Aalto-yliopisto

Case: Marks & Spencer, C-446/03

32E29000 European and International Tax Law
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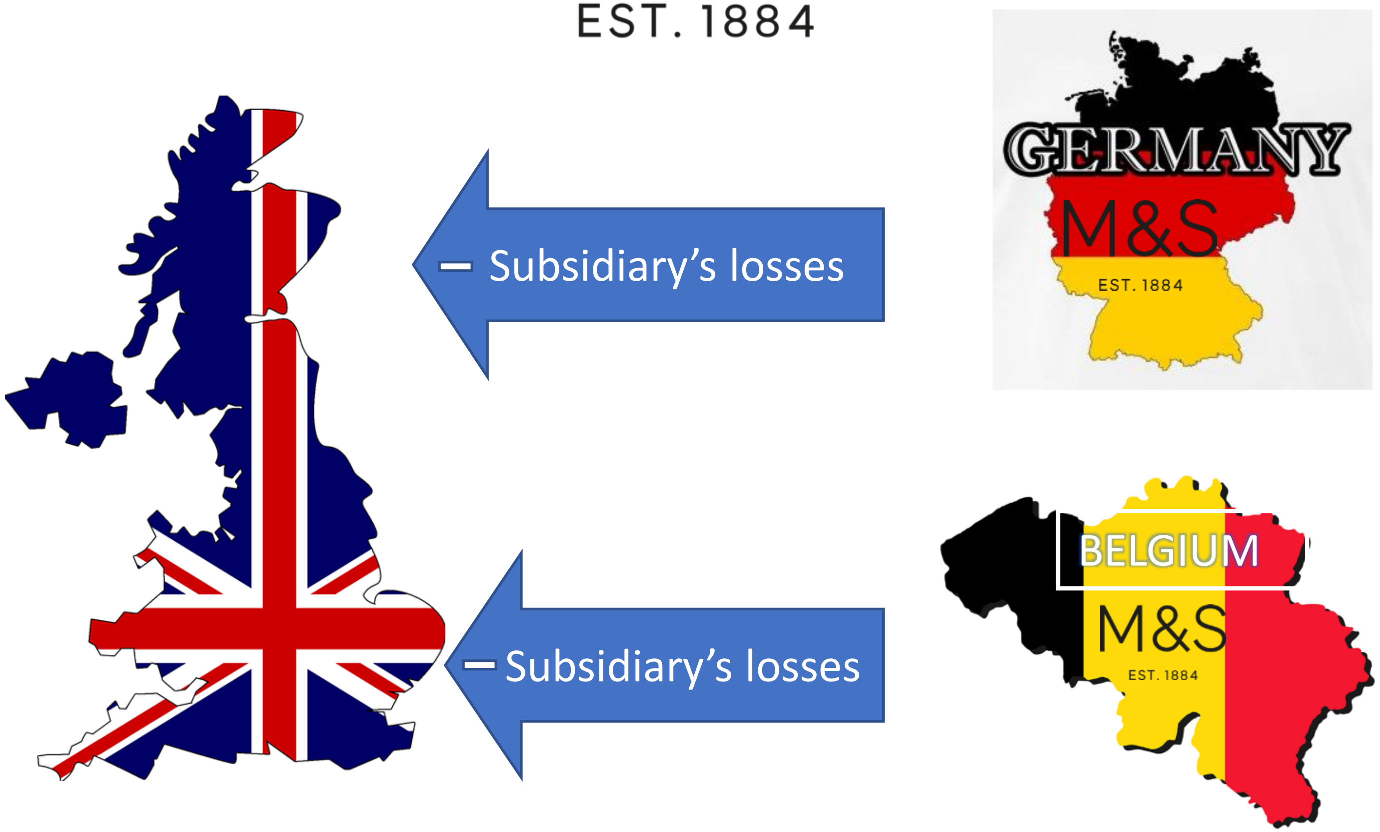
Background

M&S

EST. 1884



- In 2001, Marks & Spencer decided to divest itself of its Continental European activity due to increasing losses. Subsidiaries in Belgium and Germany had ceased trading by the end of the year.
- M&S demanded the losses incurred by the subsidiaries from 1998 to 2001 to be deducted from the parent company's taxable income in the UK. The subsidiaries had no PE in the UK.
- Under UK law the losses of the subsidiaries would have been deductible if the subsidiaries were resident in the United Kingdom.
- M&S's claim was not accepted by UK's tax authority or appeal process.
- M&S appealed to the Supreme Court (High Court of Justice of England and Wales), which decided to refer the case to the ECJ.

  European Court of Justice ruling C-446/03 Marks & Spencer is perhaps the most significant cross-border loss solution to date.

Tax treatment of cross-border losses

Two opposite views:

- sovereignty of states regarding direct taxation
- on the other hand, this power must be exercised in compliance with EU law
  - ➢ harmonization in the area of direct taxation has been non-existent
  - ➢ however, the EU law also contain general provisions on direct taxation.

