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VIEWPOINTS

Is the ECJ Consistent in Its Jurisprudence? The 'Negative Income' Cases

by Philip Laroma Jezzi

Any speculation as to whether the European Court of Justice is consistent in its jurisprudence must begin with a basic fact: The ECJ, much to the disappointment of the revenue authorities of many member states, and of many scholars, is *not* a tax court. Under article 220 of the EC Treaty (ECT), the role of the ECJ is to ensure that "in the interpretation and application of (the) Treaty the law is observed."[1] It is well known that at a community-law level there are very few provisions that deal with direct taxation as such; and those that do actually have a direct taxation object are merely instrumental to the application of domestic tax law regarding cross-border transactions within and with the EU (as the parent-subsidiary, merger, interest and royalty, savings income, and capital duties directives).

Thus, one may rightfully affirm that the ECJ neither interprets nor applies a law that may be labeled as tax law in its own merit. This clearly doesn't mean that the Court's decisions do not have an impact on the member states' tax legislation and on their double taxation conventions (DTCs)[2]; however, such an impact — which is actually significant — is not necessarily the result of a tax-centered or tax-inspired legal reasoning.

In fact, what the Court does is interpret and then apply EC law with reference to domestic or international tax law; the term "EC law" refers substantially to the fundamental freedoms[3] and state aid[4] provisions of the ECT, that is, essentially nontax provisions and concepts.

To fully recognize this feature of the ECJ's role in direct tax matters is, in my view, crucial to come to terms with its jurisprudence. There is, in fact, nothing inherently wrong in highlighting that — from a purely domestic or international tax law standpoint — that jurisprudence may be regarded as "inconsistent,"[5] provided that, however, one first recognizes that such a standpoint is by no means the appropriate one from which to assess whether the Court is fulfilling its duty as set out by the ECT.

Although such concepts as coherence and symmetry[6] are at the core of the proper functioning of tax systems, both at a domestic and international level, it is not part of the ECJ's duties to ensure that either of them are actually achieved or maintained. In principle, this is a matter only for national parliaments and constitutional courts to take care of (insofar as member

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[1]All references to articles are to the ECT provisions.

[2]The impact of Community law on member states' DTCs is the object of many in-depth analyses, as those of T. O'Shea, *EU Tax Law and Double Tax Conventions,* Avoir Fiscal Ltd., 2008; P. Pistone, *The Impact of Community Law on Tax Treaties,* Kluwer Law International, 2002; G. Maisto, *Courts and Tax Treaty Law,* IBFD, 2007; P. Essers et al., *The Compatibility of Anti-Abuse Provisions in Tax Treaties With EC Law,* Kluwer Law International, 1998.

[3]Free movement of goods (article 23), free movement of workers (article 39), right of establishment in relation to self-employed workers (article 43) and companies (article 48), freedom to provide and receive services (article 49), free movement of capital (article 56), and, more recently, the rights of EU citizenship and to move and reside freely within the territory of the member states (articles 17 and 18).

[4]Article 87 ff.

[5]Such a charge is extremely common in the EC tax law literature. *See,* in particular, P. Wattel and B. Terra, *European Tax Law,* Kluwer, 2008.

[6]Nevertheless, coherence and symmetry may come into play as constitutive elements of accepted justifications to restrictive measures (see below).

states will maintain a veto right within the council[7]). In other words, whereas fully synchronized tax systems[8] may well be in breach of the obligations that stem from the ECT, nonsynchronized systems may be fully compliant with such obligations. The ECJ is concerned only with the former situations, and it should not be blamed when the latter situations prove to be undesirable byproducts of its intervention. As pointed out by a prominent scholar:

> in its decision the ECJ is not imposing new taxes, it is liberating taxpayers from taxes that in its view should not have been levied in the first place.[9]

The Court has always been adamant that in the interaction between the ECT and the direct tax systems of member states, the former should prevail, whatever the consequences might be in terms of loss of revenue. At the outset of its decisions the Court always reminds us that:

> although direct taxation falls within their competence, the Member States must *none the less* exercise that competence consistently with Community law.[10] [Emphasis added.]

