

An Ever Distant Union: The Cross-Border Loss Relief Conundrum in EU Law

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Cross-border loss relief may well be the last milestone, barring total tax consolidation, in the European Union (EU) market integration from a tax law perspective. As the Commission's Communication on the Tax Treatment of Losses in Cross-Border Situations demonstrates, there is yet a lot of ground to be covered in harmonizing this aspect of corporate income taxes (CITs). While the Common Consolidated Corporate Tax Base (CCCTB) proposal seems to be stalled, a series of relatively recent European Court of Justice (ECJ) cases (among others, X Holding BV) may be tilting the balance in the interest of Member States, for the first time allowing the safeguard of revenues, or the 'balanced allocation of taxing powers' to be the deciding argument in allowing restrictions on the offsetting of losses. Losses cannot be analysed in isolation of the rules to determine the taxable base, as they are one more piece in the tax base puzzle. In this article, I focus on two issues: multinational groups and permanent establishments (PEs), as they comprise the main problems arising in cross-border loss relief. The different methods employed to grant loss relief are assessed, as well as the new Organisation for Economic Co-operation and Development (OECD) proposals on the taxation of PEs. My main argument is that restrictions of loss relief have an effect that go beyond discriminating or restricting – that is, beyond making it 'less attractive' to move around the EU. Such restrictions touch the core of taxation of income. If no loss relief is provided, the tax is not reflecting the real ability to pay, thus not only is it not being neutral and inefficient, it is also creating a fictional tax debt.

I. INTRODUCTION

Cross-border loss relief is one of the most significant burdens hindering European Union (EU) market integration in direct taxation.¹ The type of problems that the lack of cross-border loss relief in many transnational (EU-wide) operations brings about exemplifies the tensions that an imperfect economic integration model of the EU has on the definition of the tax base of income taxes and, namely, the notions of allocation of taxing powers and territoriality of taxes.

This was the situation that encouraged the proposal of a Common Consolidated Corporate Tax Base (CCCTB), the objectives being to remove the current obstacles to companies that undertake EU-wide activities.² Among the main obstacles mentioned in the proposal are the compliance costs, transfer pricing requirements, non-consolidation of profits and losses, difficult restructuring operations as the

Merger Directive has a limited scope, the credit *versus* exemption method inconsistencies, and the many discriminatory situations that still arise.

The 2006 Commission's Communication on the *Tax Treatment of Losses in Cross-Border Situations* demonstrates that there is yet a lot of ground to be covered in harmonizing this aspect of (corporation and individual) income taxes.³ While the CCCTB proposal seems to be stalled, a series of relevant European Court of Justice (ECJ) cases (among others, *Marks & Spencer*, *Lidl Belgium*, *OyAA*, *Anurta*, *Krankenheim Rubesitz am Wannsee-Seniorenheimstatt GmbH*, *Mertens*, and, most recently, *X Holding BV*) may be tilting the balance in the interest of Member States, for the first time allowing the safeguard of revenues, or the 'balanced allocation of taxing powers' to be the sole or main deciding argument in allowing restrictions on the offsetting of losses.

In this article, I will focus on the transfer of losses in companies (multinational groups and permanent

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¹ Direct taxes are not really harmonized, this being one of the areas that has remained almost untouched in terms of legislative initiatives. See generally on the lack of direct tax harmonization M. Aujean, 'Tax Policy in the EU: Between Harmonisation and Coordination', *Transfer: European Review of Labour and Research* 16 (2010): 12 et seq.

² Commission, Towards an Internal Market without Tax Obstacles, COM (2001) 582 final. See also, more recently, Commission, Co-ordinating Member States' Direct Tax Systems in the Internal Market, COM (2006) 823 final. For a thorough summary of such obstacles, see Commission, Company Taxation in the Internal Market (SEC (2001) 1681, 23 Oct. 2001, part III, 223–305).

³ COM (2006) 824 final. Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee on Tax Treatment of Losses in Cross-Border Situations (19 Dec. 2006). See, in particular, the Technical Annexes.

establishments (PEs)), leaving out individuals, as the former comprise the main problems vis-à-vis the internal market. My main argument is that restrictions of loss relief have an effect that go beyond discriminating or restricting – that is, beyond making it ‘less attractive’ for businesses to move around the EU. Such restrictions touch the core of taxation of income. If no loss relief is provided, the tax will then not be reflecting the real ability to pay. This means that taxation of companies in a transnational setting will not be neutral and will also be inefficient, as it will be creating a fictional tax debt. A second argument that will be presented in the following pages is that the Court’s action is not only limited when facing the essential problems that cross-border loss relief systems pose, but it may also be inadvertently creating new problems as Member States adapt their tax legislation to comply with the ECJ case law in a way that is not always optimal vis-à-vis the notion of neutrality, thus dwarfing the very purpose of the Court.

The underlying problem is of course larger than just coordinating tax losses. As I will try to demonstrate in the following pages, the seemingly incoherence of loss relief systems in the EU and the different attempts to soften them, by the Commission, by the Court, and also by projects such as the CCCTB, are a good example of the difficulties in tax harmonization in the EU in a globalized environment.⁴ It may seem that the Court is growingly taking into account the revenue interests of the Member States, but this may only hold true if we take into account the *short-term* interest in revenue enhancing. For if we pause down and consider the mid- and long-term best interests of Member States, we may conclude that it could be worth renouncing to (immediate) tax revenues in the short run, in order to maintain tax revenues in the mid and long terms. For in the long run, without a sound and coherent system of CITs in the EU, the possibilities of competing and of maintaining tax revenues are slim.

2. LOSS RELIEF AS THE CORNERSTONE OF DETERMINING A BUSINESS ENTITY TAXABLE BASE

2.1. The Problem of Taxing Losses in Income Taxes

Income taxes bestow an asymmetric treatment to income and losses, so that while the first is taxed as it is earned, losses will only generate a tax credit and eventual refund when they can be offset against the future income

(in some cases, also past income, as is the case with loss carry-back systems). By definition, any carry-forward system entails a further hidden loss in that losses are of course carried with no interest, which eventually minimizes the tax benefit of interest deductions. Finally, any given system of offsetting of losses is complicated because of the artificial adaptation of income taxes to a given (annual) time frame. Adding the cross-border element substantially contributes to this fractioning: the loss must then not only be timely offset, but it must also fit into territorial boundaries. Time and space thus define and constraint the offsetting of losses in a myriad of different combinations. We will now offer what can only be a simplified account of such possibilities.

The system and the problems of taking into account losses are intimately linked with income taxes being periodical taxes. In the case of Wealth taxes, which accrue and are assessed on an instant basis, there will be several issues to be considered when deciding what items qualify as a loss and how this must be quantified. Those issues are also present in income taxes but are intertwined with a more fundamental time frame issue. The typical structure of a Personal or Corporate Income Tax (PIT or CIT) entails taxing the net revenue accrued on an annual basis. Should there be no revenue, but only losses, tax will not ensue, and there may be an option to offset the loss in the future (or against past benefits, in some cases).⁵

In the absence of a provision that allows a carry forward (or even backwards) of the possible losses, over-taxation will ensue. An agent accruing a net benefit of 1,000 on year n but who has been incurring annual losses of 500 in years $n - 1$ and $n - 2$ has not really earned 1,000, but 0. Because Governments do not share the economic risk of the taxpayers, all tax systems are naturally asymmetric when taxing income, in the sense that benefits are taxed but losses are not, which in our example means that the agent will not have obtained any tax back in the losing years, but will be subject to tax (if not actually *taxed*, as an obligation to pay will not ensue) on the winning year.

Losses are an essential part of defining the taxable base and are the consequence of periodical (annual) taxes; the taxation of income on a yearly basis is done for obvious economic reasons (to obtain tax revenues on a yearly basis), but it is artificial or exogenous to economic cycles of entities or persons. In addition, if applied too strictly, it ends up showing an incomplete picture of the entity.

This is why taking into account losses for tax purposes is not really a *tax benefit*, but rather the only way to tax an entity in accordance to its real ability to pay.⁶ In the end,

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⁴ See W. Schön, ‘International Tax Coordination for a Second-Best World (Part 1)’, *World Tax Journal*, IFA Congress Issue (September 2009): 67 et seq.

⁵ The issue of time and income taxes has long been the object of discussions and constitutes a fascinating debate; should income taxes be annual or economic cycle sensitive? Should they be taxing persons following an age curve? See more on this in L.A. Fenner & K.J. Stark, ‘Taxation over Time’, *Tax Law Review* 59 (2005–2006).

⁶ E. Sanz Gadea, ‘Compensacion de Bases Imponibles Negativas’, *Estudios Financieros* 192 (1999): 11.

defining a loss is part of defining the tax base, and as such relates to a more fundamental issue that is the definition of profit.⁷ For this reason, any system that allows for the offsetting of losses is not establishing a *tax advantage*, as the ECJ has wrongly suggested in some occasions (*Marks & Spencer*, paragraph 38, *Lidl Belgium*, paragraph 23), but taxing income on a periodical basis in accordance, or rather following as closely as possible, the entity's real ability to pay or income.

This has exceptions, as some loss transfer relief schemes may be deemed to be tax benefits, because of their nature. That may be the case of group taxation loss compensation, which can thus be considered to be *tax advantage*.⁸

It naturally follows that losses cannot be analysed in isolation of the rules that serve to determine the taxable base, as they are one more piece, but an essential one too, in the tax base puzzle. Profits and losses are two sides of the same coin and the real discussion is only how to assess the taxable income. However, because losses may for the purpose of assessing the tax be isolated, and because different systems of integrating or compensating them coexist, it is worth examining them with a certain, if ever artificial, independence from the rest of the elements of the tax base.

2.2. The Need to Offset Losses and the Principles of Taxation: Ability to Pay and Territoriality

It has been argued that the worldwide taxation principle that, following the ability-to-pay principle shapes CITs and PITs, makes a strong case for the need to offset extraterritorial losses is the only way to fully assess the income of the tax person.⁹ This would also mean, if the argument is coherently followed, that income taxes are not

essentially territorial as long as the basis on which they were established was the ability-to-pay principle. It then follows that:

in a traditional income tax setting, any distinction between domestic and foreign source income and losses must be regarded as a contradiction to the basic assumption of the income tax as such, as an artificial distinction which is not part of the general framework which has to be shaped by the Member State alone.¹⁰

The argument is certainly attractive and coherent, from a strictly logical point of view, with ability to pay being the widely accepted underlining rationale of income taxes. There are, however, two problems with it. On the one hand, worldwide taxation cannot miss the territorial link; on the other, ability to pay is the basis (and a logic element) for taxation but not the only principle shaping taxes.

It could even be questionable whether Member States actually do have income taxes largely based on the ability-to-pay principle¹¹ or whether it can be sustained that income taxes are purely based on this principle, especially taking into account that tax laws also purport to fulfil other objectives, such as establishing incentives and disincentives to invest in certain areas, which are only loosely based on ability to pay. A good example of this is the home-ownership tax incentives, which clearly do not always benefit the worst-off.¹²

True, the ability-to-pay principle has a central relevance. While not an EU Law principle, there are grounds to maintain that to the extent that it is a principle common to most EU members, it does have relevance in EU Law, as it does in International Tax Law.¹³ However, the ability-to-pay principle is not the only fundamental element of direct taxation or even currently the most important, even in countries, such as Germany or Spain, that follow a long

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⁷ See recently J. Freedman & G. Macdonald, 'The Tax Base for CCCTB: The Role of Principles', in *Common Consolidated Corporate Tax Base*, ed. M. Lang, P. Pistone, J. Schuch & C. Staringer (Linde: Wien, 2008), 234–236. A. Auerbach, M.P. Devereux & H. Simpson, 'Taxing Corporate Income', in *Dimensions of Tax Design: The Mirrlees Review*, ed. J. Mirrlees, et al. (Oxford: Oxford University Press, April 2010), 898, ISBN: 978-0-19-955375-4, <www.ifs.org.uk/mirrleesReview>. See also Cordero E.M. González, 'Apuntes sobre el tratamiento de las bases imponibles negativas en los impuestos sobre la renta', *Estudios Financieros. Revista de contabilidad y tributación* 285 (2006): 15 et seq. See also E.M. Cordero González, 'La compensación de bases imponibles negativas en el impuesto sobre sociedades', in *La crisis económica y su incidencia en el sistema tributario AA.VV.* (Aranzadi, 2009). E. Sanz Gadea, 'La compensación de pérdidas de filiales extranjeras: Marks & Spencer', *Estudios Financieros* 276 (2006). E. Sanz Gadea, 'Impuesto sobre Sociedades y Reforma Contable (II)', *Estudios Financieros* 317–318 (2009).

⁸ See CFE, 'Opinion Statement of the CFE ECJ Taskforce on Losses Compensation within the EU for Individuals and Companies Carrying Out Their Activities through Permanent Establishments, Paper Submitted by the Confédération Fiscale Européenne to the European Institutions in July 2009', *European Taxation* (October 2009): 489 et seq.

⁹ W. Schön, 'Losing Out at the Snooker Table: Cross-Border Loss Compensation for PEs and the Fundamental Freedoms', in *A Vision of Taxes within and outside European Borders*, ed. L. Hinnekens & P. Hinnekens (The Netherlands: Kluwer Law International, 2008), 818. See, by the same author, 'Besteuerung im Binnenmarkt', *Internationales Steuerrecht* (2004): 294.

¹⁰ Schön, *supra* n. 9, 818.

¹¹ On the crisis of the 'ability to pay principle' in tax law, see recently C. Palao Taboada, *Leistungsfähigkeitsprinzip, Gleichheitssatz und Eigentumsgarantie Festschrift für Joachim Lang* (Köln: Verlag Otto Schmidt, 2010, forthcoming).

¹² See R. Wernsmann, *Verhaltenslenkung in einem rationalen Steuersystem* (Tübingen: Mohr Siebeck, 2005), 245 et seq.

¹³ See, in this regard, the two following works: J.C. Fleming, R.J. Peroni & S.E. Shay, 'Fairness in International Taxation: The Ability-to-Pay Case for Taxing Worldwide Income', *Florida Tax Review* 4, no. 4 (2001): 299–354. M. Graetz, 'Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies', *Tax Law Review* 54 (2001).

tradition of granting central relevance to this principle among the definition of tax justice.¹⁴

Granting a central relevance to a principle such as the ability to pay can also be problematic. To begin with, because it is, by definition, a relative principle and it is simply not possible to derive conclusions from it without bearing in mind public expenditures.¹⁵ This connection might at first glance seem far fetched, but it is easy to understand if we connect the ability-to-pay principle with the right to property or, largely, ownership. In the end, it is a philosophical question, but (and) a really fundamental one: property rights are perceived as moral entitlements but are in essence the result of a law and institutional system, which is financed by a tax system.¹⁶ In the end, Governments participate, via taxation, in the economic success of their citizens, a success for which they are partly responsible.¹⁷

This also means that the tax system represents a central role in defining public and private poverties and in defining the distribution of *benefits* on a large scale, be it ownership (of assets, income, and so on) and in the form of benefits provided by the Government.¹⁸ This is of course not contradictory with the recognition of property rights in the *Hegelian* sense of enabling human dignity,¹⁹ but following Kirchhof, taxes are the precondition, and not the mere consequence, of the guarantee of property rights.²⁰

Furthermore, the ability-to-pay principle is just one side or aspect of tax justice and an obligation (the actual payment of the tax) that happens *afterwards*, that is, once we assume that, as a fundamental prerequisite for existing, the States must participate in the economic success of their citizens (residents) by way of taxing them in order to finance public expenditures. This participation – taxation – means a

distribution of costs among citizens, and the main principle to shape this distribution of costs is the principle of equality.²¹ Often enough, equality will demand unequal treatment of two situations theoretically showing the same ability to pay, as happens when some transactions – easier or cheaper to evaluate or control – are more heavily taxed than others (see labour taxes *versus* the taxation of financial operations).²² In these cases, the departing point to analyse the tax from a tax justice perspective (in some countries, from a Constitutional perspective) will be the principle of equality, not the notion of ability to pay alone.

