CORPORATION TAX – Group relief – losses arising in French, Belgian and German subsidiaries of UK company – UK provisions denying group relief for losses –ICTA ss 402(3A) and (3B), 403D(1)(a) and 413(5) – whether UK provisions contrary to Article 43 of the EC Treaty – no – appeal dismissed

THE SPECIAL COMMISSIONERS

MARKS AND SPENCER PLC **Appellant**

- and -

DAVID HALSEY
(HM Inspector of Taxes) **Respondent**

Special Commissioners : DR JOHN F AVERY JONES CBE
MALCOLM GAMMIE Q.C.

Sitting in private in London on 25 and 26 November 2002.

Graham Aaronson Q.C. and Paul Farmer, counsel, instructed by KPMG for the Appellants
Dr Richard Plender Q.C. and David Ewart, counsel, instructed by the Solicitor of Inland Revenue, for the Respondent

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DECISION

1. This is an appeal by Marks and Spencer plc against the refusal of group relief claims for the years ended 31 March 1998, 1999, 2000 and 2001. The issue in the appeal is whether by virtue of European law the Appellant is entitled to relief for losses incurred by subsidiaries established and resident in Belgium, France and Germany against the profits of the Appellant parent company, which is resident in the United Kingdom.

2. We can state at the beginning that our decision is that the Appellant is not so entitled. Furthermore, as we consider that the relevant principles established by the case law of the European Court of Justice are clear on the matter, we find it unnecessary to make a reference to the Court for its guidance in reaching our decision.

The facts in outline

3. The facts had been agreed between the parties as set out in the Appendix and were not in issue before us. It is necessary to recite only a very few of them to understand the case. The Appellant established subsidiaries, incorporated and resident for tax purposes in Belgium, France and Germany. The Appellant did not own the subsidiaries directly. In the years under appeal they were held through a UK incorporated and tax resident subsidiary of the Appellant, Marks and Spencer International Holdings Limited ("MSIH"), and through a Dutch incorporated and tax resident holding company, Marks and Spencer (Nederland) BV. The parties confirmed, however, that they regarded this chain of ownership as having no significance to our consideration of Article 43 of the EC Treaty.

4. The Appellant and the Belgian, French and German subsidiaries carry on business as general retailers selling clothing, food, homeware and financial services from large stores in prime locations. The German subsidiary, Marks and Spencer (Deutschland) GmbH ("MSG"), ran four stores employing more than 160 people; the French subsidiary, Marks and Spencer (France) SA ("MSF"), ran 18 stores employing more than 1200 people; and the Belgian subsidiary, SA Marks and Spencer (Belgium) NV ("MSB"), ran four stores employing more than 200 employees. We refer to MSG, MSF and MSB collectively as "the foreign subsidiaries".

5. The Appellant exercised some control over such matters as location of stores and type of goods sold. The local activities of each of MSG, MSF and MSB were, however, managed and controlled by the directors of those companies in their respective jurisdictions. The foreign subsidiaries were not resident in the United Kingdom in the relevant years and traded only in their State of establishment. No part of the foreign subsidiaries' activities were conducted in the United Kingdom and the losses in issue accordingly arose from activities that were outside the scope of UK tax.

6. The trading performance of the foreign subsidiaries was variable but for various well publicised reasons, a trend developed towards rising losses in the second half of the 1990s. On 29 March 2001, the Appellant announced its intention to divest itself of its Continental European activities. By 31 December 2001 MSF had been sold to a third party and trading operations had been discontinued in the remainder of its Continental European subsidiaries including MSG and MSB, which are now essentially dormant.

7. The trading losses suffered by the foreign subsidiaries in their final years (as computed under UK rules and agreed with the Respondent) were as follows—

<u>Year ended 31 March 1998</u>

MSG - £4,360,327

<u>Year ended 31 March 1999</u>

MSG - £19,996,358
MSF - £11,743,059

<u>Year ended 31 March 2000</u>

MSG - £12,924,763
MSF - £15,272,142
MSB - £1,942,188

<u>Year ended 31 March 2001</u>

MSG - £9,127,919
MSF - £20,126,353
MSB - £3,692,992

8. The Appellant had sufficient other profits to absorb the foreign subsidiaries' losses in each of the years concerned and made group relief claims accordingly. The Respondent refused to allow the Appellant's claims for group relief for 1998, 1999 and 2000 on the basis that the foreign subsidiaries were not resident in the United Kingdom as required by section 413(5) Income and Corporation Taxes Act 1988. That requirement was repealed by the Finance Act 2000 so that for accounting periods beginning on or after 1 April 2000, group relief was available in cases in which the loss making company is either resident in the United Kingdom or carrying on a trade in the United

Kingdom through a branch or agency. The Respondent accordingly refused the Appellant's claim for group relief for 2001 on the basis that the foreign subsidiaries satisfied neither of those requirements.

The relevant UK tax legislation [1]

Liability to UK corporation tax

9. Corporation tax is charged on the profits of companies that are either resident in the United Kingdom or conduct trading activities in the United Kingdom through a branch or agency (s. 6(1), 11(1)). A resident company, such as the Appellant, is charged to corporation tax in respect of its worldwide profits (s. 8(1)). A non-resident company is charged to corporation tax only in respect of the profits attributable to its UK branch or agency (s. 11(1)). In the case of the foreign subsidiaries, the United Kingdom has entered into bilateral double taxation conventions with each of France, Belgium and Germany. Accordingly, the foreign subsidiaries as non-resident companies are only within the scope of UK corporation tax in respect of their trading activities if those activities are conducted in the United Kingdom through a permanent establishment within the treaty definition. As we noted in paragraph 5 above, none of the foreign subsidiaries was resident or maintained a permanent establishment in the United Kingdom or otherwise conducted its trading activities there. They were accordingly outside the scope of the UK corporation tax.

10. The Appellant, however, as a UK resident company, is subject to corporation tax on its worldwide profits. Unlike many European countries, the United Kingdom adopts a tax credit system of relieving double taxation. It is not the United Kingdom's policy to exempt UK residents from tax (whether through domestic provision or by agreement under a treaty) in respect of their foreign profits. The principle that underlies this system is capital export neutrality, i.e. that the Appellant's profits should be taxed in the same way whether it earns its profits in the United Kingdom or abroad. Thus, the Appellant must bring its foreign profits into charge to UK tax. It is then entitled to credit any foreign tax suffered on those profits against its liability to UK tax on the same profits. (Alternatively, the foreign tax may be deducted in computing profits if that would be more beneficial, for example if as a result of UK losses there is no UK tax liability against which to credit the foreign tax).

11. There are two aspects of this system that are relevant to our decision. First, if the Appellant (or any of its UK subsidiaries) were to conduct trading activities in any of France, Belgium or Germany through a branch in those countries, the United Kingdom would tax the profits attributable to that establishment and credit any foreign tax against the UK tax on the branch profits (or allow the foreign tax to be deducted in calculating branch profits or losses for UK tax purposes). The branch trading profits would be calculated on UK tax principles. If a trading loss arose that loss could be set against the Appellant's profits. Any unrelieved loss would be carried forward. The fact that the loss may also be relieved in the foreign jurisdiction against the branch's future profits does not affect the relief against UK profits.

12. Second, if the Appellant chooses (as it did) to establish in France, Belgium and Germany through foreign (non-resident) rather than UK subsidiaries, any dividends paid to the Appellant (or in this case MSIH) by those foreign subsidiaries are taken into account as part of its profits in the year of receipt. With a foreign subsidiary (instead of a branch), a UK resident parent company is not taxed on the profits of the foreign subsidiary as they arise, nor is relief given for any losses. The only exception to that rule is where the UK's controlled foreign company legislation applies, in which case the income of the foreign subsidiary is attributed to the UK parent and taxed with relief for foreign tax paid by the subsidiary. Consistently with the treatment of foreign income generally, if and when the foreign subsidiary pays a dividend to its UK parent that dividend is taxed but credit is given for the foreign tax both on the profits out of which the dividend is paid and any withholding tax (although the Parent-Subsidiary Directive [2] now prevents any such withholding tax being levied on dividends from subsidiaries established in the member States).

13. In summary, where a company such as the Appellant establishes itself abroad through a subsidiary as compared with a foreign branch, worldwide income is taxed with relief for foreign tax but with the difference that for a subsidiary such taxation is charged only as, when, and to the extent to which, dividends are paid to the United Kingdom. There is no specific relief for losses of foreign subsidiaries, although these may have the indirect effect of reducing the amount of dividends paid and therefore taxed in the hands of the parent company. For the years in question, gains and losses on the sale or other disposal of shares in a foreign subsidiary, as well as distributions on a winding up, were taxed or relieved as capital gains or allowable capital losses (rather than as income), for which there are separate computation rules.

14. If we compare the treatment of dividends from foreign subsidiaries with dividends from UK resident subsidiaries, the receipt of dividends from the latter are not taxed (s.208). While this treatment is different to that accorded to foreign dividends, it is consistent with the principle that the resident subsidiary's profits (including its foreign income and gains) are assumed to have been brought into charge to tax in the United Kingdom.

[1] References throughout this decision to statutory provisions are to the provisions of the Income and Corporation Taxes Act 1988, unless otherwise stated.

[2] Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different member States (90/435/EEC).

Group relief for losses

15. Within a group of UK resident companies a system of "group relief" allows companies within the same accounting period to offset profits and losses arising to different group companies. As a result the loss-making company no longer has the loss available to carry forward, and will accordingly pay tax on future profits sooner, and the profitable company pays tax later since the loss surrendered to it reduces its profits.

16. In relation to accounting periods both ending before and ending on or after 1st April 2000, section 402 provides:

> "(1) Subject to and in accordance with this Chapter and section 492(8), relief for trading losses and other amounts eligible for relief from corporation tax may, in the cases set out in subsections (2) and (3) below, be surrendered by a surrendering company ("the surrendering company") and, on the making of a claim by another company ("the claimant company") may be allowed to the claimant company by way of relief from corporation tax called group relief.
>
> (2) Group relief shall be available in a case where the surrendering company and the claimant company are both members of the same group..."

17. Section 403 provides that—

> "(1) If in an accounting period (the "surrender period") the surrendering company has—
>
> (a) trading losses …
>
> the amount may, subject to the provisions of this Chapter, be set off for the purposes of corporation tax against the total profits of the claimant company for its corresponding accounting period."

18. In relation to the Appellant's claims for group relief for its accounting periods ended 31 March 1998, 1999 and 2000, section 413(5) provided as follows:

"References in this chapter to a company apply only to bodies corporate resident in the United Kingdom ..."

From the year 2000, as a change in the law following the European Court's decision in Case C264/96, *Imperial Chemical Industries plc v Colmer* [1998] ECR I-4695 (ICI), which dealt with the related consortium relief, group relief is restricted to profits and losses within the scope of UK taxation. This allows a UK branch of a non-resident company to surrender its losses to another group company for offset against its UK taxable profits (or to claim a surrender of losses from another group company for offset against its UK branch profits).

19. Thus, in relation to the Appellant's claim for group relief for its accounting period ended 31 March 2001, section 402 provided:

> "(3A) Group relief is not available unless the following condition is satisfied in the case of both the surrendering company and the claimant company.
>
> (3B) The condition is that the company is resident in the United Kingdom or is a non-resident company carrying on trade in the United Kingdom through a branch or agency."

In addition, section 403D(1) provides that no amount is available for surrender by way of group relief by a non-resident company except in so far as:

> "(a) it is attributable to activities of that company the income and gains from which for that period are, or (were there any) would be, brought into account in computing the company's chargeable profits for that period for corporation tax purposes."

For the purposes of this case, the Inspector of Taxes concedes that the same relief as is given for periods beginning on or after 1 April 2000 is available by virtue of European law for earlier periods.

20. A claimant company will usually pay the surrendering company for the losses. Such payments, known as "payments for group relief", are ignored for tax purposes up to the amount of the surrendered loss (s. 402(6)).

The Appellant's contentions

21. The Appellant concedes that as a matter of UK law none of MSG, MSF or MSB is entitled to surrender the trading losses it incurred for any of the years concerned to the Appellant or to any other member of the Appellant's group. It is common ground, however, that the only reason why none of the foreign subsidiaries can surrender its trading losses is because, for accounting periods ending before 1st April 2000, none of them were resident in the United Kingdom and, for accounting periods ending on or after 1st April 2000, none of them was so resident nor did the trading losses concerned arise from the carrying on of a trade in the United Kingdom though a branch or agency.

