
DIRECT TAX: RECENT DEVELOPMENTS IN THE ECJ

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THE CONFLICT

Unlike VAT, direct tax is wholly within the competence of the Member States. Most tax systems are based on the well-recognised principle of territoriality which draws a distinction between residents and non-residents and lies at the heart of the OECD model double taxation convention on income and capital. However the principle of territoriality, based on the territory of a Member State, is the antithesis to the concept of market integration which is goal of the various freedoms laid down in the Treaty.

THE FREEDOMS

The freedoms that are of particular relevance in the tax field are:

(1) Workers

Article 39

- "1. Freedom of movement for workers shall be secured within the Community.*
- 2. Such freedom of movement shall entail the abolition of any discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work and employment.*
- 3. It shall entail the right, subject to limitations justified on grounds of public policy, public security or public health:*
- (a) to accept offers of employment actually made;*
 - (b) to move freely within the territory of Member States for this purpose;*
 - (c) to stay in a Member State for the purpose of employment in accordance with the provisions governing the employment of nationals of that State laid down by law, regulation or administrative action;*
 - (d) to remain in the territory of a Member State after having been employed in that State, subject to conditions which shall be embodied in implementing regulations to be drawn up by the Commission.*
- 4. The provisions of this article shall not apply to employment in the public service."*

(2) Right of Establishment

Article 43

"Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a Member State in the territory of another Member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting-up of agencies, branches or subsidiaries by nationals of any Member State established in the territory of any Member State.

Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the chapter relating to capital."

Article 46

- "1. The provisions of this chapter and measures taken in pursuance thereof shall not prejudice the applicability of provisions laid down by law, regulation or administrative action providing for special treatment for foreign nationals on grounds of public policy, public security or public health.*
- 2. The Council shall, acting in accordance with the procedure referred to in Article 251, issue directives for the coordination of the abovementioned provisions."*

Article 48

"Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this Chapter, be treated in the same way as natural persons who are nationals of Member States."

'Companies or firms' means companies or firms constituted under civil or commercial law, including cooperative societies, and other legal persons governed by public or private law, save for those which are non-profit-making."

(3) Services

Article 49

"Within the framework of the provisions set out below, restrictions on freedom to provide services within the Community shall be prohibited in respect of nationals of Member States who are established in a State of the Community other than that of the person for whom the services are intended."

Article 55

"The provisions of Articles 45 to 48 shall apply to the matters covered by this chapter."

(4) Capital and payments

Article 56

"1. Within the framework of the provisions set out in this chapter, all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.

2. Within the framework of the provisions set out in this chapter, all restrictions on payments between Member States and between Member States and third countries shall be prohibited."

Article 58

"1. The provisions of Article 56 shall be without prejudice to the right of Member States:

(a) to apply the relevant provisions of their tax law which distinguish between taxpayers who are not in the same situation with regard to their place of residence or with regard to the place where their capital is invested;

(b) to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.

2. The provisions of this chapter shall be without prejudice to the applicability of restrictions on the right of establishment which are compatible with this Treaty.

3. The measures and procedures referred to in paragraphs 1 and 2 shall not constitute a means of arbitrary discrimination or a disguised restriction on the free movement of capital and payments as defined in Article 56."

RESTRICTION

(1) Discrimination

Most tax cases involve provisions which distinguish between resident and non-resident persons. Are such distinctions discriminatory within the meaning of the Treaty?

It is settled law that discrimination involves the different treatment of similar situations without objective justification. In *Schumacker* [1995] ECR I-225 the ECJ, relying on the OECD Double Tax Convention, held that the position of a resident and a non-resident taxpayer was not similar because they were not in the same situation. Resident taxpayers are subject to tax on their worldwide income unlike non-residents. Only the State of residence has full knowledge of the taxpayer's overall position in terms of assets and liabilities. Thus, in principle, the denial of tax benefit to non-resident

is not discriminatory. However the ECJ held that there was discrimination on the facts of that case since the major income of the taxpayer arose in Germany where he was a non-resident.¹

This approach was applied to a difference in taxation between resident companies and branches in *Futura and Singer* [1997] ECR I-2471. The ECJ accepted that a difference in the carrying forward of losses between resident and non-resident companies (in the form of their local branches) in Luxembourg was not unlawful because their situations were not comparable. Branches of non-resident companies could make use only of local losses unlike resident companies who could carry forward all losses. Resident companies were, in principle, subject to worldwide taxation unlike non-resident companies who were subject to tax only on their local income. Thus Luxembourg was entitled, consistently with the principle of territoriality, to take account of only of local profits and losses of the branch. However, as subsequent case law has illustrated, the application of the territoriality principle, as applied *Futura and Singer*, is limited.