The ability-to-pay principle is then one of the possible consequences of the principle of equality.²³ The principle will imply two things: first, adapting the tax burden in relation to the real capacity of payment of the tax person.²⁴ This is largely a consequence of some basic economic logic, which means the Government must look for an adequate element indicating that there is an ability to pay tax and maintain the activity.²⁵ Second, the principle will often entail establishing unequal measures to take into account elements that entail a different level of need (i.e., children tax allowances, taxpayer age allowances).²⁶ Other elements may also be taken into account, which have no connection whatsoever with a purely ability-to-pay notion. For instance, *green* tax credits, that may even have a regressive effect.

What does this mean for the territoriality principle? It may well be that in its purest notion territoriality does run counter to the ability to pay and worldwide taxation binomial. However, territoriality, not ability to pay, is the basis of taxation and therefore comes *first*, bearing in mind its essential objective, which is to raise revenue in order to pay for public duties, which are carried out by a territory-based political entity such as the State. Ability to pay, in the legal

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- ¹⁴ In this regard, see Palao Taboada, *supra* n. 11. C. Palao Taboada, 'Apogeo y crisis del principio de capacidad contributiva', in *Estudios Jurídicos en homenaje al Profesor Federico de Castro AA.VV.*, vol. II (Madrid: Instituto Nacional de Estudios Jurídicos-Tecnos, 1975), 422 et seq. 'Los principios de capacidad económica e igualdad en la jurisprudencia del Tribunal Constitucional', REDF 88 (1995): 629 et seq. V. Ruiz Almendral & J. Zornoza Pérez, 'Constitución económica y Hacienda Pública', in *La Constitución a examen: un estudio académico 25 años después*, ed. G. Peces-Barba Martínez & M.A. Ramiro Avilés (Madrid: Marcial Pons, 2004), 650 et seq.; V. Ruiz Almendral, 'Impuestos y Estado Social', in *Finanzas Públicas y Constitución*, ed. J.J. Zornoza Pérez (Quito: Corporación Editora Nacional, 2004), 15 et seq. J.J. Zornoza Pérez, 'Aspectos constitucionales del régimen de tributación conjunta en el IRPF', REDC 27 (1989): 173. M.P. Alguacil Mari, 'La capacidad económica como parámetro de enjuiciamiento', *Revista de Derecho Financiero y Hacienda Pública* (RDFyHP) 253 (1999): 581 et seq.; A. Rodríguez Bereijo, 'El deber de contribuir como deber constitucional. Su significado jurídico', REDF 125 (2005): 39 and 40. In Germany, see K. Vogel, 'Die Besonderheit des Steuerrechts', in *Deutsche Steuer-Zeitung*, series A (1977), 9; D. Birk, *Das Leistungsfähigkeitsprinzip als Maßstab der Steuernormen* (Köln: Dr Peter Deubner Verlag GmbH, 1983), 52 et seq.
- ¹⁵ L. Murphy & T. Nagel, *The Myth of Ownership. Taxes and Justice* (Oxford: Oxford University Press, 2002), 9.
- ¹⁶ See recently Murphy & Nagel, *supra* n. 15, 8 et seq. and 174 et seq. See also the already classic work of R.W. Walz, *Steuergerechtigkeit und Rechtsanwendung. Grundlinien einer relativ autonomen Steuerrechtsdogmatik* (Heidelberg: Decker, 1980), 31 and 37.
- ¹⁷ See German Constitutional Court case: BVerfG, BStBl. II 1995, 655 et seq. (para. C. II. 1. b, 660) on the Wealth tax ('Vermögensteuer'). In this regard, see D. Birk & R. Eckhoff, 'Staatsfinanzierung durch Gebühren und Steuern: Vor- und Nachteile aus juristischer Perspektive', in *Vom Steuerstaat zum Gebührenstaat*, ed. Ute. Sacksofsky & J. Wieland (Baden-Baden: Nomos Verlagsgesellschaft, 2000), 55.
- ¹⁸ Murphy & Nagel, *supra* n. 15, 76.
- ¹⁹ Hegel, *The Philosophy of Right* (1821), ss 41 and 53; see also Murphy & Nagel, *supra* n. 15, 45.
- ²⁰ P. Kirchhof, 'Verfassungsrechtliche und steuersystematische Grundlagen der Einkommensteuer', in *Besteuerung von Einkommen. Deutschen Steuerjuristischen Gesellschaft e. V.*, ed. I. Ebling, Band 24 (Köln: Verlag Dr Otto Schmidt, 2001), 13. Murphy & Nagel, *supra* n. 15, 70–73.
- ²¹ Birk, *supra* n. 14, 167; Alguacil Mari, *supra* n. 14, 607 et seq., con mayores referencias. Rodríguez Bereijo, *supra* n. 14, 27 et seq.
- ²² Wernsmann, *supra* n. 12, 304 et seq.
- ²³ Birk, *supra* n. 14, 155 et seq., 165 and 170; Wernsmann, *supra* n. 12, 286 et seq.
- ²⁴ Rodríguez Bereijo, *supra* n. 14, 27 et seq.
- ²⁵ Birk, *supra* n. 14, 166 et seq.
- ²⁶ *Ibid.*, 27.

sense,²⁷ comes *afterwards*, in order to design the tax, or the tax system even.

According to Schön, ‘if a Member State decides to set up an income tax under the “ability-to-pay” principle, any territorial distinctions are artificial and not an expression of the fundamental tax autonomy of this state’.²⁸ The only way to support this view would be in the framework of EU tax coordination, stressing the fact that, at the end of the day, all EU taxpayers are supposed to pay for the cost of belonging to the EU, from which they also benefit hugely. It is of course true that territorial taxation does not make sense in a political integrated (or integrated-to-be) Union and runs counter to the notion of EU citizenship²⁹ and, more fundamentally, to the economic logic of sharing a common (also mainly economic) destiny. A look at the recent Greece bail out is a good example, both of the costs and the imperfect integration. In the future, there will be no place for strict territoriality in the EU, at least not in the fundamental taxes such as those taxing income (individual or corporate). However, the future is still a long way from here.

2.3. The Essential Issues of Loss Relief in a Transnational Setting

At least the following four basic elements must be borne in mind when assessing and comparing any given system of losses compensation and the extent to which foreign losses are taken into account:³⁰

(a) *When* was the loss incurred? Time being the main reason behind the offsetting of losses in income taxes, thus allowing to take into account a period greater than a year, it also determines the extent and mode that the loss may be offset. So the first question would be what is the tax period taken into account for the assessment of income, as well as what criteria are used for the accounting of revenues and expenses for tax purposes (cash or accrual methods).

Then, a tax system may allow for a carry forward of losses or, in some cases, a carry-back (against past profits). This of course is always linked to a more fundamental question, which is to what extent do periodical taxes on income adequately reflect the ability to pay, seeing as income, and mostly business income, is not necessarily annual. After *Marks & Spencer*, a final temporary element would be to determine whether the loss is terminal or temporary.

(b) *Where* was the loss incurred; was it in the same country or in a foreign country and, in this case, was it EU or non-EU; in both cases, is there a Double Taxation Convention or agreement (DTC or DTA) in force or, finally, was the loss incurred in a low tax jurisdiction?³¹

The source versus residence debate and perspectives are as old as international taxation, which is based upon the dichotomy between residence and source; a country where a relative permanent residence takes place and a country where income, in its various forms, is obtained. However, this traditional dichotomy is no longer so clear, as source is not always identifiable and residence, particularly for entities, is only the start of the tax powers allocation process, as when shareholders reside mainly abroad, the CIT, an ever residence-based tax, actually turns into a ‘source tax’ on the profit, which will then be paid to shareholders in another State.³²

The problem of transnational losses combines two major issues of loss compensation, as different countries will have different rules on qualification (*what* type of loss may be offset against what) and time frame (the question of *when*). However, there may also be different rules on what type of losses may be *imported* or *exported* (which would be the questions, *where from* or *where to*).

(c) *What* type of loss and *how* much does it account to? As most fundamental issues when dealing with tax losses, this question is related to the definition of the tax base. There may be limits in offsetting losses from different types of income. Depending on whether the tax system follows a schedular tax system (such as, for example, dual taxation) as opposed to a global system, the question will arise whether losses are transferable between the different schedules; would for instance a capital loss be allowed to offset any other type of income? Should imputed costs be taken into account? May all types of revenues be offset with each other or are there separate pools, for instance for active and passive incomes?

Generally, accounting for losses and loss compensation (International Financial Reporting Standards (IFRS), International Accounting Standards (IAS) 2) is located in three distinct tax accounting rules: impairment of non-depreciable assets, allowance for bad debt, and loss carry-over, of which we will pay attention to the third, also known as inter-temporal loss relief.

Eventually, *how much* the cross-border loss amounts to will depend on the type of investment as well as on the method employed to curb double taxation. There are

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²⁷ Note that the ability-to-pay principle is fundamentally an economic notion, one that derives from the sheer logic of taxing only sources of wealth, income, or consumption. Legally, the ability-to-pay principle is a notion that intends to shape taxes, in order to make them fairer and coherent with the principle of material equality.

²⁸ Schön, *supra* n. 9, 819.

²⁹ C. Closa Montero, ‘Citizenship of the Union and Nationality of Member States’, *Common Market Law Review* 2 (1995): 495 y ss. V. Ruiz Almendral, ‘Entre la discriminación y la armonización: el régimen fiscal del no residente en España a la luz del Derecho Comunitario’, *Estudios Financieros* 307 (2008): 3–68, <<http://uc3m.academia.edu/VIOLETARUIZALMENDRAL>>.

³⁰ See Commission, Company Taxation in the Internal Market, 247. A. Cordewener et al., ‘The Tax Treatment of Foreign Losses: Ritter, M & S, and the Way Ahead (Part One)’, *European Taxation* (2004): 137 et seq.

³¹ Some countries, like Spain, bestow a differential treatment for losses incurred in low tax jurisdictions.

³² Schön, *supra* n. 4, 68–69.

different ways of obtaining income in another country, typically described as direct or indirect investment. I followed an old method that tries to estimate the level of foreign ownership of the productive assets in a given country (land, factories, or other means of production).³³ For our purposes, foreign direct investment (FDI) entails a minimum substance and long-term participation and integration in the economy of another country, which will normally entail the incorporation of a subsidiary, a joint venture, or similar structures. Foreign *indirect* investment is a much looser category that would entail all non-permanent investments, most of them giving way to passive income, the clearest example being portfolio investment with no element of control³⁴ (private investment in securities, and so on). The two categories are not legal, or have a set meaning, but do help understand international tax rules.

In an international setting, quantifying a loss will depend not only on the accounting system that the income tax is following. In the case of cross-border losses, how much is the (transferable) loss will eventually depend on the method employed in order to avoid double taxation. Thus, while the exemption method will typically not allow a foreign loss, the credit method will. Losses may be offset within certain limits, such as the total net revenue accrued, or a part of a certain revenue when different 'baskets' can be partially merged. Finally, the loss may also be taken into account in an indirect manner, by way for example of granting a depreciation of (losing) foreign assets.

Article 23 of the Organisation for Economic Co-operation and Development Model Convention (OECD MC) proposes two broad methods to avoid double taxation of income: the exemption method, by which all income obtained in the Source (S) State will be exempt in the Residence (R) State,³⁵ and the credit method, by which R will tax the worldwide income of the taxpayer, then allowing her to *credit* taxes that may have been paid in S (typically, withholding or non-resident taxes). In their basic versions, the first method will not allow losses, as they will also be *exempt*, while the credit method will always take them into account in the determination of the worldwide income. The underlying rationale of these methods is either to protect Capital Export Neutrality (CEN) in the case of

the credit method or guarantee Capital Import Neutrality (CIN) in the case of the exemption method.

A last fundamental issue when assessing the transfer of losses is the method to compute them, which is to say, the method by which the taxable base has been quantified. As long as no CCCTB is established, methods vary largely in different Member States, even if the uneven adoption of the IFRS has evened things slightly, albeit only for listed companies (since 2005³⁶). Of course the problem is that, where there is no common definition of the base, there is also no common definition of what a loss is.³⁷ This is related to other issues, such as what rules, the subsidiary's or the parent's place of residence, shall be applied.

(d) *Who* can claim what losses, is it the same taxpayer – with or without a PE; is it a group of entities, have the losses been incurred by a subsidiary? This is of course related to the bigger issues of: (i) the notion of ownership, whether it is direct or indirect, whether it entails ownership in the continental civil-law sense or has a broader meaning, such as economic control; and (ii) ownership thresholds. In general terms, strict direct ownership rules are established, as well as high ownership thresholds (of 75% and more), in order to curb avoidance.³⁸

With regard to losses accrued by PEs, there are two (but in practice three) systems that permit the losses to be partial or totally relieved.

First, the *credit or imputation method* will allow the principal to credit the tax paid by the PE or to take into account the PE's losses when determining its (the principal's) tax base. In many cases, the Residence State may limit the credit to the tax that would have otherwise been paid had it been a resident PE, therefore making it less advantageous to establish a PE in a higher taxing jurisdiction.

Second, the *exemption method*, by which neither profits nor losses are taken into account when determining the principal's tax base. This is in practice the less attractive method, as a PE, especially a new established one, will normally accrue start-up losses. The method is lethal when the Host State does not allow or severely limits the carry forward of PE losses.

The exemption method may be softened by what is actually a *third method* – the *deduction or reintegration method*, which allows the taxpayer (principal) to offset losses

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³³ According to the US Bureau of Economic Analysis, FDI can be defined as the 'ownership or control, directly or indirectly, by one foreign person, or entity, of 10 percent or more of the voting securities of an incorporated U.S. business enterprise or an equivalent interest in an unincorporated U.S. business enterprise'. As the top country in the world in terms of receiving FDI, the USA has substantial data on this issue; see <www.investamerica.gov/home/ia_main_001155.asp>.

³⁴ The notion of control having substantial implications in International Tax Law, as it will determine a certain, often more advantageous, treatment when it is substantial (i.e., is above a certain threshold), at least from the perspective of the EC Parent Subsidiary Directive. Not so from a CFC legislation perspective; see generally W. Schön, 'International Tax Coordination for a Second-Best World (Part 2)', *World Tax Journal* (February 2010): 66–68.