22. The Appellant accordingly contends that by denying its subsidiaries established in other member States the right to surrender to the Appellant their trading losses for the relevant periods, the United Kingdom legislation infringes Article 43 of the EC Treaty. In this respect, in all its recent case law concerning the direct tax systems of member States, the European Court of Justice has noted that although direct taxation is a matter for the member States, they must nevertheless exercise their direct taxation powers consistently with Community law.

23. Article 43 is in the following terms—

> "Within the framework of the provisions set out below, restrictions on the freedom of establishment of nationals of a member State in the territory of another member State shall be prohibited. Such prohibition shall also apply to restrictions on the setting up of agencies, branches or subsidiaries by nationals of any member State established in the territory of any member State.
>
> Freedom of establishment shall include the right to take up and pursue activities as self-employed persons and to set up and manage undertakings, in particular companies or firms within the meaning of the second paragraph of Article 48, under the conditions laid down for its own nationals by the law of the country where such establishment is effected, subject to the provisions of the Chapter relating to capital."

24. Article 43 EC has direct effect, that is to say, a member State's nationals may rely upon Article 43 directly before the domestic courts as against conflicting domestic rules (Case 2/74, *Reyners* v *Belgium* [1974] ECR 631). Also, under Article 48 of the EC Treaty, companies formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community are treated for the purposes of the Chapter on establishment in the same way as natural persons who are nationals of Member States. According to established case law, the corporate seat in the above sense serves as the connecting factor with the legal system of a particular State (see for example Case 270/83, *Commission of the European Communities* v *French Republic (*the *Avoir Fiscal* case*)* [1986] ECR 273, para 18; Case C-264/96, *ICI*, para. 20).

25. The Appellant says that by limiting group relief for accounting periods ending before 1 April 2000 to companies resident in the United Kingdom, the group relief legislation made it less attractive to establish subsidiaries in other member States than in the United Kingdom. Unlike resident subsidiaries, non-resident subsidiaries were unable to surrender losses to their UK parents (or other members of its group with UK taxable profits). This entails a difference in tax treatment based on the residence or seat of the subsidiary.

26. The same applies to the rules introduced with effect from 1 April 2000. These deny the possibility for non-resident companies to surrender losses unless they trade in the UK though a branch or agency. They therefore continue to differentiate explicitly by reference to the residence of the company. Moreover, the losses must be attributable to activities subject to UK corporation tax, a condition which non-resident companies are less likely to meet.

27. Finally, the Appellant contends that the UK rules hinder the right of establishment of UK companies by restricting their freedom to choose the most appropriate form for pursuing activities in another member State. This arises because there is no provision for loss relief for foreign subsidiaries. By comparison, as we have noted, a UK company that establishes a branch in another member State indirectly through a UK subsidiary can automatically offset any trading losses arising in the branch in calculating the taxable profits of the UK subsidiary. The subsidiary can then surrender any surplus branch losses by way of group relief to the UK parent company (or to other members of its group with UK taxable profits).

28. In considering Article 43 and the relevant principles that the European Court of Justice has established through its case law in relation to the freedom guaranteed by Article 43, we refer for ease of illustration in the following paragraphs to the case of a UK parent company that seeks to exercise its freedom to establish in France through a branch of a UK resident subsidiary or through a French subsidiary. The same principles would apply if the UK parent company itself established a branch in France but our reference to the branch of a UK resident subsidiary tracks the Appellant's contentions and reflects that under the UK group relief rules, the UK subsidiary may be able to surrender any loss that it incurs in its French branch to its UK parent company while the French subsidiary cannot. Our consideration of the principles applicable to the case of the United Kingdom and France is equally applicable to the case of the United Kingdom and Belgium and of the United Kingdom and Germany.

The principles applicable to Article 43

Differential taxation by a host State of activities conducted through a branch or subsidiary

29. Article 43 grants to the Appellant the right to take up and pursue activities in France under the conditions laid down for French nationals. France cannot therefore apply discriminatory taxation rules to the branch activities of its UK subsidiary. In particular, it cannot require the UK subsidiary to conduct its activities indirectly in France by incorporating a French subsidiary (so as to avoid a discriminatory tax rule applicable to a branch) rather than conducting the activities directly through its French branch. If France were permitted to retain such rules it would deprive Article 43 of all meaning (Case 270/83, the *Avoir Fiscal* case, para 18).

30. As a matter of Community law, a rule is discriminatory if a different rule applies to comparable situations or the same rule applies to different situations (Case C-279/93, *Finanzamt Köln-Altstadt* v *Roland Schumacker* [1995] ECR I-225, para 30; Case C-311/97, *Royal Bank of Scotland plc* v *Elliniko Dimosio* [1999] ECR I-2651, para 26). At the heart of the matter, therefore, is the question of what is the correct comparison for the purpose of a particular rule. Direct or overt discrimination is based on nationality. Most cross-border tax rules, however, operate by reference to the taxpayer's residence rather than nationality. Rules that operate by reference to criteria other than nationality but which are likely to operate mainly to the detriment of nationals of other member States may nevertheless give rise to indirect

or covert discrimination (Case 153/73, *Sotgiu* v *Deutsche Bundespost* [1974] ECR 153, para 11; Case C-279/93, *Schumacker*, para 28).

31. In relation to direct taxes, the situations of a resident (i.e. a French subsidiary) and a non-resident taxpayer (i.e. the United Kingdom subsidiary) are not, as a rule, comparable. This is because there are usually objective differences between residents and non-residents from the perspective of the source of their income (which is of particular relevance in the Appellant's case) and the possibility of taking account of their ability to pay tax or of their personal and family circumstances (Case C-279/93, *Schumacker*, para 31; Case C-311/97, *Royal Bank of Scotland*, para 27). Whether or not a resident and non-resident are in comparable situations depends, however, on the tax rule in question. In the context of the source or host State's tax system (in our example, France), the Court has frequently taken the view that a branch of a UK subsidiary is in an objectively similar situation to a French subsidiary where France subjects the French branch to the same taxation as a French subsidiary.

32. In the *Avoir Fiscal* case this arose by reference to entitlement to the French tax credit on dividends but the Court has applied the same approach in relation to other provisions of the host State's tax system (see, for example, in relation to interest on overpaid tax, Case C-330/91, *The Queen* v *Inland Revenue Commissioners, ex parte Commerzbank AG* [1993] ECR I-4017; in relation to stamp duty on the transfer of host State property, Case C1-93, *Halliburton Services BV* v *Staatssecretaris van Financien* [1994] ECR I-1137; in relation to the benefit of treaty relief provisions, Case C-307/97, *Compagnie de Saint-Gobain, Zweigniederlassung Deutschland* v *Finanzamt Aachen-Innenstadt* [1999] ECR I-6161 (Saint-Gobain)).

33. The same principle would apply to a difference in the computation of, or the relief accorded by France (as the host State) to, losses arising in a French branch as compared with those arising to a French subsidiary where France claims the right to tax both branch and subsidiary in respect of the activities in question. In those circumstances the situations of French branch and French subsidiary would be objectively comparable (Case C-311/97, *Royal Bank of Scotland*, para 28). This would not be the case, however, where the difference in treatment reflects the different basis for taxing the income or activities of resident and non-resident persons. This is illustrated by Case C-250/95, *Futura Participations SA and Singer* v *Administration des contributions* [1997] ECR I-2471.

34. In *Futura*, the Court had to consider whether a rule governing relief for losses was valid when it required a Luxembourg branch of a French company to show that losses carried forward were economically linked to income earned in Luxembourg and subject to tax there, so that only losses arising from the French company's Luxembourg branch activities could be carried forward. That requirement did not apply to a Luxembourg company, which in the absence of a treaty exemption was taxed on foreign income with credit for foreign tax (see paragraph 5 of the Court's decision). On this aspect of the case, the Court decided as follows—

> "20. In the present case, the Luxembourg Law provides that, as regards resident taxpayers, all of their income is taxable, the basis of assessment to tax not being limited to their Luxembourg activities. Consequently, although there are exemptions under which a part or even, in certain cases, all of their income earned outside Luxembourg is not subject to tax in that country, the basis for assessment for resident taxpayers at any rate includes profits and losses arising from their Luxembourg activities.
>
> 21. On the other hand, for the purposes of calculating the basis of assessment for non-resident taxpayers, only profits and loses arising from their Luxembourg activities are taken into account in calculating the tax payable by them in that State.
>
> 22. Such a system, which is in conformity with the fiscal principle of territoriality, cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty."

35. It is important to recognise that the Court's conclusion in paragraph 22 is based on a double comparison that appears in paragraph 20. First, to the extent that the loss relief rules differed as compared to a Luxembourg company by restricting relief for Futura's Luxembourg branch losses to Luxembourg profits, the Court recognised that a Luxembourg branch was *not* in a comparable situation vis-à-vis a Luxembourg subsidiary. Accordingly, from that perspective, the difference in treatment was not discriminatory because a branch was taxed only on Luxembourg profits while a subsidiary was taxed on its worldwide income. Second, in so far as a branch was taxed on its Luxembourg profits, it was in a comparable situation to a Luxembourg subsidiary, which in any event was taxed on its Luxembourg profits. From that perspective also, therefore, the rule was not discriminatory.

36. The same point appears from the *Royal Bank of Scotland* case, where Royal Bank's Greek branch was subject to a higher rate of tax on its profits than was a comparable Greek bank. Although the Greek bank was taxed on its worldwide profits while the Royal Bank was taxed only on its branch profits, that did not prevent them being in a comparable situation as regards the determination of the Greek profits to which the differential tax rates applied (see paragraphs 29 to 31 of the decision).

37. In dealing with *Futura*, Mr Aaronson Q.C. for the Appellant submitted that it was unclear precisely what the Court had in mind in paragraph 22 of its decision by "the fiscal principle of territoriality". We think, however, that the Court had in mind the generally accepted principle of international tax practice that a State may choose to tax its companies on their worldwide income but normally only taxes non-resident companies on income associated with their establishments within the State. We note in passing that in *Futura* the bilateral tax treaty that had been agreed

between France and Luxembourg gave effect to that principle, as enshrined in the OECD's Model Tax Convention on Income and on Capital, which is also applicable in this case in the treaties that have been agreed by the United Kingdom with France, Belgium and Germany. Furthermore, in *Royal Bank of Scotland*, the Court regarded the relevant articles of the UK/Greece treaty as confirming that the Royal Bank's Greek branch was in an objectively comparable situation to a Greek bank (see Case C-311/97, *Royal Bank of Scotland*, para 31).

38. Looked at from the perspective of the source or host State (i.e. France), it is easy understand why Article 43 allows a UK subsidiary the freedom to choose whether to conduct its activities in France itself through a branch or by establishing a French subsidiary. There would be no freedom of establishment for a national of another member State without that choice. In this respect a difference in treatment to which a French branch of a UK subsidiary is subject in comparison with a French subsidiary as well as the freedom to chose between a branch and a subsidiary must be regarded as constituting a single composite infringement of Articles 43 and 48 of the Treaty (Case C-307/97, *Saint-Gobain*, para 43). The issue that the Appellant raises, however, is whether the principle that operates from the perspective of the host State's tax system applies when the matter is considered in terms of the State of origin's tax system, i.e. whether the United Kingdom is entitled to apply different taxing rules according to whether the Appellant chooses to establish in France directly, through a branch of its UK resident subsidiary, or indirectly, by incorporating a French subsidiary, which then falls to be regarded as a French national.

39. Before we consider that issue, however, it is relevant to note that it is clear from the Court's settled case law that unfavourable tax treatment contrary to a fundamental freedom guaranteed by the Treaty cannot be justified by the existence of other tax advantages for the person in question (Case C-307/97, *Saint-Gobin*, para 54; Case C-294/97, *Eurowings Luftverkehrs AG* v *Finanzamt Dortmund-Unna* [1999] ECR I-7447, para 44; Case C-35/98, *Staatssecretaris van Financiën* v *Verkooijen* [2000] ECR I-4071, para 61). Thus, France is not permitted to justify a discriminatory measure (i.e. a rule that in a comparable situation treats a branch of the UK subsidiary less favourably than a French subsidiary) by reference to some other tax advantage that the branch enjoys as compared with a French subsidiary. In Case 270/83, the *Avoir Fiscal* case, the Court said at paragraph 21—

> "Notwithstanding the French government's arguments to the contrary, the difference in treatment also cannot be justified by any advantages which branches and agencies may enjoy vis-à-vis companies and which … balance out the disadvantages resulting from the failure to grant the benefit of shareholders' tax credits. Even if such advantages actually exist, they cannot justify a breach of the obligation laid down in Article 52 [now Article 43] to accord foreign companies the same treatment in regard to shareholders' tax credits as is accorded to French companies."

