home State. International law is not influenced by these assymetrical consequences and it is not its purpose to have such an influence.

International law also recognises States' sovereignty: to impose fair tax rules or to require a minimum connection to exercise jurisdiction to prescribe in the field of tax law would precisely breach this sovereignty. Whether or not tax rules are fair[204] is therefore not a matter of international law. In practice, States often limit their tax jurisdiction either unilaterally or by means of double taxation conventions, through *e.g.* requiring the presence of a permanent establishment as a minimum connection to exercise source taxation on business profits. Such limitations are voluntary, *i.e.* they are not imposed by international law[205]. Rather, they are motivated by considerations of practicality and international tax policy.

However, in practice, taxes are often levied on the basis of a connection between a State and either a tax subject or a tax object. Indeed, although States enjoy a wide tax jurisdiction according to international law, they do

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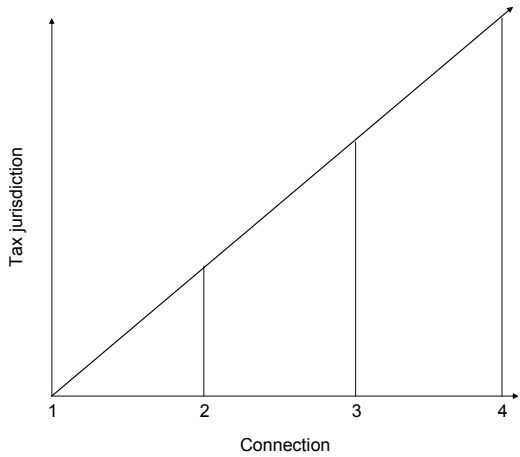
[203] Asymmetry can also be observed in other fields of the law. An example is between social security contributions and taxes: a State may tax certain persons to whom social advantages are denied or conversely. For a discussion from a Swedish perspective, see Mats Tjernberg, *Frågan om kongruens mellan rätten att erhålla vissa sociala förmåner och skyldigheten att betala skatt*, Skattenytt, 2009-4, pp. 214-224.

[204] For a discussion on fairness in international tax law, see Nancy H. Kaufman, *Fairness and the taxation of international income*, Law & Policy in International Business, 1998, pp. 145-203. See also Michael J. Graetz, *Taxing international income: inadequate principles, outdated concepts, and unsatisfactory policies*, Tax Law Review, 2001-3, p. 306: "thinking about fairness in international taxation complicates both analysis and policymaking".

[205] For a contrary view considering that customary international law may impose limits on a State's jurisdiction, see Reuven S. Avi-Yonah, *International tax as international law*, Tax Law Review, summer 2004, p. 498. This author takes the example of the original US CFC rules, which at the time of their entry into force taxed dividends deemed distributed, not directly the profits of the foreign company, because the US legislator considered that taxation of foreign subjects on their foreign income would breach international law.

exercise it with some moderation. Such a moderation in tax claims has, for example, been expressed by the OECD members in the Transfer Pricing Guidelines: "countries need to reconcile their legitimate right to tax the profits of a taxpayer based upon income and expenses that can reasonably be considered to arise within their territory with the need to avoid the taxation of the same item of income by more than one tax jurisdiction"[206]. Therefore, tax jurisdiction is often exercised depending on the connection between a State and either a tax subject or a tax object.

Different types of connections can be represented on a four-point scale, where point 1 represents the absence of any connection, point 2 represents a weak connection, point 3 represents a strong connection, and point 4 represents a very strong connection.



For each of these four points, States usually exercise different levels of tax jurisdiction, as described subsequently:

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[206] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, preface, para. 4.

- First, point 1 on the scale describes the absence of any connection, with either the tax object or with the tax subject. This corresponds to the tax jurisdiction exercised by State A with regard to a non-national, resident in State B, on income having its source outside State A, in the absence of any connection to State A. International law may forbid such a taxation, according to an *a contrario* reading of the findings of the Permanent Court of International Justice in the *Lotus* case, because the Permanent Court of International Justice did assess the validity of the Turkish claim[207]. However, one should bear in mind that the ICJ did not find a requirement to exercise jurisdiction with moderation in the *Barcelona Traction* case, so it cannot be ascerted that taxes levied in situations corresponding to point 1 on the scale are incompatible with international law.

- Point 2 on the scale corresponds to the existence of a weak connection with either the tax subject or the tax object. The taxpayer is neither a national nor a resident of State A, nor has the income its source there. In principle, State A exercises no tax jurisdiction over the income, as in the situation described at point 1 on the scale. However, a weak connection with State A exists, which may lead this State to consider that it is entitled to a limited tax jurisdiction. Tax jurisdiction exercised in the presence of a weak connection can exist in different situations, as for example in the *Agassi v Robinson* case. Another example of a weak territorial link is the holding of shares in foreign companies: residence of the shareholder is a territorial connection that may permit to tax foreign group members, either through cross-border group consolidation[208] or CFC rules[209].

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[207] This argument, however, is solely drawn *a contrario*. That the Permanent Court of International Justice did assess the Turkish claim does not necessarily mean that it considers that a connection is compulsory to exercise jurisdiction. The Permanent Court of International Justice may have wanted to elaborate on the issue of jurisdiction as the *Lotus* case was the first of its kind to be ruled by this court. See Michael Lang, *Introduction to the law of double taxation conventions*, Linde/IBFD, 2010, p. 23, para. 2: "It is only when neither the person nor the transaction has any connection with the taxing state that tax cannot be levied".

[208] Cross-border group consolidation by the parent company consists in consolidating (part of) the group's income despite the fact that foreign group members are legal subjects on

In these cases, tax jurisdiction is usually exercised with some moderation[210], *e.g.* through granting a tax credit when taxing CFCs. However, the International Court of Justice in the *Barcelona Traction* case did not find an obligation to exercise jurisdiction with moderation, so no precise minimum connection can be established. Double taxation is also likely to happen in such situations.

- Point 3 on the scale corresponds to a strong connection. A strong connection may exist with the tax subject (on the basis of residence or nationality) or the tax object (source of income).

- Last, point 4 on the scale corresponds to the reunion of a strong connection with both the tax subject and the tax object. An example is the situation in which a resident earns domestic income.

This dissertation focuses only on points 2 and 3 of this four-point scale: situations with no connection for the exercise of tax jurisdiction and domestic situations are not studied in this thesis. The situations described on points 2 and 3 are the areas where Member States' tax jurisdiction raises most compatibility issues with regard to the objective of achievement of the internal market, because States levy taxes in an uncoordinated way. Such a taxation is clearly acceptable under international law, but may not be com-

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their own and foreign residents. Examples of States applying such consolidated cross-border group taxation are Italy, Austria, France and Denmark. Although the rules in these countries differ greatly, the principle remains the same: the State of the parent company exercises tax jurisdiction despite the subsidiary having a foreign residence and earning foreign-sourced income.

[209] While the first CFC rules implemented in the US in 1962 taxed undistributed dividends, current CFC rules in some twenty countries often tax directly foreign income of foreign subsidiaries. The territorial connection is still residence of the shareholder. In contrast to group consolidation, CFC rules are not optional but compulsory.

[210] For group consolidation, moderation would imply that the consolidating State has a limited tax jurisdiction only. The limited tax jurisdiction may consist in strict conditions for group members to be consolidated, an obligation to grant a tax credit for taxes paid abroad, an obligation to apply for an agreement with the tax authorities, optionality, *etc.*

patible with EU law. This raises the question of Member States' fiscal sovereignty.

2.4.2 Member States' fiscal sovereignty with regard to EU law

Sovereignty is very much referred to by Member States when defending their tax measures before the ECJ. Part of the doctrine supports this view[211]. In particular, it has been argued that tax disadvantages that result from the parallel exercise of tax jurisdiction by Member States fall outside the scope of EU law. Such "disparities" would be a normal consequence of "the coexistence of discrete national tax systems"[212].

So, since direct taxation is not harmonised, where does the border go between EU law and Member States' tax jurisdiction? As direct taxation is not explicitly touched upon by the EU Treaties, one could consider that this field of law should be out of the scope of EU law. I do not agree with such a view. The Member States agreed upon a multilateral treaty that includes general but clearly binding provisions, among which the objective of achievement of the internal market and the provisions on the fundamental freedoms. The fundamental freedoms are hierarchically superior to any other norm, even national constitutions[213] and international agreements like tax treaties[214]. When becoming member of the European Union, Member States gave up part of their sovereignty as in any international agreement. It is true that the ECJ recognised that Member States gave up their sover-

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[211] See *e.g.* Dennis Weber, *Is the limitation of tax jurisdiction a restriction of the freedom of movement?*, *in* Accounting and taxation & assessment of ECJ case law, 2007 EATLP Congress, pp. 113-133.

[212] Opinion of Advocate General Geelhoed, delivered on 23 February 2006, case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue*, para. 43.

[213] ECJ, 1 April 2008, case C-212/06, *Gouvernement de la Communauté française and Gouvernement wallon*, para. 58: "a Member State cannot plead provisions, practices or situations prevailing in its domestic legal order, including those resulting from the constitutional organisation of that State, to justify the failure to observe obligations arising under Community law".

[214] The ECJ has found in numerous cases that provisions included in a tax treaty may be in breach with EU law. The contrary would deprive EU law from its meaning.

eignty only "within limited fields"[215]. However, this interpretation was the one the Court had a long time ago, shortly after the conclusion of the Treaty of Rome. Since then, case law shows that the ECJ has extended the scope of EU law even to areas not specifically touched upon by the EU Treaties, like direct taxation. One cannot consider that since the EU Treaties do not include provisions in direct tax law, this area of law is outside the scope of the treaty: based on the wording of the EU Treaties, one does not find a limitation of jurisdiction to matters that are expressly included in the scope of the Treaties. *A contrario*, this should imply that all domestic rules are under the obligation to respect EU law.

Also, the ECJ has the power to make sure that all the provisions of the EU Treaties are enforced[216]. A similar reasoning is applied by many supreme or constitutional courts: based on general principles like the equality principle, supreme or constitutional courts find national provisions compatible or incompatible with such principles. In my opinion the reasoning is exactly the same with regard to the provisions of the EU Treaties: the Member States have decided not to limit the scope of the provisions of the European Union to certain particular fields of law but to make them available in a more general way. By drafting some provisions of the Treaty of Rome in an ab-

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[215] ECJ, 5 February 1963, case C-26/62, *van Gend & Loos*: "the community constitutes a new legal order of international law for the benefit of which the States have limited their sovereign rights, albeit within limited fields, and the subjects of which comprise not only Member States but also their nationals". See also ECJ, 15 July 1964, case C-06/64, Flaminio Costa v E.N.E.L.: "By creating a Community of unlimited duration, having its own institutions, its own personality, its own legal capacity, and capacity of representation on the international plane and, more particularly, real powers stemming from a limitation of sovereignty or a transfer of powers from the States to the Community, the Member States have limited their sovereign rights, albeit within limited fields, and have thus created a body of law which binds both their nationals and themselves".

[216] See particularly article 19 TEU, which provides that "The Court of Justice of the European Union (…) shall ensure that in the interpretation and application of the Treaties the law is observed". See also article 267 TFEU: "The Court of Justice of the European Union shall have jurisdiction to give preliminary rulings concerning (a) the interpretation of the Treaties".

stract yet clearly binding way, the founding fathers could make sure that the provisions of the Treaty would still be relevant in the future, thanks to the interpretation power granted to the ECJ.

Accordingly, I agree with the statement that Member States' fiscal sovereignty is "neither absolute nor exclusive"[217]: Member States' fiscal sovereignty is not exclusive since the Union may also legislate, as demonstrated by the directives in the field of direct taxation. Member States' fiscal sovereignty is not either absolute since Member States are obliged to enforce EU law. Indeed, the ECJ since the *Avoir Fiscal*[218] decision and through considering that direct taxation measures must pass the test described in the *Gebhard*[219] case, has clearly included direct taxes in the scope of EU law: "although (…) direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with Community law"[220]. Therefore, one could be tempted to conclude that the "sovereignty argument" is not really convincing, since Member States must exercise tax jurisdiction in conformity with EU law. The problem is that the Court has been maintaining an ambiguity about the border between Member States' fiscal sovereignty and their obligations under EU law. Some cases relied on Member States' fiscal sovereignty to find that EU law was not applicable to particular tax rules[221], while

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[217] Frans Vanistendael, *In defence of the European Court of Justice*, Bulletin for International Fiscal Documentation, March 2008, p. 93.

[218] ECJ, 28 January 1986, Case C-270/83, *Commission of the European Communities v. French Republic*.

[219] See ECJ, 30 November 1995, case C-55/94, *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano*, para. 37: "It follows, however, from the Court's case law that national measures 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 which they pursue; and they must not go beyond what is necessary in order to attain it".

[220] ECJ, 14 February 1995, case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker* (hereafter *Schumacker*), para. 21.

[221] Examples are *Kerckhaert and Morres* and *Columbus Container*.

other cases resulted in a thorough erosion of Member States' fiscal sovereignty[222]. At the end of the day, it seems that the Court has itself created inconsistency to find an acceptable compromise between Member States' and the Union's interests. The result is not satisfying, since the internal market is still obstructed by obstacles and at the same time Member States' sovereignty is not intact. This issue is, to a certain extent, analysed during the course of the dissertation[223]. However, the purpose of the thesis is not to study the interaction between Member States' fiscal sovereignty and EU law. Instead, it is focused on the principles of taxation of companies' foreign business income with regard to the objective of achievement of the internal market, which partly contributes to the discussion on the interaction between Member States' fiscal sovereignty and EU law, but does not discuss this question exhaustively.

Member States' taxation of companies' foreign business income incurred throughout the internal market is analysed in details in the following chapters, depending on the connection existing between a Member State and a tax subject or a tax object. The next chapter analyses the taxation of foreign companies in the hands of a resident company.

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[222] Examples are *Bosal* and *Renneberg*.

[223] For additional analyses on the conflict between Member States' fiscal sovereignty and EU law see Bernard Castagnède, *Précis de fiscalité internationale*, Presses Universitaires de France, third edition, 2010, pp. 34-45; Frans Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, EC Tax Review, 2003-3, pp. 136-143; Frans Vanistendael, *Marché interne et souveraineté fiscale*, *in* Regards critiques et perspectives sur le droit et la fiscalité, Liber Amoricum Cyrille David, LGDJ, 2005, pp. 255-268; Frans Vanistendael, *Denkavit Internationaal: the balance between fiscal sovereignty and the fundamental freedoms?*, European Taxation, May 2007, pp. 210-213; Dennis Weber, *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, Kluwer Law International, 2006; Melchior Wathelet, *Souveraineté fiscale des Etats membres et Cour de justice: nouvelles tendances ou confirmation?*, Revue de Jurisprudence Fiscale, February 2008, pp. 90-102.

3 Taxation of resident companies on income of foreign group companies

3.1 Introduction

This chapter focuses on the taxation of resident companies on foreign group companies' foreign business income. It is the first of three chapters that study the conflict between Member States' rules on the taxation of companies' foreign business income and the objective of achievement of the internal market from three different territorial perspectives. Here, the territorial connection between the taxing State and the tax object is weak, because the source of income is not situated within the territory of the taxing State. The territorial connection with the tax subject seems stronger because the person actually taxed is a resident company, but the ultimate aim of such a taxation is to take into account the income of another legal person that is resident in another State. One could describe this situation as cross-border group taxation.

The principle of personality implies that a tax subject is normally taxed on its own income, not on income incurred by another person. This principle often applies to domestic group companies and it is *a fortiori* applicable to foreign group companies, because a State has no direct connection with non-residents earning foreign income. Therefore, residents are usually not taxed on non-residents' foreign business income. However, tax law may take into account the legal or economic relations between tax subjects. Income earned by a tax subject may be taxed or taken into account at the level of another tax subject. For example, in certain tax systems partnerships may be considered transparent and taxed at the level of their owner. Also, the principle of personality may be set aside as part of consolidation

rules or tax equalisation systems[224] for companies that are legally or economically related to each other. Consequently, the principle of personality is not absolute.

Tax equalisation systems are most often limited to the domestic context: a State may be willing to take into consideration a group of companies from a taxation perspective when it can exercise its tax jurisdiction on the basis of the residence of the members of the group, or on the domestic income these group members earn through permanent establishments. This means that the principle of worldwide taxation most often has very limited application towards foreign group members. However, a State may be willing to take into account a foreign group company's income (whether positive or negative), especially if it has an incentive to do so. That may be the case so as to encourage foreign investments[225] or prevent erosion of the tax base[226]. The foreign tax subject may then be territorially connected to the taxing State through a group company resident there, for example a shareholder.

Irrespective of the motives underpinning tax jurisdiction exercised on foreign companies' foreign income, similar principles of international law are applicable. One may instinctively consider that foreign residence, absent the earning of domestic income, is a legal barrier that should not be trespassed, thus depriving third States from having the competence to exercise tax jurisdiction[227]. A State may, indeed, consider that it has no legitimate connec-

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[224] Given the diversity of tax measures that take into account the existence of a group, the expression "tax equalisation" is used in this dissertation to describe the purpose of such measures. See Bertil Wiman, *Equalising the tax burden in a group of companies*, *in* International Studies in Taxation: Law and economics, Liber Amicorum Leif Mutén, Kluwer Law International, 1999, p. 364: "Tax equalisation here means the levelling of the tax burden with respect to the operating profits or losses of two or more companies".

[225] For example cross-border consolidation and unilateral relief for foreign losses.

[226] For example CFC rules.

[227] See the arguments put forward by the UK government in the *Marks & Spencer* case (Opinion of Advocate General Maduro, delivered on 7 April 2005, case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, para. 58) and the arguments put forward by the Finnish government in the *Oy AA* case (ECJ, 18 July 2007, case C-231/05,

tion with a foreign tax subject, thereby not exercising tax jurisdiction over foreign group companies' foreign business income. Yet, as demonstrated in chapter 2, international law does not prevent a third State from exercising such a tax jurisdiction. It is in accordance with international law to take into account foreign income (whether positive or negative) earned by a foreign tax subject at the level of a resident company, as this does not prevent other States from exercising their own tax jurisdiction: the fiscal sovereignty of these States is not encroached upon by the taxing rights exercised by other States.

International law also indicates that a State is sovereign and independent. As such, it is not bound by foreign elements, which means that a State is usually not forced to take into account foreign income. Therefore, fiscal sovereignty as it results from international law involves an asymmetry between a State's rights and obligations: on the one hand, it is not forbidden for a State to tax non-residents' foreign profits. On the other hand, a State cannot be forced to take into account a non-resident's foreign losses. This asymmetry is accepted by international law and may explain why States tax non-residents' foreign profits through CFC rules, while foreign losses are usually not taken into account.

As with the two next chapters of the dissertation, it is distinguished here between foreign profits and losses. This distinction is based on the fact that different types of compatibility issues with EU law arise with regard to foreign profits and losses. The taxation of foreign companies' foreign profits supposes that a State applies the principle of worldwide taxation, which triggers some compatibility issues with the objective of achievement of the internal market. On the other hand, when a State does not exercise any taxing rights on foreign group companies, *i.e.* when a State applies the fiscal principle of territoriality, other compatibility isses are raised, this time with regard to foreign losses. Consequently, this chapter studies how the objec-

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Oy AA, para. 34). See also Frans Vanistendael, *Bosal?!*, EC Tax Review, 2003-4, p. 192: "the territoriality principle indeed excludes the non resident subsidiary from the tax jurisdiction of the Member State of the parent company".

tive of achievement of the internal market interacts with the principle of worldwide taxation and the fiscal principle of territoriality in the context of groups of companies, with regard to foreign companies' foreign profits (3.2) and losses (3.3).

3.2 Application of the principle of worldwide taxation to foreign companies' foreign profits: the Cadbury Schweppes case

3.2.1 Introduction and presentation of the Cadbury Schweppes case

Foreign group companies' profits may be taxed at the level of their shareholder to prevent certain forms of tax avoidance, or simply maximise public revenues. Indeed, accumulating profits in a foreign subsidiary allows postponing taxation until dividends are distributed, if such dividends are taxable in the State of the parent company. However, dividends may never be repatriated to the home country, either because they are not at all distributed or because they are distributed to a company resident in a third State following a transfer of shares. The setting-up of a foreign company, *i.e.* a tax subject on its own, also permits to circumvent the immediate taxation of business profits in the home State: if the business activities were conducted through a permanent establishment, many countries applying the worldwide principle combined with the credit method would tax such profits. In contrast, according to the principle of personality, a foreign subsidiary is usually not taxed in the country of the shareholder.

To counter these consequences of the personality principle, foreign subsidiaries (whether direct or indirect) may be taxed at the level of a shareholder through CFC rules. CFC rules are somewhat on the edge of international law since they are based on a weak territorial connection between the taxing State and the foreign tax subject. They are, however, compatible with international law as demonstrated by their acceptance in several countries[228]. In addition, CFC rules are, in certain cases, recommended both by

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[228] See Michael Lang, *The Marks & Spencer case - the open issues following the ECJ's final word*, European Taxation, February 2006, p. 60.

the OECD[229] and the European institutions[230]. Still, such a taxation is usually discriminatory since only some foreign controlled companies are taxed at the level of the shareholder, not domestic controlled companies or other foreign companies. Therefore, CFC rules raise compatibility issues with EU law. CFC rules' compatibility with EU law and particularly the freedom of establishment was at stake in the *Cadbury Schweppes*[231] case, which provided the ECJ an opportunity to analyse the principle of worldwide taxation applied at a group level, in combination with Member States' right to prevent tax avoidance or tax planning.

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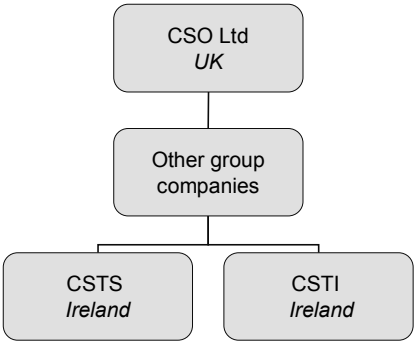
[229] CFC rules are normally accepted by the OECD members, not necessarily with the exclusive aim of preventing tax avoidance: "CFC rules may also apply in situations which do not involve harmful tax practices as defined in this Report. It is recognised that countries retain their right to use such rules in such situations": see Harmful Tax Competition, an emerging global issue, OECD, 1998, para. 98. For a comment on this report and on further reports published by the OECD, see Bernard Castagnède, *Précis de fiscalité internationale*, Presses Universitaires de France, third edition, 2010, pp. 55-57.

[230] The ECOFIN Council recognised, without however referring explicitly to CFC rules, "that anti-abuse provisions or countermeasures contained in tax laws or double taxation conventions play a fundamental role in counteracting tax avoidance and evasion": see Conclusions of the ECOFIN Council meeting concerning taxation policy, 1 December 1997, 98/C 2/01, Official Journal of the European Communities, 6 January 1998, p. 5. See also the Council Resolution on coordination of the Controlled Foreign Corporation (CFC) and thin capitalisation rules within the European Union, 8 June 2010, 2010/C 156/01, Official Journal of the European Union, 16 June 2010. Moreoever, CFC rules are accepted by the European Commission, as long as they target wholly artificial arrangements: see COM(2007) 785 final, 10 December 2007, *The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries*.

[231] ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*. For comments, see Kristina Ståhl, *EG-domstolens domar*, Skattenytt, 2007-6, pp. 350-351; Anno Rainser, Jan Roels, Otmar Thoemmes, Eric Tomsett, Hans van den Hurk, Gerben Weening, *ECJ deals setback for U.K. CFC regime*, Tax Notes International, 18 September 2006, pp. 955-956; Nikolaj Vinther, Erik Werlauff, *Tax motives are legal motives - The borderline between the use and abuse of the freedom of establishment with reference to the* Cadbury Schweppes *case*, European Taxation, August 2006, pp. 383-386; Bruno Gouthière, *Article 209 B et droit communautaire*, Feuillets Rapides Francis Lefebvre, 4 October 2006, pp. 21-23.

Cadbury Schweppes was about the compatibility of the UK CFC rules with the freedom of establishment. Cadbury Schweppes Overseas Limited (CSO Ltd), a UK-based parent company, owned subsidiaries resident in Ireland (Cadbury Schweppes Treasury Services – CSTS – and Cadbury Schweppes Treasury International – CSTI) through holdings in other group companies.



These subsidiaries were resident in Ireland and subject to a 10% tax rate. The UK tax authorities applied CFC rules and taxed the Irish subsidiaries at the level of CSO Ltd, the parent company. The Special Commissioners, wondering whether such a taxation was compatible with EU law, referred the case to the ECJ. The Court considered that CFC rules were in principle incompatible with the freedom of establishment, unless applied exclusively to wholly artificial arrangements intended to escape the tax normally payable. The Court's decision in *Cadbury Schweppes* was later confirmed in a reasoned order issued in the *Test Claimants in the CFC and Dividend Group Litigation*[232] case.

Before analysing the impact of the *Cadbury Schweppes* ruling on the application of the principle of worldwide taxation (3.2.2), the reasoning of the Court and the choice of a comparator should be discussed, since other alternatives potentially leading to different solutions could have been considered (3.2.3). The comparison chosen by the ECJ is indeed important to ana-

[232] ECJ, 23 April 2008, case C-201/05, *Test Claimants in the CFC and Dividend Group Litigation*. For a comment, see Tom O'Shea, *ECJ Clarifies Issues with U.K. Dividend Tax, CFC Rules*, Tax Notes International, 26 May 2008, pp. 666-669.

lyse because it may provide guidance as to which principle of taxation best suits the objective of achievement of the internal market.

3.2.2 Reasoning of the ECJ and choice of a comparator

The result of a comparability analysis often depends on the choice of the comparator[233]. This was a very important aspect in the *Cadbury Schweppes* case: as demonstrated below, the comparator chosen by the ECJ was not necessarily the only relevant one. The fact that the ECJ ruled as it did may be interpreted as an implicit preference for the fiscal principle of territoriality over the principle of worldwide taxation with regard to EU law.

The ECJ focused on the comparison between foreign and domestic subsidiaries owned by a UK shareholder (3.2.2.1). Other comparators, possibly leading to a different outcome, could also have been considered, particularly the taxation of dividends (3.2.2.2) and the taxation of foreign business profits earned by a permanent establishment (3.2.2.3).

3.2.2.1 Comparison between the ownership in foreign and domestic subsidiaries

Paragraphs 43 to 46 of the *Cadbury Schweppes* case indicate that the Court found CFC rules incompatible with the freedom of establishment because of the different treatment of a shareholder owning shares in a domestic or a foreign subsidiary. The ECJ found that "the separate tax treatment under the legislation on CFCs and the resulting disadvantage for resident companies which have a subsidiary subject, in another Member State, to a lower level of taxation are such as to hinder the exercise of freedom of establishment"[234]. The Court chose to look at the tax treatment of one single company (the parent company) in the domestic and cross-border contexts, to test whether cross-border situations were treated less favourably.

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[233] See Opinion of Advocate General Sharpston delivered on 8 November 2007, case C-293/06, *Deutsche Shell GmbH v Finanzamt für Grossunternehmen in Hamburg*, para. 34: "the decision as to whether there is (or is not) discriminatory treatment often turns upon the precise choice of comparator". See also Michael Lang, *Recent case law of the ECJ in direct taxation: trends, tensions, and contradictions*, EC Tax Review, 2009-3, p. 99.

[234] ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*, para. 46.

It is not surprising that the ECJ chose this comparator. In *Marks & Spencer* (issued before *Cadbury Schweppes*) the ECJ showed preference for restricting its analysis to one situation (a subsidiary) in two contexts (domestic and cross-border), instead of comparing two cross-border situations depending on the investment form, *i.e.* comparing the tax treatment of foreign subsidiaries and permanent establishments. Therefore, it is not surprising that the ECJ in *Cadbury Schweppes* kept reasoning based on one situation. The choice of this comparator is not irrelevant. Indeed, CFC rules by definition introduce a difference of treatment at the level of the shareholder between domestic and foreign subsidiaries subject to a low corporate income tax rate. Also, the drafting of the freedom of establishment in my view encourages comparisons between domestic and foreign similar situations (vertical comparison) rather than comparisons between different foreign situations (horizontal comparison). This comparator was confirmed in later decisions such as *Test Claimants in the CFC and Dividend Group Litigation* and *X Holding*.

Having decided to focus on the subsidiary comparator, the Court found that there was a difference of treatment between domestic and foreign subsidiaries. This difference seems obvious if one looks solely at the shareholder, since he is taxed on income earned by certain foreign subsidiaries while he is not taxed on income earned by domestic subsidiaries. Yet if one looks at CFC rules from a group perspective, but still in the UK, the discrimination appears less obvious. Indeed, both foreign subsidiaries subject to CFC taxation and domestic subsidiaries are eventually taxed in the UK: domestic subsidiaries pay corporate income tax on their profits, which foreign subsidiaries ultimately do when being subject to CFC taxation. The difference of treatment, although obvious from the strict viewpoint of the shareholder, is consequently mitigated when considering the corporate income tax eventually paid in the UK at the group level. Such a similar treatment from a domestic perspective, based on the application of the principle of worldwide taxation to foreign subsidiaries, tends to implement capital export neutrality. Several governments referred to this argument but it did not convince the Court, which simply observed that "under such legislation the resident company is taxed on profits of another legal person. That is not the case for a resident company with a subsidiary taxed in the United Kingdom or a subsidiary established outside that Member State which is

not subject to a lower level of taxation"[235]. It is regrettable that the ECJ did not analyse this argument in more details. Indeed, through CFC taxation, domestic subsidiaries and foreign subsidiaries subject to CFC taxation are ultimately taxed at the UK rate. This includes both the determination of the corporate tax base[236] and the rates applicable to taxable income. Also, thanks to the foreign tax credit granted for the corporate income tax paid abroad, CFC rules may tend to be neutral compared to a domestic investment[237]. The timing was possibly to the advantage of foreign subsidiaries since domestic subsidiaries are taxed upon the realisation of profits while foreign ones are not necessarily subject to CFC taxation on an annual basis as such a taxation may be levied at a later point in time. Consequently and at first sight, CFC taxation seems to put domestic and foreign subsidiaries at a rather similar level, which does not make the infringement to EU law obvious.

Since CFC rules tend to implement capital export neutrality, *i.e.* neutrality from the perspective of the home State, one may wonder whether such a neutrality is sought by the EU Treaties. If that would be the case, CFC rules should be compatible with EU law, as long as they effectively implement capital export neutrality. In contrast, if the EU Treaties give preference to capital import neutrality, CFC rules should be incompatible with EU law, because of the breach of neutrality in the host State when taxing rights are exercised in the home State. The principle of non-discrimination, provided by article 18 TFEU, does not favour neutrality in the home State or the host State as it generally prohibits "discrimination on grounds of nationality". The fundamental freedoms provide some limited guidance as to whether the EU Treaties give preference to neutrality in the home State or in the host State. The freedom of establishment, which is the most relevant freedom as far as the taxation of foreign business income is concerned, is referred to at article 49 TFEU. This article aims at getting rid of restrictions

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[235] *C. cit.*, para. 45.

[236] According to the UK CFC rules at hand in the *Cadbury Schweppes* case, foreign profits are computed in accordance with UK corporate income tax rules.

[237] However, it is not the purpose of the dissertation to analyse in details the UK CFC rules. Only questions of principle are taken into account.

to the "establishment of nationals of a Member State in the territory of another Member State". The very wording of article 49 TFEU seems *prima facie* to focus primarily on neutrality in the home State through insisting on not hindering establishments in "another Member State", *i.e.* outbound mouvements. However, the freedom of establishment applies also in the host State, where non-residents[238] or residents with foreign shareholders[239] should not be subject to a less favourable treatment than residents of this host State, *i.e.* article 49 TFEU applies also to inbound mouvements. Consequently, although the wording of the freedom of establishment may at first sight be interpreted as favouring neutrality in the home State, its application by the ECJ may also require neutrality in the host State.

The other fundamental freedoms do not either provide clear guidance as to whether the EU Treaties give preference to neutrality in the home State or in the host State. The free movement of workers does not clearly favour neutrality in the home State or in the host State: article 45(3) TFEU at (a) and (b) seems to adopt a home State perspective, while article 45(3) TFEU at (c) and (d) focuses more on the host State. The wording of the freedom to provide services seems to be favouring neutrality in the host State: according to article 56 TFEU, service providers from another Member State should not be restricted to provide services in the host State. Regarding the free movement of capital, the wording of article 63 TFEU favours primarily neutrality in the home State, because neutrality in the host State could not be required from third States. However, its application by the Court has required the host State to provide equal treatment to non-residents[240]. As a result, the fundamental freedoms do not clearly favour neutrality in the home State or in the host State, which is understandable as EU law grants general rights not to be discriminated against. It seems in line with the concept of an internal market without internal borders that EU nationals

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[238] See for example ECJ, 29 April 1999, case C-311/97, *Royal Bank of Scotland plc v Elliniko Dimosio (Greek State)*, para. 22-23.

[239] See for example ECJ, 14 December 2006, case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, para. 21.

[240] See for example ECJ, 8 November 2007, case C-379/05, *Amurta SGPS v Inspecteur van de Belastingdienst*, para. 28.

should not be hindered in outbound movements, and at the same time should enjoy the same rights as local competitors once they have exercised their freedom of movement.

To asses whether the EU Treaties give preference to neutrality in the home State or in the host State, other provisions of the EU Treaties may be of relevance, particularly the principle of an open market with free competition sought by articles 119 and 120 TFEU[241]. These articles have not been conferred direct effect in the field of direct tax law, but as they are part of primary law it is important to take them into account. The principle of an open market with free competition does not, as such, favour neutrality in the home State or in the host State: it can be conceived that neutrality is sought by the Treaty in both situations, to guarantee a free competition in the home State between companies choosing to exercise their fundamental freedoms and those choosing to keep their activities domestic, as well as in the host State to make sure that foreign investors are not treated less favourably than local competitors. Consequently, one does not find in the EU Treaties a clear preference for neutrality in the home State or in the host State.

However, even if CFC rules would perfectly implement home neutrality, it cannot be denied that CFC rules (and the principle of worldwide taxation in general) may impede the attractiveness of the host State because such rules offset the opportunity to enjoy the lower tax rates the host State offers to foreign investors[242]: all the efforts put by the host State to attract foreigners may be cancelled by the home State. These consequences of the principle of worldwide taxation are, in my view, more difficult to reconcile with the objective of achievement of an internal market without internal frontiers

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[241] On the importance of a sound tax competition see Wolfgang Schön, *International tax coordination for a second-best world (part I)*, World Tax Journal, October 2009, p. 85: "Sound tax competition, including respect for national sovereignty, is widely accepted as a reality and as an efficient policy option".

[242] It can be observed that the ECJ accepted in several cases that a taxpayer seeks for lower tax rates in other Member States: see *e.g.* ECJ, 26 October 1999, case C-294/97, *Eurowings Luftverkehrs AG v Finanzamt Dortmund-Unna*, para. 44.

where Member States act in accordance with the principle of sincere cooperation than if no such taxation was levied. Therefore, in this case it seems unsufficient to analyse CFC rules solely from the home State's perspective because such an analysis does not take into account the actual damages that the principle of worldwide taxation has on the internal market as a whole, particularly given the harms caused by CFC taxation on the efforts put by the host State to attract foreign investments.

Also, CFC rules may not perfectly implement capital export neutrality. Particularly, a difference between foreign and domestic subsidiaries may exist with regard to the distribution of dividends: economic double taxation on the distribution of domestic and cross-border dividends is often mitigated or even eliminated at the level of the parent company through a participation exemption or a tax credit. The problem is that when a foreign subsidiary is subject to CFC taxation, the home State normally grants a tax credit for the corporate income tax paid abroad by the foreign subsidiary when it is subject to CFC taxation. As a result, the home State may not grant a second tax credit upon the levy of a withholding tax at the time a dividend is distributed if this home State taxes dividends in the hands of the shareholder[243]. Consequently, CFC rules may not always implement capital ex-

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[243] See Hans-Jörgen Aigner, Ulrich Scheuerle, Markus Stefaner, *CFC legislation, tax treaties and EC law* (ed. Lang, Aigner, Scheuerle, Stefaner), EUCOTAX Series on European Taxation, 2004, pp. 41-43. See particularly p. 42 (with references to the national reports in the footnotes): "in some cases the shareholder does not only suffer a loss of interest but even has to bear economic or even juridical double taxation. The reason is that source taxes in the state of residence of the CFC are not levied until actual distribution. But the deemed dividend is already taxed at the time of accrual of the profits at the level of the CFC. At that time most CFC legislations give a credit for the taxes paid by the CFC. Nevertheless some restrict that credit to taxes paid in the state of residence of the CFC. Others even do not grant a credit but qualify the CFC taxes only as expenses. As there is no withholding tax at that time, some CFC legislations make it impossible to credit the future withholding tax at taxation according to CFC. A later credit against the taxation of the dividends is also impossible as those dividends are normally exempt due to the fact that they were already taxed as deemed dividends. Furthermore some CFC legislations even lead to taxation of later distribution if a

port neutrality perfectly, because if one takes into account the taxation of dividends, foreign subsidiaries may be subject to a double taxation heavier than the one possibly existing with regard to domestic subsidiaries.

As a result of the above analyses, it is submitted that convincing arguments plead for the uncompatibility with EU law of CFC rules despite the apparently similar taxation of domestic and foreign subsidiaries subject to CFC taxation to justify CFC rules. Even if one may agree with the outcome of the *Cadbury Schweppes* case, it can be regretted that the ECJ did not analyse the very compatibility with the freedom of establishment of capital export neutrality. This may be explained by the fact that UK CFC rules actually taxed the parent company, not the foreign subsidiary. If were was the subsidiary itself that was taxed, the Court may have paid more attention to the fact that domestic subsidiaries are also subject to corporate income tax in the UK. However, from a practical point of view, it seems difficult to levy tax on the foreign business income earned by a non-resident. It is much more practical to levy tax at the level of the parent company. The actual result, however, may be the same as if it were the subsidiary that is taxed directly by the State of the parent company. By ruling as it did in *Cadbury Schweppes*, the Court left little chance for a Member State to justify its CFC rules. The ECJ did not take the opportunity to discuss the important question of the compatibility with EU law of capital export neutrality and the principle of worldwide taxation, which was a central issue in the *Cadbury Schweppes* case. Given the way the ECJ reasoned in *Cadbury Schweppes*, and with regard to the potentially convincing argument relying on capital export neutrality (i.e. the potentially similar taxation of domestic and foreign subsidiaries), *Cadbury Schweppes* is a sign that the ECJ seems to be critical to the principle of worldwide taxation in itself and may implicitly favour the fiscal principle of territoriality, *i.e.* the exemption of foreign business income from taxation in the home State. This assumption is supported by the other comparators that could have been considered by the Court.

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specific period has elapsed since the taxation as deemed dividend. All those pitfalls might lead to double taxation".

Two other comparators may be relevant to analyse the compatibility of CFC rules with the objective of achievement of the internal market: the taxation of dividends (3.2.2.2) and the taxation of foreign business profits earned by a permanent establishment (3.2.2.3).

3.2.2.2 Comparison of CFC taxation with the taxation of dividends

Two alternatives are available for the State of the shareholder with regard to the taxation of dividends: either dividends are taxed, or they are subject to exemption in the State of the parent company[244]. If dividends are subject to an exemption, then taxing a foreign subsidiary through CFC rules based on a deemed dividend distribution is obviously a different treatment as it triggers the levy of an additional tax. This would result in switching from the exemption method (participation exemption) to the credit method (taxation of dividends deemed distributed through CFC rules). It is true that the ECJ found in *Columbus Container*[245] that a switch over from the exemption to the credit method for a permanent establishment was compatible with EU law. However, by doing so, the German rules actually put domestic and foreign establishments on the same level, *i.e.* they achieved capital export neutrality. Conversely, the taxation of foreign subsidiaries on a deemed dividend distribution does not put them on the same level as subsidiaries subject to participation exemption. Therefore, the application of a participation exemption argues for the incompatibility of CFC rules with EU law. Would the solution be different if dividends were taxed by the State of the shareholder?

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[244] According to article 4(1) of the Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, the State of the parent company shall either exempt or tax the inbound dividends that are within the scope of the directive. If the inbound dividends are taxed by the State of the parent company, a foreign tax credit has to be granted corresponding to the fraction of the corporation tax related to the distributed profits and paid by the subsidiary and any lower-tier subsidiary.

[245] ECJ, 6 December 2007, case C-298/05, *Columbus Container Services B.V.B.A. & Co. v Finanzamt Bielefeld-Innenstadt*. For a deeper analysis of the *Columbus Container* case, see *infra* at 4.2.2.

If inbound dividends received by a parent company are taxed at the same tax rate as the profits of a foreign subsidiary subject to CFC taxation, then the State of the parent company could argue that the principle of worldwide taxation is applied without distinction, thus justifying CFC rules with regard to EU law. Indeed, all subsidiaries' profits would ultimately be taxed in the hands of the parent company, whether upon the distribution of dividends or through CFC rules. However, two main differences remain as a consequence of CFC taxation: a cash-flow disadvantage and a possible double taxation.

First, taxing dividends at the level of the shareholder upon distribution while foreign subsidiaries are taxed at the time they earn a profit results in a cash-flow disadvantage for foreign subsidiaries subject to CFC taxation, because of the elimination of the deferral. The ECJ is rather cautious with regard to cash-flow disadvantages affecting cross-border situations. On the one hand the Court indicated in *Marks & Spencer* that final losses had to be deducted at the level of the parent company only when such losses could not be deducted in the country of the subsidiaries. Consequently, with regard to cross-border loss relief the ECJ does not pay strong attention to a temporary cash flow disadvantage. But on the other hand, in case law on exit taxation, particularly the *Lasteyrie*[246] and *N*[247] cases, the Court refused that taxpayers suffer a cash flow disadvantage by being taxed upon emigration, although it accepted the fact that the departure State has a taxing right on capital gains incurred when the taxpayer was a resident of this State.

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[246] ECJ, 11 March 2004, case C-9/02, *de Lasteyrie du Saillant*. For comments see Leif Mutén, *EG-domstolen och exitskatten*, Skattenytt, 2004-5, pp. 294-300; Laurent Olléon, *Exit l'exit tax*, Revue de Jurisprudence Fiscale, May 2004, pp. 347-350; Katia Cejie, *Utflykttningsbeskattning av kapitalökningar – en skattevetenskaplig studie i internationell personbeskattning med fokus på skatteavtals- och EU-rättsliga problem*, Uppsala, 2010, pp. 241-245.

[247] ECJ, 7 September 2006, case C-470/04, *N. v Inspecteur van de Belastingdienst Oost/kantoor Almelo*. For comments see Kristina Ståhl, *EG-domstolens domar*, Skattenytt, 2007-6, pp. 354-355; Katia Cejie, *Utflykttningsbeskattning av kapitalökningar – en skattevetenskaplig studie i internationell personbeskattning med fokus på skatteavtals- och EU-rättsliga problem*, Uppsala, 2010, pp. 247-251.

This was also the view of the ECJ in the *SGI*[248] case in relation to temporary double taxation pending a mutual agreement procedure on the basis of the Arbitration Convention. Consequently, although the position of the Court on this question is not completely clear, the ECJ finds certain situations involving a cash flow disadvantage incompatible with EU law. This would advocate for finding CFC rules incompatible with EU law when the State of the parent company taxes inbound dividends, as long as the subsidiary's profits are not fully distributed on an annual basis[249]. If, in contrast, the subsidiary's profits are entirely distributed each year to its shareholders, the parent company may not suffer a cash flow disadvantage.

The second argument according to which a difference remains between the taxation of inbound dividends and the taxation of foreign subsidiaries according to a deemed dividend distribution relates to the double taxation that is likely to occur outside the scope of the parent/subsidiary directive. The host State may levy a withholding tax on outbound dividends while the State of the parent company taxes both the profits of the foreign subsidiary

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[248] See ECJ, 21 January 2010, case C-311/08, *Société de Gestion Industrielle SA (SGI) v Belgian State* para. 54: "As regards the possibility of applying the Arbitration Convention, it should be pointed out, as observed by the Advocate General at point 48 of her Opinion, that where the tax authorities in question endeavour to resolve a matter by mutual agreement, as provided for by Article 6 in Section 3 of the Convention, an additional administrative and financial burden is imposed on the company which has submitted its case to such a procedure. Moreover, a procedure aimed at resolution by mutual agreement, followed, if necessary, by an arbitration procedure, may extend over several years. During that period, the company in question must bear the burden of double taxation". The ECJ consequently found at para. 55 of the judgment that the legislation at issue in the main proceedings constituted a restriction on the freedom of establishment. For comments on the SGI case, see Anne-Laure Mosbrucker, *Avantage anormal ou bénévole consenti à une société liée*, Revue Europe, March 2010, p. 22; Ludovic Bernardeau, *Jurisprudence de la CJUE: fiscalité directe (janv./juin 2010)*, Revue de Droit Fiscal, 14 October 2010, pp. 16-18.

[249] Indeed, if a subsidiary's profits are distributed during future financial years, the shareholder is taxed on dividends only at the time they are distributed. In contrast, subsidiaries subject to CFC taxation are likely to be taxed in the hands of the shareholder on an annual basis. Consequently, a parent company would suffer a cash flow disadvantage if its subsidiary is subject to CFC taxation.

and inbound dividends received by the parent company. Indeed, the risk is that the State of the parent company grants a tax credit solely for the corporate income tax paid by the foreign subsidiary subject to CFC taxation, but not for the withholding tax possibly levied on dividends distributed by the CFC[250].

Consequently, cash-flow disadvantages and a possible double taxation tend to indicate that CFC taxation is likely to be more burdensome than the taxation of inbound dividends[251]. The ECJ did not discuss this comparator in *Cadbury Schweppes*. However, it is hoped that the ECJ would have reached the same conclusion under this way of reasoning, given the disadvantages of CFC taxation compared to the taxation of dividends in the hands of the parent company. This pleads, in my view, for the incompatibility of CFC rules with EU law, thus confirming the correctness of the outcome in *Cadbury Schweppes*: the taxation of foreign subsidiaries' foreign business income cannot be convincingly justified by the potential similarities it shares with the taxation of dividends.

CFC rules may also have been compared to the taxation of a permanent establishment.

3.2.2.3 Comparison of CFC taxation with the taxation of a permanent establishment

The State of a parent company, if it is a credit country, could argue that CFC rules merely result in assimilating the taxation of foreign subsidiaries to the taxation of permanent establishments[252]. The objective of the State of the parent company could be to implement the principle of worldwide

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[250] See Hans-Jörgen Aigner, Ulrich Scheuerle, Markus Stefaner, *CFC legislation, tax treaties and EC law* (ed. Lang, Aigner, Scheuerle, Stefaner), EUCOTAX Series on European Taxation, 2004, pp. 41-43.

[251] Other disadvantages may result from CFC taxation, such as a requirement to prepare financial accounts according to the home State's legislation to assess the tax base, which leads to higher compliance costs.

[252] See Michael Lang, *CFC legislation and Community law*, European Taxation, September 2002, p. 377.

taxation and tax similarly foreign subsidiaries and permanent establishments. Before analysing whether it may be relevant to aim at implementing the principle of worldwide taxation towards both foreign subsidiaries and permanent establishments, it is first discussed whether a head office with a permanent establishment and a parent company with a foreign subsidiary may at all be in comparable situations.

A foreign subsidiary is a non-resident legal subject, while a permanent establishment is legally part of the resident company[253]. In principle, the ECJ accepts this difference and does not assimilate permanent establishments and subsidiaries *per se*, as shown from the perspective of both the home State (*e.g.* with *Marks & Spencer*[254]) and the host State (*e.g.* with *Futura*[255]). However, case law relating to both the home State and the host State has, in certain situations, mitigated the differences between a subsidiary and a permanent establishment:

- From the perspective of the home State, the Court found in *Lidl Belgium* that foreign subsidiaries and permanent establishments were not in such a different situation, considering that "a permanent establishment constitutes, under tax convention law, an autonomous fiscal entity"[256]. "That definition of a permanent es-

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[253] For a discussion on the differences between foreign subsidiaries and permanent establishments, see Peter 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, 2003-4, pp. 194-202. See also Wolfgang Schön, *International tax coordination for a second-best world (part I)*, World Tax Journal, October 2009, pp. 106-108.

[254] In *Marks & Spencer*, the Court accepted that foreign subsidiaries' losses are in principle not deductible in the State of the parent, while a head office could deduct losses incurred by its permanent establishment. See ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*.

[255] In *Futura*, the Court accepted that a permanent establishment is taxed on a pure domestic basis, foreign losses not being deducted in the State of the permanent establishment. In contrast, a resident could claim deduction of foreign losses. See ECJ, 15 May 1997, case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*. This case is discussed in more details *infra* in chapter 5 of the dissertation.

[256] ECJ, 15 May 2008, case C-414/06, *Lidl Belgium*, para. 21.

tablishment as an autonomous fiscal entity is consonant with international legal practice as reflected in the model tax convention drawn up by the Organisation for Economic Cooperation and Development (OECD), in particular Articles 5 and 7 thereof"[257]. Eventually, the Court did not require the State of residence to apply the principle of worldwide taxation and grant relief for a non-final loss incurred by a permanent establishment. This is an acknowledgment that a permanent establishment may receive the same tax treatment as a subsidiary, *i.e.* the fiscal principle of territoriality was respected although applying the principle of worldwide taxation to permanent establishments is a very common practice in international tax law.

- From the perspective of the State of source, the ECJ tends to require the host State to grant national treatment to non-residents as a consequence of the non-discrimination principle. A permanent establishment may thus be entitled, to a certain extent, to the tax treatment that a resident benefits from. An example is *Royal Bank of Scotland* in which the State of source was found in breach with EU law as it applied a higher tax rate to permanent establishments than to resident companies.

Consequently, although a head office with a permanent establishment and a parent company with a foreign subsidiary are not in comparable situations *per se*, EU law does not preclude such a comparison in certain stuations. In particular, since *Lidl Belgium* could be interpreted so that the Court accepted that a permanent establishment is treated as an "autonomous fiscal entity", it would not be unreasonable to reason in the opposite way and consider that, in certain situations, a subsidiary could be taxed as a permanent establishment. Indeed, if a permanent establishment is an "autonomous fiscal entity" and since the ECJ apparently accepts that a permanent establishment's business profits are taxed in the home State[258], it would seem logical

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[257] *C. cit.*, para. 22.

[258] See for example ECJ, 6 December 2007, case C-298/05, *Columbus Container Services B.V.B.A. & Co. v Finanzamt Bielefeld-Innenstadt.*

that the Court also accepts that a foreign subsidiary is taxed in the State of the parent company.

This being said, it remains to be discussed whether EU law should accept that a Member State, taxing residents on their worldwide income, justifies its CFC rules by the aim to achieve equal treatment between foreign subsidiaries and permanent establishments. Indeed, if the Member State of residence applies the credit method with regard to permanent establishments, the tax treatment of foreign subsidiaries subject to CFC taxation and permanent establishments gets closer, although not identical[259]. So the question is whether or not a Member State has the right to tax foreign subsidiaries as it taxes permanent establishments. One does not find sufficient support in the Court's case law to assert that EU law necessarily implies a right to grant equal treatment to foreign subsidiaries and permanent establishments. Rather, the ECJ seems to tone down some of the consequences resulting from the difference between a foreign subsidiary and a permanent establishment, when the discrimination becomes intolerable. This may explain why in some cases a permanent establishment ends up with the tax treatment of a subsidiary (*e.g. Lidl Belgium* or *Royal Bank of Scotland*), while in other cases a subsidiary may receive the tax treatment of a permanent establishment (*e.g.* the exception in *Marks & Spencer* for final losses).

In my view, the ECJ is rightfully not fond of the permanent establishment/subsidiary comparator from the perspective of the home State. The outcome reached in *Marks & Spencer*[260] and *X Holding* shows that the Court is not willing to pay too much attention to this comparator. Of course, in

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[259] See *supra* at 3.2.2.1 for a discussion of the other possible disadvantages of CFC rules, particularly a possible higher taxation upon the distribution of dividends and an additional administrative burden.

[260] For a discussion on the permanent establishment/subsidiary comparator given the aim of the British group relief mechanism and as part of the *Marks & Spencer* case, see Daniel Gutmann, *The Marks & Spencer case: proposals for an alternative way of reasoning,* EC Tax Review, 2003-3, pp. 154-158; Daniel Gutmann, *La fiscalité française des groupes de sociétés à l'épreuve du droit communautaire - réflexions sur l'affaire "Marks & Spencer" pendante devant la CJCE*, Revue de Droit Fiscal, 2004-14, pp. 681-685.

certain circumstances it is necessary to compare permanent establishments with subsidiaries, but this comparison is mainly relevant from the perspective of the host State, as indicated by article 24(3) of the OECD Model Tax Convention. This is also the approach favoured by the Court in *X Holding*[261]. When looking at tax rules in the home State, the ECJ rather compares domestic and cross-border situations (vertical comparison) instead of two different cross-border situations (horizontal comparison). In that respect it should be observed that the wording of article 49 TFEU does not require equal treatment of different investment forms: article 49 TFEU specifies that discriminations shall be prohibited "on the setting-up of agencies, branches or subsidiaries". Consequently, the purpose of article 49 TFEU is, in my opinion, to get rid of differences of treatment when setting up agencies, branches or subsidiaries in other Member States, as compared to if such agencies, branches or subsidiaries were established domestically. That is, each investing form (*i.e.* whether one sets up an agency, a branch or a subsidiary) should not be hindered when it is being used in another Member State. But this does not mean that these three different investment forms should receive the same treatment. Actually, it would be impossible to apply such an obligation in practice, because of the lack of guidance as to which tax treatment should be applicable to all three investment forms. Also, in certain situations a particular investment form may benefit from an advantageous tax treatment (*e.g.* permanent establishments' losses are often deductible in the home State), while in other situations it is another investment form that receives the most advantageous tax treatment (*e.g.* foreign subsidiaries' profits are normally not taxable in the home State).

Consequently, the permanent establishment/subsidiary comparator is, in my view, irrelevant from the perspective of the home State. It is more in accordance with the text of the freedom of establishment to make sure that the same situation receives the same treatment in a domestic and in a cross-border context (vertical comparison). It is not convincing that a Member

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[261] ECJ, 25 February 2010, case C-337/08, *X Holding BV v Staatssecretaris van Financiën*, para. 40: "the Member State of origin is not obliged to apply the same tax scheme to non-resident subsidiaries as that which it applies to foreign permanent establishments".

State justifies its CFC rules by claiming that it results in the same treatment as permanent establishments: article 49 TFEU primarily requires this Member State to make sure that foreign subsidiaries are not treated less favourably than domestic subsidiaries. As a result, I agree with the Court's rejection of the permanent establishment/subsidiary comparator from the perspective of the home State: the sole focus in *Cadbury Schweppes* on the tax treatment of subsidiaries was, in my opinion, correct[262]. Moreover, if Member States had the right under the freedom of establishment to tax foreign subsidiaries and permanent establishments similarly, then credit countries would be tempted to tax foreign subsidiaries, while exemption countries may be tempted to refuse cross-border loss relief of permanent establishments. Both situations would have negative consequences on the internal market. For these reasons, it is submitted that the permanent establishment/subsidiary comparator should not be given too much relevance when applying the freedom of establishment from the perspective of the home State.

3.2.2.4 Conclusion

The conclusion of the above analysis in my view confirms that the ECJ was right in *Cadbury Schweppes* to focus on a vertical comparison. The result of this comparison tends to reveal a preference for the fiscal principle of territoriality over the principle of worldwide taxation, however this is only an assumption based on the restrictive reasoning of the ECJ, through focusing solely on the parent company.

The solution reached by the ECJ in *Cadbury Schweppes* is now discussed with regard to its consequences, *i.e.* a limitation of the application of the principle of worldwide taxation in favour of the fiscal principle of territoriality.

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[262] In that respect see also COM 90 (595) final, 24 January 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*, point 5, where the European Commission observes that "Equality of treatment between permanent establishments and subsidiaries is not, however, a generally accepted idea".

3.2.3 Consequences of the Cadbury Schweppes case with regard to the principle of worldwide taxation

Cadbury Schweppes has important consequences on the discussion relating to the extent of Member States' tax jurisdiction. The consequences of *Cadbury Schweppes* are sometimes at tension with other cases, both older and more recent ones, which makes it difficult to identify the taxation principle that best suits the requirements of the EU Treaties.

Cadbury Schweppes should be discussed in the light of three aspects of particular importance. First, CFC rules imply the taxation of a non-resident's foreign income (3.2.3.1). Second, a Member State may wish to favour the principle of worldwide taxation instead of the fiscal principle of territoriality for the prevention of tax avoidance (3.2.3.2). Third, CFC rules imply the taxation of foreign subsidiaries at the level of the State of the parent company on the basis of the principle of worldwide taxation, while domestic subsidiaries are exempted from such a taxation, which the ECJ accepted in *FII Group Litigation*. The consistency of *Cadbury Schweppes* with *FII Group Litigation* should therefore be discussed (3.2.3.3).

3.2.3.1 CFC rules and the taxation of a non-resident's foreign income

Prima facie it could be concluded from *Cadbury Schweppes* that the ECJ considered that an extensive application of the principle of worldwide taxation to non-residents is incompatible with EU law. However, before ruling in *Cadbury Schweppes* the Court had the opportunity to consider the taxation of non-residents' foreign income in cases such as *Saint-Gobain*[263] and *van Hilten*[264]. In *Saint-Gobain*, although the core problem of the case was not the

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[263] ECJ, 21 September 1999, case C-307/97, *Saint-Gobain*. For comments see Mattias Dahlberg, *Direct taxation in relation to the freedom of establishment and the free movement of capital*, Kluwer Law International, 2005, pp. 221-231; Pasquale Pistone, *The impact of Community law on tax treaties: issues and solutions*, Kluwer Law International, 2002, pp. 145-152; René Offermanns, Carlo Romano, *Treaty benefits for permanent establishments*, European Taxation, May 2000, pp. 180-189.

[264] ECJ, 23 February 2006, case C-513/03, *Heirs of M.E.A. van Hilten-van der Heijden*. For comments see Flavien Mariatte, *Droits de succession et restriction aux mouvements de capitaux*, Revue Europe, April 2006, pp. 11-12 ; Katia Cejie, *Utflykttningsbeskattning av kapitalökningar – en*

taxation of a non-resident's foreign income but the entitlement of a permanent establishment to treaty benefits, the ECJ still accepted that a Member State taxes a permanent establishment on the foreign dividends it receives. *van Hilten*, decided a couple of months before *Cadbury Schweppes*, was about the Netherlands extension of inheritance taxes to former residents also being Netherlands nationals. The ECJ found the Netherlands rules at hand in *van Hilten* compatible with EU law.

Consequently, from a tax policy perspective *Saint-Gobain*, *van Hilten* and *Cadbury Schweppes* reached different outcomes: contrary to *Saint-Gobain* and *van Hilten*, the Court found in *Cadbury Schweppes* that the application of the principle of worldwide taxation to non-residents constituted a prohibited restriction of the freedom of establishment. One can wonder whether in *Cadbury Schweppes* the ECJ intended to revise its previous case law on the principle of worldwide taxation and limit the extent of Member States' tax jurisdiction to lean towards the fiscal principle of territoriality rather than the principle of worldwide taxation. This conclusion would not be unreasonable, given the fact that in *Cadbury Schweppes* the Court, for the first time, found that taxation of foreign income constituted a restriction. However, later case law clearly accepted the application of the principle of worldwide taxation[265]. Therefore, the reason why the Court found CFC rules incompatible with EU law in *Cadbury Schweppes* is not solely related to the restrictive effect of the worldwide principle as such. Rather, it is the difference of treatment between domestic and foreign subsidiaries that seems to motivate the judgment of the Court.

Yet, in *van Hilten* the Court accepted the Dutch rules although they did treat former residents differently depending on whether or not they were nationals: former residents being Dutch nationals were subject to worldwide inheritance tax, contrary to non-nationals. The ECJ accepted the worldwide

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skattevetenskaplig studie i internationell personbeskattning med fokus på skatteavtals- och EU-rättsliga problem, Uppsala, 2010, pp. 245-247.

[265] See for example ECJ, 6 December 2007, case C-298/05, *Columbus Container Services B.V.B.A. & Co. v Finanzamt Bielefeld-Innenstadt.*

principle applied in a discriminatory manner between nationals and non-nationals, arguing that this difference of treatment flows "from the Member States' power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation"[266]. So the ECJ in *van Hilten* accepted a discrimination between nationals and non-nationals, while it rejected a discrimination between residents and non-residents in *Cadbury Schweppes*. However, in my opinion, *Cadbury Schweppes* and *van Hilten* are not conflicting from a strictly technical point of view and with regard to the Court's case law. This is because in *Cadbury Schweppes* the UK CFC rules taxed resident and foreign subsidiaries differently; in contrast, in *van Hilten* all nationals were taxed similarly, irrespective of their residence. That is, the Netherlands taxed consistently according to one and the same connecting factor (nationality), while the UK taxed differently based on one and the same connecting factor (residence). Since the Court has always been holding that Member States remain free to determine the connecting factors for levying taxes, the negative consequences resulting from the non-discriminatory application of EU law would be compatible with the freedom of establishment. Conversely, a Member State taxing differently based on the same connecting factor would be infringing EU law.

Therefore, the reasoning of the Court in *Cadbury Schweppes* is understandable and not necessarily inconsistent with its previous case law on the taxation of non-residents' foreign income.

3.2.3.2 *May a Member State favour the principle of worldwide taxation over the fiscal principle of territoriality for the prevention of tax avoidance?*

The fiscal principle of territoriality and the principle of worldwide taxation imply opposite consequences as to the taxation of foreign income: while the fiscal principle of territoriality excludes foreign income from the domestic tax base, the worldwide principle taxes such income. An inherent consequence to the fiscal principle of territoriality is, therefore, the option to enjoy lower foreign tax rates, since the foreign activity only supports local taxation in the host State. In the context of a group of companies, the fiscal principle of territoriality is usually applied with regard to foreign

[266] ECJ, 23 February 2006, case C-513/03, *Heirs of M.E.A. van Hilten-van der Heijden*, para. 47.

group members, as a consequence of the principle of personality. The principle of personality may thus allow avoiding taxation in the home State, through the accumulation of profits in the host State. To counter such practices a State may be willing to bypass the personality principle through replacing the fiscal principle of territoriality applied to legal subjects by the principle of worldwide taxation. CFC rules have thus become an efficient mechanism to prevent tax avoidance.

The result of *Cadbury Schweppes* is a clear limitation to the application of the principle of worldwide taxation to foreign subsidiaries, thereby enhancing the fiscal principle of territoriality and mitigating Member States' rights to prevent tax avoidance through relying on this principle. It is difficult to have a single position on whether or not it is desirable that EU law limits to such a great extent Member States' initiatives to prevent tax avoidance, because the problem is twofold: on the one hand, some taxpayers may be trying to escape the normal payment of taxes, which is harmful to Member States' budgets and the stability of their economies. On the other hand, CFC rules may be an easy way to increase public revenues and deter foreign investments, thus encouraging domestic investments. The compromise reached by the ECJ in *Cadbury Schweppes* leans towards limiting Member States' rights to prevent tax avoidance, by refusing them to apply the principle of worldwide taxation in any situation. In addition, the fact that the ECJ chose to rely on the taxation of the parent company, not the taxation of the foreign subsidiary as such, leaves little chance for Member States to be able to justify their CFC rules and thereby limits the principle of worldwide taxation to the benefit of the fiscal principle of territoriality. At the same time, Member States retain the right to prevent tax avoidance in as much as their tax measures are aimed at preventing wholly artificial arrangements created with the purpose of avoiding the payment of taxes.

Two questions should be discussed in this part of the dissertation. A first question is whether EU law may, at all, be abused, or if CFC rules should have been found incompatible with EU law in any case (3.2.3.2.1). Since the ECJ found that EU law may be abused, a second question is whether the Court left enough, or, on the contrary, too much space for Member States to fight the abuse of EU law (3.2.3.2.2).

3.2.3.2.1 CFC taxation, a means to prevent the abuse of EU law

May EU law be abused, or should CFC rules have been found incompatible with EU law in any case? First of all, it can be observed that the doctrine of abuse of rights exists in different fields of the law[267]. Domestic tax laws often include some forms of anti-avoidance measures, be it a general principle of anti-avoidance or specific anti-avoidance provisions. Also, it is often considered that taxpayers may be deprived from the benefits of a tax treaty when entering into arrangements that constitute an abuse of the provisions of the tax treaty[268]. This means that in the field of tax law, it is often considered that the rights conferred by a particular source of law may be abused, which may entitle a State to deny the benefits normally enjoyed under this particular source of law[269].

The ECJ has had to deal with situations of abuse of the freedom of establishment in several different contexts[270]. It seems that the Court considers that the freedom of establishment is not absolute, *i.e.* it may be abused and

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[267] See Luc De Broe, *International tax planning and prevention of abuse*, IBFD Doctoral Series, 2008, p. 306: "The doctrine of abuse of rights between States exists in international law and is even enunciated in treaties conferring rights on individuals who are the subject of such treaties. However there is no unanimity among authors whether abuse of rights by States is recognized as a principle of international law and there is no case law of the ICJ that characterizes the concept of abuse of rights as such a principle".

[268] See the Commentary on article 1 of the OECD Model Tax Convention, 2010, particularly at para. 7-12.

[269] For an analysis of abuse of rights in the field of taxation from an international law perspective see Luc De Broe, *International tax planning and prevention of abuse*, IBFD Doctoral Series, 2008, pp. 302-337. See also pp. 377-404 for an analysis of the position of the OECD with regard to the application of domestic anti-avoidance rules to tax treaties.

[270] For a general analysis on the abuse of EU law see Luc De Broe, *International tax planning and prevention of abuse*, IBFD Doctoral Series, 2008, pp. 751-929; Melchior Wathelet, *L'abus de droit en droit communautaire: application à la TVA et la fiscalité directe*, Bulletin Fiscal, December 2006, pp. 1119-1129; Philippe Léger, Éric Ginter, Christian Comolet-Tirman, Laurent Vallée, Michel Aujean, *Libertés communautaires et abus de droit*, Revue de Droit Fiscal, 22 November 2007, pp. 13-18; Stig von Bahr, *Skatteflykt i EG-rättslig belysning*, Skattenytt, 2007-11, pp. 644-651; Kristina Ståhl, *EG-rätt och skatteflykt*, Skattenytt, 2007-11, pp. 575-594.

when it is abused a Member State may have the right to limit a Union national's rights under the EU Treaties. The ECJ indeed accepts that a Member State "is entitled to take measures designed to prevent certain of its nationals from attempting, under cover of the rights created by the Treaty, improperly to circumvent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of provisions of Community law"[271]. This solution seems rather close to the concept of *abus de droit*[272] in civil law jurisdictions[273].

To better understand when the protection offered by the freedom of establishment is made available to Union nationals, it is necessary to emphasise that the objective of the freedom of establishment is defined as allowing "a national of a Member State to set up a secondary establishment in another Member State to carry on his activities there and thus assist economic and social interpenetration within the Community in the sphere of activities as self-employed persons (…). To that end, freedom of establishment is intended to allow a Community national to participate, on a stable and continuing basis, in the economic life of a Member State other than his State of origin and to profit therefrom"[274]. Additionally, the Court observed that "the concept of establishment within the meaning of the Treaty provisions

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[271] ECJ, 9 March 1999, case C-212/97, *Centros*, para. 24.

[272] See the definition of *abus de droit* in French civil law provided by Alain Sériaux, *Dictionnaire de la culture juridique*, Presses Universitaires de France, 2003, p. 2: "La théorie dite de l'abus de droit (plus exactement, de l'abus *des droits* ou, au singulier, de l'abus *d'un droit*) a pour vocation de corriger certaines conséquences jugées néfastes de la reconnaissance de droits subjectifs au profit des personnes physiques ou morales. Par son inspiration, elle s'apparente ainsi à d'autres correctifs, tels que la bonne foi, l'équité ou la règle *fraus omnia corrumpit*. Son objet – les droits subjectifs – lui a cependant valu une considération toute particulière de la part de la doctrine juridique". For an overview of the doctrine of abuse of rights in French law, see Olivier Fouquet, *Fraude à la loi et abus de droit*, Revue de Droit Fiscal, 23 November 2006, pp. 1999-2009.

[273] See Philippe Léger, Éric Ginter, Christian Comolet-Tirman, Laurent Vallée, Michel Aujean, *Libertés communautaires et abus de droit*, Revue de Droit Fiscal, 22 November 2007, pp. 13-18.

[274] ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*, para. 53.

on freedom of establishment involves the actual pursuit of an economic activity through a fixed establishment in that State for an indefinite period (…). Consequently, it presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there"[275]. This means that a taxpayer cannot claim the protection of the freedom of establishment if he did not actually exercise it through a genuine establishment. In contrast, as long as a taxpayer exercises his freedom of establishment through a genuine establishment, he should not fear anti-abuse measures. In that respect, the ECJ in my opinion rightly confirmed in *Cadbury Schweppes* that a taxpayer may exercise his freedom of establishment with the aim of enjoying lower foreign tax rates: "it is settled case-law that any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company"[276]. Indeed, if enjoying foreign lower tax rates were considered as abuse of the freedom of establishment, taxation would no longer be a tool used by Member States to attract foreign investments. This would dampen competition between Member States, although competition is a central aspect of the objective of achievement of the internal market[277]. The freedom of establishment, however, cannot be invoked when a taxpayer has established a "wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned"[278]. I agree with this finding, as the contrary would encourage harmful tax competition, which is not in line with the principle of sincere cooperation[279].

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[275] *C. cit.*, para. 54.

[276] *C. cit.*, para. 49.

[277] See Frans Vanistendael, *In defence of the European Court of Justice*, Bulletin for International Fiscal Documentation, March 2008, pp. 94-95; Dennis Weber, *Is the limitation of tax jurisdiction a restriction of the freedom of movement?*, Accounting and taxation & assessment of ECJ case-law, 2007 EATLP Congress, p. 120.

[278] ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*, para. 51.

[279] See article 4(3) TEU.

This position seems reconciliable with other cases[280] such as *Eurowings*[281], *Barbier*[282] or case law applying secondary legislation such as *Halifax*[283] as it (i) allows a Member State national to exercise his freedom of establishment with the exclusive aim to pay lower taxes in another Member State, but (ii) on the condition that he sets up an actual establishment in accordance with the freedom of establishment provided by article 49 TFEU. This view is also supported by cases such as *Lankhorst-Hohorst*[284] and *Thin Cap Group Litigation*[285] in which an anti-avoidance measure, thin capitalisation legisla-

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[280] See Melchior Wathelet, *L'abus de droit en droit communautaire: application à la TVA et la fiscalité directe*, Bulletin Fiscal, December 2006, pp. 1119-1129.

[281] ECJ, 26 October 1999, case C-294/97, *Eurowings*, para. 44: "Any tax advantage resulting for providers of services from the low taxation to which they are subject in the Member State in which they are established cannot be used by another Member State to justify less favourable treatment in tax matters given to recipients of services established in the latter State".

[282] ECJ, 11 December 2003, case C-364/01, *Barbier*, para. 71: "a Community national cannot be deprived of the right to rely on the provisions of the Treaty on the ground that he is profiting from tax advantages which are legally provided by the rules in force in a Member State other than his State of residence".

[283] ECJ, 21 February 2006, case C-255/02, *Halifax*, para. 73 : "taxpayers may choose to structure their business so as to limit their tax liability". For a comment see Yolande Sérandour, *L'abus de droit selon la CJCE – À propos de l'arrêt Halifax*, Revue de Droit Fiscal, 20 April 2006, pp. 846-849. As the *Halifax* case related to VAT, *i.e.* a harmonised area where Member States have adopted secondary legislation, the position of the Court may not with all certainty be transposed to direct taxation as it is a non-harmonised area. However, the ECJ referred at para. 64 of *Cadbury Schweppes* to *Halifax* and a case in the field of agriculture where a regulation is applicable (ECJ, 14 December 2000, case C-110/99, *Emsland-Stärke*), with regard to the necessary reunion of both a subjective element (*i.e.* the intention to obtain a tax advantage) and objective circumstances (showing that the objective pursued by the freedom of establishment has not been achieved) to find that a wholly artificial arrangement is at hand. This reference to case law in harmonised areas tends to indicate that the conditions required for Member States to prevent abuse of EU law may be similar, whether or not secondary legislation has been adopted by Member States.

[284] ECJ, 12 December 2002, case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*.

[285] ECJ, 13 March 2007, case C-524/04, *Thin Cap Group Litigation*, see particularly para. 80-87.

tion, was found incompatible with EU law, except when it was applied in certain situations and up to a certain extent[286].

This position is, in my view, a correct interpretation of the requirements of the EU Treaties: in an internal market without internal frontiers, it seems desirable that companies be free to structure their operations so as to enjoy the advantages offered on the different places of the market. By letting taxpayers enjoy local tax rates and tax systems, one promotes the freedom of movement and at the same time enhances competition in the internal market. If, on the contrary, taking advantage of lower foreign tax rates and more advantageous tax systems would as such constitute an abuse of the freedom of establishment, this concept would be emptied from its meaning: what would then remain of the freedom of movement if a company could be accused of abusing its national legislation simply because it compared the tax rates and tax accounting rules of his home State with anoter Member State, and decided to exercise his freedom of establishment because the host State was more attractive? Not only would the freedom of establishment be significantly harmed, but also the free competition between Member States would be breached as potential host States could no longer use their tax rates and tax accounting rules to attract foreign investors. At the same time, it would go beyond the scope of article 49 TFEU to prohibit CFC rules in situations that do not correspond to a genuine establishment. By entering into the EU Treaties, the contracting Member States have decided to set the objective of achieving an internal market, in as much as the internal market meets the general purpose of the European integration. The purpose of becoming a member of the European Union can, in my view, hardly be to let a Member State's national escape the normal payment of taxes. If the Court in *Cadbury Schweppes* would not have introducted an exception to the prohibition of CFC rules to prevent wholly artificial arrangements, taxpayers would be able to set up a letterbox company in a Member State and attract all taxable income there. This would contra-

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[286] On the compatibility of thin capitalisation rules with EU law see Alexandre Maitrot de la Motte, *La sous-capitalisation à l'épreuve des libertés de circulation*, Revue de Droit Fiscal, 25 February 2010, pp. 11-21.

dict the search for a balanced allocation of the power to impose taxes between Member States.

Therefore, the exception to the prohibition of CFC rules to wholly artificial arrangements is, in my opinion, a satisfying solution, which means that the fiscal principle of territoriality should not be absolute, *i.e.* the principle of worldwide taxation should be applicable in certain situations. This exception can also be compared to case law in the field of VAT that found a possible situation of abuse when a tax advantage constitutes the essential aim of a transaction undertaken by a taxpayer[287]. However, it does not seem to be settled case law whether or not a general principle of anti-abuse exists within EU law, as illustrated by the findings of the ECJ in the *Kofoed* case[288].

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[287] In that respect see ECJ, 21 February 2006, case C-255/02, *Halifax*, para. 75: "the essential aim of the transactions concerned is to obtain a tax advantage. As the Advocate General observed in point 89 of his Opinion, the prohibition of abuse is not relevant "where the economic activity carried out may have some explanation other than the mere attainment of tax advantages". See also ECJ, 21 February 2008, case C-425/06, *Ministero dell'Economia e delle Finanze v Part Service Srl*, para. 45: "the Sixth Directive must be interpreted as meaning that there can be a finding of an abusive practice when the accrual of a tax advantage constitutes the principal aim of the transaction or transactions at issue". It can be observed that the concept of abuse may not necessarily be identical with regard to primary law and secondary law. *Prima facie* it seems to be enough that a transaction has as an essential aim to obtain a tax advantage to qualify as abuse with regard to VAT, while in the field of direct taxation the abuse of the EU Treaties seems to require that a tax advantage is the sole aim of a transaction. The findings of the *Halifax* and *Part Service* cases have been confirmed in the *Weald Leasing* case, although no abuse was at hand in this case: see ECJ, 22 December 2010, case C-103/09, *The Commissioners for Her Majesty's Revenue and Customs v Weald Leasing Ltd.*

[288] See ECJ, 5 July 2007, case C-321/05, *Hans Markus Kofoed v Skatteministeriet*. See particularly para. 46 where the ECJ found that it is "for the national court to ascertain whether there is, in Danish law, a provision or general principle prohibiting abuse of rights or other provisions on tax evasion or tax avoidance which might be interpreted in accordance with Article 11(1)(a) of Directive 90/434 and thereby justify taxation of the exchange of shares in question". By referring to the national provisions, the ECJ seems to indicate that the mergers directive does not, as such, establish a principle of anti-abuse. Tax avoidance may, accordingly, have to be prevented on the basis of a national anti-abuse provision. The finding of the ECJ in the *Kofoed* case seems to support the view according to which EU law does

Following the *Cadbury Schweppes* decision, another ruling, also about a replacement of the fiscal principle of territoriality by the principle of worldwide taxation to prevent tax avoidance, came to the opposite conclusion: in *Columbus Container*[289] the ECJ was confronted with the German rules that switched from the exemption to the credit method in relation to a transparent partnership taxed in Belgium. This ruling was issued after *Cadbury Schweppes* and given the solution found by the ECJ in this last case, one could have expected the Court to rule in a similar manner in *Columbus Container*. However, the ECJ found the German rules compatible with EU law. Therefore, from a tax policy perspective, these decisions are hardly reconciled[290]: both measures aimed at preventing tax avoidance and similarly resulted in the impossibility to enjoy foreign lower tax rates[291]. However, the *Columbus Container* case does not question the compatibility of CFC rules with EU law, as confirmed by the *Test Claimants in the CFC and Dividend Group Litigation*[292] case in which the ECJ maintained that CFC rules are, in principle, incompatible with EU law. Therefore, the analysis done by the Court of the conflict between the freedom of establishment and its abuse should not be questioned by the *Columbus Container* decision.

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not, by itself, entail a principle of anti-abuse, contrary to the *Halifax* case in which the ECJ found a right to deny deduction of VAT on the basis of primary law, not secondary law (in this respect see Stig von Bahr, *Skatteflykt i EG-rättslig belysning*, Skattenytt, 2007-11, p. 647: "Det är tydligt att bortfallet av rätten till avdraget inte baserades på någon bestämmelse i direktivet – detta hade ju varit i strid med läran om direktivs direkta effect – utan på en allmän princip vid tillämpning av EG-rätten, dvs. ytterst på primärrätten").

[289] ECJ, 6 December 2007, case C-298/05, *Columbus Container Services B.V.B.A. & Co. v Finanzamt Bielefeld-Innenstadt*. This case is discussed in more details in chapter 4 of the dissertation.

[290] The comparison between *Cadbury Schweppes* and *Columbus Container* is discussed in more details *infra*, see 4.2.2.2.2.1.

[291] A possible explanation to this difference in outcome is that CFC rules introduce a discriminatory treatment of the parent company regarding domestic and foreign subsidiaries, while a switch-over from the exemption to the credit method puts domestic and foreign establishments on an equal level.

[292] ECJ, 23 April 2008, case C-201/05, *Test Claimants in the CFC and Dividend Group Litigation*.

Now that the principle of setting limits to the protection offered by the freedom of establishment has been discussed, it is time to analyse the border between abusive and non-abusive situations.

3.2.3.2.2 The prevention of tax avoidance through CFC rules: drawing a border between abusive and non-abusive situations

As the concept of abuse is recognised by the ECJ, the means of Member States to prevent tax avoidance eventually depend on the definition of a wholly artificial arrangement. Without guidelines applicable at the Union level, interpretations of this concept may differ between Member States, which disturbs neutrality and free competition within the internal market. The ECJ has already provided some indications, especially at paragraphs 67-68 of the *Cadbury Schweppes* judgment. By providing guidance as to how to define a wholly artificial arrangement, the ECJ increases legal certainty, while it does not prevent Member States to enact more detailed provisions at the Union level.

However, it is wondered whether the Court did not leave too much space to Member States to apply their CFC rules: in particular, the ECJ requires the establishment "to carry on genuine economic activities in the host Member State"[293], which "must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the foreign subsidiary physically exists in terms of premises, staff and equipment"[294]. That is, if a foreign subsidiary does not bring together all these criteria, its Member State of origin may still apply CFC rules. Requiring a physical existence in terms of premises, staff and equipment to constitue genuine economic activities may not, in my opinion, always correctly reflect the modern and globalised economy. Indeed, the modern technologies tend to open new possibilities for companies to carry on their business with less physical presence. It becomes easier to separate different types of activities across different countries. But on the other hand, if the Court had

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[293] ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*, para. 66.
[294] *C. cit.*, para. 67.

written "or" instead of "and" when referring to "premises, staff and equipment"[295], taxpayers may have been encouraged to enter into aggressive tax planning schemes through avoiding CFC taxation by establishing either premises, staff or equipement in a certain Member State. This would move the discussion to the required level of physical presence of either criterion in the host State, which could then differ greatly from one Member State to another. Consequently, although the choice of the ECJ leaves, in my opinion, too much space for Member States to apply their CFC rules, it can be understood that it is necessary to avoid harmful tax planning within the internal market. This illustrates the need for common legislation throughout the European Union. In that respect, it should also be observed that the Council of the European Union, in a resolution dated 8 June 2010[296], broadened the criteria provided by the ECJ in *Cadbury Schweppes* through adopting a non-exhaustive list of indicators suggesting that profits have been transferred to a foreign subsidiary[297], thus encouraging Member States to apply their CFC rules in these cases. This non-exhaustive list may result in increasing the scope of CFC rules within the internal market, which I find regrettable given the abovementioned argument according to

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[295] *Ibid.*

[296] Council Resolution on coordination of the Controlled Foreign Corporation (CFC) and thin capitalisation rules within the European Union, 8 June 2010, 2010/C 156/01, Official Journal of the European Union, 16 June 2010.

[297] The following non-exhaustive list of indicators suggests that profits may have been artificially diverted to a foreign subsidiary, thereby justifying the application of CFC rules: "(a) there are insufficiently valid economic or commercial reasons for the profit attribution, which therefore does not reflect economic reality; (b) incorporation does not essentially correspond with an actual establishment intended to carry on genuine economic activities; (c) there is no proportionate correlation between the activities apparently carried on by the CFC and the extent to which it physically exists in terms of premises, staff and equipment; (d) the non-resident company is overcapitalised, it has significantly more capital than it needs to carry on its activity; (e) the taxpayer has entered into arrangements which are devoid of economic reality, serve little or no business purpose or which might be contrary to general business interests, if not entered into for the purpose of avoiding tax". See Council Resolution on coordination of the Controlled Foreign Corporation (CFC) and thin capitalisation rules within the European Union, 8 June 2010, 2010/C 156/01, Official Journal of the European Union, 16 June 2010.

which the modern and globalised economy may not necessarily be materialised through the physical presence of premises, staff and equipment. It remains to be seen whether Member States will amend their CFC legislation to take into account the recommendations of the Council.

As a conclusion, setting limits to the protection offered by the freedom of establishment is, in my opinion, correct. However, when drawing the border between abusive and non-abusive situations, a risk may exist that the principle of worldwide taxation is too easily reintroduced to prevent a taxpayer from enjoying the advantageous tax rates offered throughout the internal market.

It is now discussed whether *Cadbury Schweppes* may be reconciled with *FII Group Litigation*, as these cases came to different outcomes as to the right of a Member State to tax foreign subsidiaries, contrary to domestic subsidiaries.

3.2.3.3 CFC rules imply for the shareholder a different treatment between domestic and foreign subsidiaries: can the Cadbury Schweppes case be reconciled with the FII Group Litigation case?

Shortly after its ruling in *Cadbury Schweppes* the ECJ had to deal with another UK case, this time in relation to the taxation of dividends. The Court also compared the taxation of a parent company with regard to domestic and foreign subsidiaries, but came to a different solution: foreign dividends could be taxed together with a tax credit being granted, while domestic dividends could be exempted from taxation[298]. It has been observed in the doctrine that *Cadbury Schweppes* and *FII Group Litigation* are difficult to rec-

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[298] ECJ, 12 December 2006, case C-446/04, *Test Claimants in the Franked Investment Income Group Litigation v Commissioners of Inland Revenue*. For a comment see Trevor Johnson, *More bad news from Europe*, Tax Notes International, 22 January 2007, pp. 243-245. The findings of *FII Group Litigation* were confirmed in ECJ, 10 February 2011, joined cases C-436/08 and C-437/08, *Haribo Lakritzen Hans Riegel BetriebsgmbH, Österreichische Salinen AG v Finanzamt Linz*, para. 86.

oncile[299]. Indeed, from a tax policy point of view, both cases resulted in raising the tax rate applicable to foreign income up to the domestic level. The Court, however, came to different solutions.

I agree with the authors observing the incompatibility between *Cadbury Schweppes* and *FII Group Litigation*. The Court's decision in the *FII Group Litigation* case, as to the different methods to eliminate double taxation depending on the origin of the dividend is, in my opinion, incorrect. The ECJ recognised that "In order for the application of an imputation system to be compatible with Community law (…), it is necessary, first of all, that the foreign-sourced dividends are not subject in that Member State to a higher rate of tax than the rate which applies to nationallysourced dividends"[300]. The Court assumes that the UK system is compatible with EU law if foreign dividends (subject to the credit method) are not taxed in the residence State at a higher rate than domestic dividends (subject to the exemption method). How would that be possible? By definition the fact that foreign dividends are taxed while domestic dividends are exempt from taxation implies different tax rates. However, in practice, if the inbound dividend supports a withholding tax at least as high as the taxation in the home State, no additional tax would be levied in the home State because a tax credit would be granted for the foreign tax. If, in contrast, withholding taxes levied in the host State are lower than in the home State, the taxation of dividends in the

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[299] See Ben J.M. Terra, Peter J. Wattel, *European Tax Law*, fifth edition, Kluwer Law International, 2008, p. 823: "the exact same argument is held to be valid and decisive in *Test Claimants in the FII Group Litigation* and invalid and irrelevant in *Cadbury Schweppes*". See also Kristina Ståhl, *EG-domstolens domar*, Skattenytt, 2007-6, p. 353: "Att avräkningsmetoden tillämpas i de utländska fallen leder till att moderbolaget som sådant kan drabbas av ett skatteuttag vid utdelningar från utlandet som inte aktualiseras vid utdelningar från inhemska bolag. Det sistnämnda talar enligt min mening starkt för att de brittiska reglerna borde ha bedömts hindra den fria rörligheten, särskilt mot bakgrund av att domstolen i det ovan behandlade Cadbury Schweppes-målet avvisade att ett koncernsynsätt skulle anläggas vid bedömningen av om de där prövade CFC-reglerna utgjorde ett hinder".

[300] ECJ, 12 December 2006, case C-446/04, *Test Claimants in the Franked Investment Income Group Litigation v Commissioners of Inland Revenue*, para. 49.

latter State results in a less favourable treatment than if the dividends were subject to the exemption method.

Consequently, the ECJ – on a hardly understandable basis – accepted a worse treatment of foreign income compared to domestic income when taxes may be levied on foreign income. *FII Group Litigation* and *Cadbury Schweppes* are therefore clearly conflicting because in this latter case the Court clearly rejected any difference of treatment between domestic and foreign subsidiaries. How to interpret the *FII Group Litigation* decision and its impact on CFC rules? One could see *FII Group Litigation* as the Court willing to take some distance with the solution reached in *Cadbury Schweppes*, which is indicated by the fact that the ECJ did not even refer to *Cadbury Schweppes* in the key parts of *FII Group Litigation*. Also, in *FII Group Litigation* the ECJ did not need to refer to the prevention of tax avoidance to accept the taxation of foreign income while domestic income was tax exempt. The Court might have considered that *Cadbury Schweppes* puts too strict restrictions on Member States' tax jurisdiction, through strongly limiting the application of the worldwide principle and leaning too much towards the fiscal principle of territoriality. *FII Group Litigation* would then come as a confirmation that Member States may apply either the principle of worldwide taxation or the fiscal principle of territoriality. However, this argument is not convincing, since the *Test Claimants in the CFC and Dividend Group Litigation*[301] case confirmed the comparator and the solution found in *Cadbury Schweppes*. Therefore, *Cadbury Schweppes* should still be considered as valid, despite *FII Group Litigation*. This latter case may be an isolated decision, particularly with regard to the fact that it mainly concerned UK tax rules that were in force until 1999.

3.2.4 Conclusion on CFC rules and the application of the principle of worldwide taxation at a group level

As a conclusion, *Cadbury Schweppes* tends to reveal a scepticism of the ECJ towards the principle of worldwide taxation, which is also identified below in the *Krankenheim* case[302]. Indeed, the Court could have found CFC rules

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[301] ECJ, 23 April 2008, case C-201/05, *Test Claimants in the CFC and Dividend Group Litigation*.
[302] See *infra*, at 4.2.3.2.

compatible with EU law if it had taken into consideration the levy of corporate income tax of domestic subsidiaries. The ECJ may also have paid attention to the fact that CFC rules result in an elimination of the deferral upon the taxation of dividends when such dividends are normally taxed by the State of the parent company. That the Court did not consider these two arguments may be interpreted as a willingness to limit the application of CFC rules within the internal market, which results in mitigating the principle of worldwide taxation in favour of the fiscal principle of territoriality. Consequently, as a result of *Cadbury Schweppes* CFC rules should be restricted to preventing tax avoidance and it is therefore justified that their application be limited to wholly artificial arrangements, although this notion is difficult to define and may give rise to different interpretations by the Member States. However, when drawing the border between abusive and non-abusive situations, the jurisprudence of the ECJ and even more so the redommendations of the Council of the European Union[303] may tend to leave too much space for Member States to apply their CFC rules and reintroduce the principle of worldwide taxation. This may result in Member States still taxing foreign subsidiaries, despite the original intention of the Court.

Despite inconsistencies in the Court's case law (particularly between *FII Group Litigation* and *Cadbury Schweppes*), it is submitted that the ECJ did right in considereding that CFC rules cannot remain untouched by EU law. An internal market cannot exist without competition between the different places of this market[304]. The application of the principle of worldwide taxation to the detriment of the tax advantages offered by other Member States can hardly be reconciled with the objective of achievement of the internal market, particularly given the fact that such an achievement is an obligation since the entry into force of the Treaty of Lisbon[305]. By finding CFC rules

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[303] Council Resolution on coordination of the Controlled Foreign Corporation (CFC) and thin capitalisation rules within the European Union, 8 June 2010, 2010/C 156/01, Official Journal of the European Union, 16 June 2010.

[304] See Frans Vanistendael, *In defence of the European Court of Justice*, Bulletin for International Fiscal Documentation, March 2008, pp. 94-95.

[305] See article 3 TEU: "The Union shall establish an internal market".

in principle incompatible with the freedom of establishment, the Grand Chamber of the ECJ indicated that this fundamental freedom hardly tolerates the offsetting of advantages existing throughout the internal market. Accordingly, with regard to the purpose of the dissertation, it is concluded that the ECJ found that the principle of worldwide taxation applied to foreign group companies may raise compatibility issues with the objective of achievement of the internal market.

After having considered the taxation of foreign group companies' positive income, foreign group companies' negative income is discussed in the next section.

3.3 Deduction of negative income incurred by foreign group companies

"the ECJ was wise not to accept the principle of territoriality as a justification"[306].

3.3.1 Introduction

The question of the compatibility of CFC rules with the objective of achievement of the internal market gave the ECJ the opportunity to consider the principle of worldwide taxation applied at the group level to foreign companies' positive income. The outcome of the *Cadbury Schweppes* case resulted in the limitation of the application of the principle of worldwide taxation, thus enhancing the fiscal principle of territoriality. This outcome is strengthened when considering the fact that the ECJ could have focused on the taxation of the subsidiary, not the parent company, thereby possibly justifying CFC taxation.

When it comes to losses incurred by foreign group companies, it is the fiscal principle of territoriality that conflicts with the objective of achievement of the internal market. As explained in chapter 2 of the dissertation, a State

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[306] Michael Lang, *The Marks & Spencer case - the open issues following the ECJ's final word*, European Taxation, February 2006, p. 60.

is sovereign and as such, it is independent. That is, a State is in principle at liberty to take into account – or not – foreign elements. Consequently, international law acknowledges a fundamental right to exclude all foreign elements. Applied to taxation, a State has the right to strictly apply the fiscal principle of territoriality and refuse to take into account foreign income, whether it is positive or negative. In addition, taxation is often exercised based on the principle of personality under which each tax subject is taxed individually, both at a domestic and a cross-border level. As a result, a resident company is in principle not affected by the losses incurred by group companies, whether they are resident within the same State or abroad. However, tax equalisation mechanisms may take into account losses incurred by other tax subjects. As such mechanisms often treat worse foreign losses, a compatibility with EU law arises.

Before analysing the case law of the ECJ on cross-border loss relief, the two levels of taxation within a multinational group should be emphasised: on the one hand, a foreign subsidiary is taxed on its own profits. On the other hand, the shareholder may in parallel be taxed on a dividend or a capital gain or loss on the shares it holds in the foreign subsidiary[307]. Consequently, if a loss incurred by a foreign subsidiary is deducted by its parent company, the shareholder may benefit from two deductions for corporate income tax purposes because, in addition to the foreign loss itself, he may incur a capital loss on the value of the shares. The two levels of taxation within a multinational group are sometimes taken into account, *e.g.* when a State grants a participation exemption on dividends or capital gains in order not to levy additional taxes to the corporate income taxes paid on the basis of the subsidiary's profits. In such a case, if capital losses are not deductible, the deduction of a foreign loss would not trigger a double deduction. However, there may be situations where a parent company is entitled to the deduction of a capital loss on the shares it holds in a subsidiary, which would then add to the deduction of the corporate loss incurred by the subsidiary if this loss is to be deducted at the level of the parent company. In a purely

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[307] For a discussion of these two levels of taxation see Malcolm Gammie, *Non-discrimination and the taxation of cross-border dividends*, World Tax Journal, June 2010, pp. 162-174.

domestic context, such a double deduction may not necessarily be a problem for the State of the parent company, because transferring the loss simply changes the person entitled to utilise it. As a result, the loss can normally not be carried back or carried forward by the loss-making company, which prevents a double use of the subsidiary's loss. But at the same time, the double deduction remains, i.e. in addition to the loss of the subsidiary, the parent company may have deducted a capital loss. Consequently, even in the domestic context, tax systems are not always designed for ensuring a single and consistent taxation of companies' profits on the one hand, and capital gains or losses on the other hand. Indeed, when a company is profitable, the value of its shares may increase, in which case taxes could be paid both on the business profits of the subsidiary and on capital gains upon a transfer of shares[308]. Accordingly, if such a double taxation is accepted by international tax practice, there is no reason why a double deduction of corporate losses and capital losses should be precluded, be it in the domestic or in the cross-border context. In addition, although the value of shares may be influenced by the results of the subsidiary, there may not necessarily be a direct connection between them: the value of shares may be increasing while the subsidiary is making losses, for example if the subsidiary makes costly investments that are expected to be profitable in the future.

