

# Marks and Spencer

## Limiting Shopping in Tax Losses

On 13 December 2005 the ECJ delivered its eagerly awaited judgment in Case C-446/03 *Marks and Spencer plc v Halsey* on the extent to which a Member State may, compatibly with Community law, restrict the applicability of group relief to losses sustained by subsidiaries that are resident or trading within that State. The importance of the case to national governments is apparent from the fact that so many chose to intervene in support of the United Kingdom, seven of them participating in the oral hearing. The ECJ's judgment may well allow Marks and Spencer (M&S) to succeed on at least part of its claim in the national proceedings giving to the issue. On balance, however, the Member States may justifiably regard the judgment with relief: although national group relief systems are likely to require some modest amendment, there is no need for the root-and-branch reform anticipated by some commentators and the financial consequences of the ECJ's ruling are correspondingly limited.

### The national proceedings

M&S established subsidiaries in France, Germany and Belgium during the course of the 1970s and 1980s. By the mid-1990s, however, those subsidiaries were incurring significant losses and in March 2001 M&S announced its intention to divest itself of its activities in Continental Europe. By the end of that year the French subsidiary was sold to third parties, while the Belgian and German subsidiaries ceased trading. M&S then sought to claim group tax relief in the UK in respect of losses amounting to some £100 million incurred by its foreign subsidiaries between 1998 and 2001. Its claims for relief were rejected by the Inland Revenue on the basis that under UK law group relief may only be granted for losses recorded in the UK. M&S appealed unsuccessfully to the Special Commissioners and thence to the High

*Christopher Vajda QC and Josh Holmes, Monckton Chambers, explain how the European Court has succeeded in giving Christmas presents both to the Member States and Marks and Spencer*

Court, which decided to stay proceedings and to refer various questions to the ECJ concerning the compatibility of the limitations imposed upon group relief under domestic law with the principle of freedom of establishment guaranteed under Article 43 of the EC Treaty.

### The ECJ's decision

M&S argued before the ECJ that the UK's group loss relief rules infringed Article 43 on two independent grounds. The first infringement was said to arise because those rules operate differently as between overseas *subsidiaries* and overseas

The UK denied any infringement of Community law but argued in any event that its arrangements were capable of justification. Under EC law a national measure that infringes the 'fundamental freedoms' enshrined in the Treaty (of which freedom of establishment is one) may nonetheless escape censure if it can be shown to pursue a legitimate policy objective in a proportionate manner.

The ECJ made no reference to the first infringement alleged by M&S, which had been rejected by both the Special Commissioners and the Advocate-General. However, it agreed with M&S as

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*permanent establishments or branches*, thereby discriminating between different forms of establishment. Whereas losses sustained by the latter, whether located within or outside the UK, may generally be set against UK profits of the same company, the same facility is not afforded in respect of the former. Secondly, the UK's group loss relief rules were alleged to infringe Article 43 by conferring an advantage upon UK subsidiaries to the exclusion of EU subsidiaries, thereby rendering it less attractive for a group of companies to exercise its right of freedom of establishment in another Member State.

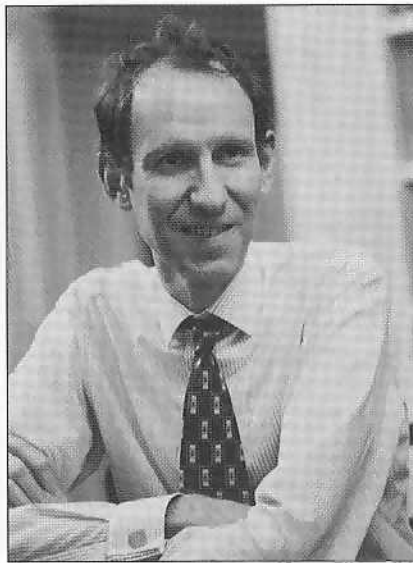
to the second infringement. Group relief constitutes a tax advantage. To deny that advantage where losses are incurred by subsidiaries established in other Member States clearly hinders the exercise of establishment.<sup>1</sup>

On the issue of justification, the Court accepted the applicability in principle of three factors advanced by the UK and other Member States in order to justify such a restriction. Cross-border loss relief might 'jeopardise a balanced allocation of the power to impose taxes between the Member States'; would give rise to the risk of 'double-dipping' (obtaining relief

in respect of the same loss in more than one State); and would facilitate 'loss-trafficking' (the transfer of losses within a group to 'the companies established in the Member States which apply the highest rates of taxation and in which the tax value of the losses is therefore the highest').<sup>2</sup>