³⁵ There are actually two types of exemption method: tax exemption and base exemption, by which the tax base that occurred in the host State is not taken into account at all in the home State. This latter method is also known as territorial taxation.

³⁶ Regulation (EC) No. 1606/2002 requires that for each financial year starting on or after 1 Jan. 2005, publicly traded companies governed by the law of a Member State are, under certain conditions, to prepare their consolidated accounts in conformity with international accounting standards as defined in Art. 2 of that Regulation. At present, the latest consolidated version of the IFRS adopted and binding in the EU is the Commission Regulation (EC) No. 1126/2008 of 3 Nov. 2008, Adopting Certain International Accounting Standards in Accordance with Regulation (EC) No. 1606/2002 of the European Parliament and of the Council.

³⁷ See Commission, *Company Taxation in the Internal Market*, 247.

³⁸ See *ibid.*, 335–336.

incurred in S, albeit only temporarily, so that once the PE is profitable again the loss is 'recaptured' by R. This way the loss is only taken into account once, and the taxpayer avoids the cash flow problem of having to wait for profits in its PE in order to offset the loss. As we will see, particularly after the ECJ *AMID* case, this would be the only way to make the exemption method compatible with EU Law, and specifically with the freedom of establishment, when applied to a PE.

The following example may serve to clarify this:³⁹ in year *n*, *Loosing* realizes a profit of 1,000 in R and a loss of the same amount in S. That year the loss is compensated in R, so no tax ensues. In year *n* + 1, *Loosing* realizes a profit of 1,000 in each R and S. That year, the taxable income in R will be 2,000, while in S there will be a zero tax base (-1,000 + 1,000). In this case, the taxable income for the taxpayer corresponds with his actual economic income.

Year	State of Residence	Source State
N	+1,000 (profit) Taxable income = 0 (loss compensation)	-1,000 (loss)
N + 1	+1,000 Taxable income = 2,000 (1,000 + 1,000)	+1,000 Taxable income = 0 (loss carry-over)

With this method, the fear of double dipping that has been expressed by Member States before the ECJ may very well be unfounded. Even in those cases where this risk may actually be present, the question is whether there is a less restrictive measure than simply denying the possibility of loss relief.

In most cases, the situation will be different for subsidiaries, as no immediate cross-border loss relief will be granted to the parent for losses incurred by its foreign subsidiaries. When it is done, it will normally follow the above-mentioned reintegration method (as in France). Likewise, in some cases, the Resident State of the parent company may allow it to write off the devaluated assets, by means of building up a provision that will reflect the lower value of the shares or participations. This certainly allows taking into account losses, even if in many cases only once these are permanent, for write-off rules may be quite harsh in that regard. Note that the provision will be tax deductible only in relation to the shares' or participations' original value of acquisition, which means the excess cannot be carried forward. The result being that, at least in many cases, part of the loss will, in fact, be lost.

Finally, for groups of companies there will normally be consolidation regimes available, but rarely will they be extended to foreign subsidiaries, which is why a preferred method of foreign investment will be to start up as a PE and then if it becomes permanently profitable, transform it into a subsidiary.⁴⁰ Moreover, even when consolidation is possible, there will be different rules concerning ownership thresholds for subsidiaries, as well as the notion of ownership itself (whether or not it also implies elements of control or not, among others).

Most tax systems have some regime that allows for the aggregation of profits and losses of different entities belonging to the same undertaking, so that losses may be offset against profits, either horizontally (between different branches or subsidiaries) or vertically (between a parent company and its subsidiaries). There are three traditional systems for taking into account foreign subsidiary losses: a total worldwide consolidation system (France, Denmark), a system where the parent company may write off devaluated foreign participations, and a mechanism that allows a claw-back (Spain, Germany, Austria. . .).⁴¹ A third system would only allow taking into account losses when the assets are transmitted and the loss is thus final.

At present, there are different systems of taking into account losses in the EU, just as there are also different ways of assessing the taxable base. These were summarized by above quoted 2006 Commission Communication on the tax treatment of losses in cross-border situations. All Member States grant a relief for losses deriving from domestic operations, which are undertaken by a single company. In the case of groups of companies, most EU countries apply some type of group taxation system that will take losses into account, treating the group as an entity, thus disregarding the rest (The Netherlands), or allowing a great scope of integration of the taxable income among the group.

Losses deriving from other EU Member States operations may, however, not be entirely corrected, as this will depend on the method used to avoid double taxation. Thus, while the credit method will normally take all losses into account, the exemption method will not. In the case of groups of companies, currently only some Member States apply their group taxation systems to include cross-border losses.

Different systems coexist under the common heading of *tax consolidation*, depending on whether the entities conforming the group are disregarded for tax purposes (as in the Dutch system), the extent of the consolidation or whether only losses are taken into account or intra-group operations are generally disregarded. Most EU tax consolidation regimes follow partial pooling systems, by which the taxable base of the different entities are *pooled* together

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³⁹ See a similar example in CFE, *supra* n. 8, n. 4.

⁴⁰ Commission, Company Taxation in the Internal Market, 251.

⁴¹ This second system is allowed by the Council Directive 90/435/EEC of 23 Jul. 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States; see J.M. Calderón Carrero, 'Reflexiones al hilo de la STJUE X Holding BV sobre el régimen de consolidación en el Impuesto sobre Sociedades, la "importación" de pérdidas extranjeras y el Derecho de la Unión Europea', *Crónica Tributaria* (October 2010, forthcoming).

and taxed jointly, while the Entities forming the group maintain their own tax obligations. Both *intra-group contribution* and *group relief* are systems where the economic unity of the group is taken into account, by means or targeted tax relief rules. The main difference among the two is that the first allows a pooling of both benefit and losses, while the group relief systems only allow the transfer of intra-group losses, so no real transfer of income is needed. Some countries, such as notably Spain, use a portfolio devaluation, which may well have the effect of a loss relief system.⁴² This is an imperfect offsetting of the losses in any event, as the system merely allows taking into account, for tax purposes, the devaluation of the portfolio owned or controlled by the resident entity.⁴³

The coexistence of such different systems is worrying to the extent that it creates serious obstacles to further EU market integration.⁴⁴ Clearly, there are currently major limits on cross-border loss relief, which in many cases lead to economic double taxation. This happens not only because most EU members do not recognize losses of foreign subsidiaries but also because losses of PEs can often only be offset against headquarter profits under limited circumstances. In any event, one of the conclusions of the above-mentioned 2006 Commission's Cross-Border Loss Relief Communication is that, by and large, the greater distortion for the internal market derives from the absence of a loss relief system for groups of companies. According to the Commission, the situation also constitutes a strong disincentive to invest in other Member States, at the same time that it favours larger Member States, with a greater market for operating. It is also substantially more favourable to large companies. In fact, the situation is also particularly disadvantageous for small- and medium-sized enterprises (SMEs), which face particular problems in cross-border situations, as the Commission's Communication on a Home State Taxation Pilot Scheme pointed out.⁴⁵ In the end, the distortions that arise because of the limited access

to cross-border loss relief result in less competition, higher consumer prices, and less overall efficiency.

3. OPTIONS FOR LOSS RELIEF IN INTERNATIONAL AND EUROPEAN TAX LAWS

3.1. The Odd Couple: EU and International Tax Law

There are several fundamental problems when trying to reconcile EU Law with International Tax Law. The main one is, to put it in a nutshell, that International Tax Law does not exist, while EU Tax Law is incomplete and asymmetric. As for the first, there exists, of course, a set of international rules and guidelines that are followed by most OECD countries, as well as a growing number of non-OECD.⁴⁶ This set of rules may also be somewhat coordinated, thus being closer to a *regime*⁴⁷ than to a mere set of tax agreements, but it is still far from being a *system* of law, one that is enforceable, foreseeable, or amendable by common and ordinary standards. This is the starting point of any analysis of the relationship between EU and International Tax Law.

When addressing non-discrimination issues in the two law *areas* (let us call them that for the time being), another fundamental issue is that the very basis of International Tax Law lies in residents and non-residents not being in comparable situations, which applies to transfer of losses as well as to many other tax provisions.⁴⁸ This may sometimes also be the result of an EU Law case, but it is not the basis of EU Tax Law, in fact the opposite may be true.⁴⁹ The larger picture is that comparing EU and International Tax Law is too much of an asymmetric comparison; the EU is an integration organization, and a system of law (*Costa/ENEL*), whose aims go beyond the coordination of certain policies. Political integration is an end objective and this shapes the

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⁴² *Ibid.*

⁴³ See this system in *ibid.* As this last author has pointed out, this portfolio depreciation system serves as a loss relief only if it can be interpreted that s. 12.3 of the Corporation Income Tax Act (TRLIS) is also applicable to EU subsidiaries, something that is not crystal clear from the article itself, although it may be derived from the Administrative ruling RDGT de 1 marzo 2010, V-0368-10. Otherwise, this provision will be clearly contrary to EU law, especially after the ECJ case of 29 Mar. 2007, C-347/04, *Revue Zentralfinanz*.

⁴⁴ As pointed out in the above-mentioned Commission Communications, Towards an Internal Market without Tax Obstacles (2001), Tax Treatment of Losses in Cross-Border Situations (2006), and Coordinating Member States' Direct Tax Systems in the Internal Market (2006), and had also been pointed out at the *Ruding* report (Commission of the European Communities (ed.), *Report of the Committee of Independent Experts on Company Taxation* (Brussels/Luxembourg: EC Commission, 1992), 14 et seq., 60 et seq., and 299 et seq. (Annex 3B), there is extensive literature on this issue. Among others, see the following two works: B. Knobbe-Keuk, 'The Ruding Committee Report – An Impressive View of European Company Taxation for the Year 2000', *EC Tax Review* 1 no. 1 (1992): 22 et seq.; and, more recently, M. Aujean, 'The CCCTB Project and the Future of European Taxation', in *Common Consolidated Corporate Tax Base*, ed. M. Lang, P. Pistone, J. Schuch & C. Staringer (Linde: Wien, 2008), 25 et seq.

⁴⁵ COM (2005) 702 final.

⁴⁶ See, in this regard, E. Baistrocchi, 'The Use and Interpretation of Tax Treaties in the Emerging World: Theory and Implications', *British Tax Review* 4 (2008): 353 et seq.

⁴⁷ See the controversial theory on the existence of an authentic *tax regime* by R. Avi-Yonah, 'International Tax as International Law', *Tax Law Review* 57 (2004): 498 et seq. and, more recently, R.S. Avi-Yonah, *International Tax as International Law. An Analysis of the International Tax Regime* (New York: Cambridge University Press, 2007), 8 et seq.

⁴⁸ For instance, OECD MC, Commentary on Art. 24, on tax discrimination, para. 77, states that: 'Since the paragraph relates only to the taxation of resident enterprises and not to that of the persons owning or controlling their capital, it follows that it cannot be interpreted to extend the benefits of rules that take account of the relationship between a resident enterprise and other resident enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfer of property between companies under common ownership). For example, if the domestic tax law of one State allows a resident company to consolidate its income with that of a resident parent company, paragraph 5 cannot have the effect to force the State to allow such consolidation between a resident company and a non-resident parent company. This would require comparing the combined treatment of a resident enterprise and the non-resident that owns its capital with that of a resident enterprise of the same State and the resident that owns its capital, something that clearly goes beyond the taxation of the resident enterprise alone.'

⁴⁹ Ruiz Almendral, 'Entre la discriminación y la armonización: el régimen fiscal del no residente en España a la luz del Derecho Comunitario', 34 et seq.

EU's economic constitution of which tax laws form a relevant part.

Just as EU freedoms have as their main objective the integration of the common EU market,⁵⁰ tax integration or tax harmonization in the EU mainly aimed to eliminate tax obstacles or distortions. Initially, the EU Treaties had an obvious bias towards coordinating indirect taxation, which is partly explained because that was the most important type of taxation in the 1950s, and because being so underdeveloped, it was hard to imagine that direct taxes would ever pose major problems to EU market integration. Sovereignty issues came later; and by the time direct taxes had become sophisticated enough to pose problems for EU economic integration, it was too late to take it from the hands of the Governments, for they soon came to represent the lion's share of the tax revenues.

Harmonization in direct taxes has followed a bumpy road, if there was ever a road. As the Commission pointed out, at best proposals in tax issues have been addressed in too isolated a manner, without putting them in the context of their broader objective, which is the political integration of the EU.⁵¹ The four main Directives affecting direct taxes (the Parent-Subsidiary Directive, the Merger Directive, the Savings Directive, and the Interest-Royalty Directive),⁵² albeit limited in scope, are the tipping point towards a more proactive approach in direct harmonization, which has been largely undertaken by the ECJ, bringing about a sort of 'silent revolution'.⁵³

The ECJ plays a major role in the economic integration of the EU. The central interpretative element for the Court is, and can only be, market integration in the EU. As there are no *tax principles* as such embedded in the Treaties, the non-discrimination principle must be interpreted in the light of the said market integration. Access to the market protects all EU movements – of persons, capital, establishments – so that discriminations and restrictions that the agents may suffer are taken into account not only when assessing the conditions to *access* the market (Source State perspective), as was the case *Commission/France* (better known as *Avoir fiscal*, ECJ, 28 January 1986 (270/83)) or *Schumacker*

(ECJ, 14 February 1995, C-279/93), but also when assessing access to other markets from the Resident State perspective, where the restriction may be imposed by that same state (as was the case in *ICI* (16 July 1998, C-264/96), *Manninen* (ECJ, 7 September 2004, C-319/02) or even *Marks & Spencer* (ECJ, 13 December 2005, C-446/03)).

The analysis undertaken by the Court on the application and scope of the fundamental freedoms revolves around the central notion of non-discrimination and restriction when accessing the EU market. This way of reasoning has experienced an interesting evolution in the past years that I will briefly refer to.⁵⁴ At first, the main objective is to curb any *discrimination*, barring overriding reasons in the public interest. In the *ICI* case, the Court introduced the notion that a tax measure may impose a *restriction* on the exercise of the economic freedoms, which has come to be known as the 'Home State restriction', as it refers to restrictions imposed by the Residence State.⁵⁵ So there may be a restriction without there being a discrimination. Of course the main problem with the notion of restriction still is that its application to direct taxes may seem strange, as it was a notion originally shaped to be applied to indirect taxes, to prevent them from becoming *barriers* within the EU market.⁵⁶

Using market integration as the main interpretative criterion has many consequences for the shaping of a *tax law* doctrine. The most obvious one is that the so-called principle of neutrality acquires great relevance. This is at best confusing, not only because neutrality per se is not really a principle – in tax or other areas – but because the very notion that a tax can be neutral is misleading, at best,⁵⁷ and probably biased towards a low impact, low pressure tax system that does not really exist in the EU. The bottom line here is that this purported neutrality is, in fact, not neutral at all.⁵⁸

Furthermore, because the ECJ naturally does not take into account the main objective of a tax system and its connection to public spending, the notion of *fiscal interest of the states* is skewed and has come to be interpreted as an element that is contrary to the interest of the EU as a sum, which is only understandable in a very narrow sense. The

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⁵⁰ On the economic case law of the ECJ, see M. Poiars Maduro, *We the Court. The European Court of Justice and the European Economic Constitution* (Oxford: Hart Publishing, 1998), 61 et seq. With an emphasis on taxation, see C. Sacchetto, 'ECJ Direct Tax Cases and Domestic Constitutional Principles: An Overview', in *Comparative Fiscal Federalism. Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence*, ed. R.S. Avi-Yonah, J.R. Hines, Jr. & M. Lang (The Netherlands: Kluwer Law International, 2007), 2.