Consequently, in my view there is no sufficient connection between the subsidiary's own business income and the taxation of the shareholder on capital gains or capital losses to preclude cross-border loss relief within the internal market. In addition, since economic double taxation of the two levels of taxation is not always eliminated – which means that it is partly accepted[309] – a possible deduction of a loss also at two levels should not nec-

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[308] *Op. cit.*, p. 167: "the economic double taxation of corporate profits – first at the corporate level in the source state and a second time in the residence state at the level of the equity investor – is therefore an integral part of cross-border corporate investment. It merits observation, however, that this outcome is not necessarily inconsistent with domestic investment".

[309] In that respect, tax treaties do not necessarily eliminate such a economic double taxation: see *Op. cit.*, p. 167: "Bilateral tax treaties are not concerned to eliminate the economic double

essarily be a problem. This conclusion strengthens the view according to which cross-border loss relief should not be precluded by the taxation of capital gains or capital losses. What seems more relevant, in contrast, is the prevention of the double use of corporate losses, *i.e.* their deduction both at the level of the subsidiary and of the parent company.

The lack of a general right to offset losses within a group has led many countries to adopt domestic rules that allow for some degree of loss relief. These rules, herein referred to as "tax equalisation" systems[310], are most often limited to group companies with residence in the same State, because this State has by definition jurisdiction over all resident companies[311]. This difference of treatment between domestic and foreign losses is in accordance with international law, which accepts that a State applies its laws on a strict domestic basis. A group may therefore end up better off in domestic situations rather than in cross-border situations, when tax equalisation opportunities are limited to the home State. However, in the context of the European Union, such a limitation may hinder the objective of achievement of the internal market. The ECJ dealt with this problem particularly in *Marks & Spencer*[312], and completed its reasoning in *Oy AA*[313] and *X Hold-*

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taxation of corporate profits". Indeed, tax treaties focus more on the elimination of juridical double taxation.

[310] See Bertil Wiman, *Equalising the tax burden in a group of companies*, *in* International Studies in Taxation: Law and Economics, Liber Amicorum Leif Mutén, Kluwer Law International, 1999, p. 364: "Tax equalisation here means the levelling of the tax burden with respect to the operating profits or losses of two or more companies".

[311] Some States may however extend loss-relief or consolidation mechanisms to foreign losses, like Austria, France, Italy and Denmark. See Aage Michelsen, General IFA Report, *The treatment of corporate losses*, vol. 83a, 1998. For a comparative analysis of Austria and Denmark see Anna Gerson, *Compensation of losses in foreign subsidiaries within the EU*, Jönköping international business school dissertation series, 2009.

[312] ECJ, 13 December 2005, case C-446/03, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes).* For some comments, see *e.g.* Michael Lang, *The Marks & Spencer case - the open issues following the ECJ's final word*, European Taxation, February 2006, pp. 54-67; Melchior Wathelet, Marks & Spencer plc v Halsey*: lessons to be drawn*, British Tax Review 2006-2, pp. 128-134; Tom O'Shea, *Marks and Spencer v Halsey (HM Inspector of Taxes): restriction, justifica-*

ing[314]. After a brief presentation of these cases (3.3.2) and an analysis of the comparators chosen by the Court (3.3.3), the solutions found for non-final losses (3.3.4) and final losses (3.3.5) are discussed in more details.

3.3.2 Presentation of the *Marks & Spencer*, *Oy AA*, and *X Holding* cases

3.3.2.1 The Marks and Spencer *case*

Marks & Spencer concerned the British group relief regime, the purpose of which is to facilitate transfers of losses within a group. However, according to UK law subsidiaries must be resident or economically active in the UK to be granted group relief. The British parent company Marks & Spencer owned through a Dutch holding company loss-making indirect subsidiaries in Germany, France and Belgium. Marks & Spencer claimed the extension of group relief to the foreign subsidiaries. Group relief was denied since the subsidiaries were neither resident nor economically active in the UK.

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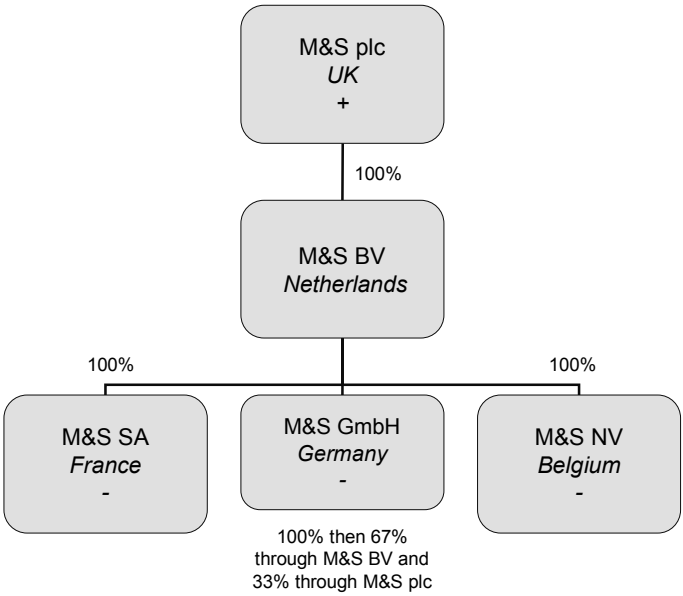
tion and proportionality, EC Tax Review 2006-2, pp. 66-82. For a description of the procedure in the UK for obtaining loss relief following the *Marks & Spencer* ruling, see Kristen A. Parillo, *U.K. court hands Marks & Spencer partial victory*, Tax Notes International, 2 August 2010, pp. 319-321; CFE ECJ Task Force, *Opinion Statement of the CFE Task Force on ECJ cases on the judgment in the case of Marks & Spencer plc v. Halsey (case C-446/03) - judgment delivered 13 December 2005*, European Taxation, January 2007, pp. 51-54.

[313] ECJ, 18 July 2007, case C-231/05, *Oy AA*. For comments see Marjaana Helminen, *Freedom of establishment and Oy AA*, European Taxation, November 2007, pp. 490-498 ; Maurice-Christian Bergerès, *L'impossibilité pour une filiale résidente de déduire de ses revenus imposables un transfert financier vers sa société mère étrangère est-elle compatible avec le droit communautaire?*, Revue de Droit Fiscal, 27 December 2007, pp. 29-36; Melchior Wathelet, *A propos de l'arrêt « Oy AA » de la CJCE: glaçon errant ou pointe d'un redoutable iceberg pour les contribuables européens?*, Feuillets Rapides Francis Lefebvre, 7 September 2007, pp. 9-11.

[314] ECJ, 25 February 2010, case C-337/08, *X Holding BV v Staatssecretaris van Financiën* (hereafter referred to as "*X Holding*"). For comments see Melchior Wathelet, *L'arrêt X – Holding: le divorce entre la liberté de circulation et le shopping fiscal*, Revue de Jurisprudence Fiscale, May 2010, pp. 377-379; Maarten F. de Wilde, *On* X Holding *and the ECJ's ambiguous approach toward the proportionality test*, EC Tax Review, 2010-4, pp. 170-182; Servaas van Thiel, Marius Vascega, X Holding*: why Ulysses should stop listening to the siren*, European Taxation, August 2010, pp. 334-349; Ludovic Bernardeau, *Jurisprudence de la CJUE: fiscalité directe (janv./juin 2010)*, Revue de Droit Fiscal, 14 October 2010, pp. 15-16.



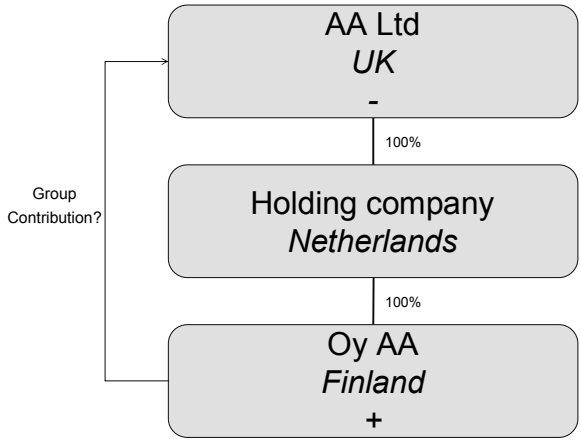
The fiscal principle of territoriality was interpreted by the British tax authorities as forbidding the deduction of foreign losses when no corresponding taxable base was available to the UK authorities[315]. Marks & Spencer contested the decision before the Special Commissioners of Income Tax and argued from the beginning of the procedure that the group relief regime was incompatible with the freedom of establishment. The Special Commissioners of Income Tax did not see a restriction of the freedom of establishment but the High Court of Justice decided to refer to the ECJ for a preliminary ruling. Partly following Advocate General Maduro, the Court considered that the UK legislation was justifiable by the need to protect a balanced allocation of the power to impose taxes between the different Member States concerned, the danger that losses would be used twice, and

[315] Opinion of Advocate General Maduro, delivered on 7 April 2005, case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, para. 58: according to the UK Government, the principle of territoriality "means that it cannot offer a tax advantage where it has no power of taxation".

the risk of tax avoidance. The British legislation was found disproportionate, however, where the possibilities for having the losses taken into account in the subsidiary's State of residence had been exhausted.

3.3.2.2 *The* Oy AA *case*

Oy AA concerned the Finnish group contribution regime. A group contribution allows for tax purposes to transfer cash or receivables within a group of companies. By this means, it is possible to transfer taxable profits to other companies belonging to the same group and achieve offsetting of profits and losses. Group contributions are deductible for the contributor and taxable for the recipient. The Finnish group contribution regime requires that both the contributor and the recipient (owned to 90%) are resident in Finland. Oy AA, resident in Finland, was an indirect subsidiary of AA Ltd, a UK company[316]. Since Oy AA was profitable and AA Ltd was loss-making, the group asked the Central Board of Taxation of Finland if a group contribution could be sent to the UK company.



All the conditions for a group contribution to be deductible were met except that the recipient did not have its residence in Finland. The board refused deduction of the group contribution and Oy AA appealed to the Su-

[316] As in *Marks & Spencer*, the companies involved were owned through holding companies situated in the Netherlands.

preme Administrative Court, which referred the case to the ECJ for a preliminary ruling. All the Governments involved in the case as well as the European Commission were against the deduction of group contributions sent to a foreign group member[317]. The ECJ followed Advocate General Kokott[318] and considered that although the Finnish group contribution regime constituted a restriction of the freedom of establishment, it was justified by need to safeguard the balanced allocation of the power to tax between the Member States and the need to prevent tax avoidance.

3.3.2.3 *The* X Holding *case*

X Holding is a case about the Dutch rules on the opportunity to constitute a consolidated tax entity between companies belonging to the same group, as it resulted from the law on corporation tax from 1969. According to article 15 of this law, a parent company and one or several subsidiaries owned to 95% could be taxed as one entity. The activities and the assets of the subsidiaries are part of those of the parent company, and tax is levied on the parent company for all the companies included in the tax unity. Consequently, internal transactions could be eliminated, assets could be transferred without tax consequences, and only one tax return could be handed in.

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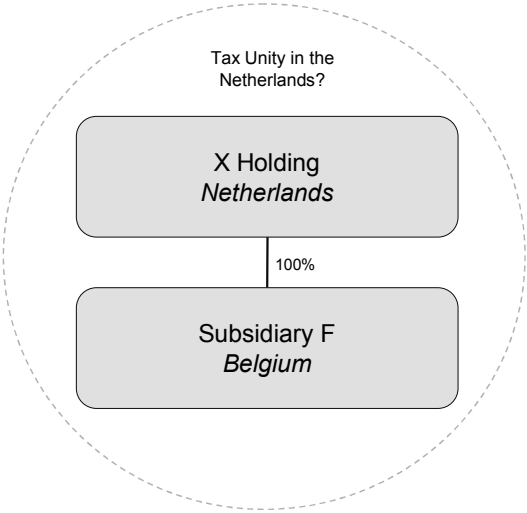
[317] Governments and the Commission invoked coherence, the three justifications found in *Marks & Spencer*, as well as the fiscal principle of territoriality. More particularly, the Finish, Swedish and UK Governments, based on the fiscal principle of territoriality, argued that the group contribution system reflects the consensus in the matter of the international allocation of the competence to tax. Even the Commission accepted the Finnish refusal of deduction, and considered that the non-deductibility of group contribution is a consequence of Member States' agreement upon sharing taxing rights.

[318] Advocate General Kokott considered that allowing for cross border group contributions would lead to a distortion in the distribution of the tax base between States of residence of the group members since the grandparent company located in the UK would not be taxed on the contribution received. She considered that "the present case concerns the fundamental interest of granting the Member States a right at all to impose taxes according to the principle of territoriality". See Opinion of Advocate General Kokott, delivered on 12 September 2006, case C-231/05, *Oy AA*. For a comment see Leif Mutén, *Finland may deny deductible group contributions, Advocate General says*, Tax Notes International, 2 October 2006, pp. 23-24.

What raised a problem from an EU law perspective is that the Dutch rules were limited to companies resident in the Netherlands, or to permanent establishments taxable in the Netherlands. Therefore, when X Holding applied for tax unity with its Belgian subsidiary that had no taxable permanent establishment in the Netherlands, the tax authorities refused this request[319].



The ECJ was asked whether the exclusion of foreign companies from tax unity was compatible with EU law, and concluded that although a difference of treatment was at hand, it was justified by the need to preserve the allocation of the power to impose taxes between Member States[320].

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[319] The Belgian subsidiary was loss-making, although this was not indicated in the wording of the ruling. See Eric Kemmeren, *The Netherlands, pending cases filed by Netherlands courts*, *in* Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (Eds.), ECJ – Recent developments in direct taxation, Linde, 2009, p. 179.

[320] It can be observed that the Dutch Supreme Court followed the X Holding decision and found that the Dutch tax unity rules did not infringe EU law: see *Hoge Raad der Nederlanden*, 7 January 2011, case number 43-484 bis.

The outcome with regard to foreign losses of *Marks & Spencer*, *Oy AA* and *X Holding* is discussed hereunder. As the question of the comparator used by the Court is a relevant issue, it is discussed first (3.3.3). It is then distinguished between the deduction of non-final losses (3.3.4) and final losses (3.3.5), in accordance with the distinction introduced by the ECJ in *Marks & Spencer*.

3.3.3 The choice of comparator

In *Marks & Spencer*, *Oy AA* and *X Holding*, the ECJ compared the situations of a domestic and a foreign company (3.3.3.1). It is important to discuss this comparator and whether or not foreign and domestic subsidiaries should at all be comparable, given the fact that the State of the parent company seldom exercises tax jurisdiction on foreign subsidiaries. It should therefore be analysed with regard to international law whether foreign subsidiaries may whatsoever be excluded from the tax jurisdiction of the State of the parent company. Alternatively, the Court could also have compared foreign subsidiaries with permanent establishments (3.3.3.2).

3.3.3.1 Comparison between domestic and foreign group companies

The choice of a comparator, and whether a comparator at all could be identified, is a complex issue. In *Marks & Spencer* and *Oy AA*, a loss relief mechanism was applicable to domestic group companies only, not to foreign group companies. Indeed, the UK and Finland did not claim tax jurisdiction over foreign tax subjects, and saw no reason to grant relief for losses incurred abroad as the foreign companies' profits were not taxed by these Member States. The rules at hand in *X Holding* did also encompass a loss relief mechanism available to domestic companies, through consolidation, but these rules were broader as they also included the single taxation of the integrated group at the level of the parent company. Therefore, in all these cases the ECJ was to consider whether domestic and foreign group companies were in a comparable situation.

It is true that in the absence of both source and residence within the territory of a certain State, foreign companies are usually not taxed. But is this situation due to an obligation imposed by international law, or to a choice made by the taxing State? It is important to analyse this question, because

Member States have in several cases referred to the lack of competence or tax jurisdiction on foreign subsidiaries to emphasise that domestic and foreign subsidiaries are not in a comparable situation. As demonstrated in chapter 2, international law does not set clear limits to a State's tax jurisdiction, so that taxation of foreign subjects is not prohibited under international law. Source, residence, nationality, are frequent connecting factors for the levy of taxes, but they are not set as compulsory factors according to international law. That is, the existence of source, residence or nationality is not necessarily required for a State to exercise tax jurisdiction. This is why CFC rules are accepted by many countries, although such rules ultimately tax foreign companies on their profits from foreign sources, *i.e.* without one of the abovementioned connecting factors being at hand. In my view, if CFC rules are compatible with international law, then the deduction of foreign companies' losses cannot be prohibited under international law. After all, taking into account foreign companies' income, whether positive or negative, does not question the primary right of the State of residence of these companies to exercise tax jurisdiction: such tax jurisdiction is exercised without taking into account whether other States may also make use of their taxing power, i.e. the tax sovereignty of the residence State of the subsidiary is not encroached upon by the taxes levied by third States.

The Court considers that, as a rule, residents and non-residents are not in a comparable situation. The contrary would extensively disrupt well established tax practices and thus, Member States' tax systems[321]. The consequence of this statement is that residents cannot, in principle, be treated as non-residents, nor can non-residents be treated as residents *per se*. Yet, in certain situations residents and non-residents may be in a comparable situation, otherwise the objective of achievement of the internal market would be deprived of its meaning. So the question to answer in *Marks & Spencer* and *X Holding* was whether a parent company with a foreign subsidiary is

[321] A consequence could be that residents and non-residents would claim the benefits of the other category of taxpayers, alternatively balancing between the fiscal principle of territoriality (to avoid being taxed on foreign positive income) and the principle of worldwide taxation (to have foreign negative income being deducted in the home State).

comparable to a parent company with a domestic subsidiary, although the home State did not tax the profits of the foreign subsidiaries. As explained above, the fact that no tax jurisdiction is exercised on foreign companies results from a choice of the home State, not from an obligation imposed by international law. In some cases, particularly with regard to CFC legislation, a home State does claim tax jurisdiction over foreign companies. Therefore, it is not convincing for a Member State to claim that domestic and foreign companies are not in a comparable situation to avoid having to grant relief for foreign losses, if on the other hand the same Member State may tax foreign income of a non-resident to safeguard its fiscal revenues. Also, article 49 TFEU guarantees the freedom of establishment for subsidiaries, and this article would be deprived of its meaning if loss relief mechanisms limited to domestic companies would necessarily fall outside its scope[322].

In *Oy AA*, comparability was less obvious. Group contribution was sought by a subsidiary, not by a parent company. The argument used in *Marks & Spencer* according to which a State should not grant a tax deduction with regard to foreign subsidiaries because it cannot tax their profits is less relevant from the perspective of the host State, because of the lack of a comparator: a State does normally not tax the profits of a parent company in the hands of its subsidiary, be it in a domestic or a cross-border context. Yet, as was found by the ECJ in the *Oy AA* case, the freedom of establishment would be threatened if the foreign seat of the recipient would, as such, be enough for the Finnish rules to fall outside the scope of EU law. One may, for example, argue that Finland could have accepted the deduction of a contribution, upon the evidence that it is taxed at the level of the recipient. Alternatively, Finland could have granted a temporary right of deduction and thereby improve the cash flows of the group, for the contribution to be reintegrated at a later point in time. Therefore, it seems reasonable that the situation at hand in *Oy AA* does not necessarily fall outside

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[322] In that respect it can be observed that the Swedish Government recognised in the *X AB & Y AB* case that the fact that a subsidiary has its seat abroad did not, as such, justify the exclusion from a tax advantage. See ECJ, 18 November 1999, case C-200/98, *X AB & Y AB*, para. 29.

the scope of EU law due to the foreign residence the parent company. Instead, this situation can be discussed at the justification level, to assess whether Member States could have realistically extended tax equalisation measures to foreign parent companies. Therefore, the Court was, in my view, right in proceeding to the justification level in these three cases.

However, comparing foreign with domestic companies was not the sole comparator available. In *Marks & Spencer* and *X Holding*, the Court was encouraged to take into consideration the foreign subsidiary/permanent establishment comparator.

3.3.3.2 Comparison between foreign subsidiaries and permanent establishments

It was established above that domestic and foreign subsidiaries were rightly found comparable by the ECJ. However, the foreign subsidiary/permanent establishment comparator may also be of relevance in *Marks & Spencer* and *X Holding*: it could replace the comparator between domestic and foreign subsidiaries in case they were not found comparable, or it may add to this analysis.

The subsidiary/permanent establishment comparator was relevant in *Marks & Spencer* and *X Holding*, but not in *Oy AA*: the subsidiary/permanent establishment comparator may be relevant from the perspective of the home State because resident companies may be taxed on their worldwide income, *i.e.* including income earned by them through foreign permanent establishments, while foreign subsidiaries are usually not taxed on their foreign business income. In contrast, no such distinction is made in the host State: the host State does not tax income earned by a foreign head office or parent company. Consequently, even if the Finnish entity in the *Oy AA* case were a permanent establishment belonging to a UK head office, no group contribution could have been given by the permanent establishment to the foreign head office.

It is distinguished hereunder between *Marks & Spencer* (3.3.3.2.1) and *X Holding* (3.3.3.2.2), because the former case concerned only losses while the latter was about consolidation in the home State.

3.3.3.2.1 Comparison between foreign subsidiaries and permanent establishments in the Marks & Spencer case

In *Marks & Spencer* a difference in treatment existed between a shareholder having a loss-making foreign subsidiary and a head office having a loss-making permanent establishment: in the former case the parent company could not deduct foreign losses, contrary to the latter case. The principle of worldwide taxation was applied to UK residents, but only partly as income earned by foreign subsidiaries was not subject to taxation. However, international law does not require a State to take into consideration foreign elements. Quite the contrary, international law recognises a fundamental right to apply the fiscal principle of territoriality and ignore foreign elements. Applied to taxation, international law implies that a State has the right not to admit foreign losses in deduction, even if that creates a difference in treatment between foreign subsidiaries and permanent establishments.

It could be argued that the aim of the British group relief is to reach a similar treatment of foreign subsidiaries and permanent establishments[323], since the UK is a country that traditionally applies the principle of worldwide taxation and taxes foreign permanent establishments. Indeed, the group relief mechanism overrides the principle of personality to let a domestic group company surrender losses to other domestic group companies, something that happens automatically between a UK head office and its permanent establishments, whether domestic or foreign. The ECJ may pay attention to the aim of a legislation: for example it found in *Papillon* that the provisions of the French tax code "aim to treat, as far as possible, a group constituted by a parent company with its subsidiaries and its sub-subsidiaries in the same way as an undertaking with a number of permanent establishments, by allowing the results of each company to be consoli-

[323] See Daniel Gutmann, *The Marks & Spencer case: proposals for an alternative way of reasoning*, EC Tax Review, 2003-3, pp. 154-158; Daniel Gutmann, *La fiscalité française des groupes de sociétés à l'épreuve du droit communautaire - réflexions sur l'affaire "Marks & Spencer" pendante devant la CJCE*, Revue de Droit Fiscal, 2004-14, pp. 681-685.

dated"[324]. This argument was also recognised in *X Holding*[325]. However, the British group relief does not fully treat domestic establishments and domestic subsidiaries in the same way as it does not implement a complete consolidation between the parent company and the subsidiaries. Each UK group company's income is computed separately, after taking into account the effects of the group relief, and each group company pays corporate income tax separately. In contrast, the income of a UK permanent establishment is fully integrated with that of its UK head office, both for profits and losses. That is, only part of the tax treatment of domestic permanent establishments is applied to domestic groups of companies through the group relief mechanism. Consequently, if the UK legislation partly treats subsidiaries as if they were permanent establishments, the British lawmaker did not aim at fully treating them identically. Rather, I believe that one could only observe that the effect of the group relief mechanism was to partly assimilate subsidiaries to permanent establishments.

So the question is whether the similarities with regard to the treatment of domestic losses should also extend to cross-border situations. In that respect, I do not believe that the aim or the effect of a legislation should, as such, play a decisive role. Identifying the aim of a legislation may not be self evident, as Member States have different legal cultures and backgrounds. Preparatory works may have diverging importance, and a legislation may have several aims with different hierarchical priorities. It may be difficult to interpret and understand the original aim of a legislation, if such an aim may at all be identified. I do not find it objective enough to consider that

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[324] ECJ, 27 November 2008, case C-418/07, *Société Papillon v Ministère du budget, des comptes publics et de la fonction publique*, para. 28. For comments see Alexandre Maitrot de la Motte, *Régime des groupes (affaire Papillon): l'atteinte à la liberté d'établissement est justifiée mais disproportionnée*, Revue de Droit Fiscal, 4 December 2008, pp. 3-5; Patrick Dibout, *Le périmètre des groupes de sociétés et la liberté d'établissement - À propos de CJCE, 27 nov. 2008, C-418/07, Sté Papillon*, Revue de Droit Fiscal, 25 December 2008, pp. 8-12; Jean-Luc Pierre, *Groupes de sociétés: une sous-filiale française détenue via une filiale étrangère peut être intégrée*, Revue de Droit Fiscal, 25 December 2008, pp. 29-32; Jérôme Delaurière, *The Papillon decision: upcoming French tax group reform*, Tax Notes International, 9 march 2009, pp. 903-906.

[325] ECJ, 25 February 2010, case C-337/08, *X Holding BV*, para. 22.

the legislation of a certain Member State may aim at granting equal treatment in certain situations, to conclude that it should be extended to cross-border situations, while the legislation of another Member State would not aim as clearly at granting such an equal treatment, thus not having to be extended to cross-border situations. It seems very difficult to assess the aim of a legislation and attribute it a decisive role as part of an analysis of the compatibility with EU law of a national tax rule.

In any case, irrespective of the weight that could be attributed to the aim or the effects of a tax legislation, the permanent establishment/subsidiary criterion is, as submitted above[326], not relevant from the perspective of the home State. In particular, finding permanent establishments and foreign subsidiaries comparable raises a basic question: should permanent establishments be entitled to the tax treatment of subsidiaries, or should subsidiaries be entitled to the tax treatment of permanent establishments? In *Marks & Spencer*, the parent company would benefit from having its subsidiaries treated as if they were permanent establishments, because the foreign losses could then be deducted in the home State. However, there is no convincing reason for a comparison between subsidiaries and permanent establishments to only work in one way: if permanent establishments and foreign subsidiaries are comparable, couldn't a company resident in the UK claim that its permanent establishments should not be taxed in the UK since foreign subsidiaries are not either taxed? It cannot, *per se*, be ruled out that a head office resident in a Member State applying the principle of worldwide taxation may claim that its permanent establishments should be tax exempt, as subsidiaries are in principle not taxed in the home State. As a result, even if permanent establishments and foreign subsidiaries were in a comparable position from the perspective of the home State, granting similar treatment would be irrelevant as far as the taxation of foreign income is concerned: it cannot be determined whether permanent establishments should be treated as subsidiaries, or the other way round. This conclusion is strengthened by the wording of article 49 TFEU, which does not guarantee equality of treatment between different investment forms (horizontal com-

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[326] See *supra*, at 3.2.2.3.

parison), but rather aims that reaching a similar tax treatment for each investment form in domestic and cross-border contexts (vertical comparison). This view seems also consistent with the one mentioned by the European Commission in the proposed directive on cross-border loss relief[327].

Therefore, I believe that it is more suitable to focus on a comparison between domestic and foreign subsidiaries (*i.e.* a vertical comparison), which was also recommended by Advocate General Maduro in *Marks & Spencer*[328].

3.3.3.2.2 Comparison between foreign subsidiaries and permanent establishments in the X Holding case

The situation in *X Holding* is different than the one at hand in *Marks & Spencer*, as *X Holding* related to a claim that concerned a whole consolidation in the home State. Should this difference exercise an influence on the outcome of the above analysis? In theory, a consolidation of foreign subsidiaries would imply the taxation of their foreign profits, as well as the deduction of their losses. Other aspects would also come into play, such as neutral intercompany transactions and the taxation of the parent company for the whole consolidated group. The situation of a foreign subsidiary and a permanent establishment would thus be closer than in *Marks & Spencer*, as the grant of a loss relief for foreign subsidiaries would let remain differences with regard to permanent establishments, particularly the taxation of their profits.

However, this reasoning is not helpful given the circumstances at hand in the *X Holding* case. Indeed, while the UK is a credit country, the Netherlands in many tax treaties exempts foreign business income from taxation. This means that if foreign subsidiaries were to be consolidated and taxed as domestic ones, a discrepancy could remain with permanent establishments

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[327] See COM 90 (595) final, 24 January 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*, point 5, *in fine*: "Equality of treatment between permanent establishments and subsidiaries is not, however, a generally accepted idea".

[328] See Opinion of Advocate General Maduro, delivered on 7 April 2005, case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)*, para. 48-50.

the profits of which are not taxable in the Netherlands. This brings the reasoning back to the inconsistency described above for the *Marks & Spencer* case: if EU law were to require foreign subsidiaries and permanent establishments to be taxed identically, such an obligation should concern the whole taxation of these entities, not only just an isolated aspect. If, in *X Holding*, the ECJ would have accepted to extend fiscal unity to deduct foreign subsidiaries' losses as permanent establishments' losses, an inconsistency would have remained with regard to profits, which would be taxed for foreign subsidiaries but not always for permanent establishments[329].

In addition, even if permanent establishments were taxed by the home State, it should not be forgotten that requiring equal treatment in a general manner may go beyond the wording of article 49 TFEU: priority should be given to a comparison between domestic and foreign subsidiaries (vertical comparison). The inappropriateness of the permanent establishment/subsidiary comparator with regard to the extent of the tax jurisdiction of the home State was actually underlined by the Court through stating that "the Member State of origin remains at liberty to determine the conditions and level of taxation for different types of establishments chosen by national companies operating abroad, on condition that those companies are not treated in a manner that is discriminatory in comparison with comparable national establishments"[330]. Therefore, the ECJ in my view correctly found that "the Member State of origin is not obliged to apply the same tax scheme to non-resident subsidiaries as that which it applies to foreign permanent establishments"[331].

Rejecting the permanent establishment/subsidiary comparator does not imply, however, that the rules at hand in *Marks & Spencer* and *X Holding* are necessarily compatible with the objective of achievement of the internal market. A difference of treatment with domestic subsidiaries remains in the

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[329] Indeed, the Netherlands in tax treaties often eliminates double taxation through the exemption method, as far as business income is concerned.

[330] ECJ, 25 February 2010, case C-337/08, *X Holding BV*, para. 40.

[331] *C. cit.*, para. 40, *in fine*.

home State. This difference is discussed hereunder with regard to non-final losses (3.3.4) and final losses (3.3.5).

3.3.4 Relief for non-final losses incurred by foreign group companies

In *Marks & Spencer*, *Oy AA* and *X Holding*, the entity that sought loss-relief was located in a Member State allowing – under certain circumstances – for the tax equalisation of the income of resident companies and permanent establishments of non-resident companies. One of the main findings of *Marks & Spencer* is that losses incurred by a foreign group company need not, as a rule, be deducted at the level of another group company, despite the disadvantage this creates in terms of tax equalisation. This finding was confirmed in *Oy AA* and *X Holding*. This solution respects the principle of territoriality as it stands in international law: as discussed in chapter 2, a State is not *per se* required to take into account elements connected to other States. Therefore, Member States may, at first sight, apply the fiscal principle of territoriality and exclude such foreign elements from their tax jurisdiction. However, EU law constitutes a separate body of law and imposes on Member States additional requirements to those stemming from international law. Therefore, if the non-deduction of foreign losses is compatible with international law, such a denial may still be incompatible with EU law.

Marks & Spencer (3.3.4.1), *X Holding* (3.3.4.2) and *Oy AA* (3.3.4.3) are discussed separately, as they raised different legal problems.

3.3.4.1 The Marks & Spencer case

Marks & Spencer is a landmark case with regard to the requirement of cross-border loss relief as a consequence of the freedom of establishment. The problem dealt with by this case is fundamental with regard to the compatibility of the fiscal principle of territoriality with the objective of achievement of the internal market. This case is analysed at the justification (3.3.4.1.1) and proportionality levels (3.3.4.1.2).

3.3.4.1.1 The justification level

Following *Futura*, one may have been confident in believing that a Member State should not fear EU law as long as it shapes its tax legislation in accordance with the fiscal principle of territoriality, through excluding foreign

positive and negative income from the domestic tax base. However, later case law proved the contrary. In *Bosal*[332] the Court stepped back from *Futura* and found that the fiscal principle of territoriality, as such, was not an acceptable justification ground when it was not applied to a single taxpayer. In *Marks & Spencer*, although the Court considered that the UK regime was "in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law"[333], it did not accept the fiscal principle of territoriality as a justification ground[334]. This solution might appear incompatible with *Futura* since in both cases a Member State applied the fiscal principle of territoriality and refused to grant a deduction right for losses with foreign origin, while on the other hand it did not tax corresponding positive income.

From an international law perspective, *Marks & Spencer* and *Futura* are comparable as they related to whether a State may be required to depart from the fiscal principle of territoriality and accept to take into account foreign negative income incurred by a non-resident. It was found in chapter 2 *supra* that international law allows a State to tax a non-resident on foreign income or refuse to take into account such income, something that is particularly likely if losses are incurred. Consequently, as *Marks & Spencer* and *Futura* were rather similar from an international law perspective, the difference between these cases relates more to practical matters and to customary international tax law: in *Futura* it was the Member State of establishment that referred to the fiscal principle of territoriality to justify why it did not deduct foreign losses, while in *Marks & Spencer* it was the Member State of

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[332] ECJ, 18 September 2003, case C-168/01, *Bosal Holding BV,* p. 38. For comments see Frans Vanistendael, *Bosal?!*, EC Tax Review, 2003-4, pp. 192-193; Dennis Weber, *The Bosal Holding case: analysis and critique*, EC Tax Review, 2003-4, pp. 220-230; Freek P.J. Snel, *Bosal Holding Case - Landmark or business as usual?*, European Taxation, November 2003, pp. 420-424; CFE ECJ Task Force, *CFE opinion Statement on the decision of the European Court of Justice Bosal Holding BV, case C-168/01*, European Taxation, November 2004, pp. 506-513 ; Harm van den Broek, *Bosal Holding and the confusion surrounding the territoriality principle*, International Transfer Pricing Journal, May/June 2003, pp. 116-123.

[333] ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 39.

[334] *C. cit.*, para. 40.

residence of a parent company. It is an established practice that the State of the permanent establishment may apply strictly the fiscal principle of territoriality and refuse to take into account foreign negative income. Such a limited tax jurisdiction may even derive from a tax treaty. Practical reasons related to the difficulty of assessing a non-resident's worldwide income and actually levying taxes also explain why non-residents are usually taxed to a limited extent in the host State. Indeed, a non-resident usually earns only part of his worldwide income in the State of source. His ability-to-pay is therefore limited, but at the same time the benefits enjoyed in the State of source may also be limited. In contrast, the State of the parent company is less limited by tax treaties and has more possibilities to tax foreign subsidiaries' profits: such a taxation may take place through the taxation of dividends distributed by foreign subsidiaries, the taxation of capital gains on shares in these companies, or through CFC rules[335]. The practical levy of such a taxation is more easily achieved than what can be levied by the State of a permanent establishment, as the ability-to-pay of a taxpayer is usually higher in the State of residence than in the State of establishment. Consequently, the State of a parent company cannot convincingly claim that the principle of territoriality as it stands in international law legally prevents it from granting relief for losses incurred by a foreign subsidiary[336]. This ar-

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[335] It should nevertheless be observed that a discussion exists on the compatibility of CFC rules with tax treaties, so States cannot always tax foreign subsidiaries' foreign income through such rules. For example, the French *Conseil d'Etat* ruled in the *Schneider Electric* case that French CFC rules were incompatible with the France-Switzerland tax treaty as it did not provide a clause authorising the application of the French CFC rules. See French Supreme Administrative Court (*Conseil d'Etat*), 28 June 2002, case number 232276, *Société Schneider Electric*. Such a clause is, for instance, provided at article 24(2)(e)(iii) of the France-USA tax treaty concluded on 31 August 1994: "nothing in the Convention shall prevent France from applying the provisions of Article 209B of its tax code (code général des impôts) or any substantially similar provisions which may amend or replace the provisions of that Article".

[336] For a similar conclusion, see Michael Lang, *The Marks & Spencer case - the open issues following the ECJ's final word*, European Taxation, February 2006, p. 60.

gument is convincing neither from a legal point of view[337] nor from a practical point of view[338].

From an international tax law perspective, I believe that the fiscal principle of territoriality (*i.e.* the decision to limit the tax jurisdiction to domestic income) should not either be an acceptable justification ground in *Marks & Spencer*. If the fiscal principle of territoriality were accepted as a justification, it would imply that Member States have a right to apply a symmetry between a taxation right and an obligation to grant a tax deduction: since the State of the parent company does not tax foreign subsidiaries profits it would not need to deduct their losses, thereby making cross-border loss relief impossible within the internal market. This would undermine the achievement of an internal market and maintain differences from what can be achieved within a domestic market, although such a "domestic market" is what the internal market eventually aims at[339]. As a result, I agree with the ECJ that the fiscal principle of territoriality was not an acceptable justification *per se* in *Marks & Spencer*: there is no convincing reason for EU law to favour a right to tax profit and losses symmetrically over the enhancement of the freedom of establishment.

Yet, the outcome in *Marks & Spencer* leans towards the fiscal principle of territoriality since the Court held that as a rule, EU law does not impose an obligation on the State of residence to take into account losses incurred by foreign subsidiaries[340]. The losses had first to be deducted in the host State.

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[337] This is because international law and tax treaties prevent neither the deduction of foreign losses nor the recapture of subsequent profits.

[338] This is because the State of the parent company may easily levy taxes on a resident shareholder.

[339] See particularly ECJ, 9 February 1982, case C-270/80, *Polydor*, para. 16: "the Treaty, by establishing a common market and progressibely approximating the economic policies of the Member States, seeks to unite national markets into a single market having the characteristics of a domestic market".

[340] See Frans Vanistendael, *In defence of the European Court of Justice*, Bulletin for International Fiscal Documentation, March 2008, p. 93: "*Marks & Spencer* is, of course, the hallmark case of territoriality".

The Court did not deal with this solution under the fiscal principle of territoriality as a formal justification ground, but under a combination of three justification grounds taken together: the need to preserve a balanced allocation of the power to impose taxes, the need to prevent tax avoidance as well as to avoid a double utilisation of losses[341]. What seems to have convinced the Court is the fact that by allowing a deduction of the foreign losses at the level of the parent company, taxpayers would be able to choose in which Member State losses are to be deducted and even try to deduct such losses more than once. Consequently, when balancing the fiscal principle of territoriality and the principle of worldwide taxation, the Court came to the conclusion that the fiscal principle of territoriality was preferable.

The approach of the Court is not so much based on legal justifications[342], but rather on the consideration of the consequences that may result from a possible extension of the UK group relief rules to foreign losses. This evidences the fundamental incompatibility with the internal market of a non-

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[341] For a discussion on justification grounds, see Frans Vanistendael, *General report on the fundamental freedoms and national sovereignty in the European Union*, 2007 EATLP Congress, p. 201: "The concepts of coherence, cohesion and territoriality that have been used by the governments of the member States can be seen as the expression of a larger concept, *e.g.* the right to operate a functioning national tax system". See also Daniel Gutmann, *Droit fiscal des affaires*, Montchretien, 2010, pp. 52-57; Peter J. Wattel, *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?*, *in* Dennis Weber (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, pp. 139-156; Maurice-Christian Bergerès, *L'impossibilité pour une filiale résidente de déduire de ses revenus imposables un transfert financier vers sa société mère étrangère est-elle compatible avec le droit communautaire?*, Revue de Droit Fiscal, 27 December 2007, pp. 29-36.

[342] See Melchior Wathelet, Marks & Spencer plc v Halsey*: lessons to be drawn*, British Tax Review 2006-2, p. 132: "it can be noted that the key measure under UK law, i.e. the total prohibition on the transfer of losses from a non-resident subsidiary to its resident parent company, is not justified in any way by the arguments advanced by the UK government. The ECJ accordingly should have concluded that the measure under UK law was not justified in light of Community law, without prejudice to the prohibition on using losses twice and the obligation to use losses incurred by a subsidiary as a priority in the Member State where this subsidiary is established".

deduction of foreign losses. I agree with the Court regarding the fact that the balance in Member States' tax systems and fiscal revenues would be threatened by an automatic option to deduct foreign group companies' losses in the State of the parent company. However, the reasoning of the Court is criticisable. The fear that a taxpayer may choose where a loss is deducted is irrelevant, because a decision of a taxpayer does not influence the tax jurisdiction of a certain Member State. A loss cannot be shifted from the host State to the home State by a requirement on the home State to deduct this loss: unless the loss is final, it will still exist in the host State. Therefore, the argument according to which "the taxable basis would be increased in the first State and reduced in the second to the extent of the losses transferred"[343] is not correct, as losses cannot be simply transferred: when a non-final loss is incurred in the host State it is deducted, carried back or carried forward according to the local domestic tax legislation in the same way as it applies to companies with domestic shareholders. The contrary would breach the principle of non-discrimination. Consequently, deducting a foreign loss in the home State does not affect the existence of this loss in the host State.

This means that the risk of comparing the tax rates of the home State and the host State so as to deduct the losses where their value is the highest is not either correct. The ECJ referred to "the possibility of transferring the losses incurred by a non-resident company to a resident company"[344], which would entail "the risk that within a group of companies losses will be transferred to companies established in the Member States which apply the highest rates of taxation and in which the tax value of the losses is therefore the highest"[345]. As losses cannot be "transferred" from the host State to the home State, there is no risk that a taxpayer compares the tax rates of these States and chooses the highest tax rates to determine where to deduct the losses. The only option for such an arbitrage to exist would be if losses could be definitely transferred from the host State to the home State, some-

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[343] ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 46.

[344] *C. cit.*, para. 49.

[345] *Ibid.*

thing that could not happen as a consequence of ECJ case law: the tax jurisdiction of the host State is not affected by the (in)compatibility with EU law of the home State's tax legislation. The righ or the obligation to deduct, carry back or carry forward losses in the host State could hardly, in my view, be denied if the loss is to be deducted in the home State.

Accordingly, the actual risk in a situation such as the one at hand in *Marks & Spencer* is a double deduction of losses, *i.e.* that losses deducted, carried back or carried forward in the host State are also utilised in the home State. The prevention of this risk is, in my opinion, quite legitimate: EU law should not result in opening such tax planning opportunities, especially since they would be available solely to multinational groups, not to national groups. This would threaten the principle of an open market with free competition and an efficient allocation of resources within the internal market[346], since the choice of location of a parent company would be influenced by these tax considerations. This risk is aggravated by the possibility to sell shares to another group company that is resident in a Member State with a higher corporate income tax rate, to maximise the value of the losses. Consequently, it seems correct to justify the discrimination in the home State by the need to prevent a double deduction of losses and the prevention of tax avoidance[347]. In contrast I believe that the first justification, *i.e.* the need to protect a balanced allocation of the power to impose taxes, is not relevant.

It could also be argued that several group companies may apply for cross-border loss relief: take the example of a parent company resident in Member State A with a subsidiary S1 resident in Member State B. It is assumed that S1, in its turn, owns a subsidiary S2 resident in Member State C, and that S2 incurs a loss.

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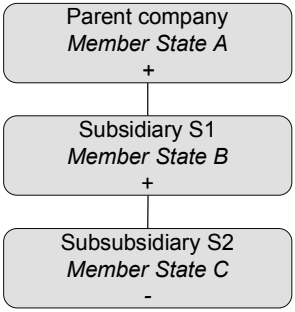
[346] See article 120 TFEU.

[347] This does not mean, however, that the rules at hand are compatible with EU law. Indeed, more proportionate measures may be available to the home State, which is discussed *infra* in the proportionality test.



In this example, relief for the loss incurred by S2 may be sought both by the parent company in Member State A and by S1 in Member State B, as long as these States have tax equalisation rules that would apply if S2 was resident on their territory. Deduction may even be sought by sister companies. Accordingly, the risk of multiple deductions of losses cannot be denied, which again justifies the refusal of cross-border loss relief in the *Marks & Spencer* case. This risk could be mitigated if it was determined which group company may apply for cross-border loss relief on the basis of EU law. However, it seems difficult for the Court to make such an analysis, because of the numerous possibilities available[348] as well as the legislative character of such a decision. Moreoever, even if the ECJ would determine which group company should be entitled to cross-border loss relief, situations of spread ownership could occur: for example, if the Court would consider that cross-border loss relief may be sought solely by a direct parent company, a loss-making subsidiary could be owned by two or more shareholders, possibly with equal participations. As a result, the risk of multiple deductions as well as the impossibility to determine which group company may apply for cross-border loss relief justifies the denial of relief in *Marks & Spencer*.

In my view, another argument – not discussed by the Court in *Marks & Spencer* – is also relevant with regard to cross-border loss relief: requiring the home State to grant relief for losses incurred in the host State may contra-

[348] Indeed, loss relief could be sought by the direct parent company, the ultimate parent company, a sister company, or even a subsidiary.

dict the arm's length principle. Under the arm's length principle the parent company may have to support certain losses incurred by a subsidiary, particularly if this subsidiary is not entitled to relatively high profits[349] or if the parent company has an own interest in providing such a support[350]. In such a situation, requiring the home State to grant relief for losses incurred by a foreign subsidiary may not necessarily breach the arm's length principle, as the parent company may have to support its subsidiary under this principle. However, under the arm's length principle a parent company may not always support losses incurred by its foreign subsidiary. Indeed, according to the OECD Transfer Pricing Guidelines, although "an independent enterprise would not be prepared to tolerate losses that continue indefinitely"[351], "associated enterprises, like independent enterprises, can sustain genuine losses, whether due to heavy start-up costs, unfavourable economic conditions, inefficiencies, or other legitimate business reasons"[352]. This means that in certain situations, the arm's length principle indicates that losses in-

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[349] According to the arm's length principle the level of profits to which a group company is entitled depends on the functions it performs, the risks it assumes and the assets it owns. The more functions, risks and assets are attributable to a subsidiary, the more profits it is entitled to, but also the more exposed to losses it is. In contrast, if few functions, risks and assets are attributable to a subsidiary, it will not be entitled to high profits. At the same time, the subsidiary should not be exposed to high losses. The level of remuneration of an associated enterprise is ultimately determined depending on a comparability analysis, *i.e.* through a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises. See Chapter 1 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010.

[350] That may be the case when the activities carried on by the subsidiary contribute to the profitability of the parent company. See for example the Court of appeals of Gothenburg (*Kammarrätten i Göteborg*), 12 May 2010, case number 4932-09, *JC Aktiebolag*, in which it was found that restructuring costs of a German subsidiary were deductible for a Swedish parent company as long as the objective of the restructuring was to improve the profitability of the subsidiary: such a support would, in the long run, increase the income of the Swedish parent company. The fact that the restructuring did not, in the end, produce the expected results was not an important parameter according to this court.

[351] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, para. 1.70.

[352] *Ibid.*

curred by a foreign subsidiary should be left at the level of the subsidiary. This explains why national courts are sometimes restrictive with regard to the deductibility of contributions to foreign group companies[353]. Necessarily granting loss relief in the home State would in certain situations result in non-arm's length results as it would move the loss to an entity which, under arm's length conditions, would not have to support it. If the ECJ would find a right to deduct foreign losses in the home State, the requirement of entering into transactions at arm's length according to article 9 of the OECD Model Tax Convention could be irrelevant because all losses would eventually be deductible in the home State, irrespective of whether or not the parent company would be entitled to support the subsidiary under the arm's length principle. Consequently, in my view the arm's length principle may, in certain cases, justify denying or at least reconsidering cross-border loss relief. However, such a justification is not acceptable if, under arm's length circumstances, the subsidiary would normally be economically supported by its parent company.

As a result, it is submitted that the ECJ was right in considering that the discrimination implied by the UK group relief rules was justified, although the reasoning of the Court is partly criticisable. However, this does not mean that the British rules should be compatible with EU law, as these rules must pass the proportionality test.

3.3.4.1.2 The proportionality level

The reasoning of the Court in the proportionality test excluded any cross-border relief for non-final losses and could be qualified as an "all in all out" solution: final losses should be deducted at the level of the ultimate parent company, while in other situations of losses, no relief has to be granted whatsoever. As discussed above, I agree with the Court on the fact that

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[353] See the French Supreme Administrative Court (*Conseil d'Etat*), 11 April 2008, case number 281033, *SA Guerlain*. For comments see Julie Burguburu, *Transfert de bénéfices et expansion à l'étranger: une jurisprudence au parfum*, Revue de Jurisprudence Fiscale, July 2008, pp. 667-671; Michel Taly, *Abandons de créances au profit de succursales appartenant à une filiale bénéficiaire: transfert indirect de bénéfices*, Revue de Droit Fiscal, 1 May 2008, p. 31.

non-final losses should not be deducted at the level of the parent company, mainly because of the risk that such losses could be deducted more than once. However, this risk could have been significantly reduced by an automatic recapture of losses in the State of the parent company once the subsidiary becomes profitable. This was the solution favoured in the draft directive on cross-border loss relief[354]. Such a system was also considered by the Commission in its Communication on the tax treatment of losses in cross-border situations[355].

One may find it regrettable that the ECJ did not take into consideration whether cross-border loss relief could be available for non-final losses at the proportionality level through a recapture mechanism. Indeed, the lack of cross-border loss relief is a real hinder to the exercise of the freedom of establishment within the internal market: losses may not be deducted for the sole reason that the parent company and the subsidiary are resident in different Member States, although these Member States belong to the same internal market. A temporary loss relief followed by a later recapture when the subsidiary becomes profitable or leaves the group would remove the cash flow disadvantage suffered by a group because of the lack of taxation on a net basis. It should be observed that the ECJ considered in certain cases that a cash flow disadvantage may constitute a restriction of the fundamental freedoms: as observed above, in case law on exit taxation (particularly the *Lasteyrie*[356] and *N*[357] cases) the Court refused that taxpayers suffer a cash flow disadvantage by being taxed upon emigration: the ECJ did not question the tax jurisdiction of the departure State, but it refused that taxpayers suffer a cash flow disadvantage upon emigration. The lack of relief for foreign losses results in the same type of obstacle on taxpayers exer-

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[354] COM 90 (595) final, 24 January 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*, article 10.

[355] COM(2006) 824 final, 19 December 2006, *Tax treatment of losses in cross-border situations*, para. 3.4.2, p. 8.

[356] ECJ, 11 March 2004, case C-9/02, *de Lasteyrie du Saillant*.

[357] ECJ, 7 September 2006, case C-470/04, *N. v Inspecteur van de Belastingdienst Oost/kantoor Almelo*.

cising their fundamental freedoms, and this obstacle could be removed by a temporary deduction followed by a subsequent recapture.

The problem is that the Court is not a lawmaker. Given the difficulties of implementing a recapture mechanism by answering to preliminary questions, the ECJ may have decided to not even discuss this aspect in the wording of the *Marks & Spencer* decision. Indeed, implementing a recapture mechanism would require the determination of several parameters such as the tax accounting rules according to which the loss and the subsequent profits are computed, as well as the events that could trigger an automatic recapture. However, these difficulties are not insurmountable: the tax accounting rules according to which the loss and the subsequent profits are computed could be those of the home State, since it is in this State that the ECJ carried on the discrimination test. The events that could trigger an automatic recapture could be the realisation of profits by the subsidiary that was previously loss-making, leaving the group, and incurring final losses. Of course, the home State would need to be aware of these events but in this respect the mutual assistance directive[358] as well as provisions on exchange of information in the tax treaties concluded between Member States could be of valuable help. One could also imagine a system according to which the host State automatically informs the home State on the realisation of the abovementioned events, for the losses to be recaptured with most certainty. Consequently, these two obstacles[359] could, in my opinion, have been overcome by the Court as part of the proportionality test.

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[358] Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, certain excise duties and taxation of insurance premiums. Exchange of information is likely to be improved in the future given that the Council of the European Union adopted on 15 February 2011 a directive aimed at strengthening administrative cooperation in the field of direct taxation to be transposed into Member States' national laws by 1 January 2013. See 6554/11, 15 February 2011, *Combating tax fraud: Adoption of directive on strengthened mutual assistance and the exchange of information*.

[359] That is, the determination of the tax accounting rules according to which the loss and the subsequent profits are computed, as well as the events that could trigger an automatic recapture.

However, there is another difficult obstacle to cross-border loss relief within groups of companies: the determination of the company that is entitled to deduct the loss. Indeed, as demonstrated above, not only could the parent company apply for cross-border loss relief but also other group companies, as long as they are resident in a Member State with tax equalisation measures. If the ECJ would have required Member States to grant a temporary relief for foreign losses under the condition that losses are recaptured, several group companies may apply for loss relief. This could result in a cash flow advantage through deducting a loss – and thereby decreasing the group's taxable income – at the level of more than one group company. Such a situation is not, in my opinion, desirable, as it would favour multinational groups over wholly national groups, which would breach a free competition within the internal market. Consequently, it would be reasonable to ensure that only one group company first deducts a foreign loss, and later recaptures it. This is a difficult matter, as the Court would need to choose between the direct parent company, the ultimate parent company, other group companies, as well as solve situations of multiple shareholders. It may even be necessary to consider a minimum level of ownership. These difficulties could be solved by granting loss relief only up to the percentage of participation in the loss-making subsidiary. By so doing, the risk of multiple deductions of losses would be significantly reduced, although difficulties may appear as to the computation of the participation level. This solution may also be difficult to apply in practice when a subsidiary has many shareholders, such as companies quoted on the stock exchange. It may be useful to consider a minimum level of ownership, which may go beyond the power of the ECJ.

Consequently, although it can be regretted that the Court did not consider whether a recapture mechanism would have been appropriate, the significant difficulties related to a recapture mechanism may hardly be dealt with by the ECJ without harmonisation of Member States' legislations. This conclusion strengthens the outcome of the justification level, *i.e.* in the lack of harmonisation of cross-border loss relief the ECJ can hardly reach a satisfying compromise.

The *X Holding* case provided the ECJ another opportunity to deal with cross-border loss relief within the internal market.

3.3.4.2 The X Holding case[360]

A difference between *X Holding* and *Marks & Spencer* is the question of determining which group company should be entitled to cross-border loss relief. Given the wide extent of the UK rules, group relief was available as long as the surrendering company and the claimant company were both members of the same group[361]. This creates an uncertainty as to which group company should be entitled to loss relief: it could be the ultimate parent company, as in the *Marks & Spencer* case, or other group companies, as allowed by the UK rules. In contrast, the Netherlands rules at hand in *X Holding* had a much more limited scope, as fiscal unity was only available to the direct parent company if it held, legally and economically, at least 95% of the shares in the subsidiary[362]. Therefore, *X Holding* provided the ECJ an opportunity to consider whether EU law required cross-border loss relief in the very context of a subsidiary directly owned by a parent company, and in a situation where the ownership is almost exclusive.

In *X Holding* the Court paid attention to the risk that a cross-border fiscal unity is dissolved. The ECJ considered that this would let the group choose to have a loss deducted in the Netherlands[363]. This argument is, however, incorrect as it does not take into account the taxing rights of the host State: irrespective of a possible consolidation in the Netherlands, Belgium would still exercise its taxing rights. This becomes particularly obvious if one assumes that the Belgian subsidiary was profitable: a consolidation in the Netherlands would not alter the taxation in Belgium, as this country has a sovereign tax jurisdiction on income incurred by companies resident on its territory according to the principle of territoriality as it stands in interna-

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[360] The questions in the *X Holding* case dealt with a whole consolidation system. However, the analysis of this case in the dissertation is limited to the consolidation of foreign losses.

[361] ECJ, 13 December 2005, case C-446/03, *Marks & Spencer plc v David Halsey (Her Majesty's Inspector of Taxes)*, para. 13.

[362] ECJ, 25 February 2010, case C-337/08, *X Holding BV*, para. 5.

[363] *C. cit.*, para. 31.

tional law. Consequently, the ECJ wrongly assumed that there was a risk of shift of income from Belgium to the Netherlands, as it did in *Marks & Spencer*. The risk was, however, a double deduction of losses, *e.g.* if the Belgian loss was carried forward and deducted in the future while it would also be deducted in the Netherlands without later recapture[364], something that could happen if the fiscal unity is dissolved.

The Court was explicitly encouraged to consider the extension of the recapture mechanism to foreign subsidiaries, as it was available to permanent establishments[365]. The ECJ refused to extend to foreign subsidiaries tax rules available for permanent establishments, which I believe is correct: as discussed above, the permanent establishment/subsidiary comparator is not relevant as far as the tax jurisdiction of the home State is concerned[366]. The right comparator was, in my view, between domestic and foreign subsidiaries (vertical comparison), which is more in accordance with the wording of the freedom of establishment. In that respect, the determination of the company entitled to cross-border loss relief was, in *Marks & Spencer*, a serious obstacle. The risk existed that a loss is deducted by several group companies. In *X Holding*, the Netherlands rules were limited to direct parent companies owning at least 95% of the shares in the subsidiary. Consequently, if the ECJ had decided to extend the Netherlands rules to foreign subsidiaries, no risk of multiple deductions would have existed, because cross-border loss relief would have been available solely for directly owned subsidiaries at 95% or more: under such circumstances, solely the parent company could have met these requirements.

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[364] For an analysis of the justification grounds referred to in the *X Holding* case, see Jérôme Monsenego, *Några synpunkter om EU-domstolens resonemang i* X Holding-*målet*, Svensk Skattetidning, 2010-6/7, pp. 671-677.

[365] ECJ, 25 February 2010, case C-337/08, *X Holding BV*, para. 35.

[366] See *supra* at 3.2.2.3. In addition, a transposition of the recapture mechanism to foreign subsidiaries would raise problems when implementing *X Holding* in other Member States: would only Member States that apply a recapture mechanism for permanent establishments have to extend it to foreign subsidiaries? Or would Member States that do have domestic tax consolidation rules, but no recapture mechanism for permanent establishments' losses, also have to extend tax consolidation rules to foreign subsidiaries?

Accordingly, the obstacles to implementing a recapture mechanism were more easily overcome in *X Holding* than in *Marks & Spencer*. The outcome of this case is, therefore, criticisable. It can be partly explained by the fact that the ECJ refused to grant cross-border loss relief in *Lidl Belgium* (which was ruled during 2008, while *X Holding* was ruled in 2010) for losses incurred by an exempt permanent establishment, thereby refusing to pay attention to a temporary cash flow disadvantage. However, as demonstrated in chapter 4 *infra*, *Lidl Belgium* builds on a wrong transposition of the *Marks & Spencer* case. Therefore, the reasoning of the ECJ in *X Holding* is not satisfying as there were convincing reasons not to strictly transpose *Marks & Spencer* to the Dutch rules. *X Holding* reaffirmed that a State could apply strictly the fiscal principle of territoriality, despite the negative consequences of this principle on the objective of achievement of the internal market, and although relatively acceptable limitations to the fiscal principle of territoriality could have significantly improved cross-border loss relief within the internal market.

Marks & Spencer and *X Holding* dealt with situations where a foreign subsidiary incurs losses. *Oy AA* was about the reverse situation in which it is the parent company that is loss-making.

3.3.4.3 The Oy AA case

In the paragraphs above it was argued that the ECJ was right in *Marks & Spencer* but not necessarily in *X Holding* to refuse cross-border loss relief for foreign subsidiaries' losses. *Oy AA* concerned the opposite situation: a parent company made a loss, the deduction of which was sought in the State of a subsidiary. Here, there were even stronger arguments than in *Marks & Spencer* to refuse cross-border loss relief. Finland had no taxation rights on the UK parent company, except if shares in the parent company were owned by the Finnish subsidiary, in which cases dividends or capital gains

may have been taxed in the hands of the Finnish subsidiary[367]. It is true that international law does not, as such, prohibit taxation of a foreign parent company on foreign income, as explained in chapter 2 *supra*. However, a tax claim on a foreign parent company with which no connection exists would clearly be in breach of established principles of international tax law, not least the arm's length principle, and also the Finland-UK tax treaty as UK companies were taxable in Finland only if they earned income attributable to a permanent establishment situated on the Finnish territory. The numerous protests in the *Barclays*[368] case, which was about the Californian worldwide unitary taxation system, illustrate how the international community may react if Finland were to tax the UK parent company. In addition, such a taxation would, as indicated by *Cadbury Schweppes*, probably be in breach of EU law. Therefore, the fiscal principle of territoriality could have been accepted as a justification in *Oy AA* as Finland did not extend its tax jurisdiction to the foreign income of the foreign parent company.

Although the ECJ focused on the justifications at hand in *Marks & Spencer* and did not accept the fiscal principle of territoriality as a justification ground[369], the outcome of *Oy AA* tends to enforce the fiscal principle of territoriality: Finland was not required to apply the principle of worldwide taxation so as to deduct contributions sent to a foreign parent company. This solution is, in my opinion, satisfying. There was no reason for Finland to grant relief for a contribution sent to a foreign parent company, while other group subsidiaries situated in other Member States could also have done that[370]. If the same group had a profitable subsidiary *e.g.* in Sweden,

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[367] However, taxation of foreign dividends received by Finnish shareholders has been limited by the ECJ in *Manninen* (see ECJ, 7 September 2004, case C-319/02, *Petri Manninen*), because domestic dividends were exempted from taxation in the hands of the parent company.

[368] US Supreme Court, 20 June 1994, case 92-1384, *Barclays Bank plc v. Franchise Tax Board of California*. On the *Barclays* case see *supra*, at 2.3.1.2.

[369] ECJ, 18 July 2007, case C-231/05, *Oy AA*, para. 66.

[370] This reasoning applies, in my view, also to final losses. It is even more convincing to refuse cross-border loss relief in case final losses are incurred by the parent company, as it would imply a definitive allocation of the loss to a subsidiary with no economic reason for such an allocation, and the risk that loss relief is sought in more than one Member State by

then extending the worldwide principle to allow for loss relief at the level of any subsidiary would let the group be able to choose which State, whether Finland or Sweden, should deduct the losses. The group could even try to deduct a contribution in both countries. Instead of promoting the European integration, such a position would disturb the internal market. The domestic tax base would be artificially diminished, while the principle of territoriality as it stands in international law should entitle Member States *"to tax income generated on their territory"*[371]. It was therefore essential that the Finnish system be found compatible with the fundamental freedoms, to safeguard what may be called the coherence of the Finnish system, a balanced allocation of the taxing powers, or the fiscal principle of territoriality[372]. In addition, as in *Marks & Spencer* I do not consider that a temporary loss relief combined with a recapture would have been a suitable solution, because of the risk of undue cash flow advantage that would result from the loss being deducted at the same time by several subsidiaries.

However, even if the solution in *Oy AA* is satisfying, this case shows some of the merits of a common consolidated corporate tax base. Indeed, a directive on cross-border loss relief would probably not help diminish the global tax burden in this situation, as loss relief would probably be made available to parent companies, not to subsidiaries. In contrast, under a common consolidated corporate tax base, the group would be taxed on a consolidated net basis. Profits and losses would be compensated, even if profits are earned by a subsidiary and losses are incurred by a parent company. This situation would be of high relevance for structures where sub-

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several subsidiaries. The court of appeals of Stockholm reasoned similarly with regard to a Swedish company which claimed relief for a group contribution sent to its liquidated parent company established in Luxembourg: see the Court of appeals of Stockholm (*Kammarätten i Stockholm*), 7 June 2010, case number 6191-09, *Thomas Cook Nordic Holdings AB*.

[371] This interpretation of the principle of territoriality was made by the Finnish, Swedish and United Kingdom Governments. See ECJ, 18 July 2007, case C-231/05, *Oy AA*, para. 47.

[372] On the relation between these concepts, see Peter J. Wattel, *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?*, *in* Dennis Weber (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, pp. 139-156.

sidiaries are owned by a loss-making holding company, which may happen often in practice[373].

3.3.4.4 Conclusion on relief for non-final losses incurred by foreign group companies

Marks & Spencer, *Oy AA* and *X Holding* show that the lack of cross-border loss relief is a problem for the achievement of the internal market. The fiscal principle of territoriality inherently conflicts with the very concept of an internal market. With regard to non-final losses the problem is essentially one of timing, and could be solved through a loss deduction combined to a recapture mechanism as long as multiple deductions can be avoided. Although the answer to this problem may not be satisfactorily provided by the ECJ, the Court could have required a simplified recapture mechanism based on the tax accounting rules of the home State, an automatic recapture along with the subsidiary's making profits, as well as a deduction of losses limited to the percentage of ownership in the subsidiary. This solution may not have been sustainable in the long run, but in the short run it would have improved loss relief within the internal market and encouraged Member States to harmonise their legislations.

Consequently, a measure on cross-border loss relief such as the directive suggested by the European Commission[374] is, in the absence of a common consolidated corporate tax base, a desirable solution to contribute to the achievement of the internal market. It can be observed that this proposed directive does not take into account the arm's length principle, as all subsidiaries' losses are similarly deductible in the State of the parent company, irrespective of the functional profile of such subsidiaries. This solution would provide an incentive to establish risk-taking functions in other Member States. Indeed, under arm's length conditions, the losses of such

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[373] For example, a parent company may be loss-making as a consequence of shareholder costs that cannot be allocated to its subsidiaries under the arm's length principle or as a consequence of a group having subsidiaries taking low risks on their local markets.

[374] COM 90 (595) final, 24 January 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*.

risk-taking functions may not be deductible in the State of the parent company through transfer prices, even start-up losses[375]. Such a relief for losses incurred by risk-taking functions is likely to encourage the exercise of the freedom of establishment, thereby enhancing the achievement of the internal market. Moreover, an incentive to locate risk-taking functions in other Member States also implies that the profits of such risk-taking functions would be primarily taxed in other Member States: as a consequence, a cross-border loss relief mechanism is likely to result in a relocation of taxable income within the internal market, thereby possibly contributing to the development of these host Member States. This seems in line with article 3 TEU according to which the Union "shall promote economic, social and territorial cohesion, and solidarity among Member States". In addition, as a measure on cross-border loss relief would allow loss relief for risk-taking functions, it is possible that European companies would relocate part of their business activities carried on in third countries to the European Union, thereby contributing to the global growth of the Union. These benefits of a legislative measure allowing cross-border loss relief would also be reached with a common consolidated corporate tax base, as all group income would first be consolidated before being allocated and taxed on a net basis.

The second main teaching of the *Marks & Spencer* case is the obligation to deduct final losses that could not be taken into account in the host State: final losses constitute a threshold for the compatibility of the fiscal principle of territoriality with the freedom of establishment.

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[375] In contrast, losses incurred by subsidiaries with low-risk profiles may be taken into account by their parent companies, *e.g.* through reduced transfer prices on goods or services, or through market contributions providing financial support to a subsidiary. For examples of such possibilities to deduct contributions intended to support a foreign subsidiary, see French Supreme Administrative Court (*Conseil d'Etat*), 30 March 1987, case number 52754, *SA Labo-Industrie*; French Supreme Administrative Court (*Conseil d'Etat*), 11 February 1994, case number 119726, *SA Jean-Claude Lattès*; Court of appeals of Gothenburg (*Kammarrätten i Göteborg*), 12 May 2010, case number 4932-09, *JC Aktiebolag*.

3.3.5 Relief for final losses incurred by foreign group companies

In *Marks & Spencer* the UK rules were justified, but they did not pass the proportionality test in case the subsidiary incurred losses that could not be deducted in another Member State. Only then was the UK obliged to grant loss relief. The ECJ considered that the discrimination became unacceptable once the foreign losses could not be deducted in the host State: the difference of treatment between domestic and foreign subsidiaries would then be too significant, as loss relief would ultimately be available only in domestic situations. That is, the fiscal principle of territoriality that the Court respected[376] in *Marks & Spencer* found a limit that justified the application of the worldwide principle by deducting final losses in the home State. The reasoning of the ECJ in that respect increases one of the consequences that the Court feared at the justification level: deducting a final loss attributable to a foreign subsidiary at the parent level creates a definitive misbalance between Member States' tax bases. On the other hand, the solution reached by the Court tones down the difference of treatment between domestic and foreign losses, thereby leaning towards capital export neutrality.

Although deducting final foreign losses is a step in the right direction for the achievement of the internal market (3.3.5.1), this solution is problematic in several respects: first, defining which losses should be considered as final is a difficult matter that can hardly be solved by the ECJ (3.3.5.2). Second, it can be observed that the Court refused a double non-deduction of losses in *Marks & Spencer* while it has accepted double taxation in certain situations (3.3.5.3). Third, it is necessary to determine which of the home State's or the host State's tax accounting rules should be used to compute final losses (3.3.5.4). Fourth, the determination of the group company that should be entitled to relief for final foreign losses is a difficult matter (3.3.5.5). It is concluded that the ECJ cannot bring a satisfying answer to cross-border loss relief within the internal market. Last, it is argued in chapter 7 *infra* that

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[376] As mentioned *supra*, the ECJ in *Marks & Spencer* rejected the principle of territoriality as a formal justification ground, but the outcome reached by the Court was in line with the fiscal principle of territoriality.

the very rationale of the *Marks & Spencer* doctrine with regard to final losses, *i.e.* an allocation of all the final losses to the home State, is intrinsically flawed.

3.3.5.1 The relevance of cross-border loss relief within the internal market

From a theoretical perspective, it is doubtless that cross-border loss relief would help achieve the internal market. The fiscal principle of territoriality is inherently in conflict with the objective of achievement of the internal market, because it segments and isolates the national markets instead of merging them into a domestic one. According to article 26 TFEU, "the internal market shall comprise an area without internal frontiers". This aim is very close to the achievement of the conditions existing within a single State[377] and by definition there are no internal frontiers within one State, as such frontiers only exist at the extreme ends of a State's territory[378]. The "free movement of goods, persons, services and capital" is indeed much greater within a single State than between different Member States, as frontiers do not exist within a single State. Therefore, it is not unreasonable to consider that the internal market should aim at functioning as one single State, even if this aim may not be always relevant or achievable. Within a single State, it cannot be guaranteed that all losses will always be deductible. For example, costs may not be deductible from the tax base, or loss carry-forward may expire after a certain period of time. However, losses incurred in a cross-border context are often not deductible because of them being incurred within another Member State, *i.e.* not necessarily because they are not deductible as such. Consequently, the lack of loss relief for foreign losses is often due to the internal market not functioning as a single State.

As a result, taxation based on the fiscal principle of territoriality is inherently harming the concept of an internal market, because it results in an impossibility to compensate profits and losses solely because they are incurred in different Member States, although these Member States should

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[377] See *e.g.* ECJ, 5 October 1994, case C-381/93, *Commission of the European Communities v French Republic*, para. 17; ECJ, 3 October 2002, case C-136/00, *Rolf Dieter Danner*, para. 29.
[378] For a deeper analysis of the concept of an internal market, see *infra* at 6.2.1.

belong to the same internal market. In contrast, within one State, taxpayers have much better possibilities to offset losses against taxable profits, although not all Member States have such mechanisms. Therefore, the ECJ rightly found the lack of cross-border loss relief incompatible with EU law, but as argued *supra* the Court was also right in *Marks & Spencer* in considering that such an incompatibility could be justified. It was concluded that the answer to this problem cannot be satisfactorily provided by the ECJ but should be the fruit of legislation at the level of the European Union.

Now the question is whether or not an exception should be made for final losses. Under a common consolidated corporate tax base, this question may not have the same importance, as losses would be allocated to the members of the group on a regular basis: final losses would be apportioned just as other losses. In contrast, absent a common consolidated corporate tax base, the question of final losses is highly relevant. Indeed, the ECJ introduced an "all in all out" approach in *Marks & Spencer* that results in providing cross-border relief only when losses become final. This argument is convincing as in a purely domestic situation, *i.e.* if all group companies were resident in the same Member State, loss relief would be available in many cases, although not in all cases. That is, if the subsidiary had been established in the home State, or if the parent company had been resident in the host State, loss relief possibilities would probably have been higher than in a cross-border situation. The lack of relief becomes intolerable when losses are final, because the only reason for their non-deduction is the isolation of tax bases in different Member States: in case of final losses the lack of relief harms definitely the internal market, while the harm was only temporary for non-final losses. This is completely in conflict with the concept of an internal market defined as an "area without internal frontiers" intended to function as a domestic market.

Consequently, requiring cross-border relief for final losses seems as a step in the right direction. However, it is argued *infra* that the solution of *Marks & Spencer* suffers several flaws, which could only be corrected by legislation at the European Union level.

3.3.5.2 Defining "final" losses

Defining which losses should be considered as final is a difficult matter that can hardly be solved by the ECJ. A relatively easy way out of the problem would be to adopt a very strict definition of final losses, the stricter being when a group company is liquidated. In such a case, this company incurs losses that it will never be able to offset against taxable profits. Also, although the conditions for a company to be liquidated may vary between Member States, the liquidation of a company is, in my view, the criterion that leaves the less room for interpretation between Member States, as it would imply an automatic loss relief in a single particular situation. Of course, Member States could still apply this criterion differently, but guidance could have been provided by the Court in future cases, thus limiting differences of interpretation between Member States.

However, limiting final loss relief to the liquidation of foreign subsidiaries tackles only part of the conflict between the fiscal principle of territoriality and the objective of achievement of the internal market. In *Marks & Spencer* the Court did not limit final losses to losses existing at the time a subsidiary is liquidated: paragraph 59 of this decision refers to situations in which "the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods and where there are no possibilities for those losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party". By considering that losses may be taken into account "for future periods" by "the subsidiary itself", the ECJ clearly requires cross-border loss relief even if the subsidiary is not liquidated, as long as it has exhausted the possibilities available in its State of residence of having the losses taken into account. This would typically be the case if a loss carry-forward expires in the host State. Although this definition of final foreign losses is positive from the perspective of enhancing the internal market, it raises several types of issues.

First, almost every word of paragraphs 55 to 57 of the *Marks & Spencer* decision may be subject to differences of interpretation[379]. This may also encourage Member States to restrict situations in which loss relief is made available. Many other questions could be asked on the relevance of the final loss criterion[380], in addition to the difficult burden of proof[381] relating to the evidence that a loss is final according to the meaning of this criterion in *Marks & Spencer*.

Second, there are aspects that are not dealt with, such as the determination of the legislation according to which the final losses should be computed and whether all the final losses are to be deducted in the State of the parent company.

Third, the extent to which Member States may refuse cross-border reflief for final losses and "adopt or maintain in force rules having the specific purpose of precluding from a tax benefit wholly artificial arrangements whose purpose is to circumvent or escape national tax law"[382] is not defined. This raises questions such as whether or not Member States may re-

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[379] The difficulties created by the final loss criterion are illustrated by the case law in the UK that followed the *Marks & Spencer* case and that was about the determination of the amount of losses that should be admitted in deduction from the UK taxable income. See UK First-Tier Tribunal, 2 April 2009, *Marks & Spencer plc and the Commissioners for her Majesty's Revenue and Customs*; UK Upper Tribunal, 21 June 2010, *the Commissioners for her Majesty's Revenue and Customs and Marks & Spencer plc*.

[380] See Melchior Wathelet, Marks & Spencer plc v Halsey*: lessons to be drawn*, British Tax Review 2006-2, p. 129, where this author asks several questions with regard to the exception to the principle of territoriality made by the Court for final losses: "Can the parent company choose not to sell its subsidiary even in the event that its losses could be transferred by selling it to a third party? Except in the event of definitive closure, could a subsidiary be obliged to carry forward its losses pending future hypothetical profits with the risk of the possibility of using these losses in the Member State of the parent company becoming time-barred when the subsidiary finally closes its doors? What exactly does 'taking into account' losses mean?".

[381] *Op. cit.*, p. 129, where it is pointed out that it will be very difficult to prove "that no options exist for 'taking into account' such losses in future tax years".

[382] ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 57.

fuse cross-border loss relief when a taxpayer has incurred final losses on purpose, for exemple if a taxpayer does not realise a capital gain against which losses could have been offset so as to incur a final loss and deduct it in a home State with a higher tax rate. Also, it is not symmetric to allow Member States to tax wholly artificial arrangements (according to the *Cadbury Schweppes* decision) while their final losses should not be offset in the home State.

Fourth, the ECJ did not pay attention to the consequences in the host State of a loss relief provided in the home State: benefiting in the home State from loss relief possibilities that are not available in the host State may breach a free and sound competition in the host State[383] with regard to local competitors that cannot benefit from tax equalisation measures, a carry back or carry forward of the losses. Indeed, by requiring the home State to grant loss relief, the foreign enterprise receives an advantage that may not be available to local competitors[384]. Such a breach of competition may happen frequently as not all Member States have domestic tax equalisation systems, and when they have such systems great differences exist from one country to another[385]. This issue is very important and relates to the debate between capital export neutrality and capital import neutrality. Case law cannot reach an outcome that is totally neutral in both the home State and the host State[386], as preference has to be given to one of these States. In contrast, under a common consolidated corporate tax base, no such choice would have to be made as all income would be consolidated and computed according to the same rules.

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[383] See articles 119 and 120 TFEU.

[384] This may have been the case for the Belgian subsidiary in the *Marks & Spencer* case, as no tax equalisation rules were in force in Belgium at the time the losses became final.

[385] For an overview of such differences, see Julien Saïac, *L'imputation des pertes des filiales communautaires selon Marks & Spencer: mode d'emploi*, Feuillets Rapides Francis Lefebvre, 24 November 2006, pp. 46-54.

[386] See Michael J. Graetz, Alvin C. Warren Jr., *Income tax discrimination and the political and economic integration in Europe*, The Yale Law Journal, April 2006, pp. 1217-1219, where it is argued that combining capital export neutrality and capital import neutrality may produce inconsistent results.

The above flaws can hardly, in my opinion, be solved by ECJ case law. Legislation at the European Union level would probably be more suitable to provide a satisfactory definition of final losses, although only a common consolidated corporate tax base could ensure a taxation on a net basis and a neutral outcome. In the lack of a harmonised legislative measure, the exception introduced by the ECJ for final losses creates a situation with a lot of uncertainty and divergences between Member States' tax laws[387], as well as a clear breach of competition in the host State.

The next issue relates to the discrepancy between international double taxation and the exception for final losses introduced in *Marks & Spencer*.

3.3.5.3 The discrepancy between international double taxation and the double non-deduction of final losses

As is discussed in more details in chapter 6 *infra*, the ECJ has not found international double taxation, in itself, incompatible with EU law. It can therefore be wondered if it is consistent to, on the one hand, refuse the double non-deduction of final losses while on the other hand, international double taxation is accepted. It may be considered that since double taxation is accepted, the ECJ should also accept the double non-deduction of final losses[388]. The ECJ itself relies on the concept of "symmetry"[389] and seems

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[387] An example of incorrect application of the *Marks & Spencer* doctrine is provided by section 35(a) para. 4(1) of the Swedish Income Tax Act, which allows cross-border group contributions only when a directly and wholly owned foreign subsidiary is liquidated.

[388] See Michael Lang, *The Marks & Spencer case - the open issues following the ECJ's final word*, European Taxation, February 2006, p. 58; Michael Lang, *Recent case law of the ECJ in direct taxation: trends, tensions, and contradictions*, EC Tax Review, 2009-3, p. 99: "Expenses that can be deducted nowhere should be treated like income or property, which is taxed twice"; Michael Lang, *Tax treaty policy*, *in* Krister Andersson, Eva Eberhartinger and Lars Oxelheim, *National tax policy in Europe – to be or not to be?*, Springer, 2007, p. 193: "not allowing deductions in either state and taxing income in both states are two sides of the same coin".

[389] See particularly ECJ, 15 May 2008, case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, para. 33; ECJ, 23 October 2008, case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v Finanzamt für Körperschaften III in Berlin*, para. 42. See also ECJ, 15 October 2009, case C-35/08, *Grundstücksgemeinschaft Busley and Cibrian Fernandez v Finanzamt Stuttgart-Körperschaften* (hereafter referred to as "*Busley*") in which the Court, al-

to have been convinced since *Marks & Spencer* that "profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system in order to protect a balanced allocation of the power to impose taxes between the different Member States concerned"[390]. Indeed, the causes and consequences of international double taxation and double non-deduction of final losses are comparable:

- Regarding causes, both international double taxation and double non-deduction of final losses happen when a taxpayer is confronted with two tax systems that are not coordinated for taxing once and on a net basis.

- Regarding consequences, both international double taxation and double non-deduction of final losses result in a final overtaxation, *i.e.* a taxpayer is taxed on a higher basis than in a domestic context.

Therefore, from a purely theoretical perspective, it does not seem unreasonable to treat profits and losses in the same way for taxation purposes. If profits may be taxed twice, there is no convincing reason to prevent losses from never being deducted: as long as the ECJ accepts double taxation in the internal market, it does not seem coherent to refuse the double non-deduction of final losses.

The case law of the Court is not, and should not be, based solely on tax principles. This may prevent the achievement of the internal market, which is the ultimate goal of the fundamental freedoms. So far, the case law of the Court has interpreted the fundamental freedoms so that they may require

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though not referring explicitly to the concept of symmetry, required Germany to offset a loss from the letting or leasing of real estate located in Spain. Similar losses arising in Germany were deductible, but the ECJ relied on the fact that the taxpayers were taxed on their worldwide income in Germany. Since their foreign profits were taxed, the Court considered that their foreign losses should be offset against taxable profits (see particularly para. 30). For a comment on the *Busley* case, see Rens Paternotte, Highlights & Insights on European taxation, 2010-1, pp. 62-63.

[390] ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 43.

net taxation or single taxation, but only insofar as a Member State discriminates between residents and non-residents. For example, non-residents may benefit from the same deductions of costs as residents in the State of source[391], thus eliminating the double non-deduction of such costs. Double taxation has also been eliminated in certain cases, *e.g.* when a higher withholding tax is levied on outbound dividends than on domestic dividends[392]. However, it is not net or single taxation, as such, that was sought by the Court in these cases[393]. Rather, it is the elimination of a difference of treatment between residents and non-residents. Accordingly, a Member State may refuse a certain deduction to both residents and non-residents and when no discrimination is at hand, the ECJ considers that EU law is of no help to solve double taxation, which is "the result of the exercise in parallel by the two Member States concerned of their fiscal sovereignty"[394]. One may be sceptical to this outcome that does not tend to enhance the internal market[395], but in any case the Court should be consistent and take into consideration the tax policy aspects of these decisions. Therefore, I believe that double taxation and double non-deduction of losses should receive the same treatment under EU law.

Cases such as *Kerckhaert and Morres, Block*, and *Damseaux* did not involve a discrimination, *i.e.* each Member State applied its tax system consistently

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[391] See *e.g.* ECJ, 15 February 2007, case C-345/04, *Centro Equestre da Leziria Grande Lda v. Bundesamt der Finanzen*. For comments, see Ludovic Bernardeau, *Jurisprudence de la CJCE: fiscalité directe (janv./mars 2007)*, Revue de Droit Fiscal, 21 Juin 2007, pp. 20-21; Laurence Idot, *Spectacles dans un autre État Membre et déduction des frais professionnels*, Revue Europe, April 2007, p. 28.

[392] See *e.g.* ECJ, 14 December 2006, case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*; ECJ, 8 November 2007, case C-379/05, *Amurta SGPS v Inspecteur van de Belastingdienst*; ECJ, 18 June 2009, case C-303/07, *Aberdeen Property Fininvest Alpha Oy*; ECJ, 19 November 2009, case C-540/07, *Commission v Italy*. These cases are discussed in more details *infra*, at 6.3.

[393] However, the *Schempp* case may be an exception in this respect. The *Schempp* case is discussed in more details *infra*, at 6.3.3.

[394] ECJ, 12 February 2009, case C-67/08, *Margarete Block v Finanzamt Kaufbeuren*, para. 28.

[395] For a discussion of the compatibility of double taxation with EU law, see chapter 6 *infra*.

without treating differently domestic and cross-border situations. In contrast, *Marks & Spencer* involved a difference of treatment between domestic and cross-border losses. It is difficult to determine whether the presence or the absence of discrimination should, as such, justify the two opposite outcomes reached by the ECJ with regard to international double taxation and double non-deduction of losses. On the one hand, it could be argued that the presence or the lack of discrimination is sufficient to explain the different outcomes reached by the Court. Indeed, if one follows a pure discrimination-based analysis, *Kerckhaert and Morres, Block*, and *Damseaux* are not incompatible with the fundamental freedoms while *Marks & Spencer* is in breach with EU law. But if one adopts a restriction-based analysis, both international double taxation (as it stands in *Kerckhaert and Morres, Block*, and *Damseaux*) and double non-deduction of losses (as it stands in *Marks & Spencer*) create obstacles to the exercise of the fundamental freedoms and obstruct the achievement of the internal market. Also, it should be emphasised that the international double taxation at hand in *Kerckhaert and Morres, Block*, and *Damseaux* is final both in the State of source and in the residence State. Therefore, the actual disadvantages that the taxpayers suffered in *Marks & Spencer* on the one hand, and *Kerckhaert and Morres, Block*, and *Damseaux* on the other hand, were in fact quite similar since a definite double tax burden was imposed.

As a result, *Marks & Spencer* is comparable with *Kerckhaert and Morres, Block*, and *Damseaux*, since in both cases a final overtaxation was suffered by the taxpayer. The different outcomes are due to the fact that the Court follows a discrimination-based analysis. Yet, the justifications at hand were convincing in *Marks & Spencer* and it is, in my opinion, difficult to understand that the ECJ made an exception to these convincing justifications to take into account a final overtaxation that it accepts in other cases involving a double taxation. If a final overtaxation is, in itself, infringing EU law to such a great extent, then a similar outcome should also be implemented with regard to double taxation. That is not what the Court did in *Kerckhaert and Morres, Block*, and *Damseaux*, although these cases were decided after *Marks & Spencer*. This means that the final overtaxation criterion is not decisive. Rather, the explanation to the exception for final losses in *Marks & Spencer* is based on the difference of treatment between foreign and domestic sub-

sidiaries. This result is not convincing, as the internal market is harmed in both situations. This shows that relying exclusively on a discrimination-based analysis is not always appropriate to meet the objective of achievement of the internal market.

Therefore, the ECJ's position with regard to final foreign losses is difficult to reconcile with its acceptance of international double taxation in situations that do not imply a difference of treatment in the home State[396].

It is now discussed from what perspective final losses should be computed.

3.3.5.4 The perspective from which final losses should be computed: capital export neutrality versus capital import neutrality

It is important to decide the country in which neutrality is sought[397]. With regard to the computation of final losses, two opposite solutions may be considered: either the income of the foreign subsidiary is recalculated under the tax accounting rules of the home State[398], or the rules of the host State should prevail and be recognised in the home State[399]. These two perspectives are, conceptually, opposite to each other and both solutions have advantages and drawbacks:

- If a loss is recalculated according to the rules of the home State, the outcome will probably be different than if the foreign losses were computed according to the rules of the host State. This may lead to significant differences related to the deductibility of costs, the taxation of profits, the method of depreciation, *etc.* As a consequence, the ultimate tax treatment is likely to differ from what is available to competitors in the host State, thereby threatening a free competition with other competitors present in the host State. But at the same time, a more equal treatment is ensured in the

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[396] Discrimination based and restriction-based analyses are discussed in more details *infra*, at 4.2.2.2.3.

[397] See Kristina Ståhl, *Aktiebeskattning och fria kapitalrörelser*, Iustus Förlag, 1996, p. 111.

[398] This tends to implement capital export neutrality.

[399] This tends to implement capital import neutrality.

home State, both with regard to the determination of the amount of final losses and to possible limitations to the amount admitted in deduction according to the tax equalisation provisions of the home State.

- If a loss is kept as it was calculated according to the rules of the host State, the final losses deducted in the home State may differ from the loss that would have been incurred if the subsidiary had been resident in the home State. Consequently, the home State is being required to accept the rules of the host State. This may result in a more favourable tax treatment than for a domestic investment, for example if costs deductible in the host State would not be deductible in the home State. But this may also result in a less favourable tax treatment, in which case there is no equal treatment between domestic and foreign investments. But on the other hand, a more equal tax treatment is reached in the host State, albeit not totally as the tax rates may differ from those of the home State.

According to international tax practice, countries applying the principle of worldwide taxation would usually recalculate foreign income according to their domestic tax accounting provisions[400]. As argued above[401], one does not find in the EU Treaties an explicit preference for neutrality in the home State or in the host State. The ECJ has been looking for implementing both capital import neutrality[402] and capital export neutrality[403], although such a combination may produce inconsistent results in the field of direct tax law[404]. In its case law the ECJ has tested whether EU law requires equal treatment both in the home State and in the host State, depending on the

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[400] Aage Michelsen, General IFA Report, *Tax treatment of corporate losses*, vol. 83a, 1998, p. 42.

[401] See *supra*, at 3.2.2.1.

[402] See Eric Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models*, Katholieke Universiteit Brabant, Tillburg, 2001, p. 134, footnote 81, where it is listed a series of ECJ cases in which a tax base exemption was accepted by the Court.

[403] Examples of cases in which the ECJ has been implementing capital export neutrality are *Bosal*, *Rewe Zentralfinanz*, *Manninen*, *Kerckhaert and Morres, Block* or *Damseaux*.

[404] See Michael J. Graetz, Alvin C. Warren Jr., *Income tax discrimination and the political and economic integration in Europe*, The Yale Law Journal, April 2006, pp. 1217-1219.

Member State in which a request has been initiated. However, the debate relating to final losses has quite understandably been focused on the home State, because taxpayers have been refused national treatment for their foreign losses. By deciding the *Marks & Spencer* case from the perspective of the home State, the ECJ had to decide whether EU law required equal treatment in the home State, *i.e.* whether EU law required a treatment in accordance with capital export neutrality. If the Court had only taken into account the tax treatment in the host States, it is may not have found any discrimination, especially in Belgium where no tax equalisation system may have allowed for a shift of losses from a liquidated subsidiary to a domestic parent company. That is, capital import neutrality may have been respected in *Marks & Spencer* without requiring cross-border loss relief. However, because the case was introduced in the country of the parent company, the ECJ had to consider whether capital export neutrality was also to be respected, which was the case for foreign final losses as compared to domestic losses.

The attempt of the ECJ to provide a relief mechanism for final foreign losses takes only into account the perspective of the home State. However, arguments exist for at least considering the perspective of the host State[405]. The ECJ stated several times that "the preservation of the allocation of the power to impose taxes between Member States might make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses"[406]. This may be interpreted as a preference for a search for neutrality in the host State through keeping the final foreign losses as they are computed under the host State's tax accounting rules, so that losses originating

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[405] It has been argued that "the various prohibitions of discrimination and restrictions and other provisions of the EC Treaty which aim to ensure equal competitive conditions, like the prohibition of state aid in Article 87 EC Treaty (…) support CLIN rather than CLEN": see Eric Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models*, Katholieke Universiteit Brabant, Tillburg, 200, p. 133.

[406] See ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 45. See also ECJ, 15 May 2008, case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, para. 31; ECJ, 25 February 2010, case C-337/08, *X Holding BV v Staatssecretaris van Financiën*, para. 28.

in the host State should not be recalculated according to the rules of the home State. Also, from an economic point of view it has since long been argued that "business competes with business, not owners with owners"[407], which makes sense within the internal market: take the example of 27 competitors with parent companies in the 27 Member States, all having a subsidiary in the same Member State. If all competitors know that in case they liquidate the subsidiary, they will all get the same loss relief calculated according to the rules of the host State, a sound basis of free competition is created at the scale of the internal market. By equating this amount admitted in loss relief to what would have been available in the host State, a free competition is also created with regard to enterprises resident in this host Member State. In contrast, competition is significantly biaised over the whole internal market by having different rules for loss relief in all the States of the parent companies, although a sound competition may be preserved in each of these Member States. Accordingly, the concept of an internal market is, in my view, better enforced if all economic players obtain a loss relief for a similar amount, which tends to favour capital import neutrality over capital export neutrality. In addition, it should be observed that the suggested directive on loss relief also favours the calculation of a permanent establishment's[408] and a foreign subsidiary's[409] losses in accordance

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[407] Michael J. Graetz, Michael M. O'Hear, *The "original intent" of U.S. international taxation*, Duke Law Journal, 1997, volume 46, p. 1037, citing Thomas S. Adams, *Fundamental problems of federal income taxation*, Quarterly Journal of Economics 527, 1921, at 542.

[408] COM 90 (595) final, 24 January 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*, article 7(2): "The income of permanent establishments shall be determined Member State by Member State in accordance with the rules of the law of the Member State in which the permanent establishment is situated". Similarly, see Aage Michelsen, General IFA Report, *Tax treatment of corporate losses*, vol. 83a, 1998, p. 50: "the country of residence must accept the determination of profit and losses made according to the rule of law of the source country".

[409] COM 90 (595) final, 24 January 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*, article 9(2): "The income of each subsidiary shall be determined in ac-

with the rules of the host State, which indicates a preference of the European Commission for neutrality in the host State.

In the absence of harmonisation of Member States' tax accounting rules, it will not be possible to find a solution that is neutral both in the home State and in the host State: a difference of treatment will still exist in either of these States. Therefore, as long as differences will exist between Member States' legislations, a choice will necessarily have to be made between seeking equal treatment in the home State or in the host State. Adopting a legislative measure on cross-border loss relief would not either solve this problem, contrary to a common consolidated corporate tax base. The ECJ did not provide clear guidance as to whether the losses should be computed according to the tax accounting rules of the host State or be recomputed under the rules of the home State, although it found that "the preservation of the allocation of the power to impose taxes between Member States might make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses"[410]. This may be interpreted as a preference for leaving the losses as they have initially been computed according to the rules of the host State, which is consistent with the above analysis and the suggested directive on cross-border loss relief. Unfortunately, in the lack of clear guidance provided by the ECJ, Member States may be tempted to adopt restrictive solutions that do not enhance the internal market[411].

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cordance with the rules of the law of the Member State in which it is situated, in proportion to the holding which the enterprise has in its capital".

[410] See ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 45. See also ECJ, 15 May 2008, case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, para. 31; ECJ, 25 February 2010, case C-337/08, *X Holding BV v Staatssecretaris van Financiën*, para. 28.

[411] For example, the Swedish group relief rules (see section 35(a) para. 8 of the Swedish Income Tax Act) require that the final foreign losses be computed according to both the foreign and the domestic rules, the lowest amount being deductible (subject to additional limitations) in the hands of the parent company.

Another problem faced by the Court in *Marks & Spencer* is the determination of the group company that should be granted a deduction right for final losses incurred by another group company.

3.3.5.5 Which group company should be granted relief for final losses?

The choice of the group company that should be granted a deduction right for final losses incurred by another group company is an important question, because it implies to choose which Member State must accept to reduce its tax base to take account of losses that arose on the territory of another Member State.

Out of *Marks & Spencer*, it is not possible to affirm with all certainty which group company should be granted loss relief for final losses incurred by another group company. In this case the ECJ concluded that it was up to the State of the ultimate parent company to grant loss relief, since it is this company that applied for cross-border loss relief. However, the ECJ did not explicitly mention that only the ultimate parent could deduct a final loss. In *Oy AA* the Court refused to grant loss relief to a subsidiary. If the Court considered that only the parent company could apply for cross-border loss relief, it may have expressed that idea in *Oy AA* as an argument to reject the claim of the Finnish subsidiary. On the contrary, the ECJ considered the claim and found Finnish legislation discriminatory, although it could be justified. The justification did not strongly refer to the fact that the claim came from a subsidiary. Therefore, it is possible that the ECJ may have accepted the claim if it concerned final losses. The same goes for *X Holding*: although the Court did not refer to final losses, it is possible that the ECJ would have required the Netherlands to deduct forein losses once they are final, which could have been interpreted as an obligation for the State of the direct parent company, contrary to *Marks & Spencer* where it was the State of the ultimate parent company that was required to grant relief for final losses.

