Member State sovereignty in the field of direct taxation – is the failure of the Court of Justice in some instances to provide a consistent and coherent scheme of analysis of alleged restrictions to the exercise of the freedoms of movement a consequence of activism, error or both?

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ABSTRACT

Competence in the field of direct taxation has not been ceded to the Union by the Member States except as regards selective areas in which harmonisation measures have been made. Because of the way in which nation states define their respective taxing jurisdictions, it is almost inevitable that national taxing provisions applicable to cross-border situations will be in conflict with the Treaty freedoms of movement unless carefully crafted to avoid infringement of those Treaty rights.

This thesis explores incidences where the Court's analysis of such conflicts has produced confusing rulings with a view to determining, on the balance of probabilities, whether such rulings are the result of 'activism' on the part of the Court seeking to perfect the Internal Market or whether such rulings result from misunderstandings of the national provisions under examination and error in its analysis of the conflicts.

The conclusion reached is that the evidence points towards misunderstandings and error. A further conclusion reached is that the reluctance of the Court to modify or correct a previous ruling when a new situation examined by it highlights the shortcomings or errors of a previous ruling undermines the principle of legal certainty and interferes with the Member States' sovereign right to design and impose their individual schemes of taxation.

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INTRODUCTION

i Preliminary.

The original inspiration for this research derived from dissatisfaction with the judgment in *Metallgesellschaft* [2001][1] and then a comment made by Philip Baker[2] in his article[3] on *SGI* [2010][4]: "*<u>This issue of justification</u> has become, perhaps, the most significant question in direct tax cases before the ECJ. It is an area where the law is still developing, with the Court elaborating on the scope and meaning on justifications that have been put forward*."

The question[5] to which Professor Baker is referring cannot be adequately summarised in a few words but might be considered to be the Court's[6] acknowledgment and acceptance that there is a point beyond which the freedoms of movement[7] guaranteed by the Treaties[8] that are, by reason of their wording, unconditional[9], will not override national law in fields such as direct taxation, a field of competence that has not been ceded to the European Union ('EU' or 'Union')[10].

At first sight, this appears to be a contradiction: how can an unconditional right be circumscribed by limitation? Has not the Court itself said that EU law cannot be

[1] The author first attempted to rationalise that dissatisfaction in Turner [2012] ECTJ .

[2] Professor Philip Baker OBE, KC, Barrister, Field Court Tax Chambers, Senior Visiting Fellow, Institute for Advanced Legal Studies, University of London, who together with the late Dr Thomas O'Shea (who passed away on 17 December 2020), formerly senior lecturer, Queen Mary College, University of London, supervised this research and to whom both I am indebted for their patient and learned guidance.

[3] Baker [2010] Intertax at page 194 (emphasis added).

[4] *SGI* [2010] Case C-311/08..

[5] "…The Court has been very strict in the admission of justifications. Some of them were declared admissible in principle to justify a difference in treatment between residents and non-residents…" Wathelet [2004] ECTR Page 2.

[6] Article 19(1) defines the institution, The Court of Justice of the European Union ("CJEU"), as including "…the Court of Justice, the General Court and specialised courts". Case references in the footnotes are identified as "CJEU" regardless of which of the CJEU courts delivered the judgment the main purpose of the identifier being to distinguish between a CJEU judgment and one delivered by a national court.

[7] Reference in this thesis to the 'freedoms of movement' or to 'Treaty freedoms of movement' is a reference to the freedom of movement of workers (Articles 45 to 48 TFEU); the right [or freedom] of establishment (Articles 49 to 55 TFEU); the freedom to provide services (Articles 56 to 62 TFEU); the free movement of capital (Articles 63 to 66 TFEU); and also the right of Union citizens to move and reside (Article 21 TFEU).

[8] 'Treaties' comprising the Treaty on the Functioning of the European Union ('TFEU') and The Treaty on European Union ('TEU'). Reference to 'Treaty' in the singular is a reference to the TFEU.

[9] *Avoir Fiscal* [1986] Case 270/83 paragraph 26.

[10] Refer: 'principle of conferral' Article 5(2) TEU discussed in Part I of this thesis *post*.

overridden by national law[11]? As Timothy Lyons commented in 2005: "…*To allow any freedom to be overridden by direct tax would turn the legally enforceable rights, derived from the fundamental freedoms, into mere economic privileges conferred at the discretion of Member States*"[12].

Disregarding the inconceivable, that the Court was wrong in its long-accepted statement of supremacy of EU law, it is necessary to identify the logic applied by the Court in its analysis of the conflicts between national direct taxation law and EU law and in its application of EU law to those situations. It is necessary to understand also how the Court construes the Treaties.

This paradox is resolved by retaining focus on the fact that the Member States did not cede sovereignty in the field of direct taxation[13]. Pursuant to the principle of conferred powers, and adapting the Court's statement in paragraph 27 of its *Opinion of the Court (conferred powers)* [1996][14], it must be concluded that: "*No Treaty provision confers on the Community institutions any general power to enact rules on [direct taxation] …*"

The purpose of the freedoms of movement is to facilitate the creation of the Internal Market[15] but perfection of the internal market cannot be achieved until all factors affecting it, such as direct taxation, are harmonised. Distortions will occur and, accordingly, a balance must be struck between the attainment of perfection[16] and respect for the competences not ceded to the EU by the Member States[17].

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[11] "It follows from all these observations that the law stemming from the Treaty, an independent source of law, could not, because of its special and original nature, be overridden by domestic legal provisions, however framed, without being deprived of its character as Community law and without the legal basis of the Community itself being called into question." *Costa v E.N.E.L* [1964] Case 6/64.

[12] Lyons [2005] BTR at page 452.

[13] Allan Rosas notes in Rosas (2018) page 207 that the Court ceased about a decade ago to recognise that direct taxation is a competence [solely] of the Member States recognising the '"legal reality" of the growing amount of secondary legislation made using the powers provided by Art. 115 TFEU. He cites *DI. VI.* [2012] Case C-380/11 as one example where the Court omitted to make that statement.

[14] *Opinion of the Court (conferred powers)* [1996] Case Opinion 2/94.

[15] Refer: Arts. 26(1) & (2) TFEU.

[16] Writing in 2015, Wolfgang Schon was seemingly critical of the Court giving any consideration to the territoriality principle: "…the ECJ is currently moving from the concept of the Internal Market as one large snooker table spanning the area of the European Union as a whole to the concept of the Internal Market as a room containing twenty-eight small snooker tables where access to these separate tables is granted on a non-discriminatory basis. Looking at the fundamentals of the Internal Market, this is a step backward to what academic writers have labelled an "imperfect internal market*"*. Schon [2015] BFIT page 283.

[17] The Internal market is a "shared competence", Art. 4(2)(a) TFEU and, by Art. 2(2) TFEU "The Member States shall exercise their competence to the extent that the Union has not exercised its competence." In the field of direct taxation, the EU has exercised its competence through the making of directives addressing specific matters using the powers provided by Art.115 TFEU. However, the freedoms of movement "…*cannot be used as a basis for the adoption of provisions*

Sometimes referred to as 'judicial activism'[18], it has long been acknowledged that "*All the way through the Treaty there are gaps and lacunae…*" and that "*…These have to be filled in by the judges, or by Regulations or directives*"[19].

Accordingly, the Court has been obliged to fill those 'gaps and lacunae' such as through "*…the determination of some general principles of Community law, including fundamental rights…in order to provide coherence to the almost bewildering mix of general objectives and principles supplemented by a host of quite detailed but somewhat incoherently drafted rules and to give effect to the obligation…that the Union Courts 'ensure that in the interpretation and application of this Treaty the law is observed'*"[20].

That the Court is influenced by the progressive integration of the EU through changes to the Treaties and the making of secondary legislation[21] is inevitable. That the Court is influenced by changes to the Treaties reflecting codification of principles derived, *inter alia*, from its own case law[22] is inevitable even more so.

Taking an economic viewpoint of 'tax neutrality' and disregarding the inconvenience of the principle of conferral, Wolfgang Schon has expressed the views that "… *Neutrality … is a concept of EU law* …"[23] and has the will to conclude from a review of the Court's case law that it has evolved "*…from a limited concept linked to discrimination of persons on the basis of their nationality to a*

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whose effect would, in substance, be to amend the Treaty without following the procedure which it provides for that purpose" *Opinion of the Court (conferred powers)* [1996] Case Opinion 2/94. That is, the freedoms of movement cannot be applied in such a manner as to "*…constitute, with regard to the aim pursued, a disproportionate and intolerable interference, impairing the very substance of [Member State sovereignty in the field of direct taxation]*" *Wachauf* [1989] Case 5/88 paragraph 18 (adapted).

[18] Rosas (2018) at page 43, the authors stated that "*…the notion of 'judicial activism' is in our view problematic…[and]…is a topic in itself*."

[19] *Bulmer v Bollinger (CoA)* Case [1974] Ch.401 Lord Denning at page 425.

[20] Rosas (2018) at page 54. The authors are referring to the obligation of the Courts under Art.19(1) TEU.

[21] By way of example, see FN 13 *ante.*

[22] See, for instance, the Explanations Relating to the Charter of Fundamental Rights 2007/C 303/02.

[23] According to Wolfgang Schon: "… [the Article 26 TFEU] definition [of the Internal Market] is rooted in the same efficiency-oriented thinking as the concept of tax neutrality. According to article 120 second sentence of the TFEU, "the Member States shall act in accordance with the principle of an open market economy with free competition, favouring an efficient allocation of resources". The underlying efficiency objective requires a legal framework, which ensures that decisions affecting the allocation of goods, persons, services and capital are not distorted by domestic law-making, including national tax legislation. The objective of the Internal Market to ensure the "free movement" of these factors not only prevents the Member States from erecting outright legal barriers to cross-border traffic, but it also prohibits the Member States from taking any action that, in the language of the ECJ, is likely to "deter", "discourage" or "dissuade" economic actors from moving freely within the confines of the European Union, even if the obstacle is "of limited scope or minor importance". These quotes emphasize the material grounding of the efficiency objective of undistorted decision-making in the legal DNA of the Internal Market. Neutrality, we can, therefore, conclude, is a concept of EU law". Schon [2015] BFIT page 272.

simultaneously simple and far-reaching prohibition on cross-border tax obstacles to economic entities and transactions generally"[24].

The review conducted in this thesis does not provide evidence of evolution to such a degree. Although the case law of the Court can be expected to evolve, there will be a stress between that need to evolve and the need of consistent interpretation in order that persons having rights and obligations under EU law have some degree of 'legal certainty'.

Occasionally, the Court makes an admitted correction to an earlier interpretation[25]. More often, though, the Court may find a point of distinction in the case under examination but will not always make clear its thinking, such as in relation to 'final losses' tax relief[26].

ii Introduction to the research question.

Timothy Lyons recently wrote: "*Of necessity, lawyers routinely reflect on the past and judgments in past cases. Yet, humanity can never be sure it understands the past whether in relation to law or more general matters*"[27]. He opined that, in its judgments relating to infringements by Member State direct tax provisions of the freedoms of movement, the Court "…*has maintained a reasonably consistent approach in this area of law over a long period of time*…"[28].

However, as will be examined and explored in this thesis, the passage of evolution of the principles applied by the Court has not always been a smooth progression[29]. There have arisen several instances of confusion and apparent

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[24] Ibid. page 273.

[25] See for a discussion Arnull [1993] CMLR and evidenced in the case law referred to therein. See also, for instance, *Burda* [2008] Case C-284/06 paragraph 61 correcting a ruling on the definitional requirements for a withholding tax stated earlier in *Athinaiki* [2001] Case C-294/99 paras. 28 & 29 but without explanation for the correction.

[26] *Marks & Spencer* [2005] Case C-446/03 paras.55 & 56: see, for instance, *W AG (AGO)* [2022] Case C-538/20 paragraph 44 highlighting the continuing uncertainty created by the 2005 ruling which may have prompted the Court to attempt a reconciliation. Anthony Arnull commented upon this practice of the Court in Arnull [1993] CMLR at page 253: "[The approach of] referring to previous decisions but the departing, often without explanation, from the outcome those decisions appear to suggest, with the result that their status is frequently left unclear…". It should be noted that AG Geelhoed voiced dissention from the ruling by the Court just two months later in *ACT IV GLO (AGO)* [2006] Case C-374/04 at paragraph 65: "…I see no reason why companies which decide to relocate their activities to another Member State, in full knowledge of the local tax legislation, should be awarded highly selective and distortional tax relief in the home State in the circumstance where their source State activities incur losses that cannot be offset in the latter State."

[27] Lyons [2022] BTR page 282.

[28] Ibid. page 299.

[29] Schon [2015] BFIT pages 271 & 272 "The most relevant question…appears to be as yet unanswered. Is the meandering path adopted by the ECJ in direct tax matters a sign of missing analytical or conceptual capacity, thereby revealing a court that is clearly not specialized in tax as being overwhelmed by intricate technical detail and torn by diverging views on political

changes of policy that have led to uncertainty of law. Common to some of those instances of confusion in relation to direct taxation is the determination of whether a restriction to a freedom of movement has been caused. This is particularly so where a national provision has application only to taxable situations or events arising within its taxing jurisdiction or application only to persons resident within its taxing jurisdiction. The principal freedoms of movement engaged in this problem area are Workers and Establishment.

It is not for the Court to progress the economic integration of the Internal Market beyond the scope defined in the Treaty by its political masters but, in the case of the 'final losses doctrine'[30], the Court appears to have effectively done just that. The decision may have been an intentional erosion of Member State direct tax sovereignty or it may have been simply the result of an error of analysis. The case and a number of subsequent cases are analysed in both Parts I & II of this thesis *post* and it is concluded that the Court erred in its analysis.

It was an earlier UK case that presented the Court with its first encounter with a provision providing relief for intra-group transactions[31]. The case concerned an election that could be made by the UK resident members of a group of companies in relation to the UK's 'Advance Corporation Tax' ("ACT") scheme. It was an unfortunate first encounter with a grouping arrangement because, as argued in Turner [2012] ECTJ[32], the Court appears to have 'misunderstood' the precise nature of the scheme.

The fault lies with the referring court[33], which should have clarified the nature of the tax and the coherence of the group election in point[34].

integration? Or is this jurisprudence a fine example for the diplomatic skills of the ECJ in navigating through the delicate issues of multi-level governance? Or has the ECJ set itself on a mission impossible, in trying to reconcile institutional claims that, from a fundamental standpoint, cannot be fulfilled simultaneously as supremacy must be granted to one or the other?...The ECJ' s judicature in tax matters is, after all, an interpretation of the written law of the EU Treaties and one should, therefore, start with the central provisions and policy goals of the Treaty on European Union (TEU) and the Treaty on the Functioning of the European Union (TFEU)".

[30] See Marks & Spencer [2005] Case C-446/03 paragraphs 55 & 56.

[31] As mentioned *ante: Metallgesellschaft* [2001] Case C-397/98 & C-410/98. The case is discussed in Parts I & II of this thesis *post*.

[32] Turner [2012] ECTJ page 36 "…it appears to the author that there was some misunderstanding by the Court of the ACT scheme…the Court's analysis proceeded on the basis that ACT was a mechanism for prepayment of corporation tax whereas, as will be strongly argued, it was a tax on distributions".

[33] It is the task of the national court to provide the Court with an interpretation of national law: "…under Article 31 the Court is only required to ensure that in the interpretation and application of the Treaty, and of rules laid down for implementation thereof, the law is observed. It is not normally required to rule on provisions of national law…" Stork v High Authority [1959] Case 1/58 P.26 (A).

[34] An election that could be made between a UK resident subsidiary and its UK resident parent that would have enabled the subsidiary to have paid a dividend to its parent without having to account for ACT when it did so was not available to the subsidiary in this case because its parent

It is noteworthy, however, that the Court did, in that case, commence its analysis with a test of comparability of situations and a finding of discriminatory treatment[35] and, on that basis, concluded that an infringement of Article [49 TFEU] occurred. The case is discussed more fully in chapter 6.2.i *post*.

In *Marks & Spencer* [2005], however, the Court noted that the treatment of the losses of non-resident subsidiaries[36] differed from the treatment of resident subsidiaries having comparable ownership qualification and, whilst noting that the UK and seven other Member States had submitted 'observations' that, for the purpose of that tax scheme, "…*resident subsidiaries and non-resident subsidiaries are not in comparable tax situations*…"[37], it nevertheless ruled that the UK Group Relief scheme created a restriction without explaining why it disregarded the 'territoriality principle' that it had previously recognised[38]. The Court's finding of a restriction is contested in this thesis. The case is referred to in many contexts in this thesis but the question of whether the restriction in the UK's group relief scheme caused an infringement of Article 49 TFEU is discussed more fully in chapter 6.2.ii *post*.

The terms "discrimination" and "restriction" are used liberally in the literature but as argued in chapter 3.3 *post*, infringements of the freedoms of movement are 'restrictions'. A restriction occurs when a person exercising a freedom of movement is *less favourably* treated under national law by reason only of his

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was not resident in the UK. Having understood the ACT to be in the nature of a prepayment of corporation tax payable by the UK subsidiary, the Court ruled that the ACT scheme was discriminatory. However, ACT was a tax on company distributions, not a prepayment of corporation tax and, whilst a UK parent receiving a dividend paid to it under the election would have to pay the ACT, or an increased amount, when it came to make its own distribution, a non-resident parent would not. A non-resident company, being outside the scope of the tax, was in a different situation from a resident company. Having been advised that the ACT was in the nature of a prepayment of corporation tax, the Court's focus was directed on the UK subsidiary. However, as ACT was a tax on distributions and the relieving provision merely allowed a group to allocate responsibility for paying the tax between the subsidiary and the parent, the focus of the Court should have been directed onto the parent company.

[35] Metallgesellschaft [2001] Case C-397/98 & C-410/98paragraphs 43 & 44. As the situation of a UK subsidiary of a non-resident parent is the same as the situation of a UK subsidiary of a resident parent as regards (assessment and) payment of UK corporation tax on its profits, the different treatment is discriminatory.: paragraph 53.

[36] Marks & Spencer [2005] Case C-446/03 paragraphs 32 to 34: the losses could not be applied against the profits of the UK resident members of the group of companies.

[37] Ibid. paragraph 36.

[38] Futura [1997] Case C-250/95 paragraph 22. The Court had already recognised in Hervein & Others [2002] Case C-393/99 & C-394/99 paragraph 51, in Weigel [2004] Case C-387/01 paragraph 55, in Lindfors [2004] Case C-365/02 paragraph 34 and in *Schempp* [2005] Case C-403/03 paragraph 45 that a person exercising a freedom of movement is not protected against suffering a disadvantage from his so doing. The disadvantage that Marks & Spencer experienced resulted from the foreign operations being conducted outside of the UK's taxing jurisdiction.

having exercised that freedom. A national provision will also infringe a Treaty freedom of movement if it deters the exercise of the freedom of movement[39].

In order to determine whether the national provision provides less favourable treatment, it is necessary to conduct a comparative study. Whilst the Court has long acknowledged in the context of direct taxation that "…*the situations of residents and of non-residents are not, as a rule, comparable*"[40], the Court, without giving adequate explanation, despite having repeated the acknowledgment, determined in *Marks & Spencer* [2005] that the right of establishment had been infringed because the UK did not extend its taxing jurisdiction to enable the losses of activities conducted outside of its jurisdiction to be relieved against the profits of activities conducted within its taxing jurisdiction[41].

A different UK grouping arrangement was in point in *Gallaher* [2023][42] and a distinction can be made between the situations examined in, respectively, *Marks & Spencer* [2005] and *Gallaher* [2023].

In *Marks & Spencer* [2005], the UK was considered by the Court to have infringed the right of establishment by failing to treat persons outside of its taxing jurisdiction in the same way as persons within its taxing jurisdiction.

In *Gallaher* [2023], the UK was considered by the Court to have infringed the right of establishment by applying what was alleged to be discriminatory treatment to a person resident within its taxing jurisdiction, although the reasoning in the judgment is confusing.

It is concluded in chapter 6.2 that the group relief provisions examined in *Marks & Spencer* [2005] do not give rise to a restriction that needs to be justified whereas the grouping provisions examined in *Gallaher* might, but only in the situation where the UK is the state of origin. In the circumstances of the case, the UK was the host state.

In both cases the Court considered and approved grounds for justification of the alleged infringements but that led to a different result in *Marks & Spencer* [2005] because the national provisions then had to be considered in the context of the principle of proportionality.

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[39] In this thesis, any reference to a disadvantage suffered by a person exercising a freedom of movement is to be read as including a reference to a disadvantage that would be suffered by such a person if the freedom of movement was exercised and that he is therefore deterred from exercising that Treaty right. It is not necessary for there to be actual evidence of deterrence "… it is sufficient that it be capable of restricting the exercise of that freedom …" *Thin Cap GLO* [2007] Case C-524/04 paragraph 62.

[40] *Schumacker* [1995] Case C-279/93 paragraph 31.

[41] This point is discussed in chapters 3.4 and 6.2.ii *post*.

[42] *Gallaher* [2023] Case C-707/20. The Court ruled that a restriction to Article 49 TFEU was caused by the provisions of a UK scheme that enabled chargeable assets to be transferred between UK resident members of a group without triggering a tax charge whilst that scheme did not provide the same relief for transfers of assets beyond the taxing jurisdiction of the UK: see chapters 3.4 and 6.2.iv *post*.

There are commentators who are less sanguine about the Court's consistency of analysis than is Timothy Lyons (FN 28) and Advocate General Kokott remarked in 2014 "*…the extent of the examination as to the comparability of situations has varied significantly recently, particularly in decisions relating to tax law…From time to time, however, the Court also dispenses entirely with an examination of the objective comparability of the situations or simply finds the situations to be comparable without giving any reasons for doing so*"[43].

The inconsistencies of analysis are evident and are causing uncertainty in the law. Furthermore, the rulings in some areas, such as in relation to grouping arrangements, are undermining the ability of the Member States to provide coherent schemes of taxation designed to enable companies trading in their territories to do so through subsidiaries without suffering taxation disadvantages.

iii The research questions and methodology.

The research question is:

Is the failure of the Court of Justice in some instances to provide a consistent and coherent scheme of analysis of alleged restrictions to the exercise of the freedoms of movement a consequence of activism, error or both?

The analysis in this thesis is divided into two parts.

In **part I**, there are reviews of:

1. The legal background including the principle of conferral.
2. The sovereignty retained by the Member States in relation to direct taxation and the meaning of direct tax sovereignty.
3. The meaning of the terms infringements, restrictions, comparability of situations and discrimination.
4. The justifications for infringements of the freedoms of movement by national tax provisions other than their application to groups of companies and foreign permanent establishments.
5. The application of the justifications to groups of companies and foreign permanent establishments.

The research question does not encompass specific instances where the Member States have ceded sovereignty in the field of direct taxation through the express measures made under Article 115 TFEU[44] and those parts of the Treaties where the Member States intentionally constrained their legislative freedom by expressly providing for, *inter alia*:

[43] *Nordea Bank Danmark (AGO)* [2014] Case C-48/13 paragraph 25.

[44] Specific harmonisation measures that remove distortions that would otherwise affect the functioning of the Internal Market, which cannot be satisfactorily achieved through national legislation.

- A prohibition of discrimination on the ground of nationality (Art.18 TFEU)[45];
- The taxation of EU officials[46];
- Union citizenship and "*the right to move and reside freely within the territory of the Member States*" (Art.21 TFEU); and
- The State Aid rules[47].

That there are specific instances of ceding of sovereignty in the field of direct taxation is evidence that the Member States had no intention of ceding it generally.

In **part II**:

There are reviews and discussions of:

6. Disadvantages suffered when exercising a freedom of movement that do not give rise to an infringement of the freedoms of movement.
7. 'Exit taxes': the Court's development of its analysis that has led to confusion and uncertainty that has had to be remedied, in part at least, by legislation.
8. Grouping arrangements and PE's: the Court's development of its analysis that has led to confusion and uncertainty, particularly with regard to what is termed the 'final loss' doctrine.
9. Other instances of the Court's development of its analysis that has led to confusion and uncertainty in such areas such as personal tax allowances.

The implication in some rulings by the Court of Justice is that the Member States retain no sovereign control over their respective tax bases in that a person might both remove some of his income, profits and gains from one Member State ("exit state") to another ("host state")[48] but retain the benefits of deductions in the exit state such as for losses that accrue in the host state[49].

[45] Formerly Art.12 EC. Acts of discrimination on the ground of nationality can be justified only by reference to the grounds specified in the Treaty.

[46] *Humblet* [1960] Case 6/60 and *Bourges-Maunoury* [2012] Case C-558/10.

[47] Art.107 TFEU The State Aid rules are an area of EU exclusive competence and schemes of taxation can be challenged if they are such as to distort competition in the Internal Market.

[48] In this thesis, for the sake of brevity, the state of origin, residence or departure may be referred to as the 'exit state' and the state to which the person exercising a freedom of movement moves to or establishes himself in may be referred to as the 'host state'.

[49] With reference to the snooker table analogy proposed by Schon (see FN 16 *ante*), the implication in some rulings is that, in relation to direct taxes, the Internal Market consists of a single snooker table on which the balls representing the income, gains and costs of all persons residing in the EU are placed. Each of such persons would then be permitted to drive any of their balls into any of the individual pockets (representing the Treasuries of the Member States) that they should please.

The source material for the discussions in Part II has consisted principally of the Treaties[50] and the judgments of the Court of Justice[51] and the judgments of the Court reviewed are primarily, but not exclusively, those in which infringements by national direct tax provisions are examined.

Other judgments, concerned with important principles of EU law, have been reviewed where appropriate to the context. The Court's analysis of any infringement of the Treaty will follow a fairly standard course and the general principles of the Court apply uniformly to EU law interpretation. Particular attention is given to cases referred to by the Court in its judgments[52].

Selective reference has been made to commentary in the 'literature'. However, as was observed by Judge Allan Rosas in 2010: "*Some of the commentaries on the ECJ's case law with respect to the free movement of goods (as well as to some other areas of EU law) suffer from a lack of consideration of the particular circumstances of each case"*[53]. As noted in chapter 3 of this thesis *post*, even Advocates General can be swayed by propositions in the 'literature' that do not appear to stand up to scrutiny when an attempt is made to view what the Court was examining when it was conducting its analysis[54].

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[50] Including, where relevant, secondary measures made by the EU.

[51] The cut-off for the Court's judgments is 29 February 2020, extended from 31 December 2019 to take into account *AURES Holdings* [2020] Case C-405/18 and *Gallaher* [2023] Case C-707/20.

[52] By way of example, the Court's original recognition of the retained sovereignty in relation to direct taxation stated in *Schumacker* [1995] Case C-279/93 paragraph 21: "Although, as Community law stands at present, 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…" was cross-referenced by it to *Commission v UK (ship registration)* [1991] Case C-246/89 paragraph 12, in which the Court had said "Nevertheless, powers retained by the Member States must be exercised consistently with Community law…".

[53] Maduro & Azoulai (2010) page 435 (emphasis added).

[54] "There are two different approaches to analysing situations of alleged infringements of freedom of establishment in the area of direct taxation in the Court's case-law: the discrimination approach and the restriction approach. It is well recognised in academic literature that over the years the Court has vacillated between these approaches (See, for example, Barnard, C., 'The Substantive Law of the EU: The Four Freedoms', 5th ed., Oxford University Press, Oxford, 2016, at p. 399 et seq; Kingston, S., 'The Boundaries of Sovereignty: The ECJ's controversial role applying internal market law to direct tax measures', *Cambridge Yearbook of European Legal Studies*,Vol. 9, 2006)" *Hornbach-Baumarkt (AGO)* [2017] Case C-382/16 Paragraph 28 and his reference 11 – AG Bobek 14 December 2017.

Member State sovereignty in the field of direct taxation – is the failure of the Court of Justice in some instances to provide a consistent and coherent scheme of analysis of alleged restrictions to the exercise of the freedoms of movement a consequence of activism, error or both?

PART I

LEGAL BACKGROUND, RETAINED SOVEREIGNTY IN THE FIELD OF DIRECT TAXATION AND THE COURT'S SCHEME OF ANALYSIS OF ALLEGED INFRINGEMENTS

Introduction to Part I.

As stated in the Introduction, to answer the question of whether a Treaty freedom of movement is infringed by a national tax provision that fails to extend a benefit enjoyed by a person within its taxing jurisdiction to a person outside of that jurisdiction, it is necessary to:

1. Establish the legal background.
2. Establish the extent to which the Member States have retained the power to determine who and what are within their taxing jurisdiction and, as importantly, who and what are not within their taxing jurisdiction.
3. Define what is meant by an infringement of a freedom of movement.
4. Define the grounds accepted for justifying infringements of Treaty freedoms of movement – introduction and general.
5. Define the grounds accepted for justifying infringements of Treaty freedoms of movement – groups of companies and permanent establishments.

The Treaties record and give effect to the sovereignty ceded by the Member States by their formation of the EU.

Chapter 1 provides an introduction to the Treaties and to the concepts of exclusive and shared competences[55] embodied within them as well as to the principle of supremacy of EU law over national law. Some introduction is also necessary to the general principles[56] that the Court observes when interpreting EU law.

Chapter 2 provides a discussion of what is meant by 'sovereignty'. It is noted that sovereignty in a field may be possessed even if it is ceded in specific areas. It has been noted that the ceding of sovereignty by a sovereign state is, in reality, only for so long as it wills that such ceding shall persist. This thesis is not concerned with such philosophy but is concerned with the ceding of sovereignty

[55] Article 4(1) TEU makes clear: "…competences not conferred upon the Union in the Treaties remain with the Member States."

[56] It is argued in this thesis that the general principle of 'legal certainty' has been undermined in certain parts of the field of direct taxation by departures of the Court from its established schemes of analysis of alleged infringements of the freedom of movement rights.

through the Treaties that impacts on the generally retained sovereignty in relation to direct taxation[57].

Having regard for what is generally addressed in a double tax treaty, the principal aspects of the competence retained by the Member States are, first, to define taxing jurisdiction[58] and, second, the design of the taxing schemes[59] both as regards assessment and collection. The grounds for justification of national direct tax provisions infringing Treaty rights as formulated by the Court are diagrammatically related to these principal aspects of direct tax sovereignty but are discussed later in Chapter 5.

Chapter 3 provides a discussion of the nature of an infringement of a freedom of movement.

Chapters 4 & 5 provide discussions of the grounds for justifications introduced in Chapter 2.4.

[57] "…although direct taxation falls within their competence, Member States must none the less exercise that competence consistently with Community law.." *Marks & Spencer* [2005] Case C-446/03 paragraph 29.

[58] That is define the tax base by defining who is to be regarded as within the taxing jurisdiction and by defining what is to be taxed in relation to those persons.

[59] Including the setting of rates of tax, defining eligible deductions, defining the basis on which the taxable amount is calculated, defining timing of assessment and mechanisms for collection.

1 THE LEGAL BACKGROUND

1.1 INTRODUCTION TO THE CHAPTER.

The original objectives in forming what is now termed the European Union are set out in the Treaty establishing the European Economic Community concluded by the six original parties[60] to that treaty in Rome on 25th March 1957 ('EEC Treaty')[61]. In the preamble to the EEC Treaty, the six contracting states:

"*Resolved to ensure the economic and social progress of their countries by common action to eliminate the barriers which divide Europe…Recognis[ed] that the removal of existing obstacles call[ed] for concerted action…Desir[ed] to contribute, by means of a common commercial policy, to the progressive abolition of restrictions on international trade*…" (emphasis added)

The Court construed the objective of the EEC Treaty to be more narrowly "…*to establish a Common Market*"[62].

The means by which the contracting states sought to achieve their objectives was the formation of a legal entity, the European Economic Community ('EEC'), which had a specified "*task*" defined in Article 2 of the EEC Treaty, which was to be achieved by actions by the EEC specified in Article 3[63]. To enable the EEC to take these actions, the EEC Treaty defined a structure of institutions peopled by real persons.

The contracting states thereby ceded their sovereignty in certain spheres and created a legal entity through which they pursued common policies and rules in those spheres. In the words of the Court in *van Gend & Loos* [1963]: "…*the states have limited their sovereign rights, albeit within limited fields*…"[64].

The consequence was that the rules made by the EEC in pursuance of the common policies in the spheres of competence devolved by the contracting states displaced conflicting national laws and overrode them (discussed in chapter 1.4 *post*). The spheres of competence that were categorised as falling within the exclusive competence of the EEC are discussed in chapter 1.7 *post*.

Successive treaties have extended the original spheres of competence devolved down onto what is now the Union. The principal 'steppingstones' seen by some as progressively eroding the sovereignty of the Member States are briefly

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[60] Belgium, Germany, France, Italy, Luxembourg and the Netherlands.

[61] The succession of treaties by which powers were devolved is summarised in chapter 1.2.

[62] *van Gend & Loos* [1963] Case 26/62 B 3rd paragraph.

[63] Summary extract of Article 3 EEC: "Elimination of customs duties and quantitative restrictions; common customs tariff; common policies for commercial policy in relation to non-Member countries, competition, agriculture and transport; the abolition of obstacles to the free movement of persons, services and capital as between the contracting states; harmonisation of laws where necessary for the proper functioning of the common market and several other joint enterprises."

[64] *van Gend & Loos* [1963] Case 26/62 B paragraph 4.

summarised in chapter 1.2 *post*. Because of that growing concern over the erosion of Member State sovereignty, the Member States formally enacted the principles of 'conferral' and 'subsidiarity' in the Treaty of Maastricht concluded on 7 February 1992. That Treaty came into force on 1 November 1993 and the principles of conferral and subsidiarity are discussed in more detail in chapter 1.5 *post*.

The principle of conferral as now enacted[65] stipulates two things: first, the Union can only act "…*within the limits of the competences conferred on it*…"; and, second, when the Union acts it may only do so "…*to attain the objectives set out [in the Treaties]* …".

Beyond those spheres of ceded sovereignty, the Member States retain sovereignty of action provided that they do not undermine the achievement of the Treaty objectives[66].

The powers of what is now the Union are not necessarily constrained by the wording of the provisions in the Treaties as powers may be implied[67]. However, whilst certain powers might be 'implied', they may not extend the fields of competence conferred on the Union[68]..

The focus of this thesis is on Member State sovereignty in the sphere of direct taxation. Because of the complexity and territorial nature of national tax systems, interference with the freedoms of movement designed to achieve the objective of creating an Internal Market[69] is bound to occur and, similarly, with the free movement of Citizens of the Union between Member States[70].

It is easy to lose sight of the original objectives of the Member States in forming the predecessor of the Union and it is necessary to recall that the Member States did not cede all sovereignty and then claw back right of action in certain spheres although the authoritative tone of Article 2(2) TFEU makes that fact more difficult to recall[71]. Despite that tone, it is contended that Article 2(2) is saying

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[65] See Article 5(1) & (2) TEU – formerly Article 3(b) EEC and Article 5 EC.

[66] See Article 4(1) TEU.

[67] *"…*specific powers….are not necessarily the express consequence of specific provisions of the Treaty but may also be implied from them." *Opinion of the Court (conferred powers)* [1996] Case Opinion 2/94 paragraph 25.

[68] "…it must be examined whether the provisions of the envisaged agreement fall within the exclusive competence of the European Union, a competence shared between the European Union and the Member States, or a competence of the Member States alone ..." *Opinion of the Court (competence)* [2017] Case Opinion 2/15 paragraph 31. To the extent that the agreement does not fall within a sphere of exclusive competence of the Union, the agreement must be signed and concluded jointly by the Union and each of the Member States.

[69] Defined by Article 26 TFEU.

[70] Provided by Article 21 TFEU.

[71] "When the Treaties confer on the Union a competence shared with the Member States in a specific area, the Union and the Member States may legislate and adopt legally binding acts in that area. The Member States shall exercise their competence to the extent that the Union has not

little more than what the Court said in the early cases in which it ruled on the supremacy of Union law.

Union law consists also of the 'general principles', including fundamental rights, that form the background law in which the Treaties were drafted. As Lord Denning observed: "*All the way through the Treaty there are gaps and lacunae. These have to be filled in by the judges*…"[72].

The judges of the Court of Justice have drawn upon the general principles to fill those gaps. The nature and source of the general principles are principles enshrined in the legal systems of the Member States: "… *not the written law, as laid down by the Treaties and by Community legislation, but principles largely based on the legal values enshrined in the legal systems of the Member States* …"[73].

As these general principles are part of Union law, they, like the Treaties and the secondary measures made pursuant to them form part of national law where the Treaties or other Union measures are engaged. They, thus, impact on Member State sovereignty and are discussed in chapter 1.8 *post*.

1.2 THE SUCCESSION OF TREATIES[74].

1.2.i Preliminary.

That the founding Treaties might be regarded as constitutional documents for the original Communities is a matter that has been subject to debate[75]. The Treaties defined and brought into being the Communities and their institutions. They defined the persons who belonged to the Communities and they defined the rights and obligations of those persons.

The succession of the principal development of the Treaties is summarised below.

1.2.ii The creation of the Communities.

The first of the Communities formed was the European Coal and Steel Community ('ECSC') under a treaty concluded in Paris on 18 April 1951. It created

exercised its competence. The Member States shall again exercise their competence to the extent that the Union has decided to cease exercising its competence."

[72] *Bulmer v Bollinger (CoA)* Case [1974] Ch.401 at page 425.

[73] Jacobs (2007) page 50.

[74] This section contains a selective review of the Treaties that had some impact on or relevance to the freedoms of movement, the retained sovereignty of the Member States or to interpretation of the Treaty provisions.

[75] Vesterdorf [2006] IJCL page 608: "The proposition that the treaties should be regarded as a constitution dates back to the beginning of the Communities' history".

a common market for coal and steel products. That treaty was for a limited term of 50 years from the date that it came into force upon completion of the ratification process on 23 July 1952. The assets and liabilities were transferred to the EEC, by then renamed European Community ('EC' – see below), with effect from 24 July 2002 by a protocol enacted by the Treaty of Nice concluded in Nice on 26 February 2001. Effectively, the ECSC became merged with, and was absorbed by, the EC.

The European Atomic Energy Community ('EURATOM') formed in 1957 is of no relevance to the matters discussed in this thesis.

1.2.iii The Treaty of Maastricht and the birth of the TEU.

The EEC was reformed and renamed the EC with substantially extended objectives by the Treaty of Maastricht signed on 7 February 1992 (entered into force 1 November 1993). To balance the substantial increase in devolved powers, the 'principles of conferral and subsidiarity' were introduced as Article 3b EC[76].

That provision required that: "*The Community shall act within the limits of the powers conferred upon it by this Treaty and of the objectives assigned to it therein*." Thus, in interpreting any provision in the Treaty or other measures, it is appropriate and necessary to have regard to the objectives stated.

Second, that provision also introduced the principle that, in areas outside the spheres of devolved exclusive competence: "*…the Community shall take action…only if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States and can therefore, by reason of the scale or effects of the proposed action, be better achieved by the Community*" [77].

The Treaty of Maastricht incorporated the first version of the TEU establishing a union between the Member States (the 'European Union') and it introduced 'Citizenship of the Union'[78] as rights given force in the EC Treaty ('TEC'), including free movement rights. In practice, the Court analyses the free movement rights of citizens[79] in much the same way as those provided under the Internal Market freedoms of movement[80].

[76] This Article was recast as Article 5 EC. This paragraph was re-enacted by the Treaty of Lisbon as Article 5(2) & 5(3) TEU and further provisions were introduced in Protocol (No.2) to that treaty. That Protocol is discussed in section 1.5 below.

[77] The 'principle of subsidiarity': now Article 5.3 TEU.

[78] New Articles 8 to 8e of the EEC, recast as Articles 17 to 22 of the EC Treaty, are now Articles 20 to 25 TFEU.

[79] Article 21 TFEU (formerly, Article 18 EC).

[80] By way of example, compare the wording used by the Court in *Pusa* [2004] Case C-224/02 paragraph 19 (Article 21 TFEU was in point) to that in *Commission v Estonia (pensioner allowances)* [2012] Case C-39/10 paragraph 58 (Article 45 TFEU was in point).

Notwithstanding this, where the freedom of movement rights of an individual[81], who is a Union Citizen, are impaired by a national provision, the Court will first consider whether any of the Internal Market freedoms are engaged and will only analyse the restriction by reference to those freedoms of movement[82].

It must be concluded that the rights provided by Article 21 TFEU were designed to supplement the Internal Market freedoms of movement (applicable where an individual is engaged in, or pursuing, an economic activity) and not to supersede them.

1.2.iv The Treaties of Amsterdam and of Nice.

The Treaty of Amsterdam, concluded on 2 October 1997 (entry into force on 1 May 1999) made some changes to the powers of the Union and of the European Parliament and amended and renumbered the TEU and the TEC. The Treaty of Nice, concluded on 26 February 2001, (entry into force on 1 February 2003) principally introduced changes to the institutions and the decision-making processes. These treaties are not of much relevance to this thesis.

1.2.v The Treaty of Lisbon – the European Community becomes the Union.

The Treaty of Lisbon, concluded on 13 December 2007[83] bestowed a legal personality onto the Union[84], which became a successor to the European Community[85]. The Union became founded on the amended TEU and the amended TEC, which was renamed Treaty on the Functioning of the European Union.

The changes brought about by the rebirth of the European Community as the Union do not appear to have altered the freedoms of movement or Member State sovereignty in the sphere of direct taxation. There appears also to be continuity of interpretation of the Treaties by the Court in these areas save that, whenever Union law is engaged, regard must be paid to the Charter of Fundamental Rights

[81] Article 20(1) TFEU states: "Every person holding the nationality of a Member State shall be a citizen of the Union" (emphasis added). Article 20(2)(b) then provides that "Citizens of the Union…shall have…the right to vote and to stand as candidates in elections to the European parliament…" It is concluded that 'person' can be interpreted only as 'individual'.

[82] See, for instance, *Schwarz (School Fees)* [2007] Case C-76/05 paragraph 34: "…it should be noted that Article 18 EC…finds specific expression in the provisions guaranteeing the freedom to provide services…If, therefore, the case in the main proceedings falls under Article 49 EC, it will not be necessary for the Court to rule on the interpretation of Article 18 EC…"

[83] It entered into force on 1 December 2009.

[84] Article 47 TEU.

[85] The European Community ceased to be 'created' by reason of the repeal of the words in the TEC: *"…HAVE DECIDED to create a EUROPEAN COMMUNITY"* in the last recital and the repeal of Articles 1 & 2 EC.

of the European Union ('the Charter') [86], which has "*the same legal value as the Treaties*"[87].

In passing, it might be noted that the limitation of the application of the Charter results in nationals of the Member States, who all qualify at all times as citizens of the Union by reason of Article 20(1) TFEU, having the benefit of Charter rights only when Treaty rights are engaged, such as when they have exercised a freedom of movement, but not having those Charter rights at other times.

1.2.vi Concluding comment.

In summary, the principal interaction of direct taxation with EU law, being in the spheres of the Internal Market freedoms of movement introduced in the EEC Treaty, and of the freedom of movement guaranteed to Union citizens introduced in the Maastricht Treaty with effect from 1 November 1993, will not have become changed as a result of the progression of Treaty changes save to extend the rights of free movement to individuals who are not engaged in any economic activity.

1.3 POWERS OF THE COURT.

The Court was created and empowered by Article 13 TEU and it "…*shall act within the limits of the powers conferred on it*….". It is tasked to "…*ensure that in the interpretation and application of the Treaties the law is observed*"[88].

The Court is, itself, 'a creature of the law'[89] and it is assumed that it abides by the law that created it and discharges the task assigned to it.

1.4 SUPREMACY OF UNION LAW.

The distinction between rights and obligations stemming, on the one hand, from an international treaty such as the EEA Agreement[90] and, on the other, from the EEC Treaty, was explained in 1991 by the Court in its Opinion on the draft EEA Agreement[91]. The key difference is that the nationals of the Member States enjoy

[86] The Charter, Article 51(1). The Charter provisions apply to the Institutions and the Member States when they are implementing Union law.

[87] Article 6(1) TEU.

[88] Article 19(1) TEU. "… the task entrusted to the Court by the Masters of the Treaties themselves … was and continues to be framed in such general terms that when gaps come to light it is quite proper for the Court to fill them". Rosas (2018) page 42.

[89] *Daily Mail* [1988] Case 81/87 paragraph 19 (by analogy).

[90] Agreement on the European Economic Area.

[91] *Opinion of the Court (EEA Agreement)* [1991] Case Opinion 1/91 Point 1 3rd Paragraph (emphasis added): "…The European Economic Area is to be established on the basis of <u>an international treaty which merely creates rights and obligations as between the Contracting Parties and provides for no transfer of sovereign rights</u> to the inter-governmental institutions which it sets

direct rights under Union law that can be enforced by them in national courts, irrespective of whether those rights have been recognised in national law.

1.4.i The Obligation to enable Union law to have primacy and direct effect.

It must be clear that Union law can only override the national law of a Member State, and grant rights to its nationals having direct effect, if the state has made some form of amendment to its constitution, or has enacted some Act in accordance with its constitution, that provides that Union law shall override conflicting national provisions and shall have direct effect in its national courts. The UK gave effect to that requirement through the enactment of the (now repealed)[92] [93] European Communities Act 1972.

The Member States are required to enable the direct effect of Union law in their national courts[94] and to give effect to the override of conflicting national provisions under the 'sincere cooperation' obligation in the Treaty[95].

In common sense terms, if the objective of a group of parties is to follow common policies through following common rules, it is those rules that must be followed by all parties to that agreement as, otherwise, the objective cannot be achieved. That is, in effect, what the Court said in *Costa v E.N.E.L.* [1964][96].

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up. In contrast, the EEC Treaty, albeit concluded in the form of an international agreement, none the less constitutes the constitutional charter of a Community based on the rule of law. The Community treaties established a new legal order for the benefit of which the States have limited their sovereign rights and the subjects of which comprise not only Member States but also their nationals. The essential characteristics of the Community legal order which has thus been established are in particular its primacy over the law of the Member States and the direct effect of a whole series of provisions."

[92] The Act was repealed with effect from 31 January 2020 by the European Union (Withdrawal) Act 2018.

[93] *Bulmer v Bollinger (CoA)* Case [1974] Ch.401 Lord Denning MR at pages 418 & 419: "…Parliament has decreed that the Treaty is henceforward to be part of our law. It is equal in force to any statute…The statute is expressed in forthright terms which are absolute and all-embracing. Any rights or obligations created by the Treaty are to be given legal effect in England without more ado. Any remedies or procedures provided by the Treaty are to be made available here without being open to question… The supreme tribunal for interpreting the Treaty is the European Court of Justice, at Luxembourg. Our Parliament has so decreed."

[94] *Rewe* [1976] Case 33/76 paragraph 5: "Applying the principle of cooperation laid down in Article 5 of the Treaty, it is the national courts which are entrusted with ensuring the legal protection which citizens derive from the direct effect of the provisions of Community law."

[95] Article 4(3) TEU. See *Von Colson* [1984] Case 14/83 paragraph 26: "…the Member States' obligation arising from a directive to achieve the result envisaged by the directive and their duty under Article 5 of the Treaty to take all appropriate measures, whether general or particular, to ensure the fulfilment of that obligation, is binding on all the authorities of Member States including, for matters within their jurisdiction, the courts."

[96] *Costa v E.N.E.L* [1964] Case 6/64 paragraph 3: "…the law stemming from the Treaty, an independent source of law, could not, because of its special and original nature, be overridden by domestic legal provisions, however framed, without being deprived of its character as Community law and without the legal basis of the Community itself being called into question."

1.4.ii Union law may encroach into spheres not devolved to the Union.

Where Union law has been made within a sphere of devolved competence that overlaps or interacts with a sphere that is not generally within its devolved competence, it is necessary to give full effect to the law made and that law will override national provisions by reason of necessity[97].

An example of such encroachment by Union law into the sphere of direct taxation is the taxation of remuneration paid to EU officials. Whilst direct taxation is not a sphere of competence that has been devolved on the Union, remuneration of Union officials is such a competence and the desire to ensure equality of remuneration, shielded from the disparities in Member States' taxation systems, justified the taking of powers over taxation of that remuneration[98].

In spheres of competence shared with the Member States[99], such as the Internal Market, the Union is empowered to legislate "…*if and in so far as the objectives of the proposed action cannot be sufficiently achieved by the Member States…but can rather, by reason of the scale or effects of the proposed action, be better achieved at Union level*"[100].

In relation to direct taxation, the Union is empowered to make harmonisation measures under Article 115 TFEU.

1.4.iii National law may be temporarily permitted in spheres devolved.

National law may be permitted in a sphere of common policy or exclusive competence where Union measures have yet to be made[101].

This rule will have no bearing on tax sovereignty issues as competence in that sphere has not been devolved on the Union.

1.4.iv Concluding comment.

A conflict between national law and Union law, regardless of whether competence has been ceded to the Union in the sphere concerned, must always be resolved in favour of Union law where the Union has made specific measures. The Member States are bound by Article 4(3) TEU, the principle of sincere cooperation, to ensure that Union law is given direct effect in their national law

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[97] *Simmenthal* [1978] Case 106/77 paragraph 18: "…any recognition that national legislative measures which encroach upon the field within which the Community exercises its legislative power…had any legal effect would amount to a corresponding denial of the effectiveness of obligations undertaken unconditionally and irrevocably by Member States pursuant to the Treaty…".

[98] See *Humblet* [1960] Case 6/604 (A) at page 577 and *Bourges-Maunoury* [2012] Case C-558/10 paragraph 30.

[99] Article 4(2)(a) TFEU.

[100] Article 5(3) TEU.

[101] *Kramer* [1976] Case 3/76, 4/76 & 6/76 paragraphs 39 & 40.

systems and to avoid making national measures that would hamper the achievement of the objectives laid down in the Treaties. The institutions of the Union are, however, constrained in their legislative zeal by the principle of subsidiarity, considered next.

1.5 THE PRINCIPLES OF CONFERRAL AND OF SUBSIDIARITY[102].

In order to curb the enthusiastic exercise by the Union institutions of competences devolved on the Union, the Member States introduced in the Treaty of Maastricht a statement of principle that the Union should only exercise its powers as a last resort, not a first resort, in spheres outside of those in which it has exclusive competence. This principle is now expressly linked to the general principle of proportionality[103] but, in contrast to that principle, was not, itself, a general principle of Union law[104].

Powers are conferred on the Union directly through the Treaties and "…*the Union shall act only within the limits of the competences conferred upon it by the Member States in the Treaties to attain the objectives set out therein. Competences not conferred upon the Union in the Treaties remain with the Member States*."[105]. As mentioned briefly in chapter 1.6 *post*, the Court feels free to 'see' powers "*implied*" by the specific provisions of the Treaties.

The principle of subsidiarity applies only to the use of the powers conferred. In 1992, the Commission said of this distinction in a Communication to the Council and the European Parliament: "…*the subsidiarity principle regulates the exercise of powers rather than the conferment of powers. The conferment of powers is a matter for the writers of our "constitution", that is to say, of the Treaty… national powers are the rule and the Community's the exception...it would be pointless…to list the powers reserved to the Member States.*"[106]

The principle of subsidiarity appeared to be simple enough as formulated and enacted in 1992 but it did not prescribe how the Union institutions should assess whether or not Union action was required in any particular sphere or how to assess to what lengths the institutions of the Union should go to satisfy themselves that such action could be better achieved by the Union.

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[102] Articles 5(2) and 5(3) TEU first enacted in the Treaty of Maastricht. The conditions for the application of the principles of subsidiarity were detailed in a protocol attached to the Treaty of Amsterdam signed on 2nd October 1997 and subsequently attached to the Treaty of Lisbon signed 13th December 2007.

[103] The express linkage was made in (now) Article 5(1) TEU and in the protocol attached to the Treaty of Amsterdam.

[104] *SPO & Others* [1995] Case T-29/92 paragraph 330: "…It must also be noted that…the principle of subsidiarity did not, before the entry into force of the Treaty on European Union, constitute a general principle of law by reference to which the legality of Community acts should be reviewed".

[105] Article 5(2) TEU (emphasis added).

[106] SEC (92) 1990 27 October 1992 Paragraph I.1 (a).

The protocol, now attached to the TFEU and TEU, was adopted to provide guidance on how such matters should be assessed. It requires the Commission to "*consult widely*", to take account of "*the regional and local dimension of the action envisaged*" and to "*give reasons for its decision in its proposal*". There are detailed procedures and details of the form of "*draft legislative acts*". National parliaments are able to challenge the proposals on the ground of non-compliance with the principle of subsidiarity in "*reasoned opinions*" and the institutions are required to have regard for them.

The distinction between 'conferral' and 'subsidiarity' can become clouded where the institutions wish to take action using a general power, such as Article 352 TFEU[107]. In *Opinion of the Court (conferred powers)* [1996], which concerned a proposal for the Community (as it then was) to accede to the Convention[108] making use of the general power as originally cast in Article 235 EEC, the Court observed: "…*Accession to the Convention would…entail a substantial change in the present Community system for the protection of human rights…Such a modification of the system…would be of constitutional significance and would therefore be such as to go beyond the scope of Article 235. It could be brought about only by way of Treaty amendment*"[109].

In one sense, powers had appeared to have been conferred on the Union in that there was a general power to take action to achieve an objective of the Union where no specific powers had been provided. But furthering human rights *per se* was not then a general objective of the Treaty and utilising the general power would have resulted in an extension of the objectives. As regards the principle of subsidiarity: the Member States, being signatories to the Convention, sought accession of the Union to the Convention to eliminate potential stress between their obligations under the Convention and being bound by the rulings of the Court.

The distinction between 'subsidiarity' and 'proportionality' defined in Articles 5(3) and 5(4) TEU are a little indistinct also in that both stress that the legislative action by the Union should extend only so far as necessary to achieve the objectives of the Treaty although Article 5(3) TEU (subsidiarity) is directed at harmonisation measures in fields of shared competence[110].

[107] Formerly Article 235 EEC and then Article 308 EC. As recast in the TFEU, it contains provisions expressly constraining its use.

[108] Convention for the Protection of Human Rights and Fundamental Freedoms of 4th November 1950.

[109] *Opinion of the Court (conferred powers)* [1996] Case Opinion 2/94 extracts from paragraphs 27,34 & 35.

[110] See comment in Petersen [2021] ECLR at page 320.

1.6 SPHERES OF SHARED COMPETENCE[111].

The spheres of shared competence might be regarded as "…*the general rule*…"[112] and there are eleven prescribed 'principal areas' of which one, the Internal Market, is of principal interest in this thesis. The Member States are prohibited from legislating in areas of shared competence where the Union has legislated[113] [114].

Shared competence can be distinguished from the areas of exclusive competence defined by Article 3 TFEU in that the Member States may only legislate in such areas "…*if so empowered by the Union*…".[115]

Shared competence can also be distinguished from the form of competence[116] granted to the Union under Article 4(3) TFEU in relation to "*research, technological development and space*" where "…*the exercise of that competence shall not result in Member States being prevented from exercising theirs*". A similar competence is provided by Article 4(4) TFEU in relation to "*development cooperation and humanitarian aid*".

The spheres of shared competence are in a sense a twilight world where the Member States retain competence but can only exercise that competence with due regard to general provisions in the Treaty, or specific Union legislation[117].

Whilst the scope of application of the specific Union legislation is generally prescribed in a reasonably clear manner, the scope of application of the Treaty shared competences is less defined. The Court has had to develop tests to apply to national provisions to determine whether they can be considered to have infringed Treaty law.

The Court has ruled that the mere fact that a person suffers a disadvantage following an exercise of a freedom of movement is not sufficient reason to engage the Treaty freedom of movement rights[118]. If that disadvantage occurs because of disparities in the systems between the exit state and the host state, the Treaty will offer no protection as only harmonisation could remedy that form of disincentive to exercise the freedom of movement[119].

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[111] Articles 2(2) & 4(1) & (2) TFEU.

[112] Rosas (2018) page 23.

[113] Protocol (No 25) to the Lisbon Treaty emphasises that "…when the Union has taken action in a certain area, the scope of this exercise of competence only covers those elements governed by the Union act in question and therefore does not cover the whole area".

[114] Such as through harmonisation measures. See *post*.

[115] Article 2(1) TFEU. See *post*.

[116] "…often referred to as parallel competence" Rosas (2018) page 23.

[117] Such as directives made pursuant to Articles 114 & 115 TFEU.

[118] See *Hervein & Others* [2002] Case C-393/99 & C-394/99 paragraph 51; *Weigel* [2004] Case C-387/01 paragraph 55; *Lindfors* [2004] Case C-365/02 paragraph 34; and *Schempp* [2005] Case C-403/03 paragraph 45 just listing the cases decided prior to *Marks & Spencer* [2005] Case C-446/03.

[119] See, for instance, *Gilly* [1998] Case C-336/96 paragraph 30.

Where, however, the disadvantage arises because of a provision in the exit state's system that penalises that person solely because he exercised the freedom of movement; or where the disadvantage arises because the host state applies less favourable provisions against him than it applies to its own residents or citizens, then the Treaty rights will be invoked by the Court to protect him. These tests applied by the Court are discussed in Part II *post*.

1.6.i The Internal Market[120] (and direct taxation).

The Internal Market is a sphere of shared competence and most of the conflicts between national direct tax provisions and the Treaty provisions occur in this sphere[121].

The Court developed its principles for enforcing Treaty law in areas of non-exclusive competence in case law that preceded the codification of the competences in the Lisbon Treaty. However, the definitions introduced by that treaty for exclusive and shared competence are "…*by no means radical, amounting essentially to a statement of what was commonly understood to be the case*…"[122].

The Treaty now provides in relation to a shared competence: "*The Member States shall exercise their competence to the extent that the Union has not exercised its competence*. *The Member States shall again exercise their competence to the extent that the Union has decided to cease exercising its competence*"[123]. Thus, it would at first appear that it is only in relation to matters or areas within the defined scope of measures made by the Union that Member State competence to legislate is overridden.

However, the principle that the exercise of 'reserved powers' by the Member States could not be permitted to undermine Treaty rights was well established before the Court had reason to consider the matter in the context of direct taxation. [124]

[120] Articles 4(2)(a) and 26 TFEU. "

[121] Distinction is generally made in the application of direct taxation to, respectively, residents of the territory, and non-residents, and this was recognised by the Court in *Schumacker* [1995] Case C-279/93 paragraph 31. Paul Farmer in his General Report to the 2006 FIDE Congress, at page 3 noted that the distinction entailed "…an inherent tension with the Treaty freedoms." Farmer P and Zalasinski A (2006)

[122] Rosas (2018) page 22.

[123] Article 2(2) TFEU.

[124] The Court had long held that "The exercise of reserved powers cannot therefore permit the unilateral adoption of measures prohibited by the Treaty." *Commission v France (exports - financial aid)* [1969] Case 6/69 & 11/69 paragraph17. In a later case concerning the same Treaty provisions, the Court's ruling had evolved to "…[whilst] the Member States remain free to employ all means of ensuring that payments made abroad relate exclusively to genuine transactions, [that is] subject always to the condition that such means do not hinder the freedom of intra-community trade as defined in the Treaty" *Commission v Italy (guarantees)* [1982] Case 95/81 paragraph17.In a

The first challenge of a scheme of direct taxation was in 1986 when the Court was presented with a referral by the Commission of the differential taxing rules applied by the French tax system to, respectively, non-resident companies trading in the territory through branches and resident companies. The Commission claimed that the resulting commercial tax disadvantage infringed the requirement of the second paragraph of [Article 49 TFEU]. The Court rejected the French State's defence argument that there had been no harmonisation of corporation tax [125].

The stated purpose of the Commission's action extended beyond seeking change to the discriminatory treatment of branches of insurance companies in France and that purpose was to establish that "*…all the Member States…must nonetheless draw all the appropriate conclusions from the Court's judgment, even in regard to other sectors*"[126].

The principle established by the judgment was subsequently summarised by the Court in relation to direct taxation: "*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*."[127]

Whether the *Avoir Fiscal* [1986] judgment might be labelled 'judicial activism' is a debatable point but the judgment appears to just apply to direct taxation principles developed in other fields of shared competence. The significance of the *Avoir Fiscal* [1986] judgment was that it extended those principles to the field of direct taxation but this, in itself, could not be viewed as 'activism' because, as the Court observed in that case at paragraph 18, to permit a Member State to exercise its legislative power to undermine the right of a non-resident to pursue its commercial activities in another state "under the conditions laid down" by that state for its own residents "*…would thus deprive [Article 49 TFEU] of all meaning*."

The Court did no more than interpret the Treaty provision and apply it to a situation in which there was a blatant discriminatory treatment of a non-resident company trading in the territory through a branch.

There appears to be no mystique to these constraints on Member State legislative action in spheres of retained competence. In the context of the Internal Market, a national provision that is such as to cause a person to be deterred from exercising a freedom of movement, or is such as to distort competition in the

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formulation adopted by the Court in *Schumacker supra*, it ruled in *Commission v UK (ship registration)* [1991] Case C-246/89 paragraphs 11 & 12 *"…*powers retained by the Member States must be exercised consistently with Community law…".

[125] *Avoir Fiscal* [1986] Case 270/83 paragraph24. The Court had noted in paragraph 20 that branches were subject to taxation on their profits in the same way as resident companies but were denied credit against taxation assessed for credits attaching to their dividend income. The Commission had taken the action against the French State in response to a complaint made to it by a non-resident insurance company trading in France through a branch and suffering a competitive disadvantage as a result of its increased tax burden as compared to that suffered by resident companies in the same sector.

[126] Ibid. paragraph 7.

[127] *Schumacker* [1995] Case C-279/93 paragraph 21.

national market, will undermine the objective of the Internal Market. To be permitted, such a national provision must be necessary to the exercise of the retained competence and must satisfy the principle of proportionality.

The Court is not considered to have engaged in 'judicial activism' when it ruled in *Avoir Fiscal* [1986] that a direct tax provision could viewed as infringing one or more freedoms of movement.

1.6.ii Internal Market harmonisation .

Where the Union has made express measures, they will override national laws for so long as they remain in force; and where express measures have been made, the Court will look at the express measures and not at the Treaty[128] unless the legality of the measure is in question[129].

The only legal basis for harmonisation measures in the sphere of direct taxation is Article 115 TFEU[130].

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[128] *Commission v France (duty free limits)* [2013] Case C-216/11 paragraph 27: "…where a particular sphere has been the subject of exhaustive harmonisation at Community level, any national measure relating thereto must be assessed in the light of the provisions of the harmonising measure and not those of the Treaty…".

[129] In *Commission v Greece (Ouzo)* [2004] Case C-475/01 the Commission sought to challenge an act by Greece made lawfully in accordance with a directive on the ground that it was in conflict with the Treaty. The Court stated (paragraph 18) that [Union] measures "…are in principle presumed to be lawful…" unless and until "… they are withdrawn, annulled…or declared invalid…".

[130] Directives made under Article 115 TFEU in relation to direct taxation are: 2011/96/EU (Parent-Subsidiary), 2009/133/EC (Merger), 2003/49/EC (Interest-Royalty) and 2003/48/EC (Savings) as well as 2011/16/EU (Administrative Cooperation ['DAC'] – replacing the Mutual Assistance Directive), 2010/24/EU (Mutual Assistance for the Recovery of claims Directive – amended by (EU) 2015/2376, (EU) 2016/ 881 and (EU) 2018/822 to include mandatory automatic exchange of information), 2016/1164/EU (Anti-Tax Avoidance Directive) and (EU) 2017/1852 (Tax Dispute Resolution Directive).

Title VII TFEU[131] provides three[132] legal bases under which measures may be made for the 'harmonisation'[133] or 'approximation'[134] of national laws and administrative practices.

The harmonisation measures made under Article 113 TFEU have a specified objective of avoiding "*distortion of competition*" and Article 114 TFEU by reason of Article 114(2) TFEU may not be used as a legal basis for making "*measures for the approximation*" of national laws and administrative practices relating to *"…fiscal provisions … free movement of persons … [or] … the rights and interests of employed person*s".

The legal basis provided by Article 115 TFEU is "*without prejudice to Article 114*" and can apply in those areas excluded by Article 114(2) TFEU. Only directives may be made under Article 115 TFEU in contrast to Article 114 TFEU, which enables the making of other forms of measure such as Regulations. Article 115 TFEU defines the objective of directives made using this legal basis as being *"… for the approximation of [Member State laws etc] … as directly affect the establishment or functioning of the internal market*". In contrast, the objective defined in Article 114 TFEU is "*… for the achievement of the objectives set out in Article 26 … adopt the measures for approximation [of Member State law etc] which have as their object the establishment and functioning of the internal market*".

The difference in the underlined wording suggests that directives under Article 115 TFEU may only be made if disparities in Member State rules are obstructing the establishment and functioning of the internal market. This conclusion is supported by the Court's case law.

The Court has ruled in relation to a directive made under Article 114 TFEU that: "*…a mere finding of disparities between national rules is not sufficient to justify having recourse to Article 114 TFEU…*"[135] and considering the more targeted wording of Article 115 TFEU, it is reasonable to assume that the same rule applies to the use of both legal bases. The Court then continued: "*…it is otherwise where*

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[131] The Treaty elsewhere provides legal bases for harmonisation measures related to specific policy areas such as (the examples are not exhaustive) agriculture (Art.41 TFEU), criminal laws (Art.67 TFEU), Judicial cooperation in civil matters (Art. 81 TFEU) and Social Policy (Art. 151 TFEU). Elsewhere, it specifically provides that promotion of common policies or rules shall not result in harmonisation of national rules such as (the examples are not exhaustive) Art. 79 TFEU, Art. 149 TFEU, Art.153 TFEU and Art. 165 TFEU. Note that measures made under the general powers provision Art.352 TFEU may not result in harmonisation of national laws where such has been specifically excluded by the Treaty (Art. 352(3)).

[132] Article 118 TFEU, relating to intellectual property rights, can be distinguished as it provides for "Union-wide authorisation, coordination and supervision arrangements" notwithstanding that it is located under Chapter 3 of Title VII headed "Approximation of Laws". The Union scheme will substitute for the national schemes within the Union.

[133] Article 113 TFEU relating to "turnover taxes, excise duties and other forms of indirect taxation".

[134] Articles 114 & 115 TFEU.

[135] *Philip Morris* [2016] Case C-547/14 paragraph 58.

there are differences between the laws, regulations or administrative provisions of the Member States which are such as to obstruct the fundamental freedoms and thus have a direct effect on the functioning of the internal market …" (emphasis added).

It is notable that the Court used an adapted formulation of the wording in Article 115 TFEU and it has construed 'direct effect on the functioning of the internal market' in terms of 'obstruct[ion of] the fundamental freedoms'. However, that does not mean that the Court will always find an infringement of the fundamental freedoms when an area of distortion in the Internal Market has not been addressed by harmonisation measures[136].

