Cross-Border Loss Compensation – The ECJ's Decision in *Marks & Spencer* and How It was Misinterpreted in the Netherlands

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1. INTRODUCTION

Last December, many bottles of champagne were uncorked after the European Court of Justice (ECJ) issued its decision in the *Marks & Spencer* case. The fact that Marks & Spencer partially won its case does not make the EU Member States less content with the judgement since the preconditions set by the ECJ will let most of the tax claim evaporate directly.[1] Not only in the United Kingdom did the Ministry of Finance anxiously await the dictum in this case. The press headlined that it would cost the United Kingdom GBP 80 billion each year, and Germany would have a financial setback of between EUR 30 billion and 60 billion. In the Netherlands, the amount would be a modest EUR 100 million. This case has clearly inspired many authors to specifically draw attention to this case.[2] Therefore, the impact of this case is huge – so huge that Mrs Dawn Primarolo, the UK State Secretary of Finance, has been working on a plan to change the EC Treaty in such a way that the ECJ would have only limited powers in the field of taxation.[3] To this author's best information, this effort has ended due to the ECJ's favourable decision.[4]

During the period that the *Marks & Spencer* case was pending, the Netherlands State Secretary announced his intention to facilitate cross-border fiscal unities within the framework of the proposal for a revised Corporate Income Tax Act (CITA) in 2007. From the State Secretary's memorandum, it can be concluded that he had concerns regarding the applicability of the current Dutch fiscal unity regime in relation to the outcome of the *Marks & Spencer* case.[5] After the case was decided, however, the State Secretary announced that he will not continue with the introduction of the facility because, in his opinion, cross-border loss compensation cannot be enforced on the basis of EC law. This is a very surprising conclusion since the Dutch fiscal unity regime is essentially different from the UK regime and both the Netherlands Supreme Court and the State Secretary have accepted cross-border fiscal unity under the old regime.[6] Therefore, the question arises whether the State Secretary can preclude cross-border consolidation based on the judgement in *Marks & Spencer*.

This article first discusses the Advocate-General's opinion and the ECJ's decision in *Marks & Spencer*. The article then examines Dutch tax law since the Dutch system differs from UK tax law in essential respects and, based thereon, discusses the Dutch provisions on cross-border consolidation. The article explains how the State Secretary misinterpreted the ECJ's decision and what the consequences are for the Dutch budgetary position. Last but not least, the article looks for a solution for the problems raised by this decision, which solution should also be applicable in tax credit systems.

1. See *Marks & Spencer*, Case C-446/03, [2005] *ECR* (not yet published) and the opinion of Advocate-General Poiares Maduro.
2. See e.g. Lang, M., "The *Marks & Spencer* Case – The Open Issues Following the ECJ's Final Word", 46 *European Taxation* 2 (2006), at 54; Meussen, G.T.K., "Cross-Border Loss Relief in the European Union following the Advocate General's Opinion in the *Marks & Spencer* Case", 45 *European Taxation* 7 (2005), at 282; and Cordewener, A., et al., "The Tax Treatment of Foreign Losses: *Ritter*, *M & S*, and the Way Ahead" (in two parts), 44 *European Taxation* 4 and 5 (2004), at 135 and 218, respectively.
3. "EU Ministers seek to defend revenues after tax setbacks", *Financial Times*, 12 October 2005.
4. The relevance for the United Kingdom and the other Member States to safeguard their state budgets seems to be gone.
5. Memorandum "Werken aan winst, naar een laag tarief en een brede grondslag", Ministry of Finance letter of 29 April 2005, *Kamerstukken* II 2004/05, 30,107, No. 2.
6. Until 2003, cross-border fiscal unities were accepted by the State Secretary and the Netherlands Supreme Court. See e.g. the decision of the State Secretary of 12 May 2004 (*BNB* 2004/284) and the judgements of the Netherlands Supreme Court of 29 June 1988 (*BNB* 1988/331), of 17 February 1993 (*BNB* 1994/163) and of 13 November 1996 (*BNB* 1998/47).

2. THE *MARKS & SPENCER* CASE

2.1. Facts

Marks & Spencer, a company resident in the United Kingdom, is the principal trading company of a group specialized in general retail, clothing, food, housewares and financial services. In the early 1990s, Marks & Spencer, intending to expand its operations, established subsidiaries in Belgium, France and Germany, which were held by an intermediary company established in the Netherlands. The subsidiaries were legally independent entities and were resident in the Member State in which they were established. In the period 1998-2001, Marks & Spencer incurred enormous losses and announced its intention to withdraw from the non-UK market. Marks & Spencer, however, wanted to transfer the losses of the foreign subsidiaries to the UK parent company. Based on the position taken by Marks & Spencer, the foreign losses could be offset against the UK profits.

Under the "group relief" regime in the United Kingdom, however, it was not possible for Marks & Spencer to offset the foreign losses. The existing group relief regime in the UK in principle means that, within a group, subsidiaries can transfer their losses to the parent company and vice versa. One feature of this regime is that it applies only to companies that are established in the United Kingdom or pursue activities there. Based on this regime, Marks & Spencer could not set off the losses of the Belgian, French and German subsidiaries against the profits derived in the UK.