40. The Court of Justice made the same point in Case C-330/91, *Commerzbank*, where it said at paragraphs 16 to 19:

> "16. In order to justify the national provision at issue in the main proceedings, the United Kingdom Government argues that, far from suffering discrimination under the United Kingdom tax rules, non-resident companies which are in Commerzbank's situation enjoy privileged treatment. They are exempt from tax normally payable by resident companies. In those circumstances, there is no discrimination with respect to repayment supplement: resident companies and non-resident companies are treated differently because, for the purposes of corporation tax, they are in different situations.
>
> 17. That argument cannot be upheld.
>
> 18. A national provision such as the one in question entails unequal treatment. Where a non-resident company is deprived of the right to repayment supplement on overpaid tax to which resident companies are always entitled, it is placed at a disadvantage by comparison with the latter.
>
> 19. The fact that the exemption from tax which gave rise to the refund was available only to non-resident companies cannot justify a rule of a general nature withholding the benefit. That rule is therefore discriminatory."

41. Thus, a French branch of the UK subsidiary is entitled to benefit from the same rules for the computation of its French profits or relief for French losses as those applicable to the French subsidiary, notwithstanding that the UK subsidiary is taxed in France only in respect of its French branch profits while a French subsidiary might be taxed on its worldwide profits (see Case 250/95, *Futura* and Case C-311/97, *Royal Bank of Scotland*). Similarly, the fact that the French branch can freely transfer its profits to the UK subsidiary's head office without formality while a French subsidiary must declare a dividend, are not features which mean that the French branch is not in an objectively comparable position to the French subsidiary as regards the rules for computing profits subject to taxation in France (Case C-307/97, *Saint-Gobain*, paras 49 to 53). The issue is whether the foreign national is treated differently from host State nationals in relation to the tax rule in question (rather than how it is treated in relation to some other tax rule) and, if so, whether the difference in treatment is based on an objective difference in situation between them.

42. The corollary of this is that if the UK subsidiary chooses to establish a French subsidiary rather than a French branch, the parent company cannot complain of discrimination on the grounds that its French subsidiary is taxed less favourably in France than its UK subsidiary would have been had it established a French branch. This is in conformity with the principle that the application of different conditions for pursuing economic activities in different member

States does not amount to discrimination. Such differences may preserve national boundaries and inhibit the exercise of the relevant freedoms but (in the absence of Community harmonisation legislation) a member State is entitled to impose stricter requirements on its nationals than are found elsewhere in the Community provided the exercise of a relevant Community right is not involved.

43. The UK parent company or the French subsidiary would be entitled to complain if the French subsidiary were subject to less favourable treatment as compared to other French companies because it was owned by a UK company rather than by French nationals (Joined Cases C-397/98 and 410/98, *Metallgesellschaft Ltd and Others, Hoechst AG, Hoechst UK Ltd* v *Commissioners of Inland Revenue* [2001] 2 CMLR 32; Case C-436/00, *X, Y* v *Riksskatteverket*, Judgment of the Court (Fifth Chamber), 21 November 2002). Provided the French subsidiary is subject to no less favourable rules than comparable French companies, however, the more favourable treatment of a French branch is a purely internal French matter not involving any exercise by the French subsidiary of its Community rights.

44. In our view, therefore, it is clear that Article 43 enures for the benefit of the UK subsidiary vis-à-vis France as the host State in its choice of a branch but cannot be relied upon by its French subsidiary as a French national against a French rule generally applicable to French companies. If, for example, France exempted particular profits arising to a French branch of the UK subsidiary, when the same profits would be taxed in the hands of a French subsidiary, the UK subsidiary could not complain that this infringed its freedom to establish in France indirectly through a subsidiary rather than directly through a branch. The exemption may exist as a matter of French domestic provision or it may be agreed through the bilateral double taxation treaty that is entered into between France and the United Kingdom. The most obvious example is the limitation under a treaty of a branch's tax liability to tax on the profits attributable to the branch.

45. It is true that a member State may only exercise its freedom to conclude bilateral tax treaties in a manner that is consistent with Community law. Thus, Article 43 will extend to the French branch of the UK subsidiary the benefit of a treaty provision between France and another country where that provision would benefit its French subsidiary (as a resident of France within the treaty definition) (Case C-307/97, *Saint-Gobain*). Nevertheless, a treaty limitation or exemption accorded by France to a French branch of the UK subsidiary under its treaty with the United Kingdom represents no more than an allocation of taxing rights between France and the United Kingdom and therefore does not confer Community rights (Case C-336/96, *Mr & Mrs Robert Gilly* v *Directeur des Services Fiscaux du Bas-Rhin* [1998] ECR I-2793; Case C-307/97, *Saint-Gobain*, para 56).

46. Whether the particular branch exemption arises under treaty or domestic provision, however, Article 43 confers no right on the French subsidiary, as a French national, to complain of unequal treatment under French tax law in comparison to a French branch of a UK subsidiary. We also think that it clear that Article 43 confers no right on the UK parent company to complain that the French subsidiary is less favourably treated than a French branch of its UK subsidiary would be and that such an outcome infringes the UK subsidiary's right to choose between establishing in France directly through a branch or indirectly through a French subsidiary.

47. We derive these conclusions both from the language of Article 43 and from the Court's case law. It also receives support, however, from the Opinion of the Advocate General (Mancini) in the *Avoir Fiscal* case, where he says (at paragraph 11 of his Opinion):

> "At the Court has seen, the Commission complains that the French rules give rise not merely to discrimination [i.e. as between the French branch and French companies] but also to an indirect restriction on the establishment of secondary establishments by foreign undertakings [i.e. on the UK company in its choice between a branch and a subsidiary]. Provided that the conditions laid down in Article 58 have been satisfied, those undertakings are free to choose the legal form in which they exercise the right granted to them by Article 52 [now article 43], and it is precisely that freedom which the rules at issue limit by refusing to grant them the benefit of the shareholders' tax credit and thereby discouraging the establishment of agencies and branches. The French Government contended that that argument was without foundation and I share its opinion. Discrimination and restrictions on establishment are different phenomena and it does not necessarily follow that a measure likely to give rise to the one will also contribute to the other. Thus, the discrimination of agencies and branches may be an aspect of the discriminatory treatment of foreign companies but does not affect their right to establish themselves in France. According to Article 52, that right includes the abolition of restrictions on 'the setting up of agencies, branches or subsidiaries'. In my opinion, those words cannot be interpreted as meaning that the three forms of secondary establishment must be subject to absolutely identical rules whether in regard to taxation or to anything else."

48. The Court of Justice did not have to address this point explicitly. There is nothing in its decision, however, that contradicts the Advocate General's Opinion on this point or is inconsistent with his conclusion. It did not endorse the argument that indirect restrictions (such as those created when a host State treats its own nationals less favourably than nationals of other member States) should not limit the freedom of choice. Instead, at paragraph 22 it restricted itself to saying that the freedom for foreign undertakings to choose between adopting a branch or a subsidiary must not be limited by *discriminatory* tax measures.

Differential tax rules of an origin State restricting the right of establishment elsewhere in the Community

49. Thus far, we have been concerned to consider the extent of the rights conferred under Article 43 in so far as it affects the taxation rules of the host State (in our example, France). We think it apparent from the above that the French tax rules need not create a level playing field as between a French branch of the UK subsidiary and its French subsidiary. All that Article 43 requires is that the playing field in the form of the French tax system is not tilted against a national of another member State (the UK subsidiary), whether it chooses to establish directly through a branch or indirectly through a host State subsidiary. This is consistent with the idea that a member State must not discriminate against nationals of other member States in comparable situations but in the absence of Community legislation requiring harmonisation in the direct tax field, equal treatment is a one-sided affair (see, for example, Case C-336/96, *Gilly*, para 47).

50. We would expect to find the same principle in operation in the State of origin (in our example, the United Kingdom). If the UK subsidiary can show that the UK tax rules operate less favourably in comparable situations when a UK national exercises his right to establish in another member State (whether directly through a branch or indirectly through a subsidiary in the other member State), we would expect those rules to be a barrier to establishment prohibited by Article 43. Thus, in Case C-141/99, *Algemene Maatschappij voor Investering en Dienstverlening NV (AMID)* v *Belgische Staat* [2000] ECR I-11619, the Court said at paragraph 21—

> "Finally, it must be pointed out that, even though, according to their wording, the provisions concerning freedom of establishment are mainly aimed at ensuring that foreign nationals and companies are treated in the host member State in the same way as nationals of that State, they also prohibit the State of origin from hindering the establishment in another member State of one of its nationals or of a company incorporated under its legislation which comes within the definition contained in [Article 48] of the Treaty."

51. There are a growing number of examples in which a provision of the tax code of the State of origin has been found to restrict the freedom of its nationals to establish elsewhere in the Community. In Case C-251/98, *Baars* v *Inspecteur der Belastingdienst Particulieren/Ondernemingen Gorinchem* [2000] ECR I-2787, Mr Baars (a Dutch national) exercised his right to establish in Ireland by setting up an Irish company in which he owned all the shares. The value of those shares were taken into account for the purposes of assessing Mr Baars to the Dutch wealth tax, whereas the value of a comparable investment in a Dutch company would have been excluded from assessment. The European Court decided that Article 43 precluded the condition attaching to the wealth tax exemption that the company had to be established in The Netherlands.

52. Similarly, in Case C-264/96, *ICI*, Article 43 rendered ineffective a condition attaching to the UK's consortium loss relief, namely that for ICI to be able to claim loss relief a majority of the companies concerned had to be resident in the United Kingdom. In Case C-141/99, *AMID*, Article 43 rendered ineffective a Belgian rule restricting the carry forward of losses within Belgium by reference to profits arising to AMID's Luxembourg establishment, which were exempt from Belgian tax.

53. The same principle operates in cases involving the freedom to provide services under Article 49 (previously Article 59) of the Treaty, which functions for the benefit both of the person providing the services and of those to whom the services are provided. In Case C-55/98, *Skatteministeriet* v *Bent Vestergaard* [1999] ECR I-7641, the Court held that a Danish rule, which presumed expenses of professional training courses held outside Denmark to be non-deductible in computing profits, infringed Article 49. In Case C-294/97, *Eurowings*, Article 49 rendered ineffective a restriction in the deduction of lease rentals in a case where the asset was leased from a lessor established in another member State rather than in Germany. In Case C-118/96, *Jessica Safir* v *Skattemyndigheten i Dalarnas Län* [1998] ECR I-1897, Article 49 struck down a Swedish insurance premium tax applicable only to policies taken out with companies not established in Sweden (whether through a Swedish branch or subsidiary). In Case C-136/00, *Rolf Dieter Danner*, judgment of 3 October 2002, the Court held that Article 49 precluded Finnish tax legislation from restricting or disallowing a deduction for contributions to pension institutions in other member States when the law allowed such contributions to be deducted when paid to Finnish pension institutions.

54. We think that it is important to recognise the basis upon which the Court decided that Article 43 (or Article 49) operated in these cases to strike down the origin State's tax rule. All these decisions were dealing with a tax rule in the State of origin that was discriminatory as described in paragraph 30 above (namely, applying a different rule to objectively comparable situations or the same rule to different situations). In every case, the complaint involved a taxation measure, the effect of which was to treat a national of the State of origin concerned *less favourably* if he sought to exercise the Treaty freedom in question (i.e. by establishing abroad or by acquiring services from a service provider based in another member State) than was the case in the *comparable* domestic situation or provision when the freedom was not exercised.

