International taxation of cross-border leasing income
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CHAPTER 8

RELEVANCE OF THE EC TREATY (CROSS-BORDER LEASING BETWEEN THE EC MEMBER STATES)

8.1. Scope of the chapter

This chapter deals with the following two aspects relevant for cross-border leasing transactions between the EC Member States:

(i) **UK capital allowance restrictions in case of outbound leases: compatibility with the EC Treaty.** As discussed at 3.5.2.4., in the case of an outbound lease, the UK Capital Allowances Act 2001 severely restricts the UK lessor's entitlement to capital allowances on the leased asset. It is examined at 8.2. as to whether the said restriction is compatible with the EC Treaty ("the Treaty") in the case of a lease transaction between a UK lessor and a lessee resident in another Member State.

(ii) **Denial of group relief in respect of losses suffered by subsidiaries resident of other Member States.** As stated earlier, a tax advantage derived by the lessor is generally passed on to the lessee by way of reduced lease rentals. Particularly, if the lessor is entitled to depreciation allowance on a written-down value basis, then the amount of such allowance would normally exceed the amount of lease rentals receivable during early years in the lease term. Such excess may result in a loss for the lessor during the early years of the lease term. In such a case, practically, a lessor can "enjoy" a tax advantage only if the lessor is able to set off the loss against other taxable income. If a financial institution from one Member State carries on leasing business in another Member State through a subsidiary incorporated in the other Member State, then the leasing subsidiary may be able to competitively carry on the business in the other Member State only if the financial institution is able to set off (in its home Member State) the losses incurred by the subsidiary, as observed in the following illustration:

A bank from the United Kingdom (hereinafter referred to as "UK Bank") sets up a wholly owned subsidiary (hereinafter referred to as

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400. In certain cases, the capital allowances are altogether disallowed.
401. See 3.1.
402. Such as excess of depreciation allowance over lease rentals.
LeaseCo) in Germany for undertaking leasing business in Germany. Assuming that LeaseCo is entitled to depreciation on its only leased asset on a reducing-balance basis, and consequentially it would incur tax losses during the initial years of the lease term, LeaseCo may be in a position to pass on the tax benefit to the lessee only if UK Bank can set off the loss (of LeaseCo) against its (or the group’s) tax liability in the United Kingdom. However, under the UK group relief regime (like most group relief regimes) UK Bank would not be eligible to set off the loss incurred by LeaseCo, although LeaseCo may amount to a member of the group in accordance with the “group” criteria under the group relief regime. On the other hand, if LeaseCo were a subsidiary incorporated in the United Kingdom (instead of Germany), then UK Bank (or one of its group companies) would have been allowed to set off the loss incurred by LeaseCo.

Since the ability of a financial institution to competitively carry on leasing business in the other Member States may essentially depend upon the financial institution’s entitlement to set off, under the home country group relief regime, losses incurred by its leasing subsidiary in the other Member States, it is examined in 8.3 as to whether a Member State’s group relief regime denying set-off of losses of a leasing subsidiary in the other Member States infringes the Treaty.

8.2. UK capital allowance restrictions in the case of outbound leases

8.2.1. The restrictive provision

As discussed at 3.5.2.4., capital allowances on plant or machinery that is the subject matter of a lease to an overseas lessee may be severely restricted, unless the overseas lessee uses the said asset in its business in the United Kingdom.

For ascertaining the legislative intent behind the said restriction, the following definition of “overseas leasing” is relevant:

403. The UK Bank may have chosen to carry on leasing activities in Germany through a subsidiary (instead of a branch) for valid commercial reasons, and not merely for tax considerations.
Plant or machinery is used for overseas leasing if it is used for the purposes of being leased to a person who –
(a) is not resident in the United Kingdom, and
(b) does not use the plant or machinery exclusively for earning profits chargeable to tax.

It is evident from the above definition that the underlying objective of the restrictive provision is to counter the potential erosion of the UK tax base in the case of the UK outbound leasing. In the case of outbound leasing of plant or machinery, the reduced 10% capital allowance rate (instead of the standard 25% rate) would substantially reduce, if not eliminate, the likelihood of erosion of the UK tax base.

The issue of compatibility of the said restrictive provision with the Treaty is analysed hereafter in the following manner:
(i) as the first step, it is analysed whether the said restrictive provision is in conflict with one or more of the Treaty freedoms;
(ii) if the said restrictive provision is found to be in conflict with a Treaty freedom, then arguments for (potential) justification of the said conflict are analysed.

8.2.2. Conflict with a Treaty freedom

In *Eurowings*, the European Court of Justice (ECJ) held that leasing constitutes a service for the purposes of Art. 60 of the EC Treaty.409

405. The potential erosion of the UK tax base may occur in the following manner: In the early years of a lease, the lessor’s capital allowances on the leased asset may substantially exceed the lease rental income, since under the reducing-balance method (as applicable in the United Kingdom) the allowable capital allowances are much greater in the early years of an asset, as compared to the later years. Thus, during early years of the lease, the lessor may derive tax deferral benefit by setting off the tax losses from leasing against other taxable income. Generally, this benefit is passed on to the lessee by way of a reduced amount of lease rentals. In the case of a domestic lease, from the viewpoint of the national exchequer, the tax deferral benefit derived by the lessor is neutralized by an increase in taxable income of the lessee on account of the lower amount of lease rentals. However, in a cross-border lease, as the lessee’s income may not be liable to tax in the residence state of the lessor, the tax deferral benefit may be passed on by the lessor to the lessee at the expense of the exchequer of the residence state of the lessor. This way, outbound leasing may erode the tax base of the residence state of the lessor.

406. In case of aggressive lease arrangements, capital allowances are denied altogether.


408. Now Art. 50.

409. See, also, Pinto, Carlo, *Tax Competition and EU Law*, paragraph 5.3.2.3.
The severe capital allowance restriction (or disallowance) in the case of outbound lease of assets could strongly dissuade UK lessors from entering into outbound lease transactions. Therefore, the said restrictive provision is expected to create a UK lessor's bias towards undertaking leasing business with lessees in the United Kingdom instead of lessees from other Member States. Accordingly, it is submitted that the said restrictive provisions are in conflict with the freedom of to provide services.

8.2.3. Potential justifications for the restrictive national tax law provision

A survey of the relevant case law of the ECJ indicates that, so far, the Member States have advanced the following arguments to defend restrictive provisions under their national tax laws:

- the need to prevent loss of revenue;
- the need to maintain fiscal cohesion;
- the need to prevent tax abuse;
- fiscal supervision;
- principle of territoriality.

8.2.3.1. Need to prevent loss of revenue

As stated earlier, the underlying objective of the restrictive provision is to counter the potential loss of tax revenue in the case of the UK outbound leasing.

Up to now, in a number of cases the Member States have attempted to justify restrictive national tax law provisions on the ground of the need to pre-
vent loss of revenue.\textsuperscript{414} However, the ECJ has consistently rejected this argument.

For instance, in \textit{Metallgesellschaft}\textsuperscript{415} and \textit{Lankhorst-Hohorst},\textsuperscript{416} the ECJ reiterated\textsuperscript{417} its settled view that reduction in tax revenue does not constitute an overriding reason to justify a measure which is in principle contrary to a fundamental freedom.\textsuperscript{418}

Accordingly, it is submitted that the UK capital allowance restriction (in the case of outbound leases to lessees in the other Member States), which is in conflict with the EC freedom to provide services, is not compatible with the Treaty solely on the ground of the need to prevent loss of tax revenue. It is also relevant to examine whether the said restriction could be justified on any other ground.

