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**Cross-border Loss Utilization Concerning the Tax
Treatment of a Taxpayer's Own Losses Attributable
to a Permanent Establishment in Relation to the
Territoriality Principle –From an International and
EU law Perspective**

by

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Summary

The European Commission has acknowledged the lack of cross-border utilization of losses. Companies operating internationally want to have a possibility to offset losses against taxable profits at the same time or as soon as possible after the losses incurred. If no such possibility is at hand, a cash-flow disadvantage arises and also, it leads to segmentation of the internal market. The asymmetries occur while Member States enjoy sovereignty and a broad competence to levy taxes and determine the geographical extent of their tax jurisdiction. Member States are competent to apply a territorial taxation system and thereby limit the utilization of companies' losses in cross-border situations. However, the meaning of territorial taxation differs depending on if it is seen from an international law or international tax law perspective. The European Court of Justice recognises a territorial taxation system from an international law perspective. This includes a right for the Member States to tax residents on their worldwide income and non-residents on their territorial income.

Member States limit cross-border utilization of losses in order to preserve their tax bases. A territorial tax system can be achieved in two different ways. The first is by a definition of the tax base for income tax purposes, i.e. by limiting the tax base to locally sourced income and capital. The second is by exempting foreign-sourced income through unilateral, bilateral or multilateral conventions. The issue arises when Member States apply a double taxation convention with the exemption method. In that case, there is no possibility to utilize the losses in either the host State or the home State. However, the European Court of Justice may in certain situations require Member States to make it possible to utilize cross-border losses, whereas in other situations the European Court of Justice has recognised Member States sovereignty by stating that Member States do not need to utilize cross-border losses. In the latter situation, the European Court of Justice recognises Member States sovereignty and it may express an underlying principle, in terms of territoriality.

The examination implies that the territoriality principle is more a consequence of Member States sovereignty than a self-supporting principle. Furthermore, the concept of territoriality falls into the background of other conceded concepts, such as the balanced allocation of taxing powers and symmetry. Yet, the concept of territoriality is still evolving within the European Union and will certainly be affected by the growing work on international level. When evolving the concept of territoriality, the European Union has to find a balance between the concept of an internal market and the Member States' sovereignty. At the moment, the European Court of Justice recognises the Member States' sovereignty even if it contradicts the concept of an internal market. Thus, cross-border losses attributable to permanent establishments are stranded when the Member States apply the exemption method in their double taxation conventions. In order for the territoriality principle to be a self-supporting principle it needs to get a clear definition and a consistent applicability.

Preface

I want to highlight my appreciation to Lund University, especially to Sofia Rosendahl and Cécile Brokelind for the extra time they have devoted by compromising and facilitating for me when writing my thesis during another period of time. I also want to thank my family and friends for supporting me during my writing and for their understanding. I am truly grateful for their support. Last but not least, my proofreaders deserve special thanks.

Abbreviation list

AG	Advocate General
BEPS	Base erosion and profit shifting
BFH	Bundesfinanzhof
CIN	Capital import neutrality
CEN	Capital export neutrality
Ch.	Chapter
DTC	Double tax convention
ECJ	The European Union Court of Justice
e.g.	For example
EU	European Union
GAAP	Generally Accepted Accounting Principles
HO	Head Office
i.e.	In example
OECD	The Organisation for Economic Co-operation and Development
TEU	The treaty on the European Union
TFEU	The treaty on the functioning of the European Union
Para.	Paragraph
PE	Permanent establishment
Sec.	Section
SITA	Swedish Income Tax Act

1. Introduction

1.1 Background

In the light of the Member States' sovereignty, there is a right to levy taxes and also to decide the geographical extent of their tax jurisdiction. While each Member State determines the criteria and thereby the scope of its taxation, Member States are free to apply the territoriality principle in situations of income taxation.¹ The territoriality principle includes a right for the Member State to tax both residents and non-residents on the income from sources in that State as well as property situated in that State.² Yet, the concept of territoriality appears to differ whether it is seen from the perspective of international law or international tax law.³ Since Member States enjoy liberty to determine the geographical scope of their tax jurisdiction regarding companies' business income, asymmetries occur.⁴ Member States may in principle disregard foreign-sourced income through double tax conventions (DTCs). Moreover, by using the exemption method, losses arising cross-border in a permanent establishment (PE) cannot be taken into account in either the host State or in the home State.⁵ Hence, the issue of non-possibility to utilize the cross-border losses attributable to the PE arises.⁶ This implies a difference in treatment as losses attributable to a domestic PE is offset against the profits in the Head Office (HO).⁷

In a European Union (EU) context, this constitutes an obstacle to the freedom of establishment since a company with a PE cross-border is in a comparable situation to a company with a domestic one.⁸ The European Court of Justice (ECJ) may, regardless of the DTC, require Member States to make it possible to utilize cross-border losses in certain constellations.⁹ Yet, the ECJ has in certain situations been recognising Member State sovereignty by stating that Member States do not need to utilize cross-border losses.¹⁰ In the latter situations, the ECJ recognises Member States sovereignty and it may be an underlying principle, in terms of territoriality. In this sense, the ECJ disregards equal treatment of a domestic PE and a cross-border PE regarding losses, since a company with a PE cross-border is not treated the same as a company with a domestic PE. Further, the ECJ has

¹ Helminen, Marjaana, *EU Tax Law – Direct Taxation*, IBFD, 1 Juni 2013, chapter (ch.) 1 p. 2.

² Definition of the *Territoriality principle*, IBFD International Tax Glossary, 2015.

³ Marres, Otto, *The Principle of Territoriality and Cross-border Loss Compensation*, INTERTAX, Volume 39, Issue 3, Kluwer Law International, 2011, p. 112.

⁴ Marres (n 3), p. 112.

⁵ COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 5; Marres (n 3), p. 112.

⁶ COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 5.

⁷ Ch. 40, section (sec.) 2 Swedish Income Tax Act (SITA); COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 4-5.

⁸ Case C-141/99 *AMID*, paragraphs (paras). 25 ff.

⁹ Case C-293/06 *Deutsche Shell*, para. 53; Lüdicke, Jürgen, Altorfer, B, Jürg, Blanluet, Gauthier, Hohenwarter-Mayr, Daniela, Inoue, Koichi, Suarez, Steve and Lange-Hückstädt, Carolin, *International Cross-Border Loss Utilization*, Bulletin for International Taxation, June/July 2014, Volume 68, No. 6/7, IBFD, published online 27 May 2014, p. 376.

¹⁰ C-250/95 *Futura Participations SA*, para. 43; Case C-414/06 *Lidl Belgium*, para. 54; Case C-157/07 *Krankenheim*, para. 55; C-686/13 *X AB v. Skatteverket* para. 41.

referred to the principle of territoriality as a criterion that may affect the determination of whether a measure by the Member State is restrictive.¹¹ Thus, it can be questioned whether the territoriality principle may serve as a justification ground for treating companies in a comparable situation differently regarding cross-border losses attributable to PEs.

The lack of cross-border offsetting leads to cash-flow disadvantages,¹² and segmentation of the internal market.¹³ In order for companies to avoid these disadvantages, companies operating internationally will want to offset losses against taxable profits at the same time or as soon as possible after the losses incurred.¹⁴ The disadvantages have been acknowledged by the European Commission and hence, various approaches and initiatives have been taken in order to tackle the problem. Even if the Commissions general tax policy and specific suggestions may influence the Member States, the initiatives have not been successful.¹⁵

Based on the aforementioned, the thesis will examine the issue concerning Member States' DTCs, which limit cross-border loss utilization where international activities of a company result in losses in the host State, and profits in the home State. It is of interest to examine to what extent a territorial approach is acceptable under EU law and its fundamental freedoms since it results in a non-utilization of cross-border losses for companies, which contradicts the concept of an internal market. In addition, the thesis will examine the differences that exist between the concept of territoriality in international law and international tax law, and also which concept the ECJ's adapts.

1.2 Aim

The aim of the thesis is to examine whether the territoriality principle can be discerned from the ECJ's case law regarding the tax treatment of loss utilization attributable to PEs in cross-border situations.

¹¹ C-250/95 *Futura Participations SA*, paras. 20-22.

¹² Lüdicke and others, (n 9), p. 376.

¹³ COM (90) 595 final, *the proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*, p. 2; COM (84) 404 final, *proposal for a directive of the Council on the harmonization of the laws of the Member States relating to tax arrangements for the carry-over of losses of undertakings*; COM (2006) 824 final European Commission, *Tax Treatment of Losses in Cross-Border Situations*; European Parliament, Resolution on Tax Treatment of Losses in Cross-Border Situations, 2007/2144 (INI).

¹⁴ Lüdicke and others, (n 9), p. 376.

¹⁵ COM (90) 595 final, *the proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*, p. 2; COM (84) 404 final, *proposal for a directive of the Council on the harmonization of the laws of the Member States relating to tax arrangements for the carry-over of losses of undertakings*; COM (2006) 824 final European Commission, *Tax Treatment of Losses in Cross-Border Situations*; European Parliament, Resolution on Tax Treatment of Losses in Cross-Border Situations, 2007/2144 (INI).

Subsequently, if a principle of territoriality can be discerned from EU law, does the ECJ's understanding reconcile with the concept of territoriality in international law or international tax law?

1.3 Definition and scope of a company's own cross-border losses

Cross-border loss utilization is limited to foreign corporate losses, where foreign losses include negative income from other tax jurisdictions.¹⁶ The term losses are defined as the excess of expenses over revenues for a period.¹⁷ The examination will cover companies' reduction of their tax burden, which lower their income tax base through offsetting losses against taxable income. Consequently, cross-border loss utilization implies a possibility for the HO to lower their income tax base through offsetting losses arising in the PE against their taxable income.

Furthermore, the examination of losses will extend to also cover currency losses; however, where the situation regards currency losses, it will be explicitly stated.¹⁸ Moreover, the losses discussed through this thesis are companies' own losses limited to negative income attributable to a foreign PE.¹⁹ In addition, negative income attributable to a foreign subsidiary will also be examined to some extent, even if PEs and subsidiaries are not generally in a comparable situation due to their different legal form and their recognition as residents for subsidiaries and as non-residents for PEs.²⁰ A parent company with a foreign subsidiary may be in a comparable situation to a company having a foreign PE where the States apply the exemption method in their DTC, which means that foreign losses cannot be utilized in any situation.

Generally, losses incurred by foreign PEs are offset against the HO profits and the existing tax exposure diminishes in the company's home State.²¹ This is possible in Sweden without time limit. However, this is true only if the States do not apply a DTC with the exemption method.²² Some States require that this deduction is recaptured and no relief for juridical double taxation of the PE's profits are available as long as the previously deducted losses are not recaptured.²³ A recapture rule permits the deduction of foreign losses at the HO level; however, as soon as the PE becomes profitable, the losses are recaptured.²⁴

Further, some home States apply a time limit within which the temporarily imported foreign losses must be offset by subsequent PE profits and thus, the loss deduction in the home State must be recaptured. If this time limit

¹⁶ Lüdicke and others, (n 9), p. 376.

¹⁷ Definition of *Loss*, IBFD, International Tax Glossary, 2015.

¹⁸ Lüdicke and others, (n 9), p. 376.

¹⁹ Lüdicke and others, (n 9), p. 377.

²⁰ Wattel, J, Peter, *Corporate tax jurisdiction in the EU with respect to branches and subsidiaries; dislocation distinguished from discrimination and disparity; a plea fore territoriality*, EC Tax Review 2003/4, p. 197-198.

²¹ Lang, Michael, *Has the Case Law of the ECJ on Final Losses Reached the End of the Line?*, European Taxation, December 2014, IBFD, p. 539; Dahlberg, Mattias, *Internationell beskattning*, upplaga 3:1, Studentlitteratur, Lund, 2012, p. 68.

