WILL LIDL GET ITS SUPERMARKET REFUND? (C-414/06)

by Tiago Pedro Rodrigues[1]

Summary

Este artigo analisa a recente opinião da Advogada Geral Sharpston no caso *Lidl* no qual está em causa a possibilidade de evitar uma desvantagem financeira de fluxo de tesouraria através da dedução imediata de prejuízos acumulados num estabelecimento estável situado fora do Estado membro da sede. O autor vai ainda tentar demonstrar o paralelo entre a dedução transfronteiriça de prejuízos e as deduções pessoais referentes ao rendimento proveniente de trabalho exercido num Estado membro diferente do da residência que, na opinião do autor, constitui o pensamento que o TJCE seguirá no futuro em situações de alocação de jurisdição tributária entre Estados Membros.

This article analysis the recent Advocate General Sharpston's opinion on Lidl case regarding the possibility of avoiding a cash-flow disadvantage by immediately deducting losses arising in a permanent establishment situated outside the head office Member State. The author will also try to demonstrate the parallel between the deduction of cross-border losses and the deduction of personal circumstances concerning income from employment exercised outside the Residence Member State which, in the author's opinion, shows the approach the ECJ will follow in the future regarding the allocation of taxing rights situations between Member States.

Contents

1. THE FACTS

Lidl Belgium GmbH & Co. KG ("*Lidl*") is a German company that has a permanent establishment ("PE") in Luxembourg, through which carries its business activities in that State.

In 1999, Lidl's PE in Luxembourg amounted losses in the sum of DEM 163.382 (EUR 83.536). Lidl tried to deduce these losses from the profits which the company had made in Germany. German tax authorities refused this alleging that according to the double taxation treaty entered into between Germany and Luxembourg ("DTT"), income arising in Lidl's PE in Luxembourg was not subject to taxation in Germany, and therefore losses incurred by the PE were not deductible in Germany.

[1] The author wishes to thank his professor Tom O'Shea, Queen Mary University of London, for all his assistance and advice and Anja Taferner from Ernst & Young Luxembourg for getting me the case I was looking for. All errors and omissions remain the sole responsibility of the author.

2. THE QUESTION REFERRED BY THE COURT

"Is it compatible with Articles 43 EC and 56 EC for a German company with income from industrial or commercial activities to be precluded, when calculating its profits, from deducting losses from a PE in another Member State (here: Luxembourg) on the ground that, according to the applicable double taxation convention, the corresponding income from such a permanent establishment is not subject to taxation in Germany?"

3. ADVOCATE GENERAL ("AG") SHARPSTON OPINION

AG Sharpston opens her opinion stating that in light of consistent case-law from the European Court of Justice ("ECJ") the relevant provision in this case is Article 43 EC[2], not Article 56 EC[3].

From there AG Sharpston begins the analysis on whether there is infringement of Article 43 on the basis of different treatment. In this topic the AG agrees with Lidl and the Commission to be *prima facie* contrary to Article 43 EC to preclude a company established in one Member State, when calculating its taxable income, from deducting losses suffered by a PE in another Member State on the grounds alleged by the German tax authorities.

> "*A German company with a permanent establishment in Luxembourg which has made a loss is manifestly treated less favourably than a German company with a domestic permanent establishment which has made a loss: in the latter case, the loss is taken into account in computing the company's profits, in the former case, it is not. That suffices to trigger Article 43 EC*".

The AG then says that the real issue in this case is whether this restriction can be justified in accordance with the grounds established by the ECJ in previous similar case *Marks & Spencer*[4] and if that is the case whether the domestic measure is proportionate.

In this aspect AG Sharpston concludes that the domestic rule is not proportionate mainly because it would have been possible to achieve the same objective using less restrictive measures. This conclusion was based on previous German legislation[5] which allowed the deduction of losses incurred by PEs situated in other states but demanded the same deduction to be brought back when the PE made profits:

> "*Such a rule, which allowed the deduction of losses while providing for the recapture of the loss relief in future profitable periods, would manifestly be a less restrictive means of avoiding the risk that losses might be used twice than a rule altogether excluding relief for such losses (…) 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. To my mind, it thus manifestly better reflects the need for proportionality than the solution adopted by the Court in Marks & Spencer*".

---

[2] Article 49 EC after Lisbon Treaty amendments
[3] Article 63 EC after Lisbon Treaty amendments
[4] Case C-446/03 [ECR I-10837]. In this case the ECJ decided that legislation which prevented a resident company from deducting from its taxable profits losses incurred by a **subsidiary** (≠ permanent establishments) established in another Member State while permitting it to deduct losses incurred by a resident subsidiary amounted to a restriction on the freedom of establishment contrary to Articles 43 and 48 EC. However, the Court went on to hold that the restriction was justified but not proportionate when the possibility for having the losses taken into account in the subsidiary's Member State had been exhausted. The three justifications were: aim of preserving the allocation of the power to impose taxes, the danger that losses might be used twice and the risk of tax avoidance.
[5] Paragraph 2a (3) of the *Einkommensteuergesetz* (Income tax law) 1997 (BGBI. 1997 I, page 821).