Therefore, at the moment the ECJ does not explicitly indicate which group company could apply for a tax equalisation system to deduct a final loss incurred by another group company. A first question is whether loss relief should be granted only to a parent company, or if other group companies

may also be entitled to loss relief (3.3.5.5.1). As it is concluded that only a parent company should be granted loss relief, a second question concerns the determination of the parent company to which loss relief should be granted (3.3.5.5.2).

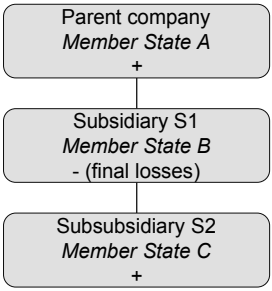
3.3.5.5.1 Should loss relief be granted only to a parent company, or could it also be granted to other group companies?

At first sight, one could argue that only a parent company should be granted cross-border loss relief. Indeed, a parent company by definition invests in a subsidiary by contributing wholly or partly to its equity. That is, the parent company assumes part of the risk linked to the setting up of a subsidiary, as the participation to the subsidiary's equity is an investment that will not necessarily be recovered. Accordingly, from the perspective of the parent company, it may appear fair to be entitled to loss relief to compensate the risk taken when investing in the subsidiary. From the perspective of the State of the parent company, it could be argued that since it may be entitled to tax capital gains and dividends on shares in the subsidiary when it was profitable, this State should also be exposed to the losses incurred by such subsidiaries[412].

Consequently, there are arguments pleading for taking into account losses at the level of a parent company. However, it is not always self-evident that it is the parent company that should be granted relief for final foreign losses incurred by a subsidiary. The argument according to which the State of the parent company may have been entitled to tax capital gains and dividends on shares in the subsidiary is not perfectly convincing: even if dividends and capital gains are at all taxable, shares may be sold to a group company resident in another Member State, in which case the State of the new parent company may not have had the opportunity to tax dividends and capital

[412] Of course, the State of the parent company may grant a participation exemption on dividends and/or capital gains in domestic law or tax treaties, thus not having the possibility to tax the subsidiary's residual profits, but this decision belongs to this State: the parent-subsidiary directive does not prohibit taxation of dividends and capital gains in the State of the parent company.

gains. More generally, it may be inapropritate to grant loss relief solely to a parent company, as illustrated by a situation in which a parent company owns a subsidiary, which in its turn owns a subsubsidiary. Assume that a parent company resident in Member State A owns a subsidiary S1 resident in Member State B, which in its turn owns a subsidiary S2 resident in Member State C. It is assumed that S1 incurs final losses.



In this situation, S1 may have entered into intercompany transactions only with S2, while the parent company may be a holding company resident in a State where dividends and capital gains are exempt from taxation. It is also possible that the final losses of S1 are aggravated by non-arm's length prices between S1 and S2. Therefore, in this example it may not be desirable that Member State A grants relief to the parent company for final losses incurred by S1, as the company has entered into business transactions solely with S2. One could also assume that a subsidiary enters into transactions with other group companies, with which no direct legal connection exists.

However, in the lack of a European legislation on cross-border loss relief, it seems that arguments pleading in favour of final loss relief at the level of the parent company overweigh the deduction of such losses by subsubsidiaries and sister companies. Three arguments support this view:

- First, attributing loss relief to the parent company compensates the risk it takes when investing equity in the subsidiary. Bearing final losses could be considered as a shareholder cost related to the

ownership in a subsidiary[413]. In contrast, no such connection exists with subsubsidiaries or sister companies.

- Second, the State of the parent company may have had the opportunity to tax dividends and capital gains from shares in the subsidiary, which the State of a subsidiary or a sister company per definition does not have.

- Third, the legal structure of groups of companies is usually so that the number of subsidiaries is greater than the number of parent companies. That is, the organisation may often be represented as a pyramid, with a narrow top and a broad base. This means that if loss relief could be granted to subsubsidiaries or sister companies, tax planning opportunities would be increased as more companies could seek loss relief. It would be very difficult to determine which subsidiary should be entitled to loss relief, and a multiple utilisation of losses would be a serious risk to take into account. By exclusing subsubsidiaries and sister companies from the scope of cross-border loss relief under EU law, these risks are significantly mitigated.

Consequently, in the lack of a legislative solution, I believe that only parent companies should be entitled to final loss relief. By so doing, a controllable limitation is made to the fiscal principle of territoriality, which both respects the connection between the parent company and the subsidiary, and also mitigates the incentives to enter into tax avoidance schemes. The question is then to determine which parent company should be entitled to cross-border loss relief.

3.3.5.5.2 Granting loss relief to the parent company: the dilemma between direct and ultimate parent companies

Letting only the ultimate parent company be granted loss relief might appear a good solution at first sight. Since the ultimate parent company is the

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[413] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, see particularly para. 7.6 to 7.18.

head of the group, it could greatly benefit from the option to consolidate positive and negative income in the whole group, as it is ultimately entitled to the residual profits of the subsidiaries through the distribution of dividends, capital gains on shares, and possibly transfer prices. This solution would also mitigate the risk that losses are deducted more than once, since most often only one company could be granted relief for final losses. Yet, this is not a satisfying solution. It makes it possible to organise the group so that the ultimate parent is resident in a country where the foreign losses have the highest value for tax purposes, which the Court found undesirable in *Marks & Spencer*[414]. In addition, it would be unfair to accumulate all final losses in one Member State, merely because the ultimate parent company has its residence there. Countries that offer attractive conditions for the establishment of a holding company would be clearly disadvantaged. Also, the ultimate parent company may be resident in a third country, thus preventing loss relief. Last, companies are ultimately owned by natural persons or a State: why should loss relief stay at the level of the ultimate parent company? For all these reasons, this solution is not completely satisfying.

A second alternative consists in granting the deduction right to the direct parent of the loss-making group company[415]. It is the direct parent company that has taken a risk by investing in a subsidiary. A right to obtain loss relief would compensate the risks taken, thus creating incentives to invest in other Member States. The direct owner is also easier to determine than the ultimate owner. The main problem here is that a company might be owned by more than one shareholder, thus making it difficult to attribute the deduction right to one in particular. Loss relief could be attributed to the shareholder with the highest participation, but this solution seems unfair to other shareholders. On the other hand, the deduction right could be apportioned between the shareholders, according to their level of participation. However, such a system may imply an overwhelming administrative bur-

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[414] ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 49.

[415] This approach was not the one followed by the ECJ in *Marks & Spencer*, as the Court required loss reflief for final losses although the subsidiaries were owned through a Dutch company.

den, *e.g.* for a company quoted on the stock exchange. In addition, if losses had to be computed according to the tax accounting rules of each Member State involved, it is possible that the losses totally deducted would not match the losses actually incurred by the loss-making subsidiary. It is also easier to shift the ownership of shares at the level of a direct parent company than the whole ownership of the group at the level of the ultimate parent company. Consequently, the solution consisting in allocating the deduction of losses to direct the shareholder(s) is not fully satisfactory either. However, this solution is, in my opinion, more advantageous than an allocation of the final losses to the ultimate parent company.

3.3.5.6 Conclusion on the relief for final losses incurred by foreign group companies

In conclusion, the attempt of the ECJ to provide a well-balanced relief mechanism for final foreign losses can be qualified as "valiant"[416], because of the importance of providing European groups with a loss relief mechanism. Indeed, losses may become final for the sole reason that the tax base is spread between two or more Member States. Not only may this impede the exercise of the fundamental freedoms, but also it is less likely to happen within one State, which the internal market should aim at. Accordingly, the fiscal principle of territoriality is clearly incompatible with the objective of achievement of the internal market, when this principle prevents offsetting losses against taxable profits.

However, the ECJ cannot through its case law find a solution to cross-border loss relief that is satisfying in the long term[417]. There are too many obstacles to cross: first, the concept of final losses, referred to at paragraph

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[416] Frans Vanistendael, *In defence of the European Court of Justice*, Bulletin for International Fiscal Documentation, March 2008, p 93.

[417] For a reflection on the possibility for the Court to deal with the current international tax rules see Kees van Raad, *Fractional taxation of multi-State income of EU resident individuals – a proposal*, *in* Liber Amicorum Sven-Olof Lodin, Kluwer Law International, 2001, pp. 211-212: "the court is simply not equipped for renovating outdated taxation regimes".

55 of the *Marks & Spencer*[418] judgement, should be defined. Second, the company that should be granted loss relief should be determined. Third, one should not breach a free competition in the host State. Fourth, the risk that losses are used more than once exists also with regard to final losses, as they may be deducted *e.g.* by both the direct parent company and the ultimate parent company. It cannot either be excluded that if a new subsidiary is set up after the liquidation of a loss-making subsidiary, the new company obtains a loss carry-forward corresponding to the previously non-deducted losses. For all these reasons, the ECJ cannot through its case law find a solution to cross-border loss relief that is satisfying in the long term. Additionally, it is argued in chapter 7 *infra* that the very rationale of the *Marks & Spencer* doctrine with regard to final losses, *i.e.* an allocation of all the final losses to the home State, is intrinsically flawed. Consequently, an alternative way of reasoning is proposed in chapter 7.

Marks & Spencer illustrates the limits of negative integration as part of the accomplishment of the internal market. Negative integration can simply not provide a satisfying answer to cross-border loss relief. This view is supported by the difficulties to reconcile these cases with other cases issued by the Court. Indeed, with regard to cross-border loss relief, *Marks & Spencer* is difficult to reconcile with *Bosal*[419], in which the Court required the Netherlands to accept in deduction interests costs borne by a parent company for investing in a foreign subsidiary: if the subsidiary had taken a loan itself to finance its activities, the interests paid on the loan may have led to a loss.

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[418] ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 55: "the Court considers that the restrictive measure at issue in the main proceedings goes beyond what is necessary to attain the essential part of the objectives pursued where: the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods, if necessary by transferring those losses to a third party or by offsetting the losses against the profits made by the subsidiary in previous periods, and there is no possibility for the foreign subsidiary's losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party".

[419] ECJ, 18 September 2003, case C-168/01, *Bosal Holding BV*.

According to *Marks & Spencer*, such a loss is not deductible in the State of the parent company. However, according to *Bosal*, if the cost is borne by the parent company, it should be deductible there. Consequently, the same cost may or may not be deductible in the State of the parent company depending on which company has taken a loan. Such inconsistencies are difficult to avoid for the ECJ, and more of those may come in the future as the number of cases in direct taxation is constantly growing.

Therefore, *Marks & Spencer* should be welcomed as the beginning of cross-border loss relief within the internal market. It should now be up to the Member States to continue and deepen this discussion, as the ECJ cannot on its own find a satisfying solution with an EU-wide sustainable application. Obviously, the discussion has to go further than the proposed directive on cross-border loss relief[420], as this proposal did not address final losses. A common consolidated corporate tax base would be an efficient solution, as losses would be shared by the members of the consolidated group on a continual basis. Final losses be apportioned as non-final losses. Another advantage offered by a common consolidated corporate tax base would be the opportunity to take into account losses made by parent companies: as argued above with regard to *Oy AA*, one cannot objectively determine which subsidiary should be able to deduct losses incurred by the parent company. This reasoning should, in my opinion, also be applicable when a parent company incurs final losses, because of the impossibility, under the *Marks & Spencer* doctrine, to allocate such final losses between the parent company's subsidiaries[421]. However, under a common consolidated corporate tax base, losses of a parent company would also be consolidated and apportioned between the members of the group. Therefore, a common consolidated corporate tax base would be of great help with re-

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[420] COM 90 (595) final, 24 January 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*.

[421] The court of appeals of Stockholm reasoned similarly with regard to a Swedish company which claimed relief for a group contribution sent to its liquidated parent company established in Luxembourg: see the Court of appeals of Stockholm (*Kammarätten i Stockholm*), 7 June 2010, case number 6191-09, *Thomas Cook Nordic Holdings AB*.

gard to cross-border loss relief in the internal market. However, as it would not apply in all situations, other solutions must also be considered. In that respect, an alternative way of reasoning with regard to cross-border loss relief is discussed in chapter 7 *infra*.

3.3.6 Conclusion on losses incurred by foreign group companies

This second part of chapter 3 has shown that the internal market cannot be achieved when Member States strictly apply the fiscal principle of territoriality with regard to losses incurred by foreign group companies. According to *Marks & Spencer*, *Oy AA* and *X Holding*, Member States are allowed not to grant relief for non-final losses incurred by foreign group companies. This solution, although not reached under the fiscal principle of territoriality as a justification ground, does lean towards a taxation in line with the fiscal principle of territoriality, as foreign losses are to be deducted first in the host State without imposing on the home state to offer an automatic right of deduction. This solution also respects Member States' fiscal sovereignty, since international law implies a right not to take into account foreign elements. But at the same time, these decisions show that the fiscal principle of territoriality is at tension with the objective of achievement of the internal market. In these cases there was an obvious difference of treatment between purely internal and cross-border situations, as net taxation without cash-flow disadvantage was available only in purely internal situations. Following these preliminary rulings, businesses still endure a less favourable treatment when crossing a border. The internal market has not been significantly enhanced by these decisions. It was argued *supra* that the ECJ was right not to require Member States to offset non-final losses, but this conclusion was based on technical arguments as well as the fact that the Court cannot bring a satisfying answer to this issue.

If the obstacles to the achievement of the internal market caused by the fiscal principle of territoriality can be accepted with regard to non-final losses, the fiscal principle of territoriality becomes unacceptable when it prevents the relief of final foreign losses. Providing for relief for final losses is a relevant idea, but it is submitted that a long term solution to final losses can hardly be provided by the ECJ. Instead, it seems that a legislative measure would be a much more appropriate solution to final loss relief. In that re-

spect, it is argued in chapter 7 *infra* that the very reasoning of the Court, requiring the home State to grant loss relief for all the final losses incurred in the home State, is criticisable. Therefore, alternative approaches to providing cross-border loss relief, which could be implemented by secondary legislation at the level of the European Union, are suggested in chapter 7.

3.4 Conclusion of chapter 3

The ECJ held in several cases such as *Gilly* and *Saint-Gobain* that Member States remain sovereign to determine the connecting factors for levying taxes. This assumption could, *prima facie*, justify the taxation of foreign companies' foreign profits (through applying the principle of worldwide taxation) and the non-deduction of their losses (through applying the fiscal principle of territoriality). However, it is clear from the case law analysed in this chapter that, at least with regard to group taxation, such consequences that stem from Member States' fiscal sovereignty are not compatible with the objective of achievement of the internal market. Therefore, a first conclusion from this chapter is that both the principle of worldwide taxation and the fiscal principle of territoriality may conflict with the achievement of the internal market. Looking at *Cadbury Schweppes* and *Marks & Spencer* one may be tempted to conclude that the ECJ tends to favour the fiscal principle of territoriality for both profits and losses, with an exception for final losses. This preference for the fiscal principle of territoriality is strengthened when one takes into consideration the fact that convincing arguments could justify CFC rules, and that loss relief for non-final losses could be granted only temporarily through a recapture mechanism.

However, this possible preference for the fiscal principle of territoriality does not at all suffice to achieve the internal market. *Marks & Spencer* has not significantly improved the functioning of the internal market, as relief for foreign losses can be obtained in limited cases. Even if final loss relief is probably positive for European groups, losses are still by and large isolated between Member States as a consequence of the fiscal principle of territoriality and the principle of personality. The disadvantage of a market segmented between Member States persists. Therefore, it is submitted that without an efficient cross-border loss relief system that moderates the negative consequences of the fiscal principle of territoriality, the achievement of

the internal market from a group taxation perspective is simply impossible. In that respect, the approach of the ECJ suffers several shortcomings, which why is a legislative solution is certainly preferable. As far as final losses are concerned, such a legislative solution may take into consideration the arguments discussed in chapter 7 *infra*, where it is submitted final losses should be split between Member States instead of being entirely allocated to the home State.

The next chapter studies the taxation of foreign permanent establishments by the Member State of residence.

4 Taxation of resident companies on foreign business income earned through permanent establishments

4.1 Introduction

In the previous chapter it was studied how the objective of achievement of the internal market affects the right of Member States to rely on the principle of worldwide taxation and the fiscal principle of territoriality in relation to foreign group companies' foreign profits and losses. Chapter 3 focused on business income incurred by the foreign company itself, whether it was positive or negative income. Chapter 4, in contrast, focuses on income incurred by a resident company itself, in relation to the business it carries on in other Member States through permanent establishments. As in the previous chapter, both the principle of worldwide taxation and the fiscal principle of territoriality raise compatibility issues with the objective of achievement of the internal market, with regard to foreign profits as well as losses. However, although the issues analysed in this chapter are, from the point of view of principle, comparable to those discussed in the previous chapter, an important difference exists between foreign subsidiaries (studied in chapter 3) and permanent establishments (studied in chapter 4): foreign subsidiaries are legal entities and subject to the principle of personality, while permanent establishments are not legal entities on their own. As a result, contrary to the situations described in chapter 3, the State of residence of a company often takes into account, for tax purposes, foreign business income incurred through permanent establishments. In such a case, the State of residence makes use of the principle of worldwide taxation. The State of residence may also favour the fiscal principle of territoriality, thereby not taking into account foreign income, whether positive or negative. A combination of both principles is found in certain tax systems, *e.g.* when foreign positive business income is exempted while losses are de-

ducted upon a later recapture[422]. Consequently, the legal analysis conducted on the conflict between Member States' rules on the taxation of companies' foreign business income and the objective of achievement of the internal market has necessarily to take into account this fundamental difference between the taxation of groups of companies and the taxation of single companies, because international tax practice largely reflects the legal differences between foreign subsidiaries and permanent establishments.

In contrast to what was discussed in chapter 3, there can be no doubt from an international law perspective on the right of a State of residence to apply either taxation principle. Indeed, residence is a strong territorial connection between a State and a tax subject. It is often with its State of residence that a taxpayer has the closest connection. The taxpayer's ability-to-pay is likely to be the greatest in the State of residence, since worldwide positive and negative incomes are often compiled in the resident's tax base. Offsetting worldwide negative income against worldwide positive income – *i.e.* computing the worldwide tax base according to the net taxation principle – reveals the actual income and ability-to-pay of a resident. It is also in the State of residence that a taxpayer is likely to benefit most from public resources, thus creating a need for fiscal revenues. The State of residence may, therefore, insist on taxing a resident's worldwide income to finance the public services. As a consequence, it is widely accepted that taxpayers are subject to unlimited tax liability in their State of residence[423]. Indeed, as discussed in chapter 2, there is no obligation under international law to limit tax jurisdiction to source income. Nevertheless, the extent of the State of residence's tax jurisdiction is a decision that traditionally lies within its sover-

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[422] An example is provided by article 209 C of the French *Code général des impôts*. This article, which applies only to small and medium-sized enterprises, provides relief for losses incurred by foreign subsidiaries held to 95% or more and permanent establishments. Losses have to be recaptured at the latest five years after their deduction from the French tax base. Guidelines on the application of article 209 C of the French *Code général des impôts* were issued by the French ministry of finance on 20 January 2010 (reference 4 H-4-10).

[423] A few States, however, consider that international law limits tax jurisdiction to source income, irrespective of whether the tax subject is resident or not. See *supra* at 2.3.1.2.

eignty: a sovereign State may decide to limit its tax jurisdiction and exempt all or part of a resident's foreign income.

The ECJ, referring to "international tax law" and the OECD Model Tax Convention, has accepted residence as a connecting factor for the levy of taxes on a resident's worldwide income[424]. However, conflicts with EU law may arise either way, *i.e.* whether the Member State of residence applies the principle of worldwide taxation or the fiscal principle of territoriality. Accordingly, compatibility issues are discussed with regard to the application of the principle of worldwide taxation and the taxation of permanent establishments (4.2), as well as with regard to the application of the fiscal principle of territoriality and the exemption of permanent establishments (4.3).

4.2 Application of the principle of worldwide taxation in the Member State of residence: taxation of foreign business income earned through a permanent establishment

[424] See ECJ, 14 February 1995, case C-279/93, *Finanzamt Köln-Altstadt v Roland Schumacker*, para. 32: "international tax law, and in particular the Model Double Taxation Treaty of the Organization for Economic Cooperation and Development (OECD), recognizes that in principle the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the State of residence". See also ECJ, 14 September 1999, case C-391/97, *Gschwind*, para. 24: "residence is the connecting factor on which international tax law, in particular the Model Double-Taxation Convention of the Organisation for Economic Cooperation and Development (OECD), is normally founded in order to allocate powers of taxation between States in situations involving extraneous elements". See also ECJ, 13 December 2005, case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)* para. 39: "by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law".

"the credit method hampers investment, the provision of services and the taking up of employment in the other EU Members States, and there is no legal justification recognizable for these impediments"[425].

"principles of Community law do not appear to be obviously contradictory to the taxation of worldwide income"[426].

4.2.1 Introduction

The taxation of companies' foreign business income earned directly in other Member States through permanent establishments is an important issue from a tax policy perspective. Indeed, the extent of the tax jurisdiction exercised by the Member State of residence is likely to have significant consequences on the actual exercise of the freedom of establishment, which ultimately influences the achievement of the internal market. In that respect, the principle of worldwide taxation (often implemented through the credit method) and the fiscal principle of territoriality (often implemented through the exemption method) have opposite characteristics, and accordingly imply opposite consequences on the achievement of the internal market. Therefore, since these two principles are inherently opposed to each other, it is important to actually identify the taxation principle that should be favoured in Member States' tax policy so as to enhance the achievement of the internal market. If no clear preference for either taxation principle can be deducted from ECJ case law, the study of the points of tension between these principles of taxation and the objective of achievement of the internal market is likely to provide some elements of answer to the question of which principle of taxation should be favoured.

The taxation of resident companies on a worldwide basis is a developed practice amongst Member States. Article 7(1)[427] of the OECD Model Tax

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[425] Klaus Vogel, *Which method should the European Community adopt for the avoidance of double taxation?*, Bulletin for International Fiscal Documentation, January 2002, p. 10.

[426] Michael Lang, *CFC legislation and Community law*, European Taxation, September 2002, p. 377.

[427] See article 7(1) of the OECD Model Tax Convention, 2010: "Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business

Convention reflects the broad compromise according to which the State of residence has tax jurisdiction over the worldwide income of resident companies[428]. Worldwide taxation in the State of residence is also implemented by European secondary law, for passive income, as the directives applicable in the field of direct taxation favour residence-based taxation over source-based taxation[429].

However, even if worldwide taxation of residents is implemented in many domestic laws, tax treaties, and European directives, Member States must still enforce the EU Treaties. It should therefore be studied whether the taxation of resident companies on their worldwide income is compatible

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in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State".

[428] See para. 19 of the introduction to the OECD Model Tax Convention, 2010, which indicates that "As a rule, this exclusive right to tax is conferred on the State of residence".

[429] The directives adopted in the field of direct taxation tend to favour taxation in the State of residence, although source taxation is not completely eliminated. See article 5 of the parent-subsidiary directive (Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States): "Profits which a subsidiary distributes to its parent company shall be exempt from withholding tax". See article 1 of the interests and royalties directive (Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States): "Interest or royalty payments arising in a Member State shall be exempt from any taxes imposed on those payments in that State, whether by deduction at source or by assessment, provided that the beneficial owner of the interest or royalties is a company of another Member State or a permanent establishment situated in another Member State of a company of a Member State". See article 1 of the savings directive (Council Directive 2003/48/EC of 3 June 2003 on taxation of savings income in the form of interest payments): "The ultimate aim of the Directive is to enable savings income in the form of interest payments made in one Member State to beneficial owners who are individuals resident for tax purposes in another Member State to be made subject to effective taxation in accordance with the laws of the latter Member State".

with the objective of achievement of the internal market. First, it should be observed that the ECJ has held, particularly in *Gilly*[430] and *Saint-Gobain*[431], that Member States remain sovereign as to the determination of the criteria for the levy of taxes. This view has been repeated in several later cases where the Court considered that Member States may base their tax jurisdiction on the OECD Model Tax Convention[432].

The ECJ answered more precisely to whether or not the taxation of foreign income constitutes, as such, a prohibited discrimination. The Court touched upon this issue in the *Schumacker* case, which related to a natural person. The ECJ held that "international tax law, and in particular the Model Double Taxation Treaty of the Organization for Economic Cooperation and Development (OECD), recognizes that in principle the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the State of residence"[433]. Additional guidance may be drawn from the *Futura* case[434] where residents were taxed on their worldwide income and non-residents on their domestic income, which the Court considered "cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty"[435]. That is, taxation of residents on their worldwide income would be compatible with EU law. This statement was repeated later on[436] until two cases in which the Court dealt specifically

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[430] ECJ, 12 May 1998, case C-336/96, *Gilly*. See particularly para. 24 and 30.

[431] ECJ, 21 September 1999, case C-307/97, *Saint-Gobain*, para. 56.

[432] See *e.g.* ECJ, 15 May 2008, case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, para. 22.

[433] See ECJ, 14 February 1995, case C-279/93, *Finanzamt Köln-Altstadt v Roland Schumacker*, para. 32.

[434] However, it should be observed that *Futura* was issued from the perspective of the host State. Accodingly, one can hardly draw far-reaching conclusions from the perspective of the home State on the basis of this case.

[435] ECJ, 15 May 1997, case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, para. 22.

[436] See particularly ECJ, 13 December 2005, case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)* para. 39: "by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State,

with the taxation of head offices with regard to business income earned by their permanent establishments: in *Columbus Container*[437] (4.2.2) and *Krankenheim*[438] (4.2.3), the ECJ ruled about the taxation of foreign partnerships and permanent establishments from the perspective of the State of residence.

Last, it is discussed whether EU law may require the grant of a full tax credit, as it may be more favourable than the exemption method or the ordinary credit method if a permanent establishment is situated in a Member State with a higher tax rate than the Member State of residence (4.2.4). It is important to study whether EU law may require the grant of a full tax credit, because if this would be the case it would imply the application of the principle of worldwide taxation but also the limitation of the tax jurisdiction of the Member State of residence and its right to levy tax on foreign income.

4.2.2 The Columbus Container case

Columbus Container is first presented (4.2.2.1) and then discussed (4.2.2.2).

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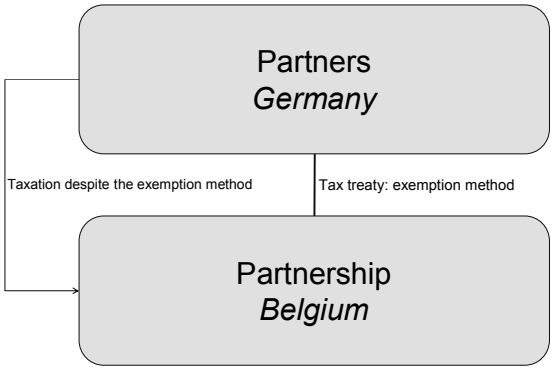
the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law". See also Opinion of Advocate General Kokott, delivered on 12 September 2006, case C-231/05, *Oy AA*, para. 51. For a comment on the use of the expression "principle of territoriality" with regard to the taxation of residents on their worldwide income in these cases see Leif Mutén, *Finland may deny deductible group contributions, Advocate General says*, Tax Notes International, 2 October 2006, pp. 23-24.

[437] ECJ, 6 December 2007, case C-298/05, *Columbus Container Services B.V.B.A. & Co. v Finanzamt Bielefeld-Innenstadt*. For a comment on this case in relation to Member States' sovereignty, see Gerard T.K. Meussen, Columbus Container Services - *a victory for the Member States' fiscal autonomy*, European Taxation, April 2008, pp. 169-173.

[438] ECJ, 23 October 2008, case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v Finanzamt für Körperschaften III in Berlin*. For a comment on this case see Gerard T.K. Meussen, *The ECJ's judgment in* Krankenheim - *the last piece in the cross-border loss relief puzzle?*, European Taxation, July 2009, pp. 361-363; Jose Calderón, Andrés Baez, *The* Columbus Container Services *ECJ case and its consequences: a lost opportunity to shed light on the scope of the non-discrimination principle*, Intertax, 2009-4, pp. 212-222.

4.2.2.1 Presentation of the Columbus Container case

In *Columbus Container* the German partners of a Belgian partnership were taxed on the profits of the partnership, although the applicable tax treaty exempted such income. Indeed, German domestic law switched from the exemption to the credit method when the partnership was taxed at less than 30%.



The question was whether German domestic law, by applying the credit method instead of the exemption method, was in breach of EU law. Despite the less favourable situation created by this switch-over, the German system was accepted by the ECJ. The Court mentioned that "the adverse consequences which might arise from the application of a system for the taxation of profits such as that put in place by the AStG result from the exercise in parallel by two Member States of their fiscal sovereignty"[439], referring to *Kerckhaert and Morres*[440]. It was also recalled that "Member States are at liberty to determine the conditions and the level of taxation for different types of establishments chosen by national companies or partnerships operating abroad, on condition that those companies or partnerships are not treated in a manner that is discriminatory in comparison with comparable

[439] ECJ, 6 December 2007, case C-298/05, *Columbus Container Services B.V.B.A. & Co. v Finanzamt Bielefeld-Innenstadt*, para. 43.

[440] ECJ, 14 November 2006, case C-513/04, *Mark Kerckhaert and Bernadette Morres v Belgische Staat*.

national establishments"[441]. This reasoning indicates that the Court is not willing to disturb the exercise of tax jurisdiction by Member States as long as they do not discriminate between domestic and cross-border situations, which resulted in the acceptance of the principle of worldwide taxation in *Columbus Container*.

4.2.2.2 Discussion of the Columbus Container case

Columbus Container provided a clear answer as to whether or not it is compatible with EU law to tax a permanent establishment or a partnership at the head office level, without, however, discussing the compatibility with EU law of the principle of worldwide taxation (4.2.2.2.1). The solution reached in *Columbus Container* recognises the taxing rights of Member States beyond the prevention of tax avoidance, which raises compatibility issues with *Cadbury Schweppes* (4.2.2.2.2). The incompatibility between *Columbus Container* and *Cadbury Schweppes* seems to be explained by the fact that the Court applied a strict discrimination-based analysis, which raises questions as to whether or not the ECJ may also carry out restriction-based analyses (4.2.2.2.3).

4.2.2.2.1 The Columbus Container case and the compatibility with EU law of the principle of worldwide taxation

Columbus Container provided the Court a good opportunity to indicate whether the principle of worldwide taxation is compatible with the objective of achievement of the internal market. This ruling is of significant importance given the abundant discussions about which principle of taxation best enforces the EU Treaties[442]. One of the main lessons from the *Colum-*

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[441] ECJ, 6 December 2007, case C-298/05, *Columbus Container Services B.V.B.A. & Co. v Finanzamt Bielefeld-Innenstadt*, para. 53.

[442] See particularly Klaus Vogel, *Taxation of cross-border income, harmonization, and tax neutrality under European Community law, an institutional approach*, Foundation for European Fiscal Studies, Kluwer, 1994; Klaus Vogel, *Which method should the European Community adopt for the avoidance of double taxation?*, Bulletin for International Fiscal Documentation, January 2002, pp. 4-10; Eric Kemmeren, *Principle of origin in tax conventions, a rethinking of models*, Tilburg, 2001; Eric Kemmeren, *Source of income in globalizing economies: overview of the issues and a plea for an origin-based approach*, Bulletin for International Fiscal Documentation, November 2006, pp. 430-452; Peter

bus Container case is that the Court considers that the principle of worldwide taxation, applied in a non-discriminatory manner to a foreign transparent partnership or a permanent establishment, is compatible with EU law. This means that for the principle of worldwide taxation to be compatible with EU law domestic and foreign income must be taxed in the same way, *i.e.* the State of residence has to implement capital export neutrality. Indeed, by applying the principle of worldwide taxation and taxing similarly a domestic and a foreign partnership, the German rules at hand implemented capital export neutrality.

Unfortunately, the ECJ did not analyse the compatibility of capital export neutrality as such with the objective of achievement of the internal market, although convincing arguments exist for favouring the fiscal principle of territoriality over the principle of worldwide taxation from the perspective of the home State:

- First, with regard to the exercise of the freedom of establishment, capital export neutrality prevents European companies from structuring their operations and enjoying foreign tax systems, *i.e.* foreign lower tax rates as well as foreign more advantageous tax accounting rules. In contrast, capital import neutrality allows benefiting from foreign lower taxes as well as foreign tax accounting rules, and therefore companies are more likely to make use of the freedom of establishment, which contributes to the accomplishment of

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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, 2003-4, pp. 194-202; Charles E. McLure Jr., *The long shadow of history: sovereignty, tax assignment, legislation, and judicial decisions on corporate income taxes in the US and the EU*, *in* Reuven S. Avi-Yonah, James Hines and Michael Lang (eds.), Comparative fiscal federalism, Kluwer Law International, 2007, pp. 119-171; Dennis Weber, *Is the limitation of tax jurisdiction a restriction of the freedom of movement?*, Accounting and taxation & assessment of ECJ case-law, 2007 EATLP Congress, pp. 113-133; Krister Andersson, *An economist's view on source versus residence taxation - the Lisbon objectives and taxation in the European Union*, Bulletin for International Fiscal Documentation, October 2006, pp. 395-401; Claude Emonnot, *Intégration financière européenne et fiscalité des revenus du capital*, Economica, 1998.

the internal market. Indeed, it can hardly be argued that capital export neutrality encourages the exercise of the fundamental freedoms as much as capital import neutrality with regard to foreign tax systems. In my opinion, the very perspective of being taxed up to the level of the home State and according to the tax accounting rules of the home State, as opposed to not being taxed on foreign income, can only hinder a taxpayer from exercising his freedom of movement. In addition, the ECJ has often repeated that a potential obstacle is sufficient to be in breach of EU law, *i.e.* no evidence of an actual obstacle has to be brought to identify an infringement to the freedom of establishment[443]. As a consequence, one does not necessarily need an economic study showing to what extent taxpayers are actually hindered from exercising their freedom of establishment by capital export neutrality.

- Second, concerning tax competition, I believe that capital import neutrality puts Member States at competition with each other, which is in line with articles 119[444] and 120[445] TFEU. These two articles emphasise the "principle of an open market economy with free competition". By being taxed at the local rate and according to

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[443] See ECJ, 13 March 2007, case C-524/04, *Thin Cap Group Litigation*, para. 62; ECJ, 18 July 2007, case C-231/05, *Oy AA*, para. 42; ECJ, 21 January 2010, case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian State*, para. 50.

[444] See article 119 TFEU: "For the purposes set out in Article 3 of the Treaty on European Union, the activities of the Member States and the Union shall include, as provided in the Treaties, the adoption of an economic policy which is based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition.

[445] See article 120 TFEU: "Member States shall conduct their economic policies with a view to contributing to the achievement of the objectives of the Union, as defined in Article 3 of the Treaty on European Union, and in the context of the broad guidelines referred to in Article 121(2). The Member States and the Union shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources, and in compliance with the principles set out in Article 119".

the local tax acconting rules of the host State, permanent establishments may compete with domestic establishments as well as other foreign establishments under similar tax conditions. In *Columbus Container*, until the application of the switch-over from the exemption method to the credit method, the partnership, exempt from taxation in Germany, competed with Belgian companies and possibly permanent establishments belonging to head offices located in other Member States on rather similar tax conditions. The same tax rate had to be applied locally[446] and it is most likely that the tax base in the host State was computed according to the same tax accounting rules as applied to resident companies, given the requirements of the non-discrimination principle. Following the application of the switch-over from the exemption method to the credit method, the partners of the Belgian partnership had to bear a much higher tax burden in their home State, which was not the case for competitors resident in Belgium. Also, the partnership probably had to compute its taxable income according to the tax accounting rules of the home State, which may have been less favourable than those of the host State[447]. The attractivity of the State of Belgium, from a corporate income tax perspective, decreased considerably. Consequently, capital import neutrality in my view promotes a free tax competition in the host State by being relieved from the additional tax burden levied in the home State. By contrast, capital export neutrality results in the competitive advantage offered by the host State being erased by the home State. In addition and as indicated above[448], lower tax rates in one Member State should be part of the advantages offered by the internal market.

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[446] As a consequence of the *Royal Bank of Scotland* case, the State of source is not allowed to tax more heavily a permanent establishment than a resident company. See ECJ, 29 April 1999, case C-311/97, *Royal Bank of Scotland plc v Elliniko Dimosio (Greek State)*.

[447] This may be the case, for example, if certain costs are deductible in the host State but not in the home State. As a consequence of taxation of worldwide income in the home State, income is usually recomputed according to this State's tax accounting rules. See Aage Michelsen, General IFA Report, *Tax treatment of corporate losses*, vol. 83a, 1998, p. 42.

[448] See *supra* at 3.2.3.2.1.

Unfortunately, these arguments were not considered by the Court, something that would have been most welcome given the need for guidance as to which principle of taxation should be favoured to implement the internal market.

4.2.2.2.2 The Columbus Container case and the prevention of tax avoidance: can Columbus Container and Cadbury Schweppes be reconciled?

Before trying to reconcile *Cadbury Schweppes* and *Columbus Container* (4.2.2.2.2.2), it should first be discussed whether these cases are comparable (4.2.2.2.2.1).

4.2.2.2.2.1 Comparing Columbus Container and Cadbury Schweppes

Columbus Container shares some similarities with *Cadbury Schweppes*, as in both cases a Member State extended its tax jurisdiction to foreign income to eliminate the advantage resulting from foreign lower tax rates. That is, the fiscal principle of territoriality was replaced in both cases by the principle of worldwide taxation. The ECJ in *Cadbury Schweppes* came to the conclusion that the British CFC rules were in breach of the freedom of establishment and could be justified only when they targeted wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned[449]. Therefore, one may at first sight feel surprised that the ECJ accepted the German rules at hand in *Columbus Container* without limiting their scope to wholly artificial arrangements, as these rules also replaced the fiscal principle of territoriality by the principle of worldwide taxation. However, three main differences existed between these cases, which may impede their comparability.

First, *Cadbury Schweppes* was about the taxation of a foreign subsidiary, while *Columbus Container* was about the taxation of a foreign partnership[450]. There is a key legal difference between a subsidiary on the one hand, and a trans-

[449] ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*, para. 51.

[450] The partnership can be assimilated to a permanent establishment for the purpose of this chapter of the dissertation, as the partnership was considered tax transparent in Germany and was taxed as a permanent establishment.

parent partnership or a permanent establishment on the other hand. A transparent partnership or a permanent establishment is often directly taxed in the home State (except in States applying strictly the fiscal principle of territoriality in their domestic law or in tax treaties), while a subsidiary is taxed separately in its own State of residence. Many other differences exist between subsidiaries and permanent establishments or partnerships[451], the point here being only to emphasise that it is legally more far-reaching to apply CFC rules than to tax a transparent partnership or a permanent establishment, because in the former case the principle of personality has to be set aside[452]. This argument could partly justify the difference of outcome between *Cadbury Schweppes* and *Columbus Container*, although as demonstrated in chapter 2 the consequences of the principle of personality do not result from binding international law[453]. Also, the ECJ does not pay strong attention to the principle of personality as such, as illustrated by *Marks & Spencer* (with regard to final losses) and *Cadbury Schweppes* (with regard to wholly artificial arrangements). Consequently, the differences between *Cadbury Schweppes* and *Columbus Container* with regard to the principle of personality should not preclude the comparability of these situations.

Second, the ECJ found a difference of treatment in *Cadbury Schweppes*, since only parent companies owning shares in certain foreign subsidiaries were subject to CFC taxation, as opposed to parent companies owning shares in domestic subsidiaries. In contrast, no discrimination was at hand in *Columbus Container*, because German partnerships were always taxed at the level of their partners: the Belgian partnership, taxed in Germany as a consequence

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451 For a discussion on the differences between foreign subsidiaries and permanent establishments, see Peter 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, 2003-4, pp. 194-202.

452 For an analysis of the differences of the situations at hand in *Cadbury Schweppes* and *Columbus Container*, see *Opinion statement of the CFE ECJ Task Force on ECJ,* Columbus Container services BVBA & Co v. Finanzamts Bielefeld-Innenstadt*, 6 December 2007, C-298/05 – April 2008*, European Taxation, October 2008, pp. 541-544.

453 International law does not require that a foreign subsidiary is taxed to a lower extent than a foreign partnership or a permanent establishment, because no clear limits are set on a State's tax jurisdiction.

of the switch-over from the exemption to the credit method, was not taxed more heavily than a German partnership. Consequently, the discrimination-based analysis usually carried out by the ECJ inevitably came to the conclusion that the rules at hand in *Columbus Container* were not in breach of the freedom of establishment. However, as discussed in chapter 3 *supra*, the discrimination found by the Court in *Cadbury Schweppes* resulted from the restrictive perspective adopted by the ECJ in this case. In particular, had the Court considered that foreign subsidiaries subject to CFC taxation are ultimately taxed in the home State as domestic subsidiaries, the discriminatory treatment was no longer so obvious. Consequently, the actual difference between *Cadbury Schweppes* and *Columbus Container* is not so significant, as it depends on the perspective in which one considers these cases.

Third, a tax treaty override[454] was at hand in *Columbus Container*, as the Belgian partnership was taxed in Germany despite the exemption method chosen in the tax treaty concluded between Belgium and Germany. This tax treaty override may be interpreted as implying that *Columbus Container* goes further than *Cadbury Schweppes*[455], *i.e.* the acceptance of the tax treaty override in *Columbus Container* would be legally more far-reaching than CFC rules such as those at hand in *Cadbury Schweppes*. This could justify different outcomes, or even the non-comparability between these cases. However, CFC rules may also be interpreted as resulting in a tax treaty override. Article 7(1) of the OECD Model Tax Convention may be considered as precluding the taxation of foreign companies unless business is carried on through a permanent establishment in the territory of the taxing State: taxing a foreign subsidiary not having a permanent establishment in the State of the parent company could be precluded by article 7(1) of the OECD Model Tax Convention[456]. Consequently, it could be held that the situations

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[454] On the concept of tax treaty override see Mattias Dahlberg, *Svensk skatteavtalspolitik och utländska basbolag*, Iustus Förlag, 2000, pp. 302-313.

[455] See Pasquale Pistone, *Ups and downs in the case law of the European Court of Justice and the pendulum of direct taxation*, Intertax, 2008-4, pp. 147-148.

[456] That was the solution found by the French *Conseil d'Etat* in the *Schneider Electric* case: *"Considérant qu'en vertu du paragraphe 1 du A de l'article 25 de la convention fiscale franco-suisse, dans sa rédaction antérieure à l'avenant du 22 juillet 1997, les revenus visés au 1 ° de l'article 7 sont exonérés de l'impôt français sur les sociétés lorsqu'ils sont réalisés par une société qui, comme la société Paramer, a en*

in both *Cadbury Schweppes* and *Columbus Container* implied a tax treaty override, although such override was more obvious in the latter case. Additionally, in my opinion, the difference between these cases with regard to their compatibility with tax treaties should not be taken into account by the Court as the purpose of the ECJ is to interpret and implement EU law, not tax treaties. Member States should not have the right to escape their obligations under the EU Treaties through concluding tax treaties. Consequently, whether or not a treaty override was at hand in these cases shall not, in my view, obstruct their comparability.

As a result, *Cadbury Schweppes* and *Columbus Container* may be compared to each other, despite the differences discussed above. A comparison evidences an apparent incompatibility between these cases.

4.2.2.2.2.2 The apparent incompatibility between Columbus Container and Cadbury Schweppes

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Suisse le siège de sa direction effective et n'a pas d'établissement stable en France; que l'objectif d'élimination des doubles impositions attribué à cette convention fiscale ne saurait justifier une méconnaissance des stipulations susmentionnées au seul motif que l'imposition par la France des bénéfices de la société Paramer n'est pas établie au nom de la société suisse mais à celui de sa société mère, qui est une entité juridique distincte et à laquelle lesdits bénéfices n'ont pas été effectivement distribués; que, par suite, la cour n'a pas commis d'erreur de droit en jugeant que les stipulations de l'article 7 de la convention fiscale franco-suisse s'opposent à l'application des dispositions de l'article 209 B du code général des impôts": see French Supreme Administrative Court (*Conseil d'Etat*), 28 June 2002, case number 232276, *Société Schneider Electric*. For comments see Patrick Dibout, *L'inapplicabilité de l'article 209 B du CGI face à la convention fiscale franco-suisse du 9 septembre 1966 (À propos de l'arrêt CE, Ass., 28 juin 2002, Schneider Electric)*, Revue de Droit Fiscal, 2002-36, pp. 1133-1141; Laurent Olléon, *Article 209 B et conventions fiscales internationales: « Après les ténèbres, la lumière »*, Revue de Jurisprudence Fiscale, October 2002, pp. 755-759. It can be observed that article 8(1) of the tax treaty concluded between the United Kingdom and Ireland on 2 June 1976 reads exactly the same as article 7(1) of the tax treaty concluded between France and Switzerland on 9 September 1966. Therefore, one may find support in the *Schneider Electric* case when arguing that a tax treaty override was also at hand in the *Cadbury Schweppes* case. On the relation between CFC taxation and tax treaties see Michael Lang, *CFC regulations and double taxation treaties*, Bulletin for international fiscal documentation, February 2003, pp. 51-58; Mattias Dahlberg, *Svensk skatteavtalspolitik och utländska basbolag*, Iustus Förlag, 2000, pp. 314-326.

The principle of worldwide taxation may be a way of preventing tax avoidance through taxing foreign profits, despite the possible existence of legal barriers such as the incorporation of a foreign subsidiary (CFC rules) or the exemption method in domestic law or a tax treaty. It was argued in chapter 3 that the freedom of establishment may be abused, in which case a taxpayer may not benefit from the protection of the provisions of the EU Treaties. However, it was also found that as long as a taxpayer exercises his freedom of establishment through a genuine establishment, he should not fear anti-abuse measures[457]. Consequently, the prevention of tax avoidance should not, in itself, constitute a sufficient argument to generally hinder the exercise of the freedom of establishment. Rather, an extended tax jurisdiction aimed at preventing tax avoidance should act as a corrective mechanism and be applied only when a situation of intolerable abuse has been identified.

In *Columbus Container*, thanks to the exemption method in the Germany-Belgium tax treaty, German taxpayers enjoyed lower tax rates for their investments in Belgian coordination centres than if they had established such activities in Germany. The German taxpayer could also compete on equal footing with Belgian competitors. However, as recalled by the ECJ in *Cadbury Schweppes*, the very fact that a taxpayer structures its operations in order to benefit from foreign lower tax rates does not, as such, constitute tax avoidance[458]: a national measure offsetting that advantage and thus restricting the freedom of establishment should be applicable only if it "specifically relates to wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned"[459]. As long as a company has an actual establishment in the host Member State and pursues a genuine economic activity there, *Cadbury Schweppes* indicates that a Mem-

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[457] See *supra* at 3.2.3.2.

[458] ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*, see particularly para. 49: "it is settled case-law that any advantage resulting from the low taxation to which a subsidiary established in a Member State other than the one in which the parent company was incorporated is subject cannot by itself authorise that Member State to offset that advantage by less favourable tax treatment of the parent company".

[459] ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*, para. 51.

ber State should not offset the advantages of the foreign establishment, even if the taxpayer has a view to minimising its tax burden. In this case, the home State should refrain from taxing, *i.e.* it should apply the fiscal principle of territoriality. The fiscal principle of territoriality may be replaced by the principle of worldwide taxation only if the subsidiary is a wholly artificial arrangement set up with the aim of escaping the normal payment of taxes.

Given the weight put by the ECJ in *Cadbury Schweppes* with regard to the limited right of a Member State to invoke the prevention of tax avoidance as a justification to offseting the advantages of the foreign establishment, and regarding the purpose of the German rules in *Columbus Container*, one may have expected the Court to carry out the same reasoning and consider whether the Belgian establishment constituted a wholly artificial arrangement aimed at circumventing the German legislation. If the ECJ would have reasoned so, it is likely that it would have come to the conclusion that the Belgian partnership had enough substance, as this entity performed "the centralisation of financial transactions and of the accounts, the financing of the liquidity of subsidiaries or branches, the computerisation of data and advertising and marketing activities"[460]. To perform such functions, the partnership certainly needed "premises, staff and equipment", which are the criteria used in *Cadbury Schweppes* to consider that a company "physically exists"[461] and should not be subject to CFC taxation. Consequently, the partnership was probably not a wholly artificial arrangement, which means that the German rules would most likely not have been justified by the need to prevent tax avoidance, thus being incompatible with EU law.

This conclusion is strengthened by later case law of the Court, which limited the right to justify a tax rule by the need to prevent tax avoidance to

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[460] ECJ, 6 December 2007, case C-298/05, *Columbus Container Services B.V.B.A. & Co. v Finanzamt Bielefeld-Innenstadt*, para. 15.

[461] ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*, para. 67: "As suggested by the United Kingdom Government and the Commission at the hearing, that finding must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment".

situations "involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory"[462]. The ECJ has, indeed, observed that "It suffices to note that the tax system at issue in the main proceedings does not specifically aim at such purely artificial arrangements which do not reflect economic reality and are created solely with a view to escaping the tax normally due on the profits generated by activities carried out on national territory, and cannot therefore be justified on grounds connected with the prevention of tax avoidance"[463]. As the German rules did not target wholly artificial arrangements according to this definition but, on the contrary, targeted all establishments subject to a tax rate lower than 30% without taking into consideration the actual substance of such establishments, it is likely that the ECJ would have found the German rules incompatible with EU law.

The British and German rules at hand in *Cadbury Schweppes* and *Columbus Container* aimed at achieving largely comparable purposes, *i.e.* depriving a resident taxpayer from the option to locate taxable profits in a low-taxed country that is normally not within the tax jurisdiction of the home State. Both the UK and Germany qualified such situations as abusive and applied anti-avoidance tax rules that rendered ineffective the structure set up by the taxpayer through replacing the fiscal principle of territoriality by the principle of worldwide taxation. That is, not only the purpose but also the effect of the British and German rules shared great similarities. That the Court reached so different outcomes in *Cadbury Schweppes* and *Columbus Container* is, from a tax policy perspective, regrettable. It can only be misleading for the Member States as to how to prevent tax avoidance and which principle of taxation should be favoured to levy tax in cross-border situations. By considering the German rules compatible with EU law, the ECJ enhanced the rights of Member States to extend their tax jurisdiction to foreign income as long as they do so in a non-discriminatory manner, without even preventing tax avoidance. Indeed, the reasoning of the Court in *Columbus*

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[462] ECJ, 18 June 2009, case C-303/07, *Aberdeen Property Fininvest Alpha Oy*, para. 64.
[463] *C. cit.*, para. 65.

Container was totally disconnected from the prevention of tax avoidance, contrary to the Opinion of Advocate General Mengozzi. This confers on *Columbus Container* a very broad scope, which may encourage Member States to extensively apply the principle of worldwide taxation in a non-discriminatory manner.

Still, it cannot be concluded from *Columbus Container* that the Court favours the principle of worldwide taxation over the fiscal principle of territoriality, as confirmed by the *Test Claimants in the CFC and Dividend Group Litigation*[464] case, issued after *Columbus Container*. Rather, *Columbus Container* illustrates the cautiousness of the ECJ given the political weight of such tax policy issues: the Court seems to refuse to make a choice as to which principle of taxation should be followed. This may explain why the ECJ limits itself to a discrimination-based analysis.

4.2.2.2.3 Compatibility with EU law of the non-discriminatory taxation of foreign income: discrimination-based analysis versus restriction-based analysis

"The non-restriction concept is necessary for establishing the internal market, because there are many instances of non-discriminatory measures that do constitute obstacles to the free movement of goods, persons, services and capital"[465].

"même à défaut d'harmonisation conséquente en cette matière, la Cour est amenée à rappeler aux États membres que, dans l'exercice de leurs compétences fiscales, ils ne peuvent taxer des revenus de manière discriminatoire ou de sorte que leurs propres résidents soient entravés dans l'exercice des libertés de circulation"[466].

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[464] ECJ, 23 April 2008, case C-201/05, *Test Claimants in the CFC and Dividend Group Litigation*. This case confirmed that CFC rules are, in principle, incompatible with EU law.

[465] Frans Vanistendael, *General report on the fundamental freedoms and national sovereignty in the European Union*, 2007 EATLP Congress, p. 173.

[466] Koen Lenaerts, *Dans le prétoire de l'Europe – entretiens avec Vassilios Skouris, Koen Lenaerts, Jean-Claude Bonichot, Philippe Léger, Antonio Tizzano, Hubert Legal et Yves Bot*, Revue Europe, April 2007, p. 7.

"The alternative view is that where cumulative burdens caused by double taxation amount to restrictions that hinder cross-border activity, the Court should apply by analogy its caselaw on the fundamental freedoms to eliminate such obstacles. Stripped to its bare essentials, the argument is that any hindrance to the exercise of a fundamental freedom is 'a bad thing'. If a true single market is ultimately to be constructed, I can see the force of that argument"[467].

The German rules at hand in *Columbus Container* resulted in applying the same tax treatment to transparent partnerships, whether they were established in Germany or elsewhere. The German rules were not discriminatory and could be considered as a way of implementing capital export neutrality. The Court paid strong attention to the absence of discrimination, and found that the German provisions did not infringe the freedom of establishment. In contrast, the ECJ found a difference of treatment in *Cadbury Schweppes*, because parent companies were taxed directly on the profits of their foreign but not domestic subsidiaries. Consequently, there was a formal difference of treatment between a domestic and a cross-border situation in *Cadbury Schweppes*, while no such difference existed in *Columbus Container*.

In my view, the discrimination criterion has been overlooked by the ECJ in *Columbus Container*. It is submitted that it is criticisable that the Court reaches so different solutions from a tax policy point of view, solely because it identified a (questionable[468]) difference of treatment in one case but not in the other. Indeed and as demonstrated above, the CFC rules at hand in *Cadbury Schweppes* and the switch-over in *Columbus Container* are largely comparable, as they share the same purpose[469] and have similar effects[470].

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[467] Opinion of Advocate General Sharpston, delivered on 17 December 2009, case C-96/08, *CIBA*, para. 29.

[468] The identification of a difference of treatment in *Cadbury Schweppes* depends on the way one considers the situation at hand in this case: see *supra* at 3.2.2.1.

[469] The purpose of both these measures was the elimination of foreign lower tax rates applicable to non-taxable income in the home State.

The discrepancy between *Cadbury Schweppes* and *Columbus Container* illustrates, in my opinion, the limits of the discrimination-based analysis carried on by the ECJ.

If one considers the situation of the taxpayer, it is difficult to state that the German rules did not prohibit, impede or render less attractive the exercise of the freedom of establishment. The switch-over from the exemption method to the credit method increased the tax burden of the taxpayer by 53%[471], and probably created an additional administrative burden[472]. Advocate General Mengozzi found that the German rules "might be regarded as having the effect of fragmenting the common market, by encouraging German nationals to establish themselves only in Member States where the level of taxation is equal to or above the German rate provided for in the AStG. Following that line of reasoning, this measure would therefore be likely to deter German nationals from setting up, acquiring or maintaining a permanent establishment in a Member State in which it is subject to a level of taxation below 30%"[473]. Accordingly, Advocate General Mengozzi considered that "the judgment in *Cadbury Schweppes and Cadbury Schweppes Overseas* (…) in the light of the Opinion of Advocate General Léger, may be interpreted as meaning that a Member State of residence cannot restrict the freedom of establishment of its nationals to part of the common market, inter alia when there is no difference between that Member State's treatment of domestic situations and cross-border situations". The Advocate General found that the "the obligation on the 'exit' State (in other words, the State of residence), in this case the Federal Republic of Germany, is to ensure, in addition to respect for equal treatment among its residents as re-

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[470] The effect of both these measures was the taxation of the non-taxable income by the home State and at the rate applied by the home State.

[471] See ECJ, 6 December 2007, case C-298/05, *Columbus Container Services B.V.B.A. & Co. v Finanzamt Bielefeld-Innenstadt.*, para. 37.

[472] However, such an additional administrative burden is not necessarily incompatible with EU law. See ECJ, 12 December 2006, case C-446/04, *Test Claimants in the Franked Investment Income Group Litigation v Commissioners of Inland Revenue*, para. 53.

[473] Opinion of Advocate General Mengozzi, delivered on 29 March 2007, case C-298/05, *Columbus Container Services B.V.B.A. & Co. v Finanzamt Bielefeld-Innenstadt*, para. 132.

gards whether they have or have not exercised their freedom of movement, that they are not deterred from establishing themselves in the Member State of their choice, inter alia by means of tax measures"[474]. These rules could, however, be justified by the need to prevent tax avoidance[475].

It is submitted that the ECJ respects neither the EU treaties nor its previous case law by refusing to pay attention to non-discriminatory restrictions. Indeed, doubts can be expressed on whether the ECJ should strictly follow a discrimination-based analysis. Article 49 TFEU refers to "restrictions on the freedom of establishment", not to "discriminations". Generally, it can be observed that the TFEU employs the word "restriction" with regard to the freedoms of movement, while the word "discrimination" is rather used with regard to differences of treatment according to nationality, religion, or gender. So the wording of the freedom of establishment does not limit its effect to discriminations, but extends it to restrictions. This is also how the ECJ has interpreted the fundamental freedoms. The Court considers that "national measures 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 which they pursue; and they must not go beyond what is necessary in order to attain it"[476]. Consequently, the mere fact that a national measure is non-discriminatory should not, in my view, be sufficient to automatically meet the obligations under the Treaty. Indeed, such a national measure must also meet the three other criteria indicated in *Gebhard*, *i.e.* it must be justified by imperative requirements in the general interest, it must be suitable for securing the attainment of the objective which they pursue, and it must not go beyond what is necessary in order to attain it. Accordingly, both the wording of the TFEU and its inter-

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[474] *Op. cit.*, para. 133.

[475] *Op. cit.*, para. 169-184.

[476] See ECJ, 30 November 1995, case C-55/94, *Reinhard Gebhard v Consiglio dell'Ordine degli Avvocati e Procuratori di Milano*, para. 37.

pretation by the ECJ tend to indicate that the fundamental freedoms should not be impeded by restrictions, be they non-discriminatory.

A restriction-based analysis has been applied by the Court in non-tax cases long before the *Gebhard* case. Since *Cassis de Dijon*[477] several cases dealing with the free movement of goods relied on a restriction-based analysis, often in order to apply the principle of mutual recognition[478]. Indeed, a pure discrimination-based analysis may not suffice to enhance the free movement of goods. Restriction-based analyses have also been applied by the

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[477] ECJ, 20 February 1979, case C-120-78, *Rewe-Zentral AG v Bundesmonopolverwaltung für Branntwein*. For a comment see Laurence Gormley, *Cassis de Dijon and the Communication from the Commission*, EU law Review, 1981-6, pp. 454-459. It should, however, be emphasised that the principles found in *Cassis de Dijon* are neither absolute nor transposable to all the fields of law. Indeed, the ECJ pointed out that restrictions to the free movement of goods may be "necessary in order to satisfy mandatory requirements relating in particular to the effectiveness of fiscal supervision, the protection of public health, the fairness of commercial transactions and the defence of the consumer" (para. 8 of the *Cassis de Dijon* ruling and article 36 TFEU). Also, the principle of mutual recognition is particularly suitable for the free movement of goods, but this principle may not be as relevant for the field of tax law. Consequently, one should be cautious when discussing the possible consequences of the *Cassis de Dijon* ruling on direct taxes.

[478] For an analysis of the principle of mutual recognition in EU law see Markus Möstl, *Preconditions and limits of mutual recognition*, Common Market Law Review, 2010-2, pp. 405-436. The principle of mutual recognition is promoted by the TFEU with regard to diplomas (see article 53 TFEU), judgments in criminal matters (see articles 67(3) and 82 of the TFEU) as well as civil matters (see articles 67(4) and 81 of the TFEU).

ECJ with regard to the free movement of workers[479] and the freedom of establishment[480].

In the field of tax law, the ECJ has been much more reluctant to apply a restriction-based analysis. So far, it did so in *Futura*[481], and *Deutsche Shell*[482]. One may also possibly argue that the ECJ applied a restriction-based analysis in *Lankhorst-Hohorst*[483], although not as obviously as in *Futura*. In my

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[479] See *e.g.* the *Bosman* case: ECJ, 15 December 1995, case C-415/93, *Union royale belge des societes de football-association v. Jean-Marc Bosman*. For comments see José María Fernández Martín, *Re-defining obstacles to the free movement of workers*, European Law Review, 1996, pp. 313-326; see also Denys Simon, *Chronique de jurisprudence du Tribunal et de la Cour de justice des Communautés européennes, institutions et ordre juridique communautaire*, Journal du Droit International 1996-2, pp. 488-490.

[480] See *e.g.* the *CaixaBank France* case: ECJ, 5 October 2004, case C-442/02, *CaixaBank France*. For a comment see Laurence Idot, *Fin de l'interdiction française de la rémunération des comptes à vue*, Revue Europe, December 2004, pp. 16-17.

[481] ECJ, 15 May 1997, case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*. The non-discriminatory aspect that was found in breach of EU law was the requirement in the Member State of source that a permanent establishment fulfils accounting requirements applicable to domestic companies. This resulted in a double burden since the company had already fulfilled accounting requirements in its Member State of residence.

[482] ECJ, 28 February 2008, case C-293/06, *Deutsche Shell GmbH v Finanzamt für Grossunternehmen in Hamburg*. The non-discriminatory aspect that was found in breach of EU law related to the fact that a foreign exchange loss on capital allotted to a permanent establishment could not be incurred if the establishment had been located in the home State. See Emmanuel Raingeard de la Blétière, *Droit communautaire: chronique de l'année 2008*, Revue de Droit Fiscal, 26 February 2009, p. 64.

[483] ECJ, 12 December 2002, case C-324/00, *Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt*. The non-discriminatory aspect that was found in breach of EU law related to whether or not a shareholder enjoyed a particular tax credit. The German government argued that the legislation at hand was not directly linked to nationality, but to whether the taxable person enjoyed a tax credit. However, the ECJ was not convinced by this argument and found that in the large majority of cases resident parent companies received a tax credit, whereas, as a general rule, non-resident parent companies did not. Consequently, even if the German legislation did not make a formal distinction depending on the residence of the shareholder, the thin capitalisation provisions concerned *de facto* companies with foreign shareholders.

view, by limiting itself in almost all tax cases to a discrimination-based analysis, the Court does not fully respect the wording and the spirit of the EU Treaties. It also creates an inconsistency – at least from the point of view of principle – with cases in which restrictions have been found incompatible with EU law. If the ECJ applies a restriction-based analysis in non-tax cases and non-harmonised areas of the law, it is difficult to convincingly justify why it should not do so in tax cases. Such a hierarchy, through which the Court is more demanding on Member States in certain areas of the law and less demanding with regard to direct tax law, does not find explicit support in the EU Treaties. The fact that direct taxes are not explicitly referred to in the EU Treaties cannot explain this lack, as non-tax cases judged through a restriction-based analysis did not necessarily concern issues expressly within the competence of the Union. Direct taxes are just one of the many areas that may be concerned by the fundamental freedoms and should, in my opinion, be subject to similar principles of interpretation and application. Also, there is no reason why only certain freedoms should be subject to a restriction-based analysis: article 26 TFEU does not differentiate between the free movement of goods, persons, services and capital, all being equally necessary to achieve the internal market.

By striking down solely discriminatory provisions, it is submitted that the ECJ cannot fully achieve the internal market. The Court can certainly strengthen the non-discrimination principle as it already stands in the OECD Model Tax Convention, but it cannot take position on the tax principles that best suit the objective of achievement of the internal market[484]. Indeed, the principle of non-discrimination is important but not sufficient to achieve an internal market. This principle is intrinsically limited to putting domestic and cross-border situations on the same level, but it does not encourage the exercise of the freedom of establishment out of the home State, nor does it enhance the attractivity of the host State. It does not ei-

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[484] See Frans Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, EC Tax Review, 2003-3, p. 139: "In the non-discrimination approach it is sufficient that each snooker player can play under the same conditions at different snooker tables. In the non-restriction approach all players are playing from different corners at the same snooker table".

ther ensure a sound competition in the host State. Although the consequences of the principle of non-discrimination may result in some favourable effects for the achievement of the internal market, this principle does not target them as such. Therefore, it cannot by itself fully achieve the internal market[485].

A possible explanation to the lack of a restriction-based analysis in tax cases is the difficulty to determine which measures are restrictive, and which are not. Such a choice would necessarily imply taking decisions with a political impact. It would also be difficult to draw up the boundaries of this analysis. For example, could it be argued that a host State applying a high but non-discriminatory tax rate discourages foreign companies from establishing themselves on its territory? Indeed, assume that a host State has high taxes to finance a very supportive welfare system: could it not be argued that a non-resident benefits from the welfare system of this host State to a limited extent only, thus being required to pay taxes for services he would not benefit from, which would ultimately infringe his freedom of establishment? This example shows that it may be difficult to apply a restriction-based analysis in practice. However, this example should not automatically prevent the Court from applying a restriction-based analysis. Indeed, the ECJ as well as domestic supreme or constitutional courts may issue judgements with very far-reaching consequences. Sometimes, it may be the purpose of a supreme or constitutional court to take such decisions from the point of view of principle, either because it is entitled to rule on matters of principle, or because of the lacks of the lawmaker. If the ECJ would use in

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[485] Concurring, see *Op. cit.*, p. 141: "From the structure of the treaty text it follows that the principle of free movement and the principle of free and fair competition are essentially the directly guiding principles for the organization of the Internal Market. The principle of non-discrimination is a general principle of Community law that is not directly relevant or the organization of the Internal Market"; p. 143: "The application of the non-discrimination principle is a rather limited instrument in the overall objective of abolishing the obstacles at the borders of the Member State". See also Michael J. Graetz, Alvin C. Warren Jr., *Income tax discrimination and the political and economic integration in Europe*, The Yale Law Journal, April 2006, p. 1207: "a requirement of nondiscrimination is too unidimensional an approach for many issues of income tax design".

direct tax cases a restriction-based analysis, it would by itelf set the bounderies of a new generation of case law, as it did in *Avoir Fiscal*[486] when it included direct taxes in the scope of EU law.

By applying a restriction-based analysis, the Court could fully analyse the compatibility with the internal market of Member States' rules on the taxation of companies' foreign business income and set by itself the boundaries of such an analysis. It is true that at the same time, the legitimacy of the Court's decisions may decrease. This factor may explain the outcome of the *Columbus Container* case, in which the Court may have considered the consequences of a judgment that would have followed the Opinion of Advocate General Mengozzi: the principle of worldwide taxation, implemented in many Member States' tax treaties and domestic laws, could have been greatly limited when it does not target the prevention of tax avoidance, at least in a more proportional manner. Case law according to which Member States remain sovereign as to the determination of the connecting factors for the levy of taxes would have been contradicted, which would have a significant impact on Member States' tax policy. However, it would have been desirable that the ECJ at least discussed the restrictive effect of the switch over from the exemption to the credit method. It is possible that the Court did not discuss it because the restrictive effect in *Columbus Container* was, as argued above, difficult to justify with regard to the need to prevent tax avoidance. Additionally, would it be justified, the switch over may not have passed the proportionality test as the German measure completely eliminated the benefit from the foreign lower tax rate. The German measure could have been more proportional if, for example, it taxed foreign income at different rates, depending on the foreign tax rate or on the level of substance of the foreign establishment. Consequently, had the Court ap-

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[486] ECJ, 28 January 1986, case C-270/83, *European Commission v French Republic*, see particularly para. 14: "the fact that the laws of the Member States on corporation tax have not been harmonized cannot justify the difference of treatment in this case". For comments see Mattias Dahlberg, *Direct taxation in relation to the freedom of establishment and the free movement of capital*, Kluwer Law International, 2005, pp. 159-161; Pasquale Pistone, *The impact of Community law on tax treaties: issues and solutions*, Kluwer Law International, 2002, pp. 104-108; Servaas van Thiel, *EU case law on income tax, Part 1*, IBFD, 2001, pp. 137-168.

plied a restriction-based analysis, it is possible that it would have found the German rules incompatible with EU law, which could have had significant consequences on the tax systems of Member States, many of which are based on the principle of worldwide taxation and the credit method.

Last, one may find it regrettable that Member States enact tax provisions that are clearly restricting a taxpayer's freedom of establishment and harming the internal market, but that are ultimately EU-proof as they also apply to domestic situations. *Columbus Container* provides an obvious example of a Member State that designed restrictive tax legislation compatible with EU law although it applied to a non-abusive situation. Another example is provided by *Kerckhaert Morres*[487], a case in which a Member State efficiently protected its tax legislation against EU law although it clearly resulted in double taxation. In this kind of cases the ECJ is confronted with a dilemma between a non-discriminatory but restrictive legislation and the actual infringement to the internal market. So far the Court has given priority to a discrimination-based analysis, thereby setting aside the actual infringement to the internal market. As a result, Member States may learn from the Court how to design their legislation in an EU-proof manner without jeopardising their fiscal revenues, and irrespective of the harm to the internal market. It may be questioned whether this attitude is consistent with the principle of sincere cooperation[488], which requires that Member States "take any appropriate measure, general or particular, to ensure fulfilment of the obligations arising out of the Treaties"[489], "facilitate the achievement of the Union's tasks and refrain from any measure which could jeopardise the attainment

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[487] ECJ, 14 November 2006, case C-513/04, *Mark Kerckhaert and Bernadette Morres v Belgische Staat*.

[488] In addition to the provisions of the TEU on the principle of sincere cooperation, one may also mention the obligation for countries having signed the Vienna Convention on the Law of Treaties to interpret international treaties in good faith, which has been recognised by the ECJ. See ECJ, 15 July 2010, case C-70-09, *Hengartner and Gasser*, para. 36: "Article 31 of the Vienna Convention on the Law of Treaties of 23 May 1969 provides in that respect that a treaty is to be interpreted in good faith in accordance with the ordinary meaning to be given to its terms in their context and in the light of its object and purpose".

[489] See article 4 TEU.

of the Union's objectives"[490]. Could this attitude, *i.e.* learning from the Court how to design legislation EU-proof while still harful to the internal market, be compared to the abuse of rights that may be committed by Union nationals? In other words, if Union nationals may commit unacceptable tax planning, could Member States draft unacceptable tax legislation? Indeed, the ECJ accepts that a Member State "is entitled to take measures designed to prevent certain of its nationals from attempting, under cover of the rights created by the Treaty, improperly to circumvent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of provisions of Community law"[491]. As a consequence, taxpayers may not always benefit from their rights under the EU Treaties as such rights may be removed in abusive situations. Advocate General Maduro even considers that the "notion of abuse operates as a principle governing the interpretation of Community law"[492]. Of course, the notion of abuse of rights primarily relates to the users of a certain right, *i.e.* taxpayers in the field of direct taxation. However, in a way Member States are also users of EU law, because they are subject to the superior provisions of the EU Treaties: these provisions grant rights (such as the right to maintain discriminatory provisions of their domestic laws that are justified) but also liabilities (such as the obligation to amend legislation that is found incompatible with EU law). By designing their laws so as to formally respect EU law (by applying a tax law to both domestic and cross-border situations) but with the actual aim of circumventing its purpose and objective (through removing the advantages offered by another country that is also part of the same internal market), Member States are, in my mind, acting in a way that closely resembles abuse of rights. This way of reasoning based on a comparison with the doctrine of abuse of rights could help the ECJ depart from a pure discrimination-based analysis and examine the actual consequences of a Member State's legislation on the achievement of the internal market.

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[490] *Ibid.*

[491] ECJ, 9 March 1999, case C-212/97, *Centros*, para. 24.

[492] See Opinion of Advocate General Maduro, delivered on 7 April 2005, case C-255/02, *Halifax*, para. 69. More generally on the relation between abuse of rights and EU law see para. 62-72 of this Opinion.

Some months after ruling in the *Columbus Container* case, the ECJ in *Krankenheim* had the opportunity once gain to consider the taxation of permanent establishments by the home State.

4.2.3 The Krankenheim case

The *Krankenheim* case is presented (4.2.3.1) and discussed (4.2.3.2) hereunder with regard to the taxation of foreign profits.

4.2.3.1 Presentation of the Krankenheim case

The *Krankenheim*[493] case is of relevance both with regard to the taxation of positive income of permanent establishments and cross-border loss relief, which is discussed *infra*[494].

This case concerned the permanent establishment situated in Austria of a company resident in Germany. Although the tax treaty between Germany and Austria exempted income of permanent establishments, Germany did not tax on a strict domestic basis but deducted foreign losses and applied a recapture mechanism: the German legislation allowed for a deduction in Germany of foreign losses incurred by a permanent establishment, followed by a taxation of the permanent establishment once it became profitable. The German legislation thereby implemented capital export neutrality for loss-making permanent establishments: during the time a permanent establishment was loss-making, domestic and foreign establishments received the same treatment in the State of the head office. After a complete recapture of the permanent establishment's losses, capital export neutrality was replaced by capital import neutrality so as to let the exemption method produce its full effects.

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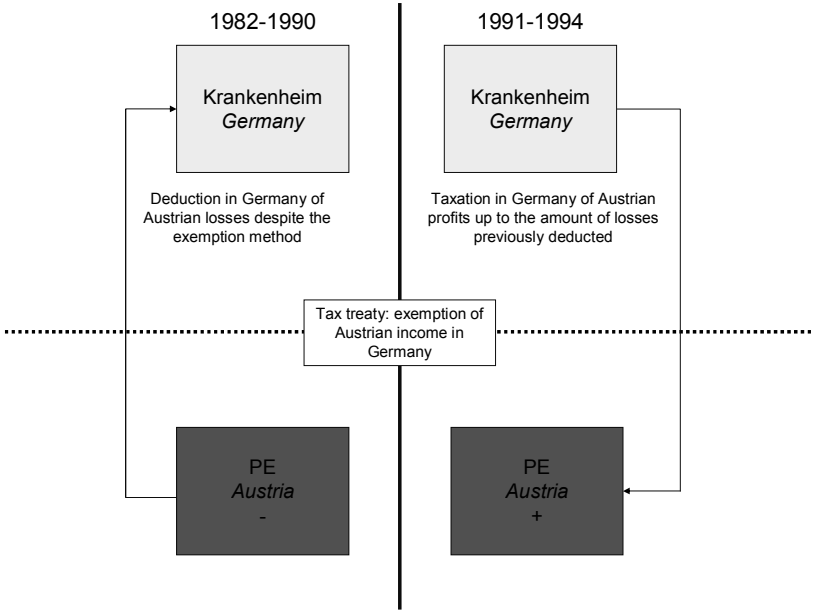
[493] ECJ, 23 October 2008, case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v Finanzamt für Körperschaften III in Berlin*.

[494] See *infra* at 4.3.3.2.2.



The ECJ found that the German rules that first deducted foreign losses and later taxed the permanent establishment up to the amount of losses previously deducted were a "restriction" of the freedom of establishment, but this restriction could be justified by the need to guarantee the coherence of the German tax system.

4.2.3.2 Discussion of the Krankenheim case with regard to the taxation of foreign profits

The ECJ considered that the taxation of the permanent establishment (to compensate the previous deduction of losses) was a restriction of the freedom of establishment[495]. It is difficult to understand why the Court came to this conclusion. The ECJ observed that Germany first granted a tax advan-

[495] ECJ, 23 October 2008, case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v Finanzamt für Körperschaften III in Berlin*, para. 37: "the German legislation thus subjected resident companies with permanent establishments in Austria to less favourable treatment than that enjoyed by resident companies with permanent establishments situated in Germany".

tage through deducting the permanent establishment's losses[496], but then withdrew this advantage by taxing such profits when the permanent establishment became profitable[497]. This would result in a "less favourable treatment than that enjoyed by resident companies with permanent establishments situated in Germany"[498]. This finding may be interpreted as a preference for the fiscal principle of territoriality, as the Court in this very situation refused a Member State the application of the principle of worldwide taxation through the taxation of a foreign permanent establishment's profits. However, the reasoning of the ECJ is difficult to understand and, accordingly, one may not rely entirely on this case to support a preference for the fiscal principle of territoriality over the principle of worldwide taxation.

In my view, what can be particularly criticised in the reasoning of the *Krankenheim* case is the finding of the ECJ that resident companies with foreign permanent establishments were treated less favourably than if such permanent establishments were located in the State of residence. This is illustrated by the following example where the situation of a company with a domestic establishment is compared to the situation of a company with a foreign establishment. It is assumed that the head office earns a taxable income of +100 during year 1 and year 2, and that the establishment makes a loss of -100 during year 1 and a profit of +50 in year 2. It is also assumed that the corporate income tax rate in the home State (A) is 30%. It is distinguished between domestic situations, cross-border situations falling under the exemption method without a recapture mechanism, and cross-border situations falling under the exemption method with the application of a recapture mechanism.

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496 *C. cit.*, para. 32-35.

497 *C. cit.*, para. 36.

498 *C. cit.*, para. 37.

	domestic situation		cross-border situation without loss deduction and recapture		cross-border situation with loss deduction and recapture	
	year 1	year 2	year 1	year 2	year 1	year 2
head office	100	100	100	100	100	100
establishment	-100	50	-100	50	-100	50
tax base in A	0	150	100	100	0	150
tax 30% (A)	0	45	30	30	0	45
total tax burden in A	**45**		**60**		**45**	

If during year 2 the establishment earns a taxable income of +50, it can be observed that under a system of exemption with recapture the tax burden in State A is the same in a purely domestic situation as in one with a foreign permanent establishment. This is a logical outcome, because during year 1 both the domestic and foreign establishments could have their loss deducted from the tax base of the head office, something that is not available in a system without recapture. In year 2, the tax burden is also identical in domestic and cross-border situations: all the profits of the domestic establishment are obviously taxed in A, which is also the case for the foreign establishment as it has not yet earned a profit that equalled the loss previously deducted.

A similar tax burden in domestic and cross-border situations can be observed until the foreign establishment earns a taxable income that equals the amount of the losses previously deducted:

	domestic situation		cross-border situation without loss deduction and recapture		cross-border situation with loss deduction and recapture	
	year 1	year 2	year 1	year 2	year 1	year 2
head office	100	100	100	100	100	100
establishment	-100	100	-100	100	-100	100
tax base in A	0	200	100	100	0	200
tax 30% (A)	0	60	30	30	0	60
total tax burden in A	**60**		**60**		**60**	

It can be observed from the above table that if during year 2 the establishment earns a taxable income of +100 (*i.e.* an amount corresponding to the loss deducted in year 1), the tax burden in State A is still the same for domestic and foreign establisments as the whole of the establishment's income is taxed in both cases.

In contrast, when the foreign establishment's income exceeds +100, *i.e.* when it exceeds the amount of the loss deducted in year 1, it can be ob-

served that the tax burden in State A is higher in a domestic situation than in a cross-border situation:

	domestic situation		cross-border situation without loss deduction and recapture		cross-border situation with loss deduction and recapture	
	year 1	year 2	year 1	year 2	year 1	year 2
head office	100	100	100	100	100	100
establishment	-100	200	-100	200	-100	200
tax base in A	0	300	100	100	0	200
tax 30% (A)	0	90	30	30	0	60
total tax burden in A	**90**		**60**		**60**	

The above outcome is logical, because the home State taxes the foreign establishment only up to the amount of the loss deducted in year 1, while all of a domestic establishment's income is taxed in State A. The remaining income of the permanent establishment may, however, be subject to taxation in the State of establishment. Consequently, the tax base in year 2 is +300 in a domestic situation (*i.e.* +100 earned by the head office and +200 earned by the domestic establishment) while it is only +200 in a cross-border situation (*i.e.* +100 earned by the head office and +100 recaptured for the foreign establishment).

The above analysis shows that foreign establishments were not subject to a less favourable treatment than domestic establishments in a situation such as the one at hand in *Krankenheim*. Consequently, since the outcome of the *Krankenheim* case cannot be explained by an actual difference of treatment between domestic and foreign establishments, it is possible that this outcome reveals an implicit preference for the fiscal principle of territoriality over the principle of worldwide taxation. This view is supported by the justification analysis and the proportionality analysis carried out by the Court:

- With regard to the justification analysis, the ECJ found that the German rules were justified by the need to safeguard the coherence of the German tax system[499]. The Court found it necessary to clearly link the taxation of the permanent establishment's profits to the previous deduction of losses, by observing that "the reintegration of losses provided for by the German tax system at issue in

[499] *C. cit.*, para. 43.

the main proceedings cannot be dissociated from their having been taken into account earlier. That reintegration, in the case of a company with a permanent establishment in another State in relation to which that company's State of residence has no power of taxation, as the referring court indicates, reflects a logical symmetry. There was thus a direct, personal and material link between the two elements of the tax mechanism at issue in the main proceedings, the said reintegration being the logical complement of the deduction previously granted"[500]. In my opinion, this lengthy analysis of the link between a deduction of the permanent establishment's losses and the later recapture of its profits indicates that the ECJ favours the fiscal principle of territoriality: it is only because the recapture compensates the deduction of losses that the taxation of the permanent establishment's profits is justified. In contrast, if no losses had been deducted in Germany, one cannot escape the impression that the Court would not have accepted a taxation of the permanent establishment in the home State. This may be an unaware avowal that the ECJ favours the fiscal principle of territoriality over the principle of worldwide taxation. This impression is confirmed by the proportionality analysis.

- With regard to the proportionality analysis, the ECJ considered that "that restriction is entirely proportionate to the objective pursued, since the reintegrated losses are reintegrated only up to the amount of the profits made"[501]. That the Court wanted the taxation of worldwide income to be limited to the amount of losses previously deducted is, in my opinion, a confirmation that the ECJ found the principle of worldwide taxation, in itself, incompatible with EU law: if Germany had taxed more foreign income than the amount initially deducted, paragraph 45 of *Krankenheim* indicates that Germany would have breached EU law.

Consequently, it is submitted that the principle of worldwide taxation has been found incompatible with EU law by the ECJ in the *Krankenheim* case.

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[500] *C. cit.*, para. 42.

[501] *C. cit.*, para. 45.

This creates an inconsistency in the Court's case law, as the principle of worldwide taxation has been accepted in many cases, particularly *Columbus Container*. *Krankenheim* could have major consequences on Member States' tax systems, depending on the way this case is interpreted. Potentially, it is a ground-breaking case. In practice, it may be an isolated decision, particularly because of the difficulty to interpret it. Only future case law may provide an answer to what the actual consequences of *Krankenheim* are. Perhaps the Court did not consider the consequences of its reasoning with regard to the incompatibility of this decision with previous case law, although some scepticism of the ECJ towards the principle of worldwide taxation was already identified with regard to *Cadbury Schweppes*.

It is now discussed whether EU law may require the grant of a full tax credit.

4.2.4 EU law and the grant of a full tax credit

4.2.4.1 Introduction

Whether or not EU law may require the grant of a full tax credit is an important question for the dissertation, as it relates to the relevance of looking for a full implementation of capital export neutrality within the internal market. This question is dealt with as part of chapter 4 of the dissertation because it is relevant from the perspective of the home State.

A full tax credit[502] is a method to eliminate double taxation in the State of residence that may, from an EU law perspective, mitigate part of the drawbacks of the ordinary credit method when the State of establishment applies higher corporate income tax rates than the Member State of residence. Provisions of tax treaties implementing a full tax credit are very rare[503].

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[502] By "full tax credit" it is meant a foreign tax credit that does not limit the creditable amount to the domestic tax on the foreign income.

[503] For an example of a tax treaty provision implementing a full tax credit, see article 23(2)(a) of the tax treaty concluded between France and Turkey on 18 February 1987: "Where a resident of France derives income which, in accordance with the provisions of this Convention, may be taxed in Turkey and France, France shall allow a deduction from the tax on the

If the tax rate in the Member State of establishment is higher than in the Member State of residence, granting a full tax credit may be more advantageous than the exemption method or the ordinary credit method. A full tax credit may thus compensate for some of the drawbacks of the ordinary credit method and the exemption method through fully implementing capital export neutrality. Therefore, it should be analysed whether or not EU law should require Member States to grant a full tax credit. If that would be the case, the fiscal sovereignty of the Member State of residence could be affected by an obligation to limit its tax jurisdiction, but at the same time home neutrality would be enhanced. Although this question has already been answered by the Court since the *Gilly* case, it raises a fundamental issue that should be discussed in this dissertation[504].

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income of that person of an amount equal to the income tax paid in Turkey" (unofficial translation provided by the IBFD). The official wording of article 23(2)(a) of this tax treaty reads as follows: "Lorsqu'un résident de France reçoit des revenus qui, conformément aux dispositions de la présente Convention, sont imposables en Turquie et en France, la France accorde une déduction sur l'impôt sur le revenu de ce résident, d'un montant égal à l'impôt sur le revenu payé en Turquie". See also article 20(2)(a)(aa) of the tax treaty concluded between Germany and France on 21 July 1959, as amended through protocols. This article concerns dividends: "Ce crédit d'impôt est égal: pour les revenus visés à l'Article 9, paragraphe 2, à un montant égal au montant de l'impôt payé en République Fédérale, conformément aux dispositions de ce paragraphe. L'excédent éventuel est remboursé au contribuable selon les modalités prévues par la législation française en matière d'avoir fiscal". These last sentences are translated in English by the IBFD as follows: "The amount of the credit shall be equal to: with respect to income referred to in paragraph 2 of Article 9, an amount which equals the amount of tax paid, by virtue of this paragraph, in the Federal Republic. Any excess amount shall be refunded to the taxpayer in accordance with the procedure governed by French tax legislation with respect to the tax credit (avoir fiscal)".

[504] The findings of the *Gilly* case have been confirmed by later case law. See ECJ, 19 November 2009, case C-540/07, *Commission v Italy*, para. 38; ECJ, 3 June 2010, case C-487/08, *Commission v Spain*, para. 60-62; ECJ, 10 February 2011, joined cases C-436/08 and C-437/08, *Haribo Lakritzen Hans Riegel BetriebsgmbH, Österreichische Salinen AG v Finanzamt Linz*, para. 88.

After illustrating the potential advantages of a full tax credit and presenting the *Gilly* case (4.2.4.2), it will be discussed whether certain concepts of the EU Treaties or the more recent case law of the Court may require the grant of a full tax credit instead of an ordinary tax credit or applying the exemption method (4.2.4.3).

4.2.4.2 Illustration of the potential advantages of a full tax credit and presentation of the Gilly case

Let us illustrate the full tax credit by a simple example: a company is resident in State R (tax rate 20%) and has a permanent establishment in State E (tax rate 40%). The tax base is 100 in both countries. Table 1 shows that under the exemption method, the total tax burden is 60.

Table 1: exemption method			
	Tax base	Tax rate	Tax burden
State E	100	40%	40
State R	100	20%	20
Total tax burden	(40+20=60)		60
Effective tax rate:	(60/200=30%)		30%

Table 2 shows that the tax burden is also 60 if State R grants an ordinary tax credit.

Table 2: ordinary credit			
	Tax base	Tax rate	Tax burden
State E	100	40%	40
State R	200	20%	40
Total tax burden	(40+40-100*20%)		60
Effective tax rate:	(60/200=30%)		30%

A similar result is reached because the State of residence limits the foreign tax credit to the amount of tax payable at home on the foreign income: a tax credit is granted on the foreign tax base (100) but with the domestic tax rate (20%). This example is, however, dependent on the progressivity of the

tax rates: in case of progressive tax rates, the credit method is similar to the exemption method with progression[505].

In contrast to the situations mentioned above, the total tax burden is lower if the State of residence eliminates double taxation through granting a full tax credit, as shown in table 3.

Table 3: full credit			
	Tax base	**Tax rate**	**Tax burden**
State E	100	40%	40
State R	200	20%	40
Total tax burden	(40+40-100*40%)		40
Effective tax rate:	(40/200=20%)		20%

The abovementioned results show that a full tax credit may, in certain situations, be more favourable than an ordinary credit or the exemption method. Indeed, the full credit allows a resident who is taxed at a higher rate in the State of establishment to decrease the tax burden down to the level of the residence State, at the expense of this latter State's fiscal revenues. A full credit may be considered as rigourously implementing capital export neutrality, since such a system allows all investments of a resident to be ultimately taxed at the home level. By this means, business decisions need not be influenced by the level of corporate income tax of the State in which an investment is made.

The question is whether taxpayers with permanent establishments exempt from taxation in the Member State of residence or subject to an ordinatry tax credit may successfully rely on EU law to obtain a full tax credit. This question was dealt with by the Court in *Gilly*[506], a case about a French resi-

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[505] See para. 62 of the Commentary on article 23B(1) of the OECD Model Convention, 2010: "in cases where the tax in State E (or S) equals or exceeds the appropriate tax of State R, the credit method will have the same effect as the exemption method with progression".

[506] ECJ, 12 May 1998, case C-336/96, *Mr and Mrs Robert Gilly v. Directeur des services fiscaux du Bas-Rhin*. For a comment, see Klaus Vogel, *Some observations regarding 'Gilly'*, EC Tax Review, 1998-3, p. 150.

dent who worked and paid taxes in Germany[507]. The German tax rate was higher than the French one, but only an ordinary tax credit was granted by the Member State of residence. The claimant argued that the ordinary tax credit penalised those who exercised the fundamental freedoms, which did not convince the Court. It consequently ruled that an ordinary tax credit was compatible with EU law. Unfortunately, the ECJ did not discuss capital export neutrality as such, but focused on the fact that the higher taxation resulted from a disparity between Member States' tax rates[508]. The position held by the ECJ in Gilly with regard to a full tax credit has been confirmed in later case law[509].

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[507] It should be stressed that only the sixth question of the *Gilly* case is discussed in this part of the dissertation (*i.e.* the compatibility with EU law of the ordinary tax credit).

[508] Disparities in principle do not constitute infringements of the fundamental freedoms, as summarised by the Court in *Krankenheim*. See ECJ, 23 October 2008, case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v Finanzamt für Körperschaften III in Berlin*, para. 50: "The Court has held that freedom of establishment cannot be understood as meaning that a Member State is required to draw up its tax rules on the basis of those in another Member State in order to ensure, in all circumstances, taxation which removes any disparities arising from national tax rules, given that the decisions made by a company as to the establishment of commercial structures abroad may be to the company's advantage or not, according to circumstances". This view had earlier been developed by Advocate General Geelhoed: see Opinion of Advocate General Geelhoed, delivered on 6 April 2006, case C-446/04, *FII Group Litigation*, para. 45: "the application of a credit based system by the UK for relieving double economic taxation on foreign source dividends, in the case where the underlying foreign corporation tax levied on company profits was at a higher rate than the UK corporation tax rate, would result in a higher tax burden on these foreign source dividends than on UK source dividends (as the UK gives credit only up to the UK corporation tax rate, and not for all foreign corporation tax paid). While, in one sense, this could be said to 'restrict' investment in foreign subsidiaries as against UK subsidiaries, this is a good example of a restriction flowing purely from disparities between national tax systems, with which Article 43 EC is not concerned".

[509] See ECJ, 12 December 2006, case C-446/04, *Test Claimants in the Franked Investment Income Group Litigation v Commissioners of Inland Revenue*, para. 52: "Where, conversely, those profits are subject in the Member State of the company making the distribution to a higher level of tax than the tax levied by the Member State of the company receiving them, the latter Member State is obliged to grant a tax credit only up to the limit of the amount of corporation tax

The Court also paid attention to the purpose of the double taxation convention, which would not be to ensure that foreign income is not taxed at a higher level than domestic income[510]. This argument is, in my view, not really convincing: if the purpose of a double taxation convention were to be respected despite infringements to EU law, the fundamental freedoms and the internal market would be deprived from their meaning. It would then be enough to confer on a tax treaty a purpose not in accordance with EU law to escape the obligations under the EU Treaties. Therefore, the key question is whether or not the objective of achievement of an internal market may require the application of a full tax credit.

4.2.4.3 May the objective of achievement of the internal market require granting a full tax credit?

Granting a full tax credit implements capital export neutrality, *i.e.* complete neutrality for residents in the home State. Under a rule ensuring that all income is taxed at the same rate, wherever such income is incurred, business decisions need not be influenced by the level of corporate income tax. In a way, a full tax credit protects a resident taxpayer from being exposed to foreign tax rates. It is true that a taxpayer may feel relieved to exercise his freedom of establishment, since by being taxed as if he invested on the domestic market, he would not suffer from a foreign higher tax rate. In that sense, from the perspective of the internal market, a full tax credit may be superior to an ordinary tax credit since capital export neutrality would be achieved towards all Member States whereas an ordinary credit exposes a

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for which the company receiving the dividends is liable. It is not required to repay the difference, that is to say, the amount paid in the Member State of the company making the distribution which is greater than the amount of tax payable in the Member State of the company receiving it". See also ECJ, 19 November 2009, case C-540/07, *Commission v Italy*, para. 38; ECJ, 3 June 2010, case C-487/08, *Commission v Spain*, para. 60-62. The position of the ECJ with regard to a full tax credit was also summarised by Advodate General Kokott in the *Haribo* case: see Opinion of Advocate General Kokott, delivered on 11 November 2010, cases C-436/08 and C-437/08, *Haribo Lakritzen Hans Riegel v Finanzamt Linz*, para. 154-155.

[510] ECJ, 12 May 1998, case C-336/96, *Mr and Mrs Robert Gilly v. Directeur des services fiscaux du Bas-Rhin*, para. 46.

taxpayer to the highest tax rates: a full tax credit should logically contribute to a more homogeneous allocation of resources[511] throughout the internal market thanks to the removal of tax differences between Member States, which is also likely to promote "economic, social and territorial cohesion"[512] between Member States to a greater extent than with the ordinary tax credit. Therefore, a full tax credit has an advantage over an ordinary tax credit, even if both methods share the same drawbacks compared to the exemption method, *i.e.* they erase the competition between Member States[513].

However, if EU law were to require Member States to grant a full tax credit, European enterprises would be tempted to move their residence to a Member State with a low corporate income tax rate and organise their European activities through permanent establishments. Such tax avoidance would seriously undermine a balanced allocation of the power to impose taxes, since the Member State of residence would absorb the difference between its own tax rates and the foreign ones. In addition, later case law of the ECJ pleads, in my view, against the adoption of the full tax credit: even if tax rules implementing capital export neutrality have been accepted[514] or even looked for[515] by the Court, these decisions relied on a discrimination-based analysis[516], *i.e.* they did not aim at reaching home neutrality. Also, the

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[511] Favouring an efficient allocation of resources is an obligation according to article 120 TFEU.

[512] See article 3 TEU.

[513] On the importance of competition within the interal market, see Frans Vanistendael, *In defence of the European Court of Justice*, Bulletin for International Fiscal Documentation, March 2008, pp. 94-95.

[514] For example in the *Columbus Container* case.

[515] For example in the *Manninen* case.

[516] See for example the *Cadbury Schweppes* case about CFC rules, which under certain circumstances may be considered as implementing capital export neutrality. In this case, the Court relied on a discrimination-based analysis to find CFC rules incompatible with EU law while from a more global perspective it could have considered that all subsidiaries were ultimately taxed in the UK, whether through CFC taxation, taxation of dividends, or taxation of domestic subsidiaries' profits. Such an approach was applied in *FII Group Litigation*.

