CONFEDERATION FISCALE EUROPEENNE

Opinion Statement of the CFE

on

X Holding (C-337/08)

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This is an Opinion Statement prepared by the ECJ Task Force[1] of the CFE on X Holding (C-337/08). Advocate General Juliane Kokott delivered her Opinion on 19 November 2009 and the ECJ decided the case on 25 February 2010.
The CFE is the leading European association of 33 national tax advisory organisations representing over 180,000 tax advisers.

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1. Decision of the Court

1. On 25 February 2010 the European Court of Justice (ECJ), largely following its Advocate General (AG), decided in *X Holding*[2] that:
   - a Dutch tax rule that allowed a Dutch parent to form a group with its Dutch subsidiary (domestic situation) but not with its Belgian subsidiary (cross-border situation) constituted discrimination contrary to the Treaty Articles on establishment (the discrimination question);
   - this denial of group treatment was nevertheless justified by the need to ensure a balanced allocation of tax jurisdiction (the justification question);
   - this denial of group treatment was also proportional. Balanced allocation of tax jurisdiction could not have been achieved with a less restrictive measure (the proportionality question) because a denial of "temporary transfer of losses"[3] was also justified by the need to ensure "balanced allocation" , and because a Member State was not obliged to treat a foreign subsidiary as a foreign permanent establishment as these were not comparable as regards the allocation of tax jurisdiction[4].

2. The CFE finds this decision surprising, in particular because the Court in this case ignored the real proportionality question whether temporary loss transfer is a less restrictive measure, focusing its attention instead on the surprising question whether the denial of temporary loss transfer is in itself justified. The ECJ's reasoning departs from the standard analysis by re-

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[2] Case C-337/08 *X Holding BV v Staatssecretaris van Financiën*, ECJ Judgment of 25 February 2010 and Advocate General Kokott Opinion of 19 November 2009, both available from the ECJ web-site at curia.europa.eu.

[3] A temporary loss transfer would allow the parent to consolidate the losses of the foreign subsidiary with its profits, but the relevant amounts are recuperated subsequently when the subsidiary is profitable again and its profits are taxable in the Member State of the parent up to the amount of previously consolidated losses.

[4] It may be noted that the ECJ's reasoning departs from the standard analysis by re-introducing a second examination of justification and discrimination at the proportionality stage. This is discussed further below.

introducing a second examination of justification and discrimination at the proportionality stage. Furthermore, the Court's reasoning on "justification" and on "proportionality" raise the larger question whether the ECJ is giving too much weight to protecting the revenue interests of the Member States rather than eliminating discrimination in the internal market.

2. Problems in the reasoning on "justification"

3. The AG and ECJ conclude that the "need to safeguard the allocation of tax jurisdiction between Member States" can justify the denial of loss consolidation to a cross border parent-subsidiary situation, but there are two problems with their reasoning and conclusion.

4. First, both the AG and the ECJ recognise that the different group treatment causes at least three disadvantages for the cross-border situation: (a) losses cannot be consolidated, (b) asset transfers trigger capital gains taxation, and (c) transfer pricing rules and documentation requirements are fully applicable. But in their analysis the AG and ECJ focus almost exclusively on loss consolidation, even though nothing in the facts of the case suggested that *X Holding* was indeed in a loss situation.

5. As to the other 2 disadvantages, the AG simply assumes that these are also justified by the need to ensure a balanced allocation of tax jurisdiction (Opinion points 81 and 83), raising questions as regards settled case law on the prohibition of exit taxes on capital gains (accrued capital gains cannot be taxed only in a cross-border situation[5]) and on the EU compatibility of national anti-abuse measures (these are justified only if they target wholly artificial constructions[6]). The ECJ focuses exclusively on loss consolidation and thus produces an incomplete decision, which is contrary to the obligation to respond to all pleas raised by an applicant.[7]

6. Second, the AG and ECJ broaden the scope of the "balanced allocation of tax jurisdiction" justification beyond the traditional understanding in *Marks & Spencer* and *OY AA* that, exceptionally, a restrictive measure can be justified if the possibility of loss trafficking and/or a double dip undermines the right of the source state to tax domestic source income of residents. They mention the risk of loss trafficking only in passing, but really base their "balanced allocation" justification on the fact that the Netherlands would not be able to tax the profits of the foreign subsidiary and thus should not be obliged to take account of the losses[8]. It is also