²² Ch. 40, sec. 2, SITA; Commentary on law ch. 14, sec. 10, SITA.

²³ Wattel, (n 20), p. 196.

²⁴ Lang, (n 21), p. 539.

for example (e.g.) is five years, and if the PE losses are still uncompensated after five years, the losses will be reinstated in the taxable profit of the company. Additionally, if no time limit exists in the home State and the PE is wound up after the loss making, the losses will have to be imported permanently in the home State. Hence, this cross-border loss utilization is not possible where the States have a DTC applying the exemption method. Therefore, there is in that situation no possibility for the PE to utilize its losses in the home State. This situation implies similarities with losses incurred in a foreign subsidiary. While these losses cannot be offset against the parent company's profits and thereby, not imported in the home State. Losses in foreign subsidiaries may not be imported even temporarily. Hence, the losses have to be rolled over to fiscal years in which the foreign subsidiary itself make profits and has a possibility to offset against.²⁵ In line with this fact, arguments concerning cross-border loss utilization for PEs will be supported with findings discerned from case law on cross-border loss utilization for subsidiaries.

1.4 Method and material

For the purposes of this thesis, the legal dogmatic research method is used. This means that the research is conducted of current law as laid down in written and unwritten European, international or national rules, principles, concepts, doctrines, case law and in literature.²⁶ The issue regarding non-utilization of cross-border losses arises due to disparities in legal pluralism. Therefore, all the different legal orders have to be examined. The method is conducted in a two-part process where the sources of law in the different legal orders are identified, and then interpreted, analysed, systemized and confronted with each other.²⁷

For the purposes of explaining taxation of PEs, the Member States domestic situations are the starting point where there is an example from Swedish law. However, the emphasis is placed on how Member States treat PE losses in cross-border situations. Therefore, Member States' DTCs, which are based on The Organisation for Economic Co-operation and Development (OECD) Model Tax Convention and its commentaries, are at the centre since these stipulate Member States taxing powers. Further, the taxation of PEs is clarified with primary and secondary sources of EU law in terms of the Treaty on the European Union (TEU), the Treaty on the Functioning of the European Union (TFEU), ECJ case law and the Commission's proposals for directives, and also doctrinal publications and academic debates.

The research regarding the definition, meaning and concept of the territoriality principle is based on soft law, whereas the principle is unwritten law. The materials used include journals, books, IBFD and reports from the Base Erosion and Profit-shifting (BEPS) project.

When analysing whether the ECJ discerns the territoriality principle when denying cross-border loss utilization attributable to PEs, the ECJ's own case law are in focus. AG Opinions and the Commission's proposals for

²⁵ Wattel, (n 20), p. 196.

²⁶ Douma, Sjoerd, *Legal Research in International and EU Tax Law*, Kluwer, 2014, p. 18.

²⁷ Douma, (n 26), p. 20.

directives complement this material. When discussing the difference between losses, German national cases will be reviewed to find guidance how to assess where a final loss exists and also, what a final loss is.

As this topic is of much debate and discussion, numerous papers and journals have been written regarding cross-border loss utilization within the EU. In that sense, the whole thesis is, on a large scale, based on doctrine in this area. This is done in order to highlight different aspects of the topic, to strengthen the reasoning and also, to achieve the aim of this thesis.

1.5 Delimitation

This paper will focus solely on the corporate aspects in taxation within the EU. While corporate taxation consists of two components, direct and indirect taxation, this thesis delimitates from examining the indirect taxation due to the significant progress towards harmonization in that area.²⁸

Neither individual deductions nor expense allocation issues (e.g. transfer pricing questions) will be examined, since the examination will be limited to cover situations regarding the reduction of the tax burden of companies that lower their tax base through offsetting losses against taxable income and currency losses.²⁹

The case law examination will not cover cross-border loss utilization regarding individuals and therefore the ability to pay principle will not be covered. This is because the principle is of relevance solely for individuals and seems to be an irrelevant criterion in the context of taxation of companies.³⁰

Further, the thesis delimitates from addressing rules regarding “losses of other entities”, in example (i.e.) situations covering a taxpayer resident in one State that is allowed to use the losses of another legally independent taxpayer resident for tax purposes in another state.³¹ “Losses of other entities” in terms of subsidiaries is solely touched upon when reviewing ECJ’s case law in order to understand, and draw guidance therefrom, regarding the territoriality principle.³² The delimitation depends on the different tax treatment of own losses and losses of other entities under domestic law and also, that this distinction regularly has an impact on the calculation of foreign tax credits in DTC situations. Own losses are reflected in the taxpayer’s own tax balance sheet or profit and loss accounts in the home State provided that this State taxes income on a worldwide basis.³³

Since this thesis largely delimitates from “losses from other entities”, cross-border group taxation and hybrid instruments are not touched upon. In addition the thesis will not cover the Commission’s efforts to establish a European Common Consolidated Corporate Tax Base (CCCTB), while it to

²⁸ Council Directive 2006/112/EC on the common system of value added tax.

²⁹ Lüdicke and others, (n 9), p. 376.

³⁰ Marres, (n 3), p. 125.

³¹ Lüdicke and others, (n 9), p. 377.

³² Lüdicke and others, (n 9), p. 377.

³³ Lüdicke and others, (n 9), p. 377.

a large extent would solve problems for groups of companies, which is not covered by this thesis.³⁴

The research for this thesis was completed on 10 November 2015. Therefore, this thesis does not take into account material published after that date.

1.5 Outline

Following the introduction, the taxation rules regarding PEs are presented (2), the purpose of which is to inform the reader about the legal pluralism and how Member States tax PEs. The starting point is Member States domestic rules, which is followed by the impact of EU requirements and Member States DTCs based on international law. The thesis proceeds with an examination of the different concepts of the territoriality principle (3). In order to achieve this thesis' aim of determining whether there is an underlying territoriality principle within EU, this thesis proceeds with an analysis of ECJ's case law regarding cross-border loss utilization of losses attributable to PEs and subsidiaries (4). Following the analysis, concluding remarks are presented, wherein the author tries to disentangle how the territoriality principle is expressed, if it is recognised and thereby, affects the outcome of ECJ's case law (5). This thesis concludes with a conclusion based on the thesis entire examination (6).

2. Taxation of PEs

2.1 Introduction

Due to the legal pluralism between international law, EU law and the Member States' domestic law, this chapter will review how the different legal orders affect the attribution of profits to PEs and thus, how the PEs are taxed due to the different legal orders.

2.1.1 Tax treatment of losses in domestic situations

The tax treatment of losses in a domestic situation within a single company is automatically and immediately granted relief, and the company will be taxed on the net result of all domestic branch activities through PEs. Subsequently, the relief will be automatically recaptured when the loss-making part of the company receives profits since the taxation takes place in the same State.³⁵ An example is Sweden's domestic law, which provides that legal entities are considered to have unlimited tax liability if they are registered or, if no registration is at hand, if they have their real seat in Sweden. Unlimited tax liability implies that the company is taxable on all income in Sweden and abroad.³⁶ All economic activities carried on by a Swedish legal person are regarded as a single business.³⁷ This implies, according to Sweden's domestic law, that profits and losses attributable to the PE shall be allocated to the HO. Consequently, income is taxed, and losses are offset in the HO. If there is a loss in the total calculation of the corporate income, it is a possibility for the HO to use the loss during the

³⁴ Lüdicke and others, (n 9), p. 383.

³⁵ COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 4-5.

³⁶ Ch. 6, sec. 3-4, SITA.

³⁷ Ch.14, sec. 10, SITA.

next fiscal year. In addition, if the company makes a loss also the next year, the previous year's loss is increased by the amount of the current year loss. Tax losses may therefore be carried forward indefinitely, without a time limit.³⁸ However, restrictions in terms of an amount limitation rule and an offset restriction rule may apply if there is a change in ownership.³⁹

2.1.2 Tax treatment of losses in cross-border situations

The EU has repeatedly attempted to co-ordinate the issue arising from companies' inability to deduct the losses incurred by PEs situated in a Member State other than where the company in question is resident for tax purposes.⁴⁰ This serves as an obstacle that might seriously hamper activities within a common market.⁴¹ The EU's endless attempts to harmonize in order for cross-border losses not to be treated less favourably than domestic losses is still not close to being adopted, and is not expected to be, in the near future. Although this does not mean that a prohibition forbidding the offsetting of losses would be consistent with the fundamental freedoms preserved by the EU.⁴²

In absence of a possibility for cross-border utilization, the offset of losses would generally be limited to the amount of profits generated in the Member State in which the company is established and its place of investment. This limitation distorts business decisions.⁴³

In international tax law, there are different principles of taxation, both resident taxation and source taxation. The ECJ has in its case law accepted both principles. However, since a PE is not a legal person in its own right, the principle of source taxation shall apply. Thus, a PE is taxed in the State where its economic activity takes place, and it is only liable to tax in the State where the PE is conducting its business.⁴⁴

Although the PE lacks legal personality and is considered a non-resident from a tax perspective,⁴⁵ the PE obtains the right from EU law, if it is in a comparable situation, to be treated in the same way as resident companies

³⁸ Ch. 40, sec 2, SITA.

³⁹ Ch. 40, sec. 10-14, SITA.

⁴⁰ COM (90) 595 final, *the proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*, p. 2; COM (84) 404 final, *proposal for a directive of the Council on the harmonization of the laws of the Member States relating to tax arrangements for the carry-over of losses of undertakings*; COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations* and Official journal of the European Union; European Parliament, *Resolution on Tax Treatment of Losses in Cross-Border Situations*, (2007/2144 (INI)).

⁴¹ COM (2001) 582 final, *Towards an Internal Market without tax obstacles –A strategy for providing companies with a consolidated corporate tax base for their EU-wide activities*, p. 12.

⁴² Gassner, Wolfgang, Lang, Michael and Lechner, Eduard, *Tax Treaties and EC Law*, Series on International Taxation, Kluwer Law International, 1997, Linde Verlag Wien, p. 81-82.

⁴³ COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 2.

⁴⁴ Ben J.M Terra and Peter J Wattel, *European Tax Law*, 5th edition, Kluwer Law International, Alphen aan den Rijn, 2008, p. 170.

⁴⁵ COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 5.

regarding the method of determining the taxable base.⁴⁶ This applies if, all other circumstances being equal. Hereby, the PE's result forms a part of the overall result for the Member State where the HO is located. However, the DTCs between Member States stipulate the allocation right for a Member State to tax an income.

Generally, the DTC gives the primary right of taxation to the host State, while the home State is given the secondary taxing rights concerning the income of the PE.⁴⁷ This implies, most commonly, that the income of the PE is exempt or the tax is credited in the State of residence and thereby, taxed in the State of establishment.⁴⁸ Member States make use of the exemption method and credit method provided for by the OECD Model Convention in order to eliminate juridical double taxation.⁴⁹ Juridical double taxation is when a taxpayer is subject to tax on the same income or capital in more than one jurisdiction.⁵⁰ It is for the Member States to choose the technique of elimination of double taxation in their DTCs.⁵¹ According to the foregoing; the taxation may therefore be different in situations where a DTC is established between the countries in question. However, the DTC has to be compatible with EU law.⁵²

Further, when the taxable amount for each State has to be determined, the income attributable to each area of the businesses has to be recognised. This attribution is usually based upon the OECD Model Tax Convention, where profits are allocated to a PE by different criteria.⁵³ The allocation of income criteria and the methods for eliminating double taxation will be further discussed in the following.