Court has in other decisions accepted[517], or even looked for[518] capital import neutrality. Therefore, recent case law of the ECJ confirms the view taken by the Court in *Gilly* according to which EU law does not require the full implementation of capital export neutrality *per se*. Additionally, many cases insist on Member States having the right to levy tax on domestic income, which is a fundamental characteristic implied by the principle of territoriality as it stands in international law[519]. The principle of territoriality as it stands in international law is significantly threatened by the application of a full tax credit as already identified in *Gilly*, because requiring the application of a full tax credit would result in the home State giving up part of its taxing rights on domestic income, to reduce the tax burden of a resident taxpayer who earns income in a foreign country with higher taxes. This jeopardises the balance in Member States' public revenues while not necessarily enhancing the achievement of an internal market. Consequently, and with regard to all these arguments taken from the case law of the Court, it seems that the ECJ has, since *Gilly*, strengthened the arguments against the requirement of a full tax credit.

To conclude, although a full tax credit has some theoretical advantages over the ordinary tax credit, the risks of tax avoidance and the case law of the ECJ plead against the requirement of a full tax credit as a consequence of EU law.

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[517] For example the *Lidl Belgium* case can be seen as accepting capital import neutrality, since losses were to be deducted in the State of source according to the same rules that applied to companies resident there.

[518] Case law on the elimination of discriminatory withholding taxes on dividends tend to implement capital import neutrality, as the purpose of such case law is to reach equal treatment of distributions in the Member State of source. Examples of such decisions are *Denkavit II*, *Amurta*, *Aberdeen*, and *Commission v Italy*.

[519] See particularly ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*, para. 56; ECJ, 12 December 2006, case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue*, para. 59; ECJ, 13 March 2007, case C-524/04, *Thin Cap Group Litigation*, para. 75; ECJ, 29 March 2007, case C-347/04, *Rewe Zentralfinanz eG*, para. 42; ECJ, 18 July 2007, case C-231/05, *Oy AA*, para. 54.

4.2.5 Conclusion on the application of the positive income of permanent establishments

The case law of the ECJ does not clearly favour either the principle of worldwide taxation or the fiscal principle of territoriality for the taxation of permanent establishments by the Member State of residence. Given the importance of taxation on the exercise by companies of the freedom of establishment and ultimately on the achievement of the internal market, and with regard to the different consequences implied by the fiscal principle of territoriality and the principle of worldwide taxation, it can be regretted that the ECJ does not take position on which principle of taxation is the most suitable to achieve the internal market. Indeed, the Court has already taken position with regard to several aspects of Member States' tax systems through indicating which of the home State or the host State is competent as a consequence of EU law[520]. Taking position on the dilemma between the fiscal principle of territoriality and the principle of worldwide taxation would continue this trend, although one cannot deny the fact that it would be uncomfortable for the Court to justify a preference for either principle.

The case law of the ECJ appears even more criticisable given the apparent incompatibility between *Columbus Container* and *Krankenheim*. On the one hand, in *Columbus Container* the Court accepted the principle of worldwide taxation applied widely and without connection to the prevention of tax avoidance, *i.e.* the principle of worldwide taxation was not found to be in conflict with the exercise of the freedom of establishment and the objective of achievement of the internal market. On the other hand, however, in *Krankenheim* the ECJ has clearly limited the scope of the principle of worldwide taxation to the very recapture of losses previously deducted, thus implicitly favouring the fiscal principle of territoriality. This means that in *Krankenheim* the Court clearly found a conflict between on the one hand the objective of achievement of the internal market through a promotion of the freedom of establishment and on the other hand the exercise of tax juris-

[520] For example, the Court decided that final foreign losses are to be entirely relieved in the home State (*Marks & Spencer*), that financing costs are to be deducted in the State of the parent company (*Bosal*), or that the host State has to grant deduction for certain costs incurred in the home State for individuals (*Renneberg*).

diction on the basis of the principle of worldwide taxation. This incompatibility between *Columbus Container* and *Krankenheim* is, from a legal perspective, not satisfying. It is also criticisable from a tax policy perspective, as it confuses Member States as well as the European institutions as to which principle of taxation should be favoured for taxing permanent establishments' profits in the Member State of residence. Moreover, an additional incompatibility was identified between *Columbus Container* and *Cadbury Schweppes*.

If one may be tempted to conclude from *Krankenheim* that taxing foreign business profits in the home State is incompatible with EU law, it should not be forgotten that the ECJ has accepted the principle of worldwide taxation in several more recent cases such as *Block*[521] and *Damseaux*[522], even if these cases did not deal with a permanent establishment. Therefore, one shall not minimise the fact that the current case law of the Court by and large still accepts the principle of worldwide taxation. However, it can at the same time be observed that *Krankenheim* confirms the scepticism of the Court towards the principle of worldwide taxation that was identified in chapter 3 *supra*.

In addition, *Columbus Container* and *Krankenheim* touch upon two important questions from a tax policy perspective:

- First, *Columbus Container* seems to indicate that a switch-over mechanism may be compatible with EU law. Consequently, if the fiscal principle of territoriality were to be favoured for the taxation of companies' foreign business income, Member States could ap-

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[521] ECJ, 12 February 2009, case C-67/08, *Margarete Block v. Finanzamt Kaufbeuren*. For a comment on this case see Eleonor Kristoffersson, *Mål C-67/08, Margarete Block*, Svensk Skattetidning, 2009-10, pp. 1088-1092.

[522] ECJ, 16 July 2009, case C-128/08, *Jacques Damseaux v État belge*. For comments on this case see Emmanuel Raingeard de la Blétière, *Droit de l'union européenne: chronique de l'année 2009*, Revue de Droit Fiscal, 25 February 2010, pp. 51-52; Jean-Christophe Gracia, *La prévention de la double imposition comme obligation des États membres*, Revue de Droit Fiscal, 18 February 2010, pp. 30-32.

parently still extend their tax jurisdiction to prevent certain forms of tax avoidance. This could reduce the fears of losing tax revenues if the fiscal principle of territoriality were to become the leading principle for the taxation of companies' foreign business income earned throughout the internal market, either outside the scope of a common consolidated corporate tax base or if such a common tax base were enacted[523]. It should be observed, however, that in *Columbus Container* the ECJ did not consider the switch-over mechanism as an anti-avoidance provision as such, but rather as a taxation method that resulted in a similar tax treatment for domestic and foreign establishments. Therefore, it cannot be ascertained from *Columbus Container* that a switch-over from the exemption method to the credit method necessarily complies with EU law. This is quite probable, however, given the fact that if the ECJ accepts a taxation mechanism as such, it should *a fortiori* accept it when it is applied to prevent tax avoidance, since the Court recognises a right to apply stricter tax rules when a taxpayer has not sufficiently exercised his freedom of movement.

- Second, *Krankenheim* indicates that a recapture mechanism is accepted by the ECJ with regard to permanent establishments, up to the amount of losses initially deducted. This outcome is particularly interesting as part of the debate on cross-border loss relief within the internal market. A recapture mechanism was part of the suggestions made by the European Commission in the proposal for a directive on cross-border loss relief from 1990[524] as well as in a

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[523] That is, it seems that Member States could switch-over from the exemption method to the credit method for profits made by permanent establishments within the European Union but situated outside the common consolidated corporate tax base area.

[524] COM 90 (595) final, 24 January 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*. The proposed directive included provisions relating to the deduction with reincorporating of losses incurred by permanent establishments (see particularly article 7 of the proposed directive) and subsidiaries (see particularly article 9 of the proposed directive).

Communication from 2006[525]. That the Court now explicitly accepts such a tax system avoids having doubts on its compatibility with EU law and should encourage Member States to follow the initiatives of the Commission.

It is now focused on the compatibility of the exemption of a permanent establishment's business income with the objective of achievement of the internal market, a question that raises issues with regard to foreign losses.

4.3 Application of the fiscal principle of territoriality in the Member State of residence: exemption of foreign business income earned through a permanent establishment

4.3.1 Introduction

Since it is part of a State's sovereignty to decide upon the extent of its tax jurisdiction[526], it is an essential characteristic of this sovereignty not to exercise such a tax jurisdiction[527]. A State is entitled to apply the fiscal principle of territoriality[528] and exempt foreign income from the tax base of resident taxpayers. Often, the fiscal principle of territoriality is applied symmetrically[529] to foreign positive and negative income: as a corollary to a limitation of their taxing rights, States applying the fiscal principle of territoriality usually limit the extent of the tax advantages they may offer in relation to for-

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[525] COM(2006) 824 final, 19 December 2006, *Tax treatment of losses in cross-border situation.*

[526] As long as international commitments, particularly tax treaties and EU law, are respected.

[527] This sovereign decision can be implemented either in domestic law or in a tax treaty.

[528] In this paragraph of the dissertation, the principle of territoriality and the exemption method are intended to have the same meaning, both referring to a full tax base exemption in the Member State of residence, *i.e.* the income of the permanent establishment is not taken into account at the level of the head office.

[529] Such a symmetry is, however, not automatic. See Michael Lang, *Introduction to the law of double taxation conventions*, Linde/IBFD, 2010, p. 125, para. 419: "the courts of many states (e.g. Austria, Belgium, the Netherlands, Spain) have stated that the exemption only applies with regard to positive items, while the courts of other states (e.g. Germany, Greece and France) have instead maintained that it also applies with regard to negative items".

eign items of income. That is, if permanent establishments are not taxed at the head office level, their losses or the costs related to their activities are usually not taken into account for tax purposes in the State of residence[530].

Such a symmetry is neither systematic nor an obligation under international law. It is, however, a right under international law. The Commentary to the OECD Model Tax Convention indicates that States often "treat losses incurred in the other State in the same manner as they treat income arising in that State: as State of residence (State R), they do not allow deduction of a loss incurred from immovable property or a permanent establishment situated in the other State (E or S)"[531].

The problem is that the decision to exempt foreign income tends to isolate tax bases in each territory. When foreign positive income is exempted, foreign negative income cannot, in most cases, be offset against positive domestic income, by way of symmetry[532]. Accordingly, the two tax bases are isolated from each other, *i.e.* no compensation is operated between positive and negative income. As a consequence of the fiscal principle of territoriality, the total tax burden of the enterprise is increased because of the isolation of domestic positive income from foreign negative income. The deduction of foreign negative income is postponed, or even lost. Hence, exemption of foreign negative income may imply a worse treatment than in a domestic context or if worldwide income was taxed at residence, which raises compatibility issues with the objective of achievement of the internal market. Indeed, as already observed in chapter 3 *supra*, losses not deductible and incurred in a cross-border context are often not deductible because of them being incurred within another Member State. As a result, taxation based on the fiscal principle of territoriality is inherently harming the con-

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[530] See for example Jörg-Dietrich Kramer, *Losses from foreign permanent establishments under Germany's tax treaties*, Tax Notes International, 15 November 2010, p. 513: "German tribunals and the tax administration have always applied the so-called symmetry thesis, under which both foreign profits and foreign losses are exempt from German income and corporation tax".

[531] Para. 44 of the Commentary on article 23A of the OECD Model Convention, 2010.

[532] *Ibid.*

cept of an internal market, because it results in the compensation of profits and losses being impossible solely because they are incurred in different Member States, although these Member States should belong to the same internal market and domestic losses are normally deductible from domestic income.

The ECJ has dealt with losses incurred by permanent establishments in two cases[533]: *Lidl Belgium*[534] and *Krankenheim*[535]. *Deutsche Shell*[536] should also be analysed although it did not concern losses incurred by a permanent establishment itself, since this case may have some relevance with regard to the discussion on final losses. These cases are first presented (4.3.2), before being discussed more in detail (4.3.3).

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[533] Germany was the State of residence in these two cases. Income earned by foreign permanent establishments was not taxed in Germany according to the exemption method included in the double taxation conventions concluded by this State. Since both the principle of territoriality and a full exemption method may, in principle, have similar consequences with regard to losses incurred by foreign permanent establishments, it is submitted that the analysis in this section of the dissertation is valid both for Member States applying a strict principle of territoriality and Member States appling the principle of worldwide taxation in their domestic law but eliminating double taxation based on the exemption method without a recapture mechanism. In practice, each Member State may treat foreign profits and losses in a particular way, but the problems with regard to EU law remain similar.

[534] ECJ, 15 May 2008, case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*. For a comment see Tom O'Shea, *ECJ Upholds German Loss Disallowance*, Tax Notes International, 30 June 2008, pp. 1078-1081.

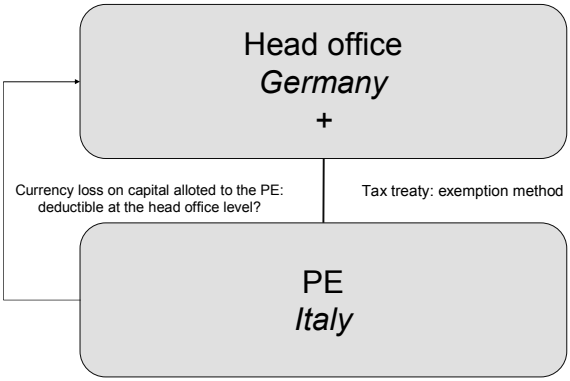
[535] ECJ, 23 October 2008, case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v Finanzamt für Körperschaften III in Berlin*.

[536] ECJ, 28 February 2008, case C-293/06, *Deutsche Shell GmbH v Finanzamt für Grossunternehmen in Hamburg*. For a comment see Anne-Laure Mosbrucker, *Rapatriement du capital de dotation*, Revue Europe, April 2008, pp. 21-22; Emmanuel Raingeard de la Blétière, *Droit communautaire: chronique de l'année 2008*, Revue de Droit Fiscal, 26 February 2009, p. 64.

4.3.2 Presentation of the Deutsche Shell, Lidl Belgium and Krankenheim cases

4.3.2.1 The Deutsche Shell case

A German company had a permanent establishment in Italy. The company suffered a loss on currency for the capital allotted to the permanent establishment, a loss that could not be deducted in Italy because this currency loss did not appear there[537]. The German tax authorities refused to deduct the currency loss, based on the Germany-Italy tax treaty that provided for the exemption method[538]. Consequently, the currency loss could not be deducted in either country.



The case was brought before the ECJ who considered that the rules at issue were incompatible with the freedom of establishment. The Court found that there was no option for the permanent establishment to have the currency loss taken into account in Italy. At the justification level, the Court rejected the preservation of the coherence of the German tax system according to which the loss should not be deducted since a capital gain would

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[537] A parallel may be drawn between *Deutsche Shell* and *Bosal* (ECJ, 18 September 2003, case C-168/01, *Bosal Holding BV*), as in both cases the home State incurred a negative income that could not be deducted in the host State.

[538] Tax treaty between Germany and Italy, signed on 31 October 1925 and terminated on 1 January 1993.

not have been taxed[539]. A justification based on the exemption method was also rejected: the ECJ considered that since the loss did not appear in Italy, only Germany could deduct it[540]. Accordingly, Germany was required to grant deduction for the foreign exchange loss[541].

4.3.2.2 The Lidl Belgium case

A German company had a permanent establishment located in Luxembourg. While the head office made a profit in 1999, the permanent establishment was loss-making that year. The head office tried to offset the foreign loss in the tax return filed for 1999, which was rejected by the tax authorities based on the Germany-Luxembourg tax treaty[542].

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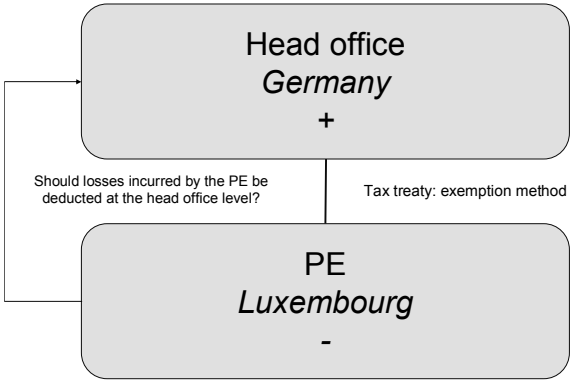
[539] ECJ, 28 February 2008, case C-293/06, *Deutsche Shell Gmbh*, para. 37-40.

[540] *C. cit.*, para. 44.

[541] For an application of the *Deutsche Shell* case with regard to a foreign currency loss in a foreign subsidiary, see the ruling of the administrative tribunal of Gothenburg (*Förvaltningsrätten i Göteborg*), 12 October 2010, case number 2184-10, *Volvo Bussar AB*.

[542] Tax treaty between Germany and Luxembourg, signed in Luxembourg on 23 August 1958. According to article 5(1) of the Germany-Luxembourg tax treaty, profits attributable to a permanent establishment are taxable only in the State where it is located: "Where a resident of a Contracting State derives profits as an entrepreneur or a co-entrepreneur from an industrial or commercial enterprise whose activities extend to the territory of the other Contracting State, the said profits shall be taxable in the latter State only in so far as it is attributable to a permanent establishment of the enterprise which is situated there" (unofficial translation provided by the IBFD).



Advocate General Sharpston found that Lidl Belgium suffered a discrimination. The discrimination was justified, but it did not pass the proportionality test. Advocate General Sharpston observed that Germany had until 1999 a recapture mechanism that permitted the deduction of foreign losses at the head office level, for them to be recaptured when the permanent establishment became profitable. Since that recapture mechanism was more advantageous for the company than a rejection of deduction of foreign losses, Advocate General Sharpston considered that the exemption method went beyond what was necessary to attain the objectives pursued. However, the Court did not follow the Advocate General. It considered that a restriction existed but was justified by the need to preserve a balanced allocation of the power to impose taxes and the need to prevent the risk that losses are used twice. This measure was also deemed proportional.

4.3.2.3 The Krankenheim case

The *Krankenheim* case was presented above[543] with regard to the taxation of the profits of permanent establishments. Foreign losses were deducted at the head office level without such a deduction being required by the applicable tax treaty. The losses were later recaptured, although they could not be carried forward in the host State. The ECJ found that the German re-

[543] See *supra* at 4.2.3.

capture rules were a restriction of the freedom of establishment but could be justified.

4.3.3 Discussion of the solutions reached in the Deutsche Shell, Lidl Belgium and Krankenheim cases with regard to foreign losses

This part of the dissertation is not intended to discuss these cases extensively. Here, it is only focused on the way the ECJ reacts to a tax jurisdiction based on the fiscal principle of territoriality, when such a tax jurisdiction leads to the isolation of foreign losses incurred by a permanent establishment[544]. The isolation of foreign losses emphasises a core problem of the fiscal principle of territoriality since it penalises taxpayers daring to cross the border and incurring losses, rather than sticking to a domestic context. This problem is of high practical relevance, as most businesses do incur losses during the first years of exploitation following the set up of a permanent establishment. Also, it is at the time an enterprise incurs losses that it should be supported in order not to risk being liquidated, the lack of cross-border loss relief being an aggravating factor if the enterprise is short of financing.

In chapter 3 *supra* it was dealt with losses incurred by foreign group companies. It was concluded that although cross-border loss relief is a real issue for corporate groups, the Court cannot bring a satisfying answer to that problem. It was argued *supra* that the ECJ was right not to require Member States to offset non-final losses, but this conclusion was based on technical arguments as well as the fact that the Court can hardly require Member States to implement an efficient recapture mechanism. Consequently, it was argued that a legislative measure to solve the cross-border loss relief problem at the EU level would be preferable.

Even if some of the issues identified for groups of companies are also relevant with regard to permanent establishments, the legal difference between a group and one single enterprise does have an impact on the reasoning on

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[544] The *Deutsche Shell* case is, therefore, not really in the scope of the dissertation, as it did not concern a foreign loss incurred by the permanent establishment itself: the loss was rather incurred by the head office on the capital it had allotted to the permanent establishment.

cross-border loss relief. Therefore, it is necessary to conduct an analysis that is focused on foreign losses incurred by permanent establishments. As in chapter 3 of the dissertation, it is distinguished between relief for non-final (4.3.3.1) and final (4.3.3.2) losses.

4.3.3.1 Relief for non-final losses incurred by a permanent establishment

Relief for non-final losses incurred by a permanent establishment has been principally dealt with in *Lidl Belgium*, where the ECJ strongly relied on *Marks & Spencer*. In chapter 3 *supra*, it was argued that the Court correctly refused to require cross-border loss relief between group companies, but this conclusion was reached because of the risk of double deduction of losses and the many reasons why the ECJ was not fit to require Member States to implement a recapture mechanism within a group of companies. Several arguments supported this view. These arguments are discussed below in the context of the relation between a head office and its permanent establishment together with other arguments that are particular to this relation. As in chapter 3, it is distinguished between the justification level (4.3.3.1.2) and the proportionality level (4.3.3.1.3), but first of all it is focused on the consequences of the exemption method chosen in a tax treaty since this issue has been discussed in the tax literature and has been referred to by Member States as an argument preventing the exercise of tax jurisdiction towards exempted permanent establishments (4.3.3.1.1).

4.3.3.1.1 Consequences of the exemption method chosen in a tax treaty

Here, the question is whether the exemption method, as agreed in a tax treaty, should protect the Member State of residence from being required to take into account foreign losses incurred by a permanent establishment[545]. It is true that, as a consequence of the exemption method, the Member

[545] On the balance sought by the ECJ, see Philippe Marchessou, *L'apport de la jurisprudence de la CJCE en matière d'imposition des entreprises*, *in* Martial Chadefaux, Florence Deboissy, Christophe de la Mardière (eds.), Écrits de fiscalité des entreprises – études à la mémoire du professeur Maurice Cozian, 2009, p. 630: "La tâche de la cour est ici en nuances, soucieuse de ne pas romper l'équilibre introduit par les conventions, mais plutôt préoccupée par le caractère juste proportionné de la restriction apportée à la liberté et par l'effectivité dans l'exercice de cette dernière".

State of residence has, in principle, no tax jurisdiction on foreign income. However, does the exemption method in a tax treaty legally prohibit the residence State from deducting foreign losses? The answer may vary depending on the constitutional law of Member States, but it can be observed that Member States do not always fully respect tax treaties. An example is the tax avoidance mechanism applied by Germany in *Columbus Container* that was not explicitly allowed by the double taxation convention, in which Germany eliminated double taxation through the exemption method[546]. Another example is the deduction with recapture mechanism in *Krankenheim* that likewise was not part of the tax treaty[547]. Therefore, the very fact that a tax treaty adopts the exemption method does not necessarily and legally exclude the tax jurisdiction of a contracting State. There may be situations in which exceptions to a tax treaty are allowed[548], or even imposed[549] by a

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[546] See article 23(1)(1) of the tax treaty concluded between Germany and Belgium on 11 April 1967: "income derived from Belgium (…) which in accordance with the foregoing Articles may be taxed in that State shall be exempt from tax in the Federal Republic of Germany".

[547] See article 15(1) of the tax treaty concluded between Germany and Austria on 4 October 1954: "The State of residence shall have no right to levy taxes where the foregoing Articles confer that right on the other Contracting State".

[548] For example, provisions of a tax treaty may allow a contracting State to apply its CFC rules, and thereby make an exception to the business profits article. In that respect, see article 24(2)(e)(iii) of the France-USA tax treaty concluded on 31 August 1994: "nothing in the Convention shall prevent France from applying the provisions of Article 209B of its tax code (code général des impôts) or any substantially similar provisions which may amend or replace the provisions of that Article".

[549] See for example the decision of the Swedish Supreme Administrative Court (*Högsta förvaltningsdomstolen*), 5 April 2008, case number 2697-05, in which it considered that the latest domestic law provision shall have priority, even if the earlier one implements a tax treaty into the internal legal order. For a comment see Leif Mutén, *Treaty override i Regeringsrätten*, Svensk Skattetidning, 2008-5, pp. 353-357; Sven Erik Holmdahl, Maria Barenfeld, *Treaty-override på svenska*, Skattenytt, 2009-10, pp. 627-634; Mattias Dahlberg, *A judicial glimpse at the status of Sweden's tax treaties*, Tax Notes International, 28 February 2011, pp. 663-664. For a different position, see for example the decision of the French Supreme Administrative Court (*Conseil d'Etat*), 20 October 1989, case number 108243, *Nicolo*, in which a more recent domestic law provision was set aside to give priority to an older international treaty.

contracting State. In addition, allowing for cross-border loss relief despite the exemption method forseen in the treaty would not threaten the taxing rights of the Member State of establishment, since it would only imply a more favourable tax treatment provided by, and at the expense of, the Member State of residence. Consequently, international law does not seem to forbid a deduction of foreign losses in the Member State of residence. Nor would cross-border loss relief jeopardise the legal certainty offered by a tax treaty, since relief for foreign losses is *prima facie* advantageous for taxpayers.

In any case, even if the exemption method would legally prevent the Member State of residence from taking into account foreign losses, a tax treaty should not be an obstacle to the enforcement of the obligations under the EU Treaties. The opposite would let Member States escape their obligations by concluding tax treaties, which would ruin the achievement of the internal market. As a result, there is no convincing legal argument that precludes a Member State of residence from granting loss relief despite the exemption method being applied in the relevant treaty.

It is submitted that the findings of the Court in *Lidl Belgium* are, in that respect, disappointing. The ECJ observed that "the Member State in which the registered office of the company to which the permanent establishment belongs is situated would, in the absence of a double taxation convention, have the right to tax the profits generated by such an entity. Consequently, the objective of preserving the allocation of the power to impose taxes between the two Member States concerned, which is reflected in the provisions of the Convention, is capable of justifying the tax regime at issue in the main proceedings, since it safeguards symmetry between the right to tax profits and the right to deduct losses"[550]. One cannot escape the impression that the ECJ found that the non-taxation of exempted permanent establishments is, in itself, a sufficient justification of the non-deduction of losses. If this interpretation is correct, *i.e.* if the choice of the exemption

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[550] ECJ, 15 May 2008, case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, para. 33.

method in a tax treaty is enough to justify a non-deduction of foreign losses, *Lidl Belgium* would be incompatible with several cases in which the Court has considered that Member States cannot escape their obligations under EU law by concluding tax treaties[551]. The internal market would be meaningless if the difference of treatment between losses incurred by a domestic and a by foreign establishment could be justified by the fact that the home State has decided to treat them differently. In addition, as demonstrated above, the exemption method in a tax treaty does not preclude the deduction of foreign losses in the State of residence.

Consequently, the symmetry argument is, in my opinion, not convincing and threatens the achievement of the internal market. It is more convincing to analyse the risks of extending domestic treatment to foreign situations, which the Court did in addition to analysing the symmetry argument. The ECJ analysed two justification grounds that were considered in *Marks & Spencer*: the need to preserve the allocation of the power to impose taxes between the Member States concerned and the need to avoid the risk of losses being taken into account twice. These two justification grounds are analysed hereunder.

4.3.3.1.2The justification level

In *Lidl Belgium* the Court relied strongly on *Marks & Spencer* and considered that "To give companies the right to elect to have their losses taken into account in the Member State in which they are established or in another Member State would seriously undermine a balanced allocation of the power to impose taxes between the Member States, since the tax base would be increased in the first State, and reduced in the second, by the amount of the losses surrendered"[552]. As a result, "to accept that the losses of a non-resident permanent establishment might be deducted from the taxable income of the principal company would result in allowing that

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[551] Indeed, the ECJ found that consequences of tax treaties may infringe EU law in cases such as *Saint-Gobain* or *Renneberg*.

[552] ECJ, 15 May 2008, case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, para. 32.

company to choose freely the Member State in which those losses could be deducted"[553].

As argued above with regard to *Marks & Spencer* and *X Holding*, this argument is not convincing[554]: the tax base in the host State is normally not affected by a possible loss relief in the home State, *i.e.* it is not correct that the tax base would be increased in the home State and reduced in the host State. Consequently, the lack of loss relief could not, in my opinion, be justified by the need to preserve the allocation of the power to impose taxes between the Member States concerned. In contrast, the need to prevent the danger that losses may be taken into account twice is a risk that cannot be denied.

The ECJ correctly observed that "It is possible that a company might deduct, in the Member State in which its seat is situated, losses incurred by a permanent establishment belonging to it and situated in another Member State and that, despite such offsetting, the same losses might be taken into account subsequently in the Member State in which the permanent establishment is situated"[555]. The Court seems to find it very important to avoid the double deduction of losses, while on the other hand it accepts the double taxation of profits. This combination is difficult to reconcile with the fact that the ECJ is willing to safeguard "symmetry between the right to tax profits and the right to deduct losses"[556]: if ensuring a symmetric taxation of profits and losses is a requirement under EU law, then either the double taxation of profits and double deduction of losses should be incompatible with EU law, or both should be accepted. The current situation, combined to the apparent requirement for symmetry, is not consistent.

However, it is true that the double deduction of losses cannot be desirable within the internal market. If one considers the internal market as the do-

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[553] *C. cit.*, para. 34.

[554] See *supra* at 3.3.4.1.1.

[555] ECJ, 15 May 2008, case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, para. 36.

[556] *C. cit.*, para. 33.

mestic market of a single State, it is highly improbable that a loss could be deducted twice. Accordingly, avoiding the double deduction of losses is a relevant idea for the internal market as the contrary would provide a cash flow advantage that is not available to domestic competitors. It would also create tax planning opportunities that threaten Member States' fiscal revenues. In the absence of an automatic recapture mechanism and an efficient exchange of information between the Member States concerned, it cannot be denied that a loss deducted in the home State could also be deducted, carried back or carried forward in the Member State of establishment. Consequently, it seems reasonable that the ECJ in *Lidl Belgium* found that the non-deduction of losses was justified.

Yet, even if the non-deduction of losses is justified, it must also pass the proportionality test.

4.3.3.1.3 The proportionality level

First of all, one should be aware of an important difference between loss relief for subsidiaries and for permanent establishments: according to the personality principle, the income of different legal subjects is normally computed for each legal subject separately. In a domestic context, a tax equalisation system is necessary to be able to depart from the personality principle, and such tax equalisation systems differ between one country and another. In contrast, income from a domestic establishment is in principle automatically included in the results of the head office. In a cross-border context, this difference between subsidiaries and establishments is even more important, since tax equalisation systems seldom take into consideration the income of foreign subsidiaries whereas many tax systems apply the principle of worldwide taxation and take into consideration the income of foreign permanent establishments as if they were established in the State of the head office. This difference between subsidiaries and permanent establishments indicates, in my opinion, that the lack of cross-border loss relief for permanent establishments is less acceptable than for subsidiaries.

This view is supported by the following analysis. If a permanent establishment subject to the exemption method incurs losses, such losses cannot be deducted in the home State. In contrast, losses would – in principle – have

been deductible for a domestic establishment. But in addition, when a permanent establishment incurs losses, such losses would probably also be deductible if the head office were located in the host State, because no tax equalisation system is needed for an establishment's income to be included in the head office's income. This means that the losses of an establishment are in principle always deductible, except in a cross-border context when a permanent establishment is subject to the exemption method. In contrast, losses incurred by a subsidiary are not always deductible in a domestic context: allowing for cross-border loss relief of subsidiaries' losses in the home State while no tax equalisation system exists in the host State impedes the free competition in the host State, because it favours competitors with a foreign shareholder compared to competitors with a domestic shareholder. Therefore, a strict application of the fiscal principle of territoriality with regard to permanent establishments is less tolerable than with regard to subsidiaries, because the losses of permanent establishments are normally deductible in a domestic context while this is not at all the case with regard to losses incurred by subsidiaries. This argument pleads strongly for deducting losses incurred by permanent establishment subject to the exemption method, and indicates that one should not simply transpose *Marks & Spencer* to the relation between a head office and its permanent establishment.

A risk for the double use of losses was identified as part of the justification analysis. Is it necessary to go as far as to preclude loss relief to avoid that losses may be deducted twice? To avoid that a permanent establishment's losses are deducted twice, one solution is to deny loss relief in the home State. However, a less restrictive measure could be available through a loss deduction followed by a recapture of such losses once the permanent establishment becomes profitable. Advocate General Sharpston found that argument convincing, given the cash flow disadvantage suffered by the company in the absence of cross-border loss relief. Unfortunately, the ECJ did not follow Advocate General Sharpston and, referring to *Marks & Spencer*, found that since the losses could be carried forward in the host State (*i.e.* the losses were not final), there was no need to apply paragraph 55 of the *Marks & Spencer* judgment.

This analysis is not perfectly convincing. As argued above, there are legitimate arguments for not requiring the State of the parent company to deduct and later recapture non-final losses incurred by foreign subsidiaries, particularly because several group companies may apply for loss relief at the same time. This would result in a cash flow advantage and possibly in a multiple deduction of the loss if it cannot be entirely recaptured. It was argued that it would be very difficult for the ECJ to implement an efficient recapture mechanism that avoids a multiple deduction of the loss. Consequently, it was concluded that legislation at the EU level is preferable with regard to cross-border loss relief within groups of companies. However, these difficulties are not the same for groups of companies as for a single enterprise. Indeed, losses of subsidiaries could be deducted several times if a subsidiary has several shareholders, or the losses could be deducted both by the direct parent company and the ultimate parent company. The risk that losses incurred by a foreign subsidiary are deducted more than once is real. In contrast, a permanent establishment in principle belongs to one and the same head office, which eliminates the difficulties of having to deal with situations where a subsidiary is owned by several shareholders. It cannot be excluded that the loss is deducted by another entity in the host State[557], but this risk could be mitigated by requiring that only losses that could not be deducted by another entity in the host State may be deducted in the home State.

Consequently, the risk of multiple deductions is much lower for permanent establishments than for subsidiaries. This risk could be strongly mitigated through a recapture mechanism. It can therefore be regretted that the ECJ merely transposed *Marks & Spencer* to permanent establishments without taking into account the particularities of a permanent establishment. The Court focused on the absence of final losses and did not discuss the possibilities of loss relief for non-final losses: a loss-deduction followed by a later recapture would be a realistic solution to cross-border loss relief within a

[557] For example if the permanent establishment receives a group contribution from a group company resident in the same State.

single company, whereas it is more complex and consequently difficult to implement by the ECJ with regard to groups of companies[558].

4.3.3.1.4 Conclusion on the relief for non-final losses incurred by a permanent establishment

The study of the relief for non-final losses incurred by a permanent establishment identified that the fiscal principle of territoriality raises compatibility issues with EU law with regard to losses incurred by permanent establishments, because such losses are isolated in the Member States in which they are incurred. This tension is inherently incompatible with the objective of achievement of the internal market, because within an internal market no such isolation of profits from losses would occur. However, when dealing with this conflict, it is submitted that the legal reasoning of the ECJ is unconvincing. Indeed, the reasoning of the Court in *Lidl Belgium* simply assimilated the situation of a single company to that of a group of companies, as illustrated by paragraphs 21 and 22 of the *Lidl Belgium* decision where the ECJ defined a permanent establishment as an "autonomous fiscal entity". However, significant differences do exist between a permanent establishment and a subsidiary[559]. In particular, a foreign subsidiary is not, in principle, taxed by the State of the parent company, unless it has a permanent es-

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[558] This solution would create a discrepancy between the tax treatment of losses incurred by a permanent establishment and those incurred by a subsidiary. Such a discrepancy is obvious if one compares the situation of a single parent company owning all shares in a subsidiary, to the situation of a head office having a permanent establishment. However, article 49 TFEU does not require that "the setting-up of agencies, branches or subsidiaries" is subject to identical rules, so differences between the tax treatment of foreign subsidiaries and permanent establishments from the perspective of the home State is not prohibited under EU law. See also ECJ, 25 February 2010, case C-337/08, *X Holding*, para. 40: "the Member State of origin is not obliged to apply the same tax scheme to non-resident subsidiaries as that which it applies to foreign permanent establishments".

[559] For a discussion on the differences between foreign subsidiaries and permanent establishments, see Peter 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, 2003-4, pp. 194-202.

tablishment situated therein[560]. In contrast, the State of residence has a natural tax jurisdiction on the worldwide income of resident companies[561], so it is more legitimate to expect the home State to take into account losses incurred by a permanent establishment than by a foreign subsidiary. Defining a permanent establishment as an "autonomous fiscal entity" is not entirely correct, since a permanent establishment is by essence part of an enterprise: it is a "fixed place of business through which the business of an enterprise is wholly or partly carried on"[562], or a person who "has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of [an] enterprise"[563]. Permanent establishments are usually considered fictively autonomous solely when allocating profits on the basis of the arm's length principle; it should be attributed to a permanent establishment the profits it "might be expected to make if it were a separate and independent enterprise"[564], which is also the case between associated enterprises[565].

This assimilation of permanent establishments to subsidiaries may explain why the Court in *Lidl Belgium* simply transposed the solution of *Marks & Spencer*, without adapting it to the particular context of the relation between a head office and its permanent establishment. Such an outcome may be criticised, as the differences between foreign subsidiaries and permanent establishments make loss relief a possible solution for permanent establishments, while the situation is more complex with regard to foreign subsidiaries. Particularly, the risk of multiple deductions of losses is much lower for permanent establishments than for subsidiaries, and could be reduced by a recapture mechanism. It is also important to emphasise that the

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[560] See para. 11 of the Commentary on article 7(1) of the OECD Model Convention, 2010: "the profits of an enterprise of one Contracting State shall not be taxed in the other State unless the enterprise carries on business in that other State through a permanent establishment situated therein".

[561] See article 7(1) of the OECD Model Tax Convention, 2010.

[562] See article 5(1) of the OECD Model Tax Convention, 2010.

[563] See article 5(5) of the OECD Model Tax Convention, 2010.

[564] See para. 15 of the Commentary on article 7(2) of the OECD Model Convention, 2010.

[565] See article 9 of the OECD Model Tax Convention, 2010.

lack of loss relief may pose a problem both in the Member State of residence and in the Member State of establishment. In the Member State of residence, the absence of relief for foreign losses creates a significant difference from domestic establishments. This is an obstacle to outbound investments, and does not enforce capital export neutrality. In the Member State of establishement, the loss may have been deducted if the head office had been located there, as long as the head office is profitable and could thereby offset the loss against taxable profits. This is an obstacle to inbound transactions and does not enforce capital import neutrality. In addition, the absence of loss relief impedes the free competition in the host State, since local competitors to the permanent establishment may benefit from loss relief in the host State[566]. Within an internal market functioning as a domestic market, such violation of a free competition would probably not occur. Therefore, in my mind it is undisputable that the lack of loss relief caused by a strict application of the fiscal principle of territoriality towards permanent establishments is incompatible with the objective of achievement of the internal market.

Consequently, I believe that the Court should have followed Advocate General Sharpston and required Member States to grant temporary loss relief, until the permanent establishment is again profitable. Not granting loss relief obstructs the freedom of establishment, respects neither capital export neutrality nor capital import neutrality, and breaches the requirement of an open market economy with free competition. The drawbacks of enacting an exemption system combined with a recapture mechanism are minimal: a multiple deduction of losses can easily be avoided and Member States' sovereignty would only be infringed temporarily. On the other hand, the gains from enacting an exemption system combined with a recapture mechanism are great: the exercise of the freedom of establishment would be encouraged, a certain level of both capital export neutrality and capital

[566] Such a breach of free competition and of capital import neutrality is much less obvious with regard to groups of companies, as it depends on the tax equalisation systems available in the host State.

import neutrality would be reached, and foreign and domestic enterprises would compete on more equal footings in the host State.

Despite the *Lidl Belgium* case, it may be hoped that Member States, together with the European Commission, consider the advantages offered by an exemption system combined with a recapture mechanism[567]. Such a system allows for cross-border loss relief and also avoids the drawbacks of the principle of worldwide taxation which, as discussed above, hinders outbound investments and may have been found incompatible with EU law in the *Cadbury Schweppes* and *Krankenheim* cases. The draft directive on cross-border loss relief[568] already identified exemption with recapture as a possible solution within the European Union but it did not favour the exemption method over the credit method. No preference either was expressed in the Communication on the tax treatment of losses in cross-border situations[569]. Such a preference has, however, been identified in *Cadbury Schweppes* and *Krankenheim*.

It is now focused on final losses incurred by a permanent establishment.

4.3.3.2 Relief for final losses incurred by a permanent establishment

In *Marks & Spencer*, only foreign subsidiaries' losses were explicitly encompassed by the exception for final losses. In *Lidl Belgium* the Court touched upon this issue but found that the losses were carried forward in the Member State of establishment, *i.e.* they were not final. Consequently, *Lidl Belgium* should first be analysed so as to identify whether the ECJ may have required loss relief if the losses had been final (4.3.3.2.1). The *Krankenheim* case is then analysed, as in this case losses were final (4.3.3.2.2). Last, it is submitted that convincing arguments plead for granting relief for the final losses of a permanent establishment (4.3.3.2.3).

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[567] Moreover, such a system has been found compatible with EU law by the Court in *Krankenheim*.

[568] COM 90 (595) final, 24 January 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*.

[569] COM(2006) 824 final, 19 December 2006, *Tax treatment of losses in cross-border situations*.

4.3.3.2.1 Analysis of Lidl Belgium with regard to final losses incurred by a permanent establishment subject to the exemption method

The losses incurred by the permanent establishment in 1999 were carried forward and offset against profits earned in 2003[570]. That is, the *Lidl Belgium* case was not about final losses, contrary to *Marks & Spencer*. However, *Lidl Belgium* provides guidance as to whether or not EU law requires the deduction of final losses incurred by a permanent establishment subject to the exemption method.

At first sight, it seems that the Court would require relief for final foreign losses incurred by a permanent establishment subject to the exemption method[571]. Indeed, the ECJ observed that "Lidl Belgium has not shown that the conditions laid down in paragraph 55 of the judgment in Marks & Spencer, for establishing the situation in which a measure constituting a restriction on the freedom of establishment for the purposes of Article 43 EC goes beyond what is necessary to attain legitimate objectives recognised by Community law, were satisfied"[572]. Consequently, if the taxpayer had shown that the conditions laid down in paragraph 55 of *Marks & Spencer* were satisfied, *i.e.* if losses could not be utilised in the host State, the wording of paragraph 51 of *Lidl Belgium* indicates that loss relief would then have been available in the home State, as in *Marks & Spencer*. This interpretation of *Lidl Belgium* is confirmed by the *Deutsche Shell* case: even if the foreign exchange loss was not incurred by the permanent establishment but by the

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[570] ECJ, 15 May 2008, case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, para. 50: "Lidl Belgium has in fact benefited from such an offsetting of the losses incurred by its permanent establishment in 1999 in a subsequent tax year, namely 2003, in which that entity generated profits".

[571] Concurring, see Daniel Gutmann, *Droit fiscal des affaires*, Montchretien, 2010, pp. 427-429; Jörg-Dietrich Kramer, *Losses from foreign permanent establishments under Germany's tax treaties*, Tax Notes International, 15 November 2010, p. 513: "Following *Marks & Spencer*, the ECJ remarked that it was a violation of the EC Treaty if the loss deduction was refused when all possibilities to have the loss taken into account in the country of the PE (that is, the source country) were exhausted".

[572] ECJ, 15 May 2008, case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, para. 51.

head office, the fact that the loss had to be deducted in the home State (while no comparable loss could be incurred domestically) indicates that the ECJ refused a loss remaining not deducted in the State of establishment. It should also be observed that the German Federal Financial Court (*Bundesfinanzhof*) interpreted *Lidl Belgium* in such a way that it requires Member States to grant relief for the final losses of a permanent establishment, as it found that final foreign losses incurred by a permanent establishment subject to the exemption method were deductible in Germany[573].

This interpretation seems, however, to be contradicted by the *Krankenheim* case.

4.3.3.2.2 The tax treatment of final losses in the Krankenheim case

In *Krankenheim*, a permanent establishment subject to the exemption method had been loss-making between 1982 and 1990. It became profitable in 1991, and was "disposed of"[574] in 1994. Until 1990, the losses were temporarily deducted in Germany, since the enterprise had been globally profitable during the whole period[575]. According to the German rules at hand, the losses deducted in Germany were to be recaptured, unless they could not be offset against taxable income in the State of establishment[576]. So the German rules granted relief for certain final losses, for example in the lack of a loss carry-forward in the State of a permanent establishment. Despite the permanent establishment becoming profitable in 1991, it could not carry forward the losses accumulated in Austria, because according to the Austrian rules, the carry forward of losses was permitted only "in cases where it was not possible to take them into account in the State where the company owning the permanent establishment was established"[577]. Since

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[573] See the German Federal Financial Court (*Bundesfinanzhof),* 9 June 2010, case number I R 107/09.

[574] ECJ, 23 October 2008, case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v Finanzamt für Körperschaften III in Berlin*, para. 15 and 53.

[575] This means that the company was making worldwide profits despite the losses in Austria.

[576] ECJ, 23 October 2008, case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v Finanzamt für Körperschaften III in Berlin*, para. 9.

[577] *C. cit.*, para. 17.

the enterprise was globally profitable and Germany applied an exemption with recapture, loss carry-forward was denied in Austria. In parallel, the losses were not deducted in Germany either (*i.e.* the recapture mechanism was applied), because the taxpayer could not demonstrate that he was not authorised to deduct losses in the State of establishment.

To sum up the facts, the losses of the permanent establishment were first deducted and later recaptured in Germany. At the same time, Austria refused to carry forward those losses. As a consequence, the losses of the permanent establishment were neither deducted in Austria, nor in Germany.

The ECJ accepted that Germany applied its recapture mechanism, although this resulted in a final loss not being deducted anywhere. This decision is difficult to interpret. One possible explanation would be that the Court changed its case law on final losses and no longer requires the home State to grant relief for such final losses. Indeed, at paragraph 53 of the ruling, the ECJ considered that the German rules were still justified by the need to ensure the coherence of the tax system although "the principal company disposed of its permanent establishment and (…) the profits and losses made by that establishment throughout its existence end with a negative result"[578]. This statement is puzzling because the ECJ upheld the symmetry of the German system, despite the existence of a loss in Austria that would never be deducted. That is, symmetry was so important to respect that it did not infringe EU law, even if it resulted in a final loss never being deducted. If this explanation is correct, *Krankenheim* would be incompatible with *Marks & Spencer*. Indeed, in *Marks & Spencer*, although the UK taxed foreign subsidiaries symmetrically, rules on group relief were found in breach of EU law because of the definitive infringement of the fundamental freedoms in case a foreign subsidiary incurred final losses. Although it is possible that the ECJ changed its case law on final losses, the Court would probably have to take such a decision at least explicitly and hopefully in the

[578] *C. cit.*, para. 53.

Grand Chamber[579]. Consequently, it is not likely that the ECJ no longer requires cross-border loss relief for final foreign losses.

Another possible explanation is that the ECJ may require loss relief solely for foreign subsidiaries and not for permanent establishments. However, *Krankenheim* would then probably conflict with *Lidl Belgium* in which the ECJ referred to *Marks & Spencer* and gave the strong impression that loss relief should be granted for the final losses of permanent establishments[580]. Therefore, the Court may still require cross-border loss relief for the final losses of permanent establishments, but it may have considered that such a relief was not to be granted in the *Krankenheim* case. The reason for that may be that no loss relief has to be granted when a loss cannot be carried forward in the host State, which was the case in *Krankenheim*. However, this decision would then conflict with *Marks & Spencer* in which the Court did include losses that cannot be carried back or carried forward in the losses that have to be deducted in the home State. Alternatively, the ECJ may consider that when a permanent establishment is "disposed of", it is not considered that its losses are final and have to be deducted in the home State. This explanation could create a discrepancy with the liquidation of foreign subsidiaries. In addition, it is hard to conceive what type of losses could be final if it is not losses accumulated at the time a permanent establishment is "disposed of".

As a conclusion, *Krankenheim* is difficult to interpret. One cannot identify with all certainty the impact of this decision on cross-border loss relief, both for losses incurred by permanent establishments and by foreign subsidiaries. However, it will be argued here that the final losses of a permanent establishment should not remain unrelieved.

4.3.3.2.3 Arguments pleading for granting relief for final losses incurred by a permanent establishment subject to the exemption method

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[579] It was indeed the Grand Chamber that ruled in *Marks & Spencer*.

[580] It can be observed that both *Krankenheim* and *Lidl Belgium* were issued by the Fourth Chamber of the ECJ within less than six months, and four out of five judges ruled in both cases.

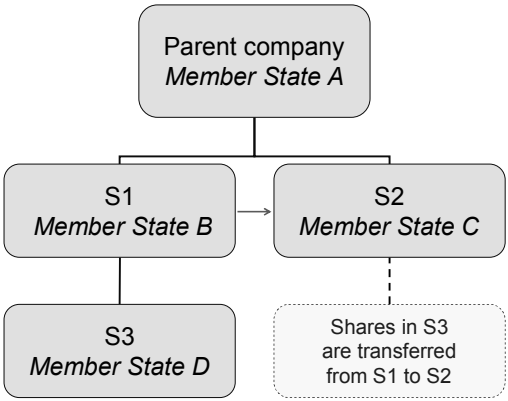
A first argument pleading for the deduction of the final losses of permanent establishments is related to a free competition in the host State. This argument is stronger for permanent establishments than in the context of a group of companies. Indeed, if a parent company and its subsidiary were located in the host State, the deduction of a final loss incurred by a subsidiary would be subject to the existence of a tax equalisation system. Even if many Member States do have such mechanisms in their domestic tax laws, these mechanisms vary to a great extent. It is not at all certain that a final loss would be deductible, although the lack of tax equalisation systems may be compensated by other measures such as the writing down of shares in the subsidiary. Consequently, the difference of treatment with local subsidiaries having a local parent company is not obvious, as it eventually depends on the tax equalisation systems in both Member States. In contrast, it is more likely that the final loss of an establishment would be deductible if the establishment and the head office were located in the same State, as there is no need for tax equalisation systems: the income of a head office and its establishment are, in principle, automatically consolidated. As a result, the probability that the loss would be deductible in the host State is higher with regard to permanent establishments than foreign subsidiaries.

Secondly, from a technical point of view, it should be emphasised that the opening for tax avoidance that exist in the context of a group of companies are less important with regard to permanent establishments. Indeed, within a group of companies it is possible to sell the shares in a loss-making subsidiary to a group company that is resident in a Member State with a high corporate income tax rate, to maximise the value of the losses for taxation purposes. This risk of tax avoidance was identified by the ECJ in *Marks & Spencer* and may explain why Member States do implement limitations in their cross-border loss relief legislations with regard to the ownership in a loss-making subsidiary[581]. Preventing such a risk of tax avoidance may ap-

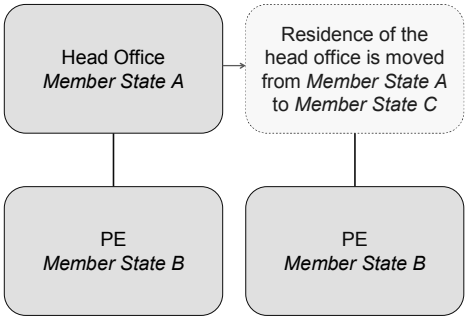
[581] See for example section 35(a) para. 8 of the Swedish Income Tax Act, which limits group relief to losses incurred during the time a subsidiary was owned by the parent company: "Vid beräkningen ska bortses från förluster som har uppkommit innan dotterföretaget blev helägt i enlighet med vad som föreskrivs i 5 § 2".

pear legitimate, although it is up to the ECJ to determine how far a Member State may set restrictions to the deductibility of final foreign losses. This risk of tax avoidance may theoretically exist with regard to permanent establishments, as the head office may be moved to a Member State with a higher corporate income tax rate to maximise the value of the losses for taxation purposes. However, it should be pointed out that the ownership in a permanent establishment is not materialised by shares, but by the relation between the head office and the business activities conducted in the State of establishment. Consequently, only two opportunities exist to move the right to deduct final foreign losses to another Member States: either the residence of the head office is moved, or the permanent establishment's business will be carried on by another company which will then own the permanent establishment instead of the original head office.

One should pay attention to the fact that it is more complex to move the residence of a head office from one Member State to another than to transfer shares, as illustrated by the following example.



Following the sale of shares, the parent company of S3 is S2, not S1 anymore[582]. Such transfers are not necessarily complicated to undertake and if Member State C as a high corporate income tax rate, groups may be tempted to transfer the ownership in S3 to this Member State. Also, once S3 is again profitable, shares could be transferred back to S1 in Member State B. As a consequence, it is possible for groups of companies to locate shareholdings in Member States with higher tax rates or favourable tax equalisation rules to maximise the value of the losses. With regard to permanent establishments, moving the head office is more complex. A first alternative consists in moving the residence of the head office. This may prove more or less complicated, depending on the circumstances, the domestic laws and tax treaties at hand. In the example below, the residence of the head office is moved from Member State A to Member State C.



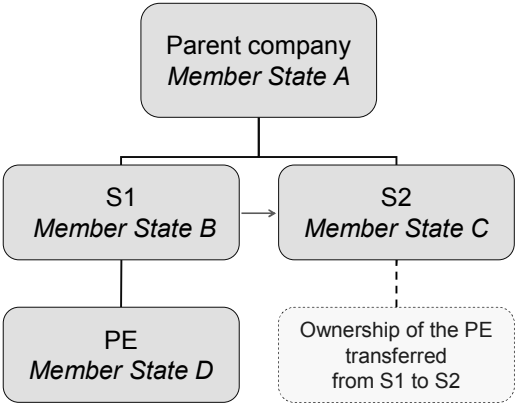
Even if moving the residence of the head office may be achieved relatively easily, *e.g.* by moving the place of effective management from A to C, the tax risks associated with this change should not be underestimated. Member States A and C may not necessarily agree on the new place of residence, which could lead to situations of dual residence. Also, by moving its residence, the company may be subject to exit taxation in Member State A[583]. Once the permanent establishment gets profitable, moving back the resi-

[582] It is assumed that all the shares are owned by one and the same shareholder. Indeed, no distinction has yet been made by the ECJ in the situation where a subsidiary is owned by more than one shareholder.

[583] Such an exit taxation would, however, be subject to the limitations imposed by EU law.

dence to Member State A would raise the same problems and could even be seen as abusive and disqualified by Member State C. Consequently, moving the residence of the head office is not an easy task. Even if it is possible, the ECJ should be aware of the fact that given the complexity and the risks associated with a transfer of residence, it is not at all certain that companies would significantly engage in such tax planning.

Another means to attract the losses of a permanent establishment to another Member State, would be to make another group company carry on the business of the permanent establishment. This last company would then own the permanent establishment instead of the initial company, and become the new head office. This is illustrated by the following example.



This alternative is also complex. It requires that it is the business of S2 that is carried on through the permanent establishment instead of the business of S1, or that an agent acts on behalf of S2 instead of S1. It would also require restructuring the dealings with the permanent establishment which, depending on the type of activity performed, could involve high costs and a reorganisation of the enterprise's operations. It is possible that Member State C will not easily acknowledge that the permanent establishment is

owned by S2[584], so the actual grant of a loss relief may be complicated and costly to obtain. In addition, the transfer of the ownership of the permanent establishment from S1 to S2 may trigger exit taxation in Member State B in case the assets in the permanent establishment included hidden reserves.

As a conclusion, both ways of transferring the ownership of the permanent establishment to another Member State with a higher corporate income tax rate are more complex, risky, and probably costly, than simply selling the shares in a subsidiary. In *Lidl Belgium* the Court did not explicitly consider the prevention of tax avoidance as a possible justification ground, which may be explained by these differences that make tax avoidance more difficult to achieve with regard to permanent establishments than to foreign subsidiaries. Consequently, the lower risks of tax avoidance should encourage the ECJ and Member States to grant loss relief for final foreign losses incurred by permanent establishments subject to the exemption method.

Although the deduction of the final losses of a permanent establishment may appear desirable as such, it is subject to part of the arguments developed above for foreign group companies, *i.e.* the problems related to the definition of final losses[585], the coexistence of loss relief requirements with the acceptance of double taxation within the internal market, and the question of the perspective from which the final losses of a permanent establishment should be taken into consideration. These problems should not, in my opinion, preclude cross-border loss relief but should instead encourage Member States to adopt a legislation at the level of the European Union. In that respect, it is referred to chapter 7 *infra* where alternative approaches to the *Marks & Spencer* doctrine are suggested.

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[584] It is likely that Member State C would react in this way to minimise the losses it would have to grant relief for according to EU law.

[585] The difficulty of determining under which circumstances losses of a permanent establishment are final are illustrated by litigation in Germany, following the *Lidl Belgium* case. See Caroline Wunderlich, *Germany in the aftermath of* Lidl Belgium, Tax Notes International, 15 March 2010, pp. 969-970.

4.3.4 Conclusion on the application of the fiscal principle of territoriality to permanent establishments

This chapter has demonstrated that the isolation of profits from losses caused by the fiscal principle of territoriality and the objective of achievement of the internal market are clearly in conflict. The internal market can simply not be fully achieved with the existing negative consequences resulting from the fiscal principle of territoriality and the exemption method. It was argued in this chapter that relief for the final losses of a permanent establishment should be granted, both for non-final and final losses. With regard to non-final losses, it was argued that the Court in *Lidl Belgium* wrongly transposed *Marks & Spencer* to permanent establishments, without taking into account their special features. A strict application of the fiscal principle of territoriality towards permanent establishments is, consequently, clearly in conflict with the concept of an internal market.

With regard to final foreign losses, the conclusion of this second part of chapter 4 of the dissertation highlights a contradiction in the case law of the Court: following *Krankenheim* it is possible that final losses incurred by a permanent establishment are not deductible under EU law, *i.e.* the fiscal principle of territoriality would be upheld even though losses are not deductible in the Member State of establishment. This conclusion is in contradiction with *Marks & Spencer*, which is all the more regrettable since loss relief should be available to permanent establishments under better conditions than for groups of companies. If loss relief were to be granted for the losses of permanent establishments, as already mentioned in chapter 3 *supra* it is submitted in chapter 7 *infra* that the very rationale of the *Marks & Spencer* doctrine with regard to final losses, *i.e.* an allocation of all the final losses to the home State, is intrinsically flawed. Consequently, an alternative way of reasoning is suggested in chapter 7.

It is now discussed whether EU law should require the most favoured nation treatment with regard to the taxation of foreign business income.

4.4 The possible requirement of *most favoured nation treatment in the Member State of residence with regard to foreign business income*[586]

4.4.1 *Introduction*

It was demonstrated above that both the principle of worldwide taxation and the fiscal principle of territoriality raise some compatibility issues with EU law, notably with regard to profits and losses incurred by permanent establishments. If a head office has a profitable permanent establishment, one may consider that the exemption method could be more favourable than the credit method, particularly if the foreign rates are lower or if the foreign tax accounting rules are more generous. In contrast, if the permanent establishment is loss-making, the credit method may be more favourable than the exemption method, since it usually implies that foreign losses are taken into account when assessing taxes at the head office level.

The compatibility with EU law of each of those methods has been discussed in the sections above. However, these discussions did not touch upon another kind of problem that

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586 It is emphasised that the issue of whether or not EU law should require the most favoured nation treatment is not solely relevant for the tax jurisdiction of the home State. It may also be relevant with regard to the tax jurisdiction of the Member State of source, as illustrated by the *D* case. The most favoured nation treatment is dealt with in this chapter of the dissertation because the practical implications of this issue, regard being had to the topic of the dissertation, seem most relevant for the tax jurisdiction of the Member State of residence of a company having permanent establishments in other Member States. Indeed, the most favoured nation treatment is of high relevance for the taxation of foreign business income when the Member State of residence has to eliminate double taxation through the exemption method or the credit method, depending on the method applicable in tax treaties. In addition, both methods are used by Member States (and to a different extent as the method articles may be drafted in different ways). In contrast, the tax treaty provisions applicable to the situations discussed in the other chapters of the dissertation are less subject to a choice of principle between the fiscal principle of territoriality and the principle of worldwide taxation. Nevertheless, it is emphasised that the issue of the most favoured nation treatment is also relevant for other chapters of the dissertation, for example chapter 5 with regard to the attribution of profits to permanent establishments according to the wording of article 7 of the tax treaties concluded between Member States.

is related not to the difference of treatment between comparable domestic and cross-border situations, but to the difference of treatment between comparable cross-border situations. Such differences are mainly the consequence of the various provisions of tax treaties concluded throughout the European Union, combined with the domestic tax laws of Member States. As a result, with regard to a permanent establishment located in a certain Member State, a taxpayer may receive a less favourable treatment than for a permanent establishment located in another Member State. This issue is commonly referred to as the most favoured nation treatment. Applied to permanent establishments from the perspective of the Member State of residence, the most important difference may be between the exemption method and the credit method as well as in how these methods are applied. The objective of this part of the dissertation is not to discuss the whole problema area related to the possible requirement of most favoured nation treatment under EU law. This topic has been discussed at length by many scholars[587]*. It is referred to this doctrine for analyses of a possible requirement of the most favoured nation treatment in EU law, particularly with regard to the relevant case law of the ECJ. Here, only a brief overview of the problem is provided, since a possible requirement of the most favoured nation treatment could significantly influence the taxation in Member States of the foreign business income of companies.*

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[587] See particularly Dennis Weber, *Most favoured nation treatment under tax treaties rejected in the European Community: background and analysis of the D case - a proposal to include a most favoured nation clause in the EC Treaty*, Intertax, 2005-10, pp. 429-444; Ines Hofbauer, *Most favoured nation clauses in double taxation conventions - a worldwide overview*, Intertax, 2005-10, pp. 445-453; Pasquale Pistone, *National treatment for all non-resident EU nationals: looking beyond the D decision*, Intertax, 2005-10, pp. 412-413; Philippe Derouin, *Différences de traitement fiscal résultant des conventions de double imposition entre États membres de l'Union européenne – Clause de la nation la plus favorisée (NPF) ou chalandage fiscal (treaty shopping)?*, Revue de Droit Fiscal, 28 July 2005, pp. 1288-1300; Stig von Bahr, *Ytterligare om EG-domstolen och skatterätten*, *in* Festskrift till Nils Mattsson, Iustus Förlag, 2005, pp. 79-91; Mattias Dahlberg, *Finns det ett EG-rättsligt krav på behandling som för mest gynnad nation i skatteavtalsrätten?*, *in* Festskrift till Nils Mattsson, Iustus Förlag, 2005, pp. 105-116; John F. Avery Jones, *Flows of capital between the EU and third countries and the consequences of disharmony in European international tax law*, EC Tax Review, 1998-2, pp. 95-106; Eric Kemmeren, *The termination of the 'most favoured nation' dispute in tax treaty law and the necessity of a Euro Model Tax Convention*, EC Tax Review, 1997-3, pp. 146-152; Klaus Vogel, *Problems of a most favoured nation clause in intra-EU treaty law*, EC Tax Review, 1995-4, pp. 264-265; Albert J. Rädler, *Most favoured nation clause in European tax law?*, EC Tax Review, 1995-2, pp. 66-67.

If EU law were to require the most favoured nation treatment, the provisions of the most advantageous tax treaty concluded by a Member State may need to be extended to bilateral relations with other Member States. This could potentially have significant consequences on the debate between the fiscal principle of territoriality and the principle of worldwide taxation, both for the taxation of business profits[588] *and with regard to the elimination of double taxation*[589]*. Indeed, the way the business profits article of a tax treaty is drafted may significantly influence the extent of the tax jurisdiction of the Member State of residence, for example if this State surrenders its taxation right to the Member State of source as soon as a permanent establishment is located therein. The method through which double taxation is eliminated, as well as the way this method is applied, may also vary from one tax treaty to another. One could also consider that, if CFC taxation is not allowed by one tax treaty, this prohibition should be extended to other tax treaties, thus limiting the tax jurisdiction of the State of the parent company.*

4.4.2 The absence of requirement of a most favoured nation treatment in ECJ case law

The Court has dealt with issues closely related to the most favoured nation treatment in several cases[590]*. The landmark case is D*[591]*, in which the ECJ explicitly rejected the requirement of most favoured nation treatment as a consequence of EU law.* The Court found in *D* that EU law did not allow a German resident assessed for wealth tax in the Netherlands to claim the benefit of a provision of the Netherlands-Belgium tax treaty that entitled non-residents to an allowance

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[588] The most favoured nation treatment would extend the most favourable article (based on a*rticle 7 of the OECD Model Tax Convention)* on the taxation of business profits *to the bilateral relations between all the other Member States.*

[589] The most favoured nation treatment would extend the most favourable article on elimination of double taxation (based on *articles 23A and 23B of the OECD Model Tax Convention) to the bilateral relations between all the other Member States.*

[590] It has been argued that the ECJ implicitly refused the most favoured nation treatment at paragraph 26 of the *Bachmann* case: see Eric Kemmeren, *The termination of the 'most favoured nation' dispute in tax treaty law and the necessity of a Euro Model Tax Convention*, EC Tax Review, 1997-3, p. 148.

[591] ECJ, 5 July 2005, case C-376/03, *D. v Inspecteur van de Belastingdienst/Particulieren/Ondernemingen buitenland te Heerlen (*hereinafter referred to as *D).*

that the Netherlands-Germany treaty did not provide[592]. The non-requirement of the most favoured nation treatment as a consequence of EU law was confirmed in *ACT Group Litigation*[593] where the UK did not grant a tax credit on outbound dividends to non-UK resident companies while it granted it to UK residents as well as some treaty countries. The ECJ accepted that the UK applied different rules in different tax treaties with other Member States. Since then, the Court has considered other cases in which a different treatment was at hand between the domestic law of a Member State and a tax treaty, both from the perspective of the Member State of residence[594] and the perspective of the Member State of source[595]. Consequently, the ECJ does not consider that EU law requires the most favoured nation treatment.

Arguments for and against a requirement of the most favoured nation treatment in the European Union are shortly presented below.

4.4.3 Arguments supporting the view that EU law should not require most favoured nation treatment as far as the taxation of business income is concerned

From a theoretical point of view, the most favoured nation treatment can be seens as consistent with the enhancement of the internal market. By granting the same advantages to all Member States, tax rules would become more uniform and foreseeable. The internal market would get closer to the situation prevailing within one single State because the tax treatment of cross-border transactions would become more homogeneous, thanks to getting rid of differences in bilateral relations between Member States. Moreover, it would be

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592 *C. cit.*, para. 58 to 63.

593 ECJ, 12 December 2006, case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue* (hereinafter referred to as *ACT Group Litigation*), para. 52. For a comment see Trevor Johnson, *More bad news from Europe*, Tax Notes International, 22 January 2007, pp. 243-245.

594 See ECJ, 6 December 2007, case C-298/05, *Columbus Container Services*, para. 33.

595 See ECJ, 20 May 2008, case C-194/06, *Staatssecretaris van Financiën v. Orange European Smallcap Fund NV*, para. 37.

symbolically strong that in harmony with the principle of a sincere cooperation[596] *a Member State accepts to offer the same advantages to all Member States.*

Granting the most favoured nation treatment in the Member State of residence could also enhance the exercise of the fundamental freedoms through outbound transactions. Indeed, by benefiting from the most favourable treatment offered by the home State, resident taxpayers can feel encouraged to actually exercise their freedom of establishment. In addition, the elimination of some differences between tax treaties is likely to make more neutral the choice between Member States in which an investment is contemplated: by getting rid of some specific features separating the tax treaties concluded by Member States, the European tax treaty network gets more homogeneous. A more homogeneous tax treaty network between Member States may also promote economic, social and territorial cohesion[597] between Member States through encouraging taxpayers to invest in all the regions of the European Union. The most favoured nation treatment may also be desirable in other fields of tax law, such as the prevention of tax avoidance[598].

Despite these arguments, it should be recognised that *applying the most favoured nation treatment in the field of direct taxes is a complex matter. Several international treaties providing for most favoured nation treatment exclude its extension to tax law*[599]*. With respect to the taxation of permanent establishments by the Member State of*

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[596] See article 4(3) TEU.

[597] See article 3 TEU.

[598] See COM(2009) 29 final, 2 February 2009, *Proposal for a Council directive on administrative cooperation in the field of taxation*, article 18: "Where a Member State provides a wider cooperation to a third country than is provided for under this Directive, it may not refuse to provide such wider cooperation to the other Member State". See also COM(2009) 201 final, 28 April 2009, *Promoting goods governance in tax matters*, p. 10.

[599] See *e.g.* articles XIV(d) and XIV(e) of the General Agreement on Trade and Services (GATS), which provides for general exceptions to the agreement for the imposition or the collection of direct taxes, or the conclusion of tax treaties for the avoidance of double taxation. See also article 2103(4)(c) of the North American Free Trade Agreement (NAFTA),

residence, four arguments could plead for not requiring the most favoured nation treatment.

A first argument is the incompatibility with the numerous statements of the Court according to which the determination of the connecting factors for the levy of taxes remains within Member States' competence[600]. Indeed, the most favoured nation treatment would contradict the intentions of a Member State that are expressed in a tax treaty. However, this statement is not, in itself, sufficient to exclude the most favoured nation treatment: Member States' tax jurisdiction should not be out of reach of EU law, otherwise EU law would be deprived of its meaning. Both the principle of worldwide taxation[601] and the fiscal principle of territoriality[602] have, actually, been challenged by the Court. Consequently, this argument is not convincing enough.

Second, requiring the most favoured nation treatment in the Member State of residence would imply a risk that companies move their residence to enjoy the best treaty benefits. Indeed, the differences between the tax treaties concluded by Member States would be obvious by the most favoured nation treatment. At once, the benefits offered in one treaty would be available between one Member State and all the other Members of the Union in their bilateral relations. However, such a risk of tax planning is not, in itself, prohibited by EU law. The Court has not found that the objective of lowering the total tax burden is, *per se*, prohibited under EU law[603]. Only in case of abuse of rights may transactions be challenged. Consequently, this argument is not perfectly convincing either, unless a taxpayer enters into tax avoidance schemes.

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which explicitly excludes the most favoured nation treatment in relation to the conclusion of tax treaties.

[600] See particularly ECJ, 12 May 1998, case C-336/96, *Gilly*, para. 24; ECJ, 21 September 1999, case C-307/97, *Saint-Gobain*, para. 56.

[601] For example in the *Cadbury Schweppes* and *Krankenheim* cases.

[602] For example in the *Marks & Spencer* case.

[603] See ECJ, 21 February 2006, case C-255/02, *Halifax*, para. 73; ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*, para. 49 and 50.

Third, the most favoured nation treatment could lead to double non-taxation or double deduction. Indeed, both the Member State of residence and the Member State of residence may be required, as a consequence of the most favoured nation treatment, to limit the extent of their tax jurisdiction or grant a certain tax advantage. For example, the Member State of residence could be required to exempt foreign business profits, while, at the same time, the Member State of establishment may be required to apply the narrowest definition of a permanent establishment. Such situations are not desirable as they do not pay attention to the balance between the various provisions of Member States' tax treaties. The most favoured nation treatment may consequently result in situations of double non-taxation or double deduction, which the Court seems to combat in decisions such as *Marks & Spencer*, *Oy AA*, *Lidl Belgium*, *X Holding*, or *Schempp*. Consequently, given the case law of the ECJ, the risk of double non-taxation or double deduction is a convincing argument for not granting the most favoured nation treatment.

Fourth, and most convincingly, it seems impossible to define the most favourable treatment in the Member State of residence *as far as the taxation of business profits and the method articles are concerned.* Is it the exemption of foreign profits? That may be the case regarding positive income, but the credit method can be more favourable with regard to losses since worldwide taxation in the State of residence usually allows for taking into account losses in that State. Is the credit method more favourable? That may apply to losses but with regard to profits, the exemption method may be more favourable if the foreign tax rates are lower or if the foreign tax accounting rules are more generous. Furthermore, the very drafting of tax treaty provisions may vary from one treaty to another and it may not be possible, with sufficient objectivity, to identify the drafting that is the most favourable. In addition, even if it would be possible to identify the most favourable drafting, what is considered the most favourable treatment varies depending on the situation at hand.

4.4.4 Conclusion

Consequently, this short presentation of some arguments for and against stipulating the most favoured nation treatment in the European Union pleads, in my view, for not granting such a treatment. The most favoured nation treatment *would be impossible to apply in practice and may produce inconsis-*

tent results. However, it should be emphasised that, from a theoretical point of view, the most favoured nation treatment seems to be in harmony with the internal market and the principle of sincere cooperation. The most favoured nation treatment would also promote economic, social and territorial cohesion between Member States. As a conclusion, this discussion illustrates part of the benefits that would result from a more coordinated tax treaty policy between Member States.

4.5 Conclusion on the extent of the tax jurisdiction of the Member State of residence

With regard to the taxation of foreign positive income, the Court in *Columbus Container* clearly accepted the principle of worldwide taxation. However, the *Krankenheim* case could be interpreted as if the ECJ refused to allow a Member State to tax a permanent establishment's profits. This interpretation is also supported by the *Cadbury Schweppes* case. Consequently, the Court does not provide clear guidance as to which principle of taxation should be favoured with regard to a company's foreign business income earned through permanent establishments. Concerning losses, the fiscal principle of territoriality clearly raises problems with regard to the objective of achievement of the internal market. The restrictive approach of the ECJ in *Lidl Belgium* and *Krankenheim* was criticised in this chapter, and it has been argued that loss relief should be available under better conditions for permanent establishments than for foreign subsidiaries given the differences between these two forms of investment.

As a result of the analyses conducted in this chapter, it appears that the internal market cannot be fully achieved by following a single principle of taxation of the foreign business income of companies earned through permanent establishments. Indeed, if the fiscal principle of territoriality were to be favoured, losses would raise a problem. Conversely, if the principle of worldwide taxation would solve the issue of cross-border loss relief, it would hinder the achievement of the internal market when a company's permanent establishment is profitable. This means that to enhance the achievement of the internal market, a combined use of the principle of worldwide taxation and the fiscal principle of territoriality seems most suitable. To my mind, such a combination should take the form of the exemption method combined with a loss deduction followed by a later recapture

of losses. Such a system would get rid of the problems created by both the principle of worldwide taxation and the fiscal principle of territoriality with regard to the objective of achievement of the internal market.

This chapter also illustrates the limits of the negative integration, because inconsistencies in the case law of the ECJ were identified with regard to both profits and losses. Given the need for consistency between the tax systems of Member States, identified particularly with regard to the discussion on the most favoured nation treatment, the conclusions of this chapter result in a call for coordination of the tax policies of the Member States. Two possible alternatives could be a directive on cross-border loss relief or a common consolidated corporate tax base. However, in the first case, such a directive should also encompass final losses. In that respect, it is referred to chapter 7 *infra* where an alternative way of reasoning to *Marks & Spencer* is suggested.

The next chapter analyses the tax jurisdiction of the Member State where a permanent establishment is situated.

5 Taxation of the foreign business income attributable to a permanent establishment by the Member State of establishment

"Sur le plan fiscal, si la situation de la filiale paraît assez claire, celle de l'établissement l'est beaucoup moins"[604].

"Fictions play an important part in the law. According to Henri Capitant, a fiction is a legal technique leading to an assumption of a fact or a situation different from reality so as to deduct therefrom legal consequences"[605].

5.1 Introduction

The analysis of the conflict between Member States' rules on the taxation of the foreign business income of companies and the objective of achievement of the internal market should take into account the tax jurisdiction of the Member State where a permanent establishment is located. Indeed, business may be carried out indirectly through a foreign subsidiary, but also directly through a permanent establishment[606].

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[604] Bruno Gouthière, *Les impôts dans les affaires internationales*, Éditions Francis Lefebvre, eighth edition, 2010, p. 208.

[605] Jacques Malherbe, Philip Daenen, *Permanent establishments claim their share of profits: does the taxman agree?*, Bulletin for International Fiscal Documentation, July 2010, p. 359.

[606] Setting up a permanent establishment differs on several points from using foreign subsidiaries. Most of these differences are related to the fact that a permanent establishment is not a legal subject on its own. Consequently, the characteristics of a permanent establishment may be particularly advantageous for certain companies, such as banks and financial institutions who can easily share capital and risks through setting up permanent establishments instead of foreign subsidiaries.

However, the tax jurisdiction of the State of establishment is not identical with the tax jurisdiction of the State of residence of a company. This may have consequences when foreign business income is attributed to a permanent establishment. Indeed, the taxation of permanent establishments differs from the taxation of resident companies. On the one hand, Member States may tax resident companies on their worldwide income. It is often considered that residents are subject to an unlimited tax liability, although the State of residence may decide to limit its tax jurisdiction and exclude foreign income from a resident's tax base. On the other hand, the State of establishment normally taxes the profits of a non-resident company only to the extent that such profits are attributable to a permanent establishment[607]. A permanent establishment is therefore often subject to a limited tax liability in the State of establishment[608]. Consequently, international tax practice usually does make a difference between the taxation of resident and non-resident companies.

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[607] It is assumed in this chapter that permanent establishments are taxed in accordance with article 7 of the 2010 OECD Model Tax Convention and the OECD Report on the attribution of profits to permanent establishments, 22 July 2010. However, it should be emphasised that permanent establishments are not always taxed according to the most recent recommendations of the OECD, particularly in the absence of tax treaty or when a tax treaty in force does not follow the wording of article 7 of the latest OECD Model Tax Convention. This is particularly the case when tax treaties are concluded on the basis of the UN Model Tax Convention, as this model adopts a limited force of attraction principle, contrary to the OECD Model Tax Convention.

[608] Several reasons may explain why a permanent establishment is usually subject to a limited tax liability in the State of establishment. The State of establishment has indeed a limited connection with a non-resident tax subject: according to the ability-to-pay principle, the tax subject should be exposed to comprehensive taxation in his State of residence, since it is most likely that he has the greatest ability-to-pay taxes in his home State. Also, the benefit principle indicates that non-residents benefit from infrastructures in the State of establishment only to a limited extent, thus mitigating the need to make them contribute to such infrastructures. Last, it may be administratively difficult for the tax authorities of the State of establishment to assess a non-resident's foreign income, while it is easier for the State of residence.

Given the usually limited tax jurisdiction of the State of establishment, the taxation of foreign business income attributable to a permanent establishment raises certain compatibility issues with the objective of achievement of the internal market. As in the previous chapters, it is distinguished between foreign positive income (5.2) and foreign negative income (5.3).

5.2 Taxation of foreign business profits attributable to a permanent establishment

5.2.1 Introduction

This section studies whether the taxation by the Member State of establishment of foreign business profits attributable to a permanent establishment is compatible with the objective of achievement of the internal market. Indeed, a permanent establishment may earn business income incurred outside the territory of the Member State of establishment[609]. A permanent establishment may also earn other types of foreign income, which may be taxed by the State of establishment as long as such income is "effectively connected" with the permanent establishment[610].

To analyse the compatibility of the taxation of a permanent establishment on foreign business income attributable to it with the objective of achievement of the internal market, the existing ECJ case law should first be considered, although such case law does not deal with the very attribution of

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[609] On the taxation of foreign income earned by a permanent establishment, see Philippe Baker, Richard S. Collier, General IFA Report, Cahiers de Droit Fiscal International, *The attribution of profits to permanent establishments*, vol. 91b, 2006, p. 42. The authors mention five reporting countries that (at the time the national reports were written) taxed permanent establishments on their worldwide income: Argentina, Brazil, the Czech Republic, Spain and the United Kingdom. For an analysis of the taxation of UK permanent establishments earning foreign income, see Mario Petriccione, *in* Raffaele Russo (ed.), *The attribution of profits to permanent establishments*, IBFD, 2005, pp. 364-365. See also Wolfgang Schön, *International tax coordination for a second-best world (part III)*, World Tax Journal, October 2010, p. 229: "The setting-up of a permanent establishment in a country leads to 'quasi-worldwide' taxation of the permanent establishment similar to a subsidiary in the country of source".

[610] See particularly article 21(2) of the OECD Model Tax Convention, 2010.

foreign business profits to a permanent establishment (5.2.2). Given the lack of sufficient case law dealing with this issue, ECJ case law is completed by some tax policy considerations (5.2.3).

5.2.2 ECJ case law transposed to the taxation of foreign business profits attributable to a permanent establishment

The ECJ has not yet dealt with the very taxation of foreign business profits earned by a permanent establishment in another Member State. Consequently, whether EU law accepts or precludes the taxation of such profits can only be discussed indirectly, on the basis of other cases.

A first assumption is that permanent establishments are not treated less favourably than resident companies. This is an application of the non-discrimination principle (also existing in the OECD Model Tax Convention) and has been established in EU law ever since the *Avoir Fiscal* case. In many rulings the ECJ has recognised that non-residents, including permanent establishments, may be taxed on a strict domestic basis. In *Futura*, the Court considered that taxing residents on their worldwide income while non-residents where taxed solely on their domestic income "is in conformity with the fiscal principle of territoriality" and "cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty"[611]. This statement was repeated later on, particularly in *Marks & Spencer*[612]. Consequently, the question comes up whether the ECJ just accepts that a Member State of establishment limits its tax jurisdiction and taxes permanent establishments on a strict domestic basis, or whether this is a requirement of EU law. In that respect, it is important to emphasise that in *Royal*

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[611] ECJ, 15 May 1997, case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, para. 22.

[612] See particularly ECJ, 13 December 2005, case C-446/03, *Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)* para. 39: "by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law". See also Opinion of Advocate General Kokott, delivered on 12 September 2006, case C-231/05, *Oy AA*, para. 51.

Bank of Scotland the ECJ stated that "foreign companies carrying on business in that State through a permanent establishment are subject-to-tax there only on the basis of profits which the permanent establishment earns there (limited tax liability)"[613]. The Court went on and observed the "limited fiscal sovereignty of the State of source"[614]. Consequently, it should be analysed whether the "limited fiscal sovereignty" of the Member State of establishment and the "limited tax liability"of a permanent establishment found by the ECJ in *Royal Bank of Scotland* are a requirement imposed by EU law.

Given the following three arguments, it seems unlikely that the ECJ would consider that EU law precludes a Member State from taxing income earned by a permanent establishment outside its territory:

- First, the Court accepted that a non-resident is taxed on foreign income in cases such as *Saint-Gobain*, *Cadbury Schweppes* and *van Hilten*. The ECJ also required the Member State of source to take into account foreign negative income of a non-resident individual in *Renneberg*. Consequently, the Court does not require that non-residents are taxed on a pure domestic basis *per se*.

- Second, taxing the foreign profits of a permanent establishment may not lead to less favourable consequences in the Member State of establishment than if such income were earned domestically, which the ECJ found to be a convincing argument in *Columbus Container*.

- Third, even if foreign business income is taxed not only by the Member State of establishment but also by other States, the ECJ

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[613] See ECJ, 29 April 1999, case C-311/97, *Royal Bank of Scotland plc v Elliniko Dimosio (Greek State)*, para. 29.

[614] *C. cit.*, para. 29. This statement has been interpreted as implying that "Equal treatment should be guaranteed within the boundaries of the limited fiscal jurisdiction of the source Member State": see Sjoerd Douma, *The three Ds of direct taxation: disparity, discrimination and double taxation*, European Taxation, November 2006, p. 527.

seems to consider that the resulting double taxation would stem from "the exercise in parallel by two Member States of their fiscal sovereignty"[615].

Consequently, it seems unlikely that the ECJ would consider that the taxation of foreign business income attributable to a permanent establishment is, as such, in breach of EU law[616]. This means that the "limited fiscal sovereignty" of the Member State of establishment and the "limited tax liability"of a permanent establishment found by the ECJ in *Royal Bank of Scotland* should not be interpreted as a requirement to actually tax non-residents on a pure domestic basis. Such a limited tax jurisdiction and tax liability would trigger certain issues, discussed in the section below.

5.2.3 The taxation of foreign business income attributable to a permanent establishment: tax policy considerations

It is submitted that the compatibility with EU law of the taxation of foreign business profits attributable to a permanent establishment would be a welcomed solution. Indeed, if income attributable to a permanent establishment would be taxable in the Member State of establishment only to the extent that such income has strictly domestic sources, it would create tax planning opportunities and trigger situations of double non-taxation when the foreign income is neither taxed in the State of residence nor in the third State. But at the same time, the possible double taxation resulting from imposing tax on foreign business profits attributable to a permanent estab-

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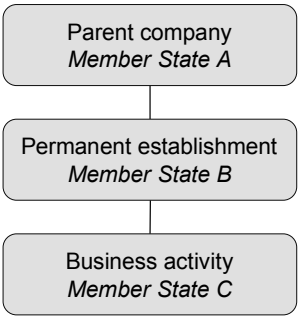
[615] ECJ, 14 November 2006, case C-513/04, *Mark Kerckhaert and Bernadette Morres v Belgische Staat*, para. 20.

[616] As a consequence of the *Saint-Gobain* case the Member State of establishment should, however, eliminate double taxation for permanent establishments as it does for resident companies: see Walter Loukota, *The credit method and Community law*, *in* Michael Lang, Josef Schuch, Claus Staringer (eds.), Tax treaty law and EC law, Kluwer Law International, 2007, p. 146. On triangular cases see John F. Avery Jones, Catherine Bobbett, *Triangular treaty problems: a summary of the discussion in seminar E at the IFA congress in Lisbon*, Bulletin for International Fiscal Documentation, January 1999, pp. 16-20; Nicolas Melot, *Territorialité et mondialité de l'impôt, étude de l'imposition des bénéfices des sociétés de capitaux à la lumière des expériences française et américaine*, Nouvelle Bibliothèque des Thèses, Dalloz, 2004, pp. 386-390.

lishment could be eliminated relatively easily. That is, the drawbacks of taxing foreign business profits attributable to a permanent establishment can be overcome and at the same time such a taxation would prevent certain undesirable tax schemes.

The issues mentioned above are illustrated by the following example. Let us assume that a parent company resident in Member State A has a permanent establishment in Member State B that carries on business activities in Member State C. It is assumed that the business activity is taxable in Member State C only if it constitutes a permanent establishment.



Here, it should be distinguished between two alternative solutions, depending on whether or not a permanent establishment exists in Member State C. If the business activity carried on by the enterprise constitutes a permanent establishment in Member State C, there is no significant risk of double non-taxation since all three States may consider having a right to tax on the income resulting from the business activities in C. There is a risk of double taxation, but such a risk should be able to be eliminated on the basis of the arbitration convention and the principles advocated by the OECD on the attribution of profits to permanent establishments. These principles should help determine which (if any) of the two permanent establishments should be attributed the income, or how to divide the income between Member States A, B and C, thereby preventing a double taxation in these States. At the same time, irrespective of whether the income is taxable in B or C, A should eliminate double taxation by granting a tax exemption or a full tax credit. Difficulties may arise, *e.g.* if Member States A, B and C do not have a common view on the attribution of the profits between the two permanent

establishments. But from a theoretical perspective, the double taxation should be able to be eliminated thanks to the guidance provided by the OECD. Consequently, when a permanent establishment has been identified in the third State, both double taxation and double non-taxation may be avoided, so there is no need to forbid a taxation of foreign business profits attributable to a permanent establishment.

If no permanent establishment exists in Member State C, double non-taxation and double taxation may also occur. In the absence of a permanent establishment in Member State C, the business profits earned in this State will normally not be taxable there, since according to article 7 of the OECD Model Tax Convention business profits may be taxable by the State of source only when such profits are attributable to a permanent establishment. In contrast, the profits earned in Member State C should be taxable in Member State A, because the Member State of residence normally has tax jurisdiction on worldwide income earned by resident companies[617]. If such profits are also taxable by the Member State of establishment double taxation may occur, but this is a matter relating to the attribution of profits to a permanent establishment that may be solved on the basis of the arbitration convention[618] by determining the part of profits that is to be attributed to the permanent establishment. The Member State of residence will then have to eliminate the possible double taxation according to the tax treaty between A and B. For the part of the profits that may be attributed

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[617] Double non-taxation may happen if the Member State of residence applies strictly the fiscal principle of territoriality, but in many cases the home State applies the principle of worldwide taxation and eliminates double taxation through the exemption method. This may imply that the profits of the permanent establishment are taxed in the home State if they are not subject to taxation in the host State. Double non-taxation may also be mitigated by subject-to-tax clauses.

[618] See particularly articles 4 and 6 of the arbitration convention (Convention 90/436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises), the scope of which includes the reassessments of profits attributable to permanent establishments. For a comment on the arbitration convention see Luc Hinnekens, *The tax arbitration convention, its significance for the EC based enterprise, the EC itself and for Belgian and international tax law*, EC Tax Review, 1992-2, pp. 70-105.

to the head office, the Member State of establishment will be obliged to refrain from exercising taxing rights. As a result, double taxation will most likely be eliminated without any need for precluding the taxation of foreign business income by the Member State of establishment. At the same time, if EU law would prevent the Member State of establishment from taxing foreign business income earned in a third State, double non-taxation could occur if the Member State of residence applies the exemption method and considers that the profits earned in Member State C are attributable to the permanent establishment. Given the case law of the ECJ in cases such as *Schempp*, *Marks & Spencer* and *Oy AA*, it seems that the Court is keen on preventing situations of double non-taxation or double deduction in the internal market. It is submitted that the risk of double non-taxation could be significantly mitigated by letting the Member State of establishment tax the permanent establishment on the profits that are attributable to it, even if such profits have a foreign origin.

5.2.4 Conclusion

As a conclusion, the right of the Member State of establishment to tax foreign business income attributable to a permanent establishment would be a satisfying outcome – as long as only profits attributable to the permanent establishment are taxed in the Member State of establishment – since this would help prevent situations of double non-taxation and would not significantly increase the risk of double taxation. This outcome also seems compatible with the case law of the ECJ. It could even be argued that the taxation of such income is desirable in the internal market. Indeed, the omission of such a taxation may open for tax avoidance, which could jeopardise a sound competition throughout the internal market and ultimately threaten the objectives of the European integration.

Below is analysed the tax treatment of foreign negative income incurred outside the territory of the Member State of establishment.

5.3 The tax treatment of foreign negative income attributable to a permanent establishment

5.3.1 Introduction

Non-residents usually have a limited tax liability in the State of source or establishment. As a consequence, a State may not be willing to take into account negative income incurred by a permanent establishment outside its territory. This view finds clear support in international law as a State cannot be required to take into account foreign elements. This is a consequence of the principle of territoriality as it stands in international law. However, requirements under EU law take precedence over international law and deserve particular attention. In this respect, after presenting the relevant case law of the ECJ on the application of the fiscal principle of territoriality in the Member State of establishment (5.3.2), it is argued that such case law is not satisfying and may be in conflict with the objective of achievement of the internal market (5.3.3).

5.3.2 ECJ case law on the tax treatment of foreign negative income in the Member State of source

The ECJ in the *Futura*[619] case accepted that a Member State of establishment does not take into account losses incurred by a non-resident company outside the territory of the Member State of establishment (5.3.2.1). The findings of *Futura* were then transposed to the deduction of costs borne by non-residents in the *Centro Equestre* case (5.3.2.2). Last, it should be considered whether case law applying the *Schumacker* doctrine, and in particular the *Renneberg* case, may contradict the findings of *Futura* (5.3.2.3).

5.3.2.1 The Futura case

The French company Futura Participations SA (hereafter "Futura") had a permanent establishment (Singer) in Luxembourg. The income of the permanent establishment was computed according to an apportionment of the

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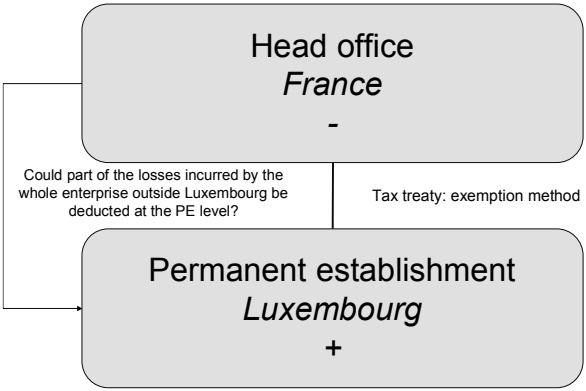
[619] ECJ, 15 May 1997, case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*. For a comment see M.A. Caamaño Anido, J.M. Calderón Carrero, *Accounting, the permanent establishment and EC law: the* Futura Participations *case*, EC Tax Review, 1999-1, pp. 24-38.

total profits of the head office, a method that was allowed under article 7(4) of the OECD Model Convention until it was deleted in the 2010 version of the Model[620].



The total profits of the company were determined based on accounts kept in France and held in French GAAPs. Profits were allocated to each entity on the basis of an apportionment of their turnover. During several years losses were incurred globally and Singer paid no taxes in Luxembourg. However, a profit was made in 1986 so the company tried to carry the previous losses forward in Luxembourg. According to Luxembourg law, a non-resident had the right to carry previous losses forward if (i) the losses were economically related to the income received in that State and if (ii) accounting was kept in Luxembourg according to local GAAPs. Singer fulfilled neither of these conditions and was denied a loss carry forward. Futura and Singer considered that this decision was in breach of the freedom of establishment and appealed it to the Supreme Administrative Court, which referred it to the ECJ for a preliminary ruling.

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[620] For a comment on the new drafting of article 7 of the OECD Model Tax Convention as part of the 2010 update of the Model Convention see Mary Bennett, *La mise à jour 2010 du modèle de convention fiscale de l'OCDE*, Revue de Droit Fiscal, 30 September 2010, pp. 18-22.

The requirement of an economic link is of particular interest for the dissertation. Luxembourg law[621] subjected the loss carry forward for non-residents to the condition that the losses be economically related to "income received locally"[622], *i.e.* the losses were to have their source in Luxembourg[623]. Since the losses attributed to Singer through an apportionment may have included losses incurred outside Luxembourg, loss carry forward was denied. The Luxembourg tax authorities considered that the apportionment did not establish a clear link with domestic income, which Futura considered a breach of the freedom of establishment because residents could deduct foreign losses. All parties deemed Luxembourg rules compatible with EU law. The Commission considered that these rules illustrated the "territoriality principle"[624], which Advocate General Lenz agreed with. In fact, Advocate General Lenz did not regard the requirement of an economic link as a problem at all[625]. Little argumentation did the ECJ need to follow the position of Advocate General Lenz, the European Commission, and the Member States represented before the Court. The ECJ first observed that residents were taxed on their worldwide income while non-residents were taxed only on their income with source in Luxembourg. The Court then considered that "such a system, which is in conformity with the

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621 Article 157(2) of the Law on Taxation of Revenue of the Grand Duchy of Luxembourg.

622 ECJ, 15 May 1997, case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, para. 9.

623 See section 160(1) of the *Loi du 4 décembre 1967 concernant l´impôt sur le revenu*, *Mémorial* number 79, p. 1277, where it is indicated that non-resident companies were subject to corporate income tax solely on their domestic income (*revenu indigène*): "Sont passibles de l'impôt sur le revenu des collectivités pour leur revenu indigène, les organismes à caractère collectif de l'article 159 qui n'ont ni leur siège statutaire ni leur principal établissement sur le territoire du Grand-Duché". See also section 157(1) of the *Loi du 4 décembre 1967 concernant l´impôt sur le revenu*, *Mémorial* number 79, p. 1276: "Les contribuables non résidents ne sont autorisés à défalquer leurs dépenses d'exploitation ou leurs frais d'obtention que pour autant que ces dépenses ou frais sont en rapport économique direct avec des revenus indigènes".

624 Opinion of Advocate General Lenz, delivered on 5 November 1996, case C-250/95, *Futura*, para. 27.

625 Advocate General Lenz considered "far more problematical" the question about the accounting requirements: see *Op. cit.*, para. 28.

fiscal principle of territoriality, cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty"[626]. Luxembourg rules were consequently found compatible with the freedom of establishment. As a result, *Futura* makes clear that the ECJ accepts that the Member State of establishment taxes a permanent establishment solely on income sourced within its territory, according to a strict application of the fiscal principle of territoriality.