[5] See, in particular, Case C-9/02 *De Lasteyrie du Saillant* [2004] ECR I-2409.
[6] See, in particular, Case C-196/04, *Cadbury Schweppes*, [2006] ECR I-7995.
[7] Joined Cases C-238 and following/99 *Limburgse Vinyl Maatschappij v. Commission* 2002 ECR I-8375 (416 to 428); C-197/99 *Belgium v. Commission* 2003 ECR I-8461 (82).
[8] Interestingly, the Hoge Raad, 13 November 1996, BNB 1998/47, decided that a foreign subsidiary that forms part of a Dutch group should be treated as a permanent establishment,

questionable from an internal market point of view and represents a departure from settled case law to the effect that, generally, revenue concerns cannot justify discrimination[9] and, more specifically, that discrimination by one Member State cannot be justified on the grounds that a person is not taxable in that Member State, but in another Member State.[10] Also the "balanced allocation" justification now seems to absorb the "anti-avoidance" justification, without applying, however, the much stricter test of "wholly artificial constructions", which has so far assured a proportional impact of justified restrictions on the internal market.

3. Problems in the reasoning on "proportionality"

7. The AG and ECJ accept that the denial of group treatment is proportional, first, because the less restrictive "temporary transfer of losses" would cause a cash flow disadvantage for Member States and would for that reason itself be justified by the need to ensure a balanced allocation of tax jurisdiction (why the justification question again?), and, second, because a Member State is not obliged to treat a foreign subsidiary as a foreign permanent establishment as these are not in the same situation having regard to the allocation of tax jurisdiction (why the discrimination question again?). Again, the reasoning and conclusion of the AG and the ECJ raise several difficult questions.

8. First, the AG and the ECJ rely on "balanced allocation of tax jurisdiction" to justify, not only the *a priori* denial of group treatment, but also the denial of "temporary loss transfer" as this would cause a cash flow disadvantage for Member States ("balanced allocation" becomes "protection of revenue"). This raises three issues:
    - A renewed focus on justification is out of place in a proportionality analysis and obscures the real proportionality questions. These include whether it would be less restrictive for the Netherlands to treat the foreign subsidiary as a foreign permanent establishment (taking account of both profits and losses), or to abolish the generous choice of companies to enter and leave the group on an annual basis, or to at least allow the consolidation of liquidation losses (*Marks and Spencer)*, or to allow *X Holding* to prove that there are no losses and thus no risks of "double dip" or loss

so that the profits of *X Holding*, if part of a group, would have been taxable in the Netherlands. The ECJ did not grant the request of one of the parties to reopen the oral procedure to correct this misunderstanding of the facts.

[9] Settled case law since Case C-270/83, *Commission v. France* ("*avoir fiscal*"), [1986] ECR 273.

[10] Settled case law since Case C-107/94 *Asscher* 1996 ECR I-3089 (Netherlands may not impose a higher tax rate on non residents because they do not contribute to social security in the Netherlands, but in Belgium) ; C-294/97 *Eurowings* 1999 ECR I-7447 (Germany may not deny deduction of expenses paid to an operator established in another Member State and subject to a low tax there).

trafficking so that the balanced allocation of tax jurisdiction is not endangered. The AG and the ECJ simply ignore these key proportionality questions;

- the conclusion that "temporary loss transfer" would jeopardise "balanced allocation" is incorrect because the Member State of the parent does not give up its tax jurisdiction over the profits of the parent, but just temporarily defers collection until the foreign subsidiary is profitable again;
- even if "temporary loss transfer" has a cost for the Member State (cash flow disadvantage[11]), it still is a less restrictive measure for persons who exercise their right to free movement. It is also less costly for the Member State than the primary Treaty obligation to grant equal treatment (cross border loss consolidation).

