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Rome, 5 December 2003

1. Role of the ECJ

Allow me to begin with a quotation:

"Nobody contests that fundamental freedoms form the yardstick for the tax legislator in devising tax law. However tax law has its own rules. Its structural features have to be taken into account by the Court. Taxes form the foundation of countries' finances. The Court cannot call this into question. A finding by the Court that tax rules are incompatible with the fundamental freedoms places countries at risk, leads to legal uncertainty and is not acceptable."

These critical remarks are not directed at ECJ case law in the tax field. They go back 45 years and concern the first judgment by the German Constitutional Court in a tax case. In 1957 the Court ruled that taxation of married couples under the then Income Tax Act was unconstitutional and the relevant provisions should be repealed. Tax specialists were initially sceptical.

This reminds me of the current criticism levelled at the ECJ's case law on direct taxation. It is said that the Court should not hand down any decisions on direct taxation matters as the European Union does not have any jurisdiction in this area, as the Court itself has repeatedly acknowledged. Nor should the Court rule in an area where the Community has no powers to act, as this remains within the jurisdiction of the Member States. This is based on the principle of specific conferment of powers which forms the guiding rule for the delimitation of powers between Community institutions and the Member States. There are even rumours that some Member States are considering amending the Treaty to prevent the Court from handing down rulings in the field of direct taxation as this is the exclusive jurisdiction of the Member States.

Such arguments completely ignore the bases of Community law. As Article 94 of the EC Treaty states, the Community can issue directives for the approximation of such laws, regulations or administrative provisions of the Member States as directly affect the establishment or functioning of the common market. Wathelet has rightly drawn attention to this fact.

The ECJ is not a tax court. Its task is to interpret and apply the rules of Community law. They have one goal: to establish a common market and economic and monetary union (Article 2 of the EC Treaty). This includes the Internal Market in which economic fundamental freedoms are to be realised. Any obstacle to this goal therefore falls within Community jurisdiction. Account must of course be taken of Member States' sovereignty but they cannot evade their obligations by insisting on their right of sovereignty.

The crucial factor here is therefore whether direct taxation has an impact on the functioning of the Internal Market. Although the drafters of the Treaties always believed indirect taxation to have an impact, direct taxation was considered to play a marginal role. It was quickly realised, and is becoming obvious day by day, that this is incorrect for two reasons.

Firstly, the difference between the impact of indirect and direct taxation on the market is imperceptible, or at least not as significant as it would appear in theory. Not only do indirect taxes act as market conditions but direct taxes also have an effect on the market. This is not new. It has always been known in international tax law as the principle of capital import neutrality. It is not therefore surprising that direct taxation quickly became, and is an ever-growing, focus of research in relation to the common market.

Secondly, as quickly as the obstacles created by indirect taxation are eliminated through harmonisation, those created by direct taxation take their place. One of the crucial measures introduced by the ECJ was therefore to recognise that direct taxation is a market condition in the same way as the rules governing the registration of companies, mandatory analyses, etc. Although this is only hinted at in the *avoir fiscal* case and the Court avoids the issue in the *Daily Mail* ruling, it is clearly spelt out in the *Biehl* ruling that differing taxation treatment leads to differing remuneration for employees, i.e. taxes economically influence business activity.

This leads us on to the jurisdiction of the ECJ and its specific task: to determine what impact the rules of direct taxation have on the market when the exercise of fundamental freedoms is guaranteed. It is not a tax court that interprets the rules of a tax system. It is a competition court that analyses the effects on the market and assesses them from the viewpoint of Community law.

Another criticism made is that the ECJ and its case law are not subject to parliamentary scrutiny as the basis of its jurisprudence cannot be changed to curb unwelcome judgments and the Court therefore exceeds its powers. Such an argument must be totally rejected. It ignores the principle of the delimitation of powers under which Parliament lays down laws and these are interpreted in a binding manner through case law. If Parliament wants to change anything it has to change the laws. This is right and proper and part and parcel of the constitutional system. The same applies to the European Union. Member States have laid down the basic rules in the Treaty and secondary legislation. These are interpreted by the ECJ. If Member States want to change anything they have to change these rules. If they cannot be changed because the requisite majority cannot be obtained, the Court cannot be prevented from exercising its powers of interpretation because individual Member States no longer apply their obligations under the Treaty.