Further, the Court does take into consideration the potential effects of its decisions on national tax systems. By highlighting some tax-focused requirements of public interest that are capable of justifying a restriction on the exercise of fundamental freedoms — coherence of the tax system,[11] balance in the allocation of taxing rights between member states (territoriality),[12] prevention of tax avoidance,[13] and effectiveness of fiscal supervision[14] — in actuality the Court is mediating between the need to enforce the ECT and to protect the competing, yet legitimate, interests of member states.

The ECJ case law should therefore undergo an unbiased scrutiny, designed only to ascertain whether its findings are supported by the provisions of the ECT (or of the appropriate secondary EU Community law), irrespective of whether they force member states into a restructuring of their tax systems or renegotiations of their DTCs.

In particular, it is well known that the coordinates of the ECJ's course of action are embedded in the discrimination-restriction and justification-proportionality dichotomies.[15] In my opinion, it is exclusively with reference to those parameters that the ECJ should be kept accountable.

In light of the scope and extension of the Court's jurisprudence in the direct tax area, there are endless subjects that may be taken into consideration to investigate to what extent the Court has adopted a consistent approach in the application of those four concepts.

One of the themes that has persistently been at the Court's center of attention and that is of the utmost importance within the EU internal market is cross-border personal and family circumstances and, more generally, "negative income." The following analysis concentrates on these issues.

The *Schumacker* Line of Cases

The Court has dealt with this subject in one of its best known and most analyzed cases, in which the freedom of movement of workers (article 39) was at stake. The milestone conclusion reached in *Schumacker*[16] is that, although as a rule residents and nonresidents may be treated differently because they are not in a comparable situation,[17] when it comes to taking into account personal and family circumstances (which, together with the aggregate income, form the ability to pay of a given taxpayer[18]), the position of a resident and the position of a nonresident who receives the major part of his income and almost all of his family income in a member state other than that of his residence[19] become comparable and, as a result, the latter is entitled to the national treatment, that is, no less favorable treatment than that reserved for the former.

Were that comparability to be overlooked, the Court concluded:

> discrimination [would arise] from the fact that the [nonresident's] personal and family circumstances

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[7]This point is clearly made by T. O'Shea in his comment on the advocate general's opinion in *Lidl Belgium*: "The Court has the power to interpret the EC Treaty, but does not have the power to make member states adopt specific (tax) laws." "ECJ Rejects Advocate General Advice in Case on German Loss Relief," *Tax Notes Int'l*, June 30, 2008, p. 1078, *Doc 2008-13863*, or *2008 WTD 123-2*.

[8]Synchronization may operate internally (for instance, by matching up taxation of corporate profits at company and shareholder levels) or internationally (for instance, preventing juridical double taxation).

[9]F. Vanistendael, "Common (Tax) Law of the ECJ," *ECTLR*, 2007, 251.

[10]*See Schumacker,* section 21; *Futura* (case C-250/95), section 19; *ACT Group Litigation,* section 36.

[11]*See Bachmann* (case C-204/90); *Commission v. Belgium* (case C-300/90); *Wielockx* (case C-80/94); *Danner* (case C-136/00).

[12]*See Futura; Marks & Spencer* (case C-446/03).

[13]*See Cadbury Schweppes* (case C-196/04); *Marks & Spencer.*

[14]*See Futura*; *Marks & Spencer*; *Lidl Belgium* (case C-414/06).

[15]For an extensive analysis thereof, see O'Shea, *supra* note 2, chapters 1, 2, and 3.

[16]Case C-279/93.

[17]*Id.*, section 34.

[18]*Id.*, section 32.

[19]*Id.*, section 38.

are taken into account neither in the State of residence nor in the State of employment.[20]

There is one aspect of this decision that is a constant feature of the ECJ's jurisprudence and, as such, constitutes evidence of a consistent approach to direct tax matters.

The Court is by no means interested in the fact that personal and family circumstances (as part of one's ability to pay) are taken into account. Had the host state legislation not taken those circumstances into consideration in the first place, there would have never been a *Schumacker* case.

This might be regarded as a trivial remark, yet it addresses a crucial feature of the ECJ's understanding of its own role.

