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by Wolfgang Kessler and Rolf Eicke

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HIGHLIGHTS

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It used to be almost certain that the European Court of Justice would follow the opinion of the advocate general in its judgment, but those days are gone. The latest examples of this change in heart are *Columbus Container* (C-298/05) and *Lidl Belgium* (C-414/06). (For the ECJ judgment in *Columbus Container*, see *Doc 2007-26756* or *2007 WTD 236-11*. For the ECJ judgment in *Lidl Belgium*, see *Doc 2008-10739* or *2008 WTD 96-18*.)

Lidl Belgium in a Nutshell

A Luxembourg branch of a German partnership (GmbH & Co. KG) generated losses. The German head office deducted those losses from its German tax return, a treatment that was rejected by the German tax authorities on the grounds that both foreign branch profits and foreign branch losses are exempt under the Germany-Luxembourg double taxation convention. This treatment is based on the principle of symmetry, which provides that if profits are not taxed, losses cannot be taken into account.

The German partnership brought proceedings against the German tax authorities and lost at the Finanzgericht Baden-Württemberg (Finance Court Baden-Württemberg). An appeal was brought to the Bundesfinanzhof (Federal Finance Court or BFH), which referred the case to the ECJ. The BFH questioned whether it is compatible with the EC freedom of establishment (article 43 of the EC Treaty) and the EC freedom of capital movement (article 56 of the EC Treaty) that a deduction of branch losses from another member state is precluded on the grounds that, according to the applicable double taxation convention, the corresponding income from the permanent establishment is not subject to taxation in Germany.

Advocate General Eleanor Sharpston stressed in her opinion that the contested measure infringes on the freedom of establishment and that two of the three grounds for justification from *Marks & Spencer* (C-446/03) dealing with the cross-border loss transfer between a parent corporation and a subsidiary apply in the present case. (See ''*Lidl Belgium*: Revisiting *Marks & Spencer* on the Branch Level,'' *Tax Notes Int'l*, Mar. 31, 2008, p. 1131, *Doc 2008-5029*, or *2008 WTD 67-8*.)

The two grounds for justification Sharpston found applicable were the allocation of tax power and the risk of double use of losses, whereas she did not see the possibility of jurisdiction shopping and thus no risk for tax avoidance. However, Sharpston maintained that the contested measure is disproportionate and thus infringes on the principle of proportionality, because the application of a deduction-and-recapture rule would be less restrictive and would be the only means to prevent the taxpayer from a cash flow disadvantage. A deduction-and-recapture rule would provide for a deduction of foreign branch losses in the year they are incurred, but would be brought back into account in later years in which the branch makes a profit. From this reasoning, Sharpston concluded that the contested measure is not in line with EC law.

ECJ Judgment

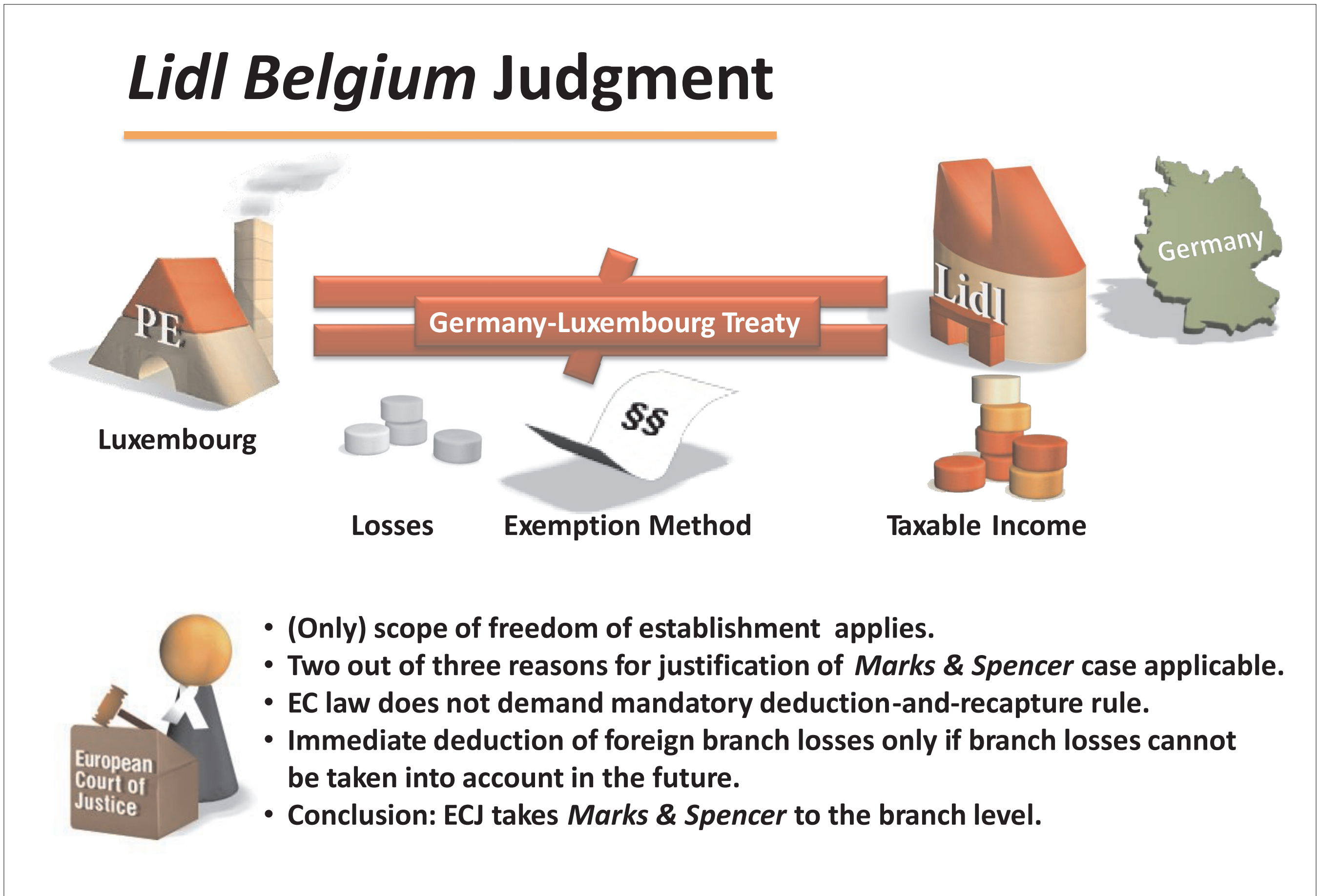
In its judgment, the ECJ found that a rule preventing the head office from deducting EU branch losses because of an applicable exemption method in a double taxation convention is in line with EC law, if the branch losses can be taken into account in future periods in the member state where the branch is located.