For the principle of territoriality/comparability does not mean that any distinction based on residence of a company is *prima facie* not a restriction. In *ICI v. Colmer* [1998] ECR I-4695 consortium relief was only available to a holding company where the majority of its subsidiaries were resident in the UK. The ECJ held that the difference in the tax treatment by reference to the residence of its subsidiaries entailed a restriction on right of establishment of the holding company through subsidiaries in other Member States. The UK failed in its attempt to justify the difference in treatment on the basis that resident and non-resident companies were in a different situation. It argued that companies could channel profits to non-resident subsidiaries and channel losses to resident subsidiaries. Hence there was a risk of tax avoidance as well as a loss of revenue arising from the existence of foreign subsidiaries. Both those defences failed. The legislation was not a tax avoidance measure and the establishment of non-resident subsidiaries did not entail tax avoidance as such companies were subject to tax in their State of establishment. Loss of revenue was not a permissible justification for a restriction.

In *Metallgesellschaft* [2001] ECR I-1727 there was a challenge to UK legislation which permitted group income election allowing distributions paid by a subsidiary to a parent not to be subject to advance corporation tax only where both the subsidiary and parent were UK resident. The ECJ rejected an argument that the position of resident subsidiaries of resident and non-resident parents was not similar owing to the different resident status of their parents. The ECJ did so because the resident subsidiaries were equally liable to mainstream corporation tax in the UK, and the fact that non-resident companies were not subject to advance corporation tax when they paid dividends was attributable to the fact that they were not liable to corporation tax in the UK because they were resident elsewhere. In other words, one could not rely on the difference in residence of the parents to justify the difference in treatment of the subsidiaries.

(2) Dislocation effect

Here the obstacle arises not from a difference of treatment but from a cumulation of similar rules in different Member States. Thus in *Futura and Singer* there was an obligation to keep branch accounts if the branch wished to carry forward losses. The effect of this was that a company had to keep two sets of accounts in two different places. This impacted more harshly a company seeking to establish itself in another Member State and so was a restriction.

¹ See also Case C-169/03 *Wallentin*, judgment of 1 July 2004; the Opinion of the A.G. in Case C-152/03 *Ritter-Coulais* (1 March 2005) where he held that a rule which precluded non-residents taking into account rental losses on foreign properties (unlike in the case of residents) was discriminatory in a case where the non-resident obtained most of his income in the State in which he was not resident.; and the Opinion of the A.G. in Case C-376/03 *D* (26 October 2004) where he held that a difference in allowances for wealth tax for residents and non-residents was discriminatory since the application of that rule did not reflect the ability of the individual taxpayer (who was subject to no wealth tax in his State of residence) to pay the tax.

(3) Neutral rule

This is a rule which prohibits certain form of activities but is not discriminatory nor does it bear particularly hard on a foreign establishment. In *Professional Contractors (2001)* the Court of Appeal, basing itself on ECJ case-law, held that such a rule (in that case IR 35) did not constitute a restriction since it did not have a direct and indisputable effect on the exercise of the right of establishment.