9. Second, even though the ECJ and the AG consider the denial of the temporary loss transfer (treatment of a foreign subsidiary as a foreign permanent establishment) also justified, they nevertheless continue to argue that this denial in itself would not be discriminatory because the foreign subsidiary is not comparable to the foreign permanent establishment from the point of view of allocation of tax jurisdiction. Apart from being out of place, asking the discrimination question again, in turn raises further issues:
    - It is unnecessary because, logically, a measure is either discriminatory (in which case the justification question is relevant), or not discriminatory (in which case the justification question is not relevant);
    - It reaches the conclusion that the foreign subsidiary is not in a similar situation because its profits cannot be taxed by the Member State of the parent, which is questionable because the profits of that subsidiary are in any case subject to tax in the other Member State[12].;
    - it has an outcome that is at odds with settled case law that the freedom of establishment expressly leaves traders free to choose the appropriate form in which to pursue their activities in another Member State and that this freedom of choice must not be limited in the host state by discriminatory tax provisions (*Commission v.*

[11] As regards cash flow disadvantages, the ECJ seems to have a different approach to different cases: In one part of the case law (*AMID*, para. 23, *Metallgesellschaft and Hoechst*, para. 54 and some decisions on losses) it considered a cash flow disadvantage for the private sector to constitute an EU incompatible discrimination. In the case law on withholding taxes (e.g. FII, para. 96) it started ignoring cash flow disadvantages. In *X Holding* it considers a public sector cash flow disadvantage to be a sufficient reason for Member States to justify a discriminatory tax measure. The problem with this last approach however is that the cash flow disadvantage is inherent in the very choice itself of the Member State to apply consolidation.

[12] See *Asscher*, paras. 53-54 and FII, paras. 89-93.

France, *CLT/UFA*).[13] In this respect the attempt of the AG to distinguish between inbound (*Commission v. France)* and outbound (*X Holding)* situations is unconvincing, because in an internal market a discriminatory access restriction imposed by the host state is as damaging as a discriminatory exit restriction imposed by the home state; indeed, this is why the ECJ reads the Treaty as prohibiting not only host state discrimination but also home state discrimination.[14]

4. The statement

11. The Confédération Fiscale Européenne is surprised by the Court's judgement in X Holding. The judgment fails to give a complete reply to the questions of the national court, focusing solely on loss relief and ignoring the other elements of fiscal consolidation. Moreover, its findings on loss relief reflect an incomplete and incoherent analysis.

The Court's main concern, that allowing cross-border groups access to group treatment would undermine the balanced allocation of taxing powers, is unconvincing. Based on the fact that groups are free under Dutch law to opt in and out of a group regime, the ECJ fails to consider that Member States have other options and that a more proportionate response would be to require (as certain Member States do) that an election be made for a minimum period. A blanket exclusion from the regime on that ground is plainly disproportionate.

The ECJ also fails to recognise that any interference with the balanced allocation of taxing powers is likely to be limited given that it is open to a Member State to apply a recapture mechanism, such as the one often applied to foreign branches, to ensure that relief given is merely temporary. There is no principle of international tax law preventing the extension of such a mechanism to subsidiaries.

The ECJ's finding, under the heading of proportionality, that foreign branches and subsidiaries are not in a comparable situation and that EU law does not require a Member State to extend to foreign subsidiaries the treatment applied to foreign branches is beside the point. It has no relevance to the proportionality question whether there is a less restrictive means of preserving the balanced allocation of taxing powers than a blanket exclusion from the group regime. There is no explanation as to why the recapture mechanism traditionally applied by the Netherlands (and

[13] Opinion point 58 (repeated in *X-Holding* para. 39) referring to 270/83 *Commission v. France* (22); C 253/03 *CLT UFA* (14); C-231/05 *Oy AA* (40). The AG also refers to Joined Cases C-439 and 499/07 *KBC Bank* (77).

[14] Para. 19 of *X Holding* and AG's Opinion point 22 which refers to other direct tax case law, including C-264/96 *ICI* [1998] ECR I-4695 (21); C-446/03 *Marks & Spencer* (31); C-418/07 *Papillon* 2008 ECR (16).

other Member States) to foreign branches cannot be extended to foreign subsidiaries; and indeed there is no technical reason why it should not.

In the absence of convincing reasoning the only plausible conclusion is that the ECJ is intent on preserving Member States short-term revenue interests at all costs and has for the moment abandoned the longer term goal of assuring the correct functioning of the internal market. By allowing Member States to operate systems of group taxation which benefit domestic over foreign investment it allows them to retain an unjustified barrier to cross-border investment, undermining the longer term growth benefits which that entails.