⁵¹ European Commission, COM (2001) 260 final.

⁵² Council Directive 90/434/EEC of 23 Jul. 1990 on the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States ('Merger Directive'); Directive 90/435/EEC of 23 Jul. 1990 on the Common System of Taxation Applicable in the Case of Parent Companies and Subsidiaries in Different Member States, ('Parent-Subsidiary Directive'); Council Directive 2003/48/EC of 3 Jun. 2003 on Taxation of Savings Income in the Form of Interest Payments ('Savings Directive'); Council Directive 2003/49/EC of 3 Jun. 2003 on a Common System of Taxation Applicable to Interest and Royalty Payments Made between Associated Companies of Different Member States ('Interest-Royalties Directive').

⁵³ F. Vanistendael, 'Tax Revolution in Europe: The Impact of Non-discrimination', *European Taxation* 40, nos 1–2 (January–February, 2000): 4.

⁵⁴ A. García Prats, *Imposición directa, no discriminación y derecho comunitario*, 46 et seq.

⁵⁵ Sacchetto, *supra* n. 50, 3.

⁵⁶ F. Vanistendael, 'The Compatibility of the Basic Economic Freedoms with the Sovereign National Tax Systems of the Member States', *EC Tax Review* 3 (2003): 138.

⁵⁷ Neutrality is a myth, as A. García Prats points out at: 'Incidencia del Derecho Comunitario en la configuración jurídica del Derecho Financiero (y III): Principios de justicia tributaria vs. Derecho Comunitario', 739 and 740. In the end, taxes cannot by nature be neutral, see F. Neumark, *Grundsätze gerechter und ökonomisch rationaler Steuerpolitik* (Tübingen: J. C. B. Mohr-Paul Siebeck, 1970), 261. Most recently, see Murphy & Nagel, *supra* n. 15, 56.

⁵⁸ I have dealt largely with this issue in V. Ruiz Almedral, *Estabilidad presupuestaria y gasto público en España* (La Ley-Wolters Kluwer, 2008), 34 et seq.

fiscal interest of the States is not really a principle common to all Member States but rather a defining element of every tax system that is legitimized because it serves the financing of public spending, therefore also curbing or avoiding future deficits, which is also an EU objective. In short, it should not be an element that is deemed to run counter to the economic freedoms.⁵⁹ Conversely, Member States are probably not always aware that they probably would be defending their own tax interest best by allowing greater tax coordination.

The past *excursus* should allow us to put in perspective the way the Court takes into account International Tax Law and what conclusions can be derived thereof. In particular when examining tax law in the light of non-discrimination, the Court has often made references to the OECD MC and its Commentaries, which may sometimes reflect an implicit acceptance of the conventional regime in International Tax Law (*Gerritse*, ECJ, 12 June 2003 (C-234/01), paragraph 45). Such Court references to what in reality is *soft law* in international taxation has helped these non-rules acquire a binding force.⁶⁰ However, the influence goes in both directions, so that ECJ rulings may also be exercising a decisive influence upon the Commentaries.⁶¹

The main question here is whether these references are erratic or even ornamental, or rather reflect a conviction by the Court that the OECD MC is a sound blueprint for the allocation of taxing powers among Member States. This is probably hardly the case, as the Court does not always follow the OECD logic even when quoting it.⁶² However, the problem nonetheless is that the *system (sic)* of allocating taxing rights designed by the OECD is hard from perfect, and it is widely used because it is convenient and agreed, not because there is a true belief that it is the perfect or fair solution.⁶³

Thus, the protection granted by the international tax of non-discrimination (Article 24 of the OECD MC) is narrower in scope than the principle of non-discrimination in the EU,⁶⁴ which is mainly explained because their

objectives are also fundamentally different. There are at least three differences.⁶⁵

First, the resident versus non-resident opposition works differently in EU and International Tax Law. For the former, residents and non-residents may be comparable when a non-justified discrimination affecting a fundamental freedom is at stake. That type of analysis is simply unfeasible in the light of Article 24 of the OECD MC that precisely departs from residents and non-residents being in totally different situations. This fundamental difference stems directly from the notion of EU citizenship, which is seldom quoted in relation to tax cases in the EU, but that fundamentally shapes the reasoning of the Court, even if the principle is not directly quoted.⁶⁶

Second, EU Law does not only prohibit discrimination but also restrictions to the internal market, thus curbing measures that may not be establishing a differential treatment among residents and non-residents as happened in the *Safir* case (ECJ, 28 April 1998 (C-118/96)).⁶⁷

Third, the scope of non-discrimination in EU is naturally broader, not only because it does not limit itself to direct taxes or to taxes for that matter, but because it also takes into account differences of treatment, which are based on *where* the investment has taken place.

Of course the fundamental difference, as I mentioned above, is that while Article 24 of the OECD Model Tax Convention (MTC) intends to smooth and facilitate economic transactions,⁶⁸ the approach of the Court is shaped by the notion of EU citizenship, which among other things explains that fundamental freedoms are protected also when no real economic activity has been undertaken. In addition, it should be borne in mind the limited scope of section 24, by nature and because of historic reasons. Thus, its reference to citizenship was initially shaped after the Free Trade Agreements, and it loses meaning and force in an international tax system that is largely based upon the notion of residency.⁶⁹

A final and fundamental issue when dealing with EU and International Tax Law is how Double Taxation Agreements are accommodated by the former. This is of course a theme

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⁵⁹ See, in this regard, W. Schön, 'Playing Different Games? Regulatory Competition in Tax and Company Law Compared', *Common Market Law Review* 42 (2005): 339 et seq.

⁶⁰ Thus incorporating International *soft law* to EU law. See J.M. Calderón Carrero, 'Una introducción al Derecho Comunitario como fuente del Derecho Financiero y Tributario: ¿Hacia un ordenamiento financiero "bifronte" o "dual"?'', *Revista Española de Derecho Financiero* 132 (2006): 708 et seq.

⁶¹ J.M. Calderón & A. Martín Jiménez name as an example the proposal to modify the taxation of services (OECD, The Tax Treaty Treatment of Services: Proposed Commentary Changes, 8 Dec. 2006), which may have been influenced by the *Gerritse*, *Conijn*, and *Scorpio* cases; see A. Martín Jiménez & J.M. Calderón Carrero, 'La inaplazable necesidad de reformar la tributación del no residente sin establecimiento permanente: la STJCE Scorpio', *Jurisprudencia Tributaria Avanzada* 21 (2006).

⁶² *Vid.* M. Lang, 'Double Taxation and EC Law', in *Comparative Fiscal Federalism. Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence*, ed. R.S. Avi-Yonah, J.R. Hines, Jr. & M. Lang (The Netherlands: Kluwer Law International, 2007), 33.

⁶³ Lang, *supra* n. 62, 34.

⁶⁴ K. Van Raad, 'Nondiscrimination from the Perspective of the OECD Model and the EC Treaty – Structural and Conceptual Issues', in *Comparative Fiscal Federalism. Comparing the European Court of Justice and the US Supreme Court's Tax Jurisprudence*, ed. R.S. Avi-Yonah, J.R. Hines, Jr. & M. Lang (The Netherlands: Kluwer Law International, 2007), 55 et seq.

⁶⁵ J.M. Calderón Carrero & A. Martín Jiménez, 'Artículo 24 MC OCDE. Principio de no discriminación', in *Comentarios a los convenios para evitar la doble imposición y prevenir la evasión fiscal concluidos por España*, ed. AA.VV. (coord.): J.R. Ruiz García & J.M. Calderón Carrero (A Coruña: Fundación Pedro Barrié de la Maza-Instituto de Estudios Económicos de Galicia, 2004), 1109.

⁶⁶ Closa Montero, *supra* n. 29, 496 et seq.

⁶⁷ See P.J. Wattel & B.J.M. Terra, *European Tax Law* (The Netherlands: Kluwer Law International, 2008), 53–54.

⁶⁸ Van Raad, *supra* n. 64, 61.

⁶⁹ *Ibid.*, 56. Sobre la incipiente formación de un sistema de Derecho tributario internacional, *vid.*, R.S. Avi-Yonah, 2007, 8 et seq.

much broader than this short article, but several elements must be borne in mind. First, the EC Treaty advice that EU Member States should try to curb double taxation (former Article 293 of the EC Treaty) was not an imposition (something that is clear after *Gilly*). That may explain its disappearance from the Lisbon Treaty.⁷⁰ As much as the Court considers tax treaties to belong to domestic law, they must abide by EU principles (*Saint Gobain*, STJCE de 21 de September de 1999 (C-307/97)). There is no ban on Community action in this matter nor can it be interpreted that the treaties consider 'tax treaties form a cornerstone of fiscal integration within the EC'.⁷¹ This may seem contradictory: to say that Member States have exclusive powers to enter into tax treaties but then establish that such treaties must also abide by EU Law. However, it is no more contradictory that the subsidiarity principle that allows Member States to retain all powers on direct taxation, while forcing them to abide by EU Law. It is finally a matter of allocation of powers among the centre (in this case, the EU) and sub-national entities (Member States in this case): An issue that has long been resolved in the federalism and public law literature (the German *Bundesstreue*),⁷² which is to say, a *bona fide* approach to the assignment of roles. When the Court states that direct taxes are under the sovereignty of Member States but that they must exercise their powers abiding by essential EU Law, it is basically referring to the *Bundesstreue*, which also intends to avoid the *emptying* of a competent (*Ausbildung*) by its abusive exercise from another entity. The Lisbon Treaty refers to this principle for the first time.⁷³

The problems derived by and the justification of the ever persistent divorce of Tax treaty law and Community law are well known. As the 2005 European Commission report on EC Law and Tax Treaties⁷⁴ explains, the origin of this separation lies in the initial focus by Community law on indirect taxation, at the same time that DTAs normally deal only with direct taxes (usually, taxes on income and capital, sometimes also gift and inheritance taxes as well as wealth taxes). However, the main difference lies in the objectives that each area of law pursues. It may then be the case that the way the questions are being posed is determining the outcome in a way that is gravely misleading. Tax treaties are just another type of domestic law: A specific one, true, and one that is partly coordinated by a think tank such as the

OECD, in the case of DTAs concluded by Member States but domestic law nevertheless. So the question is not so much International law versus Community law; we should not forget that they are not really 'two branches of the law' but specific domestic law versus Community law.

There are a growing number of ECJ cases dealing with the possible breach of EC freedoms that DTA agreed by Member States may cause. This is partly explained by the increased *activism* of the European Commission and the ECJ in direct tax law cases.⁷⁵ As it is generally known, after repeating what has become known as the 'ECJ direct tax law mantra', which states that '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',⁷⁶ the Court goes on to address specific issues where the inconsistency results in a discrimination in the treatment of EU citizens and economic activities.⁷⁷

Of course the fundamental problem is not only the different width of their objectives; that DTA have as their objective to curb double taxation (and since 2003, also generally to prevent abuse), on the one hand, and that Community law has a broader aim, political and economic integration, on the other hand. In the end, DTAs will always aim to establish a different treatment, not only between the two signatory countries and the rest of the world but also among them in a way. A DTA is not celebrated on equal footing but rather reflects the economic position of each country, thus creating differences between the different DTAs signed by the same country. By nature, DTAs are based upon the principle of reciprocity, which, among other things, explains why 'most favoured nation' clauses, recommended in the GATT framework, have never been endorsed by the OECD.

On the other hand, however, the Court is probably well aware of what it would mean to make all DTAs be renegotiated again. Curbing double taxation may not be an EU obligation, as most commentators point out,⁷⁸ but it is nevertheless a most important element in maintaining coordination between tax systems that will allow a healthy level of economic exchange. It may not be an EU Treaties objective in a direct manner, but it certainly serves the larger objective of market integration. That is the real 'elephant in the room' in many EU cases, and what probably explains the

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⁷⁰ As Aujean, *supra* n. 44, 29, has pointed out.

⁷¹ As suggested in Cordewener et al., *supra* n. 30, 139.

⁷² K. Hesse, *Grundzüge des Verfassungsrechts der Bundesrepublik Deutschland* (Heidelberg: C.F. Müller Verlag, 1995), 116 et seq.

⁷³ See, in this regard, M. Nieminen, 'Abolition of Double Taxation in the Treaty of Lisbon', *European Taxation* 64, no. 6 (2010).

⁷⁴ Taxud E1/FR Doc (05) 2306, 9 Jun. 2005.

⁷⁵ Poiares Maduro, *supra* n. 50, 61 et seq. and Sacchetto, *supra* n. 50, 2.

⁷⁶ Judgment of the Court of 14 Feb. 1995, Case C-279/93, *Schumacker*, point 21; and judgments of 11 Aug. 1995, Case C-80/94, *Wielockx*, point 16; of 27 Jun. 1996, Case C-107/94, *Asscher*, point 36; of 15 May 1997, Case C-250/95, *Futura*, point 19; of 28 Apr. 1998, Case C-118/96, *Safir*, point 21; of 16 Jul. 1998, Case C-264/96, *ICI*, point 19; etc.

⁷⁷ Among other examples, the following cases can be quoted: ECJ 23 Sep. 2003, Case C-58/01, *Océ Van der Grinten*, point 54; of 12 Dec. 2002, Case C-385/00, *F.W.L. de Groot v. Staatssecretaris van Financiën*, points 84, 94, 99 et. seq; of 8 Mar. 2001, Case C-397/98, *Metallgesellschaft*, point 71 et seq.; of 18 Nov. 1999, Case C-200/98, *X AB et Y AB*, points 10 and 31.

⁷⁸ A. Cordewener, *Europäische Grundfreiheiten und nationales Steuerrecht*, 877.

murky and contradictory case law of the Court when it comes to DTAs.

