with Member States opting in but also companies. We think that the Directive could have a psychological effect. It is also a question of national image. National sentiments could be set aside in order to support companies that wish to make a bid without being opposed the reciprocity rule. So Members States like France or Germany will be given a great incentive to fully apply the key principles. 28

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The ECJ on the Verge of a Member State Friendly Judicature?

Annotation to the Marks & Spencer Judgement, ECJ 13.12.2005, C-446/03

by

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On 13 December 2005, the Grand Chamber of the European Court of Justice (ECJ) has issued apart from the SEVIC case 1 the second decision in the field of cross-border company activities. In contrast to many literary anticipations, the Court did not reject the UK domestic focused group taxation system as a general violation of Art. 43 and 48 EC Treaty. The ECJ rather tries to balance the fundamental freedoms and the legal and budgetary interests of the Member States by emphasizing the principle of territoriality. Only if the foreign subsidiary (or a third party as a purchaser) has no opportunity to effectively use its incurred losses in the state of its domicile, the state of residence of the parent company is obliged by Community law to reduce he losses from the taxable income (ultima ratio-principle). The reasons given for the judgement leave much uncertainty and reveal a lack of dogmatic foundation.

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1 See the commentary by P. Schindler, 'Cross-Border Mergers in Europe – Company Law is catching up?', ECFR 2006, p. 109-119.
I. The Marks & Spencer decision

On 13 December 2005, the ECJ issued its long expected verdict in the Marks & Spencer case. On the bench, the ECJ was testing a so called British “group relief”. This tax rule permits inter company loss transfers within domestic affiliated companies. The petitioner, British domiciled Marks & Spencer plc, carried huge accumulated deficits in its Belgian, French and German affiliates whereas the British holding company had earned profits. As Marks & Spencer had stopped the business activities of these foreign subsidiaries and respectively sold them, the losses could not be applied in the named Member States. Consequently the group claimed a cross border loss-transfer under British “group relief” rules. Under Sec. 402 et seq. Income and Corporation Taxes Act 1988 (ICTA) the competent tax authorities denied the cross border loss-transfer. Thus the High Court of Justice referred to the ECJ on whether barring cross-border loss transfers violates the freedom of establishment as guaranteed in Articles 43 and 48 EC Treaty.

The ECJ’s judgement principally sees the British group relief rules as compatible with Community law. Indeed, the limitation of group consolidations to only resident companies was deemed to restrict the freedom of establishment as granted by Articles 43 and 48 EC Treaty. To a wide extent, however, this limitation is permissible under the known “rule of reason” formula, as it serves a compelling public interest, namely the principle of territoriality. Acknowledging the character of a foreign subsidiary as an independent tax subject does at the same time mean a Member State cannot automatically regard its profits for own tax purposes but, rather, must first respect the sovereign rights of the state of residence. In this context the ECJ predominantly follows three main arguments of the UK (and other Member States) in supporting a justification of the British group relief rules. First, a fair allocation between taxation rights of different Member States requires the application of the tax law of the state in which the establishment has been carrying out its economic activities, insofar as profits and losses are concerned. Furthermore, an unlimited possibility of cross border loss-transfer would generate the danger of a double use of these losses. Finally, extending the group relief to losses incurred by non-resident subsidiaries could trigger multinational groups of companies to transfer any losses to those companies located in Member States with the highest rates of taxation (risk of tax avoidance).

Referring to settled case law the Court, on the other hand, will only grant the justification if the restrictive national rule does not go beyond what is necessary to reach its aims (principle of proportionality). In a concrete sense this means the restrictions on the movement of establishment by the British group relief rules are only to be permitted if they could not be designed in a less restrictive way. And the ECJ indeed saw a less restrictive method. It decided a general ban on transferring foreign losses within a group of companies is unnecessary. The above mentioned aims can be reached just as well if the group relief offers a transfer of losses at least as a last resort (ultima ratio) when a foreign subsidiary (or a third party as a purchaser) has no opportunity to effectively use its incurred losses in the state of its domicile. When the primarily responsible state of domicile does not grant compensation for accumulated losses towards present or future profits or such compensation is invalid because the respective company is sold or quits its business activities, then it is the secondary responsibility of the state of the holding company to take these subsidiary’s losses into account. In this line-up the above-demonstrated risks of a general loss transfer are nonexistent, meaning that a general ban would limit the freedom of establishment to an unnecessary degree. As a result, the ECJ decided the referred question of the High Court of Justice in favour of Marks & Spencer and granted a loss transfer to the British holding company as the foreign affiliates had no further possibilities to use their accumulated losses for tax purposes.