55. Thus, in *Baars*, the Dutch wealth tax rule treated Mr Baars less favourably in relation to his investment in an Irish company than it would have done for a comparable investment in a Dutch company. In *ICI*, the UK's consortium loss relief rules allowed ICI to claim relief for losses if the consortium company (Coopers Animal Health (Holdings) Limited) established a majority of UK subsidiaries but denied ICI the right to claim losses if a majority of its subsidiaries were established in other member States. In *AMID*, AMID was accorded less favourable relief for its Belgian losses if it chose to conduct its activities partly in Luxembourg rather than wholly in Belgium. In *Eurowings*,

Eurowings received a smaller deduction for its lease rentals if it chose to lease aircraft from a lessor established in another member State than if it leased aircraft from a German lessor.

56. In each case, there was no objective difference in the particular national's situation so far as the tax rule in question was concerned, whether the other party to the transaction was someone established in the State of origin or in another member State. The question in the Appellant's case is whether the same is true here or whether there is an objective difference in situation between a claim to deduct losses arising to a UK subsidiary and a claim to deduct losses arising to the foreign subsidiaries. In this respect the Appellant seeks to make two comparisons—

(1) first, the situation of the Appellant in claiming the losses of a UK subsidiary (whether arising in the United Kingdom or through its branches in France, Belgium and Germany) as compared to its position in claiming the losses of its foreign subsidiaries, and

(2) second, the position of its UK subsidiary in choosing whether to establish abroad through French, Belgian and German branches (with the potential benefit of group relief) or through the foreign subsidiaries (without the benefit of group relief).

The choice of branch or subsidiary from the origin State's perspective

57. As regards the second comparison that the Appellant seeks to make, the Court's case law does not establish as a principle under Article 43 that the United Kingdom (as the State of origin) must apply the same taxation rule to a French subsidiary (the French subsidiary being a national of France) as the taxation rule it applies to the UK subsidiary in respect of its French branch. Indeed, you would not expect to find such a principle in Article 43.

58. Article 43 means that a host State (France) must not inhibit establishment within the host State by treating nationals of other member States *less* favourably than host State nationals in comparable situations. In those terms, a host State does not inhibit establishment by nationals of other member States (including establishment through host State subsidiaries) by treating them (or their subsidiaries) *more* favourably than its own nationals (see paragraph 42 above). The counterpart of this principle is that a State of origin may not inhibit establishment outside the State of origin by treating its nationals (including their subsidiaries in other member States) *less* favourably if they establish abroad that it does in comparable origin State situations. In those terms, a State of origin does not inhibit establishment in another member State by treating its nationals established abroad (including their foreign subsidiaries) *more* favourably than comparable domestic establishment.

59. Neither of these rules necessarily require that a host State or a State of origin should subject branches and subsidiaries to the same taxation. As indicated in the previous paragraph, neither form of establishment may be treated *less* favourably in comparable situations to a host State national or to an origin State establishment. But both forms of establishment may be treated *more* favourably, and one may be treated more favourably than the other. And to the extent that the situation of a national of one member State established in another member State through a branch is not comparable to the situation of its subsidiary (being a national of the member State in which it has its seat), a different tax rule is permitted in any event. This reflects, as *Futura* illustrates, that for direct tax purposes residents of the same State are normally in a comparable position (so that a difference in treatment based on domestic establishment or establishment in another member State infringes Article 43) but residents and non-residents are not normally in a comparable position (and so can be treated differently) unless they are subject to the same direct taxation.

60. Thus, if the State of origin applies one taxing rule when its nationals establish in another member State through a branch and a different taxing rule if they choose to establish through a subsidiary, both rules must comply with Article 43. In other words, neither rule should have the effect of treating nationals of the State of origin *less favourably* when establishing abroad through a branch or subsidiary than is the case for the comparable domestic situation in which the freedom is not exercised. This corresponds to the requirement that the host State's taxation rules should neither discriminate against a French branch of the UK subsidiary (as in Case 270/83, the *Avoir Fiscal* case) nor discriminate against a French subsidiary because its parent company is a national of another member State (as in Joined Cases C-397/98 and C-410/98, *Metallgesellschaft* and *Hoechst*). Subject to that, the existence of different rules in the State of origin for taxing the foreign branch operations of its nationals or their foreign subsidiaries, thereby influencing its nationals' choice between the two forms of organisation, does not infringe Article 43.

61. We accordingly reject the Appellant's contention that the UK group relief rules, by distinguishing between establishment in France, Belgium and Germany through a branch and establishment through the foreign subsidiaries, restricted the Appellant's freedom under Article 43 to choose its form of establishment in those member States. The issue is solely whether the UK group relief rules treat the Appellant *less* favourably when it establishes in France, Belgium or Germany (whether through a branch of a UK subsidiary or through the foreign subsidiaries) as contrasted with establishment in the United Kingdom in a comparable situation.

Non-discriminatory measures liable to hinder or make less attractive the exercise of the Treaty freedoms

62. In previous paragraphs we have stated the principles by reference to whether a particular tax rule is discriminatory or leads to unequal treatment in the relevant sense (i.e. as explained in paragraph 30 above). Before

considering how those principles apply to the Appellant's case, we should note that the European Court has recognised that national measures may involve a restriction on the Treaty freedoms (including the freedom of establishment) even though the national measures in question apply equally to nationals of all member States and are not as such discriminatory in the relevant sense.

63. It seems to us that there are a variety of ways of classifying the different cases that have come before the Court of Justice. This is apparent from the Court of Appeal's decision in *R (on the application of Professional Contractors Group Ltd and others)* v *Inland Revenue Commissioners* [2001] EWCA Civ 1945, where Counsel had agreed that the cases giving rise to a contravention of the Treaty freedoms should be classified according to whether they involved discrimination, dislocation or were 'neutral'. Particularly in the context of direct tax rules, the further distinction arises between direct or overt and indirect or covert discrimination (i.e. discrimination that arises by reference to criteria other than nationality but which are likely to operate mainly to the detriment of nationals of other member States).

64. Different approaches as to how to classify cases may account in part for the difference of view that emerged between Mr Aaronson Q.C. for the Appellant and Dr Plender Q.C. for the inspector as to whether or not the Appellant was subject to unequal treatment and, if so, whether the inspector could justify it. It may be that different issues suggest different ways of classifying the Court's case law and, in particular, in deciding what is required of a government to justify the measure in question (see paragraph 107 below). In this case, we consider that the appropriate way to classify (or to think about) the cases is as we have done thus far, namely whether the cases involve the application of a host State tax rule to a national of another member State or the application of a State of origin's tax rules to its nationals, where in either case that gives rise to a difference in treatment of comparable cross-border situations.

65. The case law of the Court of Justice, however, clearly envisages another category, represented by such cases as Case C-19/92, *Kraus* v *Land Baden-Württemberg* [1993] ECR I-1663, Case C-55/94, *Gebhard* v *Consiglio dell' Ordine degli Avvocati e Procuratori de Milano* [1995] ECR I-1141 and Case C-415/93 *Union Royale Belge des Sociétés de Football Association ASBL* v *Bosman* [1995] ECR I-4921, in which a national measure involves no discrimination or difference in treatment and yet the measure is regarded as sufficiently impeding or rendering less attractive the exercise of a particular freedom as to require justification.

66. This approach can be seen in *Gebhard*, which concerned the professional qualifications required to practice as an avvocato in Italy, and it was developed in *Bosman*, in which Advocate General Lenz sought to establish a distinction between national rules regarding access to the market and those merely governing the exercise of an economic activity within the market. Subsequently the Court gave an indication of the extent of the principle in Case C-190/98 *Volker Graf* [2000] ECR I-493, where it said at paragraph 23 that:

> "Provisions which, even if they are applicable without distinction, preclude or deter a national of a Member State from leaving his country of origin in order to exercise his right to freedom of movement therefore constitute an obstacle to that freedom. However, in order to be capable of constituting such an obstacle, they must affect access of workers to the labour market."

67. In the tax field, a case that comes within this line of authorities is Case C-250/95, *Futura*. This was regarded in the *Professional Contractors Group* case as illustrating the category of cases involving "dislocation" rather than those representing "neutral" contraventions, such as *Bosman*. The Court described "dislocation" as a species of discrimination but one that arises from the interaction of different systems in different member States (see per Robert Walker LJ at para 62). As such it can be contrasted with discrimination in the sense that we have previously explained, which involves the rules of a single member State (the host State or the State of origin) rather than the interaction of both host and origin States' rules. Thus, the host State's tax measure in question in *Futura* (the Luxembourg requirement to keep branch accounts) did not involve any discrimination because (subject to the concession noted below) both Luxembourg nationals and nationals of other member States establishing in Luxembourg were required to maintain tax accounts. As a condition of access to the Luxembourg market, however, the requirement to keep Luxembourg tax accounts imposed a greater burden on nationals of other member States (given the requirement in France (as the State of origin) that its nationals should keep tax accounts under its rules). The Luxembourg requirement therefore had to be objectively justified and proportionate.

68. We noted in paragraphs 34 to 37 above, the European Court's conclusion in *Futura* on the fiscal principle of territoriality. The second issue that arose concerned the way in which Futura's Luxembourg branch (Singer) was assessed to tax on its local profits and relief given for earlier branch losses. Its profits had been determined by apportionment based on the proportion of its turnover in Luxembourg as derived from the French accounts. This form of assessment was permitted under Luxembourg law in cases where by concession the taxpayer chose not to draw up separate Luxembourg tax accounts. Singer claimed to offset against its 1986 profits, losses brought forward from 1981 to 1985. It also calculated the brought forward losses by apportionment in the absence of separate Luxembourg tax accounts. The Luxembourg Revenue denied relief for the losses on the basis that losses could only be carried forward where the losses were economically related to the branch (see paragraphs 34 to 37 above) and [where] "accounts [complying with the relevant Luxembourg rules] are kept within [Luxembourg]." The Court of Justice held that the administrative requirement to maintain separate Luxembourg accounts in addition to Futura's French accounts was a restriction on the freedom of establishment that had to be justified on the basis of the criteria laid down in *Kraus*, *Gebhard* and *Bosman* (see Case C-250/95, *Futura,* para 26).

69. *Futura* concerned the rules of the source or host State for conducting business there, rather than those of the State of origin for conducting business in another member State. In the context of the host State, one can appreciate that it is not every local non-discriminatory rule that represents a restriction on the freedom to establish there. A different principle may apply if the host State seeks to extend its rules to a national of another Member State who is providing services in the host State without being established there (or being only temporarily established) (see Case C-76/90, *Säger* v *Dennemeyer & Co Ltd* [1991] ECR I-4221, para 23).

70. If we were to express the restriction-based principle evidenced in *Bosman* and *Futura* at its highest, it would be that every condition attaching to market entry represents a restriction and must be justified. In these terms a member State would have to justify any tax compliance requirements that it sought to impose on nationals of other member States. That would not, however, mean that a non-discriminatory difference in taxation (i.e. the application of different tax rules to non-comparable situations) arising from the existence of the different direct tax systems in member States would amount to a restriction. In *Futura*, Luxembourg was unable to justify its requirement for local branch accounts. The Court affirmed, however, that in the absence of any harmonisation of domestic rules for determining the basis of assessment for direct taxes, each member was free to draw up "its own rules for determining profits, income, expenditure, deductions and exemptions as well as the amounts in respect of which each of them which may be included in the calculation of taxable income or of losses which may be carried forward" (para 33). On that basis, Luxembourg could require Futura to compute its Luxembourg losses precisely (i.e. under Luxembourg tax rules) even though in the circumstances it could not insist that it identified its losses by reference to branch accounts maintained under Luxembourg rules.

71. Case C-250/95, *Futura* concerned the market entry requirements of the host State. There is no reason why the same non-discriminatory restriction principle should not apply equally to a condition imposed by the State of origin on its nationals with which they must comply if they wish to establish (whether as a branch or through a subsidiary) in another member State. Case 81/87, *The Queen* v *HM Treasury and Commissioners of Inland Revenue, ex parte Daily Mail and General Trust plc* [1988] ECR 5483 illustrates this, although in that case the Court decided that there had been no infringement of article 43.

72. In Case C-439/97, *Sandoz GmbH* v *Finanzlandesdirektion für Wien, Niederösterreich und Burgenland* [1999] ECR I-0000, one question that arose was whether an Austrian measure imposing stamp duty on loan agreements entered into outside Austria when they were brought into Austria or where one of the contracting parties was Austrian, amounted to a restriction on the free movement of capital. The Court endorsed the Advocate General's Opinion that the measure involved an obstacle on the free movement of capital because it deprived Austrian residents from benefiting from the absence of taxation which may be associated with loans obtained outside Austria and as such deterred Austrian residents from obtaining loans from persons established in other member States.

