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Editorial

Cross-Border Loss Relief and the 'Effet Utile' of EU Law: Are We Losing It?

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The 'effet utile' principle requires all national institutions to give full force and effect to EU law. However, the practical realization of this obligation depends on a clear interpretation of the relevant provisions of EU law by the Court of Justice (ECJ). It appears that in the area of cross-border loss relief, there is a particularly urgent need for more clarity in the Court's case law.

One of the fundamental elements of EU law is the so-called 'effet utile' principle, sometimes also referred to as principle of effectiveness. It has played a decisive role in the development of important legal institutions such as, in particular, the direct effect of provisions contained in directives[1] or Member States' liability for the violation of EU law provisions.[2] As the case law of the European Court of Justice (ECJ) has shown, the roots of the 'effet utile' principle lie at the very heart of EU law and are closely connected to the cornerstones of the whole EU legal order and its supranational character, namely the principles of direct applicability of EU law provisions and of supremacy of EU law over national law. With respect to the former principle, the ECJ had already emphasized in its pivotal *Simmenthal* judgment that rules of EU (then still Community) law 'must be fully and uniformly applied in all the Member States from the date of their entry into force and for so long as they continue in force'; as regards the latter principle, the Court had stated that:

> in accordance with the principle of the precedence of Community [now EU] law, the relationship between provisions of the Treaty and directly applicable measures of the institutions on the one hand and the national law of the Member States on the other is such that those provisions and measures … by their entry into force render automatically inapplicable any conflicting provision of … national law.[3]

Against this background, and taking into consideration also the importance of the preliminary rulings procedure, the ECJ had concluded that 'any provision of a national legal system and any legislative or judicial practice which might impair the effectiveness of Community law' must be dis-applied since they are incompatible with 'the very essence of Community law'.[4] And in the likewise seminal (first) *Factortame* judgment, the Court had added that:

> it is for the national courts, in application of the principle of cooperation laid down in Article 5 of the EEC Treaty [now in substance replaced by Art. 4(3) TEU], to ensure the legal protection which persons derive from the direct effect of provisions of Community law.[5]

Thus, not only national legislators but also national courts and administrations are under a strict obligation to cooperate faithfully with the EU and its institutions, which means that, *inter alia*, they have to give 'full force and effect' to decisions rendered by the ECJ. This concerns, in particular, the typical situation dealt with by Article 267 of the Treaty on the Functioning of the EU (TFEU), namely the 'interpretation of the Treaties' (or of 'acts of the institutions … of the Union') by the ECJ upon request by a national court. However, when it comes to tax cases, it is not only the requesting judges (and the parties to the proceeding pending before it) who expect to receive clear signals from Luxemburg in this *dialogue des juges*. Also, the tax authorities and other courts of the Member State concerned will want to know how to deal with parallel cases, and the national legislator may be required to amend the rules under discussion. Moreover, the same will normally be true for a (sometimes large) number of other Member States maintaining similar provisions in their national tax systems. And finally, taxpayers (and their advisors) have an urgent need for legal certainty as regards the exact consequences of the exercise of rights guaranteed by EU law, since their main concern is quite often not or at least not only the recovery of overpaid taxes from the past but the arrangement of their investments and business activities for the present and the future and, in

1 See, for example, ECJ, 6 Oct. 1970, 9/70, *Grad* [1970] ECR 825 para. 5; 4 Dec. 1974, 41/74, *van Duyn* [1974] ECR 1337 para. 112; 5 Apr. 1979, 148/78, *Ratti* [1979] ECR 1629 para. 20; 19 Jan. 1982, 8/81, *Becker* [1982] ECR 53 para. 22; 8 Oct. 1987, 80/86, *Kolpinghuis Nijmegen* [1987] ECR 3969 para. 12.

2 See, for example, ECJ, 19 November, Joined Cases C-6/90 and C-91/90, *Francovich* [1991] ECR I-5357 para. 34; 5 Mar. 1996, Joined Cases C-46/93 and C-48/93, *Brasserie du Pêcheur* [1996] ECR I-1020 para. 20; 30 Sep. 2003, C-224/01, *Köbler* [2003] ECR I-10239 para. 33.

3 ECJ, 9 Mar. 1978, 106/77, *Simmenthal*, *supra* n.3, paras 14, 17. In the same sense also ECJ, *Factortame*, *supra* n.3, para. 18.

4 ECJ, *Simmenthal supra* n.3, para. 22. In the same sense also ECJ, *Factortame supra* n.3, para. 20.

5 ECJ, *Factortame*, *supra* n.3, para. 19 with further references.

this respect, they might have a justified interested in receiving some guidance from the ECJ.