Can the Union legislate in anticipation of Member State legislative disparities that might cause obstruction to the exercise of the 'fundamental freedoms'?

That question was also answered by the Court in the affirmative: "…*when…it is likely that such obstacles will emerge in the future, because the Member States ... are about to take, divergent measures … Article 114 authorises the EU legislature to intervene by adopting appropriate measures* …".[137] The second recital in ATAD[138] appears to confirm that directives made pursuant to Article 115 TFEU may anticipate or seek to avert Member State legislative divergences.

ATAD is an example of 'partial harmonisation'. By Article 3 of the directive, the Member States are free to apply "domestic or agreement-based provisions aimed at safeguarding a higher level of protection for domestic corporate tax bases" and it is limited in scope to corporate tax. The directive also harmonises 'exit taxes' (Article 5), which are not necessarily properly regarded as relating to tax avoidance.

[136] The failure of a state of residence to provide credit relief for source state withholding tax levied on dividends paid to and investor was considered by the EU Commission to have just such "*a direct effect on the functioning of the internal market*" although the Court resisted the temptation to be 'activist' despite the market distortion and declined to rule that Article [63] TFEU had been infringed by that omission of the state of residence of the investor. In *Kerckhaert & Morres* [2006] Case C-513/04 paragraph 22 the Court noted that "Community law … 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 … no uniform or harmonisation measure designed to eliminate double taxation has as yet been adopted at Community law level." In a dissatisfied response to this judgment, the Commission decided to refer Belgium to the Court because of its "… discriminatory taxation of dividends paid by foreign companies to Belgian private investors …" in that Belgium did not provide 'credit relief' for foreign withholding taxes applied to 'inbound dividends' and that omission rendered foreign investments less attractive to Belgian investors. The Commission alleged that the omission resulted in an infringement of Article [63 TFEU]. (IP/07/67).

[137] *Philip Morris* [2016] Case C-547/14paragraph 62.

[138] Council Directive (EU) 2016/1164 made 12 July 2016: "In a market of highly integrated economies, there is a need for common strategic approaches and coordinated action, to improve the functioning of the internal market and maximise the positive effects of the initiative against BEPS." This refers to the OECD report released 9 months prior to the making of the directive recommending Action Items to counter BEPS by international groups of companies.

The empowerment in Article 3 of the directive raises the question of whether the Member States may apply domestic or agreement-based provisions in the areas specifically harmonised in the directive. Recital 2 of the directive states: "… *national implementing measures which follow a common line across the Union would provide taxpayers with legal certainty* …". The Court did not refer to legal certainty in its *Philip Morris* [2016] judgment but it did make the point in paragraph 71 that the "… *harmonisation effected by the directive* …" would be undermined if the Member States were permitted to apply more restrictive requirements on packaging of tobacco products than had been specified in the directive. Thus, the Court concluded that more restrictive requirements could only be imposed by domestic law in areas "… *which have not been harmonised by the directive* …"[139].

This conclusion by the Court appears to be consistent with Article 2(2) TFEU[140] and it may be assumed that the Member states remain free to "*effectively exercise their tax sovereignty*"[141] in areas not specifically covered by the directive.

1.6.iii 'Negative harmonisation'.

It appears from the 'literature' that there is a general acceptance by many that the Court seeks to achieve, through its rulings, a more perfect Internal Market than that prescribed by the Treaties and by secondary measures made pursuant to powers in the Treaties[142].

"*The Court's role is essentially negative*"[143] in that it 'strikes down' national provisions that interfere with the free movement rights guaranteed by the Treaty. The Court can therefore be regarded as providing a form of harmonisation by removing obstacles caused by national provisions.

Notwithstanding that "*The Community acts ordinarily on the basis of specific powers which, as the Court has held, are not necessarily the express consequence of specific provisions of the Treaty but may also be implied from them*"[144], it might be argued that the Court cannot step in and impose harmonisation where the EU

139 Emphasis added: See *Philip Morris* [2016] Case C-547/14 paragraph 73 by way of analogy and the discussion of that judgment in Weinzierl [2016] ELB 4 October 2016.

140 "The Member States shall exercise their competence to the extent that the Union has not exercised its competence".

141 ATAD 1st recital.

142 Vanistendael felt the Court to be justified in so doing: "Like constitutional and international courts creating new rights on the basis of the constitutions and treaties on which they have the power of interpretation, the ECJ is entitled to create 'new rights with respect to taxation' on the basis of its power of interpretation of the EC Treaty" Vanistendael [2008] ECTR at page 65. More recently, Favaloro [2020] ET at page 383: "The present article highlighted the leading role assumed by the ECJ in achieving harmonization, and its aim to ensure a smooth operation of the internal market".

143 Weatherill & Beaumont (1999) page 554.

144 *Opinion of the Court (conferred powers)* [1996] Case Opinion 2/94 paragraph 25.

and the Member States have declined to so do despite having a legal basis for so doing. The Court declined to do so in its *Kerckhaert & Morres* [2006] judgment[145], for instance.

However, insofar as the Court exercises discretion when interpretating the Treaties or secondary measures, "… *a certain margin of interpretation … is unavoidable. Exercising discretion within that margin is not, of itself, judicial activism …*"[146].

1.7 SPHERES OF EXCLUSIVE COMPETENCE[147].

These spheres are areas in which the Member States are prohibited from legislating unless directed by EU measures to do so[148] and in which conflicts between national rules and EU rules cannot be justified.

As such, they are of limited interest in this thesis and only a brief reference to them is made.

The Commission, in its 1992 Communication[149], stated its view on the "*characteristics of exclusive powers*". It identified, first, a "*functional element*" that it defined as: "*an obligation on the Community to act because it is regarded as having sole responsibility for the performance of certain tasks …. The obligation to act should be clearly and precisely imposed by the Treaty itself*". Second, it identified what it termed "*a material element*". By this, it is referring to the ability of the Member States to legislate if permitted or directed to by the EU and it said (citing agriculture as an example): "… *we cannot conclude that, because the Community has exclusive competence for an area defined in the Treaty … all responsibility for the activity in question… is covered by exclusive competence. <u>The text of the Treaty cannot be interpreted so broadly as to leave common sense out of account</u>.*"

This appears to reflect the Court's case law in earlier years. In 1969, the Court ruled in *Walt Wilhelm* [1969], addressing the situation where national rules coexisted with EU measures in the sphere of competition[150]: "… *<u>so long as a regulation … has not provided otherwise</u>, national authorities may take action against an agreement in accordance with their national law … subject however to the condition that the application of national law may not prejudice the full and*

[145] See FN 136 *ante*.

[146] Rosas (2018) page 44.

[147] See Article 3 TFEU.

[148] See Article 2(1) TFEU.

[149] SEC (92) 1990 Paragraph II.1 pages 5 & 6 (emphasis added)

[150] The competition rules in Article 101 TFEU and the prohibition of 'cartels'. This is now expressly a field of exclusive competence: Article 3(1)(b) TFEU.

uniform application of Community law or the effects of measures taken or to be taken to implement it"[151].

That 'common sense' rule still applies in spheres of shared competence and, generally, where the Union has legislated.

1.7.i Exclusive competence in areas governed by Common Policy.

Where the Treaty provides for the adoption of a common policy, such as transport or agriculture & fisheries, it is clear that there will have to be rules common to the Member States and the Treaty objective would be frustrated if the Member States retained their own legislation in those fields except as required by the EU measures to give effect to the common rules. In *ERTA* [1971], which concerned the common policy in the sphere of transport, the Court stated: "… *each time the Community, with a view to implementing a common policy envisaged by the Treaty, adopts provisions laying down common rules, whatever form these may take, the Member States no longer have the right, acting individually or even collectively, to undertake obligations with third countries which affect those rules* …"[152].

1.7.ii Competition and State Aid.

The competition rules, such as the prohibition of granting State Aid, come within a sphere linked to the *Internal Market* and the Union has been granted "*exclusive competence"* in the field of "*competition rules necessary for the functioning of the Internal Market"*[153] .

Selective direct taxation provisions providing advantages to some operators that are denied to others in a comparable situation may be regarded as constituting State Aid within the meaning of Article 107(1) TFEU[154].

Infringement of the State Aid rules cannot be justified on grounds that are expressions of sovereignty as sovereignty has been ceded in this sphere. The scope for challenge of special national tax schemes under the State Aid rules has yet to be fully explored.[155] National tax provisions causing discriminatory restrictions to

[151] *Walt Wilhelm* [1969] Case 14/68 paragraph 9: (emphasis added)

[152] *Commission v Council (AETR)* [1971] Case 22/70 paragraphs 17, 20, 21 & 22: (emphasis added).

[153] Article 3(1)(b) TFEU. (emphasis added).

[154] *Dirk Andres* [2018] Case C-203/16P paragraph 85. So-called 'reverse discrimination' (where a 'foreigner' is provided with access to a scheme of taxation less onerous than that applied to 'locals') might fall foul of State Aid rules.

[155] Paraphrasing the Court's statement in *Fidium Finanz*, "it is apparent from the wording of the Internal Market provisions and the competition and State Aid provisions, and the position which they occupy in different Titles of Part Three of the Treaty, that, although closely linked, those provisions were designed to regulate different situations and each have their own field of application*" Fidium Finanz* [2006] Case C-452/04 paragraph 28.

the exercise of freedoms of movement by providing tax advantages to domestic traders are thus examined by the Court in the context of the Internal Market provisions.

Whilst the Court may not make express reference to 'competition' in its analysis of a restrictive provision interfering with an Internal Market freedom of movement, its analysis does highlight that the differences in treatment by national provisions would distort competition[156].

The State Aid provisions may not be automatically engaged where a tax provision results in benefit to some taxpayers but not to others in comparable situations, despite the cost of the benefit falling on the State.

Problems relating to litigating against tax provisions distortive of competition are highlighted in Panayi [2004] Intertax[157] but discussion of State Aid is beyond the scope of this thesis as this is a field that has been ceded to the EU as an exclusive competence. No justification on the grounds of sovereignty can be advanced.

1.8 THE GENERAL PRINCIPLES[158]

Whilst the Treaties may have brought about a "*new legal order*"[159] they do not create a comprehensive legal regime[160].

[156] For instance, in relation to Article 56 TFEU and the distortive German trade tax rules applied to lessees of 'fixed business assets' (aircraft in this instance) examined in *Eurowings*, the Court observed: "…the legislation contains tax rules which are less favourable to German undertakings leasing goods from lessors established in other Member States, who may thus be dissuaded from having recourse to such lessors" *Eurowings* [1999] Case C-294/97 paragraph 37. Similarly, in *Metallgesellschaft*, in the context of Article 49 TFEU, the Court noted that the result of the inability of a non-resident parent company and its UK subsidiary to enter into an election that would enable the subsidiary to avoid having to pay ACT when paying a dividend to its parent company: "…gives the subsidiary of a parent company resident in the United Kingdom a cashflow advantage inasmuch as it retains the sums which it would otherwise have had to pay by way of ACT …". *Metallgesellschaft* [2001] Case C-397/98 & C-410/98 paragraph 44. The UK subsidiary's cash flow advantage can be presumed to have resulted in lower costs and, consequently, a competitive advantage over a foreign company denied that advantage.

[157] Panayi [2004] Intertax For instance, at page 305: "Due to the difficulties in addressing the generality and selectivity tests…". The EU Commission can and does pursue State Aid actions despite these difficulties.

[158] "…one of the main function[s] of general principles is to operate as interpretive aids and gap fillers…general principles can also act as overriding rules of law…" De La Feria [2020] ECTR page 142. "… the EC Treaty … is rampant with provisions overpowering in their generality and uses vague terms and expressions which are not defined. It bestows the Court with very broad powers to develop Community law…".Tridimas [1996] ELR page 18.

[159] See *van Gend & Loos* [1963] Case 26/62 II B and *Opinion of the Court (EEA Agreement)* [1991] Case Opinion 1/91 point 1 paragraph 3.

[160] As Lord Denning M.R. remarked, the Treaty: "…lays down general principles. It expresses its aims and purposes…But it lacks precision. It uses words and phrases without defining what they

The Treaties were not drafted in a legal void. When the Court came to interpret the earliest of the Treaties, the ECSC, it had to formulate rules of interpretation that it presumed the signatories had in mind when they gave effect to the Treaties[161].

The sources of those rules are to be found in the national law of the Member States and in the international treaties that they have concluded[162].

By way of further explanation of their source, Sir Francis Jacobs wrote: "*Essentially, [the principles] are derived from the legal systems of the Member States. The principles are often invoked before the ECJ when cases are referred to it by national courts. In this and other ways, the ECJ has been able to draw on principles embodied in the national systems. The principles may not be recognised to the same extent in all the systems; but they seem to reflect, to a remarkable extent, shared values. Shared values are of course part of what makes up a community; and in these respects, the European Community can be seen to share, at a fundamental level, some common values*."[163]

The principle of proportionality is of particular importance as a restrictive national provision cannot be justified if it fails to satisfy the requirements of this principle. The principles of legal certainty, equivalence and effectiveness are sometimes engaged in relation to direct tax infringements although mainly in relation to remedies for those infringements. Brief mention is made of these below.

The general principles do not, of themselves, represent further devolution of sovereign powers by the Member States. In interpreting the Treaties and secondary measures, the uniform application of EU law can only be achieved if a uniform code of principles of interpretation is applied[164].

Fundamental rights are briefly mentioned although the more formalised Charter rights have superseded the fundamental rights developed by the Court, which are, in any case, reflected in the Charter's provisions. It might be argued that the development of a code of fundamental rights by the Court as "*an integral*

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mean…All the way through the Treaty there are gaps and lacunae. These have to be filled in by the judges, or by Regulations or directives …"*Bulmer v Bollinger (CoA)* Case [1974] Ch.401 at page 425.

[161] *Federation Charbonniere* [1955] Case 8/55 at 299: (emphasis added): "…. the Court considers that… it is possible to apply a rule of interpretation…according to which the rules laid down by an international treaty or a law <u>presuppose the rules without which that treaty or law would have no meaning or could not be reasonably and usefully applied</u> …".

[162] *Algera* [1957] Case 7/56 & 3/57 to 7/57 page 55:"Unless the Court is to deny justice it is therefore obliged to solve the problem by reference to the rules acknowledged by the legislation, the learned writing and the case-law of the Member countries".

[163] Jacobs (2007) page 51

[164] *Nordina Finans* [2008] Case C-98/07 paragraph 17: "…it follows from the need for uniform application of Community law…that the terms of a provision of Community law which makes no express reference to the law of the Member States for the purpose of determining its meaning and scope must normally be given an autonomous and uniform interpretation throughout the Community…".

part of the general principles"[165] interfered with Member State sovereignty in a sphere not expressly devolved down to the Union. However, where a Union measure impacted significantly on the fundamental rights of an individual, it was necessary to formulate a code that could be applied uniformly across the Member States to test the proportionality of the measure in question. As the Court explained in *Wachauf* [1989], the code was based upon rights recognised in the constitutions of the Member States and in international agreements concluded by them.

1.8.i The Principle of Proportionality.

The principle is ancient[166] and, in the context of EU law, it applies to constrain both the scope of the measures made by the Union[167] and the extent to which national provisions, even if justified, can infringe Union rules.

A restrictive measure impacting on individuals will often impact also on their fundamental rights and the Court has stated that such restrictive measures "…[*should*] *not constitute, with regard to the aim pursued, a disproportionate and intolerable interference, impairing the very substance of those rights*"[168].

Where there is a conflict between persons seeking to exercise Treaty rights and individuals seeking to exercise fundamental rights, a balance must be struck[169].

Union Acts are constrained also by the principle of proportionality[170] but this formalised inclusion of the principle in the Treaty text merely reflected the Court's interpretation of the Treaty before amendment[171].

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[165] *Wachauf* [1989] Case 5/88 paragraph 17: "…fundamental rights form an integral part of the general principles of the law, the observance of which is ensured by the Court…the Court has to look to the constitutional traditions common to the Member States, so that measures which are incompatible with the fundamental rights recognized by the constitutions of those States may not find acceptance in the Community. International treaties concerning the protection of human rights on which the Member States have collaborated or to which they have acceded can also supply guidelines to which regard should be had in the context of Community law.".

[166] See, for instance, Exodus, Chapter 22, verses 2 & 3.

[167] Article 5(4) TEU expressly constrains actions of the Union by reference to the principle.

[168] *Wachauf* [1989] Case 5/88 paragraph 18 adapted.

[169] *Schmidberger* [2003] Case C-112/00 paragraphs 81 & 82: "…the interests involved must be weighed having regard to all the circumstances of the case in order to determine whether a fair balance was struck between those interests … it is necessary to determine whether the restrictions placed upon intra-Community trade are proportionate in the light of the legitimate objective pursued, namely, in the present case, the protection of fundamental rights."

[170] "…the content and form of Union action shall not exceed what is necessary to achieve the objectives of the Treaties": Article 5(4) TEU introduced by the Treaty of Maastricht as new Article 3b EEC, third Paragraph.

[171] *Van den Bergh* [1987] Case 265/85 paragraph 31: "…in order to establish whether a provision of Community law complies with the principle of proportionality, it must be ascertained whether the means which it employs are suitable for the purpose of achieving the desired objective and

The principle is reflected in certain provisions in the TFEU dating back to the original EEC treaty. For instance, the Court has held that the last sentence of Article 36 EEC embodies the principle[172].

To be proportionate, there must not be a less restrictive means of achieving the objective[173] and that applies also to Union measures[174].

Accordingly, even if a Member State can justify and infringement of Union rules, the means by which it seeks to achieve its justifiable objective should not obviously[175] cause greater disturbance to Union rights than is necessary. A national measure that is a barely disguised protectionist scheme will generally fail the Court's review[176] [177] .

The principle of proportionality has particular application in the direct taxation field to anti-avoidance provisions and tax grouping arrangements. However, as discussed in Part III of this thesis *post*, the principle appears to have been applied where there is a question over the finding that the national provision caused a restriction to a freedom of movement and that application of it in those instances has been challenged.

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whether they do not go beyond what is necessary to achieve it. Furthermore … if a measure is patently unsuited to the objective which the competent institution seeks to pursue this may affect its legality…".

[172] "Such prohibitions or restrictions shall not, however, constitute a means of arbitrary discrimination or a disguised restriction on trade between Member States". Re-enacted as the last sentence of Article 36 TFEU. See *Muller* [1986] Case 304/84 paragraph 23.

[173] *Papillon* [2008] Case C-418/07 paragraph 52.

[174] *Association Kokopelli* [2012] Case C-59/11 paragraph 40.

[175] There is no hard rule on what the Court will accept and it appears to rarely call for a review of alternative measures and an analysis of their respective merits and demerits.

[176] *Henn & Darby* [1979] Case 34/79 paragraph 21 (emphasis added): "…it is appropriate to have regard to the function of this provision, which is designed to prevent restrictions on trade based on the grounds mentioned in the first sentence of Article 36 from being diverted from their proper purpose and used in such a way as either to create discrimination in respect of goods originating in other Member States or <u>indirectly to protect certain national products</u>."

[177] *Commission v Italy (vinegar)* [1981] Case 193/80: Under a 1975 presidential decree, products containing acetic acid could not be marketed or used as vinegar unless fermented from wine. This national measure effectively blocked the importation of, for instance, German cider vinegar. The attempt to justify the measure on the grounds of fair trading and consumer protection failed because: "…those needs…may be fulfilled by means less restrictive to free movement than a prohibition of the marketing of all kinds of natural vinegars other than wine-vinegar……such protection may…be provided…by the compulsory affixing of suitable labels…specifying the type of vinegar offered for sale, provided that such a requirement applies to all vinegars including wine-vinegar …". Ibid. paragraph 23 & 27. Petersen [2021] ECLR at page 319 refers to the application of the proportionality test to 'smoke out' "illicit motives". "The free movement of goods was supposed to reduce protectionism…The lack of suitability or necessity of a measure could again be an indication that the challenged measure had a protectionist aim."

1.8.ii The Principle of Legal Certainty.

This principle comprises not only certainty in the law but also the different expressions of the principle: legitimate expectations, non-retroactivity and vested interests.

Takis Tridimas said that the principle: "… *expresses the fundamental premise that those subject to the law must know what the law is* …" and then citing Lord Diplock's statement in Black Clawson Ltd v Papierwerke AG [1975] AC 591 at 638 that the "… *affinity of the principle with the rule of law is evident* …"[178]. In relation to taxes, a taxpayer can rely upon this principle even if he seeks to gain an advantage[179].

The principle extends to administrative aspects of the application of national law such as finality of administrative decisions[180] and time limits imposed by national law for the making of claims[181].

Takis Tridimas suggested that a situation that might infringe the principle of legal certainty might be where: " … *[it] is governed by a thicket of successive inter-related rules of primary, secondary and judge-made law so as to make it manifestly impossible for the citizen to know the rules and the courts to apply them* …"[182].

Whilst it is not argued in this thesis that the situation arising from the Court's analysis of the conflict of certain national direct tax provisions with the Treaty

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[178] Tridimas (2009) page 242. Of this principle, *Craig & De Búrca (2008)* (page 552) say: "A basic tenet of the rule of law is that people ought to be able to plan their lives secure in the knowledge of the legal consequences of their actions…".

[179] *Halifax* [2006] Case C-255/02 paragraph 72: "Community legislation must be certain and its application foreseeable by those subject to it…That requirement of legal certainty must be observed all the more strictly in the case of rules liable to entail financial consequences, in order that those concerned may know precisely the extent of the obligations which they impose on them …" There was initial concern that the "…abstract nature of the abuse test as set out by the Court will inevitably give rise to difficulties with its application…" De La Feria [2006] BTR at page 123 but the Court subsequently made repeated reference to this decision in abuse of law and anti-avoidance cases and "…It is hard to overstate its significance: the decision is arguably one of the most important ever delivered…" De La Feria [2020] ECTR at page 142. The principle is referred to in the second recital of Directive (EU) 2016/1164 (ATAD): "…national implementing measures which follow a common line across the Union would provide taxpayers with legal certainty in that those measures would be compatible with Union Law."

[180] *Kempter* [2008] Case C-2/06 paragraph 37: Where an interpretation of EU law relevant to a tax assessment that has become final is handed down by the Court subsequent to that time, EU law will not require the re-opening of an administrative decision once considered to be final under national law.

[181] *Marks & Spencer (gift tokens)* [2002] Case C-62/00 paragraph 46: The Court views administrative time limits for making claims as consistent with the principle of legal certainty and, therefore, permissible. However, the constraint on national law is that the time limits imposed on making such claims are reasonable and the principle of legitimate expectations will protect a claimant if, after making a claim, the national rule is changed to reduce the time limit for making such a claim.

[182] Tridimas [1996] ELR page 246.

rights of free movement has quite descended into a circumstance such as that suggested by Tridimas above, it is strongly contended in Parts II and III of this thesis that the principle has been compromised by certain of the decisions of the Court discussed there.

1.8.iii The Principles of Equivalence and Effectiveness.

The Court construed from the EEC Treaty that: *"…the states have acknowledged that Community law has an authority which can be invoked by their nationals before [national] courts and tribunals…"*[183].

The principles of 'equivalence' and 'effectiveness' apply to the national procedures put in place to enable 'nationals' to 'invoke' their rights under EU law in the national courts and tribunals.

The procedural rules must be no more difficult to invoke than the rules in place for securing rights under national law and, additionally, they may not be excessively difficult to invoke[184].

1.9 CONCLUDING COMMENTS.

Whilst the sphere of direct taxation is a retained competence, it is not a reserved competence and it has been clear since the Court handed down its judgment in *Avoir Fiscal* [1986][185] that discriminatory national direct tax provisions could be regarded as restrictions to the exercise of the Treaty freedoms of movement unless justified and proportionate.

In any conflict between national provisions and EU law, the latter is regarded as having supremacy but justification for infringements of the Treaty freedoms of movement have been recognised. This is evidenced in the freedom of movement Articles themselves, which provide specific public interest derogations, and since it handed down its judgment in *Dassonville* [1974], the Court has accepted that Member State legislation in spheres in which the Union has not legislated may be justified on 'other grounds' in the public interest provided that they do not "…*constitute a means of arbitrary discrimination or a disguised restriction on trade between Member States*."[186].

Occasionally, a Union exclusive competence may encroach upon the field of direct taxation or a national tax scheme. In such cases, no justification can be advanced for the infringement because, as is argued, the grounds for justification accepted by the Court are merely expressions of retained sovereignty and, as

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[183] *van Gend & Loos* [1963] Case 26/62B 4th paragraph.

[184] *Metallgesellschaft* [2001] Case C-397/98 & C-410/98 paragraph 85.

[185] *Avoir Fiscal* [1986] Case 270/83.

[186] *Dassonville* [1974] Case 8/74 paragraphs 6 & 7. The Court took inspiration from the second sentence of [Article 36 TFEU].

explained in the chapter, sovereignty has been ceded by the Member States where the Union has been ceded exclusive competence or has legislated.

Certainty in the meaning and application of EU law is necessary to enable the Member States to design their respective systems of taxation and to enable taxpayers to know the financial consequences stemming from the application of the national law. However, much of the EU law that is engaged by national tax provisions stems from the case law of the Court and inconsistencies in its analysis and decisions may undermine certainty in the law.

Some examples of those inconsistencies are discussed in Part II of this thesis.

Member State sovereignty in the field of direct taxation – is the failure of the Court of Justice in some instances to provide a consistent and coherent scheme of analysis of alleged restrictions to the exercise of the freedoms of movement a consequence of activism, error or both?

2 DIRECT TAX SOVEREIGNTY

"*The Member States are not just institutional centres of competence and decision-making. They exercise authority over a geographical territory. Consequently, they are entitled to tax individuals and companies that are resident and economic events that arise in their territory. It is an inherent element of territorial taxation that drives a wedge between persons resident inside and outside the territory and activities performed and assets located inside and outside the territory*"[187].

2.1 INTRODUCTION TO THE CHAPTER.

To answer the research question, it is necessary to establish the extent to which Member States have a retained competence to determine who and what remain within the scope of their taxing jurisdictions and, as a corollary of that, who and what may be determined by the Member States as being outside of their taxing jurisdiction.

Determining the nature and scope of the sovereignty retained by Member States with regard to direct taxes is a matter that is not devoid of contention. On the one hand, if that sovereignty is viewed in an absolute sense, that sovereignty would override the Treaty obligations as regards the Internal Market and would call those Treaty obligations into question. On the other hand, if obligations as regards the Internal Market are regarded as always overriding direct tax sovereignty, what meaning can be given to the retained competence? Indeed, what meaning can be given to the distinction made in the Treaty between competences that are exclusive to the Union and competences that are to be regarded as shared, the Internal Market competences falling into the latter category?

The objective of this chapter is to discuss the nature and scope of the sovereignty retained by Member States in relation to direct taxation. The grounds for justification for infringements of the Treaty by national direct tax provisions discussed in Part II *post* will be related to the sovereign powers retained by Member States in the field of direct taxation.

The discussion in this chapter commences with a review of what 'sovereignty' really entails and there is then a review of infringements that cannot be justified. Primarily, the infringements that cannot be justified are those that conflict with measures made by the Union including those made in areas of exclusive competence.

Following that, the discussion proceeds with identifying the two arms of direct tax sovereignty: first, the right to define (and protect) the tax base; and second, the mechanisms for levying taxation. The grounds for justification accepted by the

[187] Schon [2015] BFIT page 280. Note Article 4(2) TEU.

Court for infringements in this area are then identified with those two arms of direct tax sovereignty.

2.2 'SOVEREIGNTY' – A DISCUSSION OF THE CONCEPT.

Dr Mathieu Isenbaert observed, that "*The classical theorists of the eighteenth and nineteenth centuries…defined sovereignty as unlimited freedom, independence and competence*…" and defined the essence of the historical concept as "… *a concept developed by political scholars to justify and clarify the nature of political power*…"[188].

However, Sir Francis Jacobs has observed that "… *sovereignty is no longer a viable concept for explaining either the role of the State in international affairs or the internal arrangements of a modern State ... Internationally, it is not viable on the political level: no State today … is able to act independently* …"[189].

Commenting on the decision of 30 June 2009 of the German Constitutional Court on the legislation enacted by the German parliament to give effect to the Lisbon Treaty, Roland Bieber said: "*The [German Constitutional] Court admits that a transfer of "sovereign powers" to the Union had taken place. One must therefore conclude, that both, member states and the Union exercise some kind of "sovereignty". But would this be a divided or a joint exercise? ... No unqualified "national sovereignty" is compatible with EU Membership*"[190].

The issue of the 'sovereignty' (of the United Kingdom Parliament) has been a discussion point on the lips of many in the United Kingdom since the referendum held on 23rd June 2016 to obtain a decision from the United Kingdom electorate on whether the United Kingdom should remain a member of the European Union. It is clear that 'sovereignty' means different things to different people and it is worth digressing for a moment and giving some consideration to whether reference to retained powers in a particular area may be referred to as 'sovereignty' even though some powers may have been ceded.

When the United Kingdom first acceded to the EEC, which was enabled by an act of Parliament[191], sovereignty could not be said to have been ceded permanently to the EEC as sovereignty could be regained through a repeal of that

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[188] Isenbaert [2009] ECTR pages 264 & 265.

[189] Jacobs (2007) pages 4 & 5.

[190] Bieber [2009] ECLR page 399. Grimm comments that: "…[the German Constitutional Court] starts from the premise that the Treaties have not established a European state but a community *sui generis*…a confederation of sovereign nation-states…" Grimm [2009] ECLR page 353.

[191] European Communities Act 1972 ('ECA').

Act. That was the view of Lord Denning giving judgment in the Court of Appeal in 1979[192].

In the absolute sense, the UK Parliament did not cede sovereignty because it retained the power to revoke powers ceded pursuant to the ECA and no UK Parliament can act in any way that purports to bind a future Parliament.

Whilst Lord Denning made only a general observation, Lord Justice Laws, in the course of his judgment in *Metric Martyrs*[193] delivered a more express statement of the law in response to an argument made by counsel for Sunderland City Council, Eleanor Sharpston[194]. Her argument was based upon the Court's statements in van *Gend en Loos* [1963][195] and on *Costa v ENEL* [1964], both of which preceded the accession of the UK.

In particular, Laws LJ construed Miss Sharpston as arguing that as a result of the supremacy of EU law prescribed by the Court in *Costa v ENEL* [1964][196], EU law "…*became part of the law of England by force of the 1972 Act*…" and he commented: "…*Miss Sharpston's submissions forget the constitutional place in our law of the rule that Parliament cannot bind its successors*…"[197].

Each of the Member States has incorporated EU law and the principle of supremacy of EU law into its national laws and constitution but each has ceded sovereign powers only to the extent defined in the Treaties (and secondary measures) and only for so long as it does not act in accordance with its constitutional procedures to revoke the ceding of those sovereign powers[198].

It cannot be said that the Member States have either generally ceded their competence in the area of direct taxation or that they have 'reserved' that competence. Had they ceded the competence, it would be an exclusive

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[192] *Macarthys v Smith* Case [1979] I.C.R. 785 Lord Denning MR at page 789 "I pause here, however, to make one observation on a constitutional point...If the time should come when our Parliament deliberately passes an Act — with the intention of repudiating the Treaty or any provision in it — or intentionally of acting inconsistently with it — and says so in express terms — then I should have thought that it would be the duty of our courts to follow the statute of our Parliament."

[193] *Metric Martyrs* [2002] Case [2002] EWHC 195 (Admin).

[194] Subsequently Advocate General Sharpston.

[195] *van Gend & Loos* [1963] Case 26/62.

[196] The passage quoted was (extract): "…By contrast with ordinary international treaties … the EEC Treaty has created its own legal system which … became an integral part of the legal systems of the member states and which their courts are bound to apply. By creating a Community … having … 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…".

[197] *Metric Martyrs* [2002] Case [2002] EWHC 195 (Admin) paragraphs 57 & 58 (emphasis added).

[198] "In almost all EU states…national constitutions constrain the authority of EU law" Chalmers [2021] ELR pages 290/291 and FN 39. "The German Constitutional Court has…insisted that legislation adopted under Art.352 TFEU…requires the ratification of the German parliament to prevent that Article being a blanket empowerment" page 291 and FN44.

competence of the Union and the Member States would be prohibited from legislating except where expressly permitted by EU law or directed to do so by it[199]. Alternatively, had the Member States 'reserved' the competence, their rights to legislate in this area might have overridden their obligations under the competence ceded to the Union in relation to the formation of an Internal Market. That is not so.

Isenbaert proposed a new concept of 'function-sovereignty' and, in the context of direct taxation, identified the "… *three main functions …[as]… the financing of government expenditure, the redistribution of income … and macroeconomic stabilisation …*"[200]. He concluded that "… *the ECJ has applied its interpretative autonomy regarding the internal market principles with a sufficient amount of self-restraint to let the Member States fulfil the functions and pursue the objectives of direct taxation as a policy area in which they have retained their function-sovereignty*"[201].

That view, suggesting that the Court might be regarded as 'handing back elements of sovereignty in this area', does not appear to be the view of the Court, which has recognised the retained sovereignty with regard to direct taxation in both negative[202] and positive terms[203].

However, those sovereign rights are nevertheless constrained by the obligations of the Member States in areas governed by the EU Treaties, such as the provisions defining the Internal Market and the rights of Union Citizens. It has been the task of the Court, therefore, to develop the criteria to be applied in the analysis of cases where direct tax provisions have caused obstruction to the exercise of the freedoms of movement.

2.3 DIRECT TAX SOVEREIGNTY – THE PRINCIPLES DEVELOPED BY THE COURT.

The Court is not tasked with providing a definition of direct tax sovereignty although, notwithstanding that, it has made some comments in the course of it judgments that assist in providing a definition.

[199] Article 2(1) TFEU.

[200] Isenbaert [2009] ECTR page 267.

[201] Ibid. page 278.

[202] "…direct taxation does not as such fall within the purview of the Community…" *Schumacker* [1995] Case C-279/93 paragraph 21.

[203] "… it must be stated that it is for each Member State to organise…its system for taxing distributed profits and, in particular, to define the tax base and the tax rate which apply to the company making the distribution and/or the shareholder receiving them, in so far as they are liable to tax in that Member State." *FII GLO* [2006] Case C-446/04 paragraph 47 (emphasis added). Echoed and expanded by dos Santos [2016] ECTR at page 298: "The power of a jurisdiction to impose (or not) taxes is one the classical features of tax sovereignty … In this regard, the State … can choose the level of imposition adequate and necessary to finance its public expenditures, the structure of tax system …".

In the absence of any harmonisation measures, the Member States retain "…*power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation*…"[204]. That right to determine the tax base, termed by the Court in the context of cross-border activity as the allocation of taxing powers or similar, and the right to protect the tax base so determined, must be distinguished from national measures taken to prevent diminution of tax revenues, which cannot be justified on that ground alone[205].

The right of a Member State to determine its tax base "…*in conformity with the fiscal principle of territoriality*…"[206] was recognised by the Court in *Futura* [1997][207] and was re-affirmed in *Gilly* [1998]. In *Gilly* [1998], the taxpayer claimed to offset foreign tax suffered by her on her foreign earnings against home state tax levied on her other taxable income arising in the home state and the Court declined to rule that the Treaty required the acceptance of that claim[208]. The Court said that to permit such an offset and consequential loss of tax revenue: "…*would thus be such as to encroach on [the home state's] sovereignty in matters of direct taxation*"[209].

The right to levy tax on gains arising to a taxpayer during his period of residence in the territory was confirmed by the Court in *National Grid Indus* [2011][210] despite those gains not having been realised.

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[204] *van Hilten* [2006] Case C-513/03 paragraph 47.

[205] *ICI* [1998] Case C-264/96 paragraph 28 and *Saint-Gobain* [1999] Case C-307/97 paragraph 50 *Marks & Spencer* [2005] Case C-446/03 paragraph 44.

[206] In the introduction to his article, van Apeldoorn notes that there is some dissention amongst commentators over the allocation of passive income under the BEPS proposals. Aside from that, citing the OECD 2017 Transfer Pricing Guideline, he opines that "…the BEPS initiative should restore the capacity of states to exercise 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'." van Apeldoorn [2019] BTR page 557.

[207] *Futura* [1997] Case C-250/95 paragraphs 20-22. Tax residents being subject to tax on income etc generated in the territory and (subject to some exceptions) elsewhere whilst non-residents are subject to tax only on income etc generated in the territory. The Court expressly confirmed the right of Member States to determine their tax bases in conformity with the territoriality principle in *Marks & Spencer* [2005] Case C-446/03 paragraph 39 saying: "….recognised in Community law…".

[208] See also *ACT IV GLO* [2006] Case C-374/04 paragraph 59 (emphasis added): The suggestion put to the Court was that the state of residence of a company paying a dividend should be responsible for ensuring that a foreign shareholder would not suffer economic double taxation of that source of income either by exempting the profits distributed by the company or by refunding to the foreign shareholder a proportionate amount of the tax paid by the company on the profits distributed. The Court responded to that suggestion saying that to require that: "…*would mean in point of fact that that State would be obliged to abandon its right to tax a profit generated through an economic activity undertaken on its territory*".

[209] *Gilly* [1998] Case C-336/96 paragraph 48. The principle of retained sovereignty to define taxing jurisdiction appears to be firstly specifically acknowledged in paragraph 30: "...the contracting parties' competence to define criteria for allocating their powers of taxation as between themselves…".

[210] *National Grid Indus* [2011] Case C-371/10 paragraph 46.

In recognition of the retained competence of Member States to determine their respective tax bases and to allocate taxing powers between themselves through double tax treaties, the Court formulated a ground for justification in *Marks & Spencer* [2005][211] as "*the allocation of the power to impose taxes*". The Court is simply recognising that the Member States have retained that competence and have not ceded it to the Union[212]. That competence applies not only to the taxation of profits, gains and income but also to the tax relief granted for losses[213].

Thus, subject to the *proviso* that "… *the freedoms of movement guaranteed by the Treaty [are] respected* …"[214], the Member States are free to define their systems for levying direct taxation as they wish[215].

However, 'respect' for EU law can be very inhibiting and where "…*in exercising their technically exclusive powers, Member States find themselves significantly constrained by EU law*…" it has been referred to as "*reverse subsidiarity*"[216].

The guidance that may be drawn from the case law is that the Court has acknowledged that the right to design direct taxation schemes, determine their tax bases, set the rates of tax and determine the methods of assessment and collection all remain with the Member States[217].

The Member States may exercise wide discretion when they legislate but, as stated in the passage from *Verest* [2014] noted *ante*, must do so retaining 'respect' or regard for EU law. In the context of Member States' direct tax provisions, the EU law that must be respected will be, principally, the Treaty freedoms of movement and fundamental rights[218].

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[211] *Marks & Spencer* [2005] Case C-446/03 paragraph 45. The Court has also termed it "balanced allocation…" in, for instance, *Cadbury Schweppes* [2006] Case C-196/04 paragraph 56. See also Turner [2013] ITR (Pt.1) and Turner [2013] ITR (Pt.2) .

[212] "Competences not conferred upon the Union in the Treaties remain with the Member States." Article 5(2) TEU.

[213] *Marks & Spencer* [2005] Case C-446/03 paragraph 43 "…in tax matters profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system…". The right to preserve that symmetry was affirmed by the Court in *K* [2013] Case C-322/11 paragraph 55: "…the refusal to allow deduction of losses arising from the sale of immovable property situated in France permits the symmetry between the right to tax profits and the right to deduct losses to be safeguarded. The measure also contributes to the objective of ensuring a balanced allocation of the power to impose taxes between the Member States".

[214] *Verest* [2014] Case C-489/13 paragraph 20. See also *Costa v E.N.E.L* [1964] Case 6/64 paragraph 3.

[215] See, for instance, *Futura* [1997] Case C-250/95 paragraph 33. See also *X (fairness tax)* [2017] Case C-68/15 paragraph 41, *DMC* [2014] Case C-164/12 paragraph 47 and *Banco Bilbao Vizcaya Argentaria* [2011] Case C-157/10 paragraph 29.

[216] Panayi [2010] BTR page 267.

[217] See FNs 203 & 215.

[218] Encoded into the Charter and regarded as included in the Treaties since the coming into force of the Lisbon Treaty (1 December 2009) Art 6(1) TEU. See also *Global Starnet* [2017] Case C-322/16

A national provision that treats a person exercising a freedom of movement 'less favourably' and causes there to be an infringement of the Treaty right might nevertheless be 'justified' and permitted provided also that it is proportionate to achieve the objective sought.

It has been clear since *Dassonville* [1974][219] that national rules considered to be in the public interest may interfere with Treaty rights provided that they do not "*constitute a means of arbitrary discrimination or a disguised restriction on trade between Member States*"[220].

The grounds for justification that have been accepted by the Court for infringements of the freedoms of movement by national direct tax provisions reflect aspects of the sovereignty retained by the Member States in that area of competence. The grounds for justification accepted by the Court are discussed in more detail in chapters 4 & 5.

2.4 Direct tax sovereignty – principal aspects.

In formulating a model for defining the primary aspects of direct tax sovereignty[221] [222] [223] to enable them to be related to the grounds for justification

paragraph 44: "…when a Member State relies on overriding requirements in the public interest in order to justify rules liable to obstruct the exercise of…[freedoms of movement]…such justification must also be interpreted in the light of the general principles of EU law, in particular the fundamental rights now guaranteed by the Charter of Fundamental Rights. Thus, the national legislation in question can fall under one of the justifications provided for only if it is compatible with those principles and those rights…".

[219] *Dassonville* [1974] Case 8/74 paragraphs 6 & 7.

[220] This is the *proviso* in the last sentence of Article 36 TFEU and is mirrored in Article 65(3) TFEU. This simple formulation defines the essence of a restriction that cannot be justified on any public interest ground whether by reason of the nature of the restrictive provisions or by reason of their lack of proportionality.

[221] Schon W [2010] BTR page 554 "Both the internal law of a sovereign state and the doctrine of international jurisdiction start from the assumption that this binary nature of statehood--the power over a well-delineated territory and the power over a particular set of subjects--forms the basic building block of the international allocation of taxing rights. Such taxing rights can be founded on the relationship to a person (i.e. what is usually called the "personal attachment" to a state) or it can be based on the relationship to a territory (i.e. what is usually called the "territorial attachment" to a state). There is no power to tax unless there is a genuine link available to a state's personal or territorial realm".

[222] Ghosh (2007) page 2: "There is a consensus that a taxing State must establish some sort of "reasonable link" between it and the subject-matter of its tax jurisdiction for the imposition of tax to have legitimacy".

[223] Schon [2015] BFIT page 283: "… Irrespective of whether territorial limitations are based on international customary law, bilateral conventions or unilateral legislation, the limits of territoriality provide a mandatory or voluntary constraint to the fiscal autonomy of a Member State and do not extend its powers with regard to other Member States or taxpayers …".

defined by the Court, regard has been had for the matters generally addressed in double tax treaties[224].

The requisite connecting factors defining taxing jurisdiction were formulated in simple terms by Lord Herschell in 1889 in the United Kingdom House of Lords: "*The Income Tax Acts, however, themselves impose a territorial limit; either that from which the taxable income is derived must be situate in the United Kingdom or the person whose income is to be taxed must be resident there"*[225].

Lord Herschell is referring to two of the three recognised criteria upon which states base their national direct tax systems: a source within the territory or tax resident status of the beneficiary, these being the "*connecting factors for the purpose of allocating jurisdiction*" referred to by the Court in *Gilly* [1998], paragraph 25.

The third is citizenship[226] or nationality, used more rarely for taxing income, profits and gains though not uncommon for levying death duties[227].

Schematically[228], the two principal expressions of direct tax sovereignty, the power to determine the tax base (who is to be taxed and what is to be taxed) and the power to determine the schemes of taxation (what taxes, their rates, the assessment rules, the deduction rules and how they are to be collected), may be related to the grounds for justification formulated by the Court as shown in the diagram below.

The right to determine taxing jurisdiction, that is, the tax base, will embody the right to protect that tax base from erosion through avoidance or evasion by taxpayers[229].

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[224] Panayi (2007) page 29: "In my view, the allocation of jurisdiction has become the primary objective of tax treaties…This objective is often neglected and under the shadow of the more popular 'elimination of double taxation' flagship."

[225] *Colquhoun v Brooks* Case (1889) L.R. 14 App. Cas. 493 Lord Herschell at page 504. This formulation was cited with approval subsequently, for instance by Lord Scarman at page 145 in *Clark v Oceanic Contractors* Case [1983] 2 A.C. 130.

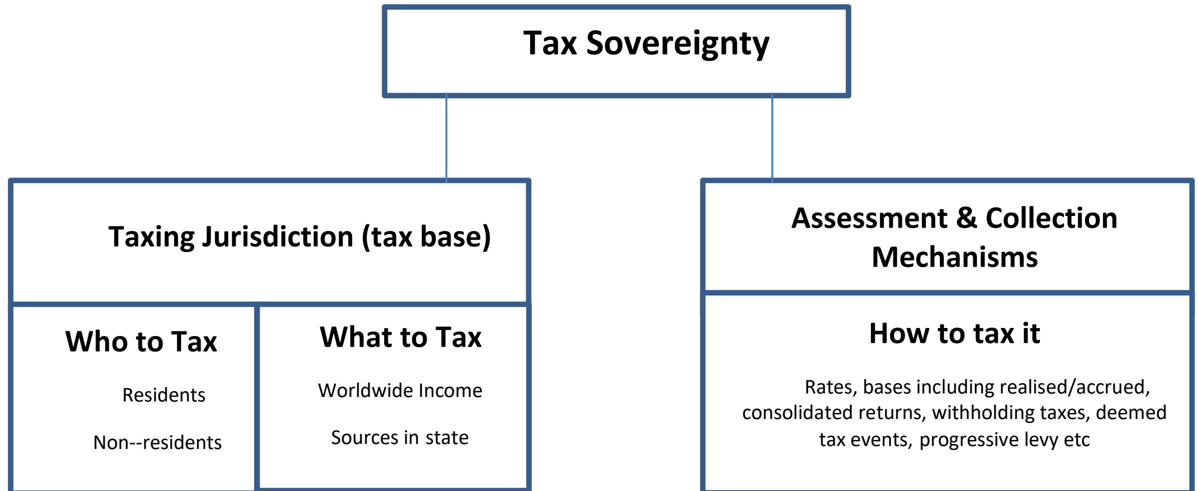
[226] The US has used this basis since 1913.

[227] An example examined in the case law is *van Hilten* [2006] Case C-513/03. The UK uses a concept of 'Domicile'.

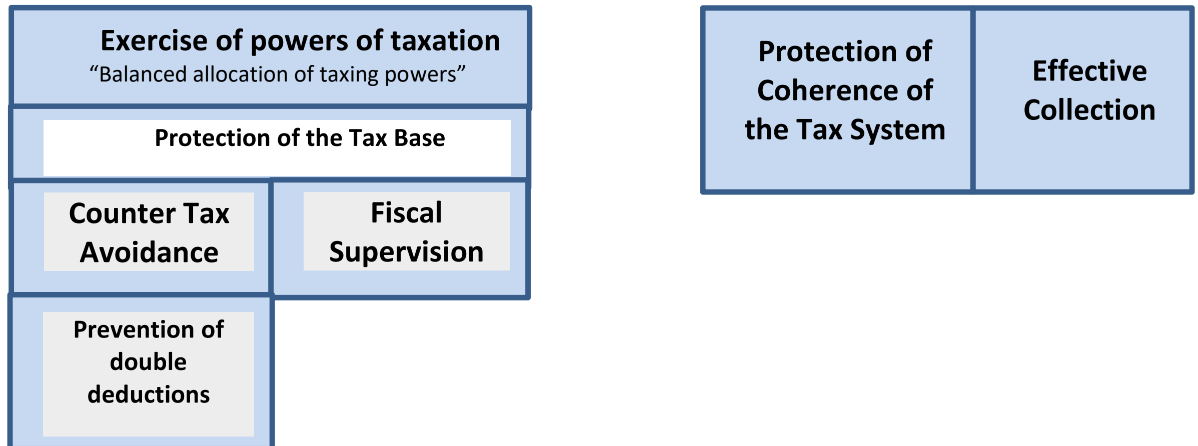
[228] See Turner [2013] ITR (Pt.1) Page 2.

[229] Protection of the tax base is variously expressed as: 'countering tax evasion', 'countering tax avoidance', 'fiscal supervision' and 'prevention of double deductions' according to the particular objective of the national provision.

Member State sovereignty in the field of direct taxation – is the failure of the Court of Justice in some instances to provide a consistent and coherent scheme of analysis of alleged restrictions to the exercise of the freedoms of movement a consequence of activism, error or both?



Grounds for Justification



The grounds for justification are discussed in detail in Chapters 4 & 5 of this thesis.

However, whilst most of the grounds for justification are relatively self-apparent, the ground for justification 'protection of the coherence of the tax system' was not properly understood for many years after being introduced in *Commission v Belgium (pension deductions)* [1992][230].

It is possible that a national direct tax provision that infringes a Treaty right of movement can be justified on more than one ground. In *Marks & Spencer* [2005]

[230] *Commission v Belgium (pension deductions)* [1992] Case C-300/90 and *Bachmann* [1992] Case C-204/90. The thinking behind the justification was explained by the Court in *Manninen* [2004] Case C-319/02 paragraph 47. That thinking is explained in chapter 4.4.i *post*. Between *Bachmann* and the next case in which the justification was accepted, *Krankenheim Ruhesitz [2008] Case C-157/07*, the Court heard some 30 cases in which the justification was advanced in defence of an infringement.

the Court considered three grounds for justification put forward by the United Kingdom and held: "*In the light of those three justifications, taken together, … constitute overriding reasons in the public interest … "* [231].

Provisions of national taxing schemes, at one and the same time, may be justified by reference to both the right to exercise taxing powers and the right to protect the coherence of the tax system[232]. The Court noted that such was the case in the context of 'exit taxation' where a national provision triggers a taxation event upon the tax migration of a taxpayer[233].

2.5 INFRINGEMENTS OF THE TREATY FREEDOMS OF MOVEMENT.

Infringements of the Treaty freedoms of movement are discussed more fully in chapter 3 *post* but some introduction is necessary to define where Member State direct tax sovereignty will have to yield to EU law.

For there to be an infringement of a Treaty right of freedom of movement:

- The person exercising (or seeking to exercise) a Treaty freedom of movement must suffer a disadvantage and be treated 'less favourably' than persons who have not, and that must be in direct consequence of, and only because of, the exercise of the freedom of movement[234].

- That disadvantage must accrue to him as a result of the legislation of the exit state or of the host state but not as a result only of differences ('disparities') in the legislation of the two states[235]; and nor,

[231] *Marks & Spencer* [2005] Case C-446/03 paragraph 51. The justifications considered were the right to exercise taxing powers; the right to prevent double deduction; and the right to prevent tax avoidance. The Court recognised them as different facets of the exercise of taxing powers but the question of whether a restriction was caused by the UK tax provisions is discussed in chapter 6.2.ii *post*.

[232] For instance: assessment on an accruals basis, year by year, or upon a realisation.

[233] See *National Grid Indus* [2011] Case C-371/10 paragraph 80.

[234] "… the refusal of the Member State … to grant an allowance provided for under its tax legislation penalises non-resident taxpayers … simply because they have exercised the freedoms of movement guaranteed by the FEU Treaty." *Commission v Estonia (pensioner allowances)* [2012] Case C-39/10 paragraph 56.

[235] "… It follows from that tax competence that the freedom of companies and partnerships to choose, for the purposes of establishment, between different Member States in no way means that the latter are obliged to adapt their own tax systems to the different systems of tax of the other Member States in order to guarantee that a company or partnership that has chosen to establish itself in a given Member State is taxed, at national level, in the same way as a company or partnership that has chosen to establish itself in another Member State …" *Columbus Container* [2007] Case C-298/05 paragraph 51.

- Should that disadvantage accrue only because the two states are exercising their rights of taxation in parallel[236].

To determine whether a person exercising a freedom of movement or seeking to do so is treated 'less favourably' or would be if he did so, it is necessary to compare the consequences to that person under the national provision with the situation of a person under national law who is a resident of the host state or, as the case may be, what the situation of the person exercising the freedom of movement would have been had he not exercised the freedom of movement.

The principles developed by the Court in conducting a comparability of situations to determine the existence of a restriction to the exercise of a Treaty freedom of movement are discussed in chapter 3.4 *post* but the Court has accepted that "… *In relation to direct taxes, the situations of residents and of non-residents are not, as a rule, comparable* …"[237].

Some uncertainty was introduced when the Court, in *Marks & Spencer* [2005], ruled: "… *the fact that it does not tax the profits of the non-resident subsidiaries … does not in itself justify restricting group relief to losses incurred by resident companies* …"[238]. This ruling appears to contradict its ruling in *Avoir Fiscal* [1986][239].

The departure is discussed in Part II *post* and is considered to be fundamental to the confusion that has arisen in relation to 'final losses'.

2.6 INFRINGEMENTS THAT CANNOT BE JUSTIFIED.

Where a national direct tax provision infringes a provision of EU law in an area of exclusive competence, whether by reason of the EU having legislated in that area or whether in contravention of a Treaty rule[240], the national provision must be regarded as overridden. It must be recognised that the Member States have ceded their sovereignty in such areas and, consequently, there is no ground on

[236] "… the adverse consequences which might arise from the application of an income tax system such as the Belgian system at issue in the main proceedings result from the exercise in parallel by two Member States of their fiscal sovereignty." *Kerckhaert & Morres* [2006] Case C-513/04 paragraph 20.

[237] *Schumacker* [1995] Case C-279/93 paragraph 31.

[238] *Marks & Spencer* [2005] Case C-446/03 paragraph 40.

[239] "… By treating the two forms of establishment in the same way for the purposes of taxing their profits … there is no objective difference between their positions in regard to the detailed rules and conditions relating to that taxation which could justify different treatment …" *Avoir Fiscal* [1986] Case 270/83 paragraph 20.

[240] Such as the State Aid prohibition: See *Luxembourg v Commission (state aid)* [2021] Case T-516/18 & T-525/18 paragraphs 139 to 141.

which the national provision can be justified except for any expressly provided in the EU measure[241].

Direct taxation is an area of competence that has been subject to harmonisation in relation to only a limited number of specific matters[242].

Where a national direct tax provision applies a disadvantageous treatment on the ground of nationality the infringement can be justified only on grounds provided in the Treaty by derogation.

These areas in which infringements of Treaty rights cannot be justified by reference to 'reasons in the public interest' are explored further in the sections following.

2.6.i Areas of exclusive competence.

The Member States' freedom to legislate in such fields is prohibited unless expressly authorised. The rationale for this ruling by the Court is explained by it in its judgment in *Walt Wilhelm* [1969] in which the Court addressed the situation where national rules coexisted with EU measures in the same field that is now defined as a field of exclusive competence[243].

The rationale for the prohibition of national rules is the need for common rules to be applied uniformly throughout the Internal Market and thus the need for EU measures to give effect to that objective.

An exclusive competence may be expressly limited to a specified situation in a field not otherwise within the competence of the EU. Such is the case for the taxation of salaries and other benefits paid to EU officials and the relevant

[241] For instance, Article 15 of the Mergers Directive (anti-abuse).

[242] The harmonisation measures are Council Directives made under Article 115 TFEU: 2011/96/EU (Parent-Subsidiary), 2009/133/EC (Merger), 2003/49/EC (Interest-Royalty) and 2003/48/EC (Savings) as well as 2011/16/EU (Administrative Cooperation ['DAC'] – replacing the Mutual Assistance Directive), 2010/24/EU (Mutual Assistance for the Recovery of claims Directive – amended by (EU) 2015/2376, (EU) 2016/ 881 and (EU) 2018/822 to include mandatory automatic exchange of information), 2016/1164/EU (Anti-Tax Avoidance Directive) and (EU) 2017/1852 (Tax Dispute Resolution Directive). Infringements of these directives can only be justified by reference to derogations in the Directive itself: by analogy *Tedeschi* [1977] Case 5/77 paragraph 35. In relation to the administrative directives, see Panayi [2019] DLR pages 35-45

[243] The competition rules in Article 101 TFEU and the prohibition of 'cartels'. This is now expressly a field of exclusive competence: Article 3(1)(b) TFEU. In *Walt Wilhelm* [1969] Case 14/68 paragraph 6 (emphasis added), the Court said: "…It would be contrary to the nature of such a system to allow Member States to introduce or to retain measures capable of prejudicing the practical effectiveness of the Treaty. The binding force of the Treaty and of measures taken in application of it <u>must not differ from one state to another as a result of internal measures</u> …conflicts between the rules of the Community and national rules in the matter of the law on cartels must be resolved by applying the principle that Community law takes precedence."

regulations were examined by the Court in *Humblet* [1960][244] and, more recently, in *Bourges-Maunoury* [2012][245]. The Court ruled that Member States are prohibited from imposing any taxation burden on such persons by taking any account of EU remuneration paid to them, no matter how indirect.

2.6.ii Areas subject to harmonisation.

Where a Member State exercises its competence in relation to direct taxation in an area that has been subject to harmonisation, the Member State is bound by the provisions of the harmonisation measure in relation to matters specifically addressed by it. That was the circumstance considered by the Court in *Cobelfret* [2009][246].

A harmonisation measure may, however, define matters that are to remain within the competence of the Member States[247]. An example of that is what is now Article 15(1)(a) of Council Directive 2009/133/EC (Mergers), which is

[244] *Humblet* [1960] Case 6/604 A at page 577 In *Humblet,* the complaint was that EU remuneration was taken into account by Belgium for determining the income tax rate under its progressive rate system that was to be applied to the non-EU income of the official and his wife. Accordingly, his non-EU income was charged to Belgian tax at a rate that was higher than the rate that would have applied had he not been in receipt of the EU income.

[245] *Bourges-Maunoury* [2012] Case C-558/10 In *Bourges-Maunoury,* the tax in issue was French wealth tax. Although the tax was not assessed on income, the national provisions required that account be taken of the taxpayer's income to set a maximum amount of wealth tax payable by him so as to ensure that the taxpayer could service the wealth tax payment obligation without having to realise capital assets. The French authorities took account of the EU income to set the cap on the amount of wealth tax payable. In Paragraph 30 the Court said:"…given that the income paid by the Union and subject to the Union's own tax cannot be taxed either directly or indirectly by a Member State and given that it is withdrawn from the tax sovereignty of the Member States, a person in receipt of such income is also exempt from any obligation to declare the amount of such income to the authorities of a Member State". (emphasis added).

[246] "…It is only in the absence of unifying or harmonising Community measures that it is for the Member States, which retain the power to define, by treaty or unilaterally, the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation, to take the measures necessary to that end…" *Cobelfret* [2009] Case C-138/07 paragraph 56 (emphasis added). The harmonisation measure in question was Council Directive 90/435 (Parent / Subsidiary directive) and Article 4(1), in particular, which provides that the state of residence of a parent company must either exempt from tax a dividend received by the parent company from a subsidiary resident in another Member State or grant the parent company a credit against tax assessed on the dividend for the tax borne by the distributing company. The Belgian rule, held by the Court to infringe Article 4(1), provided that such a dividend should be regarded as taxable income where the parent sustained tax-adjusted losses in the period of receipt of the dividend. The consequence of that Belgian rule was that the losses that could be carried forward to a subsequent period were reduced by the amount of the dividend, which was taxed without there being any means of obtaining credit for the dividend underlying tax. The Court also noted in Paragraph 64 that: "The obligation to refrain from taxing profits which a subsidiary distributes to its parent company, set out in the first indent of Article 4(1), is worded in unequivocal terms and is not subject to any condition…" (emphasis added).

[247] The Court referred to it as a "*reservation of competence*": *Leur-Bloem* [1997] Case C-28/95 paragraph 39.

concerned with abusive use that might be made of the reliefs provided in that measure. It permits "*A Member State…[to]…refuse to apply or withdraw the benefit of all or any part of [the reliefs provided]*".

The Court ruled in *Kofoed* [2007] that a Member State is not obliged to specifically transpose such a provision into national law in order to utilise the relaxation in the Directive if it has "…*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 15(1)(a) of Directive 2009/133]*…"[248].

Whilst the Court ruled in *Kofoed* [2007] that the relaxation in the Directive, Article 15(1)(a), cannot be the legal basis upon which a Member State may deny the reliefs claimed under the directive, and that the Member State must have appropriate domestic anti-avoidance or anti-abuse legislation whether enacted specifically to prevent abuse of the reliefs provided by the Directive (or whether having general application)[249], the Court, in 2019, revised that ruling. It said that "…*notwithstanding*…" that judgment, even if "…n*ational law does not contain rules which may be interpreted in compliance with…[the Directive]…the national authorities and courts [are not] prevented from refusing [the EU law benefits] in the event of fraud or abuse of rights*"[250].

2.6.iii Express Treaty prohibition – discrimination on the ground of nationality.

Where the Treaty provides an express prohibition, such as in Article 18 TFEU[251] (the prohibition of discrimination on the ground of nationality), an infringement of the prohibition by a national rule can be justified only on grounds (derogations) specified in the Treaty[252]. Whilst Article 18 provides no such grounds, the

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[248] *Kofoed* [2007] Case C-321/05 paragraph 46.

[249] Ibid. paragraph 42: "…the principle of legal certainty precludes directives from being able by themselves to create obligations for individuals. Directives cannot therefore be relied upon per se by the Member State as against individuals…". However, the refusal to grant a right or benefit under EU law sought on the basis of "abusive or fraudulent acts…does not amount to imposing an obligation on the [claimant]" *N Luxembourg & Others* [2019] Case C-115/16 C-118/16 C-119/16 C-299/16 paragraph 119. The question of whether there should be horizontal application of directives is discussed at length in Craig [2009] ELR . It is noted in Chalmers [2021] ELR at page 293 that the CJEU has only identified 6 Treaty provisions and 1 Regulation provision that have direct horizontal effect.

[250] *N Luxembourg & Others* [2019] Case C-115/16 C-118/16 C-119/16 C-299/16 paragraph 117.

[251] The Court held in *Commission v Greece (land ownership)* [1989] Case 305/87 paragraph 13 that Article 18 TFEU: "…applies independently only to situations governed by Community law in regard to which the Treaty lays down no specific prohibition of discrimination." Also confirmed in *Royal Bank of Scotland* [1999] Case C-311/97 paragraph 20.

[252] A special exception to this general rule can be found in the field of sport where a competitor representing a particular nation in an international sporting event can be expected to have the nationality of the country that they are representing although such expectation cannot "…systematically justify any restriction on the participation of non-nationals in the national championships." *TopFit & Biffi* [2019] Case C-22/18 paragraph 54. The restriction must be proportionate.

provision, by its wording, only has application where no other, more specific, provision has application. In this respect, the Internal Market freedoms of movement are regarded as being "*special provisions*" referred to in Article 18.

- With regard to Art. 45 TFEU[253].
- With regard to Art. 49 TFEU[254].
- With regard to Art. 56 TFEU[255].
- With regard to Art. 63 TFEU[256].

It should be noted that although the right of every Union citizen to freely move and reside in any Member State provided by Art. 21 TFEU contains no express non-discrimination provision, a citizen who exercises this right and is "*lawfully resident in the territory of a host Member State*" can rely upon Art. 18 TFEU[257].

2.7 Common Consolidated Corporate Tax Base[258].

The directive published as a proposal on 25 October 2016 would establish a common tax base for groups having consolidated revenue of in excess of Euro 750 million. It is proposed as a harmonising measure but, once fully rolled out, will create a wholly new system for taxing large groups. Taxation of domestic businesses and smaller groups would still remain within Member State sovereignty. The choice of legal base is (again) in question.

The powers that Member States will or might cede in relation to the CCCTB project, of which this is the first stage, will amount to a partial ceding of competence and a reduction of Member State sovereignty in this field.

2.8 Concluding comments.

The retained sovereignty of the Member States in the field of direct taxation is reflected in their acknowledged right to "*organise…its system for*

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[253] "In the field of freedom of movement for workers, the prohibition of discrimination has been specifically implemented and embodied in Article [45 TFEU]…" *Gilly* [1998] Case C-336/96 paragraph 38.

[254] "…in relation to the right of establishment, the principle of non-discrimination was implemented and specifically laid down by Article [49 TFEU]…"*Metallgesellschaft* [2001] Case C-397/98 & C-410/98 paragraph 39.

[255] "With regard to freedom to provide services, this principle is given specific expression and effect by Article [56 TFEU]. There is therefore no need to rule on the interpretation of Article [18 TFEU]" *Vestergaard* [1999] Case C-55/98 paragraph 17.

[256] "The Treaty lays down in Article [63 TFEU], in particular, a specific rule of non-discrimination in relation to the free movement of capital…" *Hollmann* [2007] Case C-443/06 paragraph 29.

[257] *Grzelczyk* [2001] Case C-184/99 paragraphs 32 and 33.

[258] Com (2016) 685 a 'relaunch' (first of two measures) of the Common Consolidated Corporate Tax Base, first proposed in 2011 (but challenged by the author with TAXUD in October 2011).

[taxation]…and…to define the tax base and the tax rate…"[259] albeit that, in the exercise of the retained sovereign powers in this field: "…*the Member States must nevertheless be…consistent[...] with Community law*"[260].

In preparation for the discussion of the grounds for justification of infringements of Treaty freedoms of movement by direct tax provisions, exercise of 'sovereignty' in this field has been identified as consisting basically of two arms: the first is the retained power to define taxing jurisdiction – that is, the power to define who is to be taxed and on what they should be taxed; and the second is the retained power to devise the schemes under which they will levy tax (including the mechanisms for assessment and collection) and the setting of the rates to be applied.

The Court has formulated three grounds for justification related to protection of the tax base and they have been grouped under the first arm as the right to define the tax base is illusory if there is not also the right to protect it from avoidance practices.

This analysis of the sovereign rights retained in the field of direct taxation reflects the broad scheme of double tax treaties in which contracting states allocate their taxing powers between them and modify their respective schemes of taxation in specific instances where a person is within the taxing jurisdiction of both contracting states with regard to specified items of income, profit or gain.

The grounds for justification formulated by the Court are discussed in chapters 4 & 5 *post*.

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[259] *FII GLO* [2006] Case C-446/04 paragraph 47 (adapted).

[260] *Schumacker* [1995] Case C-279/93 paragraph 21 (adapted).

3 INFRINGEMENTS OF TREATY FREEDOMS OF MOVEMENT

3.1 INTRODUCTION TO THE CHAPTER.

Only very rarely will a direct tax provision or related legislation expressly obstruct a freedom of movement[261] and such provisions will be disregarded.

The focus of this chapter is on restrictions resulting from national tax rules that give rise to a disadvantage to a person exercising a freedom of movement[262].