Next, AG Sharpston points out the differences between Marks & Spencer and *Lidl* cases. In the former, losses were made by subsidiaries that had been wound up or sold and thus could not be used anymore in the subsidiary's Member State. In the latter, the PE carries on its activities, which entails a possibility of using the incurred losses against future profits in the Member State where the PE is situated. Therefore, in Lidl the denial to grant the deduction and immediate use of the losses only originates a cash-flow disadvantage.

However, the AG then says that following ECJ case-law[6] a cash-flow disadvantage is considered to be a restriction of the freedom of establishment and, although the question of justification regarding this disadvantage was not directly addressed by the ECJ in the *Marks & Spencer* judgment, the decision should not be any different.

Finally, the AG dismisses the Member States' arguments regarding significant practical difficulties and their request to limit the temporal effects based on previous ECJ case-law[7] concluding that the German rule at bar is not compatible with Article 43 EC.

4. ANALYSIS

4.1. Initial comments

In *Lidl* we are looking at a German domestic rule denying the deduction of losses made foreign PEs against the profits of the German head office when calculating its taxable income. On the other hand, such deduction of losses is granted if the PE is situated in Germany.

Thus, we have an origin state case where a resident company with a PE in other Member State is being treated differently from a resident company with a PE in Germany. That which chose to exercise its freedom establishing its business cross-border is being treated differently than another that chose to remain in Germany.

Article 5 (1) of the DTT establishes that profits from a resident company from one of the Contracting States arising in the other State can only be taxed by this latter State if attributable to a PE in their territory. Thus, Luxembourg has been allocated taxing rights regarding profits attributed to German PEs in its territory. In order to avoid double taxation, the DDT also establishes that Germany will exempt those profits waiving its right to tax.

The German tax administration claims that once the right to tax the profits (positive income) arising from PEs in Luxembourg has been waived, so was the right to deduct losses generated by the same PEs in Germany.

It is possible to view this case as an extension of the *Marks & Spencer* decision concerning a fundamental distinction between final losses and temporary losses, which is very important to its proper understanding.

In *Marks & Spencer*, the ECJ was called to decide on the UK denial to the deduction of final losses arising from foreign subsidiaries, *i.e.* losses that could not be deducted anymore in the Member State where the subsidiary was situated due to time limitations, winding up or sale of the business.

[6] Joined Cases C-397/98 and C-410/98 Metallgesellschaft [2001] ECR I-1727, paragraphs 44, 54 and 76; Case C-436/00 X and Y [2002] ECR I-10829, paragraphs 36 to 38; Case C-268/03 De Baeck [2004] ECR I-5961, paragraph 24; Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECR I-11753, paragraphs 96, 97, 153 and 154; and Case C-347/04 Rewe Zentralfinanz [2007] ECR I-2647, paragraph 29.

[7] Case C-334/02 Commission v France [2004] ECR I-2229 paragraph 29 and case C-313/05 Brzeziński [2007] ECR I-513, paragraphs 57 and 58.

In *Lidl*, the ECJ has to determine if its decision in *Marks & Spencer* should be extended to temporary losses, *i.e.* losses that still can be deducted in the host Member State in future profitable years of the PE by simply carrying them forward.

4.2. Infringement of Article 43 EC

A discrimination concerning the freedom of establishment only arises if there is a difference of treatment between two comparable situations, or the same treatment given to two non-comparable situations[8].

In the present case we hold that there is no discrimination. The reason why foreign PEs are not allowed to deduct their losses in their Germany head office, while German PEs can, is that according to the DTT Germany cannot tax the profits of a foreign PE. Thus, from the origin state perspective these two situations are not equal. In one situation Germany taxes the profits arising from the German PE and in the other it exempts the profits from the foreign PE (i.e., Luxembourg is the State entitled to tax the corresponding profits).

Therefore, the German domestic provision is not discriminatory simply because from the origin state perspective it is treating different situations differently.

However, in this case the difference of treatment between a company that has chosen to establish its business abroad and a company that has chosen to remain in Germany may constitute a restriction to freedom of establishment.

This may be the case because the German domestic rule has the effect of hindering a German company from exercising its freedom of establishment in another Member State. A German company will avoid establish businesses in other Member States because it will be in a less advantageous position compared to a German company that does not exercise the relevant freedom.