Yet, when it comes to matters of cross-border loss compensation, all aforementioned 'players' are left rather confused, not to say dumbfounded, by a series of ECJ decisions. Admittedly less problematic in this respect are various cases that did *not* really involve the tax treatment of *foreign* losses within cross-border group structures or other cross-border activities,[6] or that addressed specific unilateral provisions (allegedly) serving as anti-avoidance rules.[7] Somewhat more ominous are a number of decisions concerning foreign *exchange* losses from the home state's perspective,[8] or the potential import of foreign losses into the *host* state.[9] The absolute highlight, however, are those cases dealing with the potential import of losses incurred by foreign subsidiaries or tax-treaty-exempt permanent establishments (PEs) into the taxpayer's *home* state. In this respect, already the historical development as such is remarkable: at the time when the *Marks & Spencer* referral on the possible inclusion of foreign subsidiaries in the UK group relief system reached the ECJ, Member States were still so awestruck by the Court's case law on the EU fundamental freedoms that some of them decided to introduce cross-border group taxation systems before the case had even been decided.[10] Likewise, and even long before the *Lidl* case was actually referred to the ECJ, some national courts (albeit not fully based on EU law considerations) had ruled that the exemption method under a double tax treaty should not exclude foreign PE losses from the respective head office's domestic tax base.[11]

The ECJ's decisions in the aforementioned cases, however, were disappointing not only as regards their outcome but even more so with respect to the underlying reasoning. As is well-known, the disaster began in *Marks & Spencer* when the Court first identified an infringement of the freedom of establishment (now Articles 49, 54 TFEU) but then started to show a much more relaxed attitude towards Member States' defence arguments and proportionality requirements, in particular refusing to accept that a recapture mechanism would be a less burdensome and still practicably manageable alternative to a general exclusion of foreign losses. In favour of the taxpayers concerned, the ECJ only left a tiny loophole, namely for situations where the losses suffered by the subsidiary in its own Member State of establishment could, under no circumstances, be offset there against profits (of the subsidiary itself, of its parent, or of any third party) in the past, present, or future, and even for these rather exceptional situations of 'final' losses, a *caveat* for national anti-abuse measures was made.[12] Subsequently, and despite Advocate General Sharpston's fervent pleadings for reconsideration, the same approach was applied in *Lidl* to losses suffered by a foreign PE in a situation where the relevant bilateral tax treaty, at least according to vested legal practice in the Member State of the head office, excluded those foreign losses from the head office's domestic tax base.[13] However, only a few months later, the ECJ added in *Krankenheim* that the Member State of the head office was not obliged to adjust its own behaviour to 'particularities' in other Member States' legislation and therefore did not have to take foreign PE losses into account where these losses had become 'final' due to a specific legal limitation for the use of carry-forwards in the PE state.

With these judgments, the ball was, at least temporarily, kicked back to the national courts and legislators, but it does not appear that these national players really know how to continue the match. As for the UK, it has been pointed out that the *Marks & Spencer* case has 'seen the inside of every conceivable court other than the Supreme Court'.[14] In fact, the dispute more and more got stuck in procedural issues revolving around the 'finality' of losses suffered abroad[15] and most recently even drifted off into a controversy concerning the 'breathtaking amount' of lawyers' fees to be paid as costs by the UK tax authorities,[16] while in the meantime, the European Commission had already started to attack the amended UK legislation by means of an infringement procedure (Article 258 TFEU).[17]

In Germany, the situation is even more confusing. In *Lidl*, the Federal Tax Court rather clearly indicated that foreign PE losses, once it was clear that they had become 'final', could be offset against profits derived by the head office in the same tax year in which the losses were incurred ('phasengleich') but had to

6 ECJ, 16 Jul. 1998, C-264/96, *ICI* [1998] ECR I-4695; 18 Nov. 1999, C-200/98, *Y AB and X AB* [1999] ECR I-8261; 14 Dec. 2000, C-141/99, *AMID* [2000] ECR I-11619; 12 Sep. 2002, C-431/01, *Mertens* [2002] ECR I-7073; 27 Nov. 2008, C-418/07, *Société Papillon* [2008] ECR I-8947. It may be added that also the Commission's Press Release IP/10/1253 of 30 Sep. 2010 only concerns purely domestic losses within the German *Organschaft* system. The same goes for pending case-18/11, *Philips Electronics UK Ltd.*

7 ECJ, 21 Feb. 2006, C-152/03, *Ritter-Coulais* [2006] ECR I-1711; 29 Mar. 2007, C-347/04, *Rewe Zentralfinanz* [2007] ECR I-2647; 15 Oct. 2009, C-35/08, *Busley and Cibrian Fernandez* [2009] ECR I-9807.