Marks & Spencer considered that this was incompatible with EC law and commenced litigation in the United Kingdom. The UK court referred the case to the ECJ for a preliminary ruling on the following questions:

(1) Is it a restriction on the freedom of establishment for a Member State not to tax a domestic company carrying on its enterprise through a subsidiary established in another Member State based on full consolidation of the company's profits and losses, but to tax a company with a permanent establishment located in another Member State based on full consolidation of the company's profits and losses?

(2) Is it a restriction on the freedom of establishment for a Member State to prohibit a company from including the results of a non-resident subsidiary in the group relief regime, but to grant this opportunity with regard to a resident subsidiary?

(3) If either question, or both, is answered in the affirmative, can this restriction on the freedom of establishment be justified by compelling reasons in the public interest.

2.2. Opinion of the Advocate-General

Advocate-General Poiares Maduro concluded that the UK regime is in principle incompatible with the EC Treaty. With respect to the first question, he determined that, based on the current position of Community law, although direct taxation does not as such fall within the purview of the Community, the powers retained by the Member States must nevertheless be exercised consistently with EC law.[7] The Member States should organize their tax legislation in such a way that it is not contrary to the principles of the internal market. The internal market is characterized by the abolition of obstacles to the free movement of goods, persons, services and capital between the Member States.[8] The Advocate-General then specifically examined the applicability of the freedom of establishment in the field of direct taxation. Based on settled case law, he concluded that all measures that prohibit, obstruct or make the exercise of the fundamental freedoms less attractive must be regarded as a prohibited restriction on those fundamental freedoms (Para. 35 of the Advocate-General's opinion).

With respect to the first question, the Advocate-General concluded that the UK regime, which distinguishes between companies that carry on business through non-resident subsidiaries and companies that carry on business through permanent establishments and which does not allow the former to fully consolidate their profits and losses for tax purposes, but allows the latter to do so, is not incompatible with EC law. The Advocate-General substantiated his conclusion by stating that the difference in tax treatment is not due solely to the fact that the entities are subject to different tax obligations; it is also due to the fact that they are subject to the UK system of corporate taxation. Under that system, he explained, the difference in tax treatment is determined by the legal form of the secondary establishment. Groups of companies are not entitled to consolidation for tax purposes, which applies to the income of permanent establishments. In that connection, although the group relief regime modifies the rule of separate taxation of group companies, it 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 because subsidiaries are always treated as independent legal and fiscal entities (Para. 48 of the Advocate-General's opinion). This reasoning of the Advocate-General is consistent with the settled case law of the ECJ.[9]

Regarding the second question, the Advocate-General concluded that the UK group relief regime is contrary to EC law because it makes a distinction between resident subsidiaries, which can transfer losses to their UK parent company, and non-resident subsidiaries, which cannot. UK holding companies that have used the freedom of establishment by creating subsidiaries abroad are in principle treated worse than resident companies that have not exercised the fundamental freedom.[10] This is in principle contrary to EC law unless an acceptable justification can be found.

The first justification discussed by the Advocate-General is almost a classic. The United Kingdom argued that a negative outcome could lead to a reduction in tax

7. See e.g. *Schumacker*, Case C-279/93, [1995] ECR I-225, Para. 21.
8. Art. 3(1)(c) in conjunction with Art. 14 of the EC Treaty.
9. In principle, a non-resident taxpayer and a resident taxpayer cannot be compared. It is only due to comparable circumstances that they can be treated as equal. But this is a different approach from just saying that they are equal.
10. Paras. 51 and 52 of the Advocate-General's opinion. See also *Bosal*, Case C-168/01, [2003] ECR I-9409; and *Sevic*, Case C-411/03, [2005] ECR (not yet published).

revenues. The ECJ has ruled that an appeal to this justification cannot be successful since it is the settled case law of the ECJ that a reduction in tax revenues cannot be regarded as an overriding reason in the public interest to justify a measure that in principle is contrary to a fundamental freedom.[11]

The second justification is also close to becoming a classic. The United Kingdom referred to the principle of fiscal territoriality as developed in the *Futura Participations and Singer* case, in which the ECJ, under exceptional circumstances, accepted the applicability of that principle.[12] A special feature of that case was that, according to Luxembourg's tax law, the losses of a permanent establishment in Luxembourg cannot be offset against the profits of that permanent establishment in earlier years. In Luxembourg, it is possible to fulfil legal tax obligations without keeping tax accounts. As a consequence, permanent establishments in Luxembourg are not taxed on their actual income, but on a fictitious (estimated) income. According to Art. 157(2) of Luxembourg's corporate income tax law, however, vertical loss relief was possible only if the permanent establishment kept tax accounts. For this reason, loss compensation was denied. Hardly surprisingly, the ECJ decided that Luxembourg was obligated to take losses into account only if they were borne in Luxembourg. The ECJ also decided that Luxembourg had to accept the use of these losses in the underlying situation, even if the permanent establishment did not keep accounts, since this was not required by law. Consequently, this judgement says that, for vertical loss compensation, the Member States only have to take into account profits that were derived in that Member State in previous years. The heart of the matter is that if the tax law does not require that tax accounts be kept, permanent establishments that choose this system cannot be treated disadvantageously by denying them the application of the existing rules on vertical loss compensation. But of course, if the company wants to apply the rules on vertical loss compensation, only losses incurred in that territory can be used. In this author's view, this conclusion is very logical from the perspective of both EC law and international tax law. According to the Advocate-General, there are no exceptional circumstances in *Marks & Spencer* comparable to those in *Futura Participations and Singer*. In his opinion, the principle of fiscal territoriality cannot be interpreted in such a way as to permit the UK to make the granting of fiscal facilities dependent on the possibility of taxing the corresponding profits. For the UK, there is no reason to limit the group relief regime to residents. From a legal point of view, this is fully in line with existing case law, e.g. the *Bosal* case.[13] The difference between *Futura* and *Marks & Spencer* is not that, in the latter case, the question arose whether the UK has to accept losses as a matter of principle, but merely whether the UK must always treat a situation involving a resident parent with a resident subsidiary equal to a situation involving a resident parent with an EU subsidiary resident in another Member State.

