FÉDÉRATION DES EXPERTS
COMPTABLES EUROPÉENS

FEE OBSERVATIONS ON

EUROPEAN COURT OF JUSTICE DECIDED CASE C - 446/03
MARKS & SPENCER
V.
HER MAJESTY'S INSPECTOR OF TAXES

June 2006

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1. INTRODUCTION TO FEE

The Fédération des Experts Comptables Européens (FEE) is the representative organisation for the accountancy profession in Europe. FEE's membership consists of 44 professional institutes of accountants from 32 countries. FEE Member Bodies represent more than 500,000 accountants in Europe. Professional accountants are the major providers of tax advice and services in Europe.

2. THE FACTS OF THE CASE

Marks & Spencer is a retailer group registered in the UK. By 2000 the parent company had established subsidiaries in the UK and in 35 other countries in the world although it is only the subsidiaries established in the three EU Member States which are referred to in this Case. In 2001 the parent company sold its French subsidiary and ceased trading in the Belgium and Germany subsidiaries.

Marks & Spencer claimed group tax relief in the UK in respect of the losses incurred by its subsidiaries in Belgium, France and Germany. The UK tax authorities refused such tax relief. The group appealed before the UK Special (Tax) Commissioners, who dismissed the appeal. Marks & Spencer appealed to the High Court of Justice of England and Wales, which referred the question to the ECJ.

3. THE LEGAL ISSUES

Under UK law, a UK resident parent company is taxed on its profits earned in the UK as well as on those from foreign permanent establishments (branches). The parent company can deduct from the UK tax payable the tax paid in the Member State of the permanent establishment. The losses of the permanent establishments can be offset with the profits of the parent and can also be carried forward.

On the other hand, the parent company pays taxes on the profits of foreign subsidiaries only if and when they are distributed in the form of dividends. In such cases, to avoid double taxation, the parent company can credit[1] tax paid in the other Member States on the profits out of which the dividends are distributed as well as any withholding tax. The relief for the underlying tax only applies in the case of shareholding in excess of 10% (subject to the relevant double-tax agreements). Where CFC legislation[2] is not applicable, the parent company is not taxed on its non-resident subsidiaries' profits.

[1] The UK follows the credit method adhering to the principle of capital export neutrality, according to which the state of residence should tax foreign–source income of its residents so that they are neither encouraged to invest nor discouraged from investing abroad (home neutrality).

[2] For more details see 'FEE Observations on European Court of Justice pending case C – 196/04 Cadbury Schweppes plc and Cadbury Schweppes Overseas ltd v. the Commissioners of UK Inland Revenue', December 2005

It should be noted that dividends received by a UK parent company from UK subsidiaries are not taxed in the UK. In addition, UK law allows UK resident companies in a group to offset their profits and losses amongst themselves. However, the losses of foreign subsidiaries cannot be offset against the parent company's profits.

The questions addressed to the Court by the High Court of Justice of England and Wales can be summarised as follows:

- Whether UK provisions on group relief preventing a parent company resident in the UK to set off losses incurred in other Member States by its subsidiaries resident in those Member States, even though allowing such set off for losses incurred by UK resident subsidiaries, constitute a restriction to the freedom of establishment, contrary to Articles 43 EC and 48 EC (Treaty);

- Whether it would make a difference if there were any evidence that relief for incurred losses had been obtained in the Member State where the subsidiaries were established, and if so, if the relief was obtained by an unrelated group of companies to which the subsidiary was sold.

4. OBSERVATIONS

The Advocate General's Opinion

Attention should be drawn to the points of Advocate General's Opinion[3] relating in particular to the issue of freedom of establishment.

According to the Advocate General's Opinion the UK legislation gives rise to a restriction of the freedom of establishment.

However, the restriction of the freedom of establishment in this Case cannot be based on the ground of nationality alone as '...the principle of non-discrimination on the ground of nationality is not sufficient to safeguard all the objectives comprised in the establishment of an internal market...'[4].

Nor is the restriction of the freedom of establishment connected to the choice of the legal form of the foreign establishment, as it does 'not preclude different tax treatment from being accorded to legal or natural persons in different situations'[5], i.e. permanent establishments and subsidiaries have a different legal form and therefore can be governed by different tax regimes.

The real issue in this Case is that the UK legislation constitutes an 'exit restriction' of the freedom of establishment, insofar it 'creates an obstacle such as to dissuade companies established in the UK from establishing subsidiaries in other States[6]' by not allowing them the same tax advantage they have if they establish subsidiaries in the UK.

[3] Opinion of Advocate General Poiares Maduro delivered on 7 April 2005 on Case C-446/03 Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)
[4] *ibidem,* paragraph 34
[5] *ibidem,* paragraph 49
[6] *ibidem,* 'paragraph 53

According to the Advocate General's Opinion there is no justification under Community law for the restriction operated by UK law. Neither can justification be based on the principle of territoriality, or on the need to ensure fiscal cohesion of the tax system.

The Conclusion of the Advocate General's Opinion reads as follows:

'Articles 43 and 48 EC preclude the tax legislation of a Member State, such as that at issue in the main proceedings, which prohibits a parent company established in a Member State from benefiting from the right to group relief on the ground that its subsidiaries are established in other Member States, whereas that relief would be granted if those subsidiaries were resident in that Member State.