3.2. Double Taxation Agreement Aspects of the Transfer of Losses

DTAs do not directly deal with systems of transfer of losses, although there are certain aspects that are directly or indirectly related and influence the possibility of offsetting losses: the rules of allocation of costs to PEs' head offices (Article 7 of the OECD MC), the questions aroused by losses within associated enterprises (Article 9 of the OECD MC), capital losses (Article 13 of the OECD MC), and, incidentally, the limitations on loss consideration under Limitation on benefits (LOB) clauses (Article 22 of the US Model). In addition, although the exemption method does not preclude the Member State to take foreign losses into account (Article 23 OECD MC, paragraph 44), in practice that is the result in many cases. I will focus on the allocation of costs to PE, as well as briefly mention the problem with LOB clauses. Transfer pricing issues are of course connected to the problem of transnational losses, as much as one of the fundamental questions, as I will later point out, remains whether the separate accounting and arm's length principle are really a good system of dividing taxing powers among EU Member States.⁷⁹

3.2.1. The Rules of Allocating Costs to PEs: The Redrafting of Article 7 in the 2010 OECD MC

A PE is often defined as a 'taxable presence', a term that seems taken out of a ghost movie, as it has no tangible presence to be seen by all – for the PE is, after all, a non-resident – but comes to light through the *medium* of International Tax Law and its allocation of tax power rules. A PE

is a purely tax concept; unlike other types of taxpayers, such as companies or individuals, it does not exist in the legal world for purposes different than those of International Tax Law.⁸⁰

Apart from being a taxable presence, the PE is also a way to establish a limit or threshold for source taxation. Broadly speaking, there are two different methods or options to assess the profits of a PE: the 'functionally separate entity' and the 'relevant business activity' approaches. The first is widespread as it is recognized by the OECD MC and will (most likely) continue to be.⁸¹ The notion of PE, or at least the current one, has been incorporated by EU Law in an indirect manner. For instance, in the CCCTB seminars,⁸² it was suggested that the future CCCTB legislation departs from the definition based on the OECD MC, completed with eventual and future 'detailed definitions and guidance to reflect the specific nature of the internal market.' So far, we do not know what those will be.⁸³

The notion and tax consequences of the PE have been subject to thorough analysis and proposals of change in the framework of the OECD, as the 2008 and 2010, and their amended versions, show.⁸⁴ Under the current version of the OECD MC, approved on 22 July 2010 (what is now known as the 'Authorized OECD Approach' or AOA), it is recommended that PEs be assimilated, to a certain extent, to resident entities. Up to a point, this 'new approach' of the OECD in the new version of Article 7 purports a continuity of the separate entity approach,⁸⁵ which will be largely based on economic substance rather than on legal dealings.

This of course raises in my view many questions, which I will only briefly mention here, for they deserve to be the object of a different article; first, the feasibility of relying basically on substantial operations and not legal dealings; second, whether it will be adopted by countries in their domestic legislations and whether it will be also adopted in DTA; third, whether business will be in a position to undertake a full functional analysis (and deal with the

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⁷⁹ In this regard, see the recent and thorough study by N. Herzig, M. Teschke & C. Joisten, 'Between Extremes: Merging the Advantages of Separate Accounting and Unitary Taxation', *Intertax* 38, nos 6–7 (2010): 334–349.

⁸⁰ See J. Sasseville & A.A. Skaar, 'General Report', IFA, Cahiers de Droit Fiscal International Vol. 94^a: Is There a Permanent Establishment?, 2009 Vancouver Congress, 22 et seq. In Spain, see A. García Prats, *El Establecimiento Permanente* (Madrid: Tecnos, 1996), 39 et seq.

⁸¹ See OECD, 'Report on Attribution of Profits to Permanent Establishments', <www.oecd.org/dataoecd/23/41/45689524.pdf>, version approved last 22 Jul. 2010.

⁸² See, in particular, Working Paper 57 (para. 7), which, like the rest of CCCTB documents, is available online at <http://ec.europa.eu/taxation_customs/taxation/company_tax/common_tax_base/article_4650_en.htm>.

⁸³ Of course the problem with using the OECD (pre-2010) Model PE notion, as C. Staringer has pointed out, is that it is highly disputed, so the reference alone does not necessarily eliminate uncertainty; C. Staringer, 'Requirements for Forming a Group', in *Common Consolidated Corporate Tax Base*, ed. M. Lang, P. Pistone, J. Schuch & C. Staringer (Linde: Wien, 2008), 124. In the same volume, see D. Hohenwarter, 'Moving In and Out of a Group', in *Common Consolidated Corporate Tax Base*, ed. M. Lang, P. Pistone, J. Schuch & C. Staringer (Linde: Wien, 2008), 158 et seq.

⁸⁴ See the recent work by J. Malherbe & P. Daenen, 'Permanent Establishments Claim Their Share of Profits: Does the Taxman Agree?', *Bulletin for International Taxation* (July 2010): 360 et seq., for a critical assessment of the changes.

⁸⁵ As explained in the OECD, 'Report on Attribution of Profits to Permanent Establishments': 'The interpretation of Article 7(2) under the authorised OECD approach is that a two-step analysis is required. First, a functional and factual analysis, conducted in accordance with the guidance found in the Guidelines, must be performed in order to hypothesise appropriately the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks, and entering into dealings with each other and transactions with other related and unrelated enterprises. Under the first step, the functional and factual analysis must identify the economically significant activities and responsibilities undertaken by the PE. This analysis should, to the extent relevant, consider the PE's activities and responsibilities in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the PE. Under the second step, the remuneration of any dealings between the hypothesised enterprises is determined by applying by analogy the Article 9 transfer pricing tools (as articulated in the Guidelines for separate enterprises) by reference to the functions performed, assets used and risk assumed by the hypothesised enterprises. The result of these two steps will be to allow the calculation of the profits (or losses) of the PE from all its activities, including transactions with other unrelated enterprises, transactions with related enterprises (with direct application of the Guidelines) and dealings with other parts of the enterprise (under step 2 of the authorised OECD approach)' (13, para. 10).

greater formal obligations that this might entail); and fourth, how this method will work when the PE is not formed by many people or the connections and contributions of the people are not clear enough. A final element of concern is that the new (or newest) version does not seem to close one correct interpretation of the notion of PE. The basic idea behind the new concept seems to be in particular to establish a threshold on the taxation of its profits.⁸⁶

To the moment, subparagraphs 40 a) and c) of the Commentaries have been replaced with the following text:

40. With regard to the basis of assessment of tax, the principle of equal treatment normally has the following implications:

a) Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorised by the taxation law to be deducted from taxable profits. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises [. . .]

c) *Permanent establishments should also have the option that is available in most countries to resident enterprises of carrying forward or backward a loss brought out at the close of an accounting period within a certain period of time (e.g. 5 years).* It is hardly necessary to specify that in the case of permanent establishments it is the loss on their own business activities, which will qualify for such carry-forward.⁸⁷

Clearly, this approach will not solve the problem of loss relief, which is entrenched in the separate accounting method, or separate entity approach, that the OECD intends to keep. The outcome for losses would have been different, had the AOA been to support some version of the 'relevant business activity approach'.⁸⁸

In addition, it should be noted that even though the PE is now closer to a subsidiary in the sense of being treated as an entity that has its own assets (economically, not legally, owned), the assimilation is not complete, so that the AOA does not intend that subsidiaries and PEs be treated the same way.⁸⁹

In this regard, it is worth mentioning the proposal recently put forward by Herzig et al. to introduce some unitary taxation elements in the prevailing, hard-to-change, separate entity approach method.⁹⁰

3.2.2. LOB Rules and Losses

LOB clauses may worsen the lack of loss relief as a result of denying Treaty benefits to certain transactions, and thus limit the possibilities of curbing double taxation. These clauses are a US Model of DTA creation, specifically designed to curb treaty shopping structures by excluding from treaty benefits non-qualifying residents (*inter alia*, residents *controlled* or *owned* by residents in a third Member State, not party of the DTA). Such clauses, which in reality are no more than specific anti-abuse clauses, have the main effect of denying treaty benefits to an entity where the *beneficial owner* is located in the other (third) state. They intend to set the personal scope of the treaty, in order to prevent abuse.⁹¹ Because they are specific anti-abuse measures, in their wording a 'subjective test' might be included, which may be in the form of a *bona fide* clause.⁹²

LOB clauses conflict with Community law in that they introduce a difference of treatment contingent on residency. Following the ECJ case law, and most notably *Open Skies* (a non-tax case) and *Lankborst-Hoborst*, *inter alia*, the question remains unclear although a reform has not been

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⁸⁶ Malherbe & Daenen, *supra* n. 84, 360.

⁸⁷ Author's emphasis. This was suggested in 2009 (see OECD Committee on Fiscal Affairs, Revised Draft of a New Art. 7 (Business Profits), 24 Nov. 2009) and has finally been included in the revised Commentaries. See OECD, '2010 Update to the Model Tax Convention', <www.oecd.org/dataoecd/23/43/45689328.pdf>, 74, para. 70.

⁸⁸ OECD, 'Report on Attribution of Profits to Permanent Establishments', 23 et seq. (paras 61 et seq.).

⁸⁹ There are many different divergences among the new PE notion and a subsidiary, such as the PE not having its own credit rating or that no withholding payments are levied on internal dealings; see a critic in Malherbe & Daenen, 361.

⁹⁰ Herzig et al., 335.

⁹¹ For example, Art. 17 of the Spain/USA DTA contains the following LOBC:

A person which is a resident of a Contracting State and derives income from the other Contracting State shall be entitled under this Convention to relief from taxation in that other Contracting State only if (. . .)

(e) the income derived from the other contracting State is derived in connection with, or is incidental to, the active conduct by such person of a trade or business in the first-mentioned State (other than the business of making or managing investments, unless these activities are carried on by a bank or insurance company); or

(f) the person deriving the income is a company in whose principal class of shares there is substantial and regular trading on a recognized securities exchange, or more than 50 percent of whose shares of each class is owned by a resident of that Contracting State in whose principal class of shares there is such substantial and regular trading on a recognized securities exchange; or

(g) both of the following conditions are satisfied:

(i) more than 50 percent of the beneficial interest in such person (or in the case of a company, more than 50 percent of the number of shares of each class of the company's shares) is owned, directly or indirectly, by persons who are entitled to the benefits of the Convention under subparagraphs (. . .); and

(ii) the gross income of such persons is not used in substantial part, directly, or indirectly, to meet liabilities (including liabilities for interest or royalties) other than to persons who are entitled to the benefits of the Convention.

⁹² Such as, from the same DTA: 'A person which is not entitled to the benefits of the Convention pursuant to the provisions of paragraph 1 may, nevertheless, demonstrate to the competent authority of the State in which the income arises that such person should be granted the benefits of the Convention. For this purpose, one of the factors the competent authorities shall take into account is whether the establishment, acquisition, and maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention.'

undertaken yet.⁹³ The incompatibility of many LOB clauses, in particular of those contained in US DTA with European Tax Law has been the subject of much scholarly writing.⁹⁴ After the *Gottardo* and *Open Skies* cases, it is clear that such LOB clauses will not be aligned with EU Law if they imply a discrimination of an EU resident, not signatory of the DTA. Of course *Test Claimants in Class IV of the ACT Group Litigation* (C-374/04, 2006) did allow intra-EU LOB, but there are sufficient differences with *Open Skies* to interpret that the latter is still valid EU case law.⁹⁵ This is relevant because LOB clause limit the transfer of losses by excluding the possibility of applying rules to avoid double taxation.

3.3. The EU Initiatives on Tax Loss Relief: The 2006 Commission Communication and the CCCTB Project

CITs, as other direct taxes, are not harmonized. There have been several attempts to harmonize at least some aspects of these taxes.⁹⁶ So far, the only attempt that specifically targeted losses is the short-lived 1990 Commission proposal for a Directive on cross-border offsetting of losses between group companies and between headquarters and branches.⁹⁷ Since then, two proposals are worth mentioning: the CCCTB project and the Commission's 2006 proposal.

By far, the most ambitious project to fully harmonize CITs is the CCCTB proposal,⁹⁸ which seems to be stalled at the moment, with no clear date in sight for its adoption. In the unlikely event that it is adopted, the CCCTB would substantially change the rules for trans-European loss relief, for the core of the proposal is consolidation of the tax base for EU operations. The CCCTB working groups concluded

by suggesting an unrestricted loss carry-forward system, and ruling out loss carry-back,⁹⁹ which would basically benefit company groups,¹⁰⁰ having access to establishing a consolidated base. Such a system would not only free companies from compliance with intra-group transfer pricing rules but fundamentally allow 'loss consolidation in a similar way to many internal regimes a consolidated base would contribute to creating a highly attractive area in which to do business in Europe and would help to secure a stable tax base in a competitive world environment'.¹⁰¹

This general principle would be completed by the following rules.¹⁰²

First, the pre-existing losses incurred by a taxpayer prior to entering a CCCTB group would not be taken into account but be offset against the share of the future consolidated profits attributed to this taxpayer, depending on domestic rules. This is hardly surprising as it is the standard practice in group taxation regimes¹⁰³ but has been criticized because it may contradict the idea of treating the CCCTB group as a single economic unity.¹⁰⁴ In addition, the rule eventually approved should be completed by excluding the losses arisen outside the group by an entity entering the group via reorganization.¹⁰⁵

Second, the losses accrued as a result of the consolidation should be carried forward at group level and set off against future consolidated profits, before the net profits are shared out. This is done in order to avoid 'stranded' losses, that is, losses that are kept in the companies for years to come, while other companies of the group have profits.

Third, when an entity leaves the group no losses would be attributed to it but would remain with the group. However, if the group terminates, then the existing losses will be attributed to the taxpayers that belonged to it, following the sharing mechanism of the termination date. This

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⁹³ See, on the fundamental issues between LOB clauses and EU Law, R. Mason, 'US Tax Treaty Policy and the European Court of Justice', *Tax Law Review* 59 (2005): 65. F. Vega Borrego, *Limitation on Benefits on Double Taxation Conventions* (Kluwer Law International, 2006), 237 et seq.

⁹⁴ H. Becker & O. Thömmes, 'Treaty Shopping and EC Law', *European Taxation* (1991): 173; Vega Borrego, *supra* n. 93; Wattel & Terra, *supra* n. 67, 115; D. Ramos Muñoz & V. Ruiz Almendral, 'Special Purpose Vehicles and International Tax Law (On the Perils of Applying Anti-abuse Doctrines to "Non-typical" Entities)' (forthcoming).

⁹⁵ Wattel & Terra, *supra* n. 67, 115 et seq., 773 et seq. One of the consequences of this is the growing inclusion of 'derivative benefits' clauses in order to extend Treaty benefits to non-resident controlling companies (parents) that are resident in an EU Member State. These clauses extend benefits to asset-holding non-residents of the contracting states, which have a DTA with one of the signatory countries of the Treaty. However, such clauses also pose problems of their own, are not widespread, and do not completely eliminate the claims of discrimination. See, in this regard, R. Mason, 'When Derivative Benefits Provisions Don't Apply', *Tax Notes International* (14 Aug. 2006): 565 et seq.

⁹⁶ See an updated summary of different attempts, starting with the *Neumark* report, in Aujean, *supra* n. 44, 17 et seq.

⁹⁷ Proposal for a Council Directive Concerning Arrangements for the Taking into Account by Enterprises of the Losses of Their Permanent Establishments and Subsidiaries Situated in other Member States, COM (90) 595 final, 6 Dec. 1990 (O.J. No. C 53, 28 Feb. 1991). The proposal was withdrawn because it was considered obsolete; COM (2001) 763 final/2, 21 Dec. 2001. See Wattel & Terra, *supra* n. 67, 642 et seq. Among other elements, the draft Directive granted different treatment (and loss carry-over methods) to permanent establishments and subsidiaries; it also suggested the opposite cross-border loss transfer method as the *Marks & Spencer II* case. See recently C.H. Panayi, 'Reverse Subsidiarity and EU Tax Law: Can Member States be Left to Their Own Devices?', *British Tax Review* 3 (2010): 27–54.