For a national rule to be restrictive, it is necessary for it to create a disadvantage that accrues to the person exercising the freedom of movement, or seeks to do so[263], but that is not sufficient in itself[264]. It is also necessary for the disadvantage to accrue to the person exercising the freedom of movement "…*simply because they have exercised the freedoms of movement guaranteed by the FEU Treaty*…"[265] and, in most cases, for the situation of that person to be "*objectively comparable*" to that of a person engaged only in domestic transactions who does not suffer that disadvantage[266].

There has been much discussion as to whether 'discrimination' *per se* gives rise to an infringement of the Treaty freedoms. However, having regard to the objective of the freedoms of movement - the creation of the Internal Market - a

[261] See, for example *Daily Mail* [1988] Case 81/87: UK anti-avoidance law (now repealed) made it unlawful for a company to transfer its central management and control without Treasury consent. The Court ruled that such a right of movement could not be construed from Article 49 TFEU. See also *Aladzhov* [2011] Case C-434/10 in which a Bulgarian provision of national law was used to prohibit the free movement of a national until that state had recovered an outstanding tax debt. In principle, such a provision is permitted provided that it is used in circumstances made exceptional by reason of the nature and size of the debt.

[262] The potential for taxation to cause restrictions to the freedom of establishment was specifically noted in the 'General Programme for the abolition of restrictions on freedom of establishment' 36/62 published on 15 January 1962 under Title III A.(e) "…make the taking up or pursuit of an activity as a self-employed person more costly by [or] through taxation or other financial burdens…". A similar provision can be found in 32/62 published the same day in relation to the 'General Programme for the abolition of restrictions on freedom to provide services'.

[263] "… all measures which prohibit, impede or render less attractive the exercise of … [a] … freedom must be regarded as obstacles …" *Deutsche Shell* [2008] Case C-293/06 paragraph 28.

[264] The Court observed in *Columbus Container* [2007] Case C-298/05 paragraph 38 that even though the German CFC provisions triggered by the low rate of taxation borne by the Belgian limited partnership had "… the effect of rendering the pursuit of Columbus' activities more expensive … this does not necessarily mean that those provisions constitute a restriction on the freedom of establishment …". The reason for that was that the German partners were taxed no heavier than would have been the case had the partnership been established in Germany.

[265] *Commission v Estonia (pensioner allowances)* [2012] Case C-39/10 paragraph 56.

[266] The Court made this preliminary observation in *NN*: "In order for the law of a Member State to constitute a barrier to the freedom of establishment of companies, it must result in a difference in treatment to the detriment of the companies exercising that freedom; that difference in treatment must relate to objectively comparable situations and…": *NN* [2018] Case C-28/17 paragraph 18 (emphasis added).

better view might be that discriminatory provisions that create a disadvantage to a person exercising a freedom of movement are likely to distort competitiveness by creating additional costs to arise to such persons[267] [268]. That, in turn, will act as an obstruction or deterrent to the exercise of the freedoms of movement[269].

This chapter proceeds, first, with a review of the Treaty provisions and 'discrimination' in the context of those provisions and then a review of some of the discussion distinguishing between 'discrimination' and 'restriction'.

3.2 DISCRIMINATION' IN THE CONTEXT OF THE FREEDOMS OF MOVEMENT[270].

When examining a Treaty provision, it is necessary to take account not only of its wording but also of its context and its objectives[271]. The Internal Market is defined in Title I of Part 3 TFEU (Article 26(2)) as "*…an area without internal frontiers in which the free movement of goods, persons, services and capital is ensured…*".

The provisions relating to the free movement of persons, services and capital are to be found in Title IV (Articles 45 to 66). It is the Title IV freedoms of movement that will be considered in this section.

It is to be noted that the freedom of movement of persons is addressed in three chapters: the first relating to employed persons ('workers'); the second relating to self-employed persons, including legal persons ('establishment'); and the third relating to provision of services ('services') [272].

Whilst a particular situation could engage more than one of the principal freedoms of movement, the freedoms of movement of persons are "*mutually*

[267] "… It is not disputed that this gives the subsidiary of a parent company resident in the United Kingdom a cashflow advantage inasmuch as it retains the sums which it would otherwise have had to pay by way of ACT until such time as MCT becomes payable …" *Metallgesellschaft* [2001] Case C-397/98 & C-410/98 paragraph 44.

[268] "One can, therefore, read the history of direct tax cases under EU law as an evolution from a limited concept linked to discrimination of persons on the basis of their nationality (Werner 112/91) to a simultaneously simple and far-reaching prohibition on cross-border tax obstacles to economic entities and transactions in general." Schon [2015] BFIT page 273.

[269] "A tax as such, or a particular tax provision, can be neutral if it does not exercise any influence on the decision of a person to act in a specific manner." Ibid. page 272.

[270] Richard Lyal of the EU Commission legal services in 2015 acknowledged: "…just what constitutes discrimination, just what sort of obstacles to free movement are nevertheless compatible with the common market is a difficult question. The interest in freedom of movement…is not always easy to reconcile with the interest of Member States in ensuring that they are able to tax economic activity taking place on their territory." Lyal [2015] ECTR at page 8.

[271] See, for instance, *Nordina Finans* [2008] Case C-98/07 paragraph 17.

[272] The freedom to provide services embodies a freedom of movement of persons to provide or to receive such services.

exclusive"[273]. Each freedom of movement has its own "*field of application*" [274] and, where more than one of the principal freedoms might apply, account will be taken of "*the purpose of the legislation*"[275].

Thus, while all of the freedoms of movement defined in Title IV have a common objective of enabling the formation of the Internal Market, each of the freedoms of movement is designed to regulate "*different situations*" and the wording of the non-discrimination provision within each will reflect the situation addressed by the provisions.

The nature of the Internal Market and that of infringements of its specific rules is discussed in later in this chapter 3.3.i as well as what was termed by Advocate General Bobek in his Opinion delivered in relation to *Hornbach-Baumarkt* [2017][276] as the Court's "*discrimination approach*" to analysis.

All infringements of the Internal Market rules are restrictions and, whilst the Court often makes reference to discrimination on the ground of nationality, which would not be open to justification on public interest grounds, and to 'indirect discrimination', there are relatively few cases that concern that basis of discrimination[277].

Indeed, where a person suffers a disadvantage from the application of a discriminatory rule applied to him by his state of origin because he has taken up residence in another Member State, Treaty protection is available to him despite it being impossible for the disadvantage to arise as a result of discrimination on the ground of nationality[278].

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[273] *Gebhard* [1995] Case C-55/94 paragraph 20.

[274] *Fidium Finanz* [2006] Case C-452/04 paragraph 28.

[275] *FII GLO (2)* [2012] Case C-35/11 paragraph 90. The Court then explains in Paragraphs 91 to 104 that: where a provision is targeted "exclusively" at situations where a shareholding is acquired to exert "definite influence" in a company, only Art.49 will apply. Where the provision is NOT targeted "exclusively" at such situations, Art.63 will apply in situations where the shareholding provides "definite influence" but Art 49 cannot apply. Art.63 will apply where the shareholding is acquired only as an investment. See also Turner [2008] ECTJ Conclusion: "…where the national provision is designed or intended to apply only to controlling investments in companies, Article 43 EC is engaged and is exhaustive**…".**

[276] *Hornbach-Baumarkt (AGO)* [2017] Case C-382/16.

[277] However, see *Gottardo* [2002] Case C-55/00 and *Matteucci* [1988] Case 235/87 for instances where discrimination on the ground of nationality occurred. Both cases involved bilateral agreements: *Gottardo* concerned a bilateral agreement between Italy and a third country, Switzerland, and *Matteucci* concerned a bilateral agreement between Belgium and Germany. See also *Halliburton* [1994] Case C-1/93 which concerned the denial of a Dutch exemption from property transfer duty to a German company trading in the Netherlands when it transferred its branch activity to a sister Dutch company on the ground that the transferor was not a company formed under Dutch law.

[278] See *Asscher* [1996] Case C-107/94 Mr Asscher was a Dutch national who resided in Belgium and conducted his occupation in both territories. He was subjected to discriminatory tax treatment of his earnings in the Netherlands by a Dutch rule applicable to non-residents.

Not all distinctions made on the basis of nationality are regarded as discrimination on that basis. For instance, the Court expressly stated in *Gilly* [1998] that the reference to nationality in a double tax treaty was evidently "…*for the purpose of allocation of fiscal jurisdiction, such differentiation cannot be regarded as constituting discrimination prohibited under Article 48 of the Treaty*"[279].

The Court has also stated that Article 18 TFEU "…*is not concerned with any disparities in treatment…which may result from divergences existing between the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality*"[280].

The importance of having regard to the comparability of situations in which a different rule may be applied without that rule constituting discrimination was emphasised by Sir Francis Jacobs in his book entitled *The Sovereignty of Law – The European Way*. He said with regard to the principle of equality under the law (the principle of non-discrimination) that it "… *can be regarded as the fundamental value of the law and justice …[although]… <u>Crucially its application depends, first, on what situations are to be counted as equal; and, second … in what circumstances a difference of treatment may be justified …</u>*"[281].

In the context of the freedoms of movement, the rules applied to a person resident or established in the state are compared to those applied to a person resident or established in another state[282] and a restriction is found if, in the context of the rules in point, the situations of the resident and the non-resident are comparable. A similar comparative analysis is conducted if a national rule creates a disadvantage to a person investing in[283] or moving to another state[284].

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[279] *Gilly* [1998] Case C-336/96 paragraph 30.

[280] *Schempp* [2005] Case C-403/03 paragraph 34. When Mr Schempp's former spouse took up residence in Austria, the German tax code denied the relief that Mr Schempp had been obtaining for the maintenance payments he made to her on the ground that, in her hands, they were no longer subject to taxation because the Austrian tax code classified such receipts as exempt income. The German tax code applied different rules to different situations (paragraph 35).

[281] Jacobs (2007) pages 78 & 79 (emphasis added). See also *Schumacker* [1995] Case C-279/93 paragraph 30 (emphasis added): "…It is also settled law that discrimination can arise only <u>through the application of different rules to comparable situations</u> or the application of the same rule to different situations." This latter example of discrimination is discussed in the context of pricing of life annuities having regard for the differing life expectancies of, respectively, men and women in Turner [2011] ITR .

[282] Or, in the case of companies, owned by a person established in another state. See, for instance: *Metallgesellschaft* [2001] Case C-397/98 & C-410/98 paragraph 43.

[283] This could engage Article 63 TFEU, free movement of capital.

[284] Exit state (origin state) rules: *Daily Mail* [1988] Case 81/87 paragraph 16: "…the rights guaranteed by Articles 52 et seq. would be rendered meaningless if the Member State of origin could prohibit undertakings from leaving in order to establish themselves in another Member State." See also *ICI* [1998] Case C-264/96 paragraph 21.

The 'nationality' of an individual who is an EU citizen has been of even less significance since the coming into force of the amendments to the Treaty effected by the Treaty of Maastricht[285].

Since the coming into force of what is now Article 21 TFEU, it is the *"right of every EU citizen to move and reside freely*" within the Union even if not engaged in an economic activity and, thus, an individual seeking to exercise a freedom of movement might not be a national of the state is which he is currently resident even if he had not exercised an Internal Market freedom of movement previously to establish himself in that state.

It is concluded that it is unnecessary to find a way of relating a discriminatory national provision to nationality in order to find there to be a restriction caused by that national rule despite the reference by the Court in its judgments to 'covert discrimination' or 'indirect discrimination' on the ground of nationality[286].

Examples of the confusing reference by the Court to discrimination on the ground of nationality in the context of the freedoms of movement are discussed with reference to 'workers' and 'establishment'[287].

3.2.i Freedom of movement of workers.

The prohibition in Article 45 TFEU is expressed as: "…*the abolition of any discrimination based on nationality*…".

It is suggested that this prohibition of discrimination, although expressed in terms of nationality, is to be understood as being on the basis of state of residence or establishment as well as upon nationality and that contention finds support in the Court's judgment in *Sotgiu* [1974][288].

It will have been noted in the passage from *Sotgiu* [1974] quoted that the Court sought to identify discrimination on the ground of place of residence or of

[285] "Union citizenship is destined to be the fundamental status of nationals of the Member States, enabling those who find themselves in the same situation to enjoy within the scope *ratione materiae* of the Treaty the same treatment in law irrespective of their nationality, subject to such exceptions as are expressly provided for…" *D'Hoop* [2002] Case C-224/98 paragraph 28.

[286] See *Biehl* [1990] Case 175/88 paragraph 13.

[287] The opening paragraphs of Article 56 TFEU (freedom to provide services) and that of Article 63 TFEU (free movement of capital) are similar to the first sentence in the opening paragraph of Article 49 TFEU (establishment).

[288] *Sotgiu* [1974] Case 152/73 paragraph 11"…criteria such as place of origin or residence of a worker may…be tantamount…to discrimination on the grounds of nationality…". In contention in *Sotgiu* was a 'separation allowance' paid by the German post office to workers assigned to workplaces distant from their place of residence. Different terms applied to benefits paid to non-residents, who were paid a lesser amount. However, importantly, the allowance paid to a German resident was temporary and was subject to an obligation for the worker to relocate to nearer his workplace (paragraph 12). Accordingly, the scheme terms applied to Mrs Sotgiu were not necessarily disadvantageous to her.

establishment as a proxy for discrimination on the ground of nationality. This form of analysis was followed by the Court in *Biehl* [1990] in relation to taxation[289].

The Court was obliged to abandon any reference to discrimination on the ground of nationality in *de Groot* [2002][290] as the taxpayer suffered a disadvantage as a result of the legislation of the state of which her was a national and in which he was resident.

Accordingly, despite the express reference to discrimination on the basis of nationality in Article 45 TFEU, it is concerned with any restriction to the exercise of the freedom of movement by persons employed or seeking employment.

3.2.ii Right of Establishment.

Article 49 TFEU makes no mention of 'discrimination' based on nationality but uses the words in the second paragraph: "…*under the conditions laid down for its own nationals by the law of the country where such establishment is effected*…". The explanation of this requirement given by the Court in *Avoir Fiscal* [1986]was that: "… [*it is] intended to ensure that all nationals of Member States who establish themselves in another Member State…for the purpose of pursuing activities there … receive the same treatment as nationals of that state and it prohibits, as a restriction on freedom of establishment, any discrimination on grounds of nationality* …"[291].

[289] *Biehl* [1990] Case 175/88 paragraph 14. The Luxembourg rule did not permit a person who had been employed in the state and who had suffered payroll income tax deduction from his earnings to submit a tax return for the tax period in which he ceased to reside in the state. He therefore could not recover any amount over deducted in consequence of the payroll mechanism of allocating a proportion of his personal allowance to each pay period. It is unnecessary for the Court to relate the treatment of workers leaving or arriving in the state during a tax year to the prohibition of discrimination on the ground of nationality and the Court's consideration of the Luxembourg justifications suggests that the rule in question was not discriminatory in any case. The rule certainly gave rise to a restriction, as the loss of part of the personal tax allowance arose solely because of an exercise of a freedom of movement, but there is no necessity to make a finding of discrimination on the ground of nationality.

[290] *de Groot* [2002] Case C-385/00 paragraph 95. The taxpayer in *de Groot* did not migrate his tax residence as had the taxpayer in *Biehl* but had employment in other Member States as well as in his state of origin and residence in a particular year. His complaint was that he was denied part of his personal tax allowance by his state of origin in that year proportionate to the earnings in those other states. The Court concluded that the rule constituted a restriction, termed by it as an 'obstacle', to the exercise of the freedom of movement. The national rule was discriminatory but could not be on the basis of nationality. A comparable exit state case, but concerned with establishment, is *Asscher* [1996] Case C-107/94.

[291] *Avoir Fiscal* [1986] Case 270/83 paragraph 13. The discrimination in the French tax code complained of arose in relation of taxation of dividend income in the hands of, respectively, a branch of a non-resident company and a resident company, whether a subsidiary of a foreign parent or of a French resident parent. The Court explained that there was, for the purpose of the taxing scheme in point, no difference in in situation between a French resident company and a French resident branch of a foreign company as both were subject to the same charging provisions.

The French tax legislation under examination provided that the disputed right to the tax credit could only be claimed by "…*persons who have their habitual residence or registered office in France*…"[292].

Protection under this freedom of movement can be obtained regardless of whether there is a finding of discrimination on the ground of nationality. Generally, a direct tax rule will distinguish between taxpayers on the basis of tax residence and that is because tax residence is a connecting factor used by states to define taxing jurisdiction[293].

In *Daily Mail* [1988] the Court ruled that the provisions of Article 49 TFEU applied to provide protection against restrictive exit state provisions[294].

Restrictive exit state provisions were examined by the Court in *Bosal* [2003][295] where discrimination of persons was not in point as the tax rule in question applied to a resident company.

Accordingly, a finding of discrimination on the basis of nationality is unnecessary to obtain protection under Article 49 TFEU and under the similarly worded freedoms of movement provided by Articles 56 TFEU and 63 TFEU.

3.3 DISCRIMINATION OR RESTRICTION?

3.3.i All infringements of the Internal Market freedoms are restrictions.

It is argued as a proposition that all infringements of the Internal Market freedoms by Member State direct tax provisions are restrictions: that is,

[292] Ibid. paragraph 4: it is suggested that only individuals can have "habitual residence". The restriction of the benefit to companies having their registered office in France was discriminatory on the ground of nationality (Art. 54 TFEU).

[293] Lyal [2003] ECTR at page 68: "In direct tax…residence is an essential connecting factor: it is the way in which most countries define tax competence." However, as observed by the Court in *Gilly* [1998] Case C-336/96 paragraph 30, 'nationality' is used as a criterion for "allocation of fiscal jurisdiction" in double tax treaties.

[294] *Daily Mail* [1988] Case 81/87 paragraph 16: though Article 49 TFEU is "…directed mainly to ensuring that foreign nationals and companies are treated in the host Member State in the same way as nationals of that State, they also prohibit the Member State of origin from hindering the establishment in another Member State of one of its nationals or of a company incorporated under its legislation…".

[295] *Bosal* [2003] Case C-168/01. The case concerned a restrictive Dutch tax rule that precluded a Dutch parent company from deducting the costs that it incurred in relation to an investment in a non-resident subsidiary company unless that subsidiary generated profits taxable in the Netherlands. The Court in effect observed that a Dutch parent holding shares in a Dutch resident subsidiary was in a situation comparable to that of one holding shares in a non-resident subsidiary as the parent was not taxable on the profits of the subsidiary in either case: paragraph 39.

restrictions to the exercise of the freedoms, albeit that most arise as a result of discriminatory provisions in national law[296].

The confusion over the Court's approach to analysis of alleged infringements was neatly summarised by AG Bobek in his Opinion in *Hornbach-Baumarkt* delivered on 14 December 2017. He said: "*There are two different approaches to analysing situations of alleged infringements of freedom of establishment in the area of direct taxation in the Court's case-law: the discrimination approach and the restriction approach. It is well recognised in academic literature that over the years the Court has vacillated between these approaches*"[297].

The additional questions to be considered in this section are: first, are there two approaches as suggested by the learned Advocate General? And, second, if so, what are the bases for the two approaches in the Treaty provisions?

It is to be noted that the Advocate General was considering the right to establishment. The first paragraph of Article 49 TFEU contains a prohibition of restrictions on the establishment of nationals of one Member State in the territory of another and a similar prohibition of restrictions on the setting up of agencies, branches or subsidiaries by such nationals in the territory of another. The second paragraph prescribes that nationals exercising the freedom of movement should be able to do so "*under the conditions laid down for [the hosts state's] nationals…*".

This broadly reflects what is required to achieve the Internal Market briefly described in Article 3(c) EEC and Article 3(c) EC[298]. It is there described as "…*characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital*".

Discrimination on the ground of nationality was prohibited by Article 7 EEC then by Article 12 EC and now by Article 18 TFEU. Article 49 TFEU is not concerned with discrimination as such. The purpose of Article 49 TFEU and of the other freedoms of movement is to enable the establishment of the Internal Market[299].

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[296] The discriminatory tax treatment of branches of insurance companies examined by the Court in *Avoir Fiscal* [1986] Case 270/83 was held to "constitute a restriction" (paragraph 27).

[297] *Hornbach-Baumarkt (AGO)* [2017] Case C-382/16 paragraph 28. In 2003, Lyal wrote: "The recent case law is not always clear. Sometimes the Court has based its reasoning squarely on the existence of a restriction, independently of any differentiation between domestic and foreign elements, sometimes on discrimination, and sometimes it is hard to know which. Moreover, even before the rise in this new approach it frequently confused the issue of the existence of discrimination with that of objective justification under the *Cassis de Dijon*-style rule of reason " Lyal [2003] ECTR page 69.

[298] Reference is made to the EEC and EC Treaty wordings as most of the case law is based on interpretations of those treaties and because the Court does not appear to have altered its interpretation following the revision of the wording of Article 3(c) by the Treaty of Lisbon. The revised wording can be seen in Article 26(2) TFEU.

[299] *Morson & Jhanjan* [1982] Case 35/82 & 36/82 paragraph 15 (emphasis added): "Article 7 and Article 48 may be invoked only where the case in question comes within the area to which

Accordingly, when considering a discriminatory national provision that is alleged to interfere with an Internal Market freedom, the Court is concerned to determine whether the national provision causes a restriction.

Whilst discriminatory treatment of comparable situations will always give rise to a restriction, a restriction can occur where there is no discriminatory treatment as the Court observed in *Commission v Estonia (pensioner allowances)* [2012], an exit state case [300].

The ruling by the Court did not interfere with the taxing jurisdiction of Estonia and, therefore, its sovereignty in that regard. The pensioner was subject to taxation by Estonia on his pension derived from an Estonian source and only upon that income. The ruling effectively said that the amount of tax levied by Estonia on the pensioner as a non-resident should not exceed the amount that would have been levied had he remained resident in the state and taxable on his global income. To achieve that result, it is only necessary for Estonia to allow the pensioner a personal allowance reduced by the amount of that Finnish income.

Accordingly, with due respect to the learned Advocate General, whilst the Court's analysis may in some cases appear to run as two different approaches, the objective is to identify whether a disadvantage arises from the national rule complained of and how the disadvantage arises from it. If the disadvantage arises from a discriminatory rule, it is necessary to examine whether the discriminatory rule applies to comparable situations.

The two approaches referred to by the Advocate General are considered below followed by brief discussions of, respectively, non-discriminatory and discriminatory restrictions and then a conclusion on the assertion in the literature referred to that the Court had two distinct approaches.

3.3.i.a "*The discrimination approach*".

In paragraph 31 of his Opinion, the Advocate General cites *Avoir Fiscal* [1986] as providing an example of the "*discrimination approach*". The source of the disadvantage was a discriminatory rule and the Court identified it as such[301].

The effect of the discriminatory rule was to decrease the income yield of the foreign insurance company's branch investments and, as investment of cash flows is an intrinsic part of the trade of an insurance company, the profitability of the branch operations was impaired and foreign companies trading through branches

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Community law applies…Not only does that conclusion emerge from the wording of those articles, but it also accords with their purpose, which is to assist in the abolition of all obstacles to the establishment of a common market in which the nationals of the Member States may move freely within the territory of those states in order to pursue their economic activities."..

[300] *Commission v Estonia (pensioner allowances)* [2012] Case C-39/10 paragraphs 48 & 56: "It is incompatible… with the rules on freedom of movement for a worker who has made use of that right to be the subject of less favourable treatment in the Member State of which he is a national than he would receive if he had not made use of the opportunities offered by those rules…".

[301] *Avoir Fiscal* [1986] Case 270/83 paragraph 27.

in France were placed at a competitive disadvantage in the French insurance market. That was the disadvantage but it is also necessary to determine whether the disadvantaged branches were in a comparable situation to domestic companies as regards the French tax scheme. The Court did so regard them as being in a comparable situation because the French tax charging provisions taxed the income of the branches in the same way as it taxed French companies[302]. The Court applied the same logic in *Metallgesellschaft* [2001][303].

It is contended that the Court has not pursued a particular form of analysis as a matter of principle but has merely determined whether a restriction has been caused by the application of different rules to persons in comparable situations. The form of analysis is determined by the national rules and circumstances.

3.3.i.b "*The restriction approach*".

In paragraph 36 of his Opinion, the Advocate General states that the "*…restriction approach…obviates…the need for any comparison or identification of relatively disadvantageous treatment*".

That is simply wrong, as is evidenced by the Court's statement in *Avoir Fiscal* [1986] quoted *ante*.

A further example may be found in *Keller Holding* [2006][304]. The Court noted that a German company exercising its rights under Article 49 TFEU suffered a disadvantage in consequence of the German tax provisions that it would not suffer when setting up a subsidiary in its state of residence and stated the comparability of the situations of a German parent receiving dividends from, respectively, a domestic subsidiary and a foreign subsidiary[305]

However, whilst it is discriminatory treatment that is often the cause of a restriction, a national provision does not need to be obviously discriminatory in order to constitute a restriction.

[302] Ibid. Paragraph 20 (emphasis added): *"…*By treating the two forms of establishment in the same way for the purposes of taxing their profits, the French legislature has in fact admitted that there is no objective difference between their positions….".

[303] *Metallgesellschaft* [2001] Case C-397/98 & C-410/98 paragraph 60.

[304] The discriminatory German tax provisions examined in that case permitted a German parent company to deduct for tax purposes finance costs related to an investment in a domestic subsidiary but denied deduction for finance costs incurred by the German parent company in relation to an investment in a foreign subsidiary. *Keller Holding* [2006] Case C-471/04 paragraph 35: "In the light of that difference in treatment, a parent company might be dissuaded from carrying on its activities through the intermediary of subsidiaries or indirect subsidiaries established in other Member States." This is very similar to *Bosal* [2003] Case C-168/01 considered *ante*.

[305] *Keller Holding* [2006] Case C-471/04 paragraph 37.

3.3.ii Non-discriminatory restrictions.

A non-discriminatory restriction would be unusual because the freedoms of movement seek to ensure that a person exercising a freedom of movement is treated no "less favourably" by the national legislation under examination than is a person in a comparable situation who is not exercising the freedom of movement.

However, national legislation that prescribes different schemes of taxation for, respectively, residents and non-residents, "… *cannot therefore in itself be categorised as discrimination within the meaning of the Treaty* …"[306]. A restriction could occur, however, if the amount of tax payable under the scheme applied to non-residents exceeds that payable by residents[307].

Such was the case of the non-discriminatory restriction examined in *Commission v Estonia*, which has been discussed *ante*. The restriction was not discriminatory because Estonia, in common with most states that have concluded double tax treaties based on the OECD model, applied a different charging system to non-resident taxpayers in that income tax was levied only on the income sourced in or from the state[308].

3.3.iii Discriminatory restrictions.

As indicated *ante*, determining whether a person has or would suffer discriminatory treatment when exercising rights under a freedom of movement will determine whether the Treaty freedom is engaged[309].

To determine whether that person has suffered discriminatory treatment it is necessary to compare the treatment suffered to the treatment afforded by the contested national law to persons in a comparable situation[310] or, in the case of an exit state rule, the treatment that would have been afforded to the person disadvantaged had that person not exercised the freedom of movement. In the case of a national taxation scheme, it will be the charging provision that will determine whether the person is in a comparable situation[311].

To determine whether a provision is discriminatory, regard must be paid to the "…*objective pursued by the national provisions at issue*…"[312]. The relief provision in the Dutch tax code that discriminated between domestic heritage property and

[306] *Truck Center* [2008] Case C-282/07 paragraph 39.

[307] *Gerritse* [2003] Case C-234/01 paragraph 55, second part of the ruling.

[308] As noted *ante*, the Court expressly stated in *Gilly* [1998] Case C-336/96 paragraph 30 that the use of nationality to determine taxing jurisdiction over persons is not discriminatory.

[309] See *Gebhard* [1995] Case C-55/94 paragraph 37.

[310] See chapter 3.4 *post*.

[311] *Avoir Fiscal* [1986] Case 270/83 paragraph 20.

[312] *Papillon* [2008] Case C-418/07 paragraph 27.

foreign property was held by the Court to have as its objective "… *to preserve and safeguard the cultural and historical heritage of the Netherlands*…"[313].

It is not always that a national provision held to be discriminatory will be overtly discriminatory. In *Schumacker* [1995], the Court made a point of ruling that discrimination can occur as a result of "… *the application of the same rule to different situations* …"[314].

Such was the case in *Caixa-Bank* [2004] in respect of a French banking rule that was perceived as being "… *a serious obstacle to the pursuit of … activities [in France by a subsidiary of a foreign parent bank] … affecting their access to the market* …"[315].

3.3.iv Two approaches or one?

Before concluding that the Court does not have two approaches to its analysis, a discrimination approach and a restriction approach, contrary to the contention in the 'literature' reviewed by the Advocate General, it is necessary to consider one further case, *SGI* [2010][316]. Reference to that case was made by the parties to the litigation and by the Advocate General in his Opinion to a significant extent.

Under a heading entitled "*Mixing the approaches*", the Advocate General said[317]: "*At least in part as a result of the difficulties in applying a 'pure' restriction approach to rules on direct taxation, that approach has been diluted with a dose of discrimination. The result is sometimes a strange cocktail*[318] *… Alternatively, a difference in treatment is observed but no analysis of comparability is conducted. That is followed by a finding of a 'restriction'. Such an approach can render it*

[313] *X (heritage property relief)* [2014] Case C-87/13 paragraph 29.

[314] *Schumacker* [1995] Case C-279/93 paragraph 30.

[315] The French prohibition of interest being paid by banks on current account balances in credit was viewed by the Court as being an obstacle to access to the French market by foreign banks and was ruled to constitute a restriction to the right of establishment. The Court was silent on whether the French prohibition was discriminatory but it might be viewed as such as 'the same rule was applied to banks in different situations' as regards attracting depositors. *Caixa-Bank* [2004] Case C-442/02 paragraph 12. The Court recognised that domestic banks had "… an extensive network of branches and therefore greater opportunities than those subsidiaries for raising capital from the public…" (paragraph 13).

[316] *SGI* [2010] Case C-311/08.

[317] *Hornbach-Baumarkt (AGO)* [2017] Case C-382/16 paragraphs 39 & 41. *SGI* concerned a Belgian company that provided an interest-free loan to its French subsidiary and paid fees considered to be excessive for management services provided by a Luxembourg company that owned 34% of its share capital. Belgian tax rules applied to assess the diverted profits on the Belgian company.

[318] It might be said that the judgment in *AMID* [2000] Case C-141/99 resulted from the application of that "*strange cocktail*" but the approach taken by the Court in its analysis in relation to that exit state infringement is clear although the comparability analysis conducted and the conclusion has been challenged in Chapter 8.2 *post*.

ambiguous as to whether the assessment is discrimination or restriction based (as in, for example, the SGI case …) …".

The Court observed in *SGI* [2010] that the Belgian provision only applied if the beneficiary of the diverted profits was a company resident outside the territory[319] [320]. The taxpayer would not have suffered an adjustment to its profits had the beneficiaries of the interest-free loan, and the excessive fees paid by it, been companies resident in Belgium. This observation of the Court is, presumably, what the Advocate General is referring to when he says "…*a difference in treatment is observed but no analysis of comparability is conducted. That is followed by a finding of a 'restriction'*".

That is not so. The Court did conduct an analysis[321] of comparability with a wholly domestic situation. The case concerned an exit state provision and the discriminatory rule created a disadvantage to a company that had exercised the freedom of movement that it would not have suffered had it not done so. Accordingly, the national provision applied in a discriminatory manner to cause a disadvantage to Belgian companies that had exercised a freedom of movement and a restriction consequently arose.

A number of apparent departures made by the Court from what appears to be the scheme of analysis of infringements that it developed through its case law are discussed in Part II of this thesis. However, it is not concluded that there are two alternative 'approaches' to its analysis.

3.4 COMPARABILITY OF SITUATIONS.

It might be thought that the matters referred to in the heading to this chapter have been exhaustively discussed and that clear principles had been determined and are now applied consistently. Sadly, that is not so[322]. In relation to direct taxation, the analysis of comparability of situations appears to be fraught with

[319] *SGI* [2010] Case C-311/08 paragraph 42.

[320] AG Bobek observed , taking a contrary view, in *Hornbach-Baumarkt AG* regarding the national provision under examination: "…the purpose of the relevant provisions of national law is to ensure that profits generated in Germany are not transferred outside Germany's tax jurisdiction, via transactions that are not carried out on arm's-length terms … On that basis, there would appear to be strong arguments that the cross-border and domestic situations are not in fact comparable in this case…" *Hornbach-Baumarkt (AGO)* [2017] Case C-382/16 paragraphs 58 & 59. In making that observation, AG Bobek is echoing the view of AG Geelhoed stated more than 11 years earlier in *Thin Cap GLO (AGO)* [2006] Case C-524/04 paragraph 68.

[321] *SGI* [2010] Case C-311/08 paragraphs 42 to 55.

[322] "…the criterion of comparability is vague. Given that all situations are comparable in some respect, if they are not identical, this test should in any case be abandoned". *Memira (AGO)* [2019] Case C-607/17 paragraph 46.

inconsistency and uncertainty[323]. As noted above, the inconsistencies will be discussed in Part II *post*.

Notwithstanding that uncertainty, the Court has consistently ruled: "… *the comparability of a cross-border situation with an internal situation must be examined having regard to the aim pursued by the national provisions at issue* …"[324]. However, having said that in February 2020, the Court then appears to have omitted to do such an examination of the purpose of the UK's 'Group Transfer' rules when it answered the fifth question in *Gallaher* [2023][325] in February 2023.

The application of different rules to situations that are not comparable will not infringe the freedoms of movement[326]. However, the application of the same rules to situations that are not comparable falls within the Court's definition of discrimination[327] and in *Caixa Bank* [2004], briefly discussed *ante*, the Court ruled that the French rule prohibiting the payment of interest by banks on credit balances on current accounts obstructed access to the French domestic market[328] because the branch networks of the dominant domestic banks left little room for foreign banks to compete for customer deposits[329].

The situations to be compared when applying the test are those of persons directly affected by the tax rule in question[330].

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[323] "… the case law of the CJEU with regard to the comparability analysis appears to be inconsistent and (sometimes) result-oriented. The result is legal uncertainty for taxpayers and the tax authorities of the Member States. In view of the practical consequences of the comparability analysis, clearer criteria are needed to determine whether situations are objectively comparable. Furthermore, the Court hardly indicates why it takes certain factors into account already at the level of the comparability analysis and others only at the level of justification …" Mittendorfer [2021] ECTR page 176 (conclusion).

[324] *AURES Holdings* [2020] Case C-405/18 paragraph 37 and *Bevola and Jens W Trock* [2018] Case C-650/16 paragraph 35.

[325] *Gallaher* [2023] Case C-707/20 paragraphs 82 & 83. This case is discussed in Chapter 4 *post*.

[326] "…the application of different taxation arrangements to companies established in Belgium and to those established in another Member State, relates to situations which are not objectively comparable … In those circumstances, that difference in treatment does not constitute a restriction of the freedom of establishment within the terms of Article 52 of the Treaty." *Truck Center* [2008] Case C-282/07 paragraphs 41 & 50 (emphasis added). It should be noted that dissent from the Court's ruling on comparability was expressed in the 'literature'. For instance: "…the comparability of the situations has always been assessed from the taxpayer's perspective…" De Broe & Bammens [2009] ECTR at page 133.

[327] *Schumacker* [1995] Case C-279/93 paragraph 30.

[328] *Caixa-Bank* [2004] Case C-442/02paragraph 11.

[329] Ibid. paragraph 14.

[330] Polish resident investment funds were entitled to receive dividends from Polish companies gross, without deduction of withholding tax, whilst non-resident funds suffered withholding tax deducted from dividends received from Polish companies. That Poland tax resident investors in Polish funds and provided the exemption from withholding tax to avoid economic double taxation did not help Poland's arguments because investors in non-resident funds would be equally vulnerable. *Emerging Markets* [2014] Case C-190/12 paragraph 63.

Origin or exit state rules can cause restrictions by disadvantaging persons residing there seeking to make outward investment, taking foreign employment, providing cross-border services or migrating tax residence.

It is in the analysis of exit state rules that most of the contradictions and problems appear to have arisen in the Court's case law and also where the sovereignty of Member States as regards tax matters, the determination of their taxing jurisdiction in particular, may have become inadvertently compromised. The next chapter discusses instances where a disadvantage may be suffered as a result of the exercise of a freedom of movement but the Treaty free movement rights are not infringed. In these cases, the disadvantage arises because the Member States retain competence over their direct tax systems necessary for the funding of their domestic budgets.

3.5 Concluding comments.

It is concluded that most restrictions of the exercise of the Treaty freedoms of movement by national taxing provisions arise through the application of different rules to persons in comparable situations having regard to the purpose of the national taxing provisions.

Determining the comparability of situations having regard to the purpose of the national provisions can be a challenge in some cases and this appears to have led to confusion in the Court's judgments and in commentaries on them, which are discussed in Part II of this thesis.

4 GROUNDS FOR JUSTIFICATION OF INFRINGEMENTS OF THE TREATY FREEDOMS BY NATIONAL DIRECT TAX PROVISIONS.

4.1 INTRODUCTION TO THE CHAPTER.

The Court's formulations of the grounds for justification were introduced in chapter 2.4 *ante* where they were related to the principal aspects of the direct tax sovereignty retained by the Member States.

The Court applies the same analysis and considerations to the 'public interest' grounds as it does to the express derogations in the Treaty provisions.

As mentioned *ante*, the ability of Member States to justify infringements on general public interest grounds (other than those specified in the Treaty provisions) is accepted to have been first stated[331] in the ruling of the Court in July 1974 in *Dassonville* [1974][332].

The grounds for justification of infringements of the Treaty freedoms of movement by national provisions relating direct taxation, are an evolution of the principle established by the Court in relation to what was then a retained competence, that of consumer protection.

In that early case, the Court stipulated that "*the measures [giving rise to the restriction] should be reasonable*" and it was for this reason that the 'public interest' basis for justification was sometimes referred to as the "*rule of reason*"[333].

In seeking to make an interpretation of the Court's judgments, it is imperative to take account of the context in which the Court's statements are made. That context will comprise the Court's understanding of the national provisions under examination, which is generally recorded in the judgment, and the factual circumstances in which the national provisions are applied.

It is proposed that the grounds for justification of infringements to the Treaty freedoms of movement by national direct tax provisions can be grouped by reference to the two principal expressions of the retained powers reflecting direct tax sovereignty discussed *ante* in chapter 2.4. Those principal expressions of the retained powers are:

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[331] Arnull & Others (2008) page 192.

[332] *Dassonville* [1974] Case 8/74 paragraph 6: "In the absence of a Community system guaranteeing for consumers the authenticity of a product's designation of origin, if a Member State takes measures to prevent unfair practices in this connexion, it is however subject to the condition that these measures should be reasonable and that the means of proof required should not act as a hindrance to trade between Member States and should, in consequence, be accessible to all Community nationals" (emphasis added).

[333] Craig & De Búrca (2008) page 706.

- First, the power to determine taxing jurisdiction (who to tax and what to tax); and
- Second, the mechanisms and schemes employed to assess and collect tax including the rates of tax set (how to tax).

Wattel, writing in 2022, commented that "*Gradually, the Court has seemed to realise that [the five basis grounds for justification] are essentially one basic notion: the need for measures to protect national tax base integrity…*".[334] The "five basis grounds" can be seen in the schematic diagram: three identified with protection of the tax base[335]and the remaining two are identified with the assessment and collection mechanisms[336].

The formulations accepted by the Court for the two principal expressions of direct tax sovereignty are:

- The first principal expression (the power to determine taxing jurisdiction or tax base) has been termed by the Court: "*the preservation of the allocation of the power to impose taxes between Member States*"[337].

  However, In recognition that the retained sovereignty to define the tax base could be rendered meaningless if a Member State was prevented from enacting measures for protecting the tax base against avoidance arrangements or evasion, the Court has recognised justifications formulated as "*the prevention of tax evasion*"[338] and "*effectiveness of fiscal supervision*"[339], which the Court has recognised as being "…*closely linked*…"[340] with the "…*power to impose taxes*…" and "*prevent(ing) the risk of losses being taken into account twice*"[341].

- The second principal expression (the power to design and determine the systems of taxation) "*the need to preserve the [coherence] of the*

[334] Wattel [2022] Intertax at page 736.

[335] The three grounds relating to protection of the tax base: countering tax avoidance, prevention of double deductions; and fiscal supervision: see *post*.

[336] The two remaining grounds relating to the assessment and collection mechanisms: protection of the coherence of the tax system and effective collection of taxes: see *post*.

[337] *Marks & Spencer* [2005] Case C-446/03 paragraph 45. It should be noted, however, that the situation examined by the Court in this case concerned the unilateral definition of taxing jurisdiction by the state of origin, the UK.

[338] *X & Passenheim* [2009] Case C-155/08 & C-157/08 paragraph 45.

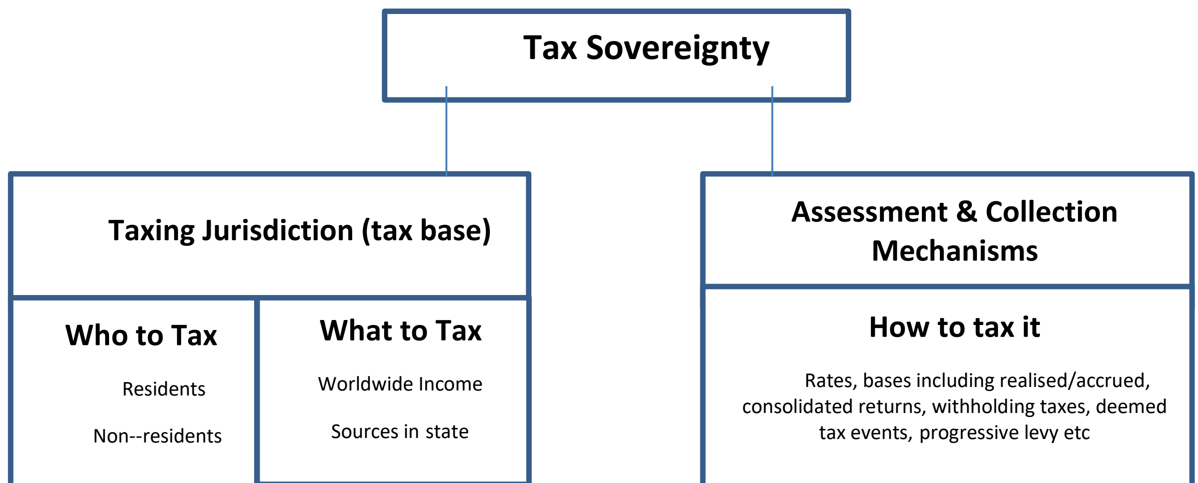
[339] *Persche* [2009] Case C-318/07 paragraph 52.

[340] *SIAT* [2012] Case C-318/10 paragraph 48.

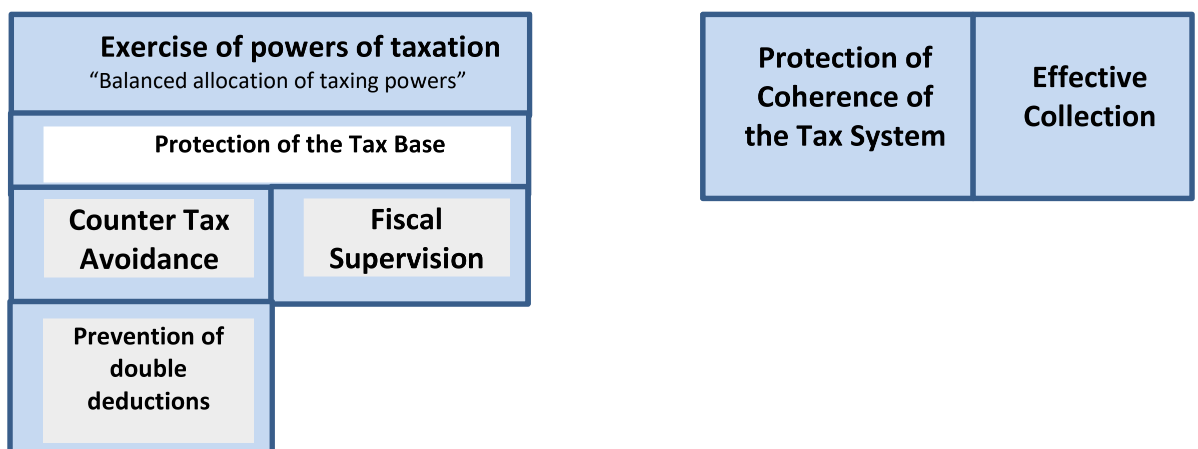
[341] *NN* [2018] Case C-28/17 paragraph 42.

> *tax system*"[342]; and "*the need to ensure the effective collection of income tax*"[343].

A general review of the grounds for justification for infringements will be conducted in this chapter by reference to the two principal retained powers reflecting direct tax sovereignty. Application of the grounds for justification to groups and to foreign permanent establishments are reviewed in chapter 5. Cases in which relief is claimed by the taxpayer for 'final losses' are reviewed in Chapter 8. The schematic diagram of the principal expressions of direct tax sovereignty and the related justifications in chapter 2.4 is reproduced here.



Grounds for Justification



[342] *Bachmann* [1992] Case C-204/90 paragraph 21: the Court termed 'coherence' as 'cohesion' in that judgment. This ground for justification can be applied, for instance, to tax schemes that enable or provide a deferral of assessment, progressive taxation or the treatment of a group of companies as a single taxable entity.

[343] *Scorpio* [2006] Case C-290/04 paragraph 35.

4.2 RIGHT TO DETERMINE THE TAX BASE[344].

The right of a Member State to determine its tax base "…*in conformity with the fiscal principle of territoriality*…" was expressly recognised by the Court in earlier case law in *Futura* [1997][345] and was re-affirmed in *Gilly* [1998][346].

4.2.i Loss of tax revenue is not a ground for justification.

There is a distinction between the situations where loss of tax revenue *per se* cannot justify a restrictive measure and where such loss can justify a restrictive measure[347]. The basic rule is stated by the Court in *ICI* [1998][348].

The context in *ICI* [1998]was a statutory test in the UK's consortium relief scheme that, at the time, restricted relief (by set-off against the profits of the consortium company or higher tiers) for losses sustained by UK resident trading subsidiaries of a consortium company if the majority of the trading subsidiaries held by the consortium company at the time were not tax resident in the UK.

The justifications[349] put forward by the UK for this strange test were, first, prevention of tax avoidance through some form of diversion of profits into non-resident subsidiaries; and second, "…*to prevent a reduction in revenue caused by the mere existence of non-resident subsidiaries*…".

The second justification was bound to fail because it flies full in the face of the very purpose of the freedom of movement engaged, the right of establishment.

[344] The retained right of Member States to determine their respective tax bases has been discussed in chapter 2.3 *ante*.

[345] *Futura* [1997] Case C-250/95 paragraphs 20-22.

[346] *Gilly* [1998] Case C-336/96 paragraph 48. The principle of retained sovereignty to define taxing jurisdiction appears to be firstly specifically acknowledged in paragraph 30: "...the contracting parties' competence to define criteria for allocating their powers of taxation as between themselves…".

[347] Where that loss is caused by erosion of the tax base or from non-compliance. For instance, a restriction can be justified if "… the specific objective of such a restriction …[is] …to prevent conduct 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 …" *Cadbury Schweppes* [2006] Case C-196/04 paragraph 55.

[348] *ICI* [1998] Case C-264/96 paragraph 28: "…diminution of tax revenue…is not one of the grounds listed in Article 56 of the Treaty and cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify unequal treatment that is, in principle, incompatible with Article 52 of the Treaty." This is expressed more generally in *Metallgesellschaft* [2001] Case C-397/98 & C-410/98 paragraph 59: "…diminution of tax revenue cannot be regarded as a matter of overriding general interest which may be relied upon in order to justify a measure which is, in principle, contrary to a fundamental freedom."

[349] *ICI* [1998] Case C-264/96 paragraph 25.

The restriction examined in *Saint-Gobain* [1999][350] was of a similar type. As was the case in *Avoir Fiscal* [1986][351], the restrictive national rule deterred a company established in another Member State from exercising its right of establishment and to choose the form of establishment that it wished to use for that purpose. Again, the loss of tax revenue could not justify a restriction that clearly flew in the face of the Treaty right.

The disadvantages to the taxpayers in *ICI* and *Saint-Gobain* arose as a result of a discriminatory restriction in the legislation of one Member State. That in *Gilly* [1998], however, arose because of the disparity in the rates at which tax was charged in two Member States exercising their taxing powers in parallel over the same income as discussed *post* in chapter 6.1.i. There was no obligation on France to suffer the loss of tax revenue that it would have suffered had it permitted offset of the surplus German income tax credit against French tax levied on other sources of income.

4.2.ii Selected case law.

Protection of taxing powers was not available as a ground for justification to Germany in *Rewe (ITS)* [2007] [352]. The restrictive provision denied a German parent company the right to claim German tax relief in respect of a write down of the book value of a non-resident subsidiary company because of its status as such.

The discriminatory provision considered in *Rewe (ITS)* [2007] was not dissimilar from the Dutch provision examined by the Court in *Bosal* more than three years earlier, which denied tax relief to a Dutch parent company for costs incurred by it in relation to subsidiaries operating wholly outside of the taxing jurisdiction of the Netherlands[353]. The Court's ruling in *Rewe (ITS)* was consistent with that in *Bosal*.

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[350] *Saint-Gobain* [1999] Case C-307/97 The German tax rules taxed dividends beneficially received by a German branch of a French company less favourably than would have been the case had the branch been incorporated as a German company. The justification appears to have been that Germany could not counter-balance the revenues foregone (by providing the reliefs in respect of the dividend income) by taxation of the redistribution of the income in the form of dividends paid, which it could levy on dividends paid by German resident companies.

[351] *Avoir Fiscal* [1986] Case 270/83 paragraph 22.

[352] *Rewe (ITS)* [2007] Case C-347/04 paragraphs 42 & 43 (emphasis added): "…there are courses of action which are capable of jeopardising the right of the Member States to exercise their taxing powers in relation to activities carried on in their territory and thus of undermining a balanced allocation of the power to impose taxes between the Member States…However, a difference in tax treatment between resident parent companies according to whether or not they have subsidiaries abroad cannot be justified merely by the fact that they have decided to carry on economic activities in another Member State, in which the State concerned cannot exercise its taxing powers".

[353] *Bosal* [2003] Case C-168/01 paragraph 27. A similar restrictive provision in the German tax code was examined by the Court in *Keller Holding* [2006] Case C-471/04. Under the German tax code, expenditure incurred by a resident taxpayer in relation to a source of exempt income could not be deducted for tax purposes (paragraph 11). Thus, where the dividend income from a foreign

The first material test of the right of a Member State to determine and enforce its powers of taxation following *Marks & Spencer* [2000] was in *N* [2006][354], which is discussed in chapter 7 ('Exit Taxes').

In *Jobra* [2008] the state of origin, Austria, supported by the host state, Germany, argued that the restriction in the Austrian legislation reserving the benefit of an 'investment premium'[355] to claims in relation to tangible assets used in an Austrian business[356] could be justified by the need to protect the balanced allocation of the power to impose taxes. However, as the Court observed in paragraph 33 of its judgment, the income that the Austrian lessor earned from leasing the assets (used in Germany) was taxable in Austria and so it could not be claimed that "…*the right of the Republic of Austria to exercise its taxing powers in relation to activities carried on in its territory would be jeopardised*."

In *Aberdeen Property*, however, the claim to justify the discriminatory tax provision on this ground was declined because the defendant state did not exercise its power of taxation to tax the income in question when received by a person established within its taxing jurisdiction. Accordingly, it could not justify taxing the income in question when received by a person not established within its taxing jurisdiction on the ground of protecting its powers of taxation[357].

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subsidiary was exempted from German taxation, costs incurred in relation to that subsidiary were non-deductible. Although dividends from domestic subsidiaries were regarded as taxable, those domestic dividends received carried a tax credit that discharged the parent company tax obligation and were effectively exempt from German taxation (paragraph 31). The provision was therefore discriminatory and restrictive.

[354] *N* [2006] Case C-470/04 paragraphs 46 & 47.

[355] In effect, the 'investment premium' reduced the cost of providing the assets for business use and the restriction resulted in lessors leasing the assets principally for domestic use having a competitive advantage over other lessors of such assets. See also *Eurowings* [1999] Case C-294/97 paragraph 37.

[356] *Jobra* [2008] Case C-330/07 paragraph 3: other than leasing for use "*primarily abroad*". See also *Tankreederei* [2010] Case C-287/10 paragraph 22: "…Tankreederei's business activities relating to the refuelling services provided in the ports of Antwerp and Amsterdam by means of the vessels in respect of which the tax credit for investments it sought are exclusively taxable in Luxembourg. Consequently, the right of the Grand-Duchy of Luxembourg to exercise its taxing powers in relation to those activities would in no way be jeopardised if the condition [… the grant of the tax advantage… dependent on the physical use of the investments concerned in national territory] … did not exist …".

[357] *Aberdeen Property* [2009] Case C-303/07 paragraph 67. Withholding tax was levied on distributions made to non-resident persons but distributions to shareholders resident in Finland were exempted from being subject to withholding tax. Also see *Emerging Markets* [2014] Case C-190/12 paragraph 99 and *Amurta* [2007] Case C-379/05 paragraph 59: "…where a Member State has chosen not to tax recipient companies established in its territory in respect of this type of income, it cannot rely on the argument that there is a need to safeguard the balanced allocation between the Member States of the power to tax in order to justify the taxation of recipient companies established in another Member State". See also *Commission v Germany (dividend tax)* [2011] Case C-284/09 paragraph 81: "…the exemption from withholding tax or the tax advantage corresponding to the withholding tax deducted by the Federal Republic of Germany, if granted to companies established in another Member State, would not in fact mean that the Federal Republic

Following on from *Aberdeen Property* [2009], the Court took the same view on the unavailability of this ground for justification *w*here the exemption of income in the hands of a resident arose, not as a result of domestic legislation, but as a result of the provisions of a double tax treaty concluded by that state[358].

Where a state has a scheme that effectively reduces the burden of tax levied on income either by way of a specific allowance or by way of a general cap on the overall burden suffered by a taxpayer in a year, the state cannot justify a withdrawal of the relief on the ground of protecting its power to levy taxation.

That was the contested restriction examined by the Court in *DI. VI* [2012]. Luxembourg's tax code required there to be a withdrawal of a tax reduction benefit from a company that migrated its tax residence in breach of a condition attaching to the benefit that it remained tax resident for a stipulated period. The claim to justify the restrictive provision on the ground of protection of taxing powers was rejected because the benefit had been granted, and the tax foregone, at the time of grant by reason of national law. Accordingly, the act of migration of tax residence by the taxpayer had not jeopardised Luxembourg's taxing powers and, in any case, had the taxpayer remained resident in the territory for the stipulated period, the benefit would have become permanent[359].

A second example, *Bouanich (tax shield)* [2014], relates to an overall cap on direct taxation of specified income introduced temporarily by France "…*to avoid direct taxes being confiscatory in nature*…"[360]. The cap was prescribed as a

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of Germany would have to waive its right to tax income generated by an economic activity carried on in its territory. The dividends distributed by resident companies have already been taxed in the hands of the distributing companies as profits realised by them".

[358] *FE Familienprivatstiftung* [2015] Case C-589/13 paragraph 71: "… having abandoned its powers of taxation on gifts to persons residing in those Member States, the Republic of Austria cannot rely on a balanced allocation of powers of taxation in order to levy a specific tax on foundations that make gifts to such persons on the basis that those persons are not subject to its tax jurisdiction. That Member State has therefore freely accepted the allocation of powers of taxation that results from the terms of the double tax treaty …" The DTC provided that only the beneficiary could be subject to taxation by his state of residence and that, therefore, no tax could be levied on the donor.

[359] *DI. VI.* [2012] Case C-380/11 paragraph 45. A company that was absorbed by *DI. VI.* transferred its residence from Luxembourg to Italy before the end of the five-year period during which it was required to retain Luxembourg tax residence in order to retain the benefit of the tax discount relating to a tax period that ended prior to the year of migration. *DI. VI.* challenged the withdrawal of the benefit as successor to the original beneficiary. The non-distributable reserve that had to be set up to qualify for the benefit was retained after the merger. Accordingly, the benefit was reclaimed by Luxembourg solely because the beneficiary had exercised a freedom of movement and ceased to be tax resident. Contrast the Luxemburg scheme with the UK intra-group transfer scheme examined by the Court in *Gallaher* [2023] Case C-707/20, which provides deferral of chargeable gains (not a permanent relief) on intra-group transfers of assets until disposal of the asset outside of the group. See chapter 6.2.iv *post*.

[360] *Bouanich (tax shield)* [2014] Case C-375/12 paragraph 67. The taxpayer in point was in receipt of dividend income from foreign companies that had borne withholding tax deducted at source. Credit relief for the withholding tax had been granted under the tax code and this meant that some

percentage and, to the extent that tax paid on specified sources of income as a percentage of that income exceeded the cap rate, French tax was refunded to the taxpayer. The French provisions excluded taking account of foreign withholding taxes suffered on income included in the calculation.

That restriction could not be justified on the ground of protecting the French state's power to levy taxes. Although the recognition of the foreign tax in the calculation potentially reduced the amount of taxation retained by the French state after granting the relief, French tax had been foregone on the foreign income by reason of the obligation to provide the taxpayer with credit relief pursuant to the double tax treaty concluded by France with the paying company's state of residence and the French state had not been otherwise prevented from taxing the income accruing to a resident of the state[361]. Indeed, it might be said that it would be inconsistent to grant credit relief when taxing the foreign source of income but then to disregard the foreign tax borne by the taxpayer when calculating her overall tax burden to test whether it was excessive.

In *Imfeld and Garcet* [2013], a case concerned with the personal taxation of a married couple, a Belgian personal allowance relating to their dependent children was offset against the income of Mr Imfeld, earned by him in Germany in the exercise of his profession and taxed there. That income was exempted from Belgian tax under the double tax treaty concluded by the two Member States. Ms Garcet, employed in Belgium and taxed there, was denied any relief in relation to the children. The Belgian state sought to justify its taxing scheme on the basis of preserving the balanced allocation of its taxing powers. In response, the Court observed that if Belgium was required to provide relief for the relevant allowances it: "…*would not surrender part of its fiscal jurisdiction to other Member States*"[362].

Concluding comment.

The justification can be used to justify refusal of deductions for losses incurred in activities conducted outside of the state's taxing jurisdiction but it cannot be used to justify disallowing costs incurred within the state's jurisdiction in connection with foreign establishments conducting operations outside of its taxing

of the tax borne by the taxpayer on her dividend income had been levied and collected by another Member State. The French capping provisions directed that such tax be left out of account for the purpose of calculating the average rate of tax that she had suffered although the income was retained in the calculation.

[361] Ibid. paragraph 85.

[362] *Imfeld & Garcet* [2013] Case C-303/12 paragraph 76. Under the Belgian system for taxation of couples, the income was aggregated and the progressive rates applied to the aggregated amount. The Belgian tax payable was then determined as the fraction of the non-exempt income over the total income. The exempt income thus affected the rates applied to the income taxable in Belgium. But no part of the allowance in question was deductible from the income taxable in Belgium in this instance.

jurisdiction except in relation to tax avoidance arrangements[363]. The ground for justification cannot be used to defend discriminatory taxation of non-residents where residents are exempted, or the withdrawal of a relief or exemption simply because the taxpayer has failed to maintain tax residence in the state for a stipulated period following the grant. However, the ground for justification can be used to defend a provision that triggers a taxable event when a taxpayer migrates his tax residence possessing an asset that has accrued a gain[364].

4.3 RIGHT TO PROTECT THE TAX BASE

A distinction must be drawn between protecting the right to tax income, gains and profits that have arisen within a state's taxing jurisdiction, on the one hand, and preventing the non-disclosure or the export of income, gains or profits on the other.

Although the basic rule is that prevention of diminution of taxation revenues is not an acceptable ground for justifying a discriminatory national rule[365], as evidenced by Article 65(1)(b) TFEU, Member States may take measures to "…*prevent infringements of national law and regulation, in particular in the field of taxation…*". As a general rule: "… *a Member State is entitled to take measures designed to prevent certain of its nationals from attempting, undercover 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 …* "[366].

The measures that may be taken can be grouped under three category headings: the prevention of evasion of tax through imposition of fiscal supervision; the prevention of tax avoidance using artificial arrangements; and the prevention of double deduction of losses[367].

4.3.i Right to impose fiscal supervision and prevent evasion of taxes.

Evasion of a tax liability on a profit or gain that has been crystallised must be distinguished from the avoidance of tax by the taking of steps to avoid crystallisation of a profit or gain assessable under national law[368]. In the instance

[363] National anti-avoidance legislation such as 'transfer pricing rules' and 'thin capitalisation rules' might be engaged and the case law relating to those provisions is reviewed in chapter 5.3 *post*.

[364] 'Exit Taxes' cases are reviewed in chapter 7 *post*.

[365] See chapter 4.2.i *ante*.

[366] *Centros* [1999] Case C-212/97 paragraph 24.

[367] The last of these categories is relevant to groups of companies and companies having foreign permanent establishments and is addressed (and dismissed) in Chapter 8 *post*.

[368] Generally, in the cases referred to the CJEU, the fiscal authorities are faced with avoidance of tax through the taking of steps by the taxpayer to 'export' profits, gains or income as they arise or to avoid the crystallisation of a potential liability within the taxing jurisdiction of the state of

of either, as a firm point of principle, the Court has stated that "…*Community law cannot be relied on for abusive or fraudulent ends*…"[369].

Whilst not all evasion of tax is necessarily countered through the implementation of effective fiscal supervision[370], it is an essential preventative measure although not, in itself, an objective separate from that of prevention of tax evasion. As the Court has observed, the implementation of effective fiscal supervision is inextricably linked to the prevention of tax evasion[371].

The Court has also held that, whilst an objective "*of a purely economic nature cannot constitute an overriding reason in the general interest justifying a restriction of a fundamental freedom guaranteed by the Treaty*"[372], the protection of the public revenues by prevention of tax evasion cannot be considered to exclusively serve purely economic ends in that the public revenues fund a state's economic and social policies[373].

Effective fiscal supervision has been recognised as a ground for justification by the Court since the origination of the 'public interest' grounds for justification in *Cassis de Dijon* [1979][374]. Though it was not concerned with evasion of direct taxation, direct reference to the statement made in *Cassis de Dijon* [1979] was made by the Court in *Futura* [1997] in the context of direct taxation[375].

Justification on this ground has been sought, unsuccessfully, for restrictive measures denying tax relief for pension contributions paid to non-resident

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residence, such as was examined by the Court in *Daily Mail* [1988] Case 81/87 and in *de Lasteyrie* [2004] Case C-09/02. These cases were concerned with avoidance of taxes on accrued gains on assets by migration of tax residence prior to the making of the disposal.

[369] *Kefalas* [1998] Case C-367/96 paragraph 20.

[370] For instance, Corporation tax could be evaded by stripping out the assets of a company having a tax liability and leaving it to go into insolvent liquidation. Targeted measures are required to neutralise the benefit sought such as those examined by the Court in *Aladzhov* [2011] Case C-434/10.

[371] For instance *X and Y* [2002] Case C-436/00 paragraph 60: "… as regards the justification … based on the risk of tax evasion and that relating to effectiveness of fiscal supervision … in the light of the objective pursued by the national provision at issue here, those justifications overlap ….".

[372] *Verkooijen* [2000] Case C-35/98 paragraph 48.

[373] See *Aladzhov* [2011] Case C-434/10 paragraph 38. The Bulgarian state rule obstructed the free movement of the director of the company owing the tax debt and justification was sought on the ground of public policy. To qualify as a ground for justification, the action of the director (having regard to the nature of the debt outstanding) had to be: " … a genuine, present and sufficiently serious threat affecting one of the fundamental interests of society … " (paragraph.40) and the Bulgarian authorities would have to have regard for: " … personal conduct of that individual … " (paragraph 43).

[374] " … Obstacles to movement within the Community … must be accepted in so far as those provisions may be recognized as being 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.": *Cassis de Dijon* [1979] Case 120/78 paragraph 8 (emphasis added). The case concerned alcoholic strength of beverages and, indirectly, duties that could be levied on the alcohol content.

[375] *Futura* [1997] Case C-250/95 paragraph 31.

providers. Both *Bachmann* [1992][376] and *Danner*[2002][377] concerned taxpayers who had established pension funds with local providers in their respective states of origin and then had taken up economic activity in another Member State. The complaint was that they had been denied tax deductions in the host states for pension contributions paid out of income taxable there to the pension providers resident in their respective states of origin. The rationale advanced for denying deduction for the contributions paid was that the pensions could not be taxed subsequently by the host states if the taxpayers moved back to their states of origin and that constituted a threat to the symmetry of their tax systems.

The Court denied a justification on the ground of fiscal supervision observing that the tax authorities could require the taxpayers to provide proof in support of their claims for the contributions paid to the pension providers[378].

The Swedish restriction examined in *Skandia* [2003] postponed tax relief for the employer company for contributions to a pension scheme paid on behalf of an employee to subsidiaries of the employer operating in different Member States. The relief under the Swedish provisions was granted by reference to the pension benefits when paid to the employee[379] and relief was thus granted only when the employee became taxable on the pension benefits. For income tax purposes, the premiums paid on behalf of the employee by the employer were treated as part of the employee's income[380] and it might be assumed that he made a claim for an allowable deduction from his taxable income in respect of those contributions. Accordingly, the Swedish tax authorities had the information that they needed to ensure taxation of the pension benefits when subsequently paid[381]. The restrictive provisions could not be justified on the ground of the need for effective fiscal supervision.

Justification on this ground is not accepted where the tax authorities have knowledge of the prospective taxable income and have information that can be followed up.

Withholding taxes both facilitate the prevention of evasion[382] and provide an effective means for collecting taxes from persons not resident in the state[383]. They

[376] *Bachmann* [1992] Case C-204/90 This case is better known for the Court's ruling on a ground for justification then termed "cohesion of the tax system". See chapter 4.4.i *post*.

[377] *Danner* [2002] Case C-136/00.

[378] Ibid. Paragraph 50, *Bachmann* [1992] Case C-204/90 paragraph 20.

[379] *Skandia* [2003] Case C-422/01 paragraph 16.

[380] Ibid. paragraph 37.

[381] Ibid. paragraph 45.

[382] *Truck Center* [2008] Case C-282/07 paragraph 48.

[383] *Scorpio* [2006] Case C-290/04 paragraph 36.

are eligible to be justified, if necessary, under both of the principal arms of tax sovereignty[384].