Those provisions do not preclude national legislation from making entitlement to group relief, such as that provided for by the Member State concerned in the main proceedings, subject to the condition that it be established that the losses of subsidiaries resident in other Member States cannot be accorded equivalent tax treatment in those Member States[7].'

The conclusion emphasises the existence of an infringement of Articles 43 and 48 EC but accepts that no infringement occurs when the other jurisdiction offers 'equivalent tax treatment' for the losses.

Our understanding of the conclusion is that losses can be deducted at parent level in any case when they cannot be recovered otherwise.

The final judgment of the ECJ

Three main issues in the final judgment of the Court can be highlighted:

A. In its final judgment the ECJ stated that UK provisions on group relief constitute a restriction to the freedom of establishment, contrary to Articles 43 EC and 48 EC, as they treat differently for tax purposes the losses incurred by a resident subsidiary and those incurred by a non-resident subsidiary[8];

B. Such a restriction of the freedom of establishment is allowed only if the following criteria are met:

   (i) It pursues a legitimate objective compatible with the Treaty;
   (ii) It is justified by imperative reasons in the public interest;
   (iii) It is proportionate. [9]

   The three justifications for the restriction put forward by the UK government were accepted by the Court in relation to the first two criteria only;

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7 *ibidem,* 'paragraph 84

8 Judgement of the Court of 13 December 2005 in Case C-446/03, Reference for a preliminary ruling under Article 234EC from the High Court of Justice of England and Wales, Chancery Division (UK), made by decision of 16 July 2003, received at the Court on 22 October 2003 in the proceedings Marks & Spencer plc v. David Halsey (Her Majesty's Inspector of Taxes)'paragraph 84

9 *ibidem*, paragraph 35

C. The Court judged that the third criterion of proportionality was not met: the restrictive measures went beyond what is necessary to attain the objectives pursued.

The issue of the restriction to the freedom of establishment A has been already discussed in detail above, while analysing the Advocate General's Opinion. Here we will therefore concentrate on the second and the third issues, namely B and C.

Acceptance by the Court of the three justifications put forward by the UK with respect to the first two criteria represents a new approach in justifying restrictions to the fundamental freedoms. The following principles can be derived from the three justifications:

1. There should be a symmetrical treatment of company profits and losses. This would 'protect a balanced allocation of the power to impose taxes between the different Member States concerned'[10].

   FEE observes that, as a consequence, since profits of foreign subsidiaries are not taxed at parent company level, losses should not be deducted either.

2. 'If the losses were taken into consideration in the parent company's Member State they might well be taken into account twice'[11].

   FEE points out that there could be a risk of double deduction of a loss in two different jurisdictions (the so-called 'double-dip' [12]).

3. 'If the losses were not taken into account in the Member State in which the subsidiary is established there would be a risk of tax avoidance'[13].

   FEE agrees that there could be the risk of tax avoidance by transfer of losses from a low-tax jurisdiction to a high- tax jurisdiction in which the tax value of the losses would therefore be the highest.

The Court considered that the restrictive measures in the UK went beyond what is necessary to attain the objective of allowing relief for the losses in the Member State of the parent company when there is no possibility in the Member State of the non-resident subsidiary to claim relief for the losses in the accounting period in which they arose, the previous period and future periods, even by transferring those losses to a third party.

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[10] *ibidem*, paragraph 43

[11] *ibidem*, paragraph 43

[12] Here follows an example of double dip.
In this example, in year 1 the parent company pays no tax as it deducts the loss of its subsidiary; in year 2 the subsidiary carries forward the loss incurred in year 1.As a result, the parent company deducts its subsidiary losses twice, i.e. it does the so-called 'double dip'.

Year 1:	*Year 2:*
P profit = 100	P profit = 100
S loss = -100	S profit = 100 -100 (loss of year 1)
Cons = 0	Cons = 100

Legend: P= parent company; S= subsidiary; Cons= Consolidation

[13] *ibidem*, paragraph 43

As a consequence, in this case (exhaustion of the tax losses in another jurisdiction) the losses of the foreign subsidiaries have to be taken into account in the calculation of the parent company taxable income.

Finally, it can be observed that the decision of the Court interprets the meaning of Article 43 EC as from the time of its entering into force, as there are no specific time limitations. This can have a significant impact on Member States tax revenues, in the cases where losses would otherwise be unused (however, this could happen only in country where group relief of losses systems are in place). In these cases, taxpayers can claim the deduction of unused losses and a refund of the related amount of corporate income tax already paid.

5. Possible implications for Member States

The ECJ Judgment in Marks and Spencer can be seen as a consistent approach in EU Taxation. The decision opens, even if under some limitations, the way towards substantial equivalent tax treatment between domestic and foreign companies.

A possible implication of the judgment for Member States might be that the current group relief systems in place could evolve towards an optional model of *tax consolidation*. According to this model, profits of foreign subsidiaries are taxed at the parent company level and the company income tax paid by the subsidiaries is credited against the tax due by the parent company. Symmetrically at parent company level, losses of foreign subsidiaries are deducted from the profit of the parent company, regardless of their use at the subsidiary level. If taxpayers do not follow this option, subsidiary losses are not taken into account at the parent company level (obviously they could still be taken into account at the subsidiary level).

This model would be in line with the principles stated by the Court in Marks and Spencer without the need to assess whether subsidiary losses can or cannot be deducted at the subsidiary level.