JUSTIFICATION

This is in practice the key battleground in the tax cases. The ECJ has ruled that the justification arguments put forward by the Member States do not fall within the Treaty justifications², and has instead considered the applicability of the so-called judge-made justifications deriving from the *Cassis de Dijon* case law, namely imperative requirements in the general interest. It would appear that it is only restrictions that are discriminatory on grounds of nationality which cannot benefit from the imperative requirements justification.³

The main justifications that have been advanced are: the principles of territoriality/comparability, cohesion of the tax system, measures to prevent tax avoidance, evasion, fiscal supervision (in the sense of keeping accounts), and loss of tax revenue. As can be seen from cases such as *ICI*, the principle of territoriality and the issue of comparability often come in at the justification stage rather than the restriction stage.⁴ The ECJ has accepted all of the above justifications as potential justifications save loss of tax revenue, see e.g. *ICI* and *Metallgesellschaft*. Any justification also needs to satisfy the proportionality test. The most important justification is cohesion.

Cohesion of the tax system

The concept of "the cohesion of the tax system" as a justification was first introduced in *Bachmann* (1992). There the ECJ upheld a Belgian rule which prevented a taxpayer obtaining a tax deduction for an insurance contribution when payment was made to a non-Belgian insurer. The justification for this rule was that the contribution paid by the taxpayer was in effect later subject to tax in the hands of the same taxpayer when payable out by the insurance company to that taxpayer as a pension or annuity. This system avoided double taxation of the taxpayer and there was a direct link between the tax deduction and the later tax charge. In effect the charge to tax was postponed. The link between the tax advantage and charge to tax meant that the rule had "cohesion". The cohesion of the tax system was an objective approved by Community law and so could justify a restriction in the tax field. On the facts the ECJ found that there was no less restrictive method of maintaining the cohesion of the tax system.

Not surprisingly since *Bachmann* Member States have frequently invoked the cohesion of the tax system as a justification for a restriction. Perhaps equally unsurprisingly the ECJ has been anxious to limit the scope of the cohesion defence. In her Opinion in *Manninen* the A.G. summarised the position as it stood in March 2004:

"53. In the wake of the Bachmann judgment, the cohesion of the tax system has been cited repeatedly as justification for restrictions on various fundamental freedoms. In an attempt to take account of the exceptional nature of this justification, the Court narrowly limited the concept of tax cohesion in subsequent judgments. In consistent case-law it has required that there be a direct link between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy, both of which relate to the same tax. (31)

² Save in the case of the free movement of capital where Art. 58 has been applicable.

³ See paragraph 39-42 of the A.G.'s Opinion in *Bosal*.

⁴ See also *Bosal* and *Marks & Spencer* where the ECJ and A.G respectively dealt with this issue under the justification heading (see below).

54. In the *Bosal* judgment the Court then continues: 'Where there is no such direct link, because, for example, one is dealing with different taxes or the tax treatment of different taxpayers, the argument based on the coherence of the tax system cannot be relied upon'. (32)

55. It is unclear whether the criteria 'one and the same taxpayer' and 'the same tax' are binding and must both be met, or whether they are only indicators – albeit strong ones – of the existence of a direct link between a tax advantage and disadvantage."

Nevertheless (as will be seen) in *Bosal* the ECJ went on to consider broader issues than just the absence of a direct link as it did subsequently in *Manninen*. While the cohesion argument failed in both those cases, it has been partially successful in the recent Opinion of the A.G. in *Marks & Spencer* despite the absence of any direct link involving the same taxpayer and the same tax.

THE APPLICATION OF THOSE PRINCIPLES IN RECENT CASES

C-324/00 Lankhorst-Hohorst (December 2002)

This involved a challenge to a German rule which treated the repayment of loan capital by a subsidiary to a parent as a distribution of profits where the parent was not entitled to a tax credit. As a general rule resident parents received the tax credit while non-residents did not. The rule was intended as anti-avoidance measure to prevent the distribution of profits by subsidiaries to non-resident parents via interest payments rather than dividends. It is more tax advantageous to finance subsidiaries by loans rather than capital (thin capitalisation) since in the case of a loan, the profits of the subsidiary are transferred to the parent which are deductible in calculating the subsidiary's profits while a dividend is not so deductible. In absence of rules against thin capitalisation, profits can in effect be transferred from one State to another without the payment of tax. Where all the companies are resident in the same State the tax deductible interest of one company will at least be subject to tax by the State in hands of another resident company.