Where the withholding tax is regarded as giving rise to a restriction, the two grounds for justification might not be available where the non-resident has an establishment in the state where the services are rendered or where the income subject to the withholding tax is earned. Whilst an obligation on the payer to withhold tax may prevent tax evasion by the non-resident recipient, the ground for justification will not be accepted unless evidence is provided to substantiate the necessity of the measure to prevent the feared evasion[385]. Where the non-resident does not have an establishment in the state in which the payer resides, the Court will take account of the fact that a non-resident is not usually " … *subject to the supervision …* " of the source state and recovery of unpaid tax " … *requires the assistance of the tax authorities of the other Member State …* "[386].

Member States have sought to justify discriminatory denial of tax benefits to charitable organisations established elsewhere using those grounds also. Whilst there is no harmonised definition of an entity having charitable status, EU law requires a Member State to recognise a foreign entity formed for charitable purposes if the objects and activities of the foreign entity would qualify it to be regarded as a charity if established in the state in point[387]. For this purpose, it would not be considered to be restrictive if the tax authorities of the Member State required the foreign entity (or a resident donor to such an entity) to submit the evidence required by them to enable them to determine whether the foreign entity would qualify to be granted charitable status under national rules[388]. Such would be a proportionate means of ensuring effective fiscal supervision and preventing tax evasion[389].

Denial of tax benefits claimed by a charity established in a third country or claimed by a donor to such a charity, however, may be more easily justified as "…*movements of capital between Member States and third countries… take place*

[384] That is, protection of the tax base and as a scheme for collection of tax. However, the taxpayer must still be protected from having to bear a greater tax burden. For instance, in *Truck Center* [2008] Case C-282/07 paragraph 49: the Court may have found a restriction had the rate of the withholding tax levied not been " … significantly lower that the corporation tax charged on the income of resident companies … ".

[385] *Strojírny Prostějov* [2014] Case C-53/13 & C-80/13 paragraphs 56 to 59.

[386] *Truck Center* [2008] Case C-282/07 paragraph 48.

[387] *Stauffer* [2006] Case C-386/04 paragraph 40. This case concerned a claim by a foreign charity for tax exemption.

[388] Ibid. paragraph 48.

[389] *Persche* [2009] Case C-318/07 paragraphs 52 to 70. This case concerned a claim for tax relief by a resident for a gift made to a foreign charity. A Member State may refuse to provide the tax benefit " … if the evidence that they consider they need to effect a correct assessment of the tax is not supplied … " (paragraph 69).

in a different legal context…"[390] and the tax authorities might be under a lesser obligation to accept whatever evidence of charitable status that is provided.

Empowering provisions relating to tax investigations involving foreign assets or foreign income not declared sometimes grant the tax authorities longer periods in which to discover the undeclared assets or income than the period granted to the tax authorities to investigate undeclared domestic assets or income. The Dutch rule examined by the Court in *X and Passenheim* [2009] granted the tax authorities a period of 5 years in which to investigate and recover taxes on undeclared income from savings accounts and on undeclared wealth where the accounts were held in the Netherlands but an increased period of 12 years where the accounts were held elsewhere. The Netherlands argued successfully that the increased period could be justified on the grounds of effectiveness of fiscal supervision and prevention of tax evasion[391].

4.3.ii Right to prevent avoidance of tax.

Tax may be avoided or mitigated by structuring commercial activities or transactions in a way that leads to a lower tax burden[392]. This head of justification can be used where the taxpayer has engaged in a structuring of a business or transaction and, either the structured business or transaction has no real existence, the terms of a transaction between connected parties do not reflect those that would be agreed between persons acting at arm's length or the objective is solely to gain a tax advantage and has no economic purpose[393].

What can be countered and justified in the context of the freedoms of movement is the avoidance of tax through the use of "…*wholly artificial arrangements which do not reflect economic reality, with a view to escaping the*

[390] *A* [2007] Case C-101/05 paragraph 60 as there is no recourse to the Mutual Assistance directive and because: " … the Community harmonisation measures on company accounts which apply in the Member States allow the taxpayer to produce reliable and verifiable evidence on the structure or activities of a company established in another Member State, whereas the taxpayer is not ensured of such an opportunity in the case of a company established in a third country which is not required to apply those Community measures … *"* (paragraph 62).

[391] *X & Passenheim* [2009] Case C-155/08 & C-157/08 paragraph 52. The Court then considered the proportionality of the measure. The Court considered, separately, the situations where: 1) the tax authorities have no knowledge of the existence of the undeclared assets, in which case the extended period was regarded as proportionate as recourse to mutual assistance from the tax authorities of the state in which the assets are held cannot be initiated before the existence of the assets is discovered ; and 2) the tax authorities are aware of the existence of the undeclared assets, in which case the extended recovery period would not be proportionate, assuming that the tax authorities have access to bilateral or Directive mutual assistance from the tax authorities of the state in which the assets are held – see *Halley & others* [2011] Case C-132/10 paragraph 39.

[392] *Halifax* [2006] Case C-255/02 paragraph 73: "… taxpayers may choose to structure their business so as to limit their tax liability … ".

[393] *Glaxo Wellcome* [2009] Case C-182/08 paragraph 91: "… the legislation … is capable of preventing practices which have no objective other than to obtain for the non-resident shareholder a tax credit for the corporation tax paid by the resident company".

tax normally due on the profits generated by activities carried out on national territory"[394].

However, the requirement that the 'arrangements' are wholly artificial has evolved to accommodate artificial pricing of otherwise potentially commercial transactions such as intra-group loans, sales of goods and provision of services. There is a review of cases addressing national provisions seeking to neutralise such means of profit shifting[395] [396] in chapter 5.3 *post*.

A constraint on tax avoidance provisions is that they must be "… *specifically designed to exclude from a tax advantage purely artificial arrangements aimed at circumventing … tax law* …"[397]. "… *Tax avoidance or evasion cannot be inferred generally from the fact that the tax residence of a physical person has been transferred to another Member State* …"[398]. National anti-avoidance provisions must have application only where tax is being avoided[399].

4.4 RIGHT TO DETERMINE THE SCHEMES FOR LEVYING TAXATION.

There is currently a proposal for some harmonisation of the rules for calculating and assessing profits of companies belonging to large groups[400] for the purpose of direct taxation. Subject to the proposal becoming implemented in a directive, the Court has recognised that Member States are free to determine their schemes for levying taxation[401].

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[394] *Cadbury Schweppes* [2006] Case C-196/04 paragraph 55. See earlier: *ICI* [1998] Case C-264/96 paragraph 26: "… preventing wholly artificial arrangements, set up to circumvent United Kingdom tax legislation, from attracting tax benefits …".

[395] See, for instance, *Thin Cap GLO* [2007] Case C-524/04 in relation to loan capital and *SGI* [2010] Case C-311/08 in relation to transfer pricing generally.

[396] *Glaxo Wellcome* [2009] Case C-182/08 paragraph 87: "… by indirectly granting the non-resident a financial advantage equal to the tax credit for the tax charged on the profits of a resident company, the profits normally taxable in that company's Member State of residence would be transferred to the Member State with jurisdiction to tax the profits made by the non-resident, thus jeopardising a balanced allocation of the power to impose taxes between the Member States …".

[397] *de Lasteyrie* [2004] Case C-09/02 paragraph 50.

[398] Ibid. paragraph 51.

[399] *Commission v Portugal (tax representatives)* [2011] Case C-267/09 paragraph 42: "… only if the legislation is aimed at wholly artificial arrangements the objective of which is to circumvent the tax laws, which precludes any general presumption of tax evasion." See also *Lankhorst-Hohorst* [2002] Case C-324/00 paragraph 37.

[400] Com (2016) 685 Article 2 (1) (c) – "CCCTB": consolidated revenue greater than €750 million. Companies falling within the scope of the proposed directive would cease to be subject to national corporate law. That raises the question of whether it is a harmonisation measure.

[401] *Futura* [1997] Case C-250/95 paragraph 33: "As yet, no provision has been made for harmonizing domestic rules relating to determination of the basis of assessment to direct taxes. Consequently, each Member State draws up its own rules governing the determination of profits, income, expenditure, deductions and exemptions as well as the amounts in respect of each of

The two principal heads of ground for justification under this arm of direct tax sovereignty are protection of the coherence of the tax system and effective collection of taxes.

Justification on the ground of coherence of the tax system is typically available where there is symmetry of an allowance and a linked tax charge applied to a particular taxpayer by a specific taxing scheme and this will often, but not always, involve a timing difference such as deferment of taxation of income. However, this head of justification is not limited to such circumstances as will become evident from the discussion of the case law in this chapter and chapter 5 *post*.

Justification based on the ground of effective collection of taxes will generally be advanced as a defence where a non-resident is subject to tax withheld at source whilst a resident taxpayer will be subject to an assessment and payment procedure that may have both cash flow and expense deduction benefits.

In instances where these heads of justification are accepted, the defending Member State has exercised its sovereign power in the design of a scheme of taxation that is not intended to provide "…*a disguised exemption for the sole benefit of [its] residents*"[402].

A selection of the case law relating to the two heads of justification is considered in the two sections below.

4.4.i Coherence of the tax system[403].

The Court's acceptance of this ground of justification of an infringement of a Treaty freedom of movement is recognition by it of the right of Member States to exercise their retained sovereignty in this area and to formulate their taxation schemes as they wish subject only to the requirement that they are not discriminatory nor distortive of competition.

This ground of justification is available where, for instance, national law denies a tax benefit to a person exercising a freedom of movement because the non-resident will potentially escape the tax levy linked under the scheme of taxation in point to the tax benefit denied[404]. This ground of justification is not available where there are other unlinked tax advantages that might be seen as compensating for the disadvantage caused by the restrictive provision[405].

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them which may be included in the calculation of taxable income or of losses which may be carried forward".

[402] *Commission v Hungary (property duty)* [2011] Case C-253/09 paragraph 84. The Court's last comment before accepting the justification on the ground of coherence of the tax system.

[403] See Turner [2013] ITR (Pt.1) and Turner [2013] ITR (Pt.2) .

[404] Such as the UK's Group Income Election for ACT examined in *Metallgesellschaft* [2001] Case C-397/98 & C-410/98 .

[405] *Verkooijen* [2000] Case C-35/98 paragraph 61.

The first case in which the ground for justification was accepted concerned a restriction in the Belgian income legislation that denied tax relief for pension contributions to claimants under policies arranged with non-resident pension providers. The symmetry of the Belgian scheme was that a recipient of a pension in payment would be exempted from tax if he had obtained no deduction for the contributions that he had made[406].

The essence of a pension contract is that taxation on the earnings funding the contributions made is deferred until they are paid subsequently as a pension in payment to the contributor together with the investment return earned. Thus, the earnings are taxed only when ultimately received into the possession of the contributor. The Court accepted the symmetry of the taxation scheme[407].

The Belgian scheme was re-examined by the Court in 2014 when action was taken by the European Commission pursuant to Article 258 TFEU alleging that the Kingdom of Belgium had failed to fulfil its obligations under the Treaty. The Commission's action was argued on the basis of the Court's ruling in 2007 in *Commission v Denmark (pension deductions)* [2007] in which the Court observed that the factor most threatening to the coherence of the symmetry of the scheme for relieving pension contributions and taxing pension receipts was a possible migration of tax residence of the contributor prior to or during drawing of the pension and not the residence status of the pension provider[408]. Accordingly, the denial of tax relief on contributions paid to a non-resident pension provider did not serve to protect the coherence of the tax system[409]. The Court, on re-examining the Belgian system, found similar fault in Belgium's claim to justify denial of tax relief on contributions made to non-resident pension providers[410].

The ruling of the Court in both cases diverged from its ruling in, for instance, *Bachmann*, because the Court took into account in the later cases that both Denmark and Belgium had concluded double tax treaties that "…*provides that pensions and other comparable payments are taxable only in the Member State*

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406 *Commission v Belgium (pension deductions)* [1992] Case C-300/90 paragraph 14.

407 The Court ruled: "The cohesion of such a tax system, the formulation of which is a matter for the Belgian State, presupposes, therefore, that in the event of that State being obliged to allow the deduction of life assurance contributions paid in another Member State, it should be able to tax sums payable by insurers." Ibid. paragraph 16 (emphasis added). The Court expanded upon its reasoning in *Manninen* [2004] Case C-319/02 paragraph 47: "The possibility … to deduct payments made … from their taxable income – with the end result of not taxing the income used to pay those contributions – was based on the justification that the capital constituted by means of those contributions would subsequently be taxed in the hands of its holders … double taxation was avoided by postponing the sole taxation due until the time when the capital … was paid." See also *Bachmann* [1992] Case C-204/90.

408 *Commission v Denmark (pension deductions)* [2007] Case C-150/04 paragraph 71 and paragraph 73: "It is only in the case where, before benefits fall to be paid, that taxpayer transferred his residence to a Member State other than the Kingdom of Denmark that it might encounter difficulties in taxing the benefits paid and where, therefore, the cohesion of the Danish tax system… would be adversely affected".

409 Ibid. paragraph 74.

410 *Commission v Belgium (pension deductions 2014)* [2014] Case C-296/12 paragraphs 37 to 40.

where the recipient of that income is resident…"[411]. Accordingly, the symmetry sought for the Belgian tax scheme was "*… shifted to another level, that of the reciprocity of the rules applicable in the Contracting States."*[412] as a result of the double tax treaties it had concluded with other states. Under such conventions it had surrendered its right to tax pension payments, which was under national law restricted to where it had provided relief for the linked contributions paid into the pension schemes, in favour of a simpler scheme, which was to tax pension payments received by residents regardless of whether relief from Belgian tax had been granted previously on the contributions made to the pension schemes.

4.4.i.a Symmetry.

The existence of a symmetry between a tax benefit and a tax levy will not automatically qualify a taxing scheme to be justified under this heading.

By way of example, the Dutch scheme for wealth tax examined by the Court in *Baars* [2000] provided a shareholder with exemption from the tax in respect of a 'substantial' holding in a company resident in the Netherlands but denied the exemption in respect of similar holding in companies resident elsewhere. The Netherlands government argued that the exemption avoided double economic taxation of profits charged to Netherlands corporation tax but the Court rejected that argument as the alleged symmetry "…*concerns two separate taxes levied on different taxpayers*…"[413].

That symmetry of a scheme of taxation can be modified by the provisions of a double tax treaty as mentioned *ante*. Such was so in the instance of the double tax treaty concluded between the Netherlands and Belgium examined by the Court in *Weilockx* [1995][414]. Under the terms of that treaty, "…*pensions…paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State*"[415]. That provision overrode national law in both contracting states and resulted in a substitution for the symmetry between allowance of contributions and taxation of pensions paid that was provided by the national schemes. The Court observed that the denial of tax relief claimed by a non-resident against income derived from the exercise of a profession conducted in the Netherlands

[411] Ibid. paragraph 38.

[412] *Wielockx* [1995] Case C-80/94 paragraph 24: see next section of this chapter *post.*

[413] *Baars* [2000] Case C-251/98 paragraph 40. The Netherlands government logic appears to have a flaw that was alluded to by the Court in Paragraph 39. That flaw is that an exemption providing relief for the value of a holding in a company will indirectly provide relief for double taxation of profits made by the company only where they have been retained and not distributed. The act of distribution will reduce the assets of the company, and therefore the amount of the exemption, but will increase the assets held directly by the shareholder, which are not covered by the exemption despite being sourced from profits subject to corporation tax.

[414] The case concerned Dutch tax rules under which a self-employed Dutch resident was permitted to transfer a proportion of his income to a pension reserve, which deferred taxation on the income until the reserve was liquidated or progressively paid out upon retirement. A non-resident self-employed person was not able to claim relief for such transfers.

[415] *Wielockx* [1995] Case C-80/94 paragraph 8.

and taxable there could not be justified under this head despite the inability of the Netherlands to tax the pension reserve when liquidated or paid out because the coherence was created by the "…*reciprocity of the rules applicable in the contracting states*"[416].

The necessity for the symmetry of a relief followed by a charge to taxation applicable to the same taxpayer in relation to the same tax was not initially understood by Member States. There were some thirty claims for justification under this head between 1992 and 2008 that were rejected by the Court. That run of failed claims under this head of justification appears to have ended with *Krankenheim Ruhesitz* [2008] [417], which concerned a German corporate tax scheme that provided companies resident in Germany having a branch in another state with temporary relief for losses incurred in the branch that reversed as profits were subsequently generated by the branch[418].

The most fundamental form of symmetry is the treatment of profits and losses. As the Court had acknowledged in *Marks & Spencer* [2005], profits and losses must be treated symmetrically[419] and an inability to claim relief for a loss on a disposal of an asset located outside the taxing jurisdiction of the state of residence is the corollary of such a disposal being outside of that taxing jurisdiction. The coherence of this tax system is in its symmetry[420].

[416] Ibid. paragraph 24 It is important to note that the Court was not saying that the symmetry should be determined in this way through a reciprocal arrangement but was, instead, observing that the two Member States had exercised their sovereign rights to agree reciprocity in a bilateral agreement.

[417] That does not mean to say that there were no failed claims in cases heard subsequent to *Krankenheim*. In *Commission v Portugal (pension funds)* [2011] Case C-493/09 the Court examined the exemption of withholding tax from dividends paid to pension funds resident in Portugal that was denied in relation to dividends paid to pension funds resident in another state. The symmetry alleged was that pensions in payment to resident individuals were subject to tax subsequently. However, the Court observed (Paragraphs 38 and 39) that Portuguese tax resident individuals in receipt of pensions from a non-resident fund were still taxable on their income from those funds notwithstanding that the non-resident funds had not benefitted from exemption in relation to Portuguese source dividends. Another distortion of symmetry was that the tax resident funds benefitted exemption on dividends received that were used to fund pensions to non-resident individuals. There was no symmetry.

[418] *Krankenheim Ruhesitz* [2008] Case C-157/07 paragraph 42 The symmetry of the scheme was recognised by the Court. The fact that the state of establishment of the branch did not permit losses incurred by a branch to be carried forward until there was a subsequent change of law, was of no consequence: Germany was not required to compensate for the consequences suffered as a result of that lack of facility in the state of establishment of the branch (paragraph 50). See also *Timac Agro Deutschland* [2015] Case C-388/14.

[419] *Marks & Spencer* [2005] Case C-446/03 paragraph 43 "…in tax matters profits and losses are two sides of the same coin and must be treated symmetrically in the same tax system…"

[420]*K* [2013] Case C-322/11 paragraphs 69 to 71. See also analysis of this lack of comparability in chapter 6 *post*.

4.4.i.b Deferral.

The previous cases examining national rules applied to pension schemes could be categorised under this heading as the income of taxpayers applied in the making of contributions to pension schemes was taxed only when paid subsequently to them as pension payments. The symmetry was a deferral of tax levied on the income contributed to a pension arrangement. Similarly, the German scheme of temporary relief for foreign branch losses examined by the Court in *Krankenheim Ruhesitz* [2008] can be considered to be a deferral scheme although it would seem that permanent relief might be obtained if the branch did not return to profit or generated insufficient profit before being closed down.

In d*e Lasteyrie* [2004], the Court examined a French assessment provision that was triggered when a person tax resident in France, owning company securities entitling the holder and persons connected with him to not less than 25% of the profits, migrated his tax residence outside France. The tax charge (if any) was applied to the increase in the value of those securities[421]. The increase in value, but for the triggering of this provision, would usually be taxed when the securities were sold and the gain realised. The symmetry and coherence of this scheme of taxation was a deferral of taxation of the appreciation in the value of the asset until the taxpayer had the proceeds of disposal with which to pay the tax[422].

However, the coherence of this scheme failed in the instance of a migration of tax residence and the triggering of the deemed gain restored the coherence of the French tax system[423].

Commission v Sweden (rollover) [2007] is a somewhat singular case because the Court raised the matter of a justification under this head but noted that Sweden had not attempted to defend the restrictive provision on this ground[424].

4.4.i.c Progressive Taxation

The property transfer duty examined by the Court in *Commission v Hungary (property duty)* [2011] was structured to be charged on the progressive amount invested in residential property in Hungary for self-occupation[425]. A person

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[421] *de Lasteyrie* [2004] Case C-09/02 paragraph 12. See chapter 7.3.iii *post*.

[422] Ibid. paragraph 61 See also *National Grid Indus* [2011] Case C-371/10 paragraph 80 approving the Advocate General's comment in paragraph 99 of her Opinion: "If the Netherlands, because of the transfer, were no longer able to tax the unrealised capital gains accrued during the period of residence of National Grid Indus in its territory, coherence of the tax system would not be possible...".

[423] The deemed gain was 'forgiven' if the taxpayer remained non-resident for 5 years or more: *de Lasteyrie* [2004] Case C-09/02 paragraph 65. Accordingly, the deeming provision could not be seen as one protecting the tax base.

[424] *Commission v Sweden (rollover)* [2007] Case C-104/06 paragraph 27. See chapter 7.3.ii *post*..

[425] *Commission v Hungary (property duty)* [2011] Case C-253/09 paragraph 2. The mechanism of assessment was to assess tax on the price of the new property and to deduct from that tax paid on the proceeds of sale of the previous residence insofar as reinvested in the new property. There

exercising a freedom of movement to move to Hungary and buy a residential property in that territory might have been in a situation comparable to that of a Hungarian resident buying a replacement principal residence, in that the migrant might have paid transfer duty in the state in which he had purchased his previous residence. In relation to a domestic situation, the Court observed the right for a credit against duty payable on the new purchase reflecting Hungarian property duty already paid when buying the previous residence in the territory "…*reflects a logic of symmetry*…"[426] having regard for the objective of the tax, which was to levy duty on the cumulative amount invested in residential property situated in Hungary and not to tax each acquisition independently[427].

Whilst *Feilen* [2016] concerned quick succession relief under German inheritance rules, and not progressive taxation of the kind examined by the Court in *Commission v Hungary (property duty)* [2011], the Court accepted the "…*logical symmetry*…"[428] of the German scheme that provided relief for German inheritance tax in the form of a discount calculated by reference to German tax previously paid in respect of the assets on a previous death.

That case required the Court to reconsider the requirement in its linkage test between the tax advantage and the subsequent levy. Previously, the Court had accepted a claim for justification under this head only where the same taxpayer enjoyed the benefit and had to bear the levy under the same tax scheme[429]. But, clearly, "…*the condition that the same taxpayer must be involved could not be applied given that the person who paid the inheritance tax at the time of the earlier inheritance is necessarily deceased*"[430]. The coherence of a scheme of taxation that partially relieves double taxation of assets that move successively between "…*close relatives of the same family*"[431] could not be denied, however.

Although the Court made no reference in *Feilen* [2016] to *Papillon* [2008], which concerned the French tax integration scheme, the effect of the French legislation was to treat the parent company and its subsidiaries included in the

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could be no refund of tax if the tax on the proceeds of disposal exceeded the tax due on the acquisition of the new property (see paragraph 84). See also *Commission v Belgium (property duty)* [2011] Case C-250/08, which concerned a similar scheme for property transfer duty.

[426] *Commission v Hungary (property duty)* [2011] Case C-253/09 paragraph 74.

[427] This system of taxing acquisitions of residential property avoids penalising individuals obliged to relocate in consequence of the demands of their employment or occupation or to take up new employment or occupation and promotes mobility of labour.

[428] *Feilen* [2016] Case C-123/15 paragraph 33.

[429] For instance, in *Verkooijen* [2000] Case C-35/98 paragraph 58 the Court said: "No such direct link exists in this case between the grant to shareholders residing in the Netherlands of income tax exemption in respect of dividends received and taxation of the profits of companies with their seat in another Member State. They are two separate taxes levied on different taxpayers", (emphasis added).

[430] *Feilen* [2016] Case C-123/15 paragraph 36.

[431] Ibid. paragraph 37.

election for such treatment as a single taxpayer[432]. Thus, for the purposes of the same tax, the profits and losses of the companies in the integration election were aggregated and deemed to accrue to a different taxpayer. The Court had previously broadened the concept of coherence of a tax system taking account of the objective of the scheme.

4.4.ii Effective Collection of Taxes.

Most often a withholding tax will be a means to tax income such as company distributions or interest, income that is generally taxed gross without deduction for expenses[433]. The basis of taxation of tax resident corporate taxpayers might be different as either or both sources of income might be included in their assessment to corporation tax and taxed at that rate. In such case, they might be exempted from suffering tax at source.

Where, in the case of other forms of income or profit, a resident recipient of services or agent appointed to collect income from, for instance, property, is required to withhold tax that is assessed on the same or similar basis as is applied to such income or profit received by resident taxpayers, the non-resident taxpayer will be in a situation comparable to that of a resident taxpayer[434] but will suffer a disadvantage in terms of cash flow at the very least. Such a restriction does need to be justified and a justification under this head may be advanced.

The Court explicitly acknowledged in *Dijkman & Dijkman-Lavaleije* [2010] that the assessment and collection of tax from non-residents "…*are not satisfactorily resolved by international recovery assistance instruments*…"[435]. Accordingly, a withholding of tax from a payment for services provided by a non-resident might "…*constitute a legitimate and appropriate means of ensuring the tax treatment of the income of a [non-resident] and ensuring that the income concerned does not escape taxation in the State of residence and the State where the services are provided*"[436]. However, whilst the Court has accepted a justification under this head for a withholding tax applied to payments to "…*service providers who provide occasional services…in a Member State…where they remain only a short period of*

[432] *Papillon* [2008] Case C-418/07 paragraph 28. The restrictive provision sought to be justified had the objective of eliminating double counting of losses: discussed in chapter 5.2.i *post*.

[433] Banks would be an exception as they make a margin on money taken as deposits or borrowed recognised by the Court in, for instance, *Commission v Portugal (interest withholding tax)* [2010] Case C-105/08 paragraph 28.

[434] Note that a restriction will arise if the person withholding tax from the payment to the non-resident is not allowed by national law to take account of the direct expenses that would be deductible for tax purposes by a resident taxpayer. See *Scorpio* [2006] Case C-290/04 paragraph 49.

[435] *Dijkman and Dijkman-Lavaleije* [2010] Case C-233/09 paragraph 44: the Court is referring to Directives (now) 2011/16/EU and 2010/24/EU.

[436] *Scorpio* [2006] Case C-290/04 paragraph 36.

time…"[437] it has declined to accept the justification under this head where the non-resident has an establishment in the host state[438].

4.5 CONCLUDING COMMENTS.

The competence retained by the Member States in relation to direct taxation is the power to determine the scope of their taxing jurisdiction and the power to determine the design of their schemes of taxation. Different schemes of taxation are generally applied to those defined in the national tax legislation as resident in the territory and to those that are not resident but possess a source of income deriving from the territory. The competence retained by Member States reserves to them the power to conclude between themselves bilateral treaties providing for the allocation of those taxing powers where they overlap.

In recognising that competence, the Court has accepted descriptive formulations of aspects of that retained sovereignty.

The internal market, through the freedoms of movement defined in the Treaty, ensures the protection of the right of residents to move to or conduct economic business in other Member States. It would be against the very objective of the freedoms of movement if the Member States could justify restrictive tax measures on the sole ground that the exercise of those freedoms of movement by persons within their taxing jurisdiction would result in a loss of tax revenue and the Court has consistently rejected claims to justify restriction tax provisions on that ground albeit that it makes exception to that principle where objective and purpose of the national law is to prevent evasion and avoidance of taxes.

A second inevitable consequence of the formation of an internal market is the necessity to ensure that the schemes for levying direct taxes do not create competitive or other disadvantages to persons exercising the freedoms of movement that would deter them from exercising those freedoms or would disadvantage them if they do.

In some cases, the exercise of a freedom of movement by a person will result in that person becoming subject to the taxing schemes of one or more other Member States. Advantages or disadvantages arising from the disparities between those schemes of taxation will occur and those can only be neutralised by harmonisation measures. The Court has recognised that disadvantages might occur as a result of those disparities and has ruled that the Treaty places no obligation on Member States to modify their national schemes of taxation to eliminate them[439]. In so ruling, the Court has recognised the retained sovereignty of Member States to draw up their own schemes for levying direct tax.

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[437] *X NV* [2012] Case C-498/10 paragraph 42.

[438] *Strojírny Prostějov* [2014] Case C-53/13 & C-80/13 paragraphs 49 to 53.

[439] See, for instance, *Deutsche Shell* [2008] Case C-293/06 paragraph 43.

The focus of this chapter has been on the grounds for justification of national provisions that treat persons exercising a freedom of movement differently simply by reason of those freedoms having been exercised. As stated in the introduction to this chapter, certain special situations involving groups of companies, companies having foreign branches and migration of tax residence are addressed in chapter 5.

The principal headings under which Member States can argue justification of infringements are, first, the exercise of sovereignty in determining their tax base and protecting it from erosion through evasion or through artificial arrangements; and second, they can argue justification in relation to the exercise of their sovereign right by determining the taxing schemes and collection mechanisms that they implement.

It is inevitable that there will be overlap between the main headings of justification and the recognised subsidiary actions. For instance, where a taxpayer migrates his tax residence, he may do so having income or gains that have not been taxed up to the point of departure because of the lack of a taxable event under the national provisions. To address this, many states treat the point of migration as a trigger event[440]. As the Court observed, in such a situation: "… *the requirements of coherence of the tax system and the balanced allocation of powers of taxation coincide*"[441]. Thus, in such a situation, the state can justify levying tax on untaxed income and gains, both on the basis of protecting its tax base, and on the basis of preserving the symmetry or coherence of having deferred taxation of such income and gains as they accrued until a normal trigger point is reached, such as the disposal of an asset.

It has been seen from the case law that the prevention of tax evasion and the enforcement of fiscal supervision (to prevent tax evasion) have a clear overlap because the very purpose of fiscal supervision is to prevent evasion.

Similarly, national provisions designed to counter profit shifting through the implementation by a taxpayer of artificial arrangements will be provisions protecting the tax base often formulated by the Court as protecting the "*balanced allocation of taxing power*".

Finally, it is inevitable that tax collection mechanisms, such enforcement of the withholding of tax by a tax resident agent, or by the recipient of service provided by a non-resident, will overlap with the prevention of evasion of tax.

Accordingly, it may be concluded that the formulated justifications for infringement of the freedoms of movement by national provisions defining and protecting the tax base and defining the taxing and collection mechanisms are simply expressions of different aspects of the exercise of direct tax sovereignty and constitute a coherent.

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[440] This is a reference to 'exit taxes' dealt with in chapter 7 *post*.

[441] *National Grid Indus* [2011] Case C-371/10 paragraph 80.

Subject to the departures from the form of analysis that it has developed, the Court's application of that procedure has proved to be consistent. The departures are discussed in part II of this thesis.

5 GROUPS OF COMPANIES AND FOREIGN PERMANENT ESTABLISHMENTS.

5.1 INTRODUCTION TO THE CHAPTER.

Conceptually, the parent company of a group of companies conducts its business through its subsidiaries[442] and, more obviously, a company conducts its business through its establishments, including permanent establishments set up in other states.

There may be commercial reasons why a company should choose to conduct its business through a subsidiary or, alternatively, choose not to. Many states have special provisions applicable to companies trading through subsidiaries that mitigate the tax disadvantages[443] that might arise from so doing. Inevitably, those special schemes will exclude non-resident subsidiaries from participating in tax consolidation groups, however defined, and this could disadvantage subsidiaries established and tax resident in other states and the group itself. It might be said, however, that these special taxing schemes do no more than offer a group an alternative scheme for taxation that effectively looks through the incorporation of the subsidiaries and treats them as branches or divisions of the parent company[444].

As is argued in chapter 6.2 *post*, a subsidiary that is excluded from participation in such tax consolidations by reason of its tax residence is in a situation objectively different from that of a resident subsidiary company by reason of it being outside the scope of the taxing powers of the state of residence of the parent company and its domestic subsidiaries. EU law does not require the state of residence of the parent company to modify its tax law to eliminate any disadvantage that might flow from such a restriction[445].

[442] See, for instance, *Bosal* [2003] Case C-168/01: "…a parent company might be dissuaded from carrying on its activities through the intermediary of a subsidiary established in another Member State…" paragraph 27 (emphasis added).

[443] For instance, setting off profits and losses accruing in different companies (*Marks & Spencer* [2005] Case C-446/03) or deferring gains on transfers of assets within a group (*Gallaher* [2023] Case C-707/20).

[444] See, for instance, *Papillon* [2008] Case C-418/07 paragraph 28: "…the provisions…aim to treat…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…".

[445] See *Columbus Container* [2007] Case C-298/05 paragraph 51: "…It follows from that tax competence that the freedom of companies and partnerships to choose, for the purposes of establishment, between different Member States in no way means that the latter are obliged to adapt their own tax systems…". See also *Block* [2009] Case C-67/08 paragraph 31.

National taxation schemes may also have special provisions enabling foreign permanent establishment losses to be 'relieved', permanently or temporarily, against the company's profits assessable in the home state[446].

There will be some overlap of case law with that reviewed in chapter 8 but the focus in this chapter will be on the grounds for justification examined in those cases before consideration of the proportionality of the restrictive provisions, which is the stage at which the Court introduced the notion of 'final losses' discussed in that chapter.

Companies that have subsidiaries or permanent establishments established in another state have an opportunity to transfer profits between the states of residence through artificial transactions and pricing of intra-group transactions. Many Member States have anti-avoidance provisions that seek to neutralise the benefit sought to be generated by such avoidance arrangements. There will be a review of some of the case law in which the anti-avoidance provisions were examined by the Court.

It will be recalled that the application of different national rules to persons depending upon whether or not they have exercised a freedom of movement will result in an infringement of the Treaty unless the differing rules apply to situations that are not comparable[447]. That is the first test and, if, but only if, the national rules do cause an infringement, it is then necessary to examine whether they can be justified[448]. There would normally follow a final test of the proportionality of the restriction, if justified.

Whilst it might seem obvious that, in any examination of a circumstance where differing national rules are applied, it is first necessary to determine whether the application of the differing rules gives rise to an infringement of a Treaty right, the record of the Court of so doing appears to be somewhat patchy as evidenced by the comment made by Advocate General Kokott in her Opinion in *Nordea Bank Danmark* [2014][449]. Contrary to the patchiness of the analysis in some judgments,

[446] For instance, the German scheme examined in *Krankenheim Ruhesitz* [2008] Case C-157/07. Note that the 'relief' had the character of a deferral of taxation of home state profits equivalent to the foreign branch losses until the fortunes of the branch reversed.

[447] *FII GLO* [2006] Case C-446/04 paragraph 167: "…for such a difference in treatment to be compatible with the…Treaty…it must concern situations which are not objectively comparable…". See also *ACT IV GLO* [2006] Case C-374/04 paragraph 46.

[448] *Papillon* [2008] Case C-418/07 paragraphs 32 & 33: "Inasmuch as…they put Community situations at a disadvantage compared with purely domestic situations, the provisions of the CGI…thus constitute a restriction…such a restriction of the freedom of establishment is permissible only if it is justified by overriding reasons of public interest…"

[449] *Nordea Bank Danmark (AGO)* [2014] Case C-48/13 paragraph 25: ""…the extent <u>of the examination as to the comparability of situations has varied significantly recently</u>, particularly in decisions relating to tax law…" (emphasis added). The Opinion was delivered on 13 March 2014.

however, there is the clear analysis in *Felixstowe Dock*[450], which was handed down just weeks after the Advocate General delivered her opinion.

5.2 COHERENCE OF THE TAX SYSTEM.

Tax grouping arrangements, by and large, seek to mitigate the type of tax disadvantages that might accrue to a parent company conducting its business through separate legal entities that it might avoid by conducting its business through departments and branches. The national schemes can address this disadvantage by fiscally treating the tax resident members of a group as a single entity or by providing tax resident members of the group with a means for transferring profits or losses between them. There are also grouping arrangements permitting assets to be transferred between the tax resident members of a group without triggering taxation on an increased value or a recovery of tax depreciation.

Distortion to a group's consolidated tax burden will occur when group members sustain losses that cannot be offset against the profits of other group members. There will be adverse cash flow consequences also where there are 'stranded losses', even if temporary, and that will impact on the ability of the group to compete in its marketplaces.

Similarly, where a company has established a branch in another tax jurisdiction, losses arising in the branch will lead to distortion of the company's tax burden unless the taxing jurisdiction of the home state is extended to the territory of establishment of the branch and the offset of branch losses against home state profits is permitted.

Distortion of the tax burden will, of course, occur in both instances where the losses arise in the home state in a period when there are profits arising in foreign establishments. There will be the attendant cash flow disadvantages and compromise of competitiveness.

Whilst such a result might be an obstruction to the successful completion of the Internal Market, it is the inevitable consequence of Member State sovereignty in direct taxation. Each of the Member States has its own budget to fund through

[450] *Felixstowe Dock* [2014] Case C-80/12 paragraph 30: *"*Whilst the objective of preserving powers of taxation as between the Member States has been recognised as legitimate by the Court (see, inter alia, Case C-371/10 National Grid Indus EU:C:2011:785, paragraph 45) in order to safeguard symmetry between the right to tax profits and the right to deduct losses (see Case C-414/06 Lidl Belgium EU:C:2008:278, paragraph 33), in a situation such as that at issue in the main proceedings the power of the host Member State, on whose territory the economic activity giving rise to the losses of the consortium company is carried out, to impose taxes is not at all affected by the possibility of transferring, by relief and to a resident company, the losses sustained by another company, since the latter is also resident for tax purposes in that Member State (see, to this effect, Philips Electronics EU:C:2012:532, paragraphs 25 and 26)*"*.

the levy of taxation and retention of the right to determine its own tax base is a necessity.

Accordingly, in the case of tax groupings, it is natural for the national scheme to restrict its relieving provisions to losses incurred within its taxing jurisdiction and, more specifically, within the scope of the application of the charging provisions.

The coherence of the schemes is that the aggregate net taxable profits generated within the scope of the charging provision is unchanged. That coherence would be undermined by any requirement to take account of losses sustained on activities conducted outside of the scope of the charging provision regardless of whether the 'parent company' conducts those activities through a subsidiary established in the other state or whether through a permanent establishment in that state.

Both principal arms of tax sovereignty are engaged. As the Court termed it in *National Grid Indus*, "*…the requirements of coherence of the tax system and the balanced allocation of powers of taxation coincide*."[451].

A company seeking to surrender 'foreign losses'[452] is not in the same situation as a company seeking to surrender losses sustained in the home state having regard to the purpose of the taxing scheme, which is to permit aggregation of the profits and losses of a group that are generated within the home state's taxing jurisdiction. As the Court stated in *Avoir Fiscal [1986]*, it is the charging provision that determines whether different situations are to be treated as comparable[453].

Similarly, in relation to companies sustaining 'foreign losses' through branches, it is to be expected that the home state will either refuse deduction of such losses from profits generated within its jurisdiction or, if temporary relief is granted, will withdraw that temporary relief as the fortunes of the foreign branch improve regardless of the taxation imposed on those subsequent profits by the state in which the foreign branch is established[454].

As has been argued, because the losses in these two situations were sustained outside of the home state's taxing jurisdiction, no restriction should arise as there is lack of comparability with losses incurred in the home state. Accordingly, in neither example should it be necessary to justify the national provisions causing the apparent disadvantage.

Nevertheless, the Court appears, in some cases, to have proceeded along the path of ruling that the national provision creating the disadvantage is restrictive

[451] *National Grid Indus* [2011] Case C-371/10 paragraph 80.

[452] 'foreign losses': Losses sustained by activities conducted outside of the home state's taxing jurisdiction.

[453] *Avoir Fiscal* [1986] Case 270/83 paragraph 20 and see also *ACT IV GLO* [2006] Case C-374/04 paragraph 68.

[454] Such was the case in *Krankenheim Ruhesitz* [2008] Case C-157/07 paragraph 17.

and then permitting justification of the restriction by reference to the coherence of the tax system.

The focus in this chapter is on the application of the ground of justification, coherence of the tax system, regardless of whether the Court's finding of a restriction might be flawed.

5.2.i Grouping arrangements.

The earliest cases in which the Court examined schemes for profit grouping arrangements were *ICI* [1998][455] and *X AB & Y AB* [1999][456] but neither of these cases involved the setting off of 'foreign losses' against profits generated in the home state either by import of losses or by export of profits. In neither case could the restriction be justified. In passing, the coherence of the Swedish scheme examined in *X AB & Y AB* [1999] was noted by the Court and it observed that the objective of the Swedish scheme was "…*to prevent the tax burden borne by a business carried on by a number of undertakings in a group from being greater than if it is carried on by a single undertaking*"[457]. That objective would have enabled Sweden to justify refusing a cross-border transfer of relief had such a restriction been in point[458].

The first material case involving profit grouping arrangements was *Marks & Spencer [2005]* which also spawned a series of further cases because of the Court's ruling in relation to 'final losses' (see chapter 6.2.ii and chapter 8 *post*).

The UK scheme permits companies in a group (as defined) to offset UK corporation tax losses against UK corporation tax profits[459]. Marks & Spencer claimed to offset the losses of its Belgian, French and German subsidiaries against UK corporation tax profits notwithstanding that the losses were sustained in operations conducted outside the scope of UK corporation tax[460]. The Court determined that the denial by national legislation of the taxpayer's claim for relief for imported losses was a restriction[461] despite there being no comparability of

[455] *ICI* [1998] Case C-264/96 This case concerned a restrictive rule that denied UK 'consortium relief' if the composition of the group owned by the consortium did not consist mainly of UK resident companies: see chapter 4.2.i *ante*.

[456] *X AB & Y AB* [1999] Case C-200/98. In this case, the Court examined a restrictive rule in the Swedish scheme for permitting transfers of profits between group companies that denied the benefit of the scheme where a Swedish group company was partially indirectly held by subsidiaries established in other Member States. The same type of restriction was examined by the Court in *Papillon Papillon [2008] Case C-418/07*.

[457] *X AB & Y AB* [1999] Case C-200/98paragraph 4

[458] Such a situation was examined by the Court in *Oy AA* [2007] Case C-231/05 see this chapter *post*.

[459] *Marks & Spencer* [2005] Case C-446/03 paragraph 16. The UK scheme pursued an objective similar to that pursued by the Swedish scheme examined by the Court previously in *X AB & Y AB*.

[460] Ibid. paragraph 22.

[461] Ibid. paragraph 34.

situations with a resident subsidiary and despite the objective[462] of the UK scheme being to permit groups to set-off UK corporation tax profits and losses. [463]

The coherence of this taxation scheme, though it was not argued by the United Kingdom, is that, to the extent that group companies so elected, they would be taxed as if the group's business was undertaken in the United Kingdom through a single entity[464].

The United Kingdom government argued three grounds for justification of the rule preventing importation of losses. The first of these[465], protection of a balanced allocation of taxing powers, overlaps with protection of the coherence of the taxation system because both are disturbed by the importation of losses[466]. The coherence of the tax system is disturbed because permitting offset of foreign losses alters the quantum of net corporation tax profits within the charge to UK tax, not merely the timing and way in which UK corporation losses can be relieved. That alteration of the quantum of UK profits chargeable to UK tax is a permanent reduction that undermines the bilateral allocations of taxing powers agreed by the Member States concerned.

That both the coherence of the tax system and the balanced allocation of taxing powers would be undermined by the import of losses was recognised by the Court subsequently in *Philips Electronics* [2012][467], which concerned a claim to set off the losses of a UK branch of a Dutch company against the profits of UK resident companies satisfying the grouping requirements, notwithstanding that the Dutch company might be able to relieve the losses of the UK branch against its profits subject to Dutch taxation[468].

The coherence of the Finnish financial transfer scheme was not recognised by the Court in the earlier case, *Oy AA* [2007], however. It was analysed by reference

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[462] See *Papillon* [2008] Case C-418/07 paragraph 27. For a detailed summary of the French system of tax integration and, for comments on other integration systems, see Durand & Rutschmann [2009] ECTR pages 122-130.

[463] The Court acknowledged 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." *Marks & Spencer* [2005] Case C-446/03 paragraph 45.

[464] The coherence of such a scheme was recognised in *Papillon* [2008] Case C-418/07 paragraphs 46 to 51.

[465] The other two grounds for justification were double counting of losses, discussed in Chapter 8 *post* and prevention of tax avoidance, discussed in section 5.3 *post*.

[466] *Marks & Spencer* [2005] Case C-446/03 paragraph 43.

[467] The Court stated in recognition of both aspects of retained sovereignty: "…preserving the allocation of powers of taxation between the Member States is a legitimate objective…That…is designed, inter alia, to safeguard the symmetry between the right to tax profits and the right to deduct losses..." *Philips Electronics* [2012] Case C-18/11 paragraphs 23 & 24.

[468] The double deduction aspect of this is more fully discussed in chapter 8 *post*. However the losses subject to the claim were those that arose in the UK as a result of activities conducted there by the branch.

to protection of taxing powers[469]. That scheme enabled a financial transfer, cash, to be transferred between Finnish resident group companies and recognised for company tax purposes so that the profits of the payor would be reduced by the amount of the transfer and the profits of the payee increased (or its losses reduced).

The Dutch tax integration system was examined by the Court in *X Holding*. The Court accepted a justification based on the ground of protection of taxing powers for the restriction in the scheme that permitted integration only of companies tax resident in the Netherlands[470]. The taxpayer's claim, if it had been supported by a ruling of the Court, would have gone further than simply undermining the coherence of the tax integration system but would have forced the Netherlands to extend its taxing powers to companies tax resident in other states, possibly in contravention of its obligations in bilateral double tax treaties.

The Court's ruling in *Groupe Steria* [2015] raises a question over the level at which the objective of the scheme is to be viewed and of how the coherence of the scheme is to be defined[471]. The Court may have misunderstood the consequences of the French tax integration scheme and it is discussed in chapter 8 *post*.

[469] *Oy AA* [2007] Case C-231/05 paragraph 56. The Finnish subsidiary (unsuccessfully) claimed relief in respect of a transfer made to its UK parent, which was clearly an export of profits out of Finland. The reference in paragraph 53 of the Court's judgement to *Rewe (ITS)* [2007] Case C-347/04 paragraph 43 is distracting because the issue in that case was a German provision that permitted a parent company to claim a tax deduction for writing down its investment in a German subsidiary but denying a tax deduction for a write down of an investment in a foreign subsidiary. That has nothing to do with importation of losses or export of profits but is comparable to the disallowance of expenses incurred by a Dutch parent of a foreign subsidiary examined by the Court in *Bosal* [2003] Case C-168/01. In both cases the denial of the tax relief was in relation to expenses incurred in the territory by a resident company and the restrictions were held to be discriminatory and unjustifiable.

[470] *X Holding* [2010] Case C-337/08 paragraph 33. The scheme was subsequently re-examined in *SCA & Others* [2014] Case C-39/13, C-40/13 & C-41/13 which concerned a restrictive provision in the Dutch scheme that denied tax integration with subsidiary companies where held indirectly by the parent company through one or more non-resident intermediate holding companies. That is a very different form of restriction and the Court followed *Papillon [2008] Case C-418/07*.

[471] The dividends were taxed by disallowing costs related to the holding equal to 5% of the dividends received grossed up for any attaching tax credit or, if less, the total relevant costs incurred by the parent company in that tax period *Groupe Steria* [2015] Case C-386/14 paragraph 6. The claim to justify the apparently discriminatory restriction in the French tax code in relation to the taxation of dividends from non-resident subsidiaries that was examined by the Court in that case was rejected by the Court. The French tax code provided that, whilst a parent company suffered no tax liability when it received dividends from subsidiaries elected into the tax integration with it, dividends received from non-resident subsidiaries, which were ineligible to elect to join the tax integration, were subject to tax.

5.2.ii The UK tax credit and ACT cases.

The UK's former scheme for Advance Corporation Tax ('ACT') and tax credits was first examined by the Court in *Metallgesellschaft* [2001][472]. ACT was a tax levied on distributions made by UK resident companies[473] and it in effect displaced corporation tax to the extent that profits were distributed[474]. Once a distribution by a UK company had been 'franked' by a payment of ACT (it was not a withholding from the distribution), no further ACT was payable in respect of that distribution no matter how many times it was received and then redistributed by UK resident companies (unless there was, in the interim, a change to the rate of ACT). In the hands of a UK resident company, the tax credit attached to the distribution served to discharge the liability to pay ACT on redistribution and, in the hands of any other person, the tax credit served to discharge income tax at the basic rate chargeable on the income.

The complaint examined by the Court in *Metallgesellschaft* [2001] concerned the special scheme under which a UK resident parent company and its UK resident subsidiaries could elect that a subsidiary could pay distributions to its parent without accounting for ACT on the distribution except to an extent (if any) specified by the subsidiary in respect of each and every distribution. The election[475] could only be concluded by companies resident in the UK and a disadvantage was experienced by UK resident (direct) subsidiaries of non-resident

[472] *Metallgesellschaft* [2001] Case C-397/98 & C-410/98. The author explained the scheme in Turner [2012] ECTJ .

[473] The nature of the tax is a question of fact so far as concerns the Court of Justice and it was misadvised on this. See *Metallgesellschaft* [2001] Case C-397/98 & C-410/98 paragraph 52 and Finance Act 1972 s.84(1), which provides: "Where a company resident in the United Kingdom makes a qualifying distribution after 5th April 1973 it shall be liable to pay an amount of corporation tax (to be known as "advance corporation tax") in accordance with this section". s.84(2) provides: "…advance corporation tax shall be payable on an amount equal to the amount or value of the distribution, and shall be so payable at a rate (to be known as " the rate of advance corporation tax ")…". Accordingly, the tax was levied when, but only when, a distribution was made by a UK company and the tax was calculated by reference to the distribution and took no account of profits or losses, whether current or past. See. *Athinaiki* [2001] Case C-294/99 paragraph 29.

[474] When enacted, the rates of corporation tax was 52% and the rate of ACT was 30%. Because of the set-off of ACT against corporation tax, distributed profits were taxed at 22% ('mainstream tax'). Because chargeable gains were then taxed at an effective rate of 30% (see FA 1972, s.93 – abatement of chargeable gains), ACT could not be set against corporation tax on that part of a company's profits – only on the income element: FA 1972, s.85(1): "…shall be set against its liability to corporation tax on any income charged to corporation tax…".

[475] Group Income Election ('GIE') Re-enacted in FA 1972 Schedule 15 Part II amending section 256(1) of the 1970 consolidation act. Korving [2016] ECTR at page 45 says: "In its *Metallgesellschaft* judgment, the CJEU leaves undecided which UK tax provision is incompatible with EU law: the restriction of group income selection or the ACT exemption that is a consequence of that." There was no "exemption": there was (effectively) an election between the parent and the subsidiary that the parent should assume an increased liability to pay ACT, when it came to redistribute its subsidiary's dividend, allowing the subsidiary to pay a lesser amount of ACT, or none at all.

parent companies in that they could not avoid paying ACT[476] on distributions made to their parent companies[477].

The symmetry and coherence of the UK's GIE was that the liability to ACT became payable by the parent company when it redistributed its subsidiary's distribution paid to it under election. That coherence would have been broken if the legislation had allowed non-resident parent companies to conclude an election with their UK resident subsidiaries because non-resident companies were not within the scope of the tax, which was assessable only on UK resident companies. The restrictive provision was therefore necessary to protect the coherence of the ACT scheme[478].

Prior to the introduction of ACT, the UK scheme involved the withholding of income tax from dividends. UK companies, both before and after the introduction of ACT were exempt from tax on dividends received from UK companies and, in that sense, the UK scheme was similar to the German scheme examined by the Court in *Commission v Germany (dividend tax)* [2011][479].

Where the German scheme differed from the UK scheme was that the UK income tax credit could only be used to 'frank' a redistribution of the dividend. In contrast, German resident companies suffering withholding tax deducted from German company distributions were able to set the tax credit against company tax or obtain a refund in cash if their liability was insufficient. Non-resident company shareholders were unable to obtain a refund. The Court rejected the claim to justify the discriminatory restriction because German resident companies were not subject to the condition that they redistribute dividends received and that there was no requirement that the tax credited to the German companies or refunded was subsequently matched with income tax payable by non-corporate shareholders on the redistributed dividend[480].

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[476]However, no ACT liability accrued to the extent that distributions were redistributions of UK dividends received by the subsidiaries.

[477] *Metallgesellschaft* [2001] Case C-397/98 & C-410/98 paragraph 43.

[478] Because the Court understood ACT to be a payment on account of corporation tax payable by the distributing companies, the justification of protecting the coherence of the tax system was not argued. It should be noted that it was only non-resident companies (whether parent companies or otherwise) that were ineligible to conclude a GIE and, being outside the scope of the charging provision they were not in a situation comparable to UK resident companies. Other cases affected by the misunderstood identity of ACT are *FII GLO* [2006] Case C-446/04 and *BT Pension Scheme* [2017] Case C-628/15.

[479] *Commission v Germany (dividend tax) [2011] Case C-284/09*.

[480] Ibid. paragraph 87. Similarly, in *Fidelity Funds* [2018] Case C-480/16, the Danish scheme applicable to UCITS in receipt of dividends paid by Danish companies subject to withholding tax provided discriminatory exemption from withholding tax for dividends paid by Danish companies to Danish resident UCITS. That exemption was matched by an obligation on the Danish UCITS to deduct withholding tax on redistributions but the Court observed that non-resident UCITS should be offered the opportunity for exemption by proving that they deducted a comparable withholding tax when making distributions subject to comparable requirements to make minimum

In summary, the coherence of the ACT scheme was that tax was paid in relation to a company distribution once and once only when distributed or redistributed by a company within the scope of corporation tax. The tax was levied on the distributing company and not on the shareholder[481], as would have been the case had ACT been a withholding tax. The coherence of the GIE, which also existed for the previous scheme, was that intra-group dividends could be disregarded and the tax collected only when distributed by the parent company. Clearly, that coherence would have failed where the parent company was outside the scope of the charging provision[482].

The misunderstanding of the nature of the tax[483] led to a ruling by the Court in relation to credit relief (imputed in relation to a foreign dividend and representing underlying tax paid on profits) against ACT payable on a distribution made by a UK resident company[484] that was absurd.

The coherence of the UK's ACT system was not recognised because of a mistaken understanding of the nature of the tax. Member State sovereignty in direct tax matters was compromised by the judgment but the fault lies with the Member State.

5.2.iii Permanent establishments.

The cases reviewed in this section, apart from *Deutsche Shell* [2008], concern the tax treatment in the home state of losses sustained by a foreign branch established in a state with which the home state has concluded a double tax treaty that provides for exemption of profits of a branch operating in the other state. The contention in relation to *Deutsche Shell* [2008] is that the loss in question actually occurred in the home state.

The Belgian tax rules applicable to losses where the company had a foreign branch[485] were examined by the Court in *AMID* [2000].

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redistributions despite the fact that Denmark would not collect that withholding tax from redistributions (paragraph 84). The Court (paragraphs 57-62) observed that it was Denmark's decision to tax income receivable by UCITS at the shareholder level and had to accept the loss of tax base where the shareholders are non-residents.

[481] See *ACT IV GLO* [2006] Case C-374/04 paragraph 61. It should be noted that in the hands of a company in charge to UK corporation tax, the tax credit attaching to a franked dividend could not be used to reduce corporation tax on profits and was not repayable unless the company had surplus Franked Investment Income ('FII') and elected under ICTA 1988 s.242 to treat the FII as corporation taxable profits.

[482] As the Court has recognised in *National Grid Indus*: "If the Netherlands…were no longer able to tax the unrealised capital gains…coherence of the tax system would not be possible." *National Grid Indus* [2011] Case C-371/10 paragraph 80

[483] Treating ACT as an advance payment of tax on profits instead of a tax on distributions made.

[484] *FII GLO (2)* [2012] Case C-35/11 paragraph 72.

[485] *AMID* [2000] Case C-141/99 paragraphs 22 – 24.

The particular facts were that *AMID* [2000] suffered a loss in Belgium but generated a profit in its Luxembourg branch that was deducted from the Belgian loss for the purpose of carrying forward losses under Belgian law. As a consequence of that, *AMID* [2000] obtained little or no deduction for the losses sustained in Belgium when it subsequently traded profitably. In effect, *AMID* [2000] suffered taxation of the Luxembourg profits in both Belgium and Luxembourg[486] but that is a consequence of two states exercising their powers of taxation in parallel[487] (see chapter 6.1.i *post*). Belgium did not argue any ground for justification.

The rules applied symmetrically and it was a scheme of taxation that applied where a Belgian company had losses in one jurisdiction but profits in another. No Belgian tax was levied if the profits generated in the foreign jurisdiction exceeded the losses sustained in Belgium and no credit was given for losses sustained in a foreign jurisdiction to the extent that they exceeded the profits generated in Belgium. It was a scheme of tax integration that applied when certain conditions were satisfied and the Court accepted in *Papillon* [2008] that a scheme of tax integration could be justified on the ground of coherence of the tax system. There was no requirement for Belgium to prevent the double taxation of profits[488]. Where the taxing scheme applied, the foreign branch was treated as if it was a domestic branch except that the excess profits or the excess losses of the branch were disregarded for the purposes of Belgian taxation.

Although the Belgian scheme enjoyed a level of symmetry in the way that it operated, there does not appear to be any basis for a claim to justify any infringement of the Treaty freedoms of movement on the ground of coherence of the tax system. However, as argued in chapter 3.4 *ante*, a comparative analysis would conclude that the scheme did not give rise to a restriction in the first place[489].

Lidl [2008] is another case where the Court considered that a taxpayer conducting activities in a territory outside the scope of the home state's taxing jurisdiction was in a situation comparable to a taxpayer conducting all of his activities within the charge to taxation by the home state. In that case the taxpayer was based in Germany and the loss-making permanent establishment was operating in Luxembourg and was exempted by double tax treaty provision. The German tax authority rejected a claim by the taxpayer for a deduction against German profits for the Luxemburg losses.

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[486] Ibid. paragraph 15,

[487] See, for instance, *Kerckhaert & Morres* [2006] Case C-513/04 paragraph 20: "…the adverse consequences which might arise from the application of an income tax system such as the Belgian system at issue in the main proceedings result from the exercise in parallel by two Member States of their fiscal sovereignty."

[488] Ibid. paragraph 22.

[489] See chapter 6.1.i *post*.

Notwithstanding the acceptance of the justification, it is argued that the German refusal to provide relief for the Luxembourg branch losses did not give rise to a restriction anyway because those losses accrued outside of Germany's taxing jurisdiction[490]. It was a situation similar to that examined in *AMID* [2000].

Krankenheim Ruhesitz [2008] [491] and *Timac Agro Deutschland [2015]*[492] both concerned the German system of providing temporary relief for losses sustained by foreign permanent establishments of a German company where the profits of such establishments were exempted from German tax by provisions in a double tax treaty. The Court, indirectly citing *Lidl* in relation to the need to protect the symmetry in a tax system of recognising both profits and losses, applied that logic to the right of Germany to clawback the relief previously granted in order to protect the balanced allocation of taxing powers[493]. That is also protection of the coherence of the tax scheme and the Court expressly acknowledged the symmetry of the scheme[494].

Those two cases and the underlying German scheme for providing temporary relief for foreign branch losses can be distinguished from *AMID* and *Lidl* because Germany, through its national legislation, did provide a temporary relief reflecting the foreign losses but was not 'required to extend its taxing jurisdiction' by EU law.

The restriction examined by the Court in *Deutsche Shell* did not protect the symmetry of taking account of both profits and losses but destroyed it. Protection of the coherence of the tax system was argued by Germany[495] but that was justly rejected by the Court.

It would appear that there was a real loss caused by the holding of a depreciating currency and that loss was incurred in Germany. Such being the case, it is not easy to understand the German contention that an exchange gain would have escaped taxation as the same amount of Lira would have been repaid and, if exchanged for a greater amount in Deutschmarks, the German company would book an operating profit reflecting that. The Court observed that the denial of

[490] The case is discussed in more detail in chapter 6.3.iii *post*.

[491] *Krankenheim Ruhesitz* [2008] Case C-157/07.

[492] *Timac Agro Deutschland* [2015] Case C-388/14. Discussed in chapter 8.7.ii *post.* Relief was granted against German taxable profits for losses incurred by an Austrian branch but the relief was recaptured when the Austrian branch was sold to an Austrian subsidiary company before the relief had been "*reintegrated*" in line with the subsequent profitability of the Austrian branch.

[493] Ibid. paragraph 38.

[494] Ibid. paragraph 41: to the extent that Germany has no right to tax the profits of the Austrian branch, the recapture of the relief granted in relation to the Austrian branch losses "…reflects a logical symmetry and is thus the indissociable complement of the deduction previously granted".

[495] *Deutsche Shell* [2008] Case C-293/06 paragraph 34: The German provision would not permit a deduction for a currency loss incurred in respect of start-up capital provided to a permanent establishment in Italy. The loss sustained arose because of the devaluation of Italian Lira against the Deutschmark over the period that the capital was invested in Italy. As no loss was recorded in the accounts of the permanent establishment, the money provided by the German company must have been converted into Lira and recorded in such currency in the PE's accounts. The loss was realised when the repaid Lira were converted back into Deutschemarks.

relief for the loss was not offset by a corresponding advantage[496] and that there was no coherence in this discriminatory regime.

5.2.iv Concluding comment.

The Court, by and large, has respected Member State sovereignty where it has understood the underlying Member State scheme of taxation, although the finding of a restriction requiring justification is, in some cases, challenged.

5.3 PREVENTION OF TAX AVOIDANCE.

Prevention of tax avoidance is protection of the tax base and, in the internal market context, which concerns cross-border activity, is also the protection of the balanced allocation of taxing powers[497].

The national anti-avoidance provisions examined in the cases concerned with groups of companies principally seek to prevent export of profits using artificial levels of debt financing ('thin capitalisation'), 'profit-shaving' and 'thick capitalisation' (over-capitalising the company to earn interest in the low tax region – 'moneybox companies') using subsidiaries established in low tax regions not conducting genuine independent businesses in their state of establishment ('controlled foreign companies' or 'CFCs') and artificial intragroup pricing of goods and services ('transfer pricing').

As a general point of principle, the Court has accepted that artificial arrangements used to enable the export of profits undermine the ability of a state to exercise its taxing powers over income, profits and gains accruing within its taxing jurisdiction[498]. Such artificial arrangements put in place between wholly owned subsidiaries of a common parent can potentially achieve tax savings at little or no commercial cost or risk to the group. Inevitably, given the objective of the artificial arrangements, the anti-avoidance provisions will primarily[499] apply to cross-border arrangements and will engage Article 49 TFEU, the right of establishment, as the parent company will orchestrate the arrangements and will exploit its "*definite influence*" over the subsidiaries involved. Equally inevitably, such anti-avoidance provisions will treat cross-border arrangements and transactions differently from purely domestic ones and will be restrictive[500].

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[496] Ibid. paragraph 40

[497] *Timac Agro Deutschland* [2015] Case C-388/14 paragraph 47: "…the objectives of safeguarding the balanced allocation of the power to impose taxes between Member States and the prevention of tax avoidance are linked."

[498] *Cadbury Schweppes* [2006] Case C-196/04 paragraph 56.

[499] Profit shifting anti-avoidance provisions may apply in domestic situations to prevent use of tax shelters, such as brought forward losses.

[500] For instance: *Lankhorst-Hohorst* [2002] Case C-324/00 paragraph 32.

The Court's first major encounter with profit shifting within groups of companies was in *Cadbury Schweppes* [2006] in relation to the UK's CFC legislation and the Court then ruled[501] that there is no protection provided by Article 49 TFEU where the CFC has "…*no genuine economic activity in the territory of the host Member State*…". Such a "*wholly artificial arrangement*"[502], representing an attempt to make abusive use of the freedom of movement, is to be distinguished from transfer pricing (including 'thin capitalisation'), which gives rise to an export of profit.

The case law relating to CFCs has been superseded and codified by Articles 7 & 8 of ATAD, which have extended application to foreign PEs that are exempt from home state taxation. There is a question whether the codified rules provide sufficient certainty, however[503].

5.3.i Thin capitalisation.

The German provisions examined by the Court in *Lankhorst-Hohorst* [2002] treated interest paid on a loan from a non-resident shareholder as a "*covert distribution of profits*" if the debt/equity ratio of the borrower exceeded three times "*at any point in the financial year*" unless such a loan could have been obtained from a third party[504]. This provision was not designed to operate only in cases involving tax evasion[505] and the Court picked up on this point[506] when rejecting the German claim for justification.

The United Kingdom thin capitalisation provisions were examined in *Thin Cap GLO* [2007][507]. The provisions had effect subject to modification by provisions in

[501] *Cadbury Schweppes* [2006] Case C-196/04 paragraphs 68, 72 and 73.

[502] The Court adapted the phrase in *Thin Cap GLO* [2007] Case C-524/04 paragraph 81 after citing *Cadbury Schweppes* [2006] to: "… in whole or in part, a purely artificial arrangement, the essential purpose of which is to circumvent the tax legislation of that Member State." This is an example of how the Court's rulings evolve to enable the underlying principles to be applied to different situations.

[503] "…many features of the provisions create uncertainties which are clearly in contradiction with the purpose of the rule itself which was to give, instead, more certainty to businesses in Europe…" Ginevra [2017] Intertax at page 131.

[504] *Lankhorst-Hohorst* [2002] Case C-324/00 paragraph 3. The circumstances were that the indirect Dutch parent company made a subordinated loan to its German subsidiary to enable it to repay bank borrowings funding its trading and losses (paragraphs 5 to 9). The German tax authorities determined that the subsidiary could not have borrowed money on similar terms from a third-party lender (paragraph 12).

[505] Ibid. paragraph 16.

[506] Ibid. paragraph 37 "…the legislation at issue here does not have the specific purpose of preventing wholly artificial arrangements, designed to circumvent German tax legislation…". The Court in paragraph 38 also noted that the subsidiary's losses in the years in point exceeded the interest paid and, thus, no part of the interest paid could be identified with underlying profit.

[507] The evolution of the UK provisions is to be found in *Thin Cap GLO* [2007] Case C-524/04 paragraphs 4 to 15 In 2004, amendments had the effect of applying the legislation to loans provided by resident companies.

double tax treaties concluded by the UK but in general the consequence of their application was to treat interest paid in excess of the amount that would have been payable on an arm's length loan between unconnected parties as a distribution and, thus, not deductible for tax purposes. The difference in treatment of UK resident companies paying interest to non-resident group companies, on the one hand, and UK resident companies paying interest to a UK resident group company, on the other, was considered to give rise to a restriction[508].