\textsuperscript{414} See, for instance, Case C-264/96, \textit{Imperial Chemical Industries Plc (ICI) v. Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes); Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt; Case C-35/98, Staatssecretaris van Financiën v. B.G.M. Verkooijen; Case C-136/00, Rolf Dieter Danner; Case C-118/96, Jessica Safir v. Skattemyndigheten I Dalarnas Län; Case C-436/00, \textit{X and Y} v. Riksskatteverket; and Case C-324/00, \textit{Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt.}

\textsuperscript{415} See paragraph 59, Joined cases C-397/98 and C-410/98, \textit{Metallgesellschaft Ltd and Others, Hoechst AG and Hoechst (UK) Ltd v. Commissioners of Inland Revenue and HM Attorney General.}


\textsuperscript{417} For ECJ’s similar decisions on the issue see, for instance, Case C-264/96, \textit{Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes), paragraph 28; Case35/98, Staatssecretaris van Financiën v. B.G.M. Verkooijen, paragraph 59; and Case C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt, paragraph 51.

\textsuperscript{418} Though in the \textit{Metallgesellschaft} and \textit{Lankhorst-Hohorst} cases the ECJ was primarily concerned with infringement of the freedom of establishment, in its decisions the ECJ referred to “a fundamental freedom” rather than making a specific reference to the freedom of establishment. Accordingly, it is submitted that the ECJ’s view on this issue equally applies to the freedom to provide services (and other Treaty freedoms) as well.
8.2.3.2. Fiscal cohesion

8.2.3.2.1. "Fiscal cohesion" argument: seldom accepted by the ECJ

"Fiscal cohesion" signifies the principle concerning the need to maintain integrity of the national tax system. Up to now, the ECJ has accepted the need for maintaining fiscal cohesion as a valid argument for restrictive provisions under the direct tax laws of Member States in only two cases i.e. Bachmann and Commission v. Belgium. The Member States' attempts to defend restrictive provisions of the national tax laws on the basis of the "fiscal cohesion" argument have not been successful in the subsequent cases.

8.2.3.2.2. Bachmann and Commission v. Belgium

In Bachmann, the taxpayer was a German national who temporarily moved to Belgium for purposes of taking up an employment in Belgium. Prior to his moving to Belgium, the taxpayer had taken out certain insurance policies with German insurance companies. Under the Belgian tax law, deductions for contributions on insurance policies were allowed only if they were paid within Belgium. As the taxpayer had taken out the insurance policy from a German insurance company, the Belgian tax authorities denied the deduction to the taxpayer. As a corollary to the denial of the deduction, the amounts receivable by the taxpayer upon maturity of the insurance policies were exempt under the Belgian tax law. Before the ECJ, Belgium attempted to defend denial of the deduction to the taxpayer on the grounds of (i) consumer protection (ii) effectiveness of fiscal supervision and (iii) fiscal co-

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421. See Case C-80/94, G.H.E.J. Wielockx v. Inspecteur der Directe Belastingen; Case C-484/93, Peter Svensson et Lena Gustavsson v. Ministre du Logement et de l’Urbanisme; Case C-107/94, P.H. Asscher v. Staatssecretaris van Financiën; Case C-264/96, Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes); Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna; Case C-55/98, Skatteministeriet v. Bent Vestergaard; Case C-251/95, C. Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem; Case C-35/98, Staatssecretaris van Financiën v. B.G.M. Verkooijen; Case C-324/00, Lankhorst-Ho- horst GmbH v. Finanzamt Steinfurt; Case C-422/01, Försäkringsaktiebolaget Skandia (publ) and Ola Ramstedt v. Riksskatteverket; Case C-234/01, Arnaud Gerrits v. Finanzamt Neukölln-Nord; Case C-136/00, Rolf Dieter Danner; and Case C-436/00, X and Y v. Riksskatteverket.
422. I.e. contributions to a Belgian insurance company or to a Belgian branch of a foreign insurance company.
hesion. The ECJ rejected the first two grounds, but accepted\textsuperscript{423} the “fiscal cohesion” argument due to a direct link between deductibility of contributions and taxation of future benefits.\textsuperscript{424}

In \textit{Commission v. Belgium}, the issue was substantially similar to the issue in the \textit{Bachmann} case, i.e. non-deductibility of payments on insurance policies in a case where future benefits from such insurance policies were not taxable in Belgium. The ECJ accepted fiscal cohesion as a valid justification for denial of deduction.

8.2.3.2.3. \textit{The two prerequisites for acceptance of the “fiscal cohesion” argument}

It seems a settled principle that, for acceptance of the “fiscal cohesion” argument, there must be:

\begin{itemize}
  \item[(i)] a direct link between deductibility and subsequent taxability (\textit{Gustavsson} case\textsuperscript{425}); and
\end{itemize}

\textsuperscript{423} The ECJ expressed that since Belgium was not in a position to tax payments from a foreign insurer to non-resident insurance policyholders, it was justified in denying a deduction for payments in respect of such insurance policies.


\textsuperscript{425} Case C-484/93, Peter Svensson et Lena Gustavsson v. Ministre du Logement et de l’Urbanisme. Though the Gustavsson case involved a dispute concerning “freedom of capital”, the substantive principle emerging from this case is equally applicable to cases concerning other EC freedoms. For instance, in the \textit{Eurowings} case concerning freedom to provide services, while dealing with the “fiscal cohesion” argument, the ECJ referred to the \textit{Gustavsson} case.
(ii) presence of such link between the same tax and the same taxpayer
(Baars case and Verkooijen case).426

Direct link between deductibility and future taxability. The Gustavsson case involved a dispute between the Grand Duchy of Luxembourg and a couple (hereafter referred to as "the Gustavssons") resident in Luxembourg. The Gustavssons had obtained a loan from a bank established in Belgium, for construction of a house. Under the laws of Luxembourg, interest rate subsidies were available in the case of housing loans obtained from a credit institution approved in Luxembourg. Since the Gustavssons had obtained the housing loan from a bank in Belgium, as per the said law, the Gustavssons did not qualify for the interest rate subsidy and, hence, were denied the subsidy. Before the ECJ, the Luxembourg government argued that the discriminatory provision under the Luxembourg law was a part of its social policy, which had considerable financial and economic repercussions. As approximately 50% of the interest rate subsidies were recouped by means of the profit tax on financial establishments, in absence of the disputed rule, the housing policy would have been a failure, or at least less generous. The ECJ, distinguishing Bachmann and Commission v. Belgium, held that the principle of fiscal cohesion was not relevant in the present case; in the said two cases, there was a direct link between deductibility of the contributions for insurance policies and the taxability of the amounts payable by the insurers under the said policies – such link had to be maintained to preserve the integrity of the relevant fiscal regime. Unlike in the said two cases, in Gustavsson, there was no direct link between the grant of the interest subsidy to borrowers on one hand and its financing by means of taxation of profits of the financial establishments on the other hand.427