⁹⁸ Communication from the Commission to the Council, the European Parliament and the Economic and Social Committee, Towards an Internal Market without Tax Obstacles: A Strategy for Providing Companies with a Consolidated Corporate Tax Base for Their EU-Wide Activities, COM (2001) 582 final.

⁹⁹ Commission: 'Possible Elements of a Technical Outline. Annotated Version', <CCCTB/WP057annotated.doc'en>, 20 Nov. 2007, 21.

¹⁰⁰ Groups are based on ownership and control criteria and would also encompass permanent establishments. See, in this regard, Staringer and M. Lang et al., *Common Consolidated Corporate Tax Base* (Linde: Wien, 2008), 117–136.

¹⁰¹ Commission, Possible Elements of a Technical Outline, 21.

¹⁰² *Ibid.*, 26–27.

¹⁰³ Y. Masui, 'General Report. International Fiscal Association: Group Taxation', *Cahiers de Droit Fiscal International* 89 (2004): 45 et seq.

¹⁰⁴ In that regard, see Hohenwarter, *supra* n. 83, 179.

¹⁰⁵ *Ibid.*, 179.

asymmetry has been criticized on the grounds that it is inconsistent, not sufficiently justified, and eventually unfair, in the case of a group that would be taken over by another CCCTB group. In that case, the losses would not be able to be set off.¹⁰⁶ To the Commission, such an inconsistency is unavoidable.¹⁰⁷

Not only the Commission but also the European Parliament¹⁰⁸ specifically states the CCCTB proposal to be the best alternative to establish a sound and smooth loss relief system. The Resolution summarizes the problems that not having such a system pose as well as the deficiencies of a DTA network that does not address losses nor really enhance cooperation on the different loss relief systems. It particularly emphasizes the disadvantage for small countries and SMEs of such discoordination; the first does not have a large enough market and is in a worse position to absorb possible losses, while the second is in a weaker position to undertake cross-border investments amid uncertainty over loss relief.

The CCCTB is a large scale harmonization Project whose ambition and scope make it the ideal means to tackle loss transfer issues, as well as many others. However, this very large scope may diminish the options for its adoption, at least for the time being. The question then is whether a more limited targeted approach would be feasible. In this regard, the 2006 Commission's Communication put forward a proposal to establish a limited method to alleviate the cross-border stranding of losses.¹⁰⁹

The proposal was drafted in the wake of the *Marks & Spencer* case, which as we will later on see, generated waves of scholarly opinion. Today, more recent cases have contributed to better shape the ECJ case law on losses.

The Commission's proposal focuses on groups of companies, where the major problems can be found, and it has a very limited scope.¹¹⁰ The basic idea is for the State of the parent company to only grant permanent loss relief for its foreign subsidiaries in those cases where the losses were final, the losing subsidiary having exhausted all possibilities of loss relief in the Residence State. Finally, in order to avoid tax avoidance by way of loss relief *shopping*, by which a group of companies would be free to choose where to have their losses set off, the measure would be limited to vertical upward scenarios, that is, the parent would be deducting the subsidiaries' losses, but subsidiaries would not be able to offset losses with each other.

The idea then would be to have EU-wide operating corporate groups be taxed as if they were active only in one, but only as far as this is possible. The proposed targeted system must permit immediate, once-only, and vertical upward (parent level) loss deduction. Income should not be shifted for good from one Member State to another unless losses are final and relief in the Member State where they were generated is not possible. Finally, possibilities of abuse must be curbed (although the Commission does not specify how).

The Communication then offers three options that differ among them in the treatment of future profits of the subsidiary at the parent company level:

(a) The first option is a definite loss transfer ('intra-groups loss transfer') within a domestic group where future profits are not taken into account. In order to compensate the loss of revenue of the Member State where the parent is a resident, a clearing system between that State and the State where the surrendering company is located could be set up. The system would be designed so as to take into account both differences in tax accounting rules and tax rates, which would make it highly complicated and would have too much of a changing nature, even for tax law standards.

(b) The second option is a temporary loss transfer where losses incurred by subsidiaries may be offset by their parent entities immediately. The deducted loss is later on recaptured ('deduction/reintegration method'), once profits ensue, that is. The loss recapture is done by establishing an additional tax burden at the parent company level. The mechanism basically avoids the cash flow problems by allowing immediate, albeit temporary, loss relief to the parent with a losing subsidiary. As the Commission concedes, this was exactly the method endorsed by the 1990 Draft Directive on losses,¹¹¹ as well as being the system in place in Germany until 1990.¹¹² The system is easy to implement, does not require the establishment of a clearing system, and allows immediate relief at the level of the parent.

(c) A third option would be to set up a system of consolidated profits, by which all profits and losses of a group that is present in more than one Member State are taken into account. PE and subsidiaries would receive equal treatment and the credit method would be applied

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¹⁰⁶ Apart from the annotated version, see a harsher critic in Hohenwarter, *supra* n. 83, 180–183. To Hohenwarter, the ultimate inconsistency remains in the fact that the CCCTB proposal only treats the group as one entity in the case of losses but allows several taxpayers when there are profits, 181.

¹⁰⁷ According to WP057, 'Although there might appear to be an inconsistency between the treatment of companies leaving the group and the treatment of companies when a group terminates this seems unavoidable. It seems reasonable to share out losses when the group terminates', para. 105.

¹⁰⁸ Resolution of 15 Jan. 2008 on Tax Treatment of Losses in Cross-Border Situations (2007/2144(INI), <www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P6-TA-2008-0008+0+DOC+XML+V0//EN>.

¹⁰⁹ Commission, Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee of 19 Dec. 2006 – Tax Treatment of Losses in Cross-Border Situations (COM (2006) 824), not published in the Official Journal.

¹¹⁰ Commission, Tax Treatment of Losses in Cross-Border Situations, 7 et seq.

¹¹¹ COM (90) 595 final. Proposal withdrawn OJ C 5, 9 Jan. 2004, 20.

¹¹² See, in this regard, as well as a critic of the Commission's proposals, T.P. Rodrigues, 'Cross-Border Loss Relief: The Portuguese Rules and the Case for Harmonisation', *The Offshore & International Taxation Review* (2009).

in order to curb double taxation; the tax paid by the subsidiary at the State of its residence would be credited against the tax paid by the parent with regard to the subsidiaries' income. According to the Commission, using the credit method should eliminate opportunities for tax arbitration, which are based on differences on the base and tax rates. Profit distribution between members of the group would be ignored for tax purposes. Because overall tax would be paid in the parent's State of residence, the compliance cost may be high, because all tax bases would have to be recalculated following the tax rules of the residency of the parent, although SMEs may benefit from the Home State taxation proposal.

Although the Commission does not directly endorse any of the methods, it can be interpreted that the second is the only feasible method, at least in the short term and as long as no CCCTB project is endorsed.

4. THE ECJ CASE LAW ON CROSS-BORDER LOSS RELIEF

In general terms, the Court now acknowledges the central role played by the principle of territoriality in tax matters and largely admits the balanced allocation of taxing powers as a *natural* limit of tax integration in the EU,¹¹³ at least while no further legislative action is completed. After *Avoir fiscal*,¹¹⁴ almost every single ECJ case on direct taxation in the last years begins by stating that Member States are free to establish and regulate direct taxes, as long as they comply with EU Law. The fact is Member States are hardly free to exercise their legislative powers in direct taxes at will but are seriously constrained by EU Law.¹¹⁵

In the following, I will briefly summarize what the ECJ has concluded on the loss transfer systems that it has had the opportunity to examine. Because this is but a summary of case law, it can only be asystematic, for not all problems have been dealt with by the Court.

4.1. The Principle: The Relevance of Granting Cross-Border Loss Relief

In general, the Court is aware that taking into account losses is tantamount to correctly determining the ability to pay of an entity. In principle, not granting immediate loss relief creates cash-flow disadvantage that can linger for years. That disadvantage alone may conflict with the freedom of

establishments (among others, see C-397/98, *Metallgesellschaft*). Claiming tax avoidance issues has not generally been effective for Member States, as the Court has always rejected the risk of losing tax revenues as a reason to accept a given tax provision.¹¹⁶ In addition, and as a matter of principle, the Court does not allow domestic measures that restrict the fundamental freedoms by constraining the compensation of foreign losses in the Residence State,¹¹⁷ unless of course a proportional justification is provided.

As we have seen, Member States' tax legislations largely grant loss relief for PEs, but the same is not true for foreign subsidiaries. According to the Court, the freedom of establishment entails the right for EU residents to access the market *under the same conditions* granted to the residents of a given Member State (*Saint-Gobain ZN*, paragraph 35). This means Member States' tax laws must in principle remain neutral with regard to the legal form by which the economic activity is taking place (*Avoir fiscal*, *Royal Bank of Scotland* (C-311/97), *Saint-Gobain ZN*). There will, also in principle, be no such neutrality when a tax law may contain a disincentive to create a subsidiary, or a PE, in another Member State (*Marks & Spencer* (paragraphs 32 and 33), *Keller Holding*, STJCE 23 February 2006 (C-471/04), paragraph 35).

However, it is at present particularly difficult to infer a sound and coherent doctrine on cross-border loss relief from the ECJ's case law, as it is growingly complicated, as are as well the systems granting loss relief. This explains the increased sophistication of the arguments employed by the Court, which is particularly evident in the recent *X Holding BV* case. The Court is becoming aware that not all systems are equal and it is hard to amend the dysfunctionalities that are in reality created by an EU system that does not have a harmonized tax base.

In the following, I will then focus on the main issues that have been lately tackled by the Court with regard to losses: the differences between PEs and subsidiaries, taking into account the methods to tackle cross-border loss relief, and the scope of consolidation regimes.

4.2. Whose Loss Is It and Where Did It Arise? PEs Are Not (Always) Similar to Subsidiaries

Who incurs the loss plays a significant role in the reasoning of the Court. Despite the established case law in favour of neutral entity forms in order to guarantee the freedom of

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¹¹³ Schön, *supra* n. 9, 815.

¹¹⁴ Case 270/83, *Commission v. France* (1986).

¹¹⁵ This is what Panayi has referred to as 'reverse subsidiarity', or 'the situation whereby, in exercising their technically exclusive powers, Member States find themselves significantly constrained by EU law'. *Supra* n. 97.

¹¹⁶ *Inter alia*, ECJ Case of 28 Jan. 1992, Case C-204/90, *Bachmann* [1992] ECR I-249, para. 22; ECJ, 12 Dec. 2002, Case C-385/00, *De Groot* [2002] ECR I-11819, para. 103.

¹¹⁷ That was the case, among others, in (in that regard) C-152/03, *Ritter Coulais*; C-182/06, *Lakebrink*; C-141/99, *AMID*; C-470/04, *N*; C-431/01, *Mertens*; C-293/06, *Deutsche Shell*; C-446/03, *Marks & Spencer*; C-264/96, *ICI*; C-414/06, *Lidl Belgium*; C-200/98, *X AB e Y AB*; C-377/07, *STEKO*; C-418/07, *Papillon*; and C-337/08, *X Holding BV*.

establishment,¹¹⁸ the fact is that not all legal entities or legal forms deserve the same treatment, which is only reasonable, as not all of them grant the same rights and obligations, or are for that matter comparable.

A salient example is the comparison between PEs and subsidiaries. The reasoning of the Court partly varies depending on the perspective, residence country or host country, that is adopted.¹¹⁹ This is particularly obvious after the *X Holding BV* case, where it is established that while the host country must grant the same treatment to PEs and (resident) subsidiaries, the Home State may establish a difference between PEs and subsidiaries. It should be noted that this was exactly the view expressed by Advocate General Geelhoed in his Opinion in the *Test Claimants in Class IV of the ACT Group Litigation* (C-374/04); the bottom line is that the comparison between a PE and a subsidiary will be correct if it is done from the Source State perspective.¹²⁰

The ECJ now seems clearer in establishing that subsidiaries and PEs are not in the same situation,¹²¹ but for some time now there has been a line of cases that have assimilated PEs to subsidiaries at least for some purposes, thus countering well-established principles in International Tax Law¹²² as well as the rationale of EU direct taxation and in particular the Parent-Subsidiary Directive.¹²³ The reasoning of the Court is not, of course, always straightforward so that instead of establishing a PE-subsidiary comparison or a migrant/non-migrant comparison for the sake of the non-discrimination principle, the Court may use the more flexible (in practice) notion of restriction. Thus, for the purpose of double taxation, it has been established that the general international tax rule by which a PE cannot access the DTA network, what normally would entail double taxation,¹²⁴ may be restrictive. Such was the conclusion in *Saint Gobain*, (paragraph 59).¹²⁵

As we have seen, loss compensation for PEs depends largely on the method employed in order to avoid double taxation. The exemption method will not allow for compensation, as it entails both losses and profits not being

included as taxable income (from the perspective of the State of residency). The credit method, on the other hand, will normally exclude foreign profits but allow for compensation of losses under the worldwide tax regime. To a certain extent, and in particular after the *Futura*, *AMID*, and *Deutsche Shell* cases, the Court has extended the possibilities of loss compensation for PEs in comparison with the established practice in international taxation. It is also now established that the head office or owner of the PE must be allowed to offset its losses (vertical upward set off), the risk of double dipping being easily curbed via a recapture mechanism. Thus, in the *Krankenbeim Rubesitz* (C-157/07) case,¹²⁶ the Court admits a recapture of losses system for PEs established by the State of residence, once the PE has made a profit, even when the Host State does not allow for a loss carry-forward system for PEs. In the case at hand, the DTA between Germany and Austria provided that the benefits of the PE be exonerated in the country where the principal company has its seat.

The latest ECJ case law seems to be examining the comparison between PEs and subsidiary a bit more carefully. The *CIBA* (C-96/08) and *X Holding BV* are good recent examples of this. The main element is that the comparison between PE and subsidiary seems to differ depending on the perspective that is adopted. Thus, from a Home State perspective, the PE and the subsidiary do not have to be treated equally. The same does not hold from a Source State perspective: this last State must treat PEs as residents. As Calderon has recently stated,¹²⁷ the Court seems inclined to establish a comparability criterion based on the position of the Member State vis-à-vis the PE or the subsidiary. As this author has pointed out, it should also be noted that the argument sometimes put forward by Member States, in order to exclude extending fiscal consolidation regimes outside their borders, which revolves around the balanced allocation of taxing powers and the territoriality principle, may be inconsistent with the way CFC regimes are designed and applied, extending their consequences to

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¹¹⁸ The Court has often stated that 'to accept that the Member State of establishment may in all cases apply different treatment solely because the registered office of a company is situated in another Member State would deprive Article 43 EC of its substance' (see Case 270/83, *Commission v. France*, para. 18, and *Marks & Spencer*, para. 37).

¹¹⁹ Calderón Carrero, *supra* n. 63.

¹²⁰ According to the Advocate General: '... it follows as a consequence of the method of dividing tax jurisdiction adopted by Member States – that is, the distinction between worldwide (home state) and territorial (source state) tax jurisdiction – that the concept of discrimination applies in different ways to states acting in home state and source state capacity. Quite simply, as the nature of the tax jurisdiction being exercised in each case differs fundamentally, an economic operator subject to home state jurisdiction cannot per se be considered to be in a comparable situation to an economic operator subject to source state jurisdiction, and vice versa. As a result, Art. 43 EC imposes two different categories of obligation on a state, depending upon the jurisdictional capacity in which it is acting in a particular case', para. 57.

