Is the limitation of tax jurisdiction a restriction of the freedom of movement?

The ECJ should show more respect for the principle of territoriality and for its own basic assumptions

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Contents

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1. Introduction

The European Court of Justice (ECJ) recognizes in its case law that in the area of direct taxation it is the Member States that have the power to determine the criteria for taxation. The Member States thus are sovereign in the way they structure their tax systems. Since Member States are sovereign in arranging their tax systems, they are free, in certain cases, to set limits to their tax jurisdiction. For example, they might choose (in certain cases) to tax only income derived in their territory (taxation based on the territoriality principle). Nevertheless, from the ECJ's case law one sees that the Court does not always accept such a limitation of tax jurisdiction when tested against the unrestricted exercise of the Treaty freedoms. In this contribution I examine these issues. In section 2, I discuss taxation on grounds of the universality principle and the territoriality principle and the role played by these principles in the Court's case law. I also try to find an answer to the question which of the two principles fits the Internal Market best. In section 3, I make a critical examination of the Court's case law on cases in which the limitation of tax jurisdiction leads to disadvantages. My conclusion is that the ECJ's case law is incorrect from a dogmatic viewpoint because the Court is not willing to pay heed the *consequences* of its own basic assumptions. There are a number of cases pending before the ECJ in which it will have the opportunity to fine tune decisions like *Bosal Holding*, *Manninen*, *Marks & Spencer* and the Opinion of Advocate General Léger in *Ritter*, all of which, in my view, are dogmatically incorrect.

2. Taxation on the grounds of territoriality rather than universality

2.1. In general

In direct taxation, residence or (for entities) seat is often used as the connecting factor in determining the extent of the taxation. Residence as a criterion embodies the universality principle. In other words, when a person has his residence or place of establishment in a certain state, he will be taxed in that state on his entire world income (or profits) (unlimited tax liability).

Taxation based on territoriality is limited to income having its origin in the state involved (in other words, income that has a direct causal link to the economic activities carried out in the territory of the state). Thus, the state has restricted its tax jurisdiction to income that is derived in the respective state.

Taxation based on territoriality is seen most often with respect to non-residents, who are subject to tax in a state only on income that is derived from sources in that state (limited tax liability). An increasingly large group of tax scholars is arguing in favor of a limited tax liability for residents on the basis of the territoriality principle. For corporate tax purpose, France taxes companies established in France on the basis of the territoriality principle. Furthermore, when levying direct tax, many countries tax their residents, in principle, on their world-wide income and then (sometimes for only a certain kind of income) allow an exemption for foreign-source profits. Ultimately, the tax levied is

levied on the grounds of the territoriality principle[1]. One cannot conclude, therefore, that a Member State that adheres to the basic principle of taxing world-wide income actually does so for every type of income.
The general distinction for tax purposes between a person who is subject to (unlimited) tax liability on world-wide income in the state in which he is resident and who is subject to tax liability in the state in which he is non-resident only on income that has its origin in that state (territoriality principle) was accepted by the ECJ for the first time in its *Schumacker* decision[2]. In this decision the ECJ held that with regard to direct taxation residents and non-residents are generally not in a comparable situation[3]. In particular, the Court accepted the general principle in the OECD Model which says that, on the basis of the residence principle, it is the residence state that has the power to tax the taxpayer's world-wide income and that, when it does this, it must take the taxpayer's personal and family circumstances into account[4]. In the *Gschwind* decision[5], the ECJ held that present-day international tax law - and, in particular, the OECD Model Convention - is generally based on the residence principle when allocating taxation rights between states in a situation with cross-border elements[6].
In the *Futura Participations* decision[7], in which the tax liability of a non-resident was at stake, the issue was whether a system with limited tax liability for non-residents and unlimited tax liability for residents is prohibited discrimination. The ECJ held that "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." The ECJ confirmed this holding later in *Marks & Spencer*[8], among other cases: "In a situation such as that in the proceedings before the national court, it must be accepted that by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law". The ECJ would appear to recognize the principle of territoriality, but at the same time it should be noted that what the ECJ views as

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1 It should be noted, however, that under certain national systems (such as the ones in the Netherlands and in Austria) foreign losses incurred by a permanent establishment are taken into account (sometimes temporarily). The system therefore is not based strictly on terrioriality.

2 ECJ 14 February 1995, case C-279/93, *Schumacker*, ECR I-225.

3 In *Royal Bank of Scotland*, case C-311/97, this decision was broadened to include companies based on the distinction between domestic and non-resident tax liability. See, however, case 270/83, *Avoir fiscal*, in which the ECJ observed that "Even if the possibility cannot be altogether excluded that a distinction based on the location of the registered office of a company or the place of residence of a natural person may, under certain conditions, be justified in an area such as tax law…"

4 See para. 32 of ECJ 14 February 1995, case C-279/93, *Schumacker*, ECR I-225.

5 ECJ 14 September 1999, case C-391/97, *Gschwind*, ECR I-545.

6 See ECJ 14 September 1999, case C-391/97, *Gschwind*, ECR I-545, para. 24.

7 ECJ 15 May 1997, case C-250/95, *Futura Participations*, ECR I-2471.

8 ECJ 13 December 2005, case C-446/03, *Marks & Spencer*, ECR I-10837, para. 39.

'territoriality' is not entirely clear. For this reason, in section 2.2, I will take a closer look at the principle of territoriality.

2.2. The principle of territoriality in the ECJ's case law

In the *Futura Participations* decision[9] the ECJ has indicated that "the fiscal principle of territoriality" is a legitimate connecting factor. In *Futura,* a company established in France had a permanent establishment in Luxembourg. The national court asked the ECJ whether it was in conformity with the freedom of establishment that a Luxembourg non-resident company could only take losses into account if the losses were connected to income derived in Luxembourg (the ECJ called this "an economic link"). The issue was thus whether the requirement of an "economic link" was permitted. The ECJ first held that resident taxpayers are taxable on their worldwide income[10] . It then went on to hold that income derived outside Luxembourg is (partially or wholly) exempt but that "the basis for assessment for resident taxpayers at any rate includes profits or losses arising from their Luxembourg activities". Despite the exemption resident companies are in any case taxed on their Luxembourg-source income (in other words, at the very least the territoriality principle applies to them). The ECJ thereafter held that non-residents (a PE, for example) are taxed only on the grounds of the territoriality principle: 'for the purpose of calculating the basis of assessment for non-resident taxpayers, only profits and losses arising from their Luxembourg activities are taken into account in calculating the tax payable by them in that State.' The ECJ held: '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'. The Court thus confirmed that application of the principle of territoriality and (thus) the making of a link to the origin of income is, in principle, permitted under Community law[11]. In the operative part of the decision, the ECJ held that the right of establishment does not preclude a Member State from making the carry forward of a non-resident's losses dependent on the condition 'that the losses must be economically related to the income earned by the taxpayer in that State, provided that resident taxpayers do not receive more favourable treatment'. The

[9] ECJ 15 May 1997, case C-250/95*, Futura Participations*, ECR I-2471.

[10] See para. 20.

[11] In its recent case law the ECJ treats the principle of territoriality as a justification on the grounds of a legitimate objective in the public interest (see, for example, the *N* case). However, in my view, the application of the principle of territoriality is not an objective of *public interest*. The principle of territoriality allows certain connecting factors to be used to delimit a Member State's taxation rights (see, in this respect, the *Trans Tirreno Express* decision concerning the application of the principle of territoriality under the Sixth VAT Directive (ECJ 23 January 1986, *Trans Tirreno Express* ECR 1986, 231). Since a state has the sovereignty to tax income that is derived on its territory, the question is whether a specific connecting factor is discriminatory. A test of the principle of territoriality must therefore occur when the issue of discrimination is examined. The ECJ dis this in *Futura Participations* when it held that the connecting factor involved (the economic link) does not result in 'discrimination, overt or covert, prohibited by the Treaty'. In *Bosal Holding* the ECJ is not as explicit, but it ultimately examines the principle of territoriality under the discrimination test (see para. 39 of the decision in which the ECJ holds that there can be said to be non-comparable situations. In recent case law, however the test has moved in the direction of an examinination of whether there is a compelling reason of public interest.