426. Case C-35/98, Staatssecretaris van Financiën v. B.G.M. Verkooijen, [2000] ECR I-4071. The ECJ applied these two requirements in its subsequent decisions in Case C-264/96, Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes), [1998] ECR I-4695; Case C-397/98, Metalgesellschaft Ltd and Others v. Commissioners of Inland Revenue and HM Attorney General; Case C-410/98 Hoechst AG and Hoechst (UK) Ltd. v. Commissioners of Inland Revenue and HM Attorney General, (joined cases) [2001] ECR I-1727; and Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna, [199] ECR I-7447. In the last-mentioned case, the ECJ held that a tax law that restricted a tax advantage only to lessees leasing assets from resident lessors and denying such advantage to lessees leasing assets from lessors resident in other Member States was a discrimination based on place of establishment, and the "fiscal cohesion" argument could not be used to defend such a restriction.
427. See, also, Terra and Wattel, European Tax Law, paragraph 3.2.8.5.
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*Link between the same tax and the same taxpayer.* This second prerequisite for acceptance of “fiscal cohesion” argument emerges from the ECJ decisions in the cases of *Baars* and *Verkooijen*. The *Baars* case involved a wealth tax dispute between the Netherlands tax authorities and the taxpayer, who was a resident and national of the Netherlands. In the Netherlands, at the material time, wealth tax was chargeable at the rate of 0.8% of total assets. The wealth tax applied to all natural persons resident in the Netherlands on their global assets and to non-resident individuals on their assets situated in the Netherlands. However, subject to certain conditions and limits, exemption was available in respect of shares of companies resident in the Netherlands. The taxpayer owned all shares of a company resident in Ireland and satisfied all other conditions for the above-stated exemption, except that the shares were not of a company resident in the Netherlands. He was denied the wealth tax exemption in respect of the said shares, since they were not shares of a company resident in the Netherlands. Before the ECJ, the Netherlands government argued that the restriction of the wealth tax exemption to shares of companies having their seat in the Netherlands was justified on the ground of fiscal cohesion. It contended that the exemption was designed to mitigate, in economic terms, the effects of double taxation arising from a company’s profits subject to corporation tax and the assets invested by the shareholders in that company subject to wealth tax; since the Dutch corporation tax did not apply to a company resident in another Member State, its shares were not exempt from the Dutch wealth tax. Rejecting the arguments of the Netherlands, the ECJ held that, even in economic terms, there was no double taxation of profits since the wealth tax was a tax on the assets of the shareholders, rather than a tax on the distribution of profits to shareholders; the fact as to whether or not the company actually earned profits did not affect the wealth tax liability of the shareholders. Also, the ECJ held that the tax charged on the profits of the company on the one hand, and the wealth tax charged in hands of the shareholders on the other hand, were two separate taxes levied on different tax-

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430. Though the profit made by a company may have an impact on the market value of its shares, that is not the only factor influencing the market value. For example, future prospects of the company may have a positive effect on the market value of the shares, in spite of a loss incurred by the company during the current financial year.
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Therefore, the exigibility of a company to the corporation tax was irrelevant for grant of the wealth tax exemption.431

The Verkooijen case involved a dispute between the taxpayer resident in and a national of the Netherlands, and the Netherlands tax authorities. For the relevant tax year, dividend income of an individual taxpayer was taxable in the Netherlands, subject to a limited exemption. This exemption did not apply to dividends distributed by foreign companies. The taxpayer owned shares of his employer company, which was established in Belgium. The Netherlands tax authorities denied the dividend exemption to the taxpayer for the reason that the dividend-paying company was not established in the Netherlands. Before the ECJ, the intervening Member States432 submitted that restriction of the exemption to dividends from companies established in the Netherlands was justified on the ground of fiscal cohesion. The ECJ, however, rejected the said submission and distinguished its decisions in Bachmann and Commission v. Belgium. The ECJ pointed out that, unlike in the said two cases, there was no direct link between a tax benefit (exemption) on one hand and income taxation on the other hand.433 The ECJ categorically held that the principle of fiscal cohesion did not apply in the present case since the taxation of companies established in the Netherlands and taxation of dividend income in hands of individual shareholders were two separate taxes levied on different taxpayers.434

8.2.3.2.4. The UK restriction of capital allowance on outbound leases: the two conditions for the "fiscal cohesion" argument not satisfied

For computing taxable income of a lessor undertaking a domestic lease, capital allowances on the leased assets are granted at the standard rate of 25%. However, in the case of a lessor undertaking an outbound lease on identical terms,435 the capital allowances on the assets leased overseas may be restricted to the reduced rate of 10%, or denied altogether. The lessor is not compensated in any manner (e.g. taxation of outbound leasing income

431. See, also, Terra and Wattel, European Tax Law, paragraph 3.2.8.5.; and Lyal, Richard, “Non-discrimination and Direct Tax in Community Law”, EC Tax Review 2003/2, p.68.
432. Italy and the United Kingdom.
433. See, also, Terra and Wattel, European Tax Law, paragraph 3.2.8.5.; Pinto, Carlo, Tax Competition and EU Law, paragraph 5.3.2.3.; and Lyal, Richard, “Non-discrimination and Direct Tax in Community Law”, EC Tax Review 2003/2, p.68.
434. See paragraph 58, Case C-35/98, Staatsecretaris van Financiën v. B.G.M. Verkooijen.
435. Except the lessee being a non-resident instead of a UK resident.
at a reduced rate) for the said disadvantage. Thus, there is no link between the capital allowance restrictions in the case of outbound leasing on the one hand, and taxation of outbound leasing income on the other hand. Accordingly, the first condition of the “fiscal cohesion” principle is not satisfied.

Further, in the case of an outbound lease, the lessor is subjected to a restricted capital allowance (or altogether denied capital allowance) for the reason that the income of the non-resident lessee is not exigible to taxation in the United Kingdom. Thus, even the second condition of the “fiscal cohesion” principle is not fulfilled.

Accordingly, it is submitted that the restrictive provision under the UK Capital Allowances Act 2001 cannot be defended on the basis of the “fiscal cohesion” argument. Rather, the phenomenon of taxation of income from outbound leasing on one hand, and restrictions or denial of capital allowances on the other hand is contrary to the very principle of fiscal cohesion.

8.2.3.3. The abuse argument

8.2.3.3.1. Argument not yet accepted by the ECJ in tax cases

Although in a number of cases the ECJ has held that a Member State is entitled to take measures designed to prevent certain nationals from attempting to circumvent (in the guise of the right to the fundamental freedoms under the Treaty) the requirements of national legislation, and although Member States have attempted to advance prevention of abuse as an argument in a number of cases, so far, the ECJ has not upheld any restrictive

436. See Case C-212/97, Centros Ltd v. Erhvervs- og Selskabsstyrelsen; Case C-33/74, Van Binsbergen v. Bedrijfsvereniging Metaalnijverheid; Case C-148/91, Veronica Omsrop Organisatie v. Commissariaat voor de Media; Case C-23/93 TV 10 v. Commissariaat voor de Media; Case C-115/78, Knoors; Case C-61/89 Bouchouca; Case 229/83 Leclerc and Others v. Au Blé Vert and Others; Case C-206/94 Brennet v. Paletta; Case 39/86 Lair v. Universitaat Hannover; Case C-8/92, General Milk Products v. Hauptzollamt Hamburg-Jonas; and Case C-367/96, Kefalas and Others v. Greece.

437. See, for instance, Case C-270/83, Commission v. French Republic (Avoir fiscal case); Case C-204/90, Bachmann; Case C-264/96, Imperial Chemical Industries Plc (ICI) v. Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes); Case C-251/98, Baars; Case C-397/98, Metallgesellschaft and Hoechst; Case C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna; Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt; and Case C-436/00 X and Y v. Riksskatteverket.

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provision under a direct tax legislation of a Member State on the basis of prevention of abuse as a valid justification. For instance, in *Avoir fiscal*, the French government sought to justify denial of shareholders’ tax credit to the French “secondary establishments” of foreign companies on the basis of, *inter alia*, the need to prevent tax avoidance. Flatly rejecting the argument of the French government, the ECJ stated that the (mere) risk of tax avoidance could not be relied upon to defend the denial of shareholders’ credit to the secondary establishments of companies having registered offices in other Member States, and Art. 52 of the EC Treaty did not permit any derogation from the fundamental principle of freedom of establishment on such a ground.