¹²¹ Panayi, *supra* n. 97, 37.

¹²² In this regard, see *Royal Bank of Scotland* (para. 31), *CLT-UFA* (C-253/03, para. 17). L. Hintsanen, 'The Attribution of Income to Permanent Establishment under EC Law', *European Taxation* 4 (2003): 114; M. Tenore, 'The Transfer of Assets from a Permanent Establishment to Its General Enterprise in the Light of the European Law', *Intertax* 8/9 (2006): 390.

¹²³ F.A. García Prats, 'Application of the Parent-Subsidiary Directive to Permanent Establishments?', *European Taxation* 5 (1995): 179 et seq.

¹²⁴ García Prats, *supra* n. 80, 422 et seq.; J.M. Calderón Carrero, *La doble imposición internacional en los convenios de doble imposición y en la UE* (Pamplona: Aranzadi, 1997), 295 et seq.

¹²⁵ See P. Pistone, 'Tax Treaties and the Internal Market in the New European Scenario', *Intertax* 35 (2007): 77 et seq.

¹²⁶ Note that the case applies Art. 31 of the European Economic Area (EEA) Agreement (which is equal to freedom of establishment in Art. 43 EC) as Austria did not enter the EU until 1995, after the facts of the case took place.

¹²⁷ Calderón Carrero, *supra* n. 63.

other jurisdictions following an entity approach.¹²⁸ By the same token, it could be argued that a Member State that establishes a non-resident tax system for PEs pursuing, to a certain extent, a principle of general ‘force of attraction’,¹²⁹ and thus attributing the PE income that have not been strictly generated in their territory will be inconsistent when trying to limit loss compensation for those same PEs.

To sum up, the Court concludes that two of the loss relief systems applicable to PEs and subsidiaries are compatible with the freedom of establishment to the extent that certain conditions are met.¹³⁰ First, a loss recapture system established by the Resident State of the PEs’ principal is valid, even when the Host State of the PE does not allow PEs to offset losses (*Krankenbeim*). The disparity arising among the two tax systems cannot be imputed to the Resident State. The second one is a system where only final or terminal losses of subsidiaries or PEs are admitted as a loss relief for the parent/principal and by the State of residence.

4.3. Consolidation and Group Relief Systems

The best known case of group relief systems for loss carry-over is the much commented *Marks & Spencer II* case (C-446/03), where the Court did not follow the strict case law of *Bosal Holding BV* (C-168/01), that may have entailed admitting all foreign losses.¹³¹ *Marks & Spencer II* has received much criticism and commentary.¹³² It has been suggested that the case has two perverse incentives: for Member States to reduce compensation periods, and for groups to engage in loss trafficking by way of wrapping up subsidiaries’ activities earlier than otherwise they would have done, so as to benefit from the terminal losses doctrine.¹³³

The Court admitted three types of justification, taking jointly (conjunctive analysis): the safeguard of a balanced allocation of tax powers, the danger of double dipping or double use of the losses, and the danger of tax avoidance via loss trafficking. However, it also found that the UK rules for

group relief were not proportional in those cases where the subsidiary had exhausted its possibilities of setting off losses in its State of residence, hence the now known as final or terminal losses doctrine. More recent cases have taken into account only one of the three, thus confirming that they may be independent.¹³⁴ The consequences of the case are not finished, and in fact UK courts are struggling in trying to determine the meaning and scope of the cryptic *final losses* doctrine.¹³⁵

As a matter of principle, the Court considers restrictions to foreign subsidiaries’ losses to be contrary to the freedom of establishment but justifiable in many cases. In the 2008 *Papillon* (C-418/07) case, the Court applied the ‘group relief’ (*ICI* case) and ‘group contributions’ doctrines (*X AB e YAB*, C-200/98). In *Papillon*, the Court, while admitting that the French regime, ‘in refusing to extend the benefit of the tax integration regime to a resident parent company wishing to include its resident sub-subsidiaries in that regime where it holds those sub-subsidiaries through a non-resident subsidiary, the provisions of the CGI at issue in the main proceedings have the effect of ensuring the coherence of that regime’ (paragraph 51), ruled that the legislation went beyond than what was necessary, in particular since Member States may request all relevant tax information (from The Netherlands in this case), under the Mutual Assistance Directive.¹³⁶ Therefore, and since ‘practical difficulties cannot of themselves justify the infringement of a freedom guaranteed by the Treaty’ (paragraph 54),¹³⁷ the risk of tax avoidance (by double dipping the losses) or to safeguard the allocation of taxing powers is not accepted as a justification. The French regime, by excluding the integration with the Parent of its French subsidiary that is held by a holding resident in the Netherlands, is then an unjustified infringement of the freedom of establishment.

Especially after *X Holding BV*, the ECJ is fine tuning its opinion bearing in mind that not all loss relief systems are the same.¹³⁸ This case dealt with the system that to a greatest extent permits the total transfer of losses among entities, that is, the tax consolidation regime. With regard

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¹²⁸ The new CFC rules announced by the United Kingdom follow precisely that approach.

¹²⁹ Which is expressly rejected by the OECD MC Commentaries, Art. 7, para. 10.

¹³⁰ See A. Martín Jiménez & J.M. Calderón Carrero, ‘La jurisprudencia del TJUE: los efectos del principio de no discriminación y las libertades básicas comunitarias sobre la legislación nacional en materia de imposición directa’, in *Convenios Fiscales Internacionales y Fiscalidad de la UE* (CISS, 2010).

¹³¹ D. Weber, ‘The Bosal Holding Case: Analysis and Critique’, *EC Tax Review* 4 (2003): 221 et seq.

¹³² This case was highly criticized, as proves the number of contributions solely dedicated to its analysis. See, among others, M. Gammie, ‘The Impact of the Marks & Spencer Case on US-European Planning’, *Intertax* (2005): 485; F. Vanistendael, ‘The ECJ at the Crossroads: Balancing Tax Sovereignty against the Imperatives of the Single Market’, *European Taxation* 10 (2010); M. Lang, ‘The Marks & Spencer Case: The Open Issues Following the ECJ’s Final Word’, *European Taxation* 54 (2006); E. Sanz Gadea, ‘La compensación de pérdidas de las filiales extranjeras: *Marks & Spencer*’, *Estudios Financieros. Revista de contabilidad y tributación* 276 (2006): 95 et seq.; J.M. Calderón Carrero, ‘Consolidación Fiscal e Importación de Pérdidas: el caso *Marks & Spencer*’, *Noticias de la UE* 257 (2006): 112 et seq.

¹³³ *Wattel & Terra*, *supra* n. 67, 654.

¹³⁴ Notably, in *Lidl* (C-414/06), the Court admits the risk of tax avoidance (via double dipping) as well as the need to preserve the allocation of the power to impose taxes and declares the German treatment of PEs to be compatible with the freedom of establishment.

¹³⁵ See Panayi, *supra* n. 97, 38 and 43–48.

¹³⁶ Directive 77/799/EEC of 19 Dec. 1977 concerning mutual assistance by the competent authorities of the Member States in the field of direct taxation.

¹³⁷ Cases C-334/02, *Commission v. France* [2004], para. 29; C-386/04, *Centro di Musicologia Walter Stauffer* [2006], para. 48; and C-446/04, *Test Claimants in the FII Group Litigation* [2006], para. 70 are quoted in that regard.

¹³⁸ See, in this regard, Calderón Carrero, *supra* n. 63.

to it, the Court has admitted that a limitation of its scope is consistent with EU freedoms.

X Holding BV dealt directly with the Netherlands tax consolidation regime, the question being whether:

Articles 43 EC and 48 EC 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.

In other words, should the Netherlands treat a foreign subsidiary as a resident one for the purposes of its tax consolidation regime?

The analysis of the Court can be summarized as follows:

- (i) The Netherlands tax consolidation regime constitutes an advantage in that it is beneficial for tax purposes.
- (ii) Not extending such a regime to a foreign EU based entity renders less attractive the exercise of the freedom of establishment ('*the exclusion of such an advantage for a parent company which owns a subsidiary established in another Member State is liable to render less attractive the exercise by that parent company of its freedom of establishment by deterring it from setting up subsidiaries in other Member States*', para. 19).
- (iii) Such a difference in treatment will only be aligned with the EU Treaties if one of two elements is present: either the two situations are not objectively comparable or they may be justified by an overriding reason in the general interest.
 - (i) The first element is NOT present: the two situations are objectively comparable.¹³⁹
 - (ii) The second element is present, therefore:
- (iv) There is an overriding reason present, which is the preservation of the allocation of the power to impose taxes; furthermore:
- (v) The measure is proportionate as permanent establishments situated in another Member State and non-resident subsidiaries are not in a comparable situation with regard to the allocation of the power of taxation.¹⁴⁰

Although the preservation of the allocation of taxing powers seems to be the only overriding reason in the Court's ruling, another second reason also looms in the text, which is the fear of abuse.¹⁴¹ This is, in our view, the ultimate reason behind this ruling and an element that brings EU case law closer to established tax law principles. As the Court states, allowing a border-wise unlimited tax consolidation regime may make a lot easier the double dipping of losses.

This argument is present in paragraphs 31 and 32 of the above cited case:

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 (...) since the dimensions of the tax entity can therefore be altered, acceptance of the possibility of including a non-resident subsidiary in such an entity would have the consequence of allowing the parent company to choose freely the Member State in which the losses of that subsidiary are to be taken into account.

So, even when it is true that *X Holding BV* differs from other similar recent cases, such as *SGI, OyAA, Lidl Belgium*, or *Marks & Spencer*, in that the overriding interest consisting of the safeguard of the allocation of taxing rights stands alone, the other element usually present – tax avoidance – is not completely absent in the reasoning. In addition, as Calderon has pointed out, the Court may not be entirely consistent with its previous case law, as the argument by which a tax consolidation regime may not be extended abroad because foreign subsidiaries are subject to a different tax regime may be in contradiction with the rulings in *C-377/07, STEKO industriemontage GmbH*.¹⁴² Finally, again, by using the balanced allocation of powers argument, the Court makes it clear that PEs and subsidiaries are in different positions, as a PE is really not comparable in terms of allocation of powers, for it is always only one taxpayer – the principal – with a taxable presence in another territory. This is (still) perfectly consistent with Articles 7.1 and 23.2 of the OECD MTC.

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¹³⁹ As Calderon, *supra* n. 63, has noted, the Court probably does not really think the situations to be alike, as its reasoning does not elaborate on exactly why they should be alike, which seems at least strange, not only in light of the arguments of the other parties but also taking into account International Tax Law, which otherwise the Court seems to follow. The murky as well as over simplistic para. 24 is appalling: 'the situation of a resident parent company wishing to form a single tax entity with a resident subsidiary and the situation of a resident parent company wishing to form a single tax entity with a non-resident subsidiary are objectively comparable with regard to the objective of a tax scheme such as that at issue in the main proceedings in so far as each seeks to benefit from the advantages of that scheme, which, in particular, allows the profits and losses of the companies constituting the single tax entity to be consolidated at the level of the parent company and the transactions carried out within the group to remain neutral for tax purposes'.

¹⁴⁰ The Court here refers to International Tax Law, adding that this conclusion can be derived from the DTA, and in particular Arts 7.1 and 23.2.

¹⁴¹ Calderón Carrero, *supra* n. 63.

¹⁴² *Ibid.* See also A. García Prats, 'Is It Possible to Set a Coherent System of Rules on Direct Taxation under EC Law Requirements?', in *A Vision of Taxes within and outside European*, ed. Luc Hinnekens & Phillippe Hinnekens (Borders: Kluwer Law International, 2008), 435 y ss; D. Weber, 'In Search of a (New) Equilibrium Between tax sovereignty and the Freedom of Movement within the EC', *Intertax*, 34 (2006): 587 et seq.

It is probably too soon to undertake a full assessment of the effects of these rulings on cross-border loss relief regimes in the EU. So far, some Member States, such as Sweden, have recently introduced changes in their group relief tax systems to align them with ECJ case law,¹⁴³ which may, however, still be problematic.¹⁴⁴ Others, such as the United Kingdom and Germany, have been advised by the Commission to do the same. In the case of the United Kingdom, the Commission contends that it has ill adapted its legislation to the *M&S* case.¹⁴⁵ As for Germany, its *Organschaft* legislation may entail a hidden discrimination of EU subsidiaries.¹⁴⁶

The rulings of the Court are often highly controversial, and it has often been stressed that they undermine the tax sovereignty of Member States.¹⁴⁷ In the most recent cases, however, the Court seems to pay particular attention to different regimes and is growingly cautious with its rulings. The fact that cross-border loss relief is effectively intertwined with the (non) harmonization of the taxable base is probably factored in the cases, especially after *Marks & Spencer II*.

5. IS EVERYONE LOSING IN THE END? WHAT IS DESIRABLE AND WHAT IS POSSIBLE FOR CROSS-BORDER LOSS RELIEF COORDINATION IN THE EU

The most obvious conclusion of this article is that, under the current system of cross-border loss relief (or rather its absence), everyone loses.

Taxpayers – companies and individuals – lose as they are deprived of the possibility of offsetting losses and, in the end, of being taxed in accordance to their ability to pay, which in practice leaves staggering percentages of losses stranded.¹⁴⁸ This is crucial for small and medium enterprises, whose relevant weight in the EU economy has been

so often pointed out. In their case, the current situation may well undermine all possibilities of expansion, especially if they are located in a small Member State.¹⁴⁹ Furthermore, even when loss relief is granted, the higher compliance cost or the different requisites would normally imply a greater administrative cost, which is in the end a type of tax pressure, albeit indirect.

Member States also lose, as there is growing uncertainty as to what type of system of loss compensation is actually EU proof. Notably, the system may end up punishing its best players, that is, Member States with existing loss relief mechanisms and a developed tax system will be in a harder position than countries, such as Slovenia, that simply have decided to do away with the system. In this regard, the consequences of the Court rulings may even run counter to the Treaty aim of ensuring neutrality, partly as a consequence of Member States' reactions to the rulings.¹⁵⁰ There are many examples of this, apart from loss relief. Thus, in the case of thin capitalization rules, after the ECJ rulings Member States mostly changed the rules to make them applicable also in domestic situations, something that runs counter to the basic logic of thin capitalization rules.¹⁵¹ After the *Marks & Spencer* ruling, the reaction of Member States was less clear, but at least five Member States decided to increase the scope of their group exemption regimes to EU activities, while another (Slovenia) decided to repeal the regime altogether.¹⁵²

This brings us to the third loser of the non-system of cross-border loss relief, which is the ECJ, as it may not be fulfilling its objective to foster neutrality and thus missing out in its role as umpire of tax law. Loss relief clearly exemplifies the limits of integration via ECJ case law. In general, tax harmonization via case law is at best complicated and most of the time biased and uncoordinated. One must bear in mind that not all cases make it to the Court,

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¹⁴³ The purpose of the Swedish new rules is to make the group contribution regime compliant with the Treaty on the Functioning of the European Union, in that the deduction for final losses of subsidiaries within the EEA, if certain requirements are met, will be allowed. The rules will enter into force on 1 Jul. 2010 and will apply to final losses of foreign subsidiaries liquidated after 30 Jun. 2010. See a full description in D. Edvinsson, 'New Rules Seek to Make Group Contribution Regime EU Law Compliant', *European Taxation* 50, no. 7 (2010).