In the light of *Metallgesellschaft* the ECJ had no difficulty in holding that the German rule was a restriction since there was a difference in treatment between resident subsidiary companies depending on the residence of their parent.

The ECJ then went on to reject all the justification defences. The difficulty in defending the measure on grounds of tax avoidance was two-fold. First, the tax avoidance in question manifested itself in the loss of revenue to other States. The ECJ reiterated its previous case law that a reduction in tax revenue was not a permissible justification.

Further, since the German rule did not apply to all inter-company loans but only to loans where the parent was situated outside Germany, it could not be justified on grounds of combating tax avoidance. The ECJ gave short shrift to the argument based on the OECD Model Convention which provides for inclusion as profits transactions between linked companies which do not correspond to market conditions. The effect of the ECJ's ruling would appear to rule out combating tax avoidance as a justification for any discriminatory measure. Since most restrictions are in practice discriminatory the practical effect of the tax avoidance justification would appear to be limited. However the ECJ appeared to leave the door open to measures to combat "wholly artificial arrangements". It is unclear whether such measures must be non-discriminatory but it is suggested, in the light of *De Lasteyrie du Saillant* that this is not necessary.

The cohesion argument was rejected on the basis that the German subsidiary of a non-German parent suffered less favourable tax treatment and there was no offsetting tax advantage to that subsidiary (unlike in *Bachmann* where the tax advantage for the taxpayer at the payment stage was offset by the tax paid by the same taxpayer when the pension was received).

C-168/01 Bosal Holding (September 2003)

Dutch law prevented a Dutch holding company setting off against its profits the costs relating to a holding unless those costs were indirectly instrumental in making profits that were taxable in the Netherlands. Bosal, a Dutch holding company, sought to deduct the financing costs of its holdings in companies established elsewhere in the EU. The right to make such a deduction was not mandated by Directive 90/435, the parent/subsidiary Directive. The ECJ had little difficulty in finding that this law was a restriction on establishment since the law might dissuade a parent company from carrying on its activities through a foreign subsidiary as such a subsidiary does not generate profits that are taxable in the Netherlands.

The Netherlands sought to justify its law by looking at the position at the group level, namely Dutch parent and non-Dutch subsidiary. The ECJ rejected this and focused instead on the position of the parent and subsidiary separately. On coherence the ECJ observed:

“As regards the argument concerning the need to preserve the coherence of the tax system, the Court of Justice pointed out in its judgment in Case G-35/98 Verkooijen [2000] ECR I-4071, paragraph 57, that, in Bachmann and Commission v Belgium, a direct link existed, in the case of one and the same taxpayer, between the grant of a tax advantage and the offsetting of that advantage by a fiscal levy, both of which related to the same tax.

Where there is no such direct link, because, for example, one is dealing with different taxes or the tax treatment of different taxpayers, the argument based on the coherence of the tax system cannot be relied upon (see, to that effect, Case C-251/98 Baars [2000] ECR I-2787, paragraph 40).

In the main proceedings in this case, there is no direct link of that kind. Nor is there any direct link between, on the one hand, the granting of a tax advantage (the right to deduct costs connected with holdings in the capital of their subsidiaries from their taxable profit) to parent companies established in the Netherlands and, on the other, the tax system relating to the subsidiaries of parent companies where the latter are established in that Member State.

Unlike operating branches or establishments, parent companies and their subsidiaries are distinct legal persons, each being subject to a tax liability of its own, so that a direct link in the context of the same liability to tax is lacking and the coherence of the tax system cannot be relied upon.

Moreover, the limitation of the deductibility of costs incurred by a parent company established in the Netherlands in connection with its holdings in the capital of subsidiaries established in other Member States is not compensated for by a corresponding advantage. The effect of implementing that limitation appears to be that costs which should normally be deductible are not taken into consideration when calculating the amount of the tax liability.

Such overtaxation cannot be justified by reference to the need to preserve the coherence of the tax system.

Nor is there any direct link between the costs which a parent company may deduct from its taxable profit in the Netherlands and the potential taxable profits of its subsidiary established in that Member State or of the stable Netherlands establishment of its foreign subsidiary. In that respect, the order for reference shows that the costs incurred in relation to holdings may be deducted from the profits of such a parent company without any account being taken of the size of the profits of the subsidiary, even if the latter did not make any profit during the year concerned.