For instance, the Court is equally uninterested in economic double taxation on dividends as an issue in its own merit; yet once a member state provides for economic double taxation relief for outbound[21] or inbound[22] dividends, the ECJ expects that tax advantage (national treatment) to be extended to the appropriate comparable situation. Should the U.K. or Finland[23] not have introduced measures to avoid economic double taxation on dividends paid out respectively to resident shareholders or by resident companies (national treatment), it would not have had to extend them to comparable situations in which the rights of establishment and of free movement of capital had been exercised.

The same may be said for the offsetting of subsidiaries' losses[24] and for many other tax advantages made available to residents[25] that the Court has become concerned with only once they were proven to be inaccessible to comparable nonresidents (in host state cases) or fellow residents who had availed themselves of the fundamental rights (in origin state cases).

What has just been noted regarding tax advantages is also true for tax disadvantages, when they are applicable to nonresidents (in host state cases) or to fellow residents (in origin state cases) who avail themselves with the fundamental rights while not being applicable to comparable residents in either case.

In other words, the Court is not concerned with direct taxation in itself but with its neutrality. To the extent that the national treatment[26] is neutral — meaning it doesn't restrict the exercise of the fundamental freedoms — there is no room for the Court to take action.

Going back to *Schumacker*, from a domestic and international tax law standpoint, it may seem incomprehensible that the source state should be required to take into account the nonresident's personal and family circumstances given that the nonresident and his family actually live in another country. Yet, because according to host state national treatment, resident taxpayers' personal and family circumstances may be taken into account in determining their overall ability to pay, and the ability of a nonresident (and his family) to pay is almost all concentrated in that state because he has availed himself of the freedom of movement of workers, the nonresident is comparable to a resident and is entitled to benefit from the national treatment.

This approach — for assessing the taxpayer's overall ability to pay, a resident is comparable to a nonresident that gains almost all of his ability to pay in the state of employment — has been confirmed by subsequent jurisprudence.

In particular, in *Gschwind*,[27] the Court held that the host state is under no obligation to take into account the personal and family circumstances of a nonresident in situations in which enough income is gained in the state of residence to maintain the possibility of account to be taken of those circumstances in that state.[28]

In *De Groot*, the ECJ rehearsed this approach in a situation in which the nonresident's total income had been generated in more than two states and the state of residence had accepted the deduction of a maintenance payment only *pari passu* to the percentage (40 percent) of the income that was taxed in that state according to the relevant DTCs. The Court concluded that it was the obligation of the state of residence, and not of the states of employment, to take into account the whole amount of the payment at issue,[29] even though it taxed only a fraction of the taxpayer's income.[30]

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[20] *Id.*

[21] *See ACT Group Litigation* (case C-374/04).

[22] *See Manninem* (case C-319/02).

[23] *See supra* notes 21 and 22.

[24] *See Marks & Spencer.*

[25] Although the fundamental freedoms provisions prohibit discrimination based on nationality, a restriction based on equivalent criteria — such as that of residence — still amounts to discrimination. The Court has held that criteria such as residence "may be tantamount, as regards their practical effect a discrimination based on nationality" (*Sotgiu* (case 152/73), section 11).

[26] *See De Groot* (case C-385/2000), section 94:

> Member States must comply with Community rules . . . and, more particularly, respect the principle of *national treatment* [italics added] of nationals of other Member States [host-state perspective] and of their own national who exercise the freedoms guaranteed by the Treaty [origin state perspective].

For the development of the national treatment principle in terms of migrant and nonmigrant analysis, see O'Shea, *supra* note 2, chapter 1.

[27] Case C-391/97.

[28] *Id.*, section 32.

[29] *Id.*, section 91.

[30] According to B. Terra and P. Wattel, *supra* note 5, the Court should have held that each host state in which the worker had gained a fraction of his overall income was obliged to take into

(Footnote continued on next page.)

Both decisions, as stated above, have come to conclusions (from different perspectives: of the host state in *Gschwind* and of the origin state in *De Groot*) that confirm the *Schumacker* approach. Regarding a national provision whereby personal and family circumstances are taken into consideration for assessing tax, the taxpayer's overall ability (national treatment), a nonresident who gains almost all his ability to pay in that state is comparable to a resident and, as such, is entitled to benefit from that fiscal treatment.[31]

It must be noted that in those cases in which a restriction was found, the Court has constantly rejected the member states' justification based on the principle of tax system coherence[32] for the lack of a direct link between the (restrictive) tax advantage at play and the offsetting of that advantage by a particular tax levy[33] that is necessary for that argument to succeed.[34]

On the other hand, the justification to ensure a correct allocation of taxing rights (territoriality)[35] was never tested in these cases. The following paragraphs examine whether the scope of that justification might encompass situations as those cases under analysis.