73. In the context of non-discriminatory restrictions on Treaty freedoms, *Sandoz* seems to us to come closest to the Appellant's contention that the failure by the United Kingdom to allow relief for the foreign subsidiaries' losses amounts to a non-discriminatory restriction on its freedom of establishment in other member States. If so, the Respondent would have to justify that restriction as (a) a measure that pursues a legitimate aim compatible with the Treaty, (b) justified by pressing reasons of public interest and (c) of such a nature as to ensure achievement of the aim in question without going beyond what is necessary for that purpose. We deal with these requirements later in this decision. We note, however, that while the Austrian measure represented an obstacle to the free movement of capital (as the different tax rules of member States may well do in the absence of harmonisation), it did not infringe the Treaty Articles on freedom of movement of capital.

74. The case-law on non-discriminatory restrictions was considered by the Court of Appeal in the *Professional Contractors Group* case in relation to the impact of the non-discriminatory tax regime for personal service companies on the freedom of establishment. Giving the unanimous judgment of the Court Robert Walker LJ said at [2001] EWCA Civ 1945, paragraph 24 that a non-discriminatory rule constitutes a restriction on freedom of establishment only when it creates "a direct and demonstrable inhibition on the establishment of a business". In relation to the scope of this principle of Community Law, he concluded that:

> "… neutral national rules could only be deemed to constitute *material* barriers to market access, if it were established that they had actual effects on market actors akin to exclusion from the market".

75. The restriction in the Appellant's case is perhaps better regarded as involving a case of 'dislocation' rather than a 'neutral' tax rule. What the Appellant is really complaining about is the interaction of the host and origin States' tax systems; that none of the countries concerned—the United Kingdom, France, Belgium and Germany—has given relief for the losses. There is no case law, however, in which the Court has characterised such dislocation as a restriction on the freedom of establishment, akin to an exclusion from the markets of other Member States. The fact that by choosing to establish through foreign subsidiaries it found itself subject to different tax rules was in this respect not a restriction akin to an exclusion from those other markets but a reflection of the failure of member States to harmonise their corporate tax systems, as Case C-250/95, *Futura* and Case C-336/96, *Gilly* illustrate.

76. The Appellant sought to rely on recent decisions of the European Court, notably *X, Y* v *Riksskatteverket* Case C-436/00 (21 November 2002), to persuade us that the principles being developed by the Court, in particular as to what could be characterised as a restriction requiring justification, were sufficient at the very least to require us to refer the

Appellant's case to the European Court to enable it to express a view on the matter. *X, Y* v *Riksskatteverket* concerned a Swedish tax rule determining whether an asset could be transferred to a company at original cost (so deferring tax on any accrued gain) or at market value. The Court identified three situations based on the relationship between the transferor and transferee—

(1) transfers to a foreign legal person in which the transferor directly or indirectly has a holding, in which case market value applied;

(2) transfers to a Swedish limited company in which such a foreign legal person either directly or indirectly has a holding, in which case market value applied;

(3) transfers to a Swedish limited company other than those in (2) and in which the transferor directly or indirectly has a holding, in which case the transfer could be at cost.

Situations (1) and (2), however, seem to us to be clear illustrations of a tax rule that involves a difference in treatment as compared with the situation in (3). In (1) the choice by a Swedish person to establish abroad attracts less favourable treatment as in *Baars*. In (2), the interposition of the foreign legal person produces a less favourable treatment of a transaction between two Swedish persons, as in *ICI* and *Metallgesellschaft and Hoechst*. As such *X, Y* v *Riksskatteverket* does not appear to us to involve any new principle or the further extension of existing principles. In particular, it does not require us to doubt the approach adopted by the Court of Appeal in the *Professional Contractors Group* case.

77. Nor do we consider that the foreign subsidiaries have any grounds for complaint on this basis against a UK rule that prevents them from obtaining relief for their losses by surrendering them to their UK parent. We agree with the Respondent's submission that the rule does not apply to companies established in other Member States by reason of the fact that they are subsidiaries of companies resident in the United Kingdom, which have decided to exercise freedom of establishment via those subsidiaries.

78. We therefore conclude that it is not possible for the Appellant to bring itself within the principle represented by Case C-415/93, *Bosman* and Case C-250/95, *Futura*, in which a hindrance to freedom of establishment arises independently of any discrimination.

Application of Article 43 discrimination principles to the Appellant's case

The nature of the difference in treatment in question

79. We therefore return to the question of whether the Appellant is correct to say that the exclusion of relief for losses incurred by its foreign subsidiaries represents a restriction on its right to establish in other member States, not in the *Bosman* sense with which we have just dealt, but in the sense that we explained in paragraphs 54 above, namely that the exclusion is a UK tax rule that treats the Appellant *less favourably* when it chooses to establish abroad through a foreign subsidiary than is the case for the comparable domestic situation in which the freedom is not exercised. The answer will depend upon what is the correct comparison for the purpose of the UK group relief rule of which the Appellant complains.

80. To justify its group relief claim, the Appellant says that had the losses arisen to its UK subsidiary (whether in its UK trading operations or in trading operations conducted through French, Belgian and German branches), it would have been entitled to claim relief for those losses. By comparison, it was unable to reduce its profits (and was therefore taxed less favourably) because it chose to establish itself through its foreign subsidiaries that were denied the benefit of the UK group relief rules.

81. The Appellant supports its submissions by reference to the European Court's decision in Case C-141/99, *AMID*. That case concerned relief for losses incurred by a Belgian company. In 1981, AMID made a loss in Belgium of BEF2,126,926 and a profit in its Luxembourg branch of LUF3,541,118. The Luxembourg profit was exempt from tax in Belgium but in calculating the amount of the Belgian loss that it could carry forward, AMID was required to reduce the Belgian loss by the amount of the Luxembourg profits. This it refused to do and subsequently claimed to deduct the Belgian loss of 1981 from its 1982 Belgian profits. The Court noted that if in 1981 AMID had not established a Luxembourg branch but had operated solely through Belgian establishments, it would have been able to carry forward the Belgian losses of that year. Thus, the Appellant says that if it had conducted all its activities in the UK, or through UK subsidiaries established abroad through branches, it would have been entitled to claim group relief.

82. At paragraph 23, the Court stated the vice of the Belgian tax system in the following terms—

> "Thus, by setting off domestic losses against profits exempted by treaty, the legislation of that Member State establishes a differentiated tax treatment as between companies incorporated under national law having establishments only on national territory and those having establishments in another member State. As the Belgian Government itself recognises, where such companies have a permanent establishment in a member State other than that of origin and a convention to prevent double taxation binds the two States, those companies are likely to suffer a tax disadvantage which they would not have suffered if all their establishments were situated in the member State of origin."

83. In effect, the Appellant would like to adapt the Court's conclusion in *AMID* so that it can be read in the Appellant's case in the following terms—

> "Thus, by failing to set off the losses incurred in France, Belgium and Germany by its subsidiaries established there against the Appellant's profits taxable in the UK, the UK legislation establishes a differentiated tax treatment as between UK companies having establishments only in the UK and those having establishments in other member States."

In other words, *any* difference that a member State seeks to draw in the way it relieves losses according to whether the losses arise within the member State or in other member States or to a resident of the member State or to residents of other member States, can amount to a difference in treatment and must be justified if it is to be allowed under Article 43.

84. As the Court's case law illustrates, each case is to be approached by applying the relevant principles to the circumstances of the case and the tax rule in issue. On that basis we have no doubt that the restriction in the UK group relief rules that prevent the foreign subsidiaries from surrendering the losses in question and the Appellant from claiming relief for them against its taxable profits do not infringe the principles established by the Court in its application of Article 43. The way in which the Appellant would like us to read *AMID* ignores the central feature of what the Court said. "A differentiated tax treatment" arose under the Belgian Income Tax Code, "by setting off domestic losses (i.e. losses from activities that *were* subject to Belgian tax) against profits exempted by treaty (i.e. profits from activities that were *not* subject to Belgian tax)". Here, however, it is the Appellant that is seeking to establish a differentiated tax treatment, "by setting off foreign losses (i.e. losses that arise from activities *not* subject to UK tax) against profits charged to tax (i.e. profits from activities that *are* subject to UK tax)". In short, the Appellant is seeking to apply the same loss relief rule to different situations.

85. *Futura* illustrates that there is no breach of Article 43 if a member State restricts relief for branch losses to future branch profits (see paragraph 34 above). *AMID* illustrates that there is a breach of Article 43 if a member State restricts future relief for domestic losses by reference to exempt foreign profits. Had AMID actually conducted its 1981 business only in Belgium and had it achieved the same aggregate result as it did through its Belgium and Luxembourg branches, it would have had no loss to carry forward to 1982. This illustrates that even after the Court's decision, AMID was less favourably treated by choosing to conduct part of its activity in Luxembourg than if it had conducted the whole of its activity in Belgium. In 1981 it paid tax in Luxembourg despite its Belgian losses and its 1981 Belgian losses were only relieved in 1982. Thus, the simple question that Mr Aaronson Q.C. would like us to answer in the Appellant's favour—is the Appellant's economic and taxation position made worse by the fact that it decided to establish itself in France, Belgium and Germany?—fails to capture accurately the relevant principle of Community law.

86. Both *AMID* and *Futura* concerned tax systems based on the accepted international principle of exempting foreign profits. They do not, therefore, directly supply the answer for a tax system, such as the UK's, that operates on the alternative basis of taxing foreign income with credit for foreign tax (although it is clear from the Court's description in *Futura* that Luxembourg taxed its companies on their worldwide income with credit where no treaty exemption was available). The issue would have arisen in *AMID* if Belgium had taxed the Luxembourg profits with credit for Luxembourg tax but denied any credit for the Luxembourg tax actually paid by offsetting the Belgium losses against the Luxembourg profits. In other words, there would have been no Belgium tax against which to credit the Luxembourg tax.

87. That outcome, however, would be an illustration of the point made in *Gilly*, where Mr Gilly's essential complaint reflected that French frontier workers taxed both in Germany on income received there and in France on their total income may be taxed more heavily than persons receiving exactly the same income but only in France (see Case C-336/96, *Gilly*, para 10). The "tax credit" referred to in paragraph 10 of the Court's decision in *Gilly* was in fact a credit of French tax rather than a credit for German tax paid (see [1999] British Tax Review 12). This does not alter the key point, however, that a taxpayer's Treaty freedoms will not have been infringed if his complaint relates not to a discriminatory national tax rule of one member State but the higher taxation he faces due to the interaction of the tax rules of more than one member State caused by the failure of member States to harmonise their direct tax systems. In *Gilly*, this did not involve any breach of article 39 of the Treaty guaranteeing freedom of movement of workers. *Gilly* is also authority for the proposition that, in the absence of any unifying or harmonising measures adopted by member States, the States retain competence to define the criteria for allocating fiscal jurisdiction amongst themselves and, in doing so, may adopt international tax practice as evidenced by the OECD Model Tax Convention on Income and on Capital (see Case C-336/96, *Gilly*, paras 30 and 31).

88. Both *AMID* and *Futura* involved cases in which treaties had been concluded between the member States concerned giving effect to international practice as so evidenced. The Court's decisions in those cases were entirely consistent with that practice. Case 270/83, the *Avoir Fiscal* case and Case C-307/97, *St Gobain* illustrate on the other hand that the treaties that member States conclude must nonetheless be consistent with Community law. That does not, however, affect the right of member States to allocate fiscal jurisdiction under their treaties. That allocation—in determining which profits are taxable in a member State and which are exempt—may necessarily affect whether two situations are comparable for the purpose of deciding whether a tax rule gives rise to unequal treatment that may infringe any of the freedoms guaranteed by the EC Treaty. In this case it means that the situations of a UK subsidiary

(subject to worldwide UK taxation) and the foreign subsidiaries (only subject to UK taxation on UK branch activities) are not comparable.