The Court recognised, however, that, whilst the existence of cross-border intra-group indebtedness "… *cannot be the basis of a general presumption of abusive practices* …"[509], such would provide the opportunity to create "*wholly artificial arrangements*" that might "*… undermine the right of the Member States to exercise their tax jurisdiction in relation to the activities carried out in their territory …*"[510]. Whilst the national legislation was found to be an "*appropriate means*" of preventing such tax avoidance[511], and was justifiable on that ground, it is also necessary for the provisions to satisfy the principle of proportionality[512]. To satisfy that principle, the taxpayer must be given the opportunity to provide commercial justification for the arrangement[513]. The adjustment made by the anti-avoidance provisions must be limited to the excess of interest paid over the amount that might have been paid under a loan agreement struck with arm's length third parties[514].

The Belgian anti-avoidance provisions were examined by the Court in *Lammers & Van Cleeff* [2008]. The interest paid by the Belgian subsidiary to its Dutch parent, which was also a director of the subsidiary, were reclassified as dividends whilst that adjustment would not have been made had the parent company been tax resident in Belgium[515]. The Court essentially followed its decision in *Lankhorst-*

[508] Ibid. paragraph 63.

[509] Ibid. paragraph 73.

[510] Ibid. paragraph 75. This is an example of where prevention of tax avoidance and protection of taxation powers are linked.

[511] Ibid. paragraph 77. The Court referred to the profit export activities as "abusive practices" rather than tax avoidance.

[512] Ibid. paragraph 78.

[513] Ibid. paragraph 82. Whether or not there is commercial justification that would cause the arrangement to cease to be regarded as abusive, a Member State is entitled to protect its tax base. See *Hornbach-Baumarkt* referred to in the next section. Professor Henk van Arendonk commented in 2016: "I also wonder whether the European Court is the appropriate body to assess the principle of 'European arm's length pricing' or, in other words, to decide on a compulsory transfer pricing method for Europe. This is not a subject for a court – not even a European court – to decide on." Van Arendonk [2016] ECTR at page 245.

[514] *Thin Cap GLO* [2007] Case C-524/04 paragraph 83.

[515] *Lammers & Van Cleeff* [2008] Case C-105/07 paragraph 21.

Hohorst [2002] because the Belgian legislation had no objective arm's length test or mechanism to make a proportionate adjustment[516].

The Court has recognised the right of the Member States to protect their powers of taxation but the anti-avoidance provisions must be proportionate.

5.3.ii Transfer pricing.

Profits can be exported from a high tax state to a low tax state by using artificial pricing of goods and services provided by a group company established in the former to another group company established in the latter. Thin capitalisation discussed *ante* can be regarded as a form of transfer pricing.

The Belgian provisions examined by the Court in *SGI* countered the grant of "*unusual or gratuitous advantages*"[517] by adding them back to the profits assessed on the Belgian company that granted them[518].

SGI granted an interest-free loan to a 65% owned French subsidiary and paid 'directors' fees', considered to be excessive by the Belgian tax authority, to a Luxembourg company that was a 34% shareholder in it and was also a director[519].

The Court, departing from the requirement that the countered transactions should be "*wholly artificial*"[520], held that the Belgian provisions might "…*nevertheless be regarded as justified*…"[521] on the grounds of protecting Belgium's taxing powers and preventing tax avoidance, which is, in reality, saying the same thing. This judgment marks a further example of evolution of the Court's prescription in *Cadbury Schweppes* [2006] of the requirement that the avoidance arrangements be "*wholly artificial*"[522].

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[516] Ibid. paragraph 33. The Court decided the matter purely on the basis that arm's length arrangements could be caught by the provision. There was no need to consider the disproportionate nature of the adjustment.

[517] *SGI* [2010] Case C-311/08 paragraphs 3 & 4: "…the advantage granted must be contrary to the normal course of events and established business rules and practice, in the light of the prevailing economic circumstances and the financial situation of the parties. A 'gratuitous' advantage is one which is granted in the absence of any obligation or consideration."

[518] Ibid. paragraph 26: the objective of the Belgian provisions was to restore the taxable profits to the level expected had the transactions in question been conducted at arm's length.

[519] Ibid. paragraphs 9 to 13.

[520] As stipulated previously in, for instance, *Thin Cap GLO* [2007] Case C-524/04 paragraph 72..

[521] *SGI* [2010] Case C-311/08 paragraph 66.

[522] With cross-reference to *Oy AA* [2007] Case C-231/05 paragraph 63 and *SGI* [2010] Case C-311/08 paragraph 66 the Court said in *Lexel* [2021] Case C-484/19 paragraph 75: "… the need to preserve the balanced allocation of the power to impose taxes between Member States, despite the fact that the measures at issue do not specifically target purely artificial arrangements, devoid of economic reality and created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory, such measures may nevertheless be justified …".

The German provisions examined in *Hornbach-Baumarkt* [2018] sought to tax a value imputed for the undertakings given by that company to a commercial bank providing debt funding to two of its Dutch subsidiaries[523]. In defence of the provisions, the German tax authorities argued only justification on the ground of protecting its taxing powers[524], a justification that the Court accepted subject to the *proviso* that the national provisions would fail the proportionality test if the taxpayer was denied the opportunity to propose argument and evidence in support for a claim that the undertakings to the banks were provided on commercial terms having regard for the circumstances[525].

To find that a transaction or arrangement is in the nature of tax avoidance, the Court has held that the transaction or arrangement must not only be artificial, having no commercial purpose, but also must be entered into for "*tax reasons alone*"[526]. That is not so much a double test but more a question of emphasis. The arrangement examined in *Hornbach-Baumarkt* [2018] avoided German tax on a fee that should have been charged by the parent company but the parent company might have taken the commercial view that it would rather provide guarantees to enable its subsidiaries to secure bank funding than to provide the subsidiaries with new equity. It might not have neglected to charge a fee, therefore, to avoid German taxation. It might, instead, have provided the guarantees *gratis* as providing them was a substitution for providing equity, for which it would not have charged a fee to its subsidiaries.

Accordingly, no justification on the ground of preventing tax avoidance was either sought or was appropriate. However, despite the arrangement having been driven by commercial considerations, the German state lost tax that should have been chargeable and it was entitled to apply its transfer pricing provisions justifying the tax adjustment on the ground of protecting its powers of taxation.

Whilst this head of justification frequently overlaps with protecting powers of taxation it is not always the case that it does and *Hornbach* [2018] provides an example of when it does not.

The claim to justify the restrictive Swedish provision examined In *Lexe*l [2021] also failed. The complaint was against the refusal of the Swedish tax agency to permit a deduction of interest by a resident member of an international group of companies that accrued on a loan taken from a French member of that group to purchase shares in a further member of the group from a Spanish member of the group. The transaction reduced the indebtedness of the Spanish arm of the group, provided interest income for the French arm of the group, which then had net losses, and created a deduction in Sweden where the group had taxable profits.

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[523] *Hornbach-Baumarkt* [2018] Case C-382/16 paragraphs 4 to 11.

[524] Ibid. paragraphs 41 & 55: "…The German Government has neither identified a wholly artificial arrangement, within the meaning of the Court's case-law, nor a desire on the part of the applicant in the main proceedings to reduce its taxable profit in Germany."

[525] Ibid. paragraph 58.

[526] *Thin Cap GLO* [2007] Case C-524/04 paragraph 82.

The Court observed that the Swedish restriction could apply to commercially justifiable transactions "… *carried out at arm's length and which, consequently, are not purely artificial or fictitious arrangements* …" and could not, therefore, be justified on the ground of protecting the tax base against loss through tax avoidance[527].

The claim to justify the restriction on the ground of protection of taxing power failed as there is a distinction between profit shifting using artificial arrangements or importation of foreign losses and reliefs, on the one hand, and prevention of erosion or reduction of tax revenue, on the other[528].

5.3.iii Controlled Foreign Companies.

The United Kingdom scheme[529] [530] was examined by the Court in *Cadbury Schweppes* [2006] and again in *CFC & Dividend GLO* [2008][531].

The Cadbury Schweppes Irish subsidiaries enjoyed the benefit of the low rate of corporation tax levied on companies established in the International Financial Services Centre in Dublin ('IFSC') and their business was to raise finance for the Cadbury Schweppes Group[532]. This was not use of heavily equity funded companies to generate interest income in a low tax state ('thick capitalisation') but the use of a treasury company to cream off a margin producing profits taxable in a low tax state.

The establishment of the Irish subsidiaries in the IFSC would be regarded as a "*wholly artificial arrangement*" that sought "…*under cover of the rights created by the Treaty, improperly to circumvent their national legislation*…"[533] unless those subsidiaries could be regarded as "…*actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there*"[534]. To qualify as genuine establishments, the Court stated that it would be necessary that the incorporation of the subsidiaries "…*reflects economic reality*…",

[527] *Lexel* [2021] Case C-484/19 paragraphs 56 & 57.

[528] Ibid. paragraph 67.

[529] See Turner [2007] ECTJ for a summary of the scheme and preliminary thoughts in May 2006 before the Court handed down its judgment. Briefly, the profits of subsidiaries established in defined low-tax states undertaking specified activities including providing finance or providing other services to group companies are assessed under the legislation on the lowest level UK resident holding company. There are provisions preventing double taxation of the profits when repatriated as dividends. A review of the UK legislative amendments following *Cadbury Schweppes* can be seen in Turner [2010] ITR .

[530] Broadly speaking, the legislation would impose a tax charge on the UK parent of the CFC calculated by reference to the profits considered to have been shifted out of the UK. The legislation specified the means of calculating the deemed profit shift and most ordinary trading companies were excluded from its scope.

[531] *CFC & Dividend GLO* [2008] Case C-201/05.

[532] *Cadbury Schweppes* [2006] Case C-196/04 paragraphs 2, 14 & 15.

[533] Ibid. paragraph 35.

[534] Ibid. paragraph 54.

that there must be "…*actual establishment intended to carry on genuine economic activities in the host Member State*…" and that any such "…*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*"[535].

The Court re-emphasised the need for the national provisions to provide the taxpayer with an opportunity to provide evidence that the business of the CFC was genuine[536].

The Court had previously ruled[537] that exploiting a tax advantage "*legally provided*" by the law of another Member State is not abuse of a Treaty right. However, that "…*presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there*"[538]. The essence of 'establishment' is a presence in the host Member State through which "…*a Community national [may] participate, on a stable and continuing basis, in the economic life [of the host state]*…"[539]. It was for the national court to determine whether the subsidiary could qualify as a genuine establishment[540] and it is also for the national court to determine whether "…*the economic activity carried out [has] some explanation other than the mere attainment of tax advantages*"[541].

There was no room for justification of the UK provisions: either the setting up of the Irish subsidiaries was abusive, in which case there was no protection under

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[535] Ibid. paragraphs 65 to 67. That finding was for the national courts to determine. In the author's opinion, based on experience, such a finding that the subsidiaries conducted a genuine financing business could not be made by reason of the security that third party banks would require (see, for instance, *Hornbach-Baumarkt* [2018] Case C-382/16 paragraph 53) and also by reason of corporate governance. Corporation tax of £8.6 million (after credit for Irish tax paid) was assessed under the UK CFC legislation on the immediate UK resident holding company in respect of the profits of one of the Irish subsidiaries in 1996, which implies profits of approximately £36 million. If the lending margin made by the Irish company on money loaned to group companies was 1%, that level of profit suggests borrowings and lending each of the order of £3.5 billion. That compares to the Group pre-tax profit of £592million and Group net assets of £1.67 billion (source 1997 Report).

[536] *Cadbury Schweppes* [2006] Case C-196/04 paragraph 70 see also *Halifax* [2006] Case C-255/02 paragraph 75.

[537] *Barbier* [2003] Case C-364/01 paragraph 71. See also *Centros* [1999] Case C-212/97 paragraph 27.

[538] *Cadbury Schweppes* [2006] Case C-196/04 paragraph 54. The Court further commented that a "…'letterbox' or 'front' subsidiary…" not carrying on a "...genuine economic activity…" would have "..the characteristics of a wholly artificial arrangement…" (paragraph 68).

[539] Ibid. paragraph 53.

[540] It has to be pointed out that only the ultimate parent company had a sufficiently large balance sheet to support the bank borrowings made by the subsidiary and that only directors of the ultimate parent company could have been authorised to conduct money movements of that scale.

[541] *Halifax* [2006] Case C-255/02 paragraph 75.

Article 49[542], or the establishment of the subsidiaries was not abusive, in which case the UK provisions created a restriction[543].

5.4 Concluding comments.

This chapter has focussed primarily on special tax schemes provided in national legislation to groups to mitigate the potential tax disadvantage of trading in a territory through separately taxable corporate entities. There has also been a review of cases concerned with national anti-avoidance provisions designed to prevent export of profits between group companies.

In the context of the grouping schemes, the coherence and symmetry of the special schemes is that they provide a group with an opportunity of being taxed as if the parent company had instead traded through branches or divisions. The grouping schemes do not affect the aggregate profits brought into charge and do not extend or reduce the taxing jurisdiction of the state in question. Accordingly, provisions excluding non-resident group companies from such a grouping can be justified by reference to both protection of the coherence of the tax scheme and protection of the powers to determine taxing jurisdiction.

The special scheme providing temporary relief in relation to losses incurred by exempt foreign branches invariably have clawback provisions that restore the tax charge on profits taxable in the home state when the branch becomes profitable or where the branch is sold before the temporarily relieved losses have been fully clawed back. The clawback provisions both protect the symmetry and coherence of the relief schemes and protect the taxing powers of the state of residence of the company concerned to levy tax on profits generated by activities conducted in or from its territory.

Accordingly, both principal arms of tax sovereignty are in point.

The anti-avoidance measures used to prevent profit-shifting by groups are justifiable on the ground of protection of taxing powers albeit that adjustment made must be limited to neutralise the artificial profit shifting and that is measured by reference to hypothetical arm's length transactions that might be concluded between unconnected parties. However, that requirement results from the engagement of the principle of proportionality, which also requires taxpayers to have the opportunity to argue and provide evidence of the commerciality of the transaction. Notwithstanding that, even if the profit-shifting transaction or arrangement is effected for commercial reasons, corrective adjustment might still be justified under the principal head of protection of taxing powers.

By and large the Court is recognising Member State sovereignty although there have been some notable exceptions discussed in chapter 8 *post* and the issue over

[542] *Cadbury Schweppes* [2006] Case C-196/04 paragraph 73.

[543] Ibid. paragraph 74.

the Court's comparability analysis has been addressed principally in chapter 3 *ante*.

Member State sovereignty in the field of direct taxation – is the failure of the Court of Justice in some instances to provide a consistent and coherent scheme of analysis of alleged restrictions to the exercise of the freedoms of movement a consequence of activism, error or both?

PART II

THE COURT'S DEPARTURES FROM ITS SCHEMES OF ANALYSIS – ACTIVISM, ERROR OR BOTH?

In 2015, Wolfgang Schon wrote[544]: "*In three recent opinions, Advocate Generals Kokott[545]and Mengozzi[546] proposed disregarding tax neutrality and affirming territoriality. EU law, the Advocate Generals wrote, should never require any Member State to deduct losses if the corresponding profits arise outside its jurisdiction. It is, in their view, "only relevant to which activity and, therefore, to which taxing power a loss belongs"[547]… Advocate General Kokott refers to the ECJ's judgement in National Grid Indus to support her view that there exists "a clear demarcation of the fiscal powers of the Member States"[548]. In academic writing, the majority view[549] still seems to be that cross-border loss compensation should be available without any interdependence with the treatment in the "loss state" but mitigated by a "recapture" proviso*."

Although the commentary is focussed on the *Marks & Spencer* [2005] judgment of the Court, it is clear that the Court's departures and inconsistencies are troubling to all who are dependent on having a clear understanding of the law. The two Advocates General are not only confused but also critical of the *Marks & Spencer* [2005] judgment and that cannot be regarded as being satisfactory. The repeated references to the Court for clarification of the law relating to the

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[544] Schon [2015] BFIT pages 286 to 287.

[545] *A Oy (AGO)* [2012] Case C-123/11 paragraphs 47 to 54 and *Commission v UK (group relief) (AGO)* [2014] Case C-172/13 paragraphs 36 to 53.

[546] *K (AGO)* [2013] Case C-322/11 paragraphs 58 to 91.AG Mengozzi remarked in paragraph 63: "… by increasingly treating the justificatory ground based on the allocation between the Member States of the power to tax as self-standing, the Court has appeared to veer towards abandoning 'the *Marks & Spencer* exception' in its more recent judgments relating to the taking into account of cross-border losses …". He further remarked in paragraph 66: "… To require a Member State that does not have tax competence to take into consideration losses arising under the competence of another Member State where those losses cannot or can no longer be taken into account in the latter Member State, would be to disregard the objective of the balanced allocation of the power to tax. In fact, in such a case that objective is no longer attained at all".

[547] *A Oy (AGO)* [2012] Case C-123/11 paragraph 50. AG Kokott comment preceding that quoted was: "The exception developed by the Court in *Marks & Spencer* is no longer appropriate for justifying the preservation of the allocation of the power to tax, that justification having in the meantime been recognised as independent. With regard to preserving the allocation of taxation powers among the Member States it is immaterial whether there is a possibility of using losses in the Member State which has the power to tax a particular business activity."

[548] *Commission v UK (group relief)* [2015] Case C-172/13, *Commission v UK (group relief) (AGO)* [2014] Case C-172/13 paragraph 51. AG Kokott is arguing for the disregard of the 'final loss' doctrine to resolve "… contradictions in relation to the Court's other case-law on tax matters …".

[549] I. Richelle*, Cross-Border Loss Compensation: State and Critique of the Judicature,* in Richelle, Schön & Traversa eds., *supra* n. 30, at p. 101; Lang *supra* n. 83, at p. 538 et seq.; W. Schön, *Losing out at the Snooker Table: CrossBorder Loss Compensation for PEs and the Fundamental Freedoms,* in Hinnekens & Hinnekens eds., *supra* n. 3, at p. 813; and Van Thiel, *supra* n. 168, at p. 51.

criticised judgment and others noted in the following chapters is evidence of the "… *chaos and despair*…"[550] that AG Kokott referred to.

Whilst Wolfgang Schon was writing in 2015, he could as well have been writing in February 2023 as uncertainty is considered to still persist and is evidenced in *Gallaher* [2023], discussed in chapter 6.2.iv *post*.

The research question might be simply answered by saying that the Court could not have intended to create mischief amounting to "*chaos and despair*" and so, whilst it is left open that some of the departures may be attributed to 'activism', the main focus on the analysis in this part of the thesis is to identify the errors of interpretation of national 'situations' and, possibly, flawed development of the Court's principles of analysis.

[550] *A Oy (AGO)* [2012] Case C-123/11 paragraph 1.

6 DISADVANTAGES NOT GIVING RISE TO AN INFRINGEMENT

For the Treaty freedoms of movement to be engaged, a person must have suffered a disadvantage as a result of exercising a freedom of movement or must have been deterred from so doing.

However, "… *the Treaty offers no guarantee to a … [person exercising a freedom of movement] … that extending his activities into more than one Member State or transferring them to another Member State will be neutral as regards … [taxation]*…"[551].

Chapter 6.1 following discusses the three instances in which a disadvantage can accrue to a person exercising a freedom of movement and not constitute an infringement of a Treaty right.

In chapters 6.2 & 6.3 there is discussion of a selection of cases considered to fall within the first instance noted: that is, where the treatment suffered by the person exercising a freedom of movement under the tax legislation of either the state of origin or the host state differs from that experienced by a person within the relevant taxing jurisdiction who is not exercising the freedom of movement in point but the situations of the two are not comparable.

6.1 'OBSTRUCTIONS' NOT CONSIDERED TO BE INFRINGEMENTS.

There are three instances where a disadvantage can accrue to a person exercising a freedom of movement where the Court has ruled that infringements of the Treaty do not arise:

1. Where there is different treatment of persons whose situations are not comparable: that is, the national provision cannot be regarded as discriminatory – see Chapters 6.2 & 6.3 *post*.
2. Where the disadvantage arises as a result of the parallel exercise of taxing rights of two Member States –- see chapter 6.1.i *post.*
3. Where the disadvantage arises as a result of "disparities" between the taxation systems of two Member States. – see chapter 6.1.ii *post.*

It is emphasised that no restriction to the exercise of a freedom of movement arises in a case where the disadvantage suffered is a result of any of the causes noted. The consequence of that is that there is no need to justify the national provisions or investigate their proportionality. The point is made strongly because the view is taken in this thesis that the Court's analysis in cases such as *Marks & Spencer* [2005] is flawed. A discussion of that case and a selection of other examples follows in chapter 6.2 *post*.

[551] *Hervein & Others* [2002] Case C-393/99 & C-394/99 paragraph 51 modified to reflect the adaptation of the principle in relation to direct taxation in, for instance, *Deutsche Shell* [2008] Case C-293/06 paragraph 43 discussed in this chapter *post*.

6.1.i Parallel exercise of taxing powers.

A typical example of a situation where a disadvantage is suffered by a person exercising a freedom of movement and the disadvantage arises from parallel exercise of taxing powers is where a resident of one Member State is employed in the other Member State and the state of employment levies higher rates of taxation on employment income than would be charged by the state of residence. Such was the situation in *Gilly*[552].

A similar type of disadvantage involving a 'frontier worker' was examined by the Court more recently, in 2018. In *Sauvage & Lejeune* [2018], the Belgian resident was employed by a Luxembourg company but discharged some of his duties outside Luxembourg. The double tax agreement required the state of residence to exempt employment income for periods in which duties were performed in the host state and Belgium sought to tax a proportion of the taxpayer's emoluments that reflected the aggregate period in which the duties were performed outside of Luxembourg. The Court ruled that: "… *a less favourable tax treatment, which stems from … the differences existing between the tax schemes of those two States, cannot be regarded as constituting discrimination or a difference in treatment prohibited [by Article 45 TFEU]*"[553].

In *Kerckhaert & Morres* [2006] Belgian tax applied to dividend income at a uniform rate regardless of whether the source was domestic or foreign but took no account of foreign withholding taxes levied. The Belgian taxpayers who suffered withholding tax on their dividend income were taxed more heavily as a result but that disadvantage stemmed from "… *the exercise in parallel by two Member States of their fiscal sovereignty*"[554]. A similar disadvantage, though relating to death duties, was considered by the Court in *Block*[555].

The Belgian tax provisions examined by the Court in 2000 in *AMID* [2000][556] did not extend Belgian taxing jurisdiction to the other state in point, Luxembourg, except in a particular manner and circumstance[557]. The complaint by *AMID* [2000]

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[552] *Gilly* [1998] Case C-336/96. As a consequence of the different rates of tax, not all of the German income tax suffered could be set against the tax on that income levied by her state of residence, France: paragraph 10. Her claim to set the balance of the German tax suffered against other income assessable to tax in France was denied and that denial of further credit was held not to infringe Article [45 TFEU]. Cross reference to *FII GLO* [2006] Case C-446/04 paragraph 52.

[553] *Sauvage & Lejeune* [2018] Case C-602/17 paragraph 28.

[554] *Kerckhaert & Morres* [2006] Case C-513/04 paragraph 20.

[555] *Block* [2009] Case C-67/08: Germany, the state of residence of the beneficiary, and Spain, the state in which one of the assets was located, both exercised taxing rights over the asset. Germany granted relief for the Spanish tax only as a deduction from the asset value brought into account for taxation. The Court ruled "… that [the] fiscal disadvantage is the result of the exercise in parallel by the two Member States concerned of their fiscal sovereignty …" paragraph 28.

[556] *AMID* [2000] Case C-141/99.

[557] The Belgian tax code at the time defined three classifications of profits and losses for the purpose of loss relief: domestic profits and losses; foreign profits subject to a lower tax and losses in such a state; and foreign profits exempted by a double tax treaty between Belgium and the host

related to a reduction of its Belgian business losses available to carry forward equal to the profits of its Luxembourg branch in the tax period in question despite Belgium having no taxing jurisdiction in respect of that branch under the terms of the double tax treaty concluded between Belgium and Luxembourg.

Accordingly, notwithstanding the double tax treaty exemption of foreign profits, it was possible to import losses from a Tax Treaty state but the *quid pro quo* was that Belgian losses might be lost by notional offset against Tax Treaty state profits.

On the matter of comparability, the Court said: "*A Belgian company which, having no establishments outside Belgium, incurs a loss during a given tax year finds itself, for tax purposes, in a comparable situation with that of a Belgian company which, having an establishment in Luxembourg, incurs a loss in Belgium and makes a profit in Luxembourg during that same tax year*"[558].

The Court did not provide an explanation of why the two situations defined were comparable.

The Belgian rule examined applied only to offset of losses and its effect, when there were losses in one jurisdiction and profits in the other, was to aggregate the profits and losses as if the non-resident branch was resident in Belgium.[559] So, the treatment of the company's branches was effectively the same in that circumstance.

The comparability of the situation examined with a purely domestic one is challenged. The Court appears to have failed to observe that the Belgian tax rule merely modifies Belgian taxing jurisdiction in the circumstance that a resident

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state and losses incurred in such a state ('Tax Treaty state'). The second classification was not relevant to the circumstances. The relevant offset priority for Belgian losses was to set them first against other Belgian profits and then to notionally offset them against profits accruing in a Tax Treaty State. This priority of offset mirrored that applied to losses incurred in a Tax Treaty state, which would be notionally (if not actually) offset first against profits arising in any Tax Treaty state and then, the balance, against Belgian profits. The purpose of the tax scheme was not discussed but it might be observed that it appears to be effective in countering tax avoidance using transfer pricing to export profits or to neutralise a situation where the home state is burdened with the whole cost of central overhead and finance costs, or a disproportionate part of them. The tax rule did provide symmetry, however, providing a notional offset of foreign branch losses against Belgian profits, if such were to be the circumstance.

[558] *AMID* [2000] Case C-141/99paragraph 29.

[559] It might be added that, had the branch in point been resident in Belgium, *AMID* would have experienced the same reduction of the losses generated by its other Belgian operations. Accordingly, it is difficult to identify the disadvantage suffered as a result of the Belgian legislation save that it effectively suffered double taxation of the branch's profits or potentially benefitted from double deduction of the branch's losses. However, as the Court observed in *Kerckhaert and Morres*: "… the adverse consequences which might arise from the application of an income tax system such as the Belgian system at issue in the main proceedings result from the exercise in parallel by two Member States of their fiscal sovereignty …". *Kerckhaert & Morres* [2006] Case C-513/04 paragraph 20.

company has profits in one jurisdiction, which might be Belgium, but losses in another jurisdiction. What Belgium had not done was to exercise any powers of taxation over profits arising in the foreign branch's jurisdiction and that distinguishes the situation of a Belgian company having a Treaty Exempt branch from a wholly domestic situation.

6.1.ii Disparities.

The Court appears to have first remarked upon non-restrictive disadvantages in the field of social security[560]. In relation to taxation, it extended its ruling to cases involving taxation on motor vehicles[561] and then to a case involving direct taxation[562].

The Treaty freedoms of movement do not protect a person exercising a freedom of movement from suffering a disadvantage unless the disadvantage derives from less favourable treatment by the exit state by reason of his exercise of the freedom of movement[563] or derives from the host state treating that person less favourably than a person resident in the host state[564].

The adaptation of this principle to the situation where a company exercises the right of establishment to set up an operation in another Member State[565] is particularly relevant to the discussion concerning whether the UK's group relief provisions infringed Article [49 TFEU][566].

Where a 'hybrid' vehicle is used as the form of establishment, Article 49 TFEU will not require the exit state to adopt for the purpose of its tax rules the

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[560] *Kenny* [1978] Case Case 1/78 paragraph 18 approved and cited by the Court in subsequent cases including *Perfili* [1996] Case C-177/94 paragraph 17, relating to national (Italian) rules for taking civil action in the Italian courts (by a UK insurer) for recovery of monies obtained as a result of a fraudulent claim by the insured.

[561] *Weigel* [2004] Case C-387/01 paragraph 55 and *Lindfors* [2004] Case C-365/02 paragraph 34.

[562] *Schempp* [2005] Case C-403/03 paragraph 45. "… the Treaty offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation. Given the disparities in the tax legislation of the Member States, such a transfer may be to the citizen's advantage in terms of indirect taxation or not, according to circumstances …". The Court cited *Lindfors* (which was an indirect taxation case) although the matter under examination in *Schempp* concerned direct taxation.

[563] *Erzberger* [2017] Case C-566/15 paragraphs 34 to 38.

[564] "… any disadvantage, by comparison with the situation in which that citizen carried on activities prior to that transfer, is not contrary to Article 18 EC, provided that the legislation concerned does not place that citizen at a disadvantage as compared with those already subject to such a tax …" *Lindfors* [2004] Case C-365/02 paragraph 34.

[565] For instance, *Deutsche Shell* [2008] Case C-293/06 paragraph 43: "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**".**

[566] Discussed in chapter 6.2.ii *post*.

categorisation of the vehicle by the host state's law. The Belgian limited partnership in *Columbus Container* [2007] was treated as a company in Belgium but as a partnership in Germany[567]. The German treatment resulted in the German 'shareholders' becoming subject to tax in Germany on the partnership profits (with credit for lower Belgian tax). Had the Belgian limited partnership been treated as a company under German law, exemption of the income would have been available under the double tax treaty.

A similar type of problem arose in relation to banking secrecy rules examined in *Sparkasse Allgau* [2016][568].

6.2 CASES INVOLVING GROUPING ARRANGEMENTS.

Although the Court recognised in *Papillon* that the *"… the provisions … 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 …"*[569], it appears to have had a problem understanding the objective of other grouping arrangements both before and since that judgment.

As it observed, the objective of the tax integration system examined is to remove the tax disadvantages[570] that the parent company would otherwise experience if it traded in the territory of the origin state through companies that are its subsidiaries instead of through departments, divisions or branches of itself.

Having regard to the objective of such national provisions, therefore, a subsidiary that is outside of the origin (or exit) state's taxing jurisdiction is in a situation that is not comparable to that of a subsidiary that is within the origin (or exit) state's taxing jurisdiction. Application of the grouping scheme to resident subsidiaries does not alter the net profits within the charge to tax in the state of origin.

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[567] *Columbus Container* [2007] Case C-298/05 paragraph 51: there was no obligation for Germany to treat the Belgian limited partnership as a company. The Court observed that the German partners were taxed no more heavily than they would have been had the partnership been established in Germany (paragraph 39). The argument put forward by Columbus that it could have avoided the additional German tax if it had established itself in Belgium through a company recognised as such under German law failed also. *Avoir Fiscal* can be distinguished because the branch was taxed on its income on the same basis as applied to companies but was denied the tax credit relief against tax assessed that was available to companies. That was discriminatory treatment by the host state. Germany was entitled to treat companies differently from partnerships (paragraph 53).

[568] *Sparkasse Allgau* [2016] Case C-522/14: Under German law, a German bank holding assets for a customer in its Austrian branch was required to report the German tax office of those assets upon the decease of the customer but Austrian banking secrecy law prohibited such disclosure.

[569] *Papillon* [2008] Case C-418/07 paragraph 28.

[570] The tax inefficiencies in point include 'stranded losses' and assets (including production assets) being locked into current locations by potential charges on change of direct ownership.

To hold that the state of origin should extend its taxing jurisdiction to non-resident subsidiaries is to provide unrestricted legal empowerment to taxpayer groups to "profit shift" by exporting gains or importing deductible losses or expenses[571], which is clearly contrary to the Court's interpretation of Member State retained sovereignty as evidenced in its acceptance of justification of otherwise restrictive anti-avoidance provisions.

Five cases where an infringement was stated by the Court to have been caused by a restrictive provision in a Member State grouping scheme are discussed below. Where cases discussed in the following sections of this chapter are discussed also in chapter 8 *post*, analysis is kept brief to avoid too much duplication.

6.2.i Metallgesellschaft [2001][572].

This was the first of the grouping cases[573].

The case concerned the UK's former company distribution imputation tax scheme named Advance Corporation Tax ('ACT')[574]. This tax on company distributions was designed to mitigate economic double taxation and it achieved that purpose by providing a non-corporate shareholder[575] with a tax credit that could be set against the shareholder's income tax liability (on all sources of taxable income) or repaid in cash to the extent that the credit exceeded that liability.

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[571] As the Court acknowledged: "… 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 …" *Marks & Spencer* [2005] Case C-446/03 paragraph 46. Professor Gutmann commented before the Court handed down its judgment: "… the economic impact of the solution is enormous. If the ECJ eventually decided that all the domestic group rules existing in the EU should be extended to international cases, the budgetary situations of EU states would probably be dramatically affected by the possibility of cross-border offset of losses …". Gutmann [2003] ECTR page 154. He comments later: "… the state of origin (like the UK in the present case) gives up its taxing right on non-residents. Accordingly, EC law should not require the state of origin to deem resident and non-resident subsidiaries to be in comparable situations."

[572] *Metallgesellschaft* [2001] Case C-397/98 & C-410/98. The case is discussed in chapter 5.2.ii *ante* from the perspective of the coherence of the grouping election.

[573] Disregarding *ICI* [1998] Case C-264/96, which did not concern the grouping arrangement benefits, just the membership.

[574] See *Metallgesellschaft* [2001] Case C-397/98 & C-410/98 paragraph 52 and Finance Act 1972 s.84(1), which provides: "Where a company resident in the United Kingdom makes a qualifying distribution after 5th April 1973 it shall be liable to pay an amount of corporation tax (to be known as "advance corporation tax") in accordance with this section". Section.84(2) provides: "…advance corporation tax shall be payable on an amount equal to the amount or value of the distribution, and shall be so payable at a rate (to be known as " the rate of advance corporation tax ")…". Accordingly, the tax was levied when, but only when, a distribution was made by a UK company and the tax was calculated by reference to the distribution and took no account of profits or losses, whether current or past. It was a tax on distributions: see *Athinaiki* [2001] Case C-294/99 paragraph 29.

[575] Companies within the charge to corporation tax were exempt from tax on dividends paid by UK resident companies.

Initially, ACT displaced corporation tax charged on a company's income but then, subsequently, displaced a company's profits including chargeable gains after the repeal of the abatement of chargeable gains[576].

Once a distribution by a UK company had been 'franked' by a payment of ACT (it was not a withholding from the distribution), no further ACT was payable in respect of that distribution no matter how many times it was received and then redistributed by UK resident companies (unless there was, in the interim, a change to the rate of ACT). In the hands of a UK resident company, the tax credit attached to the distribution served to discharge the liability to pay ACT on redistribution and, in the hands of any other person, the tax credit served to discharge income tax at the basic rate chargeable on the income.

The complaint examined by the Court in *Metallgesellschaft* concerned the special scheme under which a UK resident parent company and its UK resident subsidiaries could elect that a subsidiary could pay distributions to its parent without accounting for ACT on the distribution except to an extent (if any) specified by the subsidiary in respect of each and every distribution.

The election[577] could only be concluded by companies resident in the UK and a disadvantage was experienced by UK resident (direct) subsidiaries of non-resident parent companies in that they could not avoid paying ACT[578] on distributions made to their parent companies[579].

The Court is bound by "… *the factual and legal context, as set out in the order for reference* …"[580] and the Court was advised that "… *ACT is in no sense a tax on dividends but rather an advance payment of corporation tax* …"[581].

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[576] When enacted, the rate of corporation tax was 52% and the rate of ACT was 30%. Because of the set-off of ACT against corporation tax, distributed profits were taxed at 22% ('mainstream tax'). Because chargeable gains were then taxed at an effective rate of 30% (see FA 1972, s.93 – abatement of chargeable gains), ACT could not be set against corporation tax on that part of a company's chargeable profits – only on the income element: FA 1972, s.85(1): "…shall be set against its liability to corporation tax on any income charged to corporation tax…".

[577] Group Income Election ('GIE') re-enacted in FA 1972 Schedule 15 Part II amending section 256(1) of the 1970 consolidation act. Korving [2016] ECTR at page 45 says: "In its *Metallgesellschaft* judgment, the CJEU leaves undecided which UK tax provision is incompatible with EU law: the restriction of group income selection or the ACT exemption that is a consequence of that." There was no "exemption": there was (effectively) an election between the parent and the subsidiary that the parent should assume an increased liability to pay ACT, when it came to redistribute its subsidiary's dividend, allowing the subsidiary to pay a lesser amount of ACT, or none at all.

[578]However, no ACT liability accrued to the extent that distributions were redistributions of UK dividends received by the subsidiaries.

[579] *Metallgesellschaft* [2001] Case C-397/98 & C-410/98 paragraph 43

[580] *New Valmar* [2016] Case C-15/15 paragraph 25.

[581] *Metallgesellschaft* [2001] Case C-397/98 & C-410/98 paragraph 52. It was this misleading advice that led to the Court's ruling in paragraph 73 that "… the refusal to allow subsidiaries, resident in the United Kingdom, of parent companies resident in another Member State to make a

It is contended that, having regard to the aim of the GIE provision, which was to enable a group of UK resident companies to determine where in the group to crystallise the payment of ACT[582], the exclusion of non-resident companies, outside of the scope of ACT, was an exclusion of persons as regards the charging provision who were in a different situation, that being that they were not within the scope of the tax. Accordingly, it is contended that there was no infringement of the right of establishment.

6.2.ii Marks & Spencer [2005][583]

This case concerned the UK's system for relieving losses of group companies against the profits of other group companies in a corresponding accounting period[584].

Advocate General Kokott said[585] of this judgment[586]: "… *In the Member States' case-law and in the works of commentators … the name Marks & Spencer appears*

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group income election cannot be justified on grounds relating to the need to preserve the cohesion of the United Kingdom's tax system …", which is effectively saying that a UK resident company and a non-resident company should be permitted to elect that the company within the scope of the ACT charge should be enabled to transfer the liability to pay the tax to a company that is outside the scope of that charge and which cannot be assessed to pay that charge, which is an election to not pay the tax at all.

[582] To avoid crystallising the payment in a company that had insufficient corporation tax income (or, later, profits) to make full use of the displacement of corporation tax.

[583] *Marks & Spencer* [2005] Case C-446/03. This case is discussed in chapter 8.5 *post*. The group relief (consortium relief) provisions examined in *Felixstowe Dock* [2014] Case C-80/12 were flawed and resulted in a restriction: see Lang & Others (2012) Turner page 223. The group relief provisions engaged in *Philips Electronics* [2012] Case C-18/11 are reviewed in chapter 8.3.iii *post*.

[584] *Marks & Spencer* [2005] Case C-446/03 paragraphs 13 & 14 record part of the UK legislation as enacted at the time and the surrendering company not only was obliged to have corporation tax losses but was also required to consent to their surrender. Thus, each offset of losses against profits was, in effect, an election between the companies involved and the amount of the losses surrendered had to be agreed subject to statutory constraints. The UK group relief provisions have been amended to give effect to the Court's ruling on 'final losses': the Court dismissed the EU Commission's objections to the amending provisions in *Commission v UK (group relief)* [2015] Case C-172/13 paragraph 28: "It should be noted, however, that Sections 118 and 119(1) to (3) of the CTA 2010 allow losses sustained by a non-resident subsidiary to be taken into account by the resident parent company in the situations contemplated in Paragraph 55 of the judgment in Marks & Spencer (EU:C:2005:763)".

[585] *A Oy (AGO)* [2012] Case C-123/11 paragraph 1.

[586] Timothy Lyons QC, commenting on the decision of the Special Commissioners prior to the referral to the CJEU, said in relation to their suggestion that the alleged restriction was justified by the coherence of the system: "The subsidiaries in Marks and Spencer plc v Halsey do not obtain an advantage from the UK's tax system, offsetting their inability to surrender losses, by not being taxed. **Their profits are outside the UK's tax system altogether**. Similarly, the fact that parent companies are not taxed on their subsidiaries' profits is not because of anything within the tax system, but because the subsidiaries are separate legal entities with profits outside the UK tax system." Lyons [2003] BTR at page 447 (emphasis added). Ismer commented, referring to the fact that the parent could claim credit relief against tax assessed on dividend income derived from the

also to be synonymous with chaos and despair". Ismer commented "that Advocates General Geelhoed and Mengozzi, and many authors of academic literature "…*did not only complain about lack of clarity, but also revealed a wide range of divergent views*"[587].

The Court determined that a non-resident subsidiary[588] that had incurred foreign losses[589] was in the same situation as a resident subsidiary for the purpose of the UK's group relief scheme, despite being outside the scope of the UK's system of corporation tax. Having found there to be a restriction, albeit one that could be justified, the Court had to consider the proportionality of the restriction determined by it, which did not permit the offset of losses incurred by a 'group company'[590] against the corporation tax profits of one or more other group companies, unless the loss-making company was within the charge to corporation tax itself in the accounting period in question.

Having regard to the aim of the national scheme, which was little different from the French tax integration scheme examined by the Court in *Papillon* [2008] *"… the provisions … 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 …*"[591].

To restrict the application of that scheme to companies within the charge to corporation tax is to exclude companies that are not in the same situation as regards the scope of the charging provision, which is the basis for a comparability test established by the Court in *Avoir Fiscal* [1986]. Instead, the comparator

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subsidiaries and referencing to paragraph 10 of the judgment: "In Marks & Spencer, the ECJ thus decided that the indirect credit method established comparability". Ismer [2019] Intertax page 578. This is simply wrong: the CJEU was merely summarising the UK taxing system applicable to the parent of a non-resident subsidiary. Ismer has failed to distinguish between taxation of the profits of the subsidiary and taxation of the income derived from shares in the subsidiary. See *Cadbury Schweppes* [2006] Case C-196/04 paragraph 45: the Court recognises the distinction: "…the fact remains that under such legislation the resident company is taxed on profits of another legal person…".

[587] Ismer [2019] Intertax at page 573 and references noted.

[588] The reference to "non-resident subsidiaries" is to subsidiaries that conduct the whole of their activities outside the scope of UK corporation tax. Non-resident subsidiaries that conduct an activity within the scope of UK corporation tax are eligible to surrender the losses sustained by the UK activity or claim losses to set against the profits of the UK activity – see *Philips Electronics* [2012] Case C-18/11.

[589] The reference to "foreign losses" is to losses on activities that are not within the charge to UK corporation tax.

[590] 'Group Company': see now Corporation Tax Act 2010 s.152 for the basic definition.

[591] *Papillon* [2008] Case C-418/07 paragraph 28. The scheme was subsequently re-examined in *SCA & Others* [2014] Case C-39/13, C-40/13 & C-41/13 which concerned a restrictive provision in the Dutch scheme that denied tax integration with subsidiary companies where held indirectly by the parent company through one or more non-resident intermediate holding companies. That is a very different form of restriction and the Court followed *Papillon* [2008] Case C-418/07.

remained focussed on the parent company[592], disregarding the objective of the UK group relief scheme, which was to pool the corporation tax profits of a '75% group' including those of non-resident members trading in the UK through a branch.

Accordingly, it is contended that the UK's group relief scheme did not infringe the right of establishment by reason of the restriction of its application to UK resident companies[593].

6.2.iii X Holding [2010][594] and X and X [2018][595].

The restriction examined in *X Holding* [2010] was a rule that permitted only Dutch resident companies to be included in a tax integration election. The effect of such an election was that: "…*the profits and losses of the companies constituting the tax entity [were] consolidated at the level of the parent company and for the transactions carried out within the group to remain neutral for tax purposes*"[596].

The Dutch Tax Integration scheme had an aim or purpose similar to that of the French one examined previously by the Court[597], similar to that of the Finnish financial transfer scheme examined in *Oy AA* [2007][598] and similar to the UK Group relief scheme discussed *ante* in the context of *Marks & Spencer* [2005].

The Court ruled that the situation of a Dutch resident parent seeking to include a non-resident subsidiary in an election was the same as that of a Dutch resident parent seeking such an election to include a resident subsidiary[599].

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[592] Philip Martin, former Deputy Head of Tax of Marks & Spencer Ltd stated: "The comparator is the UK parent, which experiences differential tax treatment depending on whether or not it invests domestically or cross-border, and the way in which it invests cross-border" Martin [2005] ECTR page 63. No, it is not the comparator. It disregards the objective of the group relief scheme. In any case, the beneficiary is the surrendering company – it is that company that monetises its losses at an earlier time by being able to surrender them. The parent either pays corporation tax or it makes a payment to the subsidiary for the group relief surrendered. Martin then justifies his 'analysis' by comparison with *Bosal* [2003] Case C-168/01. He is wrong again because the deductions sought by the parent company in that case were expenses, primarily loan interest, that were incurred by it in its state of tax residence. There were not expenses or losses incurred outside of the Dutch taxing jurisdiction.

[593] Recent agreement with that proposition: "… the CJEU does not examine the possible grounds of justification if the situations are not objectively comparable. In this case, a violation of the respective fundamental freedom is excluded a priori …" Mittendorfer [2021] ECTR page 166.

[594] *X Holding* [2010] Case C-337/08.

[595] *X and X* [2018] Case C-398/16 & C-399/16.

[596] *X Holding* [2010] Case C-337/08 paragraph 18.

[597] *Papillon* [2008] Case C-418/07 paragraph 28.

[598] *Oy AA* [2007] Case C-231/05 paragraph 35.

[599] *X Holding* [2010] Case C-337/08 paragraph 24. This was despite the interventions by Germany and Portugal in support of the Netherlands arguing to the contrary on the basis that a non-resident subsidiary "…is not subject to the fiscal jurisdiction of the State in which the parent company is established…".

This ruling was followed by the Court in the more recent case, *X and X* [2018], but, in relation to one of the claims examined, the Court made an observation noting the symmetry of exemption of gains and disallowance of losses in respect of business investments[600]. The Court provided no reconciliation of its apparently contradictory views.

In effect, the ruling provides the Dutch parent company of a group including subsidiaries established in other Member States the right to elect in which state the profits and losses of those non-resident subsidiaries should be taxed, disregarding the rules laid down by the Netherlands and the provisions allocating taxing powers in double tax treaties concluded by the Netherlands with other Member States. Whilst it is true that the Court recognised the sovereign right of the Netherlands to justify the rule enabling it to determine its own fiscal jurisdiction[601], the comparability test applied by the Court disregarded the natural validity of the restriction in the Dutch provisions limiting the application of the tax integration election to companies within charge to Dutch company tax. It is a rebuttal of its objection to the UK's CFC provisions[602].

The Court followed the *Marks & Spencer* [2005] logic[603]. Despite the fact that the non-resident subsidiary was not within the state's taxing jurisdiction, a factor expressly recognised in its ruling[604], the Court considered that such a subsidiary was in a situation comparable to that of a subsidiary that was within the state's taxing jurisdiction for the purpose of assessing its profits. Again, the analysis of the Court appears to be contrary to its ruling in *Avoir Fiscal* [1986] in which it looked at the charging provisions to ascertain whether the foreign branch was within the charging scheme applied to tax resident companies.

Contrasting with this, the Court's comparability analysis in *Papillon* [2008] recognised the relevance of the tax residence of the subsidiaries sought to be included in the French tax integration scheme. The Court made a point of

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[600] *X and X* [2018] Case C-398/16 & C-399/16 paragraphs 36 & 37. In C-399/16 in relation to the taxpayer's claim for a deduction for the loss on an investment, the Court observed in paragraph 59 that "The disadvantage for a Netherlands company of not being able to deduct the currency loss it sustains, as the case may be, on its holding in a non-resident subsidiary is inseparable from the symmetrical advantage linked to the absence of taxation of currency gains …". See *X AB* [2015] Case C-686/13 paragraph 40 for a similar comment on symmetry.

[601] *X Holding* [2010] Case C-337/08 paragraphs 28 & 29.

[602] *Cadbury Schweppes* [2006] Case C-196/04 paragraph 45 "…*under such legislation the resident company is taxed on profits of another legal person*". Strictly, this is not correct because the UK parent was assessed on amounts reflecting specified items of income received by the CFC subject to deduction for reliefs that might have been claimed had the CFC been UK resident. It was not assessed on the CFC's profits.

[603] *X Holding* [2010] Case C-337/08 paragraph 23.

[604] Ibid. paragraph 43 (emphasis added): "…Articles 43 EC and 48 EC do not preclude legislation of a Member State which makes it possible for a parent company to form a single tax entity with its resident subsidiary, but which prevents the formation of such a single tax entity with a non-resident subsidiary, in that the profits of that non-resident subsidiary are not subject to the fiscal legislation of that Member State". This ruling was cited subsequently in *Groupe Steria* [2015] Case C-386/14 paragraph 25.

recognising that the taxpayer wished to only include tax resident subsidiaries within the election and that appears to have been material in its ruling that a French subsidiary owned by a non-resident intermediate holding company was in a situation comparable to that of a French subsidiary owned by a French company[605].

The rulings on comparability in *Marks & Spencer* [2005], *Oy AA* [2007] and *X Holding* [2010] are inconsistent with those in *Avoir Fiscal* [1986], *Philips Electronics* [2012], *Nordea Bank Danmark* [2014] and *Timac Agro Deutscheland* [2015]. In the rulings in the former group of cases, the Court says that a subsidiary, that is based outside of a Member State's taxing jurisdiction and conducts its activity there, is in a comparable situation to a domestic subsidiary as regards the Member State's charging provisions. In the rulings in the latter four cases, the Court says or implies the opposite.

6.2.iv Groupe Steria [2015].

The case concerned a difference of treatment of dividends received by a French parent company from subsidiaries depending upon whether the distributing subsidiary was a member of the tax integration group formed by the parent company. Only French 95% owned resident companies were permitted to join the tax integration group.

Dividends received by the parent from subsidiaries included in the tax integration group were exempt from tax whilst dividends received from other subsidiaries were partially taxable[606].

The Court ruled that the difference in treatment created a restriction[607]. That ruling was made notwithstanding that the effect of the tax integration ruling is that the parent is treated as if the integrated subsidiaries were divisions of itself and, accordingly, the profits and losses of the subsidiaries accrue to the parent.

Regard must be paid to the form of statutory fiction created by the national tax integration provisions and the dividend income charging provision. The former provides that the taxable profit of the parent is "*the algebraic sum of the results of each of the companies in the group*"[608]. Accordingly, the legislation provides a form of aggregation of results and does not create a statutory fiction of the included subsidiaries being treated as divisions[609]. The aggregation of the results

[605] *Papillon* [2008] Case C-418/07 paragraphs 28 to 30.

[606] *Groupe Steria* [2015] Case C-386/14 paragraph 18. The tax was levied by way of a disallowance of costs incurred by the parent (such as interest) in relation to investments (representing more than 5% of the issued share capital) in its subsidiaries and associates. The level of disallowance is the lower of the totality of the costs or 5% of the grossed-up dividends received.

[607] Ibid. paragraph 22.

[608] Ibid. paragraph 8.

[609] The effect of the French legislation can be contrasted with the effect of the UK Group Income legislation (ICTA 1988, s.247(1)), which disapplied specified taxing provisions applicable to UK

still included the parent company's costs relating to its investments in the elected subsidiaries and it does not appear that the parent was doubly taxed on the profits of the companies integrated into its tax group as the dividend income was not taxed as such.

Accordingly, investments in 95% owned non-resident subsidiaries were treated less favourably and the French rule infringed Article 49 TFEU despite the fact that investments in 95% owned resident subsidiaries that had not elected to join the parent's tax integration group would not benefit from the restrictive French rule.

6.2.v Gallaher [2023][610]

This case concerned another UK grouping scheme[611] but the circumstances may be distinguished from those in *Marks & Spencer* [2005] in that *Gallaher* [2023] was concerned with a relief claimed by a tax resident company on disposals made by it to non-resident companies whilst *Marks & Spencer* [2005] concerned a relief sought to be claimed by companies that were outside the scope of UK corporation tax that would have resulted in the importation of foreign losses to offset profits generated in the UK.

The intra-group transfer scheme enables UK resident companies to transfer chargeable assets intra-group without crystallising an immediate taxable event. It is a scheme of deferral in that there is no uplift of the tax base cost to market value as a result of the intra-group transfer and the full gain will be chargeable if and when the asset is sold outside of the group. To prevent tax avoidance, a group company cannot be used as an 'envelope' to dispose of an asset outside of the group as a charge will be crystallised if the recipient company leaves the group within 6 years of its acquisition of an asset by an intra-group transfer[612].

Gallaher Ltd is a UK resident subsidiary of JTH, a Dutch intermediate holding company for the Japan Tobacco Inc. group. In 2011 it made a disposal of intellectual property rights to a Swiss sister company and in 2014 it sold its interest in an Isle of Man subsidiary to JTH.

Neither disposal qualified for relief under TCGA 1992, s.171.

The right of establishment had been exercised by JTH[613] in forming Gallaher Ltd and the UK was therefore a host state as regards that exercise of the freedom

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dividends, which were, in any case, exempt income in the hands of a UK company in charge to corporation tax. Had the French legislation taxed dividends as income, the parent would have become doubly taxed on the profits of the elected subsidiaries but the charging regime did not apply in that manner.

[610] *Gallaher* [2023] Case C-707/20.

[611] Intra-group transfers - The Chargeable Gains Taxes Act ('TCGA') 1992, s.171. A 75% subsidiary is defined for the purpose of this scheme by Corporation Tax Act 2010, s.1154(3) – the 75% qualifying interest can be direct or indirect.

[612] TCGA 1992, s.179.

[613] *Gallaher* [2023] Case C-707/20 paragraph 69.

even though the UK would have been a state of origin in relation to any exercise of a freedom of movement by Gallaher Ltd.

As regards the 2011 sale, because the UK scheme potentially engages Article 49 TFEU[614], the Court ruled that no protection under the Treaty could be provided in respect of that disposal to a Swiss company[615].

With regard to the 2014 disposal, it could be argued that the principles underlying the 'exit tax' cases[616] are potentially in point. Having regard to the aim of the national scheme, which might be adequately deduced from the provisions of the scheme, it is a scheme of tax deferral. As it had done 30 years previously in relation to the reorganisation conducted by *Halliburton*[617], the Court examined whether the Dutch parent had suffered a discriminatory disadvantage resulting from the treatment of its UK subsidiary. However, in *Gallaher*[2023], the comparator was the treatment that the UK subsidiary would have received had it been owned ultimately by a UK resident company and the Court found it not to be the case that it had been treated less favourably[618].

In *Gallaher* [2003], the disposal of the Isle of Man company to the Dutch parent was not an exercise of the right to establishment by Gallaher Ltd[619] and the denial of relief under TCGA 1992, s.171 was not discriminatory by reason of Gallaher Ltd's parentage as the sale of an asset by a UK owned UK subsidiary to a sister non-resident subsidiary would have been equally chargeable.

As neither disposal engaged Article 49 TFEU, the disadvantage suffered by Gallaher Ltd did not give rise to an infringement of the Treaty freedoms of movement.

Article 49 TFEU would have been engaged, if, for instance, Gallaher Ltd had sold intellectual property rights (or its interest in the Isle of Man subsidiary) to a subsidiary of its own that was resident in the Netherlands[620]. In that case, a

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[614] Ibid. paragraph 62.

[615] Gallaher Ltd was not treated differently because it was owned (indirectly) by a Dutch company: ibid. paragraphs 72 & 73.

[616] See, for instance, *National Grid Indus* [2011] Case C-371/10 paragraphs 46 & 73.

[617] *Halliburton* [1994] Case C-1/93 In that case, the transfer of branch assets owned by a German company conducting a business in the Netherlands through a branch to a Dutch sister subsidiary did not qualify for relief from transfer duty. Had the Dutch branch been incorporated as a Dutch subsidiary of the German company, relief on the transfer would have been available. The German company had suffered a discriminatory tax burden – see also *Avoir Fiscal* [1986] Case 270/83.

[618] *Gallaher* [2023] Case C-707/20 paragraph 73.

[619] This distinguishes the situation from that considered in *National Grid Indus* [2011] Case C-371/10 – see *Gallaher* [2023] Case C-707/20 paragraph 76. It was the Dutch parent that had exercised the freedom of movement in establishing Gallaher Ltd: ibid. paragraph 69.

[620] In this hypothetical situation, Gallaher Ltd would have exercise the right of establishment and suffered a disadvantage by reason having done so as s.171 relief would have been available had it, instead, established its subsidiary in the UK.

deferral of the tax on the realised gain crystallised by the disposal could have been claimed.

Accordingly, the view is taken that the UK scheme can infringe the right of establishment in circumstances when it is the state of origin although it is contended that the freedom of movement does not appear to have been infringed in relation to the disposal in point made by Gallaher Ltd in 2014.

The Court ruled otherwise and held that the mere fact s.171 relief was not available because the disposal by Gallaher Ltd was to a non-resident group member company, whilst relief would have been available had the disposal been to a UK resident group member company, gave rise to a restriction[621]. It ruled that notwithstanding that there appears to have been no interference with the right of establishment exercised by JTH.

6.3 OTHER CASES.

A small selection of cases will be reviewed.

6.3.i Truck Center [2008][622]

Under the national law rules examined in *Truck Center* [2008], whilst connected party lenders resident in Belgium were subject to tax on the interest income as part of their total income assessed to corporation tax, non-resident connected party lenders were assessed only on their interest income by deduction of tax at source. The two taxing regimes were therefore different[623] and the

[621] *Gallaher* [2023] Case C-707/20 paragraphs 82 & 83.

[622] *Truck Center* [2008] Case C-282/07

[623] Ibid. paragraphs 41 to 43. See CFE (2009/2) paragraph 20: the 'Task Force' was unable to accept that "…the logical consequence of this decision is that residents and non-residents are never in an objectively comparable position…", which is effectively what the Court acknowledged in *Avoir Fiscal* subject to the *proviso* that they are in a comparable position when the national charging provision in point applies to them in the same way. See also *Marks & Spencer* [2005] Case C-446/03 paragraph 37.

different rules for assessment[624] and collection of tax reflected the different charging provisions[625].

The Court ruled that no restriction was caused by the differing assessment rules but, nevertheless, a restriction might have arisen if the rate of tax borne by a non-resident under the Belgian provision had exceeded the rate of tax borne by a Belgian resident. That 'unfavourable' treatment would have been regarded as a deterrent to the exercise of the freedom of movement by the non-resident. That was not the case as the rate of tax applied to interest income of non-residents was significantly lower than the rate of corporation tax borne by resident companies on their income[626].

6.3.ii Kronos International [2014][627]

This case concerned the German imputation system. Dividends paid by a German company had to be franked by a payment of corporation tax whether or not the distributing company had taxable profits. Dividends received from German companies 10% owned (at least) by the distributing company were treated as being taxable income carrying a refundable tax credit reflecting the underlying German corporation tax paid by that company. Where the distributing company had losses to offset against that German source dividend income, the tax credit on the dividend income received would be wholly or partially repaid by the tax authorities as it would frank the distributing company's dividend payments.

Where the distributing company received dividends from companies resident in other states and the relevant double tax treaties provided that the dividend

[624] Another factor of distinction between the two Belgian systems of assessing tax on interest receivable on connected party loans was that no account was taken of the cost of funding the loan provided by the non-resident company. A resident company providing similar loan capital to a subsidiary or to an associate had an advantage in this respect because a resident company would be subject to tax on its net profits after deduction of the cost of finance. An advantage could accrue to a resident provider of debt capital for this reason and that is why the Court emphasised in *Miljoen* that its ruling in *Truck Center* was based on the premise that the different treatment of non-resident providers did not "…*necessarily procure an advantage for resident recipients*…" *Miljoen* [2015] Case C-10/14, C-14/14 & C-17/14 paragraph 70 (emphasis added). For instance, the connected party loan, having the character of debt capital, might be wholly or partially financed by the lender's equity capital including reserves. The situation with regard to recognition of the costs of finance is different if the provider of the loan is a bank providing the loan on trading account. In *Commission v Portugal (interest withholding tax)* the Court recognised the necessity of taking account of costs of finance incurred by commercial lenders and stated that: "…*that profit margin plays a decisive role in the examination of whether legislation such as that at issue in the present case leads to higher taxation of non-resident legal entities, as the rate of taxation is not the only component to be taken into consideration in that regard*". *Commission v Portugal (interest withholding tax)* [2010] Case C-105/08 paragraph 28.

[625] *Truck Center* [2008] Case C-282/07 paragraph 46.

[626] Ibid. Paragraph 49: cross reference *Gerritse* [2003] Case C-234/01 paragraph 54 in relation to Article 56 TFEU and *Hollmann* [2007] Case C-443/06 paragraphs 38 to 40 in relation to Article 63 TFEU.

[627] *Kronos Interantional* [2014] Case C-47/12

income from those sources should be exempt from German taxation, the distributing company would be unable to obtain a refund of the corporation tax that it paid when making its own distributions but also did not apply any losses against the dividend income from those foreign sources or pay corporation tax on that income.

The situation of a German holding company receiving (taxable) dividends from German investments was different from that of a German holding company receiving (exempt) dividends from foreign investments because the latter were not within the taxing jurisdiction of Germany[628].

Accordingly, the German taxing scheme did not infringe the Treaty freedom of movement.

6.3.iii Lidl [2008][629]

The German taxpayer sought to deduct losses incurred by its branch trading in Luxembourg notwithstanding that the relevant double tax treaty exempted the branch from German taxation. The Court held that the taxpayer's inability to deduct the losses from its taxable profits in Germany was a restriction[630].

The Court, referring to its judgment in *Marks & Spencer [2005]*, amended its requirement that "…*the three justifications taken together*…" were necessary to justify the alleged infringement by the UK's group relief provisions examined in that case and stated: "… *it cannot be necessary for all the justifications referred to in paragraph 51 of the Marks & Spencer judgment to be present in order for national tax rules which restrict the freedom of establishment laid down in Article 43 EC to be capable, in principle, of being justified* …"[631].

[628] "…the refusal to grant a refund and the difference in treatment thus established can be explained by an objective difference in situation. In relation to refund of the tax paid by the company distributing the dividends, such as the refund requested by Kronos, a company receiving foreign-sourced dividends is not in a situation comparable to that of a company receiving nationally-sourced dividends… The Court has already held that the free movement of capital, enshrined in Article 63(1) TFEU, cannot have the effect of requiring Member States to go beyond the cancelling of national income tax payable by a shareholder in respect of foreign-sourced dividends received and to reimburse a sum whose origin is in the tax system of another Member State…" (emphasis added) ibid. paragraphs 81 & 83 and see *FII GLO* [2006] Case C-446/04 paragraph 52.

[629] *Lidl* [2008] Case C-414/06.

[630] Ibid. paragraph 26.

[631] Ibid. paragraph 40. The Court also, in paragraph 41, referred to its judgment in *Oy AA* [2007] Case C-231/05 paragraph 60 in which it diluted the requirement stated in *Marks & Spencer* [2005] Case C-446/03 paragraph 51 down from 3 out of 3 to 2 out of 3. However, it had already disregarded the M & S requirement in *Cadbury Schweppes* [2006] Case C-196/04 paragraph 56 and *Thin Cap GLO* [2007] Case C-524/04 paragraphs 75 & 76.

However, despite ruling that the inability of the taxpayer to deduct the exempt branch's losses from its profits taxable in Germany constituted a restriction[632], the Court recognised the "… *symmetry between the right to tax profits and the right to deduct losses*"[633].

Having regard to that admission by the Court of the symmetry of taxing profits and allowing deduction of losses, and having regard also to the purpose of the relevant double tax treaty provision, which is to allocate taxing jurisdiction of the branch to the host state, it is contended that the situation of Lidl with regard to that branch was not comparable to the company's situation with regard to a domestic branch for the purpose of German taxation of the company's profits and that there was, thus, no infringement of the Treaty freedom[634].

6.3.iv X AB [2015].[635]

The Swedish taxpayer sought to obtain relief against Swedish tax for a capital loss suffered in respect of a shareholding in a foreign company that qualified under Swedish law as a 'holding for business purposes'. As such, any gain on the shareholding would have been exempt from tax. Holdings in Swedish resident companies received the same treatment.

The Court ruled: "… *it cannot be inferred from the provisions of the FEU Treaty concerning freedom of establishment that that Member State would be required to exercise — asymmetrically [sic], moreover — its taxation powers so as to permit the deduction of losses from operations whose results, if they were positive, would not in any event be taxed*"[636].

There is nothing remarkable about this judgment except that it is difficult to see how the claim to offset the losses of a non-resident company discussed in chapters 6.2.ii and 6.2.iii (or exempt permanent establishment considered in chapter 6.3.iii) can be distinguished.

6.4 CONCLUDING COMMENTS.

To distinguish a case where a national tax provision causes a justifiable infringement of a Treaty free movement right from a case where the

[632] *Lidl* [2008] Case C-414/06 paragraphs 25 & 26 by reason of the different treatment afforded to, respectively, resident branches of the German company and non-resident branches.

[633] Ibid. paragraph 33 originally recognised in *Marks & Spencer* [2005] Case C-446/03 paragraph 43.

[634] In a recent case, *W AG* [2022] Case C-538/20 paragraphs 19 to 22, the Court appears to have confirmed the lack of comparability contended.

[635] *X AB* [2015] Case C-686/13.

[636] Ibid. paragraph 40 . See also paragraph 33 - the Court cited *Deutsche Shell* [2008] Case C-293/06 paragraph 43. The Court effectively ruled that the Swedish rules did not create a restriction.

discriminatory national tax provision applies to different situations[637] it is necessary to pay close regard to the purpose of the national provisions[638].

In the case of *Metallgesellschaft* [2001], the tax scheme challenged enabled companies in the group to elect which of them would pay the tax in question and a company outside the scope of that tax cannot enter into a meaningful election to be liable to pay a tax that cannot be assessed on it. It is noted in the discussion that there was a misunderstand of the background UK taxing scheme.

In the case of *Marks & Spencer* [2005] , the UK group relief scheme permitted companies to offset their corporation tax losses against the corporation tax profits of sister 75% subsidiaries thereby enabling the pooling of profits and losses within the charge to (UK) corporation tax. The losses of the non-resident companies derived from activities conducted outside of the UK's taxing jurisdiction were outside the scope of the tax.

It is contended that in neither case was there a restriction because the non-resident companies in both cases were in a different situation being outside of the scope of the tax in question.

The analysis of Dutch tax integration scheme discussed in chapter 6.2.iii appears to be little different as the ruling failed to recognise the objective of the Dutch scheme, which was to pool a group's profits and losses within the charge to Dutch corporation tax.

The UK taxing scheme in point in *Gallaher* [2023] was not a profit pooling scheme and it has been distinguished because the national provision provided deferral of tax and, in the case of an appropriate transaction, but not in the case of either of the disposals in point, a restriction of the right of establishment might arise.

The taxing scheme applied to the interest income of non-residents examined in *Truck Center* [2008] was found to be different from the scheme applied to the income and profits of residents and was not designed to be more burdensome. There was no restriction as the situations of the resident and non-resident creditors were not comparable for the purposes of taxing their interest income.

In *Kronos International* [2014], the Court acknowledged that the company was in a different situation when it was in receipt of exempt income as compared with when it was in receipt of taxable income with regard to tax on its profits. The foreign underlying tax paid by the investee company could not be imputed as tax paid in the origin state. No restriction was found but it is difficult to distinguish the situation in this case from that examined by the Court in *Lidl* [2008].

