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FEATURED PERSPECTIVES

Lidl Belgium: Revisiting *Marks & Spencer* on the Branch Level

by Wolfgang Kessler and Rolf Eicke

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Some consider the issues in the European Court of Justice's *Lidl Belgium* (C-414/06) case to be a question of symmetry in tax law. Others call the case ''*Marks & Spencer* revisited on the branch level.'' In fact, both statements are correct. The question is whether the country of the head office must take into account losses of a foreign branch, even though the applicable double taxation convention provides for an exemption of the branch profits in that country. Contrary to *Marks & Spencer* (C-446/03), which dealt with losses incurred by foreign subsidiaries (a different legal entity), *Lidl Belgium* involves losses incurred in the same legal entity.

The opinion of Advocate General Eleanor Sharpston on February 14, 2008, gave some insight on this issue. In this article we take a closer look at this opinion.

Legal Framework

In general, Germany taxes its residents on a worldwide basis and unilaterally credits foreign taxes against the domestic tax liability. However, under a double taxation convention, the longstanding German treaty policy is to exempt branch income from the German tax base. Also, some German treaties (for example, the one with Switzerland) include an activities clause. If the exemption method applies, prevailing German case law maintains that both profits and losses are exempt. At this point, the principle of symmetry comes into play. It provides that if profits are not taxed, losses cannot be taken into account. The German Supreme Tax Court (Bundesfinanzhof, or BFH) has been embracing this principle, stating that the exemption of profits and the exemption of losses are two sides of the same coin. In other words, not deducting foreign losses from the domestic tax base is part of the exemption method framework.

From 1969 to 1999, domestic law permitted the taxpayer to deduct losses of exempt foreign branches from the German tax base (section 2a(3) Income Tax Act). The legislature changed its mind in 1999 for the sake of the budget, explaining that it was impractical to keep track of the losses and to apply a deduction-and-recapture rule regarding foreign profits in the following years.

Facts and Circumstances

The company at issue is a German partnership (GmbH & Co. KG). Lidl carried out trade and sales activities in Belgium and Luxembourg through a branch and generated a loss in Luxembourg in 1999. Attempts to deduct these losses from the German tax base failed because of the exemption provision under the Germany-Luxembourg double taxation convention and the abolishment of the domestic deduction opportunity. Nonetheless, these losses were taken into account for calculating the (progressive) tax rate.

Lidl filed suit, arguing that this treatment infringed on European Community law and on German constitutional law. After losing in the first instance (with the Finanzgericht (Tax Court) Baden Wurttemberg), Lidl appealed to the BFH. The BFH found that the tax treatment was in line with domestic law. The BFH indicated that the exemption of losses under the Germany-Luxembourg double taxation convention is correct. Since the court followed the principle of symmetry, it held that the term ''income'' means both positive and negative income for purposes of the exemption method.

However, it would be a mistake to think that upholding the principle of symmetry is an inherent duty of all supreme tax courts in the world. In recent decisions, both the Austrian and Luxembourgian supreme administrative courts disregarded the principle of symmetry. (In Austria, a supreme court does not just pronounce a judgment. Instead, it issues an *Erkenntnis* — knowledge or insight.) On September 25, 2001, the Austrian Supreme Administrative Court (Österreichisches Verwaltungsgerichtshof, or VwGH) issued an *Erkenntnis* overruling the prevailing case law by finding that the double taxation convention between Germany and Austria must ensure both the aggregation of foreign branch losses with domestic income and the prevention of a double utilization of losses (double-dip situations).

> **Sharpston found that two out of three grounds for justification established in *Marks & Spencer* apply to *Lidl*.**

On August 10, 2005, the Luxembourg Supreme Administrative Court (Tribunal Administratif de Luxembourg) followed the Austrian approach and granted a Luxembourgian company the deduction of branch losses in Germany. Obviously, the BFH is not yet ready to overrule its own principle of symmetry case law. However, before referring *Lidl* to the ECJ, the BFH found that the different treatment of taxpayers deriving income from domestic branches and taxpayers with income from foreign branches could infringe on EC law. Therefore, the BFH asked the ECJ whether it is contrary to the freedom of establishment (article 43 EC Treaty) and the freedom of capital movement (article 56 EC Treaty) that losses from a branch in another member state cannot be deducted because the profits from the branch are exempt in Germany under a double taxation convention.

Analysis

Given that the foremost goal of double tax conventions is to avoid double taxation, the exemption of losses does not make any sense because double taxation does not arise for losses. Most importantly, exempting losses leads to the paradoxical consequence that in branch loss situations, taxpayers are better off if there is no applicable double taxation convention. In fact, the underlying reasoning of a double tax convention is to ease tax issues of cross-border activities and not cause detrimental effects because of the DTC's unclear existence.