As the ECJ said in *Flaminio Costa v E.N.E.L. (C - 6/64),*below (and other precedents[9] that followed):

> *"freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings under the conditions laid down for its own nationals by the law of the country where such establishment is effected. Article 53 is therefore satisfied so long as no new measure subjects the establishment of nationals of other member states to more severe rules than those prescribed for nationals of the country of establishment, whatever the legal system governing the undertaking".*

With regard to restrictions arising from the country of origin *vide* (i) *Reyners* (C-2/74) on the concept of establishment and (ii) *Knoors (C-115/78)*[10] on the extension of the freedom to origin cases*:*

> *(i) "The concept of establishment within the meaning of the Treaty is therefore a very broad one, allowing a Community national to participate, on a stable and continuous basis, in the economic life of a Member State other*

[8] See joined Cases 17/61 and 20/61 *Klöckner-Werke AG and Hoesch AG v High Authority of the European Coal and Steel Community*, Case C-279/93 *Schumacker*.

[9] See among many others Case C-270/83 Avoir Fiscal, Case C-307/97 Saint-Gobain ZN [1999] ECR I-6161, paragraph 35; Case C-196/04 Cadbury Schweppes and Cadbury Schweppes Overseas [2006] ECR I-7995, paragraph 41; and Test Claimants in the Thin Cap Group Litigation, paragraph 36.

[10] Also look at Case C-251/98 C. Baars [2000] ECR I- 2787 §29, Case C-200/98 X AB, Y AB v Riksskatteverket [1999] ECR I- 8261 §27, Case C-264/96 ICI [1998] ECR I-0000 §21, Case C-53/95 Inasti [1996] ECR I-703 §11, Case C-143/87 Stanton [1988] ECR 3877 §13, Case C-81/87 Daily Mail [1988] ECR 5483 §16.

than his State of origin and to profit there from, so contributing to economic and social interpenetration within the Community in the sphere of activities as self-employed persons".

(ii) "In fact, these liberties, which are fundamental in the Community system, could not be fully realized if the Member States were in a position to refuse to grant the benefit of the provisions of Community law to those of their nationals who have taken advantage of the facilities existing in the matter of freedom of movement and establishment and who have acquired, by virtue of such facilities, the trade qualifications referred to by the directive in a Member State other than that whose nationality they possess".

In light of the above we can conclude AG Sharpston used the correct comparator to analyze the existence of a restriction. If Lidl is denied the possibility to deduct losses from its Luxembourg PE - while the same would not happen if the PE was situated in Germany - then there is a restriction hindering the freedom of establishment.

In the present case the restriction arises from the fact that in a purely domestic situation the losses can immediately be deducted from profits made by the German head office while in a cross-border situation such deduction has to wait until the PE makes profits in following years and thus needs to carry forward their losses. This constitutes a cash-flow disadvantage.

As AG Sharpston correctly points out these types of disadvantages have been consistently considered by the ECJ case law[11] as restrictions on the freedom of establishment.

For example, in *Marks & Spencer* the ECJ said:

"Group relief such as that at issue in the main proceedings constitutes a tax advantage for the companies concerned. By speeding up the relief of the losses of the loss-making companies by allowing them to be set off immediately against the profits of other group companies, such relief confers a cash advantage on the group. The exclusion of such an advantage in respect of the losses incurred by a subsidiary established in another Member State which does not conduct any trading activities in the parent company's Member State is 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. It thus constitutes a restriction on freedom of establishment within the meaning of Articles 43 EC and 48 EC, in that it applies different treatment for tax purposes to losses incurred by a resident subsidiary and losses incurred by a non-resident subsidiary".

We can conclude from this analysis that in *Lidl* the German domestic rule constitutes a restriction on freedom of establishment represented by the denial of a tax advantage to a cross-border situation thus hindering the right of establishment in other Member States.

4.3 – Justification

Having concluded that the German domestic provision constitutes a restriction on the freedom of establishment, provided in article 43 EC, we must proceed with the analysis and determine if the restriction can be justified by pressing reasons of public interest.

---

[11] Vide Cases C-397/98 and C-410/98 Metallgesellschaft [2001] ECR I-1727, paragraphs 44, 54 and 76; Case C-436/00 X and Y [2002] ECR I-10829, paragraphs 36 to 38; Case C-268/03 De Baeck [2004] ECR I-5961, paragraph 24; Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECR I-11753, paragraphs 96, 97, 153 and 154; and Case C-347/04 Rewe Zentralfinanz [2007] ECR I-2647, paragraph 29.

Avenida Marechal Craveiro Lopes, N.º2 A, 1700-284, Lisboa | Campo Grande | Portugal
Telefone: 21 751 37 00 | Fax: 21 757 39 66 | e-mail: informacoes@isg.pt | www.isg.pt

If that is the case we should then determine if it is proportionate, according to the *Gebhard*[12] and *Kraus*[13] jurisprudence.