The need to ensure cohesion of the tax system was put forward as the final justification. This justification was accepted by the ECJ in earlier cases.[14] Although the need to ensure cohesion of the tax system can justify restrictive measures, it is required that there be a direct and necessary connection between the grant of a tax advantage and the compensation of that advantage by a specific tax charge.[15] Based on the settled case law of the ECJ, the tax advantage and the tax charge must concern the same tax and the same taxpayer.[16] The Advocate-General preferred a broader interpretation of this principle. His opinion was that the principle of cohesion applies to the parent company as well as to the (non-resident) subsidiary. In his view, the provisions on offsetting losses are subject to the same conditions that apply to resident companies, which means that, within a group, losses cannot be offset more than once. For this reason, the Advocate-General concluded that the distinction between resident and non-resident subsidiaries, whereby the former can transfer losses to the parent company but the latter cannot, in principle constitutes a restriction on the freedom of establishment. To this conclusion, however, he added that, under certain circumstances, restricting the offsetting of losses could be consistent with EC law – for example, if the United Kingdom permitted the cross-border offsetting of losses only if the non-resident company could not use the losses in the source state (Para. 76 of the Advocate-General's opinion). In other words, Marks & Spencer can take the losses of the Belgian, French and German subsidiaries into account in its UK taxable base only if, and to the extent, the subsidiaries cannot deduct the losses in Belgium, France and Germany. It is obvious that, in the Advocate-General's opinion, the losses of non-resident companies must be deductible "somewhere" if the rule under discussion fully accepts loss compensation in an internal situation. The Advocate-General did not specify at which time the losses have to be taken into account.

2.3. Judgement of the ECJ

The ECJ's judgement was mainly in line with the Advocate-General's opinion. The UK treats a resident parent company with a resident subsidiary differently from a resident parent company with a non-resident subsidiary. In the latter case, the parent company is not entitled to set off foreign losses against its domestic profits. This difference in treatment is in principle incompatible with the freedom of establishment. In this respect, this judgement is perfectly in line with the *Bosal* case, decided in 2003, in which the ECJ also ruled that no distinction may be made between resident and non-resident subsidiaries in the tax treatment of a holding company.

In addition, the ECJ agreed with the Advocate-General that a distinction such as the one involved in *Marks &*

11. See *Manninen*, Case C-319/02, [2004] ECR I-4, Para. 49, and the case law mentioned there.
12. *Futura Participations and Singer*, Case C-250/95, [1997] ECR I-2471, Paras. 18 to 22.
13. Cited in note 10, supra. See van den Hurk, Hans and Bouke Wagenaar, "The Far-Reaching Consequences of the ECJ Decision in *Bosal* and the Response of the Netherlands", 59 *Bulletin for International Fiscal Documentation* 6 (2004), at 269.
14. *Bachmann*, Case C-204/90, [1992] ECR I-249; *Commission v. Belgium*, Case C-300/90, [1992] ECR I-305.
15. *Bachmann*, id., Para. 23; *Commission v. Belgium*, id., Para. 16.
16. See e.g. *Bachmann* and *Commission v. Belgium*, both supra note 14; *Svensson*, Case C-484/93, [1995] ECR I-3955; *Wielockx*, C-80/94, 1995 ECR I-2493; and *Terhoeve*, Case C-18/95, 1999 ECR I-345.

Spencer can sometimes be justified. This would be the case if the incompatible infringement of a freedom guaranteed by the EC Treaty resulted in the offsetting of losses more than once. The taxpayer must prove that a transferable loss cannot be taken into account more than once. The ECJ seems to compare the internal market with a domestic market. And because it is to be expected that no Member State permits losses to be deducted more than once, the same principle should be applied within the European Union.[17]

The ECJ concluded its decision by explicitly saying that the Member States are still entitled to introduce specific anti-abuse provisions to prevent abuse by companies in situations where companies claim that they cannot deduct certain losses twice but actually structure the group companies in such a way as to take a double deduction.

2.4. Commentary

This author considers the outcome of this case reasonable. If the United Kingdom treated holding companies equally with regard to resident and non-resident subsidiaries, the result would be that the losses of a non-resident subsidiary could in principle be set off in both the United Kingdom and the residence state of the subsidiary. The ECJ does not want to "facilitate" this. Although this was not said in so many words, this is an understandable conclusion. The ECJ approaches the European internal market the same way as a Member State approaches its domestic market. The rationale of this reasoning is that the internal market is an analogy for the domestic market of a Member State.[18] In a domestic market, losses are deductible only once.