II. Judicial activism or judicial restraint?

1. Ever increasing limitations for national tax-legislators in the previous judicature

Nevertheless, the judgement was predominantly met with relief by the Member States. During the proceedings, it seemed likely that the Court assessed any restrictions to a free cross-border loss-transfer as contrary to the ECT, in consideration of the substantial background of previous decisions on direct taxation matters. In recent years the ECJ has become the driving force behind harmonization of tax law in the EU. In its judicature, it regularly stresses that the Member States may yield their legislative powers only in accordance with the provisions laid down in Community law. On this basis the Court exerts

3. ECJ, 13 December 2005, Case C-446/03, para. 39 et seq.
4. ECJ, para. 45 et seq.
5. ECJ, para. 47 et seq.
6. Ibid, para. 49 et seq.
7. Ibid, para. 53 et seq.
the full range of its competence and frequently cuts deep into national direct taxation systems by putting emphasis on the freedoms of movement (for people: Art. 39 EC; for services: Art. 49 EC; for establishment: Art. 43 EC; for capital: Art. 56 EC). The ECJ increasingly emphasized that these fundamentals effectively (effet utile) limit the taxation of individuals as well as companies in the Common Market. The Court interpreted the freedoms of movement's coverage extensively deeming not only differing treatments of residents and non residents but also any restrictions as a violation of the EC Treaty. This deployment of case law so far peaked in the judgements in the Manninen and Hughes de Lasteyrie Saillant cases. Both decisions reveal the ECJ’s approach, which evidently compares the legal position in tax matters solely from the market participant’s perspective and is primarily oriented toward ensuring a functioning Common Market. By contrast, even though the ECJ assumes national fiscal sovereignty, fiscal interests are regularly given only secondary consideration. A national tax system can not be viewed as a sufficient cause to justify restrictions on the freedoms of movement under the “rule of reason-formula”. Indeed, this judicature often triggered harsh criticism – and the ECJ has been subject to reproach for introducing a silent, creeping harmonization of the Member States’ tax laws.

Considering this background, the Marks & Spencer decision is remarkable and the Court apparently took seriously the concerns voiced by various


10 ECJ, 7 September 2004, C-319/02 Petri Manninen, ECR I-7477.


Member States during the proceedings – with respect to the creation of a free loss-transfer between related companies. This might indicate a change of the Court's above mentioned and very extensive interpretation of Community law, which has increasingly influenced national tax systems. Comments on the decision deem it a good balance between the Member State's interests and enforcement of the freedoms of movement. However, there is a concern that the ECJ might have been too restrictive – and could give in further to pressure from Member States that fear for their national revenue.

2. Priority for national loss compensation measures after the present decision

These concerns base on the one hand on the range of the decision itself and, on the other, on the bounteouness with which the court gave justification for restricting the freedoms of movement. On this point, the criticism is focused on the scope of loss compensation measures a foreign subsidiary must accept in its state of domicile before a cross-border loss-transfer to the holding company must be granted. Particularly controversial was the Court's holding that even future loss compensation would be adequate to justify a loss transfer ban, insofar as the subsidiary cannot make use of an instant loss-profit allocation due to lack of profits. The court did not give any consideration to the less restrictive possibility of instant loss compensation combined with a retrospective taxation clause in such cases as when a foreign subsidiary earns profit later on. To prevent the group companies from double loss compensation, it could be sufficient to apply a retrospective tax when the subsidiary can compensate its losses with a later profit in another Member State. If the tax burden differs between the two Member States, then the losses could be recognized only proportionately.

One argument against an instant cross-border loss-transfer could be the national interest of effective tax control. The fiscal authorities have to supervise the future development of the subsidiary in the other Member State to ensure retrospective taxation in such cases where a future profit is made. The domiciled parent company can be obliged to inform the tax authorities regarding the taxation of the foreign subsidiaries in the other Member States (see sec. 90 para. 2 German General Fiscal Code [Abgabenordnung]). By this national means, the burden of proof is retained by the taxpayer. Furthermore,
the council directive concerning mutual assistance in the field of direct taxation enables fiscal authorities to gather information on the determination of taxable profit in other Member States, if they are in doubt.

3. Non-harmonization of direct tax system justifies limitations of the freedom of establishment

The Commission stated during the proceedings that instant cross-border loss-transfers combined with later subsequent taxation save liquidity for the group and therefore represent a less restrictive measure. This argument was rejected, however, with reference to later all-embracing EC-harmonization rules. For the first time, with this statement, the Court explicitly acknowledged Member States' exclusive competence and sovereign rights in the field of direct taxation. Additionally, nationally retained legislative competence can serve a limiting function in favour of the Member States with respect to balancing national tax rules against fundamental freedoms – as long as the EC has not passed secondary legislative acts pursuant to Art. 94 EC Treaty. However, the argument of a deliberately non-harmonized direct tax law was introduced – at least dogmatically – as a purely balancing factor. It does not serve as a criterion to exert discretion within the "rule of reason" formula, e.g. in order to justify restrictions on the freedoms of movement, but rather as a measure to assess whether a justification goes beyond what is necessary in a specific case.