Moreover, as the referring court and the Commission have pointed out, one is entitled to question the coherence of a system of taxation based on the existence of a link between costs incurred in relation to holdings and the existence of profits taxable in the Netherlands within the same group of companies, while subsidiaries of parent companies established in other Member States cannot deduct from their profits taxable in the Netherlands the costs in relation to holdings of those parent companies.” (paragraphs 29-36)

The ECJ also rejected the justification based on the principle of territoriality. It again distinguished between the position of a parent and subsidiary:

“According to the government, the costs in connection with activities abroad, including financing costs and costs in relation to holdings, should be set off against the profits generated by those activities and the deduction of those costs is linked solely to the making or non-making of profits outside the Netherlands. According to the Netherlands Government, there is therefore no discrimination, the subsidiaries which do make profits taxable in the Netherlands and those which do not being in a situation which is not comparable.

In that respect, it should be noted that the application of the territoriality principle in Futura Participations and Singer concerned the taxation of a single company which carried on business in the Member State where it had its principal establishment and in other Member States from secondary establishments.

Having regard to the facts of the main dispute, and as the Advocate General has stated in points 50 and 51 of his Opinion, the argument that the differentiated tax treatment of parent companies is justified by the fact that subsidiaries which make profits taxable in the Netherlands and those which do not are not in comparable situations is irrelevant. The difference in tax treatment in question concerns parent companies according to whether or not they have subsidiaries making profits taxable in the Netherlands, even though those parent companies are all established in that Member State. As regards the tax situation of the latter in relation to the profits of their subsidiaries, however, it must be noted that those profits are not taxable in the hands of those companies, whether the profits come from subsidiaries taxable in the Netherlands or from other subsidiaries.

Moreover, in a case concerning the tax treatment of a subsidiary which varied in relation to the seat of the parent company, the Court has held that the difference in the tax treatment of parent companies depending on whether or not they are resident cannot justify denial of a tax advantage to subsidiaries, resident in the United Kingdom, of parent companies having their seat in another Member State where that advantage is available to subsidiaries, resident in the United Kingdom, of parent companies also resident in the United Kingdom, since all those subsidiaries are liable to mainstream corporation tax on their profits irrespective of the place of residence of their parent companies (Joined Cases C-397/98 and C-410/98 Metallgesellschaft and Others [2001] ECR I-1727, paragraph 60).” (paragraphs 37-40)

So the different treatment of a parent company could not be justified by the different situation of its subsidiaries.

C-9/02 De Lasteyrie du Saillant (March 2004)

This case involved a challenge to a French law which required a person moving his residence to pay capital gains tax (CGT) on unrealised gains on shares. The aim of the law was to catch persons who transferred their residence temporarily outside France in order to realise gains on shares without paying CGT. Again the ECJ had little difficulty in finding that the law constituted a restriction on the freedom of establishment since, although it did not prevent the moving of an establishment, it created a disadvantage for such a taxpayer compared to a taxpayer remaining in France who was only taxed on realised gains. Hence it was liable to hinder the freedom of establishment.

The ECJ rejected the justification arguments advanced on grounds on combating tax avoidance, loss of tax revenue, and cohesion.

On tax avoidance the ECJ held that the transfer of a person's residence does not, of itself imply tax avoidance. The French measure was disproportionate since the aim of subjecting persons who transferred their residence temporarily outside France to CGT could be met by taxing such persons when they returned to France which would avoid affecting those persons who were *bona fide* exercising their freedom of establishment in another Member State. The approach here suggests

that a targeted proportionate measure designed to counter tax avoidance can apply solely to cross-border situations where those situations are themselves abusive or artificial. The problem in *Lankhorst-Hohorst* was that the measure applied to all loan payments made to all companies established in other Member States (whether abusively or not). The cohesion argument (advanced by the Netherlands) was that there was a direct link between postponement of the annual tax on the growth of capital and the collection of the tax when the taxpayer moved abroad. This was rejected. First, the avowed aim of the measure was different, namely to catch those who temporarily transferred their residence abroad in order to avoid CGT on the sale of the shares and, secondly, France exonerated from French tax all tax paid in the State to which the taxpayer had transferred his residence. This could have as its consequence that all gains, including those occurring while the taxpayer was resident in France, were taxed abroad.