The Court did not, however, consider that such justifications were sufficient to support an absolute refusal by a Member State to allow group relief in respect of losses incurred by subsidiaries established in another Member State. In that regard, it accepted the arguments advanced by the Commission and M&S that there were less restrictive alternative rules sufficient to meet the legitimate concerns identified. Specifically, a restriction would be disproportionate unless it allowed cross-border group relief where two cumulative conditions were met: first, 'the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods'; and, second, 'there is no possibility for the foreign subsidiary's losses to be taken into account in its State of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party'.<sup>3</sup>

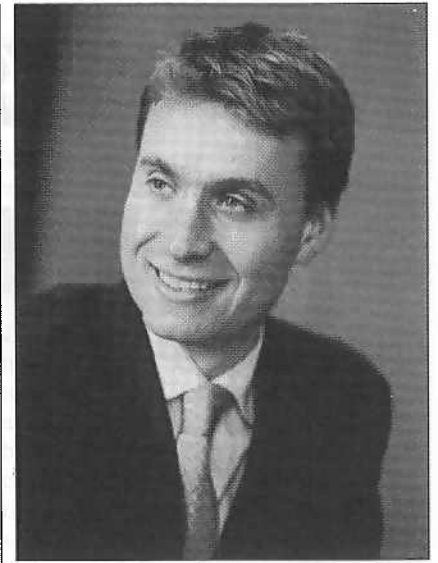
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Christopher Vajda QC

surprise in the ECJ holding that the unavailability of group relief in respect of the trading losses incurred by subsidiaries established in other Member States was a restriction within the meaning of Article 43, since there was a difference of treatment between losses incurred by resident and non-resident subsidiaries.

In recognising the concerns of Member States in the reduction of their tax base as a result of groups of companies taking advantage of the free movement provisions to set off losses incurred by a company in one Member State against profits made by another



Josh Holmes

a balanced allocation in the power to impose taxes between the Member States, this is a much broader justification than the old concept of the coherence of the tax system, which had emerged in Case C-204/90 *Bachmann* [1992] ECR I-249. For a difference in tax treatment to be justified under the coherence line of cases, there was a need to show a direct link between the grant of the tax advantage and the offsetting of that advantage in respect of the same taxpayer and the same tax. As the Advocate-General pointed out, the cohesion argument was a non-runner in the present case, since the case concerned different taxpayers (different M&S companies) and different tax schemes (UK and non-UK corporation tax). Indeed it was precisely because the cohesion argument failed in *Bosal* that the ECJ rejected the Dutch Government's argument that the inability of a Dutch holding company to set off against its profits the costs of holdings in other Member States that did not contribute to profits in The Netherlands was justified. Thus, had the ECJ applied its reasoning in *Bosal*, it would not have accepted the much broader justifications put forward by the Member States in *Marks & Spencer*.

The upshot is that a much wider justification argument is open to Member States than was ever possible under the so-called coherence test. It may well be that *Marks & Spencer* finally lays to rest the coherence argument which, as a number of Advocates-General have pointed out,<sup>5</sup> has been over-technical and not easy to apply.

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authorities in its State of residence that those conditions were fulfilled. It also reiterated the *caveat* deriving from its previous case law that Member States may adopt or maintain rules intended to preclude from a tax benefit 'wholly artificial arrangements whose purpose is to circumvent or escape national tax law'.<sup>4</sup>

#### Comment

The most interesting aspect of the judgment is what the ECJ said on the question of justification, and in particular its acceptance of the argument that Member States should be entitled to protect their tax base. There was no

company elsewhere in the EU, the ECJ adopted an approach that is in stark contrast to its approach in its earlier judgments in Case C-324/00 *Lankhorst-Hohorst* [2002] ECR I-11779 and Case C-168/01 *Bosal* [2003] ECR I-9409. The Court was plainly influenced by the fact that there are now 25 Member States with greatly varying rates of corporate taxation, particularly with, in general, lower rates in the new Member States. At the time *Lankhorst-Hohorst* and *Bosal* were decided, the accession of the 10 new Member States had not yet taken place.

Taking the first justification accepted by the Court, namely the need to protect

Although the ECJ rolled out the old formula that a reduction in tax revenue cannot constitute a justification for a restrictive tax measure, it then proceeded to accept the Member States' arguments that in deciding whether a measure is justified one cannot ignore the potential loss of tax revenue. Two points are worthy of note.