In *Marks & Spencer*, three risks taken cumulatively justified a nondeduction of foreign losses:

- risk of tax avoidance;
- risk of distortion of the balance in the allocation of taxing rights between the member states; and
- risk of double loss utilization.

We doubt that the justification for all three risks can be applied to branch loss cases. For instance, there is no risk of tax avoidance if the profits and losses were suffered by the same taxpayer. It is doubtful whether an acknowledgment of foreign branch profits would disturb the balance of allocation of taxing rights between the member states, especially when a deduction-and-recapture rule applies. The only obvious risk related to branch losses is the risk of double-dip situations. Again, this risk can be reduced by enacting a deduction-and-recapture rule to tax foreign branch profits in the following years.

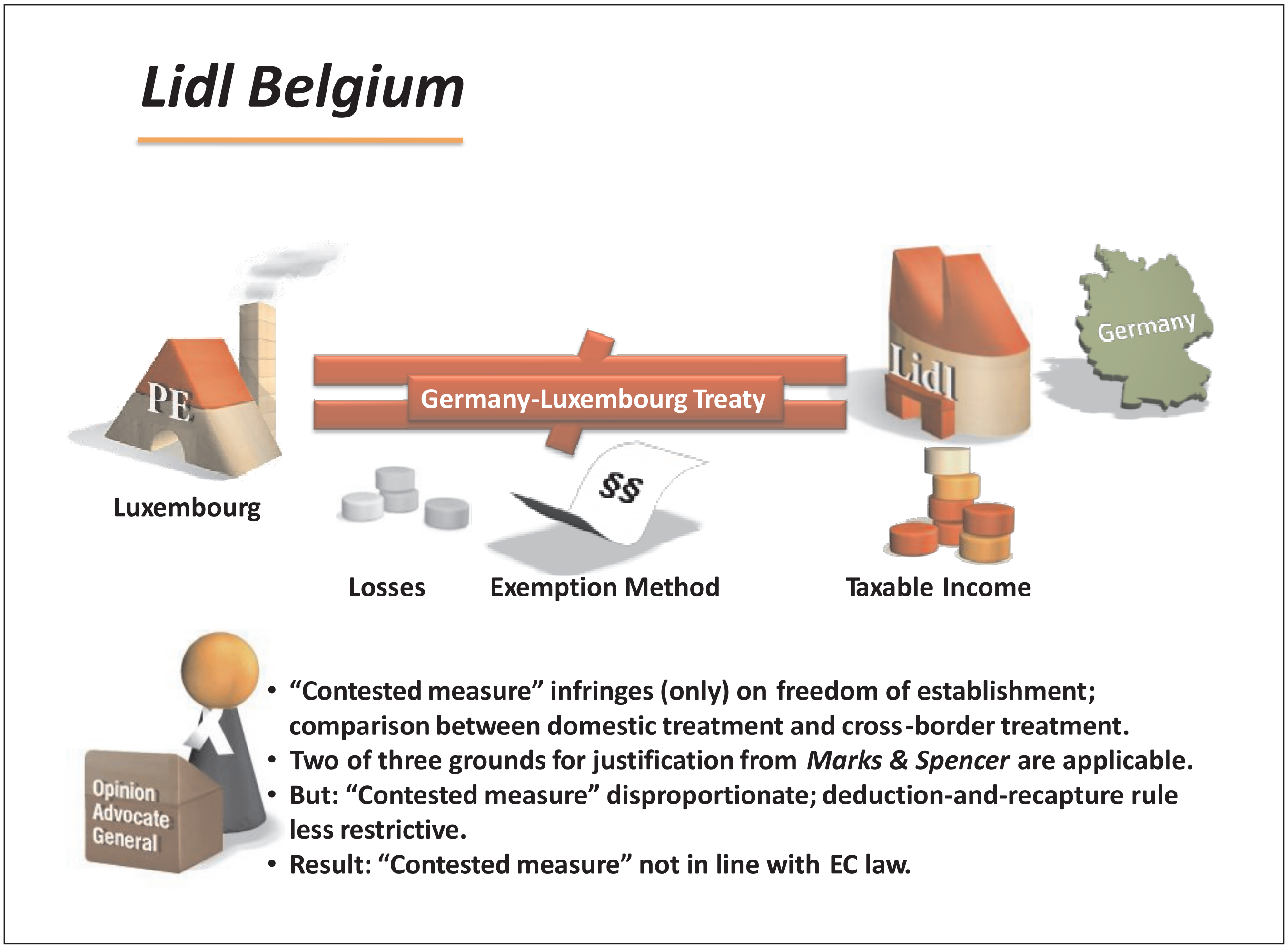
Case Law to Consider

As mentioned above, the counterpart case for *Lidl Belgium* is *Marks & Spencer*. The final judgment will show if the standards set up in *Marks & Spencer* for foreign subsidiaries can be transferred to foreign branch situations. In *Marks & Spencer*, the ECJ held that a general nondeductibility of foreign subsidiary losses is in line with EC law as long as these losses can be used in the country of origin. The BFH doubted that the justifications set out by the ECJ in *Marks & Spencer* could be applied to the present case.