ECJ recognized the principle of territoriality as such[12] in this decision, but it does impose the condition that resident taxpayers may not be treated more favourably[13]. In addition, the ECJ permitted non-residents to be taxed differently (to be subject to limited liability) than residents (who are subject to unlimited tax liability). The ECJ would appear to have confirmed this decision in *Marks & Spencer*[14]: "In a situation such as that in the proceedings before the national court, it must be accepted that by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law".

Although it would appear that the ECJ assumes that the "principle of territoriality" is also applied when residents are taxed on worldwide profits (which could be true, see above, but which is not necessarily the case), I suspect that the ECJ in the holding quoted above from *Marks & Spencer* is merely trying to say that limited tax liability for non-residents (compared to unlimited tax liability) is in accordance with the territoriality principle.

Be that as it may, the ECJ allows the territoriality principle to be applied to non-residents. An open question is whether the ECJ also allows the principle of territoriality to be applied to *residents*. In other words: does the ECJ allow the situation in which residents are not taxed on their worldwide income, but (on balance) only on domestic income (thus: on the basis of territoriality)? In *Bosal Holding*[15] the ECJ did not reject application of the principle of territoriality to residents as such, but it limited its application, in my view incorrectly, to the taxation of one single taxpayer. On the grounds of the territoriality principle the ECJ did not allow the parent company's costs to be allocated to the activities of another taxpayer, viz. a subsidiary that was established and had its activities abroad.[16] In the factual constellation of the *Manninen* case[17] Finland treated foreign-source dividends received by Finnish residents differently (*no* credit for foreign corporate tax) than domestic-source dividends (*credit* for Finnish corporate tax). Finland justified this difference on the basis of the principle of territoriality. In this specific

12 Because in *Futura Participations* the ECJ permitted a measure whereby *losses* must have an economic link to the *income* derived in a Member State, it is not entirely clear to me exactly what the ECJ means by "the territoriality principle". We can see from Advocate General Lenz' Opinion in *Futura* that he has in mind a connecting factor whereby on the grounds of some sort of connection with the territory of Member State (for example: a permanent establishment) a Member State levies tax on the income that is derived from the PE's activities. The Advocate General refers to Art. 4(2) of the France-Luxembourg tax treaty of 1 April 1958, which reads as follows (unofficial translation): 'Where an enterprise maintains permanent establishments in both Contracting States, each State may tax only the income derived from the operations of the permanent establishments situated in its territory' (translation: IBFD Tax Treaties Database).

13 Otherwise discrimination on the grounds of nationality would arise.

14 ECJ 13 December 2005, case C-446/03, *Marks & Spencer*, ECR I-10837, para. 39.

15 ECJ 18 September 2003, case C-168/01, *Bosal Holding*, ECR I-9409.

16 See in more detail: D. Weber, Het Bosal Holding-case: Analysis and Critique, EC Tax Review 2003-4, section 3.4.4.

17 ECJ 7 September 2004, case C-319/02, *Manninen*, ECR I-7477.

situation, the ECJ did not accept the territoriality principle. In *Marks & Spencer* the issue was whether, under the right of establishment, a resident of the United Kingdom (parent company) could set off losses suffered by a subsidiary established abroad against profits made in the United Kingdom. The United Kingdom justified its refusal to take into account the foreign losses on the basis of the territoriality principle, but the ECJ rejected this, although its reasons for doing so were not clear. Although so far the ECJ has never allowed the territoriality principle to be relied on with respect to residents, it does not seem to have entirely ruled out application of this principle for them. In addition, in *Marks & Spencer* the ECJ held, after first disallowing reliance on the territoriality principle: 'None the less, as the United Kingdom rightly observes, the preservation of the allocation of the power to impose taxes between Member States might make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses'. The ECJ then recognized 'the balanced allocation of the power to impose taxes between the Member States' (hereinafter: 'the balanced allocation') as a justification ground in *Marks & Spencer*. It should be observed, however, that a 'balanced allocation' can be based on the territoriality principle. It would thus seem that the principle of territoriality may play a role as justification ground after all[18]. The ECJ appears to have confirmed this in the *N* case where it makes a link between the territoriality principle and the allocation of the power to impose taxes between Member States[19].
To sum up, we can say that taxation based on the territoriality principle has been recognized by the ECJ with regard to non-residents, but that it is not yet clear to what extent it will recognize this principle for residents as well. I do not see why the ECJ should not allow the territoriality principle for residents. I will not go into this issue further here, but do so at more length in 3.2.2.

2.3. *CLIN (territoriality) and CLEN (universality): which principle fits the Internal Market best?*

According to economic theory, free competition leads to the greatest efficiency. This is achieved when production factors, as a result of the market mechanism, produce the highest possible yields[20]. It is assumed that in such a case there is as little governmental intervention as possible. In tax law two theories on neutrality are generally used: capital and labor import neutrality (CLIN)[21] and capital and labor export neutrality (CLEN)[22].

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[18] See also: P.J. Wattel, Fiscal Cohesion, Fiscal Territoriality, and Preservation of the (Balanced) Allocation of Taxing Power; What is the Difference?, in Weber (editor), The Influence of European Law on Direct Taxation - Recent and Future Developments, EUCOTAX series on European Taxation, Kluwer Law International, in print.

[19] ECJ 7 September 2006, C-470/04, *N*, not yet published in ECR, paras. 41 and 42.

[20] Compare K. Vogel, Worldwide vs. Source taxation of income – A review and re-evaluation of arguments, Intertax 1988, No. 10, p. 310; E.C.C.M. Kemmeren, Principle of origin in tax conventions – a rethinking of models, Pijnenburg, Dongen, 2001, p. 69.

[21] The majority of authors speak of CIN, which is limited to movements of *capital,* but it is clearer to add the factor 'labour". This is proposed by Kemmeren: E.C.C.M. Kemmeren, Principle of origin in tax conventions – a rethinking of models, 2001, Pijnenburg, Dongen, pp. 71-74.

In a system based on territoriality the connecting factor is the origin of the income, which amounts to a tax base exemption and is based on CLIN. This means that there is neutrality for investments made and labor performed by both residents and non-residents. In the state in which the investment is made or where the labor is performed, the tax burden on the investment and the labor will be the same regardless of whether the investor/worker is a resident or a non-resident.
A system based on universality (taxation on worldwide income of a resident) uses the connecting factor of residence and is based on CLEN. In this case there is neutrality for investment/labor in either the state of residence or in a foreign state. In this type of system there is no tax base exemption but instead the credit method is used. As a result, if the tax burden in the state in which an investment is made or where labor is performed is lower, the residence state will levy "additional tax" up to its own (higher) level of taxation. CFC-like legislation is a method that is also commonly used in order to try tax away income from passive activities that has been subject to a lower taxation. Regardless of the country in which the investment is made or the labor performed, the final taxation is the one in the residence state. One of the consequences of CLEN is that it removes any competitive advantage that may arise because of the lower tax burden[23].

The question comes up as to which system – a system based on CLIN or one based on CLEN - best fits in the EC market. To answer this it is important to look at the aim of the common market first of all. Its aim is to achieve the highest possible efficiency by allowing the market mechanism within the EC to operate in the same way as it would in a (national) market[24]. One could say that the common market is based on the principle of an open market economy and free and unadulterated competition[25]. We can see from both

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[22] For an overview, see: D.J. Frisch, The economics of international tax policy: some old and new approaches, 47, 1990, Tax Notes 581; G.C. Hufbauer and J.M. van Rooij, U.S. Taxation of international income, Blueprint for reform, Institute for international economics, Washington, 1992, Chapter 3; F.C. Bergsten, T. Horst and T.H. Moran, American multinationals and American interest, Brookings Institution, Washington, 1978 and R.E. Caves, Multinational enterprise and economic analyses, Cambrigde University Press, London, 1982; Office of Tax Policy department of the Treasury, The deferral of income Earned through U.S. controlled foreign corporations, December 2000, pp. 23-54. For an overview with regard to taxation in the common market, see: A.J. Martín Jiménez, Towards corporate tax harmonization in the European Community, Series on International Taxation, Kluwer law international, London, 1999, chapters 1 and 2.

[23] It should be observed that in practice many systems are a mixture of territoriality and universality. Thus, at present the Netherlands taxes residents for corporate tax purposes on the basis of their worldwide profits, but it does allow a tax exemption. Foreign profits are thus exempt (territoriality), but foreign losses are taken into account (universality), and the losses are recaptured later on when there are profits (thus, once again, territoriality). In addition, a system based on universality is often applied to residents only (and thus inconsistently). Non-residents are often taxed on the grounds of the principle of territoriality.

