

Cross-Border Loss Relief for Permanent Establishments under EC Law

This article analyses the jurisprudence of the European Court of Justice on permanent establishments to determine the responsibilities of Member States and their limits in respect of cross-border loss relief from the home state's perspective. The article reveals apparent inconsistencies and endeavours to answer open questions in this regard.

1. Introduction

Losses play an important role in tax law as a source for minimizing tax liability. This is especially true in an international context, where enterprises may try to transfer their profits and losses to reach a minimal overall tax liability. Naturally, governments wish to protect their revenue and, therefore, restrict multinational enterprises regarding "exporting" profits to other jurisdictions and "importing" losses into their home state. These restrictions have been under close scrutiny by the European Court of Justice (ECJ) for both international group structures and permanent establishments (PEs). This article is primarily concerned with the ECJ's jurisprudence on the latter issue; the first issue is discussed only in as far as it is necessary to understand the principles created and applied by the Court. It is questionable how far the ECJ has restricted the Member States' ability to devise their tax systems with regard to losses incurred by foreign PEs of resident taxpayers. Consequently, the objective of this article is to analyse the responsibilities of Member States and their limits in this respect as can be derived from the ECJ's judgements.

Despite claims that the matter has basically been settled in favour of the Member States in the recent ECJ decisions *Deutsche Shell* (C-293/06),¹ *Lidl Belgium* (C-414/06)² and *Krankenheim* (C-157/07),^{3,4} it can be demonstrated that several issues remain unresolved, as the Court's decisions are open to criticism with regard to both reasoning and result. Most importantly, the ECJ has failed to explain clearly the difference between discriminatory and non-discriminatory behaviour of the home state regarding foreign PE losses. It is, therefore, a further objective of this article to provide criticism regarding the question of justification and the application of the proportionality test. It is submitted that the ECJ is wrong to disregard the cash flow disadvantages inflicted on the taxpayers as a consequence of discriminatory provisions. In the author's view, the "allocation of taxing power" cannot justify this treatment. Member States should not be allowed to draw a line of distinction between temporal and final losses with regard to loss

relief – the line should be drawn along the difference of discriminatory versus non-discriminatory treatment.

The following analysis is concerned with the question of choice of Member States in applying the exemption method to foreign PE income. There are two different approaches available for the treatment of losses, which are both in use and equally correct from the point of view of international tax law.⁵ On the one hand, the "symmetric" approach results in the "exemption" of losses as well as profits, thereby disallowing taxpayers to offset their foreign branch losses. The "asymmetric" approach, on the other hand, includes foreign losses into the domestic tax base and prevents the double use of losses by recapturing foreign profits in later years.⁶

The source state view on PE losses is not discussed. In this respect, the ECJ has long made clear that Member States are allowed to restrict relief to losses that are economically linked to activities carried on under their jurisdiction following the principle of territoriality.⁷ However, the same is not necessarily true for a Member State in its role as state of residence.⁸ This appears to be clear from the fact that almost all Member States apply worldwide taxation to their resident companies. They

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1. Case C-293/06, *Deutsche Shell* (28 February 2008).

2. Case C-414/06, *Lidl Belgium* (15 May 2008).

3. Case C-157/07 *Krankenheim* (23 October 2008).

4. In this respect, see, for example, Gerard T.K. Meussen, "The ECJ's Judgement in *Krankenheim* – The Last Piece in the Cross-Border Loss Relief Puzzle?", *European Taxation* 7 (2009), p. 361; Tiago Pedro Rodrigues, "Cross-Border Loss Relief Jurisprudence", *The EC Tax Journal* (2008), p. 46 et seq.; and Laurent Leclercq and Pauline Trédaniel, "Impact of the ECJ's Judgement in *Lidl Belgium* on the Deduction of Foreign Branch Losses in France", *Bulletin for International Taxation* 5/6 (2009), p. 240.

5. For a detailed theoretical analysis of the effect of the different approaches in applying the exemption method and the credit method on loss relief, as well as an empirical analysis of the methods used by Member States, see Tigran Mkrtchyan, "In Search of Ariadne's Thread: Permanent Establishments and Losses in the European Union", *Bulletin for International Taxation* 12 (2009), p. 586 et seq.

6. Currently, five Member States appear to follow this approach and nine Member States apply a symmetric approach. See Confédération Fiscale Européenne, "Opinion Statement of the CFE ECJ Taskforce on Losses Compensation within the EU for Individuals and Companies Carrying Out Their Activities through Permanent Establishments", *European Taxation* 10 (2009), p. 488. See also Mkrtchyan, supra note 5.

7. See Case C-250/95, *Futura Participations and Singer* (15 May 1997), Paras. 18 et seq.

8. For a contrasting opinion, see Meussen, supra note 4, p. 234.

cannot, therefore, invoke the principle of territoriality to justify discrimination of resident taxpayers.⁹

2. ECJ Case Law on Cross-Border Group Relief – Results and Expectations for PE Losses

The ECJ's "modern" jurisdiction on foreign losses starts with the landmark decision in *Marks & Spencer* (C-446/03).¹⁰ This case concerned a multinational group parented in the United Kingdom with several loss-making subsidiaries resident in other Member States. The parent of the group, Marks & Spencer plc, claimed relief for the losses incurred by the subsidiaries in France, Belgium and Germany, all of which had already been sold or ceased trading by that time.¹¹ As only resident subsidiaries could surrender losses under UK tax law, the claim was denied by the UK Revenue, before the case was referred to the ECJ for a preliminary ruling.

Following along the lines of the Advocate-General Poiras Maduro's Opinion, the ECJ identified a forbidden restriction in the fact that the cash flow advantage conferred on a merely domestic group by granting it accelerated loss relief was unobtainable for a parent company with regard to its foreign subsidiaries, as the provision was "of such a kind as to hinder the exercise by that parent company of its freedom of establishment by deterring it from setting up subsidiaries in other Member States" and "[t]hus constitutes a restriction on freedom of establishment".¹²

In the author's view, it is immaterial that the ECJ found a "hindrance" or "restriction", rather than "discrimination".¹³ The ECJ used terminology inconsistently; it is commonly understood, however, that a different treatment of comparable situations is *prima facie* "discriminatory". In *Marks & Spencer*, the ECJ, indeed, compared the taxation of a company with a domestic subsidiary with a company with a foreign subsidiary and, therefore, implicitly accepted the two to be in a comparable situation.¹⁴ It is submitted that the term "discrimination" or "discriminatory restriction" should have been used there to clarify the distinction to cases where a restriction does not follow from different treatment of comparable situations.

The ECJ went on to discuss possible justifications following its familiar "rule of reason doctrine".¹⁵ The ECJ considered several grounds of justification brought forward by the Member States and finally concluded that three of these, taken together, were suitable to justify the restriction in question: the aim of preserving the balanced allocation of the power to impose taxes, the danger that losses might be used twice, and the risk of tax avoidance.¹⁶ This reasoning deserves some attention.

For the first time, the ECJ accepted a combination of several grounds of justification, where one of these – the balanced allocation of taxing power – was newly created in the judgement itself and the two others would not normally have survived the strict proportionality test put forward by the ECJ in other decisions.¹⁷ Accord-

ingly, the by far most important ground of justification must be seen in the balanced allocation of taxing power, which, in the ECJ's view, would be "significantly jeopardised" by giving companies:

the option to have their losses taken into account in the Member State in which they are established or in another Member State..., as the taxable basis would be increased in the first State and reduced in the second to the extent of the losses transferred.¹⁸

The ECJ ignored the lengthy discussion of the Advocate-General regarding the principle of fiscal cohesion, which it had rejected in its preceding judgement in *ICI* (C-264/96).¹⁹ The difference between the two cases does not explain the lack of discussion of the principle of fiscal cohesion by the ECJ after the Advocate-General had accepted this in his Opinion. One possible explanation for this curious fact is that the ECJ implicitly presumed both grounds of justification to be somewhat exchangeable.²⁰

9. See Wolfgang Schön, "Losing Out at the Snooker Table: Cross-Border Loss Compensation for PEs and the Fundamental Freedoms", in Luc Hinnekens and Philippe Hinnekens (eds.), *A Vision of Taxes within and outside European Borders, Festschrift in Honor of Prof. Frans Vanistendael* (Alphen aan den Rijn: Kluwer Law International, 2008), p. 815 et seq.

