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Editorial

Bosal?!

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The Court has spoken. The verdict is out. Just one week before the first anniversary of the publication of the advocate general's opinion the Court has taken a decision which the European community of tax lawyers has been waiting for with more than a little interest. The decision is short and crisp. It confirms and clarifies the position of the Court on a few key issues that are vital to the development of communitarian tax law. It also raises some major questions on how the Member States of the European Union should structure their national tax systems, taking into account the imperatives imposed by the fundamental economic freedoms enshrined in the Treaty.

As is generally known, the case turned on the question whether a rule limiting the deduction by a parent company of interest expenses related to the acquisition of a shareholding in a subsidiary to the amount of taxable profit derived from such shareholding in the jurisdiction of the parent company, constitutes a violation of the freedom of establishment in conjunction with the free movement of capital. In an exemption country like the Netherlands, such a rule means that interest for the acquisition of shares in a foreign subsidiary is not deductible, while interest related to shares in domestic subsidiaries is.

In arguing its decision the Court disposes of some burning issues. The first decision is on the proposition that there can be no discrimination when taxpayers who are in a similar situation are treated in the same way and that conversely taxpayers who are not in a similar situation can be treated differently. The governments of the U.K. and the Netherlands maintained that there is a great difference between subsidiaries according to whether or not they carry on business abroad. In the first case all the profits of the group are subject to taxation in the jurisdiction of the parent company, in the latter case they are not. That difference is sufficient to justify different tax treatment of interest expenses in relation to the holdings in those subsidiaries. In other words the difference between a resident and a non-resident subsidiary company is in itself sufficient to justify different tax treatment of the parent company: the territoriality principle indeed excludes the non resident subsidiary from the tax jurisdiction of the Member State of the parent company.

The answer of the Court to this argument is that the relevant comparison is not the situation of the subsidiary but that of the parent company. In both cases (resident and non-resident subsidiary) the dividends received by the parent company are exempted in exactly the same way, but the treatment of the interest deduction is different. The Court in a certain way made a reverse application of its holding in Hoechst Metallgesellschaft in which it held that a subsidiary resident in the U.K. could not be denied a tax benefit just because its parent was not subject to U.K. tax jurisdiction. In BOSAL the reasoning is that the parent cannot be denied a tax benefit just because the subsidiary belongs to the tax jurisdiction of another Member State. Although the Court did not state this explicitly, the underlying fundamental reason for this holding could very well be that as long as the subsidiaries are liable to mainstream corporation tax somewhere in a Member State their parent companies located in the another Member State should be treated alike for tax purposes by that other state.

In giving this answer the Court was absolutely right. If the fact of being subject as a non resident taxpayer to another tax jurisdiction would in itself be sufficient to exclude the discrimination test, because the taxpayers were not in a comparable situation, the freedom of establishment would become meaningless. Indeed resident and non-resident taxpayers formally always belong to a different tax jurisdiction.

In a second line of argument the Court deals with the question of territoriality according to which a Member State is entitled to require, for the compensation of profits and losses, that such profits and losses have their origin in an economic activity exercised on the territory of that State. That principle was accepted in the Futura participations case as not entailing any discrimination, overt or covert, prohibited by the Treaty. The Court points out that the economic link between the losses and profits in that case concerned one and the same legal entity, whereas in BOSAL the link concerned the profits and losses of distinct legal entities. The problem was that the different tax treatment was not applicable to the (domestic) and (foreign) subsidiaries of the group, but only to the domestic parent companies of the group, which all were similarly engaged in economic activities on the territory of the Netherlands.

In a certain sense, one could interpret the difference in opinion between the Dutch government and the Court as a difference of opinion about the identity of the taxpayer. The Dutch government considered the BOSAL group as one single taxpayer and applied the principle of territoriality to the group. The Court

considered all the members of the group as separate taxpayers to which the principle of territoriality, in the sense of the Futura participations case did not apply. The view of the Court is fully understandable, because the issue was about the establishment of foreign subsidiaries as separate legal entities, not about the establishment of foreign branches by a multinational group.

Finally there are the issues of coherence and base erosion. The Court once more specified its narrow view of the principle of coherence as a principle not supporting the coherence of a whole tax system, but supporting the coherence of a specific tax rule, applicable to a specific taxpayer for a specific assessment, whereby the tax benefit in the form of a credit, deduction or exemption is linked directly to taxation of the income, and the non taxation is linked directly to the non-deduction. For too long national tax administrations have seen the principle of coherence as a principle justifying broad compensation within the national tax system as a whole, linking different categories of taxpayers and of categories of income. In the original Bachmann decision there was room for such a wide interpretation. By now it should be clear to any Member State that the principle of coherence has a very narrow application and cannot be relied upon to shore up defensive tax measures covering different categories of taxpayers and of taxable income.

The Court quickly dismissed the argument about base erosion as an argument about loss of tax revenue in disguise and rightly so. The coherence argument has indeed often been used to hide budgetary goals of the Member States. In too many cases CFC rules, thin capitalisation rules and the like have been defended as necessary coherence rules, but have been applied with a much wider scope than necessary to stem abuses. The proof is in the remedial legislation proposed by the Dutch government after Bosal : a general thin capitalisation rule containing a ratio of 3:1 for all foreign and domestic subsidiary relationships. That is much more than just an anti-abuse rule.

The BOSAL decision is an important step in the further integration of the national tax systems of the Member States into one single market and as such it should be considered as a step in the direction prescribed by the basic goals and activities contained in art. 2 and 3 of the Treaty. It does raise some very basic issues however.

First there is the constant worry for the tax administrations of the Member States which provisions in their tax codes will next be axed by the European Court of Justice. It should be clear by now that the Court is determined to march on in the direction of a fully integrated economic and monetary union consisting of a market without borders and with free and fair competition and that no one is going to derail it from its track. Therefore, like the Dutch tax administration, all Member States should scrutinise their national tax codes for provisions that could be construed as violating the basic economic freedoms.

The Court has raised another issue, because increasingly it is forcing the Member States to adapt their internal domestic tax rules to the requirements of free movement without discrimination and restriction. The introduction of domestic thin capitalisation rules by the Dutch government is just one example of this development. In responding to the Court challenges the Member States can of course rely on 'national self-help' as they have been doing for the past couple of years, not taking into account any new developments in other Member States. It would be better however for the Member States at least to coordinate their efforts and to cooperate with the Commission to design a uniform European reply to the challenges of the Court. Last but not least such coordination would be very much facilitated by the abolition of the unanimous voting rule in tax matters. It seems just a matter of both time and how much more unbearable pain and suffering the national tax administrations are willing to endure, before the Member States are willing to swallow their national pride and abandon their unlimited national tax sovereignty.