2.2 OECD Model Tax Convention

It is stated in the OECD Model Tax Convention that profits of an enterprise of a Contracting State shall be taxable only in that State except in situations where the enterprise carries on business through a PE situated in another Contracting State. If so, the profits attributable to the PE may be taxed in that other State. The profits are allocated to the PE due to the functions performed, assets used and risks assumed. Thus, the profits attributable to the PE are the profits the PE is expected to make. Furthermore, when a Contracting State adjusts the profits attributable to the PE of an enterprise of

⁴⁶ Case C-311/97 *Royal Bank of Scotland*, paras. 28-29 and 34.

⁴⁷ OECD (2014) *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, 15 July 2014, Article 7 (p. 28-29); COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 5.

⁴⁸ OECD (2014) *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, 15 July 2014, Articles 23 A and B.

⁴⁹ OECD (2014) *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, 15 July 2014, Article 23; COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 5.

⁵⁰ Lang, Michael, *Introduction to the Law of Double Taxation Convention*, 2nd edition, IBFD, 1 January 2013, ch.1, p. 3.

⁵¹ COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 5.

⁵² Case C-307/97 *Saint-Gobain ZN*, para. 55.

⁵³ OECD (2014) *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, 15 July 2014, Article 7 (p. 28-29); COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 5.

one of the Contracting States and thereby taxes the profits of an enterprise that have been subject to tax in the other State, the other State shall make an appropriate adjustment to the amount of tax charged on those profits. This adjustment shall be done in order to eliminate double taxation. In this case, if necessary, the competent authorities of the Contracting States shall consult with each other.⁵⁴

Article 7 of the OECD model tax treaty expresses both the State of residence principle and the source State principle; the source State principle is applied when there is a PE at issue. If the economic activity meets the requirements listed in article 5 a sufficient tie exists between the activity and the source State and consequently, a PE exists. In that sense, the source State is entitled to tax the income allocated to the PE, and in situations where no PE exists, the State of residence enjoys exclusive rights to tax the income irrespective of in which State it is earned. This does not provide a complete solution to the problem of the juridical double taxation of business profits. However there is no requirement to eliminate juridical double taxation. In addition to the definition of a PE, it is necessary to have an agreed set of rules stating how the profits attributable to the PE are supposed to be calculated.⁵⁵ Consequently, rules on how the taxing rights will be allocated between the States.

Despite several amendments, the criteria for attribution of profits to a PE still remain. The principles on which article 7 paragraph 2 are based on are the separate entity and arm's length principles. The OECD has been trying to make modifications in order to clarify the purpose of the principles, since there have been variation in the interpretation of these principles. The clarification of today's wording is based on a report from 2008, *Attribution of Profits to Permanent Establishments*.⁵⁶ As a general rule, if an enterprise does not have a PE in another State, it should not be regarded as participating in the economic life of the other state, and thus the other State shall not have taxing rights. Furthermore, the right to tax for the State where the PE is located does not extend to the profits that the enterprise may derive from that State but cannot be attributable to the PE.⁵⁷ Thus, profits attributable to the PE can be both from the host State or other States. Thus, the PE may be taxed on its worldwide income under international tax law. However, what the PE is really taxed on depends on if the host State applies a territorial system or worldwide system in its domestic law.⁵⁸ Hence, the juridical double taxation needs to be avoided through the States' DTCs.

⁵⁴ OECD (2014) *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, 15 July 2014, Article 7 (p. 28-29).

⁵⁵ OECD (2014) *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, 15 July 2014, Commentary on Article 7 –Concerning the taxation of business profits, I Preliminary remarks (p. 132).

⁵⁶ 2010 *Report on the Attribution of Profits to Permanent Establishments*, 22 July 2010, OECD.

⁵⁷ OECD (2014) *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, 15 July 2014, Commentary on Article 7 –II Commentary on the provisions of the Article (p. 134-135).

⁵⁸ Yong, Singyan, *Triangular Treaty Cases: Putting Permanent Establishments in Their Proper Place*, Bulletin for International Taxation, March 2010, Volume 64, No. 3, Published online on 3 February 2010, IBFD, p. 155.

The methods for alleviation of juridical double taxation in the OECD-model are the credit method⁵⁹ and the exemption method⁶⁰, and will be further discussed in the following.

2.2.1 The Credit method

Using the credit method, the State of residence takes the worldwide income into account and thus, the tax levied in the source State is credited against the taxpayer's tax levied in the State of residence. In that sense, the credit method works in a similar way as the treatment of losses in domestic situations; any loss will thereby be taken into account when determining the worldwide income.⁶¹ This method reflects capital export neutrality (CEN). When the tax rate is higher in the resident State than in the source State, the total tax burden will be the rate applied in the resident State. This method is based on the principle of home market neutrality and does not encourage or discourage taxpayers to invest abroad.⁶²

There are two types of the credit method; full credit and ordinary credit. Under full credit, which is not usually applied, all levied source tax is credited against the resident tax. Under ordinary credit, the credit is restricted, the resident State allows credit for source taxes from its own tax, but only up to the extent it is attributable to the source income.⁶³

2.2.2 The Exemption method

Using the exemption method, the State of residence excludes foreign income taxed in the source State from its tax base. This method reflects capital import neutrality (CIN) since all income sourced within a jurisdiction shall bear the same level of tax. This method results in the same tax burden to foreign taxpayers as to resident taxpayers while they compete under the same tax conditions.⁶⁴

This method may be used in different ways, either by applying the method without loss deduction or by applying the method with temporary loss deduction. Applying the method without loss deduction implies that, since the PE result is not taken into account in the State of residence, no loss utilization will be available. Applying the method with temporary loss deduction implies that, the State of residence provides for a loss deduction sustained by the PE even if the profits are exempted. However, these losses need to be recaptured once the PE returns to profitability (hereinafter referred to as exemption with temporary loss-deduction and claw-back).⁶⁵

2.2.3 Consequences of the exemption method in a DTC

When losses incurred by PEs may not be offset against profits in the State of residence, where the State applies the exemption without deduction, there is

⁵⁹ OECD (2014) *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, 15 July 2014, Article 23 B.

⁶⁰ OECD (2014) *Model Tax Convention on Income and on Capital: Condensed Version 2014*, OECD Publishing, 15 July 2014, Article 23 A.

⁶¹ COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 5.

⁶² Lang, (n 50), ch. 10, p. 7.

⁶³ Lang, (n 50), ch. 10, p. 7.

⁶⁴ Lang, (n 50), ch. 10, p. 3.

⁶⁵ COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 5.

a difference in treatment in comparison with a purely domestic situation. Consequently, the result of the PE in a domestic situation generally forms a part of the HO result. However, when it is a border between the PE and the HO, and also, an existing DTC applying the exemption method between the States, the result of the PE does not form a part of the HO result.⁶⁶ Hereby, the losses of the foreign PE are not being deductible from the profits of the HO and the company pays an excessive amount of tax in relation to the total net result of its activity while their taxation solely will be based in the result achieved in the home State.⁶⁷ Accordingly, it will be less attractive to exercise the freedom of establishment, which may lead to companies refraining from setting up PEs in other states. This constitutes an obstacle to the freedom of establishment since a company with a PE abroad is in a comparable situation to a company with a domestic one.⁶⁸

2.2.4 Foreign own losses –different result when applying the various methods to avoid juridical double taxation

The issue arising from the limitation of cross-border loss utilization regarding the treatment of a taxpayer's own losses will be highlighted in an example.⁶⁹ The example will also show that the issue arises from the countries' DTCs, which stipulate the chosen method to avoid juridical double taxation.

Take this example. A company conducts business through its HO and also through a foreign PE. Assume that the tax rates are 30 per cent in both states, and that the host State's domestic tax law provide for a loss carry-forward but is not for a loss carry-back. This example covers a period of two years where the HO makes a profit of 100 in both years and the PE makes a profit of 100 in year 1 but suffers a loss of 100 in year 2. The methods for avoiding juridical double taxation used in this example are the credit method, the simple exemption method and the exemption with temporary loss-deduction and claw-back.⁷⁰

⁶⁶ COM (90) 595 final, *the proposal for a Council Directive concerning arrangements for the taking into account by enterprises of the losses of their permanent establishments and subsidiaries situated in other Member States*, Explanatory Memorandum, paras. 2-3.

⁶⁷ COM (90) 595 final, *the Commission's Proposal for a Council Directive concerning arrangements for taking into account by enterprises of the losses of their permanent establishments and subsidiaries in other Member States*, Explanatory Memorandum, paras. 2-3.

⁶⁸ Case C-141/99 *AMID*, paras. 25 ff.

⁶⁹ Example taken from: Lüdicke and others, (n 9), p. 378.

⁷⁰ Lüdicke and others, (n 9), p. 378.

		Year 1		Year 2		Total	
P/L	PE	+100		-100		+/-0	
P/L	HO	+100		+100		+200	
Exemption, total tax: 90							
Tax	PE		30		0	30	30
Tax	HO		30		30	30	60
Exemption with claw-back, total tax: 60							
Tax	PE		30		0	30	30
Tax	HO		30		0	30	30
Credit, total tax: 60							
Tax	PE		30		0	30	30
Tax	HO		30		0	30	30
Example taken from: Lüdicke and others, (n 9), p. 378.							

Firstly, there will be a tax of 30 in the host state in year one and the loss of year two cannot be offset against the profit in year one due to the non-possibility of loss carry-back in the host State. Secondly, regardless of the applied method, there will be a tax of 30 in year one in the home State. Furthermore, CIN and CEN are of no relevance in this case, since the tax rates are the same in both countries.⁷¹

The difference in the application of the methods is revealed in year two. Under the credit method and the exemption with claw-back method, the PE loss is offset against the profits in the home State and no tax is therefore due in the home State. Hereby, the total tax in both countries is 60, which in an overall consideration can be seen as appropriate given the total income of 200. However, this is the case when only looking at year 1 and 2 and whether or not the offsetting of the PE loss has a permanent or only temporary effect will depend on the future PE results.⁷²

An issue arises when States use the simple exemption method in their DTC, while the PE loss of 100 is disregarded in the home State. In addition the HO profit of 100 triggers a tax of 30. Even if the company's total income in both years is 200, as in the other situations, the tax differs while in this case, the total amount of tax for the States are 90. This appears in situations where the home State applies a territorial system or where the home State applies the principle of worldwide income taxation but uses the simple exemption method in their DTC.⁷³

However, if the host State applied a carry-back system the tax of 30 may be recovered also when the exemption method was applied. In that case, the total tax would be 60 in both the methods, simple exemption and exemption with claw-back. Hence, where no carry-back system is at hand, it can be discussed whether it is in the responsibility of the home State to balance

⁷¹ Lüdicke and others, (n 9), p. 378.

⁷² Lüdicke and others, (n 9), p. 378.

⁷³ Lüdicke and others, (n 9), p. 378.

such legal inadequacy in the host State. In addition, imputation of ordinary losses is primarily a timing issue and thus, it can be argued that such losses shall be deductible in the home State and subject to a recapture rule.⁷⁴ A recapture rule permits the deduction of foreign losses at the HO level. However, as soon as the PE becomes profitable, the losses are recaptured. If there are no profits, there would be no recapture of the losses and the deduction of losses would persist in place.⁷⁵

2.2.5 The necessity of cross-border loss utilization

Although companies expect to earn income, losses may occur. Practically all tax systems within the EU treat profits and losses asymmetrically. The asymmetry occurs where profits are taxed in the year they are earned. However, the tax value of the losses is not refundable by the tax administration when the losses are incurred. Therefore, it is necessary to set off losses against another positive tax base within the company in order to avoid 'over taxation'. That will avoid cash-flow disadvantages, which will otherwise result from the time lag between taking the losses into account, e.g. by a loss carry-forward rule or a set off against future profits, in comparison with an immediate set off against another positive tax base.⁷⁶

In addition, the ECJ has already held that cash-flow disadvantages arising from situations where there is no immediate relief are enough to conflict with EU law.⁷⁷ Consequently, the ability for Member States to obtain cross-border loss utilization will thus prevent losses from becoming stranded in different entities. Furthermore, a company with a domestic PE will be treated as a company with a foreign PE, where they will be automatically taxed on the net result whereas both profits and losses will automatically and immediately be taken into account. Member States can uphold this only with a specific provision.⁷⁸

The Commission emphasizes a necessity for effective systems providing for cross-border utilization within the EU while it will remove major impediments and EU firms will be more competitive on the world market.⁷⁹ Yet, the EU's essential aim conflicts with Member States' need to maintain effective tax systems. The internal market aims to guarantee the exercise of the fundamental freedoms,⁸⁰ without hindrance, for both individuals and companies while there is a necessity to maintain Member States' fiscal sovereignty in order to prevent tax base erosion due to misuse or unintentional tax exemptions.⁸¹ Therefore, the ECJ needs to find a balance between those two interests by accepting that some restrictions implemented by the Member States are justified.