From this case, however, it cannot be concluded that the ECJ will never accept losses to be transferred over the border. The ECJ noted that if the losses cannot be set off in the source state, they should be transferable to the UK holding company. It is not correct to conclude from this that the ECJ ruled that a loss in general should be deductible at least somewhere, either by the subsidiary or by the parent. The ECJ's ruling should be interpreted in relation to the facts of the case. And, again, the facts are that the UK makes a distinction between UK parents with UK subsidiaries, on the one hand, and UK parents with non-UK subsidiaries, on the other. It cannot be concluded from this case that, without such a different treatment of subsidiaries, foreign losses should be taken into account at the UK parent level if they cannot be used at the subsidiary level.

As mentioned above, the ECJ decided that the UK must allow foreign losses only if the company cannot use them in the residence state of the subsidiary. This decision, however, seems to be clear only at first sight. The problem is that the ECJ did not explain how to interpret the words "losses can be used". How can a company ever prove to the government that a foreign loss will never be used at the subsidiary level if the subsidiary's residence state has an unlimited loss carry-forward system? For this reason, the decision has led to much criticism in the newspapers by tax lawyers. According to the press, the ECJ has created a great deal of confusion by handling the case the way it did.[19]

Although the ECJ's conclusion is comprehensible, the reason the ECJ did not further explain its ruling is that the ECJ cooperates closely with the national courts of the Member States.[20] Whether certain losses can be offset is a question that must be answered by these national courts. Unfortunately, in the *Marks & Spencer* case, it is the UK court that must determine whether the losses of the Belgian, French and German subsidiaries may be offset in those Member States. This is the logical consequence of a legal system within the European Union in which the role of the ECJ is only to explain Community law, not to interpret factual matters.

In conclusion, it can be said that the Member States have the right to restrict cross-border loss compensation if, as a consequence, the loss will be offset more than once. That no double loss compensation will occur has to be proved by the company, and this ultimately must be confirmed by the national court of the parent company's residence state.[21] It is clear that the ECJ's chosen solution raises more questions than it answers.

2.5. Alternative systems of loss compensation

The ECJ decided that the UK only has to allow loss compensation if the losses cannot be compensated in the source country (in which the subsidiary is established). Because the ECJ ruled that losses which can be used in the source country cannot be surrendered to the UK, UK holding companies that have a non-UK loss-making subsidiary in a country with an unlimited loss carry-forward system have a serious problem. Investing abroad has become relatively difficult. This calls for a solution – probably a European solution, although, according to this author, the Member States are not very eager to agree on a pan-European loss compensation system.[22] For this reason, this author finds it necessary that the Member States help solve this problem themselves.

The solution should be a system that guarantees as much certainty as possible for both taxpayers and tax administrations. Several systems can provide such a solution. From the perspective of the internal market, the best would be for the Member States to allow the use of foreign losses in the year they are incurred, provided the parent companies pay back the benefit when the losses are later used in the subsidiary's residence country. If the country has a loss compensation system

17. See Lang, supra note 2.
18. See *Polydor*, Case 270/80, [1982] ECR 329, Para. 16 to 21; and *Schul I*, Case 15/81, [1982] ECR 1, Para. 33. See also Kapteyn, P.J.G. and P. VerLoren van Themaat, *Het recht van de Europese Unie en van de Europese Gemeenschappen* (6th ed., 2003), at 104.
19. "Fiscale tijdbom op ontploffen" (Fiscal time bomb to explode), in *Het Financieele Dagblad* (Dutch Financial Times), 13 December 2005.
20. See Kapteyn and VerLoren van Themaat, supra note 18, at 397.
21. Again, it is emphasized that this conclusion is based on the UK loss-surrendering system.
22. Based on Art. 94 of the EC Treaty, all the Member States must approve such a system in order for it to be accepted. This position is further supported by the fact that the proposal for an EU-wide directive on cross-border loss compensation was withdrawn in 2001. The proposal was initially withdrawn because a new proposal on the subject was forthcoming. This has been confirmed by the Commission as well. At the time of writing, however, no proposal has been made.

like the UK system and if the country uses a tax credit system, compensation can take place by deeming income in the year the losses are used twice in the amount of the losses. In an exemption system, compensation can take place by denying the participation exemption for dividends until they exceed the amount of the imported losses.[23] The lack of information and of certainty for the Member States on what is actually happening at the subsidiary level can, based on settled case law, never be reasons for infringing the internal market.[24] Moreover, because the ECJ has accepted that the Member States may enact specific anti-abuse provisions to prevent the double use of losses, in this author's view, there is no risk for the Member States that their system will be used for "abusive situations". Ideally, the above proposal would be part of a new directive designed to harmonize it EU-wide. But if it is not possible to agree on such a measure, domestic initiatives would be greatly welcomed.[25]

Although far from ideal within the internal market, another solution could be that, at the time a company requests to use foreign losses, the tax administration issues a tax assessment declaring the amount of money the company can claim back after proving the inability to use the losses in a foreign country. It must be recognized that the major part of the benefit of cross-border loss compensation, namely, the cash-flow benefit, is gone. For this reason, this alternative is not optimal in an internal market that obliges the Member States in principle to treat cross-border activities equal to domestic activities. If, however, the first alternative is rejected by the Member States, this proposal compensates at least something.