8 See ECJ, 28 Feb. 2008, C-293/06, *Deutsche Shell* [2008] ECR I-1129, and Kemmeren, *EC Tax Review 17*(2008), 4, at 10.

9 With respect to the calculation of the applicable tax *rate* see ECJ, 18 Jul. 2007, C-182/06, *Lakebrink* [2007] ECR I-6705; concerning the determination of the relevant tax *base*, see the *Renneberg* and *Futura* cases mentioned below.

10 See Italy ('consolidato mondiale' as of 2004), and Austria ('Gruppenbesteuerung' as of 2005). Cf. concerning the Swedish group taxation regime, the rather premature decision by Länsrätten i Vänersborg of 30 May 2005, discussed by Brokelind, *Tax Analysts* of 20 Jul. 2005.

11 See for Austria Verwaltungsgerichtshof, 25 Sep. 2001, 99/14/0217 E, with discussion by Lang, *Steuer & Wirtschaft International (SWI)* (2001), 86; for Luxemburg: Tribunal administratif, 19 Jan. 2005, No. 17.820, confirmed by Cour administrative de Luxembourg, 10 Aug. 2005, with discussion by Winandy, *Internationales Steuerrecht (IStR)* 2005, 594, and *Hahn*, IStR 2010, 157. It may be added that, as of 2009 and under certain conditions, also France took an interesting step by opening up its traditional 'territorialité stricte' for corporate taxation to foreign permanent establishment (PE) losses.

12 ECJ, 13 Dec. 2005, C-446/03, *Marks & Spencer* [2005] ECR I-10837 paras 42 et seq.

13 ECJ, 15 May 2008, C-414/06, *Lidl Belgium* [2005] ECR I-3601 paras 29 et seq.

14 See Whitehead, *Tax Journal* (28 Jun. 2010), 18.

15 For details, see Upper Tribunal, 21 Jun. 2010, *Commissioners for HMRC v. Marks and Spencer plc* [2010] UKUT 213 (TCC).

16 See Upper Tribunal, 12 Aug. 2010, *Commissioners for HMRC v. Marks and Spencer plc* [2010] UKUT 296 (TCC).

17 See Commission Press Release IP/09/1461 of 8 Oct. 2009.

refer the case back for closer examination to the first instance court (which still has determine whether and how the relevant foreign PE losses have become 'final').[18] Since the Federal Ministry of Finance did not agree with this interpretation of the 'finality' criterion and its consequences, it issued a decree preventing the German tax administration from applying the Federal Tax Court's ruling to similar situations.[19] A few months later, the Federal Tax Court handed down another decision concerning a German head office with a foreign PE and, based on *Krankenheim*, arrived at the conclusion that the forfeiture of a loss carry-forward in the PE state after five years did not make those losses 'final' in the sense of *Lidl*.[20] Only shortly afterwards, while the taxpayer concerned had lodged a constitutional complaint with the German Constitutional Court[21] against the aforementioned judgment and new cases had already found their way to the Federal Tax Court,[22] the German tax authorities took a rather unique step by publishing a 'position paper' (that is, not an official decree) with instructions for local tax offices on how to deal with *Lidl*, providing for a rather strict interpretation and excluding, in particular, the treatment of losses as 'final' in cases where a foreign PE had been alienated or liquidated or been transferred into a corporation in exchange of shares.[23]

In addition, right at that moment when German taxpayers, judges, and authorities started to become entrenched in their positions, the ECJ added even more fuel to the fire by deciding rather categorically in the *X Holding* case that the Netherlands was not forced to open up its fiscal unity system (*fiscale eenheid*) to losses suffered by foreign subsidiaries.[24] Above all, the fact that the Court did not even mention its *Marks & Spencer* exception for 'final' losses has triggered a lot of criticism and caused considerable confusion as to whether this exception has been overruled or not.[25] In fact, even though the *Dutch Hoge Raad* recently issued a rather short ruling to end the case, its Advocate General's lengthy conclusions make clear that it takes quite some efforts to make some sense of the ECJ's judgment.[26] From the German perspective, the timing of this judgment was particularly unfortunate, since it was rendered at a moment when also a number of cases on a possible opening of the German fiscal unity system (*Organschaft*) towards foreign losses were finding their way to the Federal Tax Court.[27] Thus, suddenly that Court was faced not only with the aftermath of *Lidl* and *Krankenheim* for foreign PEs but also with that of *Marks & Spencer* for foreign subsidiaries and, in addition, by the questions marks raised by *X Holding* with respect to the 'final' losses exception applying to both subsidiaries and PEs. On top of this, everybody who is a bit familiar with German tax literature will be aware of the fact that all these cases have been covered with a sheer hail of articles and annotations.