⁷⁴ Lüdicke and others, (n 9), p. 378.

⁷⁵ Lang, (n 21), p. 539.

⁷⁶ COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 2.

⁷⁷ Case C-397/98 *Metallgesellschaft* paras. 44 and 76.

⁷⁸ COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 2.

⁷⁹ COM (2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 10.

⁸⁰ TFEU, Articles 21, 34, 45, 56 and 63.

⁸¹ Hilling, Maria, *Justifications and Proportionality: An Analysis of the ECJ's Assessment of National Rules for the Prevention of Tax Avoidance*, INTERTAX, Volume 41, Issue 5, Kluwer Law International, 2013, p. 294.

2.3 Plurality of legal sources regarding allocation of taxing rights to PEs

In the treaties within the EU, the division of competences between EU and Member States are based on the principle of conferral.⁸² This principle implies that the EU is limited to intervene in areas for which a competence has been allocated to the Union by the treaties.⁸³ Additionally, Member States remain responsible for all the areas that have not been attributed to the Union,⁸⁴ which implies that Member States retain tax sovereignty apart from certain EU directives on the area of direct taxation.⁸⁵ Tax sovereignty refers to both a technical autonomy and an exclusive territorial application. The former means the ability to define all aspects within a domestic tax system e.g. tax base. The latter means the ability to determine the territorial application of the Member States' tax laws in accordance with the principles recognized by international tax law.⁸⁶ This implies that Member States can set up domestic rules or DTCs. Thus, Member States have the possibility to tax their residents on their worldwide income and are also free to exempt foreign income, which includes foreign losses. However, this applies only to the extent that Member States domestic law or DTCs do not conflict with EU law.⁸⁷ In other words, even if Member States remain competent to legislate freely in this area, the competence must nonetheless be exercised consistently with EU law.⁸⁸

Worldwide taxation establishes the risk of international juridical double taxation. Yet, the ECJ states that this does not constitute a restriction of the freedom of movement within the EU since it is the sequence of two Member States parallel exercise of fiscal sovereignty.⁸⁹ As stated before, since juridical double taxation is not contrary to EU law, Member States can freely unilaterally or by conventions set the criteria for allocating their taxing powers. Regarding conventions, the golden rule implies that States conventions are allowed to limit a State's right to tax; however, they cannot extend a State's right to tax a subject. Otherwise, the aim of limiting domestic taxing regimes would not be achieved.⁹⁰

Asymmetries will occur due to this system and that the EU does not have a requirement regarding consistency. However, some guidelines may be recognised. EU law takes precedence over both national and international law.⁹¹ Member States' tax rules are subordinated to EU law. Consequently,

⁸² TFEU, Articles 2-6.

⁸³ TFEU, Article 5.

⁸⁴ TFEU, Articles 4-5.

⁸⁵ TFEU, Article 4.

⁸⁶ Traversa, Edoardo and Pirlot, Alice, *Tax Sovereignty and Territoriality under Siege: How Far Should the EU Freedoms of Movement Impact on the Territorial Allocation of Taxing Powers between Member States?*, chapter 6, IBFD, November, 2014, p. 128. (Book: Principles of Law: Function, Status and Impact in EU Tax Law, editor Cécile Brokelind).

⁸⁷ Marres, (n 3), p. 114.

⁸⁸ For example, Case C-26/62 van Gend en Loos, p.12 (B –on the substance of the Case).

⁸⁹ Case C-513/04 *Kerckhaert-Morres*, paras. 20-22; Case C-128/08 *Damseaux*, paras. 27 and 35; C-67/08 *Margarete Block*, para. 31; Case C-96/08 *CIBA*, para. 28.

⁹⁰ Hilling, Maria, *Changes in the Application of Tax Treaties in Sweden*, INTERTAX, Volume 39, Issue 10, Kluwer Law International, 2011, p. 521.

⁹¹ Monsenego, Jérôme *Taxation of Foreign Business Income within the European Internal Market*, Intellecta Infolog, Göteborg, 2011, p. 306.

the ECJ respects Member States' fiscal sovereignty to the extent that they do not breach EU law.⁹² Even if EU law takes precedence over both national and international law, the ECJ tends to grant priority to Member States' domestic law and their DTCs by recognising Member States' restrictive measures to be justified.⁹³ The enforcement of the fundamental freedoms is crucial for the EU in order to achieve an internal market.⁹⁴ Problems arise since EU law, inter alia the fundamental freedoms, aims to remove the borders between Member States while the starting point of international tax law is the existence of these borders.⁹⁵

3. The territoriality principle

3.1 Introduction

Taxation principles have different status and meaning depending on if they are statutory or not and also in what legal framework they have their base. Principles can be either a descriptive term for a legal consequence or have a normative meaning. A descriptive term may not be used as a tool when interpreting, while principles having a normative meaning may be helpful when solving difficult cases or when interpretation issues arises.⁹⁶ In order for a principle to achieve a normative meaning and be able to serve as an interpretation tool, the courts should apply the principle normatively and convincing evidence should be at hand that the principle is a proper legal policy norm.⁹⁷

EU law consists of both written and unwritten law where the unwritten law fills the gaps not covered by written law. Some principles within the EU are written and stated in the treaty. However, the territoriality principle is unwritten law. The unwritten principles work as an interpretation tool of existing law and are a necessary tool in order for existing law to be settled in the fairest way.⁹⁸ Therefore, the territoriality principle reflects an elementary concept of law that has to be respected when assessing questions concerning taxation. Accordingly, an unwritten principle such as the territoriality principle is given its effect when the law is applied. Although the territoriality principle may be used as an interpretation tool, the ECJ has to ensure that the law is observed when interpreting and applying the Treaty. Generally, the principles are common to the legal orders of the Member States and the Member States may provide the EU with the background needed to solve a problem.⁹⁹ Accordingly, the meaning of unwritten principles depends to some extent on how the ECJ uses them.

⁹² C-26/62 *van Gend en Loos*, p. 12 (B-on the substance of the Case).

⁹³ For example; C-414/06 *Lidl Belgium* paras. 23, 37 and 53; C-157/07 *Krankenheim* paras. 39 and 43-45.

⁹⁴ TEU Article 3 (2) and (3).

⁹⁵ Panayi, H.J.I C., *Double taxation, tax treaties, treaty-shopping and the European Community*, Kluwer Law International, 2007, p. 143.

⁹⁶ Persson, Östman, Roger, *Kontinuitetsprincipen i den svenska inkomstbeskattningen*, Juristförlaget (Norstedts Juridik AB), upplaga 1:1, Stockholm, 1996, p. 55.

⁹⁷ Persson, Östman, (n 96), p. 56.

⁹⁸ Borchardt, Klaus-Dieter, *The ABC of European Union law*, Germany, Publications Office of the European Union, March 2010, p. 85-86.

⁹⁹ Borchardt, (n 98), p. 85-86.

3.2 Definition

A territorial tax system can be achieved, principally, in two different ways. On one hand, it can be achieved by a definition of the tax base for income tax purposes, i.e. by limiting the tax base to locally sourced income and capital. On the other hand, it can be achieved by exempting foreign-sourced income through unilateral, bilateral or multilateral conventions to prevent juridical double taxation.¹⁰⁰ This has its base in that the States' right to tax is generally based on a factor that has the power to determine connection of the income to a certain jurisdiction. Overall, tax systems are usually divided into either worldwide taxation systems or territorial taxation systems. The difference between the systems is the scope of the States' taxing powers. A worldwide taxation system taxes its residents on their worldwide income. Consequently, in a worldwide taxation system, income that is derived from sources both within and outside its territory is subject to taxation. In addition non-residents are taxed on the income derived from its territory. In contrast, a territorial system commonly taxes both residents and non-residents solely on the income derived from sources in the State's own territory.¹⁰¹ Having a worldwide taxation for residents implies an unlimited tax liability, while having a territorial taxation for non-resident implies limited tax liability.¹⁰²

The two systems can seem clear, though most of the States do not use one of the systems in pure form.¹⁰³ In addition, the territoriality principle has a different meaning whether it is international law or international tax law.

International law is the set of rules that is usually regarded and accepted as binding relations between states and between nations. These rules serve as a framework for international relations and are not only considering taxation issues, but instead States' obligations (if expressly consented to a particular course of conduct) and relations to other States. The course of conduct in terms of treaties generally delegate national jurisdiction to supranational tribunals.¹⁰⁴ There is no self-standing international tax law, while there is no international tax-code, tax-court and no binding international tax law provisions. However, for the author, international tax law is the determination of tax for a business subject to the tax laws of different countries or the international aspects of a State's tax laws. Consequently, international tax law consists of Member States domestic laws, EU law, DTCs and also other conventions drawn up by the Member States' regarding their taxing powers.

Since the territoriality principle has different meanings in international law and international tax law, it is of interest to examine the distinction to get an overall understanding before the author starts to assess whether the territoriality principle can be discerned from ECJ's case law. In addition, if the ECJ discerns a territoriality principle, to be able to discern what concept the ECJ adapts.

¹⁰⁰ Marres, (n 3), p. 114 and 119.

¹⁰¹ OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing, p. 33-34.

¹⁰² Lang, (n 50), ch. 1, p. 1.

¹⁰³ OECD (2013), *Addressing Base Erosion and Profit Shifting*, OECD Publishing, p. 33-34.

¹⁰⁴ Slomanson, R, William, *Fundamental Perspectives on International law*, 6th edition, Boston, USA, Wadsworth, 2011, p. 4-5.

3.2.1 Territoriality principle as used in international law

In international law Member States' sovereignty is recognised. This implies that Member States have a supreme authority over a territory, but also outside of their territory, over their citizens. In other words, the State has jurisdiction based on a territorial connection between the State in question and a legal subject or object. Furthermore, Member States sovereignty implies sovereignty over a jurisdiction, which includes fiscal jurisdiction. Thus, Member States are allowed to tax their citizens and also the income connected to their territory. Applying this approach a distinction can be made, on one hand personal bases of a jurisdiction and on the other hand territorial bases of a jurisdiction. Regarding personal bases, nationality is most commonly used. However, domicile can also be used. In the context of international law, it is important to consider that taxation of residence is regarded as a manifestation of territoriality where a resident is taxed on the basis of a stable link with the territory of that State. However, this is in fact a worldwide taxation, which is usually the opposite of territorial taxation.¹⁰⁵ Thus, in international law the principle means taxing its residents on a worldwide basis and non-residents on a territorial basis.