It is the decisiveness with which the ECJ granted the Member States priority and exclusivity for their national tax measures of loss compensation for group affiliated companies that, indeed, leaves one wondering as to the direction of the Court's future judicature. The omission of instant loss compensation instead of allowing its possibility in the future leads to a curious result from a cross-border perspective: Under Community law, the obligation to compensate losses of foreign subsidiaries with profits of the parent company is contingent on the degree of restrictiveness of the foreign Member State's tax regime! Additionally, nationally retained legislative competence can serve a limiting function in favour of the Member States with respect to balancing national tax rules against fundamental freedoms – as long as the EC has not passed secondary legislative acts pursuant to Art. 94 EC Treaty. However, the argument of a deliberately non-harmonized direct tax law was introduced – at least dogmatically – as a purely balancing factor. It does not serve as a criterion to exert discretion within the "rule of reason" formula, e.g. in order to justify restrictions on the freedoms of movement, but rather as a measure to assess whether a justification goes beyond what is necessary in a specific case.


rates. This conflicting result, compared to previous judicature, may be due to an unstable dogmatic foundation in the ECJ's judgements in direct tax matters – this makes them less predictable than ever.

III. Dogmatic foundation of the judgement

1. The principle of territoriality's lack of dogmatic meaning

As remarkable and important it may be to acknowledge the non-harmonization of direct taxes by the ECJ, its introduction leaves yet as one more topic without a stringent and predictable foundation in assessing a national tax rule. The Court used the principle of territoriality as a "rule of reason" to justify limitations of the freedom of establishment. Though strengthening territoriality found much approval, one cannot ignore the fact that this principle is not very meaningful. It says no more than that a Member State has no claim to tax a foreign resident tax subject. Thus in Marks & Spencer, territoriality's real meaning is only the acceptance of foreign affiliated companies being legal entities and independent tax subjects. Even the ECJ could not draw any more dogmatic features out of the principle of territoriality – it simply held that it is not able to justify British group relief alone. Instead it had to support the Marks & Spencer judgement with the abstract, abovementioned reasons of double loss usage risk and fair tax revenue allocation between the Member States. One could go as far as to say that Marks & Spencer and particularly the "strengthening of the principle of territoriality" have only won appreciation because this principle is fairly vacant and poses no real dogmatic danger for the free movers in the Common Market. This may indeed be true, but on the other hand, the ECJ once more missed an opportunity to work on a clear and predictable reason to justify direct tax rules of the Member States.

2. Establishment of a consistent principle of coherence

Relief is commonplace that the ECJ did not mention the principle of coherence of national tax systems in the Marks & Spencer decision. However,
focussing on this principle would have just been necessary. Coherence was introduced by the ECJ in the Bachmann decision as a criterion to permit restrictions of the freedoms of movement. 20 In that case, the ECJ held in a purely formal view that the coherence of a national tax system may permit rules which appear to be restrictive, standing alone, but must actually be seen in a broader picture since they are directly linked to an advantage benefiting the same tax subject in the same tax type. Later, in the well-known Manninen case, the ECJ followed General Advocate Kokott's opinion that the coherence principle may be applied in wider, interpersonal circumstances. 21 In that case, concerning the Finnish imputation tax credit system, it admitted that the advantage of a shareholder tax credit for received dividend payments was directly related to the disadvantage that the dividend payment had already been subjected to corporation tax, paid not by the shareholder but by the shareholder's company. Thus the Court did in general enhance the justification reason of a tax system's coherence – and finally, the Finnish tax imputation system failed only for reasons of lacking commensurability. 22

Considering the above-demonstrated lack of dogmatic function of the territoriality-principle, it would have been more consistent to link the argument of non harmonized national tax systems in the Member State's competence to the coherence principle. Because, just as Advocate General Maduro already made appropriately clear in his opinion on Marks & Spencer, the national tax sovereignty anchored in the EC Treaty is the foundation for an independent and consistent coherence principle. He rightly recognized that the EC Treaty left tax sovereignty ultimately to the Member States. As long as the Member States do not overcome the unanimity requirement established in Art. 95 para. 2 EC Treaty, tax policy is deliberately not harmonized – just as the ECJ has now admitted. The lack of a harmonized European tax system may be deplorable politically, but it cannot just be cancelled legally. Furthermore, non-harmonized national tax systems must not coercively interfere with the establishment of a Common Market. They must therefore be utilized neutrally to the fundamental freedoms, while on the other hand the fundamental freedoms have to be implemented as neutral as possible with regard to the national tax systems: 23