[24] See case 15/81, *Gaston Schul* and case 270/80, *Polydor*.

[25] See: Kapteyn - VerLoren van Themaat, Introduction to the law of the European Communities, third edition, 1998, Kluwer Law International, at p. 123.

the EC literature[26] and the case law, in particular on mutual recognition[27], that, in contrast to what some economists claim[28], competition between legal systems is one of the foundations of the Internal Market. This implies that CLEN should be rejected under Community law as a matter of principle[29]. CLEN is, namely, after all, characterized by a lack of recognition of the sovereignty of the state. The advantageous competitive position of a state having a low tax burden is removed (by a credit system or because under CFC legislation additional tax is levied up to the tax level in the residence state). This erodes efficiency[30] and is incompatible with the aim of the common market.
In addition, it should be noted that CLIN does in fact seem to be in line with the efficiency theory. The main objection to CLIN has been that it is not efficient, because it stimulates tax competition and encourages the use of low-tax countries[31]. Economists assume that in order to achieve the highest possible efficiency (the highest yield of production factors) governmental intervention should be as low as possible. Legislation should have as little influence as possible on the allocation of production factors. As a concomitant, it is assumed that economic motives and not tax motives (since these are caused by governmental intervention) should be the basis of the allocation of production means[32]. Tax competition (tax motives) is thus, in the eyes of many economists, not

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26 See: Kapteyn - VerLoren van Themaat, Introduction to the law of the European Communities, third edition, 1998, Kluwer Law International, at p. 123, who describe the common market as ‘a market in which every participant within the Community in question is free to invest, produce, work, buy and sell, to supply or obtain services under conditions of competition which have not been artificially distorted wherever economic conditions are most favourable’; Advocate General La Pergola in his Opinion to case C-212/97, *Centros*, point 20; T. Koopmans. Concurrentie tussen rechtstelsels, SEW 1992, p. 446-450; N. Reich, Competition between legal orders: a new paradigm of EC law? CMLrev. 1992, p. 861 and D.M. Weber, Tax avoidance and the EC Treaty Feedoms, paragraph 3.2.3.c. (‘mutual recognition: stimulus for competition between legal systems’).

27 See, for example: ECJ EG 20 February 1979, case 120/78, *Rewe-Zentral* (*Cassis de Dijon*), ECR 1979, p. 649.

28 See: P.B. Musgrave, Interjurisdictional equity in company taxation: principles and applications to the European Union, in: Taxing capital income in the European Union, issues and options for reform, edited by S. Cnossen, Oxford University Press, Oxford, 2000, p. 75.

29 On the same lines: A.C.G.A.C. de Graaf, Verlangt het gemeenschapsrecht een ‘zuivere’ vrijstelling voor de in een andere lidstaat gerealiseerde ondernemingswinst, TFO 2001, No. 54, pp. 108-110.

30 Compare: B. Terra en P. Wattel, European Tax Law, third edition, Kluwer Law International, Deventer, 2001, pp. 159-164. See also P. Wattel, Capital export neutrality and free movement of persons, Legal Issues of European Integration, 1996, p. 115.

31 For early views on this issue, see: Peggy Richman (later known under the name Musgrave), Taxation of foreign investment income. An Economic analysis, 1963; for later discussion, see: P.B. Musgrave, United States taxation of Foreign investment income, Issues and arguments, Harvard University, Cambridge, 1969, pp. 74-75.

32 See, among others, E.C.C.M. Kemmeren, Principle of origin in tax conventions – a rethinking of models, Pijnenburg, Dongen, 2001, p. 69 and 70 with references.

efficient[33]. In my view, this objection is incorrect because it is based on a logical inconsistency in economic reasoning. Tax competition and the utilization of low-tax jurisdictions stimulate efficiency. The highest possible yields of production factors can be achieved in this way. I do not see why free competition should be limited to the market. Competition between legal systems (such as tax competition) also encourages efficiency in the global economy[34].

Finally, it should be noted that CLIN fits well with the principle of 'national treatment', which is seen in particular in relation to the free movement of persons[35]. The precept of 'national treatment' amounts to an injunction directed toward the host Member State of not treating nationals of other Member States worse than its own nationals. CLIN aims at neutrality for investment and labor whether by a resident or a non-resident. This is a perfect match with the principle of national treatment. CLEN frustrates the precept of national treatment and thereby falsifies competition: by using, for example, a credit system or CFC-like legislation, the *residence* state reverses the national treatment granted by the *source* state[36].

My conclusion is that, given the aim of the common market and the precept of national treatment, a system based on territoriality fits the European Community better than a system based on universality. One disadvantage of a system based on territoriality is that foreign losses cannot be taken into account. This is certainly a disadvantage for the Internal Market, but it is one that can be removed by allowing the temporary set-off of foreign losses (followed by their 'recapture' when profits are made abroad). Although I believe that such loss set-off cannot be imposed under the EC Treaty freedoms (for more detail, see section 3.2.2. below), I can understand why the European Commission encourages the Member States to take such foreign losses into account[37].

Nevertheless, we should note that from the eighties of the previous century, more and more voices are being raised, in particular internationally, in favor of the application of the principle of territoriality[38]. In recent studies as well, more and more attention is being

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33 For example, see explicitly: P.B. Musgrave, Fiscal coordination and competition in an international setting, in Retrospectives on public finance, editor L. Eden, Duke University Press, Durham, 1991, pp. 277-305.

34 On the same lines: M.J. Graetz, Taxing international income: inadequate principles, outdated concepts and unsatisfactory policies, Tax Law Review, 2001, no. 2, p. 261, at p. 284.

35 See, for instance, Art. 43 EC Treaty, which provides that the right of establishment entails certain rights '(…) under the conditions laid down for its own nationals by the law of the country where such establishment is effected'.

36 On this point, see: P. Wattel, Capital export neutrality and free movement of persons, Legal Issues of European Integration, 1996, p. 115.

37 See: Communication form the European Commission, Tax treatment of losses in cross-border situations, Brussel, 19.12.2006, COM(2006) 824 final.

38 Propornents are, among others,: K. Vogel, Worldwide vs. Source taxation of income – A review and re-evaluation of arguments, Intertax 1988, 8/9, pp. 216-229, No. 10, pp. 310-320 and No. 11, pp. 393-402. O. Gandenberger, Kapitalexportneutralität versus Kapitalimportneutralität, in: Aufsätze zur Wirtschaftspolitik, Forschungsinstut für Wirtschaftspolitik an der Universität Mainz, Vol. 7, 1983. Graetz and O'Hear, The 'Original Intent' of U.S. International Taxation, Duke Law Journal 46 (1997), p. 1021 et seq. N.H. Kaufman, Fairness and the Taxation of international income, Law

devoted to the subject, as, for example, during the IFA Congress 2005 in Buenos Aires[39] and on the occasion of a seminar in 2006 at the Stockholm School of Economics[40].

3. The consequence of tax sovereignty: the freedom to limit tax jurisdiction

Because there are no general Community law rules on direct taxation, the power to determine the criteria for the levy of taxes with a view to defining taxation rights and avoiding double taxation lies with the Member States[41]. According to the ECJ, for example in its *Gilly*, *Saint-Gobain* and *Van Hilten*[42] decisions, the Member States are free to unilaterally define the connecting factors for the allocation of taxation rights or to do so in tax treaties. I fully agree with this as a basic assumption. Community law does not say anything about whether, and on the basis of which criteria, a Member State should levy tax. The Member States may determine the criteria for taxation (is tax levied? who is subject to tax liability? what is taxed? at what rate? etc.). Community law (and consequently the ECJ as well) will have to respect the choices made by the Member States, and thus also their sovereignty in this regard.

The basic assumption that only the Member States have the power to decide on the criteria for taxation, with a view to defining tax jurisdiction and avoiding double taxation, implies (and is inherent to the fact) that the Member States are also free (sovereign) to limit their taxation rights and thus *not* to levy tax on certain taxpayers or types of income[43].