3.2.2 Territoriality principle as used international tax law

In international tax law the territorial basis is of greater importance than the personal basis. The territorial base is built upon taxation on basis of residence and source. In addition, international tax law usually makes a distinction between subjective and objective criteria when allocating tax between different jurisdictions. The subjective criteria contain both nationality and residence while the objective criteria contains taxation of income that has a direct link to a State's territory. This implies that when a tax liability is based on a subjective criterion, the taxpayer is usually, but not always, taxed on their worldwide income. If the tax liability, on the other hand, is based in an objective criterion, e.g. source taxation, the taxation is limited to the income sources within the State's territory. The principle as stated in international tax law is based on the objective criterion, where non-residents or both residents and non-residents tax liability is limited to the income sourced in a State's territory. Therefore, residents are not normally taxed on any foreign-sourced income. This means that territoriality is used as an opposition to worldwide taxation,¹⁰⁶ where the underlying theory is that no taxes can be levied outside the State's area without violating the sovereign tax authority of another state.¹⁰⁷

As mentioned, the meaning of the territoriality principle in international tax law is different from its meaning in international law. While international law recognises worldwide taxation of its residents as a manifestation of territoriality, international tax law recognises territoriality as a tax jurisdiction solely on domestic income for both residents and non-residents. Thus, the different concepts have the same approach for non-residents; the distinction exists in the different treatment of Member States' residents.

¹⁰⁵ Monsenego, (n 91), p. 59-60.

¹⁰⁶ Monsenego, (n 91), p. 31-33; Marres, (n 3), p. 113.

¹⁰⁷ Definition of the *Territoriality principle*, IBFD International Tax Glossary, 2015.

4. ECJ's case law on cross-border loss utilization attributable to PEs and subsidiaries: in relation to the territoriality principle

4.1 Introduction

While the ECJ to a certain extent seems to offer Member States the possibility to apply a territorial approach, it is of interest to review ECJ's case law in order to examine to what extent the territorial approach is accepted and if some guidelines can be discerned.

4.2 Futura

4.2.1 Facts of the case

Futura,¹⁰⁸ involved a French company that had a PE in Luxemburg. The DTC between the two States provided that where an undertaking has a PE in both contracting States, each State may tax only the income arising from the activity of the PE located on its territory.¹⁰⁹

The total profits of Futura were determined based on accounts kept in France in line with French generally accepted accounting principles (GAAPs). Furthermore, the PE's income was computed according to an apportionment of the total profits of the HO. That method was allowed under article 7(4) of the OECD Model Convention until it was deleted in the 2010 version of the Model.¹¹⁰

Global losses were incurred during numerous years and the PE paid no taxes in Luxemburg. When profits were incurred, the company tried to carry previous years losses forward in Luxemburg. However, Luxemburg law demanded that certain conditions were fulfilled in order to be able to carry forward losses. The right to carry forward losses for non-residents applied if the losses were economically related to the income received in Luxemburg and if accounting was kept in Luxemburg according to local GAAPs.¹¹¹ The economic link condition required that the losses of non-residents had to be economically related to income received locally in order for the losses to be carried forward in Luxemburg.¹¹²

Since the losses attributed to the PE through an apportionment may have been incurred outside Luxemburg and that no proper accounts were kept within Luxemburg, the right to carry forward losses was denied.¹¹³ The issue considered by the Luxemburg tax authorities was that the apportionment did not establish a clear link with the domestic income. Futura and the PE claimed that such a refusal impaired the freedom of establishment guaranteed by the treaty since residents in Luxemburg were able to deduct foreign losses.¹¹⁴ The question whether this was in breach of

¹⁰⁸ C-250/95 *Futura Participations SA*.

¹⁰⁹ C-250/95 *Futura Participations SA*, para. 3.

¹¹⁰ C-250/95 *Futura Participations SA*, paras. 8-10.

¹¹¹ C-250/95 *Futura Participations SA*, para. 6.

¹¹² C-250/95 *Futura Participations SA*, paras. 7 and 9.

¹¹³ C-250/95 *Futura Participations SA*, paras. 10-11.

¹¹⁴ C-250/95 *Futura Participations SA*, para. 12.

the freedom of establishment was referred to the ECJ for a preliminary ruling.

4.2.2 The reasoning of the ECJ and the AG Opinion

Advocate General (AG) Lenz stated that the Luxembourg law requirement regarding an economic link was not an issue since it was compatible with EU law and also, it complied with the DTC between the countries concerned.¹¹⁵ The ECJ meant that ‘such a system, which is in conformity with the fiscal principle of territoriality, cannot be regarded as entailing any discrimination, overt to covert, prohibited by the treaty’¹¹⁶. This was based on that residents were taxed on their worldwide income while non-residents were taxed only on its income with source in Luxembourg.¹¹⁷ The ECJ admits the territoriality principle as stated in international law. The rules were not incompatible with the freedom of establishment and this case states that the ECJ admits that the Member State of establishment taxes a PE solely on income sourced within its territory.¹¹⁸ Consequently, the Member State of establishment must not take into account losses incurred by a PE of a non-resident company outside the territory of the Member State of establishment unless there is an economic link with the income earned in the State of establishment.

4.2.3 Comments on the case

The qualification stated by ECJ that the host State can ignore foreign losses provided that its resident taxpayers do not receive favourable treatment, i.e. where Luxemburg companies being able to use foreign branch losses, implies that the territoriality justification is not absolute.¹¹⁹ Even if the ECJ considers that territoriality prevents a measure from being restrictive, meaning not entailing discrimination, there are no direct tax cases in which the ECJ has expressly referred to the territoriality principle as a decisive factor that may justify a restrictive tax measure. On this basis, the territoriality cannot be said to serve as a justification ground, at least, not alone.¹²⁰

It is clear from subsequent case law that a system, such as in this case, may at least for residents be seen as a discrimination and prohibited by the ECJ. Still, this depends on the consequences of such a system. The case is from the perspective of the host State, and the ECJ found that the limitation of the amount of loss carry-forward available in the State to the losses that had an economic link with the income earned there does not entail discrimination due to that it is a manifestation of the territoriality principle as stated in

¹¹⁵ Opinion of AG Lenz in C-250/95 *Futura Participations SA*, para. 27.

¹¹⁶ C-250/95 *Futura Participations SA*, para. 22.

¹¹⁷ C-250/95 *Futura Participations SA*, paras. 20-21.

¹¹⁸ C-250/95 *Futura Participations SA*, para. 43.

¹¹⁹ Panayi, HJI, C., *The taxation of Permanent Establishments: Selected Issues*, Bulletin for International Taxation, April/May 2013, IBFD, p. 232.

¹²⁰ Lang, Michael, *The Marks & Spencer Case –Open Issues Following the ECJ’s Final Word*, European Taxation, February, 2006, IBFD, p. 59; Helminen, Marjaana, *Must the Losses of a Merging Company be Deductible in the State of Residence of the Receiving Company in EU?*, EC Tax Review 2011/4, p. 176.

international law.¹²¹ However, it has to be further examined how the ECJ discerns the territoriality principle in a home State perspective.

4.3 *Deutsche Shell*

4.3.1 Facts of the case

The case concerned a German resident company, Deutsche Shell, which established a PE in Italy where it inserted a start-up capital. The depreciation in value of the start-up capital was not taken into account in Italy since the basis for assessment for the taxation of its profits was in Italian currency. In later years, Deutsche Shell terminated the PE and transferred all its assets to an Italian subsidiary.¹²²

The amount received from those transactions was paid to Deutsche Shell and converted into German currency at the exchange rate applicable on the date of receipt. The receiving amount was less than the start-up capital inserted in the PE. Deutsche Shell regarded the difference as a currency loss. However, the German tax authorities refused to accept the currency loss as a real financial loss.¹²³ Thus, the loss was not deductible anywhere; it could not be deducted in Italy since the currency loss did not arise there and the German tax authorities refused to accept the deduction of the currency loss due to the DTC between Germany and Italy, which provided for the exemption method.

The question concerned whether it was contrary to the freedom of establishment for Germany to exclude foreign losses, which were incurred in a PE in Italy from the corporate tax base. More specific, a currency loss suffered upon repatriation of start-up capital granted to its PE in Italy.

Deutsche Shell argued that the denial of the deduction for currency loss was incompatible with the freedom of establishment since the company was placed in a less favourable situation than if they had invested the start-up capital in company established in Germany.¹²⁴ Germany, on the other hand argued that the system was coherent, while neither currency losses nor gains were considered and also, that the allocation of the taxing right through the DTC excludes deduction of such losses in the present case.¹²⁵

4.3.2 The reasoning of the ECJ

The ECJ held that the tax system at issue increases the economic risks incurred by a company established in a Member State wishing to set up a PE in another Member State where the currency used is different from that of the state of origin.¹²⁶

The arguments raised by Germany were dismissed by the ECJ,¹²⁷ stating that the coherence argument was irrelevant since there is no direct relationship between the currency losses and currency gains. By that, the

¹²¹ COM(2006) 824 final, *Tax Treatment of Losses in Cross-Border Situations*, p. 4.

¹²² C-293/06 *Deutsche Shell*, paras. 9-11 and 13.

¹²³ C-293/06 *Deutsche Shell*, paras. 14-17.

¹²⁴ C-293/06 *Deutsche Shell*, para. 21.

¹²⁵ C-293/06 *Deutsche Shell*, para. 33.

¹²⁶ C-293/06 *Deutsche Shell*, para. 30.

¹²⁷ C-293/06 *Deutsche Shell*, para. 36.

failure to take into account a currency loss in order to calculate Deutsche Shell's basis of assessment is not offset by any tax advantage in neither the State where it has its HO nor in the State where the PE is situated.¹²⁸ Further, Member States competence to decide the direct taxation criteria through tax treaties also implies that Member States do not have to deduct negative foreign income from a PE solely because they cannot be deducted in the State of establishment.

Consequently, freedom of establishment cannot be understood as meaning that Member States are required to draw up tax rules in the basis of another Member State in order to ensure that all disparities are removed.¹²⁹ This reasoning by the ECJ is in line with the territoriality principle. However, in this case, the tax advantage which relates to a loss, can only be deducted in Germany, therefore, it is undesirable to exclude losses from the HO's tax base that never, by nature, can be suffered by the PE.¹³⁰

The ECJ stated that the German rules concerning the denial of deduction of depreciation in the value of start-up capital were incompatible with EU law since the currency loss could not be deducted in either the State of residence, Germany, nor in the State of establishment, Italy. Accordingly, Germany was required to grant deduction for the foreign exchange loss only in so far as its PE does not make any tax-free profits.¹³¹

4.3.3 Comments on the case

Deutsche Shell did not concern a foreign loss incurred by the PE itself, the loss was rather incurred by the HO on the capital inserted in the PE. Similarities can be drawn with the concept relating to final losses, namely the idea that the losses needs to be taken into account somewhere. Since the PE could not suffer the losses in this case, and the losses were not to be taken into account at all, the ECJ stated that it was a restriction, which could not be justified. Thus, the ECJ maintained an internal market by requiring the home State to take the losses into consideration. Yet, Member States' sovereignty, and thereby the underlying territoriality concept, is overlooked and disregarded.

4.4 Lidl Belgium

4.4.1 Facts of the case

The case concerned a German company, Lidl Belgium, having a PE located in Luxembourg. The HO in Germany was profit making while the PE made a loss during the same year. The HO tried to offset the foreign losses in the PE against German profits in their income tax return. However, as income from the PE in Luxembourg was exempted under the DTC between the States, the German authorities argued that losses could not be offset against domestic profits. Thus, the German authorities rejected the offset. The referred question was whether the non-recognition of the losses in Germany, which arose in Luxembourg, was compatible with EU law principles.¹³²

¹²⁸ C-293/06 *Deutsche Shell*, para. 40.

¹²⁹ C-293/06 *Deutsche Shell*, paras. 41-43.

¹³⁰ C-293/06 *Deutsche Shell*, para. 44.

¹³¹ C-293/06 *Deutsche Shell*, paras. 45 and 53.

¹³² C-414/06 *Lidl Belgium*, paras. 8-11 and 13.

Consequently, whether the freedom of establishment precludes a national tax regime that does not allow a resident company to deduct losses incurred in a PE in another Member State, when the national tax regime does allow losses incurred by a resident PE to deduct such losses.