Ritter-Coulais, *Lakebrink*, and *Renneberg*

The Court, in the cases that I have so far referred to, was concerned with personal and family circumstances, the idea being that because a state takes those circumstances into consideration to assess (and tax) the total income of residents, that state must also extend that national treatment to nonresidents who are comparable for having gained their total income in that state.

In *Ritter-Coulais*,[36] *Lakebrink*,[37] and *Renneberg*,[38] the same approach is applied to situations in which nonresidents who earned all (or almost all) of their income in the state of employment (and therefore satisfied the *Schumacker* test) applied for negative income deriving from immovable property owned in the state of residence, to be taken into account for tax purposes in the former state.

In *Ritter-Coulais*, a nonresident worker, who was assessable to income tax in the state of employment (Germany), was prevented from taking into account the rental income losses from the use of a private dwelling in the state of residence (for determining his income tax rate). By contrast, the national provision permitted him to take into account:

- negative income from the use of a private house in that state; and
- positive income from the use of a private house abroad.[39]

Interestingly, the exclusion of losses generated by dwellings abroad operated also for residents; nevertheless, the Court noted that the provision was actually detrimental only for nonresidents, given that the latter are more likely "to own a home outside Germany than resident citizens."[40] The ECJ recognized that whereas residents were able to have their rental income losses taken into account (national treatment), comparable nonresidents were not. And that, consistent with the earlier decisions, meant that the latter were discriminated against.

In *Lakebrink*, the background differed from *Ritter-Coulais*, essentially because in the former case negative income derived from immovable property that had been rented out and as such was not occupied as a private dwelling by the nonresident taxpayer.[41]

On the other hand, in *Renneberg*, the nonresident actually occupied the private dwelling abroad, but the negative income deriving therefrom[42] was relevant for having it deducted from his income in the state of employment and not for determining the applicable tax rate, as in the other two cases.

In *Lakebrink* and *Renneberg*, the tax advantage denied to the nonresident claimants was secured to residents.[43] In other words, under the national treatment relevant to both cases, residents were entitled to have negative

account a corresponding fraction of his personal and family circumstances. I submit that such a conclusion would have been out of the Court's reach: For the purpose of assessing the overall ability to pay of a taxpayer, a worker who earns only a fraction of his income in the host state is not comparable to a resident of that state and, as such, is not entitled to access to that particular national treatment.

[31] *See also Zurstrassen* (case C-87/99), section 21. Although for purposes other than those at the origin of the cases so far analyzed, the *Schumacker* legacy can be seen at play also in *Gerritse* (case C-234/01), section 43.

[32] *Schumacker*, section 40; *De Groot*, section 105.

[33] This is wording used in *Deutsche Shell* (case C-293/06), section 38.

[34] *See supra* note 11.

[35] *See supra* note 12.

[36] Case C-152/03.

[37] Case C-182/06.

[38] Case C-527/06.

[39] *Id.*, section 34.

[40] *Id.*, section 36.

[41] *See* A. Taferner, "Absence of Loss Relief Rules for Non-Residents May Violate EC Treaty," *European Taxation*, 2007, 308 ff. for an accurate account of the factual background.

[42] Essentially interest paid to service the mortgage loan by means of which the nonresident had financed the purchase of the dwelling.

[43] I have noted above that this was not the case in *Ritter-Coulais* (residents were prevented from taking into account for tax purposes negative income from immovable property abroad); yet the Court has nevertheless come to the conclusion that the provision ended up discriminating nonresidents.

income from immovable property located abroad taken into account for tax purposes, while nonresidents were not.

The step forward made by the Court in its understanding of the ramifications of the *Schumacker* doctrine is essentially that the obligation of the state of employment to extend the appropriate national treatment to comparable nonresidents applies, even though the relevant circumstances to be taken into account for tax purposes in that state consist of negative income — a loss deriving from a source of income (immovable property, in the situations at hand).