C-319/02 Manninen (September 2004)

Under Finnish law, taxpayers resident in Finland received a tax credit on a dividend only when distributed by Finnish companies. The purpose of the tax credit was to prevent double taxation of profits distributed as dividends by setting off corporation tax paid by the company on distribution against the shareholder's income tax on the dividend. The ECJ held that constituted a restriction on the free movement of capital contrary to Article 56. It involved discrimination against taxpayers who received dividends from non-Finnish companies (in this case Swedish), a deterrent on investment of capital in non-Finnish companies, and an obstacle to such companies raising capital in Finland.

On justification the ECJ interpreted the justifications provisions in Article 58(1) (a) and (3) of the EC Treaty so as to accord with its case law on the freedom of establishment, namely that for a difference in treatment to be lawful, it must concern situations that are not objectively comparable or justified by overriding reasons in the general interest, such as fiscal coherence. The ECJ rejected the comparability argument that there was no similar situation; the basis of that argument being that profits distributed by Swedish companies in the form of dividends, unlike profits distributed by Finnish companies in the form of dividends, were not subject to Finnish corporation tax. The ECJ approached this argument by considering the purpose of the Finnish legislation. Its purpose was to avoid double taxation of company profits distributed in the form of dividends in the hands of Finnish taxpayer. Such a person who held shares in a Finnish company was in a similar situation to a person who held shares in a non-Finnish company except where the risk of such double taxation had been eliminated in State where the non-Finnish company was resident (by, for example, taxing only non-distributed profits) That exception did not apply since Sweden taxed profits distributed as dividends. So the two situations were comparable.

The justification argument on territoriality and cohesion also failed. On territoriality the ECJ held that the principle of territoriality did not preclude the offsetting of corporation tax paid abroad in the case of a resident taxpayer who was liable to tax on his worldwide income. On cohesion the ECJ followed the lead of the A.G. and adopted an approach that went beyond the need to show a direct link in relation to the same taxpayer and same tax. The ECJ was prepared to assume that there was such a direct link between the tax advantage for the shareholder and the offsetting levy for the company, even though that link involved different taxes (corporation and income tax) and different taxpayers (company and shareholder). However it rejected the cohesion argument since the purpose of the legislation, namely the prevention of double taxation, would not be undermined by permitting the same treatment of non-Finnish dividends. It also rejected the arguments on practical difficulties in ascertaining the tax paid in another Member State saying that the tax credit must take account of the tax actually paid by the company established in the other Member State. While there would be a loss of tax revenue, that could not be justified. As the A.G. pointed out, it is debatable how far cohesion can be relied as a justification where the tax system treats domestic and cross-border situations differently. However the A.G.'s Opinion in *Marks & Spencer* suggests that this is too narrow a reading of the cohesion principle.

C-446/03 Marks & Spencer (A.G. April 2005)

In the UK group relief is only available where company UK resident or non-resident carrying on trade in UK through branch or agency. M&S sought to set off tax losses in its continental subsidiaries against the profits of the UK company.

The A.G. had little trouble in finding a restriction. He pointed out that the tax advantage of group relief rules is denied to a group whose principal establishment is in the UK and which sets up subsidiaries elsewhere in the EU. That was an obstacle to setting up establishments in the form of subsidiaries elsewhere.

He rejected the UK argument on territoriality that a non-resident subsidiary should not be entitled to a tax advantage where there is no power to tax that subsidiary. He stated that the territoriality principle is intended to prevent conflicts of jurisdiction between States but the case here concerned a claim by a UK parent over whom UK had worldwide jurisdiction.