In *ICI*, the United Kingdom government attempted to defend denial of consortium relief in respect of losses suffered by non-resident subsidiaries by arguing that one of the reasons behind the restrictive consortium relief re-
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gime was to reduce the risk of tax avoidance.\textsuperscript{443} The Court rejected this argument since the said restriction under the consortium relief regime was not designed to prevent, specifically, only the wholly artificial arrangements aimed to circumvent the UK tax legislation but, rather, it evenly applied to all situations including those not involving any motive to avoid tax.\textsuperscript{444} The ECJ reiterated this view in its decision in \textit{Lankhorst-Hohorst}.\textsuperscript{445}

It is also relevant to note that the ECJ has consistently taken a view that an anti-abuse provision must be of a nature such that it ensures only the achievement of its underlying objective (i.e. prevention of abuse), and must not go beyond what is necessary for achieving that objective.\textsuperscript{446} Based on this reasoning, which is often referred to as the \textit{principle of proportionality},\textsuperscript{447} in a number of decisions the ECJ did not approve “the underlying objective of prevention of abuse” as a justification for restrictive provisions under the tax laws of the Member States.

\textsuperscript{443} The UK government contended that if the consortium relief was extended to losses suffered by the foreign subsidiaries of the consortium, then the members of consortium could (potentially) indulge in tax avoidance by channelling the charges of non-resident subsidiaries to a subsidiary resident in the United Kingdom and parking income with non-resident subsidiaries.


\textsuperscript{445} See, for instance, the ECJ’s decisions in Case C-55/94 \textit{Reinhard Gebhard v. Consiglio dell’Ordine degli Avvocati e Procuratori di Milano}, paragraph 37; Case C-19/92 \textit{Dieter Kraus v. Land Baden-Württemberg}, paragraph 32; Case C-415/93, \textit{Union royale belge des sociétés de football association ASBL v. Jean-Marc Bosman, Royal club liégeois SA v. Jean-Marc Bosman and others and Union des associations européennes de football (UEFA) v. Jean-Marc Bosman}, paragraph 104; and C-250/95, \textit{Futura Participations SA and Singer v. Administration des contributions}, paragraph 26.

\textsuperscript{446} See Terra & Wattel, \textit{European Tax Law}, paragraph 9.8.; and Pinto, Carlo, \textit{Tax Competition and EU Law}, paragraph 5.3.2.4.
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In *Leur-Bloem*, the ECJ has opined that a provision in a Member State’s tax legislation which automatically excludes certain categories of operations from the tax advantage regardless of, factually, a taxpayer indulging in tax evasion or tax avoidance would go further than what is necessary for preventing such tax evasion or tax avoidance.

Thus, it may be appropriate to generalize that a restrictive national tax law provision, the applicability of which is not confined only to abusive transactions, is likely to be viewed by the ECJ as incompatible with the Treaty.

8.2.3.3.2. *Can the Treaty be relied upon to shield abusive transactions?*

The above analysis of the relevant case law of the ECJ leads us to the following questions:

- Can a taxpayer rely on the Treaty freedoms to defend an abusive transaction?

- What is the connotation of “abusive transaction”?

- Can use of a captive leasing company, *per se*, be regarded as abusive?

It must be noted that in the tax cases discussed above, the Member States could not demonstrate that the taxpayers had indulged in abusive transactions. It is submitted, on the basis of the Court’s case law discussed below, that if the ECJ were to deal with a proven case of an abusive transaction, the conclusion could have been different.

In *X and Y* the ECJ stated that a national court could take into account, on a case-by-case basis and on the ground of objective evidence, a case of abuse or fraudulent conduct and deny the benefit of a provision of the Treaty.

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449. The ECJ, subsequently, reiterated this opinion in Case C-478/98, *Commission v. Belgium*.

450. See paragraph 42, Case C-436/00, *X and Y v. Riksskatteverket*. 

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In *Centros*, the ECJ stated that a Member State is entitled to take measures designed to prevent certain of its nationals from attempting, under cover of the rights created by the Treaty, to circumvent their national legislation or to prevent individuals from improperly or fraudulently taking advantage of provisions of the Treaty.

Thus, it may be concluded that a taxpayer’s entitlement to a Treaty freedom would hinge on whether the transaction undertaken by the taxpayer could be regarded as abusive. This, in turn, leads us to the next question concerning connotation of “abuse”.

As stated earlier, the ECJ has held in a number of cases that a Member State is entitled to take measures to prevent its nationals from attempting to circumvent (in the guise of the right to the fundamental freedoms under the Treaty) the requirements of a national legislation. In this respect the Court’s observations in *Kefalas* and *Emsland-Stärke* are of particular significance for the purposes of this study.

In *Kefalas*, the ECJ held that the national courts could apply the rules under the domestic law to ascertain whether the exercise of a right arising from a provision of Community law was abusive; application of such a rule could not be regarded as infringement of Community law. The ECJ, however, qualified this assertion by stating that the application of the said national rule must not prejudice the full effect and uniform application of...
Community law in the Member States, and the national courts were not allowed to alter the scope, or compromise the objectives, of Community law.

In *Emsland-Stärke*, the ECJ clarified that to determine existence of abuse, a national court must confirm the presence of an *objective element*, i.e. a situation involving non-achievement of the objective behind a Community rule in spite of observance of the conditions laid down by such a rule, and a *subjective element*, i.e. the intention to obtain an advantage from the Community rule by “undertaking” artificial operations.

In view of the above, it is submitted that for the purposes of the tax implications in the United Kingdom, whether or not a transaction is abusive must be determined by a UK national court in accordance with the general anti-avoidance principles discussed at 5.2.2. However, the national court cannot reach a conclusion that would alter the scope, or compromise the objectives, of the Community law.

As regards the question relating to use of a captive leasing company, it is possible that such a company may have been set up for valid commercial reasons. For instance, a corporate group may find it more efficient to set up a specialized leasing entity staffed with a team of knowledgeable professionals (such as specialist finance managers, lawyers, etc.) instead of duplicating the managerial efforts and resources in various group companies. It is submitted that, in such a case, the use of a captive leasing company must not be regarded as abusive. Though the lease rental payments by the various group companies to the captive leasing company may be subject to the relevant transfer pricing regulations, that must not jeopardize the captive leasing company’s entitlement to depreciation/capital allowance merely for the fact that it leased out the assets to the other group companies (whether or not within the same Member State). One related issue in this respect is: would this conclusion be affected if the captive leasing company is set up in a low-tax Member State (e.g. Ireland)? It is submitted that if the setting-up of a leasing company in the home Member State is not tantamount to abuse, then by merely setting up the leasing company in a low-tax Member State (instead of the home Member State), *per se*, must not be deemed as a case of abuse. In a number of cases, the ECJ has held that “tax jurisdic-

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457. See, also, *Terra and Wattel, European Tax Law*, paragraph 10.13.7.; *Pinto, Carlo, Tax Competition and EU Law*, paragraph 5.3.2.3.; *Venables, Robert, “Abuse of Rights In EC Law”, EC Tax Journal Volume 6, Issue 2, 2002, p.120.
458. As the leasing company may have been set up for valid commercial reasons.
tion shopping” is not contrary to the Treaty, and a restrictive provision of a national tax law cannot be justified on such a ground.459

8.2.3.3.3. The abuse argument vis-à-vis the UK restriction of capital allowances in the case of outbound leases

As stated earlier, the legislative intent behind the capital allowance restriction in the case of an outbound lease is to prevent potential erosion of the tax base, rather than prevention of tax evasion or tax avoidance.

In any case, the mere fact of a lessee being a non-resident, and not a UK taxpayer, does not necessarily involve tax abuse. The terms of a cross-border lease may be based on sound commercial (non-tax) considerations. Also, though the lessee is not exigible to income taxation in the United Kingdom, its income would be taxable in its state of residence. Therefore, a cross-border lease transaction may not have been undertaken with a motive to avoid or evade tax. Rather, in the case of a cross-border lease transaction between unrelated parties, it is a reasonable presumption that there is no motive for tax avoidance or evasion, unless the tax authorities prove it to the contrary.