10. Case C-446/03, *Marks & Spencer* (13 December 2005).

11. *Id.*, Para. 21.

12. *Id.*, Para. 33 et seq.

13. The only apparent difference between the concept of discrimination (or: discriminatory restriction of the fundamental freedoms) and a (non-discriminatory) restriction lies in the applicability of grounds of justification not explicitly mentioned in the EC Treaty. This difference, however, is becoming less obvious as it is not consistently applied by the ECJ. In this respect, see Case C-136/00, Advocate-General's Opinion, *Danner* (21 March 2002), Paras. 36-40; for a sceptical view on the inconsistent case law, see C-446/03, Advocate-General's Opinion, *Marks & Spencer* (7 April 2005), Para. 33. It appears that the ECJ most often uses the term "restriction" when concerned with *outbound* cases, confining the use of the term "discrimination" to proceedings against the source state.

14. A "vertical" comparison or "migrant/non-migrant test". In this regard, compare Tom O'Shea, "Marks and Spencer v Halsey (HM Inspector of Taxes): restriction, justification and proportionality", *EC Tax Review* (2006), p. 82. The assumption of comparability can also be derived from the ECJ's rejection of the territoriality principle as justifying the infringement (C-446/03, *Marks & Spencer*, Para. 40): the underlying notion of this is that the different tax treatment of two subsidiaries resident in different countries does not lead to incomparable situations.

15. C-446/03, *Marks & Spencer*, Para. 35.

16. *Id.*, Paras. 42 et seq. and 51.

17. The second ground of justification – the potential double use of losses – would have had to fail the proportionality test, as Member States are able to resolve the problem by relying on the Mutual Assistance Directive (77/799/EEC) to establish whether losses have been taken into account in the other Member State (see Pedro Rodrigues, *supra* note 4, p. 33). Equally, the third reason used by the ECJ – tax avoidance – has consistently been rejected in cases where the provisions in question were not specifically tailored to prevent "wholly artificial arrangements". In this respect, see, for example, Case C-264/96, *ICI* (16 July 1998), Para. 26 and Case C-196/04, *Cadbury Schweppes* (12 September 2006), Para. 51 et seq. The ECJ even noted this line of case law in C-446/03, *Marks & Spencer*, Para. 57, but did not use it in the usual way.

18. C-446/03, *Marks & Spencer*, Para. 46.

19. C-264/96, *ICI* (16 July 1998).

20. In its discussion of the ground of justification, the ECJ also appears to have the Advocate-General's argument regarding loss trafficking as a threat to the cohesion of the tax systems in mind, who argued in C-446/03, Advocate-General's Opinion, *Marks & Spencer*: "Certainly this risk [of 'loss trafficking', a/n] must not be overlooked. Nor, however, should it be overestimated. It is readily dealt with by the requirement that the benefit of the relief is subject to the condition that the losses of foreign subsidiaries cannot receive advantageous tax treatment in the State in which those subsidiaries are resident" (Para. 79). The notion of exchangeability of the two concepts appears even more convincing after the judgements in C-414/06, *Lidl Belgium* and C-

The even more interesting part of the judgement, however, lies in the arguments used in the proportionality test, which is astonishingly short. In only five paragraphs the ECJ explained that the restrictive measure went beyond what was necessary to attain the objectives of overriding interest where “the non-resident subsidiary has exhausted the possibilities available in its State of residence of having the losses taken into account” and “there is no possibility for the foreign subsidiary’s losses to be taken into account in its State of residence for future periods”.²¹ This argumentation mirrors the Advocate-General’s reasoning in Para. 79 of his Opinion in *Marks & Spencer* with regard to fiscal cohesion:

Where the State in which the foreign subsidiaries are established enables those subsidiaries to impute their losses to another person or to carry them forward to other financial years, the United Kingdom is entitled to oppose a claim for the transnational transfer of those losses.

However, the ECJ went even further in reducing the legal requirement enshrined in the fundamental freedoms that a restriction must not go further than necessary to achieve a justifiable purpose by stating “Furthermore, in so far as it may be possible to identify other, less restrictive measures, such measures in any event require harmonization rules adopted by the Community legislature”.²² As a result, the ECJ set a rather arbitrary standard of when losses have to be taken into account in complete disregard of the remaining cash disadvantage, which is conferred on the taxpayer by postponing loss relief to some future point. This standard also appears to be arbitrary from the point of view of the home state, as the group can manipulate the “finality” of its losses by liquidating or selling a subsidiary to trigger a loss offset.

The second important ECJ case (*Oy AA* (C-231/05))²³ concerned a profitable Finnish company, Oy AA, whose UK parent company incurred losses. Oy AA wished to deduct payments made to its financially troubled parent under the Finnish “group contribution regime”, which according to the Finnish provisions was only available for domestic companies.

In this case, the ECJ had no difficulty to identify a (discriminatory) restriction of the freedom of establishment in the “domestic entity”, which was a requirement of the Finnish regime. In the next step, it applied the arguments for justification established in *Marks & Spencer*, accepting a combination of only two of the three factors as sufficient.²⁴ Again, the more important and potentially convincing argument (due to a lack of opposing previous case law) was the balanced allocation of taxing power.²⁵ The proportionality analysis advanced by the ECJ was even shorter than in its preceding judgement. In one paragraph the ECJ noted a list of possible conditions which could be set to reach a less restrictive approach, but even before that the Court had already concluded that:

any extension of that advantage to cross-border situations would... have the effect of allowing groups of companies to

choose freely the Member State in which their profits will be taxed.²⁶

Accordingly, the ECJ held the Finnish exclusion of foreign companies from the beneficial group contribution regime to be justified under *any* circumstances, going beyond its judgement in *Marks & Spencer*, where the exclusion was only justified under the condition that losses are available for relief in another Member State. The ECJ was apparently more willing to accept the exclusion in this case, as the Finnish regime was more far-reaching in its effects domestically. This is a curious result indeed, as Finland would not necessarily have to extend all domestically available benefits to foreign companies.²⁷ In order to reconcile *Marks & Spencer* and *Oy AA*, it is probably necessary to consider a rather formal difference between them. Specifically, the ECJ stated that *Oy AA* was not concerned with the question of deductibility of losses and even less so with “final losses”, which was the deciding factor for the outcome of *Marks & Spencer*.²⁸ In effect, the ECJ did not consider the issue of “importing losses”, as in *Marks & Spencer*, but the issue “exporting profits”, which indeed appears to be different and may justify a more restrictive approach.²⁹

The conclusions to be drawn from these judgements can be divided into two. In respect of rather general developments of importance regarding the status of direct tax provisions in EC law, at least two have to be stated here: the concept of taking several justifications together and the creation of the “balanced allocation of taxing power”. Both are integral parts of the ECJ’s subsequent case law. Nonetheless, both innovations remain somewhat obscure from these early judgements, as the ECJ did not explain how many grounds of justifications have to accompany the argument on allocation of taxing power, nor did it clearly define the essential meaning of the justification.³⁰

In respect of more the specific issue of cross-border loss relief, it appears to be clear from the ECJ’s decisions that the fundamental freedoms do not generally require the Member States to give relief for losses incurred by for-

157/07, *Krankenheim*. See Michael Lang, “Recent Case Law of the ECJ on Direct Taxation: Trends, Tensions and Contradictions”, *EC Tax Review* (2009), p. 109.

21. C-446/03, *Marks & Spencer*, Para. 55.

22. *Id.*, Para. 58. See also the critical remarks of Timothy Lyons, “*Marks & Spencer*: something for everyone?”, *British Tax Review* (2006), p. 12.

23. Case C-231/05, *Oy AA* (18 July 2007).

24. *Id.*, Para. 60.

25. *Id.*, Para. 62 et seq. The ECJ explicitly stated that the second justification would not have applied on its own.

26. *Id.*, Para. 64.