According to the European Community Treaty ("ECT") and ECJ case law[14], restrictions on the freedom of establishment by Member States provisions can be admissible "*if the measure pursues a legitimate aim compatible with the Treaty and were justified by pressing reasons of public interest".*

Nevertheless, "*even if that were so, it would still have to be of such a nature as to ensure achievement of the aim in question and not go beyond what was necessary for that purpose"*.

Within the justifications already accepted by the ECJ we find *(i)* preserving cohesion of tax system; *(ii)* preventing tax avoidance/abuse of rights; *(iii)* ensuring fiscal supervision; *(iv)* territoriality principle and *(v)* allocation of taxing rights.

As PAUL FARMER[15] accurately points out, the "preserving the allocation of taxing rights" argument is just a development from the cohesion of the tax system justification. However, they have been considered two different justifications and analyzed separately by the ECJ[16]. Thus, the justification of preserving the allocation of taxing rights , as accepted by ECJ in the *Marks & Spencer* decision, is the one to consider in this case.

As the ECJ said in the *Marks & Spencer* decision, the fact that Member States do not tax profits arising from foreign PEs does not constitute in itself a justification for a domestic provision to hinder establishments in other Member States. It is first necessary to consider *(i)* whether the fact that a tax advantage is only made available to resident companies has any relevant objective elements that justify the difference in treatment and also *(ii)* the consequences were this advantage extended unconditionally.

As per the ECJ case law, the starting point to analyze this justification is that the lack of harmonization (positive integration) implies that in the area of direct taxation competence remains with the Member States. However, that competence must be exercised according to community law (negative integration).

Because Member States remain competent in this area they are free to allocate the powers to impose taxes in situations where there is a connection with more than one State. This is done through Double Tax Treaties, since they serve the purpose of obtaining a balance in the taxation rights of the Contracting States[17].

Therefore, the ECJ recognizes Member States have a general public interest in maintaining the symmetry of the allocation of taxing rights negotiated between the two Member States which serves as a justification to the different treatment that is given to comparable situations.

On the present case, it is comprehensible that Germany, having chosen to waive its taxing rights with regard to profits arising from foreign PEs (an exception to the principle of worldwide taxation of residents) does not want

[12] Case C-55/94 *Gebhard* [1995] ECR I-4165.
[13] Case C-19/92 *Kraus v Land Baden-Wuerttemberg* [1993] ECR I-1663, paragraph 32.
[14] Case C-55/94 *Gebhard* [1995] ECR I-4165, paragraph 37; in Case C-19/92 *Kraus* [1993] ECR I-1663, paragraph 32; and in Case C-415/93 *Bosman* [1995] ECR I-4921, paragraph 104).
[15] Paul Farmer is a partner in the Tax Litigation Group. Extensive experience in both direct and indirect tax arenas, with particular focus on European community tax law matters.
[16] In this regard see Tom O'Shea articles "*Marks and Spencer v Halsey (HM Inspector of Taxes): restriction, justification and proportionality*" in EC Tax Review 2006/02, pg. 66 and "*News Analysis: Further Thoughts on Rewe Zentralfinanz"* in Tax Notes International, vol. 46, n.º 2 from April 9, 2007, pg. 134.

[17] See Case C-290/04 *FKP Scorpio Konzertproduktionen* [2006] ECR I-9461, paragraph 54; Case C-374/04 *Test Claimants in Class IV of the ACT Group Litigation* [2006] ECR I-11673, paragraph 52; and Case C-231/05 *Oy AA* [2007] ECR I-0000, paragraph 52

to allow the deduction of losses arising from the same PEs. This would unbalance the allocation of taxing rights negotiated between the two States emptying it of any meaning or gain.

In the recent judgment *Deutsche Shell*[18] the ECJ supports this view by saying:

> "*That competence* [to determine the criteria for taxation of income] *also implies that a Member State cannot be required to take account, for the purposes of applying its tax law, of the negative results of a permanent establishment 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 permanent establishment is situated* ".

Thus, because Member States still retain competence in this area they can choose to allocate their taxing rights in any way they seem fit. In order to protect this competence they are allowed to introduce domestic provisions as long as they are proportionate. This is where lays the difference between *Marks & Spencer* and *Lidl*, as we will try to explain ahead.

It should be noted that we can have situations concerning deduction of losses where Member States introduce domestic provisions that disturb this balance and inflict different treatment to comparable resident companies without any justification.

For example, in the *AMID* case[19] there was a Belgian company with a PE in Luxembourg. Belgium introduced a domestic provision[20] allowing the deduction of losses from PEs situated in other Member States and permitting the elimination of any cash flow disadvantages.