8.2.3.4. Fiscal supervision

It is submitted that the UK capital allowance restriction in the case of outbound leases does not facilitate fiscal supervision and, hence, the “fiscal supervision” argument is not relevant.460 Nevertheless, for sake of complete-

459. See, for instance, Cases C-270/83, Commission v. French Republic (Avoir fiscal case); C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Finanzamt Aachen-Innenstadt; C-294-97, Eurowings Luftverkehrs AG v. Finanzamt Dortmund-Unna; C-35/98, Staatssecretaris van Financiën v. B.G.M. Verkooijen; C-422/01, Försäkringsaktiebolaget Skandia (publ) and Ola Ramstedt v. Riksskatteverket; and C-136/00, Rolf Dieter Danner.

460. It may be relevant to make a reference to paragraph 44, Case C-324/00, Lankhorst-Hohorst GmbH v. Finanzamt Steinfurt, where the ECJ rejected the “fiscal supervision” argument as the concerned Member State could not demonstrate how the German thin capitalization rules facilitated fiscal supervision.
ness of the analysis, it may be appropriate to take note of the ECJ’s decision in *Futura*\(^{461}\) concerning the need for fiscal supervision.\(^{462}\)

In *Futura*, the ECJ found that a provision under the Luxemburg tax law, which disallowed set-off of losses of a branch of a non-resident taxpayer against its future income unless the branch’s books of account were maintained in accordance with the Luxemburg tax accounting rules, was compatible with the Treaty. The Luxemburg government argued that the main purpose of the restrictive provision was to ensure that the losses sought to be carried forward and set off by the taxpayer indeed pertained to the activities of the taxpayer in Luxemburg. The Court, citing its earlier decision, held that a Member State could apply measures to precisely ascertain the amounts of taxable income as well as the losses.

The following two particular aspects of the said decision are relevant for the purposes of this study:

(i) The concerned Member State (Luxemburg) was a source state rather than the home state. However, it is submitted that in a case where the issue concerns the home state (such as the issue of the UK capital allowance restriction in the case of outbound leases) and where the taxpayer anyway maintains the books of account in accordance with the tax accounting rules of the home state, the ECJ’s decision (concerning fiscal supervision) in *Futura* would not be relevant.

(ii) The disputed restrictive provision was more of a procedural nature (evidential requirement) and the restriction\(^{463}\) did not apply if the taxpayer complied with the procedural rules concerning maintenance of books of account. Thus, the scope of the restrictive provision did not go beyond the underlying objective of the provision, i.e. ascertainment of the

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\(^{461}\) Case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*.


\(^{463}\) Concerning disallowance of carry forward and set off of losses against future income.
Denial of group relief in respect of losses suffered by subsidiaries resident in other Member States

correct amount of the loss arising from the activities of the branch; so that the said restrictive provision did not violate the principle of proportionality.

8.2.3.5. Territoriality argument

As the UK lessor has unlimited\textsuperscript{464} tax liability in the United Kingdom (including lease rentals from outbound leases), it is submitted that the territoriality argument is not relevant for examining compatibility of the UK capital allowance restriction concerning outbound leases with the Treaty.

8.2.4. Main conclusion on the issue

The UK capital allowance restriction in the case of outbound leases conflicts with the Treaty freedom to provide services, and it is not justifiable on the basis of an acceptable argument. Therefore, the said restriction infringes the Treaty. However, a taxpayer is not entitled to rely on the Treaty in the case of proven abusive transactions.\textsuperscript{465}

8.3. Denial of group relief in respect of losses suffered by subsidiaries resident in other Member States

8.3.1. The issue

As stated earlier, a leasing subsidiary set up in a Member State by a corporate group from another Member State may be able to competitively carry on the leasing business only if the corporate group is able to set off (in its home Member State) the losses incurred by the subsidiary. Therefore, the issue whether denial (by the home Member State) of group relief in respect of losses suffered by a subsidiary resident of the other Member State infringes the Treaty assumes significance for the purposes of this study. The said issue is examined in two steps, as follows:

(i) it is examined whether the said restriction conflicts with one or more of the Treaty freedoms; and

\textsuperscript{464} I.e. liability in respect of the worldwide income.
\textsuperscript{465} For this purpose, the tax authorities must substantiate, on case by case basis, that the transactions were undertaken solely for tax abuse purposes.
(ii) if the said restriction conflicts with a Treaty freedom, then arguments for (potential) justification of the said conflict are analysed.

Before analysing the said issue, it must be noted that the issue has been referred to, and is pending the decision of, the ECJ in the Marks & Spencer and Ritter cases.

8.3.2. The Marks & Spencer case

In Marks & Spencer, the appellant (“M&S”, a company resident in the United Kingdom) had established an intermediate holding company (“MSIH”) in the United Kingdom, which owned shares in foreign subsidiaries in Belgium, France and Germany. The said foreign subsidiaries had incurred substantial losses during the relevant tax years. None of the foreign subsidiaries undertook any activity in the United Kingdom and, therefore, the losses of the foreign subsidiaries were outside the scope of the UK tax system. Under the UK group relief rules, a group company may surrender its losses to another (“the claimant”) group company, and the claimant group company may offset such loss against its income taxable in the United Kingdom. However, the UK group relief applied only to the profits and losses that were within the scope of the UK taxation. M&S claimed to set off the losses of the foreign subsidiaries against its income taxable in the United Kingdom, which the UK tax authorities denied on the grounds that:

(i) the foreign subsidiaries were not resident in the United Kingdom; and

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466. Case C-446/03, Marks & Spencer plc v. David Halsey (HM Inspector of Taxes).
467. Case C-152/03, Ritter v. FA Germersheim. For a description of the relevant facts, see Korner, Andreas, “Reference to the ECJ by the German Federal Fiscal Court for a Preliminary Ruling: Does European Law Require Cross-Border Loss Relief?”, Intertax Volume 31, issue 12, p.489.
469. By way of group relief.
470. Computed in accordance with the UK rules.
(ii) nor were the said losses attributable to the UK branches of the foreign subsidiaries.

Before the Special Commissioners, M&S pleaded that had the foreign subsidiaries been resident in the United Kingdom, then the losses of the foreign subsidiaries would have qualified for the group relief under the UK tax law; thus, the UK group relief rules under the UK tax law dissuaded the UK companies from setting up subsidiaries in the other Member States. M&S also argued that the UK group relief rules restricted a UK taxpayer's freedom to choose the most appropriate form for pursuing activities in another Member State, since while the group relief extended to losses of a foreign branch of a UK company, it did not extend to a foreign subsidiary of a UK company. On that basis, M&S contended that denial of the group relief in respect of the losses of the foreign subsidiaries was contrary to Art. 43 (freedom of establishment) of the Treaty.

The Special Commissioners, rejecting the arguments of M&S, concluded that the UK group relief rules did not infringe Art. 43 of the Treaty. The Special Commissioners reached this conclusion on the basis of the following reasoning:

- Under the UK group relief rules, it was the foreign subsidiaries that were not allowed to surrender the losses,\(^{471}\) and therefore the said rules affected the foreign subsidiaries but not M&S. Therefore, according to the Special Commissioners, M&S did not suffer any restriction by virtue of the UK group relief rules. On the other hand, since surrendering of losses could not be equated with rendering of services, the foreign subsidiaries did not enjoy any right to complain under EC law.\(^{472}\) Thus implicitly, according to the Special Commissioners, neither M&S nor the foreign subsidiaries had any right under the Treaty to complain about the restrictive nature of the UK group relief rules. If that is the correct position prevailing under the Treaty, then the finding to this effect alone should have been sufficient and the Special Commissioners were not required to consider any other aspect of the issue. However, rather surprisingly, the Special Commissioners noted this conclusion only towards the fag end of the decision and, prior to that, founded their

\(^{471}\) To M&S.
\(^{472}\) See paragraph 97 of the decision. See paragraph 91 of the decision, wherein the Special Commissioners stated that the sale of tax losses could not be regarded as a provision of services within Art. 50 of the Treaty.
analysis solely on the premise as if M&S was the party affected by the restrictive group relief rule.