The findings of *Futura* were indirectly confirmed in the *AMID*[627] case. *AMID* was about a Belgian company that had a permanent establishment in Luxembourg. The head office was loss-making while the permanent establishment was profit-making. The tax treaty in force between Luxembourg and Belgium provided that profits of a permanent establishment were taxed in the State of establishment and exempted in the State of residence. Belgian law provided that Belgian losses should first be offset against profits made by the permanent establishment, *i.e.* the Member State of residence expected the Member State of establishment to deduct losses incurred at the head office level.

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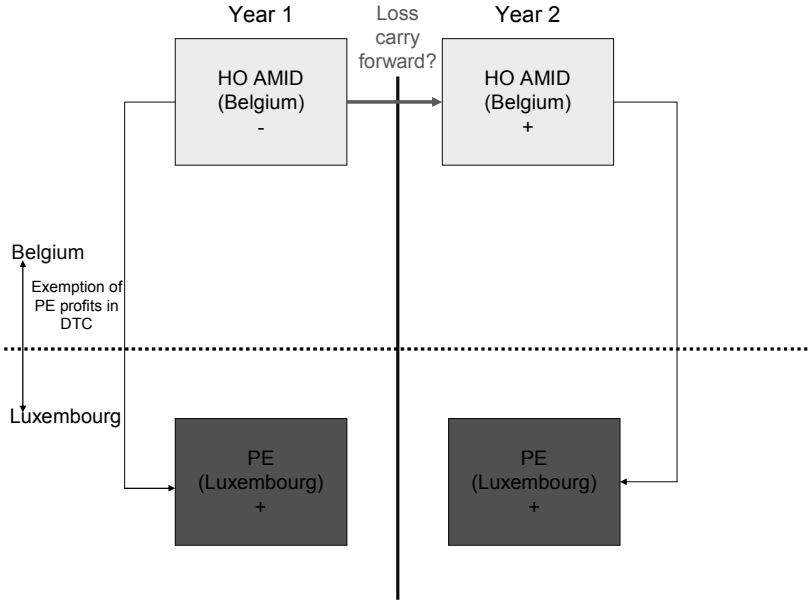
[626] ECJ, 15 May 1997, case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, para. 22. The fiscal principle of territoriality was not even discussed as a justification ground for discrimination between residents and non-residents. When reading paragraph 22 of *Futura*, one could actually consider that the ECJ found taxation according to the fiscal principle of territoriality outside the scope of the EC Treaty, thus being necessarily compatible with EC law. Later case law, however, has shown that such an assumption cannot be made.

[627] ECJ, 14 December 2000, case C-141/99, *Algemene Maatschappij door Investering en Dienstverlening NV (AMID)*. For comments see Luc Hinnekens, *AMID: the wrong bridge or a bridge too far? An analysis of a recent decision of the European Court of Justice*, European Taxation, June 2001, pp. 206-210; John F. Avery Jones, *A comment on "AMID: the wrong bridge or a bridge too far?"*, European Taxation, July/August 2001, p. 251; Frans Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, EC Tax Review, 2003-3, p. 140; Luc De Broe, Niels Bammens, *Belgian companies with foreign permanent establishments: offsetting of losses – The Belgian Velasquez doctrine in non-EU situations: an analysis under Belgian constitutional and treaty law*, Bulleting for International Fiscal Documentation, October 2010, pp. 510-516.



The Belgian tax administration confirmed the refusal to carry the losses forward and the court of appeal asked the ECJ whether this constituted a prohibited discrimination. The ECJ observed that if AMID would have set up the permanent establishment in Belgium, it would have been possible to offset the losses automatically. Consequently the Belgian law was found in breach with the freedom of establishment. As the ECJ did not expect the Member State of establishment to take into account losses from the Member State of residence, *AMID* at least does not contradict, and may even confirm, the findings of *Futura*. Consequently, *AMID* may indirectly confirm that a Member State of establishment may not be required as a consequence of EU law to take into account foreign losses incurred by non-resident companies.

The findings of *Futura* were transposed to the deduction of costs borne by non-residents in *Centro Equestre*.

5.3.2.2 The Centro Equestre case

The deduction of costs with a foreign origin is closely related to the deduction of losses, as losses are the consequence of costs exceeding profits. Ac-

cordingly, it is important to analyse the tax treatment of costs with a foreign origin from the perspective of the Member State of source. The deduction of expenses in the Member State of source was dealt with by the ECJ in cases such as *Gerritse*[628] and *Scorpio*[629], but these cases did not clearly rule on expenses incurred outside the territory of the Member State of source. In *Gerritse*, the Court explained that a non-resident shall have the right to deduct in the Member State of source expenses that are "directly linked to the activity that generated the taxable income"[630] in the State of source. This finding was confirmed and developped in *Scorpio*, where the ECJ considered that "In order to provide the referring court with a useful answer, the concept of 'economically connected business expenses' must therefore be understood as referring to expenses that are directly linked, within the meaning of the line of case-law starting with Gerritse, to the economic activity that generated the taxable income"[631].

In *Centro Equestre*[632] the ECJ had the opportunity to rule in a case that involved expenses partly incurred outside the territory of the Member State of source. In *Centro Equestre* a Portuguese company performed equestrian activities in Germany and was consequently taxed at source on income from the German shows. The Portuguese company had no permanent establishment in Germany but was taxed on the basis of the taxation of artistes and sportsmen. The company sought deduction of expenses related

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[628] ECJ, 12 June 2003, case C-234/01, *Arnoud Gerritse v Finanzamt Neukölln-Nord.*

[629] ECJ, 3 October 2006, case C-290/04, *FKP Scorpio Konzertproduktionen GmbH v Finanzamt Hamburg-Eimsbüttel* (hereinafter referred to as "*Scorpio*"). For an application of the *Gerritse* and *Scorpio* cases in Swedish tax law, see the decision of the Swedish Supreme Administrative Court (*Högsta förvaltningsdomstolen*), 30 December 2010, case number 930-09, *Ikea Services AB.*

[630] ECJ, 12 June 2003, case C-234/01, *Arnoud Gerritse v Finanzamt Neukölln-Nord*, para. 27.

[631] ECJ, 3 October 2006, case C-290/04, *Scorpio*, para. 44.

[632] ECJ, 15 February 2007, case C-345/04, *Centro Equestre da Leziria Grande Lda v. Bundesamt der Finanzen.* For comments, see Ludovic Bernardeau, *Jurisprudence de la CJCE: fiscalité directe (janv./mars 2007)*, Revue de Droit Fiscal, 21 Juin 2007, pp. 20-21; Laurence Idot, *Spectacles dans un autre État Membre et déduction des frais professionnels*, Revue Europe, April 2007, p. 28.

to the income taxable in Germany through an apportionment of costs[633] based on the place where the shows were performed[634]. Deduction was denied, though, as the German domestic law provided that deduction was available only for "operating expenses or business costs that have a direct economic connection"[635] to the income and "are greater than half of that income"[636]. The ECJ, citing *Futura*, confirmed that "it is clear from the Court's case law that a tax system under which, for the purposes of calculating the basis of assessment for non-resident taxpayers in a particular Member State, only profits and losses arising from their activities in that State are taken into account is consistent with the principle of territoriality enshrined in international tax law and recognised by Community law"[637]. As a result, the Court considered that it could not require a Member State of source to accept any foreign cost in its domestic tax base. Requiring a "direct economic connection", even if such a requirement was not applicable to residents, was therefore allowed.

The question is how the requirement of a "direct economic connection" relates to costs with a foreign origin. In that respect, the ECJ explains that "operating expenses directly connected to the income received in the Member State in which the activity is pursued must be understood as being expenses which have a direct economic connection to the provision of services which gave rise to taxation in that State and which are therefore inex-

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633 The taxpayer sought deduction of "communications, travel, accommodation, advertising and personnel costs, in addition to day-to-day expenses relating to the horses, water and electricity supply costs, costs relating to veterinary, medication and blacksmith services and to equipment for horses and riders, transporter and tax advice costs, together with writing down costs for the horses". In addition, the company claimed deduction of "further costs relating to accountancy costs and the payment of licence fees": see ECJ, 15 February 2007, case C-345/04, *Centro Equestre da Leziria Grande Lda v. Bundesamt der Finanzen* para. 10.

634 Since 11 shows out of 14 were performed in Germany, the taxpayers sought deduction of 11/14 of the total costs.

635 ECJ, 15 February 2007, case C-345/04, *Centro Equestre da Leziria Grande Lda v. Bundesamt der Finanzen* para. 6.

636 *Ibid.*

637 *C. cit.*, para. 22.

tricably linked to those services, such as travel and accommodation costs. In that context, the place and time at which the costs were incurred are immaterial"[638]. Two lessons can be drawn from these statements. First, the costs may have been incurred outside the territory of the Member State of source, as the place at which the costs were incurred is "immaterial". Second, the definition of operating expenses directly connected with the income received in the Member State of source is very restrictive: even if costs with a foreign origin may be theoretically deductible in the Member State of source, only few costs may eventually be found "inextricably linked" to the business activity. In addition, the examples mentioned by the Court, *i.e.* "travel and accommodation costs", are typically incurred partly in the State of source as it would not be possible to perform the equestrian shows without actually moving horses, material and staff from Portugal to Germany[639]. By not referring to other costs such as administrative expenses or interest costs that are likely to be incurred outside the State of source, one cannot escape the impression that the costs should be a necessary part of the very business activity as such.

Prima facie, *Centro Equestre* tends to tone down *Futura* as it opens for an option to deduct costs with a foreign origin. However, the extent to which costs with a foreign origin will be deductible in the Member State of source ultimately depends on the definition of costs with a foreign origin that are "inextricably linked" to the business activity, which may not include all costs that are, directly or indirectly, related to the activity in the Member State of source.

Last, it should be considered whether case law applying the *Schumacker* doctrine, and in particular the *Renneberg* case, may contradict the findings of *Futura*.

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[638] *C. cit.*, para. 25.

[639] The French version of the ruling confirms this restrictive approach as the ECJ considered at para. 25 that the costs should be "*indissociables*" from the services.

5.3.2.3 The tax treatment of foreign negative income in the Member State of source according to case law applying the Schumacker doctrine: the Renneberg case

The ECJ in *Schumacker*[640] established a fundamental doctrine for taxing non-resident individuals in the State of source[641]. The Court considered that "the situations of residents and of non-residents are not, as a rule, comparable"[642], given the fact that taxpayers usually earn most of their income in their State of residence[643]. The Member State of residence is then in a better position to grant personal allowances and assess a taxpayer's ability-to-pay taxes. This statement is in conformity with international tax practice: it implies that the State of source is not, as a rule, required to grant to non-residents the same treatment as it grants to its own residents[644].

However, the ECJ found an exception to this rule and considered that the situation of residents and non-residents may be comparable if the non-resident earns most of his income in the State of source, thus being unable to benefit from tax advantages that depend on his personal and family circumstances in his State of residence. Consequently, if a non-resident taxpayer receives the major part of his income from the State of source, the

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[640] ECJ, 14 February 1995, case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker*. For comments see John F. Avery Jones, *What is the difference between Schumacker and Gilly?*, European Taxation, January 1999, pp. 2-3; Peter J. Wattel, *Progressive taxation of non-residents and intra-EC allocation of personal tax allowances: why Schumacker, Asscher, Gilly and Gschwind do not suffice*, European Taxation, June 2000, pp. 210-223.

[641] The facts of the *Schumacker* case were as follows: a Belgian resident received employment income from Germany. The tax treaty between Germany and Belgium attributed an exclusive tax jurisdiction over employment income to the State of source. Mr. Schumacker was taxable in Germany according to domestic law and was refused the benefit of personal deductions that were enjoyed by German residents, which resulted in a higher tax burden.

[642] ECJ, 14 February 1995, case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker*, para. 31.

[643] *C. cit.*, para. 32-33.

[644] See article 24(3) of the OECD Model Tax Convention, 2010: "This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents".

Court requires this last State to treat him as if he were a resident[645]. Following *Schumacker*, non-resident individuals have become more protected in their State of employment[646] in cases such as *Wallentin*[647], *Gerritse*[648], *Conijn*[649], *Ritter-Coulais*[650], *Lakebrink*[651] or *Rennerberg*[652].

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[645] ECJ, 14 February 1995, case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker*, para. 41. It can be observed that the ECJ has actually been consistent in applying the criterion relating to whether or not non-residents have the possibility to benefit from personal and family allowances in their State of residence: in *Gschwind* the Court found that Germany could treat a non-resident less favourably since his personal and family circumstances could be taken into account in the state of residence where he earned 42% of the household's income: see ECJ, 14 September 1999, case C-391/97, *Frans Gschwind v Finanzamt Aachen-Außenstadt*, para. 28-29.

[646] On the comparison between residents and non-residents with regard to the deductibility of costs in the State of source, see Mattias Dahlberg, *The European Court of Justice and direct taxation: a recent change of direction?*, *in* Krister Andersson, Eva Eberhartinger and Lars Oxelheim, *National tax policy in Europe – to be or not to be?*, Springer, 2007, p 168.

[647] ECJ, 1 July 2004, case C-169/03, *Florian W. Wallentin v Riksskatteverket*. In this case, the Court required the State of source to grant a basic allowance to a non-resident as if he were resident, since the taxpayer had earned all his taxable income in the State of source. For comments see Mattias Dahlberg, *Skattenytt internationellt*, 2004-5, pp. 286-287; Anne Rigaux, *Fiscalité directe et libre circulation des travailleurs non résidents*, Revue Europe, August-September 2004, p. 20; Axel Cordewener, *Personal income taxation of non-residents*, *in* Dennis Weber (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, p. 63.

[648] ECJ, 12 June 2003, case C-234/01, *Arnoud Gerritse v Finanzamt Neukölln-Nord*. In this case, the ECJ refused to accept that a non-resident was taxed on a gross basis while a resident could deduct business expenses without restrictions.

[649] ECJ, 6 July 2006, case C-346/04, *Robert Hans Conijn v Finanzamt Hamburg-Nord*. This case confirmed the outcome of the *Gerritse* case.

[650] ECJ, 21 February 2006, case C-152/03, *Hans-Jürgen Ritter-Coulais, Monique Ritter-Coulais v Finanzamt Germersheim*. In this case the ECJ did not accept that the State of source applied a progressive tax rate with taking into account foreign positive income, while foreign negative income could not be relied upon to reduce the applicable tax rate. For comments see Gerard T. K. Meussen, *The* Ritter-Coulais *case, a wrong decision in principle by the ECJ*, European Taxation, July 2006, pp. 335-338.

[651] ECJ, 18 July 2007, case C-182/06, *État du Grand-Duché de Luxembourg v Hans Ulrich Lakebrink, Katrin Peters-Lakebrink*. In this case a non-resident was refused to take into account

Rennerberg gave the opportunity to the ECJ to apply the *Schumacker* doctrine to the determination of the tax base of a non-resident in relation to foreign negative income[653]. A Belgian resident received employment income from the Netherlands while he incurred negative income relating to a dwelling in his State of residence. The negative income could not be offset in the State of residence since no income was earned there. The taxpayer tried to offset the negative income against employment income in the State of source, which was refused by the Dutch tax authorities. Applying the *Schumacker*-doctrine, the ECJ found the refusal incompatible with the free movement of workers. This decision is difficult to reconcile with the case law of the ECJ that refused the double deduction of losses, as *Renneberg* allowed the double deduction of costs[654]. *Renneberg* is also difficult to reconcile with *Futura*, as the Court in *Futura* found no discrimination when a Member State of establishment taxed a non-resident on a pure domestic basis. Likewise, *Renneberg* cannot be fully reconciled with *Centro Equestre*. This is because in

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negative income from immovable property located in the State of residence, while residents taxed on their worldwide income could benefit from lower tax rates when they incurred foreign negative income. The ECJ found that refusal contrary to the free movement of workers. The outcome of *Ritter-Coulais* and *Lakebrink* implies that when a State applies a progressive tax rate for residents taking into account their worldwide positive and negative income, a non-resident earning most of his income in this State should be taxed in the same manner. For comments see Ludovic Bernardeau, *Jurisprudence de la CJCE: fiscalité directe (juill./sept. 2007)*, Revue de Droit Fiscal, 15 November 2007, p. 12.

652 ECJ, 16 October 2008, case C-527/06, *Renneberg v Staatssecretaris van Financiën*. For comments see Gerard T. K. Meussen, Renneberg*: ECJ unjustifiably expands Schumacker doctrine to losses from financing of personnal dwelling*, European Taxation, April 2009, pp. 185-188; Eric Kemmeren, Renneberg endangers the double tax convention system or can a second round bring recovery?, EC Tax Review, 2009-1, pp. 4-15.

653 The ECJ did not take this opportunity in *Ritter-Coulais* despite the suggestions of Advocate General Léger.

654 The taxpayer may carry the losses forward when incurring positive income in the State of residence at a later stage, thereby obtaining a deduction both in the State of source and the the State of residence. Such a double deduction has not been considered by the ECJ in *Renneberg*, which is not in line with the fears of double deduction of losses expressed by the Court in cases such as *Marks & Spencer*, *Oy AA*, or *X Holding*.

Renneberg the costs incurred in the home State were to be deducted in the host State without necessarily having a connection with income incurred in the host State, contrary to the findings of the Court in *Centro Equestre*.

Given the issues evidenced above, a question that may be of relevance is whether *Renneberg* is applicable solely to individuals, or whether this case could encourage the Court to change its case law with regard to permanent establishments and accept the deduction of foreign negative income in the Member State of establishment. The *Schumacker* doctrine relies on a particular distinction based on the part of an individual taxpayer's income that is earned in the State of employment. Such a distinction does not seem, at first sight, impossible to transpose to company taxation. However, this distinction has not been used in case law relating to corporate income tax. In my view, it is not advisable to transpose the *Schumacker* doctrine and the particular findings of the *Renneberg* case to corporate income tax: assessing the worldwide income of a non-resident company to allow the deduction of foreign costs in the Member State of establishment if most of the income of the company is incurred in this State does not correspond to the principles advocated by the OECD on the attribution of profits to permanent establishments. Indeed, transposing the *Schumacker* doctrine would prevent permanent establishments to deduct costs normally attributable to them on the sole basis that the permanent establishment does not earn a sufficient portion of the total income of the company. This would breach the arm's length principle as it stands in Member States' tax treaties and in the arbitration convention, and could additionally frequently happen in practice. It may also lead to situations of double deduction, as such costs would not have been deductible in other countries as a consequence of the arm's length principle. Therefore, it is hoped that the ECJ will not extend the *Schumacker* doctrine to corporate taxation.

The consequences of *Futura* and *Centro Equestre* with regard to the tax jurisdiction of the Member State of establishment are discussed below.

5.3.3 Discussion of the Futura and Centro Equestre cases with regard to the the tax jurisdiction of the Member State of establishment on foreign negative income

5.3.3.1 Introduction

It has been observed that "From a strictly economic point of view, there is only one economic enterprise, and therefore losses incurred by the head office should be deducted from the income of the PE"[655]. Therefore, could it not be expected from the Member State of establishment to take into account foreign losses to relieve a situation of overtaxation and let the company be taxed on a net basis? This idea is relevant within the internal market, and could be implemented in practice with a common consolidated corporate tax base. However, absent a common consolidated corporate tax base, the deduction of foreign costs and losses in the State of establishment raises several problems. Indeed, there is no convincing reason why the Member State of establishment should accept to reduce its tax base by taking into account foreign negative income that is not connected to the activities of the permanent establishment. As was observed *supra* for *Oy AA*[656], requiring the host State to take into account foreign negative income triggers two problems: first, the choice of the host State that should take into account foreign negative income, as a company could choose where to decrease its tax base. Second, the risk that such foreign negative income is taken into account by more than one State, if the company has permanent establishments in several countries and if deduction is sought in several States at the same time.

Consequently, one may feel satisfied with the solution reached in *Futura* and *Centro Equestre* and consisting in allowing a Member State of establishment to refuse to take into account negative business income that is incurred outside its territory when no direct connection exists with income earned in the Member State of establishment[657]. It should be emphasised that the

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[655] Aage Michelsen, General IFA Report, *Tax treatment of corporate losses*, vol. 83a, 1998, p. 47.

[656] See *supra* at 3.3.4.3.

[657] See Aage Michelsen, General IFA Report, *Tax treatment of corporate losses*, vol. 83a, 1998, p. 47: "As the main rule, under both domestic law and bilateral tax treaties, PEs are taxed by

ECJ reached that conclusion based on the observation that non-residents may be taxed on a pure domestic basis[658], considering that such a taxation cannot be regarded as entailing any discrimination[659]. Indeed, the Luxembourg legislation at hand in *Futura* did tax permanent establishments on a pure domestic basis[660], which may explain why, by symmetry, only domestic negative income was deductible[661]. It is true that permanent establishments are not in the same situation as resident companies: the Member State of establishment has a tax jurisdiction that is usually limited by article 7(1) of the applicable tax treaty to income attributable to the permanent establish-

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the hosting country according to a strict territoriality principle without any regard to losses of the same enterprise in another country".

[658] ECJ, 15 May 1997, case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*, para. 21.

[659] *C. cit.*, para. 22; ECJ, 15 February 2007, case C-345/04, *Centro Equestre da Leziria Grande Lda v. Bundesamt der Finanzen* para. 22.

[660] See section 160(1) of the *Loi du 4 décembre 1967 concernant l´impôt sur le revenu*, *Mémorial* number 79, p. 1277: "Sont passibles de l'impôt sur le revenu des collectivités pour leur revenu indigène, les organismes à caractère collectif de l'article 159 qui n'ont ni leur siège statutaire ni leur principal établissement sur le territoire du Grand-Duché". The Luxembourg law distinguished between "revenus indigènes" (*i.e.* domestic income) and "revenus étrangers" (*i.e.* foreign income), thereby focusing on the source of income. As non-residents were taxable only on their "revenus indigènes", they were taxable solely on their income with Luxembourg source. See also Paul Chambers, Keith O'Donnell, Luxembourg report, Cahiers de Droit Fiscal International, *The attribution of profits to permanent establishments*, vol. 91b, 2006, p. 456: "Non-resident taxpayers are only taxable in Luxembourg on Luxembourg source income".

[661] See section 157(1) of the *Loi du 4 décembre 1967 concernant l´impôt sur le revenu*, Mémorial number 79, p. 1276: "Les contribuables non résidents ne sont autorisés à défalquer leurs dépenses d'exploitation ou leurs frais d'obtention que pour autant que ces dépenses ou frais sont en rapport économique direct avec des revenus indigènes". For a concurring view see Axel Cordewener, Georg Kofler, Servaas van Thiel, *The clash between European freedoms and national direct tax law: public interest defences available to the Member States*, Common Market Law Review, 2009-6, p. 1974: "as Luxembourg only taxed the domestic source income of the permanent establishment on the basis of the tax treaty with France, it should be allowed to limit the deductibility of losses to the losses related to the activities of the permanent establishment".

ment, while any foreign business income earned directly by a resident may be taxed by the State of residence. As a result, it is reasonable not to expect the Member State of establishment to take into account any foreign negative income. However, permanent establishments are not always taxed on a pure domestic basis: a permanent establishment may carry on a business activity and earn business income outside the territory of the Member State of establishment. Such foreign business income may be taxable by the Member State of establishment, as long as it is attributable to the permanent establishment.

Therefore, at least for countries following the recommendations of the OECD, what distinguishes the taxation of residents and permanent establishments is primarily the requirement of income being attributable to a permanent establishment on the one hand, while no such requirement exists for residents on the other hand. It is not so much the fiscal principle of territoriality as such that usually distinguishes between residents and permanent establishments: residents may be taxed on a domestic basis[662], and permanent establishments may be taxed on foreign business income[663]. Also, since the theory of force of attraction is not accepted by the OECD members[664], a State of establishment may tax only income that is attributable to a permanent establishment, *i.e.* not all income earned on its territory by the non-resident company. Consequently, it is the requirement of income being attributable to a permanent establishment that usually differentiates between permanent establishments and resident companies, not necessarily a taxation based on the fiscal principle of territoriality.

The solutions reached in *Futura* and *Centro Equestre* should thus be confronted with the fact that permanent establishments are usually taxed on income attributable to them, which may include income with foreign

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[662] This may be the case if a country applies strictly the fiscal principle of territoriality in its domestic tax law, or if the exemption method is chosen in a tax treaty.

[663] See Philippe Baker, Richard S. Collier, General IFA Report, Cahiers de Droit Fiscal International, *The attribution of profits to permanent establishments*, vol. 91b, 2006, p. 42.

[664] See para. 12 of the Commentary on article 7(1) of the OECD Model Tax Convention, 2010.

sources. Accordingly, the following issues are analysed below: the attribution to a permanent establishment of costs originally incurred by another entity (5.3.3.2), the deduction of costs incurred when the permanent establishment carries on business activities in a third State (5.3.3.3), and the application of the profit split method (5.3.3.4). Last, it should be considered how the findings of *Futura* are to be interpreted when the head office incurs final losses (5.3.3.5).

5.3.3.2 The attribution to a permanent establishment of costs originally borne by a foreign entity

Under the arm's length principle, foreign negative income may be attributed to a permanent establishment by a foreign entity[665]. Until the 2008 update of the OECD Model Tax Convention, article 7(3) *in fine* made clear that permanent establishments may be attributed expenses that originate outside the State of establishment: "In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere"[666]. Although this drafting was deleted in the 2010 update of the OECD Model Tax Convention, the new article 7(2) maintains a requirement to deduct such expenses in the State of establishment[667]. It is indeed frequent that a head of-

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[665] For an analysis of the attribution of expenses to a permanent establishment and the question of whether or not a profit mark-up should be added, see Kees van Raad, *Deemed expenses of a permanent establishment under article 7 of the OECD Model*, *in* International Studies in Taxation: Law and Economics, Liber Amicorum Leif Mutén, Kluwer Law International, 1999, pp. 285-295.

[666] See article 7(3) of the OECD Model Tax Convention, 2008. This article was amended in the 2010 update of the OECD Model Tax Convention. For a comment on the new drafting of article 7 of the OECD Model Tax Convention as part of the 2010 update of the Model Convention see Mary Bennett, *La mise à jour 2010 du modèle de convention fiscale de l'OCDE*, Revue de Droit Fiscal, 30 September 2010, pp. 18-22.

[667] See para. 40 of the Commentary to article 7(2) of the OECD Model Tax Convention, 2010: "As now worded, however, paragraph 2 requires the recognition and arm's length pricing of the dealings through which one part of the enterprise performs functions for the benefit of the permanent establishment (e.g. through the provision of assistance in day-to-

fice or another associated enterprise supports costs that are partly incurred for the purpose of a permanent establishment, such as overhead costs. A head office may also incur interests costs related to the financing of the activities of the whole company, part of which should be allocated to the permanent establishment[668].

The problem is that the findings of *Futura* may, at least theoretically, result in encouraging a Member State of establishment to deny the deduction of costs originally borne by the head office or another associated enterprise but attributable to the permanent establishment according to the principles recommended by the OECD. Indeed, the ECJ in *Futura* did not even consider that it was a restriction of the freedom of establishment to refuse the deduction of losses incurred by the head office: a Member State of establishment would have, according to *Futura*, a right to apply strictly the fiscal principle of territoriality and ignore foreign negative income[669].

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day management). The deduction of an arm's length charge for these dealings, as opposed to a deduction limited to the amount of the expenses, is required by paragraph 2. The previous paragraph 3 has therefore been deleted to prevent it from being misconstrued as limiting the deduction to the amount of the expenses themselves. That deletion does not affect the requirement, under paragraph 2, that in determining the profits attributable to a permanent establishment, all relevant expenses of the enterprise, wherever incurred, be taken into account. Depending on the circumstances, this will be done through the deduction of all or part of the expenses or through the deduction of an arm's length charge in the case of a dealing between the permanent establishment and another part of the enterprise".

[668] See the OECD Report on the attribution of profits to permanent establishments, 22 July 2010, particularly pp. 43-46, where it is dealt with the determination of the funding of a permanent establishment. The attribution of interest-bearing debt to a permanent establishment supposes first to determine the funding need of a permanent establishment, which depends on the level of risks assumed by it. Once the funding need has been determined, a "free capital" is attributed to the permanent establishment, *i.e.* funding that does not give rise to a tax deductible return in the nature of interests. The remaining funding need may be provided through interest-bearing debt, in which case interest costs are attributed to the permanent establishment although it is the head office that initially bore such costs.

[669] Actually, it is possible that in *Futura* the head office incurred losses due to the fact that it did not allocate an arm's length amount of costs to the permanent establishment.

May *Centro Equestre* tone down the findings of *Futura*? Indeed, in *Centro Equestre* the ECJ considered that "the place and time at which the costs were incurred are immaterial"[670]. However, as discussed above, the ECJ was very restrictive as it required that costs were "inextricably linked"[671] to the activities, which may not include administrative costs that are not, by themselves, part of the activities performed. The examples provided by the Court, *i.e.* "travel and accommodation costs"[672], confirm this restrictive view. Consequently, although the ECJ in *Centro Equestre* accepted that certain foreign costs may be deducted from the taxable base of a non-resident company, it seems that the Court limited such an obligation to some particular costs: other costs such as overhead or interest expenses may not be "inextricably linked"[673] to the business activities. Therefore, one may have doubts as to whether *Centro Equestre* actually toned down the findings of *Futura*. It is well possible that the Court would not require the Member State of establishment to deduct management fees, overhead costs or interest expenses incurred by the head office but allocated to a permanent establishment.

In addition, *Centro Equestre* did not concern the taxation of a permanent establishment, as this case was about the taxation of artistes and sportsmen. In that respect, no such requirement exists as to the attribution of profits on the basis of the functions performed, the risks assumed, and the assets borne: article 17 of the tax treaty between Germany and Portugal did not deal with how the income of artistes and sportsmen shall be computed, and paragraph 10 of the commentary on article 17(1) of the 2010 OECD Model Tax Convention indicates that "It is for a Contracting State's domestic law to determine the extent of any deductions for expenses". Consequently, the findings of *Centro Equestre* cannot with all certainty be directly transposable to the taxation of permanent establishments. The findings of *Futura* should

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[670] ECJ, 15 February 2007, case C-345/04, *Centro Equestre da Leziria Grande Lda v. Bundesamt der Finanzen* para. 25.
[671] *Ibid.*
[672] *Ibid.*
[673] *Ibid.*

not be disregarded, especially since the ECJ referred to *Futura* in many subsequent cases.

Taxing permanent establishments on the basis of their sole domestic income and refusing to take into account costs incurred by a foreign entity (be it the head office, another permanent establishment, or a group company) raises compatibility issues with the objective of achievement of the internal market as it may imply, in addition to a discrimination between permanent establishments and resident companies, a double non-deduction of costs. Indeed, the costs borne by a foreign entity to the benefit of a permanent establishment are in principle not deductible in the country where they are incurred, as a consequence of the arm's length principle. This is due to the fact that the State in which such costs are incurred would normally consider that these costs should be allocated to the entity benefiting from them. Such a double non-deduction is difficult to reconcile with the requirement that costs or losses are always deductible somewhere according to cases such as *Bosal*, *Marks & Spencer*, *Rewe Zentralfinans*, *Deutsche Shell*, or *Renneberg*.

Furthermore, it is important to emphasise that the geographical origin of the costs is not relevant in itself. Within multinational enterprises, costs may be borne by one entity and ultimately allocated to another, precisely as goods may be sold by an entity the residual profit of which is transferred to another through transfer prices. For example, with regard to intra-group services, the OECD Transfer Pricing Guidelines make clear that "Nearly every MNE group must arrange for a wide scope of services to be available to its members (…). The cost of providing such services may be borne initially by the parent, by a specially designated group member ('a group service centre'), or by another group member"[674]. By refusing the deduction of costs originally incurred by the head office or another entity, the Member State of establishment would contradict the arm's length principle and create a double non-deduction. That would undermine the attractivity of the

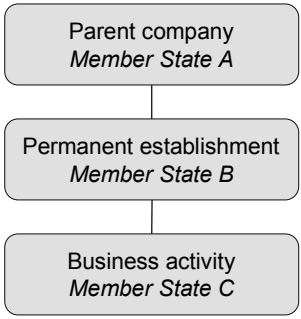
[674] See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, para. 7.2.

Member State of establishment and thereby infringe the freedom of establishment of non-residents considering setting up a permanent establishment within its territory. In addition, companies would be subject to the double non-deduction of costs, which is much less likely to happen within a single State.

Consequently, *Futura* is in conflict with other cases issued by the ECJ as it may result in a double non-deduction of costs and may discourage non-residents from setting up a permanent establishment in the host State. *Futura* also raises problems with regard to foreign negative income incurred by a permanent establishment when carrying on business activities in a third State.

5.3.3.3 Foreign negative income incurred when a permanent establishment carries on business activities in a third State

The *Futura* case may encourage the Member State of establishment not to take into account the costs incurred in a third State, as the ECJ recognised a right to apply strictly the fiscal principle of territoriality and tax a permanent establishment on a pure domestic basis. Let us assume that a permanent establishment carries on business activities and incurs costs in a third country that is a Member State of the European Union. It is also assumed that the activity does not constitute a permanent establishment in the third State and is not taxed there on another ground.



When a resident company conducts a foreign business activity that does not constitute a permanent establishment, the costs related to this activity are often deductible in the State of residence, except if this State applies strictly the fiscal principle of territoriality. According to the principle of non-

discrimination, a permanent establishment shall not be treated less favourably than a resident company: the ECJ has found in several cases such as *Gerritse*[675], *Conijn*[676], or *Centro Equestre*[677] that non-residents shall have the same deduction opportunities as residents in the Member State of source. Therefore, one might wonder whether the non-discrimination principle should imply that foreign costs incurred by a permanent establishment are deductible in the Member State of establishment, or whether *Futura* may preclude the deduction of such costs. It is true that the Court considers that residents and non-residents are, as a rule, not in comparable situations. However, there are convincing arguments pleading for requiring the Member State of establishment to grant a deduction for foreign costs related to foreign activities attributable to a permanent establishment. Indeed, it could be argued that if a permanent establishment carries on business activities in another Member State and that the income related to such activities is taxed by the Member State of establishment, it would be asymmetric not to grant relief for the foreign costs. This would conflict with the requirements of symmetry found in cases such as *Lidl Belgium*[678] and *Krankenheim*[679], as well as in non-tax cases[680]. Although it was argued above that symmetry should not always be a guiding principle[681], in this situation I believe that EU law should require the Member State of establishment to grant deduction for the foreign costs as it does for resident companies, on the condition that

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[675] ECJ, 12 June 2003, case C-234/01, *Arnoud Gerritse v Finanzamt Neukölln-Nord.*

[676] ECJ, 6 July 2006, case C-346/04, *Robert Hans Conijn v Finanzamt Hamburg-Nord.*

[677] ECJ, 15 February 2007, case C-345/04, *Centro Equestre da Leziria Grande Lda v. Bundesamt der Finanzen.*

[678] See ECJ, 15 May 2008, case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, para. 33.

[679] See ECJ, 23 October 2008, case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v Finanzamt für Körperschaften III in Berlin*, para. 42.

[680] It was observed that in non-tax cases the ECJ has accepted that Member States match income and costs: see Peter J. Wattel, *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?*, *in* Dennis Weber (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, p. 146.

[681] See *supra* at 3.3.4.1.1.

such costs are attributable to the permanent establishment[682]. If the Member State of establishment would not allow such costs to be deducted, this would result in a double non-deduction since the costs would also not be deductible in the Member State of residence as a consequence of the arm's length principle. Such a double non-deduction would conflict with cases such as *Bosal*, *Marks & Spencer*, *Rewe Zentralfinans*, *Deutsche Shell*, or *Renneberg*. Such a double non-deduction would also breach the arm's length principle, which would conflict with *Thin Cap Group Litigation* and *SGI*. Therefore, support is found in the Court's case law for considering that a Member State of establishment that taxes the foreign business income earned by a permanent establishment should also admit as deductible the costs related to such foreign business income.

Of course, there could be a risk of double deduction if both the Member State of establishment and the Member State of residence deduct the same costs. However, in principle the costs are deductible only if this is imposed by the arm's length principle, *i.e.* the foreign costs are not automatically deductible: the State of establishment is likely to accept the deduction of such costs if it considers that they are attributable to the permanent establishment under the arm's length principle, and the State of residence would consider that the costs are deductible for the head office only if they are not attributable to the permanent establishment. Therefore, it can be expected that the tax authorities of the Member States of establishment and of residence would admit as deductible only an arm's length amount of costs. In

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[682] On the importance of implementing symmetry in taxation, see Peter J. Wattel, *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?*, *in* Dennis Weber (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, p. 140, where it is considered that there is a "need to match, within the same taxing jurisdiction, tax base reductions and corresponding tax base increases". Wattel considers that the need for symmetry "is so obvious for tax experts that they never coined a word or expression for it": see Peter J. Wattel, *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?*, *in* Dennis Weber (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, pp. 153-154.

addition, the mutual assistance directive[683] as well as provisions on exchange of information in the tax treaties concluded between Member States could help tax administrations to know whether or not the costs have been deducted in the other country.

On the other hand, if the Member State of establishment taxes permanent establishments on a pure domestic basis, as Luxembourg did in the *Futura* case[684], it may at first sight appear more difficult to require the deduction of the foreign costs in the Member State of establishment. At the same time, if the costs would normally be attributable to the permanent establishment according to the principles recommended by the OECD, the Member State of residence would probably also not grant deduction for these costs. Consequently, a double non-deduction is likely to occur. May such a double non-deduction be mitigated by EU law? In that respect, it should not be forgotten that the costs would probably have been deductible in the Member State of establishment if they had been incurred there. Consequently, a difference of treatment may exist between foreign and domestic costs. Such a difference of treatment could be in breach of the principle of non-

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[683] Council Directive 77/799/EEC of 19 December 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation, certain excise duties and taxation of insurance premiums. It should be observed that the Council of the European Union adopted on 15 February 2011 a directive aimed at strengthening administrative cooperation in the field of direct taxation so as to enable Member States to better combat tax evasion and tax fraud. This directive sets out a step-by-step approach aimed at ensuring automatic exchange of information for eight categories of income and capital and is to be transposed into Member States' national laws by 1 January 2013. See 6554/11, 15 February 2011, *Combating tax fraud: Adoption of directive on strengthened mutual assistance and the exchange of information*.

[684] See section 160(1) of the *Loi du 4 décembre 1967 concernant l'impôt sur le revenu*, *Mémorial* number 79, p. 1277: "Sont passibles de l'impôt sur le revenu des collectivités pour leur revenu indigène, les organismes à caractère collectif de l'article 159 qui n'ont ni leur siège statutaire ni leur principal établissement sur le territoire du Grand-Duché". See also Paul Chambers, Keith O'Donnell, Luxembourg report, Cahiers de Droit Fiscal International, *The attribution of profits to permanent establishments*, vol. 91b, 2006, p. 456: "Non-resident taxpayers are only taxable in Luxembourg on Luxembourg source income".

discrimination, which would resemble the situation at hand in the *Laboratoire Fournier* case[685] from the perspective of the Member State of establishment.

As a conclusion, despite the fact that the ECJ upheld the fiscal principle of territoriality in the *Futura* case, there are convincing arguments speaking for requiring a Member State of establishment to deduct costs related to a foreign business activity carried on by a permanent establishment, as long as such costs are attributable to the permanent establishment according to the principles recommended by the OECD[686]. However, a very strict reading of the *Futura* case could lead a Member State to refuse the deduction of costs with a foreign connection incurred by and attributable to the permanent establishment.

Another situation in which a strict reading of the *Futura* case may trigger issues concerns the application of the profit split method within an enterprise when it is globally loss-making.

5.3.3.4 The application of the profit split method when the enterprise is globally loss-making

In its 2008 report on the attribution of profits to permanent establishments, the OECD recommends the "functionally separate entity approach" rather

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[685] ECJ, 10 March 2005, case C-39/04, *Laboratoires Fournier SA v Direction des vérifications nationales et internationales*. For a comment, see Bernard Boutemy, Eric Meier, *Crédit d'impôt recherche - La chasse aux crédits est ouverte!*, Revue de Droit Fiscal, 4 May 2005, pp. 820-822.

[686] It should be emphasised that risks of double deductions or double non-deduction may exist, but these are difficult to avoid in the absence of a harmonised corporate tax base. Even for the domestic income of a permanent establishment differences of interpretation may exist between the State of establishment and the State of residence as to where certain costs should be deducted. Double non-deduction should, in the end, be solved on the basis of the Arbitration Convention, but situations of double deduction cannot be completely avoided. A common consolidated corporate tax base would, in contrast, add all profits and costs together and take them into account no more but also not less than once.

than the "relevant business activity" approach[687]. The functionally separate entity approach is now reflected by the drafting of article 7(2) of the OECD Model Tax Convention since the 2010 update. Accordingly, the profits to be attributed to a permanent establishment are the profits it would have earned at arm's length if it were a legally distinct and separate enterprise. However, to determine the taxable income of each entity within an enterprise, a head office may, together with its permanent establishment(s), apply the profit split method[688]. The special feature of the profit split method is that the taxable income of each entity is not entirely determined on an indivual basis: when certain functions contribute to earning a global profit or incurring an overall loss, the taxable income of each entity may be allocated on the basis of a share of the combined income[689].

The result of the application of the profit split method may be a global loss, if the functions involved in the profit split have been globally loss-making[690]. The OECD Transfer Pricing Guidelines make clear that "References to 'profits' should be taken as applying equally to losses"[691]. Also, the global income should be assessed over the life-time of the arrangement,

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687 OECD Report on the attribution of profits to permanent establishments, 17 July 2008, pp. 21-27.

688 This transfer pricing method may be relevant when transactions are particularly interrelated, *e.g.* when an enterprise is involved in the global trading of financial instruments or when research and development activities are carried on jointly by several entities of the same enterprise or group.

689 This section should also be relevant for the allocation of income within the consolidated area of a common consolidated corporate tax base, as under a common consolidated corporate tax base the taxation of permanent establishments would not strictly enforce the fiscal principle of territoriality but would be consolidated and apportioned as for group companies.

690 The attribution of losses to permanent establishments may be particularly relevant with regard to banks during financial crises. In that respect see Geoff Lloyd, Raffaele Russo, *Addressing tax risks involving bank losses*, Tax Notes International, 15 November 2010, pp. 497-501.

691 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, para. 2.108.

which means that a State should not expect an enterprise to modify the mechanism of a profit split solely because it results in losses, as long as it enforces the arm's length principle[692]. Accordingly, a possible consequence of the application of the profit split method is the attribution of negative income to a permanent establishment when the functions involved in the profit split are globally loss-making. The negative income allocated to the permanent establishment may exceed the losses it incurred by itself during a particular period of time.

Consequently, there may be a conflict between the taxation of permanent establishments according to the fiscal principle of territoriality and the profit split method, when the combined income results in a global loss that is partly allocated to a permanent establishment. Indeed, on the one hand *Futura* may encourage Member States to refuse the deduction of losses with a foreign origin as a consequence of the profit split method, but on the other hand the ECJ (i) insists on avoiding situations of double non-deduction of losses and (ii) accepts the arm's length principle:

- By refusing to deduct the part of the global losses that is attributed to a permanent establishment as part of a profit split arrangement, the Member State of establishment would probably trigger a double non-deduction of such losses. This is because the negative income attributed to the permanent establishment may not be taken into account elsewhere, as each State involved in the profit split arrangement is probably not ready to accept more losses than what is prescribed by the arm's length principle. That would result in a situation of double non-deduction of the losses, which is not in line with the findings of the *Marks & Spencer* case.

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[692] *Op. cit.*, para. 2.117: "The determination of the combined profit to be split and of the splitting factors should generally be used consistently over the life-time of the arrangement, including during loss years, unless independent parties in comparable circumstances would have agreed otherwise and the rationale for using differing criteria or allocation keys is documented, or if specific circumstances would have justified a re-negotiation between independent parties".

- By refusing to deduct the part of the global losses that is attributed to a permanent establishment as part of a profit split arrangement, the Member State of establishment would not respect the arm's length principle that is prescribed by the arbitration convention and tax treaties concluded between Member States, accepted by the ECJ, and recommended by the OECD. More particularly the profit split method is, since the 2010 update of the OECD Transfer Pricing Guidelines, not anymore a method of "last resort"[693]. This means that Member States, who also are members of the OECD, should not necessarily exclude the utilisation of the profit split method. When utilising the profit split method, it should be emphasised that the OECD encourages assessing the global income of the parties involved in a profit split over the life-time of the arrangement[694]. That is, a permanent establishment may be allocated a negative income that exceeds its own income during a certain period of time, but overall the permanent establishment is meant to be attributed an arm's length income that corresponds to its own functions, risks and assets according to the functionally separate entity approach. A Member State refusing the application of the

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[693] On the position of the OECD in 2010 with regard to the profit split method see Caroline Silberztein, *La révision des principes de l'OCDE applicables en matière de prix de transfert*, Revue de Droit Fiscal, 30 Septembre 2010, p. 24: "Pour l'OCDE, la méthode du partage des bénéfices peut offrir une solution pour les activités hautement intégrées pour lesquelles l'application d'une méthode unilatérale ne serait pas appropriée". In contrast, until the 2010 update of the OECD Transfer Pricing Guidelines, the transactional profit methods were considered as methods of "last resort". See particularly para. 3.50 of the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 1995: "There are, however, cases where traditional transaction methods cannot be reliably applied alone or exceptionally cannot be applied at all. These would be considered cases of last resort. Such cases arise only where there is insufficient data on uncontrolled transactions (possibly because of uncooperative behaviour on the part of the taxpayer relative to these Guidelines), or where such data are considered unreliable, or due to the nature of the business situation. In such cases of last resort, practical considerations may suggest application of a transactional profit method either in conjunction with traditional transaction methods or on its own".

[694] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, para. 2.117.

> profit split method at the time it attributes losses to a permanent establishment, while it accepts the same profit split mechanism at more profitable times, would not correctly enforce the arm's length principle because it would isolate the profitability of a permanent establishment in a certain period of time without taking into account the life-time of the arrangement.

Consequently, convincing arguments exist for allowing permanent establishments to enter into a profit split arrangement, even if such an arrangement temporarily leads to allocating losses to the permanent establishment. However, as already observed above, there are risks that Member States rely on *Futura* to justify a strict application of the fiscal principle of territoriality.

The last issue concerns the situation in which final losses are incurred outside the territory of the Member State of establishment.

5.3.3.5 Final losses incurred outside the territory of the Member State of establishment

It was argued above that the ECJ in *Futura* was right not to let a company shift income from the head office to a permanent establishment when such income is not attributable to the permanent establishment. However, it is possible that the head office, another permanent establishment, or a subsidiary incurs final losses. Given that the ECJ, since *Marks & Spencer*, requires Member States to relieve final foreign losses in certain situations, should that affect the Member State of establishment?

It has been argued that "From a strictly economic point of view, there is only one economic enterprise, and therefore losses incurred by the head office should be deducted from the income of the PE"[695]. Indeed, it is clearly desirable that companies be taxed on a net basis in the internal market, as within the domestic market of a single State. That would be the case with a common consolidated corporate tax base. However, absent a common consolidated corporate tax base, I believe that it would not be satisfy-

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[695] Aage Michelsen, General IFA Report, *Tax treatment of corporate losses*, vol. 83a, 1998, p. 47.

ing to require the Member State of establishment to deduct final losses incurred outside its territory when such losses are not attributable to the permanent establishment. The arguments discussed as part of the analysis of the *Oy AA* case are even more valid with regard to permanent establishments, given the limited tax jurisdiction of the Member State of establishment to income that is attributable to such permanent establishments. As in *Oy AA*, the host State has no taxing rights to compensate final foreign losses. Not only would that affect the fiscal principle of territoriality as protected in *Futura*, but also it would breach the arm's length principle. In addition and more importantly, a risk of double utilisation of losses would exist as the Member State of establishment could hardly ensure that the final losses are not deducted elsewhere at the same time. Furthermore, if the head office has several permanent establishments or is part of a group of companies, it cannot be determined with objective criterion which entity should bear the final losses, so there is no reason why the final losses should be attributed to a particular Member State of establishment when these losses could also have been attributed to other States.

Consequently, even if the final losses remain unrelieved, many arguments plead for not attributing such losses to the Member State of establishment. In contrast, relief for final losses incurred in the home State could be much better provided under a common consolidated corporate tax base.

5.4 Conclusion on the tax jurisdiction of the Member State of establishment

This chapter illustrates the conflict between the fiscal principle of territoriality and the objective of achievement of the internal market, as the fiscal principle of territoriality implies an isolation of the tax base and prevents offsetting from positive income negative income incurred in another Member State. The fiscal principle of territoriality prevents taxation on a net basis when the business activity is exercised across the borders and is therefore fundamentally in conflict with the concept of an internal market, as it segments the national markets instead of merging them into a common

one[696]. It is hoped that the ECJ will not stick strictly to the findings of *Futura* in possibly forthcoming cases on the compatibility with the freedom of establishment of the attribution of profits to permanent establishments as recommended by the OECD. Indeed, *Futura* accepts a taxation in the Member State of establishment that strictly follows the fiscal principle of territoriality, which potentially leads to situations of double non-deduction and breaches the arm's length principle. Consequently, *Futura* is in conflict with other cases issued by the ECJ in which double non-deduction was rejected and the arm's length principle upheld. The Court may have wanted to tone down *Futura* in the *Centro Equestre* case, but it was found above that the limited acceptance of foreign expenses is far from being sufficient given the different types of foreign negative income that may be allocated to a permanent establishment.

As a result, the current case law of the ECJ prevents the attribution of foreign negative income to a permanent establishment. This may also be a problem meeting the apportionment of income of permanent establishments as part of a common consolidated corporate tax base[697].

Such consequences are not desirable within the internal market and conflict with more recent case law of the Court. Consequently, it is hoped that the ECJ will broaden the tax jurisdiction of the Member State of establishment and accept the approach recommended by the OECD, as far as this approach recommends taxing a permanent establishment as if it were a separate and independent enterprise[698]. Indeed, the fiscal principle of territorial-

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[696] In that respect see Christiana H.J.I. Panayi, *Double taxation, tax treaties, treaty-shopping and the European Community*, Kluwer Law International, 2007, p. 143: "Community law, through, *inter alia* its fundamental freedoms, aims at removing the borders between Member States. In contrast, the starting point of international tax law is the existence of these borders".

[697] The common consolidated corporate tax base project would include the income of permanent establishments in the consolidated tax base. See CCCTB/WP057annotated\doc, 20 November 2007, *CCCTB: possible elements of a technical outline*, para. 80: "Single companies with EU PEs should (…) be covered by the consolidation rules".

[698] It is emphasised that no statement is made on the compatibility of the whole authorised OECD approach with EU law. It is only argued that some of the principles advocated by

ity has little relevance for the Member State of establishment and as discussed above, it is in conflict with the concept of internal market. In contrast, the approach recommended by the OECD may help achieve the internal market when the fundamental freedoms are exercised through the setting up of a permanent establishment: the authorised OECD approach tends to tax permanent establishments as if they were legal subjects on their own, since article 7(2) of the 2010 OECD Model Tax Convention recommends taxing a permanent establishment as if it were a separate and independent enterprise. This objective is consistent with article 49 TFEU, which, from the perspective of the host State, tends to ensure that permanent establishments and resident companies receive the same treatment[699]. Also, the authorised OECD approach tends to attribute an arm's length amount of income to a permanent establishment, which enforces the requirement of a balanced allocation of the power to impose taxes. In addition, following the authorised OECD approach and taxing a permanent establishment as if it were a separate and independent enterprise may help reduce the risk of double non-deduction and double taxation. In case the authorised OECD approach would still result in double non-deduction or double taxation, such situations may be solved on the basis of the Arbitration Convention.

Therefore, following the authorised OECD approach may, to some extent, help reach the objective of achievement of the internal market by promoting the setting up of permanent establishments, as this approach would entitle permanent establishments to certain rights that may be denied as a result of the case law of the ECJ in *Futura* and *Centro Equestre*. This does not

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the OECD, particularly the separate entity approach, should be seen as compatible with the objective of achievement of the internal market, given the fact that this approach tends to tax permanent establishments in the host State as if they were resident companies, which is in line with the findings of the ECJ in cases such as *Royal Bank of Scotland*.

[699] See *e.g.* ECJ, 29 April 1999, case C-311/97, *Royal Bank of Scotland plc v Elliniko Dimosio (Greek State)*.

mean, however, that all aspects of the authorised OECD approach are compatible with EU law[700].

The next chapter deals with the compatibility with EU law of international double taxation.

[700] Indeed, certain aspects of the authorised OECD approach may entail issues of compatibility with EU law. An example of a potential point of tension between the authorised OECD approach and EU law is the requirement that an amount of free capital be attributed to a permanent establishment, since such a requirement is formally applicable only to permanent establishments, not to resident companies. Although this requirement is intended to make the situations of a permanent establishment and a resident company closer by avoiding that permanent establishments are entirely financed by interest-bearing debt, its practical application may result in differences of treatment with resident companies that could trigger compatibility issues with EU law, for example because of the burden imposed on permanent establishments to compute the amount of free capital. It is, however, not the purpose of this dissertation to analyse the compatibility of the authorised OECD approach with EU law.

6 International double taxation and the objective of achievement of the internal market

"Y-a-t-il plus belle entrave à la libre circulation que la double imposition juridique?"[701].

6.1 Introduction

The purpose of this thesis is to conduct a legal analysis of the conflict between the rules of Member States on the taxation of the foreign business income of companies and the objective of achievement of the internal market. ECJ case law relating to the tax jurisdiction of Member States was studied in the three preceding chapters, which identified compatibility issues with EU law and drew some conclusions relating to the extent of tax jurisdiction that seems best to suit the objective of achievement of the internal market.

These legal analyses are not sufficient, however, to get a complete understanding of the conflict between the objective of achievement of the internal market and the taxation by Member States of companies' foreign business income, because such analyses were conducted for each chapter separately. The combined effects of the taxing rights exercised by several Member States on the same tax subject or tax object were not taken into account. Indeed, as discussed in the preceding chapters, in certain situations the ECJ accepts that a Member State taxes resident companies on their

[701] Melchior Wathelet, *Souveraineté fiscale des Etats membres et Cour de justice: nouvelles tendances ou confirmation?*, Revue de Jurisprudence Fiscale, February 2008, p. 95.

worldwide income[702]. Even non-residents may be taxed on their foreign income, under certain conditions. But at the same time, the State of establishment also has a taxing right over income earned by non-residents on its territory through permanent establishments. Accordingly, the combination of the taxing rights exercised by the different States involved in a certain cross-border business activity exposes the taxpayer to international double taxation[703]. It is submitted that a comprehensive study on the conflict between the rules of Member States on the taxation of the foreign business income of companies and the objective of achievement of the internal market requires analysing the compatibility of international double taxation with EU law, because the outcome of this analysis may have crucial effects on Member States' tax jurisdiction, *i.e.* on the rights to the foreign business income of companies. Consequently, chapter 6 completes the precedings chapters and helps reach the purpose of the dissertation.

It is discussed in this chapter whether or not the objective of achievement of the internal market requires, or should require, the elimination of international double taxation, which would deviate from the situation in international law. If EU law would require the elimination of international double taxation, the tax jurisdiction of Member States on the foreign business income of Member States would be significantly affected by a requirement under EU law to eliminate or mitigate double taxation, particularly for Member States between which no tax treaty has been concluded[704]. Additionally, it could even be argued that a requirement to eliminate double taxation may imply an obligation to get rid of the double non-deduction of

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[702] See conclusions of chapter 4 *supra*. However, it should be observed that the *Cadbury Schweppes* and *Krankenheim* cases raise doubts as to the compatibility with EU law of the principle of worldwide taxation.

[703] A taxpayer may be exposed to taxation in more than two States, which can be referred to as "multiple taxation". However, given the wide utilisation of the expression "double taxation", particularly in the OECD Model Tax Convention, "double taxation" is here preferred to "multiple taxation".

[704] See Moris Lehner, *Avoidance of double taxation within the European Union*, *in* Michael Lang, Josef Schuch, Claus Staringer (eds.), Tax treaty law and EC law, Kluwer, 2007, p. 15.

negative income[705], which could have consequences on cross-border loss relief. The right of Member States to rely on the principle of worldwide taxation and on the fiscal principle of territoriality is, therefore, highly dependent on the compatibility of international double taxation with the objective of achievement of the internal market. An obligation to eliminate double taxation may impact all the different levels of tax jurisdiction over foreign business income analysed in the previous chapters of the dissertation[706]:

- CFC rules may be incompatible with the objective of achievement of the internal market, when such rules lead to double taxation.

- The State of the head office wanting to tax a foreign permanent establishment may be obliged to grant a foreign tax credit or a tax exemption, if double taxation has to be eliminated by the Member State of residence.

- The State of a permanent establishment may be deprived of its tax jurisdiction if double taxation has to be eliminated by the host State.

- Foreign losses incurred by a foreign subsidiary or a permanent establishment may have to be relieved by either the home State or the host State, to avoid situations of double non-deduction.

It was demonstrated in chapter 2 *supra* that the elimination of double taxation is not an obligation under international law[707]. Despite the conclusion of tax treaties, situations of double taxation are far from always solved. The implementation of an arbitration provision in the 2008 update of the

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[705] Indeed, both international double taxation and the double non-deduction of negative income result in a tax burden higher than what single taxation on a net basis would lead to.
[706] An obligation to eliminate double taxation may have other types of consequences. Such consequences are not analysed in the dissertation, which focuses solely on the tax jurisdiction over foreign business income.
[707] See *supra* at 2.3.3.

OECD Model Tax Convention illustrates the need to mitigate cases of double taxation that persist notwithstanding the existence of a tax treaty[708]. The situation in the European Union is, however, subject to particular requirements, in addition to the obligations resulting from the network of tax treaties concluded between Member States. It is true that Member States have been willing to eliminate double taxation in certain situations, particularly upon the cross-border distribution of dividends[709] and with regard to transfer pricing reassessments[710]. However, these particular solutions to situations of double taxation are not studied in the dissertation since they constitute secondary law and cannot, as such, result in a general obligation to eliminate double taxation within the European Union. Consequently, only primary law (6.2) and a selection of cases relating to double taxation (6.3) are discussed in this chapter[711].

6.2 The relation between the EU Treaties and international double taxation

Three types of provisions of the EU Treaties are analysed hereunder with respect to international double taxation: the concept of an internal market that includes but is also broader than the fundamental freedoms (6.2.1), the former article 293 TEC (6.2.2), and article 6 TEU (6.2.3).

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[708] See article 25(5) of the OECD Model Tax Convention as from the 2008 update. For a comment on the arbitration provision see Hugh Ault, Jacques Sasseville, *2008 OECD Model: the new arbitration provision*, Bulletin for International Fiscal Documentation, May/June 2009, pp. 208-215.

[709] Council Directive 90/435/EEC of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States.

[710] Convention 90/436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises.

[711] The purpose of this chapter is not to analyse in details the relation between international double taxation and EU law. The scope of this chapter is limited to an analysis of whether or not a general obligation to eliminate international double taxation may result from the EU Treaties as interpreted by the ECJ. Consequences of this analysis are only discussed with regard to Member States' tax jurisdiction over foreign business income as studied in chapters 3, 4 and 5 of the dissertation.

6.2.1 Double taxation and the concept of an internal market

"an area of total freedom of movement analogous to that provided by a national market"[712].

Establishing an internal market is a fundamental objective of the European Union[713]. It has been reinforced by the Treaty of Lisbon[714] as the new wording of the TEU makes the establishment of an internal market an obligation[715] for the Union, while the former wording of the TEU only made it an "objective"[716]. The internal market is a concept very closely linked to the fundamental freedoms, since it aims at establishing "an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured in accordance with the provisions of the Treaties"[717]. However, the internal market includes more than just the fundamental freedoms, as it refers to "an area without internal frontiers" in addition to a place where the free movement is ensured.

It can be observed that the objective of promotion of the freedom of movement is shared by both the European Union and the OECD. Indeed,

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[712] ECJ, 15 July 2010, case C-70-09, *Hengartner and Gasser*, para. 41.

[713] For an analysis of the concept of an internal market, see Kamiel Mortelmans, *The common market, the internal market and the single market, what's in a market?*, Common Market Law Review, 1998-1, pp. 101-136.

[714] See Official Journal of the European Union, 17 December 2007, C 306/130. For some comments see Yves Bot, *Quelques perspectives après Lisbonne*, La Semaine Juridique Edition Générale, 21 December 2009, pp. 9-12; Fabrice Picod, *Le Traité de Lisbonne : une nouvelle chance pour l'Europe*, La Semaine Juridique Edition Générale, 21 December 2009, pp. 13-15.

[715] See article 3(3) TEU: "The Union shall establish an internal market".

[716] See article 2 of the former TEU, *i.e.* before the entry into force of the Treaty of Lisbon.

[717] See article 26(2) TFEU, which broadens the definition of the internal market provided by article 14(2) TEC to include the TEU. The internal market was also closely linked to the fundamental freedoms in the TEC: according to article 3(c) TEC, the internal market was "characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital". Article 3(c) TEC was repealed by the Treaty of Lisbon but replaced, in substance, by articles 3 to 6 TFEU.

article 2(d) of the Convention that established the OECD[718] provides that in the pursuit of the aims of the OECD[719], the Members agree that they will, both individually and jointly "pursue their efforts to reduce or abolish obstacles to the exchange of goods and services and current payments and maintain and extend the liberalisation of capital movements". In the field of taxation, the objective of enhancing movements of goods, services and capital is mentioned at numerous occasions: paragraph 7 of the Commentary to article 1 of the OECD Model Tax Convention indicates that "The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons"[720]. In the annex to the OECD Model Tax Convention, the OECD members emphasise "the need to remove the obstacles that international juridical double taxation presents to the free movement of goods, services, capital, and persons between countries by the conclusion of conventions for that purpose"[721]. Also, the OECD Transfer Pricing Guidelines state that "double or multiple taxation can create an impediment to cross-border transactions in goods and services and the movement of capital"[722].

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[718] Convention on the Organisation for Economic Co-operation and Development, signed in Paris on 14 December 1960.

[719] The aims are defined at article 1 of the Convention on the Organisation for Economic Co-operation and Development: "The aims of the Organisation for Economic Co-operation and Development (hereinafter called the "Organisation") shall be to promote policies designed: (a) to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy; (b) to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and (c) to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations".

[720] See para. 7 of the Commentary on article 1 of the OECD Model Tax Convention, 2010.

[721] Recommendation of the OECD Council concerning the Model Tax Convention on Income and Capital, adopted on 23 October 1997.

[722] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, preface, para. 4.

It is true that the principles and goals of the European Union and the OECD are not identical[723]. However, one cannot deny that the OECD and the European Union do share some similarities[724] in their objectives[725]. In spite of these similarities, one can observe a gap between, on the one hand, the ambitious goals of elimination of double taxation by the OECD, and, on the other hand, the virtual absence of such ambitions at the level of the European Union[726]. The work of the OECD in the field of international tax

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[723] See Opinion of Advocate General Mischo delivered on 26 September 2002, case C-324/00, *Lankhorst-Hohorst*, para. 80: "Neither the provisions nor the objectives of the OECD model convention, on the one hand, or of the EC Treaty, on the other, are in fact the same".

[724] For example, it can be mentioned that EU Member States are "resolved to ensure the economic and social progress of their States" (see preamble of the TFEU, third indent) while OECD members are "considering that economic strength and prosperity are essential" (see preamble of the Convention on the Organisation for Economic Co-operation and Development, second indent). EU Member States are "anxious to strengthen the unity of their economies" (see preamble of the TFEU, sixth indent), while OECD members are "believing that they can further these aims most effectively by strengthening the tradition of co-operation which has evolved among them" (see preamble of the Convention on the Organisation for Economic Co-operation and Development, third indent). EU Member States are "desiring to contribute, by means of a common commercial policy, to the progressive abolition of restrictions on international trade", (see preamble of the TFEU, seventh indent) while OECD members recognise "that the further expansion of world trade is one of the most important factors favouring the economic development of countries and the improvement of international economic relations" (see preamble of the Convention on the Organisation for Economic Co-operation and Development, ninth indent).

[725] Concurring, see Eric Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models*, Katholieke Universiteit Brabant, Tillburg, 2001, p. 120: "Focusing on the economic objectives of the EC, I conclude that the main objectives of the EC Treaty and the main objective of tax conventions coincide to a large extent".

[726] The elimination of double taxation is also sought by States through their domestic law. Indeed, it is generally considered that the elimination of international double taxation is an essential purpose of international tax law. See Maurice Cozian, Florence Deboissy, *Précis de fiscalité des enterprises*, Litec, 33rd edition, 2010, p. 335: "Dans une économie largement mondialisée, le risque encouru par les entreprises qui s'implantent à l'étranger est celui de la

law aims strongly at the elimination of double taxation, particularly through the Model Tax Convention[727]. On the contrary, the European Union has not at all come that far in the elimination of double taxation, although the parent-subsidiary Directive and the Arbitration Convention do provide for the elimination of double taxation in certain situations.

Paradoxically, Member States of the European Union conclude tax treaties based on the OECD Model Tax Convention with the aim of eliminating double taxation, although not being obliged to do so under international law or under the Convention establishing the OECD. On the other hand, Member States are reluctant to enact provisions eliminating double taxation at the EU level, while the European Union has much more ambitious goals than the OECD vis-à-vis the achievement of an internal market. This paradox is even more obvious given the fact that double taxation can only hinder the exercise of the freedom of movement[728], which both the OECD and the European Union wish to enhance. As explained by Advocate General Colomer, "the fact that a taxable event might be taxed twice is the most serious obstacle there can be to people and their capital crossing internal

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double imposition des bénéfices, qui est l'une des préoccupations majeures du droit fiscal international".

[727] See para. 1 of the Introduction to the OECD Model Tax Convention, 2010: "International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods. Its harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries".

[728] See Melchior Wathelet, *Tax sovereignty of the Member States and the European Court of Justice: new trends or confirmation?*, *in* A vision of taxes within and outside European borders, Festschrift in honor of Prof. Dr. Frans Vanistendael, Kluwer Law International, 2008, p. 916: "is there any better method of restricting the freedom of movement than legal double taxation?". Melchior Wathelet, *Souveraineté fiscale des Etats membres et Cour de justice: nouvelles tendances ou confirmation?*, Revue de Jurisprudence Fiscale, February 2008, p. 95.

borders"[729]. Indeed, if one takes the example of the *Kerckhaert and Morres* case, how could the Belgian taxpayer not be tempted[730] to withdraw his investments from France and instead invest in his home State after having lost his case before the ECJ?

On several occasions, the European Commission has considered that double taxation is incompatible with the internal market[731]. Although Member States have been cautious with regard to the elimination of double taxation, the Resolution on coordinating exit taxation is noteworthy, in which they

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[729] See Opinion of Advocate General Colomer, delivered on 26 October 2004, case C-376/03, *D.*, para. 85.

[730] The Court has at several times stated that the degree to which the fundamental freedoms are threatened is immaterial, a potential infringement being sufficient to be incompatible with EU law. See *e.g.* ECJ, 21 January 2010, case C-311/08, *Société de Gestion Industrielle SA (SGI) v. Belgian State*, para. 50.

[731] See SEC(96) 487 final, 20 March 1996, *Taxation in the European Union*, p. 13: "The Single Market is clearly not compatible with either double taxation of the same taxable base or no taxation at all". See also DOC (05) 2306, 9 June 2005, *EC law and tax treaties*, p. 3: "it is clear that for nationals of Community countries exercising their basic rights under the Treaty, being taxed in different ways because of their nationality or place of residence and, in particular, the risk of being taxed twice on the same income because of the different, uncoordinated national tax arrangements existing within the Community, are obstacles to the smooth functioning of the internal Market". See also COM(2005) 532 final, 25 October 2005, *The Contribution of Taxation and Customs Policies to the Lisbon Strategy*, p. 4: "double taxation, tax-related business restructuring costs and more general differences between Member States' tax rules mean that firms may prefer to operate domestically rather than in another Member State. These are significant obstacles to achieving the full benefits of a competitive internal market. The removal of these barriers would help create new opportunities for market entrants, and the resulting competition would spur investment and innovation. Moreover, the reduction in costs associated with the removal of these tax barriers would contribute to enhancing the competitiveness of the EU productive sector". Double taxation is also discussed at length in COM(2006) 823 final, 19 December 2006, *Coordinating direct tax systems*. See also the public consultation on double taxation problems in the EU, IP/10/469, opened on 27 April 2010. This consultation evidenced several factors that may result in double taxation throughout the internal market: see *Summary report of the responses received – Commission's consultation on double taxation conventions and the internal market: factual examples of double taxation cases*, January 2011.

expressed their "willingness to avoid double taxation with regard to exit taxation"[732]. Such a willingness to avoid double taxation can also be observed in the field of cross-border mergers[733]. Therefore, given the above analysis and its confirmation by the work of the European Commission, it seems uncontroversial to state that double taxation hinders the exercise of the fundamental freedoms, thereby threatening the achievement of the internal market. The ECJ may actually be of that opinion, at least with regard to exit taxation, as it emphasised the "legitimate objective of allocating the power of taxation, in particular for the purposes of eliminating double taxation between Member States"[734]. However, as discussed below, the Court does not require Member States to eliminate double taxation as long as their tax laws are not discriminatory. The acceptance of double taxation as part of the discrimination-based analysis performed by the ECJ shows, in my view, the limits of such an analysis aimed at reaching the objectives established by the EU Treaties[735]. A similar view was expressed by Advocate

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[732] Council Resolution 16412/08 on coordinating exit taxation, 2911th council meeting, 2 December 2008, p. 1: "Recognising, therefore, the appropriateness of coordination aimed at avoiding, with due regard for the principle of subsidiarity, the double taxation which could result from the transfer of economic activities which are subject to two or more jurisdictions". The Council, in the press release 16231/1/08 REV 1, 2 December 2008, p. 23, observed that "this is the first time that the Commission's initiative on the coordination of Member States' direct taxation systems (…) has taken tangible form, in a Council Resolution", referring to COM(2006) 823 final, 19 December 2006, *Coordinating direct tax systems*.

[733] See the preamble of the Council directive 2005/19/EC of 17 February 2005 amending directive 90/434/EEC 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States, third indent: "One of the aims of Directive 90/434/EEC is to eliminate obstacles to the functioning of the internal market, such as double taxation".

[734] ECJ, 7 September 2006, case C-470/04, *N.*, para. 49. See the interpretation of the *N* case by the Commission: COM(2006) 825 final, 19 December 2006, *Exit taxation and the need for co-ordination of Member States' tax policies*, p. 4: "The Commission considers that where two MSs choose to exercise their taxing rights on the same income, they must ensure that this does not result in double taxation. This view also finds implicit support in the ECJ's decision in *N*".

[735] Concurring, see Frans Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, EC Tax Review, 2003-3, p. 143: "The application

General Sharpston, who observed in the *CIBA* case that "where cumulative burdens caused by double taxation amount to restrictions that hinder cross-border activity, the Court should apply by analogy its caselaw on the fundamental freedoms to eliminate such obstacles"[736], particularly "If a true single market is ultimately to be constructed"[737]. One may nevertheless understand the careful approach of the Court in that respect. If a restriction-based analysis would result in finding double taxation incompatible with the objective of achievement of the internal market, this would supposedly decide how to eliminate it, which requires that one or several Member States refrain from exercising taxing rights.

Furthermore, when reading the requirement of an "area without internal frontiers", one cannot escape the impression that the internal market is aimed at functioning as one single State[738]. A single State is, in principle, an area without internal frontiers. Support for that view is found in several cases. For example, in *Polydor*[739], the ECJ found that "the Treaty, by establishing a common market and progressively approximating the economic policies of the Member States, seeks to unite national markets into a single

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of the non-discrimination principle is a rather limited instrument in the overall objective of abolishing the obstacles at the borders of the Member State".

[736] See Opinion of Advocate General Sharpston, delivered on 17 December 2009, case C-96/08, *CIBA*, para. 29.

[737] *Ibid.*

[738] Concurring, see Eric Kemmeren, *The internal market approach should prevail over the single country approach*, *in* A vision of taxes within and outside European borders, Festschrift in honour of Prof. Dr. Frans Vanistendael, Kluwer Law International, 2008, p. 562: "for operations within the European Community, it is essential that the internal market be analogous in nature to the domestic market of a single state"; Eric Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models*, Katholieke Universiteit Brabant, Tillburg, 2001, p. 139: "The common market is analogous in nature to the domestic market of a single state, although it should be emphasised that a genuine internal market still does not exist".

[739] ECJ, 9 February 1982, case C-270/80, *Polydor Limited and RSO Records Inc. v Harlequin Records Shops Limited and Simons Records Limited* (hereinafter referred to as "*Polydor*").

market having the characteristics of a domestic market"[740]. The requirement to achieve an internal market having the characteristics of a domestic market has also been emphasised by the ECJ in tax cases[741]. Referring to a "domestic market" is very close or even similar to a single State, so the *Polydor* case should support the view that the internal market is aiming at implementing the economic conditions that exist within a single State. This view has even been held by the ECJ in cases such as *Commission v France*[742] and *Danner*[743]. Aiming at implementing the economic conditions that exist within a single State requires, in my mind, an evolution from an internal market based on each Member State's individual perspective to a more common perspective. In that respect, the ECJ in *Gaston Schul*[744] found a need to "merge the national markets into a single market bringing about conditions as close as possible to those of a genuine internal market"[745].

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[740] *C. cit.*, para. 16. For a confirmation of a requirement to achieve an internal market having the characteristics of a domestic market, see ECJ, 25 April 1985, case C-207/83, *Commission of the European Communities v United Kingdom of Great Britain and Northern Ireland*, para. 17.

[741] See *e.g.* ECJ, 23 April 1991, case C-297/89, *Rigsadvokaten v Nicolai Christian Ryborg*, para. 14; ECJ, 29 May 1997, case C-389/95, *Siegfried Klattner v Elliniko Dimosio*, para. 25; ECJ, 15 July 2010, case C-70-09, *Hengartner and Gasser*, para. 41: "the Court has observed that the Swiss Confederation did not join the internal market of the Community, the aim of which is the removal of all obstacles to create an area of total freedom of movement analogous to that provided by a national market".

[742] ECJ, 5 October 1994, case C-381/93, *Commission of the European Communities v French Republic*, para. 17: "In the perspective of a single market and in order to permit the realization of its objectives, that freedom likewise precludes the application of any national legislation which has the effect of making the provision of services between Member States more difficult than the provision of services purely within one Member State". Based on this assumption, the ECJ concluded at para. 18 that "Consequently, the provision of maritime transport services between Member States cannot be subject to stricter conditions than those to which analogous provisions of services at domestic level are subject".

[743] ECJ, 3 October 2002, case C-136/00, *Rolf Dieter Danner*, para. 29.

[744] ECJ, 5 May 1982, case C-15/81, *Gaston Schul Douane Expediteur BV v Inspecteur der Invoerrechten en Accijnzen, Roosendaal* (hereinafter referred to as "*Gaston Schul*").

[745] *C. cit.*, para. 33. This view was confirmed by later cases: see *e.g.* ECJ, 17 May 1994, case C-41/93, *French Republic v Commission of the European Communities*, para. 19.

If the internal market is intended to function as one State, should that imply that international double taxation is incompatible with the internal market? Not necessarily. Double taxation may occur within one State, for example when corporate profits are taxed at the company level and are distributed through dividends that are taxed again in the hands of the recipient[746]. The non-deduction of negative income may also occur within one State, for example when costs are not deductible or losses cannot be carried back or carried forward. Consequently, single taxation on a net basis is not assured within one State. Cross-border transactions are, however, more exposed to double taxation than domestic transactions[747]. This is because all cross-border transactions may potentially be taxed by more than one State, and States may tend to refuse the deduction of negative income connected with another territory. Therefore, double taxation in the European Union would probably occur less often if the internal market functioned as one State. Consequently, because double taxation and double non-deduction may also happen within one State, the objective of establishing an internal market that functions as one State cannot, in itself, make international double taxation incompatible with EU law. However, a clear tension remains between the concept of an internal market functioning as one single State and international double taxation.

In addition, what could be argued based on the concept of an internal market that functions as one State, is that the laws of only one[748] Member State should be applied to a certain economic operation[749]. Indeed, the principle

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[746] For an analysis of such double taxation see Leif Mutén, *Bolagsbeskattning och kapitalkostnader*, Almqvist & Wiksell, 1968, pp. 32-54.

[747] For a similar reasoning in the field of social contributions, see ECJ, 15 June 2000, case C-302/98, *Manfred Sehrer v Bundesknappschaft*, para. 34.

[748] Within a single State only one set of rules is applicable at a time for the determination of the corporate tax base. Different sets of rules may be applied but they would not apply in a concurrent way that could lead to double taxation. Rather, they would complete each other.

[749] Some support to this view is found in Frans Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, EC Tax Review, 2003-3, pp. 141-142: "Legally speaking a market is an area where economic activity can be conducted under similar legal rules, so that economic operators can offer their goods and ser-

of territoriality as its stands in international law indicates that the laws of only one State are applied within its territory[750]. Following this line of reasoning would then advocate for taxing business profits within the European Union based exclusively on the tax laws of one Member State, *i.e.* either the Member State of source or the Member State of residence. The example of a snooker table on which the balls could roll without obstacles[751] is better satisfied if one avoids combining the tax laws of several Member States to the same economic activity. Not only would double taxation be significantly mitigated but also uncertainty and some tax planning opportunities[752], although new tax planning opportunities may result from the application of a single set of tax rules.

By applying a single set of tax rules, business income would be taxed either on a worldwide or on a domestic basis, depending on whether priority would be given to the connection with the tax subject (through applying the principle of worldwide taxation) or the tax object (through applying the fiscal principle of territoriality). The credit method would automatically be incompatible with the concept of an internal market, as it implies the combination of the tax jurisdictions of more than one State. Applying a single set of tax rules would, as a consequence, eliminate international double

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vices under similar or comparable conditions of competition. (…) The single Act of 17 February 1987 established a very radical market concept as 'an area without internal borders in which the free movement of goods, persons, services and capital is guaranteed in accordance with the provisions of the Treaty'. This is in fact the concept of a single national market as the environment of a single legal order within which economic operators carry on their activities under the same or similar legal rules".

[750] See *supra* at 2.2.2.1.

[751] See Frans Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, EC Tax Review, 2003-3, p. 139; Frans Vanistendael, *Marché interne et souveraineté fiscale*, *in* Regards critiques et perspectives sur le droit et la fiscalité, Liber Amoricum Cyrille David, LGDJ, 2005, p. 264.

[752] It can be observed that both a common consolidated corporate tax base and home State taxation implement a single set of tax rules applicable to a certain economic activity. On home State taxation see Sven-Olof Lodin, Malcolm Gammie, *Home state taxation*, IBFD, 2001.

taxation, as no combined taxing rights would be exercised. Double non-taxation may also happen, which is not desirable but could be mitigated through measures preventing tax avoidance such as subject-to-tax clauses. This line of reasoning does not indicate, however, which State should be entitled to tax jurisdiction. Indeed, no preference for exclusive source-based taxation or exclusive residence-based taxation can be established by referring to the objective of having the internal market function as one State. However, the previous chapters identified some guidance provided by the ECJ on the dilemma between the fiscal principle of territoriality and the principle of worldwide taxation.

Consequently, several arguments indicate that international double taxation is in conflict with the concept of an internal market: the promotion of the freedoms of movement, the concept of an internal market functioning as a single State in which double taxation is less likely to occur, and the fact that in a single State only one set of laws is applicable.

A second aspect of importance with regard to the relation between international double taxation and EU law is the repeal of the former article 293 TEC.

6.2.2 Consequences of the former article 293 TEC and its repeal by the Treaty of Lisbon

Article 293 TEC was the only provision of the EC Treaty dealing explicitly with double taxation. As such, it has been very much discussed in the doctrine[753]. Since the entry into force of the Treaty of Lisbon article 293 TEC

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[753] See *e.g.* Pasquale Pistone, *The impact of Community law on tax treaties – issues and solutions*, Kluwer Law International, 2002, pp. 69-83; Michael Lang, *Double taxation and EC law*, *in* Reuven S. Avi-Yonah, James Hines and Michael Lang (eds.), Comparative fiscal federalism, Kluwer Law International, 2007, pp. 14-15; Emmanuel Raingeard de la Blétière, *Les relations entre le droit communautaire et le droit fiscal international – nouvelles perspectives*, 2008, pp. 91-105; Eric Kemmeren, *After repeal of article 293 EC Treaty under the Lisbon treaty: the EU objective of eliminating double taxation can be applied more widely*, EC Tax Review, 2008-4, pp. 156-158; Melchior Wathelet, Stéphane Austry, *Retenues à la source au sein de l'Union européenne – des conclusions inquiétantes pour le contribuable*, Feuillets Rapides Francis Lefebvre, 10 October 2008, pp. 7-8;

has been repealed[754]. As a result, double taxation is no longer mentioned in the EU Treaties.

Article 293 TEC was included in the sixth part of the EC Treaty that dealt with general and final provisions[755]. It provided that "Member States shall, so far as is necessary, enter into negotiations with each other with a view to securing for the benefit of their nationals (…) the abolition of double taxation within the Community"[756]. The scope of this article has been clarified by the Court already in the (non-tax) *Mutsch* case[757], and was confirmed with regard to direct taxation in *Gilly*: "Article 220 is not intended to lay down a legal rule directly applicable as such, but merely defines a number of matters on which the Member States are to enter into negotiations with each other 'so far as is necessary'. Its second indent merely indicates the abolition of double taxation within the Community as an objective of any such negotiations"[758]. From the wording of this article it can be identified three sources of doubts as to the binding effect of article 293 TEC:

- First, article 293 TEC invited Member States to enter into negotiations "so far as is necessary": defining in which cases such negotiations are necessary seemed to be up to Member States and not to constitute a general obligation under Community law.

Luc Hinnekens, *The uneasy case and fate of article 293 second indent EC*, Intertax 2009-11, pp. 602-609.

754 On the consequences of the repeal of article 293 TEC, see Eric Kemmeren, *After repeal of article 293 EC Treaty under the Lisbon treaty: the EU objective of eliminating double taxation can be applied more widely*, EC Tax Review, 2008-4, pp. 156-158; Luc Hinnekens, *The uneasy case and fate of article 293 second indent EC*, Intertax, 2009-11, pp. 602-609; Emmanuel Raingeard de la Blétière, *Droit de l'union européenne: chronique de l'année 2009*, Revue de Droit Fiscal, 25 February 2010, pp. 49-50 ; Jérôme Monsenego, *Réflexions sur les conséquences de l'abrogation de l'article 293, alinéa 2 du traité CE*, Revue de Droit Fiscal, 3 March 2011, pp. 15-19.

755 Article 293 TEC was originally included in the Treaty of Rome signed in 1957, at article 220.

756 Article 293 TEC, second indent.

757 ECJ, 11 July 1985, case C-137/84, *Mutsch*, para. 11.

758 ECJ, 12 May 1998, case C-336/96, *Gilly*, para. 15.

- Second, the article referred to the entry into negotiations, not to the actual elimination of double taxation.

- Third, the purpose of such negotiations was unclear, *i.e.* article 293 TEC did not clearly indicate whether Member States should enter into negotiations of mutual agreements through their competent authorities, or whether they should enter into negotiations of tax treaties.

Therefore, it seems correct that the ECJ did not conclude from article 293 TEC alone an obligation to eliminate double taxation.

Another question is whether article 293 TEC actually precluded Community law from requiring the elimination of double taxation in certain situations. On the one hand, this article could be read as excluding an obligation to eliminate double taxation as a consequence of Community law by leaving this issue in the competence of Member States[759]. By letting Member States decide whether or not they were willing to enter into negotiations and eliminate double taxation, article 293 TEC could be interpreted as a provision that actually excluded the elimination of double taxation from the competence of the Community: the intention of the Founding Fathers may have been to let Member States decide when the abolition of double taxation is necessary. On the other hand, the Court indicated in *Gilly* that "the abolition of double taxation within the Community is thus included among

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[759] See Alexandre Maitrot de la Motte, *Souveraineté fiscale et construction communautaire – Recherche sur les impôts directs*, LGDJ, 2005, p. 409: "Les directives « fusions », « mère-filiales », et « intérêts-redevances », ainsi que la directive relative à la fiscalité de l'épargne, possèdent en effet les caractéristiques communes de ne s'appliquer qu'aux opérations transfrontalières et d'éliminer les doubles impositions au sein du Marché commun. (…) la conformité de ces dispositions avec le Traité CE peut être contestée, notamment au regard des atteintes à la souveraineté fiscale des États membres qu'elles emportent. En particulier, ces directives remettent en cause le droit reconnu exclusivement aux États membres de lutter contre les doubles impositions au moyen de conventions fiscales internationales. Ce droit figure pourtant dans l'article 293 du Traité CE".

the objectives of the Treaty"[760]. Consequently, "the avoidance of double taxation is (…) not completely out of the scope of the EC Treaty"[761]. This view is confirmed by cases outside the field of direct taxation such as *Nygård*, in which the ECJ considered that "while the elimination of [the effects of double taxation] is desirable in the interests of the free movement of goods, it may result only from the harmonisation of national systems"[762]. Consequently, it seems that article 293 TEC did not exclude the elimination of double taxation from the competence of the Community[763], as illustrated by measures of secondary law such as the Parent/Subsidiary Directive and the Arbitration Convention.

Article 280 of the Treaty of Lisbon repealed article 293 TEC, without Member States officially indicating why[764]. Given the doubts that could be raised about the binding effect of article 293 TEC and the fact that it may have been intended to exclude the elimination of double taxation from the competence of the Community, the Court should now be free to assess the

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[760] ECJ, 12 May 1998, case C-336/96, *Gilly*, para. 16.

[761] Michael Lang, *Double taxation and EC law*, *in* Reuven S. Avi-Yonah, James Hines and Michael Lang (eds.), Comparative fiscal federalism, Kluwer Law International, 2007, p. 14.

[762] ECJ, 23 April 2002, case C-234/99, *Niels Nygård v Svineafgiftsfonden, and Ministeriet for Fødevarer, Landbrug og Fiskeri*, para. 38.

[763] See Michael Lang, *Double taxation and EC law*, *in* Reuven S. Avi-Yonah, James Hines and Michael Lang (eds.), Comparative fiscal federalism, Kluwer Law International, 2007, p. 15: article 293 TEC "in no way prevents the EC from also taking measures to avoid double taxation".

[764] By repealing article 293 TEC in the Treaty of Lisbon, Member States may no longer be willing to have elimination of double taxation as an objective or a field of competence of the Union. Alternatively, they perhaps considered that the objective of elimination of double taxation was reached. For discussions on the consequences of the repeal of article 293 TEC, see Eric Kemmeren, *After repeal of article 293 EC Treaty under the Lisbon treaty: the EU objective of eliminating double taxation can be applied more widely*, EC Tax Review, 2008-4, pp. 156-158; Luc Hinnekens, *The uneasy case and fate of article 293 second indent EC*, Intertax, 2009-11, pp. 602-609; Emmanuel Raingeard de la Blétière, *Droit de l'union européenne: chronique de l'année 2009*, Revue de Droit Fiscal, 25 February 2010, pp. 49-50.

compatibility of international double taxation with the EU Treaties[765]. Indeed, since article 293 TEC could have been read so that double taxation was excluded from the competence of the Community, and with regard to its interpretation by the ECJ, article 293 TEC can be seen as having been an obstacle for the Court to find double taxation, in itself, incompatible with Community law[766]. Consequently, the repeal of article 293 TEC at any rate leaves more freedom to the ECJ for deciding in cases involving international double taxation based on all the provisions of the EU Treaties, as discussed *infra*.

Another aspect of EU law that may be of importance with regard to international double taxation is the enactment of article 6 TEU.

6.2.3 International double taxation and article 6 TEU

With the adoption of the Treaty of Lisbon[767], the European Union has recognised the Charter of Fundamental Rights of the European Union[768] and agreed on the accession to the European Convention for the Protection of

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[765] For a concurring view, see Jean-Christophe Gracia, *La prévention de la double imposition comme obligation des États membres*, Revue de Droit Fiscal, 18 February 2010, p. 32. For a dissenting view, see Emmanuel Raingeard de la Blétière, *Droit de l'union européenne: chronique de l'année 2009*, Revue de Droit Fiscal, 25 February 2010, p. 52.

[766] It has even been observed that the repeal of article 293 TEC results from the fact that the internal market cannot be conceived without the elimination of double taxation: see Melchior Wathelet, *Taxation des dividendes et droit européen: la Cour européenne tranche*, Feuillets Rapides Francis Lefebvre, 12 January 2007, p. 27: "Même s'il n'a aucune force juridique obligatoire, le traité consitutionnel n'a pas repris dans sa partie III le texte de l'article 293 CE, estimant en quelque sorte que le marché intérieur ne pouvait plus se concevoir sans la suppression de la double imposition sous peine de rendre illusoires les grandes libertés de circulation"; Melchior Wathelet, *Souveraineté fiscale des Etats membres et Cour de justice: nouvelles tendances ou confirmation?*, Revue de Jurisprudence Fiscale, February 2008, p. 95.

[767] See article 6(2) TEU: "The Union shall accede to the European Convention for the Protection of Human Rights and Fundamental Freedoms. Such accession shall not affect the Union's competences as defined in the Treaties".

[768] Charter of Fundamental Rights of the European Union, 2010/C 83/02, Official Journal of the European Union, 30 March 2010.

Human Rights and Fundamental Freedoms[769]. In these texts, two particular principles may be of relevance with regard to the compatibility of international double taxation with EU law: the protection of possessions and the principle of *ne bis in idem*[770]. The wordings of the European Convention for the Protection of Human Rights and the Charter of Fundamental Rights are very close to each other, both with regard to the protection of possessions[771] and the principle of *ne bis in idem*[772].

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[769] Convention for the Protection of Human Rights and Fundamental Freedoms signed in Rome on 4 November 1950.

[770] It is assumed here that these principles are applicable to international double taxation, but more research may be necessary to ascertain this. This is especially the case with respect to the principle of *ne bis in idem*, with regard to which the levy of taxes by two States may not necessarily be considered as being the same jeopardy. Indeed, for the principle of *ne bis in idem* to apply, it is necessary that the "*idem*" criterion is fulfilled, which is not self-evident with regard to international double taxation. For a discussion on the "*idem*" criterion in the case law of the ECHR, see Elisabeth Palm, *Dubbelbestraffning och Europadomstolens praxis*, Svensk Skattetidning, 2010-6/7, pp. 620-631.

[771] Compare article 1 of the Protocol No. 1 to the Convention for the Protection of Human Rights and Fundamental Freedoms ("Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law") with article 17(1) of the Charter of Fundamental Rights of the European Union ("Everyone has the right to own, use, dispose of and bequeath his or her lawfully acquired possessions. No one may be deprived of his or her possessions, except in the public interest and in the cases and under the conditions provided for by law, subject to fair compensation being paid in good time for their loss. The use of property may be regulated by law in so far as is necessary for the general interest").

[772] Compare article 4(1) of the Protocol No. 7 to the Convention for the Protection of Human Rights and Fundamental Freedoms ("No one shall be liable to be tried or punished again in criminal proceedings under the jurisdiction of the same State for an offence for which he has already been finally acquitted or convicted in accordance with the law and penal procedure of that State") with article 50 of the Charter of Fundamental Rights of the European Union ("No one shall be liable to be tried or punished again in criminal proceedings for an offence for which he or she has already been finally acquitted or convicted within the Union in accordance with the law").

Before discussing the possible consequences of the protection of possessions and the principle of *ne bis in idem* with regard to international double taxation (6.2.3.1), attention is paid to the possible legal value in the EU legal system of the European Convention for the Protection of Human Rights and the Charter of Fundamental Rights (6.2.3.2).

6.2.3.1 The possible legal value in the EU legal system of the European Convention for the Protection of Human Rights and the Charter of Fundamental Rights with regard to double taxation[773]

It is distinguished hereunder between the Charter of Fundamental Rights of the European Union (6.2.3.1.1) and the European Convention for the Protection of Human Rights and Fundamental Freedoms (6.2.3.1.2).

6.2.3.1.1 The possible legal value in the EU legal system of the Charter of Fundamental Rights with regard to international double taxation

> "la Charte des droits fondamentaux est déjà une avancée pour les droits du citoyen européen en ce qu'elle montre à ce dernier, par le biais d'une codification des droits politiques et sociaux dans un context accessible, que son rôle dans l'Union européenne n'est pas seulement de nature économique"[774]

The TEU indicates that the Charter of Fundamental Rights of the European Union "shall have the same legal value as the Treaties"[775], which means that it becomes part of the European Union's primary law[776]. As

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[773] This section provides only a tentative analysis of the legal value in the EU legal system of the European Convention for the Protection of Human Rights and the Charter of Fundamental Rights with regard to double taxation, as this issue is – in itself – out of the scope of the dissertation.

[774] Vassilios Skouris, *Avant-propos*, *in* Bertrand Favreau (ed.), La Charte des droits fondamentaux de l'Union européenne après le Traité de Lisbonne, p. XII.

[775] See article 6(1) TEU.

[776] Bertrand Favreau, *La Charte des droits fondamentaux: pourquoi et comment?*, *in* Bertrand Favreau (ed.), La Charte des droits fondamentaux de l'Union européenne après le Traité de Lisbonne, p. 24: "la Charte (…) n'est pas incluse dans le Traité de Lisbonne mais tout sim-

such, it should be part of the ECJ's jurisdiction since the Court is competent with regard to "infringements of the Treaties"[777]. However, several aspects should be taken into account when assessing the potential effect of the Charter on international double taxation.

First, the provisions of the Charter are addressed to the Member States "only when they are implementing Union law"[778]. How to interpret Member States' "implementing Union law"? At first sight, "Union law" should exclude corporate income taxation from the field of application of the Charter because direct taxation is not harmonised[779]. On the other hand, one may argue that all tax laws enacted by Member States are, indirectly, implementing Union law, because such tax laws should be designed as part of what is allowed under the superior EU law requirements as interpreted by the case law of the ECJ[780]. This second interpretation may be rather far-

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plement annexée sous la forme d'une déclaration. Ce qui ne diminue pas sa « valeur de traité » et donc ni son appartenance au droit primaire, ni sa force contraignante".

[777] See article 263 second indent TFEU.

[778] See Article 51(1) of the Charter of Fundamental Rights of the European Union.

[779] In addition, it seems clear that domestic situations that are subject to Member States' competence, contrary to cross border situations, are undisputably outside the scope of the Charter: see Thierry Bontinck, *L'effectivité des droits fondamentaux dans le Traité de Lisbonne*, *in* Bertrand Favreau (ed.), La Charte des droits fondamentaux de l'Union européenne après le Traité de Lisbonne, p. 107: "il est évident à la lecture de la Charte qu'elle ne s'applique pas aux activités nationales qui se situent dans des domaines couverts par les compétences nationales". This means that domestic double taxation should be outside the scope of the Charter.