The problem with this case was that the same provision also denied the carry forward of losses in the resident company if, in the year when the losses occurred, any of the company's PEs made profits to which the losses could be set off.

To illustrate this let us take a look at the facts in AMID. In 1981 the Belgian resident company made losses accounting to BEF 2 126 926. In the same year its Luxembourg subsidiary made a profit of LUF 3 541 118. At the time Luxembourg did not allow the deduction of the Belgian head office losses in the Luxembourg PE, so the Belgian company carried the losses forward to use in following profitable years. In 1982, the Belgian resident company made profits and tried to deduct the previous year losses. The Belgian tax authorities denied this deduction alleging those losses should have been set off in the previous years against the profits of the Luxembourg PE.

This is the perfect example of the "*traps*" Member States can set in this area. Although at a first look it may seem that Belgium only tried to safeguard the balance of their domestic tax regime imposing companies to deduct head office losses against foreign PEs profits, this provision was not intended to safeguard any allocation of taxing rights between Member States.

Because of Double Tax Treaties and the allocation of taxing rights (according to Article 7 of the OECD Model) most of the Member States will not allow the deduction of head office losses against PE profits situated in their territory. Thus, the Belgian provision was not intended to safeguard a balance attained in the relevant Treaty but still originated an unjustified difference in treatment between a resident company with a Belgian PE and a company with a foreign PE.

---

[18] Case C-293/06 Deutsche Shell.
[19] Case C-141/99 Algemene Maatschappij voor Investering en Dienstverlening NV (AMID) v Belgische Staat.
[20] Article 66 of the Royal Decree of 4 March 1965.

While the first was allowed to deduct the head office losses against PE profits because they were situated in the same Member State and there were no DTT problems arising, the latter was denied that possibility and in fact would lose the right to deduct their losses completely (Belgium denied the deduction and the PE's Member State would invoke the DTT to deny it too) just because the PE was not situated in Belgium.

Therefore, the Belgium domestic provision created a situation of final losses.

Also, the rule was not intended to preserve the allocation of taxing rights because if that was the case Belgium (and not Luxembourg) would be the Member State that would have to accept the deduction of losses since it was the Member State with the right to tax the profits.

In this case there was a difference of treatment with no justification which led the ECJ to conclude that Article 43 EC precluded a domestic provision such as the one explained above.

4.4 - Proportionality

Having reached the conclusion that in *Lidl* there is a justification for the domestic provision hindering or make less attractive the exercise of the freedom of establishment, one must still make sure the rule is proportionate. This means the provision must *(i)* be suitable for securing the attainment of the objective which they pursue; and *(ii)* not go beyond what is necessary in order to attain it[21].

With regard to the first requirement we can conclude the domestic provision is suitable for the purpose desired by the Member State. By denying the deduction of losses arising from foreign PEs, Germany is attaining the objective of maintaining the allocation of taxing rights negotiated with Luxembourg concerning PE's profits and losses established in each of the Member States.

The second requirement was the one AG Sharpston considered not to be fulfilled by the Member State in question. In her opinion, the fact Germany did have previous provisions[22] permitting the deduction of losses exceeding profits from foreign PEs, subject to the condition that the deduction was brought back to the German resident company in subsequent profitable years of the PE, proves the failure of the second requirement.

I would rather bring another perspective to this issue. The "*deduction-and-recapture*" provision was not suitable to avoid double deduction of losses or *tax rate shopping*, for it would allow companies to raise losses in low tax jurisdictions and deduct them in high tax jurisdictions. Freedom of establishment would then only be an instrument for abusive tax planning which would be harmful for the tax competition between Member States.

This understanding was confirmed by the ECJ in its Oy AA judgment:

> *"To allow deduction of the intra-group financial transfer where it constitutes taxable income of the transferee company, or where the opportunities for the transferee company to transfer its losses to another company are limited, or to allow deduction of an intra-group financial transfer in favour of a company whose establishment is in a Member State applying a lower rate of tax than that applied by the Member State of the transferor only where that intra-group financial transfer is specifically justified by the economic situation of the transferee, as Oy AA has proposed, would nevertheless mean that, in the final analysis, the choice of the Member State of taxation would be a matter for the group of companies, which would have a wide discretion in that regard.*

---

[21] See Cases C-55/94 *Gebhard* [1995] ECR I-4165 and C-19/92 *Kraus v Land Baden-Wuerttemberg* [1993] ECR I-1663, paragraph 32.
[22] Paragraph 2a(3) of the Einkommensteuergesetz (Income tax law) 1997 (BGBl. 1997 I, p. 821).

Furthermore, Germany was not obliged to have a less restrictive measure because this type of provision would only work if Member States chose to harmonize their procedures and tax rules in the area of direct taxation.