2. The Internal Market and the principle of territoriality

International tax law has always made a distinction between the taxation of residents and non-residents. This is based on two differing underlying taxation principles. On the one hand taxation is justified by participation in State-organised markets, and on the other hand personal liability is deemed to be the basis of taxation. The result is a distinction between unlimited and limited tax liability. The Court has repeatedly accepted such a distinction and its consequences and the principle of unlimited or limited tax liability in differing circumstances. It has also levelled out this distinction in taxation on many occasions and ruled that the consequences of differing taxation are not justified.

Tax specialists are increasingly calling for taxation at source. Klaus Vogel has argued that the exemption method and the source-based taxation it introduces are particularly appropriate for the Internal Market. Eric Kemmeren has put forward the same argument. Even in the United States the trend is towards source-based taxation.

This development is based on the idea that each State may tax only transactions carried out in its own territory in accordance with its ability to enforce its rights. A distinction between limited and unlimited tax liability flows from the territorial structure of the international community too.

The basis of States' taxation systems is therefore the principle of territoriality and territorial control over national markets.

The Court has repeatedly accepted the territorial approach to tax implications. The *Futura* case concerns taxation of non-residents and the *Amid* case that of residents. In both cases, the Court's ruling is based on the apportionment of the - unified - income of a company between the parent company and its permanent establishment according to territorial aspects.

A further common factor in both rulings is that they are based on the situation in one Member State. In both cases this concerns losses sustained in one State. The Court did not allow profits in another State to be taken into account in the treatment of losses in one Member State. It accepted that two companies, one resident and the other non-resident, in the same Member State should be compared in respect of the profits earned or losses incurred in that Member State. In the *Futura* case it did not allow the Member State where the permanent establishment which had made a loss was resident to offset this against the profits of the parent company, whereas in the *Amid* case, the loss incurred by the parent company could not be offset against the profit made by the permanent establishment. In each case it has looked at the profit or loss made in one Member State.

In doing so the Court applied the principle of territoriality and the view that companies participate in the market under equal conditions, including those of taxation.

Under such an approach the European common market is no more than unhindered access to the national markets of the Member States.

However in the more recent *Bosal* ruling the Court moderated this territorial approach. This is particularly striking if the opinion of the Advocate General, who strictly follows the territorial approach, is compared to that of the Court. Does this mark a sea change? Under the principle of territoriality the European Internal Market is fragmented into individual national markets from a tax viewpoint. This creates a paradoxical situation where the European Internal Market to be established and guaranteed through the fundamental freedoms is pitched against the panoply of national tax systems. If the conditions of taxation are market factors, the approach cannot be confined to national markets and account must also be taken of all the effects of taxation.

If there is a European Internal Market, the effects of economic activity within this market as a whole, and not simply within each segment, must be taken into account. Two pending cases (*Marks & Spencer* and *Ritter-Coulais*) will provide the Court with an opportunity to resolve this paradoxical situation.

This would mean that the Internal Market is more than unhindered access to national markets. If this is the case, what is it?

I expect the Court to take a very cautious approach in answering this question, if it answers it at all, as it involves problems which the Court is not yet in a position to tackle. If the taxation approach is no longer confined to one territory but takes into account all the effects of

taxation, the division of tax powers, e.g. as under double taxation treaties, and the lack of harmonisation in company taxation become extremely relevant. ECJ case law has always tended to accept differentiation in a non-harmonised sector - although only to a certain degree. If the Internal Market is to be a genuine single market and taxation is one of the conditions governing this market, differing conditions cannot apply in different segments of this single market. Above all this calls into question the principle of territoriality in taxation.

3. Discrimination/restriction

The answer to these questions can only be found by extending the discussion to the difference between non-discrimination and no restrictions.

Discrimination and the principle of territoriality are closely linked. What has to be determined here is whether residents and non-residents are treated differently within one territorial area in relation to their activities within this area. Non-discrimination always means that residents and non-residents must be able to operate under the same conditions in a territorially-defined market. Non-discrimination means unhindered access to national markets.