The losses in point in *Lidl* [2008] arose as a result of activities conducted outside the scope of the German taxing jurisdiction and those activities are not

[637] Or the discriminatory national tax provision applies the same rule to differing situations.

[638] *Papillon* [2008] Case C-418/07 paragraph 27.

comparable to activities conducted within its taxing jurisdiction. Nevertheless, the Court ruled that the German taxing scheme was restrictive.

There was not 'less favourable' treatment of investments made in non-resident companies by the Swedish tax rule examined in *X AB* [2015] as investments in domestic companies was treated in the same way. Accordingly, there was no restriction.

As evidenced by the review of cases, whilst the Court appears to accept that a person in receipt of exempt income is in a situation that is different from a person in receipt of taxable income, both as defined by a national scheme of taxation, it has, without explanation, viewed companies trading through exempt foreign branches or non-resident subsidiaries in a different light for the purposes of its comparability analysis.

It is contended that the Court's comparability analysis of the situations as regards exempt foreign branches and non-resident companies stems from its error in the analysis of the UK group relief provisions in *Marks & Spencer* [2005].

Member State sovereignty in the field of direct taxation – is the failure of the Court of Justice in some instances to provide a consistent and coherent scheme of analysis of alleged restrictions to the exercise of the freedoms of movement a consequence of activism, error or both?

7 'EXIT TAXES'

7.1 INTRODUCTION TO THE CHAPTER.

Prior to the making of the Anti-Tax Avoidance Directive ('ATAD')[639], there had been only limited harmonisation in the field of taxation of cross-border reorganisation of economic activities by companies[640] and none specifically in relation to migration of tax residence or cross-border restructuring of an economic activity conducted by a natural person.

A Council Resolution[641] highlighted the need for "coordinating exit taxation" to "… . *restrict the administrative burden on taxpayers and authorities, and safeguard the legitimate financial interests of the Member States* …".

ATAD provides a harmonised scheme that embodies and builds on the Court's rulings. It extends an obligation on the host state, the state of destination, to accept the market value, used by the state of origin for assessing the exit tax, as the tax base cost of the assets for the purpose of its own taxing regime.

ATAD does not invalidate the discussion in this chapter[642]. The objective of the discussion is to highlight how the Court has upheld (or has undermined) Member State sovereignty in its case law and to highlight any impairment of legal certainty that might have arisen from inconsistencies or contradictions in its analysis or rulings.

Reverting to the discussion: to preserve their tax bases, many of the Member States levy a tax charge when a person possessing untaxed income or gains migrates his tax residence or when a resident 'exports' his personal assets or business beyond his home state's jurisdiction. Many of the Member States have designed their own tax relief provisions to prevent the trigger of taxable events from obstructing legitimate restructuring of commercial activities but national provisions often relieve only transactions that result in the participants or the assets subject to the transactions remaining within the tax jurisdiction of the origin

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[639] Council Directive (EU) 2016/1164 of 12 July 2016 Article 5 provides a harmonised scheme for taxation of a transfer of assets or a transfer of tax residence by a person subject to 'corporate tax'. Article 5 was to be transposed and applied on 1 January 2020. It was not amended by Council Directive (EU) 2017/952 of 29 May 2017. Further comment on the directive can be found in chapter 7.5 *post.*

[640] 2008/C 323/01 : Paragraph C of this Resolution provided that the host state should accept the market value of assets transferred that was the basis for the exit tax calculation by 'exit state'. That valuation should be agreed between the two Member States "using the appropriate procedure" (Paragraph D).

[641] Council Resolution of 2 December 2008 (2008/C 323/01).

[642] The directive does not constrain the Member States in designing their 'exit tax' provisions except to provide a minimum level of protection and, thus, 'excesses' that might be regarded as disproportionate will still have to satisfy the Court's guidance in this area: Peeters [2017] ECTR at pages 123 & 124.

state[643]. The task of the Court is to balance the sovereign right of the Member States to protect their tax bases with the Treaty objective of creating an Internal Market devoid of obstructions.

The Mergers Directive 90/434/EEC provides deferral relief for certain specified transactions effected by companies. Although the directive will not be examined in detail, the Court had examined reorganisations engaging the directive before it came to consider, in *N* [2006][644], the right of the exit state to tax an accrued gain at the time of migration of tax residence. It is possible that the Court was influenced by the form of the relief provided in the directive and the recognition in the directive of the exit state's right to tax gains that had accrued to the taxpayer prior to the migration of tax residence. The directive is therefore considered to be relevant to the discussion in this chapter for that reason.

This chapter will focus on transactions that do not come wholly within the scope of the Mergers Directive[645].

However, where the EU secondary measure fails to exhaustively prescribe all aspects of the relief to be provided, primary law[646], Article 49 TFEU in the context of transactions within the scope of that directive, is engaged and national rules can be examined by reference to that primary law, as was done by the Court in *Euro Park Service* [2017]. That case concerned national law giving effect to a reserved competence provided by (now) Article 15(1)(a) of the (2009) directive to "*refuse to apply or withdraw*" some or all of the benefits of the relieving provisions where a transaction is effected and it "*has as its principal objective or as one of its principal objectives tax evasion or tax avoidance*".

Both principal aspects of tax sovereignty (exercise of taxing powers and preservation of the coherence of the tax system) are potentially engaged when and because the taxpayer or the profits are removed from the Member State's taxing jurisdiction. The grounds for justification claimed in the 'exit tax' cases are reviewed in Chapter 7.3 *post*.

In Chapter 7.4 *post*, there is a discussion of the Court's perception of the 'proportionality' of Member State provisions protecting their taxing powers in the instance of transactions or events in which 'exit taxes' are levied. This is, perhaps, the most difficult area of discussion and it appears that the Court revised its views after *N* [2006] on whether the exit state should take account of diminutions in value of assets following their transfer or following the tax residence migration of the person owning them.

[643] For the purposes of this chapter, the Member State levying the exit tax is referred to as the 'exit state' and the destination Member State is referred to as the 'host state'.

[644] *N* [2006] Case C-470/04.

[645] Transactions falling wholly within the scope of a harmonisation measure "… must be assessed in the light of the provisions of that harmonising measure, and not in the light of the provisions of primary law…" *Euro Park Service* [2017] Case C-14/16 paragraph 19.

[646] Ibid. paragraphs 25 & 26.

In chapter 7.6 *post*, there is some conjectural discussion on the proportionality of 'exit tax' charges made to recapture accelerated depreciation or write-off of development expenditure, which are devices used by governments to encourage investment.

A parallel is drawn with the German tax scheme examined in *Timac Agro Deutschland* [2015][647] and the Luxembourg scheme examined in *DI.VI.* [2012][648] is distinguished. The revaluation of the asset at the time that it leaves the taxing jurisdiction of the exit state will recapture accelerated depreciation but revaluation of an asset under development, where that value is greater than accumulated cost, will lead to an assessment of future profit generation potential. An obligation to pay tax at the time that the asset leaves the tax jurisdiction of the exit state will deter exercise of the freedom of movement in both circumstances but, in the case of the recapture of accelerated depreciation or other costs amortised, the tax charge merely reflects a recovery of financial assistance provided to the taxpayer prior to the migration event and the requirement for an immediate payment of tax is argued as being both justified and proportionate.

7.2 THE MERGERS DIRECTIVE 2009/133/EC.

The directive addresses only specified reorganisations of companies and it proscribes the charging of tax on capital gains[649] that would otherwise fall to be charged on such transactions at the time the transactions are given effect.

The second recital of the directive sets out the problem that was to be addressed by the harmonisation measure: "…*such operations ought not to be hampered by restrictions, disadvantages or distortions arising in particular from the tax provisions of the Member States*…".

It was recognised also in the third recital that cross-border reorganisations were often denied reliefs comparable to those that could be claimed for purely internal reorganisations: "*Tax provisions disadvantage such operations, in comparison with those concerning companies of the same Member State. It is necessary to remove such disadvantages*;" (emphasis added).

The fifth recital recorded the constraint on the relief to be granted in respect of such transactions, recognising the legitimate interest of the Member States of protecting their respective tax bases: "…*while at the same time safeguarding the*

[647] *Timac Agro Deutschland* [2015] Case C-388/14.

[648] *DI. VI.* [2012] Case C-380/11.

[649] Article 4 of the directive defines such gains as the difference between "the real value of the assets and liabilities" and "their values for tax purposes", which are defined as the value basis for computing under national law any gain, income or profit upon a sale of them at the time of the reorganisation. The taxes relieved are "taxes levied on companies as well as on their shareholders" as a result of effecting the protected transactions. See *Modehuis A Zwijenburg* [2010] Case C-352/08 paragraph 51.

financial interests of the Member State of the transferring or acquired company" (emphasis added).

The Court has both recognised this constraint, safeguarding the power to levy taxation on income, profits and gains accruing within its taxing jurisdiction, and has commented on it[650]. In *3D I* [2012], having considered the [fifth] and [seventh] recitals of the directive, the Court expressly stated that the directive provided deferral relief only[651].

Thus, the Court may have been influenced by the form of relief structured into the directive, which is a deferral of tax until realisation of the asset in question, when it first considered 'exit taxes' in the context of the primary legislation. That relief itself respects the right of Member States to tax income, gains and profits that have arisen within their taxing jurisdiction.

There is evidence of that influence of the directive on the Court in the *National Grid Indus* [2011] judgment. Whilst the Court reconfirmed the right of the exit state to tax the gains that had accrued up to the time of migration of tax residence[652], it also reconfirmed it to be disproportionate to demand immediate payment of the tax assessed on the unrealised gains at the time of migration of tax residence[653].

However, at this point, the relief provided by the directive differs from the relief that the Court has stipulated as necessary for an exit tax charge to be proportionate. The relief stipulated by the directive is a deferral of assessment of the gain, albeit that the taxable amount can be evaluated at the time of the transaction, whereas the relief required by the Court to satisfy the principle of proportionality is deferral of collection of the tax assessed at the time of the transaction or act that triggered the national tax assessment[654].

The question of when the taxable event becomes assessable can be relevant if the asset in question diminishes in value subsequent to the transaction or act that

[650] *Jacob & Lassus* [2018] Case C-327/16 & C-421/16 paragraph 48: "…Among those financial interests is the power to tax the capital gain in respect of securities existing before the exchange of securities.".

[651] *3D I* [2012] Case C-2017/11 paragraph 28 (emphasis added): "[it]… establishes only a system of deferral of the taxation of the capital gains relating to the assets transferred, which, while avoiding taxation arising from the business transfer itself, safeguards the financial interests of the State of the transferring company while ensuring taxation of those capital gains at the date of their actual disposal…".

[652] *National Grid Indus* [2011] Case C-371/10 paragraph 46: "The transfer of the place of effective management of a company of one Member State to another Member State cannot mean that the Member State of origin has to abandon its right to tax a capital gain which arose within the ambit of its powers of taxation before the transfer…".

[653] Ibid. paragraph 85: "…legislation of a Member State…which prescribes the immediate recovery of tax on unrealised capital gains relating to assets of a company transferring its place of effective management to another Member State at the very time of that transfer is disproportionate…".

[654] This is discussed more fully in section 8.4 of this chapter *post.*

triggered the national tax provision. The Court has wrestled with this issue in cases in which the directive is not engaged and these cases will be discussed in chapter 7.4.i *post*. However, this issue was very much in point in the context of a reorganisation that was examined in *Jacob & Lassus* [2018] in respect of which the directive was engaged[655].

The Court noted that the directive did not address the issue of a set-off of ultimate losses suffered against the deferred assessment of the gain at the time of the reorganisation or, in other words, an adjustment to the deferred gain to reflect the subsequent diminution in value, and it ruled that the matter should be considered under the primary law, Article 49 TFEU in this instance[656].

The Court ruled[657] that it was not possible for France to justify denial of offset on the ground of fiscal competence because the later disposal, the one that triggered the entitlement of France to tax the earlier reorganisation gain, was the occasion on which France exercised its tax competence.

It has to be said that the Court's ruling, as drafted, does not appear to be totally satisfactory. It is clear that France exercised its fiscal competence at the time of the subsequent disposal of the Luxembourg company shares but it did so only in respect of the earlier reorganisation gain. The subsequent disposal of the Luxembourg company shares by a UK resident taxpayer was not within the jurisdiction of France. Whilst it might be regarded as a 'fair outcome', France had no competence to tax Mr Lassus on an additional gain had the Luxembourg company's shares appreciated in value since the time of the reorganisation and allotment to him. The comparability finding by the Court in paragraph 78[658] is questionable.

An alternative interpretation of the second paragraph of Article [8(4)] of the directive is that the exit state should have the right to tax the gain arising on the

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[655] Mr Lassus, though a UK resident at the time of the relevant share exchange involving a French company, remained prospectively taxable in respect of that reorganisation protected by the directive because the UK/France double tax treaty permitted France to levy tax on a gain realised on a disposal of a French company by a UK resident. The French administration taxed him on the gain calculated at the time of the reorganisation when he subsequently sold some of the securities issued to him in exchange for his shares in the French company. However, the holding had diminished in value and he realised a loss compared to the value taken in account for calculating the tax that was deferred in accordance with Art.8(1) of the directive. Had Mr Lassus been tax resident in France at the time of the sale, he could have offset the loss on sale against the assessed deferred gain calculated by reference to the value at the time of the reorganisation.

[656] *Jacob & Lassus* [2018] Case C-327/16 & C-421/16 paragraph 72.

[657] "…the taking into account of such a capital loss accordingly forms part of the obligation of the Member State seeking to exercise its fiscal competence in respect of that same capital gain, which actually becomes taxable on the date of that transfer." Ibid. paragraph 83. This can be distinguished from the situation under primary law under which the 'exit tax' cases are determined where the gain is assessed at the time of migration – see paragraph 82.

[658] The Court ruled that the tax residence fiction applicable at the time of the reorganisation should be equally applicable at the time of the subsequent disposal of the new assets, which was the trigger for the exercise of tax competence by France.

disposal of the new assets (the shares received in exchange) when they are subsequently disposed of, notwithstanding that any change in value after the reorganisation would fall to be within the competence of the host state to tax. However, that would leave the taxpayer potentially liable to double taxation on a gain realised after the reorganisation (as remarked above), which is not satisfactory either. It is possible that the Court declined to interpret the directive in this way for that reason and that may be the reason why it decided that the directive did not adequately address the situation in point, forcing it to review the issue under primary law[659].

In terms of influence over the Court's thinking in relation to exit taxation, the directive makes clear that the Member States are not prepared to forfeit tax on gains that have accrued within their jurisdiction and are prepared only, at most, to permit deferral of assessment at the time of the taxable event to avoid deterring corporate taxpayers from reorganising their commercial operations. The directive gives them a right to assess those gains subsequently but, absent that right when the directive has no application, the Member States have no alternative but to assess the gain at the time of the taxable event.

7.3 GROUNDS FOR JUSTIFICATION OF 'EXIT TAXES'

7.3.i Introduction.

The national tax provisions considered in this chapter are those designed to protect a Member State's tax base through the exercise of taxing powers on the occasion that a taxpayer migrates his tax residence or effects a cross-border reorganisation of his business or assets.

The first ground for justification of such national provisions is the preservation of the right to exercise powers of taxation[660] and the second ground, relating to the raising of an assessment upon the occurrence of the form of taxable event considered here, is maintaining the coherence of the tax system. Both principal arms of the expression of Member State sovereignty in matters concerning direct taxation are engaged. However, as loss of taxing jurisdiction invariably involves the loss of both the power to levy taxation and the power to raise assessment, the

[659] *Jacob & Lassus* [2018] Case C-327/16 & C-421/16 paragraph 72

[660] In 2011, Christiana Panayi commented: "…the imposition of exit taxes…does not in fact protect the allocation of taxing powers between the home State and the host State. Unless there is an underlying agreement between the home State and the host State as to *who* can tax capital gains accruing over two jurisdictions, then there is no allocation of taxing rights…" Panayi [2011] CYB at page 280 (emphasis added). The point is noted but the justification is defined in this thesis as exercise of taxing rights. There has since been harmonisation to resolve this issue: see chapter 7.5 *post*. The problem of potential double taxation is an issue also for transfer pricing anti-avoidance provisions.

second of the grounds for justification, protection of the coherence of the tax system, has been merely noted in the case law.

The Court accepted in *N* [2006] the right of the exit state to tax gains that had accrued during the taxpayer's residence in the Netherlands[661] and formulated its view more fully in *National Grid Indus* [2011][662].

This ruling in *National Grid Indus* [2011] was given in the context of an 'exit tax' charge on a company in respect of a gain that had accrued up till the time of migration of its tax residence on an asset employed in its business. It seems that there was some confusion (in the EU Commission's mind at least) as to whether the ruling applied only to companies and not to natural persons. The Court helpfully clarified this point in the negative in *Commission v Portugal (exit tax share exchange)* [2016][663].

As regards the second of these grounds for justification in the context of 'exit taxation', the Advocate General said in a passage of her Opinion in *National Grid Indus* [2011], which was approved by the Court[664]: "*If the [exit state], because of the transfer, were no longer able to tax the unrealised capital gains accrued during the period of residence of National Grid Indus in its territory, coherence of the tax system would not be possible*."[665]

The coherence to which the Advocate General was referring was the realisation basis in the exit state's taxing provisions that resulted in annual revaluations of the asset in the company's accounts being disregarded and the total (net) gain realised on disposal being substituted in the tax computation for the year of realisation of the asset in question. This (common) mechanism for taxing gains on capital assets or, indeed, in some cases, income[666], gives effect to the constraining principle in taxation of 'ability to pay' in that the taxpayer is not

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[661] *N* [2006] Case C-470/04 paragraphs 46 & 47

[662] "…in accordance with the principle of fiscal territoriality linked to a temporal component, namely the taxpayer's residence for tax purposes within national territory during the period in which the capital gains arise, a Member State is entitled to charge tax on those gains at the time when the taxpayer leaves the country…" *National Grid Indus* [2011] Case C-371/10 paragraph 46

[663] *Commission v Portugal (exit tax share exchange)* [2016] Case C-503/14 paragraph 52 and paragraph 53: "Although it is true that the judgment of 29 November 2011, National Grid Indus (C-371/10, EU:C:2011:785), was adopted in the context of the taxation of capital gains on companies, the Court subsequently transposed the principles laid down in that judgment also to the taxation on capital gains of natural persons (see judgment of 12 July 2012, Commission v Spain, C-269/09, EU:C:2012:439, Paragraphs 75 to 78, and of 16 April 2015, Commission v Germany, C-591/13, EU:C:2015:230, Paragraphs 65 to 67)." The author's understanding of the law following *National Grid Indus* is set out in Turner [2013] ITR . The Court referred to *Commission v Spain* C-591/13 but that involved the taxation of realised but untaxed income, which might be distinguished from accrued but unrealised gains from the perspective of 'ability to pay' though the Court stated (paragraph 54) that distinction to be "*irrelevant*".

[664] *National Grid Indus* [2011] Case C-371/10 paragraph 80

[665] *National Grid Indus (AGO)* [2011] Case C-371/10 paragraph 99

[666] Earned income paid away as a contribution to a pension scheme is an example of the principle applied. The untaxed income is subsequently taxed when paid out as a retirement annuity.

generally required to pay tax on a gain until he has possession of the proceeds of disposal.

The vexed question of whether the exit state, when exercising its power of taxation, should have to take account of a diminution in value of the asset after it ceases to be within its taxing jurisdiction, is considered more fully in chapter 7.4.i *post* as the Court has regarded this issue as one of proportionality[667].

It might be said, considering only the Court's statement in *N* 2006], that it is saying that the right of a Member State to levy taxation on gains arising on assets within its taxing jurisdiction can be limited by reference to changes to the circumstances subsequent to the taxable event and by reference to the availability of tax reliefs provided subsequently by the host state. As will be discussed, that notion is inconsistent with its view repeatedly expressed elsewhere that a Member State cannot be required to draft its own laws on taxation so as to eliminate a disadvantage that might accrue to a taxpayer as a result of exercising a freedom of movement so as to come within the taxing jurisdiction of another Member State[668].

However, there is a distinction to be drawn between, on the one hand, a requirement to make an adjustment to a tax assessment of an unrealised gain on a non-business asset held by an individual and, on the other hand, a requirement for the exit state to make such an adjustment in relation to assets held by a company as business assets employed in the host state in the generation of profits taxable there subsequent to the tax residence migration, that being because the host state will often grant tax relief in respect of diminution in the value of such assets.

7.3.ii Exercise of Taxing Powers and Coherence of the Tax System[669].

Whilst the freedoms of movement prohibit national provisions that would act to deter a person from exercising his rights under the Treaty, the Court has recognised that the exit state can justify national provisions that impose a tax charge on income, profits and gains that have accrued or have been realised within its taxing jurisdiction. As observed in chapter 6.1.i *ante*, the Court has recognised the right of an exit state to levy tax in such manner since *Gilly*[670] notwithstanding that a disadvantage might accrue to the person who has exercised the freedom of movement.

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[667] *N* [2006] Case C-470/04 paragraph 54: "…in order to be regarded in this context as proportionate to the objective pursued, such a system for recovering tax on the income from securities would have to take full account of reductions in value capable of arising after the transfer of residence by the taxpayer concerned, unless such reductions have already been taken into account in the host Member State."

[668] See for instance *Deutsche Shell* [2008] Case C-293/06 paragraph 43.

[669] *National Grid Indus* [2011] Case C-371/10 paragraph 80: both heads of justification are available for national 'exit tax' provisions.

[670] See *Gilly* [1998] Case C-336/96 paragraph 48.

The principle that a Member State should retain the right to tax gains is recorded and protected in the Mergers Directive as noted *ante*. The Court has made express reference to the fifth and seventh recitals of the directive, which restrict the relief to "…*only a system of deferral of the taxation…which,… safeguards the financial interests of the State of the transferring company* …"[671].

There is a tension between, on the one hand, avoiding tax distortions that would impede or deter exercise of freedoms of movement (Mergers Directive second recital) and, on the other, protecting the right of Member States to exercise their powers of taxation (Mergers Directive fifth recital).

7.3.ii.a N [2006].

The Court was obliged to consider this tension in *N* [2006] in the context of the fundamental freedoms before it had to consider it in the context of the framework set out in the Mergers Directive and, whilst it seems to have had little difficulty in concluding that the raising of an assessment by the exit state to tax an accrued but unrealised gain at the time of migration of tax residence could be justified[672], it considered that the Dutch provisions failed to satisfy the requirement of proportionality[673].

The background to *N* [2006] is that the Netherlands' tax provision in point created a taxable event, a deemed realisation at market value of an asset held by the taxpayer, upon the migration by him of his tax residence. The taxpayer was an individual and the asset in question was a valuable holding in a company that he owned. The charge on the deemed gain at the time of migration was an exercise of sovereign taxing power, not an anti-avoidance measure, in that there was no provision for waiving the charge after a period of time as was the case in the French provisions examined in *de Lasteyrie* [2004]. There was also no adjustment to the tax assessed in the event that the asset was sold for less than the value assessed at the time of migration.

The justification of an 'exit tax' on the ground of exercise of the powers of taxation, before those powers would otherwise cease, cannot be used if taxing powers are retained over the assets embodying the gains sought to be taxed. That was the situation in *X and Y* [2002] and the Court appears to have thought that that might have been the situation in *DMC* [2014] in which it expressed some uncertainty as to whether the exit state did lose its power of taxation over the gains of the assets in point[674].

[671] *3D I* [2012] Case C-2017/11 paragraph 28.

[672] *N* [2006] Case C-470/04 paragraph 46

[673] Ibid. paragraphs 51 & 54

[674] *DMC* [2014] Case C-164/12 paragraph 58.

7.3.ii.b National Grid Indus [2011][675].

The Dutch incorporated and resident company transferred its tax residence to the UK at a time when the exchange gain on money owed to it by its UK parent, measured in NLG, was NLG22.186 million. The Netherlands sought to tax the unrealised gain at the time of the migration of tax residence[676].

The Court ruled that the provision deeming a taxable event by reason of the migration of tax residence constituted a restriction[677]. However, the Court ruled also that the restriction could be justified on the ground of preservation of taxing power[678].

The Court then wrestled with its assessment of the proportionality of the deemed tax event and ruled, as a preliminary, that "… *a distinction must be drawn between the establishment of the amount of tax and the recovery of the tax*"[679].

The analysis relating to the assessment of the tax due addresses the issue of post-migration diminutions in value of the asset and is discussed *post* in chapter 7.4.i. and the analysis relating to the issue of collection of the tax assessed is discussed in chapter 7.4.ii. In both cases there was subsequent development of the decisions reached in this judgment.

7.3.ii.c DMC [2014][680].

Under the German tax code, the contribution to a company of an interest in an undertaking or partnership for an issue of shares is to be valued at market value if

[675] *National Grid Indus* [2011] Case C-371/10 The company was a wholly owned Dutch resident subsidiary of a UK company that was formed to bid for a foreign project, which it did not secure. It was capitalised by equity provided by its UK parent and which was loaned back to the UK group denominated in £sterling and in the amount of £33.113 million. The gain arose in the books of the subsidiary as a result of appreciation of the GBP against NLG.

[676] Having regard to its judgments in *Daily Mail* [1988] Case 81/87, *Überseering* [2002] Case C-208/00 and *Cartesio* [2008] Case C-210/06 the Court sought and then established that the migration of tax residence was neither unlawful nor affected the company's status of incorporation under Dutch law. Accordingly, the company could rely upon protection under Article 49 TFEU *National Grid Indus* [2011] Case C-371/10 paragraphs 26 to 33.

[677] *National Grid Indus* [2011] Case C-371/10 paragraph 41. Had the taxable event not been triggered, the gain would have been taxable under national law upon realisation. Different treatment was applied to the taxpayer company by reason of its exercise of a freedom of movement right.

[678] Ibid. paragraph 46. The Court also accepted that the determination (and assessment but not collection) of the tax on the deemed gain could be justified on the ground of preserving the coherence of the tax system (paragraphs 80 & 81).

[679] Ibid. paragraph 51.

[680] DMC KG, a limited partnership formed and trading in Germany, was owned directly and indirectly by two Austrian companies: directly as limited partners and indirectly as shareholders in a German company that was the general partner of the partnership. The two Austrian companies contributed their limited partnership interests to the general partner, the German company owned by them, for issues of shares to them. The partnership ceased to exist and the German company owned the business formerly conducted by the partnership.

Germany ceases to be able to tax the gain realised on the transfer[681]. In this instance, the Austrian limited partners ceased to have an establishment in Germany when they exchanged their partnership interests for shares. Any gain realised subsequently by the Austrian owners of the German company that issued the consideration shares would be taxable in Austria[682]. Accordingly, the limited partnership interests were deemed to have been transferred to the German company at market value and the gains realised on the disposal to the German company were taxable on the former Austrian limited partners[683].

Whilst acknowledging that Germany had ceased to have the power to tax the former Austrian limited partners for any tax period or event subsequent to the disposal of their partnership interests, the Court then went on to say: "…*it is not unquestionably clear from the facts…that the Federal Republic of Germany actually loses all power to tax unrealised capital gains on an interest in a partnership when that interest is exchanged in return for shares in a capital company. Indeed, the possibility would not appear to be precluded that such capital gains relating to the partnership interests contributed to the business assets of the capital company may be taken into account in determining the corporation tax payable in Germany by the acquiring company, namely in the present case DMC GmbH, which is a matter for the national court to establish*"[684].

The Court is referring to the fact that the German tax code applies the same valuation basis[685] to both the disposal by the Austrian limited partners and the acquisition by the German company owned by them. If the disposal is deemed to be at book value, the acquisition by the German company will be at that value and, if the German company disposes of the undertaking formerly conducted by the partnership, the gain will accrue to a company within Germany's taxing jurisdiction.

Thus, in *X and Y* [2002] the transferors remained within the tax jurisdiction of the exit state and remained potentially taxable on the transaction gain whilst it appears that in *DMC* [2014] the assets remained within the taxing jurisdiction of the exit state. The transferee, standing in the shoes of the transferors, remained potentially taxable on the transaction gain.

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[681] If Germany retains the power to tax the gain embedded in the consideration shares, the taxable event is the subsequent disposal of those shares and the undertaking, and its assets, are deemed to transfer at book value to the purchaser issuing the shares.

[682] *DMC* [2014] Case C-164/12 paragraph 19.

[683] Ibid. paragraphs 15 & 16.

[684] Ibid. paragraph 57.

[685] As did the Swedish tax code engaged in *X and Y* [2002] Case C-436/00 paragraph 3 (last paragraph of the Swedish tax code quoted).

7.3.ii.d Panayi [2017]

The point concerning retention of taxing power was made again in *Panayi* [2017][686], which involved the complex and far-reaching UK provisions relating to taxation of trusts. A migration of tax residence of the trust was triggered when new, non-resident, trustees were appointed with the result that the majority of the trustees were non-resident[687]. An 'exit tax' charge was triggered by the migration of the tax residence of the trust bringing into charge the aggregate net gains on assets held in trust on that date.

The retention by the UK of its power of taxation over the trust assets is explained in paragraph 54 of the judgment but, in this case, whilst the UK does retain some taxing jurisdiction over chargeable gains realised by the non-resident trustees, it is the beneficiaries that are subject to the charge and only to the extent that the trustees make a 'capital payment' to one or more of them. The quantum of the charge is the proportion of the capital payment made by the trustees that can be 'matched' to the chargeable gains realised by the trustees. Accordingly, the Court took the view that taxing power had not been retained in this instance[688].

The limited powers of taxation retained by the UK were regarded as insufficient to undermine the justification for the charge levied on the accumulated net gains on the trust assets at the time of the migration of tax residence of the trust.

7.3.ii.e Commission v Sweden (rollover) [2007] [689].

In contention was a relief from taxation of the gain realised on the sale of a property that had been the taxpayer's principal private residence. That relief, deferral of taxation, was granted only if the proceeds were reinvested in a replacement property purchased within the territory[690].

The objective of the relief provision is not revealed in the judgment but the condition that the taxpayer acquires a new property for use as his residence to qualify for the relief and the fact that the relief was in the form of deferral of taxation, not exemption, enables it to be deduced that the objective of the relief

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[686] *Panayi* [2017] Case C-646/15 paragraph 53.

[687] Ibid. paragraph 14.

[688] "…in so far as it causes the powers of taxation retained by the Member State concerned to be entirely dependent on the discretion of the trustees and the beneficiaries, cannot be regarded as sufficient to preserve the powers of that Member State to tax capital gains accruing within its territory" ibid. paragraph 55 (emphasis added).

[689] *Commission v Sweden (rollover)* [2007] Case C-104/06: an exit state case examined by the Court by reference to Articles 21, 45 and 49 TFEU and Articles 28 & 31 of the EEA Agreement.

[690] It was also required that he intended to reside in the replacement property. Whilst migration to another Member State would inevitably mean that the taxpayer would fail to qualify for relief, it was equally the case that the relief would be denied if he stayed within the territory but did not reinvest the proceeds of sale as required by the national legislation.

was to address the hardship that would otherwise occur because of the proceeds being unavailable to fund the payment of tax due on the gain realised. The relief also enabled residents owning residential property to more easily relocate within the territory.

If the taxpayer migrated to another Member State and purchased a residence there he would have still satisfied the perceived objectives of the deferral relief albeit that he would no longer be within the taxing jurisdiction of the exit state. The Court ruled that the unavailability of the relief in that circumstance constituted a restriction[691]. The situation would be similar to that examined by the Court in *National Grid Indus* [2011][692]. The Court intimated that it would have considered a justification based on the ground of protection of the coherence of the tax system[693].

7.3.ii.f Commission v Portugal (rollover) [2006]

Exemption from tax on the gain on the disposal of a principal residence was available if the proceeds of disposal were reinvested within 24 months in the purchase of a replacement property[694].

The Court ruled that the national rules imposed "*more unfavourable [or less favourable] tax treatment*" when the disposal proceeds were reinvested in a property in a different Member State and thus created a restriction[695].

The Portuguese tax administration advanced argument that the restriction could be justified by coherence of the tax system but the Court rejected that argument[696]. Neither tax administration argued a justification of preservation of taxing powers.

It must be concluded that, on the facts recorded in the judgments, there was no disturbance of Portuguese sovereignty in this instance as Portugal exempted the disposal of a principal residence and tax was foregone in any case.

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[691] *Commission v Sweden (rollover)* [2007] Case C-104/06 paragraph 22.

[692] *National Grid Indus* [2011] Case C-371/10. However, it is a restriction that might be justified on the ground of coherence of the tax system – see *Commission v Sweden (rollover)* [2007] Case C-104/06 paragraph 26 and see also *National Grid Indus* [2011] Case C-371/10 paragraph 80.

[693] *Commission v Sweden (rollover)* [2007] Case C-104/06 paragraph 27.

[694] *Commission v Portugal (rollover)* [2006] Case C-345/05 paragraph 5: the judgment contains less detail of the rules and conditions to be satisfied.

[695] Ibid. paragraph 21.

[696] Ibid. paragraphs 27 & 28 because of the lack of there being a subsequent levy: "…There can be no capital gains tax thereon in the future unless such gains are realised. Also, as long as the person concerned purchases a new property as his residence in Portugal, he can always rely on the exemption provided for in Article 10(5) of the CIRS."

7.3.iii Restrictions caused by national anti-avoidance provisions.

As the Court observed in *X and Y* [2002] considered below, there is an "*overlap*" between "*prevention of tax evasion*" and "*effectiveness of fiscal supervision*" when the objective of the national provision is specifically to prevent evasion and avoidance.

In *de Lasteyrie* [2004], the French provision, designed to prevent avoidance of French tax on realisation of capital gains, embodied a time limit for its application and it also provided relief in the form of adjustment of the original assessment to take account of subsequent diminution in value of the asset and credit relief for any host state taxation suffered on the disposal. Such a provision is, thus, designed to neutralise any advantage that might be gained by the taxpayer from temporarily migrating his tax residence and, accordingly, is designed to deter the taxpayer from embarking on an action in an attempt to avoid national taxation.

As such, it is not designed to be an exercise of taxing power over income, profits and gains arising during the time of tax residence of the taxpayer in the exit state. It is a provision designed to prevent tax avoidance.

A selection of cases involving such provisions are considered separately below.

7.3.iii.a X and Y [2002] [697].

The judgment was delivered before that in *de Lasteyrie* [2004], which is generally considered to be the first of the 'exit tax' cases. The case concerned Swedish reorganisation rules[698] where the transferors were individuals. The Merger Directive therefore had no application.

Relief was denied if the transfer of assets was to "*a foreign legal person*"[699] or was a transfer of assets "*to a Swedish limited company in which such a foreign*

[697] *X and Y* [2002] Case C-436/00 paragraph 60.

[698] The Swedish tax provisions provided deferral relief from tax on gains realised when Swedish individuals transferred assets at an undervalue to Swedish companies in which the transferors and their kin had holdings. In such circumstance, the relieving provisions provided that the assets were deemed to be transferred at cost and that the base cost of the transferors' interests in the transferee company would be increased by that cost. The transfer was, thus, treated as a contribution in kind to the capital of the transferee company and the embedded gains transferred stood to be taxed when the transferors realised their holding in the transferee company.

[699] *X and Y* [2002] Case C-436/00 paragraph 3. In the instance of a transfer of assets to "*a foreign legal person*", whilst the assets transferred would be outside of the Swedish taxing jurisdiction and the embedded gains on the assets would escape Swedish taxation when disposed of by that foreign company, the transferors and their kin would remain taxable in Sweden on any gain realised on the disposal of their holdings in that foreign company. It is the transferors who were claiming the benefit of the relief and they would remain within the charge to Swedish tax on the embedded gain of the transferred asset, which would be reflected in an increased value of the foreign transferee company. The transferors could only obtain value for themselves by selling their interest in that foreign transferee company and that would crystallise the taxable gain in their hands. In that respect, it makes no difference whether the transferee company is a Swedish company or a non-resident company. The contention by the Swedish tax administration that the use of the relief by

legal person either directly or indirectly has a holding"[700]. In either of those circumstances, the assets were treated as having been disposed of by the transferors at the then market value and the tax charge on the deemed or actual gain realised (if any) was not eligible for deferral. Sweden argued that the restriction in the relief was inserted to prevent tax avoidance[701].

For so long as the transferors remained within the taxing jurisdiction of Sweden, the embedded gains in the assets transferred also remained indirectly within the taxing jurisdiction. Sweden's ability to levy tax on those embedded gains for which the transferors had received relief was no different in the instance of a cross-border transaction from that of a purely internal transaction.

Swedish taxation would be evaded only if the transfers of assets were part of a scheme that involved the migration of tax residence of the transferors before they extracted value from their shareholdings. The Swedish legislation failed to achieve that objective[702].

Whilst Sweden sought to justify the restriction in the relieving provisions on the ground of coherence of the tax system, the discussion appears to be confusing. In any case, the coherence of the relieving provision is that, by restricting the uplift in the transferors' base cost of the shares in the transferee company to the base cost of the assets transferred to it, the embedded gains fell to be taxed on a subsequent disposal by the transferors of the shares in the transferee company. That coherence was retained regardless of the tax residence of the transferee company.

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the Swedish transferors to transfer the assets to a foreign transferee company to avoid Swedish taxation was flawed.

[700] Ibid. paragraph 3. Where the transfer of assets was the second of those specifically excluded from relief - to a Swedish company owned partly or wholly by a non-resident company in which the transferor and his kin held an interest - the embedded gains on the assets would remain within the taxing jurisdiction of Sweden but a disposal of the Swedish transferee company by the non-resident company in which the transferor and his kin had an interest would enable the value of the assets transferred to be realised without triggering a Swedish tax charge. Nevertheless, as observed in relation to a transfer of assets to a foreign transferee company, it is the transferors who are claiming the relief and they cannot obtain value from the transferred assets unless and until they dispose of the shares in the non-resident company owning the Swedish transferee company. The contention by the Swedish tax administration that the use of the relief by the Swedish transferors to transfer the assets to a Swedish subsidiary of a foreign company avoided Swedish tax was equally flawed.

[701] Ibid. paragraph 40.

[702] Ibid. paragraph 63 (emphasis added): "…the measure implemented by the Kingdom of Sweden is not capable of achieving the objective it is supposed to pursue…ensuring that the transferor is actually taxed in Sweden on gains made on shares transferred, particularly if the transfer is made prior to his definitive move abroad. In the case of [internal] share transfers, the transferor benefits in any event from a deferral of tax on gains made on shares transferred…the Swedish Government was unable to establish that, for this type of transfer, there were objective differences in the situation which would imply that the potential risk, for the purposes of taxation of the transferor in Sweden, inherent in a definitive move abroad by that transferor, is of an essentially different nature from that for [transfers involving a non-resident company]".

7.3.iii.b De Lasteyrie [2004].

This case concerned the exercise of the right of establishment by a French resident who moved to Belgium to conduct his profession there. By this action, the taxpayer migrated his tax residence and that migration triggered a French direct tax provision that levied tax on the unrealised gain enjoyed by the taxpayer on a material (25%) holding in a family company.

Like the Swedish provision examined in *X and Y* [2002], the French provision was designed to be an anti-avoidance provision. The French provision examined in *de Lasteyrie* [2004] had the object of neutralising the advantage that might be gained by a French resident exploiting a freedom of movement and temporarily moving to another Member State for the purpose of realising a gain. Liability under this provision ceased after a period of 5 years of non-residence.

The provision in point therefore was a means of protecting the tax base and was not a means of exercising the power of taxation as such[703]. As the national provision sought only to neutralise the advantage that might be gained by a resident taxpayer from realising his asset when temporarily resident in another Member State[704], the provision included adjustments providing credit relief for any host state tax assessed on the gain realised on disposal of the asset and the French assessment would be reduced for any diminution in value of the asset suffered after migration of tax residence of the taxpayer (although increases in value were to be disregarded)[705].

The provision was found to be restrictive, however, because there was no statutory right to defer payment of the amount of tax initially assessed at the time of departure[706]. In other respects, the Court acknowledged the right of the Member State to legislate to protect its tax base.

This form of provision is to be distinguished from one that has, as its object, the exercise by the exit state of its power to tax income, profits and gains that have arisen in its territory or to a person during their tax residence in its territory. The first of such provisions was reviewed in the context of *N* [2006] in chapter 7.3.ii.a *ante*.

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[703] *de Lasteyrie* [2004] Case C-09/02 paragraph 65.

[704] Ibid. paragraph 64.

[705] Ibid. paragraph 29. As cast, the French provision respected the right of the host state to levy tax on any gain that accrued during the taxpayer's subsequent residence in that territory. The provision also sought to avoid penalising the taxpayer for attempting to avoid French taxation on the accrued gain at the time of migration of tax residence by limiting the gain assessed to that actually realised. It was therefore proportionate. The taxpayer was deterred from exercising his freedom of movement neither by the prospect of double taxation, which was averted by the French provision providing the right of credit relief for any host state taxation, nor by the possibility of being 'over-taxed' on the gain accrued at the time of his migration of tax residence, which was averted by the provision providing for an adjustment to the amount assessed to take account of any subsequent diminution in value.

[706] Ibid. paragraphs 46 & 47.

7.3.iii.c van Hilten [2006].

This case is unusual in that the national anti-avoidance provision[707] did not give rise to a restriction to a freedom of movement.

The provision was in the nature of a tax avoidance measure preventing a person from avoiding Dutch inheritance tax by migrating to another country in anticipation of such a taxable event. Credit relief was allowed against Dutch tax for inheritance tax levied by the host state on the basis of residence in the host state[708]. Accordingly, the Dutch tax was in some respects similar to the French provisions considered above in *de Lasteyrie* [2004].

Article 63 TFEU was in point but the Dutch provision did not engage that freedom of movement as the taxpayer migrated her residence not the location of her capital, which was subsequently subject to taxation on a basis that was 'no less favourable' than the basis that would have applied had she remained resident.

The connecting factor for death duties is often different from that for taxes on income, profits and gains and, in the instance of this Dutch tax provision, the change of tax residence did not remove the taxpayer from the tax jurisdiction of the Netherlands until the taxpayer had been resident outside of the Netherlands for ten years. In that sense, the provision might be regarded as an exercise of taxing powers and not an anti-avoidance provision.

Strictly speaking, this tax was not an 'exit tax' either as it was not the migration of tax residence or the transfer of assets beyond the tax jurisdiction of the exit state that triggered the assessment. The case is reviewed here so that the distinction may be noted.

7.4 PROPORTIONALITY.

Two adverse consequences of the imposition of an 'exit tax' charge have been considered by the Court in the context of the proportionality of the national provisions. In the order addressed by the Court in *National Grid Indus* [2011] paragraph 51:

The first of the consequences relevant to taxation of unrealised profits is that the taxpayer may suffer diminution of the value of the asset after the event that triggered the 'exit tax' and he might, in consequence, suffer a higher level of exit state taxation than would have been the case had he not exercised his freedom of movement.

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[707] *van Hilten* [2006] Case C-513/03 paragraph 7. Liability under this Dutch inheritance tax provision arose only upon death although the value assessed was the value of the deceased's estate at the time of her migration of tax residence. The national provision deemed retention of tax residence in relation to Dutch inheritance tax where an individual died or made a gift within ten years of having ceased to reside in the Netherlands.

[708] Ibid. paragraph 13.

The second is the adverse cash flow consequence to the taxpayer of having to pay the tax assessed at a time earlier than would have been the case had he not triggered the 'exit tax' charge, with the possibility, where the charge relates to unrealised gains, that the levy of tax prior to the disposal of the asset in question might cause hardship contrary to the principle of 'ability to pay'.

7.4.i Adjustment to reflect subsequent diminution in value.

The requirement stated in *N* [2006] paragraph 54 to make such an adjustment implies that the exit state must limit its powers of taxation to take account of losses sustained by a taxpayer when he moves to another Member State and that is contrary to what it said earlier in *Lindfors* [2004][709].

The Court addressed that requirement in *National Grid Indus* [2011] paragraphs 56 to 64. It distinguished the situation in *N* [2006] by noting that the assets in *National Grid Indus* [2011] are (potentially) "… *assigned directly to economic activities that are intended to produce a profit … the extent of a company's taxable profits is partly influenced by the valuation of its assets in the balance sheet, in so far as depreciation reduces the basis of taxation*"[710]. Thus, potentially, any diminution in value following the migration of tax residence might be relieved by the host state although "… *a possible omission by the host Member State to take account of decreases in value does not impose any obligation on the Member State of origin to revalue, at the time of realisation of the asset concerned, a tax debt which was definitively determined* …"[711].

The Court completed the reversal of its prescription in *N* [2006] in *Commission v Portugal (exit tax share exchange)* [2016] , which concerned Portuguese tax provisions applicable to natural persons, citing the above[712].

The amended policy of the Court regarding events happening after 'a tax debt is definitively determined' is consistent with the principle of legal certainty.

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[709] *Lindfors* [2004] Case C-365/02 paragraph 34: "…the EC Treaty offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation...It follows that…any disadvantage, by comparison with the situation in which that citizen carried on activities prior to that transfer, is not contrary to Article 18 EC…". This principle was cited by the Court in paragraph 62 and was previously stated in *Hervein & Others* [2002] Case C-393/99 & C-394/99 paragraph 51 and *Weigel* [2004] Case C-387/01 paragraph 55 and subsequently restated in *Schempp* [2005] Case C-403/03 paragraph 45, *Columbus Container* [2007] Case C-298/05 paragraph 51, *Deutsche Shell* [2008] Case C-293/06 paragraphs 42 & 43, *Leyman* [2009] Case C-3/08 paragraph 45, *K* [2013] Case C-322/11 paragraph 80 and *Eschenbrenner* [2017] Case C-496/15 paragraph 46.

[710] *National Grid Indus* [2011] Case C-371/10 paragraph 57. This was not true for the taxpayer company because it was a shell company that had simply loaned back the proceeds of issue of its own capital but it would apply to a trading company. The Court was addressing a hypothetical situation.

[711] Ibid. paragraph 61.

[712] *Commission v Portugal (exit tax share exchange)* [2016] Case C-503/14 paragraph 55.

7.4.ii Timing of payment.

The Court first objected to the immediate charge to tax payable in respect of an unrealised gain assessed at the time of migration of tax residence in *de Lasteyrie* [2004][713].

The objection is not only in respect of the timing of the payment but also the fact that the taxpayer does not have 'the ability to pay' the tax liability until he disposes of the asset. The requirement to pay the tax liability in those circumstances can give rise to hardship and clearly is an obstruction to an exercise of a freedom of movement. The restriction in that case could not be justified as there was not an exercise of taxing powers as such[714].

The situation in *N* [2006] was different because the Netherlands did exercise its taxing power and, whereas the raising of the assessment at the time of the migration of tax residence by the taxpayer could be justified, the obligation to pay the tax at that time gave rise to the same hardship[715]. That hardship could be avoided using a scheme of deferral but the taxpayer had to obtain guarantees for the payment by him of the tax liability and that would incur him cost and some loss of freedom to deal with the asset. The Court considered that the requirement for the taxpayer to obtain the guarantees to be disproportionate[716] and the same would apply to a requirement to pay cash against the assessment if deferral was denied.

That hardship might not have been experienced by the taxpayer in *National Grid* Indus [2011] as the asset in point was a single inter-company debt, which could have been partially realised to pay the tax assessed.

As stated ante, it seems that the Court disregarded the facts of the case and gave a ruling based on a more typical situation where an operating company

[713] *de Lasteyrie* [2004] Case C-09/02 paragraph 46 (emphasis added): "A taxpayer wishing to transfer his tax residence outside French territory…is subjected to disadvantageous treatment in comparison with a person who maintains his residence in France. <u>That taxpayer becomes liable, simply by reason of such a transfer, to tax on income which has not yet been realised and which he therefore does not have</u>, whereas, if he remained in France, increases in value would become taxable only when, and to the extent that, they were actually realised...".

[714] The tax assessment would be voided after 5 years of non-residence.

[715] *N* [2006] Case C-470/04 paragraph 35.

[716] Ibid. paragraph 51. The German 'exit tax' provisions reviewed by the Court in *Wachtler* in the context of the Agreement on the Free Movement of Persons ('AFMP') concluded on 21 June 1999 between the European Union and the Swiss Federation, resulted in a very similar restriction: see *Wächtler* [2019] Case C-581/17 paragraph 57: In very similar circumstances*,* Mr Wachtler migrated his tax residence from Germany to Switzerland, where he conducted his profession, and was assessed to German tax on an unrealised gain on the shares of his service company. The restriction in this case was in relation to the right of establishment provided in the AFMP.

migrates its tax residence and has a large number of non-monetary assets including, possibly, those depreciated for tax purposes[717].

That would not necessarily be the case for all companies but the Court had recognised also that some or all of a company's assets "…*are assigned directly to economic activities that are intended to produce a profit*…"[718] and will be 'consumed' in generating those profits. To the extent that such assets are treated as 'consumed'[719], the company might be regarded as having proportionately realised the unrealised gain assessed at the time of the migration of residence. That was not discussed in the judgment.

Perceiving that different rules for determining payment obligations might be appropriate according to circumstances, the Court suggested that the taxpayer should be given the option of paying the tax immediately or, alternatively, of bearing the administrative cost of maintaining a trace of the assets in point and accounting for the tax assessed as the chargeable assets are realised or in accordance with some other method of deferral[720].

The Court did not suggest a form for the scheme of deferral but, in its *DMC* [2014] judgment, approved the German tax code deferral over five years[721].

This appears to have been the first mention of what might be regarded as an acceptable length of time for the deferral period. Clearly, in relation to depreciable assets, payment of the tax attributable to particular assets over their residual lives as they are depreciated for accounting purposes would create a heavy administration burden and it would not provide a mechanism for exit state recovery of the deferred tax attributable to non-depreciated assets such as land and goodwill.

'Exit taxes' will be charged also where assets or operations are transferred to a foreign branch of the transferor company. Whilst the transferor may remain

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[717] *National Grid Indus* [2011] Case C-371/10 paragraph 70: "…the asset situation of a company may appear so complex that an accurate cross-border tracing of the destiny of all the items making up the company's fixed and current assets until the unrealised capital gains incorporated into those assets are realised is almost impossible, and that such tracing will entail efforts representing a considerable or even excessive burden for the company in question."

[718] Ibid. paragraph 57.

[719] This will be reflected in the depreciation charge applied.

[720] *National Grid Indus* [2011] Case C-371/10 paragraph 73. Panayi [2012] BTR page 47 "…Here, the Court seems to indulge in judicial legislation. By stipulating what would be "less harmful to freedom of establishment", the Court is, to an extent, setting out prescriptive guidelines to Member States on how to design their exit tax rules…". This is not the first instance of the Court terming its rejection so. For instance, *Papillon* [2008] Case C-418/07 paragraph 52 and *Commission v Italy (vinegar)* [1981] Case 193/80 paragraph 23 *ante*.

[721] *DMC* [2014] Case C-164/12 paragraph 62: "…in the light of the fact that the risk of non-recovery increases with the passing of time, the ability to spread payment of the tax owing before the capital gains are actually realised over a period of five years constitutes a satisfactory and proportionate measure for the attainment of the objective of preserving the balanced allocation of the power to impose taxes between Member States."

within the tax jurisdiction of the exit state, that foreign PE might be outside of the taxing jurisdiction of the exit state. Such was the underlying transaction in *Commission v Portugal (exit tax)* [2012][722].

The Court examined a similar transaction in *Commission v Germany (rollover)*. The German tax code provided 'rollover relief' for business assets but the relief could only be claimed if the replacement asset was used for a business conducted within the German taxing jurisdiction[723]. Where the condition was satisfied, the gain on the disposal of the replaced asset was effectively taxed on the occasion of the disposal of the replacement asset or, if the replacement asset was a depreciable asset, it was effectively taxed as the replacement asset was tax depreciated as its tax base cost would have been reduced by the amount of the rolled-over gain. The Court followed its judgment in *National Grid Indus* [2011][724].

In *Verder LabTec* [2015], the asset consisted of patent rights developed by the company itself and the transaction in point was a transfer of those rights from the limited partnership's establishment in Germany to a PE in the Netherlands, which was outside of Germany's taxing jurisdiction. The German tax administration determined that the gain on the asset valued at the time of the transfer to the Dutch PE should be amortised in the German establishment's profit and loss account on a straight-line basis over ten years[725].

7.5 ANTI-TAX AVOIDANCE DIRECTIVE[726] ('ATAD')

The Member States have ceded their sovereignty through ATAD in several specific areas. Article 5 of the directive, applicable only to persons within the charge to a Member State tax assessed on companies, harmonises the tax

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[722] *Commission v Portugal (exit tax)* [2012] Case C-38/10 paragraph 32. The Court ruled that its requirement stated in *National Grid Indus* [2011] regarding the need to provide the transferor with the option of paying tax immediately or offering deferral of collection of the tax charge triggered by the transfer in order to satisfy the principle of proportionality, was equally applicable to this form of transaction. No guidance was offered by the Court in this case either on an acceptable term over which the tax was to be paid. On a transfer of assets, there could be charges recovering accelerated depreciation, in relation to which, the taxpayer has possibly previously banked financial benefit and there will be possibly trading assets producing cash flow, which would alleviate the 'hardship' of having to pay the exit charge when assessed.

[723] *Commission v Germany (rollover)* [2015] Case C-591/13 paragraph 21.

[724] Ibid. paragraph 73

[725] *Verder LabTec* [2015] Case C-657/13 paragraph 20. The original determination by the German tax administration and the complaint made by the taxpayer against it were both made before the delivery by the Court of its judgment in *National Grid Indus* [2011] and the complaint by the taxpayer appears to have been influenced by the Court's judgment in *N* [2006]. (see paragraph 3)

[726] Council Directive (EU) 2016/1164 of 12 July 2016. The directive is not wholly targeted at tax avoidance as Article 5, discussed here, evidences: "Whilst ostensibly an attempt at ensuring harmonized implementation of BEPS within the EU, the ATAD has at its heart a wider concern about establishing a level playing field within the Internal Market." De La Feria [2017] ECTR at page 110.

treatment of migration of tax residence and that of transfers of assets cross-border without change of ownership.

The provisions of Article 5 codify and extend the principles developed by the Court in its case law. They also require the host state, or destination state, to value assets, subject to an exit tax charge, at market value at the time that they come within its taxing jurisdiction (Article 5.5).

The exit state has the right to tax the asset on the basis of market value reduced by the tax base cost. Accordingly, the transfer of a tax depreciated asset out of the exit state tax jurisdiction will trigger a clawback of tax allowances and, potentially, a charge on a capital gain.

The charging rule applies only to assets removed from the taxing jurisdiction of the exit state so, for instance, if a company migrates its tax residence but retains an establishment in the exit state, the assets related to that establishment are excluded as they will not be removed from the taxing jurisdiction of the exit state.

Article 5.2 of the directive reflects the Court's acceptance in *DMC* [2014], paragraph 62, of a right of deferment of tax payable in instalments over five years. The provision applies also to transfers to an EEA state if it has concluded an agreement with the exit state relating to recovery of taxes equivalent to Council Directive 2010/24/EU.

Article 5.3 permits the charging of interest on deferred payments by the exit state and the requirement for a guarantee, both having been approved by the Court in *National Grid Indus* [2011], in paragraphs 73 and 74 respectively.

7.6 RECOVERY OF ACCELERATED DEPRECIATION AND SIMILAR: ANALOGY WITH *TIMAC AGRO DEUTSCHLAND [2015]*[727]

The universal application of market value applied to assets transferred or owned at the time of tax residence migration will automatically generate a recovery of accelerated tax deductions[728] (including depreciation). However, Article 5.2 prescribes a scheme of tax collection by the exit state by instalments over five years.

As previously mentioned, when considering the timing of collection of tax, there will be an amount representing a clawback of tax relief already monetised and a balance (if any) representing tax on a gain in value accrued.

It is not within the scope of this thesis to mount a full discussion on whether the Treaty freedoms of movement have provided taxpayers with an opportunity to make abusive use of Member State depreciation schemes but it is clear that a Member State offering special allowances or accelerated relief for, say, research

[727] *Timac Agro Deutschland* [2015] Case C-388/14.

[728] If market value is greater than tax written down value: otherwise there may be a further deduction available.

and development, might find itself granting that relief under an accelerated scheme to a taxpayer only to find that the asset created is then exported leaving it with an entitlement to clawback the tax relief but staggered over five years. In the meantime, the host state may offer similar accelerated depreciation on such assets and the taxpayer might therefore contrive to enjoy aggregated tax deductions exceeding cost for some time.

That form of abusive use of the directive is unlikely to fail as both the development of the asset and its subsequent use will be in the course of genuine commercial activity[729].

In this particular context, ATAD may be out of step with the Court's rulings and may undermine Member State sovereignty but it remains to be seen how the Court resolves the tension between Article 2 and Article 5.2.

It is possible to see a parallel between the clawback of the tax relief already monetised and the situation considered by the Court in *Timac Agro Deutschland* [2015], which concerned Austrian branch losses "*reincorporated*" into the profits of the German company that owned the branch when the branch was sold to an Austrian group company. The German tax relief scheme was examined by the Court in an earlier case, *Krankenheim Ruhesitz* [2008][730].

Effectively, the German system ensured that a German company having such a branch would not be taxed in Germany in any period of assessment on an amount greater than the profit realised by the company (including its branch) and that was achieved by deferring the taxation of German profits in an amount equivalent to the losses sustained in the host state[731]. The levy of tax achieved through the reincorporation mechanism achieved 'immediate' recovery of past reliefs granted.

Where tax depreciation of an asset commences with the time that it is first brought into use and is at a rate that amortises the cost of the asset over its useful life, there is unlikely to be much of an adjustment when the asset is revalued to market at the time of an 'exit tax' trigger event.

Where, however, tax relief for expenditure incurred has been granted before the asset has been brought into use and/or, has been granted at an accelerated rate, the national tax scheme is being used to provide financial aid to encourage

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[729] See *Cadbury Schweppes* [2006] Case C-196/04 paragraphs 34 – 38. It is not thought that Article 6 of ATAD would provide protection from this kind of exploitation by taxpayers although Article 2 permits the "…*application of domestic or agreement-based provisions aimed at safeguarding a higher level of protection for domestic corporate tax bases.*"

[730] *Krankenheim Ruhesitz* [2008] Case C-157/07. See chapter 4.4.i.a *ante*. Both situations can be distinguished from the forfeited discount on capital tax examined by the Court in *DI. VI.* [2012] Case C-380/11 as, in the first place, there was no deduction from taxable profits matched by a subsequent clawback necessary to ensure that the origin state could exercise its powers of taxation; and, in the second place, the discount became permanent after a period of five years.

[731] *Timac Agro Deutschland* [2015] Case C-388/14 paragraph 31: "…the reincorporation at issue…corresponds to the amount of the losses previously deducted. Such reincorporation thus constitutes the offsetting for tax purposes of the share of the resident company's profits that was not previously taxed."

that form of investment. If the trigger event for the 'exit tax' is before the asset is brought into use, or shortly after, and if the market value of the asset exceeds its accumulated cost, part of the charge will recover that financial aid[732] and the remainder will be value reflecting the asset's future economic benefits.

There is a parallel between the German scheme for providing relief for exempt foreign PE losses and accelerated depreciation in that the German scheme provided financial aid and a reduction in risk for investment in such foreign branches. The accelerated depreciation schemes do similarly with regard to the development or acquisition of assets to be used in the business. In the case of both schemes, there is a mechanism for clawing back the benefits as future profits are generated.

Considering the justification for the adjustment made by the German Tax administration on the ground of the "…*need to safeguard a balanced allocation of the power to impose taxes between the Member States*…"[733], the Court went on to say, following its analysis in *K* [2013][734] "*That objective…is designed, inter alia, to safeguard the symmetry between the right to tax profits and the right to deduct losses, in particular in order to prevent taxpayers from choosing freely the Member State in which profits are to be taxed or losses are to be deducted*…"[735]

The Court then observed that Germany had not "…*exercised any tax powers in respect of [the Austrian branch's] income*…" and that "…*To deprive the Federal Republic of Germany of the possibility of reincorporating into the taxable profit of the resident company the losses deducted previously in respect of the permanent establishment situated in Austria in the event of transfer of that establishment would thus be tantamount to allowing that company to choose freely the Member State in which those losses could be deducted*…"[736]

The Court concluded "…*the reincorporation…allows the symmetry between the right to tax income and the right to deduct losses to be safeguarded, and, therefore, ensures a balanced allocation of the power to impose taxes between the Member States concerned*…"[737]

It is possible to pose a similar argument based on symmetry to a situation where an asset has attracted accelerated depreciation, possibly even before first use and possibly based on an amount in excess of actual cost. In a similar way, a company is able to "…*choose freely the Member State in which those losses could be deducted*…" by incurring the development expenditure in one Member State,

[732] Had the taxpayer remained tax resident in the origin state, the financial aid would have been recovered over the useful life of the asset in the form of the excess of taxable profits over accounting profits.

[733] *Timac Agro Deutschland* [2015] Case C-388/14 paragraph 34.

[734] *K* [2013] Case C-322/11 paragraphs 50 & 51.

[735] *Timac Agro Deutschland* [2015] Case C-388/14 paragraph 35.

[736] Ibid. paragraph 37.

[737] Ibid. paragraph 38.

claiming deductions, and then transferring it to another Member State when it is ready to generate income.

As regards the proportionality of the act of the German tax administration, which resulted effectively in an immediate charge to tax following the disposal of the branch, the Court said, not specifically addressing the timing of the liability to pay the tax, "…*The need to safeguard that symmetry means that the losses deducted in respect of the permanent establishment must be capable of being offset by taxation of the profits made by it under the tax jurisdiction of the Member State in question, that is to say, both the profits made throughout the period when the permanent establishment belonged to the resident company* ***and those made at the time of the permanent establishment's transfer***…"[738]

The Court appears to have been satisfied that the immediate payment liability that arose in consequence of the assessment adjustments made by the German tax administration in consequence of the disposal was proportionate notwithstanding that, had the German company retained direct ownership of the Austrian branch, it would not have suffered adjustment to previous years' assessments and would have only borne the additional tax charges resulting from the 'reincorporation of the losses' over time as the profits arose in future years in the Austrian branch.

By analogy, the Court should accept the proportionality of an 'exit tax' charge representing the clawback of accelerated depreciation granted prior to the taxpayer or the asset ceasing to be within the exit state's taxing jurisdiction.

It is concluded that ATAD might fail the Member States' better interests in relation to taxpayer exploitation of enhanced allowances in relation to certain types of capital expenditure.

7.7 CONCLUDING COMMENTS

The prospect of triggering of a tax liability by migration of tax residence is likely to deter a taxpayer from exercising a freedom of movement and this creates a tension between, on the one hand, the sovereign right of the exit state to tax a gain or other benefit that has accrued during the period terminating with the act of migration and, on the other hand, the Treaty right to move between Member States without hindrance.

That tension is evident in the Mergers Directive 2009/133/EC as discussed in chapter 7.2 *ante*, which provides that the assessment of the accrued taxable item should be deferred until there is a disposal event. It was suggested that the Court took some inspiration from the directive when considering the cases reviewed in chapter 7.3.ii *ante*, which involved the exercise of their sovereign rights to exercise their powers of taxation by the Member States in point, but it was pointed out that the Court had also examined Member State provisions that had not had the

[738] Ibid. paragraph 48 (emphasis added)

purpose of protecting that right but had the purpose of preventing abusive use of the Treaty freedoms of movement to avoid taxation on accrued gains[739].

Where the purpose of the national provisions is to prevent that form of tax avoidance, it is appropriate to make adjustment to the tax assessed by the exit state for post-migration diminution in value and to give credit for any host state tax assessed on the same profit or income. In that way, the advantage sought by the taxpayer will be equitably neutralised.

Where the purpose of the national provisions is to exercise powers of taxation, the restriction caused by the provisions can be justified on the basis of protecting taxing powers and coherence of the tax system. However, there is no reason why the exit state should be obliged to make adjustment to the tax assessed for any diminution in value that might occur when the taxpayer is tax resident in the host state. This issue has been discussed in chapter 7.4.i *ante*.

The Court has encountered some difficulty with formulating a coherent policy over whether, in the latter form of migration, it is proportionate to collect the tax at the time that the deemed profit or gain is assessed. The Court has recognised advantages to both immediate collection and deferred collection[740] and has recognised the risk of "*non-recovery of the tax*" where a deferral scheme is provided[741]. This issue was discussed in chapter 7.4.ii a*nte*.

The EU has acted, however, to formalise a scheme of taxation for companies through Article 5 of ATAD discussed in chapter 7.5 *ante*. This directive, however, does not appear to provide protection against exploitation of accelerated tax allowances on certain assets as discussed in chapter 7.6 *ante*.

The sovereign rights of the Member States in the field of direct taxation have been upheld albeit that the Court has encountered difficulty in ruling on the proportionality of timing of collection of the tax assessed triggered by the migration provisions. In relation to companies, the protection is now largely provided by ATAD.

There is some evidence that, whilst the Court might have approached the issue of tax migration with an idealised approach in the relatively simple situation in *N* [2006], it was made aware by *National Grid Indus* [2011] that it could open the floodgates to a surge of tax avoidance, or uncertainty, if it pursued the same idealised approach in its rulings in that case.

The Court may have been influenced by the Council Resolution of 2 December 2008 and the Commission communications of 19 December 2006 referred to in that Council Resolution. The Council Resolution emphasised the need for

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[739] *de Lasteyrie* [2004] Case C-09/02

[740] *National Grid Indus* [2011] Case C-371/10 paragraph 73. The Court observed that a taxpayer might elect for immediate payment rather than bear an administration cost maintaining a record of the relevant assets. The Court has approved a period of 5 years for a deferred collection scheme: *DMC* [2014] Case C-164/12 paragraph 62.

[741] *National Grid Indus* [2011] Case C-371/10 paragraph 74.

coordination between the exit state and the host state but its very existence is evidence of the importance of certainty to the Member States and the Internal Market.

In its *National Grid Indus* [2011] judgment, the Court addressed the hypothetical situation of a trading company migrating its tax residence and it progressively modified its views in that case and subsequent cases on the two aspects of proportionality addressed in chapter 7.4 *ante.* It recognised that requiring the exit state to take account of post-migration diminutions in value would, in many cases, result in double deductions and recognising also that deferring tax collection until the ultimate disposal of an asset would entail considerable administrative effort and uncertainty, including the determination of when a depreciable asset is actually disposed of.

It is concluded that the Court commenced with an idealised approach in *N* [2006] but then modified its rulings to produce more practical solutions respecting Member State taxing sovereignty once it started to comprehend that its idealised approach could not work for tax migration of businesses.

