Court Case Analysis
C-231/05 - AA Oy

32E29000 - European and International Tax Law

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C-231/05 (KHO 2007:93)
– IG Financial Transfer, Deductibility in Taxation, Compatibility with Community Law

Background – Group Contribution to Foreign Parent

- UK Parent AA Ltd had incurred losses during 2003 (expected losses in 2004 and 2005)
- Intra-group financial transfer from a Finnish (wholly-owned) subsidiary Oy AA to secure and stabilize the group-wide financial position
- Finnish Central Tax Commission refused to issue a positive preliminary decision and rejected Oy AA's deduction right concerning the financial transfer

Key Questions – Justified Restriction of Basic Rights?

Requirement: deductible intra-group financial transfer and the corresponding taxable income had to fall *under the Finnish taxation system*

- *De facto* discrimination of foreign entities cf. domestic companies – **justifiable basis?**
- Restriction of EU basic freedoms – **necessity?**
- Protection of national interests at the expense of EU (corporate) citizens – **proportionality?**

Do **Articles 43 EC and 56 EC** (having regard to Article 58 EC and Directive 90/435/EEC) preclude the system established by the Finnish Law on Intra-Group Financial Transfers, **which makes the deductibility of intra-group financial transfers subject to the condition that the transferor and the transferee be national companies**?

Legal Context – Finnish Laws and Tax Rules

Intra-Group Financial Transfers and Tax Deductibility

- Finnish Act on Intra-Group Financial Transfers (Fin: *laki konserniavustuksesta verotuksessa*, 825/1986)
- ”**Intra-group financial transfer**” (Fin: *konserniavustus*)
  - A transfer made by a company limited by shares, or by a cooperative company which carries on a business, for the purposes of the business of another company limited by shares or cooperative company, which is not an investment of capital, not deductible from income pursuant to the Act on Taxation of Business Income (Fin: *elinkeinotulon verottamisesta annettu laki*, 360/1968)

- **National** company limited by shares or a cooperative company (*Parent*) holding **at least 9/10** of the capital of another **national** company limited by shares or cooperative company (*Subsidiary*)
- The Parent may **deduct the intra-group financial transfer from its taxable business income** (income arising from a taxable business activity of the Subsidiary)
  - Applies to transfers by the Subsidiary in favour of the Parent
- Deductible *only if* the **corresponding expense and income are entered in the accounts of the transferor and transferee concerned**

Legal Context – EU Laws

Basic Freedoms and Intra-Group Profit Distribution

- **Parent-Subsidiary Directive** (2011/96/EU, formerly Directive 90/435/EEC, as amended by Directive 2003/123/EC)
  - 5 Art. – Profits which a subsidiary distributes to its parent company shall be exempt from withholding tax
  - 6 Art. – The Member State of a parent company may not charge withholding tax on the profits which such a company receives from a subsidiary

- **TFEU** (formerly the Treaty Establishing the European Community)
  - 49 Art. (43 Art.) – restrictions on the **freedom of establishment** of nationals of a Member State in the territory of another Member State shall be prohibited
  - 63 Art. (56 Art.) – restrictions on the **movement of capital** between Member States and between Member States and third countries shall be prohibited
  - 65 Art. (58 Art.) – permitted: (a) distinction between taxpayers who are not in the same situation and (b) prevention of infringements of national law and regulations

CJEU’s Analysis – Legal Basis

Relevant EU Laws and Rights

- **Parent-Subsidiary Directive**
  - Governs the tax treatment of dividends and other benefits distributed by a subsidiary to its parent company, but <u>does not govern</u> the first taxation of income arising from a business activity or financial consequences of an intra-group financial transfer → Not relevant
- **TFEU** (EC Treaty)
  - 49 Art. (43 Art.) – freedom of establishment
  - 63 Art. (56 Art.) – free movement of capital
  - Case concerns a shareholding which gives its holder definite influence over the company’s decisions and allows that holder to determine the company’s activities
    → Provisions concerning **freedom of establishment** are decisive (see e.g. *Baars*, *Cadbury Schweppes and Cadbury Schweppes Overseas*, *Test Claimants in Class IV of the ACT Group Litigation*)
- **Prerequisites of permissibility**
  - Pursuance of legitimate objectives compatible with the EU Treaties
  - Justification by overriding reasons in the public interest, and
  - Measures are appropriate to ensuring the attainment of those objectives

CJEU’s Analysis – Justifiability, Necessity, Proportionality

Permitted Restriction on the Freedom of Establishment?