Within the internal market, it should be impossible for losses never to be compensated, either at the subsidiary level or at the parent level. In this author's view, in an internal market and in the way the ECJ has always defined the European internal market, losses should be deductible at least once, as in a domestic market. The same principle applies with respect to profits in that they should be taxed only once.[26] From this perspective, it is clear that, if a subsidiary's loss cannot be used in the subsidiary's residence country, using that loss by way of loss-surrendering fits within the concept of accepting that the subsidiary's loss is like a regular enterprise loss. The Netherlands applies this principle in relation to the liquidation of a subsidiary.[27] And although the Dutch system has been criticized, in this author's opinion it fits well within the internal market concept of accepting that a loss will be compensated once.[28] But, again, although the system fits excellently within the internal market, the rationale of this Dutch provision cannot be defended by simply referring to the *Marks & Spencer* case.[29]

Thus, with a "negative conservative assessment", companies are not able to use the foreign losses at once, but will at least be able to use them in the future. This seems to be the second best way to solve the loss compensation problem in many countries. The best and most proportionate way is to compensate directly with a reclaim of the benefit, preferably on a pan-European basis.

2.6. How does *Marks & Spencer* relate to *Bosal*?

In Para. 33 of the *Marks & Spencer* decision, the ECJ stated that if domestic losses can be transferred to the holding company, this should also be possible in a cross-border relation. The ECJ formulated a comparable reasoning in the *Bosal* decision, specifically in Para. 27. In *Marks & Spencer*, this did not lead to a victory for the taxpayer since the UK successfully appealed to the justification that, within the internal market, it is not appropriate to offset losses more than once.

After *Marks & Spencer* was decided, the judgement received much attention in the financial press. The Dutch Financial Times (*Het Financieele Dagblad*) interviewed Prof. Peter Wattel. He stated that the ECJ generally took a different approach from *Bosal* since, in its reasoning in *Marks & Spencer*, the ECJ took the financial interests of the Member State into account. According to Wattel, the ECJ for the first time considered the financial interests of the Member States to be relevant or, in other words, if *Bosal* was once again referred to the ECJ, the outcome could be different.[30]

This author does not share this opinion. Within an internal market, it does not seem right to offset losses more than once. EC law aims to create a system within the European internal market that is comparable to the domestic market of the Member States. Also in domestic situations, losses cannot be deducted more than once. This was the reason that the justification invoked by the UK was accepted. This is also how the ECJ included its view in the judgement. Nothing in the judgement indicates that the ECJ took the financial consequences for the Member States into account. For this reason, this author is of the opinion that the deci-

23. Such as Art. 13C CITA.

24. See Directive 77/799/EEC on the exchange of information; see also *Skandia v. Ramstedt*, Case C-422/01, [2003] ECR I-6817; *Danner*, Case C-136/00, [2002] ECR I-8147; and *W.N.*, Case C-420/98, [2000] ECR I-2847.

25. Additionally, in the race to be the best place of residence for holding companies, this would support the participating countries. In order to use losses, the holding company needs to make a profit, which supports the domestic economy.

26. See e.g. the preamble to the Parent-Subsidiary Directive (90/435/EEC), which states that conditions analogous to an internal market should be established in a way that tax provisions apply in a neutral way. Because in most domestic markets, losses are deductible once, the same should apply within the internal market. This principle can also be derived from *De Groot*, Case C-385/00, [2002] ECR I-11819. See also this author's annotations to *De Groot* (*SEW* 2003, at 109) and *Gschwind*, Case C-391/97, [1999] ECR I-5451 (*SEW* 2000, at 388).

27. Art. 13d CITA allows a parent company that suffered losses through the liquidation of its subsidiary to take the losses relating to the subsidiary by way of deducting the difference between the cost price paid for the subsidiary and the proceeds received from liquidating the subsidiary. For more information, see Müller, Johann, *The Netherlands in International Tax Planning* (Amsterdam: IBFD Publications, 2005).

28. See the report of Dawn Primarolo on the Code of Conduct on Business Taxation, SN 4901/99.

29. The ECJ just compared a fully domestic situation with a situation involving a domestic parent with a foreign subsidiary. Although, in this author's opinion, this Dutch rule fits well within the Netherlands tax system and the principles of the internal market, the outcome of *Marks & Spencer* cannot lead to the conclusion that Art. 13d CITA will be accepted by EC law.

30. "Europees Hof bijt minder hard" (ECJ bites less hard), in *Het Financieele Dagblad*, 15 December 2005.

sion in *Marks & Spencer* helps the Member States to guard their budget, but not that this financial consequence was of any importance for the ECJ. This outcome is merely the result of the ECJ accepting the justification relied upon by the United Kingdom. And this justification fits just as much within the internal market principles as the ECJ's judgement in *Bosal*.