To take up Frans Vanistendael's example: there are several billiard tables in the same room and the game is played according to different rules at each table. If players swap from one table to another, they must submit to rules that apply at that table but can also expect to take part in the game according to the same rules as the other players.

The situation becomes much more complicated in the case of restrictions. There are two distinct situations.

The inbound situation is very similar to discrimination. The difference is, if you like, that discrimination is more subtle. In theory there is equal treatment but non-residents face more problems in complying with the same conditions. The *Futura* case is a very good example. For losses to be carried forward in Luxembourg, accounts have to be kept there. For non-residents, however, this means keeping two sets of accounts, one by the parent company and one by the permanent establishment. In the example of the billiard players, it would be like playing at tables with cues of differing weight and length. If players switch from one table to another, they have to change cues and play with ones which they are not familiar.

In such cases equality under the law leads to inequality in practice as it is more difficult to comply with the conditions that apply.

It is more difficult to determine what actually occurs in the outbound situation. Here companies which only have domestic branches are treated differently, i.e. more favourably, in the Member State where they are resident than companies which have both domestic and foreign branches or expand operations to other countries.

The question of comparability in this case is quite different than in the case of residents and non-residents on the same market. Here there are two resident companies carrying out business on different markets, so one company is subject to the conditions of another market and the tax jurisdiction of another Member State.

If their situations are considered to be comparable, is this not simply tantamount to discriminating between nationals, in that the State is treating a national company less favourably not on its own market, but in respect of its foreign activities. Such unfavourable

and discriminatory treatment is an obstacle to international economic activity. It would result in a restriction. In our example it would be as if the playing conditions were made more difficult for players playing at more than one table.

The immediate riposte might be that companies can decide of their own free will to operate internationally and a player cannot expect the drawbacks of playing at another table to apply to his own table as well. Or in company tax law terms, the profit or loss made in another country does not concern the country where the company is resident. Such an argument, however, accepts that obstacles to international business activities be allowed and ignores the fact that the internal market is more than simply unrestricted access to national markets.

Clearly the idea that fundamental freedoms mean no restrictions is incompatible with the principle of territoriality. What is required is a pan-European approach where all players play at a huge billiard table according to the same rules.

But how far can the ECJ promote this approach through its case law in individual cases? There comes a point where the Court will have to switch from negative to positive integration.

The situation will become even more complex if a pan-European approach is adopted but the principle of territoriality is allowed and maintained. In my view, there are signs of a movement in this direction in the *AMID* ruling.

If the permanent establishment in Luxembourg makes a profit and the parent company in Belgium a loss, they could be offset and the overall profit/loss taxed under the European approach. How this is would be done and how revenue would be apportioned between Member States can hardly be decided on the basis of the fundamental freedoms. For this reason the Court accepts that profits be taxed in Luxembourg under the territorial approach. If Belgium were to take account of the profit made in Luxembourg in levying its tax, it would create a double disadvantage under the pan-European approach: the permanent establishment's profits would be taxed in Luxembourg in accordance with the principle of territoriality and in Belgium the loss would not be taken into account for tax purposes in relation to the profit made in Luxembourg. This would mean that the tax levied would not reflect the company's actual overall results.

In order to ensure that the basic freedom[-of-movement principle] serves to protect cross-border business, the Court must prohibit Belgium from looking at the European results. Foreign profits being exempt under DTTs, the Court views this as a potential restriction, although a Belgian company with only Belgian permanent establishments would be unable to carry forward a loss as its overall results would be aggregated in one country unlike a Belgian company which also has a foreign permanent establishment. However, it must be added that the profit made by a Belgian permanent establishment would not be taxed.

Another approach might be to prohibit Luxembourg from taxing the profit on the grounds that a Belgian company had incurred a loss. But this would mean that the territorial structure of international tax law and the rules of double taxation treaties which are based on international tax law would have to be ignored.

It can therefore be concluded that where a profit is made abroad and a loss is incurred in the country of origin, a consolidated tax base cannot be applied in the country of origin because the profit has been taxed in another country. Otherwise this would be a restriction on the exercise of freedom of establishment under the principle of territoriality.