[780] This interpretation may find some support in the statement of the ECJ according to which "il est de jurisprudence constante que les exigences découlant de la protection des droits fondamentaux lient les États membres dans tous les cas où ils sont appelés à appliquer le droit de l'Union, ceux-ci étant tenus, dans toute la mesure du possible, de ne pas méconnaître lesdites exigences" (ECJ, 12 November 2010, case C-339/10, *Asparuhov Estov and Others*): the wording used by the Court in this case ("appliquer le droit de l'Union ") differs slightly from the one referred to at article 51(2) of the Charter ("mettre en œuvre le droit de l'Union"), the former being possibly broader than the latter. This could imply that the effects of the Charter are not necessarily limited to the implementing of provisions of

reaching given the apparent willingness of Member States to limit the scope of the Charter through excluding areas that are not part of Union law, yet it cannot be excluded that the ECJ may accept such a far-reaching interpretation.

Second, although article 6 TEU indicates that the Charter "shall have the same legal value as the Treaties", this statement does not necessarily confer direct effect to the provisions of the Charter. Indeed, certain provisions of the EU Treaties do not have direct effect, such as the former article 293 TEC. Therefore, the binding power of the Charter is likely to be determined by case law of the ECJ.

Third, article 6(1) TEU indicates that the Charter shall not "extend" the competences of the Union. Article 51(2) of the Charter adds that "The Charter does not extend the field of application of Union law beyond the powers of the Union or establish any new power or task for the Union, or modify powers and tasks as defined in the Treaties". By refusing to "extend" the Union's competences, Member States seem to be refusing that the Charter creates new fields of competences, something that is in accordance with the principles of conferral[781] and subsidiarity[782]. However, applying the Charter to international double taxation does not really create a new field of competence, because it does not deprive Member States of their fiscal sovereignty: tax laws are still enacted and taxes are still levied by Member States themselves, not by the European Union.

Fourth, the Preamble of the Charter indicates that "This Charter reaffirms, with due regard for the powers and tasks of the Union and for the principle of subsidiarity, the rights as they result, in particular, from the constitutional traditions and international obligations common to the Member States, the European Convention for the Protection of Human Rights and Fundamen-

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EU law as such. On the interpretation of this difference see Anne Rigaux, *Champ d'application de la Charte des droits fondamentaux*, Revue Europe, January 2011, p. 11.

[781] See article 5(2) TEU.

[782] See article 5(3) TEU.

tal Freedoms, the Social Charters adopted by the Union and by the Council of Europe and the case-law of the Court of Justice of the European Union and of the ECHR". First of all, it should be emphasised that according to 31(2) of the Vienna Convention on the Law of Treaties, preambles and annexes are clearly to be taken into account when interpreting an international treaty. Therefore, the Preamble of the Charter should be taken into account for its interpretation. This Preamble "reaffirms" rights. This seems to mean that the Charter should only apply to existing rights, *i.e.* it may possibly not create new rights. Consequently, the question is whether being taxed once on the same income in a cross-border situation is an existing right that could by reaffirmed by the Charter. In this respect, it can be observed that the Preamble refers to "international obligations common to the Member States", which leads to wondering whether the tax treaty network between Member States, mostly based on the OECD Model Tax Convention, could be interpreted as "international obligations common to the Member States". As discussed in chapter 2 *supra*, double taxation is not incompatible with international law. Also, tax treaties and in general the work of the OECD in the field of taxes do not always eliminate double taxation, nor are all situations of double taxation covered by tax treaties. Consequently, since there is no right to be taxed only once according to the constitutional traditions and international obligations common to the Member States, no such right could be "reaffirmed". In addition, the rights that may be reaffirmed by the Charter are to be interpreted "with due regard for the powers and tasks of the Union and for the principle of subsidiarity". Consequently, the Preambule tends to indicate that the Charter cannot be invoked to eliminate international double taxation within the internal market. Nevertheless, the Preamble is only a preamble and its actual legal value remains to be seen.

As a result, although several arguments plead for not applying the Charter to international double taxation in the field of corporate income taxes, at the end of the day the binding power of the Charter is likely to be dependent on the interpretation of its provisions by the ECJ.

6.2.3.1.2 The possible legal value in the EU legal system of the European Convention for the Protection of Human Rights with regard to double taxation

The TEU indicates that the European Convention for the Protection of Human Rights "shall constitute general principles of the Union's law"[783]. Contrary to the Charter of Fundamental Rights of the European Union, the European Convention for the Protection of Human Rights does not have – at least explicitly – the same legal value as the Treaties. Whether or not "general principles" may have a direct effect is likely to depend on how the ECJ interprets these principles. It should be emphasised, however, that the protection of possessions[784] and the principle of *ne bis in idem*[785] are clearly binding and considered to have direct effect by the ECHR.

According to article 6(2) TEU, the European Union will become a contracting party of the Convention, the purpose of which is to let the ECHR "scrutinise all acts of the EU institutions and bodies for their compatibility with the European Convention for the Protection of Human Rights"[786]. Taxpayers should accordingly have the right to test the compatibility of ECJ's rulings with the Convention before the ECHR[787], after having exhausted domestic remedies[788]. Since, as mentioned above, the protection of

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[783] See article 6(3) TEU: "Fundamental rights, as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms and as they result from the constitutional traditions common to the Member States, shall constitute general principles of the Union's law".

[784] See for example the decision of the Grand Chamber of the ECHR, 2 March 2005, Nos 71916/01, 71917/01 and 10260/02, *Maltzan and Others v. Germany*.

[785] See for example the decision of the Grand Chamber of the ECHR, 10 February 2009, No 14939/03, *Sergey Zolotukhin v. Russia*.

[786] See MEMO/10/84, 17 March 2010, *European Commission proposes negotiation directives for Union's accession to the European Convention on Human Rights (ECHR) – frequently asked questions*.

[787] See IP/10/291, 17 March 2010, *European Commission acts to bolster the EU's system of protecting fundamental rights*.

[788] See IP/10/906, 7 July 2010, *European Commission and Council of Europe kick off joint talks on EU's accession to the Convention on Human Rights*: "Accession will also provide a new possibility of remedies for individuals. They will be able to bring complaints – after they have exhausted domestic remedies – about the alledged violation of fundamental rights by the EU before the ECHR". It should be observed that the word "individuals" should be interpreted in such a way that companies are included in the scope and benefit from the rights protected

possessions and the principle of *ne bis in idem* are clearly binding and considered to have direct effect by the ECHR, it is possible that this court will also find these principles binding in the context of international double taxation within the internal market.

However, article 6(2) TEU indicates that the accession to the Convention "shall not affect the Union's competences as defined in the Treaties"[789]. How to interpret this limitation to the consequences of the accession to the Convention? One possible interpretation could be that applying the Convention to international double taxation within the internal market may result in limiting Member States' tax jurisdiction, thus affecting the Union's competences through an amplification of the influence of EU law on Member States' tax jurisdiction. Yet, this interpretation is not sufficiently convincing because from a formal point of view, applying the Convention to international double taxation within the internal market does not affect the Union's competences. That is, as observed *supra* for the Charter, applying the Convention to international double taxation alters neither Member States' nor the Union's competence, given the fact that tax laws are still enacted and taxes are still levied by Member States themselves, not by the European Union. Therefore, I find it more convincing to consider that the accession to the Convention should allow the ECHR to apply this Convention to the acts of the European Union including rulings of the ECJ in direct tax cases, as long as the ECHR would not increase, decrease, or modify the competences of the Union.

Given the difficulty to interpret the possible legal value in the EU legal system of the European Convention for the Protection of Human Rights, case law from the ECJ or the ECHR is likely to provide useful guidance. In the absence of indications in that respect, it cannot be excluded that the Convention may have some effects in the field of international double taxation. Therefore, the possible consequences of the protection of possessions and

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by the Convention: see Marius Emberland, *The Human Rights of Companies: Exploring the Structure of ECHR Protection,* Oxford University Press, Oxford, 2006.

[789] See article 6(2) TEU.

the principle of *ne bis in idem* with regard to international double taxation should be analysed.

6.2.3.2 Possible consequences of the protection of possessions and the principle of ne bis in idem with regard to international double taxation

The European Convention for the Protection of Human Rights and Fundamental Freedoms and the Charter of Fundamental Rights of the European Union introduce two principles that may be of relevance with regard to the compatibility of international double taxation with EU law: the protection of possessions (6.2.3.2.1) and the principle of *ne bis in idem* (6.2.3.2.2). These two principles should, however, be considered with regard to the above sections on the possible legal value of the Convention and the Charter in the EU legal system. It was evidenced that their actual legal value may depend on the interpretation of the Charter and the Convention done respectively by the ECJ and the ECHR. In any case, it should be emphasised that since both the protection of possessions and the principle of *ne bis in idem* are protected by the Convention and the Charter, these two rights should receive the same interpretation, which does not prevent Union law from providing more extensive protection[790].

6.2.3.2.1 Possible consequences of the protection of possessions under article 6 TEU with regard to international double taxation within the internal market

Article 1 of Protocol No. 1 to the European Convention for the Protection of Human Rights and Fundamental Freedoms[791] as well as article 17 of the

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[790] See article 52(3) of the Charter of Fundamental Rights of the European Union: "In so far as this Charter contains rights which correspond to rights guaranteed by the Convention for the Protection of Human Rights and Fundamental Freedoms, the meaning and scope of those rights shall be the same as those laid down by the said Convention. This provision shall not prevent Union law providing more extensive protection".

[791] See article 1 of the Protocol No. 1 to the Convention for the Protection of Human Rights and Fundamental Freedoms: "Every natural or legal person is entitled to the peaceful enjoyment of his possessions. No one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law".

Charter of Fundamental Rights of the European Union[792] protect possessions. According to these provisions, the Union's nationals shall not be deprived of their possessions, except if it is in the public interest. These provisions do encompass corporate income tax[793], as the ECHR has ruled several cases in income tax matters[794]. Consequently, it could *prima facie* be argued that the double levy of taxes may violate the protection of possessions under article 6 TEU[795], since international double taxation often results from the uncoordinated levy of taxes by two or more States, which results in decreasing the possessions of a taxpayer subject to two or more tax systems. The fact that a taxpayer's possessions are actually "violated" is supported by the almost unanimous view that international double taxation is undesirable[796].

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[792] See article 17(1) of the Charter of Fundamental Rights of the European Union: "Everyone has the right to own, use, dispose of and bequeath his or her lawfully acquired possessions. No one may be deprived of his or her possessions, except in the public interest and in the cases and under the conditions provided for by law, subject to fair compensation being paid in good time for their loss. The use of property may be regulated by law in so far as is necessary for the general interest".

[793] On the applicability of article 1 of the Protocol No. 1 to the Convention for the Protection of Human Rights and Fundamental Freedoms to taxation see Rusen Ergec, *Taxation and property rights under the European convention on human rights*, Intertax, 2011-1, pp. 2-11; see particularly pp. 7-8 with regard to confiscatory taxes.

[794] See for example ECHR, 23 October 1990, No 11581/85, *Darby v. Sweden*.

[795] See Daniel Gutmann, *Droit fiscal des affaires*, Montchretien, 2010, p. 29: "il pourrait être soutenu que la subsistance d'une double imposition juridique heurte de front l'article 1er du premier protocole additionnel, en tant qu'elle porte atteinte de façon disproportionnée au droit de propriété".

[796] See para. 1 of the Introduction to the OECD Model Tax Convention, 2010: "International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods. Its harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries".

However, it should be emphasised that the second indent of article 1 of Protocol No. 1 provides that the first indent "shall not (…) in any way impair the right of a State to enforce such laws as it deems necessary to (…) secure the payment of taxes". This limit under the second indent of article 1 of Protocol No. 1 is particularly relevant regarding international double taxation. Indeed, a characteristic of international double taxation is that although it may be perceived as very unfair by taxpayers, the taxing States may simply exercise their taxing rights according to domestic law or a tax treaty. That is, international double taxation does not result from a single State taxing an item of income twice. Rather, it results from two States taxing an item of income once, with no avoidance of such a situation being provided by domestic law or a tax treaty. Therefore, each State may be exercising its right to secure the payment of taxes in accordance with the second indent of article 1 of Protocol No. 1.

Still, it should not be forgotten that the purpose of the European Convention for the Protection of Human Rights and Fundamental Freedoms is to grant rights to individuals. It cannot be denied that international double taxation threatens the possessions of a taxpayer. By being unduly taxed twice on the same income, a taxpayer loses part of all of his possessions by the payment of taxes that are due solely because he crossed the border. That a violation of the peaceful enjoyment of possessions results from the action of one or two States should not matter for a taxpayer, as long as his rights have been violated. After all, the Convention does not limit its scope to the actions of a single State.

The situation is delicate as on the one hand, taxpayers see their possessions violated by international double taxation, while on the other hand international double taxation may happen because each State exercises its rights to secure the payment of taxes. Both of these rights are protected by article 1 of Protocol No. 1 to the European Convention for the Protection of Human Rights and Fundamental Freedoms. Consequently, the question is one of balance, *i.e.* it should be established which of these two rights weighs heavier. Article 1, second indent, of Protocol No. 1 to the Convention expressly indicates that the peaceful enjoyment of possessions "shall not, however, in any way impair the right of a State to (…) secure the payment

of taxes or other contributions or penalties". This statement is highly relevant in a domestic context, to let States levy taxes to finance public expenditures. No doubt the levy of taxes is necessary. However, despite article 1, second indent, of Protocol No. 1 to the Convention, the ECHR has already ruled in cases relating to direct taxation. This means that article 1, second indent, of Protocol No. 1 to the Convention is not an absolute rule. Moreover, international double taxation supposes, by definition, that taxes have normally been paid – and public revenues have been financed – not only once, but more than once. That is, not only have the States involved in the international double taxation secured the payments of taxes, but higher taxes than that have been levied. Therefore, despite the second indent to article 1 of Protocol No. 1 to the Convention, international double taxation may still raise compatibility issues with the first indent to the same article. Of course, such compatibility issues do not indicate which State should be responsible for eliminating a possible infringement of the peaceful enjoyment of possessions. But as a matter of principle, it cannot be excluded that international double taxation may be in conflict with the right to a peaceful enjoyment of possessions. Additionally, if from the point of view of principle international double taxation violates article 1 of Protocol No. 1 to the Convention, its actual elimination could be solved in combination with other EU law provisions or case law applicable to other types of issues. Last, article 17 of the Charter does not include a limitation comparable to article 1, second indent, of Protocol No. 1 to the Convention, so the protection of possessions may be better ensured by the Charter than by the Convention.

The ECHR has not ruled in a case involving international double taxation. However, it should be emphasised that the ECHR admitted in the *Building Society* case that a domestic double taxation may violate article 1 of Protocol No. 1 to the European Convention, the taxpayer being possibly "wrongfully expropriated"[797]. This finding may not, in itself, be sufficient to con-

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[797] See ECHR, 23 October 1997, Nos 21319/93, 21449/93, 21675/93, *National & Provincial Building Society, the Leeds Permanent Building Society and the Yorkshire Building Society v. The United Kingdom*. See particularly para. 61. In this case the ECHR did not find that the UK provisions

sider that international double taxation is in breach of article 1 of Protocol No. 1 to the European Convention, because in the domestic context a State should not need to levy tax twice to secure the payment of taxes in accordance with article 1, second indent, of Protocol No. 1 to the Convention. Nevertheless, it should not be underestimated that the ECHR did find that a double tax burden may be incompatible with the peaceful enjoyment of possessions. A possible approach could be for the ECHR to expect States to make sure, together, that their tax jurisdictions do not threaten the peaceful enjoyment of possessions, for example through the conclusion of double taxation conventions.

Consequently, the protection of possessions by the European Convention for the Protection of Human Rights as well as the Charter of Fundamental Rights does not, in itself, seem to prohibit international double taxation, given the current case law of the ECHR. However, this case law could change in the future, particularly since the ECHR has found that a double tax burden may be in breach of the peaceful enjoyment of one's possessions. Also, the protection of possessions gives new tools to the ECJ as well as Union's nationals to fight international double taxation. It does not seem unreasonable to conceive that the ECJ develops its own interpretation of the European Convention for the Protection of Human Rights as well as the Charter of Fundamental Rights. In this respect, if one sets aside the issue of determining which State is responsible for eliminating international double taxation, it can hardly be denied that situations of international double taxation do result in a violation of the peaceful enjoyment of one's possessions. International double taxation seems even less acceptable if one takes into consideration the fact that it results from a taxpayer having exercised his fundamental freedoms.

Therefore, it may be hoped that in future case law the ECJ and the ECHR assess the compatibility of international double taxation with the protection of possessions. If it were to be recognised that international double taxation

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violated the rights protected by the Convention, but it clearly admitted that such a violation may be identified in situations of domestic double taxation.

is a violation of the peaceful enjoyment of one's possessions, the next step would be to determine which State, whether the Member State of source or the Member State of residence, should be held responsible for this incompatibility and should therefore eliminate double taxation. This question is not answered by article 6 TEU, but guidance may be found in the other provisions of the EU Treaties as well as their interpretation by the ECJ.

The second principle that may be of relevance with regard to the compatibility of international double taxation with EU law is the principle of *ne bis in idem*.

6.2.3.2.2 Possible consequences of the principle of ne bis in idem under article 6 TEU with regard to international double taxation

Article 4(1) of Protocol No. 7[798] to the Convention for the Protection of Human Rights and Fundamental Freedoms, and article 50 of the Charter of Fundamental Rights of the European Union[799] implement the principle of *ne bis in idem*. According to this principle, no one shall be tried or punished twice for the same offence. Even if one may *prima facie* consider that the principle of *ne bis in idem* applies solely to criminal law, this principle may also be of relevance in the area of direct tax law. An example is provided by section 51 of the French *Livre des procédures fiscales*, according to which the French tax authorities may not initiate a tax audit for taxes and periods that have already been subject to a tax audit[800]. This principle is also important

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[798] See article 4(1) of the Protocol No. 7 to the Convention for the Protection of Human Rights and Fundamental Freedoms: "No one shall be liable to be tried or punished again in criminal proceedings under the jurisdiction of the same State for an offence for which he has already been finally acquitted or convicted in accordance with the law and penal procedure of that State".

[799] See article 50 of the Charter of Fundamental Rights of the European Union: "No one shall be liable to be tried or punished again in criminal proceedings for an offence for which he or she has already been finally acquitted or convicted within the Union in accordance with the law".

[800] See section 51 of the French *Livre des procédures fiscales*: "Lorsque la vérification de la comptabilité, pour une période déterminée, au regard d'un impôt ou taxe ou d'un groupe

in Belgian tax law, although it does not result from a statutory provision[801]. Moreover, paragraph 48 of the commentary on article 24(3) of the OECD Model Tax Convention refers to countries using the principle of *ne bis in idem* for dividends distributed between companies, thereby wondering whether or not such a treatment may also be enjoyed by permanent establishments in respect of dividends on holdings forming part of their assets[802].

Accordingly, a State may find inspiration in the principle of *ne bis in idem* when designing its direct tax law. However, this does not necessarily imply that the principle of *ne bis in idem*, although it is now part of primary EU law, may have consequences with regard to double taxation within the internal market. Indeed, both article 4(1) of Protocol No. 7 to the Convention for the Protection of Human Rights and article 50 of the Charter of Fundamental Rights are explicitly targeting criminal proceedings. Clearly, the payment of taxes is not a sentence or a punishment: paying taxes on income earned is a fundamental duty, as *e.g.* illustrated by article 13 of the French *Déclaration des Droits de l'Homme et du Citoyen*[803]. However, one may argue that paying taxes a second time on an already taxed income can be

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d'impôts ou de taxes est achevée, l'administration ne peut procéder à une nouvelle vérification de ces écritures au regard des mêmes impôts ou taxes et pour la même période".

[801] See Patrick A. A. Vanhaute, *Belgium in international tax planning*, International Bureau of Fiscal Documentation, 2008, p. 70.

[802] See para. 48 of the Commentary on article 24(3) of the OECD Model Tax Convention, 2010.

[803] See article 13 of the French *Déclaration des Droits de l'Homme et du Citoyen*, 26 August 1789: "Pour l'entretien de la force publique, et pour les dépenses d'administration, une contribution commune est indispensable. Elle doit être également répartie entre tous les Citoyens, en raison de leurs facultés". In that respect, it can be observed that the French *Conseil Constitutionel* found that the levy of taxes may be in breach of article 13 of the French *Déclaration des Droits de l'Homme et du Citoyen*: see French *Conseil Constitutionel*, 26 November 2010, case 2010-70 QPC. This has been interpreted as an incompatibility of juridical double taxation with the French constitution: see Daniel Gutmann, *La double imposition: problèmes contemporains*, Revue de Droit Fiscal, 3 March 2011, p. 10. However, the case at hand was double taxation in a domestic context.

experienced as a punishment of the taxpayer for having crossed the border. Consequently, if the wording of article 4(1) of Protocol No. 7 to the Convention and article 50 of the Charter of Fundamental Rights does not concern taxation, the spirit of this provision, *i.e.* avoiding double jeopardy, may not be totally irrelevant to the context of taxation. In addition, Member States have decided at article 6(3) TEU that "Fundamental rights, as guaranteed by the European Convention for the Protection of Human Rights and Fundamental Freedoms and as they result from the constitutional traditions common to the Member States, shall constitute general principles of the Union's law". This may be interpreted as a sign that Member States are willing to broaden the scope of the principles entailed in the Convention and the Charter of Fundamental Rights, so as to implement these fundamental rights in several fields of the Union's law.

As a conclusion, although the principle of *ne bis in idem* does not explicitly aim at preventing international double taxation, it would not be unreasonable to find inspiration in this principle when considering situations of international double taxation within the internal market. It could even be argued that it may have been the intention of the Member States, when concluding the Treaty of Lisbon, to broaden the scope of the principles protected by the Convention and the Charter of Fundamental Rights, as they "shall constitute general principles of the Union's law". Therefore, the ECJ and the ECHR should offer large freedom of interpretation when dealing with these provisions in the context of international double taxation.

6.2.4 Conclusion on the relation between the EU Treaties and international double taxation

Although the EU Treaties do not explicitly prohibit double taxation within the European Union, the above analysis tends to indicate that international double taxation is at tension with several provisions of the EU Treaties. This conclusion is principally based on the very concept of an internal market, which the ECJ interprets as a requirement to implement the characteristics of a domestic market. Indeed, in a domestic market double taxation happens less frequently and normally only one set of tax rules applies. The tension between international double taxation and the primary law of the European Union also results from the rights protected under article 6 TEU,

although such rights have not yet been found as having direct effect. At any rate, the repeal of article 293 TEC should grant the ECJ more freedom to assessing the compatibility of international double taxation with the objective of achievement of the internal market.

It is now discussed how the ECJ has ruled in cases involving situations of international double taxation.

6.3 The relation between ECJ case law and international double taxation[804]

"Curieusement, c'est en face d'une situation de double imposition économique que la cour se montre le plus pugnace. La situation est curieuse parce que la double imposition économique apparaît davantage comme dommageable en termes d'attractivité économique qu'au regard de l'équité"[805].

Prima facie, one may consider that international double taxation can hardly be compatible with the objective of achievement of the internal market[806]. The ECJ may be of the same opinion[807], certain of its Advocates Gen-

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[804] It is emphasised that only few cases dealing with the compatibility of international double taxation with EU law are discussed in this section of the dissertation. Here, the purpose is to show that international double taxation has not, in itself, been found incompatible with EU law, which may create some inconsistencies with other cases ruled by the ECJ.

[805] Philippe Marchessou, *L'apport de la jurisprudence de la CJCE en matière d'imposition des entreprises*, *in* Martial Chadefaux, Florence Deboissy, Christophe de la Mardière (eds.), Écrits de fiscalité des entreprises – études à la mémoire du professeur Maurice Cozian, 2009, p. 621.

[806] See Melchior Wathelet, *Tax sovereignty of the Member States and the European Court of Justice: new trends or confirmation?*, *in* A vision of taxes within and outside European borders, Festschrift in honor of Prof. Dr. Frans Vanistendael, Kluwer Law International, 2008, p. 916: "is there any better method of restricting the freedom of movement than legal double taxation?". Melchior Wathelet, *Souveraineté fiscale des Etats membres et Cour de justice: nouvelles tendances ou confirmation?*, Revue de Jurisprudence Fiscale, February 2008, p. 95.

[807] See ECJ, 7 September 2006, case C-470/04, *N.*, para. 49.

eral[808], as well as the European Commission[809]. Based on the application of the fundamental freedoms the ECJ has, in certain cases, required Member States to mitigate or eliminate double taxation (6.3.1). However, it is not double taxation as such that has been found incompatible with EU law: non-discriminatory tax rules resulting in double taxation have been found compatible with EU law by the ECJ (6.3.2). It is submitted that this case law is difficult to reconcile with jurisprudence on double non-deduction (6.3.3).

6.3.1 International double taxation may be incompatible with EU law

In some preliminary rulings the ECJ has required a Member State to eliminate double taxation[810]. Double taxation has been found incompatible with EU law both from the perspective of the State of source (6.3.1.1) and of the State of residence (6.3.1.2).

6.3.1.1 Double taxation may be incompatible with EU law as a consequence of the taxing rights exercised by the Member State of source

Hereunder are discussed several cases in which the Member State of source has been required to restrain from exercising a taxing right to mitigate or eliminate double taxation. These cases are *Denkavit II*, *Amurta*, *Aberdeen*, *Commission v Italy*, and *Commission v Spain*. They all deal with withholding taxes levied by the Member State of source.

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[808] See Opinion of Advocate General Colomer, delivered on 26 October 2004, case C-376/03, *D.*, para. 85.

[809] See SEC(96) 487 final, 20 March 1996, *Taxation in the European Union*, p. 13. See also DOC (05) 2306, 9 June 2005, *EC law and tax treaties*, p. 3. See also COM(2005) 532 final, 25 October 2005, *The Contribution of Taxation and Customs Policies to the Lisbon Strategy*, p. 4. See also COM(2006) 823 final, 19 December 2006, *Coordinating direct tax systems*.

[810] Only some of the cases pertaining to situations of double taxation are discussed in this section, as the purpose is only to underline the fact that in certain conditions, double taxation as a result of a tax levied by a Member State of source or residence may be incompatible with EU law.

In *Denkavit II*[811] a French company distributed dividends to a Dutch parent company, subject to a 5% withholding tax according to the tax treaty in force between France and the Netherlands. In contrast, a domestic parent company would be taxable only on 5% of the dividend received. Dividends received by the Dutch parent company were not taxable in the Netherlands, so the withholding tax levied in the Member State of source could not be offset in the State of residence. Consequently, the dividend as such was not subject to a double taxation[812], but the company was subject to a double taxation[813] of its profits when distributing dividends. The ECJ observed that France had implemented a regime "designed to avoid the imposition of a series of charges to tax on the profits of subsidiaries which are distributed by way of dividend to the parent companies of those subsidiaries"[814]. That is, the French rules aimed at the elimination of double taxation upon the distribution of dividends to domestic recipients. The principle of non-discrimination required that such elimination of double taxation be extended to outbound dividends, but the French Government argued that "it is for the State in which the taxpayer is resident, and not for the State in which the taxed income has its source, to rectify the effects of double taxation"[815].

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[811] ECJ, 14 December 2006, case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*. For comments see Frans Vanistendael, *Denkavit Internationaal: the balance between fiscal sovereignty and the fundamental freedoms?*, European Taxation, May 2007, pp. 210-213; Melchior Wathelet, *Taxation des dividendes et droit européen: la Cour européenne tranche*, Feuillets Rapides Francis Lefebvre, 12 January 2007, pp. 25-27.

[812] Indeed, dividends were taxed solely upon distribution to foreign shareholders through a withholding tax, but they were not taxed in the hands of the recipient.

[813] Double taxation in France resulted from a first taxation upon the realisation of profits, and a second taxation upon distribution to foreign shareholders. It should be observed that this double taxation was not international but domestic, as it resulted from the sole tax jurisdiction of France.

[814] ECJ, 14 December 2006, case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, para. 37.

[815] *C. cit.*, para. 51.

That argument was correctly dismissed by the ECJ. Indeed, the State of residence may apply the exemption method – as the Netherlands did in *Denkavit II*, which lets the tax burden in the State of source remain. The State of residence may also apply an ordinary tax credit, which does not eliminate double taxation in the State of source: an ordinary tax credit limits, totally or partly, the tax burden in the State of residence, depending on the tax rates at hand, but it does not eliminate the effects of taxation in the State of source. Only a full tax credit could eliminate the effects of taxation in the State of source, which has been rejected by the ECJ since the *Gilly* case[816]. That argument was consequently dismissed, which in my view is particularly relevant with regard to the principle of sincere cooperation[817]. Indeed, it would not be in line with the principle of sincere cooperation for a Member State to justify its infringing tax rules by measures to be taken by another Member State. This could encourage Member States to levy taxes in a way not enhancing the objective of achievement of the internal market. As a result, the ECJ in *Denkavit II* required the Member State of source to extend to non-residents a set of rules intended at the elimination of double taxation resulting from the combination of the realisation of profits and the distribution of dividends[818].

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[816] This analysis was confirmed in later case law: see ECJ, 12 December 2006, case C-446/04, *Test Claimants in the Franked Investment Income Group Litigation v Commissioners of Inland Revenue*, para. 52; ECJ, 19 November 2009, case C-540/07, *Commission v Italy*, para. 38; ECJ, 3 June 2010, case C-487/08, *Commission v Spain*, para. 60-62. The Court recognised the possible neutralisation of a withholding tax by a higher taxation in the Member State of residence or if a full tax credit is granted, but it did not find an obligation to grant such a full tax credit. For a discussion of whether or not EU law should require the granting of a full tax credit, see *supra* at 4.2.4.

[817] See article 4(3) TEU.

[818] It should be observed that equal treatment between domestic and outbound dividends is not required when the Member State of source does not tax outbound dividends while domestic dividends are taxed: see ECJ, 12 December 2006, case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue*. For comments see Frans Vanistendael, *Denkavit Internationaal: the balance between fiscal sovereignty and the fundamental freedoms?*, European Taxation, May 2007, pp. 210-213; Melchior Wathelet, *Taxation des dividendes et droit européen: la Cour européenne tranche*, Feuillets Rapides Francis Lefebvre, 12 January 2007,

The findings of *Denkavit II* have been confirmed in the *Amurta*[819] case, in which the Netherlands levied a withholding tax on outbound dividends not falling under the Parent/Subsidiary Directive. No such withholding tax was levied on domestic dividends. The Dutch system was found incompatible with the fundamental freedoms because of the difference of treatment between domestic and foreign shareholders. In the *Aberdeen*[820] case the ECJ came to the same conclusion, as Finland taxed outbound dividends paid to parent companies not covered by the Parent/Subsidiary Directive whereas dividends paid to domestic shareholders were exempt from tax. The Court ruled similarly in *Commission v Italy*[821] and *Commission v Spain*[822].

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pp. 25-27. In this case, the UK did not grant a tax credit to outbound dividends, in contrast to domestic dividends, as it did not tax such outbound dividends. The ECJ consequently accepted that the UK treated domestic and outbound dividends differently as they were not in a comparable situation.

[819] ECJ, 8 November 2007, case C-379/05, *Amurta SGPS v Inspecteur van de Belastingdienst*. For comments see Tom O'Shea, *ECJ Strikes Down Dutch Taxation of Dividends*, Tax Notes International, 14 January 2008, pp. 103-106; Ludovic Bernardeau, Frédéric Schmied, *Jurisprudence de la CJCE: fiscalité directe (oct./déc. 2007)*, Revue de Droit Fiscal, 21 February 2008, pp. 15-16.

[820] ECJ, 18 June 2009, case C-303/07, *Aberdeen Property Fininvest Alpha Oy*. For comments see Tom O'Shea, *ECJ finds Finnish withholding tax rules unacceptable in Luxembourg SICAV case*, Tax Notes International, 27 July 2009, pp. 305-308; Romain Grau, Etienne Genot, *Application discriminatoire d'une retenue à la source sur les dividendes versés à une SICAV*, Revue de Droit Fiscal, 3 September 2009, pp. 62-64.

[821] ECJ, 19 November 2009, case C-540/07, *Commission v Italy*. For comments, see Tom O'Shea, *Italian Outbound Dividend Tax Rules Breach EU Law*, Tax Notes International, 18 January 2010, pp. 218-221; Ludovic Bernardeau, *Jurisprudence de la CJUE: fiscalité directe (juill./déc. 2009)*, Revue de Droit Fiscal, 28 January 2010, pp. 13-14; CFE ECJ Task Force, *Opinion statement of the CFE on outbound dividends:* Commission v. Italy *(C-540/07)*, European Taxation, July 2010, pp. 312-316.

[822] ECJ, 3 June 2010, case C-487/08, *Commission v Spain*. For comments see Julie Dupont-Lasalle, *Fiscalité des dividendes*, Revue Europe, August-September 2010, pp. 20-21; Ludovic Bernardeau, *Jurisprudence de la CJUE: fiscalité directe (janv./juin 2010)*, Revue de Droit Fiscal, 14 October 2010, p. 14.

Consequently, the ECJ found in the above described cases that a Member State of source may be infringing EU law by not relieving double taxation of companies' distribution of profits in a cross-border context, while it eliminates double taxation internally. However, it seems that it is not so much double taxation as such that has been found incompatible with EU law in these cases. Rather, it is the different treatment between domestic and cross-border dividends distributions that was not accepted by the ECJ, outbound dividends being treated less favourably. This is illustrated *e.g.* by the sub-conclusion drawn by the Court at paragraphs 29 and 30 of *Denkavit II*. It was enough for the Court to observe that the French rules taxed domestic and outbound dividends differently to find a restriction of the freedom of establishment. That is, if the French system taxed outbound dividends as domestic dividends, it would probably have been found compatible with EU law, although it did not completely eliminate double taxation on companies' profits. Such profits were indeed taxed upon realisation, and 5% of the profits distributed were taxed in the hands of the domestic shareholders[823]. As a result, the ECJ in *Denkavit II* did not require a complete elimination of double taxation but only a mitigation of such double taxation, to extend national treatment to foreign shareholders.

It is important to observe that in *Denkavit II* the ECJ was asked whether the treatment in the State of residence should also be considered. If the Court had applied a pure per-country approach, it would probably have refused to pay attention to the tax treatment in the Netherlands[824]. The ECJ, however, accepted to discuss an argument put forward by the French Government,

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[823] According to section 216 of the French *Code général des impôts*, 95% of domestic dividends were exempt from tax. The remaining 5% were subject-to-tax in the hands of the recipient.

[824] Contrary to the ECJ, the EFTA Court applied a per-country approach in a case that also concerned the taxation of outbound dividends. See EFTA Court, 23 November 2004, case E-1/04, *Fokus Bank*. For a comment on the *Fokus Bank* case and an analysis of the per-country approach and the overall approach see Dennis Weber, *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, Kluwer Law International, 2006, pp. 33-48. The European Commission found support in the *Fokus Bank* case to argue in favour of a per-country approach: see ECJ, 3 June 2010, case C-487/08, *Commission v Spain*, para. 17.

considering that it had to take into account the "legal framework applying to the main proceedings"[825]. Ultimately, this combined or "overall"[826] approach did not change the outcome of the case[827]. The theoretical option to compensate an infringement of the fundamental freedoms by the Member State of source through taking into account the tax treatment in the Member State of residence was confirmed in later cases such as *Amurta*[828], *Commission v Italy*[829] and *Commission v Spain*[830].

The purpose of this overall approach is not easily interpreted with regard to the elimination of international double taxation. By potentially admitting that the Member State of residence may have eliminated the discrimination, the Court accepts the tax jurisdiction exercised by the Member State of source although it may be discriminatory, something that contradicts the findings of many cases where the ECJ relied on a discrimination-based analysis. Consequently, the Court may not consider that EU law requires capital import neutrality, *i.e.* equal treatment in the Member State of source. In addition, one could interpret the analysis of the Court as an implicit preference for the elimination of double taxation by the Member State of residence, as the ECJ would not necessarily require the Member State of source to limit its taxing rights if double taxation could be eliminated by the Member State of residence. Such a preference for double taxation to be eliminated by the State of residence would be consonant with international tax practice since by tradition it requires the State of residence to eliminate

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[825] ECJ, 14 December 2006, case C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*, para. 45.

[826] For an overview of the discussion on the "per-country" and "overall" approaches, see Dennis Weber, *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, Kluwer Law International, 2006, pp. 33-48.

[827] Indeed, the Netherlands could not grant a foreign tax credit and eliminate the tax burden levied by the Member State of source, because this Member State applied a participation exemption to foreign dividends.

[828] ECJ, 8 November 2007, case C-379/05, *Amurta SGPS v Inspecteur van de Belastingdienst*, para. 79.

[829] ECJ, 19 November 2009, case C-540/07, *Commission v Italy*, para. 37.

[830] ECJ, 3 June 2010, case C-487/08, *Commission v Spain*, para. 58-59.

double taxation when taxing rights are attributed to both the State of source and the State of residence[831]. However, these possible conclusions can hardly be relied on, given the weak argumentation as part of the Court's reasoning. Consequently, it is difficult to assess the potential impact of the overall approach applied by the ECJ towards double taxation within the internal market and the way double taxation may be eliminated.

As a conclusion, it can be observed that EU law may require elimination of double taxation in the State of source. However, case law has so far required elimination of double taxation only to get rid of discriminations in the State of source. This implies that double taxation may remain if cross-border and domestic transactions are treated alike, or if the Member State of residence eliminates a difference of treatment existing in the Member State of source.

EU law may also require the State of residence to eliminate double taxation.

6.3.1.2 Double taxation may be incompatible with EU law as a consequence of the taxing rights exercised by the Member State of residence

Two cases in which the Member State of residence has been required to restrain from exercising a taxing right or obliged to grant a tax relief to eliminate double taxation are discussed hereunder[832]. These cases are *Verkooijen* and *Manninen*.

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[831] See para. 7 of the Commentary to Articles 23 A and 23 B of the OECD Model Tax Convention, 2010: "For other items of income or capital, the attribution of the right to tax is not exclusive, and the relevant Article then states that the income or capital in question "may be taxed" in the Contracting State (S or E) of which the taxpayer is not a resident within the meaning of Article 4. In such case the State of residence (R) must give relief so as to avoid the double taxation. Paragraphs 1 and 2 of Article 23 A and paragraph 1 of Article 23 B are designed to give the necessary relief".

[832] As already mentioned above, only a few cases of relevance for the topic are analysed in this chapter. The purpose of this section is solely to illustrate the fact that certain situations of international double taxation may be incompatible with EU law, when they result from the discriminatory tax rules of a Member State. Consequently, not all cases relevant for the

Verkooijen[833] was about the Netherlands' participation exemption on dividends that was available on domestic dividends only. The taxpayer received a dividend from Belgium, and was consequently denied the tax exemption given the foreign seat of the distributor. The Dutch exemption did not totally eliminate double taxation on domestic dividends but only partly, as dividends above a certain threshold were subject to taxation. An interesting point of this ruling is that all the governments argued that the exemption was justified by the need to preserve the coherence of the tax system. It was argued that the Netherlands did not need to exempt inbound dividends as no double taxation occurred on its territory, since the distributor was taxed in another Member State[834]. Indeed, if one focuses solely on the Netherlands, this Member State had a chance to tax domestic companies upon their realisation of profits, and may therefore exempt domestic dividend distributions as domestic profits had already been taxed once. In contrast, inbound dividends were distributed by companies resident in another country, thus not being taxed in the Netherlands. The lack of taxation of foreign companies' profits would somewhat be compensated by the taxation of their dividends distributed to shareholders resident in the Netherlands[835].

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study of international double taxation from the perspective of the Member State of residence are discussed in this section of the dissertation.

[833] ECJ, 6 June 2000, case C-35/98, *Staatssecretaris van Financiën and B.G.M. Verkooijen* (hereinafter referred to as "*Verkooijen*"). For comments see Patrick Dibout, *La fiscalité à l'épreuve de la liberté de circulation des capitaux (à propos de l'arrêt CJCE, 6 juin 2000, aff. C-35/98, Verkooijen)*, Revue de Droit Fiscal, 18 October 2000, pp. 1365-1372; Confédération Fiscale Européenne, *The Consequences of the* Verkooijen *Judgment*, European Taxation, June/July 2002, pp. 241-246.

[834] ECJ, 6 June 2000, case C-35/98, *Verkooijen*, para 51: "The exemption of dividends is, they say, reserved to those shareholders who receive dividends on shares in companies with their seat in the Netherlands because only the latter are taxed in the Netherlands on the profits they have realised. Where the company which distributes the dividends is established in another Member State, profits are taxed in that Member State with the result that, in the Netherlands, there is no double taxation to be compensated for".

[835] This argument relating to a possible compensation of taxing rights, or the right of a Member State to tax a profit at least once, may be challenged by the *Truck Center* case in which the Court accepted that a Member State of source levied a withholding tax on out-

This argument was rightly rejected by the Court: if double taxation were to be eliminated internally and would be acceptable in cross-border situations, taxpayers would be encouraged to keep investing in their home States. The freedoms of movement would be obstructed and no level playing field would be created in the European Union[836]. But as the Dutch regime did not exempt dividends completely but only parly, it cannot be concluded from *Verkooijen* that the ECJ sought for elimination of double taxation as such. Rather, the ECJ merely looked for equal treatment in the Member State of residence.

Manninen[837] dealt with the Finnish rules on the taxation of inbound dividends. Under the Finnish rules, dividends earned by residents were taxed in the hands of the shareholder at the rate of 29%. A tax credit was granted to Finnish residents to eliminate double taxation, but this tax credit was attributed exclusively for dividends distributed by companies resident in Finland. In this case, a taxpayer resident in Finland received a dividend from a Swedish company, on which a 15% withholding tax had been levied according to the Nordic multilateral double taxation convention, in addition to the corporate income tax levied in Sweden upon the realisation of profits. The dividend originating in Sweden was taxed in the hands of the Finnish recipient. A foreign tax credit corresponding to the withholding tax levied in Sweden was offset from the tax levied in Finland. As illustrated by the example presented by Advocate General Kokott, the Finnish system

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bound interests while it did not levy tax on interests paid to domestic recipients, because interests were later taxed in their hands.

[836] See Frans Vanistendael, *Marché interne et souveraineté fiscale*, *in* Regards critiques et perspectives sur le droit et la fiscalité, Liber Amoricum Cyrille David, LGDJ, 2005, p. 265: "Le concept du marché interne déplace fondamentalement cette notion de cohésion ou cohérence à l'égard du contribuable du niveau national au niveau européen avec la possibilité de compenser les déductions ou exonérations dans un Etat membre par l'imposition des revenus dans un autre Etat membre".

[837] ECJ, 7 September 2004, case C-319/02, *Petri Manninen*. For a comment see Lari Hintsanen, Kennet Pettersson, *The implications of the ECJ holding the denial of Finnish imputation credits in cross-border situations to be incompatible with the EC Treaty in the Manninen case*, European Taxation, April 2005, pp. 130-137.

did not take into account the corporate income tax paid in the distributing State, contrary to what happened in a purely domestic situation[838]. This resulted in a higher total tax burden, while profits distributed by Finnish companies to Finnish shareholders were altogether taxed at the 29% rate. Consequently, economic double taxation was entirely eliminated in the domestic context, but not in the cross-border context. The ECJ unsurprisingly found the Finnish system incompatible with EU law.

As a conclusion, case law from the perspective of the Member State of residence[839] confirms what was found from the perspective of the Member State of source: it is not double taxation or a higher taxation as such that the ECJ may find incompatible with EU law, but, rather rules that result in a less favourable tax burden in cross-border situations than in purely domestic situations[840].

6.3.1.3 Conclusion on situations of double taxation that may be incompatible with EU law

A first conclusion of the analysis performed in this section is that legal or economic double taxation may be incompatible with EU law as a result of the tax jurisdiction exercised either by the Member State of source or by the Member State of residence. However, it does not seem to be double taxation as such that the ECJ has mitigated or eliminated in these cases, but rather the existence of discrimination.

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[838] Opinion of Advocate General Kokott, delivered on 18 March 2004, case C-319/02, *Petri Manninen*, para. 7 to 12.

[839] The findings of the *Verkooijen* and *Manninen* cases have been confirmed by the ECJ in a later case involving Greece: see ECJ, 23 April 2009, case C-406/07, *Commission v Greece*, para. 22-29. The Opinion of Advocate General Mengozzi in the pending *Accor* case is in line with the *Verkooijen* and *Manninen* cases: see Opinion of Advocate General Mengozzi delivered on 22 December 2010, case C-310/09, *Accor*.

[840] It can be observed that the ECJ considers since the *FII Group Litigation* case that the home State may eliminate double taxation on dividends according to the exemption method with regard to domestic dividends, while inbound dividends are subject to an ordinary tax credit. This finding was confirmed in the *Haribo* case.

Second, from a tax policy perspective, the ECJ is not clearly favouring neutrality in either the home State or the host State as it aims at the elimination of discrimination both from the perspective of the Member State of residence and from the perspective of the Member State of source. This approach may be found inconsistent[841], but it is important to emphasise that the prohibition of discrimination on grounds of nationality is an obligation under article 18 TFEU, irrespective of whether such discrimination stems from the tax jurisdiction of the State of source or the State of residence. Also, one should be aware of the fact that the elimination of differences of treatment is a rather clear and objective test: decisions of the ECJ would hardly find political approval if the Court were to accept certain obvious differences of treatment so as to favour a certain tax policy. Consequently, it seems as to be a necessary step to achieve the internal market that obvious differences of treatment between comparable situations are removed. This may result in adjusting tax rules in both the State of source and the State of residence. However, this approach may not be enough to satisfactorily achieve the internal market. In that respect, the case law presented below illustrates the fact that the double taxation exercised by a Member State, when being a consequence of its non-discriminatory tax jurisdiction, is not found by the Court to be incompatible with EU law.

6.3.2 Double taxation as a result of the non-discriminatory tax jurisdiction exercised by a Member State

This paragraph analyses situations of international double taxation resulting from the non-discriminatory tax jurisdiction exercised by a Member State in direct tax cases (6.3.2.1). A parallel is also made to case law on the double levy of social contributions (6.3.2.2)[842].

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[841] See Michael J. Graetz, Alvin C. Warren Jr., *Income tax discrimination and the political and economic integration in Europe*, The Yale Law Journal, April 2006, particularly pp. 1217-1219.

[842] It can also be observed that double taxation within the field of VAT is, in principle, not accepted within the internal market: see particularly articles 59a and 59b of the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax. See also ECJ, 27 September 2007, case C-146/05, *Albert Collée v Finanzamt Limburg an der Lahn*, para. 23; ECJ, 27 September 2007, case C-409/04, *The Queen, on the application of Teleos plc and Others v Commissioners of Customs & Excise*, para. 25. In these cases, the ECJ found that double

6.3.2.1 Double burdens in direct tax cases

International double taxation resulting from the non-discriminatory tax jurisdiction exercised by a Member State raises difficult problems, as it is the double taxation as such, not a difference of treatment, that is assessed with regard to EU law. As a preliminary remark, it should be recalled that in *Gilly* the ECJ found the ordinary tax credit received by a French resident for taxes paid on German income compatible with EU law, despite the higher tax rate in Germany. That is, the Court accepted a higher tax resulting from a cross-border activity, as compared to a domestic activity. In the *Kerckhaert and Morres*, *Block*, and *Damseaux* cases the Court has found that situations of double taxation or higher taxation resulting from the non-discriminatory tax jurisdiction exercised by a Member State were compatible with EU law[843]. These cases were ruled from the perspective of the Member State of residence, as it has always been this Member State against which claims for elimination of double taxation have been introduced. Such claims could hypothetically also have been introduced against a Member State of source, since double taxation can be avoided if the State of source refrains from taxing.

In *Kerckhaert and Morres*[844] a taxpayer resident in Belgium received an inbound dividend taxed at a flat rate as domestic dividends. The Belgian sys-

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taxation is an "infringement of the principle of fiscal neutrality inherent in the common system of VAT". Double taxation in the field of VAT is, however, not included in the scope the dissertation, since it is a harmonised area where Member States explicitly prohibit double taxation, according to the Directive mentioned above.

[843] This view was also strongly advocated by Advocate General Geelhoed. See Opinion of Advocate General Geelhoed, delivered on 23 February 2006, case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation v Commissioners of Inland Revenue*; Opinion of Advocate General Geelhoed, delivered on 6 April 2006, case C-513/04, *Mark Kerckhaert and Bernadette Morres v Belgische Staat*; Opinion of Advocate General Geelhoed, delivered on 6 April 2006, case C-446/04, *Test Claimants in the Franked Investment Income Group Litigation v Commissioners of Inland Revenue*.

[844] ECJ, 14 November 2006, case C-513/04, *Mark Kerckhaert and Bernadette Morres v Belgische Staat*. For comments see Melchior Wathelet, *Taxation des dividendes et droit européen: la Cour européenne tranche*, Feuillets Rapides Francis Lefebvre, 12 January 2007, pp. 25-27.

tem was not discriminatory since it taxed both foreign and domestic dividends identically. The inbound dividend had been subject to a withholding tax at source but the State of residence did not grant a corresponding tax credit. Nevertheless, the Court did not require Belgium to grant a tax credit to eliminate double taxation. The ECJ considered that "the adverse consequences which might arise from the application of an income tax system (…) result from the exercise in parallel by two Member States of their fiscal sovereignty"[845]. Indeed, both the State of residence and the State of source exercised taxing rights and the tax treaty concluded between Belgium and France did not eliminate double taxation in that situation. The Court considered that "conventions preventing double taxation such as those envisaged in Article 293 TEC are designed to eliminate or mitigate the negative effects on the functioning of the internal market resulting from the coexistence of national tax systems"[846], but it was up to "the Member States to take the measures necessary to prevent situations such as that at issue in the main proceedings by applying, in particular, the apportionment criteria followed in international tax practice"[847]. The solution of *Kerckhaert and Morres* was reiterated by the ECJ in *Damseaux*[848]. The facts were similar to those of *Kerckhaert and Morres*, but the preliminary question targeted the tax treaty, not the Belgian legislation. As could be expected, the ECJ found that the tax treaty did not infringe EU law. The Court considered that holding the Belgian legislation incompatible with EU law would give priority to taxation in the Member State of source[849], which would not rely on provisions of EU law[850].

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[845] ECJ, 14 November 2006, case C-513/04, *Mark Kerckhaert and Bernadette Morres v Belgische Staat*, para. 20.

[846] *C. cit.*, para. 21.

[847] *C. cit.*, para. 23.

[848] ECJ, 16 July 2009, case C-128/08, *Jacques Damseaux v État belge*; for comments see Emmanuel Raingeard de la Blétière, *Droit de l'union européenne: chronique de l'année 2009*, Revue de Droit Fiscal, 25 February 2010, pp. 51-52; Jean-Christophe Gracia, *La prévention de la double imposition comme obligation des États membres*, Revue de Droit Fiscal, 18 February 2010, pp. 30-32.

[849] ECJ, 16 July 2009, case C-128/08, *Jacques Damseaux v État belge*, para. 32: "In a situation where both the Member State in which the dividends are paid and the Member State in

The compatibility of juridical double taxation with EU law was confirmed in *Block*[851], in which an heir resident in Germany paid inheritance taxes on assets that the deceased owned in Spain, and that were taxed by both countries. Germany, the residence State of both the deceased and the heir, refused to grant a credit for inheritance taxes levied by Spain. Not surprisingly, the Court reasoned as it did in *Kerckhaert and Morres* and found that "Member States are not obliged (…) to eliminate the double taxation arising from the exercise in parallel (…) of their fiscal sovereignty"[852]. Consequently, the ECJ did not require Germany to grant a foreign tax credit for the inheritance taxes paid in Spain.

As argued above, international double taxation is in conflict with the concept of an internal market and the rights protected by article 6 TEU. It is understandable that it is difficult for the Court to rule in situations where double taxation results from the non-discriminatory tax jurisdiction exercised by a Member State, but nor should the ECJ forget the convincing arguments pleading for opening its case law to restriction-based analyses[853]. In addition, as argued *supra*, the attitude of Member States enacting tax provisions that result in double taxation but that are ultimately EU-proof as they also apply to domestic situations does not seem in line with the princi-

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which the shareholder resides are liable to tax those dividends, to consider that it is necessarily for the Member State of residence to prevent that double taxation would amount to granting a priority with respect to the taxation of that type of income to the Member State in which the dividends are paid".

[850] *C. cit.*, para. 33: "Although such an attribution of powers would comply, in particular, with the rules of international legal practice as reflected in the model tax convention on income and on capital drawn up by the Organisation for Economic Cooperation and Development (OECD), in particular Article 23B thereof, it is not in dispute that Community law, in its current state and in a situation such as that at issue in the main proceedings, does not lay down any general criteria for the attribution of areas of competence between the Member States in relation to the elimination of double taxation within the Community".

[851] ECJ, 12 February 2009, case C-67/08, *Margarete Block v Finanzamt Kaufbeuren.*

[852] *C. cit.*, para. 31.

[853] See *supra* at 4.2.2.2.3.

ple of sincere cooperation[854] and could be compared to the abuse of rights that may be committed by taxpayers[855]. Accordingly, one would have hoped that in *Kerckhaert and Morres, Block*, and *Damseaux* the Court had at least analysed the effects of international double taxation, as such, on the internal market. The reluctance of the ECJ to choose which Member State should eliminate double taxation ultimately blocks the Court from actually assessing the very compatibility of international double taxation with EU law. In addition, it does not seem totally inappropriate for the Court to assess and possibly choose which Member State should eliminate double taxation. The ECJ has already challenged the sovereignty of Member States in many respects: requiring the elimination of double taxation would not, in itself, be so different from other situations of infringement of EU law in which the Court chose to favour taxation in the home State or in the host State. After all, the *Marks & Spencer* doctrine also implies the choice of which of the home and the host State has to bear the cost of final losses[856].

Last, it should be observed that a difference between *Kerckhaert and Morres* and *Damseaux* on the one hand, and *Block* on the other hand, is that no tax treaty had been concluded between Spain and Germany in the *Block* case[857]. Should the presence of a tax treaty alter the above analysis on the compatibility of double taxation with EU law? At first sight, one may be tempted to consider that the presence or the absence of a double taxation convention should not, in itself, be a significant feature in assessing the compatibility of a rule with EU law. However, the purpose of tax treaties should also be taken into consideration. Indeed, the main purpose of tax treaties is the elimination or mitigation of double taxation, as illustrated by paragraphs 1 to 3 of the introduction to the OECD Model Tax Convention. In *Kerckhaert and Morres* and *Damseaux*, the Member State of residence had concluded a

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[854] See article 4(3) TEU.

[855] See *supra* at 4.2.2.2.3.

[856] Another example is the *Bosal* case, in which the Court could have rejected the claim in the Netherlands, considering that the financing costs should be deducted in the State of the subsidiary.

[857] Such a tax treaty might only concern inheritance taxes, not income taxes, but the legal problem is the same.

tax treaty with the Member State of source, which shows the willingness of this State to mitigate or eliminate situations of double taxation. The question is whether this aspect should have played a role in the reasoning of the Court. In my view the Court was right not to pay attention to this question, for several reasons:

- First, despite the existence of a tax treaty, the double taxation at hand was not eliminated by the tax treaty between France and Belgium. This shows the Belgian State as unwilling to mitigate or eliminate such situations of double taxation.

- Second, tax treaties do not intend to eliminate all situations of double taxation, but only part of them[858].

- Third, whether or not a tax treaty is at hand should not, in itself, influence the compatibility with EU law of a particular tax rule, especially since the repeal of article 293 TEC.

Accordingly, it is submitted that the presence of a tax treaty not eliminating the double taxation in the *Kerckhaert and Morres* and *Damseaux* cases, and the absence of a tax treaty in *Block*, should not be a feature in appreciating the compatibility with EU law[859]. Indeed, it is the phenomenon of double taxa-

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[858] See para. 3 of the Introduction to the OECD Model Tax Convention, 2010, which refers to "a means of settling on a uniform basis the *most common problems* that arise in the field of international juridical double taxation" (emphasis added).

[859] The situation may be different if the Member State of residence does not respect a tax treaty that actually obliges it to eliminate double taxation, contrary to the situation in *Kerckhaert and Morres* and *Damseaux*. It could be argued that by not eliminating double taxation although it is bound to do so, the Member State of residence would then breach the principle of sincere cooperation of article 4(3) TEU, as residents take it for granted that double taxation will be eliminated and consequently exercise their freedom of movement. It should also be taken into consideration, however, that requiring Member States to fulfil their obligations to eliminate double taxation may require an interpretation of these obligations, which may prove difficult. Take the example of a Member State of residence applying the credit method in its domestic law and in tax treaties for foreign business income earned through

tion that should, as such, be assessed with regard to EU law: Member States should not escape their obligations under EU law by entering into tax treaties.

As a result of the above analysis, the ECJ for now accepts international double taxation when it is a result of non-discriminatory tax law, although arguments exist for assessing the compatibility with EU law of such double taxation. A parallel with the double levy of social contributions is made hereunder, to assess the consistency of the case law of the Court when comparing two unharmonised areas.

6.3.2.2 Double burdens in the field of social contributions

A parallel may be drawn between direct taxes and social contributions, when a Member State levies direct taxes or social contributions in a non-discriminatory manner in cross-border situtions. After presenting cases in the field of social contributions from the perspective of the host State (6.3.2.2.1) and the home State (6.3.2.2.2), the differences in the Court's position with regard to social contributions and direct taxes will be analysed (6.3.2.2.3)[860].

6.3.2.2.1 The perspective of the host Member State

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permanent establishments. This Member State of residence may refuse to relieve double taxation because it considers that no permanent establishment exists in the Member State of source: if the taxpayer could rely on EU law to obtain double taxation relief, should the ECJ request the State of residence to automatically grant a foreign tax credit? Or should the Court first complete the test of article 5 of the tax treaty, if a permanent establishment has been identified allocate profits between the permanent establishment and the head office, and lastly require the Member State of residence to eliminate double taxation for the part of the profits that the Member State of source should have taxed. Not only is such an interpretation very difficult, but it lacks support in EU law and does not form part of the tasks of the Court. Therefore, it is submitted that the misinterpretation or the non-respect of a provision of domestic law or a tax treaty should not influence the reasoning of the Court.

[860] Only a few cases relating to double burdens in the field of social contributions are discussed in this section of the dissertation, the point here being to emphasise that in certain cases the ECJ has found the double levy of social contributions incompatible with EU law, although such contributions were levied in a non-discriminatory manner.

The *Guiot*[861] case was about a company resident in Luxembourg, with personnel employed in that Member State, who provided services in Belgium. Belgium required the payment of social contributions[862], while the company had already been subject to comparable contributions in Luxembourg. The ECJ very clearly considered that the Belgian requirements were in breach of EU law although not being discriminatory[863], as they placed an additional financial burden on foreign companies that would no longer be "on an equal footing with employers established in the host State"[864]. The infringement could not be justified as workers enjoyed a similar protection in Luxembourg[865]. It should be emphasised that this conclusion was reached "Even if there is no harmonization"[866], and was confirmed in later case law such as the *Arblade* case[867].

The double levy of social contributions in the home State is discussed below.

6.3.2.2.2 The perspective of the home Member State

In *Sehrer*[868] a German resident received a pension from France that was subject to social contributions in both Member States. The ECJ very clearly found the levy of social contributions by Germany incompatible with the fundamental freedoms. The reasoning of the Court was very close to the

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[861] ECJ, 28 March 1996, case C-272/94, *Criminal proceedings against Michel Guiot and Climatec SA*.

[862] It can be observed that the ECJ accepts that a Member State levies social contributions for services provided on its territory by foreign companies: see ECJ, 27 March 1990, case C-113/89, *Rush Portuguesa v Office national d'immigration*.

[863] ECJ, 28 March 1996, case C-272/94, *Criminal proceedings against Michel Guiot and Climatec SA*, para. 15.

[864] *C. cit.*, para. 14.

[865] *C. cit.*, para. 17-21.

[866] *C. cit.*, para. 11.

[867] See ECJ, 23 November 1999, cases C-369/96 and C-376/96, *Criminal proceedings against Jean-Claude Arblade and Arblade & Fils SARL*, and *Bernard Leloup, Serge Leloup and Sofrage SARL*.

[868] ECJ, 15 June 2000, case C-302/98, *Manfred Sehrer v Bundesknappschaft*.

cases discussed *supra* that required the internal market to have the characteristics of a domestic market, as the ECJ observed that the risk for a double levy is much higher in cross-border situations than in domestic situations[869].

The findings in *Sehrer* were not confirmed in the *CIBA*[870] case on the obligation for companies resident in Hungary to pay contributions to an educational fund. A levy of contributions was calculated depending on a company's wage costs, for personnel employed both in Hungary and in foreign permanent establishments. Similar contributions were levied by the Czech Republic for personnel employed in CIBA's permanent establishment, which triggered a double burden. The ECJ considered that the levy was part of direct taxation as it did not entitle to a direct benefit[871], so the double burden was found compatible with EU law[872] even if actually benefiting from a training programme was not possible for personnel employed abroad[873].

6.3.2.2.3 Analysis of the different outcomes for social contributions and direct taxes with regard to double burdens

Case law relating to social contributions and direct taxes distinguishes between situations in which the payer (subject to a double burden) enjoys a double benefit or is solely exposed to a double burden without enjoying a double benefit. In the field of direct taxes, it is clear that a double burden

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869 ECJ, 15 June 2000, case C-302/98, *Manfred Sehrer v Bundesknappschaft*, para. 34.

870 ECJ, 15 April 2010, case C-96/08, *CIBA Speciality Chemicals Central and Eastern Europe Szolgáltató, Tanácsadó és Keresdedelmi kft v Adó- és Pénzügyi Ellenőrzési Hivatal (APEH) Hatósági Főosztály* (hereinafter referred to as "*CIBA*"). For a comment see Anne-Laure Mosbrucker, *Contribution relative à la politique publique de l'emploi*, Revue Europe, June 2010, p. 19; Ludovic Bernardeau, *Jurisprudence de la CJUE: fiscalité directe (janv./juin 2010)*, Revue de Droit Fiscal, 14 October 2010, p. 14.

871 ECJ, 15 April 2010, case C-96/08, *CIBA*, para. 24.

872 In the end, the ECJ found that the possibilities to reduce the contributions to the educational fund were incompatible with EU law, but this does not seem to affect the question of principle regarding a double burden: see *C. cit.*, para. 39-49.

873 *C. cit.*, para. 37.

does not entitle to a double benefit. In the field of social contributions, the distinction is less obvious and may vary from one case to another. Even when there is no direct benefit from a double levy of social contributions, however, the ECJ has found that such a double levy may be in breach of EU law. In *Sehrer* the German resident was subject to double contributions without benefiting from a double protection[874]. Similarly, in *Guiot* and *Arblade*, one of the risks was bad weather, which would prevent workers in the building industry from performing their tasks: it is obvious that once contributions are paid and employees are guaranteed a remuneration in case of bad weather, paying a second contribution with the same purpose does not benefit the employer and clearly infringes his freedom of movement because he pays the contributions twice without benefiting from a double advantage. In situations where the payer is exposed to a double burden without enjoying a double benefit the infringement to the fundamental freedoms seems obvious. In contrast, the breach of EU law seems less important if the payer of a double burden enjoys a double benefit: for example, if contributions to a pension system are levied by two States on the pay of the same person, it is possible that the payer also receives a pension from both States.

If one adopts this perspective, *i.e.* focusing on the presence or the absence of a double benefit when an EU national is subject to a double burden, double levies of social contributions and of direct taxes seem largely comparable, when the levy of double social contributions does not lead to double benefits. Yet, the Court reached totally different outcomes: in *Sehrer*, *Guiot* and *Arblade*, the ECJ found that a double levy of social contributions was incompatible with EU law, and in these cases no double benefit could be enjoyed by the payer subject to double social contributions. In contrast, in *CIBA*, *Kerckhaert and Morres*, *Block*, and *Damseaux*, the Court found that a double levy of direct taxes was compatible with EU law, although by definition no double benefit could be enjoyed by the payer subject to double

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[874] Concurring see Kristina Ståhl, Roger Persson Österman, *EG-Skatterätt*, Iustus Förlag, second edition, 2006, p. 122: "den aktuella avgiften enligt vad som framgår av domen inte i sig gav rätt till några förmåner".

taxation. Such a difference of outcome is, in my opinion, even less acceptable if one considers the four following arguments:

- First, both double social contributions and international double taxation are additional burdens that are triggered by the exercise of the fundamental freedoms.

- Second, both double social contributions and international double taxation expose a taxpayer to a competitive disadvantage with competitors that have not exercised their fundamental freedoms.

- Third, both double social contributions and international double taxation raise issues for enhancing the concept of an internal market functioning as a domestic market as well as respecting the rights protected by article 6 TEU.

- Fourth, both social contributions and direct taxes are unharmonised areas[875].

Last, one may question the distinction between enjoying or not a benefit to justify a discrepancy between solutions for international double taxation and the levy of double social contributions. At most, the person paying double social contributions enjoys fully a double benefit at a later stage, so that would only be a temporary double burden. However, the actual benefit corresponding to the payment of social contributions may be difficult to determine, and no benefit at all or only a part of the expected benefits may be enjoyed in certain situations. In addition, a risk exists that the person paying the social contributions and the person benefiting from the benefits are not the same person, for example when an employer pays contributions that an employee may benefit from. Consequently, the discrepancy between solutions for international double taxation and double social contributions

[875] However, social security is subject to coordination between Member States (see particularly article 156 TFEU) through Council Regulation 1408/71 of 14 June 1971 on the application of social security schemes to employed persons, to self-employed persons and to members of their families moving within the Community.

is, in my mind, hardly justified[876]. It is, however, a reality given the case law of the ECJ.

The next issue concerns the reconciliation of the acceptance of international double taxation, on the one hand, with the refusal of double non-deduction on negative income, on the other hand.

6.3.3 The acceptance of double taxation is difficult to reconcile with case law on double non-deduction of negative income

As discussed above, the ECJ does not require Member States to eliminate international double taxation *per se*. Indeed, the Court accepts the fact that a taxpayer is exposed to a higher total tax burden because he is taxed both in the Member State of residence and in the Member State of source, as long as each Member State taxes him on a non-discriminatory basis. On the other hand, the ECJ refuses the double non-deduction of negative income, both concerning losses (*e.g. Marks & Spencer* and *N.*[877]), costs (*e.g. Renneberg* and *Bosal*[878]) and personal allowances (*e.g. Schumacker*).

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[876] For a similar analysis in relation to the *Sehrer* case see Kristina Ståhl, Roger Persson Österman, *EG-Skatterätt*, Iustus Förlag, second edition, 2006, p. 122: "Det faktum att målet gällde uttag av socialförsäkringsavgift och inte av skatt borde enligt vår mening egentligen sakna betydelse, i synnerhet som den aktuella avgiften enligt vad som framgår av domen inte i sig gav rätt till några förmåner".

[877] What is interesting in the context of double taxation is paragraph 54 of the *N.* case, where the Court required the emigration State to, if necessary, grant deduction for losses that would be incurred after the taxpayer has moved his residence. That is, if the immigration State did not grant a tax base reduction for possible losses incurred during at the time the taxpayer was resident there, a claim could be filed against the emigration State for the taking into account of such losses. See ECJ, 7 September 2006, case C-470/04, *N. v Inspecteur van de Belastingdienst Oost/kantoor Almelo*.

[878] The *Bosal* case was about the Netherlands tax system that resulted in participation costs being deducted neither in the State of the parent (because of the participation exemption) nor in the State of the subsidiary (because participation costs are usually considered as shareholder costs thus not being deductible in the State of the subsidiary). It can be observed that it was the intention of the Member States in the parent-subsidiary Directive not to completely abolish economic double taxation, since Member States are free to tax or exempt dividends received by a parent company (see article 4(1) of the parent-subsidiary Di-

From the perspective of the taxpayer, double taxation and double non-deduction have similar causes, as both double taxation and double non-deduction happen when a taxpayer is confronted with two tax systems that are not coordinated for taxing once and on a net basis. Double taxation and double non-deduction also have rather similar effects that could be qualified as "overtaxation"[879]. Actually, double taxation and double non-deduction may, in certain cases, correspond to very similar situations. This is for example true in the field of transfer pricing. Take the example of a distributing company resident in Member State A, that sells products manufactured by an associated enterprise resident in Member State B. Assume the distributor's profitability is considered too low by the tax authorities of Member State A. The tax authorities would then have two alternatives: either they could reassess the taxable income of the distributor by increasing its operating profit[880], or they could deny the deduction of certain costs[881]. The result, for the group of companies, is the same: the distributor's tax base is increased in State A, which could be compensated by a corresponding adjustment in State B. It is therefore relevant, in certain situations, to consider that double taxation and double non-deduction are very close to each other.

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rective): business profits may be taxed twice, *i.e.* a first time in the hands of the distributing company, and a second time in the hands of the recipient. In addition, the State of the parent has the right to deny deduction of participation costs according to article 4(2) of the Directive, and such costs may not be deductible in the State of the subsidiary either, which indicates that Member States have explicitly accepted double non-deduction of participation costs. The Court, in *Bosal*, did not follow the explicit intention of the Member States.

[879] See Opinion of Advocate General Léger, delivered on 22 November 1994, case C-279/93, *Finanzamt Köln-Altstadt v. Roland Schumacker*, para. 67 and 83.

[880] This creates a double taxation as the manufacturer's profits have not been correspondingly decreased.

[881] This creates a double non-deduction as such costs have not been deducted by the manufacturer.

Consequently, it was argued *supra*[882] that *Marks & Spencer* is, in a way, comparable with *Kerckhaert and Morres*, *Block*, and *Damseaux*. In all of these cases a final overtaxation was at stake. However, the Court reached different outcomes in these cases. While final losses (*i.e.* a final overtaxation) have to be relieved, international double taxation is accepted when it results from non-discriminatory tax rules. If a final overtaxation is, in itself, infringing EU law to such a great extent, it would be consistent from a tax policy perspective to reach a similar outcome with regard to double taxation, *i.e.* either accept the non-deduction of final foreign losses, or require the elimination of international double taxation. As the Court accepted double taxation, *i.e.* a final overtaxation, in *Kerckhaert and Morres*, *Block*, and *Damseaux*, the final overtaxation criterion is probably not decisive in itself. Rather, the decisions eliminating double non-deduction are explained by the presence of a difference of treatment in these cases. In contrast, no difference of treatment was identified in *Kerckhaert and Morres*, *Block*, and *Damseaux*. Consequently, the compatibility with EU law of a final overtaxation, caused by either double taxation or a double non-deduction, is closely connected with the debate between a discrimination or restriction-based analysis. That the Court's case law ends up with so significant discrepancies solely because of the presence or the absence of a discrimination is a rather narrow reading of the provisions of the EU Treaties and does not pay much attention to the importance of the achievement of the internal market. Consequently, I agree with the authors considering that "not allowing deductions in either state and taxing income in both states are two sides of the same coin"[883], which should lead to closer results[884].

Last, a case accepting the search for single taxation should also be mentioned. In *Schempp*, the Court accepted the German rules that made the deductibility of alimonies depend on their taxation in the hands of a divorced

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[882] See *supra* at 3.3.5.3.

[883] See Michael Lang, *Tax treaty policy*, *in* Krister Andersson, Eva Eberhartinger and Lars Oxelheim, *National tax policy in Europe – to be or not to be?*, Springer, 2007, p. 193.

[884] See Michael Lang, *Recent case law of the ECJ in direct taxation: trends, tensions, and contradictions*, EC Tax Review, 2009-3, p. 99: "Expenses that can be deducted nowhere should be treated like income or property, which is taxed twice".

spouse who was resident in another Member State[885]. Deduction was refused in Germany because the maintenance payments were not taxable in the hands of the recipient, neither in Germany nor in Austria. Despite the difference of treatment to that of alimonies paid to a recipient resident in Germany, the Court found the rules compatible with EU law. This means that it accepted that a cost is non-deductible to avoid that it is deducted with no corresponding taxation[886]. The meaning of this case is, however, difficult to interpret since the Court in later cases such as *Aberdeen* applied a pure per-country approach and found the levy of a withholding tax on outbound dividends incompatible with EU law although the recipient was not taxed on such dividends[887]. This means that in *Aberdeen* the ECJ did not favour single taxation over getting rid of differences of treatment between domestic and cross-border situations. The same result was reached in the field of VAT in the *RBS Deutschland* case[888]. Consequently, the position of the ECJ with regard to ensuring single taxation is not clear, which is why the *Schempp* case can hardly be relied on when drawing conclusions on the compatibility of international double taxation with EU law.

6.4 Conclusion on the relation between international double taxation and the objective of achievement of the internal market

A first conclusion of this chapter is that international double taxation is, so far, accepted by the ECJ. This means that the impact of the compatibility of international double taxation with the objective of achievement of the in-

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[885] ECJ, 12 July 2005, case C-403/03, *Schempp*.

[886] It has been observed that "The background of the German rule was to ensure single taxation on a cross-border basis, and the Court accepted this approach. Ensuring single taxation seems to justify a different treatment between domestic and cross-border situations": see Michael Lang, *Double taxation and EC law*, *in* Reuven S. Avi-Yonah, James Hines and Michael Lang (eds.), Comparative fiscal federalism, Kluwer Law International, 2007, p. 21.

[887] ECJ, 18 June 2009, case C-303/07, *Aberdeen Property Fininvest Alpha O*.

[888] ECJ, 22 December 2010, case C-277/09, *The Commissioners for Her Majesty's Revenue and Customs v RBS Deutschland Holdings GmbH*. For a comment, see Tom O'Shea, *ECJ takes a stand on 'abusive practices' in UK VAT cases*, Tax Notes International, 7 February 2011, pp. 417-421.

ternal market on Member States' tax jurisdiction is currently limited. Accordingly, the findings of this chapter do not directly influence the issues discussed in the preceding chapters:

- CFC rules are not directly affected by the case law of the Court on international double taxation (this finding is related to the issues analysed in chapter 3 *supra*).

- The Member State of residence of a company may tax foreign business income earned through a permanent establishment located in another Member State even if such income is already taxed by the Member State of establishment. The Member State of residence is not required by ECJ case law to grant a foreign tax credit or a tax exemption when the permanent establishment is also subject to taxation in the Member State of establishment (this finding is related to the issues analysed in chapter 4 *supra*).

- No support for deduction of foreign losses incurred by a foreign subsidiary or a permanent establishment is found in the case law of the Court analysed in this chapter (this finding is related to the issues analysed in chapters 3 and 4 *supra*).

- No support is found in this chapter for the obligation of the State of a permanent establishment to refrain from taxing foreign business income earned by a permanent establishment in another Member State or to grant deduction for foreign losses or costs attributable to a permanent establishment (this finding is related to the issues analysed in chapter 5 *supra*).

These conclusions are, however, only based on the existing case law issued by the ECJ that was analysed in this chapter. In contrast, it has been demonstrated that international double taxation is clearly in conflict with the objective of achievement of the internal market. A tension also exists with the rights protected by article 6 TEU. The position of the ECJ is even more criticisable when one takes into account the repeal of article 293 TEC, the obligation to deduct final foreign losses according to the *Marks & Spencer* doctrine, and the incompatibility with EU law of the double levy of social

contributions. In my view, all these arguments by and large overweigh the discrimination-based analysis on which the ECJ relies to find international double taxation compatible with EU law, particularly given the criticisms formulated above on discrimination-based analyses[889]. Also, these arguments overweigh the practical problems that would be related to finding international double taxation incompatible with EU law. It is true that it is "very difficult to determine which situations of double taxation should be considered to conflict"[890] with EU law. Moreover, it would certainly be difficult to actually eliminate international double taxation throughout the internal market, particularly given the necessary choice between favouring taxation in the Member State of residence or in the Member State of source. These difficulties should not, however, preclude the Court from establishing principles. After all, it is not the purpose of the Court to be a lawmaker and find practicable solutions. As national constitutional or supreme courts often do, the ECJ could establish a principle, for the lawmaker (whether it would be the national lawmakers or the European lawmaker) to transpose it into the law.

Consequently, although the tax case law of the ECJ relating to international double taxation does not have particular consequences on the preceding chapters, it has been demonstrated that international double taxation raises trouble for the achievement of the internal market. From the point of view of principle, this should have consequences on the taxation in Member States of the foreign business income of companies. Particularly, the following consequences should be emphasised:

- The tension between EU law and international double taxation argues for finding CFC rules incompatible with EU law, when such rules lead to double taxation.

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[889] See *supra* at 4.2.2.2.3.

[890] Michael Lang, *Double taxation and EC law*, *in* Reuven S. Avi-Yonah, James Hines and Michael Lang (eds.), Comparative fiscal federalism, Kluwer Law International, 2007, p. 18.

- The tension between EU law and international double taxation argues for requiring the State of the head office to grant a foreign tax credit or to exempt foreign business income, when such foreign business income is also taxed by the Member State of establishment. Alternatively, the tension between EU law and international double taxation may argue for depriving the Member State of establishment of its tax jurisdiction if double taxation has to be eliminated by the host State. This dilemma is not solved by the findings of these chapters, but guidance is found in other chapters[891].

- The tension between EU law and international double taxation argues for admitting deductions of final losses incurred by a foreign subsidiary and a permanent establishment, to avoid situations of double non-deduction.

- The tension between EU law and international double taxation argues for taxing permanent establishments in such a way that no double taxation is incurred with regard to the attribution of profits to permanent establishments as well as in triangular situations.

The next chapter formulates particular criticisms to the *Marks & Spencer* doctrine and suggests alternative approaches to relieving final losses incurred by foreign subsidiaries and permanent establishments subject to the exemption method.

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[891] It is referred to chapter 8 *infra*, which reconciles the findings of the preceding chapters.

7 Reconsidering cross-border loss relief: should final foreign losses necessarily be deducted in the home State?

"we cannot possibly count on the ECJ by way of case law to establish a coherent and generally acceptable European tax law system"[892].

7.1 Introduction

The legal analysis conducted in the preceding chapters on the conflict between Member States' taxation of companies' foreign business income and the objective of achievement of the internal market has evidenced that the fiscal principle of territoriality is in conflict with the objective of achievement of the internal market, because this principle prevents losses incurred in one Member State from being offset from profits incurred in another Member State. That is, the fiscal principle of territoriality isolates the taxable income in each jurisdiction, something that would not happen within a domestic market. This conflict is particularly obvious when final losses are incurred in the host State. Consequently, the ECJ requires from Member States that they grant cross-border loss relief when final losses are incurred by foreign subsidiaries. Also, it is possible that the Court requires cross-border loss relief for final losses incurred by permanent establishments subject to the exemption method, although such a requirement has not yet been explicitly established by the ECJ.

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[892] Leif Mutén, *Will case law do?*, *in* A vision of taxes within and outside European borders, Festschrift in honor of Prof. Dr. Frans Vanistendael, Kluwer Law International, 2008, p. 667.

It was argued in chapter 3 *supra* that the solution reached by the Court in *Marks & Spencer* to avoid the non-deduction of final foreign losses is criticisable in several respects. However, these objections do not mean that cross-border loss relief in the European Union should be abandoned. Not only is the relief for final losses a legal obligation since the *Marks & Spencer* case, but also it is highly desirable to help achieve the internal market. Moreover, it was found in chapter 6 that several arguments plead for the elimination of international double taxation within the internal market, which also advocates for relieving final foreign losses. Accordingly, it was concluded in chapter 3 that final loss relief is highly relevant but that legislation at the European Union level would be preferable so as to provide an efficient and satisfactory cross-border loss relief mechanism within the internal market. Such a legislative solution could be a common consolidated corporate tax base. Indeed, a common consolidated corporate tax base would be an efficient way of taxing a group of companies on a net basis, so no particular mechanism would be needed for deducting losses incurred within the consolidated area, even if such losses are final. Outside the consolidated area, the question of final loss relief is yet to be solved.

If Member States were to implement a legislative solution to cross-border loss relief – outside the context of a common consolidated corporate tax base – a possible starting point could be to transpose and adapt the findings of *Marks & Spencer* into a legislative instrument such as a directive or a regulation. The European Commission's proposed directive could be a starting point that should be extended to cover final foreign losses. However, it is submitted in this chapter that the very rationale of the *Marks & Spencer* doctrine, *i.e.* an obligation for the home State to grant relief for the final losses incurred in the host State, is not at all self-evident and does not perfectly match the objective of achievement of the internal market as well as the requirement of enforcing a balanced allocation of the power to impose taxes between Member States as it results from ECJ case law. An alternative approach to relieving final foreign losses is therefore considered in this chapter, the rationale of which may help design a legislative solution to cross-border loss relief. Since it is argued that the *Marks & Spencer* doctrine may be subject to criticism, the ideas discussed in this chapter also add to the arguments pleading for harmonising cross-border loss relief within the

European Union. It seems essential to find a satisfying long term solution to cross-border loss relief within the European Union given the infringement to the objective of achievement of the internal market caused by the lack of final loss relief, and with regard to the fact that Member States' implementation of the *Marks & Spencer* doctrine in their domestic tax laws may be subject to criticisms[893].

The ideas discussed hereunder apply to final losses[894] incurred by foreign subsidiaries and are intended to contribute to the debate on a cross-border loss relief mechanism at the level of the European Union, outside the scope of a common consolidated corporate tax base[895]. These ideas are also valid if relief is to be granted for final losses incurred by permanent establishments subject to the exemption method, as it may be relevant to mitigate some of the differences in the tax treatment of losses incurred by foreign subsidiaries and permanent establishments[896]. First, it wondered whether an

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[893] This is *e.g.* illustrated by the fact that the European Commission brought the UK before the ECJ for its implementation of the *Marks & Spencer* case. The European Commission first sent to the UK a request to implement *Marks & Spencer* properly. The European Commission later referred the UK to the ECJ for an improper implementation of *Marks & Spencer*: see IP/09/1461, 8 October 2009, *Corporate taxation: Commission refers the United Kingdom to the European Court of Justice over improper implementation of an ECJ ruling on cross-border loss relief*. Another example relates to the Swedish implementation of the *Marks & Spencer* doctrine in section 35(a) of the Swedish Income Tax Act.

[894] Cross border relief for non final losses is discussed in chapters 3 and 4 *supra*.

[895] Indeed, even if the common consolidated corporate tax base project were implemented, it would not cover all cross-border situations since not all companies may be included in the consolidated area, some groups may not opt for the common tax base, and some Member States may not implement these rules. Therefore, cross-border loss relief is highly relevant outside the scope of a common consolidated corporate tax base.

[896] See COM 90 (595) final, 24 January 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*, point 5, where the European Commission observes that "An enterprise may carry on its activity outside the territory of the Member State in which its head office is situated, either through the intermediary of a permanent establishment, or through that of a subsidiary, the latter having its own legal personality and coming under the law of the Member State in which it is established. Economically speaking, these two struc-

automatic and unconditional relief for all the final losses incurred in the host State should be required from the home State (7.2). Second, it is discussed whether a tax refund could be required from the host State instead of loss relief being provided by the home State (7.3). Third, as none of the two preceding solutions is found satisfying, what appears to be a more balanced solution would be a split of the final losses between the home State and the host State (7.4). Fourth, it is focused on the possible methods according to which final losses could be split between the home State and the host State (7.5).

7.2 Requiring from the home State an automatic and unconditional relief for all the final losses incurred in the host State: a satisfying solution?

Prima facie it may appear reasonable to obtain loss relief in the home State for final foreign losses incurred in the host State. Indeed, it is in the home State that a discrimination may arise between domestic and foreign losses. In addition, attributing loss relief to the entity resident in the home State compensates for the risk taken by the parent company or the head office when investing in the host State. Moreover, the home State may have had the opportunity to tax dividends and capital gains related to shares in a foreign subsidiary: it may therefore appear reasonable that the home State is also exposed to the losses incurred by this subsidiary.

However, two arguments indicate that an automatic and unconditional loss relief should preferably not be required from the home State: first, such a loss relief creates tax planning opportunities (7.2.1). Second, such a loss relief does not take into account the fact that current profits and losses are

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tures used to carry on an activity abroad are equivalent, and the choice between them should not necessarily be influenced by tax considerations. However, the choice between them would not be neutral if the arrangements for deducting losses incurred by foreign subsidiaries were less favourable than those applicable to permanent establishments. Equality of treatment between permanent establishments and subsidiaries is not, however, a generally accepted idea".

allocated between the parent company and the foreign subsidiary on the basis of the arm's length principle (7.2.2).

7.2.1 An automatic and unconditional relief for all the final losses in the home State creates tax planning opportunities

Requiring the home State to grant an automatic relief for all the final losses incurred by a foreign subsidiary or a permanent establishment subject to the exemption method may create tax planning opportunities. The foreign subsidiary may deliberately make sure that a loss is not deducted in the host State so as to deduct it in the home State, if the loss has a higher value for tax purposes in the latter State. For example, assume that the host State offers no carry back and has a loss carry-forward limited to the two tax years following the year during which a loss is made. It is assumed that a foreign subsidiary incurs -100 of losses in year 1. It is also assumed that the foreign subsidiary owns an asset on which it expects making a capital gain of +100, and that no other profits or losses are made during years 1 to 3.

	Year 1	Year 2	Year 3	Year 4
Loss	-100	-100	-100	0
Latent capital gain	100	100	100	
Realised capital gain				100

After 31 December of year 3 the loss can no longer be carried forward, *i.e.* it becomes final. According to the legislation of the host State it cannot be carried back and it is assumed that it cannot either be transferred to an associated enterprise or a third party in the host State. According to paragraph 55 of the *Marks & Spencer* judgment, the loss should be deducted in the home State when "the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods, if necessary by transferring those losses to a third party or by offsetting the losses against the profits made by the subsidiary in previous periods, and there is no possibility for the foreign subsidiary's losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party". Here, all the four conditions of paragraph 55 of the *Marks & Spencer* judgment are met:

- First, the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for "the accounting period concerned by the claim for relief" (*i.e.* during year 3), as the loss cannot during year 3 be offset against positive income. This is because of the lack of taxable profits at that time. Consequently, the first condition of paragraph 55 of the *Marks & Spencer* judgment is met since no relief possibility exists in the host State during the very year 3.

- Second, the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account "for previous accounting periods" as the host State has no provisions on the carry back of losses.

- Third, there are no possibilities for those losses to be taken into account in the host State "for future periods" as the loss carry-forward has expired on 1 January year 4.

- Fourth, it is assumed that the losses cannot be transferred to an associated enterprise or a third party in the host State.

Consequently, in this example the loss becomes final in the meaning of *Marks & Spencer* on 31 December of year 3. The final losses should then be deductible in the home State, as long as this State has a tax equalisation system. As a result, by simply deciding to postpone the sale of the asset to year 4, *i.e.* after the loss carry-forward has expired, the whole loss becomes final in the host State while it could have been deducted if the asset had been sold. Postponing the sale of the asset has, in this example, allowed the group to have the loss deducted in the home State instead of the host State. Many other ways of designing the taxable income of the foreign subsidiary may create such tax planning opportunities through deferring the realisation of profits in the host State[897]. A group may also be tempted to maximise losses in the host State, especially if the host State grants only a loss carry-

[897] This may be achived *e.g.* by postponing the crediting of an accrual or by spreading sales over several years.

forward for a short period of time[898]. Another type of tax planning opportunity could be the decision to liquidate a foreign subsidiary or permanent establishment to benefit from final loss relief in the home State. This hypothesis is not necessarily purely theoretical: in parallel to the liquidation, the business operations formerly carried on by the subsidiary could still be carried on in the host State, *e.g.* through a third party[899]. Another example of tax planning opportunity is the decision to postpone the incorporation of a group company or the acquisition of a third party to first have a final loss deducted in the home State. Consequently, the *Marks & Spencer* doctrine creates tax planning opportunities in the bilateral relation between the parent company and the foreign subsidiary, when the home State is obliged to grant relief for all the final losses incurred by the foreign subsidiary. Tax planning opportunities may be mitigated by granting an illimited loss carry-back and loss carry-forward, but this measure could not prevent all tax planning opportunities such as the decision to liquidate a subsidiary.

Such a shift of losses from the host State to the home State is in clear contradiction with the finding of the ECJ according to which "to give companies the option to have their losses taken into account in the Member State in which they are established or in another Member State would significantly jeopardise a balanced allocation of the power to impose taxes between Member States, as the taxable basis would be increased in the first

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[898] This may be achived *e.g.* by depreciating an asset over a shorter period of time or anticipating certain costs.

[899] For example, assume a manufacturer with a parent company in Member State A has a subsidiary that distributes its products in Member State B. Member State A has a higher corporate income tax rate than Member State B. Assume that an economic downturn occurs during which the subsidiary makes significant losses, because the sales decrease while the cost structure is kept. When the subsidiary is expected to be profitable again the group would normally carry on its activities in Member State B. But if final losses are automatically deductible in the home State, the group could decide to cease the activities of its subsidiary in Member State B, liquidate it, and consequently deduct all the final losses in Member State A. At the same time, the company could keep on distributing its products in Member State B through a third party distributor.

State and reduced in the second to the extent of the losses transferred"[900]. Consequently, tax planning opportunities resulting in moving the final foreign losses to the home State are in conflict with the rationale of the *Marks & Spencer* ruling. Could such a shift of losses be countered by Member States? It is true that the ECJ in *Marks & Spencer* made an exception to the obligation to grant relief for final foreign losses with regard to "wholly artificial arrangements whose purpose is to circumvent or escape national tax law"[901]. However, the examples of tax planning schemes referred to above may have sufficient substance for not being included in the scope of the exception of paragraph 57 of the *Marks & Spencer* decision. Indeed, the ECJ seems to exclude the application of anti-avoidance measures when a taxpayer carries on "genuine economic activities in the host Member State"[902] that "must be based on objective factors which are ascertainable by third parties"[903]. The ECJ also seems to exclude anti-avoidance rules, or at least CFC rules, when a company "physically exists in terms of premises, staff and equipment"[904]. All these criteria are rather restrictive and if the ECJ would also apply them with regard to final loss relief, it would be very difficult for Member States to prove that the losses are connected to such a wholly artificial arrangement whose purpose is to circumvent or escape national tax law. This is particularly the case in the examples mentioned above, in which the increase of losses in the host State results more from a business decision than a tax avoidance scheme without substance. The burden of proof may be all the more difficult to support that the Court considers that "taxpayers may choose to structure their business so as to limit their tax liability"[905].

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[900] See ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 46. This fear of transferring losses from one Member State to another has been reiterated in other cases: see ECJ, 18 July 2007, case C-231/05, *Oy AA*, para. 55 and 58-59; ECJ, 15 May 2008, case C-414/06, *Lidl Belgium*, para. 32; ECJ, 25 February 2010, case C-337/08, *X Holding BV v Staatssecretaris van Financiën*, para. 29.

[901] ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 57.

[902] ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*, para. 66.

[903] *C. cit.*, para. 67.

[904] *Ibid.*

[905] ECJ, 21 February 2006, case C-255/02, *Halifax*, para. 73.

Accordingly, the examples discussed above may not be considered as "wholly artificial arrangements whose purpose is to circumvent or escape national tax law"[906] as long as the taxpayer proves that he conducted genuine economic activities in the host State and that the foreign subsidiary existed in terms of premises, staff and equipment. At any rate, it seems very difficult and subjective to assess the business purpose of a decision such as not selling an asset, postponing the crediting of an accrual, or liquidating a foreign subsidiary. It may even be possible that Member States are precluded whatsoever from challenging business decisions related to maximising the amount of final foreign losses as long as the foreign subsidiary actually exists in terms of premises, staff and equipment[907].

As a consequence of the above analysis, a group could have the option to shift final foreign losses from the host State to the home State while still carrying on genuine economic activities. Requiring the home State to grant an automatic relief for all the final losses incurred by a foreign subsidiary or a permanent establishment subject to the exemption method may thus create tax planning opportunities that are not desirable within the internal market and clearly conflict with the findings of the ECJ in relation to the need to preserve a balanced allocation of the power to impose taxes between Member States. However, pure tax avoidance schemes should be caught by the exception referred to at paragraph 57 of the *Marks & Spencer* ruling. An example of such tax avoidance schemes for which cross-border loss relief may, in my view, be denied could be non-arm's length transactions with group companies, such as the grant of a non-arm's length loan to accumulate interest costs and thereby losses at the level of the foreign subsidiary. This is illustrated by the example below.

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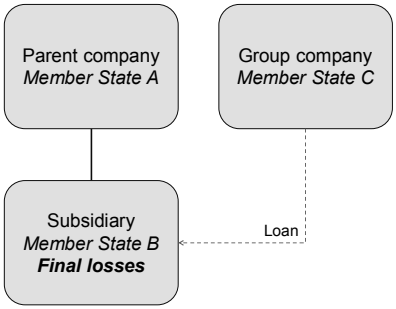
[906] ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 57.

[907] The exception to the obligation to grant relief for final foreign losses, referred to at paragraph 57 of the *Marks & Spencer* decision, would then concern more tax avoidance than tax planning.



By simply granting a loan, profits could be accumulated in Member State C while the interest costs would be accumulated in Member State B. Ultimately, these costs could become final losses and be deducted in Member State A. If this transaction is in breach of the arm's length principle, it is desirable that Member State A is not obliged, under the *Marks & Spencer* doctrine, to grant cross-border loss relief for the final losses.

Consequently, unless the final losses in the host State are the result of wholly artificial arrangements whose purpose is to circumvent or escape national tax law, the *Marks & Spencer* doctrine opens for tax planning opportunities through leaving the opportunity to design the tax base in the host State with the aim of minimising revenues or maximising the amount of final losses that are ultimately to be relieved in the home State. Such tax planning opportunities may be hardly countered by Member States, although they are in conflict with the case law of the Court. This section of the dissertation therefore pleads for not granting an automatic and unconditional final loss relief in the home State, so as not to jeopardise a balanced allocation of the power to impose taxes between Member States.

The second reason why an automatic and unconditional loss relief should not be required from the home State relates to the absence of connection, in the *Marks & Spencer* doctrine, between final loss relief and the way profits and losses are allocated between the parent company and the foreign subsidiary.

7.2.2 An automatic and unconditional relief for all the final losses in the home State may contradict the arm's length principle

The *Marks & Spencer* doctrine consists in requiring the home State to grant loss relief when a foreign subsidiary incurs final losses, as long as the State of the parent company has a tax equalisation regime available in domestic situations. The ECJ, through imposing an obligatory relief in the home State for all the final losses incurred by the foreign subsidiary, did not take into account the way profits and losses are allocated between the parent company and the subsidiary. This is, in my opinion, a key issue of the *Marks & Spencer* doctrine: irrespective of the way profits and losses are allocated between the parent company and the subsidiary during the course of their business activities, once losses become final in the host State the ECJ finds an obligation for the home State to deduct all of these losses. The problem is that the parent company and the foreign subsidiary are usually required, under domestic law and tax treaties, to enter into transactions and allocate income in accordance with the arm's length principle. That is, if the foreign subsidiary incurs losses, the arm's length principle may not necessarily require that such losses eventually be taken into account by the parent company. However, once the losses become final, the *Marks & Spencer* doctrine obliges the home State to grant loss relief to the parent company without taking into account the fact that such losses may have had to be partly or entirely supported by the subsidiary as a consequence of the arm's length principle. Accordingly, the *Marks & Spencer* doctrine may result in a denial of the cross-border allocation of profits and losses under the arm's length principle.

It should be observed that the arm's length principle has been dealt with and accepted by the ECJ, particularly in *Thin Cap Group Litigation*[908] and *SGI*[909]. Although these cases did not concern cross-border loss relief as such, they upheld the arm's length principle as an acceptable basis for allocating tax jurisdiction between Member States of the European Union,

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[908] ECJ, 13 March 2007, case C-524/04, *Thin Cap Group Litigation*, see particularly para. 80-87.