8 GROUPING ARRANGEMENTS AND 'FINAL LOSSES'.

8.1 INTRODUCTION TO THE CHAPTER.

The previous two chapters of Part II of this thesis have focussed on the Court's perceived errors in applying its comparative analysis, and finding an infringement of a Treaty freedom of movement where it is argued that none has occurred, and on the evolution of the Court's analysis of 'exit taxation' and its progressive acknowledgement of the threat to Member State taxing bases if it failed to rein in its idealised approach to the matter evidenced in *N* [2006].

In this and in the following chapter there will be reviews of further instances of what appears to be flawed analysis by the Court that has left the Member State taxing authorities and taxpayers floundering in a sea of uncertainty, particularly in relation to company grouping schemes.

8.2 DOUBLE DEDUCTION OF LOSSES.

This ground for justification was first advanced by the United Kingdom *in Marks & Spencer* [2005][742]. It is a troublesome ground for justification because, for instance, taking a different example[743] of a resident branch of a non-resident company, that the losses of the branch might be relieved in both Member States is a corollary of the branch's activities being taxed in both jurisdictions.

The same would apply if, exceptionally, a non-resident subsidiary, whose activities were conducted wholly outside the state of residence of the parent company, was nevertheless subject to taxation by the state of residence of the parent company[744].

As a general rule, an advantage can be obtained from a cross-border double deduction of losses only if the balancing income in one of the states concerned is treated as being exempt from tax[745] or if a tax credit is received in one of the states in respect of tax paid in the other that would not have been due had the

[742] *Marks & Spencer* [2005] Case C-446/03 paragraphs 43 & 47.

[743] Relevant to the situation examined in *Philips Electronics* reviewed *post.*

[744] That is the effect of the *Marks & Spencer* [2005] 'final loss' ruling of the Court, which is why it has ruled that there must be 'no possibility' of the losses of the foreign subsidiary being used elsewhere or of the parent obtaining some form of monetary consideration for those losses by sale of the loss-making subsidiary.

[745] For instance, see *Commerzbank* [1993] Case C-330/91. The UK branch of the German bank paid interest on loans and deposits to fund loans by it to US persons whose payments of interest to Commerzbank were exempt from UK tax in its hands by reason of a clause in the UK/US double tax treaty. Similar results can be obtained using hybrid instruments and hybrid vehicles – see Recital 13 of ATAD.

undertaking retained its losses for its own use and not offset them in the other state against the profits of another undertaking[746].

Otherwise, the double deduction arises in a cross-border situation because the two states exercise their taxing powers in parallel[747].

The United Kingdom was entitled to determine its own taxing jurisdiction and to stipulate in its tax code, in conformity with the territoriality principle acknowledged by the Court in *Futura*[748].

The restriction in the UK group relief provisions was simply reflective of the territorial scope of the scheme of taxation in point, which was limited to the profits of companies conducting activities in the United Kingdom or otherwise being regarded as tax resident in the United Kingdom. A non-resident company that conducts a trade in the UK through a permanent establishment is within the charge to UK corporation tax but only as regards the profits attributable to its UK permanent establishment[749].

The restriction was that only corporation tax profits and corporation tax losses could be offset. No account of the 'nationality' of companies was taken or of where they were primarily resident (subject to anti-avoidance provisions).

The restriction in point in *Philips Electronics* [2012][750] was applicable to branches of non-resident companies satisfying the required group relief ownership requirements and the effect of the restriction was to deny the non-resident company the right to surrender the losses of its UK branch to the extent that the UK branch's losses were deductible in the assessment of "*non-UK profits*" subject to "*non-UK tax chargeable under the law of a territory*".

As stated *ante*, that the losses of a resident branch of a non-resident company might be relieved in both Member States is a corollary of the branch's activities being taxed in both jurisdictions. The Court observed that taxation of the company in the Netherlands had no consequence to the UK's ability to levy corporation tax on the UK branch's profits[751]:

The restriction could not be justified on the ground of preservation of taxing powers as the UK provisions would permit deduction of the UK branch's losses only once: either by surrender of the losses to other group companies or by retention and application of the losses against the profits of another accounting

[746] In which case, the appropriate adjustment to be made by the origin state is a disallowance of the tax credit to the extent that it reflects the offset of losses against the profits of another undertaking in the host state.

[747] See *Philips Electronics* [2012] Case C-18/11 paragraphs 30 & 31.

[748] *Futura* [1997] Case C-250/95 paragraph 22.

[749] See now Corporation Tax Act 2009, s.5 disregarding the Finance Act 2016 including dealers and developers of land.

[750] Corporation Tax Act 2010 s.107.

[751] *Philips Electronics* [2012] Case C-18/11 paragraph 30.

period. Recognition of and relief for the UK branch losses in the Netherlands would not have had any effect on the UK's tax base.

The Danish group taxation rules examined in *NN* [2018] contained a restriction similar to the UK group relief restriction[752].

Before considering the effect of the Nordic Convention, a treaty determining the allocation of taxing powers between Denmark and the other Member State concerned in the case (Sweden), the Court ruled that the Danish restriction on offset of the losses of a resident branch of a non-resident company against other Danish profits of the group could not be justified. It made the observation with regard to a situation where there is concurrent exercise of taxing powers by two Member States[753].

However, after taking into account that the state of residence of the non-resident company granted a tax credit against taxation assessed by it on the Danish branch for Danish tax borne on the branch profits, it stated the amended view: "…*the ability, claimed by the Danish group to which the Swedish company belongs, to deduct the losses of such an establishment twice, that is to say, in one and the other national tax systems, does not appear to be justified*."[754]

The logic of this appears to be flawed. The fact that Sweden grants a credit for Danish tax paid in respect of the branch's profits, when profitable, does not affect the fact that Denmark is taxing the profits of the branch, when profitable, and should therefore allow relief for the losses when it is not. It is Sweden that would suffer loss as a result of the offset of the branch's losses against other Danish profits because it will grant credit for Danish tax suffered by the branch that would not have been suffered had it retained the losses for offset against its own profits in a subsequent period. Sweden would be justified in denying tax credit relief to the extent that the Danish tax borne is greater than it would have been had the losses been retained by the branch[755].

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[752] See *NN* [2018] Case C-28/17 paragraph 23.The restrictive rule was described in ibid. paragraph 7: "A loss in a [Danish resident] permanent establishment may be set off against the income of other [Danish Resident] companies only if the rules in the foreign State … in which the company is resident provide that a loss cannot be set off in the calculation of the company's income in the foreign State …". The Danish group tax system exempted from tax all non-resident companies and permanent establishments unless the taxpayer group elected for them to be taxable. If a taxpayer group so elected, the restrictive provision had no application.

[753] Ibid. paragraph 43. "…in a situation in which a permanent establishment's income is taxed by two Member States, it appears justified that the charges borne by that establishment should be capable of being deducted from that income in one and the other tax systems, in accordance with national rules."

[754] Ibid. paragraph 47.

[755] Johansson J agrees with this analysis of the potential loss to the origin state. He said in 2021: "…the Danish rule targeted the double deduction of losses. This phenomenon results in cashflow advantages commonly only enjoyed by groups in cross-border situations when a credit system is used to eliminate or reduce international juridical double taxation." Johansson [2021] Intertax pages 949 & 950.

Accordingly, whilst the Court ruled that the Danish restriction was justified in these circumstances, the rationale appears to be flawed.

'Prevention of double deduction of losses' does have meaning, however, where the national tax code permits loss relief both at subsidiary level, in the form of business operating losses, and at the parent company level, in the form of a write-down of the parent company's investment in the subsidiary making the losses[756].

Rewe (ITS) [2007][757], concerned the German tax code and provides another example of where a double deduction might be obtained as a result of a Member State tax regime permitting a tax deduction for a book write-down by a parent company of its investment in a subsidiary that has made losses.

However, these are 'internal' not cross-border issues and it is the Member State provisions that permit the deduction in relation to the book write-down of the investment in the subsidiary by the parent company that enables a duplicated deduction for a subsidiary's losses[758].

As previously stated, in a cross-border situation, an advantage from double deductions of losses will only generally occur when use of a hybrid instrument or a hybrid vehicle is contrived or when matching income in one state is exempted.

An advantage can also be obtained where the losses of a foreign permanent establishment are stripped out for local use by sister undertakings in the territory and the origin state taxes the permanent establishment subject to credit relief for foreign tax paid. In that case, the proportionate adjustment in the origin state is to restrict the credit relief to the foreign tax that would have been paid had the stripped-out losses been retained for use by the foreign permanent establishment against the foreign profits tax. However, a disallowance of the losses by the origin state is a disproportionate adjustment.

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[756] Both *Papillon* [2008] Case C-418/07 and *SCA & Others* [2014] Case C-39/13, C-40/13 & C-41/13 concerned restrictions in tax integration schemes for groups. The issue in both was a restriction against inclusion of resident subsidiaries when held through non-resident intermediate holding companies. The non-resident holding companies could not be included in the tax integration groups and, consequently, there could not be automatic adjustment for the double counting of losses arising from the tax-deductible write-downs of investments in operating subsidiaries suffering operating losses. However, the Court observed in *Papillon* [2008] (paragraph 56) that the parent company could obtain the information necessary to make the adjustment and it observed in *SCA & Others* [2014] (paragraphs 37 & 38) that the Dutch legislation in any case did not recognise write-down of investments as a deductible expense where the shareholding exceeded 5% of the capital of the investee company, thus eliminating the possibility of double counting of losses in a tax integration group, which requires 95% relationships.

[757] *Rewe (ITS)* [2007] Case C-347/04. The claim for loss relief in point was for a deduction against German taxable profit reflecting the write-down of the book value of foreign subsidiaries not carrying on 'active' activities (paragraph 28).

[758] Such provisions, as a corollary, will give rise to double taxation when the subsidiary makes profits as the provision in the parent company's balance sheet will be at least partially reversed. To restrict the entitlement of the parent company to claims only in relation to subsidiaries resident in the origin state is discriminatory and a restriction to the exercise of the freedom of establishment.

8.3 CONFLICTING AND INCONSISTENT JUDGMENTS.

The 'final loss' cases have provided fertile ground for conflicting and inconsistent judgments but there is a review of those cases in chapters 8.5 to 8.7 *post*.

Notwithstanding that, this discussion commences with mention of *Bevola and Jens W Trock* [2018] as a comment made by the EU Commission in its intervention in the case appears to have provoked the Court into providing explanation of its stance in those cases[759].

The Court stated that it was following its analysis in *Avoir Fiscal* [1986] (paragraph 20) but its ruling in *Nordea Bank Denmark* [2014] needs to be considered with its ruling in the earlier case, *AMID* [2000][760] and its ruling in *Timac Agro Deutschland* [2015] needs to be considered with its ruling in the earlier case, *Lidl* [2008][761].

All four cases concerned companies having non-resident branches in another Member State and three of them, *AMID* [2000] apart, concerned claims to relieve branch losses against head office profits in the state of origin.

Following the analysis of those four cases, there will be a review of a further four cases but involving provisions applying to groups of companies including *Marks & Spencer* [2005], a troublesome case in relation to both comparability and to 'final loss' relief, and two cases involving the Dutch tax integration scheme.

Finally, two cases concerned with host state tax provisions will be considered.

8.3.i AMID [2000] and Nordea Bank Danmark [2014].

The Danish tax provisions applicable to non-resident branches established in countries that were party to 'the Nordic Convention' were examined by the Court in *Nordea Bank Danmark* [2014]. Under that convention, Denmark was entitled to tax the profits of a resident company's branch established and operating in one of

[759] "While agreeing with that reading of the judgments…*Nordea Bank Danmark*…and of…*Timac Agro Deutschland*…the European Commission considers that they contradict the Court's earlier case-law…" *Bevola and Jens W Trock* [2018] Case C-650/16 paragraph 31 (emphasis added). In paragraph 33 the Court continued by confirming that the approach followed that in *Nordea Bank Danmark* [2014] Case C-48/13 and in *Timac Agro Deutschland* [2015] Case C-388/14 and then said (emphasis added) "…do[es] not imply the abandonment by the Court of that method of assessing the comparability of the situations, which is moreover expressly applied in later judgments…". In paragraph 34 (emphasis added), it went on to say: "…the Court merely considered that there was no need for it to look at the purpose of the national provisions concerned, since they applied the same tax treatment to permanent establishments abroad and those in national territory. Where the legislature of a Member State treats those two categories of establishments in the same way for the purpose of taxing their profits, it recognises that, with regard to the detailed rules and conditions of that taxation, there is no objective difference between their situations which could justify a difference in treatment…"

[760] *AMID* [2000] Case C-141/99.

[761] *Lidl* [2008] Case C-414/06.

the other contracting states but was obliged to provide credit relief for foreign taxes borne on the branch's profits assessed by it[762]. Denmark had extended its taxing powers to such non-resident branches and, therefore, a Danish company that had one or more branches established in Nordic Convention states was in a situation comparable to that of a Danish company having only domestic activities so far as concerned taxation of business profits and relief for losses[763].

The Belgian tax provisions examined by the Court in 2000 in *AMID* [2000][764] can be distinguished as they did not extend Belgian taxing jurisdiction to the other state in point, Luxembourg, except in a particular manner and circumstance. The complaint by *AMID* [2000] related to a reduction of its Belgian business losses available to carry forward equal to the profits of its Luxembourg branch in the tax period in question despite Belgium having no taxing jurisdiction in respect of that branch under the terms of the double tax treaty concluded between Belgium and Luxembourg.

The Belgian tax code at the time defined three classifications of profits and losses for the purpose of loss relief[765]. The relevant offset priority for Belgian losses was to set them first against other Belgian profits and then to notionally offset them against profits accruing in a Tax Treaty State. This priority of offset mirrored that applied to losses incurred in a Tax Treaty state, which would be notionally (if not actually) offset first against profits arising in any Tax Treaty state and then, the balance, against Belgian profits.

Accordingly, notwithstanding the double tax treaty exemption of foreign profits, it was possible to import losses from a Tax Treaty state but the *quid pro quo* was that Belgian losses might be lost by notional offset against Tax Treaty state profits.

The Court ruled that a Belgian company having a branch in Luxembourg and sustaining a loss in Belgium whilst making a profit in the foreign branch was

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[762] *Nordea Bank Danmark* [2014] Case C-48/13 paragraphs 3 & 4.

[763] Ibid. paragraph 24: "…by making the profits of permanent establishments situated in Finland, Sweden and Norway subject to Danish tax, the Kingdom of Denmark has equated those establishments with resident permanent establishments so far as concerns the deduction of losses…". The restriction, however, was the clawback of loss relief for the branch triggered by the sale of the branch to a non-resident group company.

[764] *AMID* [2000] Case C-141/99.

[765] 1. domestic profits and losses; 2. foreign profits subject to a lower tax and losses in such a state (not relevant to the circumstances); 3. and foreign profits exempted by a double tax treaty between Belgium and the host state and losses incurred in such a state ('Tax Treaty state'). The purpose of the tax scheme was not discussed but it might be observed that it appears to be effective in countering tax avoidance using transfer pricing to export profits or to neutralise a situation where the home state is burdened with the whole cost of central overhead and finance costs, or a disproportionate part of them. The tax rule did provide symmetry, however, providing a notional offset of foreign branch losses against Belgian profits, if such were to be the circumstance.

comparable with a Belgian company having no foreign branches sustaining a loss[766].

If so, that is disregarding the national tax code, which, notwithstanding the double tax treaty, effectively treats the exempt branch as if it is a domestic branch in the circumstance where there are profits in one jurisdiction and losses in the other.

In such circumstance, the situation of *AMID* [2000] under Belgian law applicable to deduction of losses cannot be distinguished from the situation of *Nordea Bank Danmark* [2014] under Danish law applicable to deduction of losses.

Accordingly, in the situation addressed by the Belgian provision under examination, the comparator should be a Belgian company having a domestic branch. In that situation, the losses of the head office would be reduced or absorbed by the profits of the domestic branch and, in the alternative, the losses of the branch could reduce the profits of the head office.

Thus, the Belgian company suffered no disadvantage having a branch in Luxembourg compared with what its situation would have been had it set up a branch in Belgium.

8.3.ii Lidl [2008] and Timac Agro Deutschland [2015].

The ruling in *Timac Agro Deutschland* [2015] can be contrasted with that given by the Court in the earlier case, *Lidl* [2008].

Lidl [2008] concerned a claim by the German partnership for relief in respect of losses incurred by its Luxembourg branch where the double tax treaty concluded between Germany and Luxembourg provided that profits generated by activities in Luxembourg should be exempt from German tax.

The Court did not analyse in *Lidl* [2008] the comparability of the situations of, respectively, a German entity having a domestic branch and one having a branch in another Member State whose profits, by convention, were exempted from German tax[767]. The Court merely noted the denial of the tax advantage of deducting foreign branch losses from head office profits taxable in Germany and proceeded to find that the national rule gave rise to a restriction to the exercise of the right of establishment[768].

As Germany had restricted its taxing jurisdiction through the double tax treaty and as the branch was outside of its taxing jurisdiction in consequence of that, the

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[766] *AMID* [2000] Case C-141/99paragraph 29.

[767] Lidl [2008] Case C-414/06 paragraphs 23 to 26 although the symmetry of the treatment of branch profits and losses was recognised in paragraph 33.

[768] Ibid. paragraph 26. The restriction was subsequently justified but the contention is that no restriction should have been found.

situation of Lidl was different from the situation of a German company having only domestic branches.

The Court decided differently and recognised the lack of comparability in the more recent case, *Timac Agro Deutschland* [2015], which concerned branch activities exempted from German taxation under the Austrian/German double tax treaty. Taking a revised view, the Court in that later case stated the situation of the Austrian branch was not comparable to that of a domestic branch[769].

Both cases involved situations where Germany had restricted its taxing jurisdiction under a double tax treaty and in *Bevola and Jens W Trock* [2018] discussed below, the Court confirmed, with cross reference to both *Timac Agro Deutschland* [2015] and to *Nordea Bank Danmark* [2014] that foreign branches are not generally comparable to domestic ones[770].

The specific reference to arrangements under double tax treaties muddies the water as such a treaty merely "…*forms part of the legal background*…"[771] and modifies national rules. The same comparability conclusion should arise if national legislation unilaterally provided exemption of foreign branch profits.

It has to be concluded that the Court should have determined that the German tax rule examined in *Lidl* did not, in fact, give rise to a restriction as the exemption of the Luxembourg branch's profits under the treaty with that host state resulted in a situation that was different from the hypothetical one of a German entity having a German branch.

8.3.iii Grouping provisions.

8.3.iii.a Marks & Spencer [2005][772].

The EU Commission did propose a draft directive in 1991 to address the possibility of legislating to provide cross-border loss relief for permanent establishments and non-resident subsidiaries. The Member States did not proceed

[769] *Timac Agro Deutschland* [2015] Case C-388/14 paragraph 65 (emphasis added): "…since the Federal Republic of Germany does not exercise any tax powers over the profits of such a permanent establishment, the deduction of its losses no longer being permitted in Germany, the situation of a permanent establishment situated in Austria is not comparable to that of a permanent establishment situated in Germany…".

[770] "…as regards measures laid down by a Member State in order to prevent or mitigate the double taxation of a resident company's profits, companies which have a permanent establishment in another Member State are not, in principle, in a comparable situation to that of companies possessing a resident permanent establishment…" *Bevola and Jens W Trock* [2018] Case C-650/16 paragraph 37 (emphasis added).

[771] *Bouanich* [2006] Case C-265/04 paragraph 51.

[772] A more extended review of the judgment (including reference to the Advocate General's Opinion) can be found in O'Shea (2008) pp. 135 – 138. The Author respectfully maintains his position that no restriction was and is caused by the limitation of the application of the UK's group relief scheme to activities within the scope of UK corporation tax. See chapter 6.2.ii *ante* and, for analysis of the 'final loss' doctrine based on the Court's ruling in the case, see chapter 8.5 *et sequa*.

with this proposal, which would have required them to cede sovereignty over the determination of their taxing jurisdiction[773]. However, following *Marks & Spencer* [2005], the EU Commission pursued this proposal again with a communication voicing concern about potential distortion of business decisions caused by the absence of cross-border relief for losses[774].

The freedoms of movement guarantee the right of a person to engage in commercial activities in another Member State without interference from either of the two Member States concerned but they do not provide a right to be indemnified wholly or partially against the cost of a failure of the adventure in the host Member State. The Court indicated in the earlier case, *Gilly*, that the state of origin had no obligation to indemnify an individual exercising her Treaty freedom of movement against the cost of her so doing[775]. That indication is consistent also with the Court's comment in *ACT IV GLO*[776] made the year after the judgment in *Marks & Spencer* [2005].

The national law examined in *Marks & Spencer* [2005] was the UK group relief scheme. In simple terms, that scheme enabled the 'pooling' of corporation tax profits and corporation tax losses within a '75% group'. This system of relief mitigated a disadvantage to a company trading through a group of incorporated

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[773] "…One of the obstacles which might seriously hamper the activities of enterprises in a common market having the same characteristics as an internal market…" but it noted that "…given the major disparities which exist between the Member States' domestic arrangements, it would create new distortions between their enterprises engaged in trans-border activities". COM (90) 595 24 January 1991 paragraphs 1 and 12. The fact that it was thought necessary to legislate is evidence that it was not considered that the Treaty freedoms of movement required cross-border loss relief to be provided.

[774] COM (2006) 824 paragraph 1.1. Panayi [2010] BTR termed the regime contemplated as "reverse subsidiarity". The Author takes the view that cross-border relief for losses can only be neutral to national budgets if or when the competence to levy business taxes is devolved on the EU by the Member States. It will not matter then in which Member State the taxable profits of any business enterprise accrues. Such competence might be limited companies belonging to a consolidated group having aggregate revenues exceeding €750 million as suggested in Article 2 (1) (c) of the draft directive published by the European Commission in their Proposal COM (2016) 685 on 25 October 2016 (for a Common Corporate Tax Base). The adoption of the proposed directive would be a step towards that goal.

[775] *Gilly* [1998] Case C-336/96 paragraph 48: "…if the State of residence were required to accord a tax credit greater than the fraction of its national tax corresponding to the income from abroad, it would have to reduce its tax in respect of the remaining income, which would…thus be such as to encroach on its sovereignty in matters of direct taxation."

[776] *ACT IV GLO* [2006] Case C-374/04 paragraph 59: "…to require the Member State in which the company making the distribution is resident to ensure that profits distributed to a non-resident shareholder are not liable to a series of charges to tax or to economic double taxation…would mean in point of fact that that State would be obliged to abandon its right to tax a profit generated through an economic activity undertaken on its territory." This appears to be in reaction to the decision of EFTA Court in *Fokus Bank* [2004] Case E-1/04 paragraph 38: "…the Court holds that Article 40 EEA precludes legislation whereby shareholders resident in a specific Contracting Party are granted a tax credit on dividends paid by a company resident in that Contracting Party, whereas non-resident shareholders are not granted such a tax credit." EFTA Court applied *Manninen* [2004] Case C-319/02, a host state case, to an origin state situation.

bodies controlled by it that would otherwise deter it from so doing[777]. It also enabled loss-making subsidiaries obtain the cash flow benefit from being able to monetise their losses earlier than they would be able to by carrying them forward and offsetting them against future profits. The cash benefit (on a group basis, reduced outflow to the Tax Authority) is a balance sheet benefit in the group accounts.

In its judgment in *Timac Agro Deutschland* [2015], the Court acknowledged the non-comparability of a domestic situation with a cross-border situation over which the origin state does not exercise any taxing powers[778]. As discussed in chapter 6.2.ii *ante*, that analysis applied to the UK group relief scheme would have led to the Court having to rule that there was no infringement of the right to establishment.

The finding by the Court of a restriction in *Marks & Spencer* [2005] is in direct contradiction to rulings made by it both before and after that judgment, besides being a suggestion that a Member State can indeed be required by EU law to "…*draw up its tax rules on the basis of those in another Member State*…"[779].

The ruling in *Marks & Spencer* [2005] both undermines Member State sovereignty in direct tax matters[780] and, by being inconsistent with judgments handed down both before and after it, creates considerable uncertainty in the law as has been evidenced by the long succession of cases that followed in which clarification has been sought.

8.3.iii.b Philips Electronics [2012].

The UK group relief provisions were examined again in *Philips Electronics* [2012]. The specific aspect of the provisions examined in that case was the restriction[781] on surrender of losses sustained by a UK trading branch of a non-resident group company[782] to UK resident group companies. The Court ruled that

[777] Any losses incurred by a company trading in the home state through divisions would be netted against profits as a matter of course. Trading through subsidiaries may also result in 'stranded losses': that is, losses that cannot be used by the subsidiary itself because of cessation of business.

[778] "…since the Federal Republic of Germany does not exercise any tax powers over the profits…the deduction of its losses no longer being permitted in Germany, the situation of a permanent establishment situated in Austria is not comparable to that of a permanent establishment situated in Germany…". *Timac Agro Deutschland* [2015] Case C-388/14 paragraph 65 (emphasis added).

[779] *Deutsche Shell* [2008] Case C-293/06 paragraph 43.

[780] This was also the view of Weber (2006) at pages 19 & 20: "This may be a major breach of Member States' sovereignty. In my opinion, the Member States may choose not to tax…companies established abroad…A Member State may limit its taxation rights since it is sovereign…the ECJ should have decided that there was no restriction…".

[781] Losses sustained by a UK branch of a non-resident company that could be relieved against taxable profits in another state could not be surrendered for group relief purposes. Corporation Tax Act 2010, s.107.

[782] See Corporation Tax Act 2009, Part 2, Chapter 4.

the UK branch was, with regard to the surrender of "…*losses sustained in the United Kingdom*…" in an "*objectively comparable*" situation compared to that of a UK resident surrendering company[783].

That is undeniably the case. It does, however, raise a question about the *Marks & Spencer* [2005] decision and highlights the Court's inconsistency. The reason why the foreign subsidiary in *Philips Electronics* [2012] was judged to be in a situation comparable to that of a UK resident subsidiary as regards the activities conducted in the UK was because those activities were within the charge to UK corporation tax. The activities of the Marks & Spencer foreign subsidiaries were not within the charge to UK corporation tax.

8.3.iii.c Oy AA [2007].

The Court's judgment in this case was delivered about eighteen months after that in *Marks & Spencer* [2005] and followed that earlier judgment in finding a restriction in the national legislation that protected taxing jurisdiction.

The matter under examination was the Finnish system of permitting offset of Finnish profits and losses in a group of companies through the making of 'financial transfers' from companies having profits to companies in loss[784].

Applying the *Avoir Fiscal* [1986] comparability test, a company that is outside of the Finnish taxing jurisdiction is not in the same situation as a company within it for the purpose of the netting of corporate profits in this way. However, it appears that the Court again thought otherwise on this occasion also[785].

In restricting the eligibility of 'participation' in this scheme of 'balancing out' to companies in charge to Finnish company tax, the Finnish tax code did not "*constitute a means of arbitrary discrimination*". In providing this means of assessing taxable profits of groups, it was merely providing a mechanism similar in effect to the French tax integration scheme examined subsequently in *Papillon*

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[783] *Philips Electronics* [2012] Case C-18/11 paragraph 19. See also *Felixstowe Dock* [2014] Case C-80/12 paragraph 26 and Lang & Others (2012) (UK: Felixstowe Dock and Railway Company and others Pending case C-80/12: pp. 220 – 224: Grahame Turner) for a brief history of the development of the UK law including the response to CJEU judgments.

[784] The purpose of the Finnish system of financial transfers was "…to remove tax disadvantages inherent in the structure of a group of companies by allowing a balancing out within a group that comprises both profit-making and loss-making companies". *Oy AA* [2007] Case C-231/05 paragraph 35.

[785] Ibid. paragraph 38: "…the mere fact that parent companies which have their corporate establishment in another Member State are not subject to tax in Finland does not differentiate the subsidiaries of those parent companies from the subsidiaries of parent companies which have their establishment in Finland, and does not render the positions of those two categories of subsidiary incomparable." This is an extraordinary interpretation and application of the aim of the Finnish tax scheme to a situation where the financial transfer is from a resident company to a non-resident company. It is perfectly clear that the purpose and aim of the legislation was to enable the 'balancing out' of profits and losses in group companies within its jurisdiction, not to extend its tax jurisdiction to companies resident and operating in other Member States, or, for that matter, to facilitate the diversion of taxable profits from its taxing jurisdiction.

[2008]. It enabled a Finnish group to be subject to Finnish company tax on no more than the net profits that would have been chargeable had the activities been conducted within the territory by a single company through divisions and branches.

Having regard to the purpose of the tax scheme, which provided an alternative mechanism for taxing the profits of a group within Finland's taxing jurisdiction, the consequence of that judgment is overtly such as to "*undermine the right of the Member States to exercise their tax jurisdiction in relation to the activities carried out in their territory*" [786].

It might be countered against this observation that the Court then ruled that Finland could justify the 'infringement' of the right to establishment[787] and that 'all was well in the end'. However, even if a Member State can justify an infringement it must also then satisfy the principle of proportionality and it was consideration of the application of that principle to the UK group relief provisions examined in *Marks & Spencer* [2005] that led to the doctrine on 'final losses'[788].

Accordingly, to 'arrive at the right answer', the Court was obliged to presume a purpose for the Finnish rule, that being to prevent tax avoidance by profit shifting, that was inconsistent with the purpose first identified in paragraph 35 of its judgment. This was a consequence of its failure to conduct a comparability test recognising, as it did subsequently[789], that only entities within the charge to the national company tax charge could be regarded as being in comparable situations for the purposes of the relief provisions provided by that taxing scheme.

The disadvantages arose to the complainant group because the state of origin's law did not extend to the non-resident companies and that was a consequence of the state of origin exercising its sovereign powers to determine its taxing jurisdiction, a right recognised by the Court in other judgments[790].

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[786] *Thin Cap GLO* [2007] Case C-524/04 paragraph 75.

[787] *Oy AA* [2007] Case C-231/05 paragraph 60.

[788] Ibid. Paragraph 64: the Court did accept the proportionality of the Finnish rule on the ground of prevention of tax avoidance.

[789] See *Papillon* [2008] Case C-418/07 paragraph 27: "In order to establish whether discrimination exists, the comparability of a Community situation with one which is purely domestic must be examined by taking into account the objective pursued by the national provisions at issue…". The Court then lapsed again – *see X Holding post*.

[790] For instance, see *Deutsche Shell* [2008] Case C-293/06 paragraph 42. See also *Krankenheim Ruhesitz* [2008] Case C-157/07 paragraph 49 : "…a Member State cannot be required to take account…of the possible negative results arising from particularities of legislation of another Member State applicable to a permanent establishment situated in the territory of the said State which belongs to a company with a registered office in the first State".

8.3.iv Truck Center [2008] and Sofina [2018].

Truck Center [2008] concerned a Belgian tax provision that applied only to non-resident companies[791]. The Court noted that there were: "…*two distinct charges which rest on separate legal bases*"[792].

Whilst a resident company in receipt of interest income was taxed on that income as part of its overall profits[793] for the period (if any), a non-resident was subject to Belgian tax only on the interest income sourced from the Belgian state and "…*the amount of withholding tax deducted from the interest paid to a non-resident company is significantly lower that [sic] the corporation tax charged on the income of resident companies which receive interest*"[794].

Additionally, the withholding tax mechanism meant that the Belgian state did not have to extend its fiscal supervision to non-resident companies not otherwise requiring that supervision[795], which had implications for both the Belgian state, with regard to the recovery of tax and, though not mentioned, the non-resident company, which had no need to file a tax return declaring its income.

Accordingly, the Belgian charging provisions did not place a non-resident corporate recipient of Belgian source interest in a situation comparable to that of a resident company, as the Court ruled[796].

The analysis and ruling in *Truck Center* [2008] was distinguished by the Court in *Sofina* [2018][797] although the distinction made is far from clear. Dividends paid by

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[791] *Truck Center* [2008] Case C-282/07 paragraph 35.

[792] Ibid. paragraph 43.

[793] A resident company had the advantage of being able to deduct, from its general profits, finance or other costs related to the making or funding of the loan whilst a non-resident was not permitted to take account of such costs. This difference in treatment attracted critical comment in the 'literature'.

[794] *Truck Center* [2008] Case C-282/07 paragraph 49. The rate of tax applied to the person exercising a freedom of movement and whether it is less favourable than that applied to a domestic situation will be material to whether a restriction is caused. See, for instance, *Hollmann* [2007] Case C-443/06 paragraphs 38 to 40 and *Gerritse* [2003] Case C-234/01judgment (2nd paragraph) "…provided that the rate of 25% [applied to the income of non-residents] is not higher than that which would actually be applied to the person concerned, in accordance with the progressive table…increased by an amount corresponding to the tax-free allowance…" Refer also to *Royal Bank of Scotland* [1999] Case C-311/97 paragraph 30: under Greek tax provisions, the profits of branches of non-resident banks were subject to tax at a higher rate than applied to the profits of resident banks even though the profits were calculated in the same way.

[795] *Truck Center* [2008] Case C-282/07 paragraph 48.

[796] However, the CFE considered that the Court should have considered the comparability of a Belgian company accruing (but not paying) interest on a loan from a non-resident and having to remit withholding tax on the interest accrual, suffering a cash flow disadvantage that would not have been suffered had the lender been a resident company. CFE (Truck Center) February 2009.

[797] *Sofina* [2018] Case C-575/17 paragraphs 48 to 54. The standard rate of withholding tax was 25% (paragraph 26) although reduced by the double tax treaties engaged to 15% whereas the rate of corporation tax was 33.33% (paragraph 27). The Court focussed on the fact that a domestic

companies resident in France were subject to withholding tax and French companies in receipt of such dividends were subject to corporation tax on the dividend income but could offset costs and losses from other activities. As in *Truck Center*, two different taxing systems were applied even if the change of basis of taxation on French resident companies was effected in their tax returns[798].

The ruling in *Sofina* [2018] appears to be inconsistent with that given in *Truck Center* [2008] and the Court did not commence its examination with a comparability analysis but treated comparability as a quasi-justification[799].

8.4 'Final losses' - Ability to pay.

Although the Court has not considered the principle of 'ability to pay' only in relation to 'final losses' cases, it has referred to it in *NN* [2018] and *Bevola and Jens W Trock* [2018] discussed below in chapter 8.7.ii.

The notion of ability to pay is historically fundamental to the design of taxing schemes and is evident in charging provisions that trigger charging events only upon actual receipt of income[800] or proceeds of disposals of assets.

Reference to the principle appears to have been first made by the Court in *Schumacker* [1995][801].

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corporate shareholder would not pay tax on the dividend income if it had sufficient losses in the period – paragraphs 51 & 52. However, that would have been the situation also for a domestic corporate recipient of interest under the Belgian provisions considered in *Truck Center*.

[798] It would be administratively burdensome for French resident companies to keep records of the tax residence of corporate shareholders and to disapply the withholding tax rules to such corporate shareholders. The fact that a French resident company would not pay any tax on dividend income in any particular year because its losses and costs from other activities exceeded the dividend income does not mean that the income was not in charge to tax. In such situation, it reduced the losses that could be carried forward: the Court recognised the cost of such in *AMID* [2000] Case C-141/99 paragraph 22.

[799] *Sofina* [2018] Case C-575/17 paragraphs 47 to 54.

[800] Application of the principle of ability to pay is evident in the "*capping mechanism*" in the French wealth tax provisions examined by the Court in *Bourges-Maunoury* [2012] Case C-558/10. In paragraph 29 the Court recognised its function: "…the wealth tax capping mechanism is intended to limit its confiscatory effect and reflect the real capacity to pay of the taxpayer …".

[801] *Schumacker* [1995] Case C-279/93 paragraph 32. The discrimination against the migrant worker by the host state, Germany, in not providing him with a deduction for personal allowances from his earnings taxable in that state comparable to that granted to resident taxpayers arose, not because of his 'inability to pay' the taxes levied, but because the host state had *de facto* jurisdiction to tax almost the entirety of his global income in that period by reason of the fact that his earnings in the host state constituted almost the whole of that global income in that period. In *Gschwind* [1999] Case C-391/97 the Court (having referred to ability to pay in paragraph 22) stated at paragraph 26 "… there would be discrimination … between residents and non-residents only if … having regard to the purpose and content of the national provisions in question, the two categories of taxpayers are in a comparable situation". This formulation was repeated in *X (allowances)* [2017] Case C-283/15 at paragraph 32. Accordingly, applying an *Avoir Fiscal* [1986] comparability test to

The introduction of the notion that '*there should be a deduction somewhere*' is a departure from a rigorous interpretation of the Treaty freedoms of movement and has given rise to significant confusion evidenced by the continuing referrals to the Court for analysis of fairly similar situations[802].

When the Court had to focus on the possibility of a taxpayer potentially receiving personal allowances in more than one Member State, the Court approved a scheme whereby the taxpayer would be permitted "…*to submit a claim for his right to deduct 'negative income' to each Member State of activity where that type of tax advantage is granted, in proportion to the share of his income received within each such Member State*…"[803] despite having observed previously "…*even if the different tax advantages granted respectively by the two Member States concerned are comparable and it may be concluded that the applicants in the main proceedings did actually receive a double advantage, that fact is, in any event, only the result of the parallel application of the Belgian and German tax laws*…"[804].

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him for that period, his situation under the host state charging provisions was comparable to the situation of a resident of the host state and he was, accordingly, entitled to the same deductions from taxable income. Other references to 'ability to pay' can be found in, for instance, *Zurstassen* [2000] Case C-87/99 paragraph 21, *Lakebrink* [2007] Case C-182/06 paragraph 34, *Renneberg* [2008] Case C-527/06 paragraph 66, *Commission v Estonia (pensioner allowances)* [2012] Case C-39/10 paragraph 45, *Beker* [2013] Case C-168/11 paragraph 40 and *Kieback* [2015] Case C-9/14 paragraph 23.

[802] The host state is not "…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…" *National Grid Indus* [2011] Case C-371/10 paragraph 62 and case law cited.

22 years later, in *X (allowances)* [2017] Case C-283/15, the Court ruled that discrimination arose because the taxpayer had no income in his state of residence, derived 60% of his income from activities in another Member State (the Netherlands) and the remaining 40% of his income from activities in a third country. He therefore did not get any deduction for his personal reliefs anywhere because he was taxed as a non-resident in the states where he conducted his taxable activities. But the Netherlands provided an option under which a non-resident could elect to be taxed as a resident, which he took advantage of, and he received a deduction for his personal allowances and also relief for the net loss derived from his dwelling in the state of residence. However, he wanted the allowances but also wanted to be taxed as a non-resident so that his third country income would not be taxed in the Netherlands.

[803] *X (allowances)* [2017] Case C-283/15 paragraph 48.

[804] *Imfeld & Garcet* [2013] Case C-303/12 paragraph 78. In the paragraph following the Court rules that "…it is open to the Member States concerned to take into consideration the tax advantages which may be granted by another Member State imposing tax, provided that, irrespective of how those Member States have allocated that obligation amongst themselves, their taxpayers are guaranteed that, as the end result, all their personal and family circumstances will be duly taken into account." Cerioni suggests: "…it would ideally be for the EU legislator, following the *X* ruling, to introduce a general harmonising EU measure intended to overcome worldwide taxation by the residence state when its taxpayers accrue income in other Member States and to introduce this "model", to the benefit—ultimately—both of legal certainty for taxpayers and of the tax bases of Member States themselves." Cerioni [2017] BTR page 171.

This line of reasoning conflicts with the line commencing with *Hervein & Others* [2002] recognising that "…*the Treaty offers no guarantee to a worker that extending his activities into more than one Member State or transferring them to another Member State will be neutral as regards [personal taxation]*…" [805].

The focus on 'ability to pay' and the necessity for the taxpayer to receive a personal allowance granted, either by his state of origin or by the host state, led to the need for the Court to propose a reconciling explanation in *D* [2005]. That case concerned Dutch wealth tax that was levied on residents by reference to global wealth, subject to a deduction similar to a personal allowance. The tax was levied on non-residents by reference to their assets within its territory without any such deduction. It just so happens that D 's state of origin did not levy a wealth tax and so he obtained no deduction reflecting ability to pay there.

The question of comparability in both *Schumacker* [1995] and *D* [2005] can be resolved very simply by looking at the charging provision and testing whether the non-resident is in a situation comparable to that of a resident looking at the way in which it applies to the income or wealth of a non-resident having regard for his circumstances[806]. It is not necessary to consider the purpose of the granting of the allowances and deductions.

When in *Bevola and Jens W Trock* [2018] the Court examined a claim by a Danish company to deduct from its profits taxable in its home state losses that were suffered by it in Finland through a permanent establishment there, the Court introduced the notion of 'ability to pay' to find comparability between a company suffering domestic losses and a company suffering foreign losses[807].

If the Court is saying that a Member State "…*is required to draw up its tax rules … to ensure, in all circumstances, taxation … [payable in that state does not exceed the amount that would have been payable had the taxpayer conducted the*

[805] *Hervein & Others* [2002] Case C-393/99 & C-394/99 paragraph 51.

[806] In *Schumacker* [1995], the taxpayer was taxed by the host state on *de facto* manifestly the whole of his global income and his situation in the host state was little different from that had he been classified as a resident of the host state (apart from with regard to deductions – see *Avoir Fiscal* [1986] Case 270/83 paragraph 20. In *D* [2005], the taxpayer was taxed in the host state on only a proportion of his global wealth and his situation was significantly different from that had he been classified as a resident of the host state.

[807] "…the national provisions at issue…aim more generally to ensure that the taxation of a company possessing such an establishment is in line with its ability to pay tax. Yet the ability to pay tax of a company possessing a non-resident permanent establishment which has definitively incurred losses is affected in the same way as that of a company whose resident permanent establishment has incurred losses. The two situations are thus comparable in this respect…". *Bevola and Jens W Trock* [2018] Case C-650/16 paragraph 39. The Court approved the comment made by the Advocate General in paragraph 59 of his Opinion.

By way of corollary, is the Court thus prescribing that the profits of a non-resident permanent establishment should be taxable in the home state because the ability to pay tax is enhanced by those profits? Is the Court arguing that the profits and losses of a foreign operation conducted through a non-resident subsidiary company should be included in the parent company assessment to properly reflect the parent company's ability to pay?

loss-making activities in its territory]…", then it is contradicting what it has said in in a number of cases involving disparities in relation to Member State schemes for both benefits and taxation, including in *Hervein & Others* [2002] cited above.

The Court followed *Bevola and Jen W Track* [2018] in *NN* [2018][808].

In presuming that the purpose in national tax schemes of allowing loss relief is to ensure 'ability to pay' the tax assessed, rather than to more fairly assess to taxation the profitability of activities conducted within the taxing jurisdiction, the Court has invented a factor to be taken into account in analysing comparability of situations.

Furthermore, the inference that the state of origin has an obligation to provide an indemnity to a resident engaged in outward investment against the cost of an inability to make immediate use of losses sustained in foreign operations is in contradiction to the *Lindfors* [2004] principle as expressed in *Deutsche Shell* [2008][809] and in other cases.

The conclusion reached is that the test of 'ability to pay' has no defensible basis when applied in the context of direct tax deductions.[810]

8.5 'Final losses' - Marks & Spencer [2005].

It was argued in chapter 6.2.ii *ante* that the UK group relief scheme under examination did not cause a restriction to the exercise of the right to establishment.

That conclusion was reached on the basis that, having regard to the objective, purpose or aim of the legislation, loosely described as enabling the corporation tax profits and losses of a 75% group accruing in the same or corresponding accounting periods to be pooled.

The focus here is on the Court's proportionality test[811].

The conundrum faced by the Court in *Marks & Spencer* [2005] in relation to the 'restriction' in the UK's group relief provisions was that, whilst it was justifiable

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[808] *NN* [2018] Case C-28/17 paragraph 35

[809] *Deutsche Shell* [2008] Case C-293/06 paragraph 43 quoted subsequently in *Krankenheim Ruhesitz* [2008] Case C-157/07 paragraph 50 & *K* [2013] Case C-322/11 paragraph 80 adapted to Article 63 TFEU.

[810] Subsequent to the drafting of this chapter, AG Collins, in his Opinion delivered on 22 March 2022 in relation to W AG *W AG (AGO)* [2022] Case C-538/20 at paragraph 48 said "…I am not persuaded that the ability to pay tax…is a decisive factor in determining whether the respective situations of residents and non-residents are objectively comparable…I agree with the referring court that 'the objective of taxation on the basis of ability to pay tax, as referred to in the judgment [in *Bevola and Jens W. Trock*], is a general, abstract principle of taxation…"

[811] *Marks & Spencer* [2005] Case C-446/03 paragraphs 51 to 56.

(and fair[812]) that the UK should take no account of losses incurred in another state in a circumstance where it would not levy tax on profits, the failure of the UK to provide some relief for losses incurred by a foreign subsidiary created a disadvantage to the parent company that had exercised the freedom of movement[813].

The Court did not explain why the restriction in the UK legislation allowing set-off of only corporation tax losses against corporation tax profits "*goes beyond what is necessary*"[814] in a 'final loss' situation.

One possibility is that the restriction then became no longer justified "*In the light of those three justifications, taken together* …"[815] as "… *there is no possibility for the foreign subsidiary's losses to be taken into account in its State of residence for future periods* …"[816] and, therefore no "… *danger that losses would be used twice* …"[817]. Hence, only two, not three of the accepted justifications were available as there was no need for the restriction to prevent double deduction of losses. But the Court discarded that requirement of all three grounds for justification anyway in *Oy AA* [2007][818].

The body of case law that has evolved since the Court's judgment in *Marks & Spencer* [2005] is reviewed in chapter 8.7 *post.*

It has been suggested in chapter 6.2.ii that the Court erred in holding that the UK's group relief provisions gave rise to a restriction to the exercise of the right to establishment. It is suggested here that the Court erred again when it ruled the restriction that it perceived to be disproportionate and that may have been because of its ruling that the perceived restriction could only be justified by taking

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[812] The Court noted the symmetry in the treatment of profits and losses resulting from the allocation of taxing powers between contracting states in Paragraph 43 of its judgment and subsequently in, for instance, *Lidl* [2008] Case C-414/06 paragraph 33.

[813] Advocate General Geelhoed was scathingly critical of this aspect of the Court's judgment in his Opinion on *ACT IV GLO (AGO)* [2006] Case C-374/04 paragraph 65: "…I see no reason why companies which decide to relocate their activities to another Member State, in full knowledge of the local tax legislation, should be awarded highly selective and distortional tax relief in the home State in the circumstance where their source State activities incur losses that cannot be offset in the latter State." Georg Kofler wrote: "…the Court's 'final loss' doctrine has always been a heavily debated matter…after the Grand Chamber decision in Bevola had (seemingly) resolved the uncertainties previously created by Timac Agro… Doubts remained, however, and the German Bundesfinanzhof clearly wants to have them resolved. In its reference in *W AG* [2022] Case C-538/20 the Bundesfinanzhof has asked a number of precisely worded and reasoned questions that will (hopefully) compel the Court to put its cards on the table:" Kofler [2022] ECTR page 108.

[814] *Marks & Spencer* [2005] Case C-446/03 paragraph 55.

[815] Ibid. paragraph 51.

[816] Ibid. paragraph 55.

[817] Ibid. paragraph 47.

[818] *Oy AA* [2007] Case C-231/05 paragraph 60. The Court also remarked that the remaining two were linked (paragraph 62).

together the three grounds claimed by the UK, a ruling that it subsequently rebutted.

8.6 'FINAL LOSSES' AND THE '*LINDFORS* PRINCIPLE'.

Whilst 'exit taxes', discussed in chapter 7 *ante*, are levied on taxable items that have accrued to a person migrating his tax residence during his period of tax residence in the state levying the charge, 'final losses' result from activities undertaken outside of the taxing jurisdiction of the state called upon to provide relief against domestic taxable profits.

The levy of an 'exit tax' is an exercise of taxing powers whereas the obligation for a state of origin to provide relief for 'final losses' is an interference with its taxing powers.

The sovereign right to determine taxing jurisdiction has been protected numerous times by the Court, often formulated in what is termed in this thesis as the *Lindfors* principle. As formulated in *Schempp* [2005] and, as previously quoted, it states "… *the Treaty offers no guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation* …"[819].

Accordingly, as the disadvantage accrued to the outward investor solely because he removed part or all of his taxable activities to the taxing jurisdiction of another Member State, the state of origin is not obliged to provide a remedy for that disadvantage suffered.

Whilst it is true that the UK group relief provisions enabled relief to be claimed in respect of final or terminal losses incurred by UK resident subsidiaries, or incurred by UK branches of non-resident group companies, the relief, in those situations, would be provided for losses incurred in respect of activities undertaken within the UK's taxing jurisdiction.

The Court has placed emphasis on the fiscal autonomy of a Member State and reiterated many times what it said in *Gilly* [1998][820]. In *ACT IV GLO* [2006] it dismissed the proposal that a source state should be responsible for mitigating economic double taxation on company distributions saying that it would be nothing less than to oblige the source "…*to abandon its right to tax a profit generated through an economic activity undertaken on its territory*" [821].

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[819] *Schempp* [2005] Case C-403/03 paragraph 45.

[820] *Gilly* [1998] Case C-336/96 paragraph 48 (emphasis added): "…if the State of residence were required to accord a tax credit greater than the fraction of its national tax corresponding to the income from abroad, <u>it would have to reduce its tax in respect of the remaining income</u>, which would entail a loss of tax revenue for it <u>and would thus be such as to encroach on its sovereignty in matters of direct taxation</u>".

[821] *ACT IV GLO* [2006] Case C-374/04 paragraph 59.

Accordingly, in the absence of any explanation from the Court clarifying why it distinguished the treatment of 'final losses' from the principles considered above, the further discussion of this topic must be constrained to noting the Court's discomfort with the ruling evidenced in the subsequent cases selected for analysis, although some clues might be drawn from *Lidl* [2008] discussed *post*. It should be noted here also that the Court did not feel constrained to follow the logic of *Marks & Spencer* [2005] when it decided *K*[822], considered *post*, in which Article 63 TFEU was engaged.

8.7 'FINAL LOSSES' POST MARKS & SPENCER [2005].

8.7.i Branch Loss - Lidl [2008].

Although *Lidl* [2008] did not concern 'final losses', the judgment contains a clear recognition by the Court of the relevance of the symmetry between the right to tax profits and the obligation to recognise and relieve losses.

The claim in dispute in that case was for relief against German profits for losses incurred by the Luxembourg branch of the claimant[823] where the losses were eligible for carry forward in Luxembourg and were subsequently used against profits generated by the branch. Thus, the partnership was seeking to monetise its Luxembourg losses at an earlier time.

The Court observed that the restrictive provision in the German tax code denying relief for the Luxembourg branch losses preserved the symmetry of the arrangement between the two states in relation to allocation of taxing powers[824].

This ruling by the Court relating to outbound dividends may have been triggered by the need to counter the ruling in EFTA Court re Fokus Bank *Fokus Bank* [2004] Case E-1/04 paragraph 30, which appears to incorrectly apply *Manninen* [2004] Case C-319/02, a case involving inbound dividends without making any distinction between the two situations.

[822] *K* [2013] Case C-322/11.

[823] Under the terms of the double tax treaty concluded between Germany and Luxembourg, the host state in which a resident of the other state conducts activities through a permanent establishment was entitled to tax the activities of that permanent establishment and the state of residence was precluded from taxing such activities. Thus, the Luxembourg branch's activities were outside of Germany's taxing jurisdiction. *Lidl* [2008] Case C-414/06 paragraph 11. Note that the Luxembourg branch was set up by Lidl Belgium, which was a limited partnership registered in Germany. This case concerned foreign branch losses in a 'going concern' situation. Cases involving losses of branches that had ceased activities are considered *post*.

[824] Ibid. Paragraph 33 (emphasis added): "…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." The acknowledgement of the symmetry follows on from its acknowledgment in *Marks & Spencer [2005]* that "… 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

Clearly, that symmetry would be compromised if a taxpayer was permitted to import foreign losses but could claim home state exemption from tax on profits realised in the foreign state.

In *Lidl* [2008] the Court was invited to consider ruling that proportionality could be better served if relief was provided by Germany for the Luxembourg losses in the first instance but subject to a subsequent clawback of the relief as and when the fortunes of the Luxembourg branch improved and it started to generate profit[825]. The Court declined to so rule but did comment indirectly that such a scheme would give the parent company "*the right to elect*" in which state to seek relief for the foreign branch losses and that would undermine the allocation of taxing powers between the contracting states[826].

Whilst in *Rewe (ITS)* [2007] [827] the Court recognised the distinction between, on the one hand, a claim by a resident company for tax relief in respect of a write-down of the book value of an investment in a non-resident subsidiary and, on the other, the *Marks & Spencer* [2005] claim, described by the Court as: "…*losses incurred by subsidiaries abroad which the resident parent company requires them to surrender to it in order to reduce its taxable profits*…"[828] the Court did not, however, take advantage of the opportunity to explain why "*losses incurred by subsidiaries abroad*" became losses deductible in the state of origin in the circumstance where the losses in point could be termed 'final losses'.

8.7.ii Branch losses.

The four cases discussed below are grouped because they involved branch losses although the claims for relief were more complex than that in *Lidl* [2008].

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power to impose taxes between the different Member States concerned …"*Marks & Spencer* [2005] Case C-446/03 paragraph 43. As argued previously, it must be questionable whether the Luxembourg branch can be considered to be in a comparable situation to a German branch for the purpose of German tax and, thus, whether there was a restriction to justify in this case.

[825] See *Lidl* [2008] Case C-414/06 paragraph 45 *Marks & Spencer* [2005] Case C-446/03 paragraph 54 and see *Krankenheim Ruhesitz* [2008] Case C-157/07 paragraphs 33 to 37

[826] *Lidl* [2008] Case C-414/06 paragraph 52 (emphasis added):"…to give the principal company the right to elect to have the losses of that permanent establishment taken into account in the Member State in which it has its seat or in another Member State would seriously undermine a balanced allocation of the power to impose taxes between the Member States concerned." The Court said similarly in *X Holding* [2010] Case C-337/08 paragraph 31 "Since the parent company is at liberty to decide to form a tax entity with its subsidiary and, with equal liberty, to dissolve such an entity from one year to the next, the possibility of including a non-resident subsidiary in the single tax entity would be tantamount to granting the parent company the freedom to choose the tax scheme applicable to the losses of that subsidiary and the place where those losses are taken into account."

[827] *Rewe (ITS)* [2007] Case C-347/04. The claim for loss relief in point was for a deduction against German taxable profit reflecting the write-down of the book value of foreign subsidiaries not carrying on "active" activities (paragraph 28). This case is discussed briefly in chapter 4.2.ii ante.

[828] Ibid. paragraph 47. The Court's view on the claim by Rewe (ITS) is consistent with that taken in *Bosal* [2003] Case C-168/01 and in *Keller Holding* [2006] Case C-471/04

8.7.ii.a Timac Agro Deutschland [2015].

The taxpayer had obtained relief in respect of losses suffered by an Austrian branch exempted from German tax under the Austrian/German double tax treaty but then sold the branch to an Austrian group subsidiary. The German scheme for providing the temporary relief was the one examined by the Court in *Krankenheim Ruhesitz* [2008][829]. The sale of the branch to the group subsidiary triggered a clawback of the relief.

The Court ruled that the Austrian branch was in a situation similar to that of a German branch of the German company by reason of the treatment of the Austrian branch's losses[830]. That is a strange form of comparison because the German scheme did not result in the Austrian branch's profits being in charge to German tax as was acknowledged by the Court[831]. The Court also acknowledged that the clawback provision could be justified by reference to preservation of taxing powers[832].

It is debatable whether the scheme involved the actual deduction of the Austrian losses from German profits recalculated in accordance with German tax rules[833]. The requirement for the branch losses to be first reduced by the profits of any other establishment in the host state suggests that the relief is a deferment of taxation of the German profits equal to the amount of the (adjusted) branch losses, and that interpretation is supported by the German explanation of the loss reincorporation: "…*Such reincorporation thus constitutes the offsetting for tax purposes of the share of the resident company's profits that was not previously taxed*"[834].

[829] *Krankenheim Ruhesitz* [2008] Case C-157/07.

[830] *Timac Agro Deutschland* [2015] Case C-388/14 paragraph 28: "…by permitting the deduction of losses incurred by a permanent establishment situated in Austria, the Federal Republic of Germany granted a tax advantage to the resident company to which that permanent establishment belonged, in the same way as if that permanent establishment had been situated in Germany, and, therefore, equated it with a resident permanent establishment so far as concerns the deduction of losses…".

[831] Ibid. paragraph 37. Providing temporary relief for the branch's losses does not result in the foreign branch being in a situation comparable to that of a domestic branch, which was chargeable to tax on its profits. The Court has considered only the relief granted under the scheme and not the scheme as a whole, which includes the clawback of the relief in subsequent tax periods if or when the trading fortunes of the branch changed for the better.

[832] "…the reincorporation at issue in the main proceedings allows the symmetry between the right to tax income and the right to deduct losses to be safeguarded, and, therefore, ensures a balanced allocation of the power to impose taxes between the Member States concerned. Ibid paragraph 38 (emphasis added). See also *Krankenheim Ruhesitz* [2008] Case C-157/07 paragraph 42.

[833] *Timac Agro Deutschland* [2015] Case C-388/14 paragraph 3 "…any loss relating to that revenue in accordance with the provisions of national tax law…".

[834] Ibid. paragraph 31 (emphasis added).

The Court ruled that the reincorporation of the losses upon sale of the branch to the Austrian subsidiary could be justified and was proportionate[835] but subject to the *proviso* that the losses reincorporated were not "….*definitive losses for the purposes of paragraph 55 of the judgment in Marks & Spencer*…"[836].

In finding that the reincorporation of losses under the scheme caused there to be a restriction[837], the Court obligated itself to conduct a somewhat tortuous analysis to arrive at a conclusion that the taxpayer was entitled to relief in its home state for host state 'final losses' that satisfied the conditions set out by it in *Marks & Spencer* [2005] paragraph 55.

In answer to the second question put to it, which concerned a period after the repeal by Germany of the special scheme, so that temporary relief for foreign branches was no longer available, it then acknowledged that an Austrian branch was no longer in a situation comparable to that of a domestic branch [838].

One can only really say that it never was in a comparable situation. The measures laid down to prevent double taxation were the exemption of the branch from German taxation. That exemption placed a non-resident branch in a situation different from that of a domestic branch and the scheme providing temporary relief from German taxation for German profits of an amount equal to losses sustained and not recovered by a non-resident branch did not change that exemption.

8.7.ii.b Bevola and Jens W Trock [2018] [839].

This more recent case concerned a claim by a Danish company for relief against Danish profits for losses incurred in a permanent establishment in Finland, which was by reason of national law exempted from Danish taxation. The branch had been closed and the losses could not be utilised in Finland.

In wording that echoed its judgment in *Lindfors* as expressed in *Schempp*[840], the Court remarked: "…*The Kingdom of Denmark's decision not to exercise its*

[835] See ibid. paragraphs 45 & 51.

[836] Ibid. paragraph 53. The Court commented in paragraph 56 that it had information that the losses in question might not be 'final losses' as some account might be taken of them under Austrian rules.

[837] The Court ruled so in the earlier case *Krankenheim Ruhesitz* [2008] Case C-157/07 paragraph 37.

[838] "…since the Federal Republic of Germany does not exercise any tax powers over the profits of such a permanent establishment, the deduction of its losses no longer being permitted in Germany, the situation of a permanent establishment situated in Austria is not comparable to that of a permanent establishment situated in Germany…". Ibid. paragraph 65. It appears that the German Tax Court became somewhat confused by all of this: Cordewener [2018] ECTR at pages 235/236: "…it seems that the German Federal Tax Court…made quite some efforts to introduce the CJEU's judge-made Marks & Spencer and Lidl Belgium principles into the national tax system, was led astray by the Court's Timac Agro judgment and gave up on 'final losses' too early…".

[839] *Bevola and Jens W Trock* [2018] Case C-650/16.

[840] *Schempp* [2005] Case C-403/03 paragraph 45.

powers of taxation over the permanent establishments abroad of Danish companies is not necessarily to the disadvantage of those companies, and may even constitute a tax advantage…"[841].

The Court presumed the purpose of the Danish exemption of the profits of foreign permanent establishments to be to avoid double taxation of profits[842] and, thus, "…*aim more generally to ensure that the taxation of a company possessing such an establishment is in line with its ability to pay tax*…"[843] .

This is an extraordinary presumption by the Court[844]. The Court was influenced by the Advocate General's comment in paragraph 59 of his Opinion, which it cited, but the Advocate General was specifically referring to a 'final loss' situation. However, on the basis of that presumed purpose, the Court concluded that a Danish company incurring losses through the activities of an exempt foreign branch was in a situation comparable with that of a Danish company incurring such losses through the activities of a taxable domestic branch.

Accordingly, the Court found that the rule in the Danish tax code constituted a restriction but one that could be justified on the grounds of preserving the balance of taxing powers, preventing the double deduction of losses and coherence of the tax system[845].

When considering whether the restriction was proportionate[846] in a situation where the losses of the permanent establishment satisfied the conditions set out in *Marks & Spencer* [2005], paragraph 55, the Court reasoned that there was no longer an opportunity for double deduction of losses and that there was no longer any need to protect the coherence of the tax system, that being the symmetrical exemption of profits and losses accruing to a foreign permanent establishment, presumably because the cessation of the permanent establishment's activities meant that it could no longer generate taxable profits. The Court did not comment on why the justification of the restriction on the ground of preserving the balance of taxing powers ceased to have any relevance in such a situation.

8.7.ii.c NN [2018][847].

The underlying factual situation differed in that the Danish company was conducting activities indirectly in Demark through branches of two Swedish subsidiaries. Whilst the issue was the deductibility of losses that would be 'in principle' deductible in another Member State, the losses actually arose in the

[841] *Bevola and Jens W Trock* [2018] Case C-650/16 paragraph 23.

[842] And double deduction for losses: ibid. paragraph 36.

[843] Ibid. paragraph 39.

[844] The Court's use of the notion 'ability to pay' is discussed in chapter 8.4 *ante*.

[845] *Bevola and Jens W Trock* [2018] Case C-650/16 paragraph 53.

[846] Ibid. paragraphs 55 to 60.

[847] *NN* [2018] Case C-28/17.

state of origin and were recognised by the tax code of the state of origin[848]. This case is discussed here because of that distinction.

The transaction that triggered the dispute was a merger of the two Danish branches under one of the Swedish subsidiaries or, otherwise described, a sale by one of the Swedish subsidiaries of its Danish branch to the other Swedish subsidiary. The Danish tax authorities treated the merger of the branches as a sale at market value. The sale generated a loss in the acquiring branch through the write-off of goodwill relating to the branch activities acquired by it, but the Danish tax authority declined to allow that loss to be set against the Danish group's profits in Denmark. The relief for the losses was denied because the loss could be 'in principle' relieved against the Swedish owner's taxable profits in its home state[849]. That was not, in fact, the case because, by reason of the treatment of the transaction under the Swedish tax code as a merger, the transaction was exempt from tax under that code.

The Danish provision appears to be similar to the one in the UK's group relief scheme found to be restrictive in *Philips Electronics* [2012] and similar to the scheme examined in *Nordea Bank Danmark* [2014] discussed in chapter 8.3.i *ante.* Had the Danish branch been a Danish resident company, there would have been no restriction of the claim for relief[850]. Accordingly, there was a difference in treatment of losses within the tax jurisdiction of Denmark dependent on whether the losses were also within the jurisdiction of another Member State.

The Court proceeded in paragraphs 31 to 38 of its judgment to consider "*the comparability of the situations*" by reference to the objective of the Danish restriction, which was to prevent double deduction of losses but, as the Court observed in *Philips Electronics* [2012]: "*…where the issue is that of transferring to a resident company the losses sustained by a permanent establishment situated in the territory of the same Member State, the power of that Member State to tax the profits (if any) arising from the activity, in its territory, of the permanent establishment is not affected*"[851].

Adopting a simple analysis land assuming that the profits of the Danish branches are taxable in Sweden leads one to the conclusion that the Danish

[848] See also, with regard to the UK group relief scheme *Philips Electronics* [2012] Case C-18/11 mentioned *post* and in chapter 8.3.iii *ante*.

[849] *NN* [2018] Case C-28/17 paragraphs 10 to 13.

[850] Ibid. paragraph 29.

[851] *Philips Electronics* [2012] Case C-18/11 paragraph 26. The Danish state's ability to tax the profits arising from activities conducted in its territory was unaffected by whether or not relief was allowed in Sweden in the tax assessment of the Swedish subsidiary for the losses recorded in the accounts of the Danish branch. That the losses might have fallen to be relieved in two Member States would have been merely a consequence of those two states exercising their powers of taxation in parallel (had Sweden recognised the transaction as a taxable event). A restriction to prevent double deduction of losses only has meaning where the double deduction might occur in the assessment of taxes by a single Member State.

restriction was flawed in concept and could not be justified. However, the Court concluded otherwise[852].

The Court, accordingly, then proceeded to consider the proportionality of the restriction and then took account of the exemption of the transaction under Swedish law and noted that "…*it would not be possible, in practice, to set those losses off against the Swedish subsidiary's profits*."[853] Accordingly, the Court ruled the restriction to be disproportionate[854]. Nevertheless, as argued *ante*, the restriction is a discriminatory restriction that cannot be justified.

8.7.ii.d W AG [2022][855].

The claim of the German company related to a failed trading branch in the UK that has been closed. That branch was exempted from German tax under the double tax treaty between the two states.

By reason of that exemption, the Court ruled that the UK branch could not be regarded as comparable to a domestic branch and, accordingly, the German rule denying the German company relief for the losses of the UK branch did not give rise to a restriction[856].

The Court has introduced a further mysterious distinction[857] between a waiver under a double tax treaty by the home state of the right to tax a foreign branch and a provision in its national law unilaterally exempting the profits of a foreign branch. The former is not comparable with a domestic branch but the latter is.

8.7.iii Foreign investment – K [2013].

The case concerned a claim by a Finnish resident to offset a capital loss realised by him on a property located in France against capital gains realised and taxable in Finland[858]. The freedom of movement engaged was Article 63 TFEU but nothing is

[852] "…the Law on corporation tax is specifically intended to prevent the group concerned from exploiting the same loss twice. In the absence of such a provision…cross-border situations would confer an unjustified advantage over comparable national situations, in which a double deduction is not possible. The difference in treatment established by national legislation thus appears to be justified." *NN* [2018] Case C-28/17 paragraph 48.

[853] Ibid. paragraph 53.

[854] Ibid. paragraph 54.

[855] *W AG* [2022] Case C-538/20.

[856] Ibid. paragraph 27.