27. See Werner C. Haslehner, “Group Relief for Losses – ECJ in Deviation to *Marks & Spencer*?”, *Steuer und Wirtschaft International* (2007), p. 443 et seq.

28. In this respect, the considerations of Advocate-General Kokott are illuminating. See C-231/05, Advocate-General Opinion, *Oy AA* (12 September 2006), Para. 71.

29. Compare Anno Rainer, “Anmerkung zum EuGH-Urteil *Oy AA*”, *Internationales Steuerrecht* (2007), p. 635 et seq.

30. See Joachim Englisch, “Limitation of Fundamental Freedoms to Safeguard the Allocation of the Power to Impose Taxes”, *Steuer und Wirtschaft International* (2008), p. 399.

eign subsidiaries of resident companies. However, under certain circumstances, the denial of loss relief becomes disproportionate and thus a forbidden infringement. The conditions to render a Member States' justification ineffective in this regard are commonly referred to with the term "final" (or "terminal") losses. This term is not without problems. Especially, it appears to make the obligation of the state of residence of the parent company conditional on the loss relief rules implemented in the subsidiary's state of residence.³¹

It is now crucial to ask what can be derived from that case law for losses incurred by foreign PEs. In addition to the remaining uncertainty regarding the principles established, the question is whether or not the principles can be readily applied to that situation. This should prima facie depend on whether the situations are comparable. However, in his Opinion on *Marks & Spencer*, Advocate-General Poirares Maduro clearly rejected the notion of comparability of subsidiaries and PEs from the home state perspective: "the difference in treatment of those two categories of establishments... stems from a difference in the tax regimes applicable to the different types of establishment"³² and "the provisions on freedom of establishment do not preclude different tax treatment from being accorded to legal or natural persons in different legal situations".³³

The ECJ apparently adopted the same position, as it did not oppose the Advocate-General's opinion in this point. This is not absolutely clear, though. Specifically, it can be argued that there was no need for the ECJ to discuss this detail,³⁴ as it was sufficient to use the "migrant and/or non-migrant" test to reach its conclusion.³⁵ It must also be taken into account that the Advocate-General's rejection of the "horizontal" (or cross-legal form) comparison³⁶ in that case was based on a comparative analysis of the UK provisions on group relief and on domestic branch taxation. In particular, Advocate-General Poirares Maduro concluded that:

Groups of companies are not entitled to consolidation for tax purposes which applies to the income of PEs. [Thus] the group relief system... cannot have the effect of assimilating the situation of subsidiaries to that of branches. Under that regime the transfer of losses is treated in a specific way. There is no consolidated joint taxation.³⁷

This line of reasoning obviously cannot apply for cases where the underlying group regime provisions work differently, especially when there is consolidated joint taxation. In applying a consolidation system for groups of companies, the principal distinction in tax treatment between (domestic) branches and subsidiaries as discussed by the Advocate-General is abolished, even though several others may remain, depending on the particular Member State's tax regime.³⁸ In the first step, there is a simple comparison of the tax treatment of two domestic situations: a single entity with several branches (i.e. a "branch group") and a separate-entity group. If the two situations were treated alike domestically, this would arguably result in "assimilating the situation of subsidiaries to that of branches", making the different

legal forms of establishment comparable in the cross-border situation.³⁹ If comparability was thus established, a different treatment of foreign subsidiaries and PE would prima facie lead to an infringement of EC law. This implies that Member States applying the credit method for foreign PEs would also have to include all losses of foreign subsidiaries (fulfilling the requirements for being members of a consolidation group) in the consolidated tax base.⁴⁰ On the other hand, Member States following the symmetric approach in applying the exemption method for PEs would not be required to do so, as they also disregard losses incurred by foreign PEs. In this case, however, one would expect the principle of allowing "final" losses to be offset in the home state as derived from *Marks & Spencer* to apply to final losses incurred by foreign PEs as well, as comparability arguably has to work both ways.⁴¹ That result is not affected by the fact that *Marks & Spencer* was decided on the basis of a "vertical" comparison, as both comparators may be applicable in one case. If, on the other hand, branches and subsidiaries are not assimilated in the way just shown, cross-legal form comparability cannot be found, making it less obvious to apply the principles from *Marks & Spencer* directly to PEs.

As this analysis reveals, it could have been expected that the ECJ would consider carefully whether or not the principles established in *Marks & Spencer*, especially in

31. See 6.

32. C-446/03, Advocate-General's Opinion, *Marks & Spencer*, Para. 48.

33. *Id.*, Para. 49.

34. See Lyons, supra note 22, p. 255, who noted already before the judgment that "it is not clear that the Court will find it necessary to do so".

35. See O'Shea, supra note 14, p. 82.

36. As has been noted by Michael Lang, "Zum Seminar G: Verbietaet das Gemeinschaftsrecht die Erhebung von Quellensteuern?", *Internationales Steuerrecht* (2009), p. 539, there are different scenarios that are equally called "horizontal comparison", making it necessary to distinguish between the classical "horizontal" comparator, which is applied where a cross-border situation is compared with another cross-border situation involving a different foreign country. This approach has recently been accepted by the ECJ in Case C-521/07, *Commission v. Netherlands* (11 June 2009). The second "horizontal" comparator involves two cross-border situations between the same two countries, normally involving two different legal forms of establishment. This approach has been accepted by the ECJ in Case C-253/03, *CLT-UFA* (23 February 2006) from the host state of view, but is yet unconfirmed from the point of view of the residence state. I will continue to refer to this latter comparison as a "cross-legal form" comparison from now on.

37. C-446/03, Advocate-General's Opinion, *Marks & Spencer*, Para. 48.

38. See Michael Lang, "Marks and Spencer – more questions than answers: an analysis of the Opinion delivered by Advocate General Maduro", *EC Tax Review* (2005), p. 96 et seq.

39. This follows from Advocate-General Poirares Maduro's reasoning (C-446/03, Advocate-General's Opinion, *Marks & Spencer*) *e contrario*. It must be acknowledged, however, that this outcome is not supported by any case law yet; it completely depends on the assumption that applying joint taxation to companies will make them comparable to branches for tax purposes in the eyes of the ECJ, which is disputable.

40. Correspondingly, it could of course include foreign profits in the domestic tax base as well. See Lang, supra note 38, p. 97.

41. Critical of this are Axel Cordewener, Matthias Dahlberg, Pasquale Pistone, Ekkehart Reimer and Carlo Romano, "The Tax Treatment of Foreign Losses: Ritter, M&S, and the Way Ahead (Part Two)", *European Taxation* 5 (2004), p. 232, who claim that this would not be a necessary conclusion from the ECJ's case law. However, these authors solely focus on the argument that the statement "a PE must not be treated worse than a fictitious corporation" does not automatically imply that a corporation must not be treated worse than a PE. This surely is correct, but it does not focus on the concept of comparability.

its proportionality analysis, should apply to cases regarding losses incurred by a foreign PE.⁴² Unfortunately, the ECJ did not provide any explanation as to why its reasoning should apply to those cases, even though it explicitly referred to *Marks & Spencer* and decided *Lidl Belgium* along the same lines.⁴³ In particular, the ECJ did not consider the question of cross-legal form comparability and whether or not the existence of a consolidation group regime could lead to a different result.

3. *AMID* – Does the ECJ Know How to Build a Bridge?

The first case concerned with losses incurred by a PE from the viewpoint of the home state is a curious one. It attracted stimulating discussions in academic literature, with some authors arguing that the ECJ's reasoning was flawed (the "wrong bridge"), even though the result of the case was correct.⁴⁴ From the point of view of its subsequent case law, however, it is necessary to say that both reasoning and result were incorrect.