This expansion of the *Schumacker* doctrine's scope has attracted two kinds of criticism. The first goes against the assumption that negative income from immovable property should stay under the same category with personal and family circumstances as referred to in the *Schumacker* case[44]; the second evokes the principle of territoriality to contest that the state of employment should *tout court* not be forced to take into account foreign negative income.[45]

The Court, under the guidance of AGs Léger[46] and Mengozzi,[47] addressed the first issue, stating that according to the *Schumacker* criterion, discrimination concerns:

> all the tax advantages connected with the nonresident's ability to pay which are not taken into account either in the State of residence or in the State of employment, since *the ability to pay tax may indeed be regarded as forming part of the personal situation of the non-resident* within the meaning of the judgment in *Schumacker*.[48] [Emphasis added.]

This finding, although not completely accurate, is absolutely right in its substance.

The inaccuracy derives from the fact that — contrary to the statements laid down in *Ritter-Coulais* and in *Lakebrink* — in the *Schumacker* judgment it was never held that the nonresident's ability to pay forms part of his personal situation; the Court said pretty much the opposite, that the nonresident's ability to pay is determined by reference to his aggregate income and his personal and family circumstances[49] (which makes more sense than the other way around).

The Court's reasoning is nevertheless persuasive. Because residents and nonresidents under some conditions may be regarded as comparable for taking into account their personal and family circumstances, the same conclusion should be reached for taking into account their overall ability to pay. In fact, apart from the issue of territoriality addressed below, there are no differences between the two concepts to justify the finding that there should be no comparability regarding the taxpayer's ability to pay (and his negative income).

In the cases at hand, the Court is therefore doing nothing more than correctly applying the national treatment principle that has always underpinned its jurisprudence on the fundamental rights. The ECJ has always been careful to clearly state that the fiscal treatment that was denied to the nonresident was actually part of the appropriate national treatment applicable to residents, as shown below:

- "It follows that the treatment of non-resident workers under national legislation is less favourable than that afforded to workers who reside in Germany in their own homes." (*Ritter-Coulais*, section 37.)
- "The legislation at issue in the main proceeding lays down a different tax regime depending on whether or not a worker receiving the major part of his taxable income in Luxembourg is resident here." (*Lakebrink*, section 13.)

[44]According to G.T.K. Meussen, "An Analysis of the Dutch AG's Opinion on *Renneberg*," *Tax Notes Int'l*, May 11, 2009, p. 501, *Doc 2009-8012*, or *2009 WTD 91-9*, "the taxation of a personal dwelling is a source-related item of income that should not fall under the 'personal and family circumstances' that are the constituting factors of *Schumacker*. It seems incomprehensible that the Netherlands is forced by this ruling to provide a tax incentive for a personal dwelling to a Belgian resident because he happens to work in the Netherlands." *See also* the opinion of P. Wattel (AG to the Dutch Supreme Court) handed down on Feb. 10, 2009; G. Meussen, "The *Ritter-Coulais* Case — a Wrong Decision in Principle by the ECJ," *European Taxation*, 2006, 335 ff.; M. Russo, "La compensazione delle perdite transnazionali da parte del soggetto nonresidente tra principio di territorialità e tassazione in base alla capacità contributiva," *Rivista di diritto tributario*, 4, 2008, 91 ff.

[45]E. Kemmeren, "*Renneberg* Endangers the Double Tax Convention System or Can a Second Round Bring Recovery," *EC Tax Rev.*, 2009, 9; E. Kemmeren, "ECJ Should Not Unbundle Integrated Tax Systems," *EC Tax Rev.*, 2008, 7; G. Meussen, *supra* note 44, 91; C. Sozzi, *Corte di Giustizia e perdite transfrontaliere. Il principio di capacità contributiva prevale su quello di territorialità quando si tratta di persone fisiche*, 2, 2009, 550.

[46]Opinion in *Ritter-Coulais*, points 97 to 99.

[47]Opinion in *Lakebrink*, point 36.

[48]*Lakebrink*, section 34; and *Renneberg*, section 63.

[49]*Schumacker*, section 32. *See also* section 33, in which the Court notes that:

> The situation of a resident is different [vis-à-vis a nonresident] in so far as the major part of his income is normally concentrated in the State of residence. Moreover, that State generally has available all the information needed to assess the taxpayer's overall ability to pay, taking account of his personal and family circumstances.