[909] ECJ, 21 January 2010, case C-311/08, *Société de Gestion Industrielle SA (SGI) v Belgian State*, see particularly para. 62-68.

even if this resulted in treating differently domestic and cross-border situations[910]. Accordingly, the arm's length principle should not be ruled out as a guiding principle for the purpose of considering cross-border loss relief within the European Union.

In my opinion, the arm's length principle indicates that there cannot be a single solution to loss relief[911]. The OECD Transfer Pricing Guidelines do not follow a single position for the treatment of losses incurred by associated enterprises, *i.e.* it is not decided whether or not losses made by a foreign subsidiary should necessarily be supported by the parent company or the head office: under the arm's length principle certain situations of losses are legitimate[912], which implies that such losses should remain in the host State. Under other circumstances losses may not be deductible in the host State, *e.g.* if the group as a whole is profit-making[913] or if the loss-making entity has limited functions, risks and assets that entitle it to a limited profitability[914]. So a first conclusion is that the arm's length principle does not

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[910] Moreover, the arm's length principle seems also to be important when it comes to determining whether or not a certain situation may be seen as abusive in the field of VAT. See ECJ, 22 December 2010, case C-103/09, *The Commissioners for Her Majesty's Revenue and Customs v Weald Leasing Ltd*, para. 45: "the tax advantage accruing from an undertaking's recourse to asset leasing transactions, such as those at issue in the main proceedings, instead of the outright purchase of those assets, does not constitute a tax advantage the grant of which would be contrary to the purpose of the relevant provisions of the Sixth Directive and of the national legislation transposing it, provided that the contractual terms of those transactions, particularly those concerned with setting the level of rentals, correspond to arm's length terms".

[911] For an analysis of losses under the arm's length principle, see Helmut Becker, *Losses and the arm's length principle: a German approach*, Intertax, 1997-8/9, pp. 287-290. See particularly p. 289 where this author observes that different examples of situations of losses "demonstrate that each case has to be judged separately. Dogmatic uniformity does not meet the variety of market situations".

[912] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, para. 1.70.

[913] *Op. cit.*, para. 1.71.

[914] See particularly *Op. cit.*, para. 1.42 to 1.51, where it is discussed the importance of a functional analysis.

indicate a single solution to the treatment of loss-making entities. Indeed, there is a fundamental notion of balance in the arm's length principle[915]. The underlying ground of the arm's length principle is that profits and losses should be allocated between associated enterprises depending on the allocation of functions, risks and assets within a group. This results in the allocation of taxing rights being dependent on the economic reality of a multinational enterprise. The more important functions are performed, risks are borne and assets are owned, the more reward an entity should be entitled to, but also the more exposed to losses it should be. On the other hand, enterprises performing routine functions, not bearing significant risks or owning valuable assets should not be entitled to particularly high profits, nor should they be exposed to significant losses. As a consequence of this allocation of profits and losses between associated enterprises, the host State is entitled to tax more or less of a group's profits. Consequently, the taxing rights of a State should match the actual presence of functions, risks and assets within its territory, which results in a balanced allocation of these taxing rights: a State should not tax more than what it is allowed to at arm's length, nor should it be exposed to negative income to a greater extent than what is prescribed by the arm's length principle.

Necessarily granting loss relief in the home State, as was required by the ECJ for final foreign losses in *Marks & Spencer*, may breach the arm's length

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[915] For some examples of the balance sought by the OECD when promoting the arm's length principle, see *Op. cit.*, preface, para. 4: "countries need to reconcile their legitimate right to tax the profits of a taxpayer based upon income and expenses that can reasonably be considered to arise within their territory with the need to avoid the taxation of the same item of income by more than one tax jurisdiction"; see also para. 18, where it is referred to "seeking to achieve the balance between the interests of taxpayers and tax administrators in a way that is fair to all parties". Examples are also found in the OECD Report on the attribution of profits to permanent establishments, 17 July 2008, p. 11, which refers to the "application of the arm's length principle as the fairest way to allocate taxing rights". Also, see the the OECD Report on the attribution of profits to permanent establishments, 22 July 2010, p. 18, which suggests the attribution of free capital to permanent establishments "in accordance with the arm's length principle to ensure that a fair and appropriate amount of profits is allocated to the PE".

principle if it moves the losses to a parent company that, under arm's length conditions, would not have to support the loss-making entity, or at least not wholly. It is important to emphasise that, according to the arm's length principle, a parent company may need to support its loss-making foreign subsidiary if the most important functions, the most significant risks or the most valuable assets in a cross-border transaction are located at the level of the parent company. If the foreign subsidiary has a low-risk profile[916] the host State may have only limited taxing rights[917] on this entity, while the parent company is likely to be entitled to the residual profit[918] of the cross-border controlled transactions. If a foreign subsidiary has such a low-risk profile, the parent company may have to support part or all of the subsidiary's losses under the arm's length principle. Support could be provided through different means such as a market contribution, reimbursing certain costs or decreased transfer prices, the purpose of which being a decrease in the parent company's income to increase the foreign subsidiary's income[919]. In such cases, the *Marks & Spencer* doctrine may be relevant, since it could actually enforce an arm's length allocation of losses between the subsidiary and the parent company. It is indeed possible that a group applies a transfer pricing policy that does not correctly enforce the arm's length principle, so that losses may have been unduly accumulated in the

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[916] By "low-risk profile" it is referred to an entity that does not perform important functions, bear significant risks or own valuable assets in relation to associated entities with which it enters into controlled cross-border transactions.

[917] By "limited taxing rights" it is meant that given the lack of important functions, significant risks or valuable assets at the level of the foreign subsidiary, this entity is only entitled to a low profitability.

[918] By "residual profits" it referred to the profits earned by the parent company after remunerating its subsidiary, given the subsidiary's functions, risks and assets.

[919] See for example the Court of appeals of Gothenburg (*Kammarrätten i Göteborg*), 12 May 2010, case number 4932-09, *JC Aktiebolag*, in which it was found that restructuring costs of a German subsidiary were deductible for a Swedish parent company as long as the objective of the restructuring was to improve the profitability of the subsidiary: such a support would, in the long run, increase the income of the Swedish parent company. The fact that the restructuring did not, in the end, produce the expected results was not an important parameter according to this court.

host State. Granting loss relief in the home State according to the *Marks & Spencer* doctrine would then correct a non-arm's length transfer pricing policy.

However, it is not always so that losses are unduly accumulated in the host State. It is well possible that a foreign subsidiary incurs "genuine losses"[920], for example if it has a high-risk profile[921], if it incurs start-up losses intended to establish a group on a new market, or if a group's business industry or geographical area is globally enduring an economic downturn. In such cases, the arm's length principle may indicate that at least part of the losses incurred during the course of the business operations carried on in the host State should be left at the level of the subsidiary. It would then breach the arm's length principle to allocate all the final losses to the home State, because according to the arm's length principle the parent company should not have supported the losses of the foreign subsidiary. In addition, if the foreign subsidiary has a high-risk profile, it may have earned substantial profits before incurring losses. In such a case, it is the host State that has taxed most of the profits resulting from the activities carried on by the subsidiary and it may appear fair that it is also this State that is exposed, at least partly, to the final losses.

The possible profitability of an entity with a high-risk profile is represented in the following figure. It is assumed that a company first incurred start-up losses, something that is frequent for an entity with a high-risk profile. Thereafter, it made high profits, thanks to the taking of risks and/or the ownership of valuable intangible assets. It is the host State that has taxed most of these profits.

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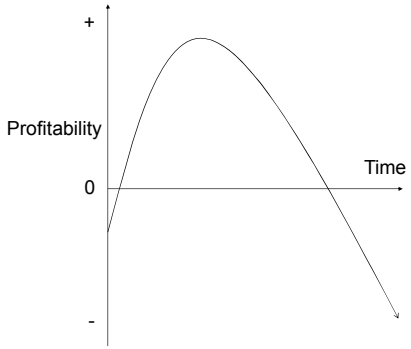
[920] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, para. 1.70.

[921] By "high-risk profile" it is referred to an entity that performs important functions, assumes significant risks or owns valuable assets in relation to associated entities with which it enters into controlled cross-border transactions.



When this company incurs final losses, it would not be in line with the arm's length principle to require the home State to grant relief for all these losses. As can be observed on the figure, the host State was first exposed to start-up losses but could then tax the profits of the subsidiary at the time its activities were thriving. Much less profits would have been earned in the host State if the subsidiary had a low-risk profile. The arm's length principle would, in my opinion, indicate that at least part of the final losses should be borne by the host State, as this State enjoyed the opportunity to tax the relatively high profits of this subsidiary as a consequence of the allocation of profits in accordance with the arm's length principle. In this situation the *Marks & Spencer* doctrine would, however, still allocate all these losses to the home State.

Consequently, the *Marks & Spencer* doctrine is not satisfying because it does not take into account the way profits and losses were allocated between the parent company and the foreign subsidiary before final losses were incurred. Instead, the *Marks & Spencer* doctrine imposes to the home State an automatic and unconditional relief for all the final losses incurred in the host State, irrespective of the foreign subsidiary's functional profile. Necessarily granting an automatic and unconditional loss relief in the home State may breach the arm's length principle if it results in allocating all the final losses to the home State, irrespective of the functional profile of the loss-making entity. On the other hand, there may be situations in which it is legitimate that a loss is moved to the home State, particularly if this loss was incurred by a low-risk taking entity. Consequently, the above analysis advo-

cates for finding a more balanced mechanism for cross-border loss relief that allows taking into account the way current profits and losses are allocated between a parent company and its foreign subsidiary[922]. The arguments discussed above support the view that the *Marks & Spencer* doctrine cannot constitute a satisfying solution in the long run for cross-border loss relief within the internal market.

Another solution would be to require from the host State to provide a tax refund corresponding to the value of the final losses for tax purposes.

7.3 Requiring from the host State a tax refund corresponding to the value of the final losses for tax purposes: a convincing alternative to the Marks & Spencer doctrine?

As an alternative to the *Marks & Spencer* doctrine, it could be conceived that relief for final losses could be provided by the host State through a negative tax, *i.e.* a refund corresponding to the value of the final losses for tax purposes computed according to the tax accounting rules of the host State. This position has already been suggested in the doctrine[923]. Indeed, the host State has had the opportunity to tax the subsidiary when it was profitable, so such a solution could expose the host State symmetrically to both the taxation of profits and the deduction of losses incurred by the same company instead of moving such losses to the home State. On the condition that a tax refund is also available to companies with domestic shareholders, this solution would provide for an equal treatment in the host State of all companies, irrespective of the residence of their shareholders. This would

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[922] The search for a balance in cross-border loss relief through avoiding to definitely moving losses from one Member State to another is also found in A.H. Coumans, E.M. Fredriks, *Loss compensation within the European Community*, Intertax, 1990-10, pp. 477-482: see particularly p. 481 where the authors discuss possible measures to preserve the consequences of cross-border loss relief measures on Member States' budgets.

[923] See Eric Kemmeren, *Principle of origin in tax conventions: a rethinking of models*, Katholieke Universiteit Brabant, Tillburg, 2001, pp. 54 and 230. See also, particularly with regard to final losses, Bertil Wiman, *The future of group taxation in Europe*, *in* Europäisches Steuerrecht, Festschrift für Friedrich Rödler zum 60 Geburtstag, Linde Verlag, 2010, pp. 954-955.

probably enhance capital import neutrality and contribute to sound conditions of competition in the host State, thereby enforcing articles 119 and 120 TFEU[924].

Also, the parent company benefits from public infrastructures in the home State and should therefore finance such infrastructures by paying taxes, which is threatened by supporting foreign losses deprived from an economic connection with this State. Similarly, the tax base in the host State may exceed the needs of public revenues if losses were transferred to the home State. Accordingly, the benefit principle could also plead for granting a tax refund in the host State. Moreover, the subsidiary's losses may not be due to loss-making transactions with the parent company but to its own economic activities. Therefore, it may be relevant to consider that the Member State of residence of the loss-making subsidiary should be exposed to its final losses, not the Member State of residence of the parent company.

However, it is submitted that necessarily granting a tax refund for a subsidiary's final losses should not be granted in the host State. Five arguments support this view. First, necessarily granting a tax refund corresponding to final losses incurred in the host State would open for tax planning opportunities. A group would be tempted to shift losses to a host State with high tax rates to maximise the value of these losses for taxation purposes. An example would be the taking up of a loan to accumulate interest costs in the host State. Also, a group of companies could perform research and development activities in a host State with high tax rates to accumulate costs – and thus losses – there, before moving the intangible assets resulting from the research and development activities to the parent company in a country with a lower corporate income tax rate. By moving the intangible assets early enough, such assets may not yet have a significant value so the profit potential associated to these assets is likely to be realised by the State of

[924] It was indeed argued above that requiring cross-border loss relief in the home State may breach a free competition in the host State, since a company may receive a more or less favourable treatment depending on where its shareholders are resident.

destination of the asset[925]. As a result, the emigration State could end up with significant losses, while the profits resulting from the research and development activities would be accumulated in the destination State. This may be in contradiction with the requirement of a balanced allocation of the power to impose taxes between Member States and the fear of "loss shopping" expressed by the Court in cases such as *Marks & Spencer*, *Oy AA*, *X Holding* and *Lidl Belgium*.

Second, the argument according to which the host State has had the opportunity to tax the subsidiary when it was profitable should be nuanced. Indeed, it is possible that the subsidiary never earned any profits but only made losses in the host State. Also, the taxing rights over the subsidiary in the host State depend on the functions it performs, the risks it assumes and the assets it owns. A high-risk taking entity may have earned substantial profits in the host State, thereby having a high ability-to-pay tax in this State. In contrast, a subsidiary with a low-risk profile may have only been entitled to a low return, thus having only a low ability-to-pay in this State. Therefore, it cannot be ascertained that the host State has taxed the subsidiary during profitable years and should consequently be exposed to all of its final losses.

Third, as argued above, the attribution of final losses should take into account the arm's length principle: it would not be satisfying to obtain an automatic tax refund for all the losses of the subsidiary in the host State irrespective of the profits to which it is entitled under the arm's length principle. This would be clearly problematic for companies that are not supposed to incur losses in the long run, which is particularly the case for companies with a low-risk profile. Consequently, a necessary refund in the

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[925] Indeed, the recommendations of the OECD on business restructurings are to avoid the taxation of an entity's future profits by the emigration State to, instead, tax the transfer of "something of value (rights or other assets)". See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, para. 9.65: "The arm's length principle does not require compensation for a mere decrease in the expectation of an entity's future profits". On the notion of profit potential, see Jérôme Monsenego, *Transfer pricing aspects of business restructurings: profit potential*, Tax Notes International, 19 July 2010, pp. 191-197.

host State for all of a company's final losses may be in breach of the arm's length principle.

Fourth, the final losses of the subsidiary may be due to non-arm's length prices applied with the parent company or other group companies. Non-arm's length prices should normally be corrected by a tax reassessment in the host State to enforce the arm's length principle, but it is possible that such an adjustment has not been performed by the tax authorities of the host State. This may happen if, for example, higher transfer prices are applied with a subsidiary before liquidating it during the same tax year. In such a case, being granted a refund in the host State while non-arm's length prices have contributed to increase the final losses would be unacceptable for the host State and would encourage tax planning aiming at increasing losses through non-arm's length prices, particularly if the subsidiary is resident in a Member State with relatively high tax rates.

Fifth, knowing that all the losses may be refunded in the host State is likely to influence investment decisions: groups could organise their operations to locate functions, risks or assets that are likely to be loss-making in a Member State with a high corporate income tax rate, while profit-making functions could be located in Member States with lower tax rates. It is true that groups may already be tempted to locate loss-making functions in high tax countries without having the right to get a tax refund in the host State, but such tax planning opportunities could be aggravated by the option to get an automatic refund in the host State. This breach of neutrality is not consistent with the principle of a balanced allocation of the power to impose taxes and the requirements of article 174 TFEU first indent, which promotes a harmonious development within the European Union, as well as economic, social and territorial cohesion[926]. The second indent of article 174 TFEU is also harmed by necessarily refunding all final losses of a subsidiary, as 174 TFEU second indent obliges Member States to reduce disparities between the levels of development of the various regions of the Union. These requirements are indeed jeopardised by the envisaged tax re-

[926] The direct effect of article 174 TFEU has, however, not been ruled on by the ECJ.

fund, as it may enhance disparities between Member States through increasing or decreasing their fiscal revenues and the type of activities that are located in their territories.

Consequently, given the arguments developed above, necessarily granting a tax refund corresponding to all the final losses incurred in the host State is, as the *Marks & Spencer* doctrine, not a sufficiently satisfying solution to cross-border loss relief within the internal market. The fact that both the *Marks & Spencer* doctrine and a tax refund in the host State are not satisfying solutions is the result of a necessary refund or deduction without efficient limitations to tax planning opportunities and without taking into account the allocation of profits and losses between the parent company and its foreign subsidiary under the arm's length principle. This advocates, in my opinion, for a split of final losses between the home State and the host State.

7.4 The suggested solution: a split of final losses between the home State and the host State

As a result of the above analysis, it was concluded that an automatic and unconditional loss relief should be required neither from the home State nor from the host State. Also, it was argued that it is important to take into account the way profits and losses are allocated between the parent company and the foreign subsidiary. Consequently, the only correct solution to final loss relief is, in my mind, a split of such final losses between the home State and the host State that takes into account the way profits and losses are allocated between the parent company and the foreign subsidiary[927]. Such a split of final foreign losses would be a compromise between a purely territorial approach (where all the final losses could be refunded in the host State, *i.e.* in the State in which such losses were incurred) and the *Marks & Spencer* doctrine (where all the final losses are attributed to the home State). But at the same time the approach suggested in the dissertation would strengthen the territorial connection between a Member State and the

[927] See *infra* at 7.5 for a discussion on the possible mechanisms enabling a split of final foreign losses between the home State and the host State.

amount of losses to be relieved as such losses would, as illustrated in the next section, be allocated between the home State and the host State depending on the economic connection between the losses and these States.

How would a split of final losses between Member States relate to the *Marks & Spencer* doctrine? In *Marks & Spencer* the ECJ focused on the home State and applied an "all in all out approach", *i.e.* it allocated either none or all of the final foreign losses to the home State. At first sight, it seems that splitting final foreign losses between the home State and the host State is not in line with the case law of the Court because it does not enforce this "all in all out" approach. That is not necessarily an insurmountable problem. Indeed, if Member States were to follow the approach suggested in this chapter through legislating at the level of the European Union, the Court may accept it in its case law. In that respect, the ECJ referred at many occasions to the lack of harmonisation of corporate taxation at the Union level[928], giving the impression that the Court was limited in the extent of its decisions by the absence of common measures at the level of the Union. Therefore, if Member States were to adopt a common set of rules allowing for cross-border loss relief that may not be fully in line with previous case law of the ECJ, the Court may not necessarily strike down such measures. Also, as the aim of a legislation on cross-border loss relief would be to enhance the achievement of the internal market, the ECJ would probably take account of such an objective.

In addition, it is submitted that four arguments support the view that splitting final foreign losses between the home State and the host State is compatible with EU law. First, a split of the final losses between the home State and the host State tends to implement a balanced allocation of the taxing powers by the Member States, as it avoids allocating all of the final foreign losses to a Member State without connection to the economic reality of the

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[928] See *e.g.* ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 58; ECJ, 13 March 2007, case C-524/04, *Test Claimants in the Thin Cap Group Litigation v Commissioners of Inland Revenue*, para. 49 and 91; ECJ, 18 July 2007, case C-231/05, *Oy AA*, para. 52; ECJ, 23 October 2008, case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v Finanzamt für Körperschaften III in Berlin*, para. 48.

cross-border activities of a group. In this respect, the case law of the Court is hardly consistent as it, on the one hand, promotes a balanced allocation of the power to impose taxes between Member States, and on the other hand adopts an "all in all out" solution with regard to final foreign losses. The approach suggested in this chapter is, in my opinion, better balanced and would have more consistent consequences on Member States' fiscal revenues.

Second, it has been evidenced above that the "all in all out" case law of the ECJ creates tax planning opportunities, *i.e.* taxpayers may structure their activities and design their tax bases in such a way that losses attributed to the home State are maximised, if the tax rate of the home State is higher than the tax rate of the host State. As argued above Member States may not be allowed to counter such arrangements on the basis of paragraph 57 of the *Marks & Spencer* decision, although the need to prevent tax avoidance is a justification ground accepted by the Court in several rulings. The solution advocated in this chapter would mitigate such tax planning opportunities, thereby reducing the risk of "loss shopping" feared by the ECJ.

Third, part of the final losses may be due to non-arm's length transactions with associated enterprises. Necessarily allocating all of the final foreign losses to the home State or the host State may create tax planning opportunities through encouraging groups of companies to entering into non-arm's length transactions. This results in a significant misbalance in Member States' tax systems, which conflicts with cases in which the Court uphelp the arm's length principle as an acceptable ground for allocating tax jurisdiction between Member States. Splitting final foreign losses between the home State and the host State would not entirely eliminate the risk that groups maximise final losses by minimising revenues or accumulating costs, but it would at least reduce the incentive for engaging into such tax planning.

Fourth, splitting final foreign losses between the home State and the host State may be more in harmony with article 174 TFEU, as a split of the final foreign losses could tend to protect the economic, social and territorial cohesion between Member States to a greater extent than the solution reached

by the ECJ in *Marks & Spencer*. Indeed, an obligatory loss relief in the home State for all the final losses would disadvantage smaller Member States that are strongly relying on export, as final foreign losses may be imported to their territory. On the other hand, bigger Member States would be disadvantaged with a compulsory tax refund for final losses incurred by residents on their territory, since because of their size they are attracting numerous foreign companies. Consequently, both of these two alternatives threaten the internal market, which is in my view better achieved by a well-balanced split of the final losses between the home State and the host State.

In conclusion, it is submitted that a split of the final foreign losses between the home State and the host State respects many of the findings of the ECJ throughout its direct tax cases. Obviously, a split of final foreign losses between the home State and the host State could not be implemented by Member States individually. Such a split would require that Member States adopt a legislative mechanism at the level of the European Union. Consequently, the findings of this chapter add to the criticisms to the *Marks & Spencer* doctrine and support the view that cross-border loss relief should be subject to harmonisation between Member States, irrespective of whether or not a common consolidated corporate tax base is implemented. Such a legislative mechanism would need to provide more than a mere requirement that losses be split between the home State and the host State. A more sophisticated framework would certainly be needed[929]. It is not the purpose of this chapter to study in depth the possible technical elements of such a cross-border loss relief mechanism. Rather, it is focused here on the questions of principle.

Since it is suggested that final losses be split between the home State and the host State, the part of the final losses that is attributed to the host State

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[929] Examples of issues that should be dealt with by such a legislative mechanism are the determination of the tax accounting rules according to which final losses shall be computed, whether or not Member States' rules on loss carry-forward and loss carry-back may need to be harmonised, the duration and the level of ownership of a subsidiary by a parent company, anti-avoidance measures as well as a possible tax refund for the part of the final losses that is allocated to the host State when the subsidiary is liquidated.

could be subject to a tax refund. Indeed, it is assumed that the losses incurred in the host State are final and that all possibilities of deduction in this State have been exhausted. Consequently, the only solution left for a relief in the host State is a tax refund corresponding to the value for taxation purposes of the part of the final losses that is attributed to this State. This means that Member States should be ready to accept to grant such a tax refund, which could be seen as providing a loss carry-back. Granting a tax refund may also be necessary in the home State, if there is not enough positive tax base to absorb the part of the final losses that has been attributed to this State. Of course, limitations to such a tax refund could be considered to safeguard Member States' fiscal revenues and prevent tax planning opportunities, such as *e.g.* a limitation of the refund to the amount of taxes actually paid during a certain period of time.

Another aspect that I find important is related to the amount of final losses that may be subject to a split between the home State and the host State. It is possible that the final losses incurred in the host State are, wholly or partly, due to cross-border transactions with associated enterprises that do not enforce the arm's length principle. It would, in my mind, be unreasonable to let non-arm's length transactions influence the amount of losses to be split between the home State and the host State, as this may encourage groups of companies to enter into such non-arm's length transactions and increase the amount of final losses incurred in the host State[930]. Accordingly, it is submitted that non-arm's length transactions could be set apart from the amount of final losses to be split between the home State and the host State[931]. As discussed above, the ECJ in *Marks & Spencer* made an exception to the obligation to grant relief for final foreign losses with regard to "wholly artificial arrangements whose purpose is to circumvent or escape

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[930] An example could be the grant of a loan with too high an interest rate by an associated enterprise to the loss-making group company, if the lender is resident in a country where interests are taxed at a lower level.

[931] It would be necessary to find a way of setting apart non-arm's length transactions. One possibility could be to let an arbitration panel analyse the composition of the final losses and set apart those losses that are due to non-arm's length prices.

national tax law"[932]. As the enforcement of the arm's length principle was accepted by the ECJ as a way to prevent that profits are transferred from one State to another, it seems that setting apart non-arm's length transactions from the amount to be split between the home State and the host State is compatible with EU law.

However, adjusting the tax base in the host State through correcting non-arm's length prices would correspondingly impact the tax base in other States: decreasing the losses in the host State because of non-arm's length transactions creates a double taxation that may only be solved through a corresponding adjustment in the other State(s) concerned. Yet, a corresponding adjustment cannot be imposed on other States. For example, if the losses incurred in the host State are decreased because it is considered that the subsidiary paid too high interests on an intercompany loan to a group company resident in another State, lowered interests (*i.e.* lowered income earned by the lender) cannot be simply imposed on the State of residence of the lender. The question is how to eliminate such a double taxation, particularly within the European Union where double taxation resulting from the correction of transfer prices is to be eliminated on the basis of the arbitration convention. A solution could be to determine the amount of adjusted final foreign losses through triangular mutual agreement and arbitration procedures, but such procedures may be very complex and lengthy. Another solution could consist in admitting all the final losses incurred in the host State in the amount of losses to be split, for the home State and the host State to possibly initiate competent authority procedures for the part of the losses that has been attributed to them and if they consider that the losses have been increased because of non-arm's length prices; this solution is also complex and may produce inconsistent results if the competent authorities of the host State and the home State have different views on the same transaction, so some coordination seems necessary.

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[932] ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 57.

The problem is that the complexity caused by these two[933] steps may be too great. In any case, the issues highlighted above illustrate the shortcomings of the *Marks & Spencer* doctrine for an efficient cross-border loss relief within the internal market. A more practical solution would be not to correct the final losses but to split all of them between the home State and the host State. This solution would be less acceptable for the home State and the host State because these they may have to take into account losses that would, at arm's length, be supported by other States. However, it seems difficult to reach a perfectly balanced solution absent a common consolidated corporate tax base.

Therefore, if the complexity of adjusting the final foreign losses to set apart losses caused by non-arm's length prices with associated entities located in third States is too great, it is suggested that the amount of final losses still be split between the home State and the host State. This solution, even without setting apart non-arm's length losses, may prove complex to implement in practice[934], contrary to the relative simplicity of the *Marks & Spencer* doctrine. However, given the arguments discussed above, it is submitted that the complexity of splitting final foreign losses should rather plead for implementing a common consolidated corporate tax base than relieving such losses according to the *Marks & Spencer* doctrine.

Outside the scope of a common consolidated corporate tax base, Member States could adopt a legislative mechanism that allows splitting the final foreign losses between the home State and the host State. The next step consists in discussing the method according to which the final foreign losses could be split between the home State and the host State.

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[933] That is, as a first step the correction of losses caused by non-arm's length prices with associated entities located in third States and as a second step the split of the remaining amount of final losses between the home State and the host State.

[934] In this respect see the opinion of Justice Brennan in the *Container Corporation* case: "Allocating income among various tax jurisdictions bears some resemblance, as we have emphasized throughout this opinion, to slicing a shadow" (US Supreme Court, 27 June 1983, case 81-523, *Container Corporation of America v Franchise Tax Board of California*).

7.5 Possible methods for splitting the final foreign losses between the home State and the host State

As explained above, it is submitted that it would not be a well balanced solution to attribute all the final foreign losses exclusively to the home State or to the host State. Therefore, it was suggested to split losses between these States, which would respect a balanced allocation of the power to impose taxes between Member States and could ultimately reinforce the territorial connection between losses and the Member States to which they are economically related. Two methods could be relevant in that respect: a split of losses could rely on an allocation key (7.5.1) or on an analysis based on the arm's length principle (7.5.2). This section does not, however, discuss the way loss relief could be technically provided, *i.e.* it is not suggested a loss relief mechanism that could be implemented by a directive or a regulation. Only the method according to which a loss relief mechanism could be provided is analysed here, and this analysis is limited to the point of view of principle.

7.5.1 Splitting the final foreign losses on the basis of an allocation key[935]

Splitting the final foreign losses on the basis of an allocation key could be both objective and foreseeable, as long as one agrees on one single formula. Groups of companies could know in advance the outcome of such a split, something that could make it more acceptable. Also, a solution to cross-border loss relief based on an allocation key would not necessarily be very complex to implement once the elements of the formula have been determined.

Splitting the final foreign losses on the basis of an allocation key would take into account the economic connection between a group of companies and

[935] This section deals only with an allocation key as a possible theoretical basis for the split of final foreign losses between the home State and the host State. The elements of such a key and their relative weight in a formula are not analysed in the dissertation. However, it can simply be observed that it may be relevant to adopt the formula chosen as part of a common consolidated corporate tax base, which would bring closer the tax treatment of losses for companies within and outside the consolidated area.

the countries where it is established, thus strengthening the territorial link between a Member State to which an amount of losses is attributed and the economic presence of a company on its territory: a Member State would have to grant loss relief to an extent that is proportionate to the relative presence on its territory of the different factors of a formula, *i.e.* not more but not less either.

In practice, once it is established that a subsidiary resident in a Member State and owned by a parent company resident in another Member State incurs final losses, such losses would be split between the host State and the home State on the basis of an allocation key. It would be necessary to assess the relative weight of the elements of the allocation key in the subsidiary and the parent company. The final losses would then be split between the home State and the host State on the basis of the allocation key[936].

However, there are two main problems with a split of final foreign losses on the basis of an allocation key. First, it is difficult to implement an allocation key without common tax accounting rules. If the tax accounting rules are different between the home State and the host State, a split of losses cannot reflect the exact economic connection between a group of companies and the countries where it is established. Indeed, the relative presence of the different factors of the formula in the territory of the two States would be influenced by the way these factors are computed. For example, if assets were included in the formula, the discrepancies between the rules on depreciation, accruals, and the classification as costs or assets may preclude a consistent comparison between the assets owned in the home State and in the host State. This problem could be mitigated by referring to common accounting standards such as the IFRS[937], to measure the relative weight of

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[936] The final loss could be split between the home State and the host State on the basis of a sharing mechanism inspired by the one suggested for the common consolidated corporate tax base. In that respect, see CCCTB/WP060\doc, 13 November 2007, *CCCTB: possible elements of the sharing mechanism*.

[937] IFRS stands for International Financial Reporting Standards. The IFRS are issued by the International Accounting Standards Board (IASB).

the elements of the formula in each State[938]. However, such a recalculation may significantly increase the administrative burden for companies or groups of companies. This may also produce results that are not consistent with the accounting rules normally used by these companies.

The second problem with a split of final foreign losses on the basis of an allocation key is that loss relief would greatly differ from the allocation and the taxation of profits as it results from current international tax practice. Profits allocated between members of a group are determined according to the arm's length principle. This principle relies on the importance of functions, risks and assets within each member of a group of companies as well as on the comparability of transfer prices or profit margins with independent enterprises. In particular, the arm's length principle puts strong emphasis on intangible property[939]. Intangible property constitutes indeed the greatest part of the value of many groups[940]. However, a formula can hardly take into account intangible assets[941]. The same goes for a formula based on

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[938] That is, the elements of the formula that rely on the financial statements of the subsidiary and the parent company could be recalculated on the basis of common accounting principles.

[939] See particularly OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, chapter 6, *Special considerations for intangible property*.

[940] See Isabel Verlinden, Yoko Mondelaers, *Transfer pricing aspects of intangibles: at the crossroads between legal, valuation and transfer pricing issues*, International Transfer Pricing Journal, January/February 2010, p. 49.

[941] Indeed, different types of intangible assets may create value, such as tradenames, patents, trademarks, copyrights, know-how, *etc*. Their importance for an enterprise may vary depending on the industry. It would not be satisfying to only select certain intangible assets in a formula, because it would breach neutrality between competitors and different industries. Therefore, it would be necessary to include all intangible assets in the formula. However, intangible assets may not be recorded on the balance sheet, so a deep analysis of each situation would be necessary to identify the legal and economic ownership of intangible assets in a certain situation. This may prove a difficult task, and at any rate requires a case-by-case analysis. Second, if the allocation key would include intangible assets it would be necessary to value such assets at a certain point in time. A valuation process is complex and Member States may not agree on its outome. Third, once the intangible asset has been valued, it would be necessary to identify its ownership. That may also be a difficult task, as intangible

the staff employed by the parent company and its foreign subsidiary, as it may not take into account the value created by this staff, particularly if the formula refers to the headcount[942]. A split of final foreign losses on the basis of an allocation key would therefore partly disregard the value created by the activities of a group of companies, and thus the contribution of this group to the fiscal revenues of a State. Such a discrepancy between the taxation of profits and a split of final losses is not, in my opinion, a satisfying solution, because a split of final losses would not match the cross-border allocation of profits: a State would be required to grant a relief for final losses that would not correspond to the taxing rights it may have been entitled to when taxing profits. In extreme cases, a State could be entitled – according to the arm's length principle – to a low taxing right while it is attributed high losses when an entity incurs final losses. That would be the case, for example, if a subsidiary resident in Member State A is performing contract manufacturing activities on behalf of a parent company resident in Member State B: according to the arm's length principle, the contract

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assets may be created or used by several entities. Fourth, intangible assets are mobile, so if they were to be taken into consideration in the formula, it would create tax planning opportunities. As a consequence, it would seem too burdensome to include intangible assets in a formula intended to allocate final losses between the home State and the host State. The same conclusion was reached by the European Commission with regard to the possible elements of the formula of a common consolidated corporate tax base: see CCCTB/WP060\doc, 13 November 2007, *CCCTB: possible elements of the sharing mechanism*, para. 33-35. In the context of a common consolidated corporate tax base, the importance of taking into account intangible assets has been emphasised by the European Commission: see CCCTB\WP\052\doc, 27 February 2007, *An overview of the main issues that emerged during the discussion on the mechanism for sharing the CCCTB*, para. 37: "The issue of intangible assets was also a source of concern for MS experts. The prevailing opinion was that intangible assets should be taken into account in a formula, although this raises important questions of valuation (especially for selfgenerated intangibles and intangibles that do not generate a stream of income) and of location (which company should account for the intangible, the company using it or the company receiving the royalty payment for granting the use of it?)".

[942] However, the value created by the staff could be partly taken into account if the formula would refer to the payroll: it may then be assumed that the level of wages corresponds to the value created by the staff employed, thereby partly taking into account the value created by the activities of the enterprise when splitting final losses.

manufacturer is entitled to a limited return[943]: the principal (*i.e.* the parent company) supports the business risks of the manufacturing activities through paying a stable remuneration to the contract manufacturer. Consequently, the principal builds economic ownership of the intangible property through financing the manufacturing activities. Although the contract manufacturer is a low-risk entity, it may still incur losses[944]. It is consequently assumed that a contract manufacturer incurs a final loss according to the *Marks & Spencer* doctrine and that such a final loss, once non-arm's length transactions have been set apart, is allocated between the home State and the host State according to an allocation key. Here, since it is likely that the manufacturing activities require important resources such as tangible assets and staff, Member State A may be allocated a relatively high part of the final foreign losses because a significant part of the factors of the formula would be situated on its territory, while only a little part of these factors would be located in Member State B. Consequently, in this example, it is likely that the State of the contract manufacturer would have to support a greater part of the final losses than the State of the owner of the intangible property. This is in contradiction with the way profits are allocated between these entities according to the arm's length principle.

Last, a split of final foreign losses on the basis of an allocation key would also create a compatibility issue with the tax treaties concluded by Member States, as the allocation of cross-border profits and losses is normally based on the arm's length principle. It is true that, with regards to permanent es-

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[943] See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, para. 1.47: "a contract manufacturer or a contract research provider that takes on no meaningful risk would usually expect only a limited return".

[944] Different reasons may justify why a contract manufacturer could be loss-making (at least during a limited period of time), such as plants becoming obsolete, loss-making transactions with third parties, comparable companies making losses, or local mismanagement. A contract manufacturer may also incur genuine losses if the prices applied with the principal are justified under the comparable uncontrolled price method, particularly given the fact that the comparable uncontrolled price method is the transfer pricing method favoured by the OECD Guidelines: OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, para. 2.3 and 2.14.

tablishments, article 7(4) of the OECD Model Tax Convention accepted until the 2008 update that profits be attributed on the basis of an apportionment of the total profits of the enterprise[945]. Yet, article 7(4) *in fine* clearly indicated that "the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article", which refers to the arm's length principle. In addition, article 9 of the OECD Model Tax Convention does not implement an apportionment, which is also rejected in the OECD Transfer Pricing Guidelines[946]. Therefore, splitting final foreign losses on the basis of an allocation key, while profits are taxed on the basis of the arm's length principle, is not a consistent with the tax treaties concluded between Member States.

As a result of the above analysis, it seems that although a split of final foreign losses on the basis of an allocation key would take into account the economic connection between a group of companies and the countries in which it is established, it is not a convincing solution because of the differences in Member States' tax accounting rules and the discrepancies it would introduce with regard to the allocation of profits and losses within a group of companies. An alternative solution would consist in splitting the final foreign losses on the basis of the arm's length principle.

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[945] See article 7(4) of the OECD Model Tax Convention, 2008: "Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary".

[946] See OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2010, para. 1.32: "OECD member countries reiterate their support for the consensus on the use of the arm's length principle that has emerged over the years among member and non-member countries and agree that the theoretical alternative to the arm's length principle represented by global formulary apportionment should be rejected".

7.5.2 Splitting the final foreign losses on the basis of the arm's length principle

From a theoretical point of view I believe that for the purpose of splitting the final foreign losses, absent a common consolidated corporate tax base, the arm's length principle has a clear superiority to an allocation key as it matches the way profits are allocated and taxed in cross-border situations. This would satisfy the requirements of symmetry[947] expressed by the ECJ in cases such as *Marks & Spencer*[948], *Lidl Belgium*[949], and *Krankenheim*[950]. The arm's length principle preserves a balanced allocation of the power to impose taxes through matching the taxation of profits to the deduction of losses, which corresponds to current international tax practice. The arm's length principle would also split losses in a way that promotes a territorial connection between the losses to be deducted and the Member State to which they are economically related, as the amount of losses attributed to each State would correspond to the location of functions, risks and valuable assets within its territory. As a result, the amount of losses allocated to each State would match the taxing rights to which each State should be entitled according to the arm's length principle.

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[947] On the need for symmetry in Member States' tax systems, see Peter J. Wattel, *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?*, *in* Dennis Weber (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, p. 140 and pp. 153-154.

[948] See ECJ, 13 December 2005, case C-446/03, *Marks & Spencer*, para. 43: "in tax matters profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system in order to protect a balanced allocation of the power to impose taxes between the different Member States concerned". See also para. 45: "the preservation of the allocation of the power to impose taxes between Member States might make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses".

[949] See *e.g.* ECJ, 15 May 2008, case C-414/06, *Lidl Belgium GmbH & Co. KG v Finanzamt Heilbronn*, para. 33.

[950] ECJ, 23 October 2008, case C-157/07, *Krankenheim Ruhesitz am Wannsee-Seniorenheimstatt GmbH v Finanzamt für Körperschaften III in Berlin*, para. 42.

From a practical point of view, splitting the final foreign losses on the basis of the arm's length principle would probably be more complex to implement that an allocation key, because an allocation key could be applied mechanically. In contrast, if final foreign losses were to be split between the home State and the host State on the basis of the arm's length principle, it would be necessary to consider the circumstances at hand and choose a split that correctly reflects the allocation of functions, risks and assets between the parent company and the subsidiary. Even if it is not the purpose of this chapter to analyse in depth the possible alternatives for implementing a loss relief mechanism that is based on the arm's length principle, one may spontaneously think of a split of the final losses determined between the competent authorities of the home State and the host State, possibly with an arbitration procedure in case of disagreement. In any case, it seems necessary that the bodies involved in splitting the final losses between a parent company and its subsidiary perform a functional analysis of these two parties over a sufficient period of time, to take into account possible cross-border redeployments of functions, risks and assets. Indeed, it is possible that the losses accumulated by a subsidiary have been incurred while this company had different functional profiles, for example if it has been restructured from being a high-risk taking entity to a low-risk taking entity. This task could be made easier if transfer pricing documentation has been continuously prepared by the group. However, it may be very complex to split final losses in case a business restructuring has taken place, which evidences some of the limits of the approach suggested in this chapter. Such difficulties to relieve final losses would not exist under a common consolidated corporate tax base, since profits and losses would be consolidated and allocated within the group on a continuous basis.

The suitability of the arm's length principle for allocating final losses is illustrated by two examples with different levels of risks in the host State. In both examples it is assumed that final losses have been accumulated by the foreign subsidiaries:

- In the first example, let us consider a parent company that decides to carry on research and development in another Member State through a foreign subsidiary. It is assumed that the host State of-

fers attractive conditions for the location of intangible assets. The group therefore decides that the research and development subsidiary shall bear most risks and costs connected to its activities so that it consequently owns the related intangible property. Income from these intangible assets is consequently taxed at the advantageous conditions offered by the host State. It is assumed that the foreign subsidiary has few employees and small facilities, most of the research being purchased from associated companies on a cost plus basis, so that the subsidiary assumes risks and consequently owns the intangible property that results from the research and development activities. It is assumed that a successful patent is registered, thus triggering substantial income from royalties. Some years later the patent is not successful anymore, and it is decided that the research and development subsidiary should invest massively in new research projects. These investments are financed by after-tax profits that were accumulated during the successful years, and significant losses are incurred as a result of the new investments. However, no new successful technology is found and the parent company decides to liquidate the subsidiary.

- In a second example, let us consider that the same parent company performs research and development on its own, and is responsible for value-adding functions such as the strategic management of the group. It also manufactures products using the technology developed through the research activities, such products being sold in another Member State through a distributing subsidiary. It is assumed that few valuable intangible assets are owned by the distributor, and that the distributor does not bear significant risks. Residual profits, *i.e.* profits earned in relation to the sale of products after remunerating the distribution subsidiary, are consequently accumulated at the level of the parent company. More staff is employed in the host State than in the first example, and storage facilities are needed. After some unsuccessful years and accumulating losses in the host State, the parent company decides to withdraw from this State and liquidate the subsidiary.

If one compares these two examples, unless intangible assets are taken into account in the formula, an allocation key could allocate more losses to the

host State of the distributor than to the host State of the research and development subsidiary: let us assume that an allocation key would use the elements considered for a common consolidated corporate tax base, *i.e.* labour, assets and sales[951]. In the above examples, the structure and resources employed by the distributor are significant. It is likely that the distributor employs more staff and owns more tangible assets than the research and development subsidiary, since the actual research activities were performed by associated enterprises: only the costs and risks were borne by the research and development subsidiary. Regarding sales, it is difficult to estimate which of the distributor or the research subsidiary is likely to have the highest turnover, as it would depend on the circumstances such as royalties received and the size of the distributor's market. As a result, it is possible that the host State of the distributing subsidiary would be allocated more losses under an allocation key than the host State of the research subsidiary, as the distributor's labour costs and tangible assets could be relatively more important than those of the research subsidiary.

However, a split of final foreign losses would probably be different at arm's length. In the first example, the research subsidiary was a risk-taking entity and owned all valuable intangible property, which has entitled its host State to tax the residual profits incurred by the economic ownership of the intangible property. In contrast, in the second example the distributing subsidiary was entitled to a limited return, as it did not own valuable intangible assets nor did it perform the most value-adding functions of the group. Therefore, splitting final losses at arm's length would result in allocating a significant part of the research subsidiary's final losses to the host State, while most of the distributing subsidiary's final losses would have to be deducted in the home State. Indeed, it would not be in line with the arm's length principle to require the home State to deduct most of the losses accumulated by the research subsidiary in the host State. Before the research subsidiary was liquidated, it is unlikely that the parent company would have financially supported this subsidiary and obtained a right of deduction for

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[951] See CCCTB/WP060\doc, 13 November 2007, *CCCTB: possible elements of the sharing mechanism.*

such a support. The home State would probably have refused the deduction of internal support, considering that the research subsidiary was a high risk-taking entity that should bear most risks of its activities. In contrast, if the distributor is loss-making, the manufacturer may have to support it, for example through market contributions or lower transfer prices. If the distributor is liquidated, the arm's length principle indicates that most, if not all the losses, should be borne by the home State, since it is this State that had the opportunity to tax most of the profits of the group on the basis of the residual profits earned by the parent company. This outcome may significantly differ from the split of losses possibly reached with an allocation key, and is at any rate more closely connected to the way profits were likely to be taxed in these two cross-border examples.

Two conclusions are reached on the basis of these examples. First, they strengthen the argument according to which final losses should be split between the home State and the host State: it is not a satisfying solution to exclusively require the home State to bear all the final losses, as the ECJ did in *Marks & Spencer*, nor would it be reasonable to exclusively lay this burden on the host State. Second, these examples show that the arm's length principle is a more suitable solution for the split of final losses than an allocation key, because it matches the deduction of losses with the way profits were or would have been taxed. By the same token the arm's length principle also strengthens the territorial connection between losses and the Member State to which they are economically related.

7.6 Conclusion

It was argued in this chapter that the *Marks & Spencer* doctrine is flawed by the necessary obligation it imposes on the home State to grant relief for all the final losses incurred by a foreign subsidiary. Although *Marks & Spencer* permits to offset final losses against profits incurred in another Member State, it does not help achieve a well-balanced allocation of the power to impose taxes within the internal market as it creates tax planning opportunities and does not take into account the way profits and losses are allocated between the parent company and its foreign subsidiary. These drawbacks add to the drawbacks already identified in chapter 3 of the dissertation, *i.e.* the definition of the concept of final losses, the possible breach of

a free competition in the host State, and the risk that final losses are deducted more than once. Consequently, although the *Marks & Spencer* doctrine is a step in the right direction for the achievement of the internal market, it does not suffice to reach this objective and, at the same time, results in other problems for the achievement of the internal market. All these arguments plead for considering the harmonisation of cross-border loss relief instead of letting final loss relief be provided by Member States' domestic tax laws on the basis of the *Marks & Spencer* doctrine.

The solution recommended in the dissertation does not lie in requiring the host State to provide a tax refund corresponding to the final losses incurred on its territory, as this approach is also problematic for a satisfactory achievement of the internal market. As a result, it was suggested to split final losses between the home State and the host State, to mirror the allocation of profits according to the arm's length principle.

The way of reasoning that is proposed in this chapter could obviously not be implemented by the ECJ or by Member States on an individual basis. It could, however, contribute to the discussions on a possible legislative measure to tackle cross-border loss relief within the European Union, outside the scope of a common consolidated corporate tax base. Indeed, relief for final foreign losses is an obligation according to the *Marks & Spencer* case and should be encouraged, as it is an important element for the achievement of the internal market.

8 Summary and conclusions

"if the case law of the ECJ can strike down national legislations, it cannot build up a system which would be compatible with the Single Market"[952].

8.1 Introduction

After summarising the main findings of each chapter of the dissertation (8.2), these findings are reconciled and discussed from the perspective of tax policy (8.3). Suggestions are then made on possible future research that could be helpful for the analysis of the conflict between Member States' taxation of companies' foreign business income and the objective of achievement of the internal market (8.4). Last, a general conclusion is drawn from the point of view of principle on the conflict between Member States' taxation of companies' foreign business income and the objective of achievement of the internal market (8.5).

8.2 Summary of the main findings of the dissertation

It was first observed that according to international law, States' sovereignty implies jurisdiction to tax both residents and non-residents on foreign income (chapter 2). At the same time, a State is not obliged to take into account foreign elements such as foreign negative income. A State's sovereignty also implies the absence of hierarchy between claims from different States: overlaps resulting from concurrent jurisdictions are a natural consequence of the current state of international law. As a result, international law does not favour the fiscal principle of territoriality or the principle of worldwide taxation, and international double taxation is not incompatible with international law. These findings can partly explain why Member

[952] Melchior Wathelet, *Direct taxation and EU law: integration or disintegration?*, EC Tax Review, 2004-1, p. 3.

States' taxation of companies' foreign business income is designed as it is, as States often tax foreign profits but do not necessarily deduct foreign losses, and international double taxation may happen as a result of States' taxing rights. These findings also render unconvincing the arguments sometimes put forward by Member States according to which they may not offer a tax advantage because a foreign item of income is not within their tax jurisdiction: this chapter demonstrates the fact that such arguments are the result of a State's choice, not the result of binding international law. Based on this finding it was argued later in the dissertation that taxing in accordance with the fiscal principle of territoriality, *i.e.* limiting a State's tax jurisdiction to domestic income, should not be a sufficient justification for infringements to EU law.

With regard to group taxation (chapter 3) it was observed that both the fiscal principle of territoriality and the principle of worldwide taxation raise compatibility issues with the objective of achievement of the internal market. However, the ECJ seems to favour the fiscal principle of territoriality over the principle of worldwide taxation, through limiting the applicability of CFC rules and requiring cross-border loss relief only for final foreign losses. At the same time, it was found that the fiscal principle of territoriality is at tension with EU law when it prevents the deduction of losses incurred by a foreign subsidiary. Although there are convincing arguments for not requiring the State of the parent company from granting relief for non-final losses incurred by foreign subsidiaries, it should not be forgotten that the lack of cross-border loss relief is a real obstacle to the achievement of the internal market. Therefore, it was suggested that Member States harmonise cross-border loss relief within the internal market given the difficulties for the ECJ to find a satisfying solution. It was also observed that a legislative mechanism to cross-border loss relief adopted at the level of the European Union would provide an incentive to establish risk-taking functions in other Member States, which could contribute to a homogeneous development of the host State and thereby enforce article 174 TFEU. With regard to final foreign losses, although it is a relevant idea to require their deduction, it was argued that the solution found by the ECJ in *Marks & Spencer* is criticisable in several respects and should be replaced by legislation

at the level of the European Union. Additional critics on the very rationale of the *Marks & Spencer* doctrine were formulated in chapter 7.

As far as the taxation of foreign permanent establishments is concerned (chapter 4) the same observation as in chapter 3 was made, *i.e.* both the fiscal principle of territoriality and the principle of worldwide taxation raise compatibility issues with the objective of achievement of the internal market. However, the balance between these principles is different than in chapter 3 of the dissertation. It was found that the ECJ accepts the application of the principle of worldwide taxation, although an implicit preference for the fiscal principle of territoriality seems to result from *Krankenheim*. Also, an inconsistency between *Columbus Container* and *Cadbury Schweppes* was identified, which results in a confusion on the extent to which the principle of worldwide taxation may be used to prevent tax avoidance. With regard to non-final losses incurred by permanent establishments, it was argued that the fiscal principle of territoriality is clearly incompatible with EU law and that loss relief should be available in better conditions for losses incurred by permanent establishments than by subsidiaries. Particularly, it was found that the risks of double deduction of losses are much less relevant with regard to permanent establishments than with regard to foreign subsidiaries. Therefore, the fact that in *Lidl Belgium* the ECJ merely transposed *Marks & Spencer* to permanent establishments was criticised, because the Court did not take into account the particularities of permanent establishments. With regard to final losses incurred by permanent establishments, an inconsistency was discussed between *Lidl Belgium* and *Krankenheim*, depending on the way these cases are interpreted. It was argued that final loss relief should be provided at least in the conditions of *Marks & Spencer*, given the particularities of permanent establishments that should make loss relief more easily available. In any case, as in chapter 3 it is suggested that Member States adopt a legislative solution to cross-border loss relief, the rationale of which could be inspired by the arguments developed in chapter 7.

When tax jurisdiction is exercised by a Member State on the territory of which a permanent establishment is situated (chapter 5), it was found that the taxation of foreign business income earned by a permanent establish-

ment should not infringe EU law, as long as such foreign business income is attributable to the permanent establishment according to the principles recommended by the OECD. With regard to foreign negative income, the ECJ seems to accept that the Member State of establishment applies strictly the fiscal principle of territoriality and excludes losses and certain costs with a foreign origin. It was argued that this approach may result in situations of double non-deduction and breaches the arm's length principle, thereby being in conflict with several cases handed in by the Court.

The analysis of international double taxation within the internal market (chapter 6) revealed a contradiction between on the one hand the acceptance of double taxation by the ECJ, and on the other hand the concept of an internal market, certain of the rights protected by article 6 TEU, case law refusing the double non-deduction of losses, as well as case law refusing the double levy of social contributions. These findings result in a clear tension of international double taxation with EU law although it is not recognised by the ECJ, which may be explained by the deep consequences on Member States' taxation of companies' foreign business income that such a recognition would have. However, it can hardly be denied that international double taxation has many negative consequences with regard to the objective of achievement of the internal market. Therefore, this chapter adds to the arguments according to which Member States should harmonise or at least coordinate some aspects of the taxation of companies' foreign business income, given the fact that the ECJ could not by itself make sure that international double taxation is efficiently eliminated within the internal market.

Last, as the ECJ requires relief for final losses incurred by foreign subsidiaries (and possibly also by permanent establishments subject to the exemption method), it was argued that one should not require from the home State to grant an automatic relief for all the final losses incurred in the host State (chapter 7). This chapter suggested an alternative approach to relieving final losses consisting in splitting final losses between the home State and the host State on the basis of the arm's length principle, to mirror the allocation of profits based on this principle. Such an alternative approach to relieving final losses could not be implemented by the ECJ or Member

States on an individual basis, but could instead be relied on if Member States were willing to harmonise cross-border loss relief.

8.3 Reconciliation of the findings and discussion from a tax policy perspective

The findings of the dissertation relating to the taxation of companies' foreign business income earned within the internal market are reconciliated hereunder and discussed from a tax policy perspective. The issues discussed below are CFC taxation (8.2.1), the taxation of permanent establishments' profits by the Member State of residence (8.2.2), the deduction of foreign losses incurred by foreign subsidiaries or permanent establishments subject to the exemption method (8.2.3) and the taxation of foreign business income attributable to a permanent establishment in the Member State of establishment (8.2.4). The observations made hereunder are only general and could be completed by future research.

8.3.1 CFC taxation

The case law of the ECJ clearly limits the taxation of foreign group companies on the basis of CFC rules applying the principle of worldwide taxation. This finding, originally based on *Cadbury Schweppes*, is strengthened by a strict reading of *Krankenheim*, the recommendations of the European Commission, the obstacle to the freedom of establishment resulting from the taxation of foreign income, the relevance of a restriction-based analysis, as well as the possible double taxation resulting from CFC taxation. So from the point of view of principle it is clear that CFC taxation is incompatible with EU law.

Nevertheless, as recognised by the ECJ[953], the European Commission[954], the Council of the European Union[955] and the OECD[956], CFC taxation may

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[953] ECJ, 12 September 2006, case C-196/04, *Cadbury Schweppes*.

[954] COM(2007) 785 final, 10 December 2007, *The application of anti-abuse measures in the area of direct taxation – within the EU and in relation to third countries*.

[955] See Conclusions of the ECOFIN Council meeting concerning taxation policy, 1 December 1997, 98/C 2/01, Official Journal of the European Communities, 6 January 1998, p. 5.

be necessary to prevent tax avoidance. Although it is not the purpose of the dissertation to analyse tax avoidance as such, it seems positive that the European Commission and the Council of the European Union encourage Member States to coordinate their CFC rules. However, it seems important that Member States grant a foreign tax credit upon the application of CFC taxation to avoid double taxation, given the clear tension between double taxation and EU law. That is, CFC taxation could be levied only on the difference between the home State's and the host State's corporate income tax rates applied to the foreign subsidiary's income. It should also be ensured that no double taxation happens upon the distribution of dividends by the foreign subsidiary[957].

8.3.2 Taxation of permanent establishments' profits by the Member State of residence

Despite the findings of the Court in *Columbus Container*, it was submitted that the objective of achievement of the internal market as well as the relevance of a restriction-based analysis argue for not taxing a permanent establishment's profits in the Member State of residence. These arguments are strengthened by a litteral reading of *Krankenheim*, the compatibility issues of double taxation with EU law, and the preferred application of a single set of rules within the internal market if it is to function as a single State. Not taxing a permanent establishment's profits in the Member State of residence could be achieved through choosing the exemption method in Member States' domestic tax laws and tax treaties, possibly on the basis of article 23 A of the OECD Model Tax Convention. However, as with foreign subsidiaries, Member States could retain a right to prevent tax avoid-

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See also Council Resolution on coordination of the Controlled Foreign Corporation (CFC) and thin capitalisation rules within the European Union, 8 June 2010, 2010/C 156/01, Official Journal of the European Union, 16 June 2010.

[956] See Harmful Tax Competition, an emerging global issue, OECD, 1998, para. 98.

[957] This observation is valid only for Member States whose CFC rules may result in a double taxation. In that respect, see Hans-Jörgen Aigner, Ulrich Scheuerle, Markus Stefaner, *CFC legislation, tax treaties and EC law* (ed. Lang, Aigner, Scheuerle, Stefaner), EUCOTAX Series on European Taxation, 2004, p. 42, where the authors refer to several situations in which double taxation may remain upon the levy of taxes according to CFC rules.

ance and include permanent establishments' profits in their taxable base. In that respect, Member States could possibly define tax avoidance and wholly artificial arrangements similarly to the definitions that are applied with regard to CFC taxation and replace the exemption method by the credit method. Alternatively, it could be considered to complement the exemption method with a subject-to-tax clause[958].

If Member States were not to apply the exemption method, it seems highly desirable that Member States at least grant a foreign tax credit upon the taxation of permanent establishments' profits given the clear tension between international double taxation and EU law. However, distortions of the free competition are accentuated by the credit method, because of the differences between Member States' rules on foreign tax credits. Permanent establishments located in a same Member State with head offices located in different Member States will ultimately be taxed differently and compete on

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[958] See Albert J. Rädler, *Tax treaties and the internal market, in Report of the Committee of independent experts on company taxation*, Brussels/Luxembourg, 1992, Annex 6, p. 376: with regard to article 23A of the OECD Model Tax Convention it is suggested to replace "may be taxed" by "has been subject to tax", to avoid double non-taxation. The importance of a subject-to-tax clause is illustrated by the fact that if the State of establishment does not tax a permanent establishment in application of its domestic law, the State of residence is normally still bound by the exemption method. In that respect see para. 56(2) of the Commentary to article 23A(4) of the OECD Model Tax Convention, 2010: "The paragraph only applies to the extent that the State of source has applied the provisions of the Convention to exempt an item of income or capital or has applied the provisions of paragraph 2 of Article 10 or 11 to an item of income. The paragraph would therefore not apply where the State of source considers that it may tax an item of income or capital in accordance with the provisions of the Convention but where no tax is actually payable on such income or capital under the provisions of the domestic laws of the State of source. In such a case, the State of residence must exempt that item of income under the provisions of paragraph 1 because the exemption in the State of source does not result from the application of the provisions of the Convention but, rather, from the domestic law of the State of source (see paragraph 34 above). Similarly, where the source and residence States disagree not only with respect to the qualification of the income but also with respect to the amount of such income, paragraph 4 applies only to that part of the income that the State of source exempts from tax through the application of the Convention or to which that State applies paragraph 2 of Article 10 or 11".

different grounds in the host State, not only because of the different corporate income tax rates of their home States, but also because of the different rules on tax credits to which their head offices are subject. Such distortions to the free competition within the internal market would be greatly mitigated by the exemption method or with a common consolidated corporate tax base.

8.3.3 Deduction of foreign losses incurred by foreign subsidiaries and permanent establishments subject to the exemption method

For non-final losses incurred by foreign subsidiaries, convincing arguments plead for granting a loss deduction followed by a later recapture on the basis of a specific legislative mechanism. Yet, many difficulties remain. A loss deduction mechanism followed by a later recapture could certainly improve the situation for multinational groups and make loss deduction closer to what may be available within a domestic market. However, even with such a mechanism, cross-border loss relief will still be subject to limitations, as long as it is based on a domestic tax equalisation system. Differences between Member States' tax equalisation systems are also likely to disturb a free competition within the internal market. In contrast, as far as loss deduction is concerned, the internal market would be much better achieved with a common consolidated corporate tax base. However, as a common consolidated corporate tax base would not be applicable to all situations, a loss relief mechanism such as the one suggested by the European Commission[959] would certainly contribute to the achievement of the internal market. Consequently, in parallel to the discussions on a common consolidated corporate tax base, it seems quite relevant to also consider a legislative solution on cross-border loss relief.

For non-final losses incurred by permanent establishments subject to the exemption method, the analysis conducted in chapter 4 of the dissertation demonstrates that the reasoning of the Court in *Lidl Belgium* is not convincing and that Member States should provide a loss deduction followed by a

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[959] See COM 90 (595) final, 24 January 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States.*

later recapture. In that respect, it is not technically necessary that Member States legislate on that issue. Member States could individually adopt such systems, but sound conditions for competition throughout the internal market argue for adopting common rules, given the important differences that may exist in how losses and future profits are computed, the duration of the loss deduction, *etc*. Therefore, the legislative solution on cross-border loss relief mentioned above could also be applicable to permanent establishments subject to the exemption method.

Last, particular consideration is necessary for final foreign losses. Loss relief is an explicit obligation for foreign subsidiaries since the *Marks & Spencer* case, and it was argued in chapter 4 that even better loss relief conditions should be granted for permanent establishments despite the hardly interpreted *Krankenheim* case[960]. In addition, the theoretical incompatibility of double taxation with EU law also argues for granting final loss relief for permanent establishments. However, the current conditions for final loss relief are not satisfying for the achievement of the internal market and may even disturb a free competition, if no tax equalisation mechanism is available in the host State. In addition, it was argued in chapter 7 of the dissertation that the very rationale of the *Marks & Spencer* doctrine is problematic given the requirement it imposes on the home State to grant loss relief for all the losses incurred in the host State. Such a requirement results in a clear misbalance in Member States' tax jurisdiction as it does not reflect the cross-border allocation of profits on the basis of the arm's length principle. Such a requirement is criticisable from a theoretical point of view and is in contradiction with certain findings of the ECJ[961].

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[960] In that respect, it could be observed that certain national court decisions tend to indicate that certain Member States interpret EU law as requiring final loss relief for permanent establishments subject to the exemption method. See *e.g.* the decision of the German *Bundesfinanzhof,* 9 June 2010, case number I R 107/09.

[961] In particular the requirement of ensuring a balanced allocation of the power to impose taxes as well as the acceptance of the arm's length principle for the attribution of tax jurisdiction between Member States.

A common consolidated corporate tax base could provide a well-balanced deduction of final losses, as such losses would be allocated and deducted in accordance with the way profits are taxed. Final loss relief would then be provided, although not on the basis of the arm's length principle. However, absent a common consolidated corporate tax base, the allocation and deduction of final foreign losses according to the *Marks & Spencer* doctrine is, in my opinion, highly problematic. It was suggested in chapter 7 *supra* that Member States could consider a loss relief mechanism that takes into account the allocation of profits on the basis of the arm's length principle, which could possibly be implemented as part of a legislative measure on cross-border loss relief. Such a loss relief mechanism could, for example, let Member States' competent authorities agree on a split of the final losses between the home State or the host State. Alternatively, or in case of disagreement between Member States' competent authorities, the power to split final losses could be delegated to an independent arbitration panel[962], a European tax authority[963], or the ECJ[964].

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[962] A possibility could consist in amending the arbitration convention to include the split of final losses in the field of competence of the advisory commission, for example by amending article 12(1) of the Convention 90/436/EEC of 23 July 1990 on the elimination of double taxation in connection with the adjustment of profits of associated enterprises. It can also be observed that there has been discussions in the doctrine on the creation of an international body or a world tax organisation that could help solve certain international tax issues. If such a body existed it could possibly deal with the setting apart of losses due to non-arm's length prices and ultimately split the final losses between the home State and the host State. On the creation of an international body of tax experts see *e.g.* Kees van Raad, *International coordination of tax treaty interpretation and application*, *in* International and comparative taxation, Essays in honour of Klaus Vogel, Kluwer Law International, 2002, pp. 217-230.

[963] For a discussion on a European tax authority that could act as a "European 'one-stop-shop'", see Klaus-Dieter Drüen, *Tax audits of multinational enterprises*, *in* Michael Lang, Pasquale Pistone, Josef Schuch and Claus Staringer (eds.), Common Consolidated Corporate Tax Base, Linde, 2008, pp. 1041-1042.

[964] See article 273 TFEU, which grants the ECJ jurisdiction on "any dispute between Member States which relates to the subject matter of the Treaties if the dispute is submitted to it under a special agreement between the parties". For example, the ECJ has been appointed as arbitrator through article 25(5) of the tax treaty between Austria and Germany concluded on 24 August 2000: "If any difficulty or doubt arising as to the interpretation or application of

8.3.4 Taxation of foreign business income attributable to a permanent establishment by the Member State of establishment

The taxation of permanent establishments and the compatibility of such a taxation with the objective of achievement of the internal market has not been subject to much discussions and case law. A possible explanation could be the protection offered by the non-discrimination principle existing in tax treaties and EU law. One may be tempted to encourage the ECJ and the European institutions to adopt the authorised OECD approach, but its overall compatibility with EU law should first be assessed. As far as the attribution of foreign business income to a permanent establishment is concerned, there is an apparent conflict between the case law of the ECJ and the recommendations of the OECD. It has been argued in chapter 5 of the dissertation that a strict application of the fiscal principle of territoriality by the Member State of establishment excluding the deduction of certain losses and costs is not desirable and may even breach certain findings of the ECJ, such as the need to avoid situations of double non-deduction and the relevance of the arm's length principle. In addition, the clear tensions between EU law and international double taxation should argue for taxing permanent establishments in a way that avoids double taxation, both in bilateral and in triangular situations.

For ensuring that the taxation of permanent establishments is in line with the objective of achievement of the internal market, while the attractivity of the European Union for the setting up of permanent establishments from third States is not hindered, a global assessment of the authorised OECD approach with regard to EU law may be considered. Soft law recommenda-

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the Convention cannot be removed by the competent authorities by the use of the mutual agreement procedure as provided for by the foregoing paragraphs of this Article within a period of 3 years from the date of initiation of the procedure, the States upon application of a person covered by paragraph 1 shall be obliged to refer the case to arbitration proceedings before the European Court of Justice pursuant to Article 239 of the EC treaty". For a comment on the legal mechanism setting the grounds for the ECJ acting as an arbitrator in matters related to the interpretation and application of tax treaties, see Mario Züger, *The ECJ as arbitration court for the new Austria-Germany tax treaty*, European Taxation, March 2000, pp. 101-105.

tions may be useful to provide guidance to Member States on triangular situations as well as how the authorised OECD approach could be interpreted within the European Union. The joint transfer pricing forum may, in this regard, provide useful help.

Below are presented some suggestions on possible future research about the conflict between the objective of achievement of the internal market and Member States' taxation of companies' foreign business income.

8.4 Suggestions on possible future research about the conflict between the objective of achievement of the internal market and Member States' taxation of companies' foreign business income

The problems analysed in the dissertation evidenced a number of issues that could be deepened in future research. In particular, additional research in the three following areas could help better understand the conflict between the objective of achievement of the internal market and Member States' taxation of companies' foreign business income. The findings of the dissertation could also be tested through research in the field of economics.

First, the compatibility of the authorised OECD approach on the attribution of profits to permanent establishments with EU law is a field that is not much explored. It was argued in chapter 5 of the dissertation that a strict application of the fiscal principle of territoriality in the Member State of establishment is not always relevant, that it is incompatible with certain cases of the ECJ, and not in line with the attribution of profits to permanent establishments as recommended by the OECD. However, the taxation of permanent establishments according to the authorised OECD approach may raise other problems such as the attribution to permanent establishments of free capital and interest-bearing debt, so it cannot be taken for granted that the authorised OECD approach is compatible with EU law. The taxation of foreign business income attributable to permanent establishments could, consequently, be subject to additional research.

Second, the consequences of article 6 TEU on Member States' direct tax laws are yet to be determined. Potentially, this article could have significant

consequences on Member States' taxation of companies' foreign business income, and more generally, on European tax law. In the dissertation only two of the rights protected by article 6 TEU were briefly analysed (the protection of possessions and the principle of *ne bis in idem*), because it was considered that these two rights were the most relevant with regard to international double taxation. However, other rights protected by the European Convention for the Protection of Human Rights or the Charter of Fundamental Rights could also have consequences on direct taxation.

Last, chapter 7 of the dissertation emphasised the misbalance created by the *Marks & Spencer* doctrine in Member States' tax jurisdiction with regard to final loss relief. Absent a common consolidated corporate tax base, it is submitted that final foreign losses should be split between the home State and the host State on the basis of the arm's length principle. It was also suggested that losses due to non-arm's length prices be set apart from the amount of final foreign losses to be split between the home State and the host State. A split of the final losses could, for instance, be based on a negotiation between Member States' competent authorities, or in case of disagreement, the power to split final losses could be delegated to an independent arbitration panel, a European tax authority, or the ECJ. Additional research would be necessary to analyse and assess different alternatives, and eventually identify which type of mechanism would be most suitable for efficiently splitting final losses.

A general conclusion is drawn below on the basis of the main findings of the dissertation.

8.5 General conclusion

> "the distinction between residence and source has no meaning within the European single market. But the ECJ must accept this distinction because the Community has no special power to harmonize direct taxation"[965].

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[965] Manfred Mössner, *Source versus residence - an EU perspective*, Bulletin for International Fiscal Documentation, December 2006, p. 504.

The analysis of ECJ case law illustrates the conflict mentioned in the introduction of the dissertation between Member States' tax jurisdiction as determined by international law and the objective of achievement of the internal market. The internal market ultimately aims at implementing the conditions of a domestic market, *i.e.* a single State. However, it was evidenced throughout the dissertation that Member States' rules on the taxation of companies' foreign business income do not meet this objective of implementing the conditions of a domestic market. The most flagrant examples are the lack of cross-border loss relief and international double taxation within the internal market, where Member States design their tax rules individually as opposed to being inspired by the objective of achievement of the internal market.

Consequently, Member States' fiscal sovereignty is in conflict with EU law[966]. This results in a twofold problem. On the one hand, the case law of the ECJ is often criticisable and disturbs the balance in Member States' tax systems. On the other hand, this case law is not sufficient for achieving the internal market. Looking at this situation from a short-term perspective may result in a certain level of frustration, both for the European enthusiasts and for the defenders of Member States' fiscal sovereignty. Looking at this situation from a long-term perspective reveals that Member States' taxation of companies' foreign business income results in a complex conflict with EU law, and therefore it is not surprising that the jurisprudence of the ECJ takes time to develop and is sometimes criticisable or inconsistent[967]. The task that lies on the ECJ is, indeed, indisputably great[968]. The

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[966] See Peter J. Wattel, *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?*, *in* Dennis Weber (ed.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, p. 144: "By definition, protecting the tax turf of a national State (i.e. preserving fiscal territorial cohesion) involves a certain degree of fiscal disintegration of the internal market".

[967] See Leif Mutén, *Lecture in honour of Klaus Vogel: European Tax law, quo vadis?*, Bulletin for International Fiscal Documentation, January 2008, pp. 2-8.

analyses carried out in the dissertation tend to evidence that the ECJ cannot efficiently solve the whole conflict between the objective of achievement of the internal market and Member States' taxation of companies' foreign business income. Without considering some level of harmonisation or co-ordination of Member States' taxation of companies' foreign business income, it seems that the internal market will not be fully achieved, ECJ case law will become more and more difficult to interpret and reconcile, and Member States will have increasing troubles in efficiently designing their tax laws. Therefore, the achievement of the internal market can hardly come solely from the negative integration.

The analyses carried out throughout the dissertation help take the full measure of the objective of achievement of the internal market with regard to the taxation of companies' foreign business income, by analysing the case law of the ECJ as well as some of the key provisions of the EU Treaties. A clear conclusion of the thesis is that both the fiscal principle of territoriality and the principle of worldwide taxation raise compatibility issues with the objective of achievement of the internal market. Such compatibility issues are accentuated if one takes into account the conflict between double taxation and EU law, which should have consequences on the extent of Member States' tax jurisdiction. Since both the fiscal principle of territoriality and the principle of worldwide taxation raise compatibility issues with the objective of achievement of the internal market, only two solutions seem to be available for Member States' taxation of companies' foreign business income to be compatible with EU law: either the fiscal principle of territoriality and the principle of worldwide taxation should be combined, so that their most conflicting aspects are eliminated, or Member States' taxation of companies' foreign business income should be based on new principles of taxation. This second solution has been identified by the European Commission as the preferred way forward to achieve the internal market for the taxation of companies, in the form of a common consoli-

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[968] See Leif Mutén, *Will case law do?*, *in* A vision of taxes within and outside European borders, Festschrift in honor of Prof. Dr. Frans Vanistendael, Kluwer Law International, 2008, pp. 658-667.

dated corporate tax base[969]. In that respect, the analyses of ECJ case law carried out throughout the dissertation partly contribute to the assessment of the need of a common consolidated corporate tax base, and also highlight some of the characteristics that such a common tax base should have to be compatible with EU law. However, a common consolidated corporate tax base would not solve entirely the conflict between Member States' taxation of companies' foreign business income and the objective of achievement of the internal market, because the common tax base would not be applicable to all European companies[970]. Its enactment is, in addition, uncertain. Therefore I believe that the first solution, *i.e.* a combination of the fiscal principle of territoriality and the principle of worldwide taxation, should be considered. It is also an easier way forward that does not prevent the future enactment of a common consolidated corporate tax base. The way the fiscal principle of territoriality and the principle of worldwide taxation could be combined has been analysed throughout the dissertation for the taxation of both foreign profits and foreign losses, in three different territorial situations.

An author wrote in 1950 that if a European organisation were to be built, it would necessarily be on the basis of the principle of territoriality[971]. This author probably referred to the principle of territoriality as it stands in international law, *i.e.* a jurisdiction principle that recognises a right to legislate

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[969] See COM(2001) 582 final, 23 October 2001, *Towards an internal market without tax obstacles*; COM(2003) 726 final, 24 November 2003, *An internal market without company tax obstacles – achievements, ongoing initiatives and remaining challenges*. See also COM(2006) 157 final, 5 April 2006, *Implementing the Community Lisbon programme: progress to date and next steps towards a common consolidated corporate tax base (CCCTB)*.

[970] Indeed, several types of requirements are likely to be fulfilled for a group of company to have the right to apply the common consolidated corporate tax base. In addition, the common consolidated corporate tax base is intended to be optional. Last, not all Member States may adopt the common consolidated corporate tax base.

[971] Jean-Hyppolite-Paulin Niboyet, *L'universalité des règles de solution des conflits est-elle réalisable sur la base de la territorialité?*, Revue Critique de Droit International Privé, 1950-4, pp. 515: "Si donc l'idée d'une organisation de l'Europe devait, un jour, prendre corps, c'est nécessairement sur la base de la territorialité que la solution de notre problème devrait être cherchée".

on the basis of a territorial connection between a State and a legal subject or a legal object, as opposed to the other jurisdiction principles recognised in international law. This statement is also relevant in the field of European tax law, because determining and optimising the territorial connection Member States and taxable income is central to enhance the well-being of European companies and ensure the levy of taxes for financing the objectives of the European integration. However, the optimal connection between Member States and European companies' business income is yet to be determined. The findings of the dissertation have demonstrated that the traditional territorial connections steming from the principle of territoriality as it stands in international law, *i.e.* essentially source and residence, raise a number of compatibility issues between the objective of achievement of the internal market and Member States' taxation of companies' foreign business income. Still, the internal market could be partly achieved on the basis of these traditional territorial connections. Some harmonisation or coordination would nevertheless be necessary to correct the most infringing aspects of Member States' taxation of companies' foreign business income. Suggestions were made in that respect throughout the dissertation, mostly on the basis of a legal analysis of ECJ case law as well as some key provisions of the EU Treaties, but also *de lege ferenda* with regard to final loss relief.

However, although such a minimum harmonisation or coordination could correct some of the conflicting aspects of Member States' tax rules while the traditional territorial connections are kept, it would not fully achieve the internal market[972] because the taxation of companies' foreign business income would still differ from the taxation of companies' domestic business income. Also, the concepts of source and residence may, as such, be criticisable with regard to their suitability to the modern and globalised economy[973]. For that purpose and as far as the taxation of companies' foreign

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[972] See Kees van Raad, *Fractional taxation of multi-State income of EU resident individuals – a proposal*, *in* Liber Amicorum Sven-Olof Lodin, Kluwer Law International, 2001, pp. 211-212: "the court is simply not equipped for renovating outdated taxation regimes".

[973] See Michael J. Graetz, *Taxing international income: inadequate principles, outdated concepts, and unsatisfactory policies*, Tax Law Review, 2001-3, p. 315: "in the case of direct investment, many

business income earned in other Member States is concerned, it seems that the common consolidated corporate tax base project would go much further in the achievement of the internal market. This project also respects the principle of territoriality as it stands in international law, but the territorial connections between Member States and companies' business income would be different than under the current taxation principles: the current legal territorial connections based mainly on the source of income and the residence of a company would be partly replaced by an economic territorial connection based on the actual presence of a company or a group throughout the internal market. Tax jurisdiction would be exercised on the basis of the territorial connection between a Member State and the physical presence on its territory of the elements of a formula, on the basis of an allocation key[974]. Therefore, a strong territorial connection between Member States and companies' business income would still exist with a common consolidated corporate tax base, although this connection would differ from today's.

The statements formulated by Niboyet in 1950 according to which a European organisation would necessarily be built on the basis of the principle of territoriality are, consequently, quite relevant for the taxation of companies' business income earned throughout the internal market.

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of the core concepts designed to enforce international income tax arrangements have become outdated".

[974] In this respect, it should be emphasised that the critics made *supra* on an allocation key as a possible way of splitting final foreign losses between the home State and the host State are not valid within a consolidated area where all profits and losses are computed and allocated on the basis of the same principles.

9 Résumé en langue française

« Le travail accompli par les juges du Kirchberg est à la mesure des enjeux qu'affronte l'économie européenne. Avec une approche plus pragmatique que celle pratiquée par les juridictions de culture latine, elle vient accomplir une tâche qui n'était pas prévue mais qui se révèle bien nécessaire. Le magistère qu'elle exerce sur la fiscalité des affaires permet au jour le jour d'oublier que le droit positif est rare, en réussissant la gageure de tracer le cadre qui libère les énergies transnationales des entreprises sans désespérer pour autant les États »[975].

Tout au long de la thèse nous avons analysé le conflit entre l'objectif d'établissement du marché intérieur et les principes d'imposition des revenus étrangers des entreprises. Ce résumé présente tant le problème et la méthode de recherche que les résultats des analyses effectuées. Il est toutefois important de préciser que ce résumé ne fait que reprendre une partie des idées développées au cours du travail de recherche, c'est-à-dire qu'une sélection des idées principales a été effectuée. Par ailleurs, seules les conclusions des raisonnements sont présentées ici.

Après une introduction au sujet de la thèse, ses différents chapitres seront successivement présentés.

9.1 Résumé du chapitre 1 : introduction

Après avoir exposé le sujet (9.1.1), nous présenterons l'objectif de la thèse et le plan qui a été suivi (9.1.2).

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[975] Philippe Marchessou, *L'apport de la jurisprudence de la CJCE en matière d'imposition des entreprises*, *in* Martial Chadefaux, Florence Deboissy, Christophe de la Mardière (éditeurs), Écrits de fiscalité des entreprises – études à la mémoire du professeur Maurice Cozian, 2009, p. 630.

9.1.1 Présentation du sujet

Il est courant de distinguer le principe de mondialité de l'imposition des entreprises, en vertu duquel leurs bénéfices mondiaux sont imposés par l'État de résidence, du principe de territorialité qui limite l'imposition des entreprises aux bénéfices de source nationale. Ces deux principes d'imposition ont des caractéristiques et des conséquences différentes, de sorte que les États peuvent être enclins à faire usage plutôt de l'un ou de l'autre. Ce choix peut dépendre tant du lieu de résidence du contribuable que de considérations de politique fiscale.

En effet, le lieu de résidence du contribuable peut déterminer l'étendue des prétentions fiscales des États : alors qu'un contribuable résident peut en général être imposé sur ses revenus mondiaux dans l'État de résidence, les contribuables non résidents sont généralement imposés sur une assiette plus réduite, souvent limitée aux revenus de source nationale. Cette limitation est le fruit tant de la législation fiscale interne des États que des conventions fiscales internationales par eux conclues. Par ailleurs, des considérations de politique fiscale peuvent influer sur l'étendue des droits d'imposition exercés par les États, dans un cadre préalablement établi par le droit. C'est-à-dire que les États ne font pas toujours usage de l'ensemble de leurs prérogatives fiscales telles que définies par la combinaison du droit interne, des conventions fiscales internationales et du droit international public, de façon à pouvoir, par exemple, encourager les investissements étrangers ou promouvoir leur attractivité. Le choix entre la mondialité et la territorialité de l'imposition peut aussi varier en fonction de la classification des revenus. Cependant, nous avons limité le champ d'étude de cette thèse aux seuls bénéfices d'exploitation, ou revenus dits actifs.

Si le choix entre territorialité et mondialité de l'imposition des entreprises a longtemps été débatu celui-ci est toujours d'actualité, notamment au vu de la modernisation des technologies et de la mondialisation des économies[976].

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[976] Sur le débat entre territorialité et mondialité de l'imposition des entreprises voir Nicolas Melot, *Territorialité et mondialité de l'impôt, étude de l'imposition des bénéfices des sociétés de capitaux à la lumière des expériences française et américaine*, Nouvelle Bibliothèque des Thèses, Dalloz, 2004 ;

En effet, la modernisation des technologies n'est pas sans conséquences sur les principes d'imposition du droit fiscal international, principes dont la pertinence est remise en question par des problématiques nouvelles telles que la dématérialisation de l'établissement stable[977]. De plus, la mondialisation des économies met en exergue la difficulté de réconcilier un système fiscal attractif avec la préservation des finances publiques. Par conséquent, le

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Daniel Gutmann, *Globalisation et justice fiscale*, L'Année Fiscale, Presses Universitaires de France, 2003, pp. 109-127 ; Daniel Gutmann, *Droit fiscal des affaires*, Montchretien, 2010, pp. 410-417 ; Claude Emonnot, *Intégration financière européenne et fiscalité des revenus du capital*, Economica, 1998 ; Klaus Vogel, Rapport Général du congrès de l'IFA, *Fiscal obstacles to the international flow of capital between a parent and its subsidiary*, vol. 69a, 1984; Klaus Vogel, *Federal Republic of Germany, Taxation of foreign income – principles and practice*, Bulletin for International Fiscal Documentation, janvier 1985, pp. 4-14 ; Klaus Vogel, *Worldwide vs source taxation of income – a review and re-evaluation of arguments, (part I)*, Intertax, 1988-8/9, pp. 219-229 ; Klaus Vogel, *Worldwide vs source taxation of income – a review and re-evaluation of arguments, (part II)*, Intertax, 1988-10, pp. 310-320 ; Klaus Vogel, *Worldwide vs source taxation of income – a review and re-evaluation of arguments, (part III)*, Intertax, 1988-11, pp. 393-402 ; Eric Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models*, Katholieke Universiteit Brabant, Tillburg, 2001 ; Eric Kemmeren, *Source of income in globalizing economies: overview of the issues and a plea for an origin-based approach*, Bulletin for International Fiscal Documentation, novembre 2006, pp. 430-452 ; Reuven S. Avi-Yonah, *Back to the future? The potential revival of territoriality*, Bulletin for International Fiscal Documentation, octobre 2008, pp. 471-474 ; Dale Pinto, *Exclusive source or residence-based taxation – is a new and simpler world tax order possible?*, Bulletin for International Fiscal Documentation, juillet 2007, pp. 277-291 ; Nancy H. Kaufman, *Fairness and the taxation of international income*, Law & Policy in International Business, 1998, pp. 145-203 ; Salvador Barrios, Harry Huizinga, Luc Laevan, Gaëtan Nicomède, *International taxation and multinational firm location*, Taxation papers, Union européenne, 2009 ; Peggy B. Musgrave, *Sovereignty, entitlement, and cooperation in international taxation*, Brooklin Journal of International Law, 2001, pp. 1335-1356 ; Michael J. Graetz, *Taxing international income: inadequate principles, outdated concepts, and unsatisfactory policies*, Tax Law Review, 2001-3, pp. 261-336 ; Richard A. Musgrave, Peggy B. Musgrave, *Public finance in theory and practice*, McGraw Hill, cinquième édition, 1989 ; Michael Lang, Pasquale Pistone, Josef Schuch, Claus Staringer (éditeurs), *Source versus residence*, Kluwer Law International, 2008 ; Angel Schindel, Adolfo Atchabahian, Rapport Général du congrès de l'IFA, Cahiers de droit fiscal international, *Source and residence: new configuration of their principles*, vol. 90a, 2005, pp. 21-99.

[977] Niv Tadmore, *Source taxation of cross-border intellectual supplies - concepts, history and evolution into the digital age*, Bulletin for International Fiscal Documentation, janvier 2007, pp. 2-16.

choix entre territorialité et mondialité de l'imposition des entreprises occupe toujours une place importante dans les préoccupations fiscales des États, à commencer par des pays tels que les États-Unis[978] ou le Royaume-Uni[979] dont la tradition mondialiste pourrait évoluer vers davantage de territorialité.

Le choix entre territorialité et mondialité de l'imposition des entreprises est, en principe, du seul ressort des États, au vu des prérogatives fiscales issues de leur souveraineté et dans le cadre des principes fixés par le droit international public. En effet, l'impôt est en général considéré comme une des principales propriétés régaliennes des États. Cependant, ce choix prend une dimension particulière pour les États membres de l'Union européenne[980] : si l'immixion des institutions européennes dans la fiscalité directe des États membres est *a priori* limitée aux domaines harmonisés, il est désormais établi que leurs législations fiscales sont soumises à l'obligation de respecter les traités européens[981]. En particulier, les dispositions relatives aux libertés de circulation ont eu un impact considérable sur la souveraineté des États membres en matière de fiscalité directe[982] depuis l'arrêt *Avoir Fiscal* rendu

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[978] Barbara Angus, Tom Neubig, Eric Solomon, Mark Weinberger, *The U.S. international tax system at a crossroads*, Tax Notes International, 19 avril 2010, pp. 251-273 ; Jefferson Vanderwolk, *U.S. exceptionalism in international taxation: it's time for a change*, Tax Notes International, 3 août 2009, pp. 377-380; Samuel C. Thompson Jr., *An imputation system for taxing foreign-source income*, Tax Notes International, 28 February 2011, pp. 691-701.

[979] Bill Dodwell, Joanne Bentley, Tim Haden, *U.K. begins corporate tax reform discussion*, Tax Notes International, 6 décembre 2010, pp. 723-726.

[980] Sur le débat entre territorialité et mondialité de l'imposition des entreprises dans le cadre de l'Union européenne, voir Klaus Vogel, *Taxation of cross-border income, harmonization, and tax neutrality under European Community law, an institutional approach*, Foundation for European Fiscal Studies, Kluwer, 1994 ; Krister Andersson, *An economist's view on source versus residence taxation - the Lisbon objectives and taxation in the European Union*, Bulletin for International Fiscal Documentation, octobre 2006, pp. 395-401 ; Manfred Mössner, *Source versus residence - an EU perspective*, Bulletin for International Fiscal Documentation, décembre 2006, pp. 501-506.

[981] Par « traités européens » il est fait référence au traité sur le fonctionnement de l'Union européenne (« TFUE ») et au traité sur l'Union européenne (« TUE »).

[982] Pour des analyses du conflit entre le droit de l'Union européenne et la souveraineté fiscale des États Membres, voir Alexandre Maitrot de la Motte, *Souveraineté fiscale et construction com-*

par la CJUE en 1986[983]. Suite à l'affaire *Avoir Fiscal*, qui a sanctionné des dispositions françaises refusant l'avoir fiscal à des succursales françaises d'entreprises étrangères, la CJUE a rendu un grand nombre d'arrêt dans lesquels les législations fiscales des États membres en matière de fiscalité directe ont été considérées en violation des principes de libre circulation garantis par le TFUE de sorte qu'il est désormais de jurisprudence constante que « si, en l'état actuel du droit communautaire, la matière des impôts directs ne relève pas en tant que telle du domaine de la compétence de la Communauté, il n'en reste pas moins que les États membres doivent exercer leurs compétences retenues dans le respect du droit communautaire »[984].

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munautaire – Recherche sur les impôts directs, LGDJ, 2005 ; Emmanuel Raingeard de la Blétière, *Les relations entre le droit communautaire et le droit fiscal international – nouvelles perspectives*, 2008 ; Daniel Gutmann, *Droit fiscal des affaires*, Montchretien, 2010, pp. 40-67; Bernard Castagnède, *Précis de fiscalité internationale*, Presses Universitaires de France, troisième édition, 2010, pp. 34-45 ; Dennis Weber, *Is the limitation of tax jurisdiction a restriction of the freedom of movement?*, *in* Accounting and taxation & assessment of ECJ case law, 2007 EATLP Congress, pp. 113-133 ; Dennis Weber, *In search of a (new) equilibrium between tax sovereignty and the freedom of movement within the EC*, Kluwer Law International, 2006 ; Peter J. Wattel, *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?*, *in* Dennis Weber (éditeur), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, pp. 139-156 ; Pasquale Pistone, *The impact of ECJ case law on national taxation*, Bulletin for International Fiscal Documentation, août/septembre 2010, pp. 412-428 ; Frans Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, EC Tax Review, 2003-3, pp. 136-143 ; Frans Vanistendael, *Marché interne et souveraineté fiscale*, *in* Regards critiques et perspectives sur le droit et la fiscalité, Liber Amoricum Cyrille David, LGDJ, 2005, pp. 255-268 ; Frans Vanistendael, *Denkavit Internationaal: the balance between fiscal sovereignty and the fundamental freedoms?*, European Taxation, mai 2007, pp. 210-213 ; Melchior Wathelet, *Souveraineté fiscale des Etats membres et Cour de justice: nouvelles tendances ou confirmation?*, Revue de Jurisprudence Fiscale, février 2008, pp. 90-102.

[983] CJUE, 28 janvier 1986, affaire C-270/83, *Commission des Communautés européennes contre République française*. Voir Mattias Dahlberg, *Direct taxation in relation to the freedom of establishment and the free movement of capital*, Kluwer Law International, 2005, pp. 159-161 ; Pasquale Pistone, *The impact of Community law on tax treaties: issues and solutions*, Kluwer Law International, 2002, pp. 104-108 ; Servaas van Thiel, *EU case law on income tax, Part 1*, IBFD, 2001, pp. 137-168.

[984] CJUE, 14 février 1995, affaire C-279/93, *Finanzamt Köln-Altstadt contre Roland Schumacker*, point 21.

Dès lors, il est acquis que les législations fiscales des États membres en matière de fiscalité directe sont tenues de respecter les principes de libre circulation garantis par le TFUE sous peine de pouvoir faire l'objet d'une sanction par la jurisprudence de la CJUE.

Toutefois, plus que le seul respect des libertés de circulation, les États membres sont tenus d'établir un marché intérieur au sein de l'Union européenne[985]. L'objectif d'établissement d'un marché intérieur, déjà présent dans le TCE, semble avoir été renforcé par le traité de Lisbonne. L'article 26(2) du TFUE précise en effet que « Le marché intérieur comporte un espace sans frontières intérieures dans lequel la libre circulation des marchandises, des personnes, des services et des capitaux est assurée selon les dispositions des traités ». Cette notion de marché intérieur a parfois été rapprochée des conditions existant au sein d'un seul et même État, tant par la CJUE[986] que par la doctrine[987]. Par ailleurs, il est important de souligner que

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[985] Voir l'article 3(3) TUE : « L'Union établit un marché intérieur ». L'objectif d'établir un « marché commun » existe depuis la signature du traité de Rome le 25 mars 1957, particulièrement au vu des articles 2, 3(f), et 3(h) de ce traité.

[986] Voir CJUE, 9 février 1982, affaire C-270/80, *Polydor Limited et RSO Records Inc. contre Harlequin Records Shops Limited et Simons Records Limited*, point 16 ; CJUE, 25 avril 1985, affaire C-207/83, *Commission des Communautés européennes contre Royaume-Uni de Grande-Bretagne et d'Irlande du Nord*, point 17 ; CJUE, 23 avril 1991, affaire C-297/89, *Rigsadvokaten contre Nicolai Christian Ryborg*, para. 14 ; CJUE, 5 octobre 1994, affaire C-381/93, *Commission des Communautés européennes contre République française*, point 17 ; CJUE, 29 mai 1997, affaire C-389/95, *Siegfried Klattner contre Elliniko Dimosio*, point. 25 ; CJUE, 3 octobre 2002, affaire C-136/00, *Rolf Dieter Danner*, point 29.

[987] Voir Frans Vanistendael, *The compatibility of the basic economic freedoms with the sovereign national tax systems of the Member States*, EC Tax Review, 2003-3, pp. 141-142 : « Legally speaking a market is an area where economic activity can be conducted under similar legal rules, so that economic operators can offer their goods and services under similar or comparable conditions of competition. (…) The single Act of 17 February 1987 established a very radical market concept as 'an area without internal borders in which the free movement of goods, persons, services and capital is guaranteed in accordance with the provisions of the Treaty'. This is in fact the concept of a single national market as the environment of a single legal order within which economic operators carry on their activities under the same or similar legal rules » ; Eric Kemmeren, *The internal market approach should prevail over the single country ap-*

la Commission européenne s'attache à la promotion du marché intérieur et fait de l'établissement de celui-ci une des priorités du travail des institutions[988].

La coexistence de la souveraineté fiscale des États membres, telle qu'encadrée par le droit international, avec l'objectif d'établissement du marché intérieur aboutit inévitablement à un conflit[989]. En effet, les systèmes fiscaux des États membres et le marché intérieur européen n'obéissent pas aux mêmes logiques, une des différences principales résidant dans la perspective nationale des États membres et la perspective européenne du marché intérieur : alors que les systèmes fiscaux des États membres recherchent souvent une cohérence[990] ou une maximisation des recettes fiscales au plan national, le marché intérieur fait fi de nombre de

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proach, *in* A vision of taxes within and outside European borders, Festschrift in honour of Prof. Dr. Frans Vanistendael, Kluwer Law International, 2008, p. 562 : « for operations within the European Community, it is essential that the internal market be analogous in nature to the domestic market of a single state » ; Eric Kemmeren, *Principle of Origin in Tax Conventions: A Rethinking of Models*, Katholieke Universiteit Brabant, Tillburg, 2001, p. 139 : « The common market is analoguous in nature to the domestic market of a single state, although it should be emphasised that a genuine internal market still does not exist ».