- For tax treatment of cross-border losses the main provision is found in Article 49 of the Functioning of the European Union (TFEU):
  - ➢ Restrictions on the freedom of establishment are prohibited.

- The problem with cross-border losses especially related to the following situations:
  - ➢ Losses incurred in another MS by a subsidiary are mainly not deductible in the parent company's taxation in the home country of the parent company
  - ➢ Losses incurred in another MS by a PE are not deductible in the resident state's taxation when the tax treaty is applicable and it's possible to use the exemption method

- There is a problem in terms of the freedom of establishment
  - ➢ a company established in another MS is treated less favourably taxwise

MARKS & SPENCER

UK's group relief system

- Group relief system enables intra-group loss transfer

➢ Enables transfer of losses from a loss-making company to another company within the same group

➢ prerequisite: to be able to transfer the losses, the group companies involved in the transfer must be taxable in the UK.

➢ In the group relief system there are no actual transfer transactions to be recorded in the accounting (cf. group contribution)

- Group companies are treated as separate taxable entities

➢ The problem with EU law and freedom of establishment: under the group relief rules the **companies involved in the group relief must be UK resident or have a UK taxable presence** from which the losses arise

The Marks & Spencer case was about the group relief system's restrictive nature regarding the freedom of establishment

ECJ’s judgment C-466/03 Marks & Spencer: Cross-border loss preliminary ruling

Is it allowed to prevent the resident parent company from deducting from its taxable profit’s losses incurred in another MS by a subsidiary established in that MS if they would allow the deduction if the losses were incurred by a resident subsidiary?

<u>ECJ’s decision on 13.12.2005:</u>

- Marks & Spencer **had exercised its freedom of establishment** by setting up subsidiaries in Germany and Belgium.
- The possibility of intra-group loss relief constitutes a tax advantage for the company
- The refusal to grant this tax advantage in the case of losses incurred by a subsidiary resident in another MS may prevent the parent company from establishing itself in another MS in the form of a subsidiary.
- **There is a restriction** on freedom of establishment within the meaning of the TFEU
- **Different tax treatment of the two comparable situations must have acceptable justifications**

ECJ's judgment C-466/03 Marks & Spencer: The justifications for restricting the freedom of establishment

ECJ examined the justification grounds based on the consequences of the unconditional application of the group relief regime also in cross-border situations.

1. A balanced allocation of taxing rights between MSs

- *in principle, the reduction in tax revenue cannot be regarded as a justification for the restriction of the fundamental freedom.*
- *However, the ECJ held that a balanced allocation of fiscal powers would be jeopardized.*

2. The need to prevent from losses being taken into account twice

- *ECJ: There is a risk of double use of losses → MSs have the right to prevent such a risk*

3. Preventing tax evasion

- *The right to transfer losses between MSs involves the risk of transferring losses to the MS with the highest tax rates → this risk can be prevented by allowing intra-group loss transfer only in domestic situations*

ECJ's judgment C-466/03 Marks & Spencer: The justifications for restricting the freedom of establishment

- ECJ accepted the grounds of justification 'considered together': none of the three grounds alone would have been sufficient
- ➢ Such a review of justification criteria has not been the subject of previous case law on income taxation.
- However, **the provision** restricting the freedom of establishment **did not meet the criteria of proportionality** insofar as a subsidiary resident in another MS had exhausted all the possibilities to take losses into account in its own state of residence.
- **UK had to accept foreign subsidiaries final losses deduction in taxation of the parent company in the UK.**
- On the other hand, it was not contrary to the freedom of establishment that the transfer of losses was not allowed to cover the temporary losses of a foreign subsidiary.

The system was considered to limit the freedom of establishment, but this restriction resulting could be acceptably justified

BUT

However, the restriction could not be accepted when the subsidiaries were disbanded and the losses were final.

Marks & Spencer is a milestone regarding the development of the ECJ case law

- Before the Marks & Spencer judgment, there was barely any EU law-based justifications for discriminatory or restrictive tax provisions
  - ➢ In this respect, the Marks & Spencer and subsequent case law on cross-border losses have changed the situation

- A clear change was **the joint review of the justification criteria**, which was not previously reported in the case law on income taxation.
  - ➢ Now the ECJ accepts a combination of several justification grounds as justification.
  - ➢ In the judgments given after the Marks & Spencer judgment, one or more acceptable justification grounds could be found for the restriction of the freedom of establishment.
  - ➢ Finding the justification is already almost clear in cases of cross-border losses, and nowadays the interest lies mostly in the matter of proportionality analysis.

- The ECJ's departure from the subject-to-tax principle was originally due to its objective of making the final losses deductible.
  - ➢ According to the subject-to-tax approach, the comparability of the two situations is resolved according to whether the MS has the right to tax in both cases. A MS must treat situations that are both subject to its tax jurisdiction on an equal footing. However, the United Kingdom did not have the right to tax a subsidiary located in another MS for its earnings. Compliance with the subject-to-tax approach should have led to a lack of comparability between the cross-border and domestic situations.