– The Special Commissioners held that a differential treatment in respect of the losses of a UK subsidiary\textsuperscript{473} vis-à-vis the losses of a foreign subsidiary did not constitute a restriction under the Treaty since a UK subsidiary\textsuperscript{474} was not comparable to a foreign subsidiary. The Special Commissioners based this conclusion on the principle of territoriality\textsuperscript{475} and heavily relied upon the ECJ’s decision in \textit{Futura}.\textsuperscript{476}

– On one hand, the Special Commissioners acknowledged that a differential host country tax treatment in respect of a subsidiary (vis-à-vis a branch) of a national of another Member State was prohibited by Arts. 43 and 48 of the Treaty.\textsuperscript{477} On the other hand, however, the Special Commissioners asserted that if the home Member State taxed income of a foreign subsidiary less favourably than income of a foreign branch of its own national, the home Member State national could not complain of discrimination. The Special Commissioners, again, founded this conclusion on the basis of the principle of territoriality.\textsuperscript{478}

Further, in spite of asserting that the denial of group relief in respect of the losses of the foreign subsidiaries did not constitute a restriction under the Treaty, the Special Commissioners decided, apparently of their own volition, to figure out any (potential) justification in case such denial was to be

\textsuperscript{473} Or loss of its foreign branch.

\textsuperscript{474} Or its foreign branch.

\textsuperscript{475} See paragraphs 31-37, 41, 59, 67, 68, 71, 85, 86 and 99 of the decision, wherein the Special Commissioners have emphasized, explicitly or implicitly, the territoriality principle.

\textsuperscript{476} In this regard, it is relevant to refer to paragraph 35 in the Special Commissioners’ decision, which states as follows: “... to the extent that the loss relief rules differed as compared to a Luxembourg company by restricting relief for Futura’s Luxembourg branch losses to Luxembourg profits, the Court recognized that a Luxembourg branch was not in a comparable situation vis-à-vis a Luxembourg subsidiary. Accordingly, from that perspective, the difference in treatment was not discriminatory because a branch was taxed only on Luxembourg profits while a subsidiary was taxed on its worldwide income. Second, in so far as a branch was taxed on its Luxembourg profits, it was in a comparable situation to a Luxembourg subsidiary, which in any event was taxed in its Luxembourg profits. From that perspective also, therefore, the rule was not discriminatory.”

\textsuperscript{477} See paragraph 38 of the decision.

\textsuperscript{478} See paragraph 42 of the decision, wherein the Special Commissioners offer the following explanation to justify such a position: “... This is in conformity with the principle that the application of different conditions for pursuing economic activities in different member States does not amount to discrimination.”
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dehemed as constituting a restriction under Art. 43 of the Treaty.\(^{479}\) The Special Commissioners concluded that even if the denial of group relief\(^{480}\) were to be viewed as constituting a restriction under the Treaty, such a restriction was justifiable on the following basis:

- from the perspective of the foreign subsidiaries, the Special Commissioners held that denial of group relief in respect of the losses was justifiable for the need to maintain fiscal cohesion. It is important to note that the Special Commissioners reached this conclusion in spite of recognizing that:
  
  (i) the ECJ has not approved the “fiscal cohesion” argument in any case other than *Bachman* and *Commission v. Belgium*;\(^{481}\)
  (ii) for the “fiscal cohesion” argument to succeed there must be a direct link between the discriminatory rule and a “compensatory” tax treatment;\(^{482}\)
  (iii) such a direct link must exist between a single tax and a single taxpayer;\(^{483}\) and
  (iv) in the present case, though the link was in respect of a single tax, it was in respect of two separate taxpayers;\(^{484}\)

- from the perspective of M&S, the Special Commissioners concluded that such a restriction was justifiable on the basis of the principle of territoriality.\(^{485}\)

With due respect to the learned Special Commissioners, it is submitted (on the basis of the case law discussed hereafter in this chapter) that the conclusions reached by the Special Commissioners are not supported by the jurisprudence of the ECJ, but rather, they are inconsistent with the ECJ’s case law. Also, in spite of the fact that up to now the ECJ has not directly ruled on the issue, the Special Commissioners did not consider it necessary to re-

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\(^{479}\) The following sentence in paragraph 107 of the decision gives an impression that the UK government did not advance any argument for justifying (at least hypothetical) Treaty restriction, and the Special Commissioners chose to “visualize” any potential justification: “... Nevertheless should, contrary to our view, the prohibition on the surrender of losses by the Appellant’s foreign subsidiaries constitute a restriction on the freedom of establishment requiring justification we have considered whether the UK government can indeed justify that restriction.”

\(^{480}\) In respect of the losses of the foreign subsidiaries.

\(^{481}\) See paragraph 110 of the decision.

\(^{482}\) See paragraph 110 of the decision.

\(^{483}\) See paragraph 112 of the decision.

\(^{484}\) See paragraph 112 of the decision.

\(^{485}\) See the first sentence in paragraph 114 of the decision, which states as follows: “Furthermore, even if the Respondent must also justify the rule from the Appellant’s perspective, we think that he can do so. The Appellant cannot claim relief for its foreign subsidiaries’ current losses but neither is it subject to tax on their current profits.”
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quest the ECJ for a preliminary ruling on the matter. Subsequently, however, in the taxpayer’s appeal against the decision of the Special Commissioners, the High Court has referred the issue to the ECJ. While the anxiety of the various Member States as regards this issue is discernible,\textsuperscript{486} it would not be quite surprising if the ECJ reaches a conclusion that the restrictive UK group relief rules infringe Art. 43 of the Treaty. An analysis of the present case law of the ECJ indicates that such a conclusion by the ECJ seems likely, mainly due to the following reasons:

- the denial of group relief in respect of the losses of a foreign group company, indeed, constitutes a restriction and conflicts with a Treaty freedom (freedom of establishment); and
- such a conflict is not justifiable on the basis of one or more arguments accepted by the ECJ up to now.

8.3.3. Conflict with a Treaty freedom (freedom of establishment)

In \textit{Baars},\textsuperscript{487} the ECJ has held that a national (parent) of a Member State owning the entire share capital of a company (subsidiary) in another Member State is entitled to the freedom of establishment,\textsuperscript{488} since the parent has a definite influence over the subsidiary’s decisions.\textsuperscript{489}

It is submitted that, as also argued by the taxpayer in \textit{Marks & Spencer}, denial\textsuperscript{490} of group relief benefits in respect of losses suffered by a group company resident in another Member State conflicts with the Treaty freedom of establishment, since the said denial is expected to dissuade a corporate group from setting up subsidiaries in the other Member States. Also, such

\textsuperscript{486} Especially in view of the fiscal repercussions in case they are required to grant group relief in respect of the losses of the foreign group companies.
\textsuperscript{487} Case C-251/98, \textit{C. Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem}.
\textsuperscript{488} Art. 43 of the Treaty prohibits restrictions by a Member State on freedom of establishment of nationals of other Member States. The prohibited restrictions include restrictions on the setting-up of agencies, branches, or subsidiaries by nationals of a Member State in another Member State. As per Art. 48 of the Treaty, for the purposes of freedom of establishment, companies and firms formed in accordance with the laws of a Member State and having their registered office, central administration or principal place of business within the Community must be treated in the same manner as nationals (natural persons) of Member States.
\textsuperscript{489} In this respect, also see Pinto, Carlo, \textit{Tax Competition and EU Law}, paragraph 5.3.2.5.
\textsuperscript{490} By the home Member State.
a denial may restrict the choice of legal form and compel the group to set up branches (and not subsidiaries) in the other Member States.