988 Voir à ce sujet COM(2010) 608 final, 27 octobre 2010, *Vers un acte pour le marché unique – Pour une économie sociale de marché hautement compétitive : 50 propositions pour mieux travailler, entreprendre, et échanger ensemble*. Voir aussi COM(2010) 2020 final, 3 mars 2010, *Europe 2020 – Une stratégie pour une croissance intelligente, durable et inclusive*.

989 Voir Peter J. Wattel, *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?*, *in* Dennis Weber (éditeur.), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, p. 144 : « By definition, protecting the tax turf of a national State (i.e. preserving fiscal territorial cohesion) involves a certain degree of fiscal disintegration of the internal market ». Voir aussi Christiana H.J.I. Panayi, *Double taxation, tax treaties, treaty-shopping and the European Community*, Kluwer Law International, 2007, p. 143 : « Community law, through, *inter alia* its fundamental freedoms, aims at removing the borders between Member States. In contrast, the starting point of international tax law is the existence of these borders ».

990 Cette cohérence au plan national peut, par exemple, expliquer la recherche d'une symétrie entre l'imposition des bénéfices et la déduction des pertes.

ces considérations afin de prendre en compte l'intérêt général tant des ressortissants européens que des États membres, pris dans leur globalité.

Par conséquent, l'existence en parallèle de règles fiscales mises en œuvre par les États membres avec l'objectif d'établissement du marché intérieur aboutit à un conflit. Ce conflit est patent au regard du débat entre territorialité et mondialité de l'imposition des entreprises, car ces deux principes d'imposition présentent des incompatibilités avec les principes de libre circulation et l'objectif d'établissement du marché intérieur. La principale difficulté posée par le principe de mondialité de l'impôt a trait à la perte de l'attractivité fiscale des États membres offrant une fiscalité plus légère que celle de l'État d'origine. Le principe de territorialité de l'impôt pose, quant à lui, problème pour la compensation des pertes et des bénéfices lorsque ceux-ci prennent leur source dans des États différents.

9.1.2 Objectif de la thèse et annonce du plan

Les législations fiscales des États membres relatives à l'imposition des revenus étrangers des entreprises ont plusieurs fois été remises en question par la jurisprudence de la CJUE, aussi bien lorsque ces règles étaient fondées sur le principe de territorialité que sur le principe de mondialité de l'impôt. La jurisprudence de la Cour peut néanmoins être sujette à critiques, tant au regard de l'interprétation des traités européens faite par la CJUE que des solutions pratiques proposées par celle-ci. En effet, la réalisation du marché intérieur en matière d'imposition des revenus étrangers des entreprises paraît bien trop complexe pour être atteinte par la seule jurisprudence de la Cour. Dès lors, l'objectif de cette thèse est double :

- D'une part, il a été procédé à une étude de la jurisprudence de la CJUE relative aux principes de territorialité et de mondialité de l'imposition des entreprises, afin d'analyser la position de la Cour sur le débat entre ces principes d'imposition et d'en mesurer la portée.

- D'autre part, les conséquences de la jurisprudence de la CJUE quant aux principes de territorialité et de mondialité de l'imposition des entreprises ont été discutées tant au regard de l'interprétation

des traités européens faite par la Cour que de la pertinence des solutions proposées par celle-ci.

Le champ d'étude de la thèse est limité à l'imposition des sociétés sur leurs revenus d'exploitations, dits revenus « actifs ». Par ailleurs, seules les situations transfrontalières mais internes à l'Union européenne ont été étudiée dans cette thèse.

Afin d'analyser la jurisprudence de la CJUE il nous a fallu suivre une méthode de recherche pour pouvoir distinguer et classifier les arrêts de la Cour. Plutôt que d'étudier ceux-ci dans l'ordre chronologique ou par thème, nous avons privilégié une approche ancrée dans les systèmes fiscaux des États membres. Cette démarche permet de mettre en évidence les conséquences de la jurisprudence de la CJUE mais aussi les nécessités de l'établissement du marché intérieur par rapport aux principes d'imposition traditionnellement utilisés par les États membres pour imposer les revenus étrangers des entreprises. Il peut ainsi être constaté que les États exercent fréquemment leur pouvoir d'imposition en fonction du lien existant avec les entreprises assujetties à l'impôt. Lorsque la connexion entre un État et une entreprise est faible, les prétentions fiscales de cet État seront souvent limitées. En revanche, lorsque le lien entre un État et une entreprise est fort, celui-ci aura en général tendance à exercer de plus amples droits d'imposition.

Cette distinction s'opère traditionnellement en fonction de la résidence d'une entreprise : les entreprises résidentes peuvent être imposées sur leurs bénéfices mondiaux, alors que les entreprises non-résidentes sont en général imposées uniquement sur les bénéfices imputables à un établissement stable, hormis les cas exceptionnels dans lesquels une entreprise non-résidente est imposée entre les mains d'une entreprise résidente qui sera souvent son actionnaire. Par conséquent, l'approche choisie dans la thèse consiste à suivre cette *summa divisio* entre résidents et non-résidents, de facon à pouvoir mettre en évidence les conséquences de la jurisprudence de la CJUE sur les principes d'imposition des revenus étrangers des entreprises traditionnellement utilisés par les États membres.

Au sein de cette séparation entre résidents et non-résidents, il est par ailleurs distingué entre l'imposition des bénéfices et des pertes. En effet, s'il est vrai que les États leur appliquent souvent les mêmes principes d'imposition[991], le droit de l'Union européenne ne requiert pas nécessairement que ceux-ci soient imposés de façon symétrique. Il est par conséquent nécessaire de distinguer entre l'imposition des bénéfices et des pertes pour chacune des situations décrites *supra*, afin d'identifier les problèmes qui leur sont spécifiques ainsi que les solutions les plus aptes à permettre l'établissement du marché intérieur pour l'imposition des revenus étrangers des entreprises.

Dès lors, après avoir précisé les principes issus du droit international public quant à l'étendue de la juridiction fiscale des États (chapitre 2 de la thèse), l'imposition des entreprises résidentes sur les revenus de source étrangère des entreprises non-résidentes a fait l'objet d'une analyse détaillée (chapitre 3 de la thèse). Puis, c'est l'imposition des résidents sur leurs revenus propres de source étrangère qui a été confrontée à la jurisprudence de la CJUE (chapitre 4 de la thèse). L'imposition des établissements stables par l'État de la source a par la suite été analysée (chapitre 5 de la thèse). Par ailleurs, la double imposition internationale a fait l'objet d'une étude particulière, dans la mesure où nous considérons que l'étendue des pouvoirs d'imposition des États membres devrait être sujette à la compatibilité de la double imposition internationale avec le droit de l'Union européenne (chapitre 6 de la thèse). Enfin, une attention particulière a été portée à la prise en compte des pertes finales étrangères, dont la CJUE requiert la déduction dans l'État d'origine depuis l'arrêt *Marks & Spencer*[992]. Les écueils inhérents à la solution issue de la jurisprudence *Marks & Spencer* ont été mis en avant quant à l'obligation pesant sur l'État d'origine de prendre en compte l'ensemble des pertes finales (chapitre 7 de la thèse). La thèse est conclue par des observations de politique fiscale fondées sur les analyses des cha-

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[991] Un exemple de cette symétrie est décrit au paragraphe 44 du commentaire relatif à l'article 23 A de la convention modèle OCDE.

[992] CJUE, 13 décembre 2005, affaire C-446/03, *Marks & Spencer*.

pitres précédents (chapitre 8 de la thèse). Ces chapitres sont à présent résumés dans les sections suivantes.

9.2 Résumé du chapitre 2 : principes issus du droit international public quant à l'étendue de la juridiction fiscale des États

Le droit fiscal est, en tant que discipline juridique, soumis aux principes supérieurs du droit international public. En effet, les États tirent leur droit d'imposer de la souveraineté qui leur est reconnue par le droit international public. Par conséquent il convient, afin de mieux comprendre l'étendue territoriale du droit d'imposer des États, d'en étudier les fondements à la lumière du droit international public. Cette analyse est particulièrement nécessaire dans le cadre d'une thèse consacrée au conflit entre le droit de l'Union européenne et les principes d'imposition des entreprises utilisés par les États membres. Ainsi, il convient d'étudier la juridiction fiscale en droit international public afin de mieux comprendre son étendue et ses possibles limitations. Ceci permet aussi de mieux analyser la jurisprudence de la CJUE et de formuler des suggestions qui sont compatibles avec le droit international public. Par ailleurs, la Cour fait souvent référence à des concepts inspirés du droit international public, et leur utilisation est parfois malaisée. Il est en effet difficile de discerner entre les différents concepts auxquels la CJUE fait référence, de sorte qu'une étude de l'étendue territoriale du droit d'imposer des États permet de s'affranchir du vocabulaire de la Cour pour se concentrer sur la portée des principes d'imposition des entreprises utilisés par les États membres. Dès lors, nous avons analysé la juridiction en droit international public avant d'en appliquer les principes au droit fiscal. Cette analyse n'a pas pour objectif d'être exhaustive, mais seulement de présenter certains des aspects du droit international public qui sont nécessaires à une compréhension de la juridiction en matière de droit fiscal international.

La juridiction fiscale d'un État, c'est-à-dire son pouvoir de décider de l'existence d'un impôt ainsi que de le prélever, prend sa source dans la notion de souveraineté. Celle-ci attribue à un État le droit de légiférer. Un État peut exercer cette compétence en vertu de plusieurs principes de droit international public, le principe de territorialité étant prédominant. Ce prin-

cipe, aux origines historiques lointaines, reconnait à un État une compétence exclusive et absolue sur son territoire[993]. Le principe de territorialité permet aussi à un État de légiférer au-delà de ses frontières, mais celui-ci devra attendre qu'une personne ou un bien se trouve sur son territoire afin de mettre en œuvre sa compétence. En effet, la souveraineté d'un État est si forte qu'il peut être compétent vis-à-vis de situations présentant un élément d'extranéité. Toutefois, la mise en œuvre des mesures législatives et décisions de justice est bornée au territoire d'un État, sous réserve de coopération avec d'autres États[994]. Le droit de légiférer peut aussi être exercé sur le fondement d'autres principes de droit international public, qui toutefois reposent partiellement sur l'existence d'un lien avec le territoire d'un État. Par conséquent, le principe de territorialité est fondamental en matière de droit international public.

Afin de mieux comprendre la juridiction fiscale d'un État, il convient d'en affiner la compétence telle qu'elle est définie par le droit international public. En premier lieu il convient de s'interroger sur l'éventuelle existence d'une connexion minimale entre un État et une personne ou un bien pour que celui-ci puisse exercer légalement sa compétence. Une partie de la doctrine soutient la thèse en vertu de laquelle une connexion minimale est re-

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[993] Maxime Chrétien, *A la recherche du droit international fiscal commun*, Sirrey, 1955, p. 11, point 14 : "la souveraineté de l'Etat sur son territoire est une compétence non seulement exclusive (par rapport aux autres Etats et aux organisations internationales) mais encore illimitée: c'est à la fois la *suprema potestas* et la *plena potestas*. Elle signifie que chaque Etat est seul maître et maître absolu de ses décisions en toutes matières, à l'intérieur de son territoire. Ainsi entendue, la souveraineté – pouvoir exclusif et absolu – est synonyme et d'indépendance à l'égard des autres Etats et d'égalité entre les divers Etats". Voir aussi Colin Warbrick *in* Malcolm D. Evans, *International law*, Oxford University Press, 2003, p. 231.

[994] Maxime Chrétien, *A la recherche du droit international fiscal commun*, Sirrey, 1955, p. 22, point 25 : "Un Etat peut prendre sur son territoire des lois qui s'étendent à des personnes ou à des biens se trouvant sur le territoire d'un autre Etat, sans le consentement de ce dernier. Mais il ne peut pas les appliquer sur le territoire de cet autre Etat, sans le consentement de celui-ci. Il ne pourra les appliquer que sur son territoire, ce qui suppose que les personnes ou les biens s'y retrouveront un jour".

quise par le droit international public pour qu'un État soit compétent[995]. Cependant, l'arrêt de principe *Lotus*[996], rendu par la Cour Permanente de Justice Internationale, ne semble pas requérir de lien minimum ou suffisant pour accepter la compétence d'un État en présence d'un élément d'extranéité, ce qui semble avoir été confirmé dans l'arrêt *Barcelona Traction*[997]. Tout au plus nous semble-t-il possible de supposer que l'existence d'une connexion est nécessaire, sur le fondement d'une interprétation *a contrario* de l'arrêt *Lotus*[998]. Il est néanmoins impossible de définir les contours d'une telle connexion, de sorte qu'en l'état actuel du droit international public la compétence d'un État n'est pas clairement limitée. L'absence de limites clairement définies par le droit international public pour l'exercice par un État de sa compétence ne permet pas de formuler avec exactitude une connexion minimale en-deçà de laquelle un État serait dépourvu de toute compétence. Au vu de cette approche du droit international public que l'on pourrait qualifier de permissive, il est patent que des conflits de juridiction sont susceptibles de résulter soit de l'utilisation de principes de juridiction différents, soit lorsqu'un même principe est interprété différemment par plusieurs États. Dès lors, il convient de s'interroger sur la question de savoir si l'exercice concomitant de leurs compétences par plusieurs États est com-

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995 Voir Cedric Ryngaert, *Jurisdiction in international law*, Oxford University Press, 2008, pp. 31-32, avec de nombreuses references.

996 Cour Permanente de Justice Internationale, 7 septembre 1927, Ser. A, No 10, *S.S. Lotus*.

997 Cour internationale de justice, 5 février 1970, *Barcelona Traction*.

998 Cette affirmation prend sa source dans une interprétation *a contrario* de l'arrêt *Lotus* (voir Cour Permanente de Justice Internationale, 7 septembre 1927, Ser. A, No 10, *S.S. Lotus*). La Cour a, en effet, analysé si la requête de la Turquie était compatible avec le droit international. *A contrario*, il pourrait être déduit de cet arrêt que si la Cour considérait que tout exercice de juridiction est compatible avec le droit international, quelle que soit la connexion existant avec la situation présentant un élément d'extranéité, la Cour n'aurait pas eu à analyser les arguments mis en avant par la Turquie et aurait accepté sa compétence sans devoir la légitimer au regard du droit international public. Cependant, il ne s'agit que d'une interprétation *a contrario* et il ne peut pas être affirmé avec certitude que les juges de la Cour Permanente de Justice Internationale ont considéré qu'une connexion doit exister pour qu'un État exerce sa compétence. Il serait, par ailleurs, impossible de définir une telle connexion au vu de la jurisprudence *Lotus* et *Barcelona Traction*.

patible avec le droit international public, ou si celui-ci s'oppose à de tels conflits et donne priorité à un certain principe ou une certaine interprétation d'un principe juridictionnel. À ce sujet, de nombreux auteurs considèrent que le principe de territorialité est prioritaire sur les autres principes de juridiction[999]. Toutefois, l'analyse de la jurisprudence *Lotus* et *Barcelona Traction* semble indiquer l'absence de principe juridictionnel prioritaire ou d'interprétation prioritaire. L'exercice concurrent de leurs compétences par plusieurs États ne semble pas être contraire au droit public international, à l'exception des situations réglées par des traités internationaux[1000].

Transposées au droit fiscal, ces conclusions tendent à indiquer qu'un État peut imposer tant les résidents que les non-résidents sur leurs revenus de source étrangère, à moins qu'il ne soit stipulé autrement dans une convention fiscale. Par exemple, nous avons pu observer que la jurisprudence de la Cour Suprême des États-Unis et de la House of Lords britannique ont ainsi accepté l'imposition de non-résidents sur leurs revenus de source étrangère. Comme le droit international public ne semble pas faire de hiérarchie entre les prétentions des États, celui-ci ne favorise ni le principe de territorialité ni le principe de mondialité de l'impôt. Par conséquent, les États qui imposent les résidents seulement sur leurs revenus de source nationale le font non pas en conséquence d'une obligation imposée par le droit international public, mais d'un choix de politique fiscale. Ainsi nous soutenons que la France, qui impose les entreprises conformément au principe de territorialité, mais aussi certains pays d'Amérique latine, pourraient étendre leurs droits d'imposition aux revenus de source étrangère sans enfreindre le droit international public. Cette constatation semble d'ailleurs s'appliquer à l'imposition des non-résidents, dans la mesure où le droit international public ne définit pas clairement de limites à la compétence des États et ne semble pas exiger de connexion minimale pour l'exercice par un État de sa juridiction. L'arrêt *Agassi v Robinson*[1001] est particulièrement intéressant dans

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[999] Pour un exposé de la doctrine à ce sujet, voir Cedric Ryngaert, *Jurisdiction in international law*, Oxford University Press, 2008, pp. 27-31.

[1000] Cedric Ryngaert, *Jurisdiction in international law*, Oxford University Press, 2008, p. 129.

[1001] House of Lords, 17 mai 2006, (2006) UKHL 23, *Agassi v her Majesty's Inspector of Taxes*. Cet arrêt est commenté par Christopher Norfolk, Agassi v Robinson*: territorial limitation on*

la mesure où il concernait l'imposition d'un revenu de source étrangère perçu par une société non-résidente au prorata du temps passé par un sportif au Royaume-Uni dans le cadre d'une compétition sportive. La House of Lords a accepté l'imposition prélevée par l'administration fiscale britannique, ce qui tend à confirmer les conclusions tirées de l'analyse fondée sur le droit international public en ce que les non-résidents peuvent être imposés sur des revenus de source étrangère.

Nous nous sommes aussi interrogés sur la question de savoir si la coutume internationale pourrait justifier une connexion minimale afin qu'un État puisse exercer sa compétence fiscale. Un exemple concerne les profits d'exploitation, dont la pratique internationale soumet l'imposition dans l'État de la source à l'existence d'un établissement stable et à l'imputation de tels profits à celui-ci. Cependant, nous avons soutenu qu'une connexion minimale obligatoire en droit international public ne peut résulter de la coutume ou du modèle de convention fiscale de l'OCDE. En effet, le modèle de convention fiscale de l'OCDE n'est qu'un exemple et les conventions de double imposition ne le suivent pas nécessairement. Cet exemple est, par ailleurs, évolutif. De plus, la définition d'un établissement stable varie d'une convention à l'autre. Par conséquent, s'il est vrai que l'existence d'un établissement stable est en général requise pour l'imposition des revenus d'exploitation d'une entreprise non-résidente, il est impossible d'en établir une définition coutumière en droit international public, qui donc déterminerait une connexion minimale afin qu'un État puisse exercer sa compétence fiscale.

L'absence de limites clairement établies par le droit international public sur la juridiction fiscale des États peut donner lieu à des situations de double imposition internationale, lorsque plusieurs États exercent leur juridiction fiscale. Nous soutenons que la double imposition internationale est compa-

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withholding obligation – some confusion in the House of Lords, British Tax Review, 2006-6, pp. 684-687.

tible avec le droit international public[1002], au vu (i) de l'absence d'incompatibilité avec le droit international public des prétentions fiscales concurrentes et (ii) l'absence de hiérarchie entre les principes d'imposition. En effet, si le droit international public ne tolère pas la double imposition internationale, il lui appartient de l'éliminer en favorisant un certain principe juridictionnel. Cela reviendrait à empêcher certains États d'exercer leurs compétences fiscales, ce qui serait en contradiction avec la souveraineté et l'indépendance que le droit international public reconnait aux États. Par conséquent, nous soutenons que la double imposition internationale est compatible avec le droit international public. La thèse selon laquelle l'État de la source aurait priorité par rapport à l'État de la résidence ne trouve pas de fondement dans le droit international public, quand bien même la double imposition est parfois éliminée de façon à donner priorité à l'État de la source.

Une autre conséquence de l'étude de la juridiction en droit international public est l'indépendance d'un État par rapport aux situations présentant un élément d'extranéité. En matière fiscale, ceci résulte dans une absence d'obligation de prendre en compte les revenus de source étrangère, notamment les pertes de source étrangère. Ce principe a été mis en avant par l'observation de Lord Mansfield dans une affaire datant de 1775 : « no country ever takes notice of the revenue laws of another[1003] ». Cette analyse explique en partie pourquoi la double imposition internationale n'est pas toujours éliminée, mais aussi pourquoi les systèmes fiscaux des États imposent certains profits étrangers mais ne déduisent pas toutes les pertes de source étrangère.

En conclusion, la juridiction fiscale reconnue aux États par le droit international public n'est pas clairement limitée par celui-ci, de sorte que les con-

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[1002] Pour une opinion similaire voir Klaus Vogel, *Klaus Vogel on double taxation conventions*, Kluwer Law International, troisième édition, 1997, para 8, p. 12.

[1003] King's Bench, 5 juillet 1775, 1 Cowp. 341, 98 Engl. Rep. pp. 1120-1122, *Holman v. Johnson*. Voir le commentaire par Jürgen Basedow, Jan von Hein, Dorothee Janzen, Hans-Jürgen Puttfarken, *Foreign revenue claims in European courts*, Yearbook of private international law, 2004-6, pp. 5-6.

flits de juridiction fiscale sont inhérents à l'état actuel du droit international public. Nous avons aussi pu observer un déséquilibre entre, d'une part, l'absence d'obligations liées aux revenus négatifs de source étrangère, et, d'autre part, le droit d'imposer les profits étrangers. Un tel déséquilibre n'est pas interdit par le droit international public, qui ne requiert pas de traitement symétrique entre l'imposition des bénéfices et la déduction des pertes. Cette permissivité du droit international public permet de mieux comprendre les systèmes fiscaux des États membres de l'Union européenne. En effet, en l'absence d'obligations ou de limitations imposées par le droit international public, les États membres de l'Union européenne ont eu une grande latitude dans l'adoption de leurs systèmes fiscaux. Dès lors, il n'est pas surprenant que certaines de ces règles soient incompatibles avec les principes des traités européens, dans la mesure où les objectifs des États et de l'intégration européenne divergent[1004]. La remise en question de telles règles porte, certes, atteinte à la souveraineté des États membres, mais il a été affirmé que cette souveraineté en matière fiscale n'est ni absolue ni exclusive[1005]. Il convient donc d'étudier en détails l'impact de l'objectif de réalisation du marché intérieur sur les règles d'imposition des revenus étrangers des entreprises afin d'analyser la position de la CJUE sur le débat entre les principes de territorialité et de mondialité et d'en mesurer la portée. Il convient aussi d'analyser les conséquences de la jurisprudence de la Cour tant au regard de l'interprétation des traités européens faite par la CJUE que de la pertinence des solutions proposées par celle-ci. Cette étude a été menée dans les chapitres suivants de la thèse.

1004 À ce sujet voir Christiana H.J.I. Panayi, *Double taxation, tax treaties, treaty-shopping and the European Community*, Kluwer Law International, 2007, p. 143 : "Community law, through, *inter alia* its fundamental freedoms, aims at removing the borders between Member States. In contrast, the starting point of international tax law is the existence of these borders". Voir aussi Peter J. Wattel, *Fiscal cohesion, fiscal territoriality and preservation of the (balanced) allocation of taxing power; what is the difference?*, *in* Dennis Weber (éditeur), The influence of EU law on direct taxation, recent and future developments, Kluwer Law International, 2007, p. 144 : "By definition, protecting the tax turf of a national State (i.e. preserving fiscal territorial cohesion) involves a certain degree of fiscal disintegration of the internal market".

1005 Frans Vanistendael, *In defence of the European Court of Justice*, Bulletin for International Fiscal Documentation, mars 2008, p. 93.

9.3 Résumé du chapitre 3 : l'imposition des entreprises résidentes sur les revenus de source étrangère d'entreprises non-résidentes

À l'exception des sociétés de personnes, chaque société est en principe imposée uniquement sur ses propres revenus. S'il est vrai que le droit fiscal écarte parfois l'habillage sociétaire pour prendre en compte la notion de groupe de sociétés, cette exception est le plus souvent applicable au seul plan national. Au plan international, les résultats des sociétés étrangères ne sont en général pas pris en compte pour l'imposition d'une société résidente, ce qui traduit une préférence pour le principe de territorialité de l'impôt. Toutefois, dans certains cas les États peuvent être tentés d'écarter l'habillage sociétaire non pour permettre une imposition nette au niveau du groupe mais pour imposer des revenus non distribués, et ce en substituant le principe de mondialité au principe de territorialité. Dans le cadre de l'Union européenne ces deux principes d'imposition des entreprises créent des tensions avec l'objectif d'établissement du marché intérieur. C'est pourquoi nous avons étudié dans un premier temps les règles sur les sociétés étrangères contrôlées. En second lieu nous avons analysé le principe de territorialité au regard de la déduction des pertes subies par des filiales étrangères.

L'application du principe de mondialité de l'impôt aux sociétés étrangères a été abordée par la CJUE dans l'affaire *Cadbury Schweppes*[1006]. Cette affaire concernait l'imposition au Royaume-Uni de filiales irlandaises bénéficiant en Irlande d'un régime de faveur. Par le biais de règles sur les sociétés étrangères contrôlées, un État membre peut imposer les bénéfices non distribués par une filiale étrangère. En effet, un groupe de sociétés peut être tenté d'établir une filiale dans un pays à fiscalité privilégiée sans toutefois en distribuer les dividendes. De ce fait, tant les résultats d'exploitation que les dividendes peuvent échapper à l'impôt dans l'État de la société mère. Si une telle imposition des sociétés étrangères contrôlées semble compatible avec le droit international public et est même recommandée dans certaines situations par l'OCDE et l'Union européenne, celle-ci pose problème au regard

[1006] CJUE, 12 septembre 2006, affaire C-196/04, *Cadbury Schweppes*.

des principes protégés par les traités européens car l'imposition des sociétés étrangères contrôlées repose en général sur une différence de traitement avec les filiales résidentes. Par conséquent, cette application extensive du principe de mondialité a été largement limitée par la CJUE dans l'arrêt de principe *Cadbury Schweppes*, dont le raisonnement est selon nous critiquable. La Cour a fondé son raisonnement sur une comparaison avec les filiales résidentes, qui ne sont pas imposées entre les mains de la société mère. Si cela est incontestable, il nous semble pertinent de souligner que les filiales résidentes sont imposables sur l'ensemble de leurs bénéfices dans le même État. C'est-à-dire qu'en fin de compte, les filiales non-résidentes imposées en application des règles sur les sociétés étrangères contrôlées ne sont pas nécessairement imposées plus lourdement que les filiales résidentes. La CJUE n'a pas pris en compte cet argument, préférant adopter une approche restrictive limitée à la situation de la société mère, imposée sur les filiales étrangères mais non imposée sur les filiales résidentes. Par conséquent, la différence de traitement dépendait de la perspective adoptée par la Cour. La position des juges de Luxembourg revient à largement limiter l'application du principe de mondialité de l'imposition des entreprises. La relative rapidité avec laquelle la CJUE est arrivée à cette conclusion pourrait, selon nous, être interprétée comme une préférence implicite pour le principe de territorialité, c'est-à-dire une préférence implicite pour l'exemption des revenus étrangers.

Le résultat de cette jurisprudence paraît néanmoins satisfaisant, dans la mesure où nous soutenons que les règles sur les sociétés étrangères contrôlées, et de façon générale le principe de mondialité de l'impôt, peuvent porter atteinte à l'exercice des libertés de circulation des ressortissants et à la concurrence entre États membres[1007] au sein du marché intérieur. En effet, la mondialité de l'impôt empêche de tirer parti de certains des avantages fis-

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[1007] Sur l'importance d'une concurrence entre États membres voir Wolfgang Schön, *International tax coordination for a second-best world (part I)*, World Tax Journal, octobre 2009, p. 85 : "Sound tax competition, including respect for national sovereignty, is widely accepted as a reality and as an efficient policy option".

caux offerts par les États membres[1008]. Par conséquent, il nous semble insuffisant d'analyser la compatibilité des règles sur les sociétés étrangères contrôlées avec le marché intérieur seulement du point de vue de l'État d'origine : quand bien même ces règles imposent similairement les filiales résidentes et non-résidentes[1009], il ne faut pas perdre de vue que l'État d'accueil perd en partie son attractivité à cause de l'imposition prélevée par l'État d'origine. Par conséquent, même si les règles sur les sociétés étrangères contrôlées peuvent mettre en œuvre la neutralité des capitaux à l'exportation et imposer similairement les filiales qu'elles soient ou non résidentes, nous soutenons que la réalisation du marché intérieur doit permettre à l'État d'accueil de faire jouer la concurrence.

Enfin, l'exception faite à l'incompatibilité des règles sur les sociétés étrangères contrôlées en cas de montage purement artificiel nous paraît justifiée, dans la mesure où, selon nous, les pères fondateurs des Communautés n'ont probablement pas souhaité offrir de droits absolus aux ressortissants de celles-ci, mais ont plutôt souhaité encourager l'exercice des libertés de circulation afin de contribuer à l'établissement d'un marché intérieur. Nous soutenons aussi la CJUE en ce qu'elle considère que la recherche d'une imposition plus légère n'est pas, en tant que telle, constitutive d'abus de droit. L'inverse porterait atteinte à la liberté d'établissement ainsi qu'à une compétition saine entre les États membres. En revanche, il ressort de l'analyse de l'arrêt *Cadbury Schweppes* ainsi que des recommandations du Conseil que l'exception en cas de montage purement artificiel pourrait être déclenchée trop facilement, dans la mesure où la réunion de plusieurs critères cumulatifs semble nécessaire afin d'échapper à cette exception : la réunion de tous ces critères peut ne pas correspondre à la réalité des affaires, en particulier au regard de la dématérialisation de l'économie et de la modernisation des moyens de communication. Par conséquent, nous craignons que le principe de mondialité ne soit réintroduit trop facilement pour contrer des montages

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[1008] Voir Frans Vanistendael, *In defence of the European Court of Justice*, Bulletin for International Fiscal Documentation, mars 2008, pp. 94-95.

[1009] Cela n'est pas nécessairement le cas, au vu des risques de double imposition et des lourdeurs administratives causés par les règles sur les sociétés étrangères contrôlées.

qui ne sont pas nécessairement abusifs. Au vu des difficultés de la CJUE à se prononcer sur la notion de montage purement artificiel, nous avons soutenu qu'une solution pourrait consister dans l'adoption de critères communs au plan européen pour définir plus en précision les règles sur les sociétés étrangères contrôlées. Dans ces conditions le principe de mondialité de l'imposition des entreprises pourrait être instauré de façon équilibrée, afin de préserver la réalisation du marché intérieur tout en permettant aux États membres de lutter efficacement contre les situations abusives.

L'application du principe de territorialité de l'impôt pose lui aussi problème au sein du marché intérieur, cette fois au regard des pertes subies par les filiales non-résidentes. La souveraineté des États implique, ainsi que nous l'avons discuté dans le chapitre 2 de la thèse, une indépendance vis-à-vis des autres États, c'est-à-dire qu'un État est libre de ne pas prendre en compte les situations présentant un élément d'extranéité. Par conséquent, il est fréquent qu'un État refuse de prendre en compte les pertes subies par les filiales non-résidentes, à l'inverse des pertes ayant une source nationale. Avant d'étudier la jurisprudence de la CJUE, nous avons consacré quelques réflexions au double niveau d'imposition existant au sein des groupes de sociétés. En effet, si une société mère peut déduire les pertes de sa filiale, elle peut aussi – dans certains cas – déduire une perte sur titres. Nous avons toutefois conclu qu'une telle double déduction n'est pas nécessairement problématique, mais fait partie intégrante de la fiscalité des groupes de sociétés. Par conséquent, le double niveau d'imposition existant au sein des groupes de sociétés ne devrait pas, selon nous, empêcher la déduction des pertes des filiales étrangères.

La CJUE s'est prononcée sur la déduction des pertes des filiales étrangères dans trois affaires : *Marks & Spencer*[1010], *Oy AA*[1011], et *X Holding*[1012]. La première affaire concernait des pertes dites finales, à l'inverse des deux autres affaires. Aussi, *Marks & Spencer* et *X Holding* concernaient des pertes

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[1010] CJUE, 13 décembre 2005, affaire C-446/03, *Marks & Spencer*.

[1011] CJUE, 18 juillet 2007, affaire C-231/05, *Oy AA*.

[1012] CJUE, 25 février 2010, affaire C-337/08, *X Holding BV v Staatssecretaris van Financiën*.

subies par une filiale étrangère, alors que l'arrêt *Oy AA* concernait des pertes subies par une société mère dont le groupe a cherché la déduction au niveau d'une filiale. Nous avons étudié la combinaison de ces trois arrêts afin d'analyser la position de la CJUE sur le conflit entre le principe de territorialité (manifesté par le refus de la déduction des pertes) et le droit de l'Union européenne.

Une première question concerne la comparabilité entre filiales résidentes et filiales non-résidentes. En effet, les États membres ont mis en avant l'absence de compétence par rapport aux filiales étrangères afin de justifier la non-déduction des pertes étrangères. Cependant, nous avons soutenu que cet argument n'est pas convaincant dans la mesure où la déduction des pertes étrangères ne porte pas atteinte à la souveraineté de l'État où ces pertes ont été subies. Par conséquent, le droit international public ne s'oppose pas à une prise en compte des pertes étrangères. Par ailleurs, les États membres font preuve de leur compétence par rapport aux résultats des filiales étrangères dans le cadre des règles sur les sociétés étrangères contrôlées. Dès lors, le refus de la déduction des pertes étrangères ne peut être justifié par l'absence de compétence sur les filiales étrangères.

Nous nous sommes interrogés sur la pertinence de la comparaison entre pertes subies par des filiales et des succursales étrangères. En effet, si le droit de l'Union européenne exigeait un traitement similaire des filiales et des succursales étrangères, la déduction des pertes subies par des filiales étrangères serait facilitée dans les États membres qui appliquent le principe de mondialité de l'impôt. Si cet argument parait *a priori* séduisant, nous soutenons qu'il n'est pas convainquant car il ne repose pas sur un fondement explicite des traités européens. De plus, selon nous si une telle comparaison devait être effectuée, elle ne devrait pas s'appliquer dans un seul sens (traitement des succursales à transposer aux filiales) mais dans les deux sens (traitement des filiales à transposer aux succursales). Dès lors, l'on serait en présence de situations où le traitement des succursales doit être étendu aux filiales (déduction des pertes étrangères), mais aussi de situations où le traitement des filiales pourrait être étendu aux succursales (par exemple la non-imposition de leurs bénéfices). Par conséquent, la comparaison entre filiales

et succursales étrangères ne nous parait pas pertinente, du point de vue de l'État d'origine.

La jurisprudence de la CJUE illustre le fait que le principe de territorialité de l'impôt est, en tant que tel, problématique pour l'établissement du marché intérieur. Ceci est dû au fait que la non-déduction de pertes résulte du seul fait que les activités d'un groupe sont étendues au territoire de plusieurs États membres. En effet, le principe de territorialité de l'impôt en principe exclut la déduction des pertes étrangères, à l'inverse des pertes subies par les filiales résidentes qui, à condition qu'un État membre dispose d'un système national d'imposition des groupes, peuvent dans certains cas être déduites. La Cour n'a pas accepté le principe de territorialité comme justification formelle dans l'affaire *Marks & Spencer*, mais la solution adoptée par la CJUE s'en inspire largement. Toutefois, nous avons soutenu que cette solution est davantage motivée par des considérations liées aux conséquences d'une éventuelle obligation de déduction des pertes étrangères, que par des arguments juridiques convaincants. En particulier, parmi les trois justifications prises ensemble par la Cour, la possibilité de transférer des pertes d'un État membre à l'autre et donc de choisir où les déduire ne nous parait pas fondée : en effet, quel que soit le traitement des pertes dans l'État d'origine, les pertes existant dans l'État d'accueil ne sont pas affectées. Ainsi, il existe un risque de double déduction des pertes, mais pas un risque de transfert de celles-ci. De plus, nous avons soutenu qu'il peut exister un risque que les mêmes pertes soient déduites par plusieurs sociétés, par exemple l'actionnaire direct et la société tête de groupe. Par conséquent, si le raisonnement de la CJUE pour refuser la déduction des pertes étrangères nous parait critiquable, cette solution nous parait préférable au vu de l'impossibilité pour la Cour de mettre au point un système de déduction des pertes qui dépasse les nombreuses difficultés que nous avons relevées. Il est vrai que le risque de double déduction des pertes aurait pu être contenu par une obligation de réintégration ultérieure de celles-ci (ce qui n'a pas été analysé par la CJUE dans le cadre du contrôle de proportionnalité), mais nous avons soutenu que la réintégration ultérieure des pertes ne résout pas le problème de la détermination de la société qui pourrait déduire les pertes étrangères. Par conséquent, la solution choisie par la Cour nous parait justifiée, mais ses lacunes mettent en évidence le besoin que les États membres

légifèrent. En effet, la CJUE n'a pas considéré que le droit de l'Union requiert une déduction des pertes non finales, ce qui paraît convainquant non d'un point de vue théorique mais d'un point de vue pratique, dans la mesure où, selon nous, la seule jurisprudence de la Cour peut difficilement mettre en place un système de déduction des pertes avec réintégration ultérieure qui soit suffisamment efficace. Cependant, cette jurisprudence devrait être interprétée comme un aveu de faiblesse de la Cour plus qu'une absence d'exigence de déduction des pertes, de sorte qu'il serait bienvenu de la part des États membres qu'ils coordonnent leurs systèmes fiscaux afin de permettre la déduction des pertes subies par les filiales étrangères. Par conséquent, en l'absence d'assiette commune consolidée pour l'impôt sur les sociétés, il semble qu'une directive telle que celle proposée par la Commission européenne[1013] soit une solution à envisager. Nous avons par ailleurs observé qu'en vertu de cette proposition de directive, toutes les pertes seraient déductibles, sans devoir prendre en compte les fonctions, risques et actifs incorporels des filiales étrangères. Par conséquent, une possible déduction des pertes étrangères serait de nature à encourager l'établissement de fonctions à risques dans d'autres États membres, alors que les pertes subies par des entités supportant des risques élevés (notamment les pertes de démarrage) ne sont pas toujours déductibles dans l'État d'origine conformément au principe de pleine concurrence. Un tel établissement de fonctions à risques peut contribuer au développement du marché intérieur et inciter certains groupes à relocaliser au sein de l'Union européenne certaines de leurs activités conduites dans des pays tiers.

Le principe de territorialité de l'impôt est encore plus problématique en ce qui concerne les pertes dites finales, c'est-à-dire les pertes qui ne peuvent être déduites par les filiales étrangères dans l'État d'accueil. Tout d'abord, nous avons soulevé l'incohérence qui existe dans la jurisprudence de la CJUE entre le traitement des pertes finales et la double imposition internationale. En effet, dans des affaires telles que *Kerckhaert et Morres, Block* et

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[1013] COM 90 (595) final, 24 janvier 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*.

Damseaux, la CJUE a accepté la double imposition internationale. Pourtant, il nous semble que la double imposition internationale et les pertes finales ont des causes (la superposition de plusieurs systèmes fiscaux) et des conséquences (une augmentation de la charge fiscale) similaires, de sorte qu'il nous paraitrait logique de soumettre ces deux phénomènes au même traitement juridique. Cette incohérence entre les pertes finales et la double imposition ne devrait pas, selon nous, empêcher une déduction des pertes finales. En effet, au vu de l'incompatibilité si évidente du principe de territorialité avec l'établissement du marché intérieur lorsque des pertes finales sont subies et qu'elles auraient pu être déduites dans un contexte national, l'initiative de la Cour peut être saluée[1014]. Cependant, nous avons pu observer que la CJUE peut difficilement proposer un système de déduction des pertes finales qui soit parfaitement satisfaisant dans le long terme. Les obstacles à surmonter paraissent trop importants :

- Un premier obstacle consiste dans la définition de la notion de « pertes finales », dont nous avons démontré qu'elles ne sont pas limitées aux pertes subies lors de la liquidation d'une filiale. Par ailleurs, la Cour n'a pas précisé en vertu de quelle législation les pertes peuvent être considérées comme finales et doivent être calculées, bien que ce choix présente une certaine importance au niveau du pays dans lequel la neutralité fiscale est recherchée. Nous avons pu observer qu'en général les pays appliquant le principe de mondialité recalculent les résultats étrangers[1015] et c'est cette perspective qui a été adoptée par la Cour en ne considérant l'existence d'une différence de traitement qu'avec les situations nationales. Toutefois, nous avons démontré que le raisonnement de la CJUE empêche une concurrence saine dans l'État d'accueil, car chaque acteur économique obtient *in fine* des possibilités de déduction en fonction de la législation du pays où est établie la société mère. Il nous semble que la notion de marché intérieur devrait davantage prendre en

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[1014] Voir à ce sujet Frans Vanistendael, *In defence of the European Court of Justice*, Bulletin for International Fiscal Documentation, mars 2008, p. 93.

[1015] Aage Michelsen, Rapport Général du congrès de l'IFA, *Tax treatment of corporate losses*, vol. 83a, 1998, p. 42.

compte la nécessité de permettre une concurrence saine sur le marché où elle prend forme, c'est-à-dire dans l'État d'accueil, non dans l'État d'origine.

- Deuxièmement, la CJUE permet aux États membres de refuser la déduction des pertes finales lorsque celles-ci sont liées à un montage purement artificiel, mais sans toutefois définir les situations dans lesquelles un tel montage pourrait être reconnu.

- Troisièmement, nous soutenons que la Cour aurait du porter attention à la situation dans l'État d'accueil, où une concurrence saine pourrait être perturbée lorsqu'un acteur économique obtient la déduction de pertes du seul fait que son actionnaire est résident dans un certain État membre.

- Quatrièmement, il semble difficile de déterminer quelle entreprise peut bénéficier d'une déduction des pertes finales (sans toutefois porter atteinte à une concurrence équilibrée dans l'État d'accueil) et empêcher la déduction de ces pertes par plus d'une entité.

Tous ces obstacles ne remettent pas en cause la pertinence d'une déduction des pertes finales subies par les filiales étrangères, mais tendent à indiquer que les difficultés sont nombreuses et seraient plus aisément surmontées par un processus législatif entre les États membres.

Enfin, il a été suggéré dans le chapitre 7 que le mécanisme de l'arrêt *Marks & Spencer* est intrinsèquement contestable en ce qu'il attribue automatiquement l'ensemble des pertes finales à l'État d'origine. Par conséquent, il semble nécessaire que les États membres légifèrent à ce sujet. Ils devront nécessairement aller plus loin que la directive proposée par la Commission européenne en 1990, puisque celle-ci ne s'appliquait pas aux pertes finales. Une assiette commune consolidée pour l'impôt sur les sociétés résoudrait le problème des pertes à la fois finales et non finales, même lorsque celles-ci sont subies par la société mère, chose que la CJUE ne pouvait résoudre dans l'affaire *Oy AA*. Cependant, l'assiette commune consolidée pour l'impôt sur les sociétés ne s'appliquerait pas à tous les groupes européens, de sorte qu'une solution alternative semble nécessaire.

9.4 Résumé du chapitre 4 : l'imposition des entreprises résidentes sur leurs revenus de source étrangère

À l'inverse du chapitre 3 qui concernait l'imposition d'une entreprise résidente sur les revenus de source étrangère imputables à une entreprise non-résidente, le chapitre 4 étudie l'imposition des entreprises résidentes sur leurs propres revenus de source étrangère. Ainsi, le chapitre 3 était consacré à la fiscalité des groupes de sociétés, alors que le chapitre 4 est dédié à la fiscalité des sociétés opérant par le biais d'une succursale étrangère. La différence principale entre ces deux situations résulte du fait que le principe de personnalité expliquait qu'en général, les revenus de source étrangère imputables à une entreprise non-résidente ne sont pas pris en compte par l'État d'origine. En revanche, aucun principe ne s'oppose à ce que les revenus de source étrangère des entreprises résidentes soient pris en compte par l'État d'origine, puisque nous avons démontré dans le chapitre 2 que le droit international public n'interdit pas l'imposition des revenus de source étrangère. C'est pourquoi il est fréquent que les entreprises résidentes soient imposées sur leurs revenus d'exploitation de source étrangère en application du principe de mondialité de l'impôt. Un État peut, toutefois, se refuser à imposer de tels revenus et choisir d'appliquer le principe de territorialité. Le principe de territorialité et le principe de mondialité de l'impôt soulèvent tous deux des incompatibilités avec l'objectif d'établissement du marché intérieur, car si le premier s'oppose à la prise en compte des pertes étrangères, le second n'incite pas à s'établir sur le territoire d'un autre État membre. Ces deux principes sont donc analysés successivement.

Le principe de mondialité de l'impôt a été abordé par la CJUE dans plusieurs affaires. En particulier, l'application de ce principe aux bénéfices d'exploitation de source étrangère était au cœur de l'affaire *Columbus Container*[1016]. Cet arrêt concernait une législation allemande qui remplaçait la méthode de l'exemption par la méthode du crédit d'impôt lorsque les revenus étrangers étaient soumis à un taux d'imposition trop faible. La Cour a eu à s'interroger sur la question de savoir si cette substitution du principe de mondialité au principe de territorialité était compatible avec le droit de

[1016] CJUE, 6 décembre 2007, affaire C-298/05, *Columbus Container*.

l'Union européenne. Bien que les conséquences financières de ce mécanisme soient clairement désavantageuses pour le contribuable, la CJUE a considéré que la législation allemande était compatible avec la liberté d'établissement au motif que les bénéfices étrangers étaient *in fine* imposés similairement aux bénéfices de source nationale. Nous avons soutenu qu'il est regrettable que la Cour refuse d'analyser cette question sous l'angle des entraves non-discriminatoires. En effet, les juges de Luxembourg n'ont pas évalué l'effet réel de la législation allemande sur le marché intérieur, tant pour ce qui est d'inciter les ressortissants européens à mettre en œuvre leur liberté d'établissement, que pour encourager la concurrence entre les États membres.

La position retenue par la CJUE dans l'arrêt *Columbus Container* peut difficilement être réconciliée avec celle adoptée dans l'affaire *Cadbury Schweppes*. Les législations en question dans ces affaires visaient toutes deux à prévenir l'évasion fiscale. Leurs effets étaient largement comparables, en ce que ces législations substituaient le principe de mondialité au principe de territorialité lorsque des bénéfices d'exploitation de source étrangère étaient imposés trop faiblement. Cependant, le principe de mondialité a été largement limité dans *Cadbury Schweppes*, alors qu'il a été clairement accepté dans *Columbus Container*. *Columbus Container* est donc difficilement réconciliable avec *Cadbury Schweppes*. La seule explication à cette incompatibilité entre *Cadbury Schweppes* et *Columbus Container* semble résider dans le fait que la CJUE se refuse à sanctionner les entraves non-discriminatoires. Il nous parait criticable que la Cour arrive à des conclusions si différentes d'un point de vue de politique fiscale, et ce au vu de l'existence (discutable)[1017] d'une différence de traitement dans *Cadbury Schweppes*. Par ailleurs, nous avons pu constater que la CJUE a reconnu l'incompatibilité de certaines entraves non-discriminatoires avec le droit de l'Union européenne, ce qui pourrait être un raisonnement utile pour faciliter la réalisation du marché inté-

[1017] En effet, nous avons démontré que la différence de traitement identifiée dans l'affaire *Cadbury Schweppes* dépendait de la perspective adoptée par les juges : il aurait pu être considéré que tant les filiales résidentes que les filiales non-résidentes sujettes aux règles sur les sociétés étrangères contrôlées font l'objet d'une imposition dans l'État de la société mère.

rieur[1018] mais que la Cour n'a pour l'instant pas souhaité développer en matière de fiscalité directe. En effet, peu nombreuses sont les affaires dans lesquelles la CJUE a considéré que la législation fiscale d'un État membre était incompatible avec le droit de l'Union européenne malgré l'absence de discrimination[1019], bien que les libertés de circulation et les articles des traités relatifs au marché intérieur ne limitent pas leurs effets à l'élimination des discriminations. Par ailleurs, nous avons proposé un raisonnement faisant un parallèle entre les législations non-discriminatoires mais néfastes pour la réalisation du marché intérieur, et les pratiques abusives des ressortissants européens. En effet, il nous semble légitime de nous interroger sur le fait que les ressortissants européens peuvent se voir reprocher des pratiques abusives, alors que les États membres peuvent, en l'état actuel du droit, mettre au point des législations euro-compatibles par le seul fait qu'elles s'appliquent similairement aux résidents et aux non-résidents. L'attitude des États membres consistant dans la mise aux point de législations euro-compatibles mais néfastes pour la réalisation du marché intérieur nous parait contraire à l'exigence de bonne foi dans l'application des traités internationaux, ainsi que difficilement réconciliable avec l'article 4 du TUE. Ce raisonnement pourrait servir de base à une jurisprudence plus ouverte sur les

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1018 Frans Vanistendael, *General report on the fundamental freedoms and national sovereignty in the European Union*, 2007 EATLP Congress, p. 173.

1019 On retiendra trois affaires dans lesquelles une législation *a priori* non discriminatoire a pu être considérée incompatible avec les libertés de circulation : *Futura, Lankhorst-Hohorst*, et *Deutsche Shell)*. La législation non discriminatoire ayant été considérée incompatible avec les libertés de circulation dans l'affaire *Futura* concernait une obligation faite aux établissements stables et aux entreprises résidentes du Grand Duché du Luxembourg de préparer leurs états financiers conformément aux règles comptables de cet État Membre. La législation non discriminatoire ayant été considérée incompatible avec les libertés de circulation dans l'affaire *Lankhorst-Hohorst* concernait le fait qu'en pratique les sociétés ayant un actionnaire résident d'Allemagne étaient soustraites à la législation allemande en matière de sous-capitalisation au motif qu'elles pouvaient bénéficier d'une exemption d'impôts dont les actionnaires étrangers ne pouvaient que difficilement se prévaloir. La législation non discriminatoire ayant été considérée incompatible avec les libertés de circulation dans l'affaire *Deutsche Shell* visait le fait qu'une perte de change réalisée sur le capital de dotation alloué à un établissement stable ne pouvait se produire vis-à-vis d'un établissement allemand.

entraves non-discriminatoires. Enfin, s'il est vrai que reconnaitre l'incompatibilité avec le droit de l'Union des entraves fiscales non-discriminatoires peut impliquer une difficile appréciation sur l'État membre devant limiter ses prétentions fiscales, nous considérons que la CJUE a déjà fait de telles appréciations : par exemple la Cour a, dans l'arrêt *Marks & Spencer*, considéré que c'est à l'État membre d'origine de supporter les pertes finales subies par des filiales étrangères. À l'inverse, dans un arrêt comme *Renneberg*, la CJUE a confié à l'État membre d'accueil de déduire certains coûts, quand bien même ceux-ci étaient liés à l'État de la résidence et pouvaient y être déduits. Par conséquent, le fait de décider quel État membre doit limiter ses prétentions fiscales ne devrait pas empêcher de reconnaitre la possible incompatibilité avec le droit de l'Union d'entraves fiscales non-discriminatoires.

L'acceptation du principe de mondialité de l'impôt dans l'affaire *Columbus Container* semble s'expliquer non pas par des considérations de principe, mais davantage par des considérations politiques. Toutefois, nous avons soutenu que le principe de mondialité de l'impôt fait perdre le bénéfice du taux d'impôt étranger plus faible et donc n'incite pas les ressortissants européens à exercer leur liberté d'établissement. Par ailleurs, selon nous la mondialité de l'impôt fausse la concurrence dans l'État d'accueil, dans la mesure où les acteurs économiques sont soumis au niveau d'imposition de leur État d'origine sans pouvoir se battre à armes égales avec les concurrents locaux[1020]. C'est d'ailleurs ce que la CJUE a peut-être reconnu de façon implicite dans l'arrêt *Krankenheim*[1021], au sujet de la mesure de réintégration ultérieure de pertes étrangères déduites dans l'État d'origine. L'arrêt *Krankenheim* concernait une législation allemande qui permettait la déduction des pertes subies par les succursales étrangères, sous condition que celles-ci soient réintégrées ultérieurement. La Cour a en effet clairement limité le droit de réintégrer les pertes et donc d'imposer les bénéfices étran-

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[1020] Cette situation pourrait être incompatible avec l'article 120 du TFUE, en vertu duquel les États membres « agissent dans le respect du principe d'une économie de marché ouverte où la concurrence est libre ».

[1021] CJUE, 23 octobre 2008, affaire C-157/07, *Krankenheim*.

gers par l'État d'origine au montant des pertes initialement déduites, c'est-à-dire que toute imposition des bénéfices étrangers allant au-delà de la déduction initiale est incompatible avec le droit de l'Union, en vertu d'une lecture à la lettre de l'arrêt *Krankenheim*. Ceci pourrait être interprété comme une incompatibilité du principe de mondialité avec le droit de l'Union, et être irréconciliable avec l'arrêt *Columbus Container*. L'arrêt *Krankenheim* semble toutefois isolé, au vu de la jurisprudence nombreuse ayant accepté l'imposition de bénéfices étrangers par l'État d'origine.

Le principe de territorialité pose lui aussi problème dans le cadre du marché intérieur, en ce qu'il empêche la déduction de pertes étrangères. La CJUE s'est penchée sur cette question lorsqu'un État membre s'abstient d'imposer les revenus de source étrangère d'une entreprise résidente en application de la méthode de l'exemption. L'affaire *Lidl Belgium*[1022] concernait la compatibilité avec le droit de l'Union européenne de la méthode de l'exemption dans une convention de double imposition entre l'Allemagne et le Luxembourg, qui empêchait une entreprise allemande de pouvoir, dans son État de residence, déduire les pertes subies par une succursale luxembourgeoise. Dans cet arrêt la Cour a transposé les conclusions de l'arrêt *Marks & Spencer* aux établissements stables, pour conclure que le droit de l'Union européenne n'exige pas la déduction des pertes étrangères non finales par l'État d'origine. Cependant, après avoir analysé les différences entre filiales et succursales étrangères, nous concluons que les risques identifiés pour les filiales étrangères sont bien moindres dans le cas de succursales étrangères. En effet, contrairement aux filiales, les succursales sont une émanation du siège, de sorte qu'une déduction suivie d'une réintégration des pertes pourrait plus facilement être contrôlée afin d'éviter une double déduction. Par conséquent, les arguments qui justifiaient le respect du principe de territorialité dans l'affaire *Marks & Spencer* et donc que les pertes non finales ne soient pas déduites dans l'État d'origine, ne sont guère convaincants lorsque les pertes étrangères sont subies par des succursales. En particulier, ne se pose pas le problème de déterminer quelle(s) société(s) devrai(en)t bénéficier d'un droit de déduction. Le risque que les pertes

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[1022] CJUE, 15 mai 2008, affaire C-414/06, *Lidl Belgium*.

soient déduites plus d'une fois peut ainsi être largement maitrisé. Un mécanisme de réintégration ultérieure parait aussi moins complexe à mettre en place, surtout par la seule action de la CJUE. Enfin, la déduction de pertes au sein d'une seule et même entreprise est en général possible dans la plupart des États membres, contrairement à la déduction des pertes subies par des sociétés juridiquement distinctes qui suppose l'existence d'un mécanisme de groupe et que certaines conditions soient remplies. Dès lors, les conséquences néfastes du principe de territorialité sur le marché intérieur semblent bien moins tolérables vis-à-vis des pertes étrangères subies par des succursales que par des filiales.

Lorsque des pertes étrangères et finales sont subies par des enterprises résidentes, la jurisprudence de la CJUE ne requiert pas explicitement leur déduction dans l'État d'origine. Si le raisonnement de la Cour dans l'affaire *Lidl Belgium* semble indiquer *a contrario* que de telles pertes devraient être déductibles[1023], l'affaire *Krankenheim* parait indiquer la solution inverse. L'arrêt *Krankenheim* concernait une entreprise allemande ayant une succursale en Autriche. Alors que la convention fiscale entre ces deux pays prévoyait la méthode de l'exemption, la législation allemande permettait une déduction temporaire des pertes étrangères, sous condition de réintégration ultérieure. Les pertes subies dans l'affaire *Krankenheim* n'ont pu être déduites ni dans l'État d'origine ni dans l'État d'accueil, ce qui n'a pas empêché la CJUE d'en accepter la réintégration ultérieure en application de la législation allemande. Si le droit de l'Union europénne acceptait la non-déduction des pertes finales subies par les succursales étrangères, nous avons soutenu que cette jurisprudence serait largement criticable dans la mesure où, comme nous l'avons démontré dans le cadre des pertes non finales, les conséquences néfastes du principe de territorialité sur le marché intérieur semblent bien moins tolérables vis-à-vis des pertes étrangères subies par des succursales que par des filiales. Aussi, les risques d'évasion fiscale existant dans les groupes de sociétés (par exemple par l'intermédiaire de la vente de titres à une autre société du groupe) nous paraissent moindres dans le cadre

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[1023] C'est aussi l'interprétation faite par le *Bundesfinanzhof allemand dans une décision du* 9 juin 2010, affaire I R 107/09.

d'une seule entreprise. Dès lors, il nous parait souhaitable que les pertes étrangères subies par des succursales soient au moins aussi bien traitées que celles subies par des filiales étrangères, pour lesquelles la CJUE exige la déduction depuis l'arrêt *Marks & Spencer*. Nous avons par conséquent plaidé pour que les États membres permettent la déduction des pertes finales étrangères subies par des succursales, lorsqu'une telle déduction est empêchée par le principe de territorialité en application de la méthode de l'exemption. Cependant, nous avons soutenu dans le chapitre 7 de la thèse que le méchanisme de déduction des pertes instauré par la CJUE dans l'arrêt *Marks & Spencer* semble intrinsèquement contestable en ce qu'il attribue automatiquement l'ensemble des pertes finales à l'État d'origine. Un raisonnement alternatif est par conséquent proposé dans le chapitre 7.

Le chapitre 4 nous a aussi permi d'aborder la question de savoir si le droit de l'Union européenne devrait requérir l'application d'un crédit d'impôt à hauteur de l'ensemble des impôts payés à l'étranger. Cette méthode est, en effet, la plus favorable lorsque le taux d'impôt de l'État d'accueil est plus élevé que le taux d'impôt de l'État d'origine. Cela permet une application pleine et entière du principe de neutralité des capitaux à l'exportation. Cependant, nous avons mis en lumière certains des risques associés à un crédit d'impôt à hauteur de l'ensemble des impôts payés à l'étranger, en particulier en matière d'évasion fiscale. Ces risques confirment le refus d'accorder un tel crédit d'impôt par la CJUE dans l'arrêt *Gilly*[1024].

Enfin, nous avons étudié si le droit de l'Union européenne devrait exiger l'application de la clause de la nation la plus favorisée. Nous avons conclu que si d'un point de vue théorique une telle clause pourrait contribuer à l'établissement du marché intérieur, son application pratique serait très complexe. Par conséquent, l'analyse que nous avons conduite plaide en faveur de l'adoption d'une convention multilatérale au niveau de l'Union, ou au moins l'adoption d'un modèle de convention fiscale, afin de minimiser les différences entre les différentes conventions conclues par les États membres.

[1024] CJUE, 12 mai 1998, affaire C-336/96, *Gilly*.

La conclusion de ce chapitre tend à indiquer que l'objectif d'établissement d'un marché intérieur ne saurait se satisfaire d'un principe d'imposition unique. Il semble en effet nécessaire de combiner la territorialité et la mondialité, par exemple en exemptant les revenus étrangers dans l'État d'origine, mais en laissant la possibilité aux entreprises de déduire provisoirement leurs pertes étrangères. Les pertes finales devraient aussi pouvoir être déduites.

9.5 Chapitre 5 : l'imposition des établissements stables sur les revenus de source étrangère qui leurs sont imputables

L'imposition ou la prise en compte de revenus de source étrangère peut concerner des entreprises non-résidentes ayant un établissement stable sur le territoire d'un État membre. En effet, conduire des activités économiques par la voie d'une succursale présente certaines différences par rapport à une filiale, différences très importantes pour certains secteurs d'activité tels que les banques et institutions financières. La juridiction fiscale de l'État de la succursale est, toutefois, l'objet de certaines particularités. Si ces particularités ne sont pas issues du droit international en tant que tel, les États concluent le plus souvent des conventions fiscales qui tendent à limiter le droit d'imposer de l'État de la succursale. Ainsi, il est fréquent que les États limitent leur juridiction fiscale aux revenus imputables à une succursale, contrairement aux entreprises résidentes dont les revenus mondiaux sont le plus souvent imposables par leur État de résidence. Par conséquent, les principes de territorialité et de mondialité ont une application particulière dans le cadre de la fiscalité des établissements stables. Ce chapitre a, cependant, été divisé entre les bénéfices et les pertes, comme les chapitres précédents.

En ce qui concerne les bénéfices de source étrangère imputables à une succursale, la question est posée de savoir si leur imposition dans l'État de la succursale est compatible avec le droit de l'Union européenne. La jurisprudence de la CJUE relative aux revenus imputables aux succursales est très peu nombreuse, et inexistante en ce qui concerne l'imputation de bénéfices de source étrangère. Il nous a par conséquent fallu analyser des arrêts qui ne

concernent pas directement cette problématique pour les transposer à l'imposition des succursales. Il serait possible, au vu d'arrêts tels que *Royal Bank of Scotland*, que la CJUE ne reconnaisse qu'une juridiction fiscale limitée à l'État de la succursale[1025]. Cette impression est confirmée par la jurisprudence de la Cour dans laquelle il a été estimé que l'imposition des non-résidents en application du principe de territorialité est compatible avec le droit de l'Union. Cependant, au vu de la jurisprudence de la Cour relative à l'imposition des revenus étrangers des non-résidents, il ne semble pas que cette imposition soit, en tant que telle, contraire aux principes des traités européens. En particuler, les affaires *Saint-Gobain*[1026], *Cadbury Schweppes* et *van Hilten*[1027] semblent indiquer qu'un État membre de source peut imposer des revenus de source étrangère imputables à un non-résident, c'est-à-dire appliquer le principe de mondialité de l'impôt à un non-résident. De plus, une telle imposition n'est pas nécessairement moins favorable que l'imposition de revenus domestiques, ou l'imposition de revenus étrangers imputables aux sociétés résidentes. Il reste toutefois nécessaire que l'État de la succursale impose celle-ci de façon non-discriminatoire par rapport à une entreprise résidente.

Nous avons par la suite analysé si une transposition de cette constatation à l'imposition des succursales était ou non souhaitable. Nous concluons que le droit de l'Union ne devrait pas empêcher l'imposition des revenus de source étrangère par l'État membre de source, tant que seuls les revenus étrangers imputables à la succursale sont assujettis à l'impôt. La motivation principale de cette conclusion réside dans la nécessité d'éviter la double non-impostion, qui d'ailleurs a souvent fait partie des préoccupations de la CJUE dans sa jurisprudence au même titre que la double déduction des pertes. Il a aussi été constaté qu'une telle imposition ne créé pas de risques majeurs de double imposition internationale, grâce à la protection offerte par la convention européenne d'arbitrage. Par conséquent, nous concluons

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[1025] CJUE, 29 avril 1999, affaire C-311/97, *Royal Bank of Scotland*, voir en particulier le point 29 qui fait référence à la souveraineté limitée de l'État où est établie une succursale.

[1026] CJUE, 21 septembre 1999, affaire C-307/97, *Saint-Gobain*.

[1027] CJUE, 23 février 2006, affaire C-513/03, *van Hilten*.

que le droit de l'Union ne devrait pas exiger une application stricte du principe de territorialité quant à l'imposition des bénéfices de source étrangère imputables à une succursale. La solution inverse pourrait permettre des montages d'évasion fiscale qui mettraient en péril les finances publiques des États membres et une concurrence équilibrée au sein du marché intérieur.

Le principe de territorialité est aussi en conflit avec l'objectif d'établissement d'un marché intérieur lorsque des pertes ou charges de source étrangère sont imputables à une succursale. En effet, le principe de territorialité, lorsqu'il est appliqué strictement, revient à imposer une succursale sur une base purement nationale, à l'exclusion des revenus étrangers imputables à celle-ci. En conséquence, des charges ou pertes peuvent ne pas être déductibles à l'échelle de l'entreprise, et ce malgré le principe de pleine concurrence. Cette question est particulièrement d'actualité, au vu des travaux récents de l'OCDE en matière d'attribution des bénéfices aux établissements stables. Il convient donc de s'interroger sur les conséquences du droit de l'Union européenne sur la juridiction fiscale de l'État où est établie une succursale, lorsque celle-ci est imposée sur une base strictement territoriale. Cette question s'est posée pour la première fois dans l'affaire *Futura*[1028], qui concernait une législation luxembourgeoise exigeant pour le report en avant des pertes subies par une succursale que celles-ci soient de source nationale. Or l'entreprise calculait les résultats de la succursale sur la base d'une clé de répartition, qui ne permettait pas d'isoler avec précision des résultats de source purement luxembourgeoise. Le report en avant des pertes subies par la succursale a donc été refusé, ce que l'entreprise considérait incompatible avec la liberté d'établissement.

Dans l'affaire *Futura*, une des premières en matière de division de l'assiette imposable d'une entreprise entre États membres, la CJUE a finalement permis à un État membre de se fonder sur une interprétation stricte du principe de territorialité. La déduction de pertes subies par l'entreprise et imputées à une succursale sur la base d'une clé de répartition a, par conséquent, pu être refusée dans l'État de la succursale, ce qui a pu être implici-

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[1028] CJUE, 15 mai 1997, affaire C-250/95, *Futura*.

tement confirmé par la CJUE dans l'arrêt *AMID*[1029]. Nous avons considéré qu'une telle interprétation stricte du principe de territorialité peut résulter dans des situations de non-déduction de pertes ou de charges, ce qui est en conflit avec tout un pan de la jurisprudence de la Cour, notamment les arrêts *Marks & Spencer* et *Bosal*[1030]. Par ailleurs, cette jurisprudence peut aussi être incompatible avec le principe de pleine concurrence et résulter dans des situations de non-déduction de pertes ou de charges lorsqu'une entreprise souhaite appliquer la méthode du partage des bénéfices et qu'une telle méthode résulte dans des pertes attribuées à une succursale. Enfin, une application stricte du principe de territorialité par l'État de la succursale peut aussi aboutir à des situations de non-déduction de pertes ou de charges lorsqu'une succursale poursuit elle-même des activités dans un État tiers et y subit des pertes.

Cependant, nous avons souligné que l'affaire *Centro Equestre*[1031] parait assouplir la jurisprudence *Futura*, en ce que la CJUE dans *Centro Equestre* a considéré que l'État de la source devait admettre en déduction des frais exposés à l'extérieur de cet État. En effet, dans l'affaire *Centro Equestre* une entreprise portugaise exerçait une activité en Allemagne, pour laquelle l'administration fiscale allemande avait refusé la déduction de coûts supportés en dehors du territoire allemand. La CJUE a considéré que l'Allemagne devait permettre la déduction des coûts indissociables de l'activité allemande. Toutefois, nous soutenons que cet assouplissement n'est pas suffisant, au vu des exigences posées par la Cour que ces frais soient indissociables des services fournis par l'entreprise non-résidente dans l'État de la source. En effet, les frais imputables à une succursale en application du principe de pleine concurrence peuvent ne pas avoir de lien indissociable avec l'activité dans l'État de la source, par exemple en matière de frais généraux ou d'intérêts sur prêt. Dès lors, le risque subsiste que l'État de la succursale refuse d'admettre de tels frais en déduction, créant par-là une situa-

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[1029] CJUE, 14 décembre 2000, affaire C-141/99, *Algemene Maatschappij door Investering en Dienstverlening NV (AMID)*.

[1030] CJUE, 18 septembre 2003, affaire C-168/01, *Bosal Holding BV*.

[1031] CJUE, 15 février 2007, affaire C-345/04, *Centro Equestre*.

tion de non-déduction (et donc de double imposition) car ces frais ne sont normalement pas déductibles dans l'État du siège. Par conséquent, la CJUE ne semble pas permettre aux entreprises européennes de pouvoir bénéficier pleinement des recommandations de l'OCDE en matière d'attributions des bénéfices aux établissements stables, dans la mesure où une succursale peut ne pas bénéficier entièrement des conséquences du principe de pleine concurrence. Nous avons considéré, toutefois, que certaines des recommandations de l'OCDE seraient bénéfiques à l'établissement du marché intérieur, dans la mesure où un des objectifs de l'OCDE est l'élimination des doubles impositions.

Par conséquent, les conclusions de ce chapitre tendent à indiquer qu'une application stricte du principe de territorialité par l'État d'accueil d'une succursale ne serait pas souhaitable. Un assouplissement de ce principe, supporté par les recommandations de l'OCDE, devrait contribuer à l'établissement du marché intérieur. Nous avons néanmoins observé qu'une étude approfondie des recommandations de l'OCDE en matière d'attributions des bénéfices aux établissements stables est nécessaire, afin d'analyser si toutes les recommandations de l'OCDE sont compatibles avec les principes posés par les traités européens[1032].

9.6 Résumé du chapitre 6 : la double imposition internationale et l'objectif d'établissement du marché intérieur

L'objectif de la thèse est d'analyser les conséquences de l'objectif d'établissement du marché intérieur sur l'imposition des revenus de source étrangère des entreprises. Outre l'analyse en tant que telle de cette imposition dans la jurisprudence de la CJUE, il nous parait fondamental de nous interroger sur la relation entre le droit de l'Union européenne et la double imposition internationale. En effet, les analyses conduites dans chacun des chapitres précédents ne peuvent suffire à comprendre pleinement les conséquences de l'objectif d'établissement du marché intérieur sur l'imposition des revenus de source étrangère des entreprises, parce que ces analyses ont

[1032] Ainsi, nous avons pris pour exemple l'attribution de capital libre aux établissements stables qui, formellement, créé une différence de traitement avec les entreprises résidentes.

été conduites séparément, chapitre par chapitre. Cependant, les effets combinés des pouvoirs d'imposition exercés par les États membres doivent aussi, selon nous, être pris en considération afin de déterminer l'étendue souhaitable des règles de territorialité de l'impôt sur les sociétés dans le cadre du marché intérieur. En particulier, l'exercice combiné de ces principes d'imposition par plusieurs États membres créé le risque d'une double imposition internationale. Par conséquent, il nous parait nécessaire d'étudier la compatibilité de la double imposition internationale avec le droit de l'Union européenne afin de pouvoir faire une analyse complète du conflit entre l'objectif d'établissement du marché intérieur et les règles de territorialité de l'impôt sur les sociétés. Le résultat de cette étude pourrait avoir des conséquences importantes sur l'imposition des revenus actifs de source étrangère par les États membres : les règles sur les sociétés étrangères contrôlées pourraient être davantage encadrées afin d'éviter une double imposition, l'État du siège imposant les bénéfices mondiaux d'une entreprise pourrait devoir éliminer la double imposition lorsqu'une succursale est aussi imposée dans l'État d'accueil (si la double imposition devrait être éliminée par l'État de résidence, à moins que l'État de la source ne doive s'abstenir d'imposer la succursale), les pertes étrangères pourraient devoir être prises en compte, et l'État où une succursale est établie pourrait devoir éliminer la double imposition dans certaines situations triangulaires.

En premier lieu, l'étude du concept de marché intérieur fait apparaitre plusieurs points de tension avec les situations de double imposition internationale. En particulier, l'établissement du marché intérieur est étroitement lié à la promotion des libertés de circulation, qui sont aussi un objectif fondamental des travaux de l'OCDE. Ceux-ci tendent à démontrer qu'il y a un lien évident entre l'élimination de la double imposition internationale et la promotion de la libre circulation. Nous avons par conséquent souligné qu'il est paradoxal que l'OCDE s'attache si clairement à l'élimination de la double imposition internationale sans que la promotion de la libre circulation ne soit une obligation pesant sur les membres de cette organisation, alors que la promotion de la libre circulation est une obligation pour les États membres de l'Union européenne sans que ceux-ci ne prennent de mesures afin d'éliminer la double imposition internationale au sein du marché intérieur.

Par ailleurs, l'article 26 du TFUE fait référence à « un espace sans frontières intérieures », ce qui tend à rapprocher le marché intérieur des conditions existant au sein d'un seul et même État[1033]. Une jurisprudence nombreuse supporte cette idée. Nous avons soutenu que si des doubles impositions peuvent se produire au sein d'un seul et même État, par exemple l'imposition en cascade des bénéfices des sociétés lors de la distribution de dividendes, celles-ci sont bien plus fréquentes et complexes à éliminer dans des situations présentant un élément d'extranéité. L'idée d'un marché intérieur ayant des conditions similaires à celles existant au sein d'un seul et même État tend donc à limiter les situations de double imposition. Par ailleurs, au sein d'un seul et même État les contribuables ne sont assujettis qu'à un seul ensemble de normes fiscales. À l'inverse, dans les situations de double imposition internationale plusieurs ensembles de normes fiscales sont applicables de façon concurrente, notamment les règles d'État de résidence et de l'État de la source. Cette constatation plaiderait pour une imposition exclusive soit par l'État de la résidence soit par l'État de la source. Dans les deux cas la double imposition internationale serait éliminée. Ce raisonnement n'indique pas quel État devrait être prioritaire, mais cette priorité pourrait être déduite d'autres principes des traités européens. En conséquence, plusieurs arguments liés au concept de marché intérieur indiquent que la double imposition internationale est en conflit avec celui-ci. Nous avons par ailleurs pu observer que l'abrogation de l'article 293 du TCE devrait en tout état de cause libérer la CJUE des limites posées par cet article. En effet, si l'exégèse de cet article confirme la jurisprudence *Gilly* en ce qu'il ne requiert pas l'élimination de la double imposition internationale, l'article 293 du TCE pouvait être interprété en ce qu'il excluait l'élimination de la double imposition de la compétence de l'Union. Son abrogation per-

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[1033] Voir par exemple CJUE, 3 octobre 2002, affaire C-136/00, *Rolf Dieter Danner*, point 29 : « Dans l'optique d'un marché unique, et pour permettre de réaliser les objectifs de celui-ci, l'article 59 du traité s'oppose à l'application de toute réglementation nationale ayant pour effet de rendre la prestation de services entre États membres plus difficile que celle purement interne à un État membre ».

met donc de lever ces doutes et devrait libérer la CJUE des limites posées par cet article[1034].

En second lieu, la double imposition internationale pourrait être en conflit avec le droit de propriété, voire avec le droit à ne pas être jugé ou puni deux fois pour une même infraction. Ces droits sont en effet protégés par la Convention européenne de sauvegarde des droits de l'Homme et des libertés fondamentales ainsi que la Charte des droits fondamentaux de l'Union européenne, auxquelles l'article 6 du TUE fait référence. Certes, il n'est pas certain que la Convention européenne de sauvegarde des droits de l'Homme et des libertés fondamentales ainsi que la Charte des droits fondamentaux de l'Union européenne soient applicables aux situations de double imposition internationale au sein du marché intérieur. Cependant, nous avons identifié certains arguments dans ce sens, et il ne peut être exclu que la CJUE ou la Cour européenne des droits de l'Homme adopte une interprétation extensive du champ d'application de ces deux textes. Dès lors, il nous parait intéressant d'en étudier les conséquences potentielles au regard de la double imposition internationale. S'il ne peut pas être établi de façon parfaitement convaincante que la double imposition internationale est incompatible avec ces droits, il n'en demeure pas moins une tension qui pourrait être constatée par la CJUE ou la Cour européenne des droits de l'Homme. À ce sujet, nous avons pu observer que la Cour européenne des droits de l'Homme a déjà affirmé qu'une double imposition nationale peut être incompatible avec le droit de propriété[1035]. Par ailleurs, si le droit à ne pas être jugé ou puni deux fois pour une même infraction est manifestement limité au domaine du droit pénal, il peut être observé que les États membres ont souhaité à l'article 6(3) du TUE faire des droits fondamentaux des principes généraux du droit de l'Union européenne. Par conséquent, il ne peut être exclu que la jurisprudence future élargisse le champ d'application de ces droits fondamentaux. En conclusion, à défaut

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[1034] Jérôme Monsenego, *Réflexions sur les conséquences de l'abrogation de l'article 293, alinéa 2 du traité CE*, Revue de Droit Fiscal, 3 March 2011, pp. 15-19.

[1035] Cour européenne des droits de l'Homme, 23 octobre 1997, Nos 21319/93, 21449/93, 21675/93, *National & Provincial Building Society, the Leeds Permanent Building Society and the Yorkshire Building Society v. The United Kingdom*. Voir en particulier le point 61 de cet arrêt.

d'incompatibilité, nous avons identifié une tension entre la double imposition internationale et certains des droits protégés par la Convention européenne de sauvegarde des droits de l'Homme et des libertés fondamentales ainsi que la Charte des droits fondamentaux de l'Union européenne. Cette tension parait d'autant plus problématique que la double imposition internationale est créée au sein du marché intérieur par l'exercice même des libertés de circulation.

En troisième lieu, nous avons pu observer que la double imposition internationale n'est pas, en tant que telle, sanctionnée par la CJUE dans sa jurisprudence en matière de fiscalité directe. Il est vrai que la Cour requiert un traitement sans discrimination tant dans l'État de résidence (cela ressort notamment des arrêts *Verkooijen*[1036] et *Manninen*[1037]) que dans l'État de la source (cela ressort notamment des arrêts *Denkavit II*[1038], *Amurta*[1039], *Aberdeen*[1040], *Commission v Italy*[1041], et *Commission v Spain*[1042]). Cependant, la CJUE ne considère pas que la double imposition internationale est, en tant que telle, une entrave non-discriminatoire prohibée par le droit de l'Union européenne. C'est notamment ce qui ressort des arrêts *Kerckhaert et Morres*[1043], *Block*[1044] et *Damseaux*[1045] dans lesquels des mesures non-discriminatoires résultaient dans des situations de double imposition internationale. S'il est vrai que donner priorité à un État pour éliminer des situations de double imposition internationale est un choix malaisé, il n'en demeure pas moins que l'état actuel du droit reste critiquable. Nous avons aussi constaté que la

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1036 CJUE, 6 juin 2000, affaire C-35/98, *Staatssecretaris van Financiën and B.G.M. Verkooijen*.

1037 CJUE, 7 septembre 2004, affaire C-319/02, *Petri Manninen*.

1038 CJUE, 14 décembre 2006, affaire C-170/05, *Denkavit Internationaal BV, Denkavit France SARL v. Ministre de l'Économie, des Finances et de l'Industrie*.

1039 CJUE, 8 novembre 2007, affaire C-379/05, *Amurta SGPS v Inspecteur van de Belastingdienst*.

1040 CJUE, 18 juin 2009, affaire C-303/07, *Aberdeen Property Fininvest Alpha Oy*.

1041 CJUE, 19 novembre 2009, affaire C-540/07, *Commission v Italy*.

1042 CJUE, 3 juin 2010, affaire C-487/08, *Commission v Spain*.

1043 CJUE, 14 novembre 2006, affaire C-513/04, *Mark Kerckhaert and Bernadette Morres v Belgische Staat*.

1044 CJUE, 12 février 2009, affaire C-67/08, *Margarete Block v Finanzamt Kaufbeuren*.

1045 CJUE, 16 juillet 2009, affaire C-128/08, *Jacques Damseaux v État belge*.

Cour pourrait choisir lequel entre l'État de la résidence et l'État de la source devrait éliminer la double imposition, car de tels choix ont déjà été faits dans des arrêts tels que *Marks & Spencer* ou *Renneberg*. De plus, la jurisprudence *Kerckhaert et Morres*, *Block* et *Damseaux* est difficile à réconcilier avec certains des arrêts de la CJUE en matière de contributions sociales (en particulier les arrêts *Guiot*[1046], *Arblade*[1047] et *Sehrer*[1048]), pour lesquelles la Cour a considéré qu'un double paiement peut enfreindre le droit de l'Union européenne. Une réconciliation pose aussi problème avec l'exigence que les pertes finales et certains coûts soient toujours déductibles dans un État membre, tel qu'il ressort des arrêts *Bosal* et *Marks & Spencer*.

En conclusion, si la double imposition internationale n'est pas, en tant que telle, incompatible avec le droit de l'Union européenne dans la jurisprudence de la CJUE, l'analyse conduite dans ce chapitre met en avant de nombreuses difficultés à accepter la compatibilité de la double imposition internationale avec les principes des traités européens. La relative réserve de la Cour pourrait être expliquée par les conséquences potentielles d'une incompatibilité de la double imposition internationale avec le droit de l'Union européenne et les difficultés à l'éliminer, notamment par la détermination de l'État devant renoncer à ses prérogatives fiscales. Cela ne saurait occulter les tensions patentes entre la double imposition internationale et l'objectif d'établissement du marché intérieur. En l'absence de jurisprudence incitant les États membres à éliminer la double imposition internationale, il semble souhaitable que ceux-ci prennent acte de cette tension dans le cadre de l'élaboration de leurs règles sur la territorialité de l'impôt sur les sociétés.

[1046] CJUE, 28 mars 1996, affaire C-272/94, *Criminal proceedings against Michel Guiot and Climatec SA*.

[1047] CJUE, 23 novembre 1999, affaires C-369/96 et C-376/96, *Criminal proceedings against Jean-Claude Arblade and Arblade & Fils SARL*, et *Bernard Leloup, Serge Leloup and Sofrage SARL*.

[1048] CJUE, 15 juin 2000, affaire C-302/98, *Manfred Sehrer v Bundesknappschaft*.

9.7 Résumé du chapitre 7 : observations et suggestions quant à la prise en compte des pertes finales étrangères

Dans ce chapitre nous sommes partis de la constatation que la CJUE requiert la déduction des pertes finales de source étrangère subies par des filiales ou succursales établies dans un autre État membre, c'est-à-dire que le principe de territorialité est – dans cette situation – incompatible avec le droit de l'Union européenne. Il est donc du devoir des États membres de trouver une solution à la prise en compte des pertes finales de source étrangère. À ce sujet, nous avons plaidé au cours de la thèse pour une harmonisation ou une coordination des législations des États membres quant à la prise en compte des pertes finales, au vu des difficultés soulevées par la situation actuelle qui est de pure création prétorienne. Les critiques formulées dans le chapitre 3 de la thèse et adressées au mécanisme proposé par la CJUE dans l'arrêt *Marks & Spencer* ne remettent pas en cause la pertinence de la déduction des pertes finales étrangères. Cependant, dans ce chapitre 7 nous proposons une analyse critique du mécanisme même imposé par la Cour, c'est-à-dire une obligation pour l'État d'origine de déduire les pertes finales subies dans l'État d'accueil. En effet, dans le cadre d'une possible harmonisation ou coordination des législations en matière de déduction des pertes, il serait intéressant d'avoir une réflexion sur le principe même de l'arrêt *Marks & Spencer* en ce qu'il exige de l'État d'origine que celui-ci prenne en compte l'ensemble des pertes finales de source étrangère. Cette réflexion est valable en l'absence d'assiette commune consolidée pour l'impôt sur les sociétés.

Le mécanisme proposé par la CJUE dans l'arrêt *Marks & Spencer* consiste à mettre en œuvre le test de comparabilité et de discrimination dans l'État d'origine. Ce mécanisme parait *a priori* correct, dans la mesure où il existe le plus souvent une différence de traitement entre pertes nationales et pertes étrangères dans les systèmes nationaux de consolidation des groupes de sociétés. Par ailleurs, la société mère prend un risque en investissant dans sa filiale (ou le siège en investissant dans une succursale), de sorte que la déduction des pertes pourrait compenser ce risque. Enfin, l'État d'origine peut avoir la possibilité d'imposer les dividendes ou plus-values en capital entre les mains de la société mère, si bien que la déduction des pertes pour-

rait exposer cet État tant aux bénéfices qu'aux pertes subies par les filiales étrangères. Cependant, nous avons démontré qu'une telle obligation ouvre des possibilités d'évasion fiscale. Il est, par exemple, possible d'organiser le résultat de façon à ne pas reporter de profits afin de rendre des pertes finales et en obtenir la déduction dans l'État d'origine. Un groupe pourrait aussi être tenté de liquider une filiale afin de pouvoir bénéficier d'un droit de déduction des pertes plus avantageux dans l'État d'origine. De telles possibilités de faire remonter des pertes artificiellement vers l'État d'origine sont, selon nous, en contradiction avec le principe d'une répartition équilibrée du résultat imposable auquel la CJUE a fait référence dans de nombreux arrêts. Il est vrai qu'au paragraphe 57 de l'arrêt *Marks & Spencer* la Cour a reconnu un droit de refuser la déduction de pertes en présence d'un montage purement artificiel, afin de prévenir l'évasion fiscale. Cependant, les conditions requises pour refuser la déduction d'une perte pourraient ne pas prévenir le type de montage décrit plus haut, qui peut parfaitement être pourvu de substance et donc échapper à l'exception applicable en cas de montage purement artificiel. Par conséquent, il nous semble que le principe de l'arrêt *Marks & Spencer*, en ce qu'il exige de l'État d'origine que celui-ci prenne en compte l'ensemble des pertes finales de source étrangère, soit critiquable au vu des possibilités d'évasion fiscale permises par cet arrêt.

Un second argument vient appuyer la critique précédemment formulée. En effet, une obligation pour l'État d'origine de déduire l'ensemble des pertes finales subies dans l'État d'accueil contredit selon nous le principe de pleine concurrence, dont la CJUE a reconnu le bienfondé notamment dans les arrêts *Thin Cap Group Litigation*[1049] et *SGI*[1050]. En effet, la répartition des résultats entre la société mère (ou le siège) et la filiale (ou la succursale) doit respecter le principe de pleine concurrence, dans la mesure où ces entités sont entrées dans des transactions intragroupes. Or le principe de pleine concurrence n'implique pas nécessairement que les pertes d'une filiale soient sup-

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[1049] CJUE, 13 mars 2007, affaire C-524/04, *Thin Cap Group Litigation*, voir particulièrement les points 80-87.

[1050] CJUE, 21 janvier 2010, affaire C-311/08, *Société de Gestion Industrielle SA (SGI) v Belgian State*, voir particulièrement les points 62-68.

portées par la société mère, ce qui doit normalement dépendre de la répartition des fonctions, risques et actifs incorporels entre ces entités. Il est par conséquent tout à fait possible qu'en vertu du principe de pleine concurrence, les pertes d'une filiale soient entièrement ou en partie supportées par celle-ci et non par la société mère (ou une autre société du groupe). Dès lors, nous avons soutenu que le principe même de l'arrêt *Marks & Spencer* est critiquable en ce qu'il nie les implications du principe de pleine concurrence, c'est-à-dire que quelles que soient les conséquences du principe de pleine concurrence, le mécanisme de l'arrêt *Marks & Spencer* peut résulter dans une déduction automatique de l'ensemble des pertes au niveau de la société mère. Ces conséquences nous paraissent incompatibles avec l'exigence de préserver une répartition équilibrée du pouvoir d'imposition entre les États membres, principe désormais consacré par la Cour. Nous avons ainsi pu soutenir que le principe de pleine concurrence plaide non pour une solution unique et prédéterminée à la déduction des pertes finales étrangères, mais pour une solution adaptée à la réalité de chaque groupe.

Nous avons aussi analysé une autre possibilité, suggérée par une partie de la doctrine, qui consiste à obtenir un remboursement du trop d'impôt perçu par l'État d'accueil lorsque des pertes finales sont accumulées dans celui-ci. Nous soutenons que cette possibilité est grevée des mêmes défauts que celle suggérée par la CJUE dans l'arrêt *Marks & Spencer* en ce qu'elle attribue l'ensemble des pertes finales à un État membre prédéterminé et cela de façon automatique. Cette suggestion ouvre donc des possibilités d'évasion fiscale et contredit le principe de pleine concurrence.

Par conséquent, nous avons proposé une autre solution à la prise en compte des pertes finales qui consisterait en une division de celles-ci entre l'État d'origine et l'État d'accueil. Une telle division permettrait d'établir un lien économique entre le montant des pertes à prendre en compte par chaque État et la répartition des activités du groupe ou de l'entreprise entre l'État d'origine et l'État d'accueil. Il nous a fallu, dans un premier temps, nous interroger sur la compatibilité d'une telle approche avec les principes de l'arrêt *Marks & Spencer*, dont nous avons conclu qu'ils ne devraient pas empêcher une solution législative entre les États membres inspirée par les suggestions de ce chapitre. Dans un deuxième temps, nous avons soutenu

que d'un point de vue théorique, il nous paraitrait correct de soustraire du montant des pertes finales la part de celles-ci qui est due à des transactions intragroupe avec des entreprises etablies dans des États tiers ne respectant pas le principe de pleine concurrence. Le montant restant, apuré des pertes non conformes au principe de pleine concurrence, pourrait par la suite être divisé entre l'État d'origine et l'État d'accueil. Chaque État pourrait alors envisager le traitement du montant de pertes finales qui lui est attribué. Pour ce faire, nous avons étudié deux méthodes possibles de division des pertes : une clé de répartition et une division fondée sur le principe de pleine concurrence. Dans le premier cas, le montant des pertes pourrait être divisé en fonction d'une formule prédéterminée qui pourrait, par exemple, reprendre les éléments de la clé de répartition de l'assiette commune consolidée pour l'impôt sur les sociétés. Cette possibilité se heurte à l'absence de connexion avec la façon dont les profits intragroupes sont imposés, ce qui n'est pas une solution pertinente en l'absence d'une assiette commune consolidée pour l'impôt sur les sociétés. Par conséquent, la seconde possibilité serait, selon nous, plus appropriée. Elle consisterait à prendre en compte la situation d'un groupe de sociétés à la lumière du principe de pleine concurrence, en étudier la répartition des fonctions, risques et actifs incorporels, et décider de la division des pertes finales en fonction de l'analyse fonctionnelle. Il serait naturellement nécessaire de conduire une réflexion particulière quant aux modalités d'une telle division des pertes finales, qui pourrait par exemple être assurée par les autorités compétentes des États membres, une commission d'arbitrage, la CJUE[1051], ou une administration fiscale européenne.

9.8 Résumé du chapitre 8 : conclusion

Le chapitre 8 résume la thèse et en tire des conclusions. Celles-ci sont classées par thèmes relatifs à la territorialité de l'impôt sur les sociétés et concernent les règles sur les sociétés étrangères contrôlées, l'imposition des bé-

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[1051] Voir à cet égard l'article 273 du TFUE. La CJUE a, par exemple, été choisie par l'Allemagne et l'Autriche pour résoudre certains conflits d'interprétation relatifs à la convention fiscale entre ces deux pays : voir Mario Züger, *The ECJ as arbitration court for the new Austria-Germany tax treaty*, European Taxation, mars 2000, pp. 101-105.

néfices d'exploitation de source étrangère, la déduction des pertes subies au sein du marché intérieur par les filiales et succursales étrangères, ainsi que les règles de territorialité en vigueur dans l'État où est établie une succursale. Toutefois, avant de présenter ces conclusions, nous pouvons observer qu'un des enseignements principaux des analyses conduites au cours de la thèse est que le marché intérieur ne peut être établi par une application exclusive du principe de territorialité ou de mondialité de l'impôt sur les sociétés. Ces deux principes ont des avantages et des inconvénients et devraient, partant, être combinés afin de contribuer au mieux à l'atteinte des objectifs ambitieux posés par les traités européens.

L'imposition des filiales étrangères à l'aide des règles sur les sociétés étrangères contrôlées parait nécessaire uniquement lorsqu'il s'agit de faire face aux montages purement artificiels. Cependant, au vu de la tension entre le droit de l'Union européenne et la double imposition internationale il est souhaitable que les États membres, lorsqu'ils appliquent leurs règles sur les sociétés étrangères contrôlées, fassent en sorte d'éviter la double imposition internationale lors de l'imposition des bénéfices des filiales étrangères (ceci en donnant un crédit d'impôt correspondant aux impôts payés dans l'État de la filiale) mais aussi lors de la distribution par celles-ci de dividendes.

Pour ce qui est de l'imposition des bénéfices d'exploitation de source étrangère, nous avons soutenu que l'objectif d'établissement du marché intérieur ainsi que l'importance de limiter certaines entraves non discriminatoires plaident pour éliminer la double imposition par la méthode de l'exemption plutôt que par la méthode du crédit d'impôt. Ces arguments sont, par ailleurs, soutenus par le raisonnement de la CJUE dans l'affaire *Krankenheim*. Il n'en demeure pas moins que certaines situations d'évasion fiscale doivent être prévenues, ce qui pourrait être réalisé par la substitution de la méthode du crédit d'impôt à celle de l'exemption. Une autre possibilité serait de compléter la méthode de l'exemption par un mécanisme tel que celui décrit à l'article 23 A(4) de la convention modèle OCDE.

La question des pertes subies au sein du marché intérieur est particulièrement problématique. Nous avons soutenu que seule l'assiette commune consolidée pour l'impôt sur les sociétés pourrait résoudre ce problème de

manière satisfaisante, tant pour les pertes finales que pour les pertes non finales. Cependant, ce projet d'harmonisation n'étant pas destiné à s'appliquer à toutes les situations, il semble nécessaire que les États membres harmonisent ou tout au moins coordonnent leurs systèmes fiscaux afin de permettre la prise en compte des pertes étrangères, que celles-ci soient finales ou non. Un mécanisme de déduction avec réintégration ultérieure parait adapté tant pour les filiales que pour les succursales étrangères. À cet effet, la directive proposée par la Commission européenne en 1990 pourrait servir de modèle[1052], étant entendu qu'il conviendrait de la compléter par des dispositions relatives aux pertes finales. Une directive relative aux pertes de source étrangère pourrait, d'ailleurs, prévoir un mécanisme de division de celles-ci afin de préserver un lien économique entre les pertes et les États devant les prendre en compte.

En ce qui concerne les règles de territorialité en vigueur dans l'État où est établie une succursale, il semble nécessaire que la jurisprudence de la CJUE soit ouverte à certaines recommandations de l'OCDE, afin d'éviter des situations de double imposition ou de double non-imposition ainsi que des situations de double non-déduction. Nous soutenons, toutefois, que la compatibilité des recommandations de l'OCDE en matière d'attribution des bénéfices aux établissements stables devrait être évaluée au regard du droit de l'Union européenne et de l'objectif d'établissement du marché intérieur. Une solution pourrait, par exemple, consister dans l'édiction de recommandations sans force obligatoire telles que celles préparées par le forum conjoint sur les prix de transfert.

Enfin, nous avons pu constater que si les règles de territorialité de l'impôt sur les sociétés peuvent être corrigées afin de mieux contribuer à l'établissement du marché intérieur, celles-ci n'en sont pas moins toujours

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[1052] Voir COM 90 (595) final, 24 janvier 1991, *Proposal for a Council directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*.

fondées sur des principes d'imposition, notamment la source et la résidence, dont certains considèrent qu'ils sont dépassés[1053].

[1053] Voir par exemple Kees van Raad, *Fractional taxation of multi-State income of EU resident individuals – a proposal*, *in* Liber Amicorum Sven-Olof Lodin, Kluwer Law International, 2001, pp. 211-212 : "the court is simply not equipped for renovating outdated taxation regimes" ; Michael J. Graetz, *Taxing international income: inadequate principles, outdated concepts, and unsatisfactory policies*, Tax Law Review, 2001-3, p. 315 : "in the case of direct investment, many of the core concepts designed to enforce international income tax arrangements have become outdated" ; Manfred Mössner, *Source versus residence - an EU perspective*, Bulletin for International Fiscal Documentation, décembre 2006, p. 504 : "the distinction between residence and source has no meaning within the European single market".

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