In *Bosal*, a domestic company was not entitled to deduct the interest paid on a loan to finance a foreign participation because the profits of that participation are not taxable in the Netherlands. In the case of a domestic participation, the profits are also not taxable at the parent level, but the financing costs at the level of the holding company are still deductible. In Wattel's opinion, the financing costs should be at the expense of the non-resident participation instead of the resident holding company. From a scholarly point of view examining how the ideal situation would work, this author fully agrees with Wattel, but EC law does not currently support this view. The legislation of the other Member States does not provide for this and, according to EC law, the disparities can only be eliminated through harmonization (Art. 96 of the EC Treaty). Thus, from this perspective, the ECJ can really do nothing. The discussion now is whether this disparity constitutes a distortion and whether the ECJ can intervene in the case of an affirmative answer. The answer is, at least in this author's opinion, in the negative since a foreign tax inspector does not have to allow a deduction for the interest paid by a foreign holding company that has establishments in his Member State if there is no direct connection with the Member State in which the operational company is established.[31] In this author's view, the ECJ would therefore come to the same conclusion if the *Bosal* case were decided again. In any event, this seems to be the most logical to this author based on the current state of EC law. If necessary, the ECJ can always restrict the operation of a judgement in time. This has happened before.[32]

3. CROSS-BORDER LOSS COMPENSATION IN THE NETHERLANDS

Because many countries have the possibility of loss compensation in earlier or later years, it will be difficult in many cases for a UK holding company with European subsidiaries to take foreign losses into account. Even if the foreign subsidiary is discontinued, the legislation of several Member States provides that losses will accompany the discontinued company at the time of its sale.[33] Consequently, the possibility arises that losses will be offset more than once. In the Dutch system, the regulation of cross-border loss compensation is fundamentally different. And although the Dutch system does not officially provide for cross-border fiscal unities, such a facility can be enforced based on the case law of the ECJ.[34] This is explained below. The discussion first considers the question why a cross-border fiscal unity is worthwhile and then looks at the arguments based on the current state of EC law.

3.1. Why is a cross-border fiscal unity worthwhile?

How does the Dutch cross-border fiscal unity work? First, it should be noted that the Dutch fiscal unity as discussed here applies only for corporate income tax purposes.[35] As a consequence, a foreign subsidiary is deemed to be merged into the holding company. In a cross-border situation, the result is that, from the perspective of the CITA, the foreign subsidiary is seen as a permanent establishment. The Netherlands takes into account the worldwide income of Dutch resident companies in determining the taxable base. Consequently, foreign profits are included in the taxable base and subsequently exempted. As mentioned above, foreign losses may be deducted from domestic profits. However, when the permanent establishment becomes profitable, the foreign profits are exempt only to the extent they exceed the losses that were already taken into account once. Therefore, offsetting foreign losses under the Dutch system is well regulated, and there is virtually no risk to the Dutch government of double loss offsets.[36] The deduction of foreign losses only seems to have a timing advantage.

As stated above, having a fiscal unity does not change anything regarding the situation in the other Member State. That Member State still sees only a subsidiary of a foreign holding company. Therefore, using the advantages of the Dutch system seems to provide opportunities that do not have any consequences abroad.[37]

There are several other advantages in addition to the advantage of cross-border loss compensation explained above. The most important is the advantage that intra-fiscal unity supplies and services do not generate taxable profits. Profits will not be taxed before the goods leave the company or an invoice has been sent.[38] This is also an interesting advantage if an active Dutch company in a fiscal unity makes a supply to a foreign associated company included in the fiscal unity because taxable profits are generated only at the time

31. One could argue that there is a direct connection between the interest paid and the foreign subsidiary. But because a corporation is an independent taxpayer, the tax inspector can only take into account the elements that legally belong to the corporation.
32. See e.g. *Denkavit*, Case 61/79, [1980] ECR 1205, Para. 17; and *Griesmar*, Case C-366/99, [2001] ECR I-9383, Para. 74. For a VAT-related case on this subject, see *MyTravel*, Case C-291/03, *ECR* 2005 (not yet published).
33. An exception is the Netherlands. With extensive conditions, the Netherlands tries to prevent a trade in loss compensation from arising. See e.g. Arts. 20(4) and 20a CITA.
34. Before 2003, a cross-border fiscal unity could be enforced based on the case law of the Netherlands Supreme Court, mainly *BNB* 1998/47. As from 2003, these fiscal unities must be enforced based on the freedom of establishment in conjunction with the *Bosal* decision.
35. A few exceptions in favour of the taxpayer exist, however. The only disadvantageous exception (personal liability for all the included companies) is discussed later in 3.1.
36. Since in *Marks & Spencer* the ECJ ruled that specific anti-abuse provisions are allowed, the legislature may enact measures to prevent double loss relief.
37. Based on tax treaties, the residence state of the parent company is not allowed to tax the profits of a foreign subsidiary. Thus, theoretically, this can result in a problem. However, the consequences are purely domestic and apply only if the company wants it this way.
38. Netherlands Supreme Court, *BNB* 57/208.

the product leaves the fiscal unity. After all, the Dutch rules on determining the taxable base prescribe that profits have to be taken into account only if they are reasonable or ultimately at the time an agreement is reached for the supply of goods or services to other companies.[39]

At this time, there are not many cross-border fiscal unities. This can be attributed to several reasons. First, if a cross-border fiscal unity is requested because of the foreign subsidiary's loss position, an examination must be conducted on whether a future liquidation of the company can be expected. The liquidation loss provision (Art. 13d CITA) does not apply in the context of a fiscal unity. Consequently, liquidation losses are no longer deductible.[40] The route to split up before liquidation in order to take into account the liquidation loss does not work. If the fiscal unity is dissolved in the future, the net value of the subsidiary at the time of the split-up will be considered as the purchase price of that company, and the actual purchase price will not be taken into account.[41] Thus, both the advantages and disadvantages should be considered.