First, the Court accepted the new concept of 'a *balanced* allocation of the power to impose taxes between the different Member States' (emphasis added). A balanced allocation implies that a Member State should not lose its tax base and is entitled to take measures to protect it. The Court was concerned to ensure that giving a corporate group an unrestricted option to choose the Member State where it could take account of its losses would upset such a balanced allocation. Second, the Court in effect redefined the concept of tax avoidance – which was the third justification accepted by the Court. It defined tax avoidance as involving the risk of a group of companies transferring losses to companies established in the Member State which applied the highest rate of taxation and where therefore the tax value of the losses was the highest. There is no suggestion that such transfer needs to be artificial for it to constitute tax avoidance. The contrast with the Court's approach in *Lankhorst-Hohorst* and *Bosal* is striking. In *Lankhorst-Hohorst* it rejected the Member States' arguments that the German thin capitalisation rules were justified as measures to prevent tax losses and tax evasion arising from the transfer of a tax debt from one country. It did so because the German legislation in issue did not have the *specific* purpose of preventing wholly artificial arrangements. But neither did the UK rules on group relief. In *Bosal* it dismissed the Dutch government's argument on the need to take measures to prevent the erosion of its tax base.

Having established that the protection of the tax base is a legitimate objective, the Court then employed the familiar concept of proportionality to create a result that seeks to achieve a balance between the legitimate objectives of Member States in protecting their tax base and fairness to companies which, under the Court's new approach, would not be able to set losses of a subsidiary resident in one Member State against profits of a parent in another Member State. The application of the proportionality test permits such set-offs

where the non-resident subsidiary has definitively exhausted the possibility of using its losses, not just for present and past accounting periods but also for future accounting periods. Even here, the Court's approach is favourable to the Member States. First, the burden is on the resident parent company to prove to its own tax authorities that it has exhausted all such possibilities of local set-off. Unless it is able to discharge that burden, its claim will fail. Second, the Court expressly recognised the right of Member States to adopt or maintain in force rules having the specific purpose of precluding from a tax benefit wholly artificial arrangements, the purpose of which is to circumvent or escape national tax. Since one of the ways in which tax losses can be definitively exhausted by a non-resident subsidiary is by transfer of those losses to a third party, this means that such a transfer of losses may be the subject of investigation to see that it is not artificial. The application of the proportionality test means that in practice the UK rules on group relief are likely to survive in cases where an overseas subsidiary is carrying on an ongoing business (since it will be difficult to establish definitively that its losses cannot be used locally) but may not survive where the overseas operations have terminated as a result of locally incurred losses. Applying this to the *Marks & Spencer* facts, it would appear that M&S may be able to benefit

would have done in the UK. One of the questions raised in that reference is whether the CFC legislation can be justified on grounds of tax avoidance, namely to prevent the reduction or diversion of profits liable to UK tax. Given the ECJ's acceptance in *Marks & Spencer* of a Member State's right to protect its tax base, the omens for HMRC look favourable. *Cadbury Schweppes* is, however, a case where none of the exceptions to a charge to tax under the CFC legislation applied but the more recent reference in *Vodafone 27* raises the question of its compatibility with Community law in a case where the company alleges that the main reason for setting up the overseas subsidiary was not to achieve a reduction in UK tax by a diversion of profits from the UK.

Whatever is decided in those cases, there is no doubt that *Marks & Spencer* has changed the terms of the debate. In that sense we are in a better position than the late Chinese Prime Minister Chou En Lai who, when asked in the 1950s about the consequences of the French revolution, said it was too soon to tell.

#### Notes

<sup>1</sup> See paragraphs 32 to 34 of the judgment.

<sup>2</sup> See paragraphs 43 to 51 of the judgment.

<sup>3</sup> See paragraphs 53 to 55 of the judgment.

<sup>4</sup> See paragraphs 56 and 57 of the judgment.

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from the proportionality 'harbour', since the overseas losses were incurred by companies that have either ceased trading or have been sold to a third party.

#### Implication for future cases

The change of direction signalled by the Court in *Marks & Spencer* is likely to affect a number of pending tax cases. One of the first to come up for decision will be *Cadbury Schweppes*,<sup>6</sup> where the ECJ has to rule on the compatibility of the controlled foreign company legislation (the CFC legislation), which permits the UK tax authorities to tax the profits of a subsidiary in another State if those profits have borne a lower rate of tax than they

<sup>5</sup> See, for example, A-G Kokott at para. 51 *et seq* of her Opinion in Case C-319/02 *Manninen* and A-G Maduro at para. 65 *et seq* of his Opinion in *Marks & Spencer*

<sup>6</sup> Case C-196/04.

<sup>7</sup> Case C-203/05.

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