This was implied by the ECJ in their *Marks & Spencer* decision:

> *"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" (Paragraph 58).*

Therefore, we hold that the fundamental aspect is that Germany is not obliged to have a rule less restrictive at this stage of direct tax integration between Member States.

Germany may choose to have a rule allowing the cash disadvantage to be neutralized, although according to Community law it is not obliged to do it.

In light of the above we conclude that, notwithstanding the fact that lesser restrictive measures could be envisaged, none would be satisfactory in preserving the balance in the allocation of taxing rights without some type of harmonization which as we learned remains in the competence and will of the Member States. Therefore, Germany is not obliged to have a less restrictive rule regarding losses arising from foreign PEs.

In spite of this conclusion we still need to analyze if in general terms the German domestic provision goes beyond what is necessary to attain the objective of preserving the allocation of taxing rights.

This was the test in *Marks & Spencer* where the UK domestic provision failed. In this case the provision simply denied any deduction of losses. However, in that particular situation, it meant Marks & Spencer was in a situation where its losses could not be deducted in either Member State (in the host State because the company had been wound up or sold and in the origin State because of the UK domestic provision[23]).

Thus, the ECJ considered such UK domestic provision went beyond what was necessary when trying to preserve the allocation of taxing rights, denied the deduction of losses of foreign subsidiaries which could not be deducted anymore in the other Member State. This provision created an unequal treatment incompatible with the ECT.

The same thing did not happen in *Lidl*. In this case we are looking at temporary losses. The foreign PE carried on their business activities in the host Member State and was able to carry forward the losses and deduct them in subsequent years.

Thus, Lidl was only facing a cash flow disadvantage since it was not allowed to deal with the losses in the same year they were made and had to wait until they made profits in the PE.

In my opinion, that is only a consequence of having a business in two different tax systems and, as mentioned above, the lack of harmonization in the area of direct taxation.

When a company is established in two Member States there may be differences regarding tax rates and limits for carrying losses forward. But that does not mean companies are treated differently, it just means they are in two different Member States with two different sets of tax rules.

I support the view taken by TOM O'SHEA[24] when he says AG Poiares Maduro has already shed some light over this issue in paragraph 80 of his opinion regarding *Marks & Spencer*:

[23] A similar thing happened in *AMID* but regarding lack of justification.

[24] Tom O'Shea is a Lecturer in Tax Law at Queen Mary, University of London and a Tax Consultant. He teaches on the EC Tax Law,

"First, it is accepted that establishment, which involves the ability 'to participate, on a stable and continuous basis, in the economic life of a Member State, (81) imposes specific constraints to which the economic operator in principle remains subject. (82) Provided that the treatment of losses is equivalent as regards the group, those constraints do not affect freedom of establishment. ***Under those conditions the differences in treatment which might arise for the group are caused only by the disparities existing as between national tax laws.*** *Second, such a condition permits the cohesion and integrity of national tax systems allowing group relief to be maintained".*

As we learned from recurrent ECJ case law[25] differences in treatment arising from disparities between national tax systems or laws are a consequence of the lack of harmonization in the area of direct taxation and therefore are out of the scope of the ECJ's negative integration efforts.

Although the ECJ has been drawing our attention for the problem of lack of harmonization regarding free movement of goods and trade for three decades now[26], it only recently extended this approach to the freedom of establishment.

For example in the recent *Deutsche Shell* judgment the ECJ states the following:

"Freedom of establishment cannot be understood as meaning that a Member State is 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 (see, by analogy, Case C-403/03 Schempp [2005] ECR I-6421, paragraph 45)".

Therefore, I think that in the *Lidl* we cannot say the provision went beyond what as necessary to attain the purpose of preserving the allocation of taxing rights because a cash flow disadvantage is only a consequence of disparities between tax systems which States are not obliged to prevent through their domestic provisions.

For the reasons above explained I believe the ECJ will not follow AG Sharpston's opinion in *Lidl* case.

5. CONCLUSIONS

We have to begin with an important remark. The difference of treatment arising in this case is without a doubt a distortion to the single market as an EU's objective. It is also not what is desirable in a single market perspective. However, in the present status of EU's integration these situations cannot be addressed without invading the competence Member States reserved for themselves when negotiating the ECT. Thus, we can only hope that future positive integration by the Community brings some new light on this issue eliminating all remaining distortions on the single market.

The fact that currently five Member States allow the deduction of losses sustained by PEs situated in other Member States is in my opinion a step forward in the right direction[27]. However, given the current status of Community integration, or lack of it, this step still cannot be required of Member States who are not prepared to take it.

International Tax Law and European Internal Market courses on the intercollegiate LLM Programme.

[25] Case C-403/03 Schempp, Case C-379/92 Peralta, Case C-336/96 Gilly.