- **Rationale of the national legislation**
  - System of intra-group financial transfers in force in Finland is to **remove tax disadvantages inherent in the structure of a group of companies** by allowing a balancing out within a group that comprises both profit-making and loss-making companies
  - The intra-group financial transfer is thus designed to **promote the interests of a group of companies**
  - **N.B.** Deductibility tied to nationality – foreign companies receive less favourable tax treatment than their local/domestic counterparts

- **Justification** – limited territorial competence of a Member State and threat of tax avoidance
  - In a cross-border situation, a Member State cannot influence the tax treatment of the transfer by the Member State of the transferee and is not able to:
    a) ensure that the deduction allowed corresponds to the taxable income of the transferee in its State of residence, and
    b) prevent a situation in which the transfer made is not taxed at all

CJEU's Analysis – Justifiability, Necessity, Proportionality (*cont'd*)

Permitted Restriction on the Freedom of Establishment?

- **Arguments *pro***
  - *Coherence of tax systems* – Need to ensure the coherence of the tax system concerned, and by the allocation of taxation powers between the Member States, the fear of tax avoidance and the principle of territoriality
  - *Prevention of tax avoidance and evasion* – Safeguarding of a balanced allocation of the power to tax between the various Member States, the risks of the double use of losses and of tax avoidance as well as evasion to low taxation jurisdictions
    - **N.B.** Finnish system of intra-group financial transfers does not concern the deductibility of losses
  - *Principle of territoriality* – Member States are entitled to tax income generated on their territory, the system at issue in the main proceedings reflects the consensus in the matter of the international allocation of the competence to tax

CJEU’s Analysis – Justifiability, Necessity, Proportionality (*cont’d*)

Permitted Restriction on the Freedom of Establishment?

- **Arguments *contra***
  - A Member State may make deductibility of the intra-group financial transfer from the transferor’s taxable income subject to conditions concerning the treatment to be applied to the transfer by that other Member State
  - Subsidiaries of parent companies which have their corporate establishment in another Member State do not differentiate from the subsidiaries of parent companies which have their establishment in Finland with respect to the aims pursued by the (Finnish) system of intra-group financial transfers (the two categories *are not* incomparable)
  - Mere possibility to attain the pursued objective by creating a local branch (UK Government) is not relevant (TFEU Art 49, para 1: “*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*”)

CJEU's Analysis – Justifiability, Necessity, Proportionality (*cont'd*)

Court's Analysis and Conclusions

- Balanced allocation of the power to tax between Member States cannot justify systematically refusing to grant a tax advantage to a resident subsidiary, on the ground that the income of the parent company is not capable of being taxed in the first Member State, but is acceptable when the system is designed to prevent conduct capable of jeopardising the right of the Member States to exercise their taxing powers in relation to activities carried on in their territory
- Where companies are given the right to elect to have their losses taken into account in the Member State in which they are established or in another Member State this would seriously undermine a balanced allocation of the power to impose taxes between the Member States
- Finnish system of intra-group financial transfers is able to prevent tax avoidance practices exploiting disparities between the bases of assessment or rates of tax applied in the various Member States and designed only to avoid the tax normally due in the Member State of the subsidiary on its profits.
- Finnish legislation can be regarded as proportionate to the objectives pursued, taken as a whole (taken into account its additional effects on prevention of artificial arrangements and tax evasion)

Conclusions and Discussion

- **Key objects of legal protection**
  - Safeguarding the balanced allocation of the power to tax between the Member States
  - Prevention of tax avoidance
- **Key arguments**
  - Groups of companies would be allowed to choose freely the Member State in which their profits will be taxed, to the detriment of the right of the Member State of the subsidiary to tax profits generated by activities carried out on its territory (*excessive/detrimental discretion*)
  - Such detriment cannot be prevented by imposing conditions concerning the treatment of the income arising from the intra-group financial transfer in the Member State of the transferee, or concerning the existence of losses made by the transferee (*proportionality*)
- **Implications**
  - National focus – limited possibilities to adjust group-fide result with 'national' instruments
  - Emphasised the need for further harmonization of corporate taxation(?)

- **N.B.** treatment of final losses – C-123/11, C-607/17 (pending) and C-608/17 (pending)