4.4.1 The reasoning of the ECJ and the AG Opinion

The possibility for the German company to offset losses in a domestic PE constitutes a tax advantage while such an offset is not available when the PE is located in another Member State. Hence, the ECJ considered it a restriction of the freedom of establishment.¹³³

The ECJ did not follow AG Sharpston's reasoning. AG Sharpston found that Lidl Belgium had suffered discrimination that was seen as justified but not proportionate. The underlying reason for AG Sharpston's reasoning was that Germany had a recapture mechanism. The recapture mechanism permitted the deduction of foreign losses at the HO level to be recaptured when the PE became profitable. As the recapture mechanism was more advantageous than a rejection of deduction of foreign losses, the exemption method was going beyond what was necessary in order to attain the objectives pursued.¹³⁴

The ECJ, however, did not seem to agree that Member States must apply a recapture rule. The ECJ considered the restriction to be justified and proportionate. It was seen as justified due to the need to preserve a balanced allocation of the right to impose taxes and also, the need to prevent the risk that losses are used twice. Thus, the ECJ stated that it is not contrary to EU law that a Member State prohibits the offsetting of losses of a PE situated in another Member State, if the DTC allocates the right of taxation of the PE's income to the other Member State and the PE's losses may be offset in a later accounting period, in that Member State.¹³⁵

4.4.2 Comments on the case

The ECJ does hereby allow a territorial approach and Germany has a possibility to preserve its tax base, due to the consequences and circumstances following the legislation in the Member State where the PE was located. It could be of interest how the ECJ would have decided if Luxembourg did not provide for carry forward of tax losses. If Luxembourg did not provide for such a possibility, Germany might have been forced to allow deduction of losses. That argument is in line with the arguments raised in *Deutsche Shell*. Through this reasoning, it is clear that the circumstances in each case regarding home State perspective affect the ECJ's judgment. In home State cases, the ECJ seems to accept restrictions and thereby a territorial approach where the losses can be taken into account somewhere else, i.e. in the State of establishment. Nevertheless, if that is not the case, the territorial approach is not justified and has to be considered by the State of residence as a "last resort choice". Consequently, the

¹³³ C-414/06 *Lidl Belgium*, paras. 23-26.

¹³⁴ Opinion of AG Sharpston in case C-414/06 *Lidl Belgium*, paras. 22-25.

¹³⁵ C-414/06 *Lidl Belgium*, para. 54.

requirement for the home State to deduct foreign losses tends to arise when the losses are final or definite.¹³⁶

4.5 *Krankenheim*

4.5.1 Facts of the case

Krankenheim concerned a company situated in Germany, having a PE located in Austria. According to the applicable DTC, the PE's income was only subject to tax in Austria and tax exempt in Germany.¹³⁷ Nevertheless, Germany did not tax on a strict domestic basis since it allowed deduction of foreign PE losses and applied a recapture mechanism to the extent that the PE generated profits in the future.¹³⁸ Stated in other words, the German legislation provided for a deduction of foreign losses incurred by a PE, and moreover, a taxation of the PE once it became profitable. Thus, Germany applied CEN for a loss-making PE during the time the PE was loss making. Germany treated domestic and foreign establishments in the same way. After the losses of the PE had been completely recaptured, Germany replaced CEN with CIN in order for the exemption method to generate its full effects. In other words, German rules first allowed deductions of foreign losses and later demanded to tax the PE up to the amount of losses previously deducted. However, this recapture was not applicable if the PE's losses not generally could be deducted in the source State, namely Austria.

Further, Austria provided for a loss carry forward, but only to the extent that the PE losses in Austria exceeded the positive worldwide income of the foreign HO in Germany. This applied irrespective of whether the losses were finally deducted in the home State.¹³⁹ The worldwide taxation of the HO exceeded the losses of the Austrian PE, therefore, Austria denied a loss carry forward and a loss deduction.¹⁴⁰

4.5.2 The reasoning of the ECJ

The ECJ stated that the deduction of losses in Germany constituted a tax advantage, whereas the following recaptures undid the advantage. Thus, the provision provided for an unfavourable treatment of a foreign PE compared to a domestic PE.¹⁴¹

Furthermore, the ECJ was of the opinion that this constituted a restriction of the freedom of establishment.¹⁴² Hence, it was seen as justified by the need to guarantee the coherence of the German tax system and the allocation of taxing rights due to the States' DTC. ECJ found that the recapture was applied in a perfectly symmetrical manner and that Germany could not be required to take into account the possible negative results arising from the allocation of taxing rights to Austria.¹⁴³

¹³⁶ Lüdicke and others, (n 9), p. 378.

¹³⁷ C-157/07 *Krankenheim*, paras. 7-8.

¹³⁸ C-157/07 *Krankenheim*, para. 9.

¹³⁹ C-157/07 *Krankenheim*, paras. 11-12.

¹⁴⁰ C-157/07 *Krankenheim*, para. 17.

¹⁴¹ C-157/07 *Krankenheim*, paras. 35-37.

¹⁴² C-157/07 *Krankenheim*, paras. 38-39.

¹⁴³ C-157/07 *Krankenheim*, paras. 42-45 and 55.

4.5.3 Comments on the case

While the recapture rule applied in a perfectly symmetrical manner, it could not constitute a disadvantage but instead, an equal treatment in comparison to a domestic PE and thereby did comply with EU law. However, the denial of loss carry forward in Austria constituted a disadvantage and did not comply with EU law. If it can be assumed that Krankenhaus did choose the wrong state to claim the rights guaranteed by the fundamental freedoms. It can be argued that this case regarding the non-deductibility of remaining losses in Austria reconciles with the findings in *Lidl Belgium*. As recognised before, Germany cannot be required to draw tax rules on the basis of Austria in order to ensure taxation removing disparities arising from national tax rules. Hereby, the ECJ acknowledges Member States' sovereignty.

4.6 *X AB v Skatteverket*

4.6.1 Facts of the case

The ECJ recently ruled on another case regarding currency losses,¹⁴⁴ and it can be discussed whether this judgment overrules the judgment in *Deutsche Shell*.

The Swedish company X AB established a subsidiary in the United Kingdom in 2003. X AB owned 45 per cent of the shares in the subsidiary. The shares were issued in USD and were owned by 'holdings for business purposes' within the meaning of the Swedish law. In the years between 2003 and 2009, X AB made capital contributions in cash to its subsidiary. After this, X AB wished to end the subsidiary's activities, however, X AB was then faced by a risk of currency loss due to the capital contributions made to its subsidiary. Consequently, the capital contributions were made at an exchange rate more favourable than at the existing time of the transfers. The Swedish tax authorities denied X AB the possibility to deduct a currency loss resulting from their disposal of 'holdings for business purposes' in its subsidiary.¹⁴⁵

The Swedish law did not apply different treatment from investments in domestic or foreign subsidiaries with respect to capital losses on holdings from business purposes. Sweden exempted all profits and all losses for both domestic and foreign shareholders. Hence, this is the key difference to *Deutsche Shell*, where it was a difference in treatment between a foreign PE compared to a domestic PE.¹⁴⁶

The issue was whether the Swedish legislation denying deductibility of a foreign currency loss was compatible with the freedom of establishment whereas X AB's holding represented a definite influence over its subsidiaries decisions.¹⁴⁷

¹⁴⁴ C-686/13 *X AB v Skatteverket*.

¹⁴⁵ C-686/13 *X AB v Skatteverket* paras. 7-8 and 10-12.

¹⁴⁶ C-686/13 *X AB v Skatteverket* para. 30.

¹⁴⁷ C-686/13 *X AB v Skatteverket* para. 15.

4.6.2 The reasoning of the ECJ and the AG Opinion

It was held by the ECJ that it did not constitute a restriction due to the fact that the legislation applied irrespective of whether the shares were held in a company established in another Member State or in Sweden.¹⁴⁸

The ECJ's decision was in line with AG Kokott's opinion. AG Kokott concluded that Member States were not required by EU law to provide for a deductibility of currency losses, which occurs in connection with shares held in a foreign company.¹⁴⁹ This means that a Member State of origin does not have to adapt its tax system so as to take account of possible exchange risks faced by companies since the existence within the EU of diverse currencies have no fixed exchange rates. Thus, the Member State of origin must not create tax systems dependant on the different tax systems of other States.¹⁵⁰

4.6.3 Comments on the case –overruling *Deutsche Shell*

It can be argued that the outcome in *X AB v Skatteverket* can be seen to overrule the ECJ's decision in *Deutsche Shell*. Stating that, if the decision in *Deutsche Shell* would be based on the decision in *X AB v Skatteverket*, it would not constitute a restriction and even if it would, it would be justified by the need to preserve coherence in the tax system. However, the ECJ and AG Kokott states that the cases imply different legal contexts arising from the application of the Member States' domestic laws and thereby, also from a coherence perspective.¹⁵¹ In other words, in *X AB v Skatteverket* the freedom of establishment does not require a Member State to asymmetrically exercise taxation powers as to permit a deduction of losses, whereas if the same operations would give a positive result, it would not be taxed.¹⁵² Nevertheless, such symmetry was not at hand in the *Deutsche Shell*,¹⁵³ where denial of deduction constituted a restriction of the freedom of establishment due to the different treatment of domestic and foreign PEs and required Germany to grant a deduction for the foreign exchange loss.¹⁵⁴

4.7 Final remarks from the case law examination

Due to Member States' competence and fiscal sovereignty, the EU is as fragmented as the many Member States there is and it has to respect each and every one of them. This appears to result in a disadvantage regarding cross-border loss utilization, while it is, in principle, not possible when the States applies a DTC using the exemption method.

It is not of relevance how Member States achieve a territorial system when assessing whether the territorial system is a restriction and whether it could be justified. Regarding the question if a restriction may be justified, the ECJ has held that, in absence of a DTC, the Member State in which the HO of the company is located, to which the PE belongs to, would have the right to

¹⁴⁸ C-686/13 *X AB v Skatteverket* paras. 32 and 41.

¹⁴⁹ C-686/13 *X AB v Skatteverket* para. 41.

¹⁵⁰ C-686/13 *X AB v Skatteverket* para. 34.

¹⁵¹ C-686/13 *X AB v Skatteverket* paras. 38-39; Opinion of AG Kokott in case C-686/13 paras. 50-51.

¹⁵² C-686/13 *X AB v Skatteverket* para. 40.

¹⁵³ C-686/13 *X AB v Skatteverket* para. 38.

¹⁵⁴ C-293/06 *Deutsche Shell*, paras. 45 and 53.

tax the profits generated by such an entity. Thus, the objective of preserving the allocation of taxing powers between two Member States, which is disclosed in the provisions of the convention, is capable of justifying a tax regime where it safeguards symmetry between the right to tax profits and the right to deduct losses.¹⁵⁵

Consequently, the ECJ has come to the conclusion that the freedom of establishment does not preclude a situation in which a company is established in a Member State and cannot deduct from its tax base losses that relate to a PE in another Member State. However, this applies only to the extent, by virtue of a DTC, that the profits arising from the PE are not taken into account. In other words, if a State does not have the right to tax a PE's profits, the State would not be obliged to take a PE's losses into consideration.¹⁵⁶ This argument is closely linked with the appearance of the symmetry argument regarding for example the link between profits and losses or tax burden and tax advantage, which has been evaluated by the ECJ in its case law.¹⁵⁷ Furthermore, Member States may therefore, tax the worldwide income of its residents and allow deductions of foreign losses, or to tax only the income sourced in the same Member State as a territorial approach and not allow deductions of foreign losses, which are commonly used for non-residents.¹⁵⁸

The ECJ's acceptance regarding disadvantage resulting from no cross-border loss utilization applies solely to a certain extent. The ECJ still makes reservations and holds it possible to interfere in cases where the disadvantage would be disproportional. That the ECJ keeps some doors open seems necessary, there should always be a 'last resort choice' for situations where the consequences appear to be disproportionate. It is not possible for the ECJ to set out all these exceptions now, and by that, state all situations where it is accepted to refuse cross-border loss utilization. Those guidelines will have to be drawn up with time, even if it brings uncertainty to the taxpayers. Yet, some final remarks regarding the ECJ's case law shall be settled.