In Marks & Spencer, though it was the foreign subsidiaries that were not allowed to surrender the losses to M&S, the end result was that M&S and the group as a whole suffered due to the restrictive feature of the UK group relief rules. As a consequence of the foreign subsidiaries being barred from surrendering the losses to M&S, M&S had enhanced UK tax liability. Therefore, it is submitted that the Special Commissioners were not correct in concluding that M&S did not suffer any restriction. If the conclusion reached by the Special Commissioners in Marks & Spencer is to be regarded as consistent with the Treaty, then it would make it possible for the Member States to dodge a Treaty obligation (i.e. the freedom of establishment) by simply designing their group relief rules in a manner similar to the UK group relief rules, i.e. basing the group relief regime on a “system of loss surrendering” by a loss-making group company to a profit-making group company. Such a group relief regime, as contended by the taxpayer in Marks & Spencer, has a definitive effect of dissuading a corporate group from setting up subsidiaries in the other Member States, and therefore conflicts with the Treaty freedom of establishment. Therefore, it is submitted that a Member State’s group relief regime, irrespective of its procedural features, conflicts with the Treaty if the regime has the consequence of dissuading the nationals of a Member State from setting up subsidiaries in the other Member States. Whether or not such a conflict is justifiable on the basis of an acceptable argument is a separate issue, but in any case, an eventual justification would not overturn the conflicting characteristic of the regime.

8.3.4. Potential justifications for the restrictive national tax law provision

As the denial of group relief conflicts with the Treaty, the same would amount to Treaty infringement unless the said denial can be justified.

491. I.e. branch v. subsidiary.
492. As compared to the amount of the UK tax liability, if the foreign subsidiaries were allowed to surrender the losses to M&S and if M&S was allowed to offset the said losses against its other income taxable in the United Kingdom.
493. Such as surrendering of losses by a loss-making group company to a profit-making group company.
Similar to the approach adopted in 8.2., the following five arguments for the potential justification of the denial of group relief are examined hereafter:

- the need to prevent loss of revenue;
- the need to maintain fiscal cohesion;
- the need to prevent tax abuse;
- fiscal supervision;
- principle of territoriality.

8.3.4.1. The argument relating to the need to prevent loss of revenue

As mentioned in 8.2.3.1., the ECJ has consistently rejected this argument, and it is a settled position that reduction in tax revenue does not constitute an overriding reason to justify a measure which is in principle contrary to a fundamental freedom.

Accordingly, it is submitted that the denial (by the home Member State) of group relief in respect of losses of a subsidiary (group company) set up in another Member State cannot be justified on the ground of the need to prevent loss of tax revenue.

8.3.4.2. The “fiscal cohesion” argument

As stated earlier, for acceptance of the “fiscal cohesion” argument, the following two conditions must be satisfied:

- there must be a direct link between deductibility of an expense/loss and subsequent taxability of income (hereafter referred as “the first condition”); and
- there must be of a link between the same tax and with the same taxpayer (hereafter referred as “the second condition”).

In Bachmann and Commission v. Belgium, the only two cases where the ECJ has accepted the “fiscal cohesion” argument up to now, there was certainty that the insurance contributions would give rise to income in future (upon maturity of the insurance policies). For that reason, the ECJ recognized a link between non-deductibility of insurance contributions and non-taxability of the future income. However, as regards grant of group relief, there is no certainty that the losses incurred by a group company would be recouped by it in future. It is not rare that a company incurs losses for several consecutive years (or even never earns income during its lifetime), re-
sulting in winding-up of the company on account of bankruptcy or otherwise. Even in such cases, under the group relief regime of a Member State, a group company is generally allowed to claim group relief in respect of losses suffered by another group company resident in the same Member State. Thus, it could be argued that by granting group relief a Member State shares the risks of a group and, for that reason, the grant of group relief is not exclusively based on taxation of the future income of the loss-making group company. Accordingly, the grant of group relief is not dependent on a link between deductibility of loss incurred by a group company and the taxability of future income of the said group company. Therefore, it is submitted that the first condition is not satisfied.

The second condition for acceptance of the “fiscal cohesion” argument requires that the link (if any) between allowability of group relief and taxability of future income of the loss-making company must be between the same tax and with the same taxpayer. As regards this second condition, even if such a link between allowability of the group relief and taxability of the future income is assumed to exist, then, although such link would be in respect of the same tax, it would not be in respect of the same taxpayer since the two group companies would have legally distinct personalities. In this regard, it is relevant to take note of the Baars case, which involved 100% ownership of an Irish company by a Netherlands-resident shareholder, where the ECJ held that the Irish company and its shareholder were two separate persons.

For the purposes of this study, it is relevant to refer to the ECJ’s recent decision in Bosal. In that case, the Netherlands tax authorities rejected the taxpayer’s claim for deduction in respect of the cost of financing holdings in companies established in nine other Member States. Had the taxpayer incurred financing costs in respect of holdings in the companies established in the Netherlands (instead of the other Member States) then, since such

494. For a comparable conclusion, see ECJ decision in Case C-168/01, Bosal Holding BV v. Staatssecretaris van Financiën, paragraph 35.
495. I.e. the loss-making company and the company claiming group relief.
costs would have been directly or indirectly instrumental in generating taxable profits in the Netherlands, they were deductible under the Dutch tax law. Before the ECJ, the taxpayer argued that the restrictive provision under the Dutch tax law (allowing deduction for financing costs only if they were instrumental in generating profits taxable in the Netherlands) inhibited the exercise of the freedom of establishment as it penalized the creation of subsidiaries in the other Member States. For defending the said restrictive provision the Netherlands and the UK governments advanced, inter alia, the “fiscal cohesion” argument. Rejecting the “fiscal cohesion” argument, and referring to its earlier decision in Baars, the ECJ held that in situations involving tax treatments of different taxpayers (such as parents and subsidiaries), the “fiscal cohesion” argument could not be relied upon. Particularly, the ECJ stated that unlike operating branches or establishments, parent companies and their subsidiaries are distinct legal persons, each being subject to a tax liability of its own, so that a direct link in the context of the same liability to tax was lacking and the principle of fiscal cohesion could not be relied upon. Further, the ECJ stated that, also, there was no direct link between the deductibility of financing costs in respect of holdings in the Dutch subsidiaries and the potential taxability of the income of the Dutch subsidiary, since financing costs were deductible even if the Dutch subsidiary did not earn any income during the concerned taxable year.

497. See paragraph 40, Case C-251/98, C. Baars v. Inspecteur der Belastingen Particulieren/Ondernemingen Gorinchem.
498. In this context, it would be relevant to note the settled position under the English common law. More than 100 years ago, in Salomon v. Salomon & Co. Ltd. [1887] AC 22, the House of Lords in the United Kingdom held that upon incorporation, a company derives a personality of its own distinct and independent from the persons forming the company. Even contemporarily, this principle is regarded as equally acceptable. For instance, in a decision dated as recent as 16 March 2001, the Chancery division of the High Court reiterated observations of the Court of Appeals in Adams v. Cape Industries plc [1990] 2 WLR 657 that the Court is not free to disregard the principle of Salomon merely because it considers that justice so requires. Thus, under the UK law, a company is treated separate from its shareholder(s) (whether individual or a company), as if there was a notional veil (corporate veil) between the company and its parent. In that regard, the House of Lords has held, in Woolfson v. Strathclyde Regional Council 1978 SC (HL) 90, 96, that it would be appropriate to pierce the corporate veil only where special circumstances exist indicating that the company is a mere facade concealing the true facts.
499. I.e. requirement under the second condition for acceptance of fiscal cohesion.
500. See paragraph 32, Case C-168/01, Bosal Holding BV v. Staatsecretaris van Financiën.
501. I.e. the first condition for acceptance of fiscal cohesion argument.
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Accordingly, it is submitted that the denial of group relief to a parent company (or a group company) in a home Member State in respect of losses suffered by a subsidiary (or another group company) resident in another Member State is not justifiable on the ground of fiscal cohesion.502

