IS THIS A BREACH OF FREEDOM?

THE EUROPEAN COURT OF JUSTICE'S POWER OVER MEMBER STATES TAX CASES IS FAR REACHING – BUT ISN'T IT TIME FOR CHANGE, ASK PRICEWATERHOUSECOOPER'S **PETER CUSSONS** AND **MICHELE FRANKLAND**

Since the 1980s, there have been about 64 direct tax cases and there are currently 20 pending cases heard by the European Court of Justice (ECJ) referred from practically every state in the current European Union (EU). In 60 or so of these, the taxpayer or Commission won.

There are normally two consequences of a Member State losing an ECJ direct tax case. One, the Member State is liable in damages for the past losses suffered by the claimant and others, subject to time limits and procedural issues. Two, the Member State has to change its law prospectively to conform with the EC treaty. Coupled with the fact that issues referred to the ECJ are becoming increasingly fundamental, the impression is of national tax systems under siege from the ECJ. We are talking billions of euros of damages/reduced tax take for many, if not most, Member States.

Among the areas considered, or to be considered by the ECJ are controlled foreign companies (CFCs), transfer pricing, cross-border loss relief, differential taxation of foreign as compared to domestic dividends, company migration toll charges, and thin capitalisation. For all of these, there is either an existing ECJ case, a referral or pending referral from a domestic court, which will result in an ECJ case being heard, probably in 2003 or 2004.

CONTROLLED FOREIGN COMPANIES (CFCs). Nine of the current Member States (Denmark, Finland, France, Germany, Italy, Portugal, Spain, Sweden and the UK) have a CFC regime. In all cases, these apply to some extent to subsidiaries in fellow Member States.

The issue here is that the deemed taxation on the parent of the profits of a subsidiary established in another Member State, compared with the absence of deemed taxation for a domestic subsidiary, is contrary to the freedom of establishment enshrined in Articles 43 and 48 of the EC treaty. If the operation of a CFC regime against the parent of a subsidiary in another Member State is a breach of the freedom of establishment, can it be justified?

We don't think so. No case since *Bachmann* (heard in 1992) has followed the 'Bachmann fiscal coherence defence' of allowing relief only where the related benefit could be taxed. *Bachmann* applies only to circumstances involving the same tax, the same taxpayer, and a linked fiscal disadvantage and advantage (*Verkooijen*).

The imputation of the profits of a foreign subsidiary to the domestic parent involves two separate legal entities, so the same taxpayer requirement of the defence is not met.

Under ECJ case law (*Cassis de Dijon, Halliburton*), covert or indirect discrimination (against the parent in respect of its subsidiary in another Member State) is nonetheless discrimination.

In March, the Finnish Supreme Administrative Court heard a case relating to a Belgian co-ordination centre subsidiary of a Finnish parent company. The taxpayer lost, but it appears the Court did not consider the relevant ECJ cases on indirect discrimination.

TRANSFER PRICING. Transfer pricing is an even more fundamental ground rule of most developed tax systems. However, the German District Court of Munster has already ruled that there is a *prima facie* case that German transfer pricing provisions are in contravention of the EC treaty freedoms, as they apply only to cross-border flows of goods and services under common control and not to purely domestic transactions. The case is likely to be heard by the ECJ towards the end of 2004.

The 22 November 2002 decision in the Swedish *Re X and Y* ECJ case (see below) supports the view that transfer pricing rules applied only in a cross-border situation are indefensible.

Some countries within the EU, such as Ireland, have no comprehensive cross-border transfer pricing legislation. Others (Austria, Greece, The Netherlands, Portugal and Spain) require the price to be arm's length in transactions under common control, even where both parties are domestic taxpayers.

The majority, however (Belgium, Denmark, Finland, France, Germany, Italy, Luxembourg, Sweden and the UK) may be affected if the District Court of Munster case is finally referred to the ECJ and the Court finds against Germany.

CROSS-BORDER LOSS RELIEF. Is the restriction of group relief or tax grouping in most of the Member States (with the possible exception of Denmark, France and, from 2004, Italy) to locally resident taxpayers or permanent establishments of non-resident taxpayers a breach of the freedom establishment?

The *AMID* case strongly suggests that the absence of cross-border loss relief breaches the freedom of establishment, and is unlikely to be justifiable. The proper comparison appears to be with a subsidiary in the parent's home state, so that if the parent can offset losses of a subsidiary in its home country against parent company profits then the same should apply to loss-making subsidiaries elsewhere in the EU.

The UK Special Commissioners have recently (25 and 26 November 2002) heard a case in respect of a UK plc claiming cross-border loss relief for losses of continental EU subsidiaries. Judgment has been reserved.