Other considerations concern the possibility that a loss is taken on the depreciation of a foreign subsidiary in accordance with Art. 13ca CITA. Taking such a loss means that, at the time of including the subsidiary in the fiscal unity, the "13ca"-based loss on depreciation that is still open must be recaptured.[42] If a permanent establishment is converted into a foreign subsidiary, one consequence of including the subsidiary is that the recapture possibility will arise at once.[43] Last but not least, probably the most important reason is that the cross-border facility must be enforced through a court proceeding.[44]

3.2. Dutch cross-border fiscal unity in 2006

The Dutch legislation (Art. 15(4) CITA) provides that an operating company can be part of a fiscal unity only if both companies are residents of the Netherlands. In several cases, the ECJ ruled that, if a domestic situation is facilitated, a cross-border situation must be facilitated as well.[45] Only if specific circumstances exist can it be justified not to facilitate the cross-border situation.[46]

Consequently, a cross-border fiscal unity should be allowed in a Dutch situation based on the settled case law of the ECJ. The justification accepted in *Marks & Spencer* has no effect on this situation because foreign losses are taken into account only temporarily in the Dutch taxable base. Thus, no double loss compensation occurs. The Netherlands State Secretary of Finance was also convinced of this, and he therefore included in his proposal for a new CITA (for 2007 and subsequent years) that the Netherlands facilitate cross-border fiscal unities in the future.[47] In the process, he also expressed his intention to establish several preconditions to prevent abuse. But this is also part of the idea to further the position of the Netherlands as an attractive country for company residence. This reasoning of the State Secretary should be highly appreciated. To make use of a cross-border fiscal unity and thus to take foreign losses into account at the expense of domestic profits, the group has to generate taxable profits in the Netherlands. In many cases, a non-EU entity that wants to establish itself within the EU must have taxable activities in the Netherlands in order to fulfil this condition. The temporary loss of corporate income tax revenues will therefore be considerably compensated by the additional revenues generated by the wage tax and VAT.[48] For the Dutch government, therefore, cross-border fiscal unities mean an advantage with every draw (or at least a small advantage).

Therefore, it was very surprising that, almost a week after the ECJ's judgement in *Marks & Spencer*, the State Secretary withdrew his proposal for a cross-border fiscal unity in the new CITA. His opinion was that the judgement does not require that the legislature allow the deduction of foreign losses from domestic profits. This reasoning is based on an evidently wrong and publicly undesirable interpretation of the judgement. The Member States may apply facilities for their territory only, and they must do so consistently. France, for instance, taxes companies established in France only on their domestic income. Thus, the profits of foreign permanent establishments are not taken into account in determining the French taxable base. In this situation, France also does not have to take into account foreign losses. The Netherlands, however, taxes the worldwide income of corporations, which means that the profits of a permanent establishment are in principle taxable in the Netherlands. Therefore, it seems impossible that the legislature will be able to establish a consistent system of territoriality. And, since it is not likely that current Dutch legislation will be changed, the State Secretary's reasoning that he does not have to allow cross-border fiscal unities is evidently wrong. It is also unwise not to allow cross-border fiscal unities because, based on the argument that they are possible under EC law, the State Secretary passed over an opportunity to limit the possibility of cross-border fiscal unities by means of legislation in order to limit the loss of corporate income tax revenues. Consequently, he effectively achieved the one thing that he did not want to achieve. This author assumes that the State Secretary will soon realize his mistake and indicate that he still wants to introduce cross-border fiscal unities as he proposed earlier.

39. Of course, this does not work in the case of a supply from a subsidiary to its parent company because the lack of an obligation to take profits has effect only from a Dutch tax perspective.
40. The liquidation loss under Art. 13d CITA is calculated by deducting the total liquidation proceeds from the purchase price of the subsidiary.
41. See Art. 11(b) of the "Special Conditions" (*Standaardvoorwaarden*) for a fiscal unity.
42. In accordance with Arts. 13ca(4) and 15ab(1) CITA. Although Art. 13ca CITA was repealed in 2006, the recapture rules still apply with respect to previous years.
43. In accordance with Arts. 13c(3) and 15ab(1) CITA.
44. Some other less important disadvantages exist, but they are beyond the scope of this article.
45. See e.g. *Bosal* and *Sevic*, both supra note 10, as well as *Marks & Spencer*. In *Sevic*, the ECJ ruled that, if a Member State allows domestic mergers, it must also allow cross-border mergers under the same conditions.
46. For instance, the justification in *Marks & Spencer* that losses in a domestic situation may also not be taken into account more than once.
47. One of the reasons for the CITA 2007 is to make the CITA EC-proof.
48. The cash-flow disadvantage of the corporate income tax is temporary because of the recapture and Art. 13c CITA.