¹⁴⁴ As Edvinsson points out (see footnote above), the strict rules requiring direct ownership of the subsidiaries, among others, make the new laws hardly compatible with the ECJ case law.

¹⁴⁵ IP/09/1461, 8 Oct. 2009. According to the Commission (reference number 2007/4026), 'the UK continues to impose conditions on cross-border group loss relief which in practice make it impossible or virtually impossible for the taxpayer to benefit from such relief in accordance with the judgment in *Marks & Spencer*. This in particular concerns the following aspects: an unnecessarily restrictive interpretation of the condition that there should be no possibility of use of the loss in the State of the subsidiary (paragraph 7 of Schedule 18A of the Income and Corporation Taxes Act (ICTA) 1988); the parent company should demonstrate that the condition that there should be no possibility of use of the loss in the State of the subsidiary is met as from immediately after the end of the accounting period in which the loss arises (Part 1, paragraph 7(4), of Schedule 18A ICTA 1988); the legislation states that it applies only to losses incurred after 1 April 2006 (Part 3 of Schedule 1 of the Finance Act 2006)'.

¹⁴⁶ For Germany, Procedure No. 2008/4409, 29 Jan. 2009. See, in this regard, Calderón Carrero, *supra* n. 63.

¹⁴⁷ García Prats, *supra* n. 142, 435 y ss; Weber, *supra* n. 42, 585.

¹⁴⁸ See, in this regard, the data presented by the 'Survey of Losses on Cross-Border Activities within the EU by the Federations of Swedish Industries', available in S. Lodin & M. Gammie, *Home State Taxation* (Amsterdam: IBFD, 2001).

¹⁴⁹ There is widespread agreement that losses are hardest on small and medium companies; see J. Freedman, 'Reforming the Business Tax System: Does Size Matter? Fundamental Issues in Small Business Taxation', in *Australian Business Tax Reform in Retrospect and Prospect*, ed. C. Evans & R. Krever (Thomson Reuters, 2009), 176 et seq.

¹⁵⁰ R. De La Feria & C. Fuest, 'The Economic Effects of European Tax Jurisprudence', WP (2010, forthcoming) – quoted with permission of the authors.

¹⁵¹ *Ibid.*; the paper's table show that as many as thirteen Member States actually did just that. Spain was not one of them; instead, it was decided to make thin capitalization rules not applicable for domestic or EU-wide operations; for a critic of the reforms, see V. Ruiz Almendral, 'Subcapitalización y libertad de establecimiento: el caso "Test Claimants in the Thin Cap Group Litigation" como una oportunidad para rehabilitar el artículo 20 del TRLIS', *Noticias de la Unión Europea* 283 (2008): 121–134.

¹⁵² De La Feria & Fuest, 24 (Austria, Ireland, Latvia, Lithuania, Sweden, the United Kingdom).

partly because not all countries/courts submit questions to the Court.¹⁵³

Finally, the EU as a whole also loses, as there is less coordination, less market integration, and therefore less international competition.

It is then obvious that restrictions to loss relief have an effect that go far beyond discriminating or restricting, that is, beyond making it less attractive to move around. Such restrictions touch the core of taxation of income. If no loss relief is provided, the tax is not reflecting the real ability to pay, thus not only is it not being neutral and inefficient, it is also creating a fictional tax debt.

That being said, the options, from a realistic point of view, are not so clear. Most likely, the only long-term solution to curb the disadvantage that having so many different and often incompatible loss relief schemes is the adoption of some type of unitary taxation scheme, such as the CCCTB.

Of course this does not look feasible, at least in the short term,¹⁵⁴ especially in light of the current crisis, when losing tax revenues is particularly problematic for deficit-laden EU countries. To the moment, there are several works dedicated to assessing the economic consequences that the adoption of the different systems may bring about for Member States.¹⁵⁵

A recent paper suggests that a loss consolidation system such as that proposed in the CCCTB project may cause significant revenue falls of the corporate tax, in particular because of the new loss consolidation possibilities,¹⁵⁶ which hardly makes the project more attractive. It has also been suggested that an EU-wide cross-border loss offsetting will upset tax revenues for some Member States,¹⁵⁷ something that could be avoided using a formulary apportionment system, as it would establish a basic insurance against revenue loss, which, according to some, may then enable Member States to set up competitive (lower) tax rates in order to attract foreign investors.¹⁵⁸ According to another paper,¹⁵⁹ establishing an optional CCCTB with a formulary apportionment system would have uneven consequences in Member States, as well as causing an overall reduction of tax revenues.

A salient element of these analyses, as yet another paper points out,¹⁶⁰ is that estimating losers and winners in terms of tax revenue is difficult as so many different elements must be taken into account, such as the type of economy or industrial composition of the country, the final definition of the tax base and the tax rates, even if these are not originally an element of the CCCTB.

Barring, at least 'cross-border-loss-wise' ideal scenario of a CCCTB, the Commission's 2006 proposal stands out as not-too-bad second-best option. Ideally, a system of temporary loss transfer, with an afterwards recapture, could be set up in the form of a Directive on losses, thus unearthing the discarded original proposal. The rulings of the Court may pave the way to the final adoption of such a system, especially bearing in mind that they may imply harder conditions for offsetting of losses, with regard to EU initiatives, such as the Draft Directive.¹⁶¹

In this regard, it is probably true that the current situation of loss carry-over tax chaos is somewhat parallel to the situation tackled by *Schumacker* and the like, on the problems with migrating workers and the corresponding freedom. The ultimate argument for forcing EU States to establish a non-resident EU worker optional tax regime was that even though it was the State of residence, the territory with primary taxing rights and the one in the best position to take into account personal and family circumstances in order to assess the individual's final tax liability when the State of residence was not in a position to do that, because the individual derived more than 75% (or 90%, in *Gilly*) of her income in the Source State, then this same State had to take on the role of the State of residence and tax according to family circumstances, among others. The present situation would be similar in that the losing subsidiary's Home State should be the one primarily granting loss deduction, but maybe the Home State of the parent should take on that role when the subsidiary cannot, as only this last State would be in a position to take into account such a loss, when the subsidiary's Residence State cannot.¹⁶²

Notes

¹⁵³ J.H.R. Weiler, 'A Quiet Revolution: The European Court of Justice and Its Interlocutors', *Political Studies* 26 (1994): 510. J. Baquero Cruz, *Entre competencia y libre circulación. El derecho constitucional económico de la Comunidad Europea* (Madrid: Civitas, 2002), 108.

¹⁵⁴ Unless it is adopted via enhanced coordination, as suggested by L. Cerioni, 'Postponement of the Commission's Proposal for a CCCTB Directive: Possible Ways Forward', *Bulletin for International Taxation* (2010).

¹⁵⁵ See generally J. Mintz & J.M. Weiner, 'Some Open Negotiation Issues Involving a Common Consolidated Corporate Tax Base in the European Union', *Tax Law Review* 62 (2008–2009): 111.

¹⁵⁶ L. Bettendorf et al., 'Corporate Tax Consolidation and Enhanced Cooperation in the European Union', *Oxford University Centre for Business Taxation WP 10/01* (2009): 19–20, <www.sbs.ox.ac.uk/centres/tax/papers/Pages/PaperWP1001.aspx>.

¹⁵⁷ M. Gerard & J. Weiner, 'Cross-Border Loss Offset and Formulary Apportionment: How Do They Affect Multijurisdictional Firm Investment Spending and Interjurisdictional Tax Competition?', CESifo Working Paper No. 1004, <<http://papers.ssrn.com/abstractid=434080>>, 2003.

¹⁵⁸ Mintz & Weiner, 112 et seq.

¹⁵⁹ M.P. Devereux & S. Loretz, 'The Effects of EU Formula Apportionment on Corporate Tax Revenues', *Fisc. Stud.* 29, no. 1 (2008): 2, <www.sbs.ox.ac.uk/centres/tax/Documents/working_papers/WP0706.pdf>.

¹⁶⁰ A. Van Der Horst, L. Bettendorf & H. Rojas-Romagosa, 'Will Corporate Tax Consolidation Improve Efficiency in the EU?', Tinbergen Inst. Discussion Paper No. 2007-076/2, <www.tinbergen.nl/discussionpapers/07076.pdf>, 2007.

¹⁶¹ As it is pointed out in Panayi, *supra* n. 97, 43.

¹⁶² This has been suggested in T.P. Rodrigues, 'Cross-Border Loss Relief Jurisprudence', *EC Tax Journal* 10, no. 1 (2008). This would be the 'always somewhere' approach by the ECJ, as put in A. Rivolta, 'Transfer of Residence within the European Union: The Treatment of Pre-existing Losses – Part 2', *European Taxation* (February–March, 2010): 67 et seq. Critical with this (Rodrigues') approach is Schön, *supra* n. 9, 828.

The problem with the 'do-nothing approach' that EU Law subsidiarity principle in tax matters produces is that far too often, when faced with an EU compatibility problem of their tax systems, Member States do one of three things, all of them damaging to the internal coherence of tax systems and, in the end, to neutrality in the EU. First, they may increase the scope of the rule. Thus, when the problem is an anti-abuse rule that is stricter for transnational situations, the rule may be changed so that it is also applied in domestic situations. This is what happened, to name just one example, with thin capitalization rules and was a perfect blunder, for these types of rules are designed for an international arena and it simply does not make sense to have them for domestic operations.¹⁶³

Second, when the problematic provision is some type of tax advantage or benefit that was only available for domestic operations or agents, the solution may be either to extend it to other EU members and (third) to simply eliminate it altogether, which will be less challenging for tax revenues. In all cases, the result may be equally dissatisfying, for at least part of the agents loses the benefit, with nobody winning it. The conclusion is always the same: in the long run, it does not make sense to respond to the ECJ or the Commission by patching up the tax systems. A more fundamental reform is needed, and recent cases just make it more pressing. Loss relief is a good example of this. The question remains whether it is possible to coordinate the loss relief systems while waiting for the more ambitious objective, in this case the CCCTB, to be attained. Just extending domestic regimes to transnational situations will not work, as the tax bases are different.

Finally, there are a number of underlying unresolved issues that will necessarily shape the debate on the cross-border set off of losses. The main one is that the problem of cross-border losses is at the heart of the territoriality problem in the EU. Strict (tax) territoriality in loss compensation is clearly disadvantageous in many scenarios, in comparison with a purely domestic situation, even when that disadvantage is not contrary to EU Law as it now stands. A profit-making PE will not be allowed by the Source State to offset the losses incurred by its Home State-based principal, something that is not contrary to the freedom of establishment. So, as much as the ECJ has ruled that there has to be *some* type of loss compensation, the fact is that Member States do retain tax powers to define the taxable event in their territories and it is extremely hard to figure out a system that would account for all losses. However, as the situation now stands, there is clearly room for improvement, in order to avoid that losses, in particular from subsidiaries, become stranded for long.

6. REFERENCES

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Note

¹⁶³ I elaborate on this point on Ruiz Almendral, 'Subcapitalización y libertad de establecimiento: el caso "Test Claimants in the Thin Cap Group Litigation" como una oportunidad para rehabilitar el artículo 20 del TRLIS', 121-134 and 'Entre la discriminación y la armonización: el régimen fiscal del no residente en España a la luz del Derecho Comunitario', 3-68 (this last paper is available at <<http://uc3m.academia.edu/VIOLETARUIZALMENDRAL>>).

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Annex: Summary of the Most Relevant ECJ Cases on Tax Losses

Case (Alphabetical Order)	Ruling
C-141/99, <i>AMID</i>	Cross-border loss offset for PE (Home State perspective). The Belgian system proves disadvantageous for those companies with a PE in another Member State, in an inequality of treatment in relation to companies without establishments outside Belgium. There is no objective justification to treat a Belgian PE located in Luxemburg any different than if that PE (branch) had been located in Belgium.
C-293/06, <i>Deutsche Shell</i>	PE Currency losses must be taken into account.
C-250/95, <i>Futura</i>	Cross-border loss offset for PE (Host State perspective). The Source or Host State may limit the offsetting of losses to those that have an economic link to its territory (territoriality principle) but may not make it harder to prove losses than it is to prove benefits (profit split for the second, separate allocation for the first)
C-182/08, <i>Glaxo Wellcome</i>	Group relief via portfolio depreciation write-off. There is a restriction of free movement of capitals, which may be justified by the allocation of tax powers and the need to curb tax avoidance
C-264/96, <i>ICI</i>	UK Group relief system (consortium relief). Consortium relief is available only to companies controlling, wholly or mainly, subsidiaries whose seats are in the national territory. This is inconsistent with the freedom of establishment as it discriminates against UK companies holding EU entities versus UK companies holding UK companies.
C-157/07, <i>Krankenheim Rubesitz</i>	Permanent establishments.
C-414/06, <i>Lidl Belgium</i>	German clawback loss relief system for PEs.
C-446/03, <i>Marks & Spencer</i>	UK Group relief system. Temporal losses may not be offset, final losses must (domestic legislation needed to be reformed).
C-431/01, <i>Mertens</i>	Discrimination and free movement of workers. Individual taxpayer, similar facts to <i>Amid</i> .
C-231/05, <i>O y AA</i>	With regard to Finish/Swedish Group contributions, it is not contrary to EU Law to deny a deduction for group contributions from a Swedish company to its foreign parent company or its foreign sister company, even if under similar circumstances a deduction would have been granted in a purely domestic situation. Swedish rules are not contrary to the freedom of establishment where the deduction is claimed on the basis that the subsidiary's losses may not be utilized due to the expiry of a loss carry-forward period in the subsidiary's country of residence.
C-418/07, <i>Papillon</i>	French Group tax integration system is a restriction to the freedom of establishment because it excluded French resident subsidiaries indirectly held via a Dutch parent. The measure was justified to preserve coherence of tax system but was disproportional.
C-527/06, <i>Renneberg</i>	Individual taxpayer cannot deduct his negative income from a personal dwelling in his Home State, where his income is taxed in the Source State.
C-347/04, <i>Rewe-Zentralfinanz</i>	Group relief via portfolio depreciation write-off.
C-377/07, <i>STEKO industrie-montage GMBH</i>	Group relief via portfolio depreciation write-off.
C-200/98, <i>X AB and Y AB</i>	Finish/Swedish Group contributions.
C-337/08, <i>X Holding BV</i>	The Netherlands Group tax consolidation system. The Netherlands regime may exclude non-resident entities from its tax consolidation system in order to safeguard the allocation of tax powers. In addition, PE and subsidiaries are not comparable for tax reasons.
C-96/08, <i>CIBA</i>	PE costs offsetting. (Hungarian) Tax law imposing a vocational training levy (VTL) is incompatible with the freedom of establishment in situations when a Hungarian undertaking with a branch in the Czech Republic cannot benefit from some advantages, which may reduce the levy paid in connection with employees of that branch.