[26] See for example C-120/78 *Rewe-Zentral* or best known as *Cassis de Dijon*.

[27] Except if Member States try to take advantage of it as in the AMID case.

I also believe that the cash-flow disadvantages in previous case law[28] referred by AG Sharpston in her opinion are slightly different from the one under analysis in the *Lidl* case.

In *Metallgesellschaft*[29] the cash-flow disadvantage concerned dividends which according to the OECD Model can be taxed in both States (residence and source) using the credit method to relief double taxation and therefore there is no need to preserve the allocation of taxing rights. If countries use the exemption method like Germany regarding business profits arising from PEs the jurisdiction remains within one of the Member States. On the other hand, whereas dividends are concerned there is allocation of taxing rights but using the credit method and only partial relief for double taxation originated by the overlapping rights is given. The same situation is applicable to *Test Claimants in the FII Group Litigation*[30].

In *X and Y*[31], concerning capital gains, we have a similar situation to *Metallgesellschaft* where both States can tax the income as a result of the word "*may*" in the OECD Model. However, in this situation the domestic provision challenged disturbed the allocation of taxing rights negotiated between the Member States:

> *"In the present case, insofar as the Kingdom of Sweden has concluded double-taxation conventions with other Member States, there is no fiscal coherence in relation to any one taxpayer in establishing a strict correlation between the deferral of capital gains tax and the final taxation of the gain. Coherence is at another level, namely, the reciprocity of the rules applicable in the Contracting States in terms of the convention on the basis of connecting factors for the purposes of apportioning competence in tax matters.(…) The effect of double taxation conventions such as the Belgo-Swedish Convention, and, in particular, its Article 13(4), which is, in fact, identical to the same article of the OECD model convention, is that, as a general rule, a State taxes all gains on shares received by transferors resident on its territory, but, conversely, does not impose tax on gains made by transferors residing in the territory of the other Contracting State, regardless of whether the transferor has benefited from deferral of tax at the time of a previous transfer of the shares concerned. The hypothetical risk of the transferor's moving definitively out of the country in the case of type A share transfers, which the national provision at issue seeks to deal with by refusing deferral of taxation, is thus covered by Article 13(4) of the Belgo-Swedish Convention on a basis of reciprocity, insofar as, in that event, only the Contracting State to which the transferor has moved his residence has authority to tax the gains concerned".*

Finally, *Rewe Zentralfinanz*[32] concerned a write-down on the value of shares which had an immediate impact in the accounts of the parent company. The losses suffered by the subsidiary company resulted in an amendment by the parent company on the book value of the shares. Because the shares belonged to the parent company this procedure generated a loss equal to the value of the write-down.

However, in this case there was a difference of treatment in the write down of shares value whether the subsidiary was a resident or not.

In my opinion, *Rewe Zentralfinanz* does not relate directly to the deduction of profits but only to an indirect effect of losses affecting the parent company like we see in *Deutsche Shell*. They are losses suffered by the parent company and not by its subsidiary or PE.

As regards the deduction of foreign establishment losses, I believe the ECJ must find a balance between the single market's demand and the lack of harmonization in the area of direct taxation. That balance can only be attained by analyzing each case, considering all the factors and looking at all possible consequences of each decision.

[28] Note 24 of the opinion.
[29] Cases C-397/98 and C-410/98 Metallgesellschaft [2001] ECR I-1727.
[30] Case C-446/04 Test Claimants in the FII Group Litigation [2006] ECR I-11753.
[31] Case C-436/00 X and Y [2002] ECR I-10829.
[32] Case C-347/04 Rewe Zentralfinanz [2007] ECR I-2647.

It is the author's belief that in *Lidl* balance should be attained resorting to the *Marks & Spencer*[33]*, AMID* and *Deutsche Shell* decisions. In a situation where the allocation of taxing rights is established according to article 7 of the OECD Model, a PE should only be allowed to deduct its losses in a foreign head office if they are final losses (whether because the PE was sold or because the limit to carry losses forward has ended).

The ECJ confirmed this balance in its recent *Deutsche Shell* judgment concerning a similar situation of expenditure deduction:

> *"As far as concerns the specific argument alleging that Deutsche Shell is likely to benefit from a double advantage from the currency loss, it must be observed that a Member State which has waived its tax powers by concluding a double taxation convention such as that applicable in the main proceedings cannot rely on the lack of tax powers with respect to the results of a permanent establishment which belongs to a company established in the territory of that State in order to justify the refusal to deduct expenditure incurred by that company which, by its nature, cannot be taken into account in the Member State where that establishment is situated"*

In fact, a similar balance has already been attained back in 1993 in direct taxation cases of individuals regarding free movement of workers.