Disadvantages arising because a certain person is not liable to tax or because certain (negative) income falls outside the tax base are, in my view, not prohibited restrictions. Such disadvantages come into existence because a Member State has chosen to limit its taxation rights either unilaterally or bilaterally (certain persons or types of income are not subject to tax). It is inherent to the Member States' sovereignty that they may limit their tax jurisdiction in the way they see fit. Any resulting disadvantages fall outside the scope

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and Policy in International Business, 1998; G.C. Hufbauer and J.M. van Rooij, U.S. Taxation of international income, Blueprint for reform, Institute for international economics, Washington, 1992; E.C.C.M. Kemmeren, Principle of origin in tax conventions – a rethinking of models, 2001, Pijnenburg, Dongen and S. van Weeghel, Thoughts on territoriality in relation to dutch corporate tax reform, in Liber Amicorum – Jacques Malherbe, Bruylant, Bruxelles, 2006, p. 1129.

39 Source and residence: new configuration of their principles, Cahiers de droit fiscal international, IFA 2005, Buenos Aires Congress.

40 Subject of the seminar was: 'The source of income in a globalized economy: Developing source rules for the 21st Century'; the papers presented at the seminar by Rosenbloom and Andersson were published in European Taxation 2006-10; by Kemmeren and Halkyard, in Bulletin 2006-11 and by Mössner and Easson in Bulletin 2006-12.

41 There is (secondary) Community law on direct taxation only for specific areas: the Parent-Subsidiary Directive, Directive 90/435/EEC, the Merger Directive, Directive 90/434/EEC, the Interest and Royalties Directive, Directive 2003/49/EC and the Savings Directive, Directive 2003/48/EC.

42 See ECJ 21 September 1999, case C-307/97, *Saint-Gobain*, ECR I-6161, para. 56 and ECJ 12 May 1998, case C-336/96, *Gilly*, ECR I-2793, paras. 24 and 30, ECJ 12 December 2002, *De Groot*, C-385/00, ECR I-11819, para. 93 and ECJ 23 February 2006, case C-513/03, V*an Hilten*, not yet published in ECR, para. 47.

43 It should be noted, however, that prohibited State aid may not be created (Art. 87 EC).

of the Treaty freedoms. If limiting tax jurisdiction were to be considered a restriction in certain circumstances (and the ECJ were thus actually to require that a person or type of income had to be subject to tax), Community law would be *creating* taxation rights. This would be a direct breach of Member State sovereignty. The *Bosal Holding, Marks & Spencer*, *Manninen* cases and in the Opinion of Advocate General Léger in the *Ritter* case show us that the ECJ does not always have sufficient respect for a Member State's tax jurisdiction.

3.1. *Insufficient respect for a Member State's right to limit its taxation rights: Bosal Holding*, *Marks & Spencer*, *Manninen* and *Ritter*

3.1.1. *Bosal Holding*
At issue in the *Bosal Holding* decision[44] was a Netherlands provision that allowed the participation costs (often interest) incurred by a parent company in connection with the participation only to be deducted by the *parent* company if the *subsidiary* had taxable profits in the Netherlands. In the decisions in which the preliminary ruling was requested, the Supreme Court (*Hoge Raad*) had observed that there was an economic link between the participation costs incurred by the parent and the profits of the subsidiary, but in cross-border situations a connection between costs and taxable profits within one tax system was lacking. The ECJ held that the Netherlands limitation of the deduction of costs infringed the freedom of establishment. With respect to the Netherlands' contention that the deduction limitation was justified on the grounds of fiscal cohesion, the Court held that there was no direct link between the participation costs and the subsidiary's profits. An attempt to justify the provision on the grounds of the territoriality principle was unsuccessful. The Netherlands contended that the costs connected to activities abroad, including financing and participation costs, have to be allocated to the profits made with these activities and that the limitation of the deductibility of these costs is exclusively linked to making profits or not abroad. According to the Netherlands government, discrimination was not at stake since subsidiaries that made taxable profits in the Netherlands and subsidiaries that do not do this are not comparable.
The ECJ rejected this contention by observing that i) the territoriality principle, as seen in *Futura Participations*, was related to *one* taxpayer and that ii) the argument that subsidiaries with domestic and foreign profits are not comparable is irrelevant because what is at stake is the tax treatment of the parent company and the subsidiary's profits are not taxed in the hands of the parent.
It is striking that, in examining the fiscal cohesion justification and territoriality principle the ECJ did not give weight to the Netherlands Supreme Court's observations that there is an economic link between the parent company's participation costs and the subsidiary's profits. The ECJ did not allow the costs incurred legally by one taxpayer to be allocated to the profits of another taxpayer since this would restrict the freedom of movement. In my opinion, the ECJ is going too far here and has eroded the Member States' sovereignty. The starting point is that it is the Member States who may define the criteria for taxation themselves and in doing so a Member State may allocate the costs of a taxpayer on the basis of objective criteria (such as an economic link) to the profits of

44 ECJ 18 September 2003, case C-168/01, *Bosal Holding*, ECR I-9409.

another taxpayer. This may result in a disadvantage in a cross-border situation, since the costs are not deductible, but this is a disadvantage that everyone understands: the Netherlands does not have tax sovereignty over the profits of foreign subsidiaries. If the Netherlands may not tax these foreign profits, it does not have to take into account the costs that are allocated to them. In his Opinion in the *ACT class IV* case, Advocate General Geelhoed observed that he feels that in *Bosal Holding* the ECJ showed insufficient respect for the allocation of taxation rights among the Member States[45]. He also pointed out that it is not the Netherlands that has taxation rights over the subsidiary's profits but that it is the Member State of residence of the subsidiary has taxation rights. Thus, the fact that the Netherlands did not take the participation costs into account should have been allowed.

3.1.2. *Marks & Spencer*

In the *Marks & Spencer* decision[46], a parent company established in the United Kingdom (hereafter: UK) had loss-making subsidiaries in various Member States. Because the subsidiaries were not subject to tax in the UK (they were not resident in the UK and had no other activities there that would create tax liability) the losses could not be taken into account in the UK. Had the non-resident subsidiaries been established in the UK, the group relief regime whereby losses of the resident subsidiaries could be transferred to the parent company and set off against its profits would have applied. The issue before the ECJ was whether it was a restriction of the freedom of establishment that the losses of a non-resident subsidiary could not be set off against the parent company's profits, while domestic losses of a UK-resident subsidiary *could* be set off. The ECJ held that it was indeed a restriction because a tax advantage, viz. a cash-flow advantage, was lost in situations where subsidiaries were established in another Member State. The UK and a number of other Member States observed that the tax situation of a resident subsidiary and that of a non-resident subsidiary are not comparable. Under the territoriality principle, which applies in both international law and in Community law, the Member State of establishment of the parent company does not have tax jurisdiction over non-resident subsidiaries. It was the UK's view that, in accordance with the usual allocation of taxation rights, non-resident subsidiaries fall under the tax jurisdiction of the states in which they are established and where they carry on trading activities.
The ECJ observed in paras. 37 to 40 inclusive:

> 37 In that regard, it must be noted that, in tax law, the taxpayers' residence may constitute a factor that might justify national rules involving different treatment for resident and non-resident taxpayers. However, residence is not always a proper factor for distinction. In effect, acceptance of the proposition that the Member State in which a company seeks to establish itself may freely apply to it a different treatment solely by reason of the fact that its registered office is situated

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45 Opinion in case-374/04, *Test Claimants in Class IV of the ACT Group Litigation*, not yet published in ECR, point 63.

46 ECJ 13 December 2005, case C-446/03, *Marks & Spencer*, ECR I-10837, para. 46.

> in another Member State would deprive Article 43 EC of all meaning (see Case 270/83 *Commission* v *France* [1986] ECR 273, paragraph 18).
> 38 In each specific situation, it is necessary to consider whether the fact that a tax advantage is available solely to resident taxpayers is based on relevant objective elements apt to justify the difference in treatment.
> 39 In a situation such as that in the proceedings before the national court, it must be accepted that by taxing resident companies on their worldwide profits and non-resident companies solely on the profits from their activities in that State, the parent company's Member State is acting in accordance with the principle of territoriality enshrined in international tax law and recognised by Community law (see, in particular, *Futura Participations and Singer*, paragraph 22).
> 40 However, the fact that it does not tax the profits of the non-resident subsidiaries of a parent company established on its territory does not in itself justify restricting group relief to losses incurred by resident companies.