After an analysis of the ECJ case law, a relationship between Member States' sovereignty and the territoriality principle can be acknowledged. Mostly considering that the latter is an expression of the geographical limits concerning taxing rights derived by the former.¹⁵⁹ In line with this acknowledgement, the territoriality principle can be highlighted in the shadows of Member States' tax sovereignty. However, even if there are facts pointing in that direction, stating that the territoriality principle can be discerned within EU law, the author is uncertain. This is due to the fact that the principle as such is generally overlooked by the Member States' tax sovereignty as the overall term and also, since it is closely linked with other principles within EU, e.g. the principle of symmetry, which seems to be of

¹⁵⁵ C-414/06 *Lidl Belgium*, para. 33.

¹⁵⁶ C-414/06 *Lidl Belgium*, para. 54.

¹⁵⁷ Garcia Prats, F, Alfredo, *Revisiting "Schumacker": Source, Residence and Citizenship in the ECJ Case Law on Direct Taxation*, Springer-Verlag, Berlin Heidelberg 2013, p. 27-31.

¹⁵⁸ Marres, (n 3), p. 112.

¹⁵⁹ Traversa and Pirlot, (n 86), p. 139.

greater importance in ECJ's assessments. Hence, it is difficult to give a straight answer and to establish whether the ECJ's case law actually expresses a territoriality principle or whether it is an expression for an underlying desire for symmetry. However, the author is of the opinion that it may not be necessary for the ECJ to prefer one principle rather than another. The ECJ has to consider several principles due to different factual circumstances in each case; thus, it is an expected consequence that the outcomes are different.

4.8 The differentiation between losses

In *Lidl Belgium* and *Krankenheim*, the ECJ states that when a resident with a foreign PE has incurred losses, which cannot be offset against taxable income in the State of establishment, the losses can be off set in the State of residence. However this applies only in cases where the losses are to be considered final based on the factual circumstances.¹⁶⁰

The fact that the ECJ's statement concerning the territoriality principle differs if it is a final loss leads to uncertainty. It could be argued whether the ECJ overstretches its judicial power where it forces Member States, in case of final losses, to take them into consideration. It is for the ECJ to keep a balance between the internal market and Member States' fiscal sovereignty. Member States cannot predict the situations where a territorial approach is justified, as it depends on the different circumstances in each case. Yet, certain guidelines may clarify some parts of uncertainty.

Final losses seems to be at hand when there is no further possibilities for a loss to be deducted e.g. when the PE is transformed into a corporate entity, the PE is transferred to a third party or the PE is shut down definitively. When a loss is considered final, a denial of deductibility by the State of residence violates the freedom of establishment. Although, it must be remembered that this exemption is not allowed in all cases where losses become non-usable. It must also be kept in mind that the general principle where the exemption method is applicable to the PE due to a DTC is that income and losses derived from the PE can only be taken into account where the PE is located and thus, under that State's tax law. This implies that, the losses would not be seen as final within the meaning of the courts statement if a PE cannot take the losses into consideration due to a limitation of loss carry forwards according to the tax law of that State. Consequently, such losses cannot be deducted from the State of residence tax base.¹⁶¹ Furthermore, it can by this be affirmed that the 'always-somewhere approach', meaning that final losses shall be deductible somewhere, is applicable also for PEs.¹⁶²

5. Territoriality within EU –concluding remarks

5.1 Territoriality according to ECJ

The distinction between ECJ's understanding and the understanding in international tax law is apparent. Exempting residents' foreign-sourced

¹⁶⁰ C-414/06 *Lidl Belgium*; C-157/07 *Krankenheim*.

¹⁶¹ Bundesfinanzhof (BFH) Docket No. I R 107/09 and Docket No. I R 100/09.

¹⁶² Ben J M Terra and Peter J Wattel, *European tax law*, 6th edition, Kluwer, 2012, p. 899.

income would be regarded as a manifestation of territoriality under international tax law while that is, as earlier stated, not the ECJ's understanding.¹⁶³ The principle as it stands in international law is the main jurisdiction principle since States have a fundamental right to independently rule on their internal standpoint concerning subjects and objects connection to their territory. ECJ seems to refer to the principle as is done in international law, stating that a State has a right to tax all persons, property or activity within its borders. Although, in the context of direct taxation within the EU; it should be noted that the precise meaning of the territoriality principle is still evolving.¹⁶⁴

The ECJ rules that States exempting residents' foreign-sourced income shall not to be regarded as a manifestation of territoriality.¹⁶⁵ For example, in *Rewe Zentralfinanz*, concerning the German legislation, which restricted a German resident company to deduct its losses in respect of write-downs to the book value of its shareholdings in foreign subsidiaries. The ECJ held that the legislation at issue could not be considered as an implementation of territoriality principle by meaning that the purpose of the principle is to establish the need to take into account the limits of a Member State's power to tax. This assessment had its basis in that it would not result in a competing tax jurisdiction becoming involved, while it concerned solely German-resident companies being subject to unlimited tax in Germany.¹⁶⁶

According to the ECJ, the territoriality principle's purpose is to establish the necessity to take into account the limits on Member States' taxing powers.¹⁶⁷ Thus, the principle implies that non-residents' income, which is not sourced in the State in question, does not need to be taken into account.¹⁶⁸ This applies even if the worldwide profit was lower.¹⁶⁹ The ECJ's interpretation of the territoriality principle implies different treatment for residents and non-residents. This difference in treatment may, however, be justified while residents and non-residents are not in the same position while a Member State usually only has the right to levy tax on non-resident to the extent that they earn income in that State.¹⁷⁰ Consequently, in relation to direct taxes, residents and non-residents are as a rule not comparable.¹⁷¹

A territorial system as understood by the ECJ, resulting in the impossibility of cross-border loss utilization is accepted regarding corporate non-residents. Yet, a territorial system based on international tax law, which makes it impossible for both residents and non-residents to deduct foreign losses is not in conformity with EU law since the disallowance for a resident may be seen as a restriction of the free movement, especially the freedom of

¹⁶³ Marres, (n 3), p. 114.

¹⁶⁴ Definition of the *Territoriality principle*, IBFD International Tax Glossary, 2015.

¹⁶⁵ Opinion of AG Ruiz-Jarabo Colomer in Case C-440/08 *Gielen*, para 58; Case C-470/04 *N*, para. 46.

¹⁶⁶ Case C-347/04 *Rewe Zentralfinanz* para. 69.

¹⁶⁷ Marres, (n 3), p. 123.

¹⁶⁸ Chiara Bardini, *The Ability to Pay in the European Market: An Impossible Sudoku for the ECJ*, INTERTAX 38, no. 1, 2010, p. 20.

¹⁶⁹ Case C-250/95 *Futura Participations SA*, para. 22.

¹⁷⁰ Marres (n 3), p. 123.

¹⁷¹ Case C-279/93, *Schumacker*, para. 31.

establishment.¹⁷² An example is where losses incurred by a domestic PE are taken into account in calculating the profits and taxable income of the HO, while such tax advantage is not granted to a foreign PE. It is a restriction due to the discouragement on carrying on its business through a PE located in another State.¹⁷³ In fact, that restriction cannot be justified due to the territoriality principle while EU applies another concept of territoriality, whether it could be justified on other grounds will not be discussed further.

5.2 Comparable situations

The EU shapes its tax policy by the fundamental freedoms guaranteed in the TFEU,¹⁷⁴ and the ECJ interprets these fundamental freedoms. Hence, the ECJ judgments are an important factor for the Member States to consider when designing their loss utilization regimes. Consequently, the Member States need to consider if their regime results in a prohibited unequal treatment, which is considered a restriction on the fundamental freedoms.¹⁷⁵ It has to be a discrimination of the fundamental freedoms in order for the ECJ to be able to state that it is a restriction which is not justified, and thereby, requires the Member State to take the loss into consideration. The following definition of discrimination has been adopted by the ECJ and is used when examining comparable situations:

*“Discrimination occurs when equals are treated differently or when unequals are treated the same without such treatment having an objective justification”.*¹⁷⁶

However, the restrictions may be justified under certain circumstances. Nevertheless, according to the foregoing, it can be stated that the ECJ’s case law on freedom of establishment only provides for a minimum standard regarding cross-border loss utilization.¹⁷⁷ If the measure is justified and proportionate to the attainment of its objective the Member State does not need to utilize the foreign losses,¹⁷⁸ otherwise, the Member State can be required to utilize the losses.¹⁷⁹ However, that applies only if the restrictive measure depends on that Member State’s law. Therefore, the Member State is not required to utilize losses if the restriction depends on disparities from other domestic laws.¹⁸⁰

¹⁷² Marres (n 3), p. 124.

¹⁷³ C-414/06 *Lidl Belgium* paras. 23-26.

¹⁷⁴ TFEU, Articles 21, 34, 45, 56 and 63.

¹⁷⁵ Lüdicke and others, (n 9), p. 377.

¹⁷⁶ Caamaño Anido, Calderón Carrero, *Accounting, the permanent establishment and EC law: Futura Participations case*, EC Tax Review 1999/1, p. 26.

¹⁷⁷ Lüdicke and others, (n 9), p. 377.

¹⁷⁸ C-250/95 *Futura Participations SA*, para. 43; C-414/06 *Lidl Belgium*, para. 54; C-157/07 *Krankenheim*, paras. 42-45 and 55.

¹⁷⁹ C-293/06 *Deutsche Shell*, paras 45 and 53.

¹⁸⁰ C-686/13 *X AB v Skatteverket* para. 34; C-293/06 *Deutsche Shell*, paras. 41-43.

5.3 Justification grounds closely linked to territoriality

Since direct taxation falls within the competences of each Member State, Member States shall be granted appropriate remedies to uphold their tax jurisdictions. Therefore the ECJ has accepted certain possibilities in order for Member States restrictive measures to be justified.¹⁸¹ There are several similarities between the justification ground of maintaining a balanced allocation of taxing rights and other justifications grounds. It can, for example, be overlapped by the territoriality principle since it concerns a State's right to tax income from activities in that State.¹⁸² In order to get an understanding for their systematic structure and the links between the balanced allocation of taxing rights and the territoriality principle, it will be further examined.

5.3.1 The territoriality principle as a justification ground

It can be questioned whether the territoriality principle has been accepted by the ECJ as a justification ground. However, the territoriality principle may affect the issue whether a Member State's measure constitutes as a restriction or not. The ECJ does not recognise a restrictive measure in cases where a Member State only taxes income of a non-resident with a sufficient connection to that Member State's territory.¹⁸³ In addition, where a State allows deduction only in relation to costs that have a purpose of acquiring or maintaining income within the State in question.¹⁸⁴

However, in reality, this argument is closely linked with the coherence of a Member States' tax system and also the balanced allocation of taxing rights. In the author's opinion, these two are superior concepts to the territoriality principle, since territoriality only has been discussed as a supplement to these concepts. Therefore, the principle of territoriality has, in principle, only been accepted as a part of the justification when the tax system of the Member State in question was based on a coherent application of the territoriality principle. This implies situations where the taxpayer is subject to tax only in relation to domestic-sourced income in the Member State in question. For example, in *Futura*, where the court concluded that a system for taxation of non-resident PE's income in which only income and expenses related to the PE does not constitute a restrictive tax measure.¹⁸⁵ The concept on coherence goes further while it is built on the assumption that there is a connection between the benefit arising from a national provision and the offsetting of that advantage by a certain tax levy.¹⁸⁶ The ECJ recognises the concept of coherence, as a direct link that creates symmetry in the Member States' systems of taxation that otherwise would have been limited to their territorial limitation of taxing rights. The link is

¹⁸¹ Martin, Poulsen, *Freedom of Establishment and the Balanced Allocation of Tax Jurisdiction*, INTERTAX, Volume 40, Issue 3, Kluwer Law International, 2012, p. 200.