[857] Ibid. paragraph 25. The Court was attempting to reconcile with its judgment in *Bevola and Jens W Trock* [2018] Case C-650/16 discussed in chapter 8.7.ii.b *post.*

[858] The Finnish rules permitted pooling of losses on immovable property situated in Finland against other chargeable gains but the double tax treaty with France restricts taxation of immovable property to the contracting state in which the property is located *K* [2013] Case C-322/11 paragraphs 24 & 25.

thought to have turned on that[859]. As noted by the Court, the French tax code did not permit offset of the loss that he incurred on disposal of the French asset against any other gains or income[860] and the loss satisfied the conditions of the Court in *Marks & Spencer* [2005], paragraph 55.

The Court determined that the Finnish rule denying relief for the loss suffered on the disposal of the French property gave rise to a restriction[861] despite recognition of the symmetry of the Finnish exemption relating to foreign immovable property[862].

On the face of it, it yet again appears that there is the finding of comparability of an investment made in circumstances where the capital return on the investment is outside of the taxing jurisdiction of the state of residence of the investor with one where the capital return is within the taxing jurisdiction of the state of residence.

However, the exemption from Finnish tax on capital gains realised on French assets was not straightforward in that "*…the France-Finland Convention allows income that is taxable in France to be taken into account in the calculation of the tax on income that is taxable in Finland <u>in order to apply progressive taxation…income from capital assets which is taxed at a fixed rate</u>*"[863].

But for the fact that Finland, at that time, did not apply progressive rates to taxation taking account of capital gains, the taking into account of the otherwise exempted capital gains for determining progressive rates of taxation applied "*…leads to the imposition on taxpayers of a tax which is indirectly charged on the [exempted capital gains]…*"[864].

It might be argued that there would be comparability between an investment held in France and one held in Finland in a period when the Finnish taxpayer's tax liability might be altered through a progressive rate system by taking account of an exempt gain for determining the rates applicable to taxable income and gains.

However, that was not so in the relevant tax period and it would seem that no account of exempt gains was taken by Finland for the purposes of applying progressive rates of tax.

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[859] Ibid. Paragraph 75: the Court made express reference to *Marks & Spencer* [2005] paragraph 55.

[860] See also the Advocate General's Opinion paragraph 32: "…that loss is final in France — owing either to the circumstances set out by the referring court or, more generally, to the fact that, as the Commission indicated, losses on immoveable property incurred in France on an immoveable property situated in that Member State can never be deducted either from overall income or from a gain realised on the sale of another asset…".

[861] *K* [2013] Case C-322/11 paragraph 31. The Court salvaged the desired outcome by ruling that it was not disproportionate (paragraph 82).

[862] Ibid. paragraphs 55 & 68.

[863] Ibid. paragraph 44.

[864] *Bourges-Maunoury* [2012] Case C-558/10 paragraph 26 (adapted).

It is contended that there was no such restriction. The state of origin had no jurisdiction to tax any income or profit derived from the French property and that situation cannot be equated with a situation where it does have such jurisdiction to tax[865].

8.7.iv Foreign subsidiaries.

The three cases three cases discussed below all involved claims to obtain relief in the state of residence of the respective parent companies in respect of losses incurred by non-resident subsidiaries whose foreign activities had been terminated.

The Court handed down its judgments for *Memira* [2019] and *Holmen* [2019] on the same day[866]. Both cases involved Swedish companies seeking to import losses generated by failed foreign operations but whilst *Memira* [2019] was concerned with a simple structure consisting of a Swedish parent seeking to absorb by merger a directly owned German subsidiary, the group structure in *Holmen* [2019] was more complex in that there was a sub-group of companies in the other Member State, Spain.

The questions put to the Court by the national courts in both cases sought to clarify the doctrine established by the Court in *Marks & Spencer* [2005] in relation to ‘final losses’. The Court did not, therefore, address the comparability issue in either case.

8.7.iv.a A Oy [2013].

The Finnish legislation examined in *A Oy* [2013] had not been amended to comply with the Court’s ruling in *Marks & Spencer* [2005] regarding relief for ‘final losses’.

The parent company resident in Finland sought to claim relief in respect of losses generated in Sweden by its failed Swedish subsidiary by absorbing its

[865] Contrast that decision with “…by making the profits of permanent establishments situated in Finland, Sweden and Norway subject to Danish tax, the Kingdom of Denmark has equated those establishments with resident permanent establishments so far as concerns the deduction of losses…”. *Nordea Bank Danmark* [2014] Case C-48/13 paragraph 24.

[866] The judgments were given by the same chamber on 19 June 2019 and AG Kokott delivered her Opinions on both cases on the same day also on 10 January 2019.

subsidiary by way of merger[867]. The double tax treaty exempted the Swedish company from Finnish tax[868] and the claim was rejected.

The Court ruled that a merger of a parent company with its non-resident subsidiary was objectively comparable to a merger with a resident subsidiary having regard for the objective of the Finnish legislation[869].

The Court considered the justifications for the Finnish restriction and followed *Marks & Spencer* [2005]. The restriction denying the Finnish parent the right to claim relief for the losses incurred by the subsidiary in another Member State preserved the taxing powers of Finland[870] including its right to tax profits generated in its own territory without reduction by losses incurred elsewhere. The restriction also prevented schemes of tax avoidance[871]. The Court further accepted a justification based upon prevention of double deduction of losses[872]. Following *Marks & Spencer* [2005], the Court ruled that the requirements of the principle of proportionality would only be satisfied if the Swedish subsidiary's losses satisfied the 'final loss' test in *Marks & Spencer* [2005][873].

[867] The absorption of a Finnish subsidiary by its Finnish parent would have enabled the parent to claim the losses accrued by the subsidiary. The Advocate General reported in paragraph 20 of his Opinion that the relief would have been permitted under Finnish law for losses incurred by a non-resident subsidiary to the extent attributable to a branch operating in Finland. That would be a consistent extension of the relief. The relief, thus, enables the preservation of losses generated by activities conducted in the territory of the Member State that might be lost under the standard rules where there is a reorganisation of the business activities. The losses are instead treated as following the business activities merged into another company resident in the Member State. See comparable treatment of resident branches of non-resident companies by the UK legislation in *Philips Electronics* [2012] Case C-18/11 paragraph 19.

[868] *A Oy* [2013] Case C-123/11 paragraph 3.

[869] Ibid. paragraph 35: "…the aim of tax legislation such as that at issue in the main proceedings, <u>which is intended to allow the parent company to benefit from the tax advantage consisting in being able to deduct from tax the losses incurred by the subsidiary</u>" (emphasis added). The apparent aim of the legislation is to enable a Finnish group to reconstruct its business activities and to merge business activities conducted within the territory without losing the right to relief for pre-merger losses. The legislation removes an obstruction to reconfiguring the way in which the business is conducted within the taxing jurisdiction of the Member State. It also reduces the risk of stranded losses arising where a parent company conducts its business through companies that are its subsidiaries.

[870] Ibid. paragraphs 41 to 43.

[871] Ibid. paragraph 45. Although the Court did not elaborate, it would be possible to design a structured transaction that would generate profits initially followed by losses. If the profits were generated in a state having a tax rate that was lower than the state of residence of the parent, a scheme involving the merger of the subsidiary once the profitability of the transaction had reversed into losses would result in a profitable tax rate arbitrage.

[872] Ibid. paragraph 44. This ground of justification has been challenged in a cross-border context in chapter 8.2 *ante*.

[873] Ibid. paragraphs 49 to 55.

The right of Finland to tax profits generated in its territory without reduction by losses incurred in another Member State thus depended upon whether any use of those losses could be made in Sweden, no matter how little use.

In both *K* [2013] and in *A Oy* [2013] the Court was examining claims by taxpayers to import losses generated by activities conducted outside of their respective home state's taxing jurisdiction. The contention is that there was no restriction in either case because there was no comparability of the domestic situation to the cross-border situation.

8.7.iv.b Memira [2019][874].

The Swedish parent sought to merge its loss-making German subsidiary into itself and the question before the Court concerned the definition of 'final losses.

German tax law provided that the German subsidiary's losses would cease to be recognised after the subsidiary became absorbed into its Swedish parent[875]. No evidence appears to have been presented to the Court on whether German law prescribes a similar voiding of the deductibility of the losses in the event of a sale of the German subsidiary (with or without change in ultimate ownership) to another person and the Court ruled that it was for the Swedish parent to provide evidence that the subsidiary's losses would be voided if such a disposal was effected[876].

The link with the 'prevention of double deduction of losses' doctrine discussed in chapter 8.2 *ante* is evident in the Court's ruling. If any monetary value can be realised from the foreign losses, allowing a deduction for those losses in the state of origin of the parent would result in a (partial) double deduction.

8.7.iv.c Holmen [2019][877].

The Swedish parent sought to gain the benefit in Sweden of the losses accumulated in one of the Spanish subsidiaries of a wholly owned Spanish intermediate holding company.

The Court considered two alternative structures.

The first structure involved three or more Member States with intermediate holding companies not resident in either the Member State of residence of the ultimate parent or that of the loss-making sub-subsidiary[878]. The Court ruled then that "… *It is not therefore disproportionate for a Member State to make cross-*

[874] *Memira* [2019] Case C-607/17

[875] Ibid. paragraphs 8 & 22.

[876] Ibid. paragraphs 25 to 27. If the German losses could have been preserved in the event of such a sale of the subsidiary, the Swedish parent may have realised some monetary value for the losses in the price obtained for the sale of the company.

[877] *Holmen* [2019] Case C-608/17

[878] Ibid. paragraphs 26 & 27.

border tax relief conditional on a direct link …"[879] as the group could then choose between the state of residence of the ultimate parent and that of an intermediate holding company where to take credit for the losses of the sub-subsidiary.

The Court then considered a second alternative, that being that of the Holman group, where the intermediate holding company is resident in the same state as the loss-making sub-subsidiary[880]. Then the group would not have a choice of Member States in which to take relief for 'final losses' as defined in paragraph 55 of *Marks & Spencer* [2005]. In that case, it would be disproportionate for the Member State of residence of the ultimate parent to insist upon a direct ownership of the loss-making sub-subsidiary by the ultimate parent[881].

The Court's analysis is far from clear and it appears to have included one 'negative' too many in its conclusion[882].

8.8 CONCLUDING COMMENTS.

The Court has been resolute in following the analysis and reasoning established in *Marks & Spencer* [2005] despite the EU Commission's intervention in *Bevola and Jens W Trock* [2018][883].

The Court's response to that was "…*Where the legislature of a Member State treats those two categories of establishments in the same way for the purpose of taxing their profits, it recognises that, with regard to the detailed rules and conditions of that taxation, there is no objective difference between their situations which could justify a difference in treatment*…"[884].

Yet the Court has refused to accept the antithesis to that, being that where the tax code treats a non-resident establishment differently from a resident establishment by, for instance, not extending its taxing jurisdiction to the non-resident establishment, then the situations of the establishments in that circumstance are not comparable for the purpose of the tax code of the Member State in point.

In consequence, in order to justify its stance on 'final losses' whilst reconciling to principles previously stated, the Court has had to resort to an analysis of growing complexity.

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[879] Ibid. paragraph 29.

[880] Ibid. paragraph 30.

[881] Ibid. paragraph 32.

[882] Ibid. paragraph 33

[883] *Bevola and Jens W Trock* [2018] Case C-650/16 paragraph 31 (emphasis added): "While agreeing with that reading of the judgments…*Nordea Bank Danmark*…and of…*Timac Agro Deutschland*…the European Commission considers that they contradict the Court's earlier case-law…"

[884] Ibid. paragraph 34. This is uncontroversial as it is what the Court said in *Avoir Fiscal*.

The conjecture is that the Court erred in two respects when it decided *Marks & Spencer* [2005].

The first error was to find the rule in the UK group relief scheme limiting the application of the scheme to corporation tax profits and losses as constituting a restriction to the exercise of the right to establishment. It was no such thing. Having regard to the purpose of the group relief scheme, which was to enable the pooling of the corporation tax profits and corporation tax losses of a 75% group (as defined in the legislation), it cannot be argued that a group member having losses that are not corporation tax losses is in a comparable situation to a group member having corporation tax losses. The exclusion applied also to capital losses incurred by UK resident group members that would be chargeable to corporation on capital gains. There was no provision enabling them to use the group relief scheme to pool their capital losses with the chargeable gains of other group members.

There was also too much focus on the perceived disadvantage to the UK parent company in terms of group cash flow and little recognition that it is the loss-making subsidiary companies that would have been the beneficiaries of an extension of the UK's taxing jurisdiction as they would have been able to monetise their losses.

However, regardless of that, the Court has repeatedly stated that the Treaty makes no guarantee that a person exercising a freedom of movement will not suffer a disadvantage as a result of so doing. The Marks & Spencer subsidiaries suffered the disadvantage because their activities were not conducted within the taxing jurisdiction of the UK and, more particularly, within the scope of corporation tax.

The second error was to blindly accept the notion of "double deduction of losses" without rationalising it. It was the UK HMRC that threw that ground of justification into the ring and it is clear from the enactment[885] thrown out in *Philips Electronics* [2012] that HMRC did not understand the notion themselves.

As stated in chapter 8.2 ante, an advantage can be obtained from a cross-border double deduction of losses only if the balancing income in one of the states concerned is treated as being exempt from tax[886] or if a tax credit is received in one of the states in respect of tax paid in the other that would not have been due had the undertaking retained its losses for its own use and not offset them in the other state against the profits of another undertaking.

[885] Then: Income and Corporation Taxes Act 1988 s.403D (Corporation Tax Act 2010, s.107 following re-enactment.).

[886] Using a hybrid vehicle or a hybrid instrument.

Otherwise, the availability of a cross-border double deduction is merely the consequence of two states exercising their powers of taxation in parallel as the Court has acknowledged[887].

[887] *Philips Electronics* [2012] Case C-18/11 paragraphs 30 & 31.

9 OTHER CONFLICTS IN JUDGMENTS.

9.1 INTRODUCTION TO THE CHAPTER.

Chapters 6 to 8 *ante* have addressed what are perceived to be failings and conflicts in the Court's judgments concerned with, primarily, national direct tax rules and schemes for companies.

The focus of this final chapter is on a selection of other instances of failings and conflicts in the Court's analysis coupled with a brief discussion of the principles of interpretation.

9.2 INTERPRETATION - IN THE CONTEXT OF THE OBJECTIVES AND OF THE GENERAL SCHEME

Where there is ambiguity in a provision or where there is an omission or uncertainty in a provision, the Court will look at the part of the Treaty or other measure that contains the provision in order to discern what effect is to be given to the provision under examination[888].

The early legislation setting out the task of creating a common market, now Internal Market, was contained in the EEC Treaty and was largely replicated in the EC Treaty. Article 2 EEC & EC set out the 'tasks' or objectives of the Community in very general terms and Article 3 EEC & EC set out the 'activities' or means of achieving the tasks in the form of more specific objectives and acts to be achieved or undertaken within the powers conferred on the Community under the Treaty.

The 'activity' defined in Article 3(c) EEC & EC was: "*an Internal Market characterised by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital*". In interpreting the more specific provisions relating to the Internal Market, the Court, where necessary, looks at that provision to determine the nature of what the more specific provisions are seeking to achieve[889].

[888] When the Court was asked whether the United Kingdom had the unilateral right to withdraw its notification under Article 50 TEU to the European Council of its intention to withdraw from the Union, the Court, noting that Article 50 TEU neither expressly permitted nor prohibited such an act, commenced saying: "…the interpretation of a provision of EU law requires that account be taken not only of its wording and the objectives it pursues, but also of its context and the provisions of EU law as a whole. The origins of a provision of EU law may also provide information relevant to its interpretation…". *Wightman and others (Art 50)* [2018] Case C-621/18 paragraph 47. The Court has not changed its position on this since 1979: "In order to interpret that provision, therefore, it is necessary to consider its context and the objective of the rules in question.". *Netherlands v Commission (interpretation)* [1979] Case 11/76 paragraph 6.

[889] *Polydor* [1982] Case 270/80 paragraph.16 (emphasis added): **"**The scope of that case-law must indeed be determined in the light of the Community's objectives and activities as defined by Articles 2 and 3 of the EEC Treaty. As the Court has had occasion to emphasize in various contexts, the Treaty, by establishing a common market and progressively approximating the economic

The chapters in the Treaty containing the more detailed provisions normally referred to are "*devoted*" to the "*implementation*" of the "*general principles of the Internal Market*"[890].

In this regard, where more than one of the freedoms might be engaged, the Court will not consider one of the freedoms as a proxy for another but will determine which of the freedoms of movement is primarily engaged, or whether more than one is. To determine the relevant freedom engaged, it will consider the circumstances under examination and the objectives of the freedoms of movement engaged[891].

The overlap between the spheres of application of Articles 49 and 63 TFEU have led to confusion[892]. The Court was obliged to clarify the respective applications of the two Articles in relation to investments in companies in *FII GLO (2)* [2012][893]. In that case, the Court was required to consider national provisions in the context of third country subsidiaries and the parent companies' claim for protection under Article 63 TFEU[894].

Conceptually, as recognised in the drafting of the Article itself, a controlled company is a vehicle through which the controller pursues his business[895]. Where such a company is a device that conducts no genuine economic activity, it will not constitute an 'establishment' for the purposes of Article 49 TFEU[896].

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policies of the Member States, seeks to unite national markets into a single market having the characteristics of a domestic market"

[890] *Opinion of the Court (conferred powers)* [1996] Case Opinion 2/94 paragraph 23.

[891] *Fidium Finanz* [2006] Case C-452/04 paragraph 28 (emphasis added): "…it is apparent from the wording of Article 49 EC and Article 56 EC, and the position which they occupy in two different chapters of Title III of the Treaty, that, although closely linked, those provisions were designed to regulate different situations and they each have their own field of application"

[892] See, for instance, Hemels [2010] ECTR . The authors note in their conclusion on page 31: "contradictory judgments of the national courts and the fact that the ECJ itself has developed two conflicting rules: the applicable-legislation-rule followed by the German, French and UK courts and the facts-of-the-case-rule followed by the Dutch Supreme Court…". This comment may have led to the Court subsequently clarifying its thinking and analysis as noted below in FN893.

[893] *FII GLO (2)* [2012] Case C-35/11 paragraph 104 but see paragraphs 91 to 104 and particularly paragraphs 96 to 104 in which the Court resolves the applicability of Art. 63 where the relationship between the shareholder and a third country investee company provides significant or definite influence: "…a company that…has a shareholding in a company resident in a third country giving it definite influence…may rely upon Article 63 TFEU…[where the Member State legislation in point] relates to the tax treatment of dividends originating in the third country and does not apply exclusively to situations in which the parent company exercises decisive influence over the company paying the dividends."

[894] "Accordingly, the Court is not looking simply at percentage shareholdings or, necessarily, only at voting rights in the capital. The Court is looking at the ability of the person claiming protection under Article 43 EC to conduct his business in the territory in which the company is established through that company by having the legal power to determine its operations." Turner [2008] ECTJ

[895] See also *Cadbury Schweppes* [2006] Case C-196/04 paragraph 54.

[896] See ibid. paragraph 68.

Before leaving this important conceptual definition, the Court has made it clear that the power of control can be exercised indirectly. In its answer to the 'first indent' to Question 2 put to it in the *Thin Cap GLO* [2007] case[897], the Court ruled that the freedom of establishment is exercised where a company established in a third country, but controlled[898] by a parent company established in a Member State, makes a loan to its subsidiary established in a Member State. The Court indicated also that it matters not how long the chain of control is provided that there is control at each level.

9.3 INFRINGEMENT OF TREATY RIGHTS.

Whether a national rule is regarded as causing an infringement of Article 34 TFEU, or Article 49 TFEU, or any of the freedoms of movement for that matter, is determined by reference to its effect on a person exercising the freedom in question and upon whether he is, would be or could be[899] put at a disadvantage to a person operating in the market that he wishes to gain access to.

The purpose of the national provision is relevant when considering whether the national provision is such as to "*constitute a means of arbitrary discrimination or a disguised restriction on trade between Member States*"[900]. The Court will look at the objective of a national provision to determine whether there is discrimination when comparing a cross-border situation with a domestic one[901].

Even where the national provision causing the restriction can be justified, it must also pass the test of proportionality. Where the objective of the restrictive national provisions can be achieved through "*measures which are less restrictive of the freedom of [movement]*"[902], the national provision will fail the test of proportionality.

Where the EU has exercised its competence in a particular area and has produced secondary measures, the Court will consider any conflict by a national measure in the context only of the relevant secondary measures[903].

[897] See *Thin Cap GLO* [2007] Case C-524/04 paragraph 95.

[898] A company that controls 40% of the shares of 'subsidiary' and 40% of the shares of another company that controls the remaining 60% of the shares in 'subsidiary' does not control 'subsidiary' even though it is entitled to 64% of its distributed profits. The chain would be broken.

[899] *Thin Cap GLO* [2007] Case C-524/04 paragraph 62: "…it is sufficient that it be capable of restricting the exercise of that freedom…"

[900] See *Henn & Darby* [1979] Case 34/79 and the passage of the judgment quoted.

[901] See *Papillon* [2008] Case C-418/07 paragraph 27: "In order to establish whether discrimination exists, the comparability of a Community situation with one which is purely domestic must be examined by taking into account the objective pursued by the national provisions at issue."

[902] Ibid. paragraph 61.

[903] *Commission v France (duty free limits)* [2013] Case C-216/11 paragraph 27: "…where a particular sphere has been the subject of exhaustive harmonisation at Community level, any national measure relating thereto must be assessed in the light of the provisions of the harmonising measure and not those of the Treaty…".

Member State sovereignty in the field of direct taxation – is the failure of the Court of Justice in some instances to provide a consistent and coherent scheme of analysis of alleged restrictions to the exercise of the freedoms of movement a consequence of activism, error or both?

9.4 THE PRINCIPLE OF LEGAL CERTAINTY APPLIED TO THE COURT'S RULINGS.

Legal certainty is dependent upon the consistency of the analysis and the clarity of the rulings of the Court and there are two aspects of this that are discussed.

The first is the reluctance of the Court to depart from its *obiter dicta*[904] and the second is the occasional failure of the Court to distinguish between different circumstances.

As regards the first, Sir Konrad Schiemann[905] recognised the reluctance of the Court to depart from analysis previously made and gave the following explanation: "*Although there is no formal doctrine of precedent, in practice the Court is extremely loath to depart from anything included in an earlier judgment. This is for the perfectly good reason that Member States and their citizens will have organised their affairs … on the basis that the interpretation given by the Court in the earlier judgment is definitive*"[906].

This practice of the Court, however, can lead to it becoming shackled by *obiter dicta* in its judgments and that can lead to confusion amongst national courts and other users of its rulings. It can also lead to lines of decisions that are questionable[907].

The second aspect of the Court's rulings that is discussed in this chapter is that the Court may in later cases follow the analysis undertaken in an earlier case bearing similarities but it may find it necessary to diverge from that early analysis in recognition of the differing underlying circumstances. The result of grafting the new analysis onto the previously established analysis can lead to confusion.

It is contended that both of these practices of the Court can lead to errors in rulings and the Court is reluctant to admit to error [908].

9.4.i Shackled by *obiter dicta.*

Schumacker [1995][909] and three subsequent cases have been selected to demonstrate the point, which has been, in any case, demonstrated in relation to 'exit taxes' and 'final losses'.

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[904] Foster (2009) section 2.6.4.2 pp 72 & 73: "While there is no formal system of precedent, the ECJ, just like courts in civil-law jurisdictions, tries to maintain consistency in its judgments … unofficially, the system of case law developed by the ECJ increasingly seems to resemble a true case-law system relying on precedents to take the law forward …".

[905] Judge of the Court of Justice 8 January 2004 to 8 October 2012.

[906] Arnull & Others (2008) page 4.

[907] The analysis by the Court of cases involving groups and 'final losses', is one example.

[908] See for a discussion Arnull [1993] CMLR and evidenced in the case law referred to therein.

[909] *Schumacker* [1995] Case C-279/93.The Court's definition of 'discrimination' in paragraph 30 of the judgment is frequently cited.

9.4.i.a Schumacker [1995].

The Court had to rule whether the taxpayer, who was a resident in Belgium but worked in Germany and was taxed there as a non-resident, had suffered discrimination by Germany by being taxed as a non-resident. That treatment resulted in him being denied the personal tax allowances and reliefs that his German co-workers could claim. His circumstance was that his employment in Germany produced manifestly the whole of the family income.

The Court appears to have been side-tracked into considering the general recognition under international tax law that "…*the overall taxation of taxpayers, taking account of their personal and family circumstances, is a matter for the State of residence*"[910]. In its determination that the taxpayer had suffered discriminatory treatment under the German tax law, the Court made the observation that neither the taxpayer's state of residence nor the state of employment provided him with a deduction from taxable income recognising his 'personal and family circumstances'[911].

Germany, *de facto*[912], levied tax on manifestly the whole of the taxpayer's global income, thus putting him in the same situation, under the German tax code, as a German resident in that tax period, but denying him German personal allowances and reliefs. That is discriminatory, as observed by the Court in *Avoir Fiscal* [1986][913].

It might be said that 'it was not Germany's fault' that the non-resident had little or no income outside of its jurisdiction but it is not a question of fault. It is a question of whether the worker is in a comparable situation to that of a resident worker as regards taxation of his *de facto* global income and whether he would be deterred from exercising the freedom of movement guaranteed by Article 45 TFEU.

It is, thus, perfectly possible to provide a simple and rigorous analysis of why the Treaty freedom of movement is infringed and what needs to be done to remedy it without making any reference to the policies underlying the grant of income tax personal allowances to taxpayers. Germany taxed him more harshly than it taxed its own residents and he would have been liable to less tax if he had been taxed as a resident of Germany.

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[910] Ibid. paragraph 32.

[911] Ibid. paragraph 38. He had little or no income in his state of residence and was taxed as a non-resident in Germany.

[912] The determination of this case on the basis that *Schumacker* had suffered discriminatory treatment because as a point of fact he had little or no income outside of the host state attracted criticism – Lang [2009] ECTR pages 101 to 104.

[913] *Avoir Fiscal* [1986] Case 270/83 paragraph 20.

So, the test is simply that: would being taxed as a resident in the host state result in a lighter tax burden?[914] If, so, that alternative should be provided.

9.4.i.b Wallentin [2004]

The case concerned a German student supported by his parents during term time who took up a temporary position with an employer in Sweden to gain some work experience. The student was subjected to a marginally lower rate of income tax by deduction from his income but was denied any deduction for the personal allowances that could be claimed by a resident of Sweden. The Court applied the same analysis as it did in *Schumacker* [1995][915].

Again, the question is, or should be, whether the taxpayer would be taxed heavier under Swedish tax law if classified as a resident and the nature of the income received in the state of residence is irrelevant[916].

9.4.i.c D [2005][917].

The taxpayer resided in Germany but owned property in the Netherlands (the 'host state'), which levied wealth tax. Approximately 90% of the taxpayer's wealth consisted of assets located in Germany, which did not levy a wealth tax. Residents of the host state were entitled to a deduction from their net assets in assessing the tax but were assessable to the tax on their global net assets. Non-residents

[914] See, for example, *Gerritse* [2003] Case C-234/01 paragraph 54: "It is for the referring court to verify … whether the 25% tax rate applied to Mr Gerritse's income is higher than that which would follow from application of the progressive table. In order to compare comparable situations, it is necessary in that respect, as the Commission has rightly pointed out, to add to the net income received by the person concerned in Germany an amount corresponding to the tax-free allowance …": which seems to be an awkward way of saying that the tax-free allowance should be disregarded when applying the progressive rates applied to a resident.

However, the suggestion in this thesis is that there should be a calculation of how much tax would be payable by the non-resident if taxed as a resident (including the rest of his global income if that is the basis of taxation of residents) and that should be compared to the tax actually levied on him as a non-resident. Where other income is small, he might pay less tax if taxed as a resident and that option should be provided.

[915] *Wallentin* [2004] Case C-169/03 paragraph 18: "That is exactly the situation in the main proceedings, whose distinguishing feature is that Mr Wallentin did not have, at the material time, any taxable income in his State of residence, since the monthly subsistence allowance from his parents and the grant paid to him by the German State did not constitute taxable income under German tax legislation".

[916] By analogy, *Schempp* [2005] Case C-403/03 paragraph 34: "…Article 12 EC is not concerned with any disparities in treatment…which may result from divergences existing between the various Member States, so long as they affect all persons subject to them in accordance with objective criteria and without regard to their nationality." If maintenance payments made to a Swedish student by his parents were exempt from Swedish tax, it is irrelevant how Germany treated the maintenance payments. The taxpayer should not have to bear a levy of taxation in the host state greater than that payable by a resident of host state in receipt of precisely the same mix of income.

[917] *D* [2005] Case C-376/03.

were taxable only on their net assets located in the territory but were denied the deduction. The taxpayer claimed that the host state denial of a deduction was discriminatory.

The Court, first, recited the '*Schumacker doctrine*'[918] but then jumped to a pure comparability analysis[919].

Applying the simple test suggested *ante*, would D pay less wealth tax in the Netherlands if assessed as a resident of the Netherlands on his global wealth reduced by the allowance that he sought?

By allowing itself to be side-tracked into conjuring up a fictional Treaty right to personal tax allowances, and by feeling shackled by the need to maintain consistency in the analysis in its judgments, the Court has caused there to be confusion and unnecessary litigation.

The host state tax provision is considered to be discriminatory if the taxpayer suffers a higher burden of tax in the host state when assessed as a non-resident (on his income from the territory or his wealth situated there) than he would have incurred in the host state had he been assessed as a resident (on his global income or wealth) [920].

9.4.i.d X [2017].

The issue in X [2017] , an individual treated as non-resident in the Netherlands, was the imputed 'income' derived from ownership of a property in Spain, where he was considered to be resident. The imputed income can be reduced by expenses, including finance costs, incurred in relation to the ownership of the property and can result in a net deduction[921].

X received income from companies that he controlled in the Netherlands (60% of his income) and Switzerland (40% of his income), where he was taxed as a non-

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[918] Ibid. paragraph 37: "…the view is to be taken as regards wealth tax that the situation of a non-resident is different from that of a resident in so far as…the major part of his wealth is normally concentrated in the State where he is resident. Consequently, that Member State is best placed to take account of the resident's overall ability to pay by granting him, where appropriate, the allowances prescribed by its legislation."

[919] Ibid. paragraph 38 (emphasis added): "…a taxpayer who holds only a minor part of his wealth in a Member State other than the State where he is resident is not, as a rule, in a situation comparable to that of residents of that other Member State and the refusal of the authorities concerned to grant him the allowance to which residents are entitled does not discriminate against him."

[920] Peter Wattel, Advocate General, *Hoge Raad der Nederlanden*, wrote a furious article criticising the Court's failure to rule in relation to these cases that the non-resident taxpayers should receive a personal allowance proportionate to their income or wealth in the host state: see Wattel [2005] BTR .

[921] *X (allowances)* [2017] Case C-283/15 paragraphs 9 & 10. In the circumstances of the case, there was a net deduction.

resident. Pursuant to the double tax treaties between the three states, the income fell to be taxed where sourced.

The Court by means of an analysis that appears to lack coherence ruled that the Netherlands should allow the deduction for the 'negative income' related to the Spanish property against his assessment in the Netherlands based on his source there only, as a non-resident[922]. The Court then proposed that, in a multi-source state situation, the Member State source states should shoulder the cost of the personal allowances proportionately[923]. In so ruling, the Court is giving further support to a perceived doctrine prescribing that a deduction must be allowed somewhere and that appears to fly in the face of the *Lindfors* principle that the Treaty does not provide that form of protection.

The simple test referred to *ante* would be for the taxpayer to ascertain in each relevant source stay whether he might be better off being treated as a resident and be taxed on his global income reduced by allowances adjusted for double tax treaty benefits that would be available to a resident, which might vary from source state to sources state.

As many (if not most) Member States levy progressive rates of income tax on aggregate taxable income after allowances, avoiding the higher rates of tax that would result from the aggregation of his income might be to his benefit even if he got no adjustment for allowances in any source state, which is precisely the result that he experienced in the Netherlands[924]

9.4.ii Circumstantial differences.

The development of the Court's analysis in the 'exit tax' cases reviewed in chapter 7 *ante* provides an example of progressive massaging of the analysis to accommodate different circumstances. The cases in point are those relating to tax events triggered by a resident taxpayer's migration of tax residence.

The first of the cases was *de Lasteyrie* [2004][925], which was materially different from the cases that followed in one very important respect: the French provisions examined in that case were designed to counter temporary migration of tax residence to avoid French tax chargeable on chargeable gains that had accumulated on assets during the taxpayer's residence in the territory. The charge under the provisions was cancelled if the tax migration of the taxpayer was deemed to be genuine and he remained non-resident for a stipulated period of time.

[922] Ibid. paragraphs 37 to 42.

[923] Ibid. paragraphs 46 & 47. There will doubtless be a further reference to clarify how those proportions will be calculated (should third country source states be disregarded?) whether each state should allow the calculated proportion of its own standard allowance or whether it should be the calculated proportion of that provided by his state of residence or something else.

[924] Ibid. paragraphs 13 & 14.

[925] *de Lasteyrie* [2004] Case C-09/02.

In contrast, the Dutch provisions examined by the Court in *N* [2006][926] and in *National Grid Indus* [2011][927] were designed to capture tax on gains that had accrued on assets owned by the taxpayer during his period of residence regardless of whether the migration was for a temporary period or not.

The assets in point in *de Lasteyrie* [2004] and in *N* [2006] were personal assets: that is assets not used for the purposes of a business.

When it subsequently came to consider a company migration of tax residence and an asset owned by the company[928], the Court took care to distinguish the situation. In that case, the Court recognised that relief for diminution in value of such assets following migration of tax residence might well be granted by the host state as a deduction from profits taxable in the destination state[929].

The restriction to free movement determined was the charge to taxation triggered prematurely by the migration of tax residence.

The restriction caused by the French provisions triggering a tax event could not be justified on the ground of protection of taxing powers because of the potential voiding of the charge upon satisfaction of the condition that the taxpayer remained non-resident for the stipulated period of time.

The French state did not reserve to itself the right to tax the gain that had arisen during the taxpayer's residence in the territory[930] and could not be justified on the ground of preservation of taxing powers.

In contrast, the Dutch provisions could be so justified[931].

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[926] *N* [2006] Case C-470/04

[927] *National Grid Indus* [2011] Case C-371/10

[928] The asset was an inter-company currency receivable denominated in GBP and it could only diminish in value subsequent to the migration of the company's tax residence to the UK by reason of default, in which case, there would have been no tax relief granted under UK tax rules. The judgment addressed a hypothetical situation contrary to the Court's stated policy: "…The Court may refuse to rule on a question referred by a national court only where it is quite obvious that the interpretation of Community law that is sought bears no relation to the actual facts of the main action…" *Amurta* [2007] Case C-379/05 paragraph 64.

[929] *National Grid Indus* [2011] Case C-371/10 paragraph 58.

[930] By analogy: *DI. VI.* [2012] Case C-380/11 paragraph 45: "…withdrawing from a company the capital tax reduction…when the company transfers its seat to a Member State other than the Grand Duchy of Luxembourg do not ensure either the powers of taxation of the latter Member State or the balanced allocation of the powers of taxation between the Member States concerned…The very nature of the mechanism of withdrawing an advantage implies that the Member State had agreed, in advance, to grant that advantage and, consequently, to reduce the capital tax of resident taxpayers if the conditions…were satisfied."

[931] *N* [2006] Case C-470/04 paragraph 46: "…in accordance with that principle of fiscal territoriality, connected with a temporal component, namely residence within the territory during the period in which the taxable profit arises, that the national provisions… provide for the charging of tax on increases in value recorded in the Netherlands…*"* Cited by the Court in *National Grid Indus* [2011] Case C-371/10 paragraphs 46 – 48.

However, unlike the French provision considered in *de Lasteyrie* [2004], the Dutch provisions provided no adjustment to the tax assessed in the event that the asset was sold for less than the value assessed at the time of migration, an omission that the Court considered in *N* [2006] to be disproportionate to the objective of the provision[932].

It is that last aspect of the judgment that is questionable. It is possible that the Court was looking at the French provisions that it had examined in *de Lasteyrie* [2004] and considered them to be proportionate to the objective of those provisions, which was to neutralise the advantage that might be achieved by a French resident becoming non-resident temporarily to enable a valuable asset to be realised free of French tax and that advantage would be the gain actually realised.

The Netherlands provisions had a different objective. That objective was to exercise a sovereign right to tax a gain that had accrued to a person during a period in which the taxpayer was tax resident in its territory. If, as ruled in *N* [2006], the state of origin is required to take account of diminutions in value of the asset subsequent to the migration of tax residence, there is a lack of symmetry: the state of origin is required to make allowance for subsequent diminution in value of the asset but is unable to gain from any increase in value of the asset. Such would appear to run counter to the Court's ruling in *Deutsche Shell* [2008][933].

The Court had to reconsider the asymmetrical treatment prescribed by it in *N* [2006] when it came to consider *National Grid Indus* [2011] and it found itself obliged to depart from its analysis in that earlier case, distinguishing between assets that are personal assets and assets that are employed in a taxable business. As clarified in *Panayi* [2017], however, the proportionality requirement in *N* [2006] was overruled by the Court in paragraph 61 of its judgment in *National Grid Indus* [2011][934] for both types of asset.

That its judgment on the matter of proportionality in *N* [2006] was a rogue decision is evident from the judgments in several cases subsequent to *National Grid Indus* [2011] but no express cross reference to paragraph 61 of *National Grid Indus* [2011] was made in those judgments. Those subsequent cases include *DMC*

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[932] *N* [2006] Case C-470/04 paragraph 54.

[933] *Deutsche Shell* [2008] Case C-293/06 paragraph 43: "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"

[934] *Panayi* [2017] Case C-646/15 paragraph 58 (emphasis added): "…it must be made clear that deferred payment cannot result in the Member state of origin being obliged to take into account losses that occur after the transfer of the place of management of a trust to another Member State (see, to that effect, judgment of 29 November 2011, National Grid Indus, C-371/10, EU:C:2011:785, paragraph 61)".

[2014][935], *Verder LabTec* [2015][936] and, in relation to rollover relief claimed in relation to a 'replacement' asset purchased outside the territory of the state of residence, *Commission v Germany (CGT deferral)* [2015][937].

Certainty of law might be considered to have been compromised by the Court's failure to clearly retract its decision in *N* [2006] on the proportionality requirement for the state of origin to take account of diminutions in value of the assessed asset subsequent to the migration of tax residence.

9.4.iii Concluding comments.

The benefit of consistency of analysis used by the Court in the judgments handed down is impaired by the difficulty that the Court has in correcting itself.

The failure of the Court to clarify its changes of position only serves to increase uncertainty, which results in Member States and citizens of the Union being unable to organise their affairs with confidence.

The two examples addressed in this section demonstrate how uncertainty can arise when the principles applied in the analysis are not clarified in clear and simple terms.

In *Schumacker* [1995] the Court introduced the notion that the decision revolved around whether the taxpayer was able to obtain the benefit of personal allowances. As should be clear from the judgments in *Gerritse* [2003] and in *D* [2005], the test is whether the taxpayer suffers a higher tax burden taxed by the host state as a non-resident than he would suffer if he was taxed by the host state as a resident (on his global income or wealth reduced by allowances). In *Commission v Estonia (pensioner allowances)* the test is similar but the restriction arose in consequence of the taxation basis applied by the state of origin.

In *N* [2006] the Court sought to maintain consistency with *de Lasteyrie* [2004] as regards the necessity for the taxing provision to incorporate a mechanism to adjust the tax assessed at the time of migration of tax residence to take account of subsequent reductions of value but failed to observe that the objective of the taxing provision examined in *de Lasteyrie* [2004] was different from that of the taxing provision examined in *N* [2006]. Had the Court re-examined the circumstances in *de Lasteyrie* [2004] more closely to see why the French provision incorporated such an adjustment mechanism, it might have avoided the confusion created, which subsisted for about 11 years until it clarified in *Panayi* [2017] what it said in *National Grid Indus* [2011].

[935] *DMC* [2014] Case C-164/12.

[936] *Verder LabTec* [2015] Case C-657/13.

[937] *Commission v Germany (rollover)* [2015] Case C-591/13.

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9.5 ABUSE OF LAW[938]

Member State sovereignty in spheres of competence not ceded to the Union can be compromised where abusive use is sought to be made of Treaty rights. However, the Court is not sympathetic towards such endeavours to circumvent national laws and it has a general rule that EU law "…*cannot be relied on for abusive or fraudulent ends*…".[939]

Exploiting the freedoms of movement to establish a genuine activity in a state offering administrative benefits[940] or tax advantages[941] is not an abuse of EU law. However, creating a "*wholly artificial arrangement*" that has no "*economic reality*" for the purpose of gaining an advantage such as the avoidance of tax will be considered to be abusive to the freedom of movement exploited[942] and "…"*it is incumbent upon the national authorities and courts to refuse to grant entitlement to rights provided for by [EU law] where they are invoked for fraudulent or abusive ends*"[943].

In 2019, the Court modified its requirement that, as a general principle, abusive practices can only be invoked where the contested arrangements are 'wholly artificial' and lack 'economic reality'. It said it will apply "*even if the transactions at issue do not exclusively pursue such an aim…as the Court has held that the principle…in tax matters, [has application] where the accrual of a tax advantage constitutes the essential aim of the transactions at issue…*".[944]

This appears to accord with the comment made by Koen Lenaerts in 2015: "…*whilst a Member State may not prevent genuine tax mitigation, EU law does not*

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[938] "…the question that still lingers is whether the principle of prohibition of abuse of law should be characterised as a general principle, or as an interpretive principle…This editorial presents the case in favour of characterising the principle…as a general principle…now settled case-law." De La Feria [2020] ECTR page 142.

[939] *Kefalas* [1998] Case C-367/96 paragraph 20.

[940] *Centros* [1999] Case C-212/97 paragraph 27.

[941] *Cadbury Schweppes* [2006] Case C-196/04 paragraphs 34 – 38.

[942] Ibid. paragraphs 68, 73 & 73. See chapters 5.3 and 5.3.iii *post.*

[943] *N Luxembourg & Others* [2019] Case C-115/16 C-118/16 C-119/16 C-299/16 paragraph 110. The Court, in paragraphs 99 & 100 usefully lists cases in which the principle was explored in a number of varied fields.

[944] Ibid. paragraph 107. This dilution of the test for an abusive transaction or arrangement has been criticised by Pibworth. He observed that the Court (in paragraph 127) had said that a group might be regarded as an artificial arrangement where "…its principal objective or one of its principal objectives is to obtain a tax advantage…". He said, in comment on this development of the Court's 'approach': "Although , in principle, that could be said to be a reasonable approach it requires uniform application otherwise there is a risk of taxpayer uncertainty where equivalent phrases are given different interpretations…the approach adopted and guidance issued is also open to be interpreted and applied inconsistently by tax authorities and courts across Europe…creating unwelcome unpredictability…" Pibworth [2020] BTR pages 60 & 61. The author noted that the Court's new form of test was similar to the 'principal purpose test' now included in Double Tax Treaties following the OECD BEPS Action 6-2015 report.

provide a shield for tax evaders"[945] and suggests that the Court may have been influenced by the actions taken by the OECD following its BEPS review.

Putting an interesting twist on the concept, Stan Stevens recently posed the question of whether a Member State may be charged with committing abuse of law if it designs new tax measures (or modifies existing tax measures) so as to avoid conflict with EU law, specifically citing the drafting of two Dutch provisions in a manner so as to avoid engagement of Article 63 TFEU[946].

When first handed down, the judgment of the Court in Keck [1993][947] stimulated much discussion about whether the apparent change of interpretation and application of Article 34 TFEU marked a form of 'departure from precedent'.

The Court appears to have reacted to what it perceived to be abusive use of the protective provision to circumvent national provisions and this is revealed by the comment in the course of its analysis: "… *<u>in view of the increasing tendency of traders to invoke Article 30 of the Treaty as a means of challenging any rules</u> whose effect is to limit their commercial freedom even where such rules are not aimed at products from other Member States* …"[948].

Commentators of the time complained that the Court had diverged from what was considered by the 'literature' to be its interpretation of Article 34 TFEU and had defined a new distinction between movement of goods, on the one hand, and marketing arrangements, on the other.

In relation to companies, the Court's jurisprudence relating to abuse of law has been codified into Article 6 of ATAD[949]. Member States were required to transpose the directive and apply this Article from 1 January 2019.

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[945] Lenaerts [2015] MJEC at page 330.

[946] Stevens [2022] ECTR Reference should be made to the Opinion of AG Geelhoed in *Thin Cap GLO (AGO)* [2006] Case C-524/04 at paragraph 68: "…I find it extremely regrettable that the lack of clarity as to the scope of the Article 43 EC justification on abuse grounds has led to a situation where Member States, unclear of the extent to which they may enact *prima facie* 'discriminatory' anti-abuse laws, have felt obliged to 'play safe' by extending the scope of their rules to purely domestic situations where no possible risk of abuse exists… it is anathema to the internal market".

[947] *Keck* [1993] Case C-267/91 and C-268/91.

[948] Ibid. paragraph 14 (emphasis added).

[949] Council Directive (EU) 2016/1164 of 12 July 2016 (Anti-Tax Avoidance Directive). G Bizioli concludes, however, that: "…a coherent tax coordination in line with the past tradition and the objectives of the Treaties should have first considered the introduction of a common set of rules applicable to the corporate income taxation and, then, provided the measure to prevent abusive (or aggressive) tax practices. The consequence of the different solution is to frustrate the effectiveness of the fundamental freedoms and, therefore, of the Single Market." Bizioli [2017] ECTR at page 172

9.6 COMMISSION V HUNGARY (PROPERTY DUTY) [2011] AND AURES HOLDINGS [2020].

These two judgments do not, at first sight, have anything in common that might be contrasted. *Commission v Hungary (property duty)* [2011][950] was concerned with a progressive indirect tax levied on private residences in Hungary and *Aures Holdings* [2020][951] was concerned with a claim by a company that had migrated its tax residence to use losses previously suffered when resident in the exit state against profits arising to it in the host state.

Whilst the Court in its judgment on the Hungarian provisions considered that there was comparability of situations as between an individual migrating to Hungary having owned and sold a property in the exit state, on the one hand, and a resident of Hungary having previously owned and sold a property situated within the territory[952], on the other, the Court in its judgment on the Czech provisions took the view that there was no comparability of the situations of a company that incurred a loss in the exit state in a previous period with that of a company that incurred a loss in the host state in a period so far as concerns the ability to offset prior year losses against future profits[953].

In both cases, the migrant moved from the exit state taxing jurisdiction to the host state taxing jurisdiction[954].

9.7 CONCLUDING COMMENTS

In fields of shared competence, the Court has to find a balance between respect for retained Member State sovereignty and enforcement of Treaty rights and obligations.

As the Court itself has said, the "…*requirement of legal certainty must be observed all the more strictly in the case of rules liable to entail financial*

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[950] *Commission v Hungary (property duty)* [2011] Case C-253/09: The indirect tax examined in this case provided that the amount of duty payable upon the acquisition of a residential property in Hungary would be reduced by the amount of the duty already paid on a previous purchase of residential property in Hungary, subject to certain conditions. The issue was whether a person exercising a freedom of movement, taking up residence in Hungary and purchasing a property there, was in the same situation as a resident of Hungary purchasing a property there where both had previously purchased and sold properties and the person taking up residence in Hungary had undertaken his previous property transactions in the state of his previous residence.

[951] *AURES Holdings* [2020] Case C-405/18: Aures migrated its tax residence from the Netherlands to the Czech Republic and sought to claim tax losses incurred during its residence in the Netherlands for use against taxable profits accruing to it following the migration in the Czech Republic.

[952] *Commission v Hungary (property duty)* [2011] Case C-253/09 paragraph 58: "…In both situations, the persons in question will have bought a property in Hungary in order to settle there and, when purchasing their previous principal residence, will have paid a tax of the same nature as that at issue, either in the Member State in which that residence was situated or in Hungary."

[953] *AURES Holdings* [2020] Case C-405/18 paragraph 39.

[954] Ibid. paragraph 40.

consequences, in order that those concerned may know precisely the extent of the obligations which they impose on them…"[955] but, as discussed in this chapter, the Court appears to have itself broken this rule in some themes by shackling itself to past, questionable, analysis.

As has been seen from the reviews in chapter 8 of the 'final loss' cases, the Court appears to embark upon barely coherent analysis at times in order to reconcile to previous analysis and rulings. At other times, it appears to produce contradictory rulings such as discussed in chapter 9.6 *ante*.

[955] *Halifax* [2006] Case C-255/02 paragraph 72.

CONCLUSIONS

The Research Question.

The research question is: "**Is the failure of the Court of Justice in some instances to provide a consistent and coherent scheme of analysis of alleged restrictions to the exercise of the freedoms of movement a consequence of activism, error or both?**

The research has focussed on areas or themes where inconsistencies have been noted and it would not be correct to draw a conclusion from the evidence provided in Part II on the general performance of the Court in resolving conflicts between Member State taxing provisions and the Treaty freedoms of movement.

It is clear that the Court has suffered stress in seeking to find a point of balance between giving effect to the concept of an Internal Market "… *without internal frontiers in which the free movement of goods, persons, services and capital is ensured* …"[956], on the one hand, and recognising the overriding prescription that "… *competences not conferred upon the Union in the Treaties remain with the Member States*."[957], on the other.

Evidence of that stress is the Court's ruling in *X* [2017] that the taxpayer's allowances and deductions should be given effect somewhere[958], on the one hand, and the recognition of taxing jurisdiction[959], on the other, although there is considerable confusion concerning this in the case law. That confusion has been one of the principal areas of review in this thesis and there is specific comment on that evidence of stress later in these conclusions.

However, there is also evidence that the Court has become distracted by matters such as the underlying reason for provision of personal allowances (ability to pay) , which has led to decisions, such as in *X* [2017], in which its focus was on one side of the equation, so as to speak, looking at the deductions that a resident taxpayer could expect to receive, and disregarding the disadvantage of being taxed as a resident, which will usually result in paying tax at higher rates on the aggregated global income.

The research has revealed the extent to which later judgments can become distorted by a slavish adherence to rulings made in earlier cases. Such action is supposedly in the interests of legal certainty but results in confusion and uncertainty that, perhaps, can only be remedied by EU legislation such as has been done in Article 5 of ATAD in relation to exit taxes.

[956] Article 26(2) TFEU.

[957] Article 4(1) TEU.

[958] *X (allowances)* [2017] Case C-283/15 paragraphs 46 & 47.

[959] See *AURES Holdings* [2020] Case C-405/18 paragraph 41. A person who migrates tax residence cannot expect the host state to recognise losses incurred prior to the move in the exit state.

The research has also revealed apparent misunderstandings of national law, confusion in identifying the appropriate comparator in the comparability analysis conducted, if conducted, and unexplained divergences from previous forms of analysis.

These findings from the research are discussed in more detail under separate headings below.

The answer to the Research Question.

In answer to the research question, the conclusion drawn from the research is that the inconsistencies and lack of coherence found in some instances of the case law relating to alleged infringements of the Treaty freedoms of movement by Member State direct taxation provisions are due to error with little evidence of 'activism'.

Corrective action proposed.

As stated above, a fast-track legislative solution for remedying confusion and uncertainty created by rulings, such as the 'final loss' doctrine in *Marks & Spence*r [2005] may be necessary.

The underlying cause of the confusion created by a ruling, which could be the result of ambiguous legislation, is of no consequence. The priority must be to restore certainty, the importance of which the Court has emphasised itself[960].

[960] *Halifax* [2006] Case C-255/02 paragraph 72: "… Community legislation must be certain and its application foreseeable by those subject to it … That requirement of legal certainty must be observed all the more strictly in the case of rules liable to entail financial consequences, in order that those concerned may know precisely the extent of the obligations which they impose on them …".

REVIEW OF THE PRINCIPAL RESEARCH FINDINGS

i Finding the point of balance.

The retained sovereignty in relation to direct taxation derives from the principle of conferral[961]: that is, the EU can only wield those competences ceded to it by the Member States. As no overall competence in the field of direct taxation has been ceded to the EU, the competence remains with the Member States[962]. However, that sovereignty is not absolute.

That sovereignty is subordinate to EU law made on the basis of exclusive competences ceded to the EU under the Treaties and to express measures made by the EU on the basis of competences shared with the Member States[963]. However, as discussed in chapter 2.2, Member State sovereignty is not absolute even disregarding obligations under the Treaties[964].

The principle of supremacy of EU law over national law[965] was formulated partly on the basis of common sense and also out of necessity. There is no point in formulating common objectives if Member States are free to pick and choose those that they wish to pursue. Furthermore, the rules formulated to achieve the common objectives cannot vary from one Member State to another and the interpretation of those rules must be uniform.

Extending upon this, there is the equally obvious rule that Member States cannot legislate in an area where the EU has exclusive competence or has introduced measures[966] even if those measures intrude upon areas of retained competence. By way of example[967], there are the rules prescribing a reserved right for the EU to levy taxation on the salaries of officials to avert the difference in after-tax pay that would otherwise arise if EU officials were subject to home state taxation. These are very specific intrusions into Member State sovereignty and can be seen as necessary.

[961] Refer to Articles 4(1) and 5(2) TEU.

[962] *Schumacker* [1995] Case C-279/93 paragraph 21 "…as Community law stands at present, direct taxation does not as such fall within the purview of the Community…". This is subject to the measures made by the EU under powers in Article 115 TFEU detailed in chapter 1.6.ii *ante*.

[963] Article 3 TFEU defines the areas of exclusive competence and Article 4 TFEU defines the areas of shared competence.

[964] Being members also of the international community, the Member States have accepted constraints under international law and other international treaties, although such subordination of the national will persist only for so long as the nation is willing to comply with those obligations.

[965] Refer chapter 1.4

[966] Re exclusive competence, Article 2(1) TFEU. Re areas covered by EU measures, Article 2(2) TFEU.

[967] Refer chapter 2.6.i.

The Court has stated clearly that sovereignty may not be exercised in such a way as to undermine the objectives of the EU as laid out in the Treaties[968]. It has been observed in this thesis that, in relation to justifiable interference with shared competences, such as that of the internal market, the Court has had regard to the second sentence of Article 36 TFEU requiring that such restrictions should not "*constitute a means of arbitrary discrimination or a disguised restriction on trade between Member States*"[969], as is mentioned in the preliminary comments.

Where a national direct tax provision appears to be in conflict with a Treaty freedom of movement, the Court is tasked with finding a balance[970] between enforcing the freedom of movement and respecting the Member State's right to design and determine its schemes for taxation[971] of matters within its defined taxing jurisdiction.

However, critical to the ability of Member States to exercise their sovereign right to design and determine their schemes of taxation is legal certainty over the constraints that the Treaty freedoms of movement will have over their choice of design of such schemes of taxation. That introduces a third component of the balancing task: the principle of legal certainty[972], which is a principle imported by the Court from Member State general law into its 'general principles of interpretation'.

The lack of legal certainty is likely to influence the design and modification of national schemes of taxation by Member States and unnecessary administration and other inefficiencies may result.

An early example of that, in relation to anti-avoidance legislation designed to prevent profit-shifting through cross-border debt, was commented on by AG Geelhoed in 2006[973]. He was critical of "… *the lack of clarity* …" that forced the Member State to "… '*play safe' by extending the scope of their rules to purely domestic situations where no possible risk of abuse exists* …" and termed it an "… *anathema to the internal market*[974] …".

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[968] "…powers retained by the Member States must be exercised consistently with Community law…" *Commission v UK (ship registration)* [1991] Case C-246/89 paragraph 12. See also Article 4(3) TEU.

[969] It is suggested that the Court took inspiration from that provision when it ruled in *Dassonville* [1974] Case 8/74 and the wording is repeated in Article 65(3) TFEU with specific reference to tax provisions distinguishing between residents and non-residents (Article 65(1)(a)).

[970] By analogy: *Schmidberger* [2003] Case C-112/00 paragraph 81.

[971] "… it must be stated that it is for each Member State to organise…its system for taxing distributed profits and, in particular, to define the tax base and the tax rate which apply to the company making the distribution and/or the shareholder receiving them, in so far as they are liable to tax in that Member State." *FII GLO* [2006] Case C-446/04 paragraph 47.

[972] Refer to chapter 1.8.ii.

[973] *Thin Cap GLO (AGO)* [2006] Case C-524/04 paragraph 68.

[974] The Advocate General said: "Such an extension of legislation to situations falling wholly outwith its rationale, for purely formalistic ends and causing considerable extra administrative

The stress on the Court to follow previous rulings in the interest of preserving legal certainty is discussed in **section ii** below.

In relation to Member States' retained sovereignty, the main issue that has emerged in the cases examined has been interference with the Member States' right to determine their respective taxing jurisdictions.

In relation to this, two underlying issues have been identified (see **section iii** below):

- The comparability analysis applied; and
- The misunderstanding of the national law (addressed in section iii).

It is not contended that the Court seeks to undermine Member State sovereignty in this regard, which it has in more recent case law positively affirmed its recognition of that retained sovereignty[975].

However, the effect of the, in some cases, flawed comparability analysis conducted by the Court has been to undermine that sovereignty especially in relation to the 'final loss' doctrine. In some cases, the flawed analysis might stem from a misunderstanding of the Member State legislation.

The point of balance relies upon strict adherence to the constraints put upon the Member States by the Treaty freedoms of movement and the Court has affirmed that a person exercising a freedom of movement is not, in all cases, protected from suffering a disadvantage[976].

Accordingly, it has been concluded that the damage done to Member State sovereignty is largely as a result of flawed comparability analysis, misunderstanding of national law or the need to slavishly adhere to previous rulings.

There is one further source of error that has led to confusion and that is the Court's distraction by irrelevant considerations such as a principle underlying the design of taxation schemes that requires them to take account of 'ability to pay'. The purpose, aim or objective of a charging provision is to levy taxation. The design of the charging scheme will take account of ability to pay but that consideration is not part of the purpose of the scheme. There is a brief discussion of this in section iv below.

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burden for domestic companies and tax authorities, is quite pointless and indeed counterproductive for economic efficiency."

[975] *AURES Holdings* [2020] Case C-405/18 paragraphs 40 & 41: " The situation of a company which effects such a transfer is subject successively to the tax jurisdiction of two Member States … the situation of a company … [which has migrated its tax residence] … is not comparable to that of a company … [which was tax resident in the host state - as regards losses that were incurred by the migrating company in the exit state] …".

[976] Some of the case law in which the Court has affirmed this principle is summarised in chapter 6.1.ii *ante*.

ii Constrained by previous rulings.

The slavish following of previous rulings was discussed in chapter 9.4.i *ante* and there is discussion of the cases in section iv below because the Court gave undue importance to a feature of an income tax system reflecting the principle of 'ability to pay' instead of focussing on whether the scheme of taxation applied to the taxpayer by reason of his non-resident status resulted in him becoming more heavily taxed than he would have been had he been taxed as a resident.

The slavish following of the *Marks & Spencer* [2015] ruling on 'final losses' has been the subject of extensive review in chapter 8 *ante* and there is little purpose in repeating it or the critical comments made by commentators on the decisions based on that initial ruling, including by the Commission and by Advocate General Kokott.

Two issues with the judgment were identified. The first was the comparability test, if such can be regarded as having been conducted: further discussion of that is made in section iii below. The second issue was the acceptance of the ground of justification termed 'prevention of double deduction of losses' and the importance awarded to it without looking beneath the phrase to consider what the UK court was referring to if, indeed, it understood that itself.

The ground for justification has been discussed in chapter 8.2 *ante*. The group relief scheme was, in simple terms, a scheme for pooling corporation tax profits and corporation tax losses arising to companies within a defined 75% group. Once a group member had consented to surrender its losses to another group member under the scheme, it lost the right to set off the losses in question against any profits of its own[977].

If relief for the same loss is available to a group member in another taxing jurisdiction[978], it will be by reason of that group member being subject to taxation in that other taxing jurisdiction on the activities of the UK branch. As the Court subsequently observed, the taxing of the activities of the branch in that other jurisdiction would not affect "… *the power of [the UK] to tax the profits (if any) arising from the activity, in its territory, of the permanent establishment is not affected*"[979]. The advancement of that ground of justification for denying deduction of non-corporation tax losses in *Marks & Spencer* [2005] is nonsense.

The slavish following of the "*wholly artificial*" prescription handed down by the Court in *Cadbury Schweppes* [2006][980] had to be modified by the Court in *Thin Cap GLO* [2007] to enable the principle to be applied to artificial pricing of debt

[977] The prohibition of double deduction is now found in CTA 2010, s.137(7).

[978] For instance, if the group member is a non-resident company trading in the UK through a branch and the losses are corporation tax losses related to that branch.

[979] *Philips Electronics* [2012] Case C-18/11 paragraph 26.

[980] *Cadbury Schweppes* [2006] Case C-196/04 paragraph 51.

interest[981]. The judgment in Lexel [2021] [982] marked a further and, possibly, final example of evolution of that prescription.

On each occasion of modification, the Court has to review previous rulings and, in some but not all instances, it will attempt to argue reasons for taking a different view.

iii Comparability Analysis.

A number of cases were reviewed in chapter 6 *ante* where it is claimed that no infringement of the Treaty freedoms of movement were caused by the national provision examined by the Court.

Whilst the Court did proceed to examine grounds for justification of the alleged restrictions and may have, in most, come out of that analysis with 'the right result', examination of the national provision by reference to the principle of proportionality, which is then engaged, can produce something other than 'the right result', as was the case in *Marks & Spencer* [2005].

The reason why the foreign subsidiaries of Marks & Spencer PLC were not entitled to relieve their losses against the profits of other group members having corporation tax profits was because their losses were not corporation tax losses. Those subsidiaries were not resident in the UK and did not conduct a trade in the UK[983].

Had the Court conducted a comparability analysis having regard to the purpose of the scheme[984] it might have concluded that the scheme did not create a restriction, especially having regard to what it said in *Lindfors* [2004] about the Treaty not offering any "… *guarantee to a citizen of the Union that transferring his activities to a Member State other than that in which he previously resided will be neutral as regards taxation* …"[985].

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[981] Ibid. paragraphs 80 & 81.

[982] With cross-reference to *Oy AA* [2007] Case C-231/05 paragraph 63 and *SGI* [2010] Case C-311/08 paragraph 66 the Court said in *Lexel* [2021] Case C-484/19 paragraph 75: "… the need to preserve the balanced allocation of the power to impose taxes between Member States, despite the fact that the measures at issue do not specifically target purely artificial arrangements, devoid of economic reality and created with the aim of escaping the tax normally due on the profits generated by activities carried out on national territory, such measures may nevertheless be justified …".

[983] Contrast with LG Philips Displays Netherlands BV which had a branch trading in the UK and the claim by Phillips Electronics UK Ltd. to set off corporation tax losses sustained by that branch against its own corporation tax profits: *Philips Electronics* [2012] Case C-18/11.

[984] Such as it did in *Papillon* [2008] Case C-418/07 paragraphs 28 and 37 to 39.

[985] *Lindfors* [2004] Case C-365/02 paragraph 34.

The *Marks & Spencer* [2005] decision seems to have influenced the decision in *X Holding* [2010] where the Dutch tax integration scheme was in point[986]. The Court focussed on the pooling of profits and losses, not making any distinction between those generated in the Netherlands and those generated in other tax jurisdictions. That makes a mockery of the retained sovereign power to define taxing jurisdiction. The taxing scheme cannot be treated as an accounting consolidation and it is clear in the reported Dutch legislation that the integration system was open only to Dutch resident companies excepting the specific situations defined in the statute.

The argument in chapter 6.2.i *ante* in relation to *Metallgesellschaft* [2001] is different in that the claim is that the Court was misled on the nature of the national taxing scheme that it was examining and the Court is obliged to accept the analysis of the national law provided by the national court.

Despite stressing that a comparability analysis must be conducted having regard for the objective, aim or purpose of the national legislation[987], the Court has failed in some instances to identify that objective within the context of the national taxing legislation.

iv Distracted by irrelevancies.

The slavish following of the ruling in *Schumacker* [1995] was discussed in chapter 9.4.i *ante.* It was proposed that instead of seemingly creating a Treaty right to receive a personal allowance or other deductions to set against income in charge to tax, the Court should have conducted a simple comparability test to see whether the host state taxing scheme applied to the taxpayer resulted in him becoming more heavily taxed than if he had been taxed as a resident.

The Dutch scheme for levying income tax considered in *X* [2017] provided an option for a resident to elect to be taxed as a resident and it is not uncommon for national schemes to provide such an option.

The result of the deviation from a pure comparability analysis and of giving Treaty rights to the grant and receipt of personal allowances has been confused rulings and surprising conclusions, such as the obligation of host Member States to provide a just proportion of allowances to a non-resident having a source of income derived from their territory.

[986] *X Holding* [2010] Case C-337/08 paragraph 5: where a Dutch parent company and its Dutch 95%-owned subsidiary elect, "… tax shall be levied on them as if they were a single taxable person, with the activities and assets of the subsidiary forming part of the activities and assets of the parent company …". The ability to elect to joint a tax integration group was extended to non-resident companies operating in the Netherlands through a branch if the Netherlands had power to levy taxation on that company.

[987] *Papillon* [2008] Case C-418/07 paragraph 27.

The principle 'ability to pay' was wheeled out in *Bevola and Jens W Trock* [2018][988] as part of the argument in support of a ruling that a company trading partially in another Member State through a permanent establishment exempted from national tax was in the same situation as a company trading at home through a branch there as regards terminal losses sustained. The Court (in paragraph 39) identified the purpose of the exemption of the exemption from tax "… *aim[s] more generally to ensure that the taxation of a company possessing such an establishment is in line with its ability to pay tax* …". It is not understood that the aim of a double taxation measure is such. The aim of measures mitigating or eliminating double taxation is to remove an obstruction to cross-border trade and investment.

The Court then continued: "… *the ability to pay tax of a company possessing a non-resident permanent establishment which has definitively incurred losses is affected in the same way as that of a company whose resident permanent establishment has incurred losses. The two situations are thus comparable* …". Comparable for the purpose of deducting those losses generated in the host state taxing jurisdiction against profits generated in the home state taxing jurisdiction?

These two examples highlight the danger of giving excess consideration to a factor that distracts from the real comparability that should be tested.

[988] *Bevola and Jens W Trock* [2018] Case C-650/16: see chapter 8.7.ii.b *ante*.

Member State sovereignty in the field of direct taxation – is the failure of the Court of Justice in some instances to provide a consistent and coherent scheme of analysis of alleged restrictions to the exercise of the freedoms of movement a consequence of activism, error or both?

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