The ECJ's comment in the last sentence is surprising. It is clear that the ECJ is fully aware of the fact that the UK does not tax the profits of non-resident subsidiaries. Nevertheless, the ECJ holds that there is a restriction of the freedom of establishment. Despite the fact that the UK chose not to tax non-resident subsidiaries (which choice it has the fullest right to make), the Court has actually created tax liability for the losses of non-resident subsidiaries in the UK, since, in principle, the losses of the subsidiary have to be taken into account at the level of the parent company. This is a major breach of Member States' sovereignty. In my opinion, the Member States may choose not to tax certain persons (in this case, companies established abroad). A Member State may limit its taxation rights since it is sovereign and making political choices lies in its hands. The ECJ's decision has quite rightly been criticized[47].
Advocate General Geelhoed's observation on *Marks & Spencer* in his Opinion in the *ACT class IV* case is striking[48]:

> Conversely, in *Marks & Spencer*, the Court held that, in principle, insofar as a Member State does not exercise tax jurisdiction over a non-resident subsidiary of a resident parent company, then it does not have to give loss relief. Put otherwise, if a home State has divided its tax base so that it does not exercise tax jurisdiction over a foreign subsidiary of one of its corporate residents, it is in principle consistent for that State to refuse to take into account deductions relating to that foreign-source income in assessing its resident's tax.

It seems to me that the Advocate General reads into *Marks & Spencer* exactly what the ECJ did *not* decide. I agree with him that in *Marks & Spencer* the ECJ *should* have decided that there was no restriction, because the UK does not have tax jurisdiction over a subsidiary established abroad; however, the ECJ did in fact decide that there is a

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[47] See Wattel's note to *Marks & Spencer* published in BNB 2006/72, points 9 through 11.

[48] Opinion in case C-374/04, *Test Claimants in Class IV of the ACT Group Litigation*, not yet published in ECR, point 59. See also his Opinion in case C-524/04, *Test Claimants in the Thin Cap Group Litigation*, point 89.

restriction and explicitly considered the fact that the non-resident subsidiary is not subject to tax irrelevant.

3.1.3. *Ritter*

The factual constellation in the *Ritter* case[49] was as follows: a married couple (Ritter-Coulais) lived in France and worked in Germany. Because they were civil servants, Germany considered them to be subject to unlimited tax liability and taxed them on their worldwide income. One of the issues brought before the ECJ was whether Germany had to take into account the losses incurred from the use of their own home in France. The German tax authorities did not allow these losses to be taken into account, because under the tax treaty between Germany and France both positive and negative income from real estate is exempt. This means that income from real estate is only taxable in the country in which it is located - in this case, in France. According to the ECJ, Mr. and Mrs. Ritter-Coulais requested the tax authorities to take their losses into account only for the determination of the applicable German tax rate and not for the tax base.

This was why the ECJ refused to give the first preliminary ruling on whether under EC law Germany was required to take foreign losses into account. It did rule on the second preliminary question on whether the French losses had to be taken into account in the determination of the applicable German tax *rate*. The German provision took positive foreign income into account in determining the tax rate, but not losses. According to the ECJ, non-residents are more likely to be owners of a house located outside the territory of Germany than residents and thus the German provision treated non-resident employees less favorably employees who have their home in Germany. The ECJ held explicitly that it was relevant that the provision was asymmetrical (positive foreign income taken into account but not foreign losses).

As mentioned, the ECJ did not answer the important first preliminary question. Advocate General Léger did examine it in his Opinion. He took the position that the *Schumacker* case law should be applied to the case at hand. Under that case law, until then applicable to personal and family tax allowances, it is the residence state that in principle must take the allowances into account. Nevertheless, if i) the residence state cannot do this because there is too little income *and* the non-resident earns his income exclusively or almost exclusively in the work state, then it is the work state that has to take the allowances into account. Even though in *Ritter* at issue was a source-based deduction (and not personal and family tax allowances), the Advocate General was of the opinion that the *Schumacker* case law could be applied here. His reasoning was as follows: in the *Ritter* case there was insufficient positive income in France against which to set off the losses; the Ritters earned the largest part of their income in Germany. Since the (other) conditions in the *Schumacker* case law had been met, Germany had to take the French losses into account, according to the Advocate General.

Because the ECJ refused to answer the first preliminary question, it did not give a ruling on Advocate General Léger's proposal. Until now, the ECJ has held with respect to source-linked deductions (such as the one in the is case) that for non-residents a Member State may only tax income from domestic sources, "provided that resident taxpayers do

[49] ECJ 21 February 2006, case C-152/03*, Ritter*, not yet published in ECR.

not receive more favourable treatment" (see, among other things, the *Gerritse* decision). In the *Gerritse* case, however, we are discussing a domestic (German) source, whereby the issue is whether non-residents must be taxed on this source as heavily as residents. In the *Ritter* case the issue revolved around whether a Member State must treat a foreign (French) source in the same way as a domestic (German) source. My answer is: yes, unless Germany does not have taxation rights over the foreign source. In the *Ritter* case it is clear that Germany did not take foreign-source losses into account because Germany had given up its taxation rights with respect to this income under national law and under the France-Germany tax treaty[50]. In other words: Germany had no taxation rights over (positive or negative) income from real property in France. In my opinion, the fact that Germany did not exercise its taxation rights should be respected by the ECJ. The disadvantage that the Ritters faced was caused by a disparity (in the case at hand, this is also called a dislocation of the tax base). France did take the losses into account, but in France there is no positive income against which to set them off. Germany did not take the losses into account because its tax system does not tax income from foreign real property. The solution proposed by Advocate General Léger should, in my view, not be followed in future case law. It would entail a serious breach of the Member States' sovereignty. If the Advocate General's reasoning is followed a Member State that has exercised its sovereignty in such a way that its taxation rights do not include foreign-source income (instead, the foreign country has the power to tax it) would be *forced* to take foreign-source income into account. The ECJ would be creating a kind of (negative) taxation right for the Member State in question.

Moreover, and this is often forgotten, the ECJ had already held in *Futura Participations* that there was no restriction. In *Futura* the issue was whether a non-resident could set off its foreign (French) losses in Luxembourg. In the operative part of the *Futura* decision the ECJ held that the right of establishment does not preclude the fact that loss set-off by a non-resident may be subject to the condition, 'that the losses must be economically related to the income earned by the taxpayer in that State, provided that resident taxpayers do not receive more favourable treatment'. This is *precisely* the issue in the *Ritter* case. Germany took negative income into account only for owner-occupied dwellings in Germany. Germany applied the territoriality principle equally to both resident and non-resident taxpayers. It is very striking that Advocate General Léger did not even *mention* (let alone discuss) the *Futura Participations* decision in his Opinion on *Ritter*.

In the meantime there is a new Dutch case pending before the ECJ that is very similar to the *Ritter* case. This case, known as the 'cross-border civil servant' case, is discussed in 3.2.3.

3.1.4. *Manninen*

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[50] In his Opinion Advocate General Léger denies this (see in particular points 103 through 111). However, this is based on the incorrect interpretation of the tax treaty between Germany and France. In its reference the German Federal Finance Court (*Bundesfinanzhof*) stated that the exclusion of the French losses is based on the France-Germany tax treaty.

At issue in the *Manninen* decision[51] was the application of the Finnish imputation system. Under this system, corporate tax paid was considered to be a pre-payment of the Finnish income tax. Economic double taxation was avoided in this way. When a dividend was paid by a company established in Finland to a shareholder resident in Finland, the shareholder was granted a credit for the Finnish corporate tax paid by the company. This credit was not granted for dividends paid by non-resident company. With a reference to decisions like *Verkooijen,* the ECJ held that the Finnish system discourages Finnish resident persons from investing in companies that are established in another Member State. What the ECJ did not take into account is that it is completely logical that an imputation system only takes Finnish corporate tax into account and not foreign corporate tax. An imputation system, in principle, has the effect that the total income a shareholder receives is taxed in Finland at the income tax rate (in the case at hand, a rate of 29%). The *method* used to achieve this is to give a credit for Finnish corporate tax. In an imputation system the corporate tax ultimately functions as a pre-payment of the income tax. Other methods can be used to ensure that a shareholder's income is only subject to income tax. For example, one might levy only income tax instead of corporate tax (at a rate of 29%) or simply a corporate tax at a rate of 29% (probably only when dividends are paid) but no income tax. In all these situations the ultimate Finnish income tax burden is 29%. If there is a tax burden in Finland of 29% on domestic dividends, then in my view Finland is entitled to tax foreign dividends with 29% income tax. In order to arrive at this result both foreign and domestic dividends can be taxed at one single rate (29%) as Belgium did, for example, in *Kerckhaert-Morres*[52]. I do not see what the difference is if a Member State decides to chop up its tax on distributed profits into different taxes. For example, a Member State levies corporate tax of 20% on profits and when the profits are distributed another 9% income tax (in other words, a total of 29%). Or a Member State first levies a corporate tax at a rate of 20% en then an income tax at a rate of 29% with a credit for the 20% (in other words, a total again of 29%). Finland, in my opinion, should be allowed to simply levy 29% Finnish income tax on foreign dividends. Finland does not levy any corporate tax on profits distributed as dividends. From the Finnish perspective, an imputation system is completely neutral: Finland levies a direct tax of 29% in domestic and foreign situations, whereby the taxation of domestic dividends is chopped up into two different taxes (corporate tax and income tax) and the tax on foreign dividends is levied only when they are distributed. The fact that no credit is given for *foreign* corporate tax arises from a disparity and is the result of the fact that other countries also exercise their sovereignty to levy tax on the profits made by companies established there. In my opinion, the Court paid insufficient attention in *Manninen* to the fact that the distinction being made is concomitant to Finland's sovereignty to tax profits once they enter Finland's tax jurisdiction. Viewed from the perspective of Finland's tax jurisdiction, the imputation system is totally neutral and the assumption of discrimination is nothing more than a consequence of the method used. Not crediting foreign corporate tax is a disadvantage that arises because several Member States are exercising their