¹⁸² Hilling, (n 80), p. 299.

¹⁸³ C-250/95 *Futura Participations SA*, paras. 20-22.

¹⁸⁴ Helminen, (n 1), ch. 2, p. 52.

¹⁸⁵ Case C-250/95 *Futura Participations SA*, paras. 20-22.

¹⁸⁶ Weber, Dennis, *An analysis of the Past, Current and Future of the Coherence of the Tax System as Justification*, EC Tax Review, Kluwer Law International, 2015, Issue 1, p. 54.

examined in the light of the objective pursued by the Member States' tax rules.¹⁸⁷

A general acceptance of the territoriality principle as a justification ground for Member States' restrictive tax measures would allow Member States to treat non-residents and residents in comparable situations differently.¹⁸⁸ This contradicts the concept of an internal market and while it most likely results in a restriction of the fundamental freedoms, the ECJ would have to balance these interests.

5.3.2 The need to maintain balanced allocation of taxing rights

The need to maintain a balanced allocation of taxing rights has played a vital role as a justification ground in the ECJ's assessments regarding the limitation of cross-border loss utilization.¹⁸⁹ The central idea of this justification is that Member States have the right to ensure that incomes subject to the balanced allocation of taxing rights in a State actually can be taxed there. It has in some cases been accepted as a sole ground, but also in conjunction with Member States goal of preventing tax avoidance.¹⁹⁰ Stated in other words, these justification grounds have their bases in Member States' work to preventing the erosion of tax bases from one State to another.

In later years the ECJ has tended to show an altered attitude against Member States' attempts to justify their tax systems. Consequently, Member States' attempts to make their restrictive rules justified have successfully increased.¹⁹¹ This evolution by the ECJ is of interest since this justification ground has a close connection with the territorial approach as such. The balanced allocation of taxing rights can be invoked when a Member State has a reasonable tie to the tax subject, the tax object or both. Therefore, if the legislation at issue is proportionate, Member States have a possibility to invoke the rules and prevent transfer of tax bases outside their tax jurisdiction.¹⁹² This indication can be seen as to have a close connection with the territoriality principle, while a territorial approach constitutes a right for a State to tax income linked to that particular State. However, the difference between the balanced allocation of taxing right and the territoriality principle is that the link regarding the balanced allocation of taxing rights does not have to be territorial but may instead be tied to the State on other criteria.

The ECJ has elaborated a comprehensive case law regarding this justification ground. Hence, there are some unresolved issues, which have not been answered by the current assessments. It is obvious that the justification ground's main goal is to prevent the transfer of tax bases between States, which also is the basis for Member States territorial

¹⁸⁷ Case C-157/07 *Krankenheim* paras. 43 and 53; Schön, Wolfgang, *Neutrality and Territoriality –Competing or Converging Concepts in European Tax Law?*, Bulletin for International Taxation, vol. 69, no. 4/5, p. 279-280.

¹⁸⁸ Poulsen, (n 181), p. 202.

¹⁸⁹ Hilling, (n 81), p. 298; C414/06 *Lidl Belgium*.

¹⁹⁰ Hilling, (n 81), p. 296.

¹⁹¹ Hilling, (n 81), p. 298.

¹⁹² Hilling, (n 81), p. 298.

approach regarding taxation. At the same time, Member States have a protection-worthy right to tax activities conducted on its territory. There is no conflict when the income has been earned in the State of residence, because in that situation, the State of residence and State of establishment are the same. However, the issue appears when those two statements by the ECJ point in different directions.¹⁹³

Further, it seems that the traditional international tax interpretation of balanced allocation of tax jurisdictions, where a tax jurisdiction is based on a distinction between residents and non-residents taxpayers regarding the right to levy taxes between different jurisdictions cannot be transposed fully to the area of EU direct taxation.¹⁹⁴ This reasoning is in line with the early judgement in *Avoir Fiscal*, where the ECJ rejected different treatment of residents and non-residents.¹⁹⁵ This reasoning does not imply that Member States way of allocating taxes based on the distinction between residents and non-residents never applies with EU law.¹⁹⁶ Firstly, the ECJ has stated that Member States retain the competence to define their own scope of taxation and therefore the relevant factors for establishing tax liability.¹⁹⁷ Secondly, the fact that the ECJ even considers the concept of ‘balanced allocation’ in its case law implies that the ECJ is willing to accept an allocation of tax jurisdiction based on the traditional international tax interpretation. However, only to the extent that it does not result in different treatment of taxpayers in otherwise comparable situations.¹⁹⁸

It can be questioned what distribution of taxing rights the EU wants to ensure. In line with the above reasoning, it is clear that EU law does not provide any concrete guidance on the allocation of income between Member States. The case law shows that the ECJ is prepared to decide in line with international principles concerning direct tax cases, essentially regarding allocation of income between Member States.¹⁹⁹ Consequently, the EU must consider the principles that form the basis for the OECD model tax convention as expressions of the balanced allocation of taxing rights. This conclusion has support in the ECJ’s assessment, for example, *SGI*,²⁰⁰ where it is stated that it is worth protecting a Member State’s right to tax income from business conducted in the Member State. The reasoning is in line with article 7 of the OECD model treaty, stating that where a PE is deemed to exist, the source State is entitled to tax the income allocated to the PE. Additionally it has also its basis in another statement by the ECJ where the ECJ states that it is not unreasonable for Member States when allocating their powers of taxation to find inspiration from international practice, namely the OECD.²⁰¹

¹⁹³ Hilling, (n 81), p. 300.

¹⁹⁴ Poulsen (n 181), p. 203.

¹⁹⁵ Case C-270/83 *Commission v. French Republic (Avoir Fiscal)*, paras. 17-20.

¹⁹⁶ Poulsen, (n 181), p. 203.

¹⁹⁷ Case C-336/96 *Gilly*, paras. 23-29.

¹⁹⁸ Poulsen, (n 181), p. 203.

¹⁹⁹ Case C-336/96 *Gilly*, para. 31; Case C-414/06 *Lidl Belgium*, para. 22.

²⁰⁰ C-311/08 *SGI*, para 64.

²⁰¹ Case C-513/03 *Van Hilten –van der Heijden*, para. 48.

5.4 Final remarks

It is reasonable that Member States by accepting these justification grounds are entitled to prevent taxpayers from freely choosing the State in which their income is taxed. The author finds it reasonable mostly because the EU's internal market includes no common rules for the calculation of income and no common tax rates. Consequently, no common consolidated corporate tax base currently exists even if it has been up for discussion several times.²⁰² Member States still have the responsibility to maintain effective tax systems in order to sustain their welfare systems. However, the author would prefer more precise guidelines that are clearer regarding in what situations the justification grounds are applicable to and at the same time, when they are proportionate. If so, it would increase the foreseeability for the Member States when creating restrictive measures to prevent erosion of their tax bases and to apply a territorial taxation.

Due to Member States' fiscal sovereignty, juridical double taxation and denied cross-border loss utilization are potential issues. While juridical double taxation is not considered a restriction of the freedom of movement,²⁰³ it could be argued whether a restriction should be at hand where cross-border loss utilization is denied. Accordingly, Member States do generally not have the possibility to tax foreign income due to their fiscal sovereignty. If that is the case, then foreign losses should also not be taken into account. This reasoning is based on that it would be inadequate if Member States on one hand, tax their residents on their worldwide income and the ECJ does not require Member States to prevent juridical double taxation, and on the other hand chooses to exempt foreign income but still have to set off foreign losses. In the author's opinion, a balanced allocation of the taxing power is connected to that the profits and losses shall both be taken into account in order to uphold symmetry. Where Member States use the exemption method, there is no such symmetry since the income is exempted. Inherently, it appears reasonable that the losses are not taken into account when the profits are exempted.

6. Conclusion and future aspects

From an overall perspective regarding the topic of cross-border loss utilization concerning the treatment of the taxpayer's own losses in a PE, there is a gap between the concerns expressed by the business community and the large evolution of international rules. This gap may increase due to that the OECD BEPS project can affect the international rules by enabling Member States to preserve their tax bases. The co-ordination of tax rules between States is desirable since many mismatches arise from States different tax laws; however, it is a far-reaching problem not solved overnight. The EU's attempts to co-ordinate and harmonize the area of direct taxation has led to great developments. However, it is necessary to

²⁰² COM (2011) 121/4, *Proposal for a Council Directive on a Common Consolidated Corporate Tax Base (CCCTB)*.

²⁰³ Case C-513/04 *Kerckhaert-Morres*, paras. 20-22; Case C-128/08 *Damseaux*, paras. 27 and 35, Case 67/08 *Margarete Block*, para. 31; Case C-96/08 *CIBA*, para. 28.

have a balance between on one hand, the effectiveness of rules and on the other hand, their fairness and appropriateness.

Overall, businesses are affected where a State of residence uses a territorial system or where the State of residence applies the principle of worldwide income taxation and uses the simple exemption method in its DTC. Mostly due to that foreign losses are lost or cannot be offset in either the host State or the home State. Thus, legislators shall take the business perspective into account in future legislative processes, while, in the author's opinion, companies' business decision shall not be influenced by tax considerations and if offsetting of losses is possible. Consequently, companies shall not refrain from establishing a PE in another State.

The aim of this thesis was to examine whether a territoriality principle can be discerned regarding the tax treatment of loss utilization in cross-border situations attributable to PEs. In the author's view, with respect to the examination, the ECJ has not been expressing a clear meaning of the territoriality principle and has not been using it as a sole justification ground. The author is of the opinion that concept of territoriality is an underlying part of Member States' sovereignty, which the ECJ wants to respect due to the area of direct taxation to a large extent, still remain in the Member States' competence.

As the Member States want to preserve their tax base, the territorial approach becomes a consequence of Member States' sovereignty rather than self-supporting principle of its own. However, the concept of territoriality is still evolving within EU and hopefully the BEPS project will highlight the necessity of a territoriality concept. The concept may solve issues related to foreseeability, tax avoidance and for Member States to be able to protect their tax bases. The issue seems to continuously return to the overall problem arising from deficient guidelines. Member States needs guidance and it ought to be achieved if the ECJ can find a balance between on the one hand, the concept of an internal market and on the other hand, Member States' sovereignty. As the current law stands, Member States sovereignty is acknowledged, which leads to that cross-border losses attributable to PEs are being stranded where a DTC applying the exemption method exists.

However, it remains difficult to accept a territorial approach within EU due to several reasons. Firstly, the concept of territoriality is not clear. Secondly, Member States within EU have an inconsistent and diverse perception of territoriality. Thirdly, the role by territoriality to be assumed from an EU law justification point of view is controversial, since it is difficult to predict the evolution of territoriality and its proper understanding as a justification ground. This depends predominantly on its close connection to balanced allocation of taxing powers and thereby also, symmetry. Fourthly, because worldwide taxation has been recognised to be in conformity with EU law.²⁰⁴

As regards the subsequent aim, which can be answered even though the ECJ case law did not recognise a self-supporting territoriality principle, the ECJ's understanding of territoriality reconciles with the concept in

²⁰⁴ Garcia Prats, (n 157), p. 9-10.

international law. This is because the ECJ has stipulated that a Member State acts in accordance with the territoriality principle if it taxes resident taxpayers on their worldwide income and non-resident taxpayers on their income sourced in the State in question.

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