'The concept of fiscal cohesion performs an important corrective function in Community law. It serves to correct the effects of the extension of the Community freedoms to the tax systems whose organisation is in principle a matter for the sole competence of the Member States. In fact, the application of the freedoms of movement has to be prevented from giving rise to unwarranted interference with the internal logic of national tax regimes. In the words of the Court, the conception of the tax system is 'a matter for each Member State'. In those circumstances, plainly, the Member States have a legitimate interest in ensuring the integrity and the equity of their tax systems. However, it does not follow that that concept can be used as an argument to be deployed against the objectives pursued in the context of the internal market. It cannot be accepted that a tax system be arranged in such a way as to favour national situations or traders. The function performed by fiscal cohesion is the protection of the integrity of the national tax systems provided that it does not impede the integration of those systems within the context of the internal market'.

If the EC Treaty assumes the sovereignty of the Member States on the field of direct taxation, it must also enable them to design consistent national tax systems with respect to cross-border cases, as well. This is reflected in a mutual balance between the fundamental freedoms of the Common Market and coherent national tax systems. Both goods have to be weighed carefully against one another to maximize their respective effect, without sacrificing one for the other in a one-sided way. Maximum possible achievement of a national tax system's integrity and the integration of tax systems in a Common Market can be characterized as a rule of mutual neutrality. 24 This dogmatic foundation appropriately clarifies that a limitation of the coherence principle to only one tax subject and one tax type is unsustainable. 25

IV. Conclusion: the principle of national tax system consistency as the concrete term of the coherence principle

The need for an enhanced coherence principle as a potential justification for restrictive national taxation rules has lately been recognized once more by

21 ECJ, 7 September 2004, C-319/02 Petri Mikael Manninen, ECR I 7477, para. 45; L. Hintsanen/K. Pettersson, 'The implications of the ECJ holding the denial of Finnish imputation credits in cross-border situations to be incompatible with the EC Treaty in the Manninen case', 45 European Taxation – ET 4 (IBFD, Amsterdam, 2005), p. 130–137, p. 133; see also U. Kline, note 11, p. 301–304.
22 Lastly, the ECJ dwelled on the coherence-principle in the decision of 21. February 2006, C-152/03, Rüter-Coulais v. Finanzamt Germersheim. The Court rightly denied a limitation of Art. 39 EC Treaty because the German tax law system itself was not consistent in the controversial point.
23 ECJ, Advocate General M. Poiares Maduro's Opinion, 7 April 2005 C-446/03 Marks & Spencer plc v. H. M. Inspector of Taxes, para. 66.
24 ECJ, Advocate General M. Poiares Maduro's Opinion, note 23, Para. 66 et seq.
Advocate General Tizzano in his opinion on the Meilicke case. Without referring explicitly to Advocate General Maduro, he conveys similar ideas of coherence. By emphasizing that it was ‘coherent’ to prevent negative consequences for the Member States, if possible, he does implicitly adopt the idea of mutual neutrality. But instead of explicitly enhancing the idea of coherence and limiting the far-reaching interpretation of Community Law, materially he votes in favour of formally limiting the legal effects of ECJ decisions. His proposal to restrict the consequences of judgements to a limited period in time should be far more deplorable than clarifying the idea of coherence.

Advocate General Tizzano’s opinion does evidently show a dilemma in the recent ECJ jurisprudence. Its former efforts to influence the national tax systems and to enforce the Common Market by nearly unlimited interpretation of the freedoms of movement has sparked more and more protests by the Member States. Now we can see the pendulum swinging nearly uncontrollably back. The ECJ and the Advocate Generals increasingly try to take national revenues and interests into account – but so far they cannot find a consistent and dogmatically tenable vehicle. In this context, the opinion delivered in Meilicke reveals another and even more severe danger for the stability of the Court’s judicature in tax matters: The non-legal, factual argument of the fiscal and economic consequences of an ECJ judgement obviously becomes more and more important for the outcome of proceedings. Ultimately, the ECJ and the Advocate Generals argue with abstract ideas of fair revenue allocation and preventing tax abuse, but they fail to put these arguments into a legal form. The results of this development may please national legislators, but their newly gained influence on the ECJ is bought at the price of instability. They face the principles of territoriality, of coherence and maybe the possibility of timely but limited ECJ judgements in a completely unpredictable diversity.

27 ECJ, Advocate General Antonio Tizzano’s Opinion, note 26, para. 42.
29 For the importance of the economic consequences of an ECJ’s judgement, see particularly the two opinions on the Banca di Cremona case, ECJ, Advocate General Francis Jacob’s Opinion, 17 March 2005, C-475/03, Banca popolare di Cremona v. Agenzia Entrate Ufficio Cremona, para. 42, and ECJ, Advocate Christine Stix-Hackl’s Opinion, 14 March 2006, C-475/03 Para. 157 et seq. respectively.