51 ECJ 7 September 2004, case C-319/02*, Manninen*, ECR I-7477.

52 In this case Belgium taxes dividends received *once* at a rate of 25%.

sovereignty to levy tax (disparity) and it is not the consequence of a discriminatory tax system in *one* Member State.

As I observed above, there are very few differences between the *Kerckhaert-Morres* and the *Manninen* cases. In *Kerckhaert-Morres* both domestic dividends and foreign dividends were taxed in Belgium at a rate of 25%. The ECJ held that there is a difference between *Manninen* and *Kerckhaert* because in the latter 'the Belgian tax legislation does not make any distinction between dividends from companies established in Belgium and dividends from companies established in another Member State'. The ECJ then held that in cases of cross-border dividends Belgium does not have to grant relief for foreign withholding tax because 'In circumstances such as those of the present case, the adverse consequences which might arise from the application of an income tax system such as the Belgian system at issue in the main proceedings result from the exercise in parallel by two Member States of their fiscal sovereignty'. I agree with the decision in *Kerckhaert-Morres*, but do not agree with the Court's observation that there is a difference between the *Kerckhaert* and the *Manninen* decisions. In *Manninen* Finland, on balance, levied tax at the same rate (29%) in domestic and foreign situations; it was only the *technique* of levying the tax that was different (namely in domestic situations first corporate tax was levied and then income tax and in foreign situations income tax only). This means that there *appeared* to be a difference between the domestic and foreign situations, but in reality no such difference exists. Suppose that in *Kerckhaert* Belgium had not had a final tax of 25% on dividends, but instead levied a withholding tax of 25% on dividends, which could then be credited against the income tax, the rate of which was also 25%. In foreign situations only an income tax of 25% was levied. Under these circumstances the national legislation has exactly the same effect as that in the factual constellation of *Kerckhaert* (on balance, 25% tax on dividends in both domestic and foreign situations); however, should one all of a sudden draw the conclusion, on the basis of *Manninen*, that because Belgium grants a credit for domestic withholding tax in a domestic situation, it should also grant a credit for foreign withholding tax?!

3.2. *Pending cases before the ECJ*

3.2.1. *Orange European Smallcap Fund: refund of foreign dividend withholding tax*

In April 2006 the Netherlands Supreme Court requested a preliminary ruling in the *Orange European Smallcap Fund* case (C-194/06). If the complexities that play a role in this case are ignored, one of the most important questions is a difference in the tax treatment of domestic and foreign-source dividends. In the case at hand, an investment fund established in the Netherlands (subject to a tax rate of 0%) has sought a full refund of the foreign withholding tax levied on dividends received. Dividend tax is levied on domestic dividends and is then refunded to the investment fund. The Supreme Court has observed the following on the issues involved:

> 'With respect to the relief, a distinction is made – even if the investment fund were to have only Dutch shareholders – on the basis of whether the dividends are received from Netherlands resident companies or from non-resident companies. This distinction – which leads to a more favorable treatment of the Dutch dividends – is a restriction of the free movement of capital which the taxpayer is

> entitled to exercise. In light of the purpose of the relief – to relieve an investment fund from tax on incoming dividends – an investment fund that holds investments solely in the Netherlands and an investment fund that also invests abroad are in a comparable situation with regard to where their capital is invested. Whether this is also the case if the purpose of the special regime for investment funds is looked at its totality and consequently the comparison is made at the level of the shareholders is an open question. Shareholders who invest directly also are faced with the difference in treatment between Dutch dividends, which may be granted a credit in the Netherlands, and foreign-source dividends that do not receive a credit. On the grounds of the decision of the Court of Justice of the European Communities of 7 September 2004, Manninen, C-319/02, ECR 2004, p. I-7477, *BNB* 2004/401, such a distinction, if its disadvantageous effects are not removed by a tax treaty, is in conflict with Article 53 EC, unless there is an objective difference in the situation. The question arises whether from the point of view of the investment fund and its shareholders the withholding of foreign dividend tax and the withholding of Netherlands dividend tax can be seen as comparable. In contrast to the national regulation at issue in the Manninen case, the Netherlands regulation on the withholding, taxation and crediting of dividend tax is not aimed at avoiding (economic) double taxation of the profits of the company distributing dividends. The credit for domestic withholding tax is a pre-payment of the income and corporate tax owed by the shareholder on the dividends received. In this respect, the credit is different from the one at stake in the Manninen decision and it is also different from the credit for foreign dividend tax. The possibility of crediting foreign dividend tax is based on the desirability of preventing two countries from taxing the same person on the same item of income; nevertheless, because from the point of view of the country giving up taxation rights reciprocity is viewed as being fair, it depends on the provisions in the applicable tax treaty. Seen thus, grounds 1 leads to a question on European law which the case law of the Court of Justice has yet answered completely.' (author's translation)

The Supreme Court observed that the circumstances in this case are different from those in the *Manninen* decision. I wonder, though, whether there really is a difference here. The Supreme Court observed that the Netherlands regulation does not have the aim of avoiding (economic) double taxation of the distributed profits of the company paying the dividends but that the credit for domestic withholding tax has the aim of serving as a pre-payment of the income and corporate tax owed by the Dutch shareholder on the dividends received. This is, however, not a *real* difference. The Finnish corporate tax functions in the imputation system as a pre-payment for the Finnish income tax. The ECJ was not aware of this in *Manninen*, but recently Advocate General Geelhoed pointed it out to the Court in his Opinion in the *FII* case[53]. The difference between the Finnish and the Netherlands system is a consequence of a difference in the method used to levy tax. As I pointed out earlier, one can very well levy tax at different points in time and on different persons on the profits made and subsequently distributed (see section 3.1.4).

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[53] Opinion of Advocate General Geelhoed in case C-446/04, *Test Claimants in the FII Group Litigation*, point 5.

Another difference the Supreme Court mentioned is that in *Manninen* there is an issue of economic double taxation (because tax is levied first in the hands of the company and later in the hands of the shareholder). In *Orange European Smallcap Fund*, in contrast, there is juridical double taxation (because tax is levied in hands of the same person on the same income). But even the difference between economic and juridical double taxation is merely the consequence of the method of levying taxes. Let us suppose that the Netherlands withholding tax was not levied by means of a dividend tax on the shareholder but by means of corporate tax levied on the company distributing the dividends (the Netherlands used to have exactly this kind of tax to prevent the distribution of "superdividends"). All of a sudden there is not much of a difference with *Manninen* because there *is* economic double taxation. In my view, the difference in the method used to levy tax is not enough for an objective difference in the situation. Thus, in *Orange European Smallcap Fund* there is no difference between a domestic and a foreign-source dividend. In both situations the dividend is taxed at 0%. In the domestic situation dividend tax at a rate of 25% is levied, but this is refunded because an investment fund pays tax at a rate of 0%. The Netherlands "levies" tax at a 0% rate on foreign-source dividends in the hands of the investment fund and thus does not have to refund Netherlands dividend tax, because no Netherlands dividend tax was levied. That dividend tax *is* levied abroad on the dividends is the consequence of the application of the Member State's discrete tax systems. Here we see a disparity, and not a prohibited restriction. As I have explained in section 3.1.4., the ECJ should have given this holding in *Manninen*. The ECJ held instead that there was a restriction of the free movement of capital.