The reverse situation – a loss abroad and a profit in the country of origin – forms the basis of the *Marks & Spencer* case. The problems involved here are enormous.

This case might be seen, as the Special Commissioners view it, as part of the tradition of the principle of territoriality and non-discrimination. This simply involves equal treatment in the United Kingdom and in the other countries in which subsidiaries are located. It is the duty of States in which companies are resident to ensure that losses between companies are offset in their territory. This is in essence the message of the *ICI* ruling.

The situation might, however, be approached in a very different way: as an international situation where the territorial restriction on UK loss relief would be an obstacle to the exercise of the freedom of establishment guaranteed under Community law. As Meussen has suggested, a UK company with a foreign permanent establishment is comparable to a UK company with a foreign subsidiary. If losses are offset at international level in the first situation but not in the second, this would be a form of discrimination against foreign investment. This leads on to another question: does freedom of establishment oblige the State in which the investing company is resident to treat any foreign investment irrespective of its legal form equally, i.e. in a non-discriminating manner.

However a UK company with a UK subsidiary is not comparable to a UK company with a foreign subsidiary. The Special Commissioners reject such a comparison as the profits of the foreign company are also not taxable in the UK – a typical territorial and, from their viewpoint, consistent argument. If, in such circumstances, the tax burden in the UK is higher in the second case than in the first, and in the light of the *Bosal* ruling that the territoriality principle does not apply to the relationship between parent and subsidiary companies, international offsetting of companies' profits/losses would have to be allowed. This was the aim of the European Commission's Directive on losses which has since been withdrawn. Home State taxation and a common assessment basis are also a step in this direction.

What would the ECJ decide in such a case? It would simply rule that the non-application of the loss relief system to foreign subsidiaries within the Community is a restriction on freedom of establishment. How this situation is to be resolved is open to question. The United Kingdom could perhaps totally abolish the loss relief system.

4. Outlook

This leads us to the relationship between Member States and the ECJ. At the moment Member States seem to be in a state of paralysis like rabbits mesmerised by a snake. They react only to individual rulings, in many cases with the result that they eliminate discrimination by treating domestic cases in the same way – badly – as international ones. Germany's reaction to the *Lankhorst-Hohorst* ruling is a typical example.

There is a phase of legal uncertainty between a ruling by the Court and a Member State's reaction.

It is therefore high time that Member States cast a critical eye on their own law to see whether it is compatible with Community law and work out intelligent solutions together. A list was recently published in Germany of some 100 provisions of German tax law which are incompatible with Community law. To me this a bottom-up approach: analysis of national law

is followed by the development of a, possibly diverse, Community standard and a number of options for Member States.

The other approach that has been used in the past, admittedly with some success is: the Community develops a Community standard – usually on the basis of theoretical studies and this is incorporated into national law in the form of a Directive. The Merger Directive is a typical example of such a top-down approach as it deliberately does not take account of the multiplicity of national rules.

To put it more simply:
A top-down approach is harmonisation of national law through a common approach whereas a bottom-up approach is coordination of national laws where national sovereignty is maintained as far as possible.

I am therefore convinced there is no need to take further ambitious Community action. All that is required is to establish what national tax law actually says and see how it can be adapted to European requirements.

For me the way ahead, as long as the Community has no clearly defined legislative power, is to continue developing direct taxation in Europe through a "restatement" of European tax law as an academic task following the example of American law. The idea would be to create a European Tax Institute which could complete its work in five to ten years, culminating in a European Code of Taxation – not a binding legal document but an inventory of national direct taxation rules which are compatible with European law. Member States would then be free to select from this inventory the measures which best suit their tax policy (while retaining their national sovereignty and maintaining fair tax competition).

Another possible approach would be for the ECJ not simply to examine existing national rules but to be involved in an evaluation from the very start. This would, however, mean a radical change in its role of interpreter and scrutiniser of legislation to a proactive institution.

This brings me to the following conclusion:

The ECJ has now reached the stage where it can no longer solve problems through the "traditional" distinction between discrimination and restriction. Traditional approaches are becoming irrelevant as markets become more complex and fundamental freedoms gain in importance. The time has come for a paradigm shift. The other topics of this Conference take precisely this direction.