In *AMID* (C-141/99),⁴⁵ the ECJ had to consider the Belgian rules regarding a restriction of loss carry-forwards in the head office due to profits incurred by a PE in Luxembourg. Belgium had implemented a rule according to which the domestic losses would be set off against profits from the foreign PE, which, however, were exempt in Belgium. By doing so, the losses were not available for a loss carry-forward in Belgium against the profits attributable to the head office in the following year. Effectively, the offset against exempt profits in the first year did not yield any relief to *AMID*. Accordingly, the company claimed that it constituted a restriction of the freedom of establishment, as it deterred them from setting up a foreign branch. The ECJ basically followed this claim and held that:

by setting off domestic losses against profits exempted by treaty, the legislation of that Member State establishes a differentiated tax treatment as between companies incorporated under national law having establishments only on national territory and those having establishments in another Member State.⁴⁶

The ECJ, therefore, found the situation of a company with a domestic branch to be comparable to the situation of a company with a foreign company in respect of a loss carry-forward.⁴⁷ This may be correct in principle, but the ECJ failed to carry out the next step properly. In the case of a Belgian company with a domestic branch incurring profits, the losses incurred by the head office would also be set off against those profits immediately, and there would be no loss to be carried forward either. In fact, the Belgian rules treated the foreign PE just as if it was a domestic PE.⁴⁸ If the idea of comparability of companies with domestic branches and those with foreign PEs is upheld, there was no discrimination to be found in the case. Accordingly, a restriction of the freedom of establishment could only be found by looking at the end result. In effect, *AMID* was subject to double taxation with regard to its foreign PE profits.⁴⁹ The ECJ did not discuss this issue, but according to its later case

law, this negative effect would not constitute an infringement of EC law.⁵⁰

Alternatively, discrimination could have arisen from the fact that Belgium did not heed the effects of the tax treaty to "treat foreign source-income of its residents consistently with the way it has divided its tax base"⁵¹ from the equal treatment of situations that should be distinguished on the fact that the cross-border situation was governed by a tax treaty. It is, however, very clear from subsequent case law that the mere existence of a tax treaty and the consequential difference with regard to the home state's right to tax foreign activities does not amount to different situations; it can only work as a justification.⁵² Accordingly, in addition to the fact that the ECJ's reasoning appears to have already been flawed at the time of its delivering, even an alternative reasoning would, taking later case law into account, not lead to the same result in this case today.

4. *Deutsche Shell* – Are Member States Free to Allocate Currency Losses?

Deutsche Shell again troubled the ECJ with regard to establishing the right comparator. The case concerned the rather specific situation of a currency loss arising to the German *Deutsche Shell GmbH* through its Italian PE. The loss became apparent when, after transferring the PE to a subsidiary and selling its shares, the proceeds of the sale were set against the start-up capital initially granted to the PE. Even though the PE itself, as well as the transaction leading to its dissolution, had been profitable in Italy, the consistent devaluation of the Italian lira against the German mark resulted in a loss in the books of the German company. The German tax authorities, however, did not allow the loss to be deducted as an expense for tax purposes, arguing, inter alia,⁵³ that the losses formed part of the income attributable to the Italian PE, which could not be taken into account in

42. Critical is Gunter Mayr, "Moderne Konzernbesteuerung im Lichte der EuGH-Rechtsprechung", *Betriebs-Berater* (2008), p. 1314 et seq.

43. See 5.

44. Compare Luc Hinnekens, "AMID: The Wrong Bridge or a Bridge Too Far? An Analysis of a Recent Decision of the European Court of Justice", *European Taxation* 6 (2001), p. 206 et seq.; John F. Avery Jones, "A Comment on 'AMID: The Wrong Bridge or a Bridge Too Far?'" *European Taxation* 7/8 (2001), p. 251; and Axel Cordewener, *Europäische Grundfreiheiten und nationales Steuerrecht* (Cologne: Otto Schmidt, 2002), p. 799 et seq.

45. Case C-141/99, *AMID* (14 December 2000).

46. Id., Para. 23.

47. Id., Para. 29.

48. See Cordewener, supra note 44, p. 794 et seq.

49. Hinnekens, supra note 44, p. 208 et seq. and Cordewener, supra note 44, p. 795 et seq.

50. Case C-513/04, *Kerckhaert and Morres* (14 November 2006), Para. 18 et seq. and Case C-67/08, *Block* (12 February 2009), Para. 31.

51. Compare Case C-374/04, Advocate-General's Opinion, *ACT Group Litigation* (23 February 2006), Para. 58.

52. C-446/03, *Marks & Spencer*, Para. 40 et seq. and Case C-347/04, *Rewe Zentralfinanz* (29 March 2007), Para. 69. A further, detailed discussion of the issue is provided in Axel Cordewener, Georg Kofler and Servaas van Thiel, "EC Fundamental Freedoms and Direct Taxation", *LexisNexis 2010*, in preparation.

53. In addition, they argued that the loss could not be regarded to be a "real financial loss". It is not necessary to discuss this issue here, as the ECJ left it to the national court to decide.

Germany under the “principle of symmetry”. Had the company experienced a profit from a shift in exchange rates, it would equally not be taxed in Germany.⁵⁴ Deutsche Shell GmbH argued that denying loss relief constituted an infringement of the freedom of establishment, as it placed it “in a less favourable situation than if the ‘start-up capital’ had been invested in a company established in Germany”.⁵⁵

Implicit in this argument is the idea that the establishment of a domestic branch would constitute a comparable situation to the one at issue. It is obvious, however, that in a mere domestic situation, a currency loss could never have come into existence. The loss itself can nonetheless not result in a forbidden restriction of a fundamental freedom, as it is simply the consequence of the existence of two different currencies. There is no situation to be found where a currency loss as a result of the repayment of start-up capital would be deductible in Germany. Consequently, Advocate-General Sharpston and the ECJ refrained from trying to find the right comparator and simply concluded that the provisions at issue constituted a non-discriminatory obstacle (a genuine “restriction”), as the additional financial risk incurred by Deutsch Shell GmbH. In setting up an Italian branch, it did not only have to “face the normal risks associated with setting up such a body, but... an additional risk of a fiscal nature where it provides start-up capital for it”.⁵⁶ It has been argued, however, that the ECJ did in substance find discrimination to be at hand in the form of the less often used notion according to which discrimination can arise through the application of the same rule to different situations.⁵⁷ According to this argument, as the situations of a foreign and a domestic PE were different with regard to the risk of a currency loss, Germany would discriminate by not taking that risk into account in devising its tax system. However, following this argument appears to be odd, as it would hold the home state responsible for the existence of different currencies, which can clearly only be seen as an irrelevant disparity.

The ECJ then did not accept the symmetry argument brought forward by the German government as a suitable ground of justification, stating that:

the comparison between the currency losses, on one hand, and currency gains, on the other, is irrelevant, since there is no direct relationship between those two elements [as required to invoke the principle of cohesion, a/n].⁵⁸

This has been criticized as being too much focused on the facts of the concrete case and ignoring the aim of the tax rule.⁵⁹ The ECJ, however, appears to be consistent in demanding an actual advantage to offset an actual disadvantage to assess the existence of a “direct link” between the two. Even though currency profits and losses may be seen as two sides of the same coin, no such direct link exists between the two as they do not depend on each other.⁶⁰ The ECJ, therefore, clearly rejected the idea of symmetry to be the same thing as coherency.

Germany had also argued that the non-deductibility was justified by the fact that it followed from the tax treaty concluded with Italy and, therefore, was part of the allocation of tax competence between the two Member States. The ECJ accepted the validity of the ground of justification in general and stated that:

a Member State cannot be required to take account, for the purposes of applying its tax law, of the negative results of a PE situated in another Member State which belongs to a company with a registered office in the first State solely because those negative results are not capable of being taken into account for tax purposes in the Member State where the PE is situated.⁶¹

However, in the case in question, the ECJ did not accept the currency loss to be a negative result of the PE by stating it to be “unacceptable for a Member State to exclude from the basis of assessment of the principal establishment currency losses which, by their nature, can never be suffered by the PE”.⁶²

In essence, the ECJ explained the limits on when a Member State can rely on the overriding interest of the protection of the balanced allocation of taxing power. A Member State cannot invoke it as a justification with regard to income that has not been allocated to it in the tax treaty to prevent double taxation. Currency profits or losses can never arise in the source state and are, therefore, never at risk of being subject to double taxation. Consequently, the decision to exclude both from the tax base of the German company has to be qualified as a unilateral one taken by Germany’s domestic law. Even though the allocation of taxing power itself is outside the scope of EC law, its implementation via domestic tax law clearly is not.