The entire EU appears to be affected, apart from Belgium, Greece and Italy (which have no form of tax grouping whatsoever) and perhaps Denmark (and Italy from 2004), who have elective cross-border tax consolidation.

DIFFERENTIAL TAXATION OF FOREIGN COMPARED WITH DOMESTIC DIVIDENDS. The *Verkooijen* ECJ case held that the Dutch system of fully taxing cross-border portfolio dividends, compared with the partial exemption of domestic portfolio dividends, was contrary to the free movement of capital. Although this decision is expressly confined to individuals, as a matter of pure logic, why would the same principle not apply to intercorporate dividends? Companies are also persons, albeit juridical, as opposed to natural, and should similarly enjoy the free movement of capital.

If so, then any company tax regime that differentiates between foreign and domestic dividends is likely to be scrutinised. In the UK, while after onshore pooling no UK tax may be due on foreign dividends, the mechanics to reach that conclusion are more onerous than the simple exemption of domestic dividends. Following the *Safir* freedom of services case, the burden of complying with a more onerous system to gain tax exemption is itself likely to be an infringement of freedom of establishment and free movement of capital.

Ten Member States (Austria, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Portugal and the UK) currently differentiate to some extent as regards the taxation of foreign as opposed to domestic dividends.

COMPANY MIGRATION TOLL CHARGES. All Member States (apart from Greece and Portugal) have a company migration toll charge by reference to the market value of the company's assets if it ceases to be locally resident. A French personal tax case on the deemed disposal at market value of assets on emigration, initiated by a Monsieur de Lasteyrie, was referred to the ECJ earlier this year.

Moreover, the decision in the *Re X and Y* Swedish case suggests that the ECJ would not tolerate company migration toll charges. The ECJ held that the differential Swedish tax treatment (cost versus market value) for assets transferred to a directly owned Swedish company, compared with a Belgian parented Swedish transferee company, was an infringement of the freedom of establishment and (for portfolio shareholdings) free movement of capital and cannot be justified.

THIN CAPITALISATION. The decision in the *Lankhorst-Hohorst* case (12 December 2002) held that the German thin capitalisation system (before the abolition of imputation from 1 January 2001) infringes the freedom of establishment under the EC treaty, and cannot be justified.

'THE ECJ IS INCREASINGLY STRIKING DOWN MANY ASPECTS OF MEMBER STATES' TAX SYSTEMS. THIS IS DESPITE THE CONTINUING NEED UNDER THE EC TREATY FOR UNANIMITY AS REGARD MANDATORY TAX MEASURES'

Eight EU countries (Belgium, Denmark, France, Germany, Italy – from 2004, Portugal, Spain and the UK) have thin capitalisation regimes that are likely to be affected. Moreover, it is arguable that the new German thin capitalisation provisions, which basically apply where the lender is not in charge to German corporation tax, are also in breach of the freedom of establishment. This comment applies equally to the UK.

There is, of course, the possibility of 'harmonisation down'. As for transfer pricing, the relevant governments could extend their thin capitalisation to loans from lenders in charge to their local corporation tax. However, this would not block claims for past damages. Nor, generally, would it raise much revenue, as in most countries a disallowance of interest from a lender in charge to local corporation tax should be treated as a distribution in the hands of the lender and not taxable.

'OPEN SKIES' DECISIONS. On 5 November 2002, the ECJ found against eight Member States (Austria, Belgium, Denmark, Finland, Germany, Luxembourg, Sweden and the UK) in the *Open Skies* decisions.

The UK case concerned an air services agreement concluded with the US which allows the revocation of traffic rights where a UK carrier becomes majority owned by non-UK nationals. The UK maintained that, as this was a sovereign choice of the US, the UK itself had no power to discriminate against Member States. The ECJ held that, by signing the agreement, the UK had failed to fulfil its obligations under the freedom of establishment provisions of the EC treaty.

The impact of the *Open Skies* decisions is far-reaching: Member States appear to be on notice that they cannot negotiate any bilateral agreement with non-Member States that may prejudice other Member States, including tax treaties.

IT'S NOT OVER YET. The ECJ is increasingly striking down many aspects of Member States' tax systems. This is despite the continuing need under the EC treaty for unanimity as regard mandatory tax measures.

A recent PricewaterhouseCoopers survey of 15 Member States on the above issues found that there was 70% non-compliance with the EC treaty. Member States seem to have little defence to the ECJ crusade. Unless the EC treaty itself is amended, or the role of the ECJ curtailed, this process appears set to continue.

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