- "The taking into account of the relevant negative income, or the refusal to do so, thus depends in reality on whether or not those taxpayers are resident in the Netherlands." (*Renneberg*, section 58.[50])

Once the foregoing facts were recognized, the *Schumacker* doctrine (residents and nonresidents who receive almost all their income in the state of employment are comparable) left the Court no other choice — lacking any acceptable justification — than to extend to the nonresident the relevant national treatment that the member states had withheld in violation of EC law.

Consistent with its case law, the ECJ is therefore by no means interfering with member states' sovereignty in tax matters or with their willingness to take (or not take) into account for tax purposes, say, a taxpayer's personal and family circumstances or negative income deriving from immovable properties. It is only ensuring that inasmuch as those measures are actually laid down (and thus form part of a member state's national treatment), they are made available *either* to residents[51] and nonresidents[52] who have not exercised the fundamental freedoms *or* to comparable residents and nonresidents who have availed themselves of those freedoms.[53]

The claim[54] whereby negative income cannot be assimilated to personal and family circumstances for the purposes of applying the *Schumacker* jurisprudence seems to miss this very point: What really matters is comparability (as that recognized in the *Schumacker* judgment); once that comparability has been established for a given treatment, the Court will extend it in accordance with the national treatment principle, with the exception of those situations in which one or more justifications might be applicable.

A Territoriality Issue?

In *Futura* the ECJ recognized that the basis of assessment for nonresident taxpayers may legitimately take into account only profits and losses arising from activities carried out in the host state:

> Such a system, which is in conformity with the fiscal principle of territoriality, cannot be regarded as entailing any discrimination, overt or covert, prohibited by the Treaty.[55]

In the subsequent decisions rendered in *Marks and Spencer*,[56] *Oy AA*,[57] *Deutsche Shell*,[58] and *Lidl Belgium*,[59] the Court has consistently maintained that:

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[50]*See also* sections 71 and 79.

[51]In origin state cases.

[52]In host state cases.

[53]As persuasively noted by T. O'Shea in "Dutch Rental Income Loss Rules Incompatible With Free Movement of Workers, ECJ Says," *Tax Notes Int'l*, Jan. 5, 2009, p. 36, *Doc 2008-26363*, or *2008 WTD 244-9*, "If the Netherlands did not provide such a tax advantage for its own residents, then it would not have to grant them in situations like Renneberg's."

[54]*See supra* note 44.

[55]*Futura*, sections 21 and 22. For an analysis of the principle of territoriality in *Futura*, see A. Cordwener, M. Aahlberg, P. Pistone, E. Reimer, and C. Romano, "The Tax Treatment of Foreign Losses: *Ritter*, *M & S* and the Way Ahead (Part Two)," *European Taxation*, May 2004, 220.

[56]Case C-446/03, sections 45-46.

[57]Case C-231/05, sections 51-56.

[58]Case C-293/06, sections 42-43.

[59]Case C-414/06, sections 31-34. The *Krankenheim* decision (case C-157/07), which also deals with cross-border loss relief, needs to be addressed separately. The Court in that case has justified the restriction imposed on a resident company to the offsetting of losses suffered by its foreign permanent establishment on the basis of the "need to ensure the coherence of the tax system" rather than of the "need to safeguard the allocation of the power to tax between member states." In that case the restrictive regime at play (section 38) was the German "deduction and reintegration system" whereby losses of foreign PEs were deductible conditional on their recapture in subsequent tax years when that PE made profits. The taxpayer challenged that regime once Germany taxed the profits of the foreign PE up to the amount of losses that had been deducted in the previous years. The reason behind the differing outcomes in *Marks & Spencer* and *Lidl Belgium* (in which the territoriality justification came into play) vis-à-vis in *Krankenheim* (in which the coherence of the tax system justification came into play) may be that in the latter case Germany had actually agreed to give relevance to foreign losses although (on account of the exemption provided by the relevant DTC) it did not tax the profits (section 35). In other words, once a member state takes into account foreign losses (regardless of whether they are temporary or final), it essentially waives its right to have any restriction thereto justified on the grounds of territoriality. As a result, territoriality was no longer an issue there. This has left the Court with the task of ascertaining whether the restriction caused by the "loss and reintegration system" might be justified other than on the need to safeguard the allocation of the power to tax between member states (section 40 and ff.). From this (new) analytical standpoint the Court has retrieved the justification, accepted in *Bachmann* (case C-204/90), whereby "in the event of a State being obliged to allow the deduction of life assurance contribution paid in another MS, it should be able to tax sums payable by insures" (*Bachmann*, section 23). In *Krankenheim* (section 42) the Court stated:

> That reintegration, in the case of a company with a permanent establishment in another State in relation to which that company's State of residence has no power of taxation, as the referring court indicates, reflects a logical symmetry. There was thus a *direct, personal and material link* between the two elements of the tax mechanism at issue in the main proceedings, the said reintegration being the logical complement of the deduction previously granted. [Emphasis added.]

There is also a constitutional explanation to the Court's assessment in *Krankenheim*, as pointed out by T. O'Shea in "German Loss Deduction and Reintegration Rules and the ECJ" (*Tax Notes Int'l*, Mar. 16, 2009, p. 967, *Doc 2009-4463*, or *2009 WTD 52-11*). The author argues:

(Footnote continued on next page.)

> the preservation of the allocation of the power to impose taxes between Member States may make it necessary to apply to the economic activities of companies established in one of those States only the tax rules of that State in respect of both profits and losses.[60]

The recognition of the safeguard of "symmetry between the right to tax profits and the right to deduct losses"[61] as a possible justification to restrictive measures always must be tested in light of the "rule of reason"[62] conditions, particularly to ascertain that those measures ensure the appropriate objective and do not go beyond what is necessary (proportionality).[63]

The Court has consistently recognized that, as far as restrictions to cross-border loss relief systems are concerned,[64] member states may rely on the principle of territoriality as a justification only up to a point, that point being that the losses at issue (suffered either by subsidiaries[65] or branches[66] in other member states) must not be terminal or final. In further detail, in the area of cross-border loss relief, freedom of establishment is being interpreted to provide that member states are under the obligation to take into account losses suffered in other member states to the extent that they satisfy the two-pronged "no possibilities" test[67] laid down in paragraph 56 of the *Marks & Spencer* decision, that is:

- the nonresident subsidiary has exhausted the possibilities available in its state of residence of having the losses taken into account for the accounting period concerned by the claim for relief and also for previous accounting periods, if necessary by transferring those losses to a third party or by offsetting the losses against the profits made by the subsidiary in previous periods; and
- there is no possibility for the foreign subsidiary's losses to be taken into account in its state of residence for future periods either by the subsidiary itself or by a third party, in particular where the subsidiary has been sold to that third party.

In light of the foregoing, is there any room for claiming that the Court is being inconsistent in its approach to cross-border loss relief of individuals (on the one hand) and of legal bodies (on the other), or at least that it is making a distinction between the two by recognizing the existence of a territoriality issue only when the latter are concerned?

In other words, because the prevention of the cross-border setoff of losses (arising either from subsidiaries or branches) is regarded as compatible (justified) with the treaty when legal bodies are concerned (other than in situations in which the limitation is deemed nonproportionate, such as final losses), should the Court have accepted that justification in the cases analyzed in the previous paragraph?[68] The answer to that question, in my opinion, should be no.

In cases such as *Ritter-Coulais* and the ones that have followed, the need to maintain symmetry between positive and negative income was taken into account at the level of the comparability assessment that the Court had carried out since the *Schumacker* decision; consequently, there has never been analytical room for ascertaining whether the restriction could be justified on the grounds of territoriality. To the extent that the *Schumacker* approach presupposes that almost all the positive income of the nonresident is gained in the state of

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In *Krankenheim*, because the rules existed, the Court had to take them into account in determining whether the tax rules of the member state (Germany) breached article 31 of the EEA Agreement. They were a necessary part of the German tax regime, and accordingly, the Court was at liberty to determine that the rules were necessary to ensure the coherence of the German tax system.

In *Marks & Spencer*, however, the rules did not exist and the ECJ had no power to force the United Kingdom to introduce the rules because it is limited to a "negative harmonisation" role. In other words, while the Court was able to say to the United Kingdom that its group relief rules breached the freedom of establishment provisions of the EC Treaty, it was not able to say that a less restrictive way of having a group relief system would be to have a loss deduction and recapture mechanism. The United Kingdom could not be forced to introduce such a mechanism. Similarly, in *Lidl Belgium*, Germany could not be forced to reintroduce such a mechanism.

Contra G. Meussen, "The ECJ's Judgment in *Krankenheim* — the Last Piece in the Cross-Border Loss Relief Puzzle?" *European Taxation*, July 2009, 361.

[60] *Lidl Belgium*, section 31.

[61] *Id.*, section 33.

[62] *See Gebhard* (case-55/94).

[63] *See, for example, Marks & Spencer*, sections 51-53.

[64] It is superfluous to state that the existence of a restriction in the field of cross-border loss relief presupposes that such relief is granted domestically.

[65] *See* the *Marks & Spencer* decision.

[66] *See* the *Lidl Belgium* decision.

[67] As referred to by T. O'Shea, "Tribunal Finds in Favor of Marks & Spencer" (*Tax Notes Int'l*, June 1, 2009, p. 739, *Doc 2009-11847*, or *2009 WTD 100-3*), commenting on the First-Tier Tribunal's ruling in *Marks & Spencer v. HMRC* that gave effect to ECJ decision.

[68] This is essentially the question raised by the authors referred to at notes 45 and 46: Why is the Court accepting the principle of territoriality as a justification to limits posed by member states to the setoff of foreign losses only as far as legal bodies are concerned? Shouldn't the Court have applied the *Futura* reasoning (whereby the state of source is under an obligation to take into account foreign losses (section 22)) also to *Renneberg*?

employment, it is consistent with the principle of territoriality that that state also should take into account the negative income whenever the national treatment principle requires it to do so.

Futura and *Renneberg* are therefore perfectly reconcilable:

- In the former, the host state was entitled to tax only the nonresident's profits arising from activities carried out in its territory. According to the principle of territoriality, that state might not be forced to take into account losses arising from activities carried out elsewhere.
- In the latter, the antefact was that the host state was taxing the *whole* positive income of the nonresident. As a result, the principle of territoriality could by no means justify the failure of that state (in accordance with the *Schumacker* doctrine) to take into account the whole negative income of the nonresident taxpayer, no matter where it had arisen.

So as profits and losses are two sides of the same coin, the same should be said for negative and positive income — the coin being, in either case, a taxpayer's liability to tax. As a consequence, the principle of territoriality may be able to justify a restriction to the setoff of a taxpayer's foreign negative income only because the member states that enact that restriction have no right to tax the foreign positive income of that taxpayer (provided, in any event, that the "final loss" test is satisfied). This is clearly not the situation that comes into play in the *Schumacker* line of cases, including *Renneberg*, in which the member state that has laid down the restriction was taxing either the foreign or the domestic income.

Conclusions

This analysis has confirmed that there is nothing new under the sun. The Court is progressively unearthing more and more ramifications of the national treatment principle, which has been at play since the early cases.

From the standpoint of the enforcement of that principle, there is therefore no significant analytical shift between *Schumacker* and, say, *Renneberg*. They both confirm that the Court's target is not national treatments, but their application to comparable situations.

The *Renneberg* judgment seems to me immune from both of the shortcomings it has been accused of.

First, in terms of the fundamental freedoms' scope, there is no such difference between foreign personal and family circumstances and negative income arisen from a foreign source. To the extent that the state of source takes into account either of them with reference to the assessment of the tax base of its residents, that state has undertaken to extend that (national) treatment to comparable nonresidents.

Second, member states' restrictions on taking into account foreign negative income are not justifiable under the principle of territoriality because those member states are entitled to tax the positive income of the taxpayer who has made such a claim. This is confirmed either by the *Schumacker* line of cases (in which an issue of territoriality has never arisen given that the state of source had the right to tax the foreign incomes of the taxpayer) or by the *Marks & Spencer* line of cases (in which the said issue has arisen because the state of residence was not entitled to tax the foreign incomes of the taxpayer). It is also confirmed by the *Krankenheim* decision,[69] in which no territoriality issue has arisen, not because the member states at play had a right to tax foreign positive income, but because that state had voluntarily given relief to foreign negative income, thereby setting aside the protection granted under the principle of territoriality. ◆

[69] *See supra* note 59.