In effect, the ECJ’s judgement apparently echoed the result from *Marks & Spencer*, increasing the consensus amongst scholars that the primary distinction with regard to cross-border loss relief has to be drawn between “temporary” and “final” losses.⁶³ It remained an open question, however, whether the ECJ would accept the cash disadvantage conferred on a taxpayer by disallowing relief for “temporary” losses with regard to for-

54. Neither, it could be added, would it be taxable in Italy, which is unable to “see” the profit or the loss, both of which only come into existence in the books kept in Germany. In the case of currency profits, therefore, double non-taxation arises.

55. C-293/06, *Deutsche Shell*, Para. 21.

56. *Id.*, Para. 30.

57. See Lang, *supra* note 38, p. 99.

58. C-293/06, *Deutsche Shell*, Para. 40.

59. Eric C.C.M. Kemmeren, “Exemption method for PEs and (major) shareholdings best services: the CCCTB and the internal markets concerned”, *EC Tax Review* (2008), p. 132 et seq.

60. This interpretation of the meaning of fiscal cohesion can easily be inferred from the few judgements where it was actually applied to justify an infringement of EC law. In this respect, see Case C-204/90, *Bachmann* (28 January 1992), C-157/07, *Krankenheim* and Case C-418/07, *Papillon* (27 November 2008) (although in the last case the measure taken by the French government was too restrictive, the idea of disallowing another deduction for losses already taken into account was accepted in principle).

61. C-293/06, *Deutsche Shell*, Para. 42.

62. *Id.*, Para. 44.

63. See Tom O’Shea, “German Currency Loss Rules Incompatible With EU Law, ECJ Says”, *Worldwide Tax Daily* (2008), 44-2.

eign PEs.⁶⁴ This issue was subsequently under scrutiny in *Lidl Belgium*.

5. *Lidl Belgium* – *Marks & Spencer* Applied to PEs

This case concerned a simple example of temporary losses. The German company Lidl Belgium GmbH & Co KG (“Lidl”) had a PE in Luxembourg, which, in 1999, incurred losses. Lidl sought to set these losses against its German profits, which was denied by the tax authorities with reference to the “principle of symmetry” after the abolition of the exception to this doctrine in Sec. 2a, Para. 3 of the German Income Tax Code (*Einkommensteuergesetz*). In its request for a preliminary ruling on this issue, the German Supreme Court (*Bundesfinanzhof*)⁶⁵ considered whether the principles derived from *Marks & Spencer* could be applied in effect. Even though the Court stated that the ruling was not directly applicable to PEs, it was of the opinion that there was no material difference with regard to the disadvantage and the grounds of justification accepted in that judgement. In addition, it asked whether the immediate offset of losses accompanied by a recapture would have to be regarded as a less restrictive alternative to the existing German tax rules and, therefore, would have to be implemented. Advocate-General Sharpston took this position. Specifically, after applying the principles from *Marks & Spencer* to ascertain the existence of discrimination and possible justifications, she went on to deny the proportionality of the German principle of symmetry as:

a deduction-and-recapture rule is unarguably less restrictive of the taxpayer’s fundamental right of establishment than an outright prohibition of deducting from the profits of a company losses made by a PE in another Member State. At the same time it is still appropriate for attaining the objectives of preserving the balanced allocation of the power to impose taxes and of avoiding the danger that losses would be used twice.⁶⁶

The ECJ did not follow the Advocate-General’s assessment. With regard to the German Supreme Court’s doubts regarding the applicability of the *Marks & Spencer* principles because of the different nature of a PE and a subsidiary, it started its reasoning by stating that a PE “constitutes, under tax convention law, an autonomous entity”.⁶⁷ This presumption clearly is incorrect. The separate-entity fiction applying to a PE is, for one thing, a mere fiction, and for another, a fiction which is merely put up to attribute profits to this fictitious entity from the point of view of the source state; even there the fiction does not apply without exceptions. With regard to the home state of the enterprise, the fiction is only applied to determine the correct amount of profits to be relieved. Both do not make a PE an autonomous taxable unit, and even less so from the home state’s point of view. It is also striking that the ECJ had not referred to this alleged comparability in *Marks & Spencer*, where Advocate-General Pöiares Maduro had concluded in his Opinion that subsidiaries and PEs are not in comparable situations.⁶⁸ It would have been convenient had the ECJ clarified the relationship between the two judgements in this respect.

However, even without such reference, the establishment of a forbidden (discriminatory) restriction in the case in question is convincing. The ECJ identified the immediate offset of losses incurred by domestic PEs to be a tax advantage, which was not conferred on foreign PEs, thereby discouraging a German company from carrying on its business through a PE in another Member State.⁶⁹

After this finding, the ECJ went on to examine possible justifications and applied two of the three grounds of justification used in *Marks & Spencer*: the balanced allocation of taxing power and the possible double use of losses. Recalling the argument from *Marks & Spencer* and *Oy AA*, the ECJ accepted both arguments to be applicable.⁷⁰ With regard to the first justification, this is, in the author’s view, disputable. The ECJ had explained in its earlier judgements with regard to the balanced allocation of taxing power, that it may only be invoked: “where the system in question is designed to prevent conduct capable of jeopardising the right of the Member States to exercise their taxing powers in relation to activities carried on in their territory”,⁷¹ whilst it “cannot in itself justify a Member State systematically refusing to grant a tax advantage to a resident parent company, on the ground that that company has developed a cross-border economic activity which does not have the immediate result of generating tax revenues for that State.”⁷²

This is also the reason why the balanced allocation of taxing power does not provide for a sufficient justification on its own, but requires another justification to accompany it. In particular, the balanced allocation of taxing power can only be in jeopardy when there is the danger that losses are taken into account twice or that a taxpayer could shift profits freely and choose the Member State to tax them. The right to exercise a Member State’s taxing power is, however, not necessarily in danger in the case of a PE following the rules agreed on in a bilateral tax treaty. Such a treaty does not include a rule that prevents Germany from exercising its right to tax activities carried on in its territory. Indeed, it may even assume a right to tax foreign activities to recapture an

64. See Hanno Kube, “Grenzüberschreitende Verlustverrechnung und die Zuordnung von Verantwortung”, *Internationales Steuerrecht* (2008), p. 311 et seq. and Werner C. Haslechner, “ECJ Judgment in the *Deutsche Shell GmbH* Case (C-293/06): Does Community Law Bring an End to the Symmetry Proposition?”, *Steuer und Wirtschaft International* (2008), p. 167.

65. *Bundesfinanzhof*, 28 June 2006, IR 84/04, BStBl II 2006, 861.

66. C-414/06, Advocate-General’s Opinion, *Lidl Belgium* (14 February 2008), Para. 25.

67. C-414/06, *Lidl Belgium*, Para. 21.

68. See 2. Compare also the criticism provided by Oliver Dörfler and Martin Ribbrock, “Negierung der Inländergleichbehandlung bei Nichtberücksichtigung ausländischer Betriebsstättenverluste – Verletzung fundamentaler Besteuerungsprinzipien”, *Betriebs-Berater* (2008), p. 653 et seq.

69. C-414/06, *Lidl Belgium*, Para. 23 et seq.

70. *Id.*, Para. 37 et seq., also explaining that two of the three justifications taken together are sufficient. The ECJ even appears to suggest that only one of the two could suffice as well, by stating that “the two justifications put forward must each be considered as being capable of justifying a restriction”.

71. C-231/05, *Oy AA*, Para. 54.

72. C-347/04, *Rewe Zentralfinanz*, Para. 43.

earlier loss, as is confirmed by the OECD Commentary⁷³ and can also be derived from Sec. 2a, Para. 3 of the German Income Tax Code. Furthermore, even if Germany was prevented from recapturing a loss following the tax treaty, this argument should not be held sufficient to justify a discriminatory treatment according to the ECJ's older case law. In *Wielockx* (C-80/94),⁷⁴ the ECJ held that a Member State cannot invoke the principle of cohesion if it has waived its right to tax in a tax treaty. Much as in *Deutsche Shell*, it was a unilateral decision made by Germany to exclude foreign losses from the right to a carry-forward, and not a necessary consequence of the allocation of taxing power. Accordingly, despite the ECJ's decision to the contrary, the tax treaty itself cannot provide an acceptable justification.