8.3.4.3. The abuse argument503

Generally, the primary rationale behind denial of group relief benefit in respect of losses of foreign subsidiaries is to prevent erosion of the tax base (hence prevention of loss of revenue). Accordingly, the group relief restriction is not designed to only prevent abuse and it applies even to the foreign group companies set up for demonstrable business purposes. In this regard, it is relevant to note the ECJ’s decisions in *Metallgesellschaft and Hoechst*,504 and in *ICI*,505 where it opined that the establishment of a company in another Member State does not, of itself, necessarily entail tax avoidance. Further, in *X and Y*, the ECJ held that the exercise of one of the freedoms506 guaranteed by the Treaty could not, in itself, constitute an abuse.507

One question relevant for the purposes of this study is: “Could a group of companies from one Member State setting up a leasing company in another Member State imposing a substantially lower level of corporate tax (for instance, Ireland) be regarded as a case of tax abuse?” It is submitted, as discussed at 8.2.3.3.2., that if the setting-up of a leasing company in the home Member State is not tantamount to abuse,508 then by merely setting up the leasing company in a low-tax Member State (instead of the home Member

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502. Accordingly, it is also submitted that the fiscal cohesion approach adopted by the Special Commissioners in the *Marks & Spencer* case is not consistent with the case law of the ECJ.

503. See 8.2.3.3. for a discussion on relevant ECJ jurisprudence on abuse.


505. See paragraph 26, Case C-264/96, *Imperial Chemical Industries plc (ICI) v. Kenneth Hall Colmer (Her Majesty’s Inspector of Taxes)*.

506. Freedom of establishment for the purposes of this study.

507. See paragraph 44, Case C-436/00, *X and Y v. Riksskatteverket*.

508. As the leasing company may have been set up for valid commercial reasons.
Chapte rr  8  -  Relevanc e  o f  th e  E C  Treat y  (cross-borde r  leasin g  betwee n  th e  E C  
Membe rr  States )

State), per se, must not be deemed as a case of abuse. In a number of cases, 
the ECJ has held that “tax jurisdiction shopping” is not contrary to the Treat- 
y, and a restrictive provision of national tax law cannot be justified on such 
a ground.509

However, as concluded in 8.2.3.3.2., a taxpayer cannot rely on the Treaty 
for indulging in abusive practices. Accordingly, where a Member State (the 
home state) is able to demonstrate that a group company was set up in an-
other Member State solely for abusive purposes, then the denial of group 
relief by the home state in respect of losses of the subsidiary in the other 
Member State should not be viewed as a Treaty infringement.

8.3.4.4. “Fiscal supervision” argument

As stated earlier, in Futura, approving the “fiscal supervision” argument, 
the ECJ held that a Member State could apply measures to precisely ascer-
tain the amounts of taxable income as well as the losses. Accordingly, the 
home Member State could require the books of account of the loss-making 
group company (resident in the other Member State) to be maintained in ac-
cordance with the home Member State’s tax accounting rules as a condition 
for allowance of group relief. However, it is submitted that the “fiscal su-
pervision” argument does not help a home Member State to justify denial 
of group relief in respect of the losses of a subsidiary resident in another 
Member State if the books of account of the said subsidiary are maintained 
in accordance with the tax accounting rules of the home Member State. In 
such cases, denial of group relief would be contrary the principle of propor-
tionality since, where fiscal supervision (i.e. ascertainment of the correct 
amount of loss) is the objective of the restrictive provision and where the 
books of account of the loss-making group company are indeed maintained 
in accordance with the tax rules of the home Member State, denial would 
go beyond the objective of the restrictive provision.

509. See, for instance, Cases C-270/83, Commission v. French Republic (Avoir fiscald 
case); C-307/97, Compagnie de Saint-Gobain, Zweigniederlassung Deutschland v. Fi-
nanzamt Aachen-Innenstadt; C-294/97, Eurowings Luftverkehrs AG v. Finanzamt Dort-
mund-Unna; C-35/98, Staatssecretaris van Financiën v. B.G.M. Verkooijen; C-422/01, 
Försäkringsaktiebolaget Skandia (publ) and Ola Ramstedt v. Riksskatteverket; and C- 
136/00, Rolf Dieter Danner.
8.3.4.5. Territoriality argument

In *Futura*, the ECJ recognized the *principle of territoriality*. In that case, the ECJ was required to determine whether the Luxembourg tax law’s restrictive rule, concerning carry-forward and set-off of losses of a non-resident taxpayer’s Luxembourg branch against the branch’s future income, was compatible with the Treaty. The ECJ took into account that under the Luxembourg tax law, in the case of a Luxembourg branch of a non-resident taxpayer, only income arising from the branch’s Luxembourg activities were taxable and, in accordance with the principle of territoriality, only losses from such activities could be set off against the branch’s future taxable income. The Court held that such a system could not be regarded as entailing any discrimination prohibited by the Treaty.

In *Marks & Spencer*, in reaching the conclusion that denial of group relief in respect of the losses of foreign subsidiaries did not conflict with the Treaty, the Special Commissioners extensively relied on the territoriality principle, including the ECJ’s decision in *Futura*. Probably, however, the Special Commissioners might have reached a different conclusion if they were to decide on the issue subsequent to the ECJ’s decision in *Bosal*.

In *Bosal*, the Netherlands government sought to justify denial of deduction in respect of financing costs for holdings in nine companies in other Member States on the basis of the principle of territoriality. However, the ECJ dismissed this argument by distinguishing *Futura*, which involved the taxation of a “single company” carrying on business in a Member State

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510. See paragraphs 18 to 22, Case C-250/95, *Futura Participations SA and Singer v. Administration des contributions*.

511. The “principle of territoriality” connotes a link between taxability of income and deductibility of related expenses within a jurisdiction. Under this principle, an item of expenditure incurred by a foreign taxpayer would be deductible in a host country, if it is incurred for earning income that is taxable in the host country.


514. See paragraph 37, Case C-168/01, *Bosal Holding BV v. Staatssecretaris van Financiën*.

515. See paragraph 38, Case C-168/01, *Bosal Holding BV v. Staatssecretaris van Financiën*. 
where it had its principal establishment and in another Member State through secondary establishment. Thus, it may be inferred from *Bosal*, that while the Court may consider discrimination in the case of a single entity as justifiable on the ground of the territoriality principle, the Court is unlikely to entertain an argument based on the territoriality principle in cases involving a parent company and a subsidiary or a group of companies (multiple entities).

For that reason, it appears that the ECJ is unlikely to find denial of group relief by a home Member State, in respect of losses of a subsidiary (or a group company) in another Member State, to be compatible with the Treaty on the ground of the principle of territoriality.

### 8.3.5. Main conclusion on the issue

The denial (by a home Member State) of group relief in respect of losses of subsidiaries (or group companies) in other Member States conflicts with the Treaty freedom of establishment, and it is not justifiable on the basis of an acceptable argument. Therefore, the said denial infringes the Treaty. However, a taxpayer is not entitled to rely on the Treaty in the case of proven abusive transactions.\(^{516}\)

### 8.4. Final conclusions

The UK capital allowance restriction in the case of outbound leases and the denial (by the home Member State) of group relief in respect of losses of subsidiaries (or group companies) in other Member States conflict with the Treaty freedom of establishment, and they are not justifiable on the basis of an acceptable argument. Therefore, the said restrictions infringe the Treaty. However, a taxpayer is not entitled to rely on the Treaty in the case of proven abusive transactions.

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\(^{516}\) For this purpose, the tax authorities must substantiate, on a case-by-case basis, that the subsidiaries (or the group companies) were set up in the other Member States solely for tax abuse purposes.