3.3. What is the best way forward?

The State Secretary intended to impose specific conditions to prevent the cross-border facility from harming the Dutch budget too much. For this reason, four conditions are important.[49] They are discussed briefly. *First*, if a company wants to establish a cross-border fiscal unity, it must include all corporations in a particular country in the fiscal unity. An example is a Dutch holding company that has two profit-making subsidiaries in France, one loss-making subsidiary in France, and one profit-making subsidiary in the United Kingdom. If the Dutch company wants to include only the loss-making subsidiary, the company can leave the UK subsidiary out of the fiscal unity; if, however, the company wants to include the French loss-making subsidiary in the fiscal unity, the company must include all the French subsidiaries or none of them. From a budgetary point of view, this is a logical approach. From a purely economic position, this is probably a missed opportunity because, as discussed earlier, in order to benefit from foreign losses, there must be a taxable base in the Netherlands and, even if the company does not effectively pay any corporate income tax, the Netherlands still receives the wage tax and VAT, which benefit the economy. However, it is understandable that the legislature focuses on the budgetary constraints.

The *second* condition relates to double taxation relief. The condition is that, with respect to such relief, the foreign profits and losses derived/incurred in all other countries must first be set off against each other before the excess loss can be offset against the Dutch profits – the "overall method". The question has been raised whether this condition infringes the EU principles of freedom of establishment and the free movement of capital because some treaties are based on the "per-country" method.[50] Another question is whether a company confronted with the overall method can try to apply a comparable treaty that is based on the per-country method. The ECJ recently ruled that an individual can apply only the treaty that covers the circumstances of the case.[51] From this much criticized decision, it can be concluded that most of the situations in which a non-comparable tax treaty applies will fail because the ECJ ruled that, due to the lack of an internal market with respect to direct taxation, tax treaties are the only means to prevent double taxation. For this reason, the ECJ's view is that differences in tax treaties are acceptable. It is for this reason that the State Secretary's suggestion to demand that the overall method be applied seems to be acceptable.

The *third* condition is that only subsidiaries resident in one of the EU Member States may be included. This condition infringes principally the European Economic Area (EEA) Treaty,[52] which created a special internal market that included the EU Member States, Norway, Liechtenstein and Iceland. The ECJ has ruled several times in the past that, although the wording of the EEA Treaty differs from the wording of the EC Treaty, the meaning is identical. Whether the same goes for third countries, such as those with whom the EU has concluded European or association agreements is still an open question.[53]

The *last* relevant condition is that if, after being included in a fiscal unity, the foreign subsidiary ceases to exist, the tax advantage must be paid back at once. Taking into account the ECJ's decision that specific anti-abuse provisions are acceptable, there seems to be a reasonable chance that this condition will be upheld.

To a large extent, the suggested conditions seem to be EU-proof and, for that reason, it is surprising that the State Secretary withdrew his plan. This is bad news not only for companies that wanted more certainty in advance, but also for the Netherlands as the preferred country of residence.

3.4. Concluding observations

Based on existing case law, the Netherlands has to allow the cross-border fiscal unity of a Dutch resident holding company and a subsidiary resident in another Member State. Since no legal basis has been established for this facility, the legislature has deprived itself of most of the possibilities to protect the government from the undesirable effects of this facility.

Based on an analysis of *Marks & Spencer* and taking into account the principles of the internal market, an exemption system with the horizontal and conditional use of foreign losses is the system that approaches perfection. The proposed Dutch system is an example of an almost perfect system. Therefore, introducing this system would have been a good example to the other Member States. Withdrawing the proposed system will not only result in a loss of revenue for the government, but also takes the Dutch system further away from the desired internal market.

4. SUMMARY

The *Marks & Spencer* decision makes it clear that cross-border loss compensation must be possible if, in a comparable domestic situation, loss compensation is possible. As an exception to this rule, the Member States are not obliged to grant cross-border loss compensation if double loss compensation will actually be the result. While the *Marks & Spencer* case was being litigated, the Netherlands State Secretary planned to introduce the facility of cross-border fiscal unity into the Dutch legislation in the near future, but a few days after the ECJ's judgement, he withdrew his plan. This is bad luck for companies because there is now no legal certainty if a company wants to make use of that facility. It is also bad luck for the Netherlands as a residence

49. The fifth condition refers to a minimum period during which the fiscal unity must exist.

50. See Bender, T., S.C.W. Douma and F.A. Engelen, "Werken aan winst? Werken aan de interne markt! (2)", *WFR* 2005/1069; and Bender, T., "Grensoverschrijdende verliesverrekening: niet afschaffen maar uitbreiden", *WFR* 2004/1519.

51. The "*D*" case, Case C-376/03, [2005] ECR (not yet published).

52. See van den Hurk, Hans, "Does the Reach of the European Court of Justice Extend Beyond the European Union?", 56 *Bulletin for International Fiscal Documentation* 6 (2002), at 275; and van den Hurk, Hans and A. Theunissen, "Several institutional and fiscal aspects of the European Economic Area", *EC Tax Review*, January 2001, at 26.

53. See van den Hurk, "Does the Reach of the European Court of Justice Extend Beyond the European Union?", supra note 52.

state because, since cross-border fiscal unities can successfully be enforced under the current legislation in combination with case law, it is a missed opportunity for the Netherlands to return to the shortlist of companies as an attractive residence state. Last but not least, the Dutch system is moving away from the desired optimum in the internal market, which is bad for a country that is planning to introduce a new CITA in 2007 in order to make the CITA fully EC-proof. Entrepreneurs are advised to examine what advantages can be gained from a cross-border fiscal unity and then decide whether the facility is worthwhile.