I wonder what the ECJ will do with regard to *OESF*. If the ECJ takes a dogmatic position and follow *Manninen* (in my view, an incorrect one), it will consider the Netherlands provision to be a restriction of the freedom of movement. It is possible, however, that the ECJ will mend its ways and, encouraged by the Supreme Court's observations, realize that there is an objective difference between the *OESF* case and the *Manninen* case and thus move back in the direction of *Kerkhaert-Morres*.

3.2.2. *Lidl Belgium, SEW and Deutsche Shell: set-off of foreign PE losses*

In 2006 a number of German cases were referred to the ECJ that give it the opportunity to hand down a ruling on the application of the territoriality principle to residents.

In *Lidl Belgium* (case C-414/06)[54] and *Stahlwerk Ergst Westig* (*SEW*; case C-415/06)[55] at issue is the fact that losses of a foreign permanent establishment may not be set off. In *Lidl Belgium* there is a loss-making PE in Luxembourg; in *SEW* a loss-making PE in the United States. Although Germany taxes its residents on their worldwide income, a tax base exemption applies under the tax treaties with Luxembourg and the US, respectively. This exemption is applied strictly; in other words, both profits and losses are removed from the taxable base. On balance, with respect to income derived in those countries, Germany taxes only income derived in the territory of Germany and thus applies the

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54 *Lidl Belgium GmbH & Co. KG/Finanzamt Heilbronn*, C-414/06, OJ 30-12-2006, C 326/26.

55 *Stahlwerk Ergste Westig GmbH/Finanzamt Düsseldorf-Mettmann*, C-415/06, OJ 30-12-2006, C 326/26.

territoriality principle. In *Deutsche Shell* (case C-293/06)[56] there is a variation on this theme. A currency exchange loss is allocable to an Italian PE of a German resident. Germany does not take this loss into account since as a result of the tax base exemption the loss is not included in the taxable base. Italy does not take the loss into account because there has not been a currency exchange loss there.
In *Lidl Belgium* and *SEW* one can argue[57] that there is a restriction of the freedom of movement because in a domestic situation Germany *does* take the losses of a second establishment into account. Suppose a person has a hairdressing salon in Bonn and makes a profit of 10. He decides to open a second shop in Munich and makes a loss there of 4. He will be taxed in Germany on 6 (10 minus 4); however, if he decides to open his second salon in Paris instead of Munich, he will have a profit of 10 in Germany and a loss of 4 in France. Germany does not take the French loss into account (tax base exemption) and in France he has no possibility to utilize the loss because he has no profits there against which it can be set off. The taxpayer could argue that Germany has restricted him in his right to open a second establishment in another Member State. If there is an establishment in Germany, 6 will be taxed, but when there is an establishment in France 10. In the tax literature the position is taken that in this kind of situation there can be said to a restriction of the freedom of movement.[58] The same standpoint can be taken in the *Deutsche Shell* case, where moreover the fact that in this case the currency exchange loss will never taken into account (neither in Germany nor in Italy) will be examined.
In my view, the ECJ should hold in the above cases that there is no restriction. The fact that a domestic situation is treated differently results from the fact that Germany has limited its tax jurisdiction to income from German sources (application of the territoriality principle). In the relevant tax treaty Germany and the other Member State have agreed that PE profits and losses will be allocated to the PE state for purposes of taxation (if any). Member States are free to limit their tax jurisdiction and to allocate their taxation rights among themselves. The disadvantageous effect of such an allocation is a disparity; it is the consequence of the fact the taxpayer in question falls under two

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56 *Deutsche Shell GmbH/Finanzamt für Grobunternehmen in Hamburg*, C-293/06, OJ 30-09-2006, C 237/3.

57 It should be noted that in *SEW* the permanent establishment is in the United States and thus, in a third country. The right of establishment is thus not applicable (this freedom is only applicable to establishment in 'another' Member State). The first question to be answered here is whether SEW may avail itself of the free movement of capital between the Member States and third states (Art. 56 EC).

58 See: E. Lechner, Implications of EC law on the 'exemption' of losses under tax treaties, in Tax treaties and EC law, Gassner/Lang/Lechner (eds.), Series on International Taxation No. 16, Kluwer, 1997, p. 73 and more recently (based on, among other cases, the *Ritte* case): A. Cordewener, Foreign losses, tax treaties and EC fundamental freedoms: a new German case before the ECJ, European Taxation 2003/9, p. 294; A. Cordewener, M. Dahlberg, P. Pistone, E. Reimer en C. Romano, The tax treatment of foreign losses: Ritter, M&S, and the way ahead (part one), European Taxation 2004-4, p. 135 en part two (European Taxation 2004-5, p. 218), in particular section 5; A. Körner, Reference to the ECJ by the German federal fiscal court for a preliminary ruling: does European law require cross-border loss relief, Intertax 2003-12, p. 489.

different tax systems. This kind of situation is also described as a ‘dislocation’[59]. It is clear that not being able to set off foreign losses is disadvantageous for the Internal Market, but this does not mean that there is a prohibited restriction of the freedom of movement. The disadvantage has to be removed by a unilateral, bilateral or multilateral measure or by means of Community law. If the ECJ were to hold that a restriction exists, this would seriously infringe the tax sovereignty of the Member States since it would mean that Member States are no longer free to choose how to delimit their tax jurisdiction and how to allocate their taxation rights. A tax system based on territoriality would no longer be possible. Member States would always be compelled (in the case of losses) to take worldwide income into account. The Court would be directly contravening its own case law (for example, *Gilly*), in which the Member States *are* allowed such freedom.

3.2.3 *The Dutch cross-border civil servant: the* Ritter *case issues once again before the ECJ*

The issues in the first preliminary question in the *Ritter* case were once again brought before the ECJ in a similar Dutch case. The Netherlands Supreme Court requested a preliminary ruling in the case on 22 December 2006.

The taxpayer in this case has the Netherlands nationality. In December 1993 he emigrated from the Netherlands to Belgium. During the years in question (1996 and 1997) he lived in his own dwelling, which he had bought at the end of 1993 and which was financed by a mortgage from a Dutch bank.

The taxpayer was employed in 1996 and 1997 by a Netherlands municipality and earned his entire employment income in the Netherlands.

In making the assessments that are at issue in the case the tax inspector did not accept the deduction of the losses of the taxpayer’s Belgian residence, namely the interest paid on the mortgage and the rental value of the home.

Under the Netherlands law in force at that time a Netherlands national who was employed by a Netherlands governmental body (as was the case here) was considered to reside in the Netherlands (deemed residence provision). This meant that he was a resident taxpayer and subject to tax on his worldwide income. For resident taxpayers a deemed amount with respect to owner-occupied dwelling is added to income as the “rental value” of the dwelling and the financing costs (the amount of interest paid) may then be deducted from this amount. Generally, the result is a negative amount from an owner-occupied dwelling. This amount may then be deducted from employment income, thus creating a tax advantage. In the case at hand, the taxpayer had negative income from his own dwelling because of the deductible mortgage interest and wanted to deduct this amount from his Netherlands income. In principle, it is possible to do this under

59 See: Terra/Wattel, European Tax Law , Fourth edition, 2005, KLI, p. 58. For more detail on the concept ‘dislocation’: S. Doema, The three Ds of direct tax jurisdiction: Disparity, Discrimination and Double Taxation, European Taxation 2006-11, p. 522. I agree with Douma that a ‘dislocation’ is not a separate category from (permitted) disparities and prohibited discrimination. However, I do not agree with him that situations such as these can considered to be prohibited discrimination. Dislocations result from the fact that in a cross-border context a taxpayer falls under two tax systems, each of which have determined their own (limited) tax jurisdiction. In this case, there is thus a (permitted) disparity.