With regard to the second justification, there are two observations to be made. First, it has been argued that double use of losses of a PE is substantially different from the problem of "loss trafficking" at issue in *Marks & Spencer* and follows naturally from a PE's status.⁷⁵ Furthermore, the "rule-exception relationship" with regard to foreign losses was argued to be quite the opposite, making the ground of justification inapplicable to the PE situation.⁷⁶ Second, in applying the proportionality test, the ECJ deviated from the Advocate-General's Opinion, and upheld the general applicability of its *Marks & Spencer* ruling, according to which the state of residence had to take foreign losses into account only in a situation where the taxpayer could not obtain relief in the state of source either in the same or in any future period.⁷⁷ As Lidl had already deducted the loss from profits incurred by the PE in later years, the *Marks & Spencer* criteria were not met and Germany was not obliged to grant loss relief.⁷⁸ As in *Marks & Spencer*, the ECJ was not bothered by the remaining cash flow disadvantage for Lidl. This has correctly been criticized as going too far. Apart from general observations,⁷⁹ the cash flow disadvantage may eventually equal a final loss as the net value of the carry-forward tends towards zero.⁸⁰ However, the ECJ has consistently rejected arguments based on a cash flow disadvantage in recent judgements, leading Advocate-General Kokott to question whether or not older case law in this respect was still valid.⁸¹

It appeared to follow from the judgement that the distinction between temporary and final losses as allegedly advanced by the ECJ in its decisions regarding foreign subsidiaries must be fully applied to PEs as well.⁸² Still, the ECJ had not explained in detail the essential features of a "final" loss. Especially, it was unclear whether the responsibility of the residence state may depend on the loss carry-forward rules implemented by the source state. This question was answered in *Krankenheim* in the negative.

6. *Krankenheim* – Exploding the Myth of "Final Losses"

In this case, the ECJ was again confronted with a question to provide a preliminary ruling on German tax law

regarding foreign PE losses. Again, the facts were quite simple. The German company *Krankenheim Ruhesitz am Wannsee Seniorenheimstatt GmbH* ("Krankenheim") carried out part of its business activities through a PE situated in Austria. For the time the PE incurred losses (1982 to 1990), *Krankenheim* was allowed a deduction from its German profits under the exception rule in Sec. 2a, Para. 3 of the German Income Tax Code. After the PE turned profitable in 1990, Germany included so much of the profits in the tax base in Germany as to recapture the loss initially deducted, despite the fact that Austrian domestic law did not allow the losses incurred by the PE to be carried forward against the same profit under its domestic law, leaving *Krankenheim* with no loss relief in either Member State. *Krankenheim* subsequently argued that the German reintegration rule constituted an infringement of EC law as it led to an unrelieved "final loss" for the company.

The ECJ decided to give its judgement without an Advocate-General's Opinion, apparently regarding the issue as not involving a new question of law. The reasoning of the ECJ, however, does not appear to be completely flawless on several issues. In fact, the judgement appears to be erroneous already at its outset, where the ECJ finds the German rules to constitute a (discriminatory) restriction of the company's freedom of establishment. The ECJ rightly observed that Germany granted the same advantage of offsetting losses immediately to foreign and domestic branches. The Court then went on to determine that Germany withdrew this advantage by reintegration of losses in case of subsequent profits. This is true, but it does not amount to a less favourable treatment than that of domestic PEs, whose profits are

73. Para. 44 of the Commentary on Art. 23 of the OECD Model Tax Convention.

74. Case C-80/94, *Wielockx* (11 August 1995), Para. 24 et seq.

75. Schön, supra note 9, p. 824 et seq.

76. Wolfgang Kessler and Rolf Eicke, "Cross-Border Loss Transfer After *Lidl Belgium*", *Tax Notes International* (2008), p. 645.

77. C-414/06, *Lidl Belgium*, Para. 47 et seq.

78. Id., Para. 53.

79. For example, Kessler and Eicke, supra note 76; Christoph Watrin, Anas Wittkowski and Friederike Lindscheid, "EuGH: Keine Sofortverrechnung ausländischer Betriebsstättenverluste – Das Urteil in der Rs. *Lidl Belgium* aus betriebswirtschaftlicher Sicht", *Internationales Steuerrecht* (2008), p. 639 et seq.; Christian Wimpissinger, "Cross-border transfer of losses, the ECJ does not agree with Advocate General Sharpston", *EC Tax Review* (2008), p. 173; Leclercq and Trédaniel, supra note 4, p. 240; and, in the same vein, see Michael Tumpel, "Losses by Permanent Establishments in the European Union", *Steuer und Wirtschaft International* (2001), p. 58 et seq.

80. Englisch, supra note 30, p. 403.

81. Case C-282/07, Advocate-General's Opinion, *Truck Center* (18 September 2008), Para. 48. However, it does not follow from that case that cash flow disadvantages imposed on taxpayers by their home state are irrelevant from an EC law point of view; if anything, it might follow that cash flow disadvantages are insignificant where a non-resident taxpayer is subject to a different mode of taxation than a resident taxpayer in the source state. This may be justified by the principle of territoriality as it concerns the source state. It cannot, however, be justified by the same principle for the home state that taxes its resident taxpayer's worldwide income. See 1.

82. Compare Tom O'Shea, "ECJ Upholds German Loss Disallowance", *Tax Notes International* (2008), p. 1081.

always taxed as a part of the company's profits.⁸³ The less favourable result in the present case, if any,⁸⁴ merely followed from the fact that Austria did not grant a loss carry-forward. Disregarding this fact, the ECJ, after identifying discrimination, went on to search for a justification and accepted the need to guarantee the coherence of the German tax system as applicable in this case, as there was a:

direct, personal and material link between the two elements of the tax mechanism at issue in the main proceedings, the said reintegration being the logical complement of the deduction previously granted.⁸⁵

This once again clarifies the ECJ's understanding of the principle of fiscal cohesion and the requirement of a direct link between a disadvantage and a corresponding advantage conferred on the taxpayer through a Member State's legislation. In *Deutsche Shell*, the ECJ had denied a direct link between currency losses and currency profits. The difference to that decision, however, is clear (i.e. the disadvantage of not taking a currency loss into account occurred without any necessity of the existence of currency profits). In *Krankenheim*, however, the alleged disadvantage of taxing profits could only occur in a case where, in previous years, a corresponding advantage had already been conferred on the same taxpayer. Consequently, the ECJ had no difficulties to conclude the restriction to be appropriate and proportionate.

With regard to the previously discussed judgements, the question arises how it is possible to reconcile the fact that in *Krankenheim* allegedly a "final loss" came about. First, the result is consistent with the ECJ's reasoning in *Deutsche Shell*, where it had explained that a Member State cannot be required to:

draw up its tax rules on the basis of those in another Member State in order to ensure, in all circumstances, taxation which removes any disparities arising from national tax rules, given that the decisions made by a company as to the establishment of commercial structures abroad may be to the company's advantage or not, according to circumstances.⁸⁶

The negative effect in question was a result of the lack of coordination of the German and Austrian rules; insofar, the ECJ correctly applied its reasoning from *Deutsche Shell*.

It is less obvious, however, whether the judgement is also in line with *Marks & Spencer* and *Lidl Belgium*. The ECJ's reasoning implies that a recapture rule like the one implemented in German tax law was justified under all circumstances. Following the common understanding of its preceding case law, one would have expected the ECJ to take a narrower view and disallow a recapture in a case where there was no loss relief available in Austria (the "final loss" argument). By not doing so, the ECJ apparently applied a different standard with regard to proportionality of restrictive measures, without providing any explanation.