89. In our view, therefore, the principles established by the case law of the European Court of Justice do not support the application of the freedom guaranteed under Article 43 to permit the group relief claims made by the Appellant in this case. Furthermore, we have arrived at that conclusion from two perspectives, first from the perspective of the foreign subsidiaries, as the persons who are the object of the UK tax rule in question, and second from the Appellant's perspective as the person who wishes to claim relief for its foreign subsidiaries' losses.

Article 43 from the perspective of the foreign subsidiaries

90. While it is the Appellant that claims the relief (so as to reduce its taxable profits), group relief is framed in terms of the losses or other amounts that are available for surrender by the surrendering subsidiaries and those subsidiaries must consent to the Appellant's claim because the losses or other amounts will cease to be available to the subsidiaries for UK tax purposes in the future (see s.402(1), paragraph 16 above). The idea that group relief is properly viewed as something provided by the foreign subsidiaries to the Appellant is underlined by the fact that the Appellant would usually pay its subsidiaries the equivalent value of its tax saving by way of a payment for group relief payment (see paragraph 20 above).

91. It is appropriate, therefore, to consider whether the UK rule infringes Community law from the perspective of the foreign subsidiaries. Those subsidiaries, however, are to be treated as nationals of France, Belgium and Germany and not as nationals of the United Kingdom. As the Court's case law illustrates, Articles 43 and 49 prevent a member State from maintaining discriminatory rules vis-à-vis nationals of other member States that establish in its jurisdiction (when it is the host State) or discriminatory rules vis-à-vis its own nationals (when it is the State of origin) which inhibit their exercise of Treaty freedoms. As we have previously explained, those Articles do not confer rights on nationals of *other* member States to complain in the latter case, i.e. of an origin State rule. Furthermore, the sale of tax losses cannot in our view be regarded as a provision of services within Article 50 of the EC Treaty. Article 49 on the freedom of provision of services is therefore not in issue. The Appellant did not so argue, correctly in our view.

Article 43 from the Appellant's perspective

92. In relation to accounting periods ending before 1st April 2000, the foreign subsidiaries might clearly claim (as the Respondent conceded for the purposes of this case) that the UK group relief rules did not give effect to Article 43 in relation to any establishment that they might have set up in the United Kingdom. In relation to their activities in France, Belgium and Germany, however, we think that none of the foreign subsidiaries can rely on Article 43, whether before or after 1st April 2000. Can the Appellant (as a national of the origin State) complain, however, that the restriction on its foreign subsidiaries' right to surrender and be paid for their losses restricts the *Appellant's* freedom to establish in other member States?

93. In every case dealt with by the European Court, the discriminatory origin State tax rule that gave rise to a restriction, whether in respect of establishment or services, was a rule that applied to a national of the origin State directly and in respect of which national of the State could complain that its freedom was restricted as a result. In this case, the Appellant (as a national of the United Kingdom) will pay less tax if its foreign subsidiaries can surrender their losses. The tax rule complained of, however, relates to who may surrender losses rather than who may claim them. It is therefore the Appellant's foreign subsidiaries to which the rule applies, not the Appellant.

94. It is true that in *ICI*, ICI was in an equivalent position to the Appellant in this case as a claimant of losses. In that case, however, the discriminatory rule complained of did not relate to the identity of the loss making company but concerned ICI's right to establish subsidiaries in other member States. If ICI exercised its right to do so, it would no longer be among the category of eligible claimants for the losses in question. As such, the rule complained of was a restriction on ICI as a claimant of relief rather than on the loss-making company as a person seeking to surrender its losses. Here, by contrast, the rule complained of prevents the foreign subsidiaries surrendering their losses. The Appellant's inability to claim those losses to reduce its profits is no more than the inevitable consequence of the restriction that the UK rules place on the foreign subsidiaries.

95. Thus, we think that this case could be answered against the Appellant solely from the perspective of the foreign subsidiaries as the persons to which the rule in question applies. Assuming, however, that the Appellant can complain that the elimination of its foreign subsidiaries from the category of surrendering companies infringes its position as a potential claimant of the losses, the difference in treatment of which the Appellant complains must still be discriminatory. It must be treated less favourably in relation to the comparable situation or provision in question. Thus, how Mr Baars' is taxed in respect of his Irish investment is contrasted with how he is taxed in the case of a Dutch investment; the deduction that Eurowings can claim for lease rentals paid to an Irish lessor is contrasted with its deduction for lease rentals paid to a German lessor; the deduction that Mr Danner can claim on pension premiums paid to a Finnish pension institution is contrasted with the disallowance of contributions paid to non-Finnish institutions; and so on.

96. The Court's case law makes clear that how the other party to the transaction or provision is taxed is not a relevant factor to the comparison or a matter by reference to which a member State may justify a restriction on the Treaty freedoms. For example, it is not relevant to the comparison that must be made that a German lessor pays German trade tax but an Irish lessor does not. On this basis, the Appellant submits that we should have regard solely to the

losses that the Appellant's foreign subsidiaries wish to surrender; that it is irrelevant that those subsidiaries are not subject to UK on any profits that they may have made.

97. We are unable to accept that submission. How the recipient of a payment is taxed in relation to a receipt of investment moneys (*Baars*), lease rentals (*Eurowings*) or pension contributions (*Danner*) is irrelevant to the nature of the payment in each case. Stated in those terms, of course, emphasises that in this case the Appellant is the recipient (of the surrendered tax losses) and that, as we have suggested above, it is the foreign subsidiaries and not the Appellant who suffer the restriction (about which they have no relevant Community right to complain).

98. Leaving that point aside, however if (as the Appellant suggests) the appropriate comparison is between a loss that arises to a UK subsidiary and the loss that arises to the Appellant's foreign subsidiaries, is one comparing like with like? The Appellant invited us to consider this question solely by reference to the treatment of losses and without regard to the question of profits. This seems to us, however, quite impossible. Trading profit and trading loss are merely two sides of the same coin. No doubt the Appellant hopes that the outcome of its trading operations is less a matter of chance than flipping a coin. Whatever the relative odds that attach to conducting business or flipping a coin, however, in any period the possibility exists of profit or loss; that the coin may land heads or tails up. The outcome in either case is the product of one, indivisible computation under a single set of rules designed to arrive for tax purposes at the results (positive or negative) of the trading activity for the period.

99. The Appellant invites us to say that losses are no different whether they arise from the conduct of activities that are subject to the charge to UK tax or from those that are not. We think that this self-evidently is not comparing like with like. Accordingly, to the extent that the UK accords different treatment to each—allowing the Appellant to claim group relief in respect of one set of losses but not the other—we consider that there is no infringement of Article 43.

100.As we have indicated, we regard this conclusion as entirely compatible with the Court of Justice's decision in *AMID*. As we have previously described, AMID concerned Belgian losses being reduced by Luxembourg profits. Belgium was applying the same rule (offset of profits and losses) to non-comparable situations (activities within and outside the scope of Belgian tax). This does not mean that the reverse situation, which seems to have been possible, namely Luxembourg losses being allowed to reduce Belgian profits, was an infringement of Article 43 or otherwise calls into doubt the conclusion that we have just reached. Allowing the losses arising from Luxembourg activities to reduce Belgian profits, where the comparable Luxembourg profits would *not* be taxed in Belgium, still involves a difference in treatment. In this case, however, establishment by a Belgian taxpayer in Luxembourg is being treated *more* (not less) favourably than establishment in Belgium. As we explained in paragraph 59 above, this is not a difference that involves any breach of Article 43.

The relevance of the UK's taxation of dividends paid by the Appellant's French, Belgian and German subsidiaries

101.It was our initial understanding that an aspect of the Appellant's submissions was that the UK did subject profits arising to the Appellant's French, Belgian and German subsidiaries to tax when those profits were paid to the United Kingdom as dividends. Mr Aaronson Q.C. for the Appellant submitted, however, that this was irrelevant to our decision as to whether the prohibition on the surrender of the foreign subsidiaries' losses was a restriction on the Appellant's freedom of establishment. As we have rejected Mr Aaronson's broad formulation of what amounts to a relevant restriction, we have considered whether the United Kingdom's decision to tax foreign dividends received by the Appellant or MSIH and derived from the foreign subsidiaries, affects our conclusion.

102.It is true that the United Kingdom subjects the profits of controlled foreign companies to tax under Chapter IV of Part XVII of the Income and Corporation Taxes Act 1988. We believe that none of the Appellant's French, Belgian or German subsidiaries would have been subject to tax under Chapter IV or Part XVII had they made profits in the accounting periods in question and the Appellant therefore placed no reliance upon the existence of those provisions as a feature of the UK tax system.

103.The question then is whether the United Kingdom, by taxing dividends paid to a UK parent company by its foreign subsidiaries, can *in a relevant sense* (see below) be said to tax the profits of those subsidiaries. If so, our conclusion at paragraph 99 above might be called into question on the basis that if the United Kingdom, ultimately, subjects the foreign subsidiaries' profits to tax, it ought in similar measure to give relief for any losses incurred by its foreign subsidiaries. Mr Aaronson Q.C. drew attention to the ways in which the rules of other member States were less restrictive on foreign subsidiaries' losses and to the proposals contained in the proposed Council Directive on losses.[3] To put his point by reference to *AMID*, is the United Kingdom seeking to establish a differentiated tax treatment "by denying relief for foreign losses (i.e. which arise from activities the profits of which are subject to UK tax on distribution) against profits charged to tax (i.e. profits from activities within the charge to UK tax)" (see paragraph 83 above)?

104.By taxing foreign dividends and, in particular, by grossing up foreign dividends for the purpose of giving credit relief for the foreign tax borne on the profits out of which the dividends are paid, the United Kingdom is in one sense taxing the profits of its foreign subsidiaries. We do not believe, however, that this amounts to subjecting the foreign profits to UK tax in the relevant sense, i.e. for the purpose of comparing losses of a foreign subsidiary from particular

[3] Proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other member States (COM(90) 595 final).

activities for a current accounting period with the losses from the activities of a UK subsidiary in the same period to determine whether the exclusion of the former is a restriction on the Appellant's freedom of establishment under Article 43. In this respect, we consider that this comparison has to be made by reference to the activities in question, as the source of the profit or loss that is the subject of the UK rule in question, rather than by reference to the position of shareholders as investors in those activities.

105.In reaching this conclusion we have ignored issues of timing (i.e. whether the foreign subsidiary distributes the profits of its current accounting period immediately, at some later time or never) and the existence of intermediate holding companies (i.e. whether the foreign subsidiary is held directly by the UK parent company or through one or more intermediate holding companies established outside the United Kingdom). Even leaving those matters aside, we nevertheless think that there are several reasons why the taxation of foreign subsidiary dividends is not to be equated for these purposes with the taxation of the subsidiary's profits in the relevant sense—

(1) As a matter of general international tax practice we think it is clear that dividends fall to be treated as taxable subject matter that is distinct from the profits out of which the dividends are declared. This is apparent from Article 10 of the OECD's Model Treaty and the Commentary thereon. This is not determinative by itself, especially when one is considering the compatibility of the United Kingdom's tax provisions with Community law. Nevertheless, in the context of the issue that arises in this case, nothing in the structure of the UK's system for taxing the dividends of foreign subsidiaries appears to us to be inconsistent with the generally accepted approach under international tax practice. Economists may disagree with the distinction that legal systems (and international tax practice) draw in this respect in taxing the activity and the return on the investment in the activity. The Community principles with which we are dealing are, however, founded on the principles enshrined in legal systems (and international tax practice) rather than on what economists would or would not endorsed.

(2) As a matter of Community law, the UK approach of taxing dividends paid by a subsidiary in another member State with credit for foreign tax is clearly permitted by the Parent/Subsidiary Directive; see in particular Article 4 of the Directive. Again, that does not determine that the United Kingdom's tax provisions are in this respect compatible with Community law. Nevertheless, there is nothing in the Parent/Subsidiary Directive to indicate that a member State that adopts this method of avoiding the double taxation of distributed profits of foreign subsidiaries must, as a corollary of doing so, afford relief for losses of foreign subsidiaries.

(3) It is also the case that over time a company's dividends may be expected to represent the net profits of the subsidiary concerned, in other words after taking into account current and past losses and the need to recoup amounts lost in the business before returning profits to shareholders. Thus, the United Kingdom does not tax later profits that make good earlier losses and are never distributed. Similarly, earlier profits that are reinvested abroad and subsequently lost will never come into the scope of UK taxation. We appreciate that in this case, the losses arose in periods leading up to the closure of the foreign subsidiaries and there was no scope to recoup the losses by setting them against earlier the profits of (or dividends paid by) the French, Belgian or German subsidiaries. That, however, is as much a reflection on the failure of the French, Belgian and German tax systems to allow terminal losses to be carried back to recover tax paid on earlier profits (as would be permitted in the United Kingdom) as any failing in the UK tax system.

106.These points confirm our view that the comparison we have to make, as indeed the Appellant has urged upon us, is by reference to the treatment accorded to the losses according to whether they arise in UK or foreign subsidiaries. In deciding whether we are comparing like with like, therefore, we need to consider how the activities are dealt with in the hands of those subsidiaries, not how dividends from those companies would be dealt with if, as and when they reach the Appellant or MSIH as shareholders. Apart from the factors to which we have drawn attention in paragraph 105, we think that this is entirely consistent with the approach adopted by the Court in the similar context of deciding whether there is discrimination and whether it can be justified. It is also consistent with the principle to which we drew attention in paragraph 41 above by reference to *St Gobain*.

Justification for the UK provisions

107.Given our conclusion that the UK group relief rule of which the Appellant complains does not constitute either a discriminatory or a non-discriminatory restriction on the exercise of its freedom of establishment under Article 43, the issue of justification does not arise. Nevertheless should, contrary to our view, the prohibition on the surrender of losses by the Appellant's foreign subsidiaries constitute a restriction on the freedom of establishment requiring justification we have considered whether the UK government can indeed justify that restriction.

108.Even if in the present case there were a restriction on freedom of establishment arising from sections 402(3A), 402(3B) and 413(5), we think that such a restriction would be compatible with article 43 because those sections are objectively justified by the logic or internal consistency of the tax system; suitable for their purpose and proportionate.

109.It is settled law that a restriction on freedom of establishment may be justified by reference to the need to safeguard the cohesion of a tax system, provided that it is suitable for this purpose and proportionate. In Case C-204/90, *Bachmann* [1992] ECR I-249 and Case C-300/90, *Commission v Belgium* [1992] ECR I-305 the Court held that a Belgian rule disallowing the deduction of insurance contributions unless the contributions were paid to an undertaking established in Belgium or to the Belgian establishment of a foreign insurance undertaking, amounted to discrimination. Nevertheless, the rule was not in the circumstances contrary to the Treaty since it was objectively justified by the need to preserve the coherence of the Belgian tax system. This was on the basis that—

> "… the loss of revenue resulting from the deduction of life assurance contributions from total taxable income - which includes pensions and insurance payable in the event of death - is offset by the taxation of pensions, annuities or capital sums payable by the insurers. Where such contributions have not been deducted, those sums are exempt from tax. The cohesion of such a system, the formulation of which is a matter for each Member State, therefore presupposes that, in the event of a State being obliged to allow the deduction of life assurance contributions paid in another Member State it should be able to tax the sums payable by insurers."

There was therefore a direct link between the deductibility of the premiums paid and the taxation of the sums paid out under those policies in question.

110.Cohesion as a basis for justifying particular tax rules has not found favour with the Court in other cases. In cases involving restrictions derived from discriminatory tax rules (which we do not consider is the case here), the Court has emphasised the requirement that there be a direct link at the level of the taxpayer concerned between the discriminatory rule complain of and the 'compensating' tax treatment. In other words, the government must be able to show that the taxpayer who complains of some discriminatory tax treatment is entitled to the benefit of a corresponding more favourable tax treatment that is designed explicitly to balance the discriminatory rule, thus producing overall a coherent tax treatment. Thus, governments have been unable to justify a discriminatory or restrictive tax rule affecting taxpayer A by reference to the particular tax treatment accorded to taxpayer B (See for example Case C-264/96, *ICI*; Case C-484/93, *Peter Svensson and Lena Gustavsson* v *Ministre du Logement et de l'Urbanisme* [1995] ECR I-3955). Even where only taxpayer A is involved, a member State may be denied the benefit of the cohesion justification if, for example, it has concluded a tax treaty that affects the balance between the discriminatory tax rule complained of and the counter-balancing favourable tax treatment. Thus, if a treaty rule creates the situation in which the member State cannot tax the receipts of policies on which it has allowed premiums to be deducted, it will be unable to justify the non-deductibility of premiums on other policies (Case C-80/94, *Wielockx* [1995] ECR I-2493; Case C-136/00, *Danner*, Judgment of the Court, 3 October 2002; Case C-436/00, *X, Y* v *Riksskatteverket*, Judgment of the Court, 21st November 2002). The cohesion of the tax system will have been removed from the level of domestic tax rules to the higher treaty level. In the Appellant's case, however, both domestic and treaty rules give effect to the same principle of international tax practice as enshrined in the OECD's model Convention.

111.Dr Plender Q.C. for the Respondent submitted that the present case is the converse of *ICI*. In *ICI* the point at issue was whether there was justification for a rule that entailed the differential treatment of holding companies according to the place of residence of the majority of its subsidiaries. The effect of this rule was that loss of relief was excluded even though the holding company, the claimant company and the surrendering company were resident and taxable in the United Kingdom simply because there were other subsidiaries in the consortium that were non-resident. By contrast with that situation there is in the Appellant's case a direct link between the group relief granted for losses incurred by a surrendering company and the taxation of profits by the claimant company: both are subject to the fiscal jurisdiction of the taxing State. There is also a direct link between the withholding of group relief in respect of losses incurred by the surrendering company and the exoneration from taxation of any profits that might have been made by that company: the company is not subject to the fiscal jurisdiction of the taxing State.

112.That presents the justification in terms of the tax position of two different taxpayers: the Appellant on one side and the foreign subsidiaries on the other. Previous cases have suggested that the coherence justification has to be presented at the level of a single tax and a single taxpayer. In this case, although there are two taxpayers, only one tax is involved, which may be an important feature. The same outcome is reached, however, by approaching the issues separately from the perspective of either the foreign subsidiaries or the Appellant.

113.From the perspective of the foreign subsidiaries, the foreign subsidiaries are subject to the rule denying them the ability to surrender losses (as Mr Bachmann was unable to deduct his pension premiums) and the compensating rule is that the foreign subsidiaries are not subject to UK tax on their profits (as Mr Bachmann was not taxed on the proceeds of his pension policies). Based on the current case law, we think that this is the better way to approach the matter. It is not a comparison that is affected by any bilateral double taxation treaty entered into by the United Kingdom, as compared to the case of The Netherlands in *Wielockx* and *Danner*. The UK treaties, as we have already noted, give effect to existing international practice.

114.Furthermore, even if the Respondent must also justify the rule from the Appellant's perspective, we think that he can do so. The Appellant cannot claim relief for its foreign subsidiaries' current losses but neither is it subject to tax on their current profits. For the reasons that we have already given (see paragraphs 105 and 106 above), the fact that the Appellant or MISH as shareholders might have included dividends derived from the foreign subsidiaries in a computation of their corporation tax profits is not something that in our view affects the balance or coherence of the UK system as regards the UK group relief rules applicable to losses arising from the trading activities of the Appellant's UK or its foreign subsidiaries.

115.We were provided with information about the systems for group loss relief in other member States and our attention was also drawn to the provisions of the proposed Council Directive for taking into account losses of permanent establishments and subsidiaries situated in other member States (COM(90) 595 final). Based on these examples, Mr Aaronson Q.C. suggested that a total restriction on relief for losses incurred by the foreign subsidiaries was a disproportionate response by the United Kingdom. The United Kingdom did not, however seek to tax the foreign subsidiaries in respect of their activities in France, Belgium and Germany and we therefore do not think it disproportionate to deny them relief for the losses they suffered in those activities. It is obviously possible to suggest that the United Kingdom government should adopt a more generous approach to the losses (and the same might be said to the French, Belgium and German governments) but that does not mean that the UK's failure to provide relief is a disproportionate response.

Conclusion

116.We according decide as follows—

(1) The United Kingdom is not required in these circumstances to accord the same group relief for losses of a branch of a UK subsidiary of the Appellant and those of its foreign subsidiaries on the basis that its failure to do so infringes the Appellant's right to choose the form of its establishment in other member States. Article 43 requires that establishments in other member States (whether taking the form of a branch or a subsidiary) receive no less favourable treatment than that accorded to nationals of the member State concerned. Subject to that, the tax treatment accorded to one form of establishment may be more favourable than that accorded to the other.

(2) The United Kingdom is not required to accord the same group relief for losses incurred by the Appellant's foreign subsidiaries as it does for losses incurred by a UK subsidiary of the Appellant. The foreign subsidiaries (being outside the scope of UK tax in respect of the activities concerned) are not in an objectively comparable situation to a UK subsidiary (which is within the scope of UK tax in respect of its worldwide activities). The application of a different rule to situations that are not objectively comparable does not amount to a discriminatory restriction on the freedom of establishment guaranteed by Article 43 of the EC Treaty.

(3) The Appellant's failure to obtain relief for the losses incurred by its foreign subsidiaries in their French, Belgian and German activities (in those countries or under the UK group relief rules) does not amount to a non-discriminatory restriction on the freedom of establishment guaranteed by Article 43. It derives from the allocation of fiscal jurisdiction among member States and the failure of member States to agree appropriate measures for the harmonisation of their direct tax systems in this respect.

(4) Even if the UK group relief rules in this respect create an obstacle to the exercise by the Appellant of its right of establishment in other member States which must be justified, the denial of UK relief for losses on activities the profits of which are not subject to UK tax can be justified as being for the maintenance of the coherence of the UK tax system and proportionate.

We therefore agree that the Respondent was correct to refuse the Appellant's group relief claims and we dismiss the Appellant's appeal in principle accordingly.

JOHN AVERY JONES **MALCOLM GAMMIE**

SPECIAL COMMISSIONERS

SC 3050/02

APPENDIX – STATEMENT OF FACTS

1. Background To The Appellant

Marks and Spencer plc ("The Appellant") was incorporated and registered in England and Wales on 17 June 1926 as a company with registered number 214436. Its registered office is Michael House, Baker Street, London, W1U 8EP.

The Appellant is the principal trading company and holding company for a number of UK and overseas companies. The Appellant is the UK's leading general retailer, selling clothing, food, homeware and financial services. The accounts and annual review for the Appellant for the years ended 31 March 2001 and 2002 are available upon request.

The Appellant is resident in the UK for tax purposes. It is not a dual resident company. Its tax affairs are dealt with at Peterborough Large Business Office (Corporation Tax), Stuart House, St John's St, Peterborough, PE1 1RJ under reference 549/96420 31360. At the time of the original claims, its tax affairs were dealt with at Bristol Large Business Office, Inter City House, Mitchell Lane, Bristol, BS1 6DQ under reference GJB/96420 31360.

2. Background To Overseas Expansion

In order to become recognised as an international retailer, the Appellant began to move into overseas jurisdictions in 1975 with the opening of the Boulevard Haussmann store in Paris. By the end of the 1990s it was operational in over 600 locations in more than 36 countries, through wholly owned subsidiaries and third party franchises. As well as Continental Europe, The Appellant has or had a presence in the US, Canada and Hong Kong. Despite this international outlook, the UK continued to account for over 80% of total sales.

Most of the overseas operations were ultimately owned via a Dutch holding company. Once a decision had been made to establish the subsidiaries in Continental Europe consideration was then given to which location would be suitable as a holding company. In common with many international groups, a decision was taken to establish a Dutch holding company to, amongst other things, facilitate effective dividend repatriation were the subsidiaries, as hoped, to be profitable.

In Continental Europe, performance was variable but a trend developed towards rising losses in the second half of the 1990s. These arose from lack of clarity in market position, over-footaged stores and too few products appealing to a broad customer base. Stores were concentrated in high cost prime city sites which became increasingly marginalised through the increase in edge of town developments. The well-publicised factors which impacted the UK business at this time relating to sourcing, values and margins were exacerbated by the consistent strength of sterling.

On 29 March 2001 the Appellant announced its intention to divest itself of its Continental European activity. By 31 December 2001 the French and Spanish subsidiaries had been sold to third parties, and trading operations had been discontinued in the remainder of the subsidiaries, including the German and Belgian companies which are now essentially dormant.

3. Summary Of Claims

The Appellant has made group relief claims in respect of losses incurred by certain of its EU subsidiaries for the four accounting periods ended 31 March 1998, 1999, 2000 and 2001 pursuant to paragraph 6 of Schedule 17A ICTA 1988. (The claims which were made in respect of the Spanish subsidiary were subsequently withdrawn.)

The amounts of the losses, which are relevant to the claim, are:

Year Ended 31 March 1998
Germany - £4,360,327 loss

Year Ended 31 March 1999
Germany - £19,996,358 loss
France - £11,743,059 loss

Year Ended 31 March 2000
Germany - £12,924,763 loss
France - £15,272,142 loss
Belgium - £1,942,188 loss

Year Ended 31 March 2001
Germany - £9,127,919 loss
France - £20,126,353 loss
Belgium - £3,692,992 loss

Germany refers to Marks and Spencer (Deutschland) Gmbh, described further in paragraph 5 below. France refers to Marks and Spencer (France) SA, described further in paragraph 6 below. Belgium refers to SA Marks and Spencer (Belgium) NV, described further in paragraph 7 below.

4. Group Structure

Extracts from the group structure chart are enclosed as Attachments A1 and A2, showing the relationships between the relevant companies.

Marks and Spencer (Nederland) BV ("BV") is a corporation organised under Dutch law, having its registered office at Koningslaan 34, 1075 AD, Amsterdam, the Netherlands. It was incorporated on 22 August 1958. It is resident in the Netherlands for tax purposes. It is not a dual resident company. Its taxation affairs are dealt with at Kingstordweg 1, 1043 GN, Amsterdam, the Netherlands under reference number 14.bg.034.

BV is a holding company for certain of the Appellant's overseas subsidiaries including MSG, MSB and (until 31 December 2001) MSF.

Marks and Spencer International Holdings Limited ("MSIH") is a UK incorporated company resident in the UK for tax purposes. It is not a dual resident company. It is an investment holding company owning certain shares in the Appellant's non-UK subsidiaries, including 100% of BV.

In summary, the Appellant owns 100% of MSIH which in turn owns 100% of BV. At the time the losses were incurred, BV owned 100% of MSF and MSB and, for the 1998 and 1999 years, 100% of MSG. For the 2000 and 2001 years (and currently), MSG was and is owned 67% by BV and 33% by MSIH. BV still owns 100% of MSB. MSF was sold in December 2001.

5. Germany

Marks and Spencer (Deutschland) GmbH ("MSG") is a corporation organised under German law, having its registered office at Antoniterstrasse 17, 50667 Cologne, Germany. The first store (in Cologne) opened in October 1996. MSG is resident in Germany for tax purposes. It is not a dual resident company. Its taxation affairs are dealt with at Finanzamt Köln-Mitte, under reference number St Nr 215/0188/3056.

MSG operated 4 retail stores in Germany for clothing, foods, home furnishings, furniture, gifts, accessories, toiletries and cosmetics and various other products under the name "Marks and Spencer". The number of employees (excluding head office functions) exceeded 160. The company ceased trading by 31 December 2001.

6. France

Marks and Spencer (France) SA ("MSF") was a corporation organised under French law, having its registered office at this time at 6-8 rue des Mauthurins, BP 252-09, 75424 Paris, Cedex 09, France. It was incorporated on 17 February 1958 and became part of the M&S Group in 1975 with the opening of the flagship Boulevard Haussmann store in Paris on 25 February 1975. MSF was resident in France for tax purposes. It was not a dual resident company. Its taxation affairs were dealt with at 44/48 Chaussée d'Antin, 75441 Paris, Cedex 09. BV sold the shares in MSF to a third party Galeries Lafayette on 31 December 2001.

MSF operated 18 retail stores in France for clothing, foods, home furnishings, furniture, gifts, accessories, toiletries and cosmetics and various other products under the name "Marks and Spencer". The number of employees (excluding head office functions) exceeded 1,200.

7. Belgium

SA Marks and Spencer (Belgium) NV ("MSB") was a corporation organised under Belgian law, having its registered office at this time at Rue D'Argent 10/20, B-1000 Bruxelles, Belgium. MSB is resident in Belgium for tax purposes. It is not a dual resident company. Its taxation affairs are dealt with at Ministère des finances, Administration des Contributions Directes, Contrôle Bruxelles 4 Sociétés, Rue des Palais.

MSB operated 4 retail stores in Belgium for clothing, foods, home furnishings, furniture, gifts, accessories, toiletries and cosmetics and various other products under the name “Marks and Spencer”. The number of employees (excluding head office functions) exceeded 200. The company ceased trading by 31 December 2001.

8. Running Of The Overseas Operations

All of the local activities were managed and controlled by the directors in the respective jurisdictions. There is no dispute between the Appellant and the Respondent that the companies were not resident in the UK in the relevant years.

Goods and services were supplied from the Appellant on an arm’s length basis, for the years concerned in these appeals. While local management could specify the lines likely to be more or less attractive to local markets, the principal M&S lines were designed, selected, commissioned and purchased in the UK. The supply of goods was regulated by agreement between the parties. Certain corporate services such as Treasury and Information Technology were co-ordinated from the UK and supplied to the subsidiaries under a service agreement between the parties.

The stores were ran in the same manner as the UK Retail business and had identical characteristics. The stores were in prime retail locations such as city centres and out-of-town malls and were typically large format stores with large retail selling areas, ranging from 1,675 to 16,100 square metres. All stores included offices, storage facilities and staff canteen/changing space.

9. Group Relief Claims

The claims are in respect of MSG for the four years ended 31 March 2001, for MSF for the three years ended 31 March 2000, and for MSB for the two years ended 31 March 2001. Group relief claims were made by the Appellant to the UK Respondent on 31 March 2000 (for 1998), 30 March 2001 (for 1999), and 24 September 2001 (for 2000 and 2001). The Respondent rejected the claim by way of decision dated 13 August 2001 (for 1998 and 1999) and 2 November 2001 (for 2000 and 2001). The Appellant appealed the Respondent’s refusal of the claim by way of letter dated 20 August 2001 (for 1998 and 1999) and elected under section 46(1) of the Taxes Management Act 1970 that the case be heard by the Special Commissioners. Subsequently the Appellant and Respondent on 31 July 2002 made a joint referral under Para 31A(1) Part IV Schedule 18 FA98 to add the 2000 and 2001 appeals to the hearing, which was agreed by the Special Commissioner on 10 September 2002.

The Appellant and Respondent both agree that the losses must be computed on a UK tax basis. At the Respondent’s request, the Appellant recomputed the losses on this basis. By way of letter dated 25 March 2002 the Respondent indicated that it was prepared to accept the revised figures, which are consequently in the sums listed in paragraph 3 above. The Appellant and Respondent both agree that, if the claims succeed, the losses as computed will be available as group relief to the Appellant (it has been specifically agreed that the losses of the subsidiaries will not be excluded from group relief by reason of the exclusion of losses of foreign trades falling within Case V of Schedule D, contained in ICTA 1988, section 403(2) later section 403ZA(2)(a)).

The Appellant has sufficient tax capacity to absorb the losses claimed as its UK taxable profits in the relevant years are currently estimated to be:

Y.E. 31/3/98	-	£958,551,573
Y.E. 31/3/99	-	£451,052,043
Y.E. 31/3/00	-	£417,103,539
Y.E. 31/3/01	-	£407,554,815

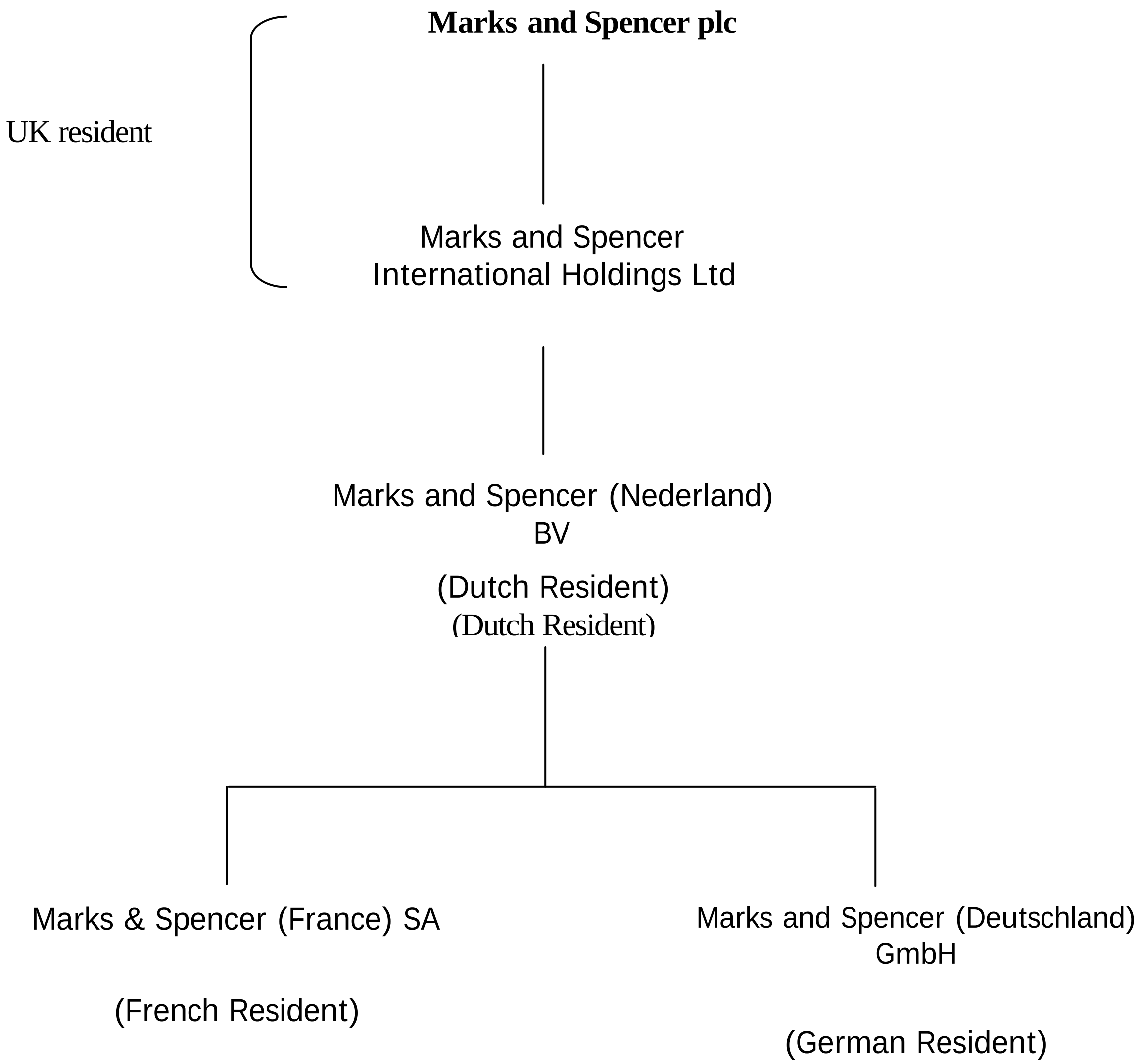
Because of the termination of the German and Belgian trading operations, and the sale of the French company, the losses have not been used, and it is the Appellant's expectation that they are unlikely to be used, to obtain effective tax relief for the Appellant in the local jurisdiction.

10. Statement Of Issue

The issue before the Commissioners is whether the UK group relief provisions preventing an EU resident subsidiary trading outside the UK surrendering losses to its ultimate UK parent (or another member of the UK group) are in breach of Articles 43 and 48 of the EC Treaty.

ATTACHMENT A1

GROUP STRUCTURE FOR 1998 AND 1999
(all holdings 100%)



ATTACHMENT A2

GROUP STRUCTURE FOR 2000 AND 2001
(all holdings 100% except where shown)

Marks and Spencer plc

UK resident

and Spencer Holdings

Marks and Spencer
International Holdings Ltd

Marks and Spencer (Nederland)
BV

(Dutch Resident)
(Dutch Resident)

Marks & Spencer (France) SA

(sold 31 December 2001)
(French Resident)

SA Marks & Spencer (Belgium)
NV

(Belgian Resident)

67% 33%

Marks and Spencer (Deutschland)
GmbH

(German Resident)