Netherlands law because the taxpayer is a (deemed) resident taxpayer and thus subject to tax on his worldwide income.
In its decision of 12 March 1980, No. 19180, BNB 1980/170, the Supreme Court held, however, that with respect to income that is allocated to Belgium under the tax treaty, in a case such as the taxpayer's, the deemed residence provision in the Netherlands law must yield to the provisions of the tax treaty. In this case, the tax treaty between Belgium and the Netherlands provides that the taxpayer for tax treaty purpose will be considered to be – exclusively – a resident of Belgium (Art. 4, Residence, of the tax treaty). Under Art. 19, the Netherlands may tax the taxpayer's employment income. Art. 6 of the treaty provides that income from immovable property may be taxed in the country where the property is located; thus, in the case at hand, in Belgium.
As a result, with respect to income from his owner-occupied dwelling the taxpayer falls under the regime for non-resident taxpayers. This means that under the treaty the income, negative or positive, allocated to Belgium for taxation does not affect the income, positive or negative, that is allocated to the Netherlands for taxation.
According to settled case law, the tax treaty thus means that the Netherlands may tax the employment income but that it may not take into account (negative) income from an owner-occupied dwelling (Belgium is allowed to tax this). The Netherlands thus – on balance - applies an exemption with respect to income from an owner-occupied dwelling located in Belgium: both negative and positive income from the Belgian dwelling is removed from the Dutch taxable base. This is *exactly* the same as in the *Ritter* case.
This means that the Dutch non-resident civil servant may not deduct the negative income from his Belgian dwelling from his Netherlands income. At issue here, just as in *Ritter*, is whether this is a restriction of the freedom of movement (the free movement of workers and the free movement of capital).
The Supreme Court is of the opinion that not taking into account the negative income from the Belgian dwelling is a restriction of the taxpayer's freedom to work in a Member State (the Netherlands) without residing there, as well as of his freedom to invest capital in a dwelling in another Member State than the one in which he works. According to the Supreme Court, such restrictions would appear in principle to be incompatible with the Treaty freedoms.
Furthermore, the Supreme Court indicates that in the case at hand there cannot be said to be an advantage as a consequence of the taxpayer's personal or family situation. The *Schumacker* decision is therefore not applicable. In addition, the Supreme Court observes that the possibility to set off negative income from one source against positive income from another within a single tax jurisdiction cannot be said to be a general characteristic of direct taxation. Under international tax law, it is thus not so that a person who is availing himself of the freedom of movement guaranteed by the EC Treaty and as a result is subject to tax in various Member States has to be given the opportunity to set off losses in at least one of the Member States. The Supreme Court observes, however, that in the Netherlands resident taxpayers (subject to unlimited tax liability) may set off negative income from a Netherlands owner-occupied dwelling against income from other sources such as employment income.

The Supreme Court then held:

> 'The taxpayer in essence argued that, since he has exercised his right to free movement, the possibility must be open (or remain open) to effectively enjoy the advantages – in the case at hand, the set-off of negative income from the Belgian dwelling – that are granted to persons in the Netherlands who are subject to unlimited tax liability, if he is to a large extent in a comparable situation with respect to his income and the place where the income is derived, as those persons who are subject to unlimited tax liability in the Netherlands. In such a situation there is no justification for the unequal treatment by the Netherlands of taxpayers subject to unlimited tax liability and the taxpayer himself with regard to the levy of tax by the Netherlands on the income derived in the Netherlands.
> A similar line of reasoning was supported by Advocate General Léger in his Opinion in the Ritter-Coulais case (see, in particular, point 98 of the Opinion). Nevertheless, there are also arguments against allowing Community law to develop in this direction. For these arguments the Supreme Court refers to the Opinion of Advocate General P.J. Wattel, under 2, of 19 April 2006, in particular parts 3 and 4.' (author's translation).

The nice thing about this decision is that the Supreme Court contrasts the views of Advocate General of the ECJ in the *Ritter* case (Léger) and the views of the Netherlands Advocate General in this case (Wattel).

The Supreme Court then made the following request for a preliminary ruling:

> Should Articles 39 and 56 EC be interpreted as meaning that one of the articles or both of the articles preclude a taxpayer who (on balance) has negative income from an owner-occupied dwelling and who earns his positive income, in particular, employment income, entirely in another Member State than the one he where he resides, from not being allowed by the other Member State (employment state) to deduct the negative income from his taxable employment income, although the employment state does allow its residents to do so? [author's translation]

As I already explained in 3.1.3., I am of the opinion that in this case there cannot be said to be a restriction. It is striking that the Supreme Court does not mention the *Futura Participations* decision. This decision clearly shows that the ECJ does not require foreign losses of non-residents have to be taken into account on grounds of the EC Treaty freedoms. This is the identical issue to the one in this case. In this respect, I am surprised that the Supreme Court is of the opinion that 'in principle' a restriction exists. *Futura Participations* shows us that in this case there is in fact *no* restriction.

4. Conclusion: the ECJ's case law is incorrect from a dogmatic point of view because the Court does not pay heed the *consequences* of its own basic assumptions

Because there are no general Community law rules on direct taxation, the Member States have the power to determine the criteria for taxation (unilaterally or in tax treaties) in order to delimit their tax jurisdiction and avoid double taxation, according to the ECJ's

settled case law. In other words, the ECJ has held that the Member States have the sovereignty to levy direct taxes.
That the Member States have the power to determine the criteria for taxation means (and is inherent to the fact that) the Member States are also free to limit their tax jurisdiction and (thus) to not levy tax on a certain person or type of income. It appears from various ECJ decisions, however, that the ECJ does not respect the freedom of the Member States to limit their tax jurisdiction. In *Bosal Holding* the ECJ forced the Netherlands to allow the deduction of participation costs, even though these costs were connected to profits over which the Netherlands had no tax jurisdiction. We see in *Marks & Spencer* that the UK, under certain conditions, had to take into account foreign-source losses of a non-resident, even though the losses fell outside the UK's tax jurisdiction. In the *Ritter* case the tax treaty between Germany and France provided that profits and losses from real property could only be taxed in the Member State in which the real property was located. The taxation rights between France and Germany were allocated and limited under the treaty. Under the tax treaty, Germany does not have to take into account losses from real property in France but nevertheless Advocate General Léger suggested to the ECJ in his Opinion in the *Ritter* case that under the Treaty freedoms Germany *did* have to take the losses incurred by a French resident for real property located in France. In *Ritter* the ECJ did not get around to answering this question; however, in the meantime there is a similar Dutch case before the ECJ so that it will be given a second chance.
In *Manninen* Finland was not allowed to subject foreign-source dividends to the same tax burden as domestic dividends because the ECJ was of the opinion that Finland had to take into account the taxation in another Member State. Finland had to give a credit for the foreign corporate tax, despite the fact that the foreign corporate tax was levied outside Finland's tax jurisdiction. In *Kerckhaert-Morres* we see that all of a sudden the ECJ does recognize the existence of various tax jurisdictions (and the disadvantages that result). However, if one looks closely there are very few differences between *Manninen* and *Kerckhaert*. In the pending case *European Orange Smallcap Fund* issues that are similar to *Manninen* are once again at stake and we will see the direction in which the ECJ is going.
In the German cases *Lidl Belgium*, *SEW* and *Deutsche Shell,* whether a residence state must always allow the set of foreign PE losses will be examined. In these cases the ECJ will have to decide whether the territoriality principle may be applied.

Cases such as *Bosal Holding*, *Manninen*, *Marks & Spencer* and the Opinion in *Ritter* conflict with the ECJ's own basic assumption: that the Member States are free to determine the criteria for taxation, in order to delimit tax jurisdiction and to avoid double taxation. Although the Member States in *Bosal Holding*, *Marks & Spencer*, *Ritter* and *Manninen* limited their tax jurisdiction in a neutral fashion (by not taxing certain persons or types of income), the ECJ does not want to accept the *consequences* of this limitation of tax jurisdiction. The ECJ considers the disadvantages that arise from the independent application of various tax systems (disparities: for example, the non-utilization of losses in *Marks & Spencer* and *Ritter* and double taxation in *Manninen*) as restrictions of the freedom of movement. In my view, the ECJ should, nevertheless, have held that here there are disadvantages that arise from allowable disparities.

Nevertheless, there is light on the horizon. In the *Kerckhaert-Morres* case the ECJ accepts the fact – and rightly – that some of disadvantages of cross-border movement have their origin in the application of different tax systems. The ECJ will be able to reconsider *Manninen* in the pending *European Orange Smallcap Fund* case; in the Dutch cross-border civil servant case the Court can overrule the Opinion of Léger in the *Ritter*-case and confirm *Futura Participations;* the German cases *Lidl Belgium*, *SEW* and *Deutsche Shell* could lead to a fine-tuning of *Marks & Spencer*. At least: I hope so. We'll just have to wait.