Fortunately, after having reached its conclusion, the ECJ put forward an additional, more convincing argument

why Germany should win the case. In what appears to be an obiter dictum, the ECJ went on to explain that, even if the remaining disadvantage (of having an unrelied loss) would constitute a restriction of the freedom of establishment, this disadvantage would not fall under the responsibility of the state of residence, but was imputable only on Austria.⁸⁷ Although convincing in its result, the further remark of the ECJ that in this case the "restriction would arise not from the tax system at issue in the main proceedings, but from the allocation of tax competences under the German-Austrian Agreement"⁸⁸ cannot be supported. Indeed, the result would have been the same if there was no treaty between Austria and Germany. The restriction, therefore, cannot be a consequence of the treaty's existence. The truth is even easier: the restriction in the case resulted from the Austrian domestic tax rules.

This does not appear to be in line with *Marks & Spencer* and *Lidl Belgium*, where the ECJ had held that the state of residence was bound to take losses into account if the taxpayer "has exhausted the possibilities available" to have a loss relieved in the source state. The taxpayer in *Krankenheim* could claim that they had.

Several solutions for this apparent inconsistency have been brought forward in academic literature.

First, it has been argued that even though a contradiction is found when comparing the outcome of *Krankenheim* to the wording used in *Marks & Spencer*, it only serves to put the notion of "final losses" in more concrete terms, explaining that the criterion of "finality" does not apply to a situation where loss relief is unobtainable in the source state because of its restrictive loss relief provisions. Following this argument, a "final loss" only entails a loss that cannot be relieved for factual reasons.⁸⁹ In the author's view, this cannot be derived directly from *Krankenheim*. The decisive factor in that case was – and had to be, if understood correctly – solely the German tax rule.

Second, it was submitted that the ECJ did not mean to contradict its earlier judgements at all. It would appear unlikely that the ECJ would change its mind within such a short time, all the more without explicitly stating the

83. Werner C. Haslechner, "ECJ Judgment in the *Wannsee* Case compared with *AMID*, *Shell* and *Lidl Belgium* – Permanent Establishment Losses Revisited", *Steuer und Wirtschaft International* (2008), p. 565; See also Meussen, supra note 4, p. 362.

84. C-157/07, *Krankenheim*, Para. 18, in which the ECJ stated that in the year in dispute (1994) Austria did not actually assess the profits of the company. It is, therefore, difficult to see where a disadvantage should have occurred. The ECJ did not elaborate on this question, but assumed its existence. See Philipp Lamprecht, "Betriebsstättenverluste, Verlustvortragsrecht und Aufteilung der Besteuerungsbefugnisse nach dem Urteil in der *Rs. KR Wannsee*", *Internationales Steuerrecht* (2008), p. 766.

85. C-157/07, *Krankenheim*, Para. 42 et seq.

86. C-293/06, *Deutsche Shell*, Para. 43, referred to by the ECJ in C-157/07, *Krankenheim*, Para. 50.

87. C-157/07, *Krankenheim*, Para. 51.

88. Id., Para. 52.

89. See Lamprecht, supra note 84, p. 768.

contradiction.⁹⁰ According to this view, the responsibility of the residence state with regard to final losses is shifted back on the source state where the finality is the result of discriminatory provisions of the source state. The promoter of this view finds the basis for this solution in the fact that the Austrian rules regarding loss carry-forward have been widely accepted to be discriminatory – a fact that might even explain why Austria, in the end, did not actually take the profits from 1994 into account.⁹¹ The author does not agree with this view for two reasons. First, the ECJ had no power to examine the compatibility of the Austrian rules with EC law in the case, and indeed did not do so in its reasoning. Second, this would be inconsistent with the “single-country approach”⁹² normally adopted by the ECJ in examining national legislation. The ECJ only asks whether or not the Member State in question has implemented discriminatory rules. Whether or not this is the case cannot depend on another Member State’s provisions.

O’Shea promotes a third explanation to reconcile the judgements, based on the ECJ’s restricted competence to alter domestic tax rules. He states that the ECJ “does not have the power to tell the Member States to adopt specific (tax) laws”, to explain why the Court accepted the recapture rule to be a proportional rule in *Krankenheim*, but did not require the United Kingdom to adopt such regime as a less restrictive measure in *Marks & Spencer*.⁹³ Not only would the author dispute this assessment with regard to the ECJ’s power as being an issue. There was no reason for the ECJ to “[impose] a recapture mechanism to the residence state”,⁹⁴ as this was of no concern to the Court in any event. The ECJ simply could have told the Member States to allow deduction for the losses and clarified that they are allowed to recapture the loss in later years. What is even more, that view only explains why the ECJ accepted the cash flow disadvantage in its judgements, but fails to explain why in *Krankenheim*, the final loss did not amount to an infringement. This argument, therefore, does not provide a clear resolution of the apparent inconsistency.

In the author’s view, the right way to reconcile the judgements is a different and more formal one, and not concerned with the problem of whether a loss in question is merely “temporary” or “final”. There is an important difference between *Krankenheim* and the preceding judgements, which is unrelated to the question of temporality and finality. The difference lies in the fact that in *Krankenheim*, the German provisions were non-discriminatory in the first place, whilst in *Marks & Spencer* and *Lidl Belgium* the home state was applying discriminatory rules. Consequently, even though an unrelieved loss remained, it was clearly not the result of any wrongdoing of the home state. In this respect, the solution is the same as it should have been in *AMID*. The negative effect in question in both cases should have been discussed as an issue of double taxation.⁹⁵ According to the ECJ’s settled case law, this only amounts to a mere disparity and neither state can, simply because of its existence, be held responsible to avoid it.⁹⁶ In the end, this

does not deviate too far from the first explanation, but it results in a different outcome where, in the same situation as *Marks & Spencer*, the impossibility to get relief in the residence state of the subsidiary stems from that Member State’s law. In the author’s view, the United Kingdom would still be required to take this “final” loss into account. Following the explanation of Lamprecht, it would not, which appears to be in contradiction to the reasoning applied in Para. 55 of *Marks & Spencer*. The same should – in the author’s opinion – apply with regard to a “temporary” loss.

The abolition of the distinction between temporary and final losses also appears to be an important issue for the application of the case law to PEs in general. It is, indeed, very difficult to determine when a loss incurred by a PE turns out to be “final”, unless it follows from restrictive loss carry-forward provisions implemented by the source state.⁹⁷ Neither the “disposal” nor the dissolution of a PE guarantees that losses cannot be taken into account in later years.⁹⁸ The only situation to be aware of where there are no losses ever to be relieved in the source state, which would be where the enterprise itself is liquidated. It would be unsatisfactory to set the limit for a “final” loss that far, though. In this situation, it will often not be possible for the home state to take the earlier loss into account either, unless the liquidation brings about a profit.

7. Conclusions and Evaluation of ECJ Case Law

In drawing conclusions from the analysis provided in 2. to 6., it appears best to start with setting out the current state of the law as it can be derived from the ECJ’s judgements. After that, a final critique of the case law will be provided.

As the case law now stands, three principles can be derived for the responsibility of the home state to give relief for losses incurred by a foreign PE:

90. See Jens Knipping, “Zur Frage des Definitivcharakters ausländischer Betriebsstättenverluste im Sinne des EuGH-Urteils in der Rechtssache *Lidl Belgium* bei fehlender Möglichkeit eines interperiodischen Verlustausgleichs im Betriebsstättenstaat”, *Internationales Steuerrecht* (2009), p. 276 et seq.

91. Lamprecht, supra note 84, p. 769.

92. Cordewener, Kofler and van Thiel, supra note 52.

93. O’Shea, supra note 82, p. 1080 and “German Loss Deduction and Reintegration Rules and the ECJ”, *Tax Notes International* (2009), p. 969. In the same vein, see Jérôme Monsenego, “Relieving Double Taxation: A Look at *Lidl Belgium*”, *Tax Notes International* (2008), p. 415.

94. Monsenego, supra note 93, p. 415.

95. Haslechner, supra note 83, p. 568. See also Meussen, supra note 4, p. 362.

96. See 3. This result, of course, only holds true in assessing the German rules at issue – it does not necessarily mean that there are no discriminatory provisions in the other state, which in turn might be held responsible. But the mere fact that a disadvantage persists, does not necessarily mean that someone has to be acting against the fundamental freedoms.