Relevant Freedom

Like the advocate general, the Court found that only the freedom of establishment applies in this case, and is restricted, and that this freedom prevails over the freedom of capital movement if a contested measure requires a dominant influence of the taxpayer to apply. This is in line with the latest case law, which restricts the scope of the freedom of capital movement in favor of the freedom of establishment.

Principle of Symmetry

One of the crucial questions of the case was whether the principle of symmetry will survive. In fact, it did. The principle of symmetry provides that in case of an exemption of branch profits under a double taxation convention, branch losses must be exempt as well. Recently, Austrian and Luxembourgian courts did not follow that principle, arguing that it does not comply with the principle of worldwide taxation. These courts



felt the need to address the paradoxical situation that a taxpayer is better off in a nontreaty situation than it is in a treaty situation where the exemption method applies. Ultimately, the Austrian and Luxembourgian courts decided in favor of the taxpayer and granted the right to immediately deduct the branch losses in the country of the head office. However, with the judgment in *Lidl Belgium* this approach was not followed by the ECJ.

Justifications

The Court also agrees with the advocate general that only two out of three reasons for justification in *Marks & Spencer* can be adopted in the present case, with only the risk of tax avoidance not being applicable. However, we maintain that there would not be a serious risk of double use of losses and a distortion of the allocation of tax power if there was a mandatory deduction-and-recapture rule in all member states. From our point of view this trade-off was not sufficiently addressed by the ECJ in its latest judgment. Moreover, it remains unclear how many reasons are needed to justify a restriction. In *Lidl Belgium* the Court requires two out of three by citing the ECJ judgment in *Oy AA* (C-231/05), without giving any further reasons why it does not demand one or even three reasons for the justifications to apply cumulatively.

Principle of Proportionality

As a very important EC principle, the principle of proportionality demands that a contested measure is necessary to obtain the pursued objective and that there is no less restrictive and equally effective measure. The evaluation of this principle constituted the most controversial part of *Marks & Spencer* and *Lidl Belgium*.

However, this test is also the reason for the difference between the advocate general's opinion and the ECJ judgment. While the advocate general focused on the cash flow disadvantage that from her point of view can only be cured by the possibility of an immediate deduction of branch losses in the country of the home office, the ECJ does not address the issue of cash flow disadvantage. From our point of view, this is one of the major weaknesses of the judgment, because the cash flow disadvantage must not be ignored. To make it very clear: With the court not addressing this issue, it will remain more favorable to invest domestically than cross border. As cross-border loss transfer is one of the crucial issues on the road to a common market, the case would have deserved a closer look at this problem.

Instead of arguing in favor of or against the cash flow disadvantage, the ECJ copied the exception rule from *Marks & Spencer* providing for immediate deductibility of losses in case these losses cannot be taken into account in the country of the branch/subsidiary in the future. Thereby, the ECJ committed the second mistake: By copying the ruling of *Marks & Spencer*, it overlooked the distinct nature of branches and subsidiaries. Branch loss situations differ from subsidiary loss situations, because there is a diametrically opposite rule-exception relationship. As a rule, branch losses can be deducted immediately from the income of the head office and there is only as an exception a preclusion of this deduction in case of an applicable double taxation convention that provides for the exemption method. Because corporations are legally separate from each other, the rule is that losses cannot be aggregated between the corporations. The deduction is allowed only as an exception, for example, in group relief.

European Commission Weighs In

With the advocate general's opinion, the EC tax law was on the path of more harmonization in cross-border loss transfer situations. The groundwork was laid by a European Commission statement of December 19, 2006, (COM(2006) 824 final and SEC(2006) 1690) that offered three different methods to solve the problem. The solution offered by the ECJ in *Lidl Belgium* only constitutes a ''minimum standard'' in this respect.

Outlook

For governments and legislators, the judgment in *Lidl Belgium* is a cause for celebration: for governments, because there are no future or retroactive budget risks; for legislators, because there is no need to draft a deduction-and-recapture rule. For all others, the judgment and its reasoning are a disappointment. The simple adoption of the reasoning in *Marks & Spencer* does not respect special branch situations, and not demanding a mandatory deduction-and-recapture rule as a minimum standard for all EU member states is a step back on the rocky road to EC tax law harmonization. ◆

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