Recently, the German Federal Tax Court has made some attempts to clean up the mess, and it started in June 2010 by deciding two more cases on foreign PEs.[28] While in the first case it affirmed the application of *Krankenheim* and rejected any obligation of Germany as the state of the head office to take foreign losses into account once the relevant time limit for a loss carry-forward in the PE state had expired,[29] the second case led to a rather favourable result for taxpayers. Based on the ECJ's case law, the Court made a distinction between a 'finality' of foreign losses due to *legal* reasons (e.g., limitation of loss carry-forward) in the sense of *Krankenheim*, as opposed to a 'finality' due to *factual* circumstances, namely the closing of the PE's business or its transfer (with or without consideration) to another person, or even the transformation of the PE into a corporation; as the Federal Tax Court explained, the ECJ's *Marks & Spencer* and *Lidl* decisions, which had accepted the import of 'final' foreign losses as an *ultima ratio*, would only make sense if, in the latter (factual) circumstances, the state of the head office would indeed be obliged to grant loss relief, for otherwise, there would not be any scope of application left for the ECJ's jurisprudence.[30] Yet, as regards the practical consequences concerning how to realize that obligation, the Court moved away from its earlier decision in the *Lidl* case and now ruled that the foreign losses (after being recalculated according to German tax standards) did not have to be offset against domestic profits in the various tax years in which they were incurred ('phasengleich', see above)

18 Bundesfinanzhof, 17 Jul. 2008, I R 84/04, *Bundessteuerblatt* II 2009, 630.

19 Bundesministerium der Finanzen, 13 Jul. 2009, IV B 5-S 2118-a/07/10004, 2009/0407190, *Bundessteuerblatt* I 2009, 835. For a similar decree, issued immediately after the aforementioned Bundesfinanhof's *Lidl* decision, see Bundesministerium der Finanzen, 4 Aug. 2008, IV B 5-S 2118-a/07/10012, 2008/0419777, *Bundessteuerblatt* I 2008, 837, concerning Bundesfinanzhof, 29 Jan. 2008, I R 85/06, *Bundessteuerblatt* II 2008, 671.

20 Bundesfinanzhof, 3 Feb. 2010, I R 23/09, *Bundessteuerblatt* II 2010, 599.

21 Case no. 2 BvR 1177/10, still pending before the Bundesverfassungsgericht.

22 Both the judgments of Finanzgericht Düsseldorf, 8 Sep. 2009, 6 K 308/04 K, *Entscheidungen der Finanzgerichte* (EFG) 2010, 389, and of Finanzgericht Hamburg, 18 Nov. 2009, 6 K 147/08, EFG 2010, 265, were appealed on points of law (I R 100/09 and I R 107/09); see *infra* nn. 29 and 30.

23 See Bayerisches Landesamt für Steuern, 19 Feb. 2010, S 1366.1.1-3/10 St32, IStR 2010, 411.

24 ECJ, 25 Feb. 2010, C-337/08, *X Holding BV*, not yet reported in ECR.

25 See, for example, Weber, Highlights & Insights on European Taxation (2010/9.3), 28; Van Thiel & Vascega, *European Taxation* 50 (2010), 334; de Wilde, *EC Tax Review* 19 (2010), 170. Opinion Statement of the Confédération Fiscale Européenne on *X Holding* (C-337/08), January 2011.

26 See Hoge Raad, 7 Jan. 2011, no. 43.484*bis*, and in particular Advocaat-Generaal Wattel, 7 Jul. 2010.

27 See, in particular, the judgments of Finanzgericht of Lower Saxony, 11 Feb. 2010, 6 K 406/08, EFG 2010, 815, and of Finanzgericht of Rhineland-Palatia, 17 Mar. 2010, 1 K 2406/07, EFG 2010, 1632, which both were appealed on points of law (I R 16/10 and I R 34/10; see *infra* nn. 35 and 36). Cf. also Bal, *European Taxation* 50 (2010), 530. Furthermore, two cases decided by the Hessian Finanzgericht, 18 May 2010, 8 K 3137/06, EFG 2010, 2024 and 18 May 2010, 8 K 1160/10, EFG 2010, 2026, which both have been appealed on points of law (I R 54/10 and I R 55/10), may gain relevance; for a discussion, see Mössner, IStR (2010), 778.