On the issue of cohesion, the A.G. accepted that if one needed to find a direct link between tax advantage and offsetting of that advantage by charge to tax at the level of the same tax and same taxpayer, M&S would win (as indeed Bosal did). However, he preferred to follow the broader approach to cohesion first advanced by the A.G. in *Manninen* that one should examine the cohesion argument in the light of the aim and logic of the tax regime rather than by reference to the existence of a direct link in respect of the same tax and taxpayer. The purpose of group relief is to ensure fiscal neutrality between companies which have subsidiaries and those that do not. Group relief enables group losses to circulate between companies but the losses that are transferred by surrendering company to the benefit of the claimant company cannot be otherwise used by the surrendering company. Where losses of a subsidiary were capable of being transferred or carried forward in the State of establishment of the subsidiary, the transfer of foreign losses to the UK would risk jeopardising the aim of the group relief. In that situation, the prohibition of the transfer of foreign losses was justified. However a Member State could not prohibit such transfer merely on the ground that it is impossible to tax foreign subsidiaries since that would go beyond the objective of group relief (and indeed would jeopardise its objective) and would be based on a desire to protect the revenue which is not permissible. Thus in order to justify its group relief, the UK has to consider whether there is an equivalent benefit in the Member State(s) of establishment, such as a transfer or carrying forward of such losses. The Netherlands objected that companies could engage in the "trafficking in losses" whereby losses would be transferred to States where there are higher rates of taxation which would threaten the budgetary equilibrium of such States. The A.G. responded to this concern by stating that the transfer of losses from a non-resident subsidiary to a resident parent could only be permitted where the non-resident subsidiary could not receive (as opposed to failing to take advantage of) equivalent tax treatment in its State of establishment. The A.G. pointed out that the freedom of establishment in general requires those taking advantage of the freedom to be subject to host rules.

The Member States are clearly concerned about the direction of this developing case law. They have responded to the AG's Opinion by setting up a "high-level committee of tax experts".

CONCLUSIONS

While the ECJ still accepts that, in principle, the position of residents and non-residents is not comparable, the application of that doctrine to companies is very limited. In particular the ECJ has ruled out looking at the company at a group level which means that companies are in a comparable position if they are both resident despite the fact that they may have non-resident parents or subsidiaries. On the issue of justification, while it is clear that loss of revenue is in general not a justification, the position appears to be qualified where the cross-border element is itself artificial or abusive. On coherence, there has been a move away from the rather formalistic approach of the need to show a direct link at the level of the same tax and taxpayer to a broader consideration of

the purpose of the tax rule in question⁵ as seen in *Manninen* and the A.G.'s Opinion in *Marks & Spencer*. If the restriction is consistent with the (lawful) purpose of the tax rule, that is capable of constituting justification on grounds of coherence. In looking at the purpose, one has to examine this in a Community context and hence loss of revenue at the national level is not a relevant consideration. If the ECJ follows the A.G. in *Marks & Spencer*, coherence can be relied on even where the national tax system applies different rule to domestic and cross-border transactions.

The A.G.'s Opinion has been criticised as being over-complex but the reality is that, in the absence of Community legislation, any balanced solution is likely to be complex. The A.G.'s solution, if followed by the ECJ, does indeed throw up further problems. How does one calculate an equivalent tax benefit? For example, if there is only a carry forward of losses in the State where the subsidiary is established does that constitute equivalent treatment to group relief? The subsidiary might never become profitable and the timing of tax benefit may differ from the timing where losses can be transferred. That could be objectionable, see *Metallgesellschaft*. What if the loss-making subsidiary is dissolved before it becomes profitable and its business transferred to a new subsidiary that has never transferred losses? Should that preclude the cross-border transfer of losses? What happens to losses in a number of jurisdictions? Does the parent have the right to choose the Member State to which to transfer the losses? If such losses are capable of being transferred between States where there are subsidiaries, can the State where the parent is resident block the transfer of losses or can the State where another subsidiary is based block the transfer of losses to it? All this points, in the continued absence of Community legislation, to more complex *national* legislation which will involve added burdens on business.

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⁵ Cf the Opinion in *Ritter-Coulais* (an Article 39 case) where the AG rejected a cohesion justification merely on the absence of a direct link. The ECJ has yet to give judgment.