As in business profits, income from employment is also allocated between Member States when negotiating their Tax Treaties. According to article 15 of the OECD Model, income from employment exercised in a State other than the residence State is taxed in the State where the employment is exercised (host State). This allocation of taxing rights raised problems concerning the taking into account of personal and family circumstances of the worker.

With regard to this issue the ECJ considered that "*in relation to direct taxes, the situation of residents and non-residents in a State are generally not comparable, because the income received in the territory of a State by a non-resident is in most cases only a part of his total income which is concentrated at his place of residence, and because a non-resident's personal ability to pay tax, determined by reference to his aggregate income and his personal and family circumstances, is easier to assess at the place where his personal and financial interests are centred, which in general is the place where he has his usual abode*"[34].

Therefore, normally the host State is not obliged to take into consideration the personal and family circumstances of the non-resident worker unless according to relevant case law[35] the worker earns 90% or more of his total income in the host Member State in which case he is considered to be in a comparable situation to a resident worker.

However, in a situation where although the worker earns less than 90% of his total income in the host State the Residence State is not in a position to take into account the worker's personal circumstances that burden must fall down on the host Member State. This happens for example in situations where the income earned in the Residence State is exempted from tax.

In this way the ECJ achieved a balance between the sovereignty of the Member States and ECT's freedoms, between their competence in the area of direct taxation and the demands of the single market.

In the *de Groot* judgment the ECJ clearly stated:

---

[33] The AG Poiares Maduro found a similar balance in regard to health services in the context of national social security systems. See Case C-56/01 *Inizan* [2003] ECR I-12403 and Case C-157/99 *Smits and Peerbooms* [2001] ECR I-5473.

[34] Case C-279/93 Schumacker, case C-391/97 Gschwind, case C-385/00 De Groot, and case C-169/03 Wallentin

[35] Case C-279/93 Schumacker, case C-391/97 Gschwind, case C-385/00 De Groot, and case C-169/03 Wallentin.

“*the mechanisms used to eliminate double taxation or the national tax systems which have the effect of eliminating or alleviating double taxation must permit the taxpayers in the States concerned to be certain that, as the end result, all their personal and family circumstances will be duly taken into to account,* ***irrespective of how those Member States have allocated that obligation amongst themselves****, in order not to give rise to inequality of treatment which is incompatible with the Treaty provisions on the freedom of movement for workers and in no way results from the disparities between the national tax laws”.*

Therefore, the allocation of taxing right in income from employment is compatible with the ECT as long as it allows the personal circumstances of the worker to be taken into account at least in one of the Member States, residence or host. This is the limit to the right to allocate taxing rights retained by Member States. If a situation arises where domestic rules have the effect of denying deduction of losses in both Member States (as it happens with personal circumstances) the domestic provision will be considered incompatible with the ECT.

I believe a parallel can be established between the freedom of workers and establishment, and that the ECJ will apply this balance regarding domestic and cross-border deduction of losses.

Thus, although the deduction of PE’s losses is normally a responsibility for host Member States because they have the taxing right of profits[36] when they cannot grant such deduction that role must be taken by the Member State of residence, thus preventing companies from not having their losses taken into account in either of the Member States. This is similar to the balance attained regarding freedom of workers.

As a final remark it is worth to point out a decision from the Luxembourg Administrative Court[37] in which a similar situation concerning whether a Luxembourg company could deduct losses from their German PE was analyzed.

In this case, the tax authorities argued that DTTs cover the right to tax positive income and negative income. Therefore, given that under the DTT entered into between Germany and Luxembourg, the taxing rights of the income derived by a Luxembourg resident company from a German PE were allocated to Germany (and exempt in Luxembourg) the losses suffered by a foreign PE could not be deducted from Luxembourg taxable income.

The Luxembourg court held that DTTs should not increase the tax burden of a taxpayer arising from domestic law. In the court’s view while the DTT refers that income derived by the German PE of a Luxembourg resident company should only be taxable in Germany, it does not prevent a Luxembourg company from deducting the losses suffered by its German PE[38]. The court said that if this interpretation leads to a double deduction of the losses it would require specific provisions.

A referral to the ECJ was not considered necessary by the court.

This decision only illustrates there is still no uniform procedure regarding referrals of the national courts which remain competent to decide whether or not the question should be referred to the ECJ under the *Act Clair doctrine*. Moreover, it shows problems arising from the lack of harmonization in the area of direct taxation because we can have to Member States treating the same situation in opposite ways. It also shows that this issue could have been addressed by the ECJ much sooner given that this case is from 2005.

[36] Presuming States have followed the OECD Model allocation of taxing rights.
[37] Case n. º 19409C from August 10, 2005 decided by the Cour Administrative.
[38] As we mentioned, in the *Deutsche Shell* judgment the ECJ disagrees from this point of view.