In *Rewe Zentralfinanz* (C-347/04), a German corporation claimed the deduction of losses for partial worthlessness of shares in subsidiaries in the U.K., Belgium, and Spain. The ECJ found that the German rule (which has since been modified) infringed on EC law.

Similar to *Lidl Belgium* was *Stahlwerk Ergste Westig (SEW)* (C-415/06), which involved a U.S. partnership of a German corporation. Foreign partnerships are treated as a branch for German international tax law purposes. The ECJ held that the case affects the freedom of establishment. However, this freedom cannot be relied on in a situation involving an establishment in a nonmember state (that is, in third-country situations).

In our recent column on *Columbus Container* (C-298/05), we explained that the ECJ does not hold itself competent to interpret the relationship between a domestic rule and a double taxation convention. (See *Tax Notes Int'l*, Feb. 18, 2008, p. 587, *Doc 2008-1701*, or *2008 WTD 37-11*.)



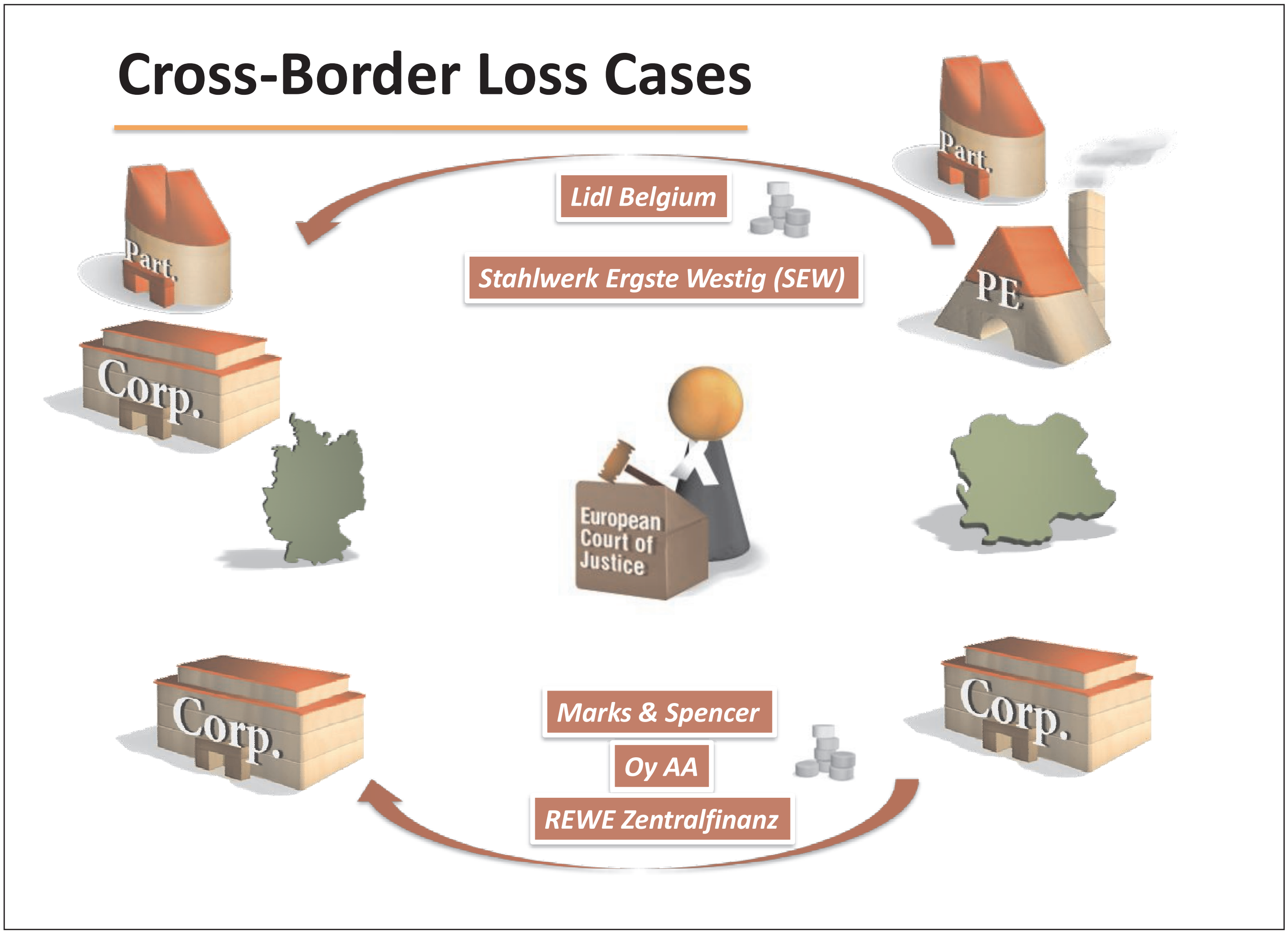
Opinion of the Advocate General

AG Sharpston found that ''the contested measure'' infringes on EC law. First, she stated that the scope of the freedom of establishment is applicable, whereas the freedom of capital movement is irrelevant for the present case. She said that cross-border branch losses are ''manifestly treated less favorably'' than branch losses in a merely domestic case. Moreover, she drew an analogy between a company deducting losses of a foreign subsidiary by way of group relief and the ability to deduct losses of a foreign branch.

The crucial question is whether the grounds for justification established in *Marks & Spencer* can be applied to this case. Sharpston found that two out of three grounds for justification established in *Marks & Spencer* apply to *Lidl*:

- **Allocation of Tax Power.** Sharpston found this ground to be applicable because the same result occurs if not asserting the right to tax a foreign subsidiary (*Marks & Spencer*) or if waiving the right to tax foreign branch profits by way of the exemption method under a double taxation convention (*Lidl Belgium*).
- **Double Utilization of Losses.** Sharpston argued that the same loss may be used twice in foreign branch situations, and thus applies this ground to the present case.
- **Risk of Tax Avoidance.** Sharpston saw no scope for ''jurisdiction shopping.''

Sharpston questioned whether it is necessary for all three *Marks & Spencer* justifications to be fulfilled cumulatively in order to conclude that the BFH's ruling on *Lidl* is incompatible with EC law. She felt that two could suffice if they complied with the principle of proportionality, which means the restrictive measure must be appropriate for securing the attainment of the objectives it pursues and must not go beyond what is necessary to attain those objectives. The principle of proportionality is especially important when national legislation excludes cross-border transactions from national rules. Sharpston concluded that taxing a company on more than its total net profits is ''manifestly