97. In addition, it can of course be argued – irrespective of C-157/07, *Krankenheim* – that the source state rules should be disregarded to determine whether a loss is “final”. See, in this respect, Kube, supra note 64, p. 310. See also 7.

98. The problem there is that the loss carry-forward is not a right of the PE, which does not constitute a taxable entity, but of the non-resident company itself. Even if a PE is dissolved, there might still be a possibility for the enterprise to obtain loss relief in the source state. Compare also Meussen, supra note 4, p. 363.

- (1) If the taxpayer is able to obtain relief in the state where the PE is established in any later year, the home state is not required to give any relief, if it domestically applies a “symmetric” exemption method. This follows from *Lidl Belgium*.
- (2) If the home state follows the symmetric approach, it must take a loss into account which, by its nature, cannot be relieved in the source state. This can be derived from *Deutsche Shell*.
- (3) If the home state follows the asymmetric approach, it may recapture a previously deducted loss even if the source state does not provide for relief of the same loss, as it was the case in *Krankenheim*. The same is true – *argumento a maiore ad minus* – if the source state does give relief.

These three principles lead to the next, so far unanswered question: whether the home state, when applying a symmetric exemption, is required to take a loss into account that cannot be relieved under the source state rules despite sufficient taxable profits to do so. This cannot be answered from the ECJ’s reasoning in *Lidl Belgium* or in *Krankenheim*, as it begs the question whether a “final” loss, which has to be taken into account following *Marks & Spencer* and *Deutsche Shell*, can be created artificially by restrictive source state rules. The only hint given by the ECJ so far can be seen in *Deutsche Shell*, where it explicitly footed its argument on the fact that loss relief could not be obtained because of its *nature*. This implies that Germany would not have been obliged to take a loss into account whose finality was not a consequence of the very nature of it, but of the particularities of the Italian loss relief rules. This assessment is further strengthened by the statement in Para. 42 of that judgement, according to which Germany cannot be required to take a loss into account “solely” because it cannot be relieved in Italy. In *Marks & Spencer*, however, the ECJ was not bothered with that criterion; furthermore, if a “final loss” cannot follow from restrictive source state rules, it will be extremely difficult to find one in case of a PE, as both a sale and dissolution of the PE do not necessarily lead to such final losses.

To sum it up, according to the ECJ’s rulings, a “final” loss has to be relieved in the home state only if there was no immediate loss offset in the year where it occurred. With regard to “temporary” losses, such relief never has to be given.

Two questions remain:

- (1) Which criteria should a Member State apply in devising a “recapture” rule, in order not to make it a discriminatory treatment?
- (2) How is “finality” of a loss to be determined?

With regard to the first question, it is the author’s view that the reintegration of relieved losses does comply with the fundamental freedoms as long as it guarantees that it is based on the profitability of the foreign PE. In that case, it cannot be found to be discriminatory, as it only applies domestic treatment to the PE. In fact, the

ECJ’s argument of cohesion is not even necessary in this respect. The only requirement for the home state is not to tax results that would not form a taxable profit of domestic branches. Accordingly, another open question can be answered: whether the home state must calculate the PE’s profits on the basis of its own or the source state’s tax rules.⁹⁹ Whilst it is acknowledged that applying the source state rules would have a greater chance to avoid all disadvantages to the taxpayer, the home state is free to apply its own rules, as it would still provide “domestic” treatment. A remaining disadvantage¹⁰⁰ would be the consequence of different rules to calculate profits in the respective Member States and the resultant (insignificant) disparity.

This solution also results in a balanced overall taxation in both countries and – ideally – does not lead to an unrelieved loss from the taxpayer’s perspective. Only in a case where the source state does not provide for loss relief, a disadvantage remains. Without prejudice to the question of whether or not the source state infringes the fundamental freedoms (which cannot be answered without taking a look at the loss relief provisions applicable to a domestic enterprise in the source state), this disadvantage is not a consequence of the home state rules and thus cannot lead to the home state’s responsibility. With regard to the disadvantage that arises to the home state where no subsequent profit is attributable to the foreign PE, this has to be seen as a logical consequence of the principle of worldwide taxation applied to resident companies, which cannot justify a discriminatory treatment.

With regard to the second question, no clear answer can be derived from case law. In the author’s opinion, the more important question is *why* the ECJ restricts the responsibility of the residence state to final losses, as compared to *how* finality is to be determined. It should be recalled that the ECJ regards denying immediate loss offset as discrimination in the first place. It is only as a matter of justification that it sets a limit to “final” losses. This limit appears to come from the ECJ’s attempt to find the right balance between the burden to be put on the Member States and on the taxpayer. In this respect, it is settled case law that the fundamental freedoms do not prevent a cross-border investment of all possible tax disadvantages.¹⁰¹ Still, it is not convincing to disregard the remaining cash flow disadvantage completely and deem it to be an issue that could only be prevented by legislative measures at Community level. The power of the ECJ is definitely sufficient to decide a justifiable measure to be disproportionate if another less restrictive measure can easily be found. Furthermore, it is unconvincing to deem this an issue which is dealt with by the Member States in their tax treaties: the Member States do not require implementation of such discriminatory treatment. It is true that the offset and/or recapture sys-

99. Compare Meussen, *supra* note 4, p. 363.

100. Arising, for example, in a situation where the home state tax rules lead to calculation of a profit, whilst the source state rules result in a loss.

101. Case C-403/03, *Schempp* (12 July 2005), Para. 45.

tem puts the Member States in the position of having to face a cash flow disadvantage instead of the taxpayer. As the burden cannot be eliminated completely in the light of non-harmonized tax systems, the decision to be made by the ECJ is who has to bear it. Is the taxpayer ultimately responsible because he chose to invest in another Member State and, therefore, has to bear all consequences, even if they arise from discriminatory treatment, or is the home state responsible, as it applies discriminatory provisions? It appears unclear to the author how the balance could be found in putting the burden on the taxpayer in this situation. Since the recapture rule would not have to depend on actual relief given by the source state, the home state would not have to take any additional loss into account where an overall profit arises to the taxpayer.

In the author's view, the distinction drawn by the ECJ between "temporary" and "final" losses is thus unsatisfactory; in both situations, a disadvantage may arise to the taxpayer following discriminatory treatment by his residence state and, so far, no convincing argument has been advanced as a justification. The only relevant question is whether or not the domestic provisions are discriminatory in the first place. Accordingly, the ECJ was right to dismiss *Krankenheim's* claim even though it could in the end not obtain any loss relief, whilst it was (in the author's view) wrong to do so in *Lidl Belgium*, even though the claimant in that case could obtain relief in later years. It should be concluded that, in applying the exemption method, Member States should always provide for immediate loss offset with a later recapture of profits to comply with EC law.¹⁰²

A final comment may be made on the idea of an alternative cross-legal form comparison. If one follows Advocate-General Poiares Maduro's reasoning to its very end, at least in cases where a subsidiary can opt to be treated like a PE (i.e. in a full consolidation group regime), comparability would be established and, therefore, any loss of a foreign subsidiary would consequently have to be treated the same as a loss of a foreign PE.¹⁰³ Under a credit system, this automatically results in an immediate loss offset, which may be recaptured by taking subsequent profits into account. Under an exemption system, the same result should apply. In order to achieve this result, however, it has to be accepted that the symmetric treatment of losses and profits as currently applied by several Member States in respect of the exemption method constitutes an infringement of the fundamental freedoms by denying multinational enterprises the cash flow advantage which is conferred on merely domestic enterprises by their state of residence. In the author's view, this infringement should not be regarded as justified on the grounds accepted in *Lidl Belgium* for reasons of proportionality.

102. See also Confédération Fiscale Européenne, supra note 6, pp. 487-490.

103. Further insights into the issue of comparability of subsidiaries and PEs are to be expected from the ECJ's decision in Case C-337/08, *X Holding* (at the time of the writing of this article, not yet decided). The situation underlying the referral question involves a Netherlands parent company claiming the right to offset its profits with its Belgian subsidiary's losses – as it could do if it was a PE.