28 For details, see Perdelwitz, *European Taxation* 51 (2011), 31.

29 Bundesfinanzhof, 9 Jun. 2010, I R 100/09, *Bundessteuerblatt* II 2010, 1065.

30 Bundesfinanzhof, 9 Jun. 2010, I R 107/09, IStR 2010, 663.

but rather in one single amount in the tax year in which they become 'final'.

Even though the German tax authorities have not yet published any official reaction to the last-mentioned judgment, it is quite obvious that they are not very happy about the large margin of possibilities it offers to taxpayers for creating 'final' losses. However, the longer it takes, the longer the whole *Lidl* issue remains 'frozen' in real life, as taxpayers will not start acting without sufficient clarity that they will not be facing years of administrative and court proceedings afterwards. On the other hand, the *Krankenheim* line of cases is a direct blow in the taxpayer's face, since time limits in the PE state will not only kill a loss carry-forward there but, at the same, time also relieve the state of the head office of any obligation under Articles 49, 54 TFEU. It may be true that one is actually dealing with a mere 'disparity' between Member States' legislation, but the outcome still is that losses get completely lost. This is in striking contrast to cases like *Renneberg*[31] where the ECJ, relying on the unfortunate *Schumacker* doctrine,[32] even allowed the plaintiff to deduct losses suffered in his *home* state from the positive tax base in the *source* state. Can the divergent approach be explained by the fact that *Renneberg* concerned natural persons while the other cases mentioned above involved companies? It could be that at least the Court itself thinks so, for otherwise it might have provided additional explanation as to whether its old *Futura* judgment[33] is to be considered overruled. But if for natural persons a loss is a personal circumstance (in the sense of *Schumacker*), would it not basically have to be the *home* state anyway to take that loss into account, even if it only became 'final' in the sense of *Krankenheim*?[34]

These developments do not only leave the taxpayers concerned but also the national tax administrations, courts, and legislators (and not to forget the scholars) confused and frustrated. This general state of mind has not been improved much by the fact that the Federal Tax Court now rendered its first decision on the treatment of losses suffered by foreign subsidiaries and, basing its reasoning on the interpretation of *Lidl* it had given a few months earlier for PEs, told the German parent corporation that it had submitted its claim for the wrong tax year and that it had to wait until the losses became final due to the closing down or liquidation of the subsidiary.[35] An additional disquieting factor is that the Federal Tax Court, in all its aforementioned decisions, did not subject the ECJ's *X Holding* judgment to any closer scrutiny with respect its potential consequences, and it is rather unlikely do so in the cases that are still pending before it.[36]

All in all, the *status quo* is far from satisfactory. If rules of EU law, and above all the fundamental freedoms, are supposed to be given 'full force and effect' within the domestic legal orders of twenty-seven EU Member States, all national players concerned need clear guidance from the ECJ. However, what is happening at the moment is that the Court, while trying to pay more respect to Member States' tax sovereignty, is sending unclear and sometimes even contradictory signals, and claims submitted by taxpayers before national tax authorities or courts get stuck in procedural issues. In this way, the 'effet utile' of EU law is becoming a blunt instrument, at least as far as cross-border loss relief is concerned. Since the means available to the European Commission are limited,[37] it should be for the ECJ to restore legal certainty in this field.

31 ECJ, 16 Oct. 2008, C-527/06, *Renneberg* [2008] ECR I-7735; for a closer discussion Kemmeren, *EC Tax Review* 18 (2009), 4.

32 ECJ, 14 Feb. 1995, C-279/93, *Schumacker* [1995] ECR I-225 paras 30 et seq.

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

34 In a recent judgment concerning a natural person with foreign PE losses Finanzgericht Münster, 17 Sep. 2010, 4 K 5045/03 E, not yet published, decided that these tax treaty exempt losses, which were 'final' in the sense of 'Krankenheim' (due to time limits in the PE State), could be taken into account for the determination of the tax *rate* under the progressivity proviso. As the case shows, however, this solution is usually much less favourable than loss relief on the level of the tax *base*.

35 Bundesfinanzhof, 9 Nov. 2010, I R 16/10, IstR 2011,110.

36 It appears that the appeal in Case I R 34/10 (*supra* n.27) has been withdrawn. Moreover in another recent case witch actually only concerned a depreciation on a foreign shareholders of the Federal Tax Court has indicated that, after *X Holding,* it was doubtful whether the German *Organschaft* rules could be considered to violate EU law; see Bundesfinanzhof, 13 Oct. 2010, IR 79/09, *Der Betrieb* 2011,387.

37 See Communication of 19 Dec. 2006, COM(2006) 824 final.