disproportionate.'' She argued that the aim of the tax treatment, which justifies the restriction, can be attained by a less restrictive measure, and referred to the deduction-and-recapture rule, which existed in Germany before 1999. Even though she conceded that such a rule would cause an asymmetry, she argued that this asymmetry would only be temporary and would be eliminated in future profitable periods. Hence, the measure would not sharply contradict the goal of a balanced allocation of the power to tax. Sharpston argued for implementing a deduction-and-recapture rule, maintaining that it ''better reflects the need for proportionality than the solution adopted by the court in *Marks & Spencer*.'' Regarding the practical difficulties and potential revenue loss in applying a deduction-and-recapture rule (which eventually led to the abolishment of such a rule in Germany), Sharpston stated that the argument cannot be taken seriously since five member states provide for such a deduction-and-recapture rule and show that the system is feasible.

We believe Sharpston makes the best point when she distinguished the merits of *Marks & Spencer* from those of *Lidl Belgium*. In *Marks & Spencer*, the subsidiaries were already wound up or sold with no opportunity to apply a deduction-and-recapture rule. Under these circumstances, the Court failed to note that the cash-flow disadvantage (due to the restriction of a loss deduction) is an overly restrictive way of attaining the objectives sought. It is our conviction that this statement is brilliant, even more so when applied to *Lidl Belgium*, which concerns an ongoing permanent establishment. We believe that the cash-flow disadvantage argument tips the scales when deeming the restriction to deduction foreign branch profits disproportionate.

Issues to Watch Out For

From our point of view, taxpayers should consider the following issues:

- Can the justifications set out by the ECJ in *Marks & Spencer* be transferred to branch loss situations, and if so, do these requirements have to be fulfilled cumulatively? One of these grounds was sufficient in *N* (C-470/04), two were sufficient in *AA* (C-231/05), and again one sufficed in *Amurta* (C-379/05).

- Does EC law require the deduction of foreign branch losses along with a deduction-and-recapture rule, and if so, how must the deduction-and-recapture rule be drafted to be in line with the proportionality test in EC law?

A Peek Into the Future

Observers of the EC tax scene can see that the road to cross-border loss recognition is being laid out. On December 19, 2006, the European Commission stated that the acknowledgment of cross-border branch losses is an indispensable prerequisite for the realization of a single market. On October 18, 2007, the European Commission formally requested Germany to modify its legislation on cross-border loss deduction, which the commission considers incompatible with the principle of freedom of establishment and the free movement of capital in the single market. Both the European Commission and Sharpston favor the implementation of a deduction-and-recapture rule. In the end, the road might lead to an